Tapping the Rainy Day Fund & School Fund Balances:

Balancing the 2010-11 Budget without Raising Taxes

<u>Key Point</u>: ***While it is demonstrably appropriate to spend some amount of the ESF to help balance the current biennium (2010-11) budget, legislators should only appropriate $3.2 billion from the fund.***

The Economic Stabilization Fund (ESF): Appropriate Uses and Legislative History

The language in the Texas Constitution governing the use of the ESF reads in part as follows:

> If an estimate of anticipated revenues for a succeeding biennium prepared by the comptroller pursuant to Article III, Section 49a, of this constitution is less than the revenues that are estimated at the same time by the comptroller to be available for the current biennium, the legislature may, by a three-fifths vote of the members present in each house, appropriate for the succeeding biennium from the economic stabilization fund an amount not to exceed this difference. [Tx. Const. Article III, Sec. 49-g(l)]

Based on this language, it is clear that a current biennium revenue shortfall is the appropriate time to consider utilizing the ESF. This is seen in the language that created the Fund (HJR2, 70R) and in analyses of the constitutional amendment. The House Research Organization (HRO) noted that "[a]mendment No. 2 would create an Economic Stabilization Fund in the State Treasury. State revenue would be set aside in the fund and saved for appropriation when revenue shortfalls occur."[i]

The HRO also quoted supporters of the amendment arguing that:

> If the Economic Stabilization Fund had existed in 1986 and 1987, <u>the state might have been spared the hard choice between reducing essential state services and raising taxes during difficult economic times</u>. Money could have been appropriated from the fund to reduce or eliminate the budget deficit that occurred when <u>state revenues fell below earlier estimates</u> and might have prevented the record tax increase.[ii] [Emphasis added]

While it is appropriate to spend some amount of the ESF to help balance the current biennium (2010-11) budget, legislators must remain vigilant and ensure that they appropriate the smallest possible amount from the Fund.

The Importance of Retaining a Balance in the ESF: why only withdraw $3.2 billion?

It is critical to appropriate the smallest possible amount from the ESF because the Fund plays a critical role underpinning the long-term fiscal health of the state. The $3.2 billion in current biennium appropriations from the Fund recommended by CSHB 275 is appropriate, given that this represents $1.1 billion less than HB 275 originally recommended.

With the agreement of Governor Perry, Comptroller Combs, and Speaker Straus, the House Appropriations Committee lowered their initial appropriation from the Fund by accounting for $800 million in additional current biennium spending reductions and adding around $300 million in additional sales tax receipts estimated by the Comptroller.[iii]

Spending no more than $3.2 billion from the ESF is important because the Fund plays a critical role underpinning Texas' fiscal health:

a. Maintaining strong bond ratings: The ESF is critical to keeping the state's borrowing costs low because the balance in the ESF is taken into account by credit ratings agencies. The Texas Bond Review Board reports that ratings agencies such as Standard & Poor's (S&P) attribute Texas' positive bond ratings partly to the substantial balance in the Fund:

> *S&P's* outlook for the state's rating also remains AA and stable. The justification for the state's outlook…is based upon a statement that "the AA rating reflects the large and steadily growing and diversifying economy which continues to outperform the nation in terms of both economic activity and employment growth; **improving reserve levels which provide a cushion in the event of an unanticipated drop off in revenues** as a result of the current economic slowdown; and low tax-supported debt burden."[iv] [Emphasis added.]

As the Standard and Poor's assessment indicates, a robust ESF allows the state to benefit from positive bond ratings while maintaining a light tax burden. The Bond Review Board notes that in the past, low balances in the Rainy Day Fund have contributed to poor bond ratings:

> In June 1999, S&P downgraded the state's rating outlook from "positive" to "stable." S&P cited a modest level of financial reserves (primarily in its "Rainy Day Fund") as the main reason for the downgrade and concluded that the state's financial flexibility could become impaired without adequate financial reserves supported by a financially sound budget.[v]

Retaining strong bond ratings will be important in the future so that Texas has affordable access to the necessary capital to fund infrastructure and construction projects to meet the needs of its growing population.

b. The cost of federal mandates: It will be important to retain a healthy balance in the ESF so that the state is well-positioned to meet future fiscal challenges resulting from the Patient Protection and Affordable Care Act of 2010 (PPACA), which will significantly increase Medicaid enrollment in Texas. The Texas Department of Health and Human Services estimates that this enrollment increase, together with other reforms mandated by PPACA could cost the state at least $27 billion in general revenue alone between 2014 and 2023.[vi]

Additionally, a report by Texas Comptroller Susan Combs released last year that examined the fiscal impact of federal reform noted that: "many factors are still unknown as the supporting rules have not been written by the federal government. In fact, out of the 78 major provisions examined in this report, there were 50 for which the fiscal impact could not be determined at this time."[vii]

The cheerleaders for Obamacare, including numerous Texas legislators, should be reminded that it is the law they championed that demands keeping revenue in reserve to help fund this onerous and costly federal mandate beginning in the 2014-2015 biennium.

