

STATE BUDGET & TAXATION TASK FORCE: PART I



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Texas Conservative Coalition Research Institute

2021-2022 State Budget and Taxation Task Force

Final Report – Part 1

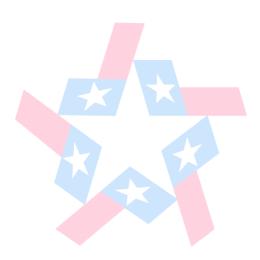


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Introduction I.

To ensure the ongoing fiscal strength of Texas, the 88th Legislature should enact a number of reforms. The TCCRI State Budget and Taxation Task Force Report has been split into two parts.

Part I of this Task Force Report will provide a brief overview of the state's current fiscal condition and then discuss various "structural" reforms intended to achieve the following:

- Strengthen the State's constitutional spending and "pay as you go" limits;
- Place limits on spending by local governments, subject to reasonable exceptions;
- Protect the Economic Stabilization Fund from being used for ongoing obligations;
- Measure the accuracy of fiscal notes used to estimate the financial impact of proposed legislation; and
- Make the budget process more transparent.

Part II of this Task Force Report, published separately, will discuss various proposals to provide tax relief and better tax administration, including a repeal or phase-out the franchise tax, various property tax relief measures, and the state's need to modernize its tax collection policies to address emerging business structures.

II. The State Budget in Perspective

After the worldwide economic downturn caused by governmental responses to the COVID-19 pandemic, the Texas economy rebounded strongly during the first half of the 2022-23 biennium. In January 2023, the Comptroller in his Biennial Revenue Estimate for the 2024-2025 Biennium (BRE) projected an ending general revenue (GR) balance of \$32.7 billion for 2022-2023 biennium, which concludes on August 31, 2023.² But that rosy forecast is subject to the usual caveats; projections of economic growth (or contractions) are always subject to serious doubt. The COVID-19 pandemic and the Russian invasion of Ukraine are recent examples of generally unanticipated events that have dramatic effects on economies and financial markets. Even when economic trends are apparent, such as the rapid spike in inflation that began in 2021, there is still uncertainty in terms of how long the inflation will persist and the proper federal fiscal and monetary policies (if any) to take in response to it.

Before turning to some key data in the BRE, several aspects of Texas' current fiscal picture deserve emphasis. First, the budget surplus at the end of the current biennium, assuming it materializes as

 $^{^2}$ This Task Force Report often refers to the projected carryover GR balance of \$32.7 billion for the 2022-23 biennium as "the budget surplus."



¹ The projected ending GR balance at the end of the 2022-2023 biennium is actually \$45.03 billion, but only \$32.69 billion will carry over to the 2024-2025 biennium due to certain constitutionally-required transfers of portions of the surplus (e.g., to the Economic Stabilization Fund).

projected, will be the largest in state history. The state has never been in a stronger fiscal condition than today.

This observation is qualified somewhat by a second: inflation over the course of the 2022-23 biennium was significant, which means that providing a given level of state services will be more expensive in the 2024-25 biennium than it was in the 2022-23 biennium. That does not mean, however, that the 88th Legislature should start with a budgetary "floor" of state spending that is calculated by simply increasing 2022-2023 biennial spending to reflect recent inflation. The Legislature should always question how past levels of spending can be cut, and Texans in the aggregate should need fewer state services over time as the state grows wealthier.

Third, the 2024-25 biennium will be the first biennium in which Senate Bill 1336 (87R; Hancock, et al.) applies. This landmark legislation imposes a cap on the rate of growth in consolidated general revenue appropriations (defined and discussed in detail further below), with the cap based an average of population growth and inflation during the 2022-23 biennium and the projections for those amounts in the 2024-25 biennium.

Fourth, it is a given that, due to the large surplus, there will be many proposed spending increases in the 88th regular legislation session. It is critical that legislators consider proposals to increase spending (other than spending to finance tax cuts at the local level) with a skeptical eye, in the same manner they would if the state had no surplus at all.

Fifth, if the constitutional spending limit is not exceeded, the state will almost certainly have a significant projected budget surplus at the end of the 2024-25 biennium. If unappropriated, these excess funds will roll over to the 2026-27 biennium, although a portion could potentially flow to the state's Economic Stabilization Fund (the "Rainy Day Fund"). A much better use of that money is appropriating it for tax relief. Even accounting for inflation, the state took in vastly more revenue than it needed during the 2022-23 biennium. Taxpayers were essentially overcharged during the 2022-23 biennium; the focus of the 88th Legislature should be on refunding most of those excess funds to the state's taxpayers.

Finally, the state still has \$3 billion in unspent COVID-19-related federal aid. The federal American Rescue Plan Act (ARPA) of 2021 provided Texas with \$16.3 billion in funds. Senate Bill 8, (87S3; Nelson) appropriated \$13.3 billion of that. Governor Abbott, Speaker Phelan, and Lieutenant Governor Patrick have all said that those remaining funds should be used for property tax relief. Because that money is federal income, it is not subject to the spending limit, or the SB 1336 limit.

III. Key Data from the BRE

As of January 2024, the Comptroller projects that there will be a mild recession in Texas and the U.S. in FY 2023, but that the state will still see average annual real growth of 1.9 percent in gross state product (GSP) in the upcoming biennium. More specifically, the Comptroller projects real growth in GSP of 1.4



percent, 1.2 percent, and 2.6 percent in FYs 2023, 2024, and 2025, respectively. However, the BRE notes the possibility that the Federal Reserve may be forced to tighten monetary policy if inflation persists, in which case the forecasted recession could be more severe.

The Comptroller estimates that there will be \$188.23 billion in general revenue-related (GRR) funds available for general-purpose spending in the 2024-2025 biennium, an increase of approximately 67 percent over the corresponding figure of \$112.5 billion from January 2021. The table below illustrates how this figure compares to balances available for certification in past BREs:

Biennial GR-Related Funds Available for Certification, 2002-2003 through 2024-2025

Biennium	General Revenue-Related Funds Available for Certification in BRE (in billions of dollars)	Percent Change in General Revenue- Related Funds Available for Certification in BRE compared to Previous BRE
2002-03	60.9	n/a
2004-05	54.1	-11.17%
2006-07	64.7	19.59%
2008-09	82.5	27.51%
2010-11	77.1	-6.55%
2012-13	72.2	-6.36%
2014-15	96.2	33.24%
2016-17	113.0	17.46%
2018-19	104.9	-7.17%
2020-21	119.1	13.54%
2022-23	112.5	-5.54%
2024-25	188.2	67.29%

It is important to note that the Comproller's estimate of revenue available for certification that is announced in January of odd-numbered years is subject to later revision, and that the above table reflects projections, rather than revenue that was actually received during the applicable biennium. Nevertheless, the data in the table is noteworthy because it shows the extraordinary jump in funds that are available for discretionary spending by the 88th Legislature. It is a distinct possibility that the state will never again see a percentage increase of 67 percent or more between projections of revenue available for certification in two consecutive BREs.

The total revenue the state expects to receive in the 2024-2025 biennium is \$342.28 billion; however, this figure does not include the carryover budget surplus of \$32.7 billion from the 2022-2023 biennium. The breakdown of that \$342.2 billion is shown by fiscal year below, along with corresponding amounts for FY 2023 for reference:

Table: Sources of All Funds Revenue, FYs 2023 through 2025 (in billions of dollars)





GR-R	80.51	81.12	84.78
Dedicated GR	3.43	3.39	3.52
Federal Income	76.69	57.68	50.68
Other Funds	31.90	30.18	30.93
ALL FUNDS	192.53	172.37	169.91

Two aspects of the above data are striking. First, the state is expected to take in less All Funds revenue in each year of the upcoming biennium than it did in FY 2023. This is attributable to a steep drop in federal income, as COVID-19-related federal aid ceases. Of course, COVID-19-related expenditures should decline dramatically in light of the pandemic fading.

Second, while GR-R is projected to grow in each of FY 2024 and FY 2025, the above table suggests that the explosive growth in biennium-over-biennium (BoB) revenue will not be repeated in the 2024-2025 biennium. The table below, excerpted from the most recent BRE, shows just how strong (BoB) revenue growth was in 2022-2023 as the state's economy rebounded from the COVID-19-related downturn:

Percent Change in State Revenue, by Source and Biennium All Funds, Excluding Trust Funds

	2020-21 Actual	2022-23 Estimated	2024-25 Estimated
TAX COLLECTIONS	Actual	Estillatea	Lotiniated
Sales Taxes	6.3 %	26.9 %	8.7 %
Motor Vehicle Sales and Rental Taxes	5.6	26.5	6.4
Motor Fuel Taxes	(4.0)	6.7	1.8
Franchise Tax	13.2	32.1	6.7
Oil Production Tax	(8.2)	77.4	11.9
Insurance Taxes	6.5	22.5	4.3
Cigarette and Tobacco Taxes	(1.3)	(7.5)	(4.3)
Natural Gas Production Tax	(20.0)	259.7	(4.3)
Alcoholic Beverages Taxes	(10.5)	40.8	8.5
Hotel Occupancy Tax	(22.5)	51.7	11.1
Utility Taxes	10.1	14.1	2.8
Other Taxes	(29.9)	28.4	10.7
Total Tax Collections	3.4 %	33.2 %	7.1 %
REVENUE BY SOURCE			
Tax Collections	3.4 %	33.2 %	7.1 %
Federal Income	71.8	6.7	(27.5)
Licenses, Fees, Fines, and Penalties	(3.0)	4.5	1.8
State Health Service Fees and Rebates	(3.0)	41.6	(25.2)
Net Lottery Proceeds	12.8	11.2	(2.9)
Land Income	(8.2)	100.6	(6.3)
Interest and Investment Income	3.5	20.8	5.2
Settlements of Claims	16.4	(6.7)	(10.4)
Escheated Estates	13.4	26.9	0.0
Sales of Goods and Services	2.1	4.9	(3.8)
Other Revenue	21.3	28.9	14.0
Total Net Revenue	25.8 %	20.4 %	(8.9) %



In short, the good news is that the state has a \$32.7 billion budget surplus due to strong growth in GR during the 2022-2023 biennium as the state rebounded from the effects of the pandemic. Moreover, state revenues should continue to grow in the upcoming biennium. However, policymakers should not expect the type of growth in tax collections that the state saw in 2022-2023 biennium. This underscores how rare the opportunity is to oversee a budget surplus of such magnitude, and how important the 88th Legislature's decisions will be for the future of the state.

Taking the steps outlined in Parts I and II will ensure that government in Texas operates within its proper scope. But above all else, the Legislature should prioritize property tax relief. Although reforms in recent years have significantly restrained growth in property taxes, the state still has a high property tax burden relative to other states. Given the state's strong financial condition and its surplus revenue, it should return significant tax revenue to Texans. The Legislature should devote, at a minimum, half of the \$32.7 billion surplus to property tax relief. As discussed in this Task Force Report, the optimal way of delivering this relief is for the state to "buy down" school district maintenance and operations tax rates; essentially, the state compresses these tax rates and then reimburses school districts for the forgone revenue.

