TEXAS TAXPAYERS
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Texas Budget Challenges Are Not Over

In a regular session marked with unprecedented rancor and divisiveness, lawmakers ultimately came together to pass the only legislation they had to—the state budget for the upcoming 2018-19 biennium.

Budget writers had been planning ahead for the 2017 session. Two years ago, the state enjoyed a massive tax haul from the oil and gas fracking boom, but that boom was ending. They left $4.3 billion unspent in the general revenue fund. This would ease the transition to a new Constitutional dedication of sales tax revenue taking effect in 2017—an amount that could be as much as $5 billion.[1]

Unfortunately, the slide in oil and gas prices lasted longer than anticipated and the expected surplus largely evaporated. When they met in January, lawmakers had less money to spend for the budget they had to write compared to the previous one.

Legislators cut the fiscal cloth to fit the pattern. But at best, Senate Bill 1—the 2018-19 state budget—is a work in progress that will require substantial ongoing management. Absent a change in federal Medicaid law, Texas may find the general revenue budget roughly $2 billion short of what will ultimately be required before the state can close its books—a number that could balloon if the federal government fails to extend the "1115 waiver"—a special, long-time provision allowing Texas certain exceptions from federal Medicaid law.

Lawmakers also relied on a number of one time measures and funding shifts that may haunt the 86th Legislature when writing the 2020-21 budget—deferring certain obligations while tapping one-time pots of money. These funding shifts coupled with the potential Medicaid shortfall could create an $8 billion structural gap—a gap which could worsen if lawmakers fund new initiatives using accounting shifts in the current special session. While none of these funding strategies are unusual in the Texas budget process, it is a gamble that sometimes pays off, and sometimes does not.

Figure 1
The Components of Revenue Change
2018-19 versus 2016-17
(General Revenue $ billions)

	2016-17	2018-19	Difference
Beginning Balance	$8.3	$1.5	($6.8)
Net Current Revenues	$99.4	$108.1	$8.7
Sales Tax Dedication	$0.0	($4.7)	($4.7)
Total	**$107.7**	**$104.9**	**($2.9)**

Source: Biennial Revenue Estimate, 2018-19, Texas Comptroller of Public Accounts, January 2017.

A rebound in oil and gas prices and investment could narrow that gap or even fill state coffers to the brim, but once again, a seemingly diversified Texas economy will be keeping one eye on world oil and gas markets for the foreseeable future.

Balancing the Budget on the Revenue Side

State Comptroller Glenn Hegar greeted lawmakers this past January at the start of the 85th session with a 2018-19 biennial revenue estimate nearly $3 billion less than what they had the previous session. (Figure 1)

Ironically, the Comptroller projected that underlying state revenue growth would be fairly robust—up $8.7 billion. But the drag on the bottom line comes from two places.

[1] In 2015, lawmakers approved Senate Joint Resolution 5, a Constitutional amendment that was ratified by Texas voters. This amendment reserved the first $2.5 billion of previously undedicated sales tax revenue each year in excess of $28 billion for highways, beginning with the 2018 fiscal year. Beginning in 2020, another dedication takes effect which reserves 35 percent of any motor vehicle sales tax revenue in excess of $5 billion for highways.

First, reflecting the boom and bust of oil prices and the corresponding drop in drilling and investment, the state's ending 2017 surplus was estimated at $1.5 billion—a drop of $6.8 billion from the previous budget. Second, a new Constitutional dedication of sales tax revenues for state highways was slated to take effect in 2018, a measure that would remove $4.7 billion from the state's general revenue stream. Once the numbers were all tallied up, the bottom line was a drop in available general revenues of $2.9 billion.

Both the House and Senate agreed that additional money would be needed in crafting a final budget, but differed in how to raise it. The Senate proposed deferring the newly slated transfer of sales tax revenue for highways. The House proposed withdrawing funds from the Economic Stabilization Fund (commonly referred to as the "Rainy Day Fund"). Ultimately, the House and Senate compromised, using a bit of each. SB 1 relied on $1.8 billion in one-time revenue by deferring the highway sales tax transfer, and also used $989 million from the Stabilization Fund (but only for various capital and non-recurring items) .

Lawmakers were also able to tap various special fund balances through funds consolidation, generating an additional $668.1 million in one-time revenue. Comptroller Hegar chipped into the total. He volunteered to accelerate the process by which he sells unclaimed securities (raising an additional $500 million in one-time revenue), and to create a tax amnesty program (which he estimated would generate an additional $46.1 million). State Land Commissioner George P. Bush also offered to seek more aggressive returns on the state's Permanent School Fund, a strategy which could generate an additional $300 million in 2018-19.

