

*Report of the  
State Budget Crisis Task Force*

# TEXAS REPORT







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Paul A. Volcker and Richard Ravitch introduced the July 2012 Full Report of the State Budget Crisis Task Force with the following statement:



## A Statement From the Task Force Co-Chairs

July 17, 2012

**CHAIRS:**

Richard Ravitch  
Paul A. Volcker

**MEMBERS:**

Nicholas F. Brady  
Joseph A. Califano, Jr.  
Phillip L. Clay  
David Crane  
Peter Goldmark  
Richard P. Nathan  
Alice M. Rivlin  
Marc V. Shaw  
George P. Shultz

Our purpose in assembling the State Budget Crisis Task Force has been to understand the extent of the fiscal problems faced by the states of this nation in the aftermath of the global financial crisis. While the extent of the challenge varies significantly state by state, there can be no doubt that the magnitude of the problem is great and extends beyond the impact of the financial crisis and the lingering recession. The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened.

The United States Constitution leaves to states the responsibility for most domestic governmental functions: states and their localities largely finance and build public infrastructure, educate our children, maintain public safety, and implement the social safety net. State and local governments spend \$2.5 trillion annually and employ over 19 million workers—15 percent of the national total and 6 times as many workers as the federal government. State governments are coping with unprecedented challenges in attempting to provide established levels of service with uncertain and constrained resources.

Within the limits of time and resources, we have examined the financial condition of six heavily populated states—California, Illinois, New Jersey, New York, Texas and Virginia. While each state varies in detail, a common thread runs through the analysis, supported by information available for states generally.

What we found will not be surprising to many knowledgeable observers, but the facts have never been assembled in a way that reflects the totality of the problems.

Certain large expenditures are growing at rates that exceed reasonable expectations for revenues:

- Medicaid programs are growing rapidly because of increasing enrollments, escalating health care costs and difficulty in implementing cost reduction proposals. At recent rates of growth, state Medicaid costs will outstrip revenue growth by a wide margin, and the gap will continue to expand.
- Pension funds for state and local government workers are underfunded by approximately a trillion dollars according to their actuaries and by as much as \$3 trillion or more if more conservative investment assumptions are used.

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- Unfunded liabilities for health care benefits for state and local government retirees amount to more than \$1 trillion.

The capacity to raise revenues is increasingly impaired:

- Untaxed transactions are eroding the sales tax base. Gasoline taxes are eroding as well, making it more difficult for states to finance roads, highways, and bridges.
- Income taxes have become increasingly volatile, particularly during and after the recent economic crisis.

The federal budget crisis will have serious spillover effects on state and local governments, and state actions will have spillover effects on local governments:

- Cuts in federal grant dollars, lower spending on federal installations, procurement, and infrastructure, and potential changes to the federal tax code all threaten states' fiscal stability.
- Pressures on local governments, caused by the weak economy and cuts in state aid, are constraining education spending, law enforcement, aid to the needy, and the institutions that make up the culture of our cities. Local government cuts pose a significant risk to the overall economic and social fabric of states.

State budget practices make achieving fiscal stability and sustainability difficult:

- While almost all states have constitutional or statutory balanced budget requirements, "revenue" and "expenditure" are not defined terms. The use of borrowed funds, off-budget agencies, and the proceeds of asset sales are not uncommon practices, often rendering balanced budgets illusory.
- The lack of financial transparency makes it more difficult for the public to understand the critical nature of problems such as pensions and other payment obligations. Temporary "one-shot" measures to avoid or delay hard fiscal decisions mask these underlying problems.
- Opaque and untimely reporting, coupled with nonexistent multiyear planning, severely hampers efforts to address these problems in a serious manner.

The Task Force is not in a position to propose changes in programmatic priorities, tax rates or structures to deal with budgetary problems. Such decisions are properly subject to the values and politics of a democratic society. Our essential goal is to inform the public of the gravity of the issues and the consequences of continuing to postpone actions to achieve structural balance. We do, however, believe that certain basic procedural approaches should be introduced and followed by all states and urge that prompt attention be given to financial relationships among all levels of government.

- The public needs transparent, accountable government. Individual states, existing associations of states, and advisory and standard-setting bodies should develop and adopt best practices to improve the quality and utility of financial reporting.

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- Multiyear planning and budgeting approaches should be a normal part of fiscal planning.
- States need better tools for managing over the business cycle. A priority for states should be better use of their existing counter-cyclical tools, including “rainy day” funds and repayment of debts in prosperous periods.
- Pension plans need to account clearly for the obligations they assume and disclose the potential shortfalls and risks they face. Legislators, administrators, and beneficiaries alike need to develop and adopt rules for the responsible management of pension plans and mechanisms to ensure that required contributions are paid. States should recognize and account for post-employment benefits, such as healthcare, that they intend to continue.
- Prompt attention is needed to the effects that federal deficit reduction and major changes in the federal tax system will have on states and localities.
- States that do not have suitable mechanisms to monitor and assist local governments experiencing fiscal distress should develop them.
- Looking ahead more broadly, the recurrent problems of state finances and the growing state fiscal imbalance suggest that more fundamental approaches require attention. Tax reform at the state level may be needed to achieve revenue systems that are adequate and predictable and that minimize volatility.
- The apparent growing gap between states' spending obligations and their available financial resources points toward a need to reexamine the relationship between the federal government and the states.

The threats and risks vary considerably from state to state, but the storm warnings are very serious. Only an informed public can demand that the political systems, federal, state and local, recognize these problems and take effective action. The costs, whether in service reductions or higher revenues, will be large. Deferring action can only make the ultimate costs even greater.

The conclusion of the Task Force is unambiguous. The existing trajectory of state spending, taxation, and administrative practices cannot be sustained. The basic problem is not cyclical. It is structural. The time to act is now.

Respectfully submitted,

**Richard Ravitch**

**Paul Volcker**

Chairmen



## *Foreword*

Former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Board Chair Paul Volcker created the State Budget Crisis Task Force because of their growing concern about the long-term fiscal sustainability of the states and the persistent structural imbalance in state budgets, which was accelerated by the financial collapse of 2008.

After extensive planning and fundraising in 2010 and early 2011, Messrs. Ravitch and Volcker recruited a board of individuals with extensive and varied careers in public service and public policy. The Task Force was officially launched in April 2011.

In addition to the co-chairs, the board of the State Budget Crisis Task Force includes these members:

|                          |                                |
|--------------------------|--------------------------------|
| <b>Nicholas F. Brady</b> | <b>Joseph A. Califano, Jr.</b> |
| <b>Phillip L. Clay</b>   | <b>David Crane</b>             |
| <b>Peter Goldmark</b>    | <b>Richard P. Nathan</b>       |
| <b>Alice M. Rivlin</b>   | <b>Marc V. Shaw</b>            |
| <b>George P. Shultz</b>  |                                |

The executive director of the Task Force is Donald Boyd, on leave from his responsibilities as senior fellow at the Rockefeller Institute of Government. Ravitch and Boyd worked together to assemble a core team of experts with budget and financial planning experience at the national, state, and local levels and practical experience derived from the management of previous fiscal crises. The names of the full project team can be found on the Acknowledgements page at the end of this report.

The Task Force decided to focus on the major threats to states' fiscal sustainability. Since it was not feasible to study each of the fifty states in depth, we decided to target six states — California, Illinois, New Jersey, New York, Texas, and Virginia — for in-depth, onsite analysis. In each state, the core team worked closely with experts who were deeply familiar with the substance, structure, procedures, documents, and politics of the state's budget. The names of budget experts consulted in each state can be found on the Acknowledgements page at the end of this report. The core team and state experts conducted detailed inquiries into major issue areas including Medicaid, pensions, tax revenues, debt, the fiscal problems of local governments, and state budgeting and planning procedures. In doing so, the core team and state experts reviewed budget documents and data from the respective states and interviewed key budget officials.

The Task Force released its main report in July 2012, focusing on issues that cut across the six states. The Task Force also is preparing reports on individual states, including this report on Texas.





## Summary

The Lone Star State was fortunate that it entered the recession later than many states and suffered less from its economic dislocations, particularly compared to other fast-growing Sunbelt states. Still, Texas has had its share of fiscal challenges; the 2011 legislative session witnessed one of the most difficult budget processes in recent history. Since then, the state economy has begun to recover and state revenues have rebounded.

The recent dramatic improvement in the revenue outlook means that the 2013 legislative session will be far less fiscally stressful than the session two years ago. Nevertheless, the structural fiscal issues that confronted the 2011 Legislature have not gone away and will present challenges in future sessions. The danger is that these long-term issues may be camouflaged in the short-run, making them easier to defer.

That is the crux of what separates Texas from other states examined by the State Budget Crisis Task Force: its fiscal sustainability issues are less immediate but no less real.

Texas manages its fiscal affairs conservatively. It has good fiscal systems and a strong tradition of sound financial management and transparency. Its pension systems, though stressed by the recent recession, are in far better shape than systems in other states, and it has built an impressive reserve balance in its rainy day fund, primarily as a result of continued high oil and natural gas prices.

What Texas lacks — and should make a priority — is a long-term financial planning process that focuses on the size and shape of major issues that will confront the state in the future. The issues this process would address are familiar. Many are driven by the state's changing demographic and socioeconomic make-up as dynamic growth makes Texas a more populous, more urban, and more ethnically diverse state.

The state's population continues to grow faster than almost any other state and now tops twenty-five million people increasingly packed into the state's major urban areas. Its population also is becoming more diverse. In the 2010 Census, about 45 percent of the state population was non-Hispanic Anglo, 38 percent Hispanic, 11 percent non-Hispanic African American, and about 6 percent non-Hispanic Other. According to state demographic projections based on 2000-2007 migration patterns, Hispanics will exceed the number of non-Hispanic Anglo Texans for the first time around 2015.

Given the large socioeconomic disparities among ethnic groups, these demographic shifts imply that the state's future population may be less educated, poorer, and more in need of state services than it is today. Much depends on the course of state policy in coming years.

Rapid population growth and urbanization also mean that the state's aging infrastructure is being stressed. Both state and local officials argue that there are not enough funds to meet transportation, water, and other infrastructure needs.

Education will also represent a major long-term challenge. To continue to do well economically, the state must educate its children to give them the skills to succeed in the future economy. Unfortunately, the sheer weight of numbers is working against this goal in Texas. The combined effects of demographic and economic change imply that educational attainment of Texas' workforce will decline in coming years. The Texas State Data Center estimates that 30.1 percent of the workforce

could lack a high school degree by 2040, compared with 18.8 percent today. This obviously represents a significant challenge for state economic growth and for public and higher education.

Significant reductions in formula funding of public and higher education in the 2011 legislative session have further strained the state's public schools, colleges, and universities. Texas currently faces six separate lawsuits over its public school funding system, and those suits, more than any single factor other than health care costs, are likely to shape the long-term direction of state finances.

In addition, the long-term trends in educational attainment will make it hard for the state to make significant inroads in its longstanding problem with poverty. Texas ranks sixth among states in its share of people living in poverty. About 18.4 percent of Texans lived in poverty in 2010, up from 17.3 percent a year earlier. The national average is 15.1 percent. Texas also leads the nation in the share of its population that is uninsured. The Census Bureau estimates that in 2009, 26.1 percent of Texans were uninsured — about 6.4 million people. Texas also had the highest uninsured rate of children, at 17.4 percent or 1.28 million children.

Beyond the human dimensions, the implications for state and local public assistance programs are enormous. Medicaid and similar health-related programs are chewing up a larger and larger percentage of the state budget; their cost will have to be solved for the state to maintain its fiscal sustainability.

Medicaid also poses a major risk as a target of potential federal budget cuts. Federal receipts in the 2012-2013 period are expected to total \$71.2 billion, representing 38.9 percent of all state revenues; Medicaid is the largest component. The future direction of federal budget policy is extremely uncertain, but significant cuts in the federal budget, while needed to deal with the deficit, will have large impacts on Texas state and local government finances and on the economy through the impact on federal spending and employment in the state.

All of these issues could exert enormous stress on state and local budgets, and the state and its communities have little fiscal capacity to draw on. The recession has forced governments to pare budgets to the bone. While further spending reforms are possible, the performance of state and local revenues will be a key to government's ability to meet the demands of its citizens.

The state and local revenue system, which relies heavily on the sales tax at the state level and the property tax at the local level, has problems meeting growing spending demand, even in a conservative-spending state like Texas. The sales tax has become more volatile over time, partly because of additional exemptions and tax incentives and partly because of online commerce.

Given the state's political climate, fundamental tax system reform is unlikely. In a sense, the tax system has become calcified. It does not produce enough revenue to allow the state to meet its likely future spending needs without biennial budget struggles, and it also is extremely difficult to adjust when more revenue is needed, mainly because of the political barriers to tax change. That means that the state will continue to face cyclical problems with its revenue whenever the economy slumps as it did in 2008 and 2009.

Given the current legislative climate, the state should continue to forecast revenues conservatively, budget conservatively, build reserves in the rainy day fund, and avoid the political temptation to add new or expanded incentives to the tax code.

Texas' 25.7 million citizens are scattered among more than 4,700 political subdivisions, including 254 counties, 1,196 cities, 1,037 school districts, and 2,245 special-purpose districts. The property tax is the critical and often only major local revenue source for the majority of these entities. It accounts for more than 80 percent of local tax revenue, including virtually all of the local own-source funding for schools. The tax is unpopular, but its performance during and after the recession was more stable than the sales tax. Texas' local governments need access to alternative revenue sources that will take some pressure off of the property tax. Absent that, lawmakers should refrain from further limitations on the use of the tax so that local officials can maintain services and avoid the sorts of fiscal problems that have plagued several cities and counties nationally in the last two years.

Texas has always focused almost exclusively on the upcoming two-year budget period without looking further ahead; after that biennium is resolved, it moves on to the next two-year cycle. This worked in the past because Texas was a young, growing state with abundant natural resources, a central location, and a conservative approach to government at both the state and local levels. But given long-term pressures, the state cannot afford to continue exclusively in such a short-sighted and incremental fashion.

Many challenges the state faces will linger for decades, regardless of current state policy. Texas is rapidly growing and economically robust, but has a large low-income population and growing problems in health care, educational achievement, and other areas. It has a remarkable public infrastructure, but that infrastructure is aging and struggling to keep pace with increasing pressures.

To meet its challenges, Texas needs to understand them – and take them seriously.



## *Introduction*

The Lone Star State was fortunate that it entered the recession later than many states and suffered less from its economic dislocations, particularly compared to other fast-growing Sunbelt states. Still, Texas has had its share of fiscal challenges; the 2011 legislative session witnessed one of the most difficult budget processes in recent history. Since then, the state economy has begun to recover and state revenues have rebounded strongly. But the structural fiscal issues that confronted the 2011 Legislature have not gone away, and will continue to spur challenges in future sessions. Most notably, the state faces six separate lawsuits over its funding policies for public education, and their outcome could significantly affect future budget decisions. Lawmakers also will wrestle with how to provide public infrastructure — bridges, roads, public transit, and water supply — to meet the needs of a growing and increasingly urban population. And, as will most states, Texas will continue to struggle with the skyrocketing cost of health care.

Drawing on the Task Force’s extensive research into Texas’ fiscal performance, this report examines the state fiscal system in detail to provide readers with a better understanding of just how ready we are to handle the challenges ahead.

## Economy and Demographics

After a period of rapid economic expansion in the mid-2000s, the Texas economy slowed in 2008. The state entered the recession about eight months after the nation in late 2008 and emerged from the downturn in the third quarter of 2009 (Figure 1).

Texas nonfarm employment began falling in September 2008. Through December 2009, the state lost 427,600 net jobs, a decline of 4 percent. Since then, the state has outpaced the rest of the country in job growth, aided by a healthier banking sector and housing market, global trade competitiveness, and an oil and natural gas boom. State employment passed its prerecession

peak in December 2011 and as of June 2012 exceeded it by 144,000 jobs. The national economy, by contrast, had recovered only 44 percent of jobs lost in the recession as of June.

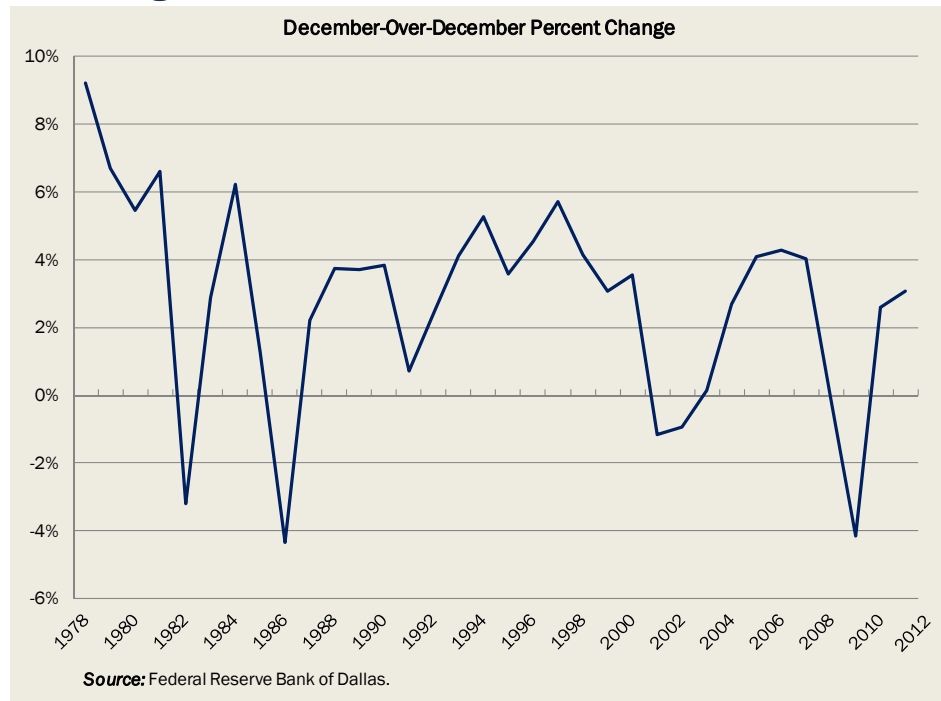
Statewide personal income also has risen steadily since the recession's end in 2009, although more modestly than in previous recoveries. Data from the Texas comptroller's office indicate that in fiscal 2010, Texas incomes rose by 2 percent, but as the oil and gas sector's expansion took hold in 2011, growth improved to 5.7 percent. Current forecasts predict a continuation of this modest growth for the next two years, with much hinging on the pace of the national recovery and the effects of international financial difficulties, particularly the Eurozone crisis.

Texas was insulated from the worst ravages of the Great Recession by a sharp rise in world energy prices that spurred oil and gas production from the state's shale reserves. Another factor, however, can be traced to the last period of severe economic recession in Texas, during the 1980s.

Plunging world oil prices, a real estate crisis and the savings and loan collapse left Texas in near-depression in the last half of the 1980s. From 1987 through 1991, Texas experienced 729 bank failures, 38 percent of the national total. But the state drew a valuable lesson from this difficult period. According to the Dallas Federal Reserve:

Following the 1980s collapse, Texas regulators bolstered rules governing loan-to-value ratios on residential real estate loans and limited or delayed implementation of home-equity lending, reverse

**Figure 1** | Texas Business Cycle Index, 1978-2012



mortgages and home-equity lines of credit. Given this oversight and other factors such as substantial land availability and fewer development and zoning restrictions, Texas housing stock increased during the national boom without the rapidly rising home prices and lax lending practices found elsewhere. Burdened by less housing fallout, and consequently less household leverage, the Texas economy remained relatively healthy, with greater job-creating capability.<sup>1</sup>

Despite recent favorable economic performance, Texas' unemployment rate has remained stubbornly high, just dropping below 7 percent in September 2012 – substantially better than the national rate, but well above the prerecession low of about 4.4 percent in March 2008. The number of unemployed Texans did not peak until July 2011, at more than one million.

The slow decline in unemployment is partly explained by young people entering the job market, but a more significant explanation is the influx of job seekers from outside the state in numbers that have exceeded job growth. According to the comptroller's office, Texas' population grew by 227,000 residents from net migration alone in fiscal 2011. This in-migration, coupled with the relatively slow progress of the national recovery, has kept state unemployment higher than would normally be expected at this point in an economic recovery. Because the Texas economy will continue to be healthier than the nation's, migration will be an important part of future state population growth, which is expected to average just under 2 percent annually in the next two years. Almost half of this growth is expected to be the result of net in-migration.

Texas' economic outlook is for continued moderate growth and a slow decline in unemployment. The comptroller estimates used to certify the state's budget for the 2012-2013 biennium anticipate that total nonfarm employment will increase by 2.1 percent in fiscal 2012 and 1.7 percent in 2013. The state unemployment rate, which averaged 8.1 percent in fiscal 2011, is expected to fall to 7.2 percent in 2012 and 7.0 percent in 2013. Total personal income in Texas will grow by 5.2 percent in fiscal 2012 and 4.2 percent in 2013. Real gross product should rise by 3.1 percent in fiscal 2012 and 2.8 percent in 2013. These forecasts represent a conservative outlook – the state unemployment rate is already below the forecast for 2013 – but the outlook is not without some risks.

The main concerns, according to an August 3 comptroller presentation to the Legislative Budget Board (LBB), relate to the national and global economic outlook. According to the presentation, “the national economy appears to be slowing – which may affect Texas – and weaker international economic conditions may impact the U.S. and Texas economies.”<sup>2</sup> The comptroller's data also showed that for fiscal 2012 to date, revenue collections, notably for the sales and use tax, motor vehicle sales tax, and oil and natural gas production taxes, have been robust. Given that our revenue streams tend to move with the business cycle, however, this rapid growth would be threatened by slower national growth.

Slowing growth in employment and personal income will be reflected in tax collections, particularly in the general sales tax and the motor vehicle sales tax. Diminishing global demand for oil due to slower growth will reduce state tax revenue from oil and natural gas production.

### **Demographic Change in Texas**

Since the early 1900s, Texas' population has risen faster than the nation's. This trend has continued into the new century despite two major recessionary periods. Today, Texas has a population of about 25.7 million, making it the second most populous state behind California. Texas' population growth exceeded all other states between 2000 and 2010, a function

both of natural increase (births and deaths) and net migration. In recent years, natural increase and net migration have contributed almost equally to Texas' growth.

In Texas' case, in-migration involves both international migration and state-to-state migration. More than half of those moving to Texas during much of the last decade were international migrants. About two-thirds of Texas migrants were members of racial and ethnic minority groups. Migration from other states increased significantly in the middle of the past decade and has remained relatively high, peaking in 2005-2006 as a result of significant migration from Louisiana in the wake of Hurricane Katrina. Migration has remained high because of the slow pace of the national economic recovery.

In addition to legal in-migration, Texas also has an estimated 1.65 million unauthorized immigrants, according to February 2011 estimates by the Pew Hispanic Center.<sup>3</sup> This represents about 6.5 percent of the total population.

Over time, the ethnic face of Texas continues to change. In the 2000 Census, about 53 percent of the state's population was non-Hispanic Anglo, 32 percent was of Hispanic descent, 11 percent was non-Hispanic African American, and 4 percent was non-Hispanic Other (largely Asian). In the 2010 Census, about 45 percent of the state population was non-Hispanic Anglo, 38 percent Hispanic, 11 percent non-Hispanic African American, and about 6 percent non-Hispanic Other. According to state demographic projections based on 2000-2007 migration patterns, Hispanics will exceed the number of non-Hispanic Anglo Texans for the first time around 2015.

Texas is also aging. While rural counties have a greater *share* of older Texans, the total *number* of Texans aged 65 years and older is increasingly concentrated in urban counties and in South Texas along the border. Texas State Data Center population projections indicate significant growth in the number of older Texans in coming years. Urban and border counties will become older, but not to the same extent as rural Texas.

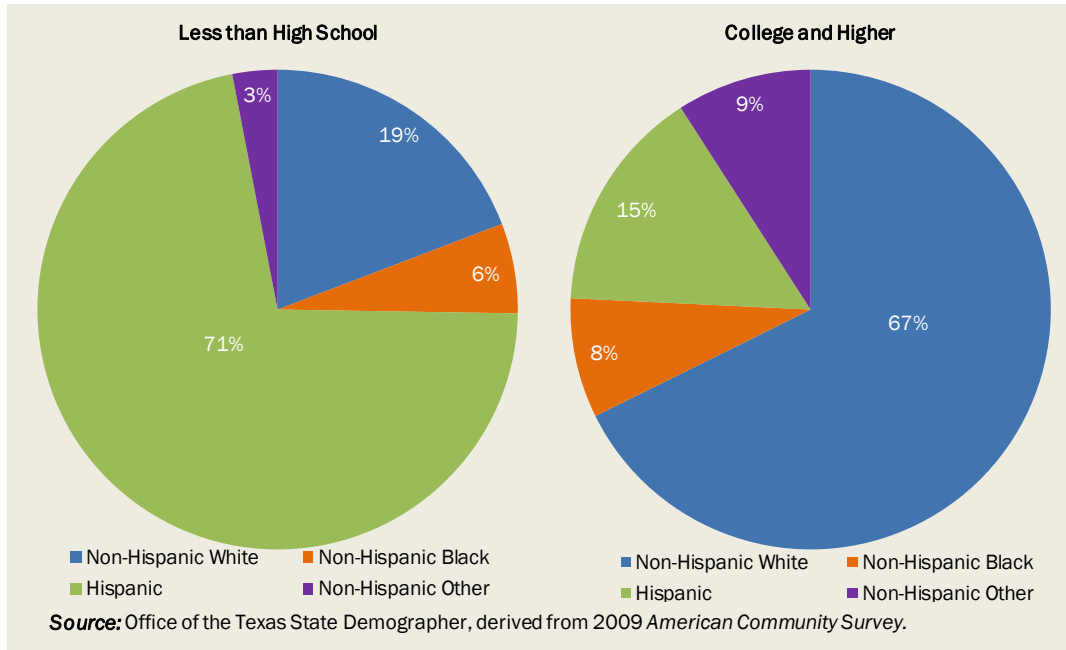
The age distribution of Texas' non-Hispanic white population is weighted heavily with the Baby Boom generation. Largely as a result of lower fertility and less net in-migration, the non-Hispanic white population trends older than the Hispanic population. In 2010, for ages thirty-seven and younger, the Hispanic population already exceeded the non-Hispanic white population.

### **Long-Term Implications of Demographic Change**

The demographic shifts reshaping Texas have important implications for the state and its communities, given large socioeconomic disparities among ethnic groups. Compared with non-Hispanic Anglos, Texas' Hispanics tend to have lower levels of educational achievement (Figure 2), earn lower wages, and depend more heavily on state services. The Dallas Federal Reserve Bank has suggested this is at least partly tied to immigration. "Mexican immigrants tend to have average wages 40 percent below those of natives," the Bank reported in 2005. "These wage differences reflect that the immigrants are young, have scant job experience and speak little English."<sup>4</sup>

While some of these differences are eliminated after time in the U.S., significant disparities remain, implying that without substantial changes in current trends, Texas' future population will be less educated, poorer, and more in need of state services than it is today.