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IV. The Constitutional Spending Limit

As discussed in a later section of this Task Force Report, Texas' current constitutional spending limit will play an even more important role in the 88th Session than it usually does. This section of the report, however, focuses only on how the constitutional spending limit can be strengthened generally. That limit, contained in Article VIII, Section 22 of the Texas Constitution, provides that:

In no biennium shall the rate of growth of appropriations from state tax revenues <u>not</u> <u>dedicated</u> by this constitution exceed the estimated rate of <u>growth of the state's</u> economy.³

The constitution grants the Legislature authority to provide statutory guidance to facilitate implementation of the spending limitation. Under this guidance, the rate of growth of the state's



economy is calculated by the Legislative Budget Board (LBB) by "dividing the estimated Texas total personal income³ for the next biennium by the estimated Texas total personal income for the current biennium."

The constitutional spending limit is an important restraint on the growth of state government. It does, however, have the following shortcomings:

- 1. The limit applies only to non-dedicated state tax revenue, rather than *all* general revenue of the state.
- 2. The limit applies only to state spending, not local government spending.
- 3. The limit may be overridden by a simple majority vote of the Legislature if it finds that an emergency exists.
- 4. The limit is based on an *estimate* of future personal income growth, and these estimates have traditionally been subject to significant margins of error.

As discussed in detail below, Senate Bill 1336 (87R; Hancock, et al.) makes tremendous progress towards a stronger spending limit. Before turning to that bill's details, each of the above shortcomings in the constitutional spending limit s first discussed.

A. All General Revenue Versus Dedicated General Revenue

The first major weakness of the state's current constitutional spending limit is that it applies only to state tax revenues not dedicated by the Texas Constitution. Thus, millions of dollars in GRR from non-tax collections are not subject to the limit. In the July 2022 revised Certification Revenue Estimate, the Comptroller estimated that \$18 billion of GR-R will be from non-tax collections (e.g., from fees). In addition, there are numerous constitutional dedications of state tax revenue that are exempted from the current spending limit, including those to the State Highway Fund and to the Foundation School Program. For the 2022-23 Biennium, an estimated \$9.74 billion in appropriations were financed by state tax revenue dedicated by the constitution. Leaving aside the considerable magnitude of this dedicated revenue, the spending limit is phrased in a manner that is not transparent. As the Senate Finance Committee pointed out in an August 2020 interim report, the spending limit could be simplified by phrasing the amount subject to the spending limit to mirror the ways in which funds are discussed in the budget (GR, GR-Dedicated, Federal Funds, Other Funds, and All Funds).

For a constitutional spending limit to be effective, it is critical that it apply to both GR and GR-Dedicated spending at the very least. Doing so would be a significant change that would enhance the state's

³ The Legislative Budget Board relies on the U.S. Bureau of Economic Analysis' definition of "personal income", which consists of "the income that...residents get from paychecks, employer-provided supplements such as insurance, business ownership, rental property, Social Security and other government benefits, interest, and dividends," but not capital gains. See https://www.bea.gov/resources/learning-center/what-to-know-income-saving.



spending limit. A spending limit that does not apply to all state funds can be circumvented and will always be a less than optimal restraint on the growth of state spending.

B. No Limit on Local Government Spending

Texas' current constitutional spending limit applies only to certain aspects of state spending; it does not impose any limit on local spending. The arguments for capping state spending by reference to population growth and inflation which are discussed below apply with equal force to local government spending.

An indication that spending at the local level in Texas has become problematic and that local governments are living beyond their means is the growing aggregate debt burden of local governments in Texas. In June 2015, the Comptroller released a 50 State Scorecard showing Texas's rankings in various categories; the state ranked 3rd worst in terms of local debt per capita. As of August 31, 2022, the combined local debt in Texas was \$284.2 billion a per capita burden of approximately \$9,462 per resident. Furthermore, these numbers do not take into account the interest that will be paid on that \$284.2 billion in principal.

Table 5: Texas Local Government Debt by Year

Table 5. Texas Local Government Best by Tear						
As of Fiscal Year End	Local Debt Outstanding (in billions)					
2007	\$141.4					
2008	\$160.3					
2009	\$174.6					
2010	\$183.8					
2011	\$192.7					
2012	\$195.8					
2013	\$200.3					
2014	\$205.3					
2015	\$212.4					
2016	\$218.5					
2017	\$218.0					
2018	\$230.0					
2019	\$240.0					
2020	\$251.8					
2021	\$266.4					
2022	\$284.2					

Source: Texas Bond Review Board Annual Reports on Local Debt

⁴ Using an estimated state population of 30,029,572 as of July 1, 2022, per U.S. Census estimates. See https://www.texastribune.org/2022/12/22/texas-population-growth-30-million-census/.



As Table 5 above shows, at the end of fiscal year 2007, the total debt held by Texas local governments was \$141.4 billion. Over the ensuing 15-year period, local governments more than doubled that, increasing their debt by a net of \$143 billion. That increase alone is vastly greater than the state's total outstanding debt of \$64.4 billion as of August 31, 2022. This substantial increase in local government debt is striking because Texas's economy experienced solid growth of 4.73 percent annually from July 1, 2007 to July 1, 2022. Despite this growth, local governments still felt compelled to borrow to finance their spending. Relying on the most recent data from the U.S. Census Bureau (census year 2019), the Bond Review Board stated in its 2021 annual report that, among the ten most populous states, Texas ranks third in local debt per capita, trailing only California and New York.

The excessive borrowing of local governments in Texas is especially concerning given the growth of property taxes in Texas in recent years. While borrowing may allow local governments to temporarily prevent property taxes from rising at an even greater rate, paying down principal of many billions of dollars in addition to the interest on that amount inexorably puts upward pressure on property taxes, which are easily the most significant revenue source for local bond repayment. The Bond Review Board's 2022 annual report indicated that \$186.7 billion of the \$284.2 in outstanding local debt is scheduled to be paid back with tax revenue (the remainder is attributable to alternatives such as revenue bonds, which are repaid with revenue generated from projects, such as water and utility fees). As noted elsewhere in this Task Force Report, the Legislature passed significant property tax relief in the 86th Session, which slowed the rate of growth of maintenance and operations (M&O) property taxes imposed by local governments. However, growing local debt is still a concern because much of it is repaid through interest and sinking (I&S) property taxes, not M&O property taxes.

Implementing a limit on spending by local governments could be accomplished by a simple statutory change. Recognizing the threat of excessive spending by local governments, Senate Bill 18 (85S1, 2017) proposed to limit local government spending by reference to population growth and inflation. Under the bill, a local government could exceed its spending limit only if the voters approved the excess spending or if the governor declared the area governed by the local government a disaster area. Importantly, the spending limit would not have applied to funds raised by voter-approved bonds, or to a gift, donation, or grant to the local government. Although it was not enacted into law, the bill struck the correct balance between fiscal prudence and flexibility.

While critics of spending limits are sure to complain that they place local governments in desperate fiscal positions, there is ample evidence that voters are willing to provide authorization to spend. For example, in November 2022, 139 of 212 bond election propositions, or about 65 percent, "carried" (i.e., were approved by voters). The approved new debt totaled \$19.3 billion. A 65 percent passage rate suggests that voters are willing to approve new local debt if local governments can make a reasonable case for it.

C. Low Bar to Override the Spending Limit



As noted above, the constitution also authorizes the Legislature to override the current spending limitation by a simple majority vote, provided that it is a record vote and that the Legislature finds that an emergency exists. ¹⁴ Although this provision has been exercised only once, it renders the existing spending limit a virtually meaningless "safeguard" against higher spending. Any budget passed by the Legislature already requires a majority vote in each house. Thus, a Legislature that collectively wishes to pass a budget which exceeds the spending limit simply faces a voting hurdle identical to the one it would face if the proposed budget were within the constitutional spending limit.

To address this shortcoming, the constitution should be amended to require a three-fifths vote requirement to override the spending limit. This change would require 90 affirmative votes in the House and 19 in the Senate to override the constitutional spending limit. A precedent for this is set by the constitutional requirements for appropriating funds from the Economic Stabilization Fund; the Constitution establishes a three-fifths requirement (Art. III, 49-g, (k)) to appropriate ESF monies to address a current biennium shortfall.

D. Shortcomings of Basing the Current Constitutional Limit on Personal Income Growth

Perhaps the most critical flaw in the current constitutional limit on state spending is the manner in which it is calculated. Under current law, prior to a legislative session, the LBB adopts the constitutional spending limit that will be enforced for the upcoming biennium based on projections of personal income growth. It should be noted that the estimates of personal income growth frequently differ from actual income growth, and sometimes wildly so (see chart below)

More broadly, it should be obvious that personal income is not a sensible basis for a state spending limit: as personal income (wages, salaries, investment income, etc.) increases, the "need" for government services and assistance programs should decrease along with the spending on those programs. A spending limit that is functionally based on personal income growth assumes that state spending should continue to grow even as Texans become better-off. State spending and personal income should have an inverse relationship - not a direct one, as Texas' current spending limit does.

A far more reasonable approach to defining a constitutional spending limit is to base the limit on a population growth and inflation formula. At the simplest level, this would allow the state to continue to provide current services even as the state's population grows. Most importantly, in times of economic surplus, state spending could not exceed this "current services" standard. Conversely, whenever population growth slows (or even declines), state spending would have to be reigned-in accordingly.

A comparison of Texas' population growth plus inflation against actual and estimated personal income growth underscores the point that the population plus inflation measure is consistently the more conservative option and would therefore be the more effective type of spending limit. Table 6 and the



accompanying graph below show the estimated and actual biennial rates of growth in personal income over the last several biennia, as well as corresponding population plus inflation growth.⁵

Table 6: Biennial Adopted and Actual Rates of Personal Income Growth and Population Plus Inflation, 1996-97 to 2024-2025

Biennium	Percent Growth in Adopted Personal Income	Percent Growth in Actual Personal Income Growth	Percent Growth in Population + Inflation*
1996-97	13.98	15.59	9.01
1998-99	11.12	17.04	7.49
2000-01	13.44	15.37	13.04
2002-03	14.09	6.84	7.64
2004-05	11.83	9.89	10.06
2006-07	11.34	18.39	10.62
2008-09	13.11	11.87	7.20
2010-11	9.14	6.46	8.57
2012-13	8.92	14.3	6.72
2014-15	10.71	10.51	5.63
2016-17	11.68	4.45	6.54
2018-19	8.00	13.14	6.74
2020-21	9.89	11.37	8.77*
2022-23	7.06	-	-
2024-25	12.33		-

Sources: Legislative Budget Board, 15 except as otherwise noted in the asterisked note immediately below.

Sources: Legislative Budget Board,¹⁶ except as otherwise noted in the asterisked note immediately below. *Population plus inflation for 2020-21 was calculated based on U.S. Census population estimates as of July 1, 2019 and July 1, 2021, and inflation data from September 2019 and September 2021.

"-" signifies data is not yet available.

14.

^{*}Population plus inflation for 2020-21 was calculated based on U.S. Census population estimates as of July 1, 2019 and July 1, 2021, and inflation data from September 2019 and September 2021.