All totaled, Senate Bill 1 (the 2018-19 budget) and House Bill 2 (the supplemental appropriations bill for 2017), balanced, leaving $41 million unspent and available to cover either additional needs that might materialize in the July special session called by Governor Abbott, or emergencies later during the interim.

Figure 2
The 2018-19 State Budget Versus 2016-17
(General Revenue $ billions)

Key Items	2016-17	2018-19	Dollar Change	Percent Change
Public Education	$41.6	$41.0	($0.6)	(1.5 %)
Higher Education	$14.7	$14.9	$0.2	1.6 %
Health/Human Svcs	$33.6	$33.5	($0.1)	(0.3 %)
Public Safety	$11.6	$11.4	($0.2)	(1.6 %)
Other	$6.5	$6.0	($0.6)	(9.0 %)
Total Spending	**$108.0**	**$106.7**	**($1.3)**	**(1.2 %)**

Notes: Numbers may not add due to rounding. 2016-17 spending and 2018-19 available revenues have been adjusted to reflect $1.0 billion of supplemental appropriations for 2017 made in HB 2. Figures above do not include $988.9 million of spending from the Economic Stabilization Fund, mostly appropriated for facilities repairs and to grant funds. Figures are preliminary and may not include all funding items.

A Conservative Budget

Senate Bill 1 by Nelson budgets a total of $216.8 billion from all funds for 2018-19—up a scant 0.2 percent from the final figures for 2016-17.

The true legislative battles, though, are fought over general revenue funds—the more discretionary moneys over which the legislature has greater flexibility (this excludes many dedicated and restricted funds). SB 1 would spend a total of $106.7 billion in general revenues—down 1.2 percent from the current budget (Figure 2).

As is usual, Texas' general revenue budget is concentrated on a few key priority areas.

General revenue funding for **Public Education** is slated to decline by $0.6 billion as local property taxpayers will shoulder a bigger share of the cost of educating students.

School finance is a shared responsibility of the state and local school districts. School districts levy a local property tax and state aid is used to smooth out disparities in local property tax yields. The state essentially guarantees school districts a certain amount of money per student. If the district's property tax does not raise that much, state aid makes up the difference. If the district raises more than the guarantee, the excess revenue may be "recaptured" and redistributed to other districts. The system has the benefit of being highly equalized across districts in a given year; however, as property values increase from year-to-year, even a "poor" district can become "wealthier," and its state aid is reduced. Over time, as a result of normal economic growth, the state's share of public school funding falls.

Public school formula appropriations for 2018-19 are based on projected annual increases in property values and tax levies of 7 percent. With school taxes today at $29.9 billion that suggests an increase near $8 billion over the biennium.

Had the state maintained its current share of school funding, the legislature would have had to spend an additional $4 billion in state aid. Senate Bill 1 actually *cut* state aid to schools by $1 billion—a net budget savings to the state of $5 billion that is to be shifted onto local taxpayers.

That savings is good news for state budget writers, who get to claim a more conservative spending tally, but it's bad news for local property taxpayers who will have to foot the bill.

Appropriations to TRS-Care, the state's health insurance program for retired teachers, are increased by $0.4 billion—an amount which should be sufficient for the program to maintain solvency through the end of the budget. The state also increased premiums costs and deductibles, a move which has generated substantial controversy among retired teachers and which the legislature may address in the special session.

Higher Education funding is up by $0.2 billion overall — one of the few areas of the budget to see an increase. In addition to formula funding, institutions of higher education traditionally receive funding for separate "special items" unique to each institution. Special item funding was a point of contention in the conference committee, with the Senate proposing sharp reductions as a possible first step in eliminating special item funding. Ultimately the conference committee re-labeled these items as "non-formula support," with specific, but less severe overall reductions.

Health and Human Services funding totals $33.5 billion, of which $25.6 billion is Medicaid—a shared state-federal program that provides health insurance for certain low income individuals and families (primarily children, their caregivers, and the elderly). The bulk of Medicaid is actually paid for by the federal government—with funds that "match" state spending obligations. That federal money comes with strings—states must provide certain services to people meeting eligibility criteria. The Medicaid appropriation is driven by three factors: 1) the number of people eligible to receive services, 2) the services the program provides, and 3) the cost of providing those services. The state's Medicaid appropriation does not fund either medical inflation or services demands, and only funds caseload growth through 2018. Unless Congress authorizes program changes, which certainly is possible, Texas lawmakers could face the prospect of a $2 billion supplemental appropriation in 2019 to make the current Medicaid budget whole.