**Figure 2 | Ethnic Composition by Educational Level in Texas for Ages 25 and Older, 2009**



The combined effects of demographic and economic change imply that educational attainment of Texas' workforce will decline in coming years. The Texas State Data Center estimates that 30.1 percent of the workforce could lack a high school degree by 2040, compared with 18.8 percent today. This obviously represents a significant challenge for state economic growth and for public and higher education.

These trends will make it hard for the state to make significant inroads in its longstanding problem with poverty. Texas ranks sixth among states in its share of people living in poverty. About 18.4 percent of Texans lived in poverty in 2010, up from 17.3 percent a year earlier, according to Census data released last fall. The national average is 15.1 percent.

Texas also leads the nation in the number of its uninsured citizens. The Census Bureau estimates that in 2009, Texas had the highest uninsured rate among states, at 26.1 percent — about 6.4 million people. Texas also had the highest uninsured rate of children, at 17.4 percent or 1.28 million children statewide.

The aging population also will represent ongoing challenges. As they retire, Baby Boomers will put large demands on Social Security and programs such as Medicare. In addition, they may drive housing demand toward move-up or second homes as well as houses more popular with older adults or combined families, which could affect future trends in property tax. This may, however, be mitigated by the rapid growth in the state's Hispanic population, which is much younger than other groups.



## State Budget Update

The 2011 legislative session was one of the most difficult in recent state history. Budget conditions were exacerbated by a combination of recession, the end of federal stimulus funding, and the impact of new spending responsibilities assumed because of school finance reforms enacted in 2006. Ultimately, lawmakers reduced state spending by \$14 billion below the previous biennium's levels in all state funds and \$640 million in general revenue — and the cuts loom larger if compared to the funding needed to meet the projected growth in public school enrollment and health and human service caseloads.

Since the legislative session ended, state revenue collections have improved dramatically; indeed, they began to improve during the session. In fiscal year 2012, state tax collections were up 13.4 percent and easily exceeded the state's forecast. The sales tax, the state's most important, rose by 12.6 percent for the year, and even that strong growth lagged that of the volatile motor vehicle sales tax, which rose by 19.5 percent for the year. Even more striking is the growth in oil and natural gas severance tax revenue, which has been buoyed by generally firm world energy prices and higher production resulting from the shale drilling boom. For the year as of July 2012, natural gas tax revenue had increased by 38.3 percent over fiscal 2011, while oil tax revenue had risen by 38.3 percent.

Even so, many observers have speculated that the 2013 legislative session could be as difficult as 2011's, both because of lingering economic problems and also because most of the available budget cuts and one-time adjustments were used to balance the budget in 2011. In other words, the problems remain but the bag of tricks is empty. This simply is incorrect.

At the end of fiscal 2012, the comptroller's forecast for improved state revenues has come to fruition. As the state deals with continued pressures to fund services for the state's residents, it is helpful that major state revenues are actually exceeding expectations by a substantial amount.

Table 1 depicts the situation lawmakers may confront next January, based on a series of assumptions about the base budget and revenue outlook. (These estimates will change based on the comptroller's Biennial Revenue Estimate, to be released by January 2013, and spending decisions made by the Legislature in next session.)

The first critical assumption is that the budget has been rebased to the level of spending approved by the 2011 Legislature, about \$81.3 billion in general revenue. This base forms the starting point for 2014-2015. Some additions, however, will be made to adjust for growth in spending demand, such as supplemental appropriations to deal with issues left unresolved in the 2012-2013 budget, notably the intentional underfunding of Medicaid.<sup>5</sup> The estimated value of these supplemental items is \$4.4 billion, including \$3.9 billion for fiscal 2013 Medicaid costs as well as an additional \$500 million in supplemental increases in other areas of the budget.

Other adjustments must be made for spending growth and other added costs; these total \$13.66 billion. A large share of this is additional Medicaid spending, essentially to match the level of underfunding in 2013 in 2014-2015. In other words, the assumption is that the Legislature will *fully fund* Medicaid in this budget cycle, which may or may not happen. The remaining additional spending reflects a forecast of needs based on state spending growth over the past decade, which has averaged about 12 percent a biennium. In all, these changes predict a general revenue budget of just under \$100 billion for 2014-2015. The estimates assume schools will be funded based on statutory formulas allowing for growth in the school in the school population. However, it is also assumed that reductions in formula funding made in 2011 will not be restored.

**Table 1** | State of Texas Budget and Revenue Outlook, 2014-2015 Biennium

|   | 2012-2013<br>(\$ millions) | 2014-2015<br>(\$ millions) |  |
|---|----------------------------|----------------------------|--|
| <b>Spending Forecast</b>                                    |                            |                            |  |
| Total General Fund Budget                                   | \$81,290                   | \$81,290                   | Carry forward of 2012-2013 appropriation base from Legislative Budget Board, Fiscal-Size Up  |
| Supplemental Appropriations                                 | N/A                        | \$4,400                    | Deferred Medicaid spending from 2012-2013 (\$3.9 billion) plus miscellaneous other (\$500 million)   |
| New Spending Demands  |                            | \$13,655                   | Based on historical growth rates and full funding of Medicaid. No adjustments for possible lawsuits or new programs or program restorations. 12% growth on base + \$3.9 billion Medicaid |
| <b>Total General Fund Spending Needs</b>                    | <b>\$81,290</b>            | <b>\$99,345</b>            |  |
| <b>General Revenue</b>                                      |                            |                            |  |
| Beginning Fund Balances                                     | \$1,136                    | \$1,606                    | From comptroller certification estimate.   |
| Estimated Surplus Above Current Estimates                   | N/A                        | \$6,500                    | Estimated  |
| Total Estimated Revenues                                    | \$82,739                   | \$94,315                   | 6.5% biennial growth on adjusted 2012-2013 base less one-time revenues used to certify 2012-2013 budget equal to \$725 million.  |
| Change in GR-Dedicated Balances Available for Certification | \$691                      | \$691                      | Estimated  |
| Transfer to Economic Stabilization Fund                     | (\$1,909)                  | (\$5,068)                  | 2012-2013 certification estimate; 2014-2015 estimated  |
| <b>Total General Revenue Funds Available</b>                | <b>\$82,656</b>            | <b>\$98,043</b>            |  |
| <b>General Fund Spending Gap</b>                            |                            | <b>(\$1,302)</b>           |  |

**Source:** State Budget Crisis Task Force.

It is important to recognize that these estimates do not adjust for several potentially large spending items the Legislature may have to address, including the effects of the federal Affordable Care Act, ongoing school finance lawsuits, and major infrastructure needs. This is, in essence, a steady-state representation of the budget outlook.

The next set of calculations defines a potential revenue base. Base revenue for General Fund spending is estimated at \$94.3 billion.<sup>6</sup> This reflects two adjustments, for normal revenue base growth of about 6.5 percent for the biennium and for revenue lost to a speedup of collections, a one-time measure used to balance the 2012-2013 budget. These assumptions are applied to an adjusted base for 2012-2013 that recognizes recent revenue growth trends.

Four other adjustments are made to reach the total amount available for budgeting in 2013. First, about \$1.6 billion is added for the current estimate of the General Fund ending balance at the end of 2013, an amount reflected in the comptroller's certification estimate at the end of the 2011 session. Second, an additional \$6.5 billion is added as an estimate of the amount by which revenues may exceed projections during the 2012-2013 biennium because of stronger revenue growth since the certification estimate was released. Third, an estimated \$691 million is added for estimated growth in General Fund-Dedicated accounts, which can be recognized as available for spending. Finally, a reduction of \$5.1 billion is made to reflect estimated transfers to the state Economic Stabilization Fund (the "rainy day fund"), an amount estimated based on recent oil and natural gas tax trends and the projected balance in the General Revenue Fund. This latter amount depends on the direction of world oil and gas prices and production; based on likely performance in 2012-2013, the estimate should be considered conservative.

In all, the revenue adjustments produce a forecast total of \$92.4 billion for the 2014-2015 biennium. Combining this with forecast spending totals indicates a budget shortfall of about \$6.9 billion, far less than the \$15 to 27 billion shortfall that greeted lawmakers in 2011.

Although no shortfall is ever desirable, the \$1.3 billion forecast in Table 1 is far more manageable than the past biennium's, implying a much less difficult budget-writing process, particularly when an estimate of the balance in the state's Economic Stabilization Fund suggests that it could exceed \$12 billion, more than enough to cover the shortfall entirely should lawmakers use it for that purpose. The shortfall also could be narrowed by any of several one-time adjustments, such as again deferring Medicaid payments. It may not be good policy, but it is feasible as a budget-balancing strategy.

## *Politics and the Budget Process*

The Republican Party controls both houses of the Texas Legislature and all major statewide elected offices, including the governor, lieutenant governor, attorney general, comptroller, agriculture commissioner, and land commissioner. The next statewide election will be in November 2014.

Texas is one of only a few states that retain a two-year biennial budgeting cycle. The Legislature meets in odd-numbered years and budgets for the upcoming two fiscal years. Thus, the budget adopted during the 2011 legislative session covers fiscal 2012 and 2013, beginning on September 1, 2011, and ending on August 31, 2013.

The Legislature meets in regular session for 140 days every odd-numbered year, beginning in January and typically adjourning at the end of May or early June. The governor can call special sessions on specific issues, each of thirty days in length, at any time when the Legislature is not in session. Historically, special sessions are not uncommon (one in 2011 immediately followed the regular legislative session), but follow no set pattern or set topics.

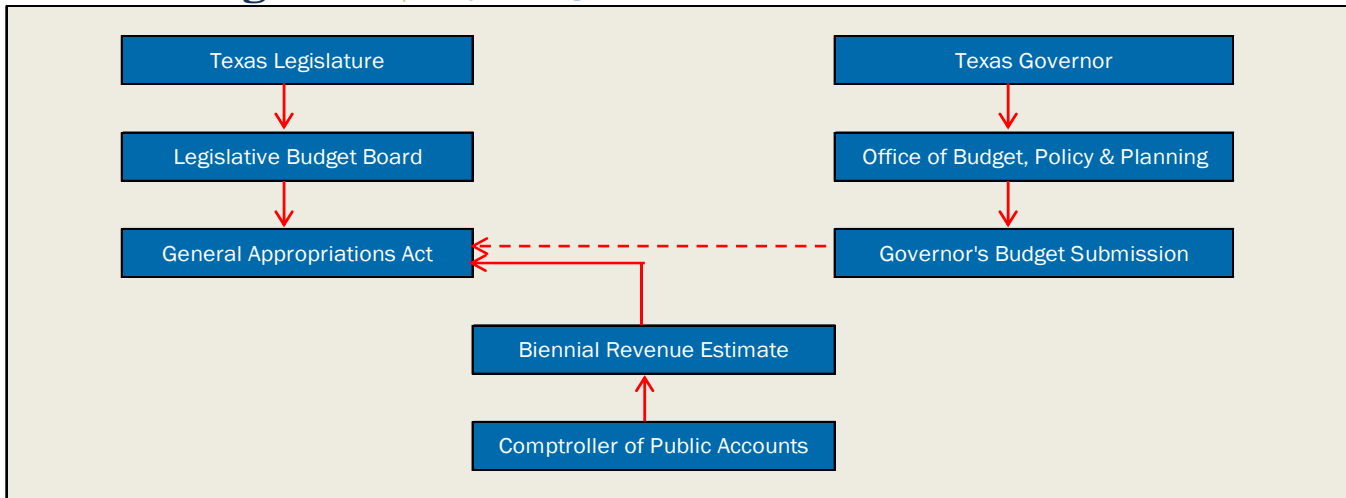
Prior to 1949, the state's financial procedures were "widely criticized as haphazard and arbitrary, and state agencies were funded by individual appropriation bills."<sup>7</sup> To the extent that the state had a budgeting process, the state's purchasing and building agency, the Board of Control, handled it. The Board, however, could exercise only limited control over agency budgets. In 1949, the Legislature created the Legislative Budget Board, a committee of key legislators, as part of an effort to improve the process.<sup>8</sup> This change was made in response to increased spending in the years following World War II, and based on a recommendation of the state auditor calling for a continuous review of state spending. The legislation required all state agencies to submit their budget requests to the LBB for review and recommendations.

Reforms in the 1940s also required the Texas comptroller to prepare official estimates of state revenue and "certify" the budget after passage. This means that the comptroller reviews the budget, verifies that it is consistent with projected revenues, and certifies that fact before sending the budget act to the governor, who then can make line-item vetoes before signing the final document into law.

The various key relationships in Texas budgeting are illustrated in Figure 3. The process is legislatively driven in comparison to most other states, where the process generally begins with the governor's executive recommendations. In Texas, the governor's budget office has at best an indirect voice in the process. The governor's budget recommendations, while they may help to frame the debate, are not the source of the base budget document introduced in the Senate Finance and House Appropriations committees.

This process typically produces a single general appropriations act (GAA) for all of government. Other bills may make appropriations, but the Legislature has worked over time to limit them. In addition, it also has become common for each legislative session to adopt a "supplemental" appropriations bill to deal with issues in the current biennium arising since the last regular session. Since the Legislature meets in January of odd-numbered years, eight months remain in the second fiscal year of each biennium when a regular session begins, making these supplemental actions possible.

**Figure 3 | Key Budget Relationships, State of Texas**



The budget process also has one other feature not found in all states, the comptroller's independent certification of the budget. After certification, the governor can veto individual line items in the GAA but not in other acts, which can only be vetoed in their entirety. Selected vetoes of GAA items are not uncommon, but they seldom amount to a sizable percentage of the total budget.

### The State Budget Ecosystem

Beyond normal interactions between lawmakers and their constituents, a complex ecosystem of groups and individuals work to influence legislative decisions. Figure 3 below provides a general overview of the major interest groups working in the Texas Legislature today. (This listing is by no means complete; the number of interest groups working with the Legislature changes continually.)

**The Lobby:** As do most states, Texas requires those who directly advocate before the Legislature to register as lobbyists (except for individual citizens, the news media, and representatives of state agencies).

The Texas lobby law regulates “direct communications” with members of the legislative or executive branches of state government to influence legislation or administrative action.<sup>9</sup> This “direct communication” includes contact in person or by telephone, telegraph, or letter. The communication must be directed to a member of the legislative or executive branches. For example, if an organization publishes a newsletter, it is not “communicating directly” with members of the Legislature, even if a legislator may read it.

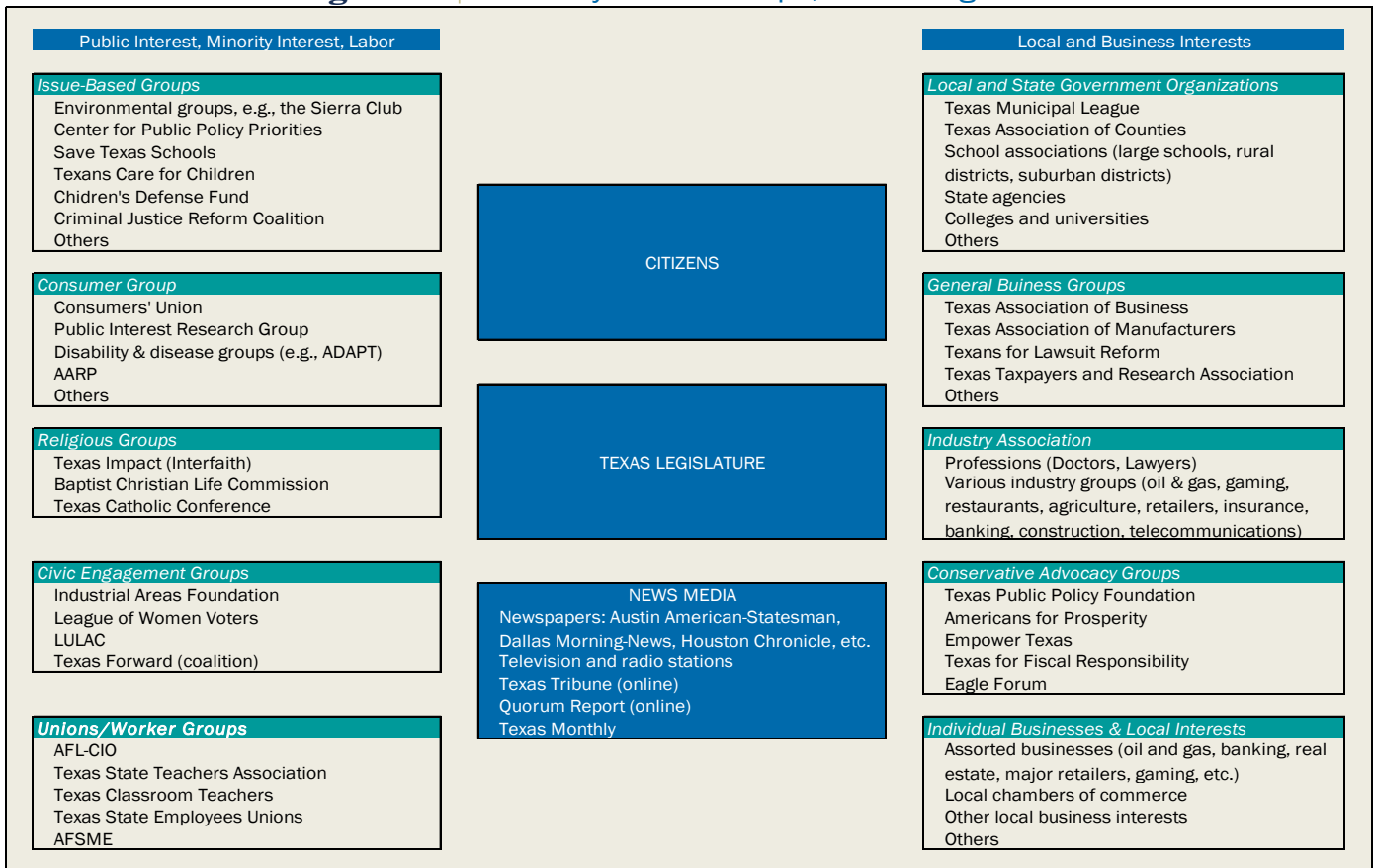
Under the lobby law, “legislation” means “a matter that is or may be the subject of action by either house of the Legislature or by a legislative committee.” “Administrative action” means any matter that may be “the subject of action by a state agency or executive branch office, including a matter relating to the purchase of products or services by the agency or office.” Even if a communication does not discuss specific legislation or administrative action, it still may constitute lobbying. If a communication is intended to generate or maintain goodwill for the purpose of influencing future legislation or administrative actions, it is lobbying, according to state ethics advisory opinions.

Lobby registration is required if a person meets either one of two thresholds – the “compensation and reimbursement threshold” or the “expenditure threshold.” A “person” required to register under the law may be an individual or a

corporation, partnership, association, or other business entity. These thresholds are relatively complex but the basic requirements are compensation of more than \$1,000 per calendar quarter or spending of more than \$500 per quarter to influence legislative or administrative action.

In a broad sense, the interests that can influence the Legislature can be subdivided into four groups: the news media, local interests, the business community, and spending and program advocacy groups.

**Figure 4 | Advocacy Relationships, Texas Legislature**



**The News Media:** This group comprises the state’s newspapers, most prominently the *Austin American-Statesman*, the *Dallas Morning-News*, the *Houston Chronicle*, the *San Antonio Express*, and the Associated Press. Scores of smaller newspapers represent other cities. Legislative sessions also are covered by a large number of major television and radio outlets.

Among other media, three bear particular mention – *Texas Monthly*, the *Texas Tribune*, and the *Quorum Report*. The *Texas Monthly* covers a wide range of topics related to Texas, from lifestyles to restaurant picks, but also publishes political reporting and the widely read “Best and Worst Texas Legislators” produced after every regular session.

The online-only *Texas Tribune*, widely cited nationally as an example of the new direction of news, provides a wide range of political reporting including written stories and video reports. It also provides extensive data sources and investigative

reports. Created only a few years ago, it is funded mainly by contributions and grants and currently accounts for a significant share of the working reporters covering the state capitol.

The *Quorum Report*, a blog carrying business and political news, produces the “Daily Buzz,” a continually updated news summary that reports breaking developments in the Legislature, often as they occur. In an era of smart phones and iPads, it provides an immediate source of information for those involved in the legislative process. No other source in Texas, including the *Texas Tribune*, produces this level of minute-by-minute news updates related to the Legislature and Texas politics.

**Local and State Government:** Local governments such as cities, counties, and school districts often deploy lobbyists at the Legislature. Many belong to larger umbrella organizations such as the Texas Association of Counties, which employs full-time lobbyists. Larger cities such as Dallas, Houston, and Austin retain their own lobbyists to work for or against bills. The chief associations representing local interests include the Texas Municipal League, the Texas Association of Counties, and the Texas Association of School Boards. Also present are representatives of various special districts, regional organizations (e.g., the North Texas Transportation Authority), and a wide range of school groups representing various coalitions of interest (large districts, rural districts, poor districts, etc.).

While they can’t register as lobbyists or advocate in public hearings for spending or legislation, most state agencies and public and private colleges and universities also have representation at the Capitol.

**Business-Related Groups:** Some business groups focus on the goals of a specific industry, while others represent multiple industries and advocate for generally pro-business policies toward taxation and government spending. Prominent groups in this list include the Texas Association of Business, the Texas Retailers Association, the Texas Manufacturers Association, the Texas Chemical Council, the Texas Medical Association, and the Texas Taxpayers and Research Association. Many individual businesses, particularly large corporations, are represented before the Legislature as well.

The business groups cover a wide range of issues, some with budget and tax implications. They may, for example, advocate for spending on public and higher education, or to hold down spending. They also may seek tax-related legislation such as exemption from sales taxes.

In addition to these groups, there are several prominent conservative advocacy groups whose general interests often parallel those of the business community. Though their issues vary, the general policy thrust is low taxes, reduced government spending, and limited business regulation. The most prominent of these at present are the Texas Public Policy Foundation and Empower Texans.

**Public Interest/Minority Interest/Labor:** A wide range of groups advocate for various areas of the budget. As Figure 3 shows, these can be broadly subdivided into issue-based groups (children’s programs, spending for low-income citizens, etc.), consumer groups, religious groups (such as Texas Impact and the Christian Life Commission), civic engagement groups (the League of Women Voters), and various labor groups representing working Texans or specific groups such as public employees and teachers. Also represented are various minority interest groups such as the League of United Latin American Citizens (LULAC), the Mexican American Legal Defense and Education Fund (MALDEF), and the National Association for the Advancement of Colored People (NAACP).

The main interests of these groups are to increase or protect funding for the budget areas affecting their focus of attention. As with the business-related groups, their interests often overlap.

Among the most prominent of these groups is the Center for Public Policy Priorities, which advocates generally for social services, public education and related budget areas, and various faith-based groups that typically support human service programs. Many of these also belong to a loose umbrella organization, Texas Forward.



## Medicaid

Like most states, Texas faces two significant budget challenges related to health care, the cost of which has skyrocketed in the past decade. Spending for health care programs from all state funds rose from \$13.4 billion in fiscal 2000 to \$33.7 billion in fiscal 2011, an increase of 151.7 percent, while health care expenditures from the state's General Revenue Fund increased from \$5.9 billion to \$12.9 billion (exclusive of federal stimulus funds), an increase of 119.6 percent. General revenue spending for health care as a percent of total expenditures rose from 21.7 percent during the 2000-2001 biennium to 30.3 percent during 2012-2013.

**Table 2 | Medicaid Enrollment in Texas**

| Fiscal Year | SFY Average Monthly Enrollees | FFY Unique Eligibles | FFY Unique Beneficiaries |
|-------------|-------------------------------|----------------------|--------------------------|
| 2010        | 3,296,512                     | —                    | —                        |
| 2009        | 3,004,380                     | 4,488,188            | 4,282,564                |
| 2008        | 2,877,203                     | 4,278,318            | 3,992,911                |
| 2007        | 2,832,214                     | 4,171,560            | 3,859,693                |
| 2006        | 2,792,007                     | 4,104,065            | 3,910,487                |
| 2005        | 2,779,373                     | 3,987,435            | 3,752,644                |
| 2004        | 2,683,227                     | 3,878,183            | 3,603,539                |
| 2003        | 2,466,119                     | 3,661,163            | 3,339,796                |
| 2002        | 2,082,697                     | 3,202,171            | 2,952,569                |
| 2001        | 1,849,573                     | 2,884,707            | 2,659,932                |
| 2000        | 1,785,693                     | 2,714,736            | 2,633,498                |

**Source:** Texas Health and Human Services Commission and Centers for Medicaid and Medicare Services.  
**Notes:** SFY is state fiscal year (September 1-August 31); FFY is federal fiscal year. FFY Unique Eligibles is all unduplicated individuals enrolled during the year and includes anyone enrolled whether services were provided or not. Beneficiaries received medical service for which Medicaid paid.

Medicaid is an important factor in this growth. Medicaid spending grew from 14 percent of the total state budget in 1991 to 25 percent in 2011. From 1991 to 2011, it rose more than twice as fast as the overall state budget.<sup>10</sup>

Medicaid enrollment rose sharply over this period, primarily due to enrollment growth and inflation rather than benefits expansion. Table 2 shows this growth expressed as an annual monthly average using the state fiscal year and total unduplicated enrollment for any length of time during the federal fiscal year, as well as the unduplicated count of people who have used Medicaid services during the federal fiscal year. State fiscal-year average enrollment has risen by 84.6 percent since 2000.

Texas enrollment in the program is growing faster than the national average. According to the Centers for Medicaid and Medicare, the number of individuals enrolled in Texas Medicaid rose by 12.6 percent from 2005 to 2009, compared to 9.6 percent nationally. Of the 4.5 million persons in Texas on Medicaid in 2009, about 2.7 million were under age nineteen and

786,000 were aged, blind, or disabled. Children represent the fastest growing segment of caseloads.<sup>11</sup> About three million children were enrolled in Medicaid and the Children's Health Insurance Program (CHIP) each month in fiscal 2012.<sup>12</sup>

Medicaid pays for about half of all Texas births; two-thirds of care for Texans in nursing homes; insurance for 4.5 million low-income, aged, and disabled Texans, including about 37 percent of Texas children; and billions of dollars in care for indigent, uninsured Texans.

Federal funds, including funds from the American Recovery and Reinvestment Act (ARRA) from 2009 to 2011, paid for about 60 to 69 percent of the cost of the program annually. Prior to the ARRA, federal funds paid for about 60 percent and, with the exhaustion of ARRA assistance, the rate returned to 60.56 percent in fiscal 2011. The match rate for Medicaid administrative costs is 50 percent. Texas received \$1.8 billion in federal ARRA funding in state fiscal 2009, \$2.7 billion in 2010, and \$1.8 billion in 2011.<sup>13</sup>

Nonfederal sources pay for the remainder and include appropriated funds and supplemental payments to hospitals that are outside the state budget and therefore are not appropriated. These include state general revenue matching funds as well as revenue from the state's tobacco lawsuit settlement, beneficiary cost-sharing, third-party reimbursements, interest earned on federal funds, refunds and rebates of premiums and claims (Medicaid program income), vendor drug rebates and intergovernmental transfers (for supplemental payments to hospitals).<sup>14</sup> General revenue matching funds include a premium tax on managed care organizations and a "quality assurance fee" assessed on Intermediate Care Facilities-Mental Retardation and Developmentally Disabled (ICF-MR DD) facilities for each day of care up to 6 percent of their annual gross income.