⁵ Although the phrase "population plus inflation" is sometimes used in this Task Force Report, calculating population plus inflation actually involves multiplication. The calculation for determining population and inflation growth is [(1 + change in population rate during previous biennium) * (1 + change in inflation during previous biennium)] - 1.



Source: See table immediately above and sources cited therein

From the 1996-1997 biennium through the 2020-21 biennium (inclusive), a population and inflation limit averaged 8.3 percent per biennium, while the average limit using estimated personal income growth averaged 11.3 percent per biennium- approximately 36 percent higher. The wide variation between the adopted spending limit and *actual* personal income growth (i.e., the difference between the blue and orange lines in the graph above) is also noteworthy. The data shows that actual biennial personal income growth over that same period is very volatile, vacillating wildly from high of 18.4 percent to a low of 4.5 percent. Forced to deal with this unpredictability, LBB frequently adopted spending limits both far below and far in excess of actual personal income growth. For example, the estimated personal income growth rates for the 2002-03, 2016-17, and 2018-19 biennia were 14.1 percent, 11.7 percent, and 8.0 percent, respectively. However, the corresponding *actual* growth rates were dramatically different: 6.8 percent, 4.4 percent, and 13.1 percent, respectively. In contrast, the population and inflation metric is considerably more stable, generally staying in a narrower band between 6 and 11 percent for each biennium.

E. Senate Bill 1336: A Landmark Reform

In 2021, the Texas Legislature enacted Senate Bill 1336 (87R; Hancock, et al.), which made critically-important strides in strengthening the spending limit. The bill imposes a statutory limit on the rate of growth in state appropriations of "consolidated general revenue" (CGR). CGR encompasses the general revenue fund in the state treasury, any dedicated fund within the general revenue fund, and any general revenue-related (GRR) fund. GRR funds include the Available School Fund, the State Technology and Instructional Materials Fund, the Foundation School Account, and the Tobacco Settlement Account.¹⁷



The limit on the rate of growth in CGR appropriations in a given biennium under SB 1336 is based on (a) the average of the estimated population growth in the state in that biennium and the preceding biennium, and (b) the average of the estimated growth in inflation in the state during that biennium and the previous biennium. The limit does not apply to appropriations made for tax relief or to pay for costs arising from a disaster. In addition, the limit can be exceeded at any time if each chamber of the Legislature finds by a three-fifths vote that an emergency exists and that the limit should be exceeded.

It is difficult to overstate the importance of SB 1336. The bill was a landmark accomplishment for conservatives in their struggle to ensure that the principle of limited government is followed in Texas. The bill's limit on the rate of growth in CGR appropriations addresses all of the shortcomings of the constitutional spending limit that are listed above on page 9 of Task Force Report, except for point 2; the bill does not impose any limit on the rate of growth in spending by local governments.

But work remains for conservatives on the issue of a spending limit. SB 1336 is a *statutory* limit, not a constitutional limit. A constitutional limit is stronger and more firmly established because eliminating such a limit (through a constitutional amendment) would require both approval by the voters as well as a two-thirds vote in each chamber of the Legislature. It may be tempting for conservatives to rely on the protection of SB 1336, but nothing prevents a majority in a future legislature from repealing the provisions of SB 1336. Therefore, conservatives should not be content with SB 1336, but rather should continue to push for a constitutional amendment which effectively places the provisions of SB 1336 in the constitution.

The Legislature recently confronted a similar situation with respect to the state's prohibition on a state income tax. Prior to the 86th Legislature, then-Article VIII, Section 24 of the Texas Constitution authorized the Legislature to enact a personal income tax, with the qualification that doing so required the approval of voters in a referendum. Under that provision, a majority of the Legislature could impose a state income tax as long as a majority of state voters agreed. Although the imposition of an income tax was not popular at that time (or now), Governor Abbott presciently called for the Legislature to draft a constitutional amendment that would forbid the imposition of a state income tax. Such an amendment would mean that a future legislature could enact a personal income tax only with a subsequent constitutional amendment, which would require both the approval of voters and a two-thirds vote in each chamber of the Legislature (as opposed to a simple majority in each chamber, as under pre-2019 law). House Joint Resolution 38 (86th; Rep. Leach, et al.) passed the Legislature and was approved by voters as Proposition 4 in November 2019.

There is some similarity between the state's lack of an income tax as of early 2019 and the current spending limit under SB 1336: as things stood in early 2019, a future legislature, with a simple majority vote, could push for a state income tax (although enacting one would also require the approval of voters). The state's policymakers wisely raised the bar to the imposition of a personal income tax by amending the constitution. By comparison, a future legislature could repeal SB 1336 with a simple majority vote, without needing any approval from voters to do so. In short, politicians opposed to



limited government have an easier path to overturning the spending limit of SB 1336 than they did in seeking a personal income tax prior to 2019. The 88th Legislature should exercise the same foresight regarding the current statutory spending limit under SB 1336 that the 86th Legislature did with regarding a personal income tax, and permit voters to enshrine the provisions of SB 1336- supplemented by a limit on the rate of growth in spending by any local government- in the constitution. Passing the necessary House or Senate joint resolution would be challenging but not impossible; in 2019, SB 1336 received a vote of 87-60⁶ in the House and 19-12 in the Senate.

Aside from enshrining the limits of SB 1336 in the constitution, the Legislature should seek another amendment to the constitution: imposing a limit on the ability of local governments to take on debt. The state is subject to four different constitutional spendings limits: the "pay-as-you-go" or balance budget limit (discussed below); the spending limit (discussed above); the limit on tax-supported debt; and the limit on welfare spending.¹⁸

The limit on tax-supported debt, found in Article III, Section 49-j, prohibits the Legislature authorizing state debt if, in any fiscal year the resulting maximum annual debt service paid out of the General Revenue Fund, excluding revenues that are constitutionally dedicated to purposes other than payment of state debt, would exceed 5 percent of the average annual unrestricted General Revenue Funds for the previous three years.

The joint resolution that led to the debt limit constitutional provision was House Joint Resolution 59 (75R; 1997). In its analysis of that resolution, the House Research Organization (HRO) summarized one argument of the supporters:

Statutory debt restrictions provide little protection against rising debt, because the Legislature can simply raise the debt limit when it wants to borrow more money. There is no guarantee that the Legislature will not incur excessive debt. The federal government and federal budget deficit provide a prime example of the historical and political tendency to take care of today's problems by spending tomorrow's revenues. Excessive debt impinges on the ability to fund current government operations.¹⁹

The point about the federal debt seems even more persuasive now. At the end of the 1997 fiscal year, federal debt was roughly \$5.4 trillion. Today, 25 years later, it is over \$30 trillion.²⁰

A limit on the debt issued by any local government entity could be phrased in terms of the taxable value of property within the local government entity's boundaries. For example, the Washington constitution imposes a cap on tax-supported (i.e., payable from property taxes), non-voter-approved debt equal to 1.5 percent of taxable values. If three-fifths of voters approve, the limit on total debt is increased to 5 percent of taxable values. Cities and school districts are permitted to issue debt of up to 10 percent of

⁶ The full tally was 87 Ayes, 60 Nays, and 1 Present Not Voting. This tally reflects the journal entries made by several representatives to correct their initial, mistaken votes.



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taxable values in certain circumstances.²¹ Notably, these constitutional caps in Washington are often supplemented by stricter statutory caps.²²

Texas could apply a similar cap to local debt. While critics would undoubtedly argue that such a provision would prevent local governments from adapting to changing circumstances or responding to a future crisis, such a provision could easily be drafted to afford flexibility. First, taxable values within local governments' boundaries will grow over time, thus giving local governments the ability to issue more debt as inflation and population grow. Second, allowances or adjustments could be made for:

- Disaster situations;
- Debt which is approved by a supermajority (perhaps two-thirds) of local voters;
- Local government entities with small populations. Such entities might have to make capital expenditures which do not scale as well as they might for larger local governments.
- "Grandfathering" to ensure that any local government currently over the proposed constitutional limit would not have its tax-funded capital improvement projects interrupted.

The table below lists the taxable values within some of Texas' largest counties and school districts and the current outstanding debt of those units.

Local Government Entity	2021 Taxable Property Value in the Entity (rounded to nearest billion dollars)	Principal of Debt as of August 31, 2021 (rounded to nearest million dollars)	Interest to be Paid on Debt as of August 31, 2021 (rounded to nearest million dollars)	Principal + Interest as a Percent of Taxable Value	
Haveter ICD	107.53	2.645	1 100	4 000/	
Houston ISD	197.52	2,615	1,106	1.88%	
Austin ISD	152.56	1,492	561	1.35%	
Dallas ISD	141.45	3,260	1,296	3.22%	
Fort Worth ISD	44.48	1,250	494	3.92%	
San Antonio ISD	22.07	1,245	687	8.75%	
El Paso ISD	17.69	936	604	8.71%	
Harris County	525.99	3,575	1,771	1.02%	
Travis County	267.20	1,055	334	0.52%	
Dallas County	336.80	117	28	0.04%	
Tarrant County	238.90	214	39	0.11%	
Bexar County	197.03	2,232	1,249	1.77%	
El Paso County	52.09	138	36	0.33%	

Sources: For taxable values, the Comptroller.²³ For debt numbers, the Bond Review Board.²⁴

The above table shows a striking range in the debt burdens of the listed counties and school districts. There are a few limitations to the data. First, the taxable value figures are not official data from the Comptroller. Second, the debt figures include debt of all types, not just tax-supported debt. Third, the



debt as a percentage of taxable values (DAPTV) includes scheduled interest, which arguably should be disregarded or at least discounted to reflect the time value of money.

The school districts in the table above clearly tend to have much higher DAPTV figures than counties do. A system similar to Washington's could be used, in that school districts are permitted to have higher DAPTV figures than other local government entities.

1. <u>Policy Recommendation</u>: Strengthen the State's Constitutional Spending Limit

Texas' constitutional spending limit should be strengthened and supplemented in order to address its fundamental shortcomings. This requires four key reforms: (1) apply the spending limit to all general revenue (including dedicated general revenue) and GRR; (2) impose a spending limit on local governments, with exceptions relating to disasters, gifts, donations, and voter-approved bonds and tax increases; (3) require a three-fifths vote of the legislature to override the state spending limit, and (4) use changes in population and inflation (rather than personal income growth) as the basis for both local and state spending limitations.

Senate Bill 1336 addresses all of the above shortcomings except for the limit on local spending.

2. <u>Policy Recommendation</u>: Exempt tax relief spending from spending limits

The Legislature should adopt a joint resolution that, if approved by voters, would enshrine the provisions of SB 1336 in the state constitution, including the provision that exempts state spending to finance tax relief from the limit.

3. <u>Policy Recommendation</u>: Limit local spending based on population and inflation

The Legislature should adopt a joint resolution that, if approved by voters, would limit the rate of increase in annual spending by a local unit to population plus inflation growth. Exceptions would be made for disaster situations and for proceeds from voter-approved bonds that comply with the policy recommendation immediately below. If adopting a joint resolution is not feasible, then consider a statutory cap, as in Senate Bill 18 (85S1).