A wild card in the Medicaid budget is the continuation of a special waiver Texas has been operating under for the past several years. Texas' 1115 Medicaid waiver, which allows Texas to draw down federal Medicaid funds using local funds and employ managed care as a cost containment tool. Texas was granted the waiver in 2011. The federal government has renewed it through December of 2017, but has not given an indication of how it might rule beyond that. Loss of the waiver could cost Texas billions of federal Medicaid dollars, wreaking substantial havoc on local hospitals while also driving up program costs—almost certainly necessitating some type of extraordinary action by the state.

General revenue funding for Child Protective Services is up by $0.4 billion, providing for up to 600 new caseworkers, a higher level of pay, and a reduced number of cases per worker.

Public Safety continues state funding levels for border security but reduces prison funding reflecting a variety of cost savings and cost shifting.

Other spending reflects a shift of $0.5 billion of general revenue funding for highways, replacing it with dedicated highway moneys.

Looking Ahead to 2019

Senate Bill 1 balances within available revenues, but by no means will it be the final statement on state spending in 2018-19. Lawmakers will meet again in regular session in January 2019 and will face some immediate and daunting challenges.

The greatest immediate risk to the bill is the likely multi-billion dollar supplemental Medicaid funding bill to make the 2018-19 budget whole. That money may have to come from the Economic Stabilization Fund absent either an unanticipated rebound in state revenue growth or cuts to spending authorized in Senate Bill 1. That spending will continue into the next budget without a permanent source of funds.

Crafting that 2020-21 budget may be an even more difficult chore (Figure 3).

The $1.8 billion in sales tax borrowed by deferring the transfer of sales tax revenues to the Highway Fund in 2019 will have to be paid back in 2020—a swing of $3.6 billion to the bad. The $668.1 million generated from funds consolidation, the $46.1 million generated from tax amnesty, and the $500 million generated by the advanced sale of unclaimed securities are all one-time pots of money that disappear once tapped. The programs they currently fund, however, will still be there.

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Figure 3

Budget Shifts Could Take a Toll in the 2020-21 Budget

(General Revenue $ billions)

Funding Mechanism	**2018-19 "Savings"**	**2020-21 Cost**	**Net Shift**
Sales Tax Deferral/Repayment[1]	$1.8	($1.8)	($3.6)
Funds Consolidation[2]	$0.7	$0.0	($0.7)
Tax Amnesty[3]	<$0.1	$0.0	(<$0.1)
Accelerated Sale of Securities[4]	$0.5	$0.0	($0.5)
Sales Tax Dedication Increase[5]	N.A.	($0.3)	($0.3)
Motor Vehicle Tax Dedication[6]	N.A.	($0.8)	($0.8)
Total	$3.0	($2.8)	($5.9)
Medicaid Funding Shortfall			($2.0)
Total Potential Structural Gap			**($7.9)**

[1] Senate Bill 1, 85:R, Article VII, Department of Transportation, Rider 42.
[2] House Bill 3849, 85:R, Fiscal Note.
[3] Senate Bill 1, 85:R, Article IX, Section 17.11. Estimated to generate $46 million.
[4] Senate Bill 1, 85:R, Article IX, Section 17.12.
[5] Senate Joint Resolution 5, 84:R.
[6] Senate Joint Resolution 5, 84:R.

Finally, the amount of current general revenue funds dedicated to the Highway Fund by 2015's SJR 5 will increase, removing even more money from the stream of general revenues. The dedication of sales tax revenue will reach its cap of $5 billion—an increase of roughly $300 million from the 2018-19 Budget. And in 2020 a new dedication of 35 percent of any motor vehicle sales tax revenue in excess of $5 billion will take effect—at a new cost of roughly $750 million.

All totaled, a likely Medicaid shortfall and the $6 billion from accounting shifts could create a structural gap totaling $8 billion. Fortunately, Texas has billions more than that in reserve in the Economic Stabilization Fund. Budget purse strings may tighten, but most certainly they will not break.

Of course, as always, there is little wrong with the Texas budget that cannot be cured by $80 per barrel oil; but absent that, lawmakers are assured of continual budget difficulties for the foreseeable future.