

Fiscal 2010-11

State Budget: Background on the Issues

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This report provides background information on many of the competing demands for funding in the fiscal 2010-11 state budget. It also provides an overview of the revenue streams, budget drivers, and many of the major policy issues for each budget article.

Budget Overview

The Legislature's budget-writing committees are considering spending proposals for fiscal 2010-11. The House and the Senate versions of initial "base budget" spending recommendations made by the Legislative Budget Board (LBB) have served as a starting point for the budget deliberations, along with the governor's budget proposal, and proposals submitted by state agencies and interest groups. As required by the Texas Constitution, all state spending decisions ultimately must be reconciled with the comptroller's estimates of available revenue.

This report provides background information on these spending proposals and other demands on state revenue, including costs from Hurricane Ike and other recent natural disasters and the implications of funds not being disbursed from the Permanent School Fund. It also examines the comptroller's revenue estimate and other sources of funding, such as the "Rainy Day Fund" and federal stimulus funds. The report examines each of the eight principal articles of the state budget and identifies many of the competing demands for spending in each article, the revenue streams unique to each article, and major budget issues for the state agencies included in those articles.

HRO State Finance Report Number 81-1, *Writing the State Budget, 81st Legislature*, summarized the steps in the state budget process and the constitutional, statutory, and procedural requirements guiding the Legislature when it considers state spending needs. When the House Appropriations Committee reports CSSB 1, its version of the proposed budget for fiscal 2010-11, the next HRO State Finance Report will focus on the major policy issues in the budget that will be considered by the House.

Proposed budgets

The House base budget spending recommendations issued by the LBB for fiscal 2010-11 propose spending \$170.8 billion in all funds and \$83.4 billion in general revenue and general revenue-dedicated funds for fiscal 2010-11. This is about 1.2 percent, or \$1.1 billion, more in general revenue and general revenue-dedicated funds spending than in fiscal 2008-09, due primarily to higher spending for teacher retirement, health and human services, criminal justice, and transportation, according to the LBB. General revenue funds include the non-dedicated portion of the General Revenue Fund that is available for general-purpose spending, as well as three education funds — the Available School Fund, the State Textbook Fund, and the Foundation School Fund. General revenue-dedicated funds include constitutionally or statutorily dedicated accounts held within the General Revenue Fund, such as the State Parks Account and the System Benefit Fund.

The Senate base budget spending recommendations issued by the LBB include about \$740 million more in all funds and \$452 million more in general revenue and general revenue-dedicated funds than the House base budget, due to a contingent appropriation to revise the system of care for individuals with developmental disabilities, an increase in teacher incentive pay programs, and making permanent spending for the Higher Education Performance Incentive Initiative. Compared to the current biennium, the Senate base budget would increase state spending from all sources by 1 percent, to \$171.5 billion, and would increase spending of general revenue and general revenue-dedicated funds by about 1.7 percent, to \$90.2 billion.

Gov. Perry's fiscal 2010-11 budget proposal adopts the LBB budget recommendations and details his budget priorities for the next biennium. The largest

spending priorities in the governor's budget proposal include appropriations for public and higher education initiatives, replenishing the Texas Enterprise and Emerging Technology funds, contingency funding for natural disasters and other emergencies, and border security initiatives.

Funding available for fiscal 2010-11

On January 12, 2009, Comptroller Susan Combs released the *Biennial Revenue Estimate, 2010-11*, projecting that the state will have \$77.1 billion available for general-purpose spending in the fiscal 2010-11 budget. This total is derived from \$76.7 billion in anticipated revenue from taxes and other sources, plus a \$2.1 billion positive balance in the General Revenue Fund anticipated at the end of fiscal 2008-09. About \$1.7 billion of fiscal 2010-11 oil and natural gas severance-tax revenues would be constitutionally reserved for future transfers to the Economic Stabilization Fund, also known as the Rainy Day Fund. The all-funds total available for the fiscal 2010-11 budget is \$167.7 billion, including \$91 billion in federal funds and other dedicated funding sources, but not counting any federal stimulus funds, which were approved subsequent to the comptroller's January estimate.

The revenue estimate for fiscal 2010-11 is 10.5 percent, or \$9.1 billion, less than the \$86.2 billion that the comptroller estimated would be available for general-purpose spending in the fiscal 2008-09 budget. The decline in the anticipated funds for general-purpose spending stems from a lower beginning balance in general revenue and general revenue-dedicated funds and from the economic downturn, which is expected to reduce state tax revenue.

Smaller starting balance. The comptroller estimates that the state will have a \$2.1 billion ending balance in the General Revenue Fund from the fiscal 2008-09 biennium available for spending in the fiscal 2010-11 budget. At the start of fiscal 2008-09, the General Revenue Fund had a \$9 billion surplus. Texas had this larger beginning balance for fiscal 2008-09 because of higher-than-anticipated sales-tax revenue and

robust oil and natural gas tax revenue during fiscal 2006-07. The Legislature appropriated most of the fiscal 2008-09 surplus to provide funding for school property tax cuts and to restore funding to social services programs that were cut by the 78th Legislature in 2003.

Decrease in tax revenue. Sales taxes generate most of the state's revenue. The comptroller expects that sales-tax collections will increase by 2.9 percent, to \$44.4 billion, in the upcoming biennium, compared to \$43.1 billion in fiscal 2008-09. This growth rate in sales-tax revenue is less than the growth rate in previous years, including growth rates of 6.6 percent in 2008, 10.9 percent in 2007, and 12 percent in 2006. The increases in past years were fueled by robust growth in the construction, energy, and retail sectors, which recently have seen growth diminish substantially. The comptroller's projection assumes that economic growth will resume at the end of 2011.

Slight but continued growth in sales-tax revenue is expected to compensate in part for declines in collections of other state taxes. Car sales, and subsequently motor vehicle sales-tax collections, have declined significantly. Motor vehicle sales-tax revenue, which is collected in a separate account from other state sales taxes, is expected to drop by 6.5 percent from the current biennium to \$5.5 billion for fiscal 2010-11. Oil and natural gas severance tax collections are expected to decrease by 43.3 percent and 26.5 percent, respectively, as fossil fuel prices decline from their highs in the summer of 2008. Business margins tax revenue is expected to increase by only 1.1 percent between fiscal 2008-09 and fiscal 2010-11, to \$8.9 billion.

Transfers to Property Tax Relief Fund. In its third called session in 2006, the 79th Legislature mandated a series of school property tax reductions. The Legislature ensured that the state would hold school districts financially harmless by reimbursing them for the revenue lost by those tax cuts. To meet this continuing obligation, the Legislature dedicated to the Property Tax Relief Fund the additional revenue raised from the new business margins tax, the increased tax rate for cigarettes and other tobacco products, and an adjustment to motor vehicle sales and use taxes beyond

the revenue that had been raised under the previous tax structure and rates. Because projected revenue generated by the new taxes alone was insufficient to cover the \$14.2 billion appropriation for property tax relief in fiscal 2008-09, the 80th Legislature appropriated \$6.1 billion in general revenue funds to make up the difference.

The 80th Legislature also allocated to the Property Tax Relief Fund \$3 billion in general revenue funds in fiscal 2009 as a “down payment” on the amount that will be required in fiscal 2010-11 to replace local tax revenue as a result of school district property tax rate reductions. This allocation significantly lowered the General Revenue Fund surplus that will be available at the beginning of fiscal 2010-11 when compared to the General Revenue Fund surplus that was available at the beginning of fiscal 2008-09.

The January 2009 projection for the dedicated revenue to be transferred to the Property Tax Relief Fund during fiscal 2010-11 is lower than earlier projections. The comptroller had anticipated revenue of \$5.9 billion from the business margins tax in fiscal 2008, but actual collections were only \$4.3 billion. These lower business margins tax collections are expected to continue in future biennia. As a result, the comptroller projects a total of \$5.5 billion in transfers from

dedicated revenue sources and interest to the Property Tax Relief Fund in fiscal 2010-11. Combined with the \$3 billion “down payment” already made, a total of \$8.5 billion will be deposited in the fund. The Legislature will have to appropriate general revenue or other funds for fiscal 2010-11 to pay for the difference between the \$8.5 billion Property Tax Relief Fund balance and the amount required to reimburse local school districts due to the school property tax rate cut. Even more alternative funding may be needed for the Property Tax Relief Fund in fiscal 2012-13 if the Legislature does not make another “down payment” of general revenue for the next biennium as it did for fiscal 2010-11.

No distributions from the Permanent School Fund. During fiscal 2008-2009, distributions from the Permanent School Fund to the Available School Fund accounted for about \$1.4 billion in public education funding. The Permanent School Fund is a trust that holds state land and mineral rights. The returns earned by the Permanent School Fund are constitutionally dedicated to the benefit of Texas public schools and distributed to the Available School Fund. The Available School Fund consists of distributions from the Permanent School Fund and revenue from one-fourth of the motor fuels tax and one-fourth of the occupations tax. The Available School Fund makes distributions to fund instructional programs.

The General Revenue Fund

general revenue funds

The non-dedicated portion of the General Revenue Fund that is available for general purpose spending, as well as three education funds:

- Available School Fund
- State Textbook Fund
- Foundation School Fund

general revenue-dedicated funds

All other constitutionally or statutorily dedicated funds held within the General Revenue Fund. Examples of dedicated funds:

- State Parks Account
- System Benefit Fund
- Department of Insurance Operating Account

The comptroller's biennial revenue estimate indicates that the Available School Fund will not receive distributions from the Permanent School Fund in fiscal 2010-2011 because the fund has failed to produce adequate investment returns to permit the transfer. Art. 7, sec. 5 of the Texas Constitution places two restraints on distributions from the Permanent School Fund to the Available School Fund. First, the constitution caps the amount of money distributed from the Permanent School Fund at 6 percent of the average market value of the fund. In addition, the constitution contains a savings clause that prevents a disbursement from the Permanent School Fund when the amount distributed from the fund during the preceding 10 years exceeds the total investment returns for this fund during the same period.

As of January 30, 2009, the Permanent School Fund was valued at \$15.5 billion, a decrease of more than 40 percent from the fund's \$26.6 billion value in October 2007. This drop in the value of the Permanent School Fund violates the savings clause and, if the losses are sustained, will prevent a distribution from the fund.

Both the House and the Senate base budgets include a Texas Education Agency rider, which, contingent upon a distribution from the Permanent School Fund, would appropriate \$1.4 billion for the Foundation School Program, the technology allotment, and instructional materials, including textbooks for English Language Arts and English and Spanish reading. In the likely event a distribution does not occur, the Legislature may choose to appropriate other funds to replace this funding. The appropriations bill also may include a contingency rider that would specify how Permanent School Fund distribution would be made if fund performance were to permit a distribution later in fiscal 2010-11.

Supplemental needs. The amount of surplus for fiscal 2008-09 available for spending in fiscal 2010-11 may be reduced by supplemental appropriations made by the 81st Legislature for agency spending in fiscal 2009.

In February, the LBB outlined agencies' supplemental needs. Most of the supplemental needs,

about \$999 million in all funds, have been reported by health and human services agencies. Of this amount, \$585 million is attributable to Health and Human Services Commission (HHSC) needs for higher-than-anticipated acute care Medicaid spending. This is due to a lower federal match rate for state spending and higher medical cost growth than was projected in the fiscal 2008-09 appropriations act. HHSC also indicates it needs \$322 million to replace funds vetoed by the governor for Texas' fiscal 2009 share of Medicare Part D prescription drug costs. The Department of Family and Protective Services indicated needs of more than \$52 million in all funds for technology support costs, higher-than-anticipated adoption subsidy caseloads, and the continuation of Child Protective Services initiatives implemented in SB 758 by Nelson, enacted by the 80th Legislature in 2007. However, much of the HHS supplemental needs could be covered with stimulus funds from the federal American Recovery and Reinvestment Act of 2009.

Other supplemental needs include:

- \$80.0 million in general revenue and general revenue-dedicated funds for higher-than-expected implementation costs for consolidating 31 state agency data centers into two data centers, as well as project transition costs owed to the state data center contractor, IBM;
- \$153.0 million in general revenue funds to reimburse community colleges for fiscal 2009 employee group health insurance contributions that were vetoed by the governor;
- \$225.9 million in general revenue funds for the Texas Department of Criminal Justice, including \$157.5 million for an operational shortfall, \$29.4 million for contraband screening equipment, and \$39.0 million for shortfalls in funds for inmate health care; and
- \$8.3 million for restoration expenses for the governor's mansion.

The House will consider HB 6 by Eiland, which would appropriate money from the Rainy Day Fund to agencies and institutions of higher education for costs and revenue losses due to natural disasters, particularly

from hurricanes Ike, Dolly, and Gustav. Entities affected by natural disasters do not anticipate being fully reimbursed for hurricane costs by either insurance or the federal government, and there is no timetable for anticipated federal reimbursements.