4. <u>Policy Recommendation</u>: Limit local government debt based on property value



The Legislature should adopt a joint resolution that, if approved by voters, would prohibit local governments in Texas from issuing tax-supported debt in an amount that exceeds a certain percentage of the taxable value of property within their boundaries. Exceptions could be made for disasters, for grandfathering, and for bonds approved by two-thirds of local voters. In addition, school districts could be permitted to carry a greater debt load than other local government units.

In all cases, provisions holding harmless parties affected by tax cuts should not count towards any spending limit (see "A note on exempting tax cuts from the above policy recommendation").

A note on exempting tax cuts from the above policy recommendation:

The Legislative Budget Board has made clear that, generally, tax cuts do not count toward the constitutional spending limit: "It is important to note that a piece of legislation resulting in a tax cut simply reduces revenue and is not an appropriation of any kind." However, appropriations that are made to hold certain entities or funds harmless from the effects of such tax cuts *are* currently subject to the spending limit. These types of appropriations are typically made in relation to property tax relief and would also have to be made in the event of significant franchise tax relief in the future. As the LBB pointed out:

A franchise tax cut would reduce franchise tax revenues deposited into and appropriations from the Property Tax Relief Fund. Reducing appropriations from the Property Tax Relief Fund, in isolation, would reduce appropriations subject to the spending limit. However, school funding formulas would shift the appropriations, equaling the amount of the shortfall, from the Property Tax Relief Fund to the General Revenue Fund. The resulting General Revenue Funds appropriation would count against the spending limit to the extent that it is financed with tax revenue that is not dedicated by the constitution.²⁶

It may be appropriate to exempt these types of appropriations from the state's constitutional spending limit since they are only necessary in order to ensure that the Legislature can meet its obligations while also providing tax relief. In the case of the franchise tax, for example, taxpayers should not be denied tax relief if the Legislature continues to meet its public education obligations.

However, it is important to acknowledge that exempting such appropriations from the spending limit may create the impression that <u>only</u> funds collected in excess of the spending limit should be used for tax relief. Indeed, a provision of this type may invite the temptation to use all GR below the spending limit *only* on government services and programs. There was a glimpse of this in the 83rd Session in the water debate. While the Legislature ultimately made the decision to tap the Economic Stabilization Fund to pay for water development projects, it remains true that there was ample revenue for water projects under the spending limit in the early stages of the budget process. Instead, revenue below the cap was used for other areas of the budget, forcing the issue of using the ESF to fund water projects. The same



pressures led to the passage of a constitutional amendment to partially fund transportation from revenue diverted before being deposited in the ESF rather than from available general revenue.

F. The "Pay as You Go" Limit and the Problem of GR-Dedicated Funds

Article 3, Section 49a(b) of the Constitution contains the state's "pay as you go" spending limitation. This limitation reads: "[Subject to certain exclusions] . . . no appropriation in excess of the cash and anticipated revenue of the funds from which such appropriation is to be made shall be valid." The Comptroller, through the Biennial Revenue Estimate released near the beginning of a regular legislative session, certifies the general revenue available to the state for the upcoming biennium. General revenue accounts include the state's main general revenue account, into which all non-dedicated tax collections are deposited.

General revenue accounts also include approximately 170 other accounts which are funded by certain taxes and fees, the revenue from which is dedicated to specific purposes. Commonly known as "general revenue-dedicated accounts," these accounts may receive revenues from a variety of sources, which are typically linked to the purpose of the fund. For instance, the Game, Fish, and Water Safety account (Account # 0009) is funded with revenue from sources such as fees for licenses and permits regarding game and fish; fines for violation of laws pertaining to wildlife protection and conservation; fees for oyster bed rentals and permits; and proceeds from the sale and lease of grazing rights.²⁷

The balances in these general revenue-dedicated accounts often have a surplus. These surplus balances are taken into account by the Comptroller in his certification of general revenue available for a given biennium. Through a process known as "funds consolidation," *general revenue-dedicated* accounts can be consolidated, and their total collective balance may be applied toward certifying that the state budget does not exceed available revenue. This funds consolidation poses two related problems.

The first problem with funds consolidation is that it creates an incentive for the Legislature to leave balances in general revenue-dedicated accounts so that they can be used to certify that the state budget is within available general revenue. When policymakers go through the often-contentious process of ensuring that appropriations do not exceed projected revenue in an upcoming biennium, the unappropriated amounts in general revenue-dedicated accounts swell the projected revenue. This allows the Legislature to spend more than it would otherwise be authorized to spend. As former House Speaker Joe Straus stated in 2012: "The practice of 'funds consolidation' has evolved from a one-time accommodation and turned into a decades-long bad habit in our state's budget process." 28

As a result of the incentive the Legislature has in allowing unappropriated balances in general revenuededicated funds to grow, large balances have accrued in many general revenue-dedicated accounts. One fund alone, the Texas Emissions Reduction Plan (TERP) account, is projected to have a \$2.18 billion



balance by the end of the 2022-23 biennium.²⁹ Aside from the TERP, the next largest fund balances in the most recent report are, in descending order:

- Clean Air (\$315.9 million);
- Employment Training and Investment Holding (\$222.3 million);
- Texas Department of Insurance Operating (\$179.9 million);
- Game, Fish, and Water Safety (\$159.2 million);
- Texas B-On Time Student Loan (\$142.4 million);
- Oil and Gas Regulation and Cleanup (\$141.7 million);
- Solid Waste Disposal Fees (\$140.2 million).

Table 7 below illustrates the extent to which funds consolidation has grown over the past two decades:

Table 7: General Revenue Dedicated Accounts and Balances Used for Budget Certification (in billions)

72nd Legislature, 1991	\$0.54
73rd Legislature, 1993	\$0.94
74th Legislature, 1995	\$1.31
75th Legislature, 1997	\$1.14
76th Legislature, 1999	\$1.34
77th Legislature. 2001	\$1.63
78th Legislature, 2003	\$2.20
79th Legislature, 2005	\$2.75
80th Legislature, 2007	\$3.08
81st Legislature, 2009	\$3.67
82nd Legislature, 2011	\$4.95
83rd Legislature, 2013	\$4.17
84th Legislature, 2015	\$3.48
85th Legislature, 2017	\$5.30
86th Legislature, 2019	\$5.76
87 th Legislature, 2021	\$5.65
CUMULATIVE TOTAL	\$47.91

Source: Texas Comptroller of Public Accounts³⁰

The "cumulative total" line in the above table is of great importance. This cumulative total to some extent double counts (or triple counts, or even more) the same unappropriated funds in a given general revenue-dedicated account that are carried forward from one biennium to the next. Nevertheless, irrespective of any double counting, the \$47.91 billion total is not an overstatement. This has allowed the Legislature to make much higher appropriations than it otherwise would have been able to make. A



simple example illustrates this effect: suppose that a general revenue-dedicated account has unappropriated funds of \$1 million. Over the course of five biennia, that \$1 million is not appropriated, and is not decreased or increased in any way. Even though it is only \$1 million, the fact that it is used to certify general revenue in five separate biennia means that it authorized the Legislature to increase total spending over that period by \$5 million.

The second problem with funds consolidation is that using general revenue-dedicated funds for budget certification creates serious transparency and accountability concerns. Dedicated revenue should be used for the purpose for which it was raised and for which the public was led to believe it would be used. If the state continuously has an aggregate surplus in its general revenue-dedicated amounts, it is essentially an admission that the taxes and fees which generated this surplus were unnecessarily high.

A detailed examination of any of these accounts illustrates the point. The Solid Waste Disposal Fees fund (SWDFF), for example, is authorized by Chapter 361 of the Health & Safety Code, which aims to "safeguard the health, welfare, and physical property of the people and to protect the environment by controlling the management of solid waste." The Texas Commission on Environmental Quality (TCEQ) raises revenue by imposing a fee on solid waste that is disposed of in the state. For example, landfill operators must pay a fee of 94 cents per ton of waste. Under current statute, the revenue from these fees is bifurcated; 66.7 percent goes to "municipal solid waste permitting programs, enforcement programs, and site remediation programs, and to pay for activities that will enhance the state's solid waste management program." The remaining 33.3 percent is dedicated to the SWDFF to fund "local and regional solid waste projects consistent with regional plans approved by [TCEQ]." **

Charging a small fee to better manage the disposal of waste and promote the health of the public and the environment sounds like excellent policy when described at a general level. But the wisdom of charging fees for solid waste disposal *at their current level* is much more questionable when looking at the history of the SWDFF. The biennial report to the 80th Legislature estimated an ending balance of \$76.2 million in the SWDFF. Since then, the SWDFF has ended each biennium with a significant balance after accounting for revenue into the fund and appropriations out of it- usually an ending balance of well over \$100 million. It is one thing for the state to have unexpectedly strong revenue in a year, which can create a surplus in a given GRD account. But when a GRD account is carrying very significant balances year after year, taxpayers have the right to ask: why are we paying taxes and fees for a specific purpose when the government is essentially hoarding money (raised through previous fees and taxes) that was supposed to be spent on that purpose? Taxpayers have a right to demand: either spend the dedicated revenue to achieve the goals for which it was raised, or cut the taxes and fees that are generating the revenue.

⁷ That is not to say that the problem did not exist before the 80th Legislature; rather, the Comptroller's reports on dedicated funds only go back to the 80th Legislature: https://comptroller.texas.gov/transparency/reports/use-of-general-revenue-dedicated/.



Due to concerns about the problems of funds consolidation, there has been some effort in recent legislative sessions to reduce the state's reliance on balances in dedicated accounts to certify the budget. The 83rd Legislature enacted House Bill 7 (83R, 2013), which directed the Legislative Budget Board and the Comptroller of Public Accounts to review the funds consolidation process and legislative dedications of revenue. The 83rd Legislature also reduced reliance on dedicated accounts by almost \$800 million compared to the previous budget, while the 84th Legislature reduced that reliance by another \$700 million. Unfortunately, as Table 7 above illustrates, that mini-trend reversed course in the 85th Session, with the \$5.76 billion mark for the 86th Session being the all-time high.

The 84th Legislature also considered a resolution authored by Rep. Darby (HJR 111, 84R) that should be pursued again. HJR 111, which passed the House unanimously but was left pending the Senate Committee on Finance, would have amended the Constitution to prohibit:

- The Comptroller from using funds in general revenue-dedicated accounts for budget certification beginning with the 2022-23 biennium;
- The Comptroller from including funds in general revenue-dedicated accounts in the preparation
 of the Biennial Revenue Estimate for all or part of a state fiscal year beginning after September
 1, 2016; and
- An appropriation from a general revenue-dedicated account being made for a purpose other than that for which the revenue was collected, unless the revenue or account dedication is repealed.

Finally, the 86th Legislature passed House Bill 3745 (2019) into law, which modified the administration of the TERP account. The bill extended the fees and surcharges which fund the TERP account, but provided that those funds will be deposited in an account outside of the state treasury beginning in FY 2022. The Texas Commission on Environmental Quality (TCEQ) oversees this account, and appropriations can be made from it for dedicated purposes only and without legislative appropriation.