### **2011 Underfunding of Medicaid**

The 2013 legislative session will have to cope with recent budget decisions related to Medicaid. As did other states, Texas reduced state Medicaid spending in 2009 and 2010, when ARRA funding increased the state reimbursement level. This effectively postponed at least some of the pain of the recession until 2011. In fiscal 2011, however, ARRA funding ran out, and as the effects of the recession on state revenues became more pronounced, the Legislature made significant cuts in most areas of the budget.

The 2011 session underfunded Medicaid for the 2012-2013 biennium by as much as \$4.8 billion. This shortfall, roughly equal to the final six months of the program's costs in 2013, will likely be met with supplemental appropriations early in the 2013 legislative session, well before the bill for the unfunded months comes due. Lawmakers must appropriate at least \$3.9 billion for this purpose from amounts available for regular 2014-2015 budget needs, including an additional \$1.2 billion above the 2012-2013 base for growth in caseloads, costs, and provider rates.

Texas has underfunded Medicaid before, but the extent of the underfunding in 2011 should be a cause for alarm. Budget writers assumed that the state economy was rebounding and that the revenue outlook would be significantly improved by January 2013. That appears to have been a reasonable assumption, but the policy remains questionable, since it not only misrepresents current state spending but also pushes a growing amount of current biennial spending into the next biennium, thereby reducing funds available for that period.

## The Affordable Care Act

Complicating the outlook for Medicaid is the anticipated impact of the federal Patient Protection and Health Care Affordability Act and the Health Care and Education Reconciliation Act of 2010, together referred to as the “Affordable Care Act” (ACA). The state impact of federal health care reform has been a subject of debate in the media since its enactment in March 2010, and while the U.S. Supreme Court ruled that most provisions of the act are constitutional in June 2012, the controversy is far from over.

In Texas, some aspects of health care reform, such as the provision requiring insurance companies to accept individuals with pre-existing conditions, have been welcomed. Other aspects, such as the requirement that all individuals carry insurance or pay a fine, are *not* welcome, and Texas joined other states in a lawsuit to prevent its implementation.

The Texas Health and Human Services Commission (HHSC) estimates that in 2010, 19.6 million Texans were insured and 5.6 million were uninsured (about 76 percent versus 24 percent). Of these, HHSC estimates that 36 percent would be eligible for a subsidy under health care reform, and 24 percent would be eligible for Medicaid if Texas pursues the Medicaid expansion. Another 14 percent are currently eligible for Medicaid but unenrolled; 11 percent would be ineligible for a subsidy under income requirements; and 15 percent would be ineligible due to being undocumented. This means that, if Texas pursues Medicaid expansion, an additional 2.7 million Texans would be insured, but the state would be left with 2.9 million uninsured individuals, about 12 percent of the state’s population. (This includes 1.8 million who would be eligible for a subsidy or Medicaid but would not enroll.) If Texas does *not* pursue Medicaid expansion, the state will be left with 3.9 million uninsured, 15 percent of the population. (This includes 1.4 million who would be eligible for a subsidy or Medicaid but would not enroll.)<sup>15</sup>

Of greatest concern to state policy makers is the potential state cost of the Medicaid expansions resulting from the ACA, which would require states to cover individuals under age sixty-five up to 133 percent of the federal poverty level (FPL). (A 5 percent income deduction means that their eligibility actually comes to 138 percent of the FPL.) In addition, the policy requiring everyone to be covered by insurance, called the “individual mandate,” will drive individuals currently eligible for but not enrolled in Medicaid or CHIP to apply for coverage.

**Table 3** | HHSC Medicaid Expenditures Estimates by Level of ACA Implementation, 2014-2017 (State Cost in Millions \$)

| Fiscal Year | Adult Expansion | Currently Eligible but Unenrolled | Partial Provider Rate Increase | Full Provider Rate Increase | Total     |
|-------------|-----------------|-----------------------------------|--------------------------------|-----------------------------|-----------|
| 2014        | \$91.9          | \$193.2                           | \$24.9                         | \$37.4                      | \$347.4   |
| 2015        | \$217.6         | \$457.5                           | \$136.6                        | \$216.0                     | \$1,027.7 |
| 2016        | \$305.4         | \$563.1                           | \$205.7                        | \$308.0                     | \$1,382.2 |
| 2017        | \$723.2         | \$585.1                           | \$223.7                        | \$332.0                     | \$1,864.0 |
| Total       | \$1,338.1       | \$1,798.9                         | \$590.9                        | \$893.4                     | \$4,621.3 |

**Note:** Totals may not add correctly due to rounding.

**Source:** Texas Health and Human Services Commission.

The burden of these changes would be higher on states with traditionally less-expansive Medicaid programs. Texas, for example, only covers parents up to 26 percent of the FPL (about \$2,900) and does not cover childless adults. As Table 3 shows, HHSC estimates that Texas will spend \$4.6 billion in state funds from 2014 through 2017 to expand Medicaid and increase provider rates, with adult expansion amounting to \$1.3 billion of that total.

Medicaid expansion was expected to extend health insurance coverage to about 17 million Americans by 2019, by covering everyone below 133 percent of the federal poverty line (about \$14,500 for an individual). In Texas, that expansion would have a significant impact. HHSC's most recent projections indicate that in 2014, about 341,000 people would be added due to the expansions, as well as another 131,000 who are currently eligible but not enrolled. This total is projected to increase to 1.5 million by 2017.<sup>16</sup> The Rand Corporation estimated an increase of 2.8 million by 2020.<sup>17</sup>

Even before the U.S. Supreme Court case on the ACA, the prospects of dealing with the expansion had already prompted the Legislature to request a block grant for Medicaid, Medicare, and commercial coverage, and the authority to enter into interstate compacts to manage it. Now it seems, though, that some states may elect not to comply with the expansion, since the Supreme Court's ruling said that they can do so without penalty.

The ACA does provide financial incentives to entice states into the expansion. The federal government will cover the entire cost of new patients for the first three years. This match, however, will decrease to 95 percent in 2017 and 90 percent by 2020. This may not be enough to interest states already struggling under the weight of growing Medicaid bills. HHSC estimates that Texas would receive \$100.1 billion in federal funds for the Medicaid expansion at a GR cost of \$15.6 billion from 2014 through 2023. While Texas may have to contribute more for indigent care if it does not expand Medicaid, since nationwide federal funds for indigent care will decline to 25 percent of current funding by the end of the decade, the state may well reject the expansion.<sup>18</sup>

Texas is, however, moving forward with other provisions of ACA, and some local officials have discussed joining together to expand Medicaid coverage in the state's biggest counties, with or without state participation.

## Pensions and Other Post-Retirement Benefits

A variety of retirement programs cover Texas employees of the state, cities, counties and special-purpose districts. As might be expected, the majority of these plans cover local employees, although a state-run program covers teachers and other public school employees.

According to the Texas Pension Review Board (PRB), the agency that oversees all Texas state and local public retirement systems, these 360-odd plans cover more than 2.3 million Texans with total net assets of about \$196 billion. Among these pension plans, nine statewide systems serve approximately two million members and have assets of about \$166 billion (Table 4).<sup>19</sup>

**Table 4** | Statewide Public Employee Retirement Systems in Texas

| Retirement System   | Valuation as of | Active Members | Member Contributions | Employer Contributions | Actuarial Value (\$ millions) | Unfunded Liabilities (\$ millions) | Funded Ratio |
|---|-----------------|----------------|----------------------|------------------------|-------------------------------|------------------------------------|--------------|
| Employees Retirement System   | 8/31/11         | 137,293        | 6.5%                 | 6.95%                  | \$23,997.4                    | \$5,052.7                          | 82.6%        |
| Judicial Retirement System Plan I (1)   | 8/31/11         | 476            | 6.0%                 | As required            | \$0.0                         | \$245.8                            | —            |
| Judicial Retirement System Plan II  | 8/31/11         | 17             | 6.0%                 | 16.83%                 | \$283.9                       | \$26.2                             | 94.6%        |
| Law Enforcement Officers and Custodial Officer Supplemental Retirement System | 8/31/11         | 36,806         | 0.5%                 | 1.59%                  | \$830.5                       | \$162.3                            | 83.7%        |
| Teacher Retirement System   | 8/31/11         | 828,919        | 6.4%                 | 6.64%                  | \$115,253.0                   | \$24,062.0                         | 82.7%        |
| Texas County & District Retirement System (2)                                 | 12/31/10        | 122,889        | 4-7%                 | Actuarially Determined | \$2,122.6                     | \$17,808.6                         | 89.4%        |
| Texas Emergency Services System   | 12/31/11        | 4,371          | 0.0%                 | \$36/member            | \$64.1                        | \$15.8                             | 80.2%        |
| Texas Municipal Retirement System (3)   | 12/31/11        | 101,151        | 3-7% (4)             | Actuarially Determined | \$18,346.2                    | \$3,216.3                          | 85.1%        |

**Source:** Texas Pension Review Board, “PRB List of Current Plan Valuations, May 2012.”

(1) Pay-as-you go system.

(2) More recent data are not available.

(3) System covers 842 municipalities.

(4) Three cities have a 3% contribution rate, which is no longer available to cities under the Texas Municipal Retirement Act.

Two systems — the Texas County and District Retirement System (TCDRS) and the Texas Municipal Retirement System (TMRS) — operate as pooled systems representing 1,434 active member systems. Including these member systems, Texas has nearly 1,800 public retirement systems.

According to PRB, these programs generally are in sound financial condition, although the market downturn of 2008 had a serious impact on their assets. The total net market value of these assets peaked in 2007, at an estimated \$210 billion.<sup>20</sup> Currently, the total net assets of the plans after a rebounded economy are estimated at less than \$200 billion. Even so, this total is a considerable improvement on the \$150 billion in assets the systems held at the bottom of the market downturn in spring 2009.

The slump in asset value increased the systems' unfunded liabilities. At the end of 2010, the most recent reporting period for all plans, PRB reported that Texas' public retirement systems were 82.6 percent funded on an actuarial basis and 72.3 percent funded on a market basis. As of May 2012, twenty-one plans in the state had amortization periods greater than forty years, outside the boundary PRB considers desirable. Those plans, which include both the very large Employees Retirement System (ERS) and Teachers Retirement System (TRS), have more than a million members. At present, according to PRB, eight of these plans can *never* eliminate their unfunded liability at current funding levels. Even so, PRB has not flagged any plan as being in imminent financial jeopardy.

Even so, Texas' public retirement systems face other problems. In the short run, these are largely political, a reflection of the national storm brewing over public pensions. Nonetheless, some concerns will be impossible for Texas to ignore in coming years, regardless of the course of the debate over pension policy.

The debate in Texas already is taking shape. In August 2011, a group of Houston business leaders announced a statewide campaign to overhaul the state's public pension systems. "I think the state needs to get the hell out of this [pension] business completely," said lawyer Bill King, who is forming Texans for Public Pension Reform with others from the Greater Houston Partnership, a chamber of commerce that claims dozens of large Houston-area companies as members.<sup>21</sup>

The Legislature has taken some actions in recent sessions to reduce the cost of health care and other employee benefits by adopting various cost-containment strategies, partly — although not entirely — reducing the future financial burden. In addition, as the economy has recovered in the past two years, the pension funds have regained their footing and recovered lost ground. Still, questions remain.

### **Other Post-Retirement Benefits**

These questions were exacerbated by recent changes in governmental financial reporting requirements that exposed another hidden problem for many pensions — the mounting cost of what are called "other post-employment benefits" (OPEBs), such as retiree health care and insurance. A major milestone in the development of this issue was the 2004 issuance of two Governmental Accounting Standards Board (GASB) statements, Statement 43 and Statement 45, which outlined new accounting, reporting and disclosure requirements for OPEBs.

Historically, state and local governments have funded these benefits on a "pay-as-you-go" basis, paying an amount each year equal only to the benefits claimed in that year. GASB, along with the various bond-rating agencies, became concerned that governmental entities were not accounting for future benefits they have promised, fearing that these obligations could affect their ability to meet bond obligations in the future — or saddle future taxpayers with significant costs.

The result was GASB 43, which establishes standards for the reporting of OPEB plans, including plan assets and liabilities, and GASB 45, which establishes standards of accounting and financial reporting for OPEB assets, expenses, and liabilities.

A picture of the long-term impact of OPEBs can be found in the actuarial reports on post-employment benefits prepared by ERS and TRS (Table 11).

According to a national study by the Pew Center on the States, Texas is one of just twenty-nine states with *any* assets set aside to cover its long-term liability for retiree health care and other benefits; however, as the table shows, the TRS set-aside is only \$891 million, a fraction of the \$50 billion in unfunded liabilities for the two major statewide systems in 2011. The Center found that retiree health care and other benefits amount to 16 percent of Texas' total retirement bill but 67 percent of the retirement funding shortfall.<sup>22</sup>

**Table 5 | Other Post-Employment Benefit Obligations — Major State Retirement Systems**  
(\$ millions)

| Actuarial Valuation as of August 31  | Actuarial Accrued Liability | Actuarial Value of Plan Assets | Unfunded Actuarial Accrued Liability | Annual Required Contribution |
|--|-----------------------------|--------------------------------|--------------------------------------|------------------------------|
| <b>Employees Retirement System</b>   |                             |                                |                                      |                              |
| 2010   | \$22,329.6                  | \$0.0                          | \$22,329.6                           | \$2,014.5                    |
| 2011   | \$21,502.4                  | \$0.0                          | \$21,502.4                           | \$1,882.7                    |
| <b>Teachers Retirement System</b>  |                             |                                |                                      |                              |
| 2010   | \$25,807.8                  | \$815.0                        | \$24,992.8                           | \$2,181.4                    |
| 2011   | \$29,785.2                  | \$890.9                        | \$28,894.3                           | \$2,419.6                    |
| <p><b>Source:</b> Employees Retirement System of Texas, “Actuarial Valuation of Other Post-Retirement Benefits Provided Under the Texas Employees Group Benefits Program, Governmental Accounting Standards Board Statement No. 43 for Fiscal Years Ending August 31, 2010 and 2011”; and Teachers Retirement System of Texas, 2011 Actuarial Valuation for the TRS-Care Fund and 2010 Actuarial Valuation for the TRS-Care Fund.<br/> <b>Note:</b> The ERS valuation assumes a 5.5% discount rate, while TRS assumes a 5.25% rate for valuation under current pay-as-you go policies. In the event that contributions were increased to fully fund the actuarial required contribution (ARC), a discount rate of 8% could be used which would significantly reduce the unfunded actuarial accrued liability (UAAL).</p> |                             |                                |                                      |                              |

Should the state decide to move away from the current pay-as-you-go system, the annual required contribution rate would be just under \$2 billion for ERS and \$2.4 billion for TRS, and neither is likely to be addressed by the Legislature in the near term. A shift away from current program structure — i.e., a reduction in benefits — is far more likely.

### The Pew Study

Also raising the visibility of the public pension issue was a February 2010 Pew report on the government pension funding gap. It found a \$1 trillion gap between the \$2.35 trillion states and participating localities had set aside to pay for employees' retirement benefits and the \$3.35 trillion price tag for those promises at the end of fiscal 2008.<sup>23</sup>

For Texas, two important facts were often overlooked in the alarming headlines associated with the study. The first is that the Center pointed out that its concerns are not tied entirely to the *nature* of the benefits offered by state and local governments, but to how they have managed them:

To a significant degree, the \$1 trillion gap reflects states' own policy choices and lack of discipline: failing to make annual payments for pension systems at the levels recommended by their own actuaries; expanding benefits and offering cost-of-living increases without fully considering their long-term price tag or determining how to pay for them; and providing retiree health care without adequately funding it.

This problem, however, has not been a major factor so far in Texas.

The second point is that Texas was not on the Center's list of problem states, and while the state certainly should improve its pension practices, Pew found the state's pension programs to be in reasonably good financial condition and acknowledged that Texas has taken action in the past several legislative sessions to maintain their integrity.

That is not to suggest that Texas' state and local governments have solved all of their problems in this area, however. Some of the state's hundreds of public retirement systems have issues that need attention. As the issues raised by the Houston business group make clear, nagging concerns persist about the long-term viability of ERS and TRS, and it is almost inevitable that this debate will continue until the state takes significant actions to fix the systems' problems, real or perceived, or until the economy rebounds to the point where spending pressures ease.

At this point, state legislators are certainly engaged in the debate. During the 2011 legislative session, lawmakers included provisions in the GAA that directed ERS and TRS to conduct interim studies related to pension changes such as eligibility, final average salary, benefit multiplier, and the creation of a hybrid plan. These reports were due to the LBB and the governor's office by September 1, 2012.

As with most controversial public policy debates, this one has generated as much heat as light, and it has become very clear from the national debate concerning public pensions that the issue is poorly understood by the public at large — and probably by most state lawmakers. While the overall issue involves a large number of complex issues, some of its aspects are well known to the most casual observers.

The Baby Boom generation is beginning to retire in record numbers, and state and local governments consequently have a heavy concentration of employees who will retire in the near future. Health care costs continue their relentless climb, and public attitudes toward many government programs, particularly those in which taxpayers see little personal benefit, have chilled considerably. Furthermore, politicians in some states have made these once-obscure programs a highly visible political issue and a focus of a more generalized effort to reduce public spending and taxes.

The pensions issue almost certainly will be a focus of interest when lawmakers next convene in January 2013. Among various options discussed to date, the most common alternative has been converting new workers to a defined contributions system, akin to a 401(k), in which the individual receives a set employer contribution without any guarantee of a specific total payout.

This idea has been considered in past legislative sessions but has yet to gain real momentum, particularly as financial markets collapsed and took the value of many 401(k)s down with them. In a 2008 interim report to the Senate, the State Affairs Committee reviewed the possibility of moving to a defined contributions structure and found no compelling need for such a change, despite the emerging problems in the financial sector.



In addition, TRS' outside actuary recently told the board that moving away from the current system would not help the state's bottom line anytime soon. This is because the state is legally obligated to provide the lifetime benefit to its retirees as well as current workers, all of whom have contributed toward that benefit throughout their time with the state.

## Revenue System Performance

Two main issues concerning state revenue performance should concern decision-makers. The first and simplest is how the revenue system performs over time relative to the state economy. Ideally, revenue growth should keep pace with state economic growth without the necessity of tax increases. This is especially desirable if the state's population is growing rapidly.

A second critical concern is *volatility*, the fluctuation in tax and other revenue collections over time. Ideally, a revenue system's growth pattern should be relatively stable and therefore predictable. The performance of Texas' severance taxes in the 1980s is a classic example of how volatility can affect the state budget process, as these revenues fluctuated dramatically in a relative short period due to changes in the world energy markets.

The structure and composition of the state tax system plays a critical role in determining its growth and stability. Most states rely on personal and corporate income taxes and a general sales tax as their primary sources of tax revenue. Texas, of course, relies instead on a broad-based, high-rate general sales tax as well as a business tax tied to a base broader than profits and therefore presumably more stable. The state also depends on a range of selective sales taxes, a holdover from the state's early history of taxing "luxuries" almost exclusively as opposed to general sales. Another key difference is that Texas relies much more heavily on natural resource taxation than most states, with severance taxes on oil and natural gas now making up about 5 percent of state taxes.

Historically, federal funds have played a major role in the state budget. Texas has a large, growing population, with a large share qualifying for key federal programs such as Medicaid. Over time, the state has generated more than half of its total revenue from taxes and about a quarter from federal funds of one sort or another. In the 2000s, this pattern shifted, at least in some years (Table 6).

At times, factors beyond normal economic growth can affect the performance of individual taxes. Many states have had periodic difficulties with the personal income tax because of its capital gains component. This is partly a function of the economy, but capital gains also can fluctuate because of other factors not necessarily tied to the economy, including investor psychology and federal policy. Other taxes, such as the motor fuel tax, may fluctuate depending on factors such as changes in fuel prices that may be related only indirectly to the general economy.

**Table 6** Major Components of the Texas State Revenue System by Decade, 1960-2010

|  | 1960          | 1970          | 1980          | 1990          | 2000          | 2010          |
|--|---------------|---------------|---------------|---------------|---------------|---------------|
| General Sales Tax  | 0.0%          | 18.0%         | 23.7%         | 32.1%         | 28.0%         | 22.5%         |
| Severance Taxes  | 14.1%         | 8.8%          | 14.3%         | 4.6%          | 2.2%          | 2.0%          |
| All Other Taxes  | 41.2%         | 31.6%         | 21.6%         | 21.0%         | 20.4%         | 16.0%         |
| Federal Funds  | 28.0%         | 27.7%         | 24.5%         | 25.1%         | 29.7%         | 42.2%         |
| Land Income  | 4.8%          | 2.4%          | 5.2%          | 1.2%          | 0.5%          | 0.9%          |
| Licenses and Fees  | 9.2%          | 7.6%          | 4.5%          | 6.7%          | 8.5%          | 7.9%          |
| All Other Sources  | 2.7%          | 3.8%          | 6.3%          | 9.3%          | 10.5%         | 8.6%          |
| <b>Total All Revenues</b>  | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Source:</b> Computed from Texas Comptroller of Public Accounts, <i>Annual Financial Report</i> , various years. |               |               |               |               |               |               |

## Performance Over Time and Base Erosion

As Texas emerged from the late 1980s oil bust, its economy had become more diversified, largely as a consequence of the recession's devastating effects on key state industries such as oil and gas, banking, real estate, and construction. That is, the importance of various industries in the state's business mix was shuffled by the impact of the economic downturn. This transition was difficult, but once achieved, the results generally have been positive.

Since the early 1990s, the Texas economy has consistently outperformed the nation. This continued to be the case during the economic difficulties of the past decade. Between 1997 and 2010, Texas averaged a higher rate of growth in real gross product than the U.S., at 3.6 percent versus 2.9 percent. Texas entered the most recent recession later than the nation as a whole and recovered more quickly.

The state revenue system, though, has performed somewhat differently. Table 7 compares the performance of the state tax mix and overall state revenues, including federal funding, with two economic measures — personal income and population growth — for each of the past five decades. The table reveals some striking results. The tax system in particular outperformed personal income growth in the 1960s, largely due to numerous tax increases during those years, and during the 1970s due to several factors — the strength of the economy, high levels of inflation affecting sales tax collections, rapid population growth, and the effects of rising oil and gas prices on severance tax collections.

**Table 7** | Growth of the Texas State Revenue System by Decade, 1960-2010

|  | 1960-1970 | 1970-1980 | 1980-1990 | 1990-2000 | 2000-2010 |
|--|-----------|-----------|-----------|-----------|-----------|
| Growth Decade to Decade — Taxes        | 157.52%   | 255.86%   | 114.90%   | 85.46%    | 39.89%    |
| Average Annual Growth                  | 9.92%     | 13.53%    | 7.95%     | 6.37%     | 3.41%     |
| Growth Decade to Decade — All Revenues | 144.02%   | 249.50%   | 121.58%   | 111.01%   | 75.25%    |
| Average Annual Growth                  | 9.92%     | 13.33%    | 8.28%     | 7.35%     | 5.77%     |
| State Personal Income Growth           | 116.61%   | 247.09%   | 108.03%   | 102.80%   | 59.51%    |
| Average Annual Growth                  | 8.04%     | 12.25%    | 7.60%     | 7.33%     | 4.78%     |
| State Population Growth                | 16.76%    | 27.60%    | 18.96%    | 22.79%    | 20.59%    |
| Average Annual Growth                  | 1.56%     | 2.47%     | 1.75%     | 2.07%     | 1.89%     |

**Source:** Computed from Texas Comptroller of Public Accounts, *Annual Financial Report*, various years.

In more recent decades, though, tax revenue growth fell behind that of personal income, although the growth in all revenue sources generally exceeded income growth. An analysis of tax performance from 1960 to 2010 shows that tax revenues (without adjusting to eliminate tax increases) grew only fractionally faster than personal income, meaning that without the tax increases of the 1960s and 1980s, tax revenue growth likely would have lagged behind state income growth fairly consistently for a half-century.

These trends can be seen even more clearly in Table 8, which compares the short-term elasticity of selected taxes, federal funds, and total revenues with the trend in state personal income growth. This measure shows the relationship between fluctuations in the economy and fluctuations in revenues. The sales tax in particular has underperformed the economy consistently since the 1980s, despite the expansion of the sales tax base to a range of services in the late 1980s. Its

performance exceeded personal income growth significantly only in the 1970s, a period of dynamic economic growth (and high inflation) in Texas.

**Table 8** | Performance Characteristics of the Texas Revenue System, 1960-2010

| Selected Revenue Source     | Effect of a 1% Change in Personal Income on the Percentage Change in Revenues |           |           |           |           |
|-----------------------------|---|-----------|-----------|-----------|-----------|
|                             | 1960-1970   | 1970-1980 | 1980-1990 | 1990-2000 | 2000-2010 |
| Sales Tax                   | (1)   | 1.45%     | 0.81%     | 0.82%     | 0.68%     |
| Oil Production Tax (2)      | 0.33%   | 1.44%     | -0.32%    | -0.19%    | 2.39%     |
| Natural Gas Production Tax  | 0.72%   | 2.68%     | -0.21%    | 0.22%     | 0.07%     |
| Motor Vehicle Sales Tax (2) | 2.18%   | 1.43%     | 1.38%     | 1.51%     | -0.09%    |
| Franchise Tax               | 1.58%   | 1.25%     | 1.60%     | 3.42%     | 0.90%     |
| Federal Funds               | 2.07%   | 1.25%     | 2.10%     | 2.43%     | 4.19%     |
| All Taxes                   | 1.35%   | 1.04%     | 1.06%     | 0.83%     | 0.67%     |
| Total Revenue               | 1.24%   | 1.01%     | 1.13%     | 1.08%     | 1.26%     |

**Source:** Computed from Texas Comptroller of Public Accounts, *Annual Financial Report*, various years.  
 (1) The sales tax was enacted in 1961.  
 (2) A negative value indicates a decade during which the revenue source declined from the start to the end of the decade.

This outcome was not entirely unexpected. State fiscal analysts have recognized since the 1980s that the composition of consumer expenditures was shifting to a greater mix of services and fewer purchases of goods. Consumer spending represents about 55.1 percent of the sales tax base, according to the comptroller's office, with the remainder generated by business-to-business transactions.

Although the state added some services to the sales tax base in the 1980s, the range added was relatively narrow, and the variety of services available in the economy has continued to expand since then. Since the 1980s, there have been relatively few changes to the sales tax base other than the exemption of nonprescription drugs, the addition of an annual sales tax holiday, and a few other minor exemptions. The sales tax base, then, has failed to change with the changing nature of the economy and is falling behind in its performance as a result.

This divergence can be better understood by examining Table 9. Changes in consumer expenditures for items subject to the sales tax can be determined with data from the annual Consumer Expenditure Survey compiled by the Bureau of Labor Statistics. The data used here are for the South for 2000, 2005, and 2010, serving as a proxy for Texas. The table shows both the change in income before taxes and expenditures for items subject to the state sales tax. While consumer unit income rose by 40.1 percent between 2000 and 2010, purchases of items subject to the sales tax increased by only 15.9 percent. This indicates that the Texas sales tax base is an inferior bundle, as its growth is markedly lower than that of income. Fortunately for Texas, a 20 percent population increase during the period helped to offset some of the base erosion.