The ESF and School District Fund Balances

It is simply not a tenable policy position to leave the Economic Stabilization Fund untouched while drafting future budgets that may require school districts to tap their fund balances, which they should in the current environment.

According to the Texas Education Agency, all school districts combined have more than $10.1 billion in net fund balances. There is also $2.1 billion in federal stimulus funds that are still available to school districts:

Total Fund Balance All ISDs	
Number of ISDs with an Excess Fund Balance	591
Number of ISDs with a Deficit Fund Balance	419
Number of ISDs with no difference	20
Total	**1030**
Total ISDs Excess Fund Balance	$1,336,369,206
Total ISD Deficit Fund Balance	-$897,010,833
Total Excess Fund Balance All ISDs	**$439,358,373**
Total Excess Fund Balance All ISDs	$439,358,373
Remaining Stimulus Balance Available to ISDs and Charters as of 1/31/2011*	$2,138,745,993
Total Excess Fund Balance All ISDs PLUS Available Stimulus	**$2,578,104,366**
Total Fund Balance All ISDs	$10,151,827,668
Remaining Stimulus Available to ISDS and Charters as of 1/31/2011*	$2,138,745,993
Total Fund Balance All ISDs PLUS Available Stimulus	**$12,290,573,661**
*****Amounts obtained from ISDs' Audited Financial Statement for the Fiscal Year Ending 2009; Audited Financial Statements for the ISDs' Fiscal Year Ending 2010 will not be available until early spring 2011.***	
****Amount obtained from the Texas Education Agency ARRA Grants with Remaining Balances by Grantee Report as of 1/31/11 available at http://www.tea.state.tx.us/index2.aspx?id=6588&menu_id=934&menu_id2=941***	
In addition, unless specified, totals do not include charter school amounts because charter schools are non-profit organizations and report a net asset balance instead of fund balance.	

Source: Texas Education Agency

While some portion of these funds may already be earmarked for ongoing obligations incurred by school districts, and some cash reserves are necessary to fund normal operating expenses, at minimum those districts which retain excess funds cannot demand more money from the Legislature if they refuse to spend money held by them and decline to take action to reduce long-term operating costs.

It would be disingenuous for a school district to retain cash balances in their operating accounts during a state budget shortfall and claim they simply cannot make ends meet, while many superintendents (notably Beaumont, Fort Worth, Dallas, Alief, and Houston ISDs[viii]) maintain lucrative compensation packages that are far in excess of those paid to those at the very top of State Government, including the Governor, the Attorney General, and the Comptroller. Meanwhile other superintendents receive pay increases (see Duncanville ISD[ix]) while teachers are being dismissed.

The state and the school districts must be partners in balancing the budget without raising taxes, at the state and local level. Serious consideration must be given to how to utilize portions of the total fund balances retained by all school districts given the impact this could have on the public education budget, even if that means the Texas Education Agency providing flexibility to the districts.

Tapping the ESF is not the central debate: Reforming the Public Sector is.

The debate over the Economic Stabilization Fund, while critically important, has diverted serious attention away from meaningful policy *reforms* that will have a far longer-term beneficial impact on the state's fiscal strength than will one-off budget reductions for the 2012-13 biennium. It is essential to refocus the budget debate on reform ideas, such as the following:

- **Repeal prevailing wage law**

The federal Davis-Bacon Act (DBA) was enacted in 1931 to help preserve rapidly declining construction wages during the Great Depression. Still in effect, DBA wages are significantly higher than those in the private sector, in many cases driving up the cost of taxpayer-funded projects. A recent study found that DBA wages increase the cost of federally funded construction projects by 9.9 percent and wages are 22 percent higher on average than market wages.[x] Not surprisingly, prevailing wages are often the same as those of construction unions.