1. <u>Policy Recommendation</u>: Prohibit the Use of Statutorily Dedicated Accounts for Budget Certification

Prohibiting the practice of funds consolidation is a critical reform that will restore truth-in-budgeting. Dedicated accounts should be used only for their intended purpose- not to grow the state budget. Expressly prohibiting the use of statutorily-dedicated accounts for budget certification in the constitution would be the most effective way to end the funds consolidation process. This would improve the transparency of the state budget and would ensure that statutorily-dedicated accounts are used only for their intended purpose. If the use of these balances for funds consolidation were prohibited, the Legislature would have to appropriate the balances in these funds to their dedicated purposes over time, since retaining a balance in these funds would no longer serve a broader budgetary purpose.



Furthermore, each tax or fee imposed by the state should be set at a rate that sufficiently meets the needs of the purpose for which it is being collected, lowering the unnecessary burden on taxpayers. Since many GR-D accounts currently hold a large aggregate balance, it is clear that many of the associated taxes and fees are higher than what is necessary for the accounts to achieve their intended purposes. The House Ways and Means Committee and the Senate Finance Committee should undertake a review, engaging with industry stakeholders and the general public, to establish appropriate fees and tax rates as part of the process of ending the practice of funds consolidation.

Given the often-fierce debates over how best to appropriate state funds, reforming the manner in which GRD accounts are used in the budget certification process is most feasible when the state has a large budget surplus, as it will in the 2024-2025 biennium. As the LBB acknowledges, "The extent to which the Legislature implements measures to reduce reliance on these [GRD] balances [to certify the budget] should consider the prevailing fiscal conditions." The 88th Legislature should seize the opportunity and make the necessary changes.

V. The Economic Stabilization Fund (The "Rainy Day" Fund)

The Economic Stabilization (Rainy Day) Fund (ESF) was created after its approval by voters in the November 1988 constitutional amendment election. Article III, Section 49-g of the Texas Constitution establishes four sources of revenue for the ESF:

- 50 percent of any unencumbered general revenue (GR) balances on the last day of a biennium;
- 37.5 percent of oil and natural gas production tax revenues in excess of what those taxes generated in the fiscal year ending August 31, 1987 (\$531.9 million for oil and \$599.8 million for gas³⁶);
- Interest earned on the balance of the Fund; and
- Any additional amounts appropriated directly to the ESF by the Legislature.

The Constitution directs the Comptroller to calculate and deposit these revenues into the ESF; however, deposits to the ESF balance in a given biennium do not take place if the ESF balance reaches a figure that is equal to ten percent of deposits (subject to certain exclusions) to general revenue in the previous biennium.^{37 8} In this case, the funds that otherwise would be deposited to the ESF instead remain in the general revenue fund. The limit for the 2024-2025 biennium is \$26.38 billion,³⁸ up from the limit of \$20.26 billion in the 2022-23 biennium.³⁹

While there is no minimum required balance for the ESF, oil and gas tax revenue that would otherwise flow into the State Highway Fund (SHF) is directed to the ESF if the ESF falls below a "sufficient

⁸ For this purpose, "general revenue" includes a significant amount of the federal income received by the state.



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balance."⁹ The sufficient balance for ESF purposes is equal to seven percent of the certified GR-related appropriations made for that state biennium.⁴⁰ For the 2022-23 biennium, that figure was \$8.26 billion.⁴¹ As discussed below, the Comptroller projects that the constitutional limit on transfers to the ESF will (absent any appropriations from the ESF) come into play in the 2024-2025 biennium; as a result, the sufficient balance for that biennium will not be relevant.

Senate Bill 69 (86R; Nelson) made two important changes to how the ESF is administered. First, the sufficient balance of the ESF for a given biennium, starting with the 2022-23 biennium, was no longer be set by a legislative committee, but rather is equal to seven percent of the certified general revenue-related appropriations made for that biennium. Second, SB 69 greatly expanded the ability of the Comptroller to invest a portion of the ESF as a prudent investor would, which will help the fund at least keep pace with inflation. As the Comptroller stated in 2017, the pre-SB 69 guidelines for investing the ESF were so cautious and restrictive that they led to investing the fund in a manner akin to "burying the money in a hole on the Capitol lawn." In contrast, SB 69 permits the Comptroller to invest up to three-quarters of the ESF in accordance with the prudent investor standard. The remainder will be invested in safe, liquid investments to ensure the state can tap the fund as needed. Over time, SB 69 should yield hundreds of millions of dollars in additional revenue for the state and ensure that the ESF's value is not eroded by inflation. That bill appears particularly prescient now, given the tremendous growth in the ESF balance since the 86th Legislature.

A. Current and Projected Balances in the ESF

The forecast for the state's rainy day fund has never been rosier. After a COVID-related decline in deposits to the ESF, the oil and gas industry has come roaring back: the BRE indicates that a deposit of more than \$3.6 billion was made to the ESF in November 2022, which was attributable to FY 2022 oil and gas activity. This is a vast improvement over the \$1.46 billion that was deposited in November 2021.⁴³

The projected ending balance of the ESF for the 2022-23 biennium is \$13.72 billion. By the end of FY 2024- just one year later- the balance is projected to soar to \$23.52 billion. This projection is of course due in large part to expectations of strong oil and gas activity. But in addition, the Comptroller anticipates that a full \$5.7 billion in unencumbered general revenue at the end of the 2022-2023 biennium will be deposited to the ESF in early FY 2024.

The Comptroller projects that the constitutional limit on transfers to the ESF will be reached in FY 2025 due to the fund's balance reaching \$26.38 billion (assuming that no appropriations are made from the ESF). As a result, the projected transfer of funds to the ESF in FY 2025 (which is attributable to tax collections in 2024) will be reduced by \$689 million, which will remain in general revenue. Due to investment income generated by the ESF balance, which is not relevant to the constitutional limit on

⁹ The term "sufficient balance" is no longer used in statute as a result of Senate Bill 69 (86R, 2019); however, this Task Force Report continues to use the term because the concept remains in statute.



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transfers of severance tax revenue to the ESF, the ESF balance is projected to reach \$27.13 billion by the end of the 2024-25 biennium.

The Comptroller notes that the constitutional limit will again likely limit transfers to the ESF in FY 2026 (i.e., the 2026-2027 biennium), but to an even greater extent: \$3.79 billion that would otherwise flow to the ESF in FY 2026 would instead remain in general revenue. Of course, all of these ESF projections do not take into account appropriations the Legislature might make from the ESF the corresponding reduction in the ESF balance.

B. Use of the Economic Stabilization Fund

Article III, Section 49-g, subsections (k), (l), and (m) outline the three situations in which the Legislature may appropriate funds from the ESF:

- (k) For the current biennium: If the Comptroller certifies that appropriations from GR made by the preceding legislature exceed available GR and cash balances for the remainder of that biennium. This type of appropriation from the ESF requires a **three-fifths vote** in both the House and Senate.
- (I) For a succeeding biennium: If the Comptroller estimates that anticipated revenues for the succeeding biennium will be less than the revenues that the Comptroller estimates to be available in the current biennium. This type of appropriation from the ESF requires a three-fifths vote in both the House and Senate.
- (m) For any purpose and at any time: this type of appropriation requires a two-thirds vote in both the House and Senate.

C. The Importance of Maintaining a Healthy Balance in the ESF

Maintaining a healthy balance in the ESF is critical to ensuring that the state can meet future revenue shortfalls, and to retain Texas' strong bond ratings. In its 2022 annual report on state debt, the Texas Bond Review Board noted that credit rating agencies such as Moody's and Fitch had given Texas' general obligation bond debt their highest ratings. In giving Texas this rating, Moody's noted that the state's high credit rating "reflects multiple strengths, including a strong economy that in the long run will outpace the nation, robust population growth, reserves that provide a very healthy buffer to economic and revenue downturns, strong fiscal management and governance, and low bonded debt..."⁴⁴

When voters endorsed the creation of the ESF in 1988, they approved a constitutional amendment "establishing an economic stabilization fund in the state treasury to be used <u>to offset unforeseen</u> <u>shortfalls in revenue</u>." Until the 83rd Legislature, with two narrow exceptions, the ESF had only been used to make supplemental appropriations related to revenue shortfalls: SB 7 (71S6, 1991), HB 7 (78R,



2003), HB 10 (79R, 2005), and HB 4 (82R, 2011). The two exceptions, SB 171 (73R, 1993) and SB 532 (73R, 1993), related to Texas Department of Criminal Justice (TDCJ) capacity issues and totaled less than \$200 million.

Despite the clear wording of the 1988 constitutional amendment, the Texas Constitution states that the ESF may be used for any purpose with the appropriate legislative approval. Article III, Section 49-g(m) states that "the Legislature may, by a two-thirds vote of the members present in each house, appropriate amounts from the economic stabilization fund at any time and for any purpose." It was under this constitutional provision that the 83rd Legislature passed legislation proposing a \$2 billion appropriation from the ESF for water infrastructure and considered legislation appropriating ESF revenue for transportation infrastructure. The 83rd Legislature also used the ESF to undo the \$1.75 billion deferral of the final Foundation School Program payment of the 2012-13 biennium, underscoring the beginnings of a troubling trend of the Legislature using the ESF for what should be core GR expenditures. In the supplemental appropriations bill for the 2018-19 biennium (86R; SB 500), the Legislature included more than \$500 million appropriation from the ESF for one-time payments to certain participants in the Teacher Retirement System, even though the state's fiscal position at the time was relatively strong. That bill also appropriated an additional \$5.5 billion for various purposes, although many of them were related to Hurricane Harvey. House Bill 2 (87R), the supplemental bill for the 2020-21 biennium, continued the trend by appropriating more than \$530 million, although this was understandable given the COVID-19-related downturn that was affecting the state's finances then.

It is only through the defects of the original constitutional language creating the ESF that expenditures from the Fund such as those during the 83rd Session are permitted. As noted above, Article III, Section 49-g(m) of the Texas Constitution allows funds to be spent from the ESF for any purpose upon a two-thirds vote of the Legislature. In order to protect the balance of the ESF and promote fiscal restraint, this provision should be substantially narrowed.

1. <u>Policy Recommendation</u>: Amend the Texas Constitution to narrow the permissible uses of the ESF to cover revenue shortfalls, state debt retirement, one-time infrastructure projects, and expenses related to a state of disaster.

Narrowing the uses of the ESF would achieve what is frequently considered a best practice in governance of state rainy day funds. For instance, the Institute on Taxation and Economic Policy has argued that "rainy day funds should only be used to reduce the impact of budget shortfalls that arise from cyclical economic downturns—not to cope with long-term structural problems." Similarly, the Mercatus Center at George Mason University has suggested that states should "[e]nact rules governing the use of rainy day funds":

State legislators can do more to ensure fiscal stability for their states by adopting requirements for deposits made to their rainy day funds and by setting strict rules about



withdrawals. States that have already adopted such rules have, on average, lower spending volatility across years than states without such rules.⁴⁶

Amending Article III, Section 49-g(m) of the Texas Constitution to specify that other than in times of budget shortfall for a current biennium, the ESF may only be used for retirement of existing debt, one-time infrastructure payments, or to cover expenses related to a state disaster as declared by the Governor under the Texas Government Code §418.014 would achieve this goal. House Joint Resolution 94 (84R, Burkett) should be used as a model for future legislation. HJR 94 proposed amending Article III, Section 49-g(m) as follows:

...the legislature may, by a two-thirds vote of the members present in each house, appropriate amounts from the economic stabilization fund <u>to:</u>

- (1) retire state debt;
- (2) pay costs associated with a state of disaster declared by the

governor; or

(3) pay nonrecurring costs of infrastructure projects [at any time and for any purpose].