General revenue-dedicated fund balances.

Government Code, sec. 403.095 requires that the comptroller include in the estimate of funds available for general-purpose spending the amounts in general revenue-dedicated accounts expected to exceed appropriations from those accounts at the end of the current biennium. The Legislature also may direct the comptroller to transfer these general revenue-dedicated account balances to the unobligated portion of the General Revenue Fund. Accounts exempt from this provision include dedicated accounts created by a court or the Constitution, trust funds, and funds outside the treasury.

The \$77.1 billion that the comptroller's January 2009 revenue estimate projects would be available for general-purpose spending in the next biennium includes about \$3.4 billion in anticipated general revenue-dedicated account balances. In addition, because the Legislature has never directed the comptroller to transfer these account balances to the unobligated portion of the General Revenue Fund, many general revenue-dedicated account balances have grown as revenue in these accounts has exceeded appropriations. For example, in fiscal 2009, the beginning account balance and anticipated revenue in the System Benefit Fund, a general revenue-dedicated account containing an assessment collected from electric ratepayers to assist low-income utility customers and fund education programs, total more than six times the estimated expenditures from this account. According to the comptroller's revenue estimate, the fiscal 2009 ending balance for the System Benefit Fund account will be \$565 million, \$62 million more than the beginning balance that year.

SB 736 by Watson, filed this session, includes a statement of legislative intent that as of September 1, 2011, unexpended balances in general revenue-dedicated accounts no longer would be used to certify general-

purpose spending in the state budget. Supporters of this legislation believe it would encourage the Legislature to "free" dedicated account balances for spending on the purposes for which these monies were collected and would make more accurate and transparent the forecasts of revenue available for general-purpose spending.

Sources of additional funding

For fiscal 2010-11, the Rainy Day Fund will contain up to \$9.1 billion. At least an additional \$16.0 billion, with certain spending restrictions, will be available from the federal American Recovery and Reinvestment Act.

Rainy Day Fund. The Rainy Day Fund is held outside of general revenue and contains a portion of any balance remaining in the General Revenue Fund at the end of a biennium, as well as certain revenue from oil and natural gas production taxes.

Based on the comptroller's January estimate of revenue that will be transferred to the Rainy Day Fund in fiscal 2010-11, the fund will contain up to \$9.1 billion in the next biennium. Since part of this estimate assumes that the current surplus will not be reduced, the projected amount in the fund will be less if all or part of the surplus is diverted for other uses before the end of the current biennium.

The Constitution permits the Legislature to appropriate money from the Rainy Day Fund for any purpose if at least two-thirds of the members present in each house approve it. The Legislature also may appropriate money from the Rainy Day Fund by a smaller three-fifths vote of the members of each house under two circumstances. One applies to eliminating deficits that arise during a biennium when previously projected revenues fall below appropriated spending. The other applies when the comptroller's January revenue estimate for a succeeding biennium is lower than the revenue estimate for the current biennium. The Legislature may appropriate money from the Rainy Day Fund for the succeeding biennium up to the amount of the difference. However, the comptroller must compute the actual amount of revenue raised at the end of each

fiscal year, and if the estimated revenue difference exceeds the actual difference and the Legislature spent more than the actual difference, the comptroller must transfer general revenue to the Rainy Day Fund to make up for the excess.

Federal recovery funding. On February 17, 2009, President Obama signed into law HR 1, the American Recovery and Reinvestment Act of 2009. The act contains appropriations and tax cuts totaling an estimated \$787 billion, at least \$16.0 billion of which will be made available to Texas. The act also contains appropriations for competitive grant programs for which the state may apply. Highlights of the federal entitlement appropriations made available to the state for specific purposes as of March 2009 include:

- \$5.6 billion for education, including \$3.3 billion for state support for K-12 schools;
- \$4.7 billion for health and human services programs, including \$4.2 billion for an increase in the percentage of the federal match rate for Medicaid for fiscal 2009 and fiscal 2010-11;
- \$2.7 billion for transportation, of which \$2.3 billion is available for highway and bridge construction and repair;
- \$700 million for other government services, including assistance for education in the state or for renovation of school facilities, including higher education, and for public safety;
- \$612.4 million for low-income housing programs, including \$345.9 million for home weatherization improvements for low-income families;
- \$560.7 million to assist in paying unemployment insurance benefits, \$530.1 million of which would be available if the state made certain legislative changes to eligibility criteria it uses to disburse benefits;
- \$518.8 million for energy programs and for water and wastewater infrastructure;
- \$424.5 million for the Child Care Development Block Grant and other labor-related programs, not including unemployment insurance; and
- \$169.3 million for criminal justice programs.

The act also includes allocations for other state programs, such as funds for transportation security enhancements and for repairing leaking underground petroleum tanks.

The Recovery Act specifies that the funds first be directed to state governors' offices and that each governor may choose to certify whether that state will request the available funds and that the state will use the funds to create jobs and promote economic growth. Alternatively, the state legislature may request the funds by adopting a concurrent resolution. On February 18, Gov. Perry wrote a letter to President Obama certifying Texas will accept the funds made available by the Recovery Act.

The LBB estimates that federal stimulus funds could replace at least \$4.8 billion in state general revenue funds, potentially allowing it to be used for other general-spending purposes. Of this amount, \$4.1 billion would come from an increase in the federal match rate for Medicaid, and \$700 million would come from fiscal stabilization funds provided for general government services. Recovery funds for child support programs, other education funds, and the Temporary Assistance for Needy Families allocations could be used to replace more general revenue. The Recovery Act prohibits any funds made available from the increase to the federal match rate for Medicaid from being placed into a reserve or rainy day account. Federal regulators have yet to clarify what constitutes a reserve fund.

General Government

The 21 agencies within Article 1 perform some of the core operations of state government. They include:

- offices of the governor, secretary of state, attorney general, and comptroller;
- agencies charged with general operations of state office buildings and bond issues;
- agencies that support and coordinate statewide and federal priorities; and
- agencies that administer state employee benefits, pensions, and workers' compensation payments.

The budgets for the Legislature and legislative agencies appear in Article 10.

For Article 1 agencies, the House and the Senate initial base budgets recommended by the LBB both propose to spend about \$3.5 billion in all funds for fiscal 2010-11 or 2.1 percent of the total state budget, including \$2.8 billion in general revenue and general revenue-dedicated funds. Total appropriations would decrease by \$364.1 million, or 9.5 percent, from fiscal 2008-09.

Selected budget issues

Employees Retirement System. The Employees Retirement System (ERS) administers benefits programs, including retirement benefits and health insurance for state employees. For fiscal 2010-11, LBB recommends \$3.28 billion in all funds for ERS, including \$1.94 billion in general revenue funds, \$118.2 million in general revenue-dedicated funds, and \$617.6 million in federal funds. This would be an increase in all funds of \$336 million, or 11.4 percent, from fiscal 2008-09.

Under Government Code, sec. 811.006, ERS cannot increase benefits from its pension fund for retirees unless the fund is "actuarially sound." It is considered actuarially sound if it can amortize all of its liabilities over a term of not more than 30 years. Since 2003, the total value of the ERS pension fund has remained below the level of actuarial soundness. From 1989 to 2001, the state's contribution rate fell from 7.4 percent of payroll

to the constitutionally mandated minimum of 6 percent (Texas Constitution, Art. 16, sec. 67(b)(3)). The 79th Legislature in 2005 acted to move the pension system toward actuarial soundness by raising its contribution to 6.45 percent of payroll. Based on an evaluation on August 31, 2008, the state would need to contribute 9.45 percent of payroll for the fund to reach actuarial soundness, assuming an employee contribution rate of 6 percent. This would require an additional \$208.8 million in general revenue and general revenue-dedicated funds and \$127.5 million in other funds beyond the LBB's baseline recommendations for fiscal 2010-11.

Supporters of raising the state contribution rate in order to restore the pension fund to actuarial soundness say it is the only way to ensure the state meets its long-term obligations to retirees, many of whom live on fixed pensions with no cost-of-living adjustment. Opponents of raising the state contribution rate in order to restore the pension fund to actuarial soundness say raising the rate to 9.45 percent would cause other important budget needs to go unmet and that the state should consider other options, such as raising its contribution rate by a smaller amount or increasing the employee contribution from its current 6 percent.

Restoring the governor's mansion. The State Preservation Board has requested \$25.2 million in general revenue funds to restore the governor's mansion, which was heavily damaged by arson in 2008. These funds would not include \$8.5 million in remodeling and stabilization costs incurred before and immediately after the fire.

The Mansion Restoration Project would be divided into "restoration" and "support initiatives." Restoration would require an estimated \$21 million in state funds and would cover expenses for construction, restoration, and landscaping, as well as expenses for bringing the mansion into compliance with the Americans with Disabilities Act. Support initiatives would include costs for improving mansion site security, building a two-story addition to the mansion's north side, and closing Colorado Street in front of the mansion for a new traffic entrance.

An additional \$2.1 million in private funds would supplement state expenditures on the two-story addition, landscaping, design fees, and studies.

Supporters of funding the mansion restoration say the funds would repair the existing structure, make it more accessible to disabled individuals, and provide enhanced site security with upgraded camera surveillance and a controlled entrance at Colorado Street. Opponents of funding the mansion restoration say that the current costs are difficult to justify, given the \$8.5 million already spent before and after the arson, and that the State Preservation Board has not adequately considered alternatives, such as relocating the governor's residence and converting the mansion into a museum open to the public.

More border security funding. The governor's budget proposal for fiscal 2010-11 includes \$135 million for increased border patrols and funds for three new priorities: combating transnational gangs, providing more investment in local law enforcement, and preventing border corruption. The funds would go to grants awarded by the governor and in some cases be administered by DPS and benefit law enforcement agencies along the border.

The proposed grants would fund gang enforcement initiatives, including surge operations, investigation, prosecution, gang prevention, and a new multi-agency gang intelligence section in the Texas Fusion Center. The Texas Fusion Center facilitates data sharing among state agencies and is focused on the prevention and early warning of natural, accidental, and intentional disasters. The funds would provide overtime and operational costs for local law enforcement, including grants for 200 new FTEs ("full-time equivalent employees") and oversight of the funds distributed. Some of these oversight funds would be used for six new Texas Ranger FTEs with another \$1 million to fund audits of border security programs.

Health and Human Services

The health and human services (HHS) agencies in Article 2 constitute Texas' second-largest budget function after education. For fiscal 2010-11, HHS agencies account for almost 34 percent of all funds appropriations in the LBB-recommended House and Senate initial base budgets, and more than 27 percent of general revenue and general revenue-dedicated funds appropriations. The funding proposed in the initial base budgets would support more than 55,000 full-time employees.

The Health and Human Services Commission (HHSC) oversees four other HHS agencies. The commission performs some administrative duties for all HHS departments, including human resources, administrative procurement and contracting, and strategic planning. In addition, HHSC administers and performs eligibility determination for HHS programs, including Medicaid, the Children's Health Insurance Program (CHIP), the vendor drug program, and Temporary Assistance for Needy Families (TANF), among other services. The four departments under HHSC are:

- the Department of Aging and Disability Services (DADS), which administers nursing home services; community care for people with disabilities; guardianship services for adults; and mental retardation services, including state schools and community care services;
- the Department of State Health Services (DSHS), which oversees mental health programs, including state hospitals; health services, such as prevention, epidemiology, and disaster response; vital health statistics record-keeping and reporting; and substance abuse services;
- the Department of Family and Protective Services (DFPS), which administers child and adult protective services, including early intervention and prevention services; and child care regulation; and
- the Department of Assistive and Rehabilitative Services (DARS), which implements rehabilitation services; early childhood intervention; and services for the blind and the deaf.

The House and the Senate base budgets would fund Article 2 agencies at \$57.2 billion and \$57.7 billion from all funds, respectively, for fiscal 2010-11, 4.9 percent and 5.8 percent more than in fiscal 2008-09. The general revenue and general revenue-dedicated funds portions, \$24.3 billion and \$24.5 billion respectively, would represent an 8.3 percent and 9.2 percent increase from the current biennium.

The difference in funding between the House and the Senate base budgets is attributable to a single provision contained in the Senate version but not in the House version – \$487 million in all funds and \$200 million in general revenue funds to revise the system of care for the developmentally disabled, contingent on enactment of appropriate legislation. Other spending increases in both versions are due to CHIP and Medicaid caseload growth, maintaining health care provider rate increases enacted by the 80th Legislature, and a less favorable federal Medicaid match rate. Spending in fiscal 2010-11 could further exceed spending in the current biennium if the Legislature chose to appropriate all or part of the \$4.7 billion in federal Recovery Act funds available to Texas HHS agencies.