Texas Government Code 2258.022 governs the oversight of prevailing wage rates within the state. While DBA applies to all federal work projects, it does not automatically apply to state public projects. Texas law currently states that in addition to the DBA standards at the federal level determined by the Department of Labor, Texas may also use a study or survey of wages may be used to determine prevailing wage. Regardless of the method used to determine the prevailing wage rate for Texas, the result is generally wages inflated beyond the market value.

Texas should join the 18 other states without prevailing wage laws and repeal this outdated and economically harmful Depression-era relic.

- **Repeal "meet and confer" provisions**

Similar to collective bargaining, "meet and confer" is a process through which public employees meet collectively with their employer to bargain for wages, benefits and working conditions. From a policy perspective, collective bargaining and meet and confer procedures have negative impacts for taxpayers because they give public employee groups significant power to bargain for wages and benefits. As the Mackinac Center points out:

> Unlike consumers in the private sector, taxpayers cannot easily 'vote with their feet' to choose a better service provider. Public sector unions, therefore, experience little external pressure to moderate their demands. This is one reason why the salaries and benefits of government employees are often higher than those of employees performing comparable work in the private sector.[xi]

Many cities across Texas have granted meet and confer privileges to their public employees under authority delegated to them by the legislature. In effect, legislators have adopted a piecemeal approach to extending meet and confer privileges to a large number of local government employees across the state. However, in the aggregate, meet and confer bills have a statewide impact that imposes additional burdens on taxpayers.

Repealing these meet and confer privileges that have granted to cities would be an important reform to protect taxpayers at the local level.

- **Move from a "defined benefit" to a "defined contribution" retirement plan for state employees**

Currently, state employees have defined-benefit plans. While 84 percent of state and local governments have similar plans around the country, only 21 percent of employees in the private sector (and only 16 percent of the nonunion workers among them) have defined-benefit plans.[xii] Defined benefit plans guarantee a rate of return without regard to the amount actually earned in the investment. This, in turn, causes massive budget deficits in times of economic downturns or even slowdowns. As the Mercatus Center at George Mason University notes:

> The key difference between the DC plan and the DB plan is the assignment of risk. In a DC plan, the risk or reward of varying investment performance is borne by the employee, who receives a higher or lower pension based upon the returns generated by investments held in his account…The risk is transferred from the employer (or in the case of the public sector, the taxpayer) to the employee.[xiii]

From the perspective of state budget-writers, a key advantage of defined-contribution plans—such as 401(k) and 403(b) accounts—is that they cannot develop funding deficits, while still allowing the state government to dedicate funds to each employees plan. Michigan and Florida have already offered defined contribution alternatives to their state employees. From the perspective of employees, defined-contribution plans are an attractive alternative because they are typically portable, unlike defined-benefit plans.

Texas could begin the transition to a defined contribution model by placing all employees earning over a specified annual income level onto a defined contribution plan while retaining lower-earners on the existing defined benefit model.

In the 82nd Legislative Session, two bills relating to defined benefit models have been filed: HB 1974 by Representative Sheets and HB 2506 by Representative Chisum. If passed, they would likely yield significant long-term fiscal benefits to the state.

- **Offer Health Savings Accounts (HSAs) to State Employees**

Currently, the state offers a defined benefit plan offering state employees little choice in the type of coverage offered. This one-size-fits-all approach raises costs and limits choice. In contrast, HSAs allow the state and state employees considerable choice. By contributing to an HSA account, the employee has more control over their own health care.

By allowing some employees to opt for Health Savings Accounts the state can expect to generate cost savings compared to the traditional public employee health benefit plan provided by a Health Maintenance Organization (HMO). Research from the Michigan-based Mackinac Center for Public Policy found that in Michigan the cost of public employee health care plans was increasing by 7.6 percent per year for HMO health insurance premiums. By contrast, the Mackinac Center noted that state costs for a HSA employee benefit package would grow, conservatively, at an annual rate of just 3.5 percent.[xiv]

At the state level, Indiana has had significant success implementing HSAs for state employees. 70 percent of Indiana's state employees are enrolled in high-deductible health plans coupled with HSAs, which are offered as part of the standard benefits package for state workers. As a result of this high take-up rate, these employees have a total of $30 million in their accounts ($2,000 per employee) and their health care costs have fallen.

The Legislative Budget Board noted in its 2010-11 Fiscal Size-Up that:

> State contributions for employee and retiree group health insurance total $4.1 billion for the 2010–11 biennium, approximately 2.2 percent of the state budget. Appropriations for employer contributions to employee and retiree group insurance increased by $2 billion, or 94.1 percent, from the 2000–01 biennium. This is an average biennial increase of 18.8 percent.