It is important to note that legislation like HJR 94 would *still allow funds from the ESF to be used to address budget shortfalls*, since those situations are covered under Sections 49-g(k) and (l) of Article III of the Constitution.

2. <u>Policy Recommendation</u>: Dedicate all funds that would otherwise flow to the ESF but for its balance reaching the constitutional limit to property tax relief.

When the ESF balance swells to such a figure that the constitutional limit on transfers to it applies, that is a sure sign that the state's taxpayers are overfunding government. Given the unpredictability of oil and gas prices, it is possible that the limit will not be reached. If it is, however, the Legislature should dedicate any such excess revenue to tax relief, preferably to the reduction of school M&O taxes.



VI. State Budget Transparency

A. Background

Texas' General Appropriations Act (GAA) contains a vast amount of information. Indeed, literally every dollar that the state spends is, by definition, accounted for in the state budget. This is necessarily a vast amount of information because in the current biennium, the legislature appropriated more than \$248 billion in all funds,⁴⁷ or approximately \$8,400 for every man, woman, and child residing in the state. These appropriations come from four main sources of revenue:

- **State general revenue (GR)**: Tax revenues collected by the state that are not dedicated for a specific purpose.
- **Dedicated general revenue (GR-D)**: Tax revenues collected by the state that *are* collected for a specific purpose.
- Federal funds: Funds received from the federal government for specific purposes or programs
- Other funds: Funds that do not fall into any of the other criteria listed above (this includes funds from the State Highway Fund, trust funds, bond proceeds, and interagency contracts).⁴⁸

These funds are allocated by the GAA among more than one hundred state agencies, commissions, boards, departments, and offices, almost every one of which operates programs to achieve its legislatively-defined objectives. Prior to each legislative session, each state governmental entity must submit a legislative appropriations request (LAR) to the Legislative Budget Board (LBB) in order to request the funding that it wants for each program that it operates. The GAA, however, does not contain most of the programs operated by state government. Instead, it divides the funding for each entity into "strategies". Similarly, while the GAA shows how much each state governmental entity receives of each of the major types of revenue – GR, GR-D, federal funds, and other funds – it does not show how much of each of these types of revenue is appropriated for each strategy, and much less each program within those strategies.

This lack of transparency in the GAA is problematic. Without direct access to information showing how much and what type of revenue is being used to fund specific state programs, legislators, voters, taxpayers, and indeed all Texans are immediately presented with a barrier to their effective participation in the legislative appropriations process.

Texas has made great strides in recent years to enhance the transparency of state government spending and operations. An online database of state contracts is available for public perusal as a result of legislation enacted in 2007, ⁴⁹ all documents related to the state budget prepared by LBB are required to be posted online and publicly accessible as a result of legislation enacted in 2011,⁵⁰ audits of state agency financial activities are required to be posted online as a result of legislation enacted in 2013, ⁵¹ and local government budgets and bond proposals have been subjected to a much higher level of transparency also as a result of legislation enacted in 2013 and 2019.⁵² The time has come to build on



these outstanding successes by reformatting the state budget in a way that clearly identifies all major programs and shows how much GR, GR-D, federal funds, and "other" funds are appropriated to each program. These changes would make Texas' state budget more transparent and would build on the best practices from other states while making Texas a national leader in budget transparency.

B. Transparency and Democratic Engagement

Transparency in government is one of the foundation stones of democracy. Writing in the 1820s, James Madison stressed the importance of public access to governmental information, arguing that "A popular government without popular information, or the means of acquiring it, is but a prologue to a farce or a tragedy ... Knowledge will forever govern ignorance: And a people who mean to be their own governors, must arm themselves with the power which knowledge gives." This is an important philosophical point and also one that has numerous practical implications.

Implicit in each of the pieces of government transparency legislation that the Texas Legislature has enacted over the past decade or more, is the notion that making as much information about state spending available to the public as possible allows engaged voters to play the role that the democratic process requires of them. Absent timely, accurate, and accessible information about state government, voters have a harder time engaging with their elected officials to influence legislation and are necessarily less-well equipped to make informed decisions at the ballot box. To that point, supporters of House Bill 3430 (80R, 2007), which required all state contracts above a certain value to be posted online in a publicly accessible and searchable database, argued that the legislation was necessary because:

Letting Texans know the level of detail of the state budget, down to the comptroller's budget for pencils, would serve as an additional system of checks and balances ... Most of this information already is public record but currently remains scattered among scores of written reports and agency websites. A more comprehensive approach to provide this information to citizens is particularly important now that the state budget has grown in recent years to more than \$160 billion per biennium.⁵⁴

With a state budget that now approaches \$250 billion 15 years after HB 3430 was enacted, it is more important than ever to push for transparency in state budget documents. Indeed, the arguments above about citizen involvement in the democratic process can just as well be applied to legislators. In Texas, the appropriations process places a significant burden on the staff of the LBB and the members and staff of the two legislative standing committees with jurisdiction over the state budget: the Senate Committee on Finance and the House Committee on Appropriations. Taken together, the membership of these two committees comprises slightly less than one quarter of the entire legislature. In other words, fully three quarters of the members of the legislature have a limited ability to impact the appropriations process until the GAA reaches the House or Senate floor for debate. For these legislators in particular, it is critically important that the state budget be presented in a format that allows them to engage in a meaningful way during floor debate and the amendment process.



An illustration from the current state budget for the 2016-17 biennium is instructive. The first governmental entity in the GAA is the Texas Commission on the Arts. In the scheme of the entire state budget, it is a relatively small state agency with total biennial appropriations just over \$23 million. The revenue appropriated to the Commission is shown in the GAA in the same way as every other governmental entity that receives an appropriation. Each source of revenue from which the Commission receives an appropriation is shown in the aggregate for both years of the biennium:

COMMISSION ON THE ARTS

	For the Years Ending			0
	August 31, 2022		August 31, 2023	
Method of Financing: General Revenue Fund	\$	10,164,493	\$	10,164,492
GR Dedicated - Commission on the Arts Operating Account No. 334	\$	45	\$	46
Federal Funds	\$	1,087,800	\$	1,087,800
Other Funds Appropriated Receipts License Plate Trust Fund Account No. 0802, estimated	\$	152,000 100,000	\$	152,000 100,000
Subtotal, Other Funds	\$	252,000	\$	252,000
Total, Method of Financing	\$	11,504,338	\$	11,504,338

This shows that the Commission on the Arts receives about \$10.16 million in each of FY 2016 and FY 2017 GR; \$45 in FY 2016 and \$46 in FY 2017 from GR-D; about \$1.09 million in each year of the biennium from federal funds; and \$252,000 in each year of the biennium from "other" funds. Below the aggregation of appropriations to the commission, the GAA then breaks down these appropriations by goals and strategies for both years of the biennium:

Items of A	р	pro	pr	iat	ion:
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A. Goal: ARTS AND CULTURAL GRANTS				
Provide and Support Arts and Cultural Grants.	_		_	
A.1.1. Strategy: ARTS ORGANIZATION GRANTS	\$	4,000,926	\$	4,000,926
A.1.2. Strategy: ARTS EDUCATION GRANTS		710,787		710,787
A.1.3. Strategy: CULTURAL TOURISM GRANTS		5,670,000		5,670,000
A.1.4. Strategy: DIRECT ADMINISTRATION OF GRANTS		629,498		629,498
Total, Goal A: ARTS AND CULTURAL GRANTS	\$	11,011,211	\$	11,011,211
B. Goal: INDIRECT ADMINISTRATION				
B.1.1. Strategy: CENTRAL ADMINISTRATION	\$	368,902	\$	368,902
B.1.2. Strategy: INFORMATION RESOURCES		124,225		124,225
Total, Goal B: INDIRECT ADMINISTRATION	\$	493,127	\$	493,127
Grand Total, COMMISSION ON THE ARTS	\$	11,504,338	\$	11,504,338



The goals and strategies give the reader a broad idea of how the Commission is to spend the money appropriated to it, but there is little detail and certainly no indication of which strategies are comprised of GR, GR-D, federal, or other funds. Five riders below these goals and strategies then direct how some of the funding received by the Commission is intended to be spent and the riders also describe the performance measures being applied to the Commission. This, essentially, is the entirety of the information that the GAA contains about the Commission.

There is no way to tell how the different sources of funding received by the Commission – GR, GR-D, federal, and other funds – are allocated between the different strategies. There is no way to tell how appropriations to the Commission have changed since the previous biennium or how spending on different strategies has grown or declined. These might seem like minor details in a state budget that exceeds a thousand pages, but they repeat throughout the entire budget, and a legislator or citizen who wants to impact the legislative appropriations process in an effective manner would need to know things like how much GR as opposed to federal funds is being used by the Commission on the Arts (or any other agency or commission) on a particular strategy.

Any effort to alter proposed appropriations requires this kind of knowledge because federal funds often have certain constraints or conditions associated with them, whereas state GR is typically entirely flexible. Reducing "Cultural Tourism Grants" might be an attractive proposition for some legislators, but if the strategy is funded entirely by federal money it may not be possible to reduce or reallocate that funding elsewhere without incurring federal penalties. Similarly, knowing whether a particular source of funding or an appropriation to a particular strategy has dropped significantly compared to the previous biennium may prompt a citizen or a legislator to ask why such a decline has occurred. The current format of the budget provides virtually no context of this kind for any of the numbers it contains.

Informed observers may point out at this juncture that the LBB produces a number of documents related to the state budget that provide a greater level of detail: the biennial "Fiscal Size Up" and the "Summary of Appropriations" that accompanies each iteration of the GAA during a legislative session, to name a couple of the most prominent such publications. The "Fiscal Size Up" indeed contains a vast array of information and detail about state appropriations, agency spending, and government programs. The Size Up is published biennially in the spring of even numbered years – approximately one year after the mid-point of the previous legislative session. In other words, it is not a sufficiently timely document to be useful during a legislative session for the purposes of understanding a new state budget that is under consideration by the legislature. LBB's "Summary of Appropriations" is a far timelier document that is typically produced within 48 hours of whenever an Appropriations Act is set for a public hearing or legislative debate. The Summary of Appropriations does provide somewhat detailed explanations of major appropriations and shows the biennial change in appropriations to many agencies, but it is still not sufficiently detailed to allow citizens and legislators to engage as effectively as they might in the legislative appropriations process.



