Texas Conservative Coalition Research Institute

Testimony to the Senate Committee on Finance

December 3, 2019

Regarding the Committee's Charge: *Examine options and make recommendations for strengthening restrictions on appropriations established in Article VIII, Section 22, of the Texas Constitution, including related procedures defined in statute. Consider options for ensuring available revenues above spending limit are reserved for tax relief.*

Background

Texas' current constitutional spending limit, contained in Article VIII, Section 22 of the Texas Constitution, reads as follows:

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

The Texas 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 income[i] for the next biennium by the estimated Texas total personal income for the current biennium," per Government Code 316.002(b).[ii]

The most important factors to consider in relation to Texas' constitutional spending limit are that:

1. <u>The limit applies only to non-dedicated General Revenue (GR)</u>, rather than *all* state spending.
2. The limit <u>may be overridden by a simple majority vote of the Legislature.</u>
3. Perhaps most importantly, the limit is based on an *estimate* of future <u>personal income growth.</u>

General Revenue versus All Funds

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. There are numerous constitutional dedications of state tax revenue that are exempted from the current spending limit, including to the State Highway Fund and to the Foundation School Program. For the 2018-19 Biennium, an estimated 9.9 percent of all state appropriations- or more than $11 billion- was dedicated by the constitution.[iii]

For a constitutional spending limit to be effective, it is critical that it apply to at least both GR and GR-Dedicated state spending. Doing so would be a significant change that would enhance the state's spending limit. A spending limit that does not apply to all state funds will always be a less than optimal restraint on the growth of state spending.

Overriding the Spending Limit

As noted above, the Texas Constitution also authorizes the Legislature to override the current spending limitation by a simple majority vote. Although this provision has never been exercised, it has the potential to significantly weaken the existing spending limit since any budget must be approved by a simple majority of the legislature. Therefore, any budget that has sufficient legislative support to pass may also be passed even if it exceeds the spending limit. To address this shortcoming, the Texas 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.

Shortcomings of the Personal Income Growth Standard

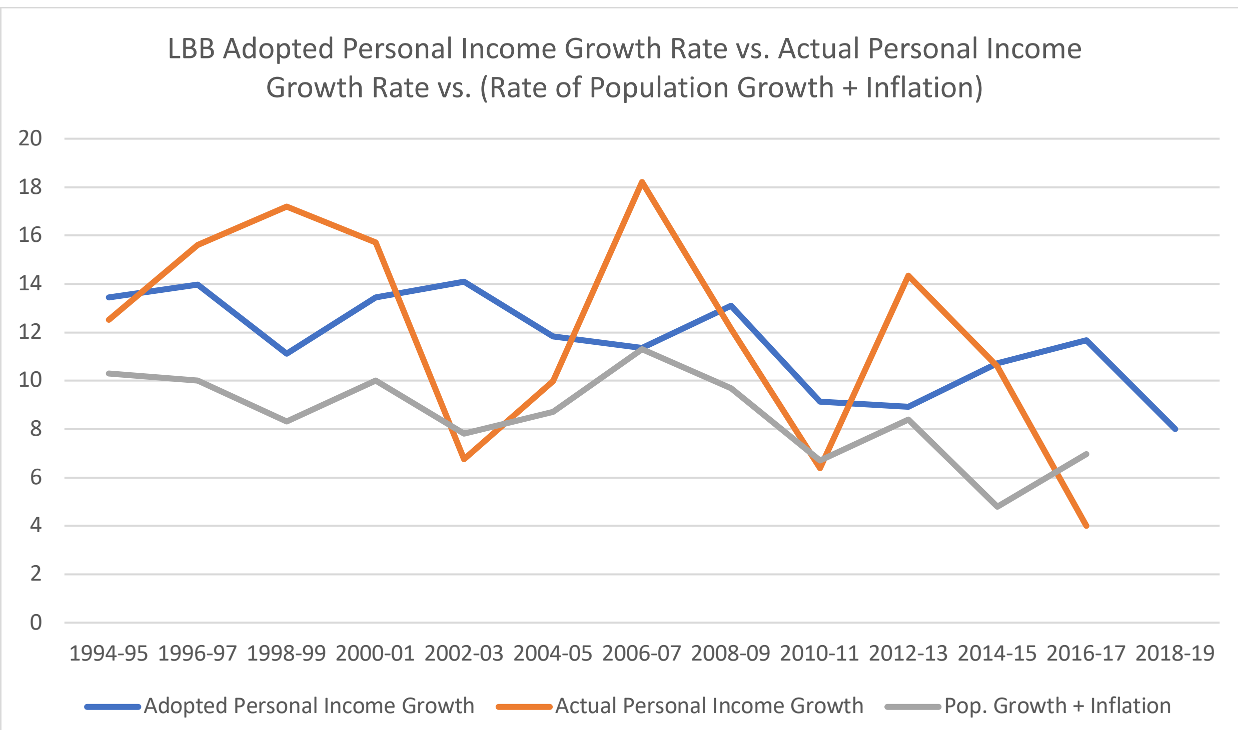
Perhaps the most critical flaw in the current constitutional limit on state spending is the manner in which it is calculated. Under current law, prior to a legislative session, the LBB adopts the constitutional spending limit that will be enforced for the upcoming biennium based on projections of personal income growth. It should be noted that the estimates of personal income growth frequently differ from actual income growth, and sometimes wildly so: most stark are the adopted rate of 14.1 percent for the 2002-03 biennium, when actual personal income growth only hit 6.8 percent, and the 2016-17 biennium adopted rate of 11.7 percent, when actual growth was only 4.0 percent.[iv]