**Table 9 | Income Before Taxes and Consumption of Sales Tax Items  
2000, 2005, 2010**

|   | 2000     | 2005     | 2010     | Growth, 2000-2010 |
|---|----------|----------|----------|-------------------|
| Income Before Taxes   | \$41,984 | \$53,311 | \$58,824 | 40.1%             |
| Consumption of Sales Tax Items  | \$8,275  | \$10,071 | \$9,591  | 15.9%             |
| Percent   | 19.7%    | 18.9%    | 16.3%    |                   |
| <b>Source:</b> U.S. Department of Labor & U.S. Bureau of Labor Statistics, Consumer Expenditure Survey. |          |          |          |                   |

Another trend developing since the 1980s contributed to the erosion of the sales tax base – the annual increase in remote sales and especially sales of consumer and business goods through the Internet. These sales by businesses without a physical presence in Texas are not taxed effectively. The loss of revenues to remote sales has risen annually since the beginning of online commerce in the late 1990s, and the prospects are that it will continue to grow. The comptroller’s office currently estimates the loss of tax revenue due to remote sales at about \$600 million a year. Estimates by economists at the University of Tennessee, however, put the state’s total loss from e-commerce at \$774 million in 2011, under a baseline scenario.<sup>24</sup>

Oil and natural gas taxes, by contrast, are tied only indirectly to state economic activity, being mainly determined by the level of production and world energy prices. The volatility of severance taxes over time, clearly shown in Table 8, is due in large part to fluctuations in world energy prices.

The motor vehicle sales tax, with its narrow base, has performed well over most of the state’s history, mainly because the population and the price of motor vehicles both rose during most of the period. The one anomaly in this pattern was the past decade, when the tax registered a decline. Actually, the tax grew for most years during the 2000s, but with its narrow base tied to a large consumer good, its performance was erratic during the decade’s economic ups and downs.

On the other hand, the state’s business franchise tax has performed relatively well during most of the period, although its growth also declined somewhat relative to income growth during the 2000s. In part, this was a byproduct of tax rate changes and tax base reform in the 1980s, 1991, and in 2006. The tax has developed a questionable reputation for underperformance in Texas because revenues fell short of predictions based on the 2006 change to its tax base. It is difficult, however, to make the case that it has underperformed any more than some of the state’s other major taxes, although (as will be shown below) its growth has been more volatile than that of most state taxes.

The most stable source of revenue growth over the fifty-year period examined in Table 8 is federal funding. This source has consistently outperformed growth in personal income, due to Texas’ increasing population and its large low-income population. The level of federal funds from 2000 to 2010 was comparatively high primarily due to stimulus funding in the latter years of the decade.

In all, Texas’ revenue system presents two contrasting stories. It has kept pace with the economy in aggregate, but it is still possible to discern the outlines of potential future fiscal problems. While the state has had few major tax increases since the beginning of the 1990s, the tax system’s growth relative to personal income has eroded and is now well below personal

income growth. Federal funding essentially is supporting the overall system, and these revenues are not available for general spending — and may be subject to cuts as Congress wrestles with the federal deficit.

The elasticity measures for the last decade probably are somewhat distorted by the effects of the recession and its aftermath, but the trends in Table 8 show a distinct divergence between overall economic growth and the tax system. This should be a particular concern for the state because spending on many vital programs, including education and transportation, depends heavily on general revenue derived primarily from tax revenues.

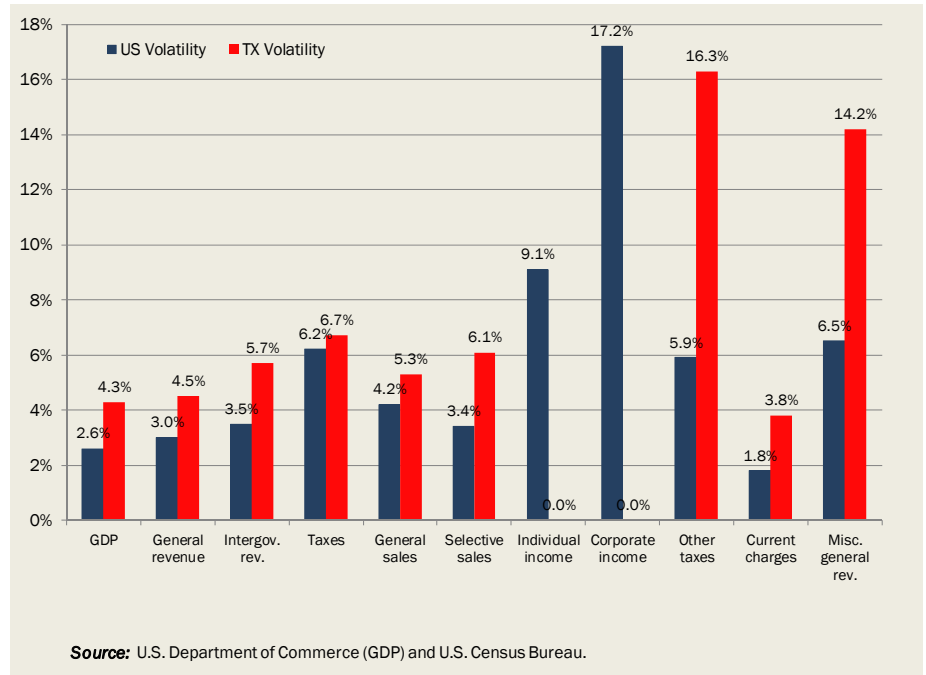
**Volatility**

Texas experienced greater volatility than the U.S. in both its economic growth and its revenue growth over the past decade. This pattern can be seen in Figure 4, which shows a simple measure of volatility for several key indicators — gross domestic product (GDP) and major state revenues — between 2000 and 2009. Volatility is represented by the standard deviation between annual growth rates for each item over the period, an indicator of how growth has fluctuated. A higher value for any given factor implies a greater degree of volatility over time.

Note that during the ten-year period, the Texas economy was 65.4 percent more volatile than that of the U.S., at 4.3 percent versus 2.6 percent. While both total general revenue and intergovernmental revenue were each more volatile in Texas than the U.S. as a whole, tax volatility was relatively equivalent. The high volatility for personal and corporate income taxes in other states appears to have increased overall tax volatility, resulting in near-parity between Texas and the U.S. average.

Table 10 shows the estimated volatility for each major tax source for two time periods — 1985-2011 and 2000-2011 — based on comptroller data. One of these periods clearly illustrates long-term trends since the oil bust of the 1980s, while the other reflects trends spanning the two recent recessions. By comparing the two periods, it is possible to get a sense of how various taxes have changed over time — that is, whether they were more or less volatile during the 2000s than they were over the entire twenty-six-year period in the base analysis.

**Figure 5** | Growth in Gross State Product and State Revenue Sources, U.S. and Texas, 2000-2009



The degree of tax volatility is determined by the size of the value during the period examined; the larger the value, the greater the volatility. In this regard, note that no effort has been made to adjust the figures for tax increases for two reasons. First, there have been few state tax increases since the late 1980s, and, second, data are limited on the effects of the few tax changes that did occur. These changes likely do have an effect on the measured level of volatility, however, both in the sales tax in the late 1980s and more recently in the business franchise tax due to changes made in 2006 and implemented in 2008.

**Table 10** | Volatility of Texas State Tax Sources, 1985-2011 and 2000-2011

| Tax Source   | 1985-2011   | 2000-2011   |
|--|-------------|-------------|
| Sales Tax  | 6.5%        | 5.8%        |
| Oil Production Tax   | 29.8%       | 32.3%       |
| Natural Gas Tax  | 55.0%       | 41.0%       |
| Motor Fuel Taxes   | 6.6%        | 1.6%        |
| Motor Vehicle Sales Tax  | 8.9%        | 10.1%       |
| Corporation Franchise Tax  | 17.0%       | 14.1%       |
| Cigarette and Tobacco Products Taxes   | 27.1%       | 27.7%       |
| Alcoholic Beverage Taxes   | 3.6%        | 2.4%        |
| Insurance Companies Taxes  | 15.3%       | 9.0%        |
| Utility Taxes  | 51.9%       | 0.4%        |
| Hotel-Motel Tax  | 8.7%        | 7.3%        |
| Other Taxes  | 33.3%       | 27.6%       |
| <b>Total Taxes</b>   | <b>6.0%</b> | <b>7.2%</b> |
| <b>Source:</b> Computed from Texas Comptroller of Public Accounts, <i>Annual Cash Reports</i> , various years. |             |             |

The table shows the state's tax system becoming more volatile in the past decade, although the observed volatility declined for a number of taxes including the sales tax. Other state taxes experiencing lower volatility included the motor fuels tax, corporation franchise tax, alcoholic beverage tax, insurance company tax, and hotel-motel tax. A large portion of the volatility of the overall system thus was a result of *extreme* volatility in the oil and gas severance taxes and motor vehicle sales tax.

The volatility of severance taxes over both periods is easily explained. Texas' production of oil and natural gas has been influenced since the mid-1990s by the increased use of enhanced technologies that slowed or reversed what was, in the 1980s, a precipitous decline in production. This development, however, was a smaller factor in the volatility of the tax than was price, which has fluctuated dramatically at several points since 1985, starting with the price collapse in 1986 and continuing on to the 2008 worldwide price spike. These events had a greater impact on oil prices than natural gas prices. Natural gas supplies are more closely tied to domestic production because of transportation issues and the increasing availability of so-called high-cost gas reserves, and prices tend to be less volatile, hence the comparative difference seen in Table 10.

By contrast, the Texas sales tax was much less volatile over the shorter period and slightly more volatile over the longer term than it was in the past decade, probably reflecting the effects of high inflation in the 1980s and changes in the sales tax base in the late 1980s. The selective sales taxes show patterns that seem reasonable given their nature. The motor fuel taxes and alcoholic beverage taxes show relatively low volatility over both periods. Both groups of taxes are based primarily on the quantity of product consumed and have not experienced any major rate changes during most of the period.<sup>25</sup> The higher volatility of the motor fuel taxes over the longer term reflects the change in tax rates enacted in 1991.

Cigarette and tobacco products taxes show extreme volatility. Tobacco taxes generally are the one category of taxes lawmakers can increase without fear of political backlash. In Texas, the tobacco products taxes underwent more and larger rate increases over both periods than any other taxes in the state mix.

The motor vehicle sales tax shows higher levels of volatility than the general sales tax. Like the sales tax, the motor vehicle tax is based on a percentage of sales prices. While there have been no rate increases, the tax base is highly volatile due to the effects of interest rates, fuel prices, and special deals on product sales, as well as the condition of the general economy.

The corporation franchise tax is more volatile than sales-based taxes. For much of the period covered in the analysis, the franchise tax base mainly comprised profits, which can be highly volatile over the business cycle. The tax also has been affected by major changes in the tax base in 1991 and 2006 that had significant effects on collections.

Given the volatility measure for total taxes in Table 10, it is possible to draw the general conclusion that, despite lacking an income tax to provide balance, the Texas tax system was not exceptionally volatile in aggregate over either period, given the economic and revenue changes that occurred. In fact, the volatility measure for all taxes closely mirrors the results for the sales tax, which dominates Texas' tax system. It also appears that the relatively limited volatility of the selective sales taxes helped to offset the extreme volatility of oil and natural gas taxes.

In other words, in aggregate, the portfolio composition of the tax system is not particularly volatile, although individual components are. The real problem for the tax system over the longer term is underperformance relative to general economic growth.

### **Volatility of Nontax Revenues**

Unlike tax sources, the volatility of no-tax revenue sources diminished over the period 2000-2011 compared to 1985-1999 (Table 11). Revenue sources that contributed to this decline included federal funds, land income, other revenue sources, and lottery proceeds. Federal funds accounted for more than half of the change in state revenue over the period 2000-2011 and declined in growth only once during this period. This decline, in fiscal 2007, was comparatively minimal, amounting to \$350 million or 1.4 percent.

Table 11 establishes that the overall volatility of nontax sources is determined largely by the size and stability of federal funding. Other nontax sources have proved to be highly volatile, particularly lottery proceeds, which fluctuate depending on the games and prizes offered, and land income, which is tied directly to the value of oil and natural gas production from state lands.



The volatility of federal funding proved surprisingly low during the 2000-2011 period, given that two federal aid programs provided added revenue during the period. One came on the heels of the 2002-2003 recession, while the other was ARRA funding reflected in the state budget in 2009-11; these account for the higher percentage of total state revenue provided by federal funds in those years.

One key factor in the relative stability of the overall revenue system may be how federal funds interact with the sales tax. The sales tax grows rapidly when the economy is expanding. Federal funds tend to rise during periods of economic stress. Federal funds, then, perform countercyclically, providing a balance to fluctuations in the tax system generally and the sales tax specifically.

### The “Fiscal Rollercoaster”

In a recent study of state budget crises, David Gamage of the University of California’s Berkley School of Law noted that, “states have been on a fiscal rollercoaster in recent years.”<sup>26</sup> Timothy Schiller of the Philadelphia Federal Reserve Bank used the same metaphor in another recent analysis of state fiscal problems.<sup>27</sup> In reality, states have ridden a fiscal rollercoaster for decades, their fortunes rising and falling with the economy, and Texas is no exception. Many state budget experts, however, believe that today’s Texas revenue system is more volatile than at any time since the 1980s.

**Table 11** | Volatility of Texas Nontax Revenue Sources, 1985-2011 and 2000-2011

| Tax Source   | 1985-2011   | 2000-2011   |
|--|-------------|-------------|
| Federal Funds  | 6.2%        | 5.9%        |
| Interest Income  | 13.6%       | 18.0%       |
| Licenses and Fees  | 11.6%       | 14.4%       |
| Land Income  | 36.0%       | 34.0%       |
| Other Revenue Sources  | 27.8%       | 21.5%       |
| Net Lottery Proceeds   | 49.3%       | 30.5%       |
| <b>Total Nontax Sources</b>  | <b>7.5%</b> | <b>6.1%</b> |
| <b>Source:</b> Computed from Texas Comptroller of Public Accounts, <i>Annual Cash Reports</i> , various years. |             |             |

This perception has been reinforced by the economic upheavals characterizing the first decade of the twenty-first century. The state faced difficult fiscal problems in 2002-2003 and an even more difficult situation in the aftermath of the recent recession. Tax revenues have fluctuated significantly, most prominently the sales tax, the state’s most important tax source, spurring recurring budget challenges followed by periods of recovery.

In large part, this is a result of how the state’s revenue system has evolved in relation to the state economy. The Texas revenue system has changed substantially in the past half century, as has the state itself. Because of the state’s economic growth and the presence of oil and natural gas resources, Texas has been able to maintain conservative spending without increasing taxes for long periods. It has also suffered through two periods of extreme fiscal stress, however, first in the 1980s and more recently during the 2000s.

The evidence suggests that today's tax system is growing less robust over time and particularly since the late 1980s, when the state significantly revised the system to deal with that era's fiscal problems. Over those thirty years, the nature of the economy has changed dramatically, but the tax system has not. It remains moored to the sales tax for more than half of total tax revenue, and world energy markets can still affect it, although the role of the oil and gas taxes has declined. The question is how long the state can sustain its spending demands given the growing divergence of its tax mix from the general economy.

While federal funds have been reasonably stable in recent history and have provided a countercyclical counterweight to the revenue system, the outlook for this revenue source is uncertain. State governments receive about \$500 billion annually in federal funding, and this offers a tempting target for federal budget cutters. This could add to the fiscal stress that Texas and other states will face as they work to climb out of the revenue hole created by the Great Recession.

## Local Government

Texas' 25.7 million citizens are scattered among more than 4,700 political subdivisions, including 254 counties, 1,196 cities, 1,037 school districts, and 2,245 special-purpose districts. While state law affects and to a large degree controls Texas' local governments, most exercise fairly extensive autonomy, imposing and collecting taxes and providing many public services. The point at which the state's preeminent position rubs against local autonomy is an ongoing source of tension.

The impact of these local jurisdictions on the delivery of public services and on statewide finances is large and growing. Local governments have direct expenditures one-and-a-half times as great as those of state government, and more than five times as much bonded debt. They are responsible for delivering many of the services that Texans most closely associate with government. Almost all levy and collect taxes, and with the exception of school districts, they receive very little intergovernmental aid from the state.

### The Structure and Financing of Texas Local Government

Table 12 shows the total number of local governments in Texas and the degree to which they use three key local tax sources — the property tax, sales tax, and hotel tax. In all, Texas has about 4,742 total local governments. Almost 4,000 of them, including all counties, most cities, and all school districts, rely on the property tax for a major portion of their funding. More than 1,400 impose a general sales tax and 417 rely on the hotel-motel tax, a tax often used for economic development purposes.

**Table 12** | Texas Local Governments by Type and Major Taxes

| Type of Unit      | Number       | Major Tax Sources |              |            |
|-------------------|--------------|-------------------|--------------|------------|
|                   |              | Property          | Sales        | Hotel      |
| Counties          | 254          | 254               | 123          | 20         |
| Cities            | 1,196        | 1,059             | 1,117        | 392        |
| School Districts  | 1,037        | 1,025             | 0            | 0          |
| Transit Agencies  | 10           | 0                 | 8            | 0          |
| Special Districts | 2,245        | 1,639             | 191          | 5          |
| <b>Totals</b>     | <b>4,742</b> | <b>3,977</b>      | <b>1,439</b> | <b>417</b> |

**Source:** Texas Comptroller of Public Accounts.

### State-Local Issues

Texas state government has a somewhat schizophrenic relationship with its local governments. On one hand, it provides far less direct monitoring and funding of local programs than do many other states. The one major exception is public education, where the state provides nearly half of all school funding and imposes significant controls in many programmatic and financial areas.

In 2007, for example, the state provided 21.7 percent of all Texas local government revenue through intergovernmental aid. If public school funding is eliminated from the total, however, state aid accounted for just 5.7 percent of all funding for cities, counties, and special districts. The fifty-state U.S. average, by contrast, is 28.5 percent for all local governments and 17.9 percent for cities, townships, counties, and special districts excluding school districts.

Despite this limited financial stake, the Texas Legislature plays a prominent role locally by adopting legislation that affects the services local governments must provide; the extent of their authority to act; and the flexibility and use of their revenue systems. Two recurring themes in this interaction are unfunded or underfunded local mandates and state limitations on local taxation.

### **Unfunded Mandates**

Texas local government officials have long complained about unfunded and underfunded state mandates that effectively push various responsibilities – and their attendant costs – from the state to the local level.

The loudest complaints generally have come from counties and school districts, which face the most extensive lists of mandates constraining their budget options. A report on unfunded mandates by the Texas Association of Counties outlined the scope of the problem as locals see it:

Unfunded mandates impose costs on Texas counties and their taxpayers into the millions of dollars statewide and force counties to increase local property tax rates to pay for edicts from above – edicts most often in the form of legislation and sometimes from state agency regulations. High-dollar examples include indigent defense and indigent health care, but there are many other ‘nickel-and-dime’ mandates that add up to major costs.... Many times, unfunded mandates are unintended consequences of legislation, not a massive plot to foist additional costs onto county government and local property taxpayers. Unfortunately, the end result is the same—local property taxpayers bear the financial brunt of state directives.<sup>28</sup>

The Legislature has attempted to address, or at least acknowledge, this problem in the past. The 1997 Legislature established an interagency workgroup to compile information about unfunded mandates.<sup>29</sup> This effort, however, did not lead to any reduction in their number. In the view of local governments, in fact, the problem has grown significantly in the past decade. During the 2003 session, for instance, the state faced a \$10 billion shortfall, and its efforts to balance the budget brought a rash of increased mandates.

Following the 2003 session, 253 of Texas’ 254 counties adopted resolutions calling on the Legislature to address the problem, saying that state mandates had hijacked their budgets, forcing them to cut programs and raise taxes to afford obligations imposed by the state. The counties were particularly upset by two state laws they viewed as the most onerous – the Indigent Health Care and Treatment Act of 1985, which requires counties to offer basic health care services to indigent residents, and the Fair Defense Act of 2001, which requires counties to provide legal defense for indigent defendants.

The indigent health care problem is particularly acute because of the relentless rise of health care costs generally and because many local officials see the problem as being compounded by the effects of illegal immigration, a potentially explosive political issue. The problem for counties, which provide the bulk of public hospital care, is significant. One HHSC study estimated the cost of uncompensated care provided by public hospitals at about \$1.1 billion in 2009, with the cost to nonprofits being even higher.<sup>30</sup>

The counties’ solution was a proposed constitutional amendment prohibiting the Legislature from requiring local governments to undertake a new activity without appropriating adequate funding for it. Opponents of the amendment

argued that mandates are not nearly as one-sided as counties and other local governments believe, and that a constitutional ban would inappropriately limit the Legislature's ability to implement statewide public policy.

After the 2005 session, local government officials convinced the House of Representatives to conduct an interim study of unfunded mandates and cost drivers through the House Local Government Ways and Means Committee.<sup>31</sup> The committee suggested a number of "possible improvements," but again, the effort produced little tangible effect on legislative practices. In both the 2007 and 2009 sessions, constitutional amendments to prohibit many future unfunded mandates died in the House Calendars Committee.

In February 2011, Governor Rick Perry created a bipartisan task force of local officials charged with "identifying burdensome, unfunded mandates that have been passed down from the state to local governments, such as cities, counties and school districts."<sup>32</sup> The governor asked the group to report in March, but its report was filed on May 6, with less than a month remaining in the legislative session.

The group presented a long list of mandates and provided specific recommendations regarding education, public safety, transportation, jails, public health, retirement systems, human resources, public information, the judiciary, licensing, and elections. In addition, the 2011 session saw proposed constitutional amendments prohibiting unfunded mandates that were related to but not specifically reflecting the work of the task force. House Joint Resolution (HJR) 56 and its companion Senate Joint Resolution (SJR) 17 as well as HJR 89 would have set standards strictly limiting legislative mandates on local governments.

HJR 56 provides a good example of how the limitations would have worked. The resolution proposed amending Article III of the Texas Constitution to prohibit any law enacted on or after January 1, 2012, that requires a local government "to establish, expand, or modify a duty or activity that requires the expenditure of revenue by the local government from becoming effective unless the Legislature appropriates or otherwise provides for the payment or reimbursement from a source other than the revenue of the local government." Once again, however, the bill and its Senate companion died in committee.

Another area of state policy making causing heartburn for local governments involves the Legislature's failure, as they see it, to provide enough services to meet local needs, in effect devolving their cost to the local level.

The prime example is transportation funding. A substantial amount of state transportation funding not directed at the highway system is applied to local road projects, particularly the interchanges that link the highway system as it moves through the state's largest urban areas. The local argument in this case is that the state's unwillingness to increase funding for transportation has hurt local transportation and economic development. The state funds local road projects with the motor fuel tax, but has not increased its rate in twenty years; it is among the lowest in the nation at twenty cents a gallon and is not linked to any inflation factor.

Frustrated with the problem, local officials from the Dallas-Fort Worth area and other major metropolitan areas sought in both in 2007 and 2009 to impose a local-option fuel tax or an increased local sales tax to pay for their transportation needs. In both cases, the efforts fell short because lawmakers essentially view even a local-option tax as a tax increase and therefore politically undesirable. Local governments did not follow up in the 2011 session, probably because the Legislature

became even more conservative as a result of the 2010 elections and because the state faced such significant fiscal challenges.

It seems likely that if problem areas in state finance, notably indigent health care and transportation, continue to fester, more aggressive local action will be sought. It is difficult, however, to imagine a scenario in which local governments can persuade the Legislature in its current composition, so the alternative could be litigation.

### **Tax Limitations**

Closely associated with the issue of unfunded mandates are limitations the state places on local governments' use of taxation. In general, these limitations affect the sales tax, the hotel occupancy tax, and, most importantly, the property tax.

The limitation on the sales tax is straightforward. The state limits the rate individual local governments can impose, and limits the *total* local rate in any given geographic area to 2 percent. Cities normally levy one of these 2 percentage points, with the remainder divided among counties, transit authorities, and a handful of other special districts. The 2 percent rate ceiling is closely guarded by business interests who apparently suspect that any further increases in the sales tax are likely to be imposed at the local level.

The state also imposes varying limits on the hotel occupancy tax rate. In addition to the 6 percent state rate, all cities and some counties can apply local taxes. Any home-rule or general-law city can impose a hotel tax of up to 7 percent. In addition, cities, counties, and sports and community venue districts can impose a separate hotel tax to finance certain projects. Adoption of these so-called venue taxes requires voter approval.

Some cities, primarily large cities that have carved out exceptions, can impose a higher rate — typically 9 percent, as in Dallas, Fort Worth, San Antonio, Austin, and Corpus Christi, but as high as 13 percent in at least one city, Pearland. Cities can impose the hotel tax without voter approval.

Texas counties face more limits on their use of the hotel tax, and those that can impose the tax have been authorized to do so through arcane legislation. By law, to impose hotel taxes, counties must border Mexico, the Gulf of Mexico, or the Edwards Aquifer Authority. Population criteria for the tax range from county population to city population, in a county bordering Mexico, to the absence of a municipality in the county. Forty-eight counties meet these criteria, but fewer actually impose the tax.

### **Property Tax Limits and Caps**

A much more important issue for local governments is the web of state controls on the property tax, which has become a politically charged issue due the tax's importance in the revenue mix and its perceived economic effects, particularly on residential housing costs.

The rapid and largely unbroken growth Texas has experienced since the 1990s, particularly in urban areas, brought sharp increases in population as well as property values. In the past decade, at least some Texas property levies have grown at eye-opening rates, prompting understandable concern among homeowners and business taxpayers. On the other hand, these growth spurts have been relatively brief, and the overall growth in property tax levies has been more modest than many seem to envision.

Upon examining a decade of trends in Texas' appraised taxable values, it is difficult to argue that the tax system is badly out of control; it is, in fact, performing pretty much as one would expect (Table 13). The levy rose sharply in the early 2000s, reflecting rapid growth in property values, with more modest growth since 2005. In all, growth in the levy closely tracked the growth in local spending.

The Legislature imposes stringent taxpayer notification requirements on local governments considering property tax rate increases, and provides a mechanism to limit such increases. This process begins with the "Truth in Taxation" provision. This concept, as written into the Texas Constitution and the tax code, requires local governments to make taxpayers aware of tax increase proposals and afford them the opportunity to "roll back" or limit them. To ensure this, the law establishes detailed guidelines for what must be reported, how and when, and provides procedures for taxpayers to force a rollback election on a proposed tax increase.

If a local government, other than a school district or certain small taxing jurisdictions and special water districts, proposes a tax rate that exceeds the lower of its effective or "rollback" rate (calculated by a formula set in law), it must publish a quarter-page notice in a local newspaper to announce two public hearings. These hearings allow taxpayers to provide their opinion on the proposed rate increase. The taxing unit then publishes another quarter-page ad to announce a meeting for the governing body to adopt the tax rate. (Separate but similar provisions cover school districts, small taxing jurisdictions, and special water districts, mainly to recognize differences in their resources and operations.)

**Table 13** | Total Local Property Tax Levy, 1999-2009

| Year                       | Total Local Levy (\$ millions) | Percent Change from Prior Year |
|----------------------------|--------------------------------|--------------------------------|
| 1999                       | \$20,278                       | 6.4%                           |
| 2000                       | \$22,513                       | 11.0%                          |
| 2001                       | \$25,310                       | 12.4%                          |
| 2002                       | \$27,320                       | 7.9%                           |
| 2003                       | \$28,893                       | 5.8%                           |
| 2004                       | \$30,974                       | 7.2%                           |
| 2004                       | \$33,479                       | 8.1%                           |
| 2006                       | \$35,553                       | 6.2%                           |
| 2007                       | \$35,115                       | -1.2%                          |
| 2008                       | \$38,980                       | 11.0%                          |
| 2009                       | \$40,034                       | 2.7%                           |
| Annual Average Growth Rate |                                | 6.6%                           |

**Source:** Texas Comptroller of Public Accounts, *Annual Property Tax Report*, January 2011.

If a unit — other than a school district, in this case — adopts a tax rate higher than the calculated rollback rate, voters can petition for an election to roll back the adopted rate. The taxing unit's governing body determines the petition's validity and, if valid, must call an election. If a majority of voters vote to roll back the tax rate, the rollback rate becomes the adopted local tax rate. Taxpayers who have already paid their taxes at the higher rate receive a refund and the delinquency date is extended.

The petition is not needed for school districts. The school board must call an election if the adopted rate exceeds the calculated rollback rate. Unless a majority of voters agree to the adopted rate, the board cannot adopt a tax rate higher than the rollback rate.

Rollback elections occur from time to time but are not particularly common. In 2009, for example, just 48 Texas school districts exceeded the rollback rate, compared with 116

in 2008.<sup>33</sup> Voters in half of these elections rejected the proposed tax rate.

Local officials obviously do not like these limitations, particularly when combined with the various exemptions and appraisal limitations the Legislature has imposed over the years, such as homestead exemptions, a special valuation method for agricultural lands, and others. Generally, though, they are content to live with them. One item of ongoing legislative interest, however, could undermine local fiscal stability — tax caps.

These caps normally take one of two forms, *appraisal* caps similar to California's Proposition 13 and *revenue* caps that limit total property tax revenue growth in any given year.

Since 1997, Texas has imposed a 10 percent annual limit on the growth of residential homestead appraisal values. This limitation has posed only limited problems for local governments because the annual growth in appraisals only rarely reaches double-digit rates. Governor Rick Perry, however, has proposed further limitations; in 2004 and 2005, he argued for a plan that would lower the existing 10-percent appraisal cap to 3 percent.

In addition, recent sessions have seen multiple bills designed to restrict the growth in appraised values further, including some proposals to expand the existing limit to business properties. Most of 2011's legislation would have limited the growth in residential values to 5 percent annually rather than the current 10 percent. None of these proposals passed, but the idea will continue to be an issue, particularly when property values are rising rapidly.

The Legislature also has considered revenue caps, with various proposals to limit the annual growth in property tax revenue to as low as 1 percent. One 2011 bill contained a variation on this idea, reducing the rollback trigger from 8 to 5 percent except in certain highly limited cases.

A 2006 Task Force on Property Appraisal created by Governor Perry suggested using both approaches in an aggressive effort to contain property tax growth.<sup>34</sup> Among its recommendations was a proposal to require any local taxing entity to gain voter approval for any change in the prior year's budgeted tax revenue exceeding 5 percent — a proposal echoed in later legislative proposals — and to give all taxpayers (including residential, commercial, and industrial properties) the option of paying their property taxes based on a five-year rolling average of appraised value.

Again, none of these proposals has been enacted, but local governments view state involvement in their tax policy as a major ongoing concern, and while property appraisals have leveled off in the last two years, this issue will continue to be raised in future legislative sessions — and probably in 2013.

## **The Problem of School Finance**

One area of local government very likely to affect state finances in the near future is public education. Texas has faced numerous lawsuits over public school funding since the 1970s. The current school finance system was born in the face of a legal threat, and revised in 2006 under another. Under the revised system, the state assumed a significantly larger share of total public education funding, putting significant stress on the state budget. This stress came near a breaking point in 2011, when the state cut spending below current service levels, adjusted for enrollment growth, for the first time since the 1940s. This reduced projected public education funding by about \$4 billion — and spurred another round of litigation.

Now the state is headed back to the courts again, facing not one but six lawsuits challenging its funding system on various grounds. It will take some time for this legal mess to sort itself out, but it seems entirely possible that the final result will



increase the state's costs. The lawsuits may not be an issue in the 2013 regular legislative session, but they could occupy lawmakers in a special session later in the biennium.

## **State Oversight and the Future of Texas Local Government**

Texas local governments face significant future challenges. Many are experiencing the same problems as the older cities of the East and Midwest. Populations are aging, with evidence of migration from the core urban centers. A disproportionately larger share of the population in the central cities is low income and least able to pay taxes to support municipal services. Crime rates are high in some areas, and many face a growing problem with deteriorating infrastructure. Yet federal and state governments have imposed additional mandates on the cities and counties that are increasingly difficult to meet.

At the same time, Texas' population continues to grow, putting increased pressure on aging infrastructure. Limits on the political ability to raise taxes coupled with the recent recession pose serious budget issues for many local governments. And these challenges are affecting not only cities and urban counties but also the schools that must cope with enrollment growth rising by 80,000 students annually.

Local governments are experimenting with a variety of techniques to deal with their problems. Cities have used their annexation powers and extraterritorial jurisdiction to expand their tax bases and exercise limited controls over nearby development, and instituted public improvement districts to permit targeted areas to impose additional taxes for vital services. Both counties and cities are privatizing governmental functions to cut costs and increase efficiency. Interlocal contracting permits governments to provide services to one another, and many counties and cities are engaged in aggressive economic development programs. Some advocate governmental consolidation, but Texas has seen only limited support for this alternative.

As all of this develops, the state occupies a middle ground, both deeply involved in and separated from local decision-making. Each session brings new legislation affecting local governments in various ways, some of it bracketed in definitions that affect only one particular government or group of governments. In all, legislators spend a considerable amount of time on local issues, and if a poll were taken most local officials might prefer to do without their attentions.

On the other hand, the state exercises little formal oversight over local finances, beyond the legislative process. It does not set accounting standards, although it does offer some technical assistance. It does not establish fund balance targets, or prescribe other financial requirements other than the limitations of state law and the Texas constitution. The only state agencies with any responsibility for monitoring local finances are the Bond Review Board and the Pension Review Board, and their duties mostly involve aggregating data reported by local governments. (The Texas Education Agency, of course, plays a significant role in local government through its authority over curriculum and various administrative requirements.)

Given the current level of legislative involvement in their operations, it seems unlikely that local governments would welcome greater oversight. If such a system were put in place, as has been done in other states, it would have to be accomplished in a way seen more as an aid than an outright hindrance. And it could not be accomplished without a major legislative battle.

## *Planning, Budgeting, and Reporting*

### **Long-Range Planning**

Although Texas' state government has an extensive strategic planning process, long-range *financial* planning is underdeveloped. Most planning efforts are limited primarily to the upcoming two-year budget period. Certainly, though, the availability of longer-term impact assessments could have important implications for legislative decisions.

The state budget process follows a biennial cycle. For example, the Legislature met in January 2011 to prepare the budget for fiscal 2012 and 2013. This budget, which becomes the General Appropriations Act, does not include formal projections of revenues or expenditures beyond the two-year cycle. In Texas, one Legislature cannot obligate a future one, so even long-term capital projects must be approved biennially.

Texas' most significant attempt to present a longer-term outlook is an informal look at the implications of current spending decisions for the two years beyond the next biennium (e.g., 2014-15) that LBB presents to lawmakers at periodic intervals. It is not a rigorous forecast and typically is not released to the public for general review.

On the revenue side, the comptroller's office prepares state revenue forecasts under a responsibility assigned by the state constitution. The comptroller's models can generate long-term forecasts; in practice, however, the agency limits its formal forecasts to the short term. These forecasts update the outlook for the current fiscal year and also cover the next two fiscal years of the budget cycle, typically covering about thirty-six months at the most.<sup>35</sup> This biennial forecast is presented to the governor and Legislature prior to the convening of regular legislative sessions. Updates are required before special legislative sessions; at other times, the comptroller is free to update the estimates as conditions require.

Perhaps surprisingly, Texas has seen little criticism of this approach, though certainly some outside groups, particularly spending advocates, would like longer-term projections to provide a more extensive and thoughtful examination of the state's fiscal situation. Due to Texas' generally conservative approach to budgeting, rating agencies have not pressed it to prepare more detailed long-range revenue forecasts, instead generally focusing on issues that will confront the next session of the Legislature.

The state's lack of focus on long-range fiscal planning is somewhat at odds with its approach to long-range *strategic* planning. The 1991 Legislature's House Bill 2009 established a comprehensive strategic planning process for all state agencies within the executive branch.<sup>36</sup> The 1993 Legislature amended this law to consolidate certain planning requirements and change the required planning horizon from six to five years (i.e., the second year of the current biennium and the next two biennia). Agencies must complete and submit plans every two years. They typically receive instructions for the update in March of even-numbered years, prior to a regular legislative session, and must provide their plan updates to LBB and the governor's office between mid-June and early July of the same year.<sup>37</sup>

While this is the timeline for the formal process, agencies generally plan on a continuous basis and may adjust their plans internally as conditions dictate. Some prepare annual business plans that update estimates of client populations and other service drivers.

The statewide strategic plan focuses exclusively on goals and objectives, outcomes, output and efficiency measures, and any explanatory measures each agency chooses to employ. Agency plans may include action plans for the strategies they propose, but these are not incorporated in the statewide plan. From the material submitted by individual agencies, the state budget agencies prepare the statewide plan, which sets statewide goals and benchmarks for all major areas of government and, along with the individual agency plans, provides a basis for agency appropriations requests.<sup>38</sup>

Although the agency-level strategic plans contain a substantial amount of data on statewide needs and affected populations, they normally do not include financial forecasts. For example, the strategic plan for the Texas Department of Transportation (TxDOT) provides extensive data on construction costs, traffic congestion, pavement and bridge conditions, vehicle miles traveled, and lane mile growth. These factors are described in detail as are limitations on state transportation funding — specifically the declining purchasing power of state motor fuel taxes — but that is as far as the analysis goes.<sup>39</sup> TxDOT has prepared a long-range forecast of spending needs and revenue sources, but that effort is highly unusual among state agencies.

### **Individual Agency Forecasts**

In a few cases, some agencies do complete long-range forecasts concerning their areas of responsibility. TxDOT, for example, presented a long-range transportation plan to the Texas Transportation Commission (TTC), the agency's governing board, in November 2010. The plan covered twenty-four years — through 2035 — and included detailed long-range forecasts of the cost of statewide needs and forecasts of available funding sources.<sup>40</sup> This plan was developed in the course of almost a year of analysis and may be updated, but will not be repeated until TTC asks for a new forecast.

In October through December 2010, the Texas Water Development Board (TWDB) approved sixteen regional water plans that include long-term water demand and supply forecasts, including financial data, for a fifty-year period (2010-2060). Because of the importance of water supply to Texas, this represents an ongoing financial planning commitment for water resource development.

The source of long-range water planning in Texas dates from 1997's Senate Bill 1. According to the TWDB,

This comprehensive water legislation was an outgrowth of increased awareness of the vulnerability of Texas to drought and to the limits of existing water supplies to meet increasing demands as population grows.<sup>41</sup>

With Senate Bill 1, the Legislature established a “bottom-up” water planning process that asks individuals representing eleven interest groups to serve as members of Regional Water Planning Groups (RWPGs) to prepare water plans for their respective areas. These plans, which outline how to conserve water supplies, meet future needs, and respond to drought in the planning areas, are updated every five years.

Another example is HHSC's detailed estimates of the state budget impacts of the federal Affordable Care Act through 2024, which were presented to the Legislature prior to the 2011 session. The estimates will be updated over time, but they address only the portion of state costs that will be affected by federal legislation.<sup>42</sup>

The Texas Education Agency provides enrollment projections, including detailed demographic and other breakdowns by school district through 2017, and the Texas Higher Education Coordinating Council provides enrollment projections through 2020.<sup>43</sup>

The Texas Higher Education Coordinating Board's long-term strategic plan, 2000's *Closing the Gaps by 2015*, seeks improvements in four main areas — participation, student success, excellence, and research. The plan includes strategies for each goal, and the agency has developed an annual performance measuring system to track its progress. Texas' public colleges and universities, as well as other agencies affected by higher education, use it to inform their own strategic plans. Although the plan includes some funding goals for research, it does not provide detailed projections of costs associated with most strategies.<sup>44</sup>

The state also produces a five-year workforce development plan as required by the federal Workforce Investment Act. The plan involves all affected agencies, which then use it in their own planning. It includes detailed action plans but does not include financial estimates.<sup>45</sup>

### **The Fiscal Noting Process**

The 1973 Legislature directed the LBB to establish a system of fiscal notes identifying the probable costs of any bill or resolution that would authorize or require the expenditure of state funds for any purpose other than those provided for in the GAA, the principal state budget document.

Fiscal notes cover a five-year period and may be updated as a bill proceeds through the legislative process. In practice, the spending and revenue impacts identified in enacted legislation are incorporated into state appropriations totals and state revenue estimates; no ongoing effort is made, however, to track these fiscal impacts separately once a session ends, or in estimates for the upcoming biennium, unless a legislator specifically requests it.

### **Tax Expenditure Reporting**

State law requires the comptroller to produce a report on the effect of various tax exemptions, including their revenue effect and impact on the incidence of taxation, once every two years, typically in concert with the regular legislative session.<sup>46</sup> Although the study is relatively detailed, it is not comprehensive; taxes covered by the study include the sales tax, the business franchise tax, school district property taxes, motor vehicle taxes, and any other revenue source generating more than 5 percent of state tax revenue in the prior fiscal year.

The law requires an analysis of each special provision that reduces the amount collected over a six-year period or that reduces revenue by more than 1 percent of total revenue; the effect of each provision on the distribution of the tax burden by income class and industry or business class, as appropriate; and the effect of each provision on total income by income class. The report must be submitted to the governor, lieutenant governor, House speaker, and members of the Legislature each time it begins its biennial session.<sup>47</sup>

### **The Role of the Economic Stabilization Fund**

After the collapse of world oil prices created a period of sustained instability in Texas state finances in the early 1980s, the Legislature created the Economic Stabilization Fund (ESF), often called the "rainy day fund." The fund holds excess revenue from state severance taxes during periods of high energy prices, the theory being to avoid building unrealistically high oil

and natural gas tax revenue into the spending base only to see prices fall — a major part of the state’s budget problems in the early 1980s. The enabling law also allowed the Legislature to deposit other “excess revenues” into the fund if it desired.

Texas voters approved a constitutional amendment creating the fund in November 1988.<sup>48</sup> The ESF receives most of its funding based on a formula involving the base year of 1987. If the state’s annual oil and/or gas production tax collections exceed those collected in fiscal 1987, 75 percent of the amount above that level is transferred into the fund, with the remainder going to general revenue. The Comptroller’s office typically makes these transfers in November, depending on world energy prices. Transfers have been made in 17 of the last 22 years and will be made in 2012 as well. Transfers also are anticipated in fiscal 2012 and 2013.

The rainy day fund also receives half of any “unencumbered” general revenue — that is, unspent and not reserved for a specific purpose — left at the end of each biennium, and retains interest earned on its balance. The Legislature can make direct appropriations to the fund but has never done so. The amount in the ESF is capped at 10 percent of general revenue income during the previous biennium. There is no required balance.

Table 14 shows the fund’s transaction history. The ESF received its first funds in 1990, with a transfer of \$18.5 million. Deposits and withdrawals directed by the Legislature usually kept the balance below \$100 million until 2001. In 2002, however, ESF deposits and interest exceeded \$700 million, pushing the fund’s balance above \$900 million. In that session, the Legislature appropriated virtually all of the fund’s revenues. The ESF grew rapidly in the last decade, although revenues slowed when oil and gas prices plunged following the price spike in 2008. This growth was due largely to substantial increased collections from the natural gas production tax.

Over the years, natural gas taxes have contributed almost \$7.3 billion to the ESF. Oil tax transfers accounted for \$2 billion, and unencumbered balances transferred in 1992 and 2008 added another \$1.8 billion, according to the comptroller’s office. When the 2011 Legislature convened, the ESF estimate for end of the 2012-13 biennium was in excess of \$9 billion. About \$3.2 billion from the fund was appropriated during the regular session to close an expected budget deficit in fiscal 2011.

The Legislature can appropriate money from the ESF at any time and for any purpose with a two-thirds (67 percent) vote of members present in each house. It also can appropriate money from the fund by a three-fifths (60 percent) vote of members present in each house under certain conditions.

The first of these conditions concerns the current two-year budget period. The Legislature can appropriate money from the stabilization fund for the current biennium only with a three-fifths vote of members present in each house, and only if the comptroller had certified that the current fiscal biennium would end with a budget deficit. That condition was met in the 2011 legislative session.

If the comptroller certifies that a deficit is looming, lawmakers can appropriate from the ESF an amount no larger than the deficit. This deficit is defined as the difference between already appropriated revenue and a revenue estimate made when the comptroller is asked to certify a bill making an appropriation from the stabilization fund.

During a regular session, the Legislature can appropriate money from the fund only for a purpose for which a general-revenue appropriation had been made by the preceding Legislature. During a special legislative session, the Legislature can appropriate money from the fund only for a purpose for which a general-revenue appropriation had been made in a previous session of the same Legislature, generally the regular session that preceded the special session.

**Table 14** | Economic Stabilization Fund History (\$ millions)

| Fiscal Year  | Deposits          | Interest       | Net Transfers/<br>Expenditures | Ending Balance    |
|--------------|-------------------|----------------|--------------------------------|-------------------|
| 1990         | \$18.5            | \$0.8          | —                              | \$19.3            |
| 1991         | \$7.8             | \$1.9          | (\$29.0)                       | —                 |
| 1992         | \$156.6           | \$6.8          | —                              | \$163.4           |
| 1993         | —                 | \$7.4          | (\$119.0)                      | \$51.7            |
| 1994         | \$31.0            | \$3.0          | (\$56.6)                       | \$29.1            |
| 1995         | —                 | \$0.6          | (\$21.5)                       | \$8.1             |
| 1996         | —                 | \$0.4          | (\$0.5)                        | \$8.0             |
| 1997         | —                 | \$0.4          | —                              | \$8.5             |
| 1998         | \$47.5            | \$2.3          | —                              | \$58.3            |
| 1999         | \$17.9            | \$3.8          | —                              | \$80.0            |
| 2000         | —                 | \$4.7          | —                              | \$84.7            |
| 2001         | \$103.1           | \$8.7          | —                              | \$196.5           |
| 2002         | \$685.8           | \$21.6         | —                              | \$903.9           |
| 2003         | \$83.6            | \$19.4         | (\$446.5)                      | \$560.5           |
| 2004         | \$352.6           | \$5.5          | (\$553.0)                      | \$365.6           |
| 2005         | \$594.5           | \$17.3         | (\$970.5)                      | \$6.9             |
| 2006         | \$905.0           | \$21.5         | (\$528.3)                      | \$405.2           |
| 2007         | \$1,551.9         | \$65.8         | (\$691.5)                      | \$1,331.4         |
| 2008         | \$2,978.5         | \$136.0        | (\$90.5)                       | \$4,355.4         |
| 2009         | \$2,241.9         | \$128.8        | (\$0.4)                        | \$6,725.7         |
| 2010         | \$869.9           | \$97.0         |                                | \$7,692.6         |
| 2011         | \$451.5           | \$26.5*        | N/A                            | N/A               |
| <b>Total</b> | <b>\$11,097.6</b> | <b>\$553.7</b> | <b>(\$3,507.3)</b>             | <b>\$23,054.8</b> |

**Source:** Texas Comptroller of Public Accounts, “Rainy Day Fund 101,” *Fiscal Notes*, January/February 2011.  
\* Estimated interest income for the first four months of fiscal year 2011.

The second condition concerns the upcoming biennium. Lawmakers can appropriate money from the fund for a succeeding biennium by a three-fifths vote in each house only if the comptroller estimates that anticipated revenues for an upcoming biennium would be lower than the revenues for the current one. At the end of each fiscal year, if the actual revenue shortfall is less than the estimated shortfall, the comptroller must transfer money from general revenue back to the ESF to make up the difference. If the difference between estimated and actual revenue was affected by a change in the tax rate or tax base,

the comptroller must adjust the calculation of the revenue difference by determining what it would be if the tax rate or tax base had remained unchanged.

During the 2011 legislative session, the use of the ESF balances became a subject of intense debate. Facing a shortfall estimated at between \$15 and \$25 billion, the Legislature elected to use only a portion of the ESF balance, about \$3.2 billion, to eliminate a projected deficit in 2011. Legislators declined to make additional appropriations from the fund to help balance the budget, arguing that the budget problem should be addressed primarily through budget cuts and that the fund balances might be needed in the future. This was a reasonable assumption, given that the Legislature intentionally underfunded Medicaid by more than \$4 billion, and used timing shifts to reduce appropriations in the upcoming biennium that will be due in the following two-year budget period.

### **Nonrecurring Budget Items**

All governments use nonrecurring items — one-time measures and outright “gimmicks” to help balance their budgets on occasion. Sometimes, the nonrecurring items are part of an overall budget strategy, and at other times they are used for unanticipated problems, whenever shortfalls must be bridged. The temptation to use nonrecurring items is large, since they can fix a fiscal problem with a minimum of political cost. They can help a government weather a budget crisis or simply adjust for an unanticipated — and presumably one-time — situation such as a natural disaster.

States rely on nonrecurring actions most heavily in times of budget stress. Regardless of their wisdom, they make practical political sense. States are eternally short of funds, and because state laws typically require a balanced budget, legislators face enormous pressure to use all of the tools at hand to make the budget math work.

Problems arise, however, when states lean too heavily on nonrecurring items. Legislatures that do so can find themselves criticized in the media for relying on “smoke and mirrors” to avoid painful decisions. Their use also may create structural issues in future budget periods, when the nonrecurring items no longer are available and alternatives must be found.

On the other hand, states typically run out of nonrecurring gimmicks long before they solve fundamental budget problems. Only so many are available to most states, even at their most creative, and they can seldom fill a sizable budget hole by themselves. Only so many delays are possible; reserve balances are eventually drained; underestimates have to be addressed at some point.

In Texas, the use of nonrecurring items goes back at least to the 1950s and probably much earlier. Over time, the state has evolved a fairly extensive set of nonrecurring options. Table 15 shows the range of nonrecurring actions used in the Texas budget for the past five biennia, in eight broad categories. Some are used routinely, such as supplemental appropriations, while others are less common, such as across-the-board reductions and tax amnesties. The past decade has been a high-water mark in Texas’ use of nonrecurring items, bracketed as it has been by two recessions.

Table 15 demonstrates that nonrecurring items can be found in *all* recent legislative sessions, regardless of the condition of the budget. Each session presents a unique set of circumstances that lawmakers must deal with, and into which the one-time strategies are fit like pieces in a jigsaw puzzle.

Five of the eight options are what might be called “normal” budget adjustment strategies. For example, the state typically makes some adjustments to the two-year budget each time it meets, usually through *supplemental appropriations* that are,

in effect, budget amendments. *Across-the-board reductions* may be ordered as a simplified way of dealing with budget stress, and the resulting reductions may be built into future spending plans — or not, depending on the Legislature. *Tax initiatives* such as tax amnesties and special enforcement or audit programs are routine ways of producing more revenue or, in some cases, speeding up revenue collections. *Federal fiscal relief*, such as the ARRA, can provide short-term budget relief but is unpredictable and outside the state’s control. Finally, the state can dip into the *Economic Stabilization Fund*, and has, frequently, over its life.

More troublesome as a matter of state fiscal policy are the remaining nonrecurring items in the list — the spending delays, underestimations, and other budget maneuvers that could fairly be called “gimmicks.”

**Table 15** | Use of Nonrecurring Items in Texas State Budgeting: Biennial Budget Periods; 2003-2011 Legislative Sessions

| Strategy  | 2004-2005 | 2006-2007 | 2008-2009 | 2010-2011 | 2012-2013 |
|---|-----------|-----------|-----------|-----------|-----------|
| Supplemental appropriations   | X         | X         | X         | X         | X         |
| “Rosy” Scenarios & Underestimated Appropriations  | X         | X         | X         | X         | —         |
| Economic Stabilization Fund   | X         | X         | X         | —         | —         |
| Across-the-Board Reductions   | X         | —         | —         | —         | X         |
| Transfer and Payment Delays and Diversions  | X         | X         | —         | —         | X         |
| “Frozen” General Fund-Dedicated Balances  | X         | X         | X         | X         | X         |
| Tax Initiatives   |           |           |           |           |           |
| Amnesties   | X         | X         | —         | —         | X         |
| Special Tax Enforcement and Audit Programs  | X         | —         | X         | —         | —         |
| Federal Fiscal Relief   | X         | —         | X         | X         | X         |
| <b>Source:</b> Compiled from legislative data, including Legislative Budget Board, <i>Fiscal Size-Up</i> , various years; General Appropriations Acts, various years; supplemental appropriations bills, various years; “fiscal matters” bills, various years; Comptroller of Public Accounts, Biennial Revenue Estimate and Certification Revenue Estimate, various years. |           |           |           |           |           |

#### **“Rosy” Scenarios and Underestimated Appropriations**

One of the most difficult problems in budget planning is forecasting error. This is often associated with revenue forecasts, but can also affect *spending* projections, particularly for programs affected by economic conditions such as health and human services. In this regard, the recession and its aftermath have posed a particular challenge for estimators in Texas and other states. According to the Pew Center on the States and the Rockefeller Institute of Government, in fiscal 2009, “errors by states in forecasting personal income, sales, and corporate income tax collections added up to a \$49 billion unexpected revenue shortfall.”<sup>49</sup> That’s a staggering amount in a year in which state lawmakers faced \$63 billion in midyear budget gaps — atop \$47 billion they had already closed when they adopted their budgets.

Texas has had difficulty in projecting the trajectory of state revenue and spending in the period surrounding the recessions of the past decade. Revenue overestimates caused significant problems for the state in the form of a projected deficit of \$4.3 billion at the end of fiscal 2011.



Some have speculated that the overestimate was a result of an overly rosy outlook adopted for political reasons, but that does not appear to be the case. As a statewide elected official, the comptroller has nothing to gain and much to lose politically by overestimating state revenues. The actual cause of these overestimates was, essentially, the same problem faced in state after state – a fragile and uncertain economic environment.

Spending forecasts have presented similar problems. One trend in Texas over the past decade or more is consistent underestimation of Medicaid demand and its resultant costs. Until 2011, this was not so much a budget strategy as the result of lawmakers' selection of conservative – and therefore optimistic – forecasts of program demands from among various possible scenarios. This trend toward underestimation is reflected in the number of times lawmakers have had to adopt supplemental appropriations for Medicaid, to make up shortfalls normally running into the hundreds of millions of dollars.