C. A More Transparent State Budget

The Sunlight Foundation, a defunct non-profit organization that was committed to improving access to government information, emphasized ten principles of government openness in relation to availability of data to the public. Although it ceased to exist in 2020, its message about the importance of these principles remains valid. The principles include: completeness, timeliness, and ease of access. ⁵⁵ Applying these principles to the Texas state budget format, it is clear that the information contained in the state budget is:

- <u>Incomplete</u> because it does not show how the GR, GR-D, federal, and other funds received by each governmental entity are allocated between the various goals and strategies that the entity oversees.
- <u>Incomplete</u> because it does not show in a uniform way the programs that each governmental entity operates or the specific sources of revenue for each program.
- <u>Incomplete</u> because it does not show the biennial change in appropriations to any state governmental entity, goal, strategy, or program.
- <u>Not timely</u> because the detailed information that would facilitate greater citizen and legislator engagement in the legislative appropriations process is typically only made available at a much later date (see the LBB's Fiscal Size Up, for example).

It would be relatively straightforward to address these issues by reformatting the GAA to include, for each state governmental entity in the budget:

- (1) A separate line item for each program that accounts for one percent or more of the entity's total appropriations.
- (2) The appropriation each program receives from each source of revenue (GR, GR-D, federal, and other funds).
- (3) The biennial change in funding for each program, broken down by source of revenue.
- (4) Significant budget drivers that are noteworthy (changes in federal eligibility guidelines for Medicaid or CHIP that may impact caseloads which directly impacts the budget).
- (5) Juxtaposing the applicable agency's LAR for a given program with the proposed legislative appropriation. While not essential, this change would provide readers of the budget with useful context.

By making these five simple changes, the GAA would become a substantially more complete document that would be available in a timely fashion and in way that would allow citizens and legislators to engage in the legislative appropriations process in a more meaningful way.

1. <u>Policy Recommendations</u>: Reformat the General Appropriations Act to Show Greater Detail



The current format of the state budget lacks transparency, showing only total amounts of funding appropriated to agencies for broad strategies. The state budget should show the source of revenue for each program exceeding one percent of an agency's total budget, the change in spending for each program compared to the previous biennium, and the applicable agency's legislative appropriations request (LAR) for the program.

Implementing the five suggested reforms above would yield a vast improvement over the current format of the state budget and would enable legislators and citizens to engage more effectively with the state budget process. A renewed focus on program-based budgeting, rather than obscuring programs behind strategies and goals would also further enhance the accountability of the budgeting process. This can be achieved by the members of the Legislative Budget Board directing staff to prepare the GAA for the upcoming 2024-2025 biennium in this new format, and could further be implemented statutorily via an addition to the Government Code, Section 322.

A related point should be considered. Under Section 403.031 of the Government Code, the Texas Comptroller of Public Accounts (CPA) is charged with maintaining "accounts and information as necessary to show the sources of state revenues and the purposes for which expenditures are made and shall provide proper accounting controls to protect state finances." Under this authority, CPA "establishes and monitors appropriations to more than 170 state agencies and institutions of higher education for more than 660 funds and accounts each year." 56

Through its State Fiscal Management (SFM) division, CPA tracks appropriations to, and expenditures from, each strategy in the state budget to ensure that agencies expend funds in accordance with state law.⁵⁷ It should be anticipated that reformatting the state budget to include a greater number of strategies (or line-items) may require CPA to adjust how it monitors state agencies in this regard. For example, a larger number of strategies could require CPA to focus its resources on riskier strategies where the most oversight is warranted, or to increase staffing levels to a point at which each strategy can be given a similar level of oversight as under the current system. However, it should also be noted that since the proposal is to simply increase the number of strategies in the state budget, the overall burden on CPA to ensure that state funds are utilized as intended by the Legislature through GAA does not change – it is simply the way those appropriations are monitored that may have to be adjusted.



VII. Legislative Budget Board

A. Background and Context

The Legislative Budget Board (LBB or "the Board") was created in 1949 upon a recommendation from the State Auditor's Office to create a joint legislative committee to provide a "continuous review of state spending." Prior to 1949, state agencies were funded through standalone appropriations bills and state budgeting was overseen by the Board of Control (the predecessor agency to what is now the Texas Facilities Commission). Following the creation of the LBB, agencies were directed to submit appropriations requests to the newly created Board, which in turn made budget recommendations to the Legislature.

This remained the core function of LBB until 1973, when the 63rd Legislature significantly expanded its role. House Bill 169 (63R) authorized the Board to "administer a performance auditing function," while House Bill 171 (63R) directed the Board to provide fiscal notes for future pieces of legislation that authorized or required the expenditure of state funds.⁵⁹ House Concurrent Resolution 96 (63R) also directed LBB to produce a "program budget" based on the concept of zero-based budgeting that would be "more informative about the way in which the state's money is to be spent so that the development of a set of priorities is facilitated."⁶⁰ The development of a budget that showed proposed expenditures for each program was in addition to the traditional "line-item" budget that was traditional up to the mid-1970s.⁶¹

In 1978, upon adoption via constitutional amendment of the state's current spending limit, the LBB was charged with adopting the biennial limitation on the growth of state appropriations. In 1985, "budget execution authority" was created, which allows both the Governor and the LBB to propose prohibiting an agency from spending any part or all of an appropriation for a specific purpose, transferring an appropriation from one agency to another, and changing the purpose for which an appropriation was made. Both the Governor and the LBB must agree to any such proposed change.

In the early 1990s the LBB and the Office of Governor Ann Richards developed a performance-based budgeting system, which culminated with the inclusion of agency goals, strategies, and performance targets in the General Appropriations Act (GAA) for the 1994-95 biennium. That system is still in use today. Also in the 1990s, the LBB was directed to guide, review, and finalize agency strategic plans, and was required to prepare a variety of "impact statements" analyzing specific types of legislation in addition to the fiscal notes that were already required.⁶²

Over time, the Legislature has added to the LBB's responsibilities under Chapter 322 of the Government Code, some of which are phrased in discretionary terms. For example, the Board may periodically "review and analyze the effectiveness and efficiency of the policies, management, fiscal affairs, and operations of state agencies." Even more broadly, the Board may evaluate the operations of any



institution, department, agency, or commission that received an appropriation in the most recent General Appropriations Act, provided that institution has operated for at least one fiscal year.⁶⁴ The LBB's website indicates that it has exercised its discretion to examine a variety of state government matters. For 2019, the LBB published approximately 35 "staff reports," ranging from "Modify the Graduated Driver License Program to Decrease Traffic Fatalities" to "Improve Oversight of Mental Health Targeted Case Management and Rehabilitative Services in the Texas Medicaid Program." ⁶⁵

The LLB is authorized, but not required, to develop and perform functions that promote more effective criminal justice policy. ⁶⁶ The board may also "develop and perform functions to promote a more effective and cohesive state criminal justice system;" ⁶⁷ conduct performance reviews for community colleges, interscholastic competitions, and institutions of higher education; ⁶⁸ and is required to publish a report on the performance of the state's major investment funds, such as its public retirement systems. ⁶⁹ The LBB is required to maintain a database of most major contracts entered into by government entities, as well as solicitations of bids relating to such contracts. ⁷⁰

In 2019, Senate Bill 68 (86R; Sen. Nelson) formalized an activity that LBB had been conducting for several years: strategic fiscal reviews (SFRs) of state agencies. Each SFR describes the activities the applicable agency undertakes, the authority for that activity, an evaluation of the agency's performance, a ranking of the agency's current activities in order of importance to the agency's mission, a quantitative estimate of any adverse effects that would occur if a given activity ceased, and a list of itemized expenditures needed to maintain the activity at both the current level and at the minimally-required level under statute or other law. Under SB 68, the LBB conducts SJRs of agencies that are under review by the Sunset Commission (other than river authorities).

B. The Legislative Budget Board Today: Expanded Influence and Responsibilities

At its inception, the Board was given the narrow function of making budget recommendations to the legislature based on appropriations requests submitted by state agencies. Since then, LBB's functions have expanded in both scope and authority.

Beyond the statutory responsibilities outlined above, LBB provides a wide range of services and informative documents not required under general law, including the Fiscal Size-up, agency performance assessments, and online computer access to performance and budget information. In the 84th legislative session, LBB was also given extensive (but not statutory) oversight and authority over the state contracting process and large state contracts in particular.⁷¹

It is important to remember that LBB is fundamentally a joint legislative committee comprised of the Lieutenant Governor and Speaker of the House, and four members each from the Texas Senate and House of Representatives. Over time, however, the Board has grown into a quasi-state agency with more than 110 full-time employees.⁷² Many of the LBB's core responsibilities – adopting the



constitutional spending limit and budget execution authority – are clearly an appropriate and necessary function of a joint legislative committee, but many of the Board's newer functions underscore that it has gradually morphed into a powerful bureaucracy that, entirely at a staff level, wields significant influence over the state budget and related legislation.

LBB staff are currently able to: (1) recommend appropriate levels of state spending (through the base budget), (2) recommend legislative changes, (3) lobby the legislature to enact changes that it recommends (legislative testimony), (4) influence legislation (fiscal notes), and (5) provide oversight of the state procurement processes. None of these five items requires approval from the legislators who sit on the LBB; they are entirely within the purview of LBB staff.

The following two sub-sections of this Task Force Report will focus on two issues that pertain to reform of the LBB: (1) the accuracy of fiscal notes and (2) oversight of state contracting.

C. Fiscal Notes

Each legislative session, thousands of bills are considered in both chambers. Legislators are provided a variety of resources to determine the merits and impact of a given bill. Of these resources, the fiscal note- required by Chapter 314 of the Texas Government Code and both the House and Senate Rules- is perhaps the most important. The LBB is responsible for identifying the probable costs of each bill or resolution, other than the general appropriations act, that authorizes the expenditure of funds or diversion of state resources. The fiscal note must be attached to the bill or resolution before a committee may consider the proposed legislation, and all fiscal notes must remain with the bill throughout the legislative process until it reaches the governor. Arrival at the governor's desk marks the end of the fiscal note's lifespan. There is no systemic analysis of the actual effect of enacted legislation, fiscal or otherwise, so there is no measure of the accuracy of fiscal notes relied upon by the legislature and governor in considering legislation. This lack of post-enactment analysis undermines the reliability and utility of fiscal notes.

To improve confidence in the fiscal note process and the methodologies used to arrive at an estimate, the legislature should amend Chapter 314 of the Government Code to require an independent audit by the State Auditor (SAO) of the fiscal notes of at least some adopted legislation. An audit would determine the overall accuracy and reliability of LBB fiscal notes across multiple issues, agencies, and legislative sessions and could inform future legislative decisions on how best to ensure lawmakers, stakeholders and Texas taxpayers are provided with timely and accurate information.

An audit would provide legislators and the public better insight into the effect of adopted legislation, allow for better contextual analysis of pending legislation, and likely result in improved fiscal note accuracy in future legislative sessions. It would also provide more accountability to the LBB's process.



D. Background: The Fiscal Note Process

If a House committee chair determines that a bill or resolution (other than the GAA) authorizes the expenditure or diversion of state funds, the chair notifies the LBB so that the LBB can prepare a fiscal note. The fiscal note must be distributed prior to the bill or resolution being heard in committee. The Under Senate rules, a fiscal note must be prepared and attached to the proposed legislation (other than the GAA) before the applicable Senate committee takes a final vote on the legislation.