Put simply, the cost of health benefits for state employees and retirees is growing at a faster rate than state expenditures generally. This statistic should focus policymakers on finding a more fiscally prudent way of funding health benefits for state employees. Health Savings Accounts can achieve this target while empowering state employees by giving them greater control over their health care.

House Bill 1766 (82R) by Representative Crownover is recommended, and would provide state employees the option to have a Health Savings Account rather than the standard state health benefit package.

- **Stricter Constitutional Spending Limit**

Texas' current constitutional spending limit must be improved so that it can provide a meaningful check on the growth of state spending into the future. The current limit, contained in Article III, Section 49a of the constitution, reads as follows:

> In no biennium shall the rate of growth of appropriations from state tax revenues not dedicated by this constitution exceed the estimated rate of growth of the state's economy… In no case shall appropriations exceed revenues as provided in Article III, Section 49a, of this constitution.

To provide meaningful protections for taxpayers, the flawed constitutional spending limit should be rewritten to limit growth of the state budget to the lesser of population growth plus inflation or increases in gross state product. In using this measure, the state will be able to continue to provide necessary services to the population as it grows. Any budget growth above this would be constitutionally restricted. In addition, a new limit should apply to dedicated general revenue funds as well as non-dedicated general revenue, and a two-thirds vote of the legislature should be required to override the limit.

Currently proposed legislation that would create a stricter constitutional spending limit includes: HB 380/HJR 42 by Representative Callegari; HB 2775/HJR 42 by Representative Bohac; HB 756/HJR70 by Representative Paxton; HB 581/HJR 58 by Representative Hancock; and, SB 828/SJR27 by Senator Patrick.

- **Consolidate agency field offices**

Many state agencies lease properties across the state in order to operate field offices away from their central offices which are typically located in Austin. The Office of the Comptroller estimates that agencies spend around $66 million per year leasing field offices, including $29 million by the Health and Human Services Commission, and $25 million by the Department of Family and Protective Services. Agencies should examine the extent to which field offices are necessary and if possible, consolidate field offices to achieve financial savings.

- **Sell surplus property**

The state should aggressively pursue the sale of surplus property. There are large potential revenue gains for the state by pursuing this policy option. This would be a sensible course of action so that the state can access the equity in its unused property and also save on maintenance and other costs associated with owning such a large amount of land and property.

Currently proposed legislation that would allow for sale of surplus state property includes HB 1727 by Representative Brown and HB 1414 by Representative Chisum. In addition, Lieutenant Governor Dewhurst has convened a "non-tax revenue" subcommittee to study issues including the sale of unused state land as a vehicle to find non-tax sources of revenue for the state.[xv]

- **Remove provisions related to historically underutilized businesses in state contracting**

According to the Office of the Comptroller, a historically underutilized business (HUB):

> ...is at least 51% owned by an Asian Pacific American, Black American, Hispanic American, Native American and/or American woman,
>
> ...is an entity with its principal place of business in Texas, and
>
> ...has an owner residing in Texas with a proportionate interest that actively participates in the control, operations and management of the entity's affairs.[xvi]

The Comptroller also notes that under Texas Administrative Code §20.13, "each state agency shall make a good faith effort to utilize HUBs in contracts for construction, services (including professional and consulting services) and commodities purchases."

When state agencies enter into contracts with the private sector, they should only consider factors related to the potential contractors ability to perform the services that the state needs and the value that the contractor would provide for state taxpayers. Prioritizing certain contractors for the reasons outlined above should have no place in state contracting processes since it might result in otherwise-qualified businesses being excluded from state contracts for reasons not related to their ability to perform the services required by the state.

- **Moratorium on creating new taxing entities**

At the local level, there is a proliferation of taxing entities in Texas. In addition to federal and state taxation, the typical Texan is taxed by their resident county government, their resident school district, and their resident municipal government (if they live inside the corporate boundaries of a city). In addition, they might also be taxed by any number of "special districts" such as a community college district, a water district, a utility district, or a hospital district (just to name a few). Each one of these taxation units represents a new level of government (and thus some form of an elected or unelected governing body). In many cases, distinctions between the various different levels of government are vague and confusing.

While cogent arguments can be made for many of the services that are provided by cities, counties, school districts, and water and utility districts, many other local taxing entities are duplicative of the mission of cities and counties.