More broadly, it should be obvious that personal income is not a sensible basis for a state spending limit: as personal income (essentially 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. Notably, SB 9 (85R, 2017) would have based the spending limit in terms of population growth and inflation rather than personal income growth. Although the bill did not become law, it passed the Senate and brought greater attention to a key flaw in the current calculation of the spending limit.

A comparison of Texas' population growth plus inflation against real 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.

Over the period from the 1994-95 biennium through the 2016-17 biennium (inclusive), a population and inflation limit averages 8.6 percent per biennium, while the average limit using estimated personal income growth is 11.9 percent per biennium- approximately 38 percent higher. The wide variation between the adopted spending limit and *actual* personal income growth (as reported by LBB) is also noteworthy. The data shows that actual personal income growth is very volatile, vacillating wildly from high of 18.2 percent to a low of 4.0 percent. Faced with this unpredictability, LBB frequently adopted spending limits both far below and far in excess of actual personal income growth. On the other hand, the population and inflation metric is considerably more stable, generally staying in a narrower band between 6 and 11 percent.



Source: Legislative Budget Board (except for population and inflation for 2014-15 and 2016-17, which is from the Texas State Library and Archives Commission (population growth, using U.S. Census estimates) and the Federal Reserve Bank of Minneapolis (inflation rate as measured by the Consumer Price Index)).

Exempting Tax Cuts

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."[v] However, it is appropriations that are made to hold certain entities or funds harmless from the effects of such tax cuts that 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, which, as LBB points out, "would reduce margins tax revenues deposited into and appropriations out of the Property Tax Relief Fund (PTRF). Current methods of finance for the Foundation School Program would shift that appropriation from the PTRF to GR. The resulting GR appropriation would count against the spending limit."[vi]

Similarly, HB 3 (86R, 2019) provides significant relief from school district property taxes, but, as LBB explains, the legislature is required to appropriate state funds to "offset" the effects of the bill:

> The bill [will] reduce local property tax collections by a total of $2.7 billion in the 2020-21 biennium. This decrease in local maintenance and operations property tax collections would be partially offset by an increase in state aid related to the compression of local maintenance and operations tax rates. In subsequent years, ongoing tax compression would continue to decrease tax revenue collections. Under the provisions of the bill, additional state aid would be provided to school districts and charter schools relative to current law for fiscal years 2020 and 2021.[vii]

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 penalized because the legislature continues to meet its public education obligations, forestalling fundamental tax relief.

However, it is important to acknowledge that exempting such appropriations from the spending limit may create the impression that only 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 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 available general revenue.

Policy Recommendation and Conclusion:

Texas' constitutional spending limit must 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 and dedicated general revenue, (2) require a three-fifths vote of the legislature to override the state spending limit, and (3) use changes in population and inflation (rather than personal income growth) as the basis for the state's spending limit.

ENDNOTES

[i] The Legislative Budget Board relies on the U.S. Bureau of Economic Analysis' definition of "personal income", which reads as follows: "...the income received by persons from all sources, that is, from participation in production, from both government and business transfer payments, and from government interest. Personal income is the sum of wage and salary disbursements, supplements to wages and salaries, proprietors' income, rental income of persons, personal dividend income, personal interest income and transfer payments, less personal contributions for social insurance."

[ii] "Tax Relief Amendment Implementation Limit on Growth of Certain State Appropriations," Legislative Budget Board, available at www.lbb.state.tx.us/Notice/Technical_Memo.pdf.

[iii] Legislative Budget Board, Fiscal Size-Up 2018-19 Biennium (September 2018). *Note: LBB's summary of the 2020-21 budget does not indicate the proportion of the GR budget that is subject to the spending limit.*

[iv] Legislative Budget Board memorandum (November 7, 2018), http://www.lbb.state.tx.us/LBB_Meetings/Memo_LBB_Growth_Rates_Tech_Memo_11-7-18.pdf.

[v] "Tax Relief and the Spending Limit," Legislative Budget Board, February 2015.

[vi] *Ibid.*

[vii] Legislative Budget Board, Fiscal Note for Conference Committee Report on House Bill 3 (86R, 2019).