The LBB is tasked with producing fiscal notes. As legislation is amended, a new fiscal note is required before consideration. There are four basic types of fiscal notes: (1) No fiscal implication (NFI), where it is determined that there would neither be a state revenue impact nor a need for any additional state resources; (2) No significant fiscal implication (NSFI), where the change in resources necessary to implement the legislation can be reasonably absorbed within an agency's existing budget; (3) Fiscal implication, either positive or negative, where state fiscal resources will be affected or there could be a state revenue impact; and, (4) Indeterminate fiscal impact (IFI), where the fiscal implications to the state cannot be determined. A note bearing a fiscal implication will provide information on the cost or savings to state over a five-year period, beginning with the upcoming biennium.⁷⁷

The LBB consults with affected agencies to determine the potential costs or gains, but is not bound by an agency's cost estimate or information provided. Notably, the LBB reviews an agency's Legislative Appropriations Request (LAR) prior to a legislative session, which provides the Board with insight on the agency's operations and capabilities. The fiscal note will generally provide a description of the LBB's methodology, including the assumptions and source agencies used to generate the projections. The LBB must revisit the process if any amendments are made to the legislation to produce an updated fiscal note.

An important weakness of the fiscal note process is that it is generally limited to the direct projected effects of the legislation analyzed. It considers the dynamic effects of a bill, such as how a tax relief bill will spur economic activity or a bill creating a new government program will create new and different incentives in the private sector economy, only in certain circumstances. A "dynamic fiscal impact statement" models dynamic changes only when the bill proposes altering the amount of, or rate of, a tax or fee and the fiscal note to that bill shows an annual impact of at least \$75 million.⁷⁸ Moreover, the fiscal note process does not consider aggregate effects on state resources. In other words, while a single bill could be absorbed within an agency's existing resources, the aggregate effect of a dozen other bills that would not individually affect resource allocation could significantly increase agency costs when considered together.

E. Fiscal Notes Within the Texas Legislative Process

As mentioned above, fiscal notes are required before legislation is considered and must be updated as proposed legislation is amended throughout the legislative process. The LBB is also responsible for



preparing a handful of other documents (impact statements), as well as supporting the appropriations process. Each session, the LBB prepares several thousand fiscal notes and impact statements.

The preparation of fiscal notes and impact statements is done within the context of fixed and fast-approaching legislative deadlines that can forestall a bill's passage. This puts pressure on LBB to produce a fiscal note as quickly, not necessarily as accurately, as possible. LBB faces a substantial workload during a legislative session, and this fact alone warrants a review of the accuracy of fiscal notes because their projections are relied upon by legislators and those in the executive branch who are charged with implementing new legislation, determining actual costs during implementation, and, if legislation requires ongoing agency activity, building an appropriations request in an LAR.

Indeed, there is reason to be skeptical of the overall accuracy of these fiscal notes, as a glance at certain bills and their associated fiscal notes illustrates. For example, Senate Bill 445 (76R, 1999) created the State Children's Health Insurance Program (CHIP). During the 76th session, LBB projected that, once up and running, CHIP would cost the state \$160 million in FY 2002 and \$174 million in FY 2003.⁷⁹ In fact, per LBB's own Fiscal Size-Up report for the 2002-03 biennium, CHIP actually cost the state \$204 million in FY 2002 and \$215 million in FY 2003.⁸⁰ The original LBB fiscal note was, therefore, off by 28 percent and 24 percent, respectively, for just the third and fourth fiscal years of the program's existence.

At the other end of the spectrum, the fiscal note for legislation that created the State Lottery (HB 54; 72S1) projected that the lottery would generate \$483 million for the state's General Revenue (GR) fund in FY 1994 and \$500 million in FY 1995. In fact, the lottery generated \$928 million and \$1.015 billion respectively in FYs 1994 and 1995. Those projections missed the mark on the low side by 92 percent and 100 percent respectively. Although oil and gas prices are volatile and notoriously difficult to predict, a similar underestimate was made with respect to Senate Joint Resolution 1 (83S3), which dedicated a portion of oil and gas severance taxes to the State Highway Fund (SHF). The fiscal note for SJR 1 projected that the constitutional amendment would bring in roughly \$3.9 billion to the SHF over four fiscal years. The actual revenue brought in over that time period was approximately \$5.4 billion 84-38 percent more than projected.

Another way to look at this issue is to focus on the new responsibilities assigned to a particular agency during a legislative session. In 2011, for example, ten bills affecting the Texas Department of Licensing & Regulation (TDLR) were enacted. The final fiscal notes on eight of these bills were NSFI,⁸⁵ one anticipated net gains and losses to cancel each other out resulting in a five year \$0 projected impact,⁸⁶ and one bill was projected to have a fiscal impact through new fees, but otherwise duties and responsibilities could be absorbed within existing resources.⁸⁷

TDLR's licensing schemes for a broad array of professions were affected by these pieces of legislation in 2011. In many cases, the Department was required to develop, adopt, and implement new licensing standards or procedures. That routinely occurs with respect any licensed profession to at least some extent, but , in 2011, TDLR was assigned these tasks with respect to a remarkably long list: barbers, cosmetology operators, and shampoo apprentices; dog and cat breeders and dealers; military spouses;



providers, administrators, and sellers of service contracts and identity service contracts; towing, booting, and vehicle storage; inspections and license renewals; cosmetologists and the application of eyelash extensions; talent agencies and personnel services; certain property tax professionals; and elevator, escalator, and related equipment, perpetual care cemeteries established or operated by certain religions and sects in certain municipalities, and certain air conditioning and refrigeration contractors.

Similarly, in the 83rd legislative session in 2013, TDLR was tasked with developing, adopting, and implementing new licensing standards for: barbers, cosmetology licensees; journeyman linemen; certain building contractors; persons with shampoo or artificial hairpiece specialty certificates; veterans; rental-purchase agreements including a loss damage waiver provision; property tax professionals; polygraph examiners; ringside physicians and timekeepers for combative sports events; industrial housing and buildings; elevator, escalator, and related equipment standards. In addition, TDLR policies on e-mail and website technology were all affected by legislation in 2013. Yet, according to the Department and LBB fiscal notes, no significant fiscal impact can be associated with these requirements.

In two consecutive legislative sessions, 24 bills directly affecting TDLR were enacted, yet only one was anticipated to have any fiscal impact whatsoever. Perhaps TDLR is uniquely situated to absorb these new tasks because of its size or expertise. However, in the 2010-11 biennium TDLR was appropriated \$48.5 million in All Funds and allotted 407.5 FTEs.⁸⁸ In the 2016-2017 biennium, after the aforementioned legislation was implemented, the agency's appropriations increased to more than \$60 million in All Funds for 448.2 FTEs.⁸⁹

F. Fiscal Notes Best Practices

A 2015 study found that 38 states routinely prepare fiscal impact statements for legislation anticipated to have a significant fiscal impact.⁹⁰ All but Hawaii had some form of statutory or legislative rule-based fiscal note process.⁹¹ Although Texas was one of only five states to receive the highest mark for fiscal note transparency, the process in Texas remains short of the ideal. Legislators and the public have timely access to non-partisan fiscal notes, but they have no information on the reliability or accuracy of these fiscal notes. Fiscal notes are valuable tools only insofar as they are accurate, or accurate within some reasonable margin of error.

The State of Oregon recognized the importance of post-enactment review of fiscal notes in 2006. In a report to the Oregon Legislature, the Oregon Legislative Fiscal Office (LFO) noted several problems with the fiscal impact process – chief among them was that fiscal impact statements were "untested." The LFO recognized that the failure to conduct reviews of enacted legislation in subsequent biennia along with tight legislative deadlines could undermine the accuracy of information provided to stakeholders, but potential inaccuracies had little impact on overall confidence in the fiscal impact statements. Ninety-four percent of responding legislators indicated that they always or usually find fiscal impact statements to be reasoned and fair. Another 93 percent believed that the information contained within a fiscal



impact statement was always or usually "complete and accurate." This is a remarkable degree of support for a product of indeterminate reliability.

1. Policy Recommendation: Require an Audit of Fiscal Notes

A significant degree of trust is placed in the accuracy and reliability of fiscal notes prepared by the LBB. Although the LBB is well- respected for its depth and breadth of knowledge in the state budgetary process, the office is tasked with the gargantuan effort of completing thousands of fiscal notes each legislative session with finite resources and staff. The LBB provides the critical first step of estimating costs, but a post-enactment audit could bolster those efforts and improve the future work of the LBB.

Auditing the fiscal note process would have several direct and long-term benefits. Most notably, auditing fiscal notes will inform and improve future fiscal notes by identifying failures in the process that can be corrected in the future. These types of systemic analyses are common in other areas of government and business, and they should also exist here.

Certain considerations should be taken into account during any audit of enacted bill fiscal notes. Each session, a large number of bills become law; 1,060 House and Senate bills were enacted by the 87th Legislature in its regular session, another 1,383 by the 86th. ⁹⁵ An audit need not review the final fiscal impact statement of every measure passed into law to achieve its purpose. A random sample of enacted legislation across legislative sessions could be reviewed to determine the overall accuracy and reliability of LBB fiscal notes and to identify issues of concern and areas for improvement. In addition to this random sample, fiscal notes showing an impact beyond a certain figure (perhaps \$25 or \$50 million) could be reviewed to determine how accurate their projections were.

Fiscal notes project a bill's impact across two-year and five-year periods, typically beginning in the first year of the next biennium. Effective dates, rule-making, and other aspects of implementation may delay the fiscal impact of enacted legislation well into this period. An audit should account for this by reviewing fiscal notes from multiple legislative sessions. This approach would ensure that the review is not premature, potentially reveal timing based differences in forecast accuracy, and help identify best-practices for future legislative sessions.

Finally, the audit should be conducted by the State Auditor's Office, rather than LBB. A "self-audit" would not ensure the reliability of the results and thus not confirm the accuracy of fiscal notes. Moreover, tasking the LBB with conducting the audit could result in the establishment of a permanent task and new FTEs. Neither risk exists by tasking the State Auditor's Office. The State Auditor's Office is accustomed to producing one-off audit reports without institutional growth.



VIII. Endnotes

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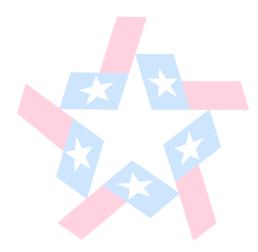


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- 61 http://www.lrl.state.tx.us/scanned/sessionoverviews/63 Accomplishments 1.pdf
- 62 LBB must now provide actuarial impact statements for bills affecting public pension funds, criminal justice impact statements for bills changing the sanctions for felony crimes, equalized education funding impact statements for bills amending the public school finance formulas, higher education impact statements for bills creating new institutions of higher education or certain new higher education programs, open government impact statements for bills that reduce public access to government records or meetings, tax/fee equity notes for bills that create, increase, or decrease a state tax or fee, and water development policy impact statements for bills that create new water districts).
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