Any duplication of service provision is significant because it demonstrates that each level of government is overreaching its responsibilities and arguably spending tax dollars inefficiently. Requiring a two-thirds vote in both the House and Senate to approve the creation of new entities or political subdivisions with taxing authority is recommended. Taxpayers need to be protected from the proliferation of local taxing entities. Legislators could amend statute (The Local Government Code) to require two-thirds of the legislator to vote in favor of the creation of new entities with taxing authority (sales taxes and property taxes are the two most common forms of taxation authorized for local entities).

- **Improve off-peak use of educational facilities**

There is a vast number of educational facilities across the state that could be better-utilized in order to provide savings for school districts, community colleges, and even universities. Encouraging school districts and higher education institutions to share available facilities outside regular hours would reduce the extent to which new facilities are required, and would also provide savings associated with operations and maintenance costs. As the Comptroller notes:

> The Texas Higher Education Coordinating Board's most recent evaluation concerned the fall 2009 semester. The vast majority of public universities, state and technical colleges scored below target levels on at least one of the three measures, indicating unused hours and space for additional classroom activities. In short, Texas' higher education classroom space appears to be underused…
>
> …Classes offered during evenings and other off-peak times allow for more efficient usage of existing educational space, reducing the need for more classrooms in times of high enrollment growth. They also offer schedule flexibility to students who prefer to, or must, take classes during non-traditional hours.[xvii]

For additional public sector reforms, please see TCCRI's "Blueprint for a Balanced Budget": http://www.txccri.org/TCCRIStateBudgetTaskForceReport.pdf

Summary

The $3.2 billion appropriation from the ESF proposed by HB 275 is a reasonable approach that retains a substantial balance in the Fund while accounting for current biennium spending reductions and additional tax revenue projected by the Comptroller. This use of the Fund is also constitutionally appropriate because it helps address a current biennium revenue shortfall without raising taxes.

In addition to appropriating revenue from the Fund, school district fund balances should be utilized to the maximum extent allowable in order to help address the shortfall in the state's public education budget. Any distinction between state funds and school district funds is false given the equalized funding system for public schools. School districts must also spend a reasonable portion of their fund balances to help mitigate impact of budget reductions depending on local circumstances.

Moving beyond the Economic Stabilization Fund, conservative legislators must refocus their efforts on long-term budget reforms – and particularly public sector reforms – that will keep the state on a sound fiscal footing for decades to come.

ENDNOTES

[i] House Research Organization, Special Legislative Report, 1988 Constitutional Amendments, July 15, 1988.
[ii] *Ibid.*
[iii] "Appropriations OKs $3.1 Billion From Rainy Day Fund," Texas Tribune, March 15, 2011.
[iv] Texas Bond Review Board, Annual Report (2008).
[v] *Ibid.*
[vi] HHSC presentation to TCCRI Insurance Task Force, April 1, 2010.
[vii] "Diagnosis: Cost – An Initial Look at the Federal Health Care Legislation's Impact on Texas", Texas Comptroller of Public Accounts, June 2010.
[viii] Top Ten Superintendent Salaries, 2008-09 School Year, Texas Tribune; http://static.texastribune.org/media/images/121609_toptensuperintendent001_jv_jpg_800x1000_q100.jpg
[ix] "With a hefty pay hike, Duncanville's school chief is doing way better than most," DallasNews.com; March 7, 2011.
[x] Sarah Glassman et al., "The Federal Davis-Bacon Act: The Prevailing Mismeasure of Wages," Beacon Hill Institute, February 2008.
[xi] La Rae Munk, "Collective Bargaining: Bringing Education to the Table," (1998); available from http://www.mackinac.org/archives/1998/S1998-04.pdf.
[xii] Underfunded Teacher Pension Plans: Its Worse Than You Think, Manhattan Insititute for Policy Research, April 2010
[xiii] "The Crisis in Public Sector Pension Plans," Mercatus Center, June 23, 2010.
[xiv] "State Should Adopt Health Savings Accounts," The Mackinac Center for Public Policy, September 28, 2007.
[xv] "Dewhurst triggers hunt for $5 billion: Investments, sale of property could be targeted," Houston Chronicle, March 17, 2011.
[xvi] Texas Comptroller, Historically Underutilized Business Program; http://www.window.state.tx.us/procurement/prog/hub/
[xvii] Texas Comptroller of Public Accounts, Financial Allocation Study for Texas, December 2010.