In a widely reported effort to balance the budget within available revenues and without the need to tap the rainy day fund, lawmakers in 2011 budgeted only the first eighteen months of Medicaid costs for the 2012-2013 biennium, producing budget “savings” of approximately \$4.8 billion that will have to be made up by the 2013 Legislature. Clearly, this sizable and intentional underestimate raised the question of why more of the state's Economic Stabilization Fund reserves were not used instead. As the *Fort Worth Star-Telegram* reported,

Of all the accounting tricks Texas lawmakers used this year, their decision to under-fund Medicaid by about \$4.8 billion drew the most attention.... Based on the size of that single obligation, many lawmakers argue that the state's rainy-day fund, which had over \$6 billion in it earlier this year, is largely already spent.<sup>50</sup>

This decision is difficult to explain in a straightforward way, given the rainy day fund's still ample reserves. The best explanation is that lawmakers wanted to deal with the budget shortfall directly with cuts in services rather than use reserves that might be needed in 2013, and hoped that an economic recovery would reduce Medicaid program costs in coming months. In any case, the budget that finally emerged from the 2011 session contained one of the largest packages of nonrecurring measures in legislative history.

Ironically, given the state's strained fiscal situation, lawmakers actually made no supplemental catch-up appropriation for Medicaid for the 2010-2011 biennium in the 2011 session. This was, to a large degree, a function of budgetary luck. Congress extended the enhanced FMAP rate in 2010, which netted Texas an additional \$980 million to \$1 billion for fiscal 2011 in addition to earlier federal stimulus funding. The state also ran a \$105 million surplus in one facet of its Medicaid program, which also helped to head off a supplemental appropriation. The underfunding problem, however, will return with a vengeance in 2013, and, unless the state sees significant economic improvement or new federal assistance, it will have to deal with 2011's \$4.8 billion underfunding decision.

### ***Transfer and Payment Delays and Diversions***

The Texas constitution requires that the state budget be balanced within available revenue, under its “pay-as-you-go” amendment. The comptroller must certify that a finished budget is within available revenue before the bill is sent to the governor.

This requirement, however, is not as straightforward as it seems. Under what is known as the “bookkeeping bill,” passed in the 1950s, the comptroller is required to count as part of the revenue estimate only receipts and disbursements anticipated to occur within a two-year budget period. Although the state uses modified accrual accounting for state financial reporting, the revenue estimate is based on strict cash accounting.

This means that any revenue received in the period can be counted in the revenue estimate, and *also* that if a particular expenditure item isn’t disbursed in the biennium — in other words, if the cash payment has not been made — for the purposes of the revenue estimate, it never happened. The spending does not show up in the current estimate and therefore does not add a cost to the budget. It is effectively pushed forward and becomes a problem for the next biennium.

One of the earliest and clearest examples of this strategy at work is also one that turned out not to be a one-time event. In the early 1990s, the state moved the monthly pay date for public employees from the last day of the month to the first day of the following month. For purposes of budget certification, this had the effect of saving one month’s salary in the biennium in which it was first adopted.

The 2011 session provided another example of how this strategy can be used to help fill a current budget hole. Under the provisions of the Foundation School Program, the state makes regular payments to school districts during the biennium, with a final payment made near the end of the month of August, just as school is resuming after the summer break. If this payment is delayed for a few days — from the end of August to the beginning of September — it has a *powerful* impact on the budget, moving more than \$2 billion in spending out of the current budget period and into the next. Also delayed was a transfer of motor fuel tax collections from the General Fund, where it is initially deposited, to the State Highway Fund, effectively “saving” the budget in excess of \$400 million in the current biennium.

The difficulty with these gimmicks — for that is certainly what they are — is that they can be used only once unless they are subsequently undone by a catch-up appropriation. Because of their inherent limitations, spending delays and diversions tend to be used only during periods of high budgetary stress, and then undone when the economy improves. In the past five legislative sessions, Texas made use of significant delays and diversion in two of five budgets, in 2003 and 2011.

The 2003 school payment delay, for example, resulted in a one-time reduction in spending needs in the 2004-2005 budget of about \$800 million. Lawmakers reversed this delay in 2007, which allowed the trick to be used again in 2011. The delay in the state payday mentioned earlier, by contrast, has never been undone.

In addition to spending delays, the Legislature also occasionally makes use of revenue diversions, temporarily using revenues intended for one purpose as general spending. For example, under House Bill 2 in the third called session of 2003, lawmakers diverted a portion of the revenues for certain driver license and record fees intended for a transportation-related fund, the Texas Mobility Fund, for use as general revenue.

The Mobility Fund diversion was repeated in 2005’s Senate Bill 1863, which amended various legal provisions relating to state fiscal matters.<sup>51</sup> Among the bill’s revenue-generating provisions was a transfer of revenue in fiscal 2006 and 2007 from the Mobility Fund to the General Revenue Fund. In addition, an assessment normally deposited into the Telecommunications Infrastructure Fund was extended until September 1, 2011, and deposited instead into general revenue.

### **“Frozen” General Fund-Dedicated Balances**

The Legislature also uses another tool that, like the spending delays described above, relies on the unique accounting rules used in the revenue estimate. This is one of the facets of the Texas budget that is the most difficult for the public – and particularly spending advocacy groups – to understand. It involves the underappropriation of General Revenue-Dedicated accounts to retain balances. To understand the concept, it is important to understand the composition of the General Revenue Fund.

The General Revenue Fund is the state’s “purse” for general expenditures. A large share of state receipts and disbursements move through this fund, which contains both nondedicated and dedicated accounts. The dedicated accounts are a result of the state’s ongoing efforts at funds consolidation. Prior to a process initiated in 1991, most of the dedicated accounts within General Revenue Fund existed as separate special funds. During consolidation, some special funds were abolished, but most were brought into the General Revenue Fund as dedicated accounts.

According to LBB, the General Fund contains approximately 200 of these dedicated accounts, ranging from the State Parks Account to college operating accounts that receive tuition revenue. Some of these are quite substantial. One, the System Benefits Account, which is tied to electric utility deregulation, was projected to have a balance of \$623.4 million at the end of fiscal 2011, according to the comptroller’s office. Other significant balances include the Emissions Reduction Plan account, the 9-1-1 Services account and the Designated Trauma Facility and EMS account. In all, the comptroller estimated that balances in the General Revenue-Dedicated accounts would total \$4.07 billion at the end of fiscal 2011.

In some cases, the Legislature appropriates the total estimated biennial revenue for an account and the fund’s balance for its dedicated purpose. In many cases, though, the Legislature instead appropriates a *portion* of the fund’s resources for its purpose and retains the rest in general revenue. The balances in General Revenue-Dedicated accounts are available for general spending according to the provisions of Section 403.095, Government Code.

In this regard, it is important to understand that, as in the case of the spending and transfer delays, the balances can be counted for general appropriations purposes only once. Thus, any gains that can be appropriated in this manner each session come from growth in the dedicated account balances, due to new revenue collections and interest income. The downside – and this is what many program advocates find difficult to accept – is that once dedicated account balances are used for general appropriations, they cannot be spent down for their intended purposes without reducing the funds available for general spending. Thus, the Legislature consistently underappropriates these funds to increase balances, effectively “freezing” them in the General Fund and leaving only a “trickle” of appropriations to the intended programs.

This procedure was first used in the 1980s, to break a legislative deadlock caused by a budget shortfall, and has been used by the Legislature each biennium since fund consolidation began in 1991. Over time, the balances “frozen” in dedicated accounts have increased in almost all legislative sessions, with some variance between sessions. In the 2007 legislative session, for example, balances were spent down for their intended purposes to a greater extent than in most other budget periods in the past decade. In most cases, though, the process generates substantial revenue for general spending – typically in the range of \$450 to \$900 million in recent biennia. Since this is a longstanding, if controversial, legislative practice, it is noted but not treated as a nonrecurring item for purposes of the trend analysis later in this section.

### ***Trends in the Use of Nonrecurring Actions***

One of the problems with understanding the impact of nonrecurring actions is that no official report or analysis compiles these actions in any systematic way. Legislators are generally aware of some of the key one-time provisions as the budget is developed, as are various advocacy groups that follow the Legislature. Members of the Senate Finance and House Appropriations committees, legislative and gubernatorial budget staffs, and the comptroller's office track one-time measures as they are added and deleted from the developing budget; no one, however, bothers to add them up once a session ends.

This report addresses that information gap in a small way. Table 16 compiles all nonrecurring items, including “budget gimmicks,” developed from the original source documents, including the last five GAAs. It shows the key categories of one-time measures used in each session and compares them to overall state spending to get some idea of relative magnitude.

This table requires several caveats. First, the estimates included are taken from official data available *at the time each of the budgets for the five biennia was compiled*. They reflect what lawmakers had before them at the time the various measures were adopted. Second, the list is not intended to be comprehensive, owing to the size and scope of the policy documents involved. It does, however, cover major items matched to the fiscal periods in which they had their effects. Third, the totals do not include supplemental appropriations unless they *actually reduce appropriations* in a given period. Most legislative sessions include at least some supplemental appropriations covering items from the current biennium that were not anticipated in the previous session. The items in this list are the “tricks,” if that is the correct term (lawmakers would disagree) used to squeeze additional dollars out of the state budget. The table includes Economic Stabilization Fund transfers, federal fiscal relief, and other similar one-time items.

With those cautions in mind, the estimates demonstrate a relatively predictable pattern in the use of one-time measures. First, every budget includes some nonrecurring items. That doubtless reflects the difficulty of writing a balanced two-year budget with so many competing needs, particularly given the Legislature's aversion to revenue increases. The nonrecurring items help meet the need for additional spending authority in good times and bad.

On the other hand, it clearly shows that the use of nonrecurring items escalates dramatically in times of budget stress, such as the 2003, 2009, and 2011 legislative sessions. In each of these cases, the nonrecurring actions used to balance the budget approached or exceeded 10 percent of general revenue spending for the biennium and about half that for All Fund appropriations.

**Table 16** | Major Nonrecurring Actions of the Texas Legislature,  
2003-2011 by Two-Year State Budget Period (1)

| Nonrecurring Item  | 2002-2003 (2)      | 2004-2005          | 2006-2007          | 2008-2009          | 2010-2011          | 2012-2013 (3)      |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| Economic Stabilization Fund Transfers                                  | \$449.5            | \$811.0            | \$1,219.8          | \$90.9             | \$0.0              | \$3,199.0          |
| Across-the-Board Appropriation Reductions                              | 1,061              | 210                | 0                  | 0                  | 1,282              | 250                |
| <b>Transfers/Delays/Diversions of Funds:</b>                           |                    |                    |                    |                    |                    |                    |
| Foundation School Program Payment Delay (4)                            | \$0.0              | \$800.0            | \$0.0              | \$0.0              | \$0.0              | \$2,300.0          |
| Motor Fuel Tax Transfer to State Highway Fund Delay                    | \$0.0              |                    | \$0.0              | \$0.0              | \$0.0              | \$403.0            |
| Texas Mobility Fund Revenue Diversion                                  | \$0.0              | \$231.7            | \$254.7            | \$0.0              | \$0.0              |                    |
| <b>Tax and Revenue:</b>  |                    |                    |                    |                    |                    |                    |
| Tax, including Tax Amnesties, Certain Refund Delays, and Tax Speed-Ups | \$0.0              | \$335.3            | \$353.2            | \$0.0              | \$0.0              | \$391.0            |
| Unclaimed Property Change  | \$0.0              | \$0.0              | \$0.0              | \$0.0              | \$0.0              | \$0.3              |
| Federal Fiscal Relief Assistance (5)                                   |                    | \$1,300.0          | \$329.0            | \$2,309.3          | \$12,058.8         | \$0.0              |
| General Revenue Fund Portion Only                                      |                    |                    |                    |                    | \$8,300.0          | \$0.0              |
| Extension of Higher Federal Medical Assistance Percentage              |                    |                    |                    |                    | \$1,000.0          | \$0.0              |
| Medicaid Underestimates  | \$440.3            | \$1,976.9          | \$283.9            | \$1,026.4          | \$0.0              | \$4,800.0          |
| <b>Totals</b>  | <b>\$1,950.8</b>   | <b>\$5,665.1</b>   | <b>\$2,440.6</b>   | <b>\$3,426.6</b>   | <b>\$13,340.8</b>  | <b>\$11,343.3</b>  |
| <b>All Funds Budget Total at Passage (6)</b>                           | <b>\$114,119.8</b> | <b>\$118,200.4</b> | <b>\$138,161.9</b> | <b>\$167,787.2</b> | <b>\$182,188.0</b> | <b>\$172,300.0</b> |
| <b>General Revenue-Related Budget at Passage (6)</b>                   | <b>\$61,487.1</b>  | <b>\$58,894.7</b>  | <b>\$64,125.5</b>  | <b>\$78,951.5</b>  | <b>\$80,614.2</b>  | <b>\$80,500.0</b>  |
| <b>Estimated Percent of All Funds Budget</b>                           | <b>NA</b>          | <b>4.79%</b>       | <b>1.77%</b>       | <b>2.04%</b>       | <b>6.62%</b>       | <b>6.44%</b>       |
| <b>Estimated Percent of General Revenue Budget Only</b>                | <b>NA</b>          | <b>9.62%</b>       | <b>3.81%</b>       | <b>4.34%</b>       | <b>10.30%</b>      | <b>13.78%</b>      |

**Source:** Compiled from Texas Legislature, General Appropriations Acts; supplemental appropriations acts; and state "fiscal matters" bills; Legislative Budget Board, Fiscal Size-Up (various years).

These totals cover the major nonrecurring items in the budget. The budget of the State of Texas is a complex document and some nonrecurring items have been omitted, although not major items.

(1) All totals are based on estimated appropriations and revenues at the time the budget was adopted. Actual amounts received and spent vary from these totals, often substantially. These totals are those the legislature worked with in each given legislative session.

(2) Totals reflect actions of the 2003 Legislature only. Nonrecurring actions during the 2001 legislative session affecting the 2002-2003 are not reflected in these totals.

(3) To match the total for the 2011 legislative session shown in Table 3 of this paper, it is necessary to add the across-the-board reductions in the 2010-2011 biennium, which were enacted in 2011, with the total for the 2012-2013 biennium for a total of \$12.625 billion for all nonrecurring actions of the 2011 legislature.

(4) The Foundation School Program delay approved in the 2003 session was repaid in the 2007 legislative session; however, it is not shown in these totals since the repayment did not significantly affect the budget outcome in that year. This table measures only items that freed up spending authority or revenue for additional appropriations.

(5) Includes aid from the Jobs Growth Tax Relief and Reconciliation Act of 2003, disaster relief for Hurricanes Katrina and Rita, and aid from the American Recovery and Reinvestment Act of 2009. In fiscal 2010-2011, the ARRA increased Texas' FMAP to a high of 70.94 percent. The enhanced funding level, originally set to expire December 2010, subsequently was extended and was phased out by June 2011. This increased funding in 2011 by \$1 billion, which was recognized in the 2011 legislative session but was not part of 2009 budget decision making.

(6) Totals include supplemental appropriations bills.

### ***The 2011 Legislative Session***

The 2011 legislative session generally is viewed as the “worst” of recent sessions in terms of its use of nonrecurring items, a fact extensively discussed in the news media and elsewhere. And this is true, if the measure of size is the percentage of general revenue-related spending accounted for by one-time measures. In dollar terms, however, the 2011 Legislature’s one-time measures actually came in lower than those of the 2009 legislative session.

The difference is that in 2009, most nonrecurring funding came from federal stimulus funding. These funds were mostly exhausted before the 2011 session. In effect, their use in 2009 allowed the 2010-2011 biennial budget to be balanced with a lesser number of “gimmicks,” but *also* created a budget cliff over which the budget tumbled in 2011, helped along by the aftereffects of the recession and the large-scale increase in state spending for public education approved in 2006.

The table shows that one-time measures accounted for nearly 13.8 percent of General Fund spending in 2011 and 6.4 percent of All Fund spending. The General Fund percentage was substantially greater than in 2009, the next-highest year, but the All Funds total was less. This reflects two factors. First, the actual dollar amounts of nonrecurring items in the 2009 budget were actually higher than in 2011, almost entirely because of federal stimulus aid. Secondly, however, the 2011 Legislature made significant reductions in all appropriations that did not occur in 2009. As the table shows, the reported All Fund appropriations for 2012-2013 were nearly \$10 billion less than in 2010-2011, even including the across-the-board reduction in 2011 appropriations.

In both sessions, the amount of nonrecurring items used to balance the budget probably is much higher than sound budget policy would dictate, and each session compounds the problem. Whether this apparent trend will be borne out over time remains to be seen. One-time measures reached very high levels in 2003 on the heels of the 2002 recession but then fell back in subsequent legislative sessions as the economy and state revenues recovered. In fact, many of the cuts made in 2003 were restored in part in 2005, mainly through the appropriation of growing state revenues.

It is simply too early to say if that pattern will occur again. Both in the 2009 and 2011 legislative sessions made extensive and troubling use of one-time measures in response to the recession and its aftermath. On the other hand, the school finance reforms of 2006 clearly exerted a significant fiscal drag on the state’s finances that was compounded by the recession. Under the 2006 reforms, the state undertook about \$43 billion in new spending over six years. It did not, however, fully fund this new spending with additional revenue, and the final plan was at least \$25 billion short of balanced over six years. This gap has lingered.

## The Impact of Federal Actions

Like many other states, Texas often finds itself frustrated with federal policy. The recent controversy over the impact of the health care reform on state finances is an obvious example. It is misleading, however, to judge the state's relationship with Washington solely by policy differences. The state partners with the federal government on a range of programs, particularly in health and human services, and federal funding occupies a prominent place in the state budget.

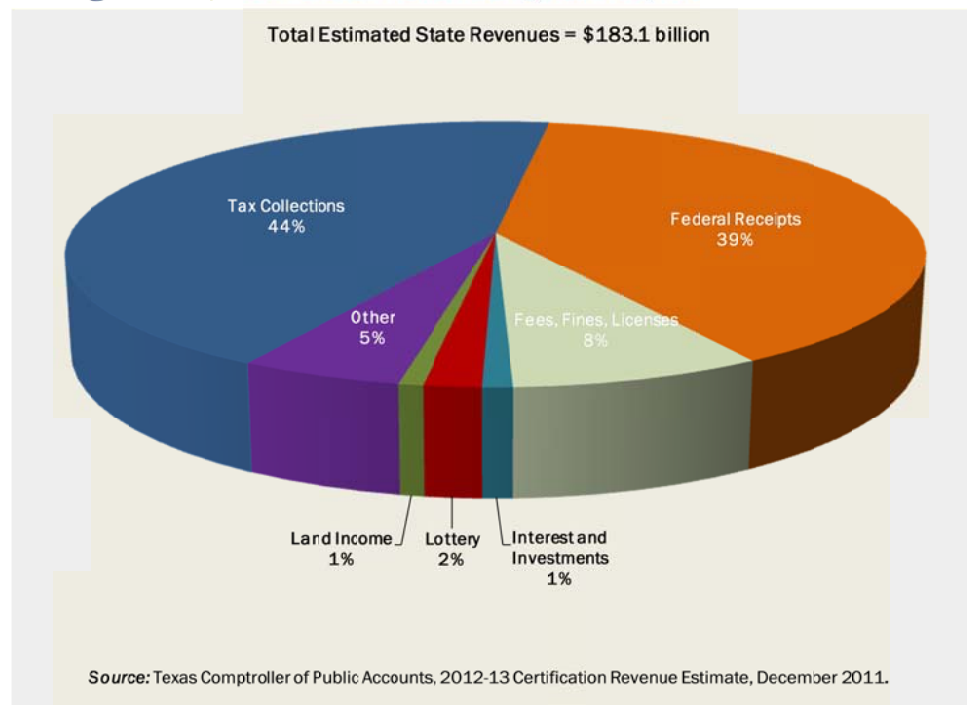
While Texas might wish for less federal intrusion on its decision-making, it could be dramatically affected in the future if Congress follows through on various plans for deficit reduction. Such plans would not only open a sizable gap in state and local budgets, but could have potentially significant effects on the economy.

Federal receipts are expected to total \$71.2 billion in Texas' 2012-2013 budget period, representing 38.9 percent of all state revenues (Figure 5). This total is actually lower than the amounts received in 2010-2011 because of the exhaustion of federal assistance under ARRA. In 2010-2011, because of falling state tax collections and the effects of ARRA, federal funds actually exceeded state tax collections in importance in the state budget.

This suggests that serious efforts at federal deficit reduction would present major budget problems for Texas, particularly if they focus on nondefense discretionary spending. The federal government has already reduced this spending by 9 percent in real terms since 2010. According to the Center on Budget and Policy Priorities, discretionary spending caps established in the federal debt limit deal this past summer will result in an additional 6 percent cut by the end of the next decade.<sup>52</sup> This analysis concluded that additional cuts by the end of the next decade would grow to 11 percent if sequestration — the automatic, across-the-board cuts also established in the debt limit deal — takes effect.

The fiscal impacts of deep federal cuts on state and local governments would be dramatic if not dire. Fully a third of federal nondefense spending flows through state and local governments, funding education, health care, human services, law enforcement, transportation, and other services. The State Budget Crisis Task Force has estimated this funding at about

**Figure 6 | Total State Revenue by Source, 2012-13 Biennium**



\$612 billion nationally in federal fiscal 2012. Large cuts in this funding would worsen state budget problems, put enormous pressure on state taxes and fees and probably cause more job reductions in the public sector.

### Estimating the Impact of Federal Cuts on State and Local Revenues

Just how difficult this fiscal problem could be can be seen in Table 17, which shows the State Budget Crisis Task Force's estimates of the impact of a 10 percent reduction in federal grants on major Texas programs. This is hypothetical, since no targets for reduction have been set, but it is instructive. Texas would lose about \$4.4 billion a year, with just under half of the cuts coming in Medicaid and related programs. There also would be sizeable cuts in funding for the Highway Trust Fund, child nutrition programs, education programs, and human service programs such as Temporary Assistance to Needy Families (TANF).

Cuts in federal procurement, federal employment, and other direct federal spending would affect the Texas economy as well. While Texas is far less reliant on federal programs than some states with a larger federal presence, such as Virginia, cuts in federal outlays still would have a significant effect on the state economy. The Task Force estimates that Texas received \$40.6 billion in procurement spending and \$29.9 billion in federal workforce salaries in 2010. In all, federal expenditures in these two categories represented about 5.9 percent of total gross state product.

**Table 17** | Potential Impact of a 10 Percent Reduction in Federal Grants to Texas

| Program  | \$ millions      |
|--|------------------|
| Medicaid and Related Programs                        | \$2,010.0        |
| Highway Trust Fund                                   | \$161.0          |
| Temporary Assistance to Need Families (TANF)         | \$67.0           |
| Tier 1 Education Programs                            | \$181.0          |
| Child Nutrition Programs                             | \$191.0          |
| <b>Total Reductions</b>                              | <b>\$4,373.0</b> |
| <i>Per Capita Reductions</i>                         | <i>\$174.0</i>   |
| <b>Source:</b> State Budget Crisis Task Force, 2012. |                  |

Another factor that could affect Texas is the possibility of federal tax reform. This is a somewhat smaller direct concern because the state does not have a personal income tax, and its business franchise tax is not directly tied to the federal corporate tax base. Texas *could* feel a pinch, however, if Congress decides to limit tax expenditures under the income tax, perhaps eliminating the deductibility of key sources such as sales and property taxes and the interest on tax-exempt debt. For example, the State Budget Crisis Task Force estimates that a scaling back of the deduction for state and local taxes would cost Texans about \$6.7 billion a year, just below the fifty-state average. California, on the other hand, would lose almost double that figure, and the loss in New York would amount to a staggering \$16.9 billion.

### The Uncertainty of Federal Policy

The problem with all of this speculation, of course, is that the path of federal action is unclear, even on the most pressing current issue in the federal budget debate, the implementation of the automatic spending reductions called for in the Budget Control Act of 2011, which will take effect on January 2, 2013, in the absence of Congressional action. The



automatic cuts, as currently formulated, would slash defense spending by about \$800 billion, nondefense discretionary spending by \$700 billion, and mandatory programs such as Medicare by approximately \$200 billion over the next decade.

According to one analysis, this sequestration would reduce GDP by \$215 billion and cost the national economy 2.14 million jobs in 2012 and 2013.<sup>53</sup> Admittedly, this analysis was prepared for an association representing defense industry contractors, but still, the estimates of the potential impact by state give pause. As might be expected, the projected job losses are not spread evenly across the country, but instead fall where there are large federal establishments. Texas faces a loss of 159,473 jobs, including 98,979 jobs tied to defense cuts and 60,494 jobs related to other reductions.

### **Creating a Dialogue**

Most states maintain some sort of representation in Washington, and state and local governments are also represented at the federal level by national associations such as the National Governors Association, the National Conference of State Legislatures, and the National League of Cities. These organizations do their best to affect federal policy debates on the budget and other issues concerning state and local governments. Even so, in its analysis of this issue the State Budget Crisis Task Force spotlighted a major piece lacking in the U.S. system of federalism — what it described as “standing structures and procedures within the federal government for analyzing the impacts on states and localities of reduced federal spending and federal tax changes.”

The report suggests recreating an organization such as the U.S. Advisory Commission on Intergovernmental Relations, created in 1959 to promote just such an intergovernmental dialogue and disbanded in 1996. As the Task Force report points out:

If the federal government and state groups like the National Governors' [sic] Association and the National Conference of State Legislatures do not seek forums for joint modeling, discussion, and planning in this time of retrenchment and realignment, they will miss a critical opportunity to reduce uncertainties and harmful consequences, intended and unintended.<sup>54</sup>

## *Education*

Texas has the second-largest school-aged population in the country, an estimated 4.6 million students. Texas students are served in 9,161 school units located in 1,046 local and state school districts and 210 charter school districts. The statewide school population increases by about 80,000 students a year, and public school campuses are increasingly diverse.

Complementing the public education system is the state's public higher education establishment, including thirty-eight general academic teaching institutions; three lower-division institutions; fifty community and junior college districts; one technical college with four main campuses; nine health-related institutions, including seven state medical schools; three dental schools; and numerous other allied health and nursing units. More than 1.4 million students are enrolled in Texas' public higher education institutions and, as with public schools, the numbers increase annually.

Texas' primary fiscal challenge in education is maintaining a large physical and human infrastructure while expanding it to accommodate rapid enrollment growth. At the same time, the state must improve education outcomes for its rapidly growing economically disadvantaged student population. Complicating this challenge is the requirement to fund the system equitably from both a per-pupil and taxpayer standpoint, and the need to ensure equitable access to higher education given rising tuition rates and a growing financial aid gap. In addition, the growth in public school debt and viability of the Teachers Retirement System are of potential concern.

Education plays a pivotal role in the state's budget. In the current biennium, higher and public education represents about 56.6 percent of state general revenue funding and 42 percent of total state funding, including federal funding and other sources.