Revenue streams for health and human services

HHS agencies receive funding from multiple federal, state, and local sources, but federal funds would finance about 57 percent of all HHS spending in the fiscal 2010-11 base budget proposals. Article 2 contains almost 62 percent of all federal funds in both the House and the Senate base budgets. The majority of this federal funding requires matching contributions from the state. Texas also may receive up to \$4.7 billion from the federal Recovery Act to assist with several programs that receive a significant portion of their funding from federal sources, such as TANF and Medicaid.

Medicaid. Medicaid, the federal-state health insurance program for the poor, elderly, and disabled, is the largest source of federal funds in the state budget. Medicaid spending in the House and the Senate base budgets represents more than 74 percent of the total HHS budget proposed.

Fiscal 2010-11 base budgets. The House and the Senate base budgets would appropriate for Medicaid in fiscal 2010-11 \$42.6 billion and \$43.1 billion in all funds, respectively, 5.8 percent and 7.0 percent more than in fiscal 2008-09. The general revenue and general revenue-dedicated funds portions, \$17.8 billion and \$18.0 billion respectively, would represent a 9.4 percent and 10.7 percent increase from the current biennium. The Senate base budget is higher because it includes a contingent rider to revise the system of care for the developmentally disabled. Also, Medicaid acute care accounts for the largest component of Medicaid caseloads, and acute-care caseloads are anticipated to increase about 4.3 percent, to 3.02 million, in fiscal 2011.

Medicaid eligibility. Medicaid is an entitlement program through which the state and federal governments must provide benefits to all who meet the eligibility criteria. Medicaid clients fall into various eligibility categories based on age, income, and disability status, and eligibility criteria for all Medicaid categories includes a requirement that a client's income not exceed a certain percentage of the federal poverty level. In 2009, 100 percent of the federal poverty level is \$10,830 for a single adult and \$22,050 for a family of four.

FMAP, the state-federal funding match. Medicaid expenditures are split between the federal government and the states according to each state's average per-capita income relative to the national average, which is adjusted annually. The state-federal match rate derived from this calculation is called the Federal Medical Assistance Percentage (FMAP). The base budgets assume an FMAP of 58.79 percent for state fiscal year 2010 and 58.94 percent for state fiscal year 2011. This means that the federal government would provide nearly 59 cents of every dollar spent in Texas on Medicaid in the next biennium.

FMAP increase in federal Recovery Act. If Texas were to accept FMAP increases authorized by the federal Recovery Act, Texas would receive a higher FMAP retroactive to October 1, 2008, and expiring December 31, 2011. These higher match rates could mean an estimated \$4.1 billion in state general revenue funds could be replaced with federal funds. If Texas accepted the FMAP

increase, Texas could not reduce current Medicaid services. Also, any amount of funds attributable to FMAP, directly or indirectly, could not be deposited into a reserve or "rainy day" fund. Federal entities have yet to clarify what constitutes a reserve fund.

Provider rates. For Medicaid services provided on a fee-for-service basis, HHSC develops more than 150,000 rates specific to the particular service provided and the type of practitioner or facility providing it. Rate increases are determined by the Legislature, and the amount at which provider rates are set often is a point of debate. Many providers say certain reimbursement rates do not cover the cost to provide a service. Provider rate-setting also is often central to the discussion about maintaining adequate provider networks for Medicaid clients. Some health care providers cite inadequate reimbursement rates as the reason they choose not to serve Medicaid clients or limit how many Medicaid clients they serve.

CHIP. The Children's Health Insurance Program (CHIP) provides primary and preventive health care to low-income, uninsured children whose family income or assets are too high for them to qualify for Medicaid. Subject to certain family asset restrictions, 12 months of CHIP eligibility is granted to children under age 19 whose net family income, excluding Medicaid-allowable childcare expenses, is at or below 200 percent of the federal poverty level. As of February 2009, CHIP enrollment was 448,010, and in January 2009, enrollment was 61,675 in the CHIP perinatal program. The perinatal program provides prenatal care to low-income women between 185 and 200 percent of the federal poverty level.

EFMAP, the state-federal funding match. Similar to the Medicaid program, CHIP appropriations are paid through a state-federal match based on an enhanced FMAP (EFMAP), which is a percentage of the state Medicaid FMAP. The base budgets assume an EFMAP of 71.15 percent for state fiscal year 2010 and 71.26 percent for state fiscal year 2011. The federal Recovery Act does not include increases for state EFMAPs.

Federal CHIP reauthorization. Because CHIP is not an entitlement program, the federal government caps the annual federal CHIP allotment to states, and enrollment

is limited to appropriated funds. The 2009 federal CHIP program reauthorization signed by President Obama in February increases the amount of federal funds allotted to state CHIP programs, permits coverage of pregnant women, and permits increases of income eligibility criteria to 300 percent of the federal poverty level. States may receive bonus payments if their CHIP programs exceed enrollment targets and meet five of eight criteria to simplify enrollment and renewal procedures. The Texas CHIP program currently would not qualify for CHIP program bonuses without statutory changes by the Legislature.

The federal CHIP reauthorization increased Texas' federal allocation from \$549.6 million to \$945.5 million for fiscal 2009, a 72 percent increase. Under the reauthorization, Texas will have two years to use an annual CHIP allotment, and funds unspent during this period will be returned to the federal government.

The Legislature may debate increasing CHIP eligibility to 300 percent of the federal poverty level and permitting pregnant women to receive benefits in order to use a larger share of the federal allotment. Some proposals to increase eligibility criteria beyond 200 percent of the federal poverty level have included cost-sharing measures, such as a CHIP "buy-in" program in which families at higher incomes would pay a greater share of program costs.

With current eligibility criteria and inclusion of new state and federal program requirements, LBB estimates a caseload of 460,793 by 2011 and a biennial cost of \$521.5 million in general revenue funds. If eligibility were increased to 300 percent of the federal poverty level and no new cost-sharing measures were implemented, LBB estimates a caseload of 615,993 by 2011 and a biennial cost of \$650.2 million in general revenue funds.

TANF. Texas uses federal Temporary Assistance for Needy Families (TANF) block grant funds to fund initiatives, such as foster care, youth dropout and delinquency prevention, child care regulation, and job training. In order to serve a projected caseload of 108,327 in fiscal 2011, the initial base budgets would appropriate \$200 million in all funds, including \$131 million in general revenue funds, to provide TANF monthly cash assistance grants to needy families. A monthly grant of up to \$244

may be provided to a family of three with a monthly income of \$188 or less, if the caregivers meet certain work-participation requirements.

As a state with high rates of population growth and low historic cash assistance benefit levels, Texas receives a supplemental TANF grant that was set to expire at the end of fiscal 2009. The federal Recovery Act extends this supplemental grant so that Texas could continue to receive an additional \$52.7 million in TANF funds through the end of fiscal 2010.

SNAP. The Supplemental Nutrition Assistance Program (SNAP), formerly known as the federal Food Stamp Program, provides help with buying food to certain families with incomes below 100 percent of the federal poverty level. The nearly \$3 billion in SNAP assistance projected for Texas families in fiscal 2010-11 is 100 percent federally funded, and these funds do not appear in the HHSC budget. However, HHSC must pay 50 percent of the costs to administer SNAP.

Tobacco-settlement money. In 1998, Texas finalized a settlement of its lawsuit against major tobacco companies that awarded the state \$17.3 billion over 25 years, subject to adjustments. In 1999, the 76th Legislature established 21 health-related permanent trust funds and higher education endowments out of tobacco money and designated the first money left over from these funds to support CHIP. For fiscal 2010-11, the initial base budgets would appropriate almost \$1.2 billion in tobacco-settlement funds for various health-related programs, primarily CHIP.

Hospital funding. The Medicaid Disproportionate Share Hospital (DSH) Program is a source of reimbursement to state-operated and local Texas hospitals that serve a disproportionately large number of Medicaid and indigent patients. The state uses general revenue funds appropriated to state-owned hospitals and intergovernmental transfer (IGT) funds from nine public hospital districts to draw down and reallocate Medicaid funds. The federal Recovery Act includes an estimated \$23.4 million more in federal funds in fiscal 2009 and \$47.4 million more in fiscal 2010 for the DSH Program than current fiscal 2009 levels.

Upper Payment Limit (UPL) is a financing mechanism through which local hospitals can use IGTs to draw Medicaid funds to pay providers the difference between Medicaid and Medicare reimbursement rates. The Medicare rate is the amount the hospital charges for services. If provider rates are inadequate, hospitals often must use DSH and UPL payments for additional funding.

Budget drivers for health and human services

Changes in the age, ethnicity, and health composition of the population, poverty rates, and overall economic trends drive much of the demand for HHS services.

CHIP and Medicaid caseloads. CHIP and acute-care Medicaid caseloads are two of the biggest drivers in the Article 2 budget. Combined CHIP caseloads, including for the CHIP perinatal program, are projected to increase by almost 7 percent to 557,508 by fiscal 2011 and could increase more if eligibility criteria were expanded. HHSC projects acute-care Medicaid caseloads will grow by more than 4 percent, to 3,017,673, in fiscal 2011.

Demographic changes. Projections of rising birth rates, combined with high costs, likely will lead to higher Medicaid program costs. Monthly per-client costs for newborn coverage up to age one, projected to be \$765 a month in fiscal 2010, are significantly higher than costs for other Medicaid recipients.

Aging and disabled clients will account for 27 percent of the total Medicaid population but 60 percent of acute-care Medicaid costs in fiscal 2010, according to HHSC. The state demographer projects the growth rate of the 65-and-older age group will increase to three times the rate of growth of the rest of the population by 2040, and overall life expectancy also is increasing.

Almost 28 percent of Texas adults are obese, and that figure could climb to more than 42 percent by 2040, according to the state demographer. Obesity rates are highest among Latinos and the elderly, the fastest-growing populations in the state. Obesity leads to a spectrum

of costly chronic health problems, including diabetes, heart disease, high blood pressure, high cholesterol, and respiratory ailments.

Medical cost growth. Health care costs are rising faster than standard inflation. Monthly costs per acute-care Medicaid client are trending upward from an estimated \$261 per month in fiscal 2007 to \$288 per month in fiscal 2009, according to HHSC.

Economy. As economic conditions and incomes decline, demand for social services increases. Employers also may feel pressure to cut health benefits. Eligibility criteria for most HHS programs measure personal income as it compares to the federal poverty level. In 2007, 3.9 million Texans, or 16.5 percent of the state population, lived below the federal poverty level, which was \$20,650 for a family of four and \$10,210 for a single adult.

Lack of health insurance increases the severity of budget difficulties, because the uninsured are more likely to seek care in more costly settings such as emergency rooms and be unable to pay the bill. Unpaid medical bills for the indigent must be either absorbed by a facility, or in some cases, local tax rates may be increased to compensate for losses incurred at hospitals.

Selected budget issues in health and human services

Caseload and cost-growth forecasts. Budget writers often have elected to address shortfalls from low caseload or cost-growth assumptions in supplemental appropriations during the subsequent legislative session. HHSC requested supplemental appropriations for fiscal 2008-09 of \$152.9 million in general revenue funds to address an anticipated shortfall related to higher average costs than was accounted for in appropriations to the agency in their fiscal 2008-09 budget. However, this anticipated shortfall likely will be paid for with the increase in FMAP included in the federal Recovery Act.

The House and the Senate base budgets would maintain general cost-growth assumptions at 2009 levels and

include the LBB's assumptions about Medicaid caseload growth. Because HHSC anticipates higher caseloads and cost-growth than included in the base budgets as well as a more costly mix of acute-care Medicaid clients, the agency has requested an additional \$5.0 billion in all funds, including \$1.9 billion in general revenue and general revenue-dedicated funds, to fund fiscal 2010-11 Medicaid entitlement services.

Staff pay. HHSC requested \$66.8 million in all funds, including \$44.9 million in general revenue funds, to provide targeted salary increases of 10 to 15 percent for four health care professions — registered nurses, licensed vocational nurses, physicians, and psychiatrists — in order to combat annual turnover rates that in most cases exceed 20 percent. Direct service delivery staff in HHS agencies assist clients in state schools and hospitals, protective services, and benefit eligibility determination. HHSC requested an additional \$141.3 million in all funds, including \$88.2 million in general revenue funds, to increase wages for about 25,000 full-time employees by 10 percent. In addition, DSHS and DFPS each have made agency-specific requests to enhance recruitment and retention practices at their agencies.

State schools versus community care. Eligible Texans with cognitive and developmental disabilities may qualify for Medicaid assistance to receive care in one of the following settings:

- the 13 state schools providing campus-based, long-term care for the cognitively disabled;
- smaller private or state-run intermediate care facilities for the mentally retarded (ICF-MRs); or
- in the community through Medicaid waiver services, most commonly the Home and Community-based Services (HCS) waiver.