Texas education agencies face a wide range of challenges that will only become more complex as the state's population continues to grow. At the heart of these problems is how the state will pay for public schools and institutions of higher education as they compete with other budget demands, a problem exacerbated by the budget challenges of 2011.

### **2011 Funding Reductions**

In the short term, Texas faces the results of underfunding its education system in the last legislative session. To help balance the state budget in 2011, lawmakers chose to fund schools largely at the level of the previous two-year budget period, meaning that enrollment growth over the next two years was not accounted for in state funding and so falls to local school districts. Similarly, higher education institutions experienced significant funding cuts for the 2014-2015 biennium, continuing a trend that has helped to push state tuition levels to ever-higher levels.

In 2011, lawmakers appropriated \$72.9 billion to fund public and higher education for the 2012-2013 biennium, \$3.5 billion or 4.6 percent less than in the previous budget period. Appropriations to public schools totaled \$47.4 billion from all state funds, a decrease of \$2.8 billion or 5.6 percent from 2010-2011. General Fund-related appropriations actually increased by a minimal \$154.2 million from the previous two-year budget period, a difference attributed to \$3.3 billion in one-time federal stimulus funds for school funding — funds no longer available for 2012-2013.

Appropriations for colleges and universities also fell. Total appropriations were \$19.8 billion from all state funds in 2012-2013, \$474.5 million or 2.3 percent less than 2010-2011 funding levels. This amount includes \$10.2 billion in general revenue plus federal funding and funding from other budget sources.

For the 2012-2013 biennium, lawmakers appropriated \$4 billion less than required by statutory funding formulas for the Foundation School Program’s maintenance and operations funding for school districts.<sup>55</sup> The Legislature also cut \$1.4 billion in discretionary grants to fund the half-day of prekindergarten not included in the statutory funding formula, as well as other grants to improve student success; \$208.6 million in preK funding was lost for the biennium. In addition, the August payment to school districts in 2013 was pushed forward to September, in effect pushing it to a new biennium, to reduce the current deficit by \$2.3 billion.

The state’s institutions of higher education received a 4.3 percent cut in all funds, amounting to about \$1 billion, including a 7.8 percent decrease in unrestricted general revenue and General Revenue-Dedicated funding. The cuts included \$121 million in financial aid.<sup>56</sup>

The net effect of these decisions sends a somewhat confusing message to anyone not familiar with the details. While overall state spending on public education rose modestly, the state still did not cover the cost of additional students in its public schools, thus pushing the financial problem back to the local level. Reductions were made in funding for higher education as well. In all, reductions from the level of projected need totaled at least \$6 billion for public and higher education combined.

## Elementary and Secondary Education

### *Legal Challenges to the School Finance System*

This budget provoked an almost immediate response from public education advocates. The state has been challenged by six separate lawsuits since the session ended. Five of the six lawsuits have been consolidated into one case. A sixth, more recent suit filed by charter schools is likely to be consolidated as well.

Legal problems with Texas public school finance are hardly new. The state has faced legal challenges to its school finance system since the early 1970s, but the latest challenge is one of the most broad-based — and therefore likely to be most complex.

The issues surrounding school finance typically boil down to three issues — efficiency, adequacy, and a concept known as “meaningful discretion.” The Texas constitution requires the state to fund its public schools efficiently and adequately. It also prohibits a statewide property tax, a provision that courts have interpreted to mean that school districts must have “meaningful discretion” in setting their property tax rates. When a majority of schools reach statutory tax rate limits, for example, they lack meaningful discretion to fund education locally.

The Texas Taxpayer and Student Fairness Coalition, a group organized by the Equity Center, which represents mostly low- and mid-property wealth districts and about 1.3 million students, is using *efficiency* to argue that the school funding system is constitutionally inequitable. MALDEF and a group of schools led by Fort Bend Independent School District also raise this argument. The charter school lawsuit takes a different approach. They argue that the cap on charter contracts, which limits the number of state-approved charter schools, and a lack of facilities funding hinders their growth, which they believe

makes the system unconstitutional. Yet another suit, filed by Texans for Real Efficiency and Equity in Education, a group led by six parents and the Texas Association of Business, argues that because the state doesn't know how much it costs to educate a child, the system *can't* be efficient.

The *adequacy* argument holds that the state has failed to dedicate enough money to public schools to meet increasingly tougher standards set by the state and federal governments. The key evidence of this failure is the reduction in public school funding in the 2011 legislative session. At least four lawsuits include this argument.

Finally, four of the lawsuits argue that by underfunding schools and constraining local property taxes, the state has not given local school districts enough *meaningful discretion* and have, in effect, enacted an unconstitutional statewide property tax, since many districts have raised tax rates to the point where they are at or near the current statutory limit.

### **Enrollment Growth**

Compounding the problem is the inescapable fact that enrollment in Texas public schools rose by 20.9 percent in the last decade, an increase of more than 830,000 students. The U.S. Census estimated that the Texas population aged five to nineteen increased by 15.7 percent during the same period, a much lower rate than the increase in enrollment. Comparing the two groups indicates a larger share of the five- to-nineteen population enrolled in 2010 than in 2000.<sup>57</sup>

The Hispanic population rose by 48.4 percent and comprised 74 percent of the net increase. White enrollment declined by 6.7 percent or nearly 115,000 students. Minorities now comprise two-thirds of enrollment in Texas public schools, but in Dallas and Houston they represent 92 percent and 95 percent of enrollment, respectively. Economically disadvantaged children increased by nearly 900,000 during the decade and now represent 59 percent of the total population, up from 49 percent in 1999-2000.<sup>58</sup>

The National Center for Education Statistics (NCES) estimates that from 2008 to 2020, the PreK-8 school population will rise by 9.2 percent nationally and by 21.9 percent in Texas. Projections for grades 9-12 indicate enrollment growth of 1.6 percent for the nation and 24.7 percent in Texas, making the state first in the nation in projected high school enrollment growth.<sup>59</sup>

### **School Debt**

Compounding state funding issues is a potential debt squeeze. Districts forced to construct buildings because of rising enrollment need more debt. So they leverage their existing debt and extend it to thirty or forty years. According to testimony last year before a Senate subcommittee on public education funding, from 2001 to 2009-2010, student enrollment rose by 14.9 percent. At the same time, principal debt rose by 127 percent, taxable valuation rose by 75.6 percent, and 50-cent debt by rose 87.5 percent. At the same time, *state funding* for debt declined by a quarter.

The result has become a matter of real concern. Texas has the highest outstanding debt for public schools in the nation, \$59.2 billion in 2010. The number of districts with debt rose by 8.5 percent in the past five years, to 816. School districts have increased debt by an average of \$4.4 billion annually for the last five years and, since 2006, outstanding principal has increased by 48.5 percent, to \$19.3 billion. The average debt per student rose by 38.5 percent from 2005 to 2010, to \$13,884.<sup>60</sup>

In part, this use of debt is a function of state school finance policy. The state guarantees school debt with the Permanent School Fund (PSF), its permanent endowment for education. This allows local school districts to enter the debt market at favorable rates, making a larger level of debt possible. In addition, property tax formulas favor debt financing because they do not enter into the calculation of the rollback tax rate discussed earlier. Thus, school districts often find it easier to issue tax-supported debt than to raise taxes that may require voter approval.

Over time, though, this state program could reach practical limits apart from the debt load individual districts are carrying. The current allowable limit for bond guarantees by the PSF under federal law is \$117.3 billion. The state limit set annually by the State Board of Education is \$74.4 billion. The board raised the state cap in May 2010 from 2.5 times to 3.0 times the cost value of the fund; the federal cap is five times the cost value. At the end of fiscal 2011, PSF assets guaranteed \$52.7 billion in bonds issued by 791 local school districts.

During 2011, the number of outstanding issues guaranteed by the state increased by 3.4 percent, while the dollar amount of guaranteed school bond issues outstanding rose by 6.8 percent. The guarantee capacity of the fund, however, increased by 4.8 percent during fiscal 2011, due to investment performance. Thus, the fund confronts a delicate balancing act to meet growing debt needs with the actual resources in the fund.

#### ***Outlook for Public Elementary and Secondary Education***

Texas' rankings among the states indicate that it makes a greater-than-average *funding* effort based on a number of measures, and a lower-than-average *spending* effort per pupil (excluding capital outlay and debt), although this measure does not take into account differences in the cost of education among the states. With the exception of the last session's cuts, Texas has been increasing its funding effort on a per-pupil basis fairly steadily, but has ongoing issues concerning the equitable distribution of that funding.

Texas public education faces four main budget pressures in the future: enrollment growth, lawsuits over funding adequacy and equity, an increasing share of economically disadvantaged students, and the goal to improve student outcomes. In addition, growing public school debt and viability of teachers' retirement are of potential concern. The most promising mitigating factor is online education, although some other efforts are under way to improve efficiencies.

Texas' high enrollment growth will drive the need for more schools, teachers, and associated costs. Although enrollment growth increases overall funding requirements, it also indicates a growing economy that could generate revenues necessary to sustain that growth. Pressure on the budget will depend on the tension between enrollment and economic growth.

Although Texas has the highest school debt in the nation, it is not of concern yet, due primarily to the backing of the state's PSF; it could be of concern in the future, however, due to the aging of the current physical plant as well as the need for new facilities.

Given that equity lawsuits historically have increased public education costs, it is highly likely that the current set could do so as well. The growth in the share of economically disadvantaged students means that such lawsuits will continue to be filed in the future unless a permanent solution can be found to address equity issues.

Similarly, improving student outcomes is likely to drive up funding per student unless offsetting efficiencies can be found. If the Texas economy improves, absorbing some additional costs per pupil should be possible, even without a tax increase; other budget pressures, however, particularly in health and human services, may preclude this option.

While the present situation is filled with challenges, it also offers the state an opportunity to rethink its approach to education, from funding methods to education delivery. Seizing this opportunity could accelerate the state's progress toward its goals while maximizing its effectiveness in using tax dollars.

## Higher Education

Higher education fiscal issues in Texas, particularly for public institutions, currently center on the recent, sharp increases in tuition, the adequacy of financial aid, and the sufficiency of funding levels to meet state higher education goals, especially in light of the \$1 billion cut for the 2012-2013 biennium. The tuition increases followed a 2003 funding agreement between the Legislature and the universities that allowed tuition "deregulation" in exchange for reduced general revenue funding.

Still another issue that has surfaced recently is a debate over "outcomes-based" higher education supported by Governor Perry. This debate turns on a set of "Seven Breakthrough Solutions," or "7Solutions," written by Acton School of Business founder Jeff Sandefer. These "breakthrough solutions," first unveiled in 2008, include the following:

1. Measure teaching efficiency and effectiveness.
2. Publicly recognize and reward extraordinary teachers.
3. Split research and teaching budgets to encourage excellence in both.
4. Require evidence of teaching skill for tenure.
5. Use "results-based contracts" with students to measure quality.
6. Put state funding directly in the hands of students.
7. Create results-based accrediting alternatives.<sup>61</sup>

The first solution measures teaching effectiveness through student evaluations, which faculty members argue could erode true accountability by creating a disincentive to grade students properly. The second solution is also measured by student evaluations and prompts the same objections. The third proposal would split teaching and research budgets, which faculty fear would compromise institutional quality.<sup>62</sup> It is also unclear how these new policies would affect the state's master plan, which includes funding increases for research, and how they might affect the state's national university rankings.

In addition, other areas of fiscal tension include:

- funding to increase the college-going rate in general and close the gaps for all ethnic groups and the economically disadvantaged;
- appropriate criteria for state financial aid programs;
- overpromising (or underfunding) state financial aid;
- the sufficiency of funding to improve student outcomes in college;
- adequate funding for research, especially to close gaps in the state's master plan;
- appropriate levels of state versus local funding for community college operations;
- state funding for community colleges versus four-year institutions;

- the state share of financial aid for students attending community colleges versus four-year institutions;
- the use of tuition revenue through set-asides to fund financial aid;
- expanding educational facilities versus expanding online offerings;
- the practice of charging substantial extra fees for online courses and degrees in addition to tuition;
- transferability of courses among state institutions;
- the cost of remediating students who are not college-ready;
- a lack of access to upper-level classes for students in certain geographic locations, particularly South Texas;
- the state of participation in 529 savings plans; and
- the need for funding to move the state's flagship institutions, the University of Texas at Austin and Texas A&M University at College Station, into the nation's top ten public institutions.

### **Enrollment Growth**

NCES estimates that total enrollment in U.S. postsecondary, degree-granting institutions will grow by 13 percent from 2009 to 2020. It has not published projections by state, but has estimated that the number of students graduating from high school from 2007-2008 to 2020-2021 will fall by 0.6 percent nationally while increasing 25.6 percent in Texas, making the state second in projected growth. This increase implies more than 64,000 additional graduates in 2020-2021, and many will attend Texas colleges and universities.<sup>63</sup>

The Texas Higher Education Coordinating Board (THECB) projects that enrollment in public higher education institutions will grow by 10.8 percent or more than 140,000 students from 2010 to 2020.<sup>64</sup> Historically, THECB's estimates have been conservative. Given that public higher education enrollment has risen by about 470,000 in the last ten years, however, this estimate may be even more conservative than usual.

### **Outlook for Higher Education**

Whether or not Texas reaches the participation goals in its statewide master plan, enrollment growth *will* cause total costs to increase. Yet state and local funding is not likely to increase at its historical rates, given the economy and the Legislature's reluctance to raise taxes. Stimulus funds are gone, and federal funding is unlikely to increase. In addition, recent large tuition increases appear to preclude significant amounts of new revenue from that source in the near future, without undoing the state's progress toward closing gaps in attendance rates.

If Texas is to reach and exceed its higher education goals, it will have to look inside the public and higher education systems for the resources to do so. Institutions may have to consider other options for educating students besides classrooms. Perhaps it is time for the state and its higher education institutions to rethink their entire approach. THECB cost-efficiency recommendations are impressive and deserve credit, as do those of other institutions, but much more needs to be done.

## Infrastructure

Texas' infrastructure includes *natural resources*, such as water, lands, minerals, and wildlife, and *built* infrastructure, such as transport systems, water and mineral extraction facilities, utilities, public buildings, and parks. It also has *protective* infrastructure, such as flood control, waste management, coastal and environmental protection programs, and emergency response. Built infrastructure has grown substantially in the past twenty years, and will continue growing, primarily due to the state's continuing population growth. Some of our natural infrastructure has become stressed as the population has grown, and the state has increased its protective infrastructure in response.

Texas is unique among states in that it entered the U.S. owning millions of acres of state lands. These include tidelands extending three marine leagues (about 10.3 miles) into the Gulf of Mexico, much farther than the three nautical miles (about 3.5 miles) allowed for other states under federal law. With the oil and gas boom, this asset has generated sizable income for Texas, much of which has been placed in permanent funds to assist public and higher education.

Also unlike many other states, Texas prohibits private ownership of beaches up to the mean high tide, which adds significantly to the state's infrastructure inventory. Another resource that most states lack is Texas' ample potential for wind and solar energy. By leasing state-owned lands to wind and solar electricity companies, the state has capitalized on this natural resource as well. The state's land ownership also has translated into a large state park and wildlife management system that has been instrumental in preserving Texas' natural, historical, scientific, and cultural resources, while generating tourism revenue and recreational opportunities. Texas' size also means that it has substantial water resources, even though certain areas of the state face water shortages.

On the other hand, Texas' sheer size and growing population has necessitated investment in and maintenance of a large highway system at a considerable expense to the state. In addition, our new commitment to wind energy has required a sizable expansion in transmission lines to bring electricity from West Texas to urban areas, a \$7 billion expense.

Texas' water resource issues have led to major investments in water development and flood control infrastructure as well. The state's reliance on coal for electric generation has created air quality issues that will cost ratepayers substantial amounts to address, and will contribute to electricity shortages if certain plants must close next year under recent Environmental Protection Agency (EPA) orders. Plans to expand Texas' nuclear power resources now are up in the air after recent events in Japan highlighted the industry's vulnerability to environmental upheaval. In addition, the impact of one proposed nuclear plant's water usage on Texas' whooping crane habitat has made the project unlikely, and announced plans for another recently were dropped altogether. Texas will find it challenging to keep up with its growing energy demands while avoiding increased environmental risk and degradation; the state's commitment to wind energy is certainly insufficient to meet future demand increases, much less replace existing infrastructure.

In the future, the risk of key underground aquifers being exhausted due to mass irrigation means that Texas will have to increase its use of expensive water projects and conservation activities. The declaration of endangered species in West Texas' public lands, already under consideration, could interfere with oil and gas production, forcing the state to find alternatives to replace revenue lost from this activity. The concentration of the state's projected population growth along the



coastline and in urban areas heightens the vulnerability of these areas to adverse events affecting infrastructure, and highlights the need to protect fragile coastland ecosystems and the human populations that depend on them.

In addition, the possibility of lower federal funding may restrict the state's ability to maintain and expand its infrastructure, or require the development of alternative funding sources. Loss of federal funding for transportation, water conservation and development, coastal and environmental protection, disaster assistance, and homeland security would be particularly devastating.

In the past twenty years, the state's population has risen by 48 percent. The U.S. Census Bureau projects that between 2010 and 2030, the state's population will increase by another 32.5 percent, from about 25.1 million to 33.3 million, compared to 17.7 percent nationally.<sup>65</sup>

To accommodate and plan for this growth, Texas has significantly expanded its strategic planning process and consolidated it in certain areas such as transportation to view these systems as an integrated whole. Furthermore, it has consolidated numerous state programs and agencies that oversee and protect the state's major infrastructure and its debt financing.

While Texas has made substantial progress in strategic planning, it could benefit from a consolidated, "state-of-the-state" report providing an overview of the state's infrastructure, its current major needs and issues, projected needs and costs, and projected methods of finance.

Particular concerns that will continue to be a focus of legislative concern — and future budget stress — are the critical areas of transportation, water, and electric power infrastructure.

## Transportation

Texas' current system of roads, bridges, and public transit is funded in large measure by taxes on motor fuels and various vehicle and driver fees. The state gasoline tax, currently twenty cents a gallon, is among the nation's lowest and has not been increased since 1991. Because they are levied at a flat rate per gallon, the motor fuel taxes have not risen with inflation. Transportation costs *have*, of course, and problems associated with traffic congestion have grown steadily worse as well, as more and more of the state's population is concentrated in major urban areas.

In March 2011, the Texas 2030 Committee, created by the Texas Transportation Commission, released estimates of likely demands for transportation investment in the state, concluding that, "Unfortunately, transportation investments have not kept pace with the state's growth."<sup>66</sup> This "investment gap," as the Committee calls it, will grow worse in coming years if not addressed. Among the sources of the growing problem are the addition of fifteen million new Texans in the next twenty-five years; freight traffic increasing at double the rate of passenger vehicle traffic; a growing need to invest in road preservation; and mounting congestion in urban areas.

Local governments have become sufficiently concerned with the state's inaction on the issue to seek authority to levy their own local taxes to pay for transportation and transit projects in the 2007 and 2009 legislative sessions, without success. (Local interests did not push the issue in 2011, largely because the depth of the state budget crisis made any action unlikely.)

Assuming the Texas 2030 projections reflect needs accurately, the required investment will total billions that are not available from the state's current revenue system. Table 18 shows the 2030 Committee's estimates of need under various scenarios, the most aggressive of which would only maintain the state's transportation infrastructure at 2010 levels.

**Table 18** | Texas Statewide Transportation Funding Needs, 2011-2035 (\$ billions)

| System Requirements   | Current Trend Unacceptable Conditions | Worst Acceptable Conditions | Minimum Competitive Conditions | Continue 2010 Conditions |
|---|---------------------------------------|-----------------------------|--------------------------------|--------------------------|
| Total Estimated Cost — Pavement, Bridge, Mobility, and Rural — Alternative Solutions  |                                       |                             |                                |                          |
| 2011-2015   | \$26.2                                | \$30.6                      | \$47.4                         | \$49.6                   |
| 2016-2019   | \$20.6                                | \$28.3                      | \$31.0                         | \$44.8                   |
| 2020-2035   | \$53.2                                | \$115.0                     | \$139.1                        | \$175.8                  |
| Total Projected Need Under Scenario   | \$100.0                               | \$173.9                     | \$217.5                        | \$270.2                  |
| Total Available Revenue — Current Structure   | \$100.0                               | \$100.0                     | \$100.0                        | \$100.0                  |
| Current Shortfall to Meet Target  | \$0.0                                 | (\$73.9)                    | (\$117.5)                      | (\$170.2)                |
| <b>Source:</b> Texas Department of Transportation, 2030 Committee, "It's About Time: Investing in Transportation to Keep Texas Economically Competitive," March 2011. |                                       |                             |                                |                          |

Even to continue 2010 conditions, the Committee estimates that an additional \$270.2 billion must be spent between 2011 and 2035. At present, the state's financing system, including federal aid, would cover only about \$100 million of this total. The *minimum* added funding requirement, according to the Committee, is \$73.9 billion, and failure to act will produce a marked deterioration in the system over time. The Committee's estimates suggest that the state must come up with between \$6 and \$14 billion in new revenue each biennium to meet these needs.

## Water

Water is another issue that could dramatically change Texas' fiscal picture. The state is only slowly emerging from a serious drought — in 2011, Texas experienced its worst single-year drought since recordkeeping began — and according to a recent comptroller report, "it may prove to be one of most devastating economic events in our history."<sup>67</sup> Estimates by the Texas AgriLife Extension Service put Texas' direct agricultural losses last year at \$5.2 billion. A December economic analysis by BBVA Compass Bank found that indirect drought losses to the state's agricultural industries could add another \$3.5 billion to the total.

According to the Texas Water Development Board (TWDB), demand for water will rise by 22 percent by 2060. The board says that, should we experience another multiyear "drought of record" such as that of the 1950s, it could cost Texas businesses and workers \$116 billion in income by 2060. As the 2012 Texas Water Plan notes:

The primary message of the 2012 State Water Plan is a simple one: In serious drought conditions, Texas does not and will not have enough water to meet the needs of its people, its businesses, and its agricultural enterprises.<sup>68</sup>

Needless to say, these conditions raise concerns over the effects of water shortages that were already significant even before the rainless days of 2011.

As with transportation, Texas does have fairly detailed long-range water development planning. This begins at the regional level, with sixteen regional water planning groups, each consisting of about twenty members representing at least eleven interests, as required by Texas law, including agriculture, industry, the public, environmental groups, municipalities, business, water districts, river authorities, water utilities, counties, and power generators. The 2012 plan is the third such effort, with plans developed every five years.<sup>69</sup>

During each five-year planning cycle, planning groups evaluate population and water demand projections and existing water supplies that would be available in times of drought. Planning groups recommend strategies that could address shortages and estimate their costs. Once the planning groups adopt their regional water plans, these are sent to the Texas Water Development Board, the state's water supply planning and financing agency, for approval. TWDB then uses them to compile the state water plan, which serves as a guide to state water policy, with recommendations for legislators.

According to TWDB, to avoid future water supply disruptions during drought, the state must make significant investments in various water projects over the coming decades. The estimated total capital cost of the 2012 State Water Plan is \$53 billion. This represents about a quarter of a total \$231 billion in needed water supplies, water treatment and distribution, wastewater treatment and collection, and flood control the state will require in the next fifty years; the balance would come from private investment.

The majority of these costs (about \$46 billion) would go toward municipal needs. Based on plan estimates, water providers will need nearly \$26.9 billion in state financial assistance for municipal water projects alone (Table 19). This is an average of about \$540 million a year from state government over fifty years; as Table 19 shows, however, the plan front-loads costs in the 2010-2019 decade to meet current, critical supply needs. This implies state assistance levels of about \$1.6 billion annually during this decade. Much of this assistance presumably would come from state bond issues, the usual vehicle for funding water projects.

## **Electric Power**

The Public Utility Commission of Texas (PUC) regulates electric utilities, electric grid infrastructure, and electricity delivery in the state. A large area of the state operates in a competitive market; even so, PUC still regulates the rates and services of transmission and distribution utilities in those areas, as well as investor-owned utilities that chose not to enter competitive markets. Local governing boards or city councils set utility rates and service policies for municipal utilities and electric cooperatives.

The PUC's purview includes overseeing the Electric Reliability Council of Texas (ERCOT), a nonprofit cooperative that manages the flow of electric power to about twenty-three million Texas customers and 75 percent of Texas' land area. The council's board of directors comprises independent members, consumers, and representatives from each of ERCOT's electric market segments. The remainder of the state, approximately 15 percent of the total electric load, falls within the interstate Southwest Power Pool, the Southeastern Electric Reliability Council, and the Western Electricity Coordinating Council.

**Electricity Generation:** Texas had 108,258 megawatts (MW) of summer capacity in 2010 and net generation of 411.7 million megawatt hours (MWH), ranking the state first nationally in capacity and net power generation.<sup>70</sup> In response to 2007 legislation encouraging electricity generation from alternative energy sources, the PUC ordered the construction of 3,500 miles of transmission lines at an estimated cost of nearly \$7 billion, to provide an additional 18,456 MW of wind-generated electricity from West Texas and the Panhandle to the state's urban areas by the close of 2013.<sup>71</sup>

In 2010, Texas relied on coal for 36.5 percent of its electricity. Nuclear power supplied 10 percent; natural gas, 45.4 percent; wind energy, 6.4 percent; and other sources accounted for 1.7 percent.<sup>72</sup> Although new wind capacity and announced plans for more indicate an increased interest in renewable alternatives, the state is also adding new coal, nuclear, and natural gas capacity, and will continue to rely on these sources for a substantial share of its needs. This fact has been underscored by the increase in natural gas production from shale formations in South and North Texas, some of which will find its way into state gas-fired power plants.

Despite projected increases in generating capacity from renewable sources, and the recent discovery of new natural gas reserves, Texas' population growth will require the state to increase its dependency on coal and nuclear for electricity unless it takes extremely aggressive and immediate measures. And Texas' increased dependency on coal will increase the pollution problems of a state that already ranks first in carbon dioxide and nitrogen oxide emissions and third in sulfur dioxide pollution.<sup>73</sup>

## Outlook for Infrastructure

Like many states, Texas has an aging infrastructure, but unlike many it is also growing rapidly. This combination means that Texas must both renovate and expand its existing infrastructure to meet future needs. Dwindling water supplies in some of the state's largest agricultural regions heighten the dilemma, not only because additional funding will be needed for water conservation, but also because the economic losses from reduced agricultural production could be substantial.

In addition, the state will need to prepare for the growing risk of environmental disruptions, such as the 2011 drought and the fires that accompanied it. Many of the challenges will not come from nature, however. Texas is arguably the most pipeline-congested state in the nation, and the number of onshore and offshore drilling rigs and increasing port traffic also increases the risk of oil spills. Increasing amounts of nuclear waste stored near the state's two most important urban areas

**Table 19 | Texas Statewide Water Funding Needs, 2010-2060**

| Time Period   | Anticipated Need (\$ billions) |
|---|--------------------------------|
| 2010-2019   | \$15.7                         |
| 2020-2029   | \$4.2                          |
| 2030-2039   | \$4.1                          |
| 2040-2049   | \$1.9                          |
| 2050-2059   | \$0.6                          |
| 2060  | \$0.4                          |
| <b>Total Need</b>   | <b>\$26.9</b>                  |
| <b>Source:</b> Texas Water Development Board, Water for Texas: 2012 Water Plan, January 2012. |                                |

add to the environmental risks. In addition, greater population density along the coast will heighten the cost of natural disasters such as storm surges, which climate change models indicate will increase in the future.

Federal budget cuts could make this situation even more challenging. Texas depends more on the federal government for some purposes than others; cuts to infrastructure funding could strongly affect the state's transportation system.

Regardless of federal action, Texas will need to look for additional funding sources to meet future needs. Given that they are being permanently extracted and thus made unavailable to future generations, some argue that the state should extend severance taxation to *all* minerals, and place some amount aside in perpetuity as outlined in the state's constitution. Several other states have moved to do this; Wyoming recently began taxing the extraction of helium, a rapidly dwindling resource of which Texas is the nation's largest producer.

Some also want to see groundwater designated as a nonrenewable resource, and to consider its extraction beyond natural replacement levels as taxable. In addition, they argue that the state should establish a "compensation" tax on water diverted from agricultural to municipal use, since the state suffers a consequent loss in agricultural production and associated tax revenue. As with severance taxes, Texas could set aside a portion of these revenues in perpetuity for future generations.

Some advocates also suggest that Texas impose a "risk" tax on commercial enterprises such as pipelines, nuclear plants, hazardous waste facilities, uranium mining, and drilling rigs that carry environmental risks, and hold the funds in perpetuity in the event of a disaster. In the interim, the fund could be used to back bonds for conservation, coastal protection, and other environmental protection efforts.

Realistically, however, these revenue alternatives are highly unlikely to receive any serious consideration at the present, and are likely to be considered only if the revenue picture becomes truly dire or the state experiences a major economic dislocation caused by the failure of some aspect of its current infrastructure.

While natural resources supply and rights have always been an issue in Texas, the magnitude of the problem will grow exponentially in the coming decades. The clash of population growth and increasingly limited resources will generate economic stress and may disrupt services. In addition, legal activity will increase and inevitably could translate into more regulation and heightened enforcement, two things Texans generally abhor. Any way forward will involve a delicate balancing act.

## Debt

When Texas became a state in 1845, it retained both its public lands and its public debt from its years as a republic as part of the annexation agreement. It managed its public finances more conservatively as a state but debt continued to accumulate, topping \$12.4 million in 1851, a huge sum for the time.<sup>74</sup> Eventually, the state's debt problem was relieved as part of the Compromise of 1850. The Compromise, passed in September 1850, defused a four-year confrontation between the slave and free states over the status of territories acquired during the Mexican-American War. Under the Compromise, Texas surrendered its claim to what is now New Mexico but received debt relief in the form of a \$10 million payment and land that is now the Texas Panhandle and El Paso.

Mindful of its financial struggles as a republic, lawmakers wrote stringent debt controls into the state constitution. In its original form, Article 3, sec. 49, of the Texas constitution prohibited state borrowing "except to supply casual deficiencies of revenue of less than \$200,000, repel invasion, suppress insurrection or defend the state." The issuance of debt for any other purposes or for amounts greater than the amount permitted for "casual deficiencies" required a constitutional amendment. As a result, the constitution has been amended many times to authorize the issuance of general obligation bonds.

This constitutional obstacle has constrained the accumulation of state debt. Texas only developed significantly high levels of debt during the Depression. In the mid-1930s, state debt was in the \$14 million range, and Governor Miriam Ferguson repeatedly urged the Legislature to enact both a state sales tax and an income tax to deal with the problem. The Legislature refused, although it did approve a two-cent-a-barrel tax on oil. Thus the state's deficits could be reduced only by cutting appropriations — and thus they lingered. The 1930s later were called the "decade of deficits," a period finally ended by the economic resurgence accompanying World War II and the post-war expansion of petrochemicals and other industries.

Well into the 1980s, the state still handled many major infrastructure costs on a pay-as-you-go basis, including public facilities and state highway construction. The Legislature did not authorize debt financing of highways until the 1990s.

Over time, lawmakers have imposed additional restrictions on the state's use of debt. While these constraints were eased to some degree in the 1980s and 1990s to accommodate additional infrastructure investments, the Legislature also prohibited the state (i.e., future Legislatures) from authorizing general obligation or revenue bonds, and large lease-purchase agreements to be repaid from general revenue, if the resulting annual debt service would be more than 5 percent of the average amount of general revenue (excluding constitutionally dedicated funds) over the preceding three fiscal years.<sup>75</sup>

In 1997, Texas voters approved a constitutional debt.<sup>76</sup> Following the general framework of the earlier statutory ceiling, the constitutional provision prohibits the Legislature from authorizing additional state debt if the resulting annual debt service payable from unrestricted general revenue exceeds 5 percent of the average amount of general revenues, excluding constitutionally dedicated revenues, for the preceding three fiscal years.<sup>77</sup>

"State debt payable from the general revenue fund" is defined here as general obligation and revenue bonds, including authorized but unissued bonds, and lease-purchase agreements in amounts greater than \$250,000 that are designed to be repaid with state general revenues. The term does not include bonds that, although backed by the full faith and credit of

the state, are “reasonably expected to be paid from other revenue sources” and not expected to create a draw on general revenue, such as highway fund bonds payable from dedicated highway revenues.

Local debt is not subject to this constitutional limitation, but state law effectively establishes debt limitations for local governments by setting maximum property tax rates.

## State Debt

The Texas Legislature has authorized a variety of debt instruments in addition to regular general obligation bonded debt, including revenue bonds, commercial paper, and lease-purchase arrangements. *Revenue bonds* typically carry a higher interest rate because they are not backed by the state’s full faith and credit. *Commercial paper* can be secured by the state’s general obligation pledge or by a specified revenue source. It generally offers maturities ranging from one to 270 days. As it matures, it can be paid off or reissued — “rolled over” — at a new interest rate. Although the interest rates on commercial paper vary, they are usually lower than long-term interest rates. *Lease-purchase agreements* are used to finance purchases of capital equipment and other items through an amortized payment schedule. Unless another source of repayment is specified, the state uses general revenue to pay principal and interest on these instruments.

In October 1986, the state authorized the treasurer (later the comptroller) to issue tax and revenue anticipation notes (TRANS), short-term notes used to smooth cash flow peaks and valleys during the fiscal year that are retired before the end of a given fiscal year.<sup>78</sup>Texas’ public institutions of higher education have a separate series of authorized debt. These include:

- *Revenue bonds*: under Chapter 55 of the Education Code, universities may issue revenue bonds or notes to finance permanent improvements. Most universities have established financing programs that pledge all system-wide revenue except for legislative appropriations to the repayment of revenue bonds and notes.
- *Tuition revenue bonds*: the Legislature can authorize these bonds for an institution’s specific purposes or projects and appropriate general revenue to offset its debt service. (Direct legislative appropriations for debt service would be unconstitutional.)
- *Permanent University Fund/Higher Education Assistance Fund debt*: Article VII, Section 18, of the Texas constitution authorizes the University of Texas and Texas A&M systems to issue debt backed by income from the Permanent University Fund (PUF), a permanent endowment to finance the two systems. Texas’ other higher education institutions may issue Higher Education Assistance Fund (HEAF) bonds in accordance with the Texas constitution, Article VII, Section 17.

The Legislature controls the amount of debt issued in each two-year budget period through its appropriations. The Bond Review Board (BRB) is the primary oversight agency for the state’s twenty-one debt issuers, including the Texas Public Finance Authority and two nonprofit corporations. It approves all state debt issues and lease purchases greater than \$250,000 or a term longer than five years, excluding PUF debt and TRANS. (The Cash Management Committee, comprising the governor, lieutenant governor, comptroller, and Speaker of the House as a nonvoting member must approve TRANS.) BRB also collects, analyzes, and reports information on state and local debt and administers the state’s Private Activity Bond Allocation Program. The Texas Public Finance Authority issues bonds for nineteen agencies, including three universities, for special projects authorized by the Legislature. It also administers the state’s master lease program.

### **Growth in State Debt**

Despite the limitations imposed by state law and the Texas constitution, state debt levels have risen substantially in the past decade. The state's total debt outstanding rose from \$13.18 billion in fiscal 2000 to \$40.50 billion at the end of fiscal 2011, an average annual growth rate of 10.7 percent. Of 2011's outstanding debt, about \$14.03 billion or 34.6 percent was backed by the state's general obligation pledge, 8.8 percent or \$1 billion more than in fiscal 2010. This increase was primarily the result of a large bond issue for transportation capital spending. The remainder, and largest share, of the state's outstanding debt is self-supported or revenue debt tied to and repaid by a specific project. The constitution prohibits any pledge of state funds beyond the current biennium.

Despite this growth, the state remains comfortably within constitutional limits on debt issuance. According to BRB, the state's constitutional debt limit (CDL) remains below the 5 percent maximum, ending fiscal 2011 with 1.35 percent calculated for debt outstanding and 3.70 percent including authorized but unissued debt. These figures represent a decrease of 0.7 percent and 9.8 percent, respectively, from the end of fiscal 2010. In large measure, this improvement was a result of the marked improvement in the revenue outlook and fiscal condition.

Several factors help to explain this growth. In part, it is simply a function of the state's rapid population growth and urbanization, which have increased pressure on public infrastructure ranging from university facilities to roads and bridges. Secondly, much of the state's infrastructure is aging and requires more expenditure for maintenance and replacement. Finally, the increase is due at least in part to a conscious state policy decision to use debt rather than tax increases to fund a variety of public programs, particularly transportation.

A clear example is the use of debt to finance highway construction and maintenance, purposes traditionally supported with revenue from motor fuel taxes and motor vehicle registration fees. While motor vehicle registration fees have increased over time, motor fuel taxes have not, based as they are on volume rather than price. Therefore the funding structure for highway finance has lagged far behind the needs of a growing state. Increased use of debt has filled a portion of the gap, but has increased the state's debt load as well.

Despite these trends, the state's bond rating has remained high. Texas' GO bond rating is either AAA or AA+, according to the three bond rating agencies, and has actually improved since the mid-2000s. It is now rated as AAA by Moody's and Fitch and AA+ by Standard and Poor's. According to Moody's 2011 *State Debt Medians*, Texas ranked thirty-ninth among all states in net tax-supported debt per capita compared to fortieth in the 2010 report. Texas had \$612 in net tax-supported debt per capita compared to the national median and mean of \$1,066 and \$1,404, respectively.

### **Local Government Debt**

Texas local governments issue debt to finance the construction and renovation of government facilities (schools, police stations, city halls, county courthouses, and so on); public infrastructure (roads, water, and sewer systems); and various projects for economic development. The Legislature authorizes this borrowing, and over time has approved debt issuance by a broad range of local entities including cities, counties, school districts, and a wide range of special districts.

Local borrowing accounts for almost 87 percent of Texas' public debt. In large measure, this is a byproduct of the decentralized character of Texas government and the large number of local entities authorized to issue debt (approximately 4,000, according to LBB).



As noted above, the Texas constitution indirectly limits local debt issuance by setting maximum property tax rates. These vary by government type, but must generate sufficient funds based on annual tax collections to pay the principal and interest on all general obligation debt. Additionally, all local debt issues must be approved by the attorney general and registered with the comptroller.<sup>79</sup>

Other than legal limitations imposed by state law and the constitution, the state plays no part in local government debt issuance, although the BRB is responsible for providing the Legislature with statistical information concerning bonds and other debt obligations issued by local governments.<sup>80</sup>

### **Local Debt Outstanding**

Texas cities have relied on bond sales for capital projects for some time now, and have increased their use in recent years due to slow revenue growth and rising infrastructure and facility needs. From 2006 through 2010, the cities' overall debt outstanding rose from \$127.4 billion to \$183.8 billion, an increase of \$56.4 billion or 44 percent.<sup>81</sup> This growth rate easily outpaced inflation and population growth, averaging about 9.6 percent a year, reflecting both ongoing infrastructure needs and a favorable interest rate during much of this period.

It should be remembered that Texas did not enter the recession as early as many states, and tax revenue growth remained strong through much of this period. Of the BRB's two major debt categories, tax-supported debt and revenue bond debt, tax-supported debt showed the greatest increase, rising by \$38.8 billion or 10.4 percent annually. Revenue bond debt rose by \$19.6 billion for an overall growth of 37.6 percent over the period.

Much of this growth was tied to cities and school districts. Texas' 1,025 school districts with taxing authority accounted for nearly half of the total dollar growth in tax-supported debt, which in turn accounts for virtually *all* of the districts' bonded debt. (School district revenue bonds typically are used for sporting and athletic facilities.) Cities accounted for \$5 billion of the increase in tax-supported debt and \$4.8 billion in revenue debt over the period.

### **The Relationship Between State and Local Debt**

The increase in state debt usage was due at least in part to the two recessions of the first decade of the twenty-first century. It *also* reflects a conscious policy decision to use debt for a variety of public programs, transportation in particular, rather than increasing taxes. The state's funding structure for highway finance has lagged far behind the state's needs. Debt filled in a portion of the gap at the cost of an increased debt load.

Local officials have faced similar circumstances, also feeling the effects of the recessions and facing their own political problems with increasing taxes, particularly the property tax. Their problems have been compounded by the fact that local governments other than school districts receive very little in aid from the state, in marked contrast to the usual practice in other large, urban states.

In practical terms, this means that while state debt has risen in the last decade, it has remained low compared to other states facing the same or worse fiscal circumstances. But while state debt has been relatively restrained, the local debt of cities, counties, school districts, and special districts is quite high. This disparity can clearly be seen in Table 20, which compares state and local debt totals for the ten most populous states as of 2008-09.

As Table 20 shows, Texas ranks in the middle of the large states in terms of overall debt, with about \$9,212 per resident; but less than 15 percent of that debt resides at the state level. The rest is local debt. This creates the odd situation in which the state ranks last among the most populous states in state debt but second to New York in local debt per capita. While more recent data are not yet available, it seems likely that the trend has continued.

**Table 20** | Total State and Local Debt Outstanding, 10 Most Populous States, Fiscal Year 2008-09

| State          | Population (000s) | Total State and Local Debt |                      |                   | State Debt      |                      |                 | Local Debt        |                 |                      |                 |                   |
|----------------|-------------------|----------------------------|----------------------|-------------------|-----------------|----------------------|-----------------|-------------------|-----------------|----------------------|-----------------|-------------------|
|                |                   | Per Capita Rank            | Amount (\$ millions) | Per Capita Amount | Per Capita Rank | Amount (\$ millions) | % of Total Debt | Per Capita Amount | Per Capita Rank | Amount (\$ millions) | % of Total Debt | Per Capita Amount |
| New York       | 19,541            | 1                          | \$293,510            | \$15,020          | 1               | \$122,652            | 41.8%           | \$6,277           | 1               | \$170,858            | 58.2%           | \$8,744           |
| Illinois       | 36,962            | 2                          | \$373,694            | \$10,110          | 3               | \$134,572            | 36.0%           | \$3,641           | 3               | \$239,122            | 64.0%           | \$6,469           |
| Pennsylvania   | 12,910            | 3                          | \$128,100            | \$9,923           | 2               | \$56,962             | 44.5%           | \$4,412           | 6               | \$71,138             | 55.5%           | \$5,510           |
| California     | 12,605            | 4                          | \$117,684            | \$9,336           | 4               | \$41,924             | 35.6%           | \$3,326           | 4               | \$75,760             | 64.4%           | \$6,010           |
| <b>Texas</b>   | <b>24,782</b>     | <b>5</b>                   | <b>\$228,282</b>     | <b>\$9,212</b>    | <b>10</b>       | <b>\$30,438</b>      | <b>13.3%</b>    | <b>\$1,228</b>    | <b>2</b>        | <b>\$197,844</b>     | <b>86.7%</b>    | <b>\$7,983</b>    |
| Florida        | 18,538            | 6                          | \$147,177            | \$7,939           | 8               | \$38,885             | 26.4%           | \$2,098           | 5               | \$108,292            | 73.6%           | \$5,842           |
| Michigan       | 9,970             | 7                          | \$77,976             | \$7,821           | 5               | \$29,591             | 37.9%           | \$2,968           | 7               | \$48,385             | 62.1%           | \$4,853           |
| Ohio           | 11,543            | 8                          | \$73,943             | \$6,406           | 6               | \$27,949             | 37.8%           | \$2,421           | 9               | \$45,994             | 62.2%           | \$3,985           |
| North Carolina | 9,829             | 9                          | \$52,977             | \$5,390           | 9               | \$13,455             | 25.4%           | \$1,369           | 8               | \$39,522             | 74.6%           | \$4,021           |
| Georgia        | 9,381             | 10                         | \$50,178             | \$5,349           | 7               | \$19,991             | 39.7%           | \$2,122           | 10              | \$30,267             | 60.3%           | \$3,226           |
| Mean           |                   |                            | \$154,352            | \$8,651           |                 | \$51,634             | 33.8%           | \$2,986           |                 | \$102,718            | 66.2%           | \$5,664           |

**Source:** U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2008-09*, the most recent data available; and Texas Bond Review Board, 2011 Annual Report, December 2011.

**Note:** Detail may not add to total due to rounding.

During most of its history, Texas has set relatively conservative limits on the use of debt by the state and local governments. To some degree, these limits have loosened over the past decade, as state and local officials sought to meet pressing needs with limited ability to increase taxes.

At the state level, this is largely a political issue. The state has ample fiscal capacity to increase taxes to meet its capital needs — if not the political will. This is less true at the local level, so heavily dependent on property and sales taxes. Property tax increases are subject to strict “truth-in-taxation” requirements and associated limitations, and most local governments that can levy the sales tax are at their statutory limits already.<sup>82</sup>

Because of its conservative approach, Texas state and local governments have maintained fairly strong credit ratings. The state has literally thousands of debt-creating local entities, making generalizations difficult but, in general, they appear sound. Certainly none appear to be facing issues on the scale of those encountered by Harrisburg, Pennsylvania, and Stockton, California.

Such problems *could* occur, but the state has a reasonable system of controls in place, including the BRB, to spot problems before they become serious. If the state and local governments continue to rely as heavily on debt financing as they have in the last decade, however, some risks could arise, particularly in the absence of brisker economic growth,

## Conclusions and Recommendations

This is a watershed moment for American state and local governments. The State Budget Crisis Task Force concluded in its initial report that this is the “most serious fiscal crisis since the Great Depression” and that there are fundamental problems that will not vanish when the economy improves.

The Task Force identified six major threats to the long-term sustainability of state and local governments — challenges understood by those who study state and local finances, but not well understood by the broader public. These were:

- Medicaid spending growth is crowding out other needs.
- Federal deficit reduction threatens state economies and budgets.
- Underfunded retirement promises create risks for future budgets.
- Narrow, eroding tax bases and volatile tax revenues undermine state finances.
- Local government fiscal stress poses challenges for states.
- State budget laws and practices hinder fiscal stability and mask imbalances.

Texas fares relatively well in dealing with many of these threats, but the long-term outlook for the state is not without clouds, and it would be a mistake for Texans to believe that the problems other states have struggled with since 2008 cannot happen here. Although the 2013 legislative session is unlikely to confront the fiscal difficulties that legislators faced in 2011, there will be challenges, and regardless of the budget decisions made next year, the state will continue to struggle with many of its fiscal issues for years into the future.

**Medicaid:** Over the past two decades, health care has been the fastest growing element of the state budget, driven by a growing client population and the rising cost of care. Texas’ approach to this has been to attempt to strike a balance between providing basic coverage and cost control. Given Texas’ growing population and new pressures from federal health care reform, future budget pressures will become more and more difficult to sustain unless alternatives to the current approach are found.

Finding these solutions will require the combined efforts of federal, state, and local governments. The state should work with the federal government and monitor developments in other states to find ways to control Medicaid costs and implement reforms. Texas provides a model for limiting costs, and yet, the size of the program continues to absorb a greater share of state resources. This issue will be a preoccupation of state finances for some time to come regardless of the course of federal policy.

Medicaid also could be affected by future federal deficit reduction efforts, as could other important programs, such as transportation and education. As noted in the Task Force’s July report, a 10 percent reduction in federal assistance to the states would cost Texas about \$4.4 billion annually, just under half of that coming from Medicaid and related programs. Sizeable cuts also would hit the Highway Trust Fund, child nutrition programs, education programs, and human service programs. Deficit reduction also would hit federal purchasing, employment, and other direct spending in Texas. Texas had \$40.6 billion in federal procurement spending and \$29.9 billion in federal salaries in 2010, together representing about 5.9 percent of the total gross state product.

The Task Force recommends a continuing dialogue between federal decision makers and state leaders. Congress should understand the impact of its decisions, and it will be up to the states to make their cases, both individually and collectively.

**Pensions and Other Post-Retirement Obligations.** Texas also faces long-term fiscal stress from its pension obligations, although it is in a far better position than most states. Its major pension plans are funded at or above 75 percent of actuarial liability, and as the economy improves funded ratios are likely to rise. And Texas is one of a handful of states that has set aside some funds, however inadequate, for future employee retirement benefits. The state also has taken steps to limit the scope and size of state benefits, raising the retirement age and eligibility requirements for employees hired after September 1, 2009, and raising employee contribution rates for ERS members.

Texas is in a good position to manage a “soft landing” where pensions and post-retirement benefits are concerned. Further changes to the current pension programs are almost certainly necessary, but the main goal of state policy should be to look for ways to contain future costs without undermining the economic future of its retirees. Most importantly, the state should not underfund its pension funds in future budgets regardless of the other challenges it faces. This approach to pension costs has produced massive fiscal difficulties in other states the Task Force studied, a self-inflicted wound that should not be repeated in Texas.

**Education Funding:** One of the most important long-term issues for the state is public education funding. The state currently is in court addressing school funding lawsuits, and the outcome of those lawsuits is likely to have a profound effect on the current funding system. It seems certain that the Legislature will have to address these issues in 2013, either during the regular session or in a special session later in the year. If lawmakers finally develop a solution to the school funding problem, it would be a monumental achievement — the issue has troubled the state for forty years. Clearly, lawmakers will focus on ways to manage the cost of public schools and find innovative educational alternatives, but the bottom line is that good schools cost money, and a large percentage of that money should come from the state.

The same is also true of higher education funding. Efforts to reduce higher education costs are laudable and needed, but the state has adopted a strategy of reducing its overall commitment to higher education, effectively flattening the growth pattern in state General Fund support of colleges and universities. Tuition, which was “deregulated” in 2002, has been allowed to pick up the slack. The balance between state support and family funding must be addressed before a generation of young Texans is priced out of the market and left without the skills Texas will need to rely on for its future economic success.

**Infrastructure:** If there is a true long-term threat to the state’s fiscal sustainability other than health care costs, it is the growing need to maintain and extend the state’s aging infrastructure. Transportation and water present the most formidable and visible problems. The Legislature appears likely to begin addressing these needs directly during the 2013 legislative session. The state needs to avoid pushing its very real infrastructure needs further into the future. With a growing — and increasingly urban — population and questions about the future adequacy of its water resources, these issues will only grow larger and more intractable with the passage of time. They cannot be cured in one session or even one decade, but the process of addressing them should begin immediately

**Budget Gimmicks:** Another threat to the state’s fiscal sustainability is the budget practices and fiscal maneuvers that have been used to balance the budget. This threat covers a range of practices from inadequate planning to the use of funding

delays and budget “gimmicks” that push costs to the next biennium. On the other hand, Texas is one of the few states with a significant rainy day fund reserve, and during the 2011 session, lawmakers were notably unwilling to use these funds to meet short-term budget demands, preferring to save the balances for the upcoming biennium.

Lawmakers may begin to address some of these budget gimmicks used to balance the budget in 2011 in the upcoming session, and they should. They should also increase their transparency. So long as there are budgets to be balanced and funding needs to be met, budget gimmicks are likely to be used to make a few more dollars available, but the use of these budget maneuvers should be limited in amount, short in duration, and fully disclosed.

**The State Revenue System:** The problem with many of the long-term challenges facing Texas is that their solution almost certainly will cost a lot of money. This likely will pose a major obstacle for policy makers in future legislative sessions because of the practical limitations the state places on the state and local revenue system.

Like the revenue systems in many states, Texas’ tax system faces problems with base erosion and volatility. Texas relies on the sales tax for more than half of its tax revenue, and the property tax occupies a similarly prominent role at the local level. In the absence of income taxes, the traditional “third leg” in the state and local fiscal structure is provided by a combination of excise taxes and severance taxes. Over time, the state sales tax base has eroded due to the increasing economic importance of largely untaxed services as well as online sales. In addition, the state tax base has been more volatile in the last decade than in the past, although the local tax base has been relatively stable.

Given the political climate in the state, fundamental tax system reform is unlikely. In a sense, the tax system has become calcified. It does not produce enough revenue to allow the state to meet its likely future spending needs without biennial budget struggles, and it also is extremely difficult to adjust when more revenue is needed, mainly because of the political barriers to tax change. That means the revenue system will continue to cause cyclical difficulties for the state’s finances.

Given the current legislative climate, the best way to deal with this situation is for the state to continue to forecast revenues conservatively, budget conservatively, build reserves in the rainy day fund, and avoid the political temptation to add new or expanded incentives to the tax code, which will further erode the current tax base.

In addition, given the state’s reliance on the sales tax, it should be more active in national efforts to find a solution to the problem of online and catalogue sales that currently cost the state hundreds of millions of dollars in lost sales tax annually.

**Local Governments:** The Texas local government revenue system also needs reform. Because of the state’s decentralized system, local governments bear the burden of an immense amount of governmental costs, ranging from public education to local transportation infrastructure. With the exception of schools, they receive little or no assistance from the state, and in each legislative session have to fight to protect their tax bases from further limitation and to avoid new unfunded mandates. Moreover, the Legislature has placed statewide limits on the use of both the sales tax and the local property tax.

Local governments need additional revenue options that can be adopted by local voters on a local-option basis. Such a reform would help relieve the pressure to increase property taxes. However, until such reforms are made, the Legislature should, at a minimum, refrain from imposing further limitations on the property base or rate or the approval of further tax abatement and incentive programs. Current provisions in state law are adequate to protect taxpayers from unreasonable

tax increases and further constraints would only create the potential of future fiscal disruptions like those experienced by many local governments nationally in recent years or will lead to an unacceptable increase in local debt.

**Long-Range Planning:** Texas is in an enviable fiscal position today, but it may not be in the future if it does not have a strategy for dealing with its many long-term challenges. At present, the state has no mechanism for multi-year fiscal planning. Revenue estimates and state spending estimates focus only on the upcoming two-year budget cycle. Since writing the budget occupies a large percentage of any legislative session, that is understandable, but the state *must* give greater attention to long-term financial planning. Many of the challenges the state faces will linger for decades, regardless of the direction and commitment of current state policy. Texas is a rapidly growing and economically robust state, but it also has a large low-income population and growing problems in areas such as health care and educational achievement. It has a remarkable public infrastructure that is aging and struggling to keep pace with increase pressures.

To meet its challenges, Texas needs to understand them — and take them seriously.

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# ACKNOWLEDGEMENTS

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