In fiscal 2008, 4,843 Texans resided in state schools. Qualifying individuals are entitled by the Medicaid program to treatment in a state school or ICF-MR. However, those choosing to “waive off” their right to this Medicaid entitlement may join the waitlist for Medicaid waiver services, including the HCS waiver program, to receive various services in the community rather than in an institutional setting. The five Medicaid waiver programs

from which those with cognitive disabilities could receive community-based services have a combined waitlist exceeding 65,000, with some wait times of eight to nine years.

Reports of abuse and neglect in the state's system of care for developmentally disabled Texans have led to enhanced state and federal scrutiny. A U.S. Department of Justice study of Texas' state schools issued its findings in a December 2008 report. The report found “serious problems and deficiencies of care” and cited 450 reports of abuse and 53 preventable deaths in 2007 and 800 direct-care staff firings or suspensions since 2004.

A number of proposals, each differing in cost, have been developed to reduce abuse and neglect in state schools and possibly provide more care in the community. SB 1060 by Ellis and HB 1589 by Rose would direct HHSC to develop a 10-year plan by December 2010 to improve the state school system. The plan would include strategies to improve choice and reduce waiting lists for community-based facilities as well as a plan to consolidate or close some state schools, shifting money from these institutions to community-based care. The Senate base budget contains Art. 2, Special Provisions, sec. 48, which would provide \$487 million in all funds, \$200 million in general revenue funds, to limit the number of residents at state schools and increase the number of waiver slots available for those wishing instead to receive care in their homes or communities.

Frew lawsuit. The 80th Legislature, in HB 15 by Chisum, appropriated \$1.8 billion in all funds, including \$707 million in general revenue funds, for fiscal 2008-09 to fund the *Frew v. Hawkins* lawsuit settlement. This suit, filed in 1993, alleged that Texas failed to meet its obligation to provide certain federally mandated health benefits to Medicaid patients under age 21. Most of the \$1.8 billion was used to increase provider rates for medical professionals serving Medicaid recipients under age 21. HHSC also was directed to spend \$150 million in general revenue funds on strategic dental and medical initiatives.

An advisory committee was formed to recommend how the \$150 million should be spent. Of the \$150 million, \$38.5 million of the strategic initiative appropriation will

be spent this biennium, and HHSC has planned for \$90 million more in spending in fiscal 2010-11. Some observers are dissatisfied both with the current and planned spending, saying it is short of the \$150 million intended for spending in fiscal 2008-09. Others contend that HHSC has funded as many initiatives as it concluded would be successful and will fulfill its spending obligation on other evidence-based initiatives in the future.

Public Education

Public education is the largest single function funded by the state. Nearly all public education funding is appropriated to the Texas Education Agency (TEA), with Article 3 funding also appropriated to the State Board of Education, State Board for Educator Certification, the Texas School for the Deaf, the Texas School for the Blind and Visually Impaired, and the Teacher Retirement System.

The Senate base budget would appropriate \$49.1 billion in all funds to TEA, of which \$36.8 billion would be dedicated to the Foundation School Program (FSP). The House base budget would appropriate \$48.9 billion in all funds to TEA, of which \$36.8 billion would be dedicated to the FSP. The \$148 million difference is due to higher funding in the Senate base budget for teacher incentive pay. The House and the Senate base budget appropriations to the FSP would meet the state's statutory funding obligations to school districts and would account for student growth. Each base budget includes a rider that prioritizes appropriations up to \$1.4 billion should the Permanent School Fund (PSF) make a distribution to the Available School Fund if the PSF's market performance permits. In the total appropriations to public education, both budgets assume the \$1.4 billion distribution from the PSF to the ASF.

Revenue streams for public education

Four major sources of funding finance public education, including the: Foundation School Program; Permanent School Fund (PSF), Available School Fund (ASF); and State Textbook Fund.

Most state funding — including money for facilities, maintenance, operations, technology, and textbooks — is distributed to school districts through the FSP. Funding for school district maintenance and operations is distributed using weights and adjustments based on student and district characteristics to account for the varying costs of educating different types of students and for other factors.

The Permanent School Fund is a trust that holds state lands and mineral rights. The PSF's investment returns are

constitutionally dedicated to the benefit of Texas public schools and, if the fund's investment performance permits, distributions are made to the Available School Fund. The ASF consists of distributions from the PSF and revenue from one-fourth of motor fuels taxes and one-fourth of occupations taxes. Distributions to the ASF are used to fund instructional programs, including the State Textbook Fund, which finances the purchase of textbooks for local school districts.

Locally, most new school facilities are financed by bonds approved by local school district voters and paid with local property-tax revenue. The PSF may guarantee payment of bonds issued by school districts for the maintenance and construction of instructional facilities. The state also provides facility funding through the Instructional Facilities Allotment and the Existing Debt Allotment. The Teacher Retirement System is funded through state appropriations and a percentage of employee payroll as determined by the Legislature.

Federal stimulus funds. The federal Recovery Act includes \$5.6 billion in federal stimulus funds to support elementary, secondary, and higher education in Texas. This total includes \$3.3 billion in fiscal stabilization funds to schools, including institutions of higher education, to restore levels of state support received in fiscal 2008 or fiscal 2009, whichever is higher. Remaining fiscal stabilization funds would be distributed to districts based on standard federal allocation formulas. Restored funding for schools could include funds for textbooks, which may otherwise be unavailable due to a constitutional restriction preventing distributions from the Permanent School Fund to the Available School Fund.

Additional stimulus funds for education include \$1.2 billion in grants to local educational institutions to help disadvantaged children meet state standards, \$1.0 billion for Individuals with Disabilities Act (IDEA) grants to cover costs of providing special education programs, and \$59.4 million in funds to promote the use of technology in K-12 education programs.

Budget drivers for public education

Student growth is the main driver of public education spending. The public education system consists of 1,200 school districts with 8,200 campuses. Total average daily attendance is expected to increase 3.6 percent from 4,398,692 in fiscal 2009 to 4,557,004 in fiscal 2011.

Selected budget issues in public education

Permanent School Fund. In 2003, the Legislature and Texas voters approved a constitutional amendment (HJR 68) allowing capital gains on the Permanent School Fund (PSF), rather than only dividends and interest, to be distributed to the Available School Fund (ASF). However, to preserve the principal of the PSF, Art. 7, sec. 5 of the Constitution not only caps the percentage of PSF investment returns that may be distributed to the ASF, but also prohibits any distribution in years when the PSF value falls below a certain level (*see pages 5-6*). The comptroller has indicated that the ASF likely will not receive a distribution from the PSF during fiscal 2010-11 because the PSF has experienced a significant decrease in the value of its assets. This would mean a loss of about \$1.4 billion in available funding for public education.

Instructional materials. A significant portion of funding for instructional materials and textbooks is contingent upon the distribution of funds from the PSF to the ASF or the replacement of this revenue. If funds are distributed from the PSF, the House and the Senate base budgets would appropriate \$895 billion for instructional materials – \$547.5 million to fund 2010 instructional materials and \$347.6 for continuing contracts with providers of instructional materials. If the funds are not distributed, no textbook appropriations are provided for under the base budgets. To replace these funds, the Legislature may consider other funding sources, such as appropriating money from the Rainy

Day Fund, using federal stimulus money, or shifting spending elsewhere to free up general revenue funds.

Technology allotment. The technology allotment is used to buy electronic textbooks or technological equipment that contributes to student learning and to train teachers in using the technologies. Contingent upon funds being distributed from the PSF to the ASF, both base budgets would fund the technology allotment fully at the rate of \$30 per student with a total appropriation of \$270.9 million, an increase of \$7.5 million over the fiscal 2008-09 appropriation.

Public school finance. Both base budgets would appropriate a total of \$36.8 billion, meeting the state's current statutory obligation to the Foundation School Program (FSP), which is the same amount appropriated to the FSP in fiscal 2008-09. The fiscal 2008-09 budget for the FSP was higher than the biennial statutory funding obligation due to a one-time appropriation of \$1.5 billion to reverse the deferral of the August 2003 FSP payment.

To certify the state budget in 2003, the 78th Legislature had shifted the final monthly FSP payment to the start of the next fiscal biennium, making 23 months of FSP payments rather than 24. To reverse that deferral, the Legislature in the fiscal 2008-09 budget paid 25 months of FSP payments to school districts rather than 24. Since fiscal 2010-11 will return to the normal schedule of 24 monthly payments, the one-time appropriation of \$1.5 billion no longer will be needed.

The 79th Legislature in 2006 enacted HB 1 in its third called session, in response to the Texas Supreme Court's holding that school districts lacked "meaningful discretion" in setting local school property tax rates, effectively resulting in an unconstitutional state property tax. At the time, most local governments were taxing at or near the state property tax rate cap of \$1.50. In HB 1, the Legislature compressed local property-tax rates to \$1.00.

HB 1 also included a target revenue provision – a "hold-harmless" mechanism to ensure school districts

did not lose funding by guaranteeing they would receive, at minimum, their 2005-06 funding. This target revenue was compared to the amount a district would receive using the formulas in statute at the compressed tax rate. If the formula calculation did not equal the target revenue, the state provided additional funding to reach target revenue. If the formula calculation exceeded the target revenue amount, the district received the target revenue only. As a result, most school districts have received state funding frozen at their 2005-06 levels.

Of the \$36.8 billion FSP appropriation, both base budgets would direct, through TEA Rider 89, an additional \$1.9 billion above current law obligations to fund a return to a formula-driven public school finance system, contingent upon corresponding enacting legislation. Under such a system, funding for school district operations and support would be distributed using weights and adjustments based on student and district characteristics to account for the varying costs of educating different types of students.

Hurricane Ike. The LBB estimates Hurricane Ike cost Texas public schools about \$300 million and TEA about \$3 million. TEA has not received federal reimbursement funds for this unexpected expense, nor does the LBB anticipate federal reimbursement. Hurricane Ike displaced 7,892 students statewide, and 6,900 still are not living in their home school districts. Many school districts may request appropriations to rebuild damaged or destroyed buildings, and some school districts have applied directly to the federal government for reimbursements. With a May 20 waiver deadline, TEA already has approved 1,327 waivers exempting schools from scheduling make-up days for school closures resulting from the hurricane.

Recapture payments are a feature of the school finance system that require certain property-wealthy school districts to give a portion of their local property tax revenue to the state for redistribution to property-poor school districts. Legislators may consider suspending the collection of these payments from school districts that sustained severe damage from the hurricane. A proposal has been made to forgive recapture payments under certain trigger conditions, including when a school district was

damaged significantly by Hurricane Ike. It is estimated that about three school districts would qualify for recapture payment forgiveness. The proposal would include an appropriation from the Rainy Day Fund to the Foundation School Program so that the public school finance system would not absorb the estimated \$18 million revenue loss in recapture payments. No provision in current law allows for the suspension of recapture, even in cases of a natural disaster.

Facilities. The Instructional Facilities Allotment helps property-poor school districts pay for new bond debt or for lease-purchases for new instructional facilities or renovations. Districts apply to TEA for the Instructional Facilities Allotment. The state guarantees the eligible districts \$35 per student in average daily attendance per penny of local tax effort dedicated specifically to that project. To determine eligibility and the amount of money a district would receive, the school district's tax revenue yield is subtracted from the state's guaranteed yield amount of \$35. If the difference is zero, then the district does not qualify. As a district's property values increase, the state's share of the Instructional Facilities Allotment decreases.

Because the state's guaranteed yield has been \$35 since 1999 and most areas of the state have experienced significant increases in property valuations, fewer and fewer school districts are eligible for the program. Currently, 408 school districts receive money through the Instructional Facilities Allotment. About \$9 million appropriated to the Instructional Facilities Allotment was not granted to school districts in fiscal 2008-09 because the remaining applicants were considered too property wealthy under the current requirements. The LBB estimates that in fiscal 2010-11, 584 districts serving about 2.6 million students will be eligible under the current guaranteed yield down from 886 districts.

The LBB's *Texas State Government Effectiveness and Efficiency* report notes that increasing the state guaranteed yield from \$35 to \$60 would increase the state's share of facility costs to 66.7 percent from 42.9 percent. This adjustment would require increasing the appropriation to the Instructional Facilities Allotment

by \$316 million, which is not reflected in either base budget. Both base budgets would fund the IFA at \$20 million, which would fulfill current law obligations.

Educator incentive pay programs. Texas operates two programs for educator incentive pay, or pay for performance. In June 2006, the 79th Legislature in its third called session enacted property tax relief legislation that established the Awards for Student Achievement program and the Educator Excellence Awards program. TEA subsequently renamed both programs, which now are known as the Texas Educator Excellence Grant (TEEG) program and the District Awards for Teacher Excellence (DATE) program.

TEEG first was funded in fiscal 2007 with \$100 million in general revenue funds. Grants are used to retain teachers certified in the subjects they teach, especially in critical subject areas such as math and science, as well as to retain teachers at hard-to-staff schools. Campuses may customize their incentive plans to their needs, with approval from TEA. Generally, the incentive payments are between \$3,000 and \$10,000 per teacher and based primarily on quantifiable student achievement.

All district and charter schools are eligible to apply for DATE funding and must, among other things, provide a 15 percent match in funding. District-level committees must develop a local plan that awards at least 60 percent of the funds to classroom teachers who improve student achievement. The remaining funds may be used to provide stipends for mentors or to provide incentives to teachers certified in the subject they teach, especially in critical subject areas such as math and science, and those holding advanced degrees. According to the LBB, about 213 school districts and charter schools, serving a little less than half the students in the state, are participating in the program for the 2008-09 school year. District grant awards range from about \$4,000 to more than \$13 million for academic year 2008-09, with the average grant being about \$700,000.

TEA has requested a total of \$684.9 million in general revenue funds for fiscal 2010-11 for TEEG and

DATE. The Senate base budget would increase funding for both programs by \$147.8 million, for a total of \$490.6 million. The House base budget would continue funding at the current level of \$342.8 million. The governor has recommended \$622.5 million to expand and continue both programs.

Teacher Retirement System. The Teacher Retirement System (TRS) provides retirement benefits, group insurance, and death, survivor, and disability benefits for employees of public school districts and institutions of higher education. For fiscal 2010-11, the base budgets would appropriate almost \$4 billion in all funds to TRS, an increase of \$235.9 million, or 6.3 percent above fiscal 2008-09 spending. The total amount reflects funding for the retirement trust fund for public education and higher education employees, TRS-Care, and administrative operations.

The base budgets would appropriate \$3.4 billion in all funds in fiscal 2010-11 for TRS state retirement contributions, an increase of \$190.2 million from fiscal 2008-09. This would provide for a state contribution of 6.4 percent of payroll, compared to the fiscal 2008-09 contribution rate of 6.58 percent. The 80th Legislature in 2007 prohibited by statute the state contribution from falling below the contribution rate of active TRS members, which currently is 6.4 percent.

Government Code, sec. 811.006 prohibits the Legislature from granting benefit increases to retirees unless the TRS fund is considered “actuarially sound,” meaning that pension system would be able amortize all of its liabilities over 31 years. In November 2007, the TRS board determined that the TRS fund’s actuarial condition allowed issuance of a “13th check,” adding an extra monthly payment of up to \$2,400 to TRS retirees in January 2008. Since then, the value of the TRS fund has dropped substantially as world market values have plummeted.

Higher Education

Public institutions of higher education funded by the state include 35 general academic teaching institutions, nine health-related institutions and the private Baylor College of Medicine, 50 community and junior college districts, three lower-division state colleges, the state technical colleges, and the Texas Higher Education Coordinating Board (THECB). Also funded are Texas A&M University System service agencies doing research in agriculture, engineering, transportation, veterinary medicine, forestry, and other programs.

The Senate and the House base budgets would appropriate \$22.2 billion and \$22.1 billion, respectively, in all funds for higher education in fiscal 2010-11. The Senate base budget would include an increase of about \$1 billion from fiscal 2008-09, and the House base budget would include an increase of about \$946 million, in both cases an increase of about 5 percent from fiscal 2008-09. The Senate budget would allocate to higher education institutions \$12.9 billion in general revenue funds, and the House base budget would allocate \$12.8 billion in general revenue funds.

Both bills would make permanent the Higher Education Performance Incentive Initiative. The Senate would allocate \$200 million in general revenue funds for the initiative, while HB 1 would allocate \$100 million in general revenue funds. The 80th Legislature in 2007 appropriated \$100 million for fiscal 2009 to the THECB to establish the initiative to improve teaching and educational excellence at Texas public general academic institutions.

Another difference between the Senate and the House base budgets is that the Senate would shift about \$66 million in general revenue funds from special-item and excellence funding to formula funding.

Revenue streams for higher education

Public higher education institutions and agencies receive state funding from a variety of sources, but tuition and fees and state appropriations are the major revenue sources for core instruction and operations. Institutions receive appropriations in lump sums, and

unlike most state agencies, are not required to spend the money within a specified funding strategy. Institutions rely on state funding to varying degrees. State appropriations include:

- direct appropriations through funding formulas and direct appropriations for special items for a particular institution's area of expertise or special need;
- indirect appropriations, or those not made directly to each institution, that are used to pay for staff health insurance, retirement benefits, and social security; and distributions from the Available University Fund.

In addition, funds are "trusteed" to the THECB for distribution to institutions, mostly to support student financial aid. The remaining trusteed funds provide incentive funding for general academic institutions, grants from the Advanced Research Program, and support for the Baylor College of Medicine. State appropriations for private institutions include financial aid programs for Texas residents attending private institutions.

General academic institutions. General academic institutions receive direct appropriations through both funding formulas and non-formula appropriations. Formula funding is based primarily on an institution's enrollment numbers and the types of courses it offers. Nearly 53 percent of all state funding for general academic institutions is allocated through two funding formulas — an instruction and operations (I&O) formula and an infrastructure formula — and with two supplements — a teaching experience supplement and a small institution supplement. Like the formulas, the supplements are based primarily on enrollment.

Formula funding calculations include statutory tuition revenue. The statutory tuition rate, which is set by the Legislature, is \$50 per semester credit hour for Texas residents. For budgeting purposes, revenue from statutory tuition is estimated, meaning that universities may spend the actual amount that is collected, even if it exceeds the estimate.

A significant portion of funding does not flow through the formulas. Non-formula funding includes appropriations for “institutional enhancement” or special items, which are projects that are specific either to an institution’s area of expertise or a special purpose.

Other non-formula funding includes debt service for tuition revenue bonds; research development funding; excellence funding that supports most general academic institutions, except the University of Texas at Austin and Texas A&M University; and distributions from constitutional funds, which include the Available University Fund (AUF), which supports the University of Texas and Texas A&M Systems, and the Higher Education Fund (HEF), which supports institutions that are not eligible for the AUF. The HEF is funded with general revenue appropriations.

Other non-formula funding includes funding for the Higher Education Performance Incentive Initiative. The 80th Legislature in 2007 appropriated \$100 million in fiscal 2009 to the THECB for outcome-based funding for general academic institutions based on degrees awarded, especially in critical fields, and to degree recipients who are at-risk students. In October 2008, \$80 million was disbursed to the general academic institutions, and \$20 million will be used to fund scholarships for students graduating in the top 10 percent of their high school class.

Revenue for Texas Public Education Grants (TPEG) is derived from statutory tuition, a portion of which institutions are required to set aside for this purpose.

Institutions also have access to funds that are not reflected in the state appropriations process because institutions generate this money from external sources. Examples include board-authorized tuition (“designated tuition”) and fees, auxiliary income, indirect cost recovery income from research grants and contracts, and gifts. In 2003, the 78th Legislature delegated authority to university system boards of regents to set designated tuition rates.

Health-related institutions. Most health-related institutions offer undergraduate medical, nursing,

pharmacy, allied health, and dental programs. They also provide residency training and graduate medical education to new physicians.

Health-related institutions receive state funding through three primary formulas — instruction and operation (I&O), infrastructure, and research enhancement. Like general academic institutions, they receive most general revenue funding through the I&O formula. They also receive non-formula funds from revenue generated from patient care, special-item funding, revenue for TPEG, funding for employee benefits and tuition revenue bond debt service, indirect cost recovery, and interest earnings from tobacco settlement funds. For budgeting purposes, income from patient care is estimated, and institutions may spend the actual amount that is collected.

Health-related institutions also have access to funds outside the appropriations process, including certain tuition revenue, grants, and gifts. Special-item funding supports residency programs, academic outreach, public service, research, and other items. Health-related institutions are eligible for constitutional funding from the AUF and the HEF, just like general academic institutions.

Texas A&M system agencies. The Texas A&M System agencies’ missions are different from other higher education institutions. Each agency focuses on research, extension, or services such as emergency response, training, and educational programs. They do not receive formula funding and do not generate tuition and fees like the other institutions, although some may charge fees for their services. They are eligible to receive funds from the PUF. Their staff benefits, including employee group health insurance, are paid for the same way as other higher education institutions.

Community colleges. Community colleges are funded primarily based on student contact (classroom) hours. They also are supported by local property taxes and by tuition and fees. Community colleges are not eligible for HEF or AUF allocations or for state tuition revenue bonds. Certain institutions receive appropriations for isolated special items.

More than 99 percent of general revenue funding for community colleges is generated through one funding formula. State funding must be used exclusively to pay salaries of instructional and administrative employees and to buy supplies and materials for instruction. No state funding is provided for physical plant operations and maintenance of facilities because those costs are borne by the institutions and usually funded by local property taxes. Tuition and fees also provide income for community colleges, along with state funding for group insurance.

Like general academic and health-related institutions, community colleges receive state general revenue fund contributions for group insurance. According to the LBB, the funding is fully discretionary because community college employees are locally employed.

A budgetary principle known as “proportionality” — the proportional cost-sharing between the state and institutions that receive funding — is used to determine the state’s obligation to pay for employee benefits. It requires that payments for salaries and associated benefits be proportional to an institution’s sources of income. In other words, the state’s obligation to pay for benefits is limited to those employees whose salaries are paid with state general revenue. All state agencies and public higher education institutions determine the proportional cost-sharing split for employee benefit costs. However, the Legislature has not applied proportional cost-sharing to community colleges and has provided full funding for group health insurance for eligible faculty and staff.

Gov. Perry exercised his line-item veto authority in June 2007 to remove \$154 million from the fiscal 2009 budget that would have funded higher education group insurance contributions for community colleges. In the fall of 2007, an agreement was reached between the governor and legislative leaders to restore the funds. Supplemental appropriations could allocate \$153 million to reimburse community colleges for costs associated with the veto.

Selected budget issues in higher education

Community college funding/proportionality.

The House and the Senate base budgets would allocate \$1.8 billion in state general revenue funds to community and junior colleges. THECB recommended total funding of \$2.4 billion for community colleges for fiscal 2010-11. This includes an increase of \$648.2 million in formula funding as well as \$95 million for institutional performance funding to recognize achievement in meeting student success goals and funds for growth at new and expanded campuses.

The base budgets include \$110 million in formula funding that is contingent upon applying proportional cost-sharing between the state and community colleges for employee health insurance benefits. Community college officials say that applying proportionality to health benefits and distributing the funding through formulas would create “winners” and “losers” because some institutions would lose funding while others would gain. Formula funding is driven by contact hours, so fast-growing districts would draw down more formula funding at the expense of some other districts that are experiencing slower growth. Some colleges would lose funding for health insurance benefits that they would not get back through formula funding.

Student financial aid. THECB recommends increased funding for the two major financial aid programs for needy students — TEXAS Grants, the state’s premier grant program, and the Texas Educational Opportunity Grant (TEOG) for students attending community colleges and other two-year institutions.

The TEXAS Grants program serves a little more than 50 percent of eligible students and was allocated \$427.8 million in general revenue funds for fiscal 2008-09. To increase support to at least 67 percent of eligible students, or 64,000 more students, THECB has requested an additional \$367.5 million for TEXAS Grants. The House and the Senate base budgets would

allocate about the same level of funding as fiscal 2008-09. The governor proposed increasing funding for TEXAS Grants by \$110 million.

Funding for TEOG in fiscal 2008-09 of \$14 million in general revenue funds allowed grants to 4 percent of eligible students. In its original budget request for fiscal 2010-11, THECB requested an additional \$193.5 million for TEOG, which would support at least 33 percent of eligible students, or 98,425 additional students. The House and the Senate base budgets would allocate about the same level of funding as fiscal 2008-09. The governor proposed increasing the TEOG from \$14 million to \$42 million for fiscal 2010-11.

Tuition deregulation/tuition freeze. According to THECB, from fall 2003 through fall 2007, statewide average total academic charges for students taking 15 semester credit hours increased by 53 percent. Universities have reported that tuition increases are providing a growing share of their operations income and that they use these funds for a variety of purposes, including faculty recruitment and retention, academic course offerings, student services, and financial aid.

Several bills have been filed that would limit tuition and fee increases in various ways, with the fiscal impact to the state varying depending on how the limit was achieved. Any proposal to limit designated tuition increases would mean a loss of revenue to academic institutions that would require either program reductions or a higher cost to the state to reimburse the institutions for lost tuition revenue.

Formula funding for general academic institutions. THECB recommended total funding of \$4.7 billion for general academic institutions for fiscal 2010-11, which includes a \$300 million increase in formula funding from fiscal 2008-09, and \$178 million for performance funding to recognize achievement. The House and the Senate base budgets would allocate \$4.4 billion in general revenue funds to general academic institutions and system offices for fiscal 2010-11. They do not incorporate a THECB recommendation to base funding on completed semester credit hours, rather than attempted hours.

Incentive funding. The THECB proposed in its formula recommendations that a new “performance” component be added to the base formula for general academic institutions and community colleges. The Task Force on Higher Education Incentive Funding, established by Gov. Perry, recommended the Legislature appropriate an average annual increase of \$470 million for incentives at general academic institutions, two-year institutions, and the health-related institutions, in addition to the current level of funding of \$50 million per year. The governor proposed increasing incentive funding by \$168.9 million for fiscal 2010-11.

The House and the Senate base budgets would allocate \$200 million and \$100 million, respectively, in general revenue funds for incentive funding for general academic institutions. State leaders say that institutions should be rewarded for increasing outcomes that are in line with the state higher education plan. Some university officials suggest that before funding is enhanced by incentives, the state first should adequately fund the formulas that support basic functions, as THECB recommended.

Special item funding. The Legislature provides general revenue funding directly to higher education institutions to support specific programs or activities that cannot be paid for with formula funding. Examples of special item funding include the Obesity, Diabetes, and Metabolism research program at UT Southwestern Medical Center at Dallas and the McDonald Observatory at the University of Texas at Austin. Some institutions request special item funding to pay debt service on tuition revenue bonds (TRBs). Special item funding allocated through the institutional enhancement strategy usually is not tied to a particular program or activity. For example, many institutions report that institutional enhancement funding is used on student-centered programs, like freshman retention programs and hiring more student counselors, or to cover the cost differential when Texas Tomorrow Fund contracts do not cover the full cost of tuition.

The governor has proposed that \$645.7 million of special item and excellence funding be reallocated to student financial aid and other priorities. The Senate

base budget would allocate \$291 million for institutional enhancement funding, and the House base budget would allocate \$319 million. Both the House and the Senate base budgets would allocate \$299 million for special items for general academic institutions and system offices. The Senate base budget would shift about \$66 million in general revenue from special item and excellence funding to the general academic funding formula. Some say that once funded, many special items continue indefinitely, even after a project has terminated. Emerging institutions rely on the funding to increase their faculty numbers and “grow” programs until student enrollment is up. Others say it would be difficult to start a new campus — like the Regional Academic Health Center (RAHC) in the lower Rio Grande Valley — without the funding until enrollment is sufficient to sustain the campus. University officials say that any changes to institutional enhancement funding should be phased in over time.

Flagship university. Debate continues about establishing another national research university to join the ranks of the state’s two public, tier-one research universities, the University of Texas at Austin and Texas A&M University. Discussion centers on whether to allocate state dollars, how to fund a pathway to tier-one status, and which of the state’s seven emerging research institutions should get research funding to boost it to tier-one status — Texas Tech University, the University of Houston, the University of North Texas, UT-Arlington, UT-Dallas, UT-El Paso, or UT-San Antonio. Preliminary estimates suggest a cost of between \$50 and \$75 million per institution per year for at least 10 years for an institution to attain tier-one status.

One proposal would provide matching funds to the institutions when they receive major research grants or hire top-flight faculty. The House Select Committee on Higher and Public Education Finance in February recommended helping three to five institutions achieve tier-one status over the next 10 years, starting with \$300 million from the Rainy Day Fund during the next biennium.

Hurricane Ike recovery. According to early estimates, the University of Texas Medical Branch at Galveston (UTMB) suffered around \$1 billion in damages, disruption, and lost revenue from Hurricane Ike, of which \$100 million is covered by insurance. UTMB is seeking immediate, one-time funding for unreimbursed expenses. Deliberations center on whether to restore UTMB health services to pre-hurricane conditions. University officials report that 59 percent of the annual budget was derived from patient care operations, and that revenue stream has been significantly reduced due to damage at the John Sealy Hospital and outpatient clinics. UTMB officials have requested about \$354 million to rebuild and renovate the island-based facilities of the medical school. This includes \$150 million for the state’s match for FEMA funds, \$150 million in capital funds for repair and mitigation costs and about \$54.5 million to restore business losses. In addition to state appropriations, UTMB officials expect to get about \$100 million from insurance and \$600 million from FEMA.

HB 6 by Eiland, the disaster relief supplemental appropriations bill, would appropriate state funds from the Rainy Day Fund to help restore UTMB.

Judiciary

Article 4 includes the Texas court system — two high courts, 14 intermediate appellate courts, 449 state district courts, and 2,236 county, municipal, and justice-of-the-peace courts. The state pays for almost all functions of the Supreme Court and the Court of Criminal Appeals and most functions of the 14 courts of appeal. The state also pays:

- the base salaries of all 547 appellate and district judges;
- some of the travel expenses for district judges with jurisdiction in more than one county;
- salary supplements for constitutional county, statutory county, and statutory probate judges;
- salaries for child support and child protection court associate judges; and
- funding to prosecutors for salary and expenses.

Some of the appellate courts receive funding from the counties where they are located. Counties and cities cover the cost of most county, justice-of-the-peace, and municipal court personnel and the courts' capital and operating expenses. Other state-funded judiciary functions include the Office of Court Administration (OCA), the State Law Library, the Office of the State Prosecuting Attorney, the State Commission on Judicial Conduct, the Court Reporter's Certification Board, the Judiciary Section of the Comptroller's Office, the Public Integrity Unit, and the Office of the Special Prosecutor.

Major budget drivers for judiciary

Court budgets are based not on the number of cases but on the number of judges and staff. A continuing issue for courts is showing the number of cases disposed compared to the number filed, both per court and per judge. Such measures gauge staffing needs and help determine the potential need for more courts. In general, the number of cases filed increases every year, with criminal case filings increasing faster than civil case filings in most parts of the state. The Supreme Court and the Court of Criminal Appeals have some discretion over which cases they hear, but the intermediate appellate courts must dispose of every case filed. As dockets have

grown relative to the number of judges, the appellate courts have relied on staff increases and on visiting judges to help work through dockets and avoid creating a backlog of cases.

Selected budget issues in judiciary

Collapse of IOLTA funds. Funding for civil-legal aid in Texas has declined because of the recent recession. As part of its efforts at economic recovery, the Federal Reserve has lowered the benchmark interest rate to historic lows of zero to .25 percent, affecting one of the funding sources for civil legal assistance in Texas, the Interest on Lawyers' Trust Accounts (IOLTA). Since the mid-1980s, attorneys in Texas have taken the short-term interest on funds held on behalf of clients and turned it over to the Texas Access to Justice Foundation. The Supreme Court of Texas oversees the foundation. The foundation's function is to disperse grants to legal aid groups throughout Texas. The drop in interest rates diminished the IOLTA program from \$20 million in fiscal 2007 to \$12.2 million in fiscal 2008. It is estimated to fall to \$1.5 million in fiscal 2009. These funds are generated and administered outside of the state appropriations process.

Civil legal aid provides emergency legal services to Texans who fall below 125 percent of the poverty line. Legal aid programs help Texans dealing with economic hardship, such as eviction or domestic violence and other emergencies. Family law issues make up about half of the legal aid caseload. A recent, high-profile, legal aid case involved the state's removal of more than 200 children from the ranch operated by a polygamist group in Schleicher County in West Texas.

The Supreme Court has asked that the Legislature appropriate an additional \$37 million for fiscal 2010-11 to make up for the IOLTA shortfall. IOLTA funds are not reflected in the Supreme Court's budget but would be appropriated directly to the Texas Access to Justice Foundation. Supporters of appropriating funds for this purpose say civil legal aid is more important than ever because those least able to fend for themselves are even more vulnerable during times of economic hardship.

4 Judiciary

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Opponents say that if the state cannot afford to fund current programs, it cannot afford to appropriate new funding for others.

OCA has requested an additional \$815,000 in general revenue and general revenue-dedicated funds for fiscal 2010-11 to fund the Judicial Emergency Data Infrastructure project (JEDI). JEDI would assist the courts by providing offsite computer operations in the event of an emergency. In addition, the Supreme Court has requested nearly \$1 million in general revenue and general revenue-dedicated funds to restore funding of Multi-District Litigation grants. These grants fund operations for courts with certain cases that have been referred for consolidated hearings. This consolidation occurs when cases from multiple districts are referred to a single court for convenience and more efficient use of judicial resources. The Court of Criminal Appeals has requested an additional \$1 million in general revenue and general revenue-dedicated funds for training judges, prosecutors, defense attorneys, and court personnel.

Criminal Justice

Article 5 covers state agencies responsible for criminal justice and public safety. The largest agency is the Texas Department of Criminal Justice (TDCJ), which operates the adult correctional system. TDCJ receives about two-thirds of the general revenue and general revenue-dedicated funds in Article 5. Together, the Texas Youth Commission (TYC) and the Texas Juvenile Probation Commission (TJPC) are responsible for juvenile offenders and receive about 8 percent of Article 5 funding. Other Article 5 agencies include the Department of Public Safety (DPS), Texas Alcoholic Beverage Commission (TABC), Commission on Jail Standards, Adjutant General's Department, Military Facilities Commission, and two boards that license and regulate criminal-justice professionals.

General revenue and general revenue-dedicated funds make up about 80 percent of Article 5 spending and the majority of spending for most Article 5 agencies. One exception is the Department of Public Safety (DPS), which in fiscal 2008-09 received about 60 percent of its funding from State Highway Fund 6. Fund 6 receives revenue from federal reimbursements, state motor fuels taxes, motor vehicle registrations, and various fees.

The House and Senate base budgets would appropriate \$8.2 billion in general revenue and general revenue-dedicated funds for Article 5 in fiscal 2010-11, an increase of about \$88.7 million or 1.1 percent from fiscal 2008-09.

Budget drivers for adult criminal justice

Spending on adult criminal justice is driven mainly by trends in the number of adult offenders incarcerated by the state and the number on parole and probation. Operating state prisons accounts for the bulk of spending on adult criminal justice, but since July 2005, Texas has been leasing beds from counties to handle additional prisoners.

Prison population and state capacity. As of December 1, 2008, the Texas Department of Criminal Justice had an operational capacity of 156,613 beds, including 1,899 beds under contract from counties. The "operational capacity" of TDCJ is calculated as 97.5 percent of bed capacity to account for the need to house

inmates appropriately and for flexibility in moving inmates. Under Government Code, sec. 499.121, the state has a 45-day deadline for moving prisoners from county jails to state facilities once they have been sentenced to a state facility and all processing for the transfer has been completed.

The adult incarcerated population is expected to remain steady in fiscal 2009, decline beginning in fiscal 2010, and begin increasing again in fiscal 2012, if there are no changes in the current sentencing practices and statutes, according to a January 2009 report released by the LBB. The LBB reports the population projections for these years to be: 156,928 at the end of fiscal 2008-09; 155,589 at the end of fiscal 2010-11; and 157,831 at the end of fiscal 2012-13. The decline in the population in 2010 is due to the expansion of treatment and diversion programs in fiscal 2008-09, according to the LBB.

With these projections, the expected adult prison population in fiscal 2010-11 could be housed within the current state operating capacity, and the House and the Senate base budgets would not appropriate any money to construct new state prisons. However, both base budgets do include some proposed changes in funding for beds operated by others under contracts with TDCJ. Both include \$14.1 million for scheduled increases to the per-day rate paid for privately operated beds under contract with the agency and a decrease in the total amount, \$27.6 million in general revenue funds appropriated in fiscal 2008-09 for temporary beds leased by TDCJ through contracts with counties. This means that under the base budgets, TDCJ would have no funding set aside for the beds currently under temporary county contracts.

Parole population. The number of adults being supervised by the state parole system is projected by the LBB to increase annually through fiscal 2012 due to relatively higher parole release rates and lower parole revocation rates. The end-of-month yearly average is projected to be 78,462 parolees in fiscal 2009; 80,052 parolees in fiscal 2011; and 82,602 parolees in fiscal 2013.

Probation population. The number of offenders on probation (community supervision) for committing felony offenses began an annual increase in fiscal 2006 that is

projected to continue through fiscal 2014, according to the LBB. The end-of-month yearly average for probationers under direct supervision for felony offenses is estimated to be 172,808 in fiscal 2009; 175,075 in fiscal 2011; and 178,216 in fiscal 2013. The number of offenders on probation for committing misdemeanor offenses is projected to be 125,158 in fiscal 2009 and is expected to grow slightly for the next five years, reaching 126,444 in fiscal 2014. The House and the Senate base budgets include an increase of \$11.7 million in general revenue funds for payments to local probation departments for the increases in probation population.

Budget issues for adult criminal justice

TDCJ: Continuing or increasing funding for offender treatment and diversion programs. In 2007, the 80th Legislature addressed a growing adult offender population and a projected need for new state prison beds by both increasing the state's correctional capacity and expanding treatment and diversion programs. For fiscal 2008-09, TDCJ received \$63.1 million to increase the state's 3,250 substance-abuse felony punishment (SAFP) beds by 1,500 and \$22.2 million for 500 new beds for offenders convicted of driving while intoxicated. The agency also was appropriated \$15.9 million to convert two Texas Youth Commission facilities into adult prisons and to operate those facilities and \$10.3 million to operate a mental health facility transferred from the federal government to the state.

The agency also received funds to add beds to the parole and local probation systems, including 300 new halfway house beds, 800 probation residential treatment beds, and 1,400 intermediate sanction facility beds for probationers and parolees. In-prison, jail, and out-patient substance abuse treatment programs were expanded, and money was put toward mental health services for defendants in local jails.

The House and the Senate base budgets contain funding to continue in fiscal 2010-11 most of these programs initiated by the 80th Legislature. However, the proposals do not include funding for 480 of the

intermediate sanction facility beds and 316 of the SAFP beds. TDCJ has requested \$28.6 million as an exceptional item to fund these beds fully in fiscal 2010-11.

TDCJ: Contraband screening. TDCJ has requested a new appropriation of \$66 million for fiscal 2010-11 to expand efforts to detect contraband, such as cell phones, tobacco, and narcotics, being smuggled into prisons. The proposal would fund surveillance cameras for all prison units and contraband screening devices, such as metal detectors and x-ray machines. The agency also has requested supplemental funding for this item.

The problem of contraband in the state's prisons was highlighted in October 2008 when a death row inmate was caught with a cell phone. The inmate made hundreds of calls, including threatening calls to a state senator. TDCJ instituted a search of all prisons and found about 128 cell phones. The agency has instituted new search procedures for those entering prisons, including mandatory pat searches. The agency continues to find phones through these and other procedures, with about 94 being found in December 2008 and 164 as of the end of January 2009.

TDCJ: Correctional officer pay raise. TDCJ is asking for an average 20 percent salary increase in fiscal 2010-11 for correctional and parole officers to help the agency recruit and retain more officers. The proposal, not included in the House or the Senate base budgets, would cost \$453.3 million during the fiscal 2010-11 biennium and would raise the starting correctional officer salary from \$26,016 to \$30,179. The maximum salary after seven and one-half years would increase from \$34,624 to \$42,242. The maximum salary for parole officers after 10 years would increase from \$36,363 to \$43,636.

The agency's proposal also includes a request to begin using annual retention bonuses for officers who remain in or take jobs at certain units that are short-staffed. This follows the agency's establishment in 2008 of recruitment bonuses for officers taking jobs at these units and modifications made to the correctional officer career ladder. The career ladder changes increased pay for officers with up to 20 months of service and decreased the amount of time it can take for an officer to move up

the ladder and receive the higher pay that comes with advancement. Both base budgets include funds to continue the adjustments made in 2008.

The agency currently is authorized to hire 26,302 correctional officers but has about 2,400 correctional officers jobs unfilled. About 40 of TDCJ's 1,278 field parole officer jobs are vacant.

TDCJ: Increased funding for inmate health care. The system used to deliver health care to prison inmates is based on a managed health care model and is operated by the Correctional Managed Health Care Committee (CMHCC), which was created by the Legislature in 1993. The CMHCC's appropriation is within TDCJ's budget. TDCJ contracts through the committee with the University of Texas Medical Branch at Galveston (UTMB) and the Texas Tech University Health Sciences Center (TTUHSC) to provide the statewide managed care network, which is similar to health maintenance organizations that operate in the open market and offers a full range of medical, dental, and psychiatric services. UTMB's contract covers about 121,200 of the state's approximately 150,000 inmates, and TTUHSC's contract covers the remainder.

The state's costs for inmate health care are driven by the size of the prison population, the age of inmates and their health issues, health care costs, and a need to provide a constitutional prison health care system. In fiscal 2008-09, the state spent about \$750.1 million on inmate health care and \$91.0 million on inmate psychiatric care. This is an increase of about \$81.9 million on these items from the previous biennium.

Hurricane Ike evacuations. Inmates needing certain medical services are moved to a prison hospital in Galveston and receive services provided by UTMB. About 208 inmates were evacuated from the hospital due to Hurricane Ike. One hundred of those inmates were in skilled nursing beds and the rest in acute care beds, which require the highest level of care. The inmates needing the skilled nursing services were transferred to two other TDCJ units with health care facilities, and the agency expects to keep placing inmates needing skilled nursing

at those units instead of the prison hospital, Hospital Galveston. The other 108 inmates were transferred to free-world hospitals and kept under TDCJ security. About 72 of these acute care beds are back in operation in Hospital Galveston, with the rest expected to be open within a few months. Of the approximately 65 inmates in free-world hospitals, 31 are in the hospital at the University of Texas Health Science Center at Tyler, and the rest are in hospitals around the state. Normally, even without the dislocations due to Hurricane Ike, about 15 inmates are in free-world hospitals at any time.

Request for additional fiscal 2010-11 and 2008-09 funding. The CMHCC requested \$181.1 million in additional funding, with almost one-third of the increase going for actual spending that has been incurred providing services. The CMHCC requested the following:

- \$56.8 million to adjust the committee's funding base to reflect expenses incurred in fiscal 2008-09 for the delivery of services;
- \$46.3 million to increase salaries to reflect market rates and for drug and medical supplies;
- \$29.4 million for hospital and specialty care;
- \$5.7 million for updated equipment, including x-ray, dialysis, and dental chairs;
- \$4.4 million for biopsies for hepatitis C patients;
- \$35.2 million to hire more staff to meet the recommendations of a staffing study; and
- \$3.2 million for additional staff, work space, and equipment.

The CMHCC also has requested \$39.0 million in supplemental appropriations for fiscal 2008-09 for expenses it has incurred above its fiscal 2008-09 appropriation for salaries, drugs and pharmacy services, medical supplies and services, and hospital care.

Budget drivers for juvenile justice

The Texas Youth Commission (TYC) and the Texas Juvenile Probation Commission (TJPC) together are responsible for juvenile offenders and receive about 7.6 percent of Article 5 funding.

In 2007, the 80th Legislature made many changes to the Texas Youth Commission in the wake of sexual abuse and other problems in TYC facilities. Changes included prohibiting youths from being sent to TYC for misdemeanor offenses and lowering the maximum age limit for those in TYC from 21 to 19. The TYC population at the end of fiscal 2008-09, according to LBB, is projected to be 2,563, down from a high of near 5,000 at the end of fiscal 2006. The TYC population is projected to drop slightly by the end of fiscal 2010-11, to 2,544, and to drop again by the end of fiscal 2012-13, to 2,523. However, this projection assumes no change in current policies.

The 80th Legislature increased funding in fiscal 2008-09 to the Texas Juvenile Probation Commission for community corrections services by \$57.8 million from the \$68.6 million spent in the previous biennium. This increase was, in part, to handle youths who might otherwise have been committed to the TYC.

Budget issues for juvenile justice

Sunset review of Texas Youth Commission and Texas Juvenile Probation Commission. Both the TYC and the TJPC will be under Sunset review during the 81st Legislature, and decisions made during that process will affect the agencies' appropriations, especially a decision on the Sunset Advisory Commission's proposal to merge the agencies into a single state agency dealing with juvenile justice. The Sunset Commission staff has estimated that combining the two agencies and enacting other commission recommendations would save the state as much as \$27.6 million per year, with most savings realized by reducing staff and closing facilities.

TYC facilities. The House and the Senate base budgets would appropriate \$425.0 million in general revenue funds and \$463.4 million in all funds to TYC for fiscal 2010-11. Several proposals are under consideration both to close TYC facilities and to open new TYC facilities. Proposals have included closing the West Texas State School in Pyote and the Victory Field Correctional Academy in Vernon.

Other options identified by the LBB to reduce TYC's budget include reductions of about \$29.8 million to reflect a decreased youth population; reductions of \$26.4 million in administrative costs; and reductions of \$40.9 million from closing two facilities, the Corsicana Residential Treatment and Ron Jackson II Unit in Brownwood.

In November 2007, voters approved \$27.9 million in general obligation bonds for construction at existing TYC facilities and for a new facility in a metropolitan area. The agency has a pending request to use \$2.9 million of those bonds for construction at existing facilities and has asked for guidance on the use of the remaining \$25 million. TYC wants to use the \$25 million in bond funds to build or to buy and renovate three smaller facilities. The agency says that smaller facilities would result in more effective treatment and rehabilitation for the youths and that, if possible, the agency would close or downsize older facilities in rural locations. The LBB has recommended letting lapse the authority for the agency to use the bonds in fiscal 2008-09 and that the bond proceeds be reappropriated with legislative direction.

Other proposals include shifting responsibility and funding to the counties for handling some juvenile offenders who would be sent to TYC, perhaps through pilot programs.

Budget issues for public safety

Fund 6 appropriations. Since its creation in 1935, DPS has received a portion of its appropriations from the highway fund. Several lawmakers have expressed an interest in replacing this funding source for DPS with general revenue in order to redirect Fund 6 money to highway construction. Gov. Perry reiterated support for ending Fund 6 funding for DPS in his January 2009 state of the state address.

The 80th Legislature in 2007 appropriated \$1.01 billion from Fund 6 to DPS for a variety of purposes in fiscal 2008-09. About 61 percent of DPS's recommended fiscal 2010-11 appropriations would come from Fund 6, disbursed across a number of departmental functions.

The funding principally would go to law enforcement activities, including highway patrol, vehicle inspections and enforcement, and roadside alcohol testing. Other funds support the criminal law enforcement division, including narcotics enforcement, motor vehicle theft investigations, criminal intelligence services, and the crime laboratory.

Driver's license operations. Recent reports from both the Sunset Advisory Commission and Deloitte Consulting identified driver's license operations as the most common point of contact with citizens and the source of the most complaints about DPS operations. Most concerns revolve around long waits, particularly in larger cities, and limited hours of operation. The Sunset Commission and Deloitte reports recommend that the operations be managed by civilians rather than DPS officers, which would allow commissioned DPS troopers to be available for law enforcement duties. DPS has proposed that its driver's license and regulatory divisions expand hours and days of operation and use televisions and signs to direct patrons to service desks. According to DPS, restructuring the driver's license division along a business model would require 395.5 FTEs and cost \$62.4 million.

DPS recruitment and retention. In its highest-priority exceptional item, DPS requests \$113.7 million for more personnel, salary increases, and recruitment. Included in the request is \$48.8 million for additional pay increases for commissioned officers and another \$17.8 million for non-commissioned personnel.

The agency also has requested \$27 million to buy and equip 450 more black-and-white patrol cars. The cars would be equipped with in-car computers and with "cages" to separate those taken into custody during highway stops. DPS officials testified that the additional patrol cars would allow for up to 561,000 more hours on patrol for the highway division because all troopers would have their own assigned cars, encouraging them to better maintain the vehicles. One possible source of funding for patrol vehicles could be law enforcement grants available through the federal stimulus package.

Border security. Another DPS exceptional item calls for \$24.5 million for 101 more law enforcement FTEs and 17 non-commissioned personnel for the border security and highway corridor program. This request could be funded as part of Gov. Perry's proposed \$135 million border security and gang strategy initiative (*see p. 10*).

Information technology. DPS also has requested exceptional funding of \$70.5 million for technology to allow information collected by one division, such as data on the 4 million traffic stops made annually by the highway patrol, to be accessed by the intelligence and counter-terrorism units.

Natural Resources

Article 6 includes Texas' natural resource agencies, which are entrusted with protecting, managing, and developing the state's agricultural, wildlife, environmental, water, and oil and gas resources, as well as state parks and lands. Agencies under Article 6 include the Texas Commission on Environmental Quality (TCEQ), Texas Parks and Wildlife Department (TPWD), General Land Office (GLO), Texas Water Development Board (TWDB), Texas Railroad Commission (RRC), Texas Department of Agriculture (TDA), Texas Animal Health Commission (TAHC), Texas State Soil and Water Conservation Board (TSSWCB), and river compact commissions.

Natural resource agencies are funded largely by general revenue and general revenue-dedicated funds. Some, like TCEQ, are funded mainly by fees, while others, like the Department of Agriculture, are supported mainly by federal funds.

Both the House and the Senate base budgets would appropriate \$3.4 billion in all funds to Article 6 agencies for fiscal 2010-11, an increase of \$15.8 million or 0.5 percent from fiscal 2008-09. About \$2.1 billion in general revenue and general revenue-dedicated funds would be appropriated for Article 6 in fiscal 2010-11, a decrease of \$10.4 million or 0.5 percent from fiscal 2008-09. Federal funds would account for about \$1 billion, an increase of about \$32 million or 3.2 percent.

Selected budget issues in natural resources

Federal air quality standards. Texas must comply with U.S. Environmental Protection Agency air quality standards to reduce ground-ozone emissions in non-attainment and near non-attainment areas. Recent tightening of federal air quality standards from 85 parts-per-billion (ppb) to 75 ppb will change the status of several urban areas from attainment to non-attainment, increasing the number of Texas cities that exceed acceptable ozone standards from three to seven.

The TCEQ has requested an additional \$7.2 million from the general revenue-dedicated Clean Air Account

to provide 22 more FTEs in fiscal 2010 and 30 more in fiscal 2011 in order to develop State Implementation Plans showing how areas not in compliance will attain the new ozone standard, and for eight to 10 new ambient monitoring stations.

Parks and wildlife funding. The Texas Parks and Wildlife Department (TPWD) manages the natural and cultural resources of Texas and provides hunting, fishing, and outdoor recreational opportunities. In addition to a small amount of general revenue, the Legislature appropriates revenue for TPWD from several dedicated sources, including:

- sporting goods sales tax;
- boat motor sales-and-use tax;
- unclaimed refunds of motorboat fuel tax; and
- 15 percent of boat registration and title fees.

The sporting goods sales tax, the primary source of general revenue-dedicated funds for parks, generates more than \$100 million each year from sales of bicycles and related supplies, hunting and firearms equipment, exercise equipment, and fishing tackle. In 2007, the 80th Legislature removed the previous statutory cap of \$32 million per year for the three general revenue-dedicated fund accounts for state and local parks that receive funds from the sporting goods sales tax. The cap instead was set at whatever amount the Legislature provides TPWD in the general appropriations act. Of the amount appropriated, 94 percent of the proceeds from the sporting goods sales tax must be deposited among the general revenue-dedicated fund accounts for state and local parks and 6 percent deposited into a new general revenue-dedicated fund account, Historic Site Account No. 5139.

TPWD also is requesting \$8.5 million in general revenue funds and \$11.5 million in general revenue-dedicated funds for fiscal 2010-11 for a more competitive staff compensation package; \$105.3 million for fiscal 2010-11 in general obligation bond proceeds for statewide capital repairs and construction; and \$11.6 million in general revenue funds, \$600,000 in general revenue-dedicated funds, and 92.5 FTEs to support expanded public access to outdoor recreation.

Coastal management and erosion control. The Texas General Land Office (GLO) is responsible for managing the 367 miles of Texas coastline from the vegetation line on the beach to 10.3 miles into the Gulf of Mexico, and millions of acres of submerged land in the coastal bays.

For fiscal 2008-09, GLO received about \$25 million of the proceeds from the sporting goods sales tax for coastal programs through an interagency contract with TPWD. GLO is requesting that the Legislature instead provide the \$25.2 million in direct funding from a dedicated account. This would not be an overall cost to the general appropriations act because it is assumed that a corresponding decrease in appropriations to TPWD for these pass-through funds would be made. GLO also is requesting an additional \$25 million in dedicated revenue from the sporting goods sales tax, for a total of \$50 million for all agency coastal programs. SB 539 by Estes would provide GLO with a permanent funding source for coastal programs by redistributing the proceeds of the sporting goods sales tax to 74 percent for state and local parks, 6 percent for historic sites, and 20 percent for coastal programs (about \$50 million).

Water programs and infrastructure. Four agencies have primary responsibility for water issues in Texas: Texas Water Development Board, Texas Commission on Environmental quality, Texas State Soil and Water Conservation Board, and the Texas Parks and Wildlife Department.

Water infrastructure and water project funding. The 2007 Texas State Water Plan projected that the demand for water will increase about 18 percent by 2060, serving an estimated statewide population of about 46 million. The state does not have a dedicated funding source for water infrastructure to support the rise in public demand for services. The TWDB has identified \$2.4 billion in state funding that will be needed to support \$30.7 billion in local projects identified in the State Water Plan.

The TWDB provides grants and loans to communities to plan, design, and build water and

wastewater-related projects through the Economically Distressed Areas Program (EDAP), the State Participation Program, the Water Infrastructure Fund, the Clean Water State Revolving Fund, and the Drinking Water State Revolving Fund. The TWDB is requesting an additional \$98.9 million of general revenue for debt service related to a request to issue \$1.09 billion in general obligation bonds in fiscal 2010-11 for state water plan projects. The TWDB also is requesting \$6 million in general revenue related to a request to issue \$50 million in general obligation bonds in fiscal 2010-11 for EDAP projects. The TWDB also is expecting \$179.1 million for the Clean Water State Revolving Fund and \$160.7 million for the Drinking Water State Revolving Fund from the federal stimulus package.

TCEQ - Water Fees. A shortfall of \$30.6 million in general revenue-dedicated funds is anticipated from the Water Resource Management Account No. 153. This account is the primary source of funding for TCEQ's water programs, which seek to protect water quality and manage state water resources. Revenue in the account is derived from 27 fees from different sources, including water utilities, water rights holders, and industrial water users. In recent years, the Legislature has appropriated fund balances from the account to TCEQ to offset decreases in general revenue to the agency. With the continued use of fund balances in Account 153, that balance is now almost depleted.

Both base budgets include \$18.8 million in general revenue funds for TCEQ for fiscal 2010-11. TCEQ will not have adequate funds to cover the costs of its water program activities in fiscal 2010-11 without an increase in certain fees or in general revenue. Rider 32 in both base budgets would allow TCEQ to access up to \$28.9 million in general revenue. Not all of the \$28.9 million would be needed if the agency increased fees through its rulemaking authority, if revenue streams were higher than expected, or if the Legislature created a new revenue stream for TCEQ water programs.

TCEQ and TSSWCB - Dam Safety and Flood Control. Based on recommendations by the State Auditor's Office for improved efforts to regulate the 7,603 dams across the state, the TCEQ is seeking \$2.5

million more in general revenue and 36 FTEs for fiscal 2010-11 to expand dam safety activities.

Texas has 1,995 floodwater-retarding structures that initially were built to protect agricultural lands and property, rural roads, and small towns from flood damage. Most originally were built as low-hazard dams, but population growth and urban expansion have required that many of these dams be reclassified as high-hazard dams as downstream development has continued. The TSSWCB is requesting \$17.7 million more in general revenue for fiscal 2010-11 to operate, maintain, and repair these structures, and for seven new FTEs.

TSSWCB - Water Supply Enhancement Program. Both base budgets would increase fiscal 2010-11 general revenue funding for the TSSWCB's Water Supply Enhancement Program by \$4.8 million, a 111.6 percent increase over the previous biennium. The program enhances water availability and conservation by removing water-depleting brush and trees, such as juniper, mesquite, and salt cedar.

TDA - Food and nutrition programs. Both base budgets include an increase in federal funding of about \$85 million for food and nutrition programs at TDA due to an anticipated increase in participation. TDA is requesting an additional \$50 million in general revenue for grants to reward schools for best practices in nutrition and to support nutrition education.

TDA - Texas Agricultural Finance Authority uncollectible bad debt payoff. Between 1987 and 2002, the Texas Agricultural Finance Authority financed agricultural loans that were never paid back, leaving the agency with uncollectible debt. TDA is requesting a one-time state appropriation of \$14.7 million in general revenue to retire the defaulted loans, saying it is needed to reduce the program's debt and interest expenses.

Hurricane Ike recovery. TPWD estimates their overall Hurricane Ike related costs to be \$99.3 million, including \$18.5 million for debris removal services provided by TxDOT and some various expenditures out of the TPWD's operating budget, resulting in direct costs to TPWD of \$80.8 million. TPWD requested an

emergency appropriation for the current calendar year of \$11.55 million and has requested an additional \$69.25 million for fiscal 2010-11 for restoration and rebuild of two heavily damaged state parks. Galveston Island State Park and Sea Rim State Park, are complete losses after suffering severe damage from Hurricane Ike, with Galveston Island State Park experiencing complete infrastructure loss and heavy beach erosion. TPWD is expecting a 75 percent reimbursement rate from Federal Emergency Management Agency (FEMA) for a portion of the expenses.

GLO estimated their initial cost for Hurricane Ike recovery along the Texas coastline to be about \$44.5 million, with \$39 million for debris removal. The agency is anticipating 100 percent reimbursement from FEMA for debris removal and is requesting state funds of \$500,000 for costs associated with direct response to the hurricane. GLO also is requesting \$15 million in general revenue for matching state dollars to help local governments buy out structures on Texas beaches that pose a threat to public health and safety as a result of hurricane damage. Many of these structures qualify for FEMA grant funds at 75 percent, and the \$15 million is needed for the 25 percent local match. GLO is requesting \$6 million for the closure of Rollover Pass, a manmade cut from the gulf to the bay on Bolivar Peninsula, arguing that it is accelerating erosion, threatening public infrastructure and the Inter-coastal waterway. This has been an ongoing problem that has been worsened by Hurricane Ike. GLO is also requesting \$13.7 million for matching state dollars to repair and rebuild parts of County Road 257. County Road 257 serves as a direct link between Galveston Island and Brazoria County and is a major evacuation route for that area. HB 6 by Eiland, the disaster relief supplemental appropriations bill, would appropriate state funds from the Rainy Day Fund for these purposes.

In addition, TDA is requesting \$40 million in general revenue for increased costs to the Texas Boll Weevil Eradication Foundation resulting from recent hurricanes.

Business and Economic Development

Article 7 includes agencies charged with supporting business and economic development, transportation, and community infrastructure. These agencies include the Texas Department of Transportation (TxDOT), Texas Workforce Commission (TWC), Texas Department of Housing and Community Affairs (TDHCA), Texas Lottery Commission, and Office of Rural and Community Affairs (ORCA).

Both the House and the Senate base budgets recommend \$20 billion in all funds for Article 7 agencies for fiscal 2010-11, a 7.2 percent decrease from fiscal 2008-09. TxDOT would receive \$16.4 billion of the cumulative recommended Article 7 appropriations for fiscal 2010-11, the TWC, \$2.1 billion, the Texas Lottery Commission, \$383.3 million, and TDHCA, \$313.1 million.

In both base budgets, federal funds account for about 42.9 percent of fiscal 2010-11 appropriations for Article 7, and other funds make up 53.2 percent of the recommended appropriations. General revenue and general revenue-dedicated funds account for the remaining 3.9 percent of the article's recommended appropriations for fiscal 2010-11.

Revenue streams for business and economic development

Funds other than state general revenue make up most of the total appropriations for Article 7 for fiscal 2010-11 in both base budgets and would be derived from several sources. Legislative initiatives beginning in 2001 expanded the range of funding options for transportation projects. New funding options include the authority to issue bonds, borrow from public and private interests, and enter into comprehensive development agreements (CDAs) to build and maintain toll roads. (For more on highway funding in Texas, see HRO Focus Report 81-5, *Highway Funding in Texas: A Status Report*, February 23, 2009).

Transportation. Fund 6 is the state's primary highway funding mechanism. The fund collects

highway-related revenue from federal reimbursements, state motor fuels taxes, motor vehicle registrations, toll revenue and concessions payments, and various fees. The Legislature may appropriate money from Fund 6 for highway-related purposes, in accord with constitutionally and statutorily established limits. Appropriations for TxDOT in both base budgets from Fund 6 for fiscal 2010-11 would total \$5.9 billion, excluding bonds and toll project revenue.

Since 2003, the Texas Transportation Commission (TTC) has been authorized to issue bonds secured by revenue in Fund 6. In 2007, the Legislature increased the total Fund 6 bonding authority available to \$1.5 billion per year, not to exceed a total of \$6 billion. TTC recently authorized TxDOT to issue the \$2.9 billion still available in Fund 6 revenue bonds, and the Bond Review Board approved \$1.5 billion to be issued in fiscal 2009. Recommended appropriations in both base budgets for fiscal 2010-11 include issuing the \$1.4 billion remaining capacity of Fund 6 revenue bonds.

The Texas Mobility Fund (TMF) serves as a revolving account through which TTC may borrow funds from public and private interests and may issue bonds to help fund state highways and publicly owned toll roads. Bonds and debt obligations are secured by funds in the TMF and by the state of Texas. TxDOT is obligated to pay debt service on all bonds issued in an amount and for a duration agreed to as part of the bond sale. Before issuing more bonds from the TMF, the comptroller must certify that the fund has available revenue equal to at least 110 percent of the amount necessary to pay principal and interest due yearly for the term of the proposed bonds. Fiscal 2010-11 appropriations in both base budgets include issuing the remaining \$550.4 million capacity of TMF bonds, a decrease of 76.5 percent from fiscal 2008-09 appropriations.

Fiscal 2010-11 appropriations to TxDOT in both base budgets also include one-time concession payments for the rights to develop and operate toll roads. In fiscal 2008, Fund 6 revenue included a \$3.2 billion payment to the state from the North Texas Tollway

Authority (NTTA) for SH 121 in the Dallas-Fort Worth metropolitan area. It also included \$25.8 million from an up-front payment as part of a private agreement between TxDOT and Cintra-Zachry to develop two segments of SH 130. While current state law requires revenue received as part of toll agreements to be spent in the geographic area in which it was collected, this money is deposited into Fund 6 and counted toward the available revenue appropriated. Recommended TxDOT appropriations from Fund 6 include \$1.4 billion in revenue from tolls and concessions fees.

Federal stimulus funds. Article 7 appropriations also could include a one-time distribution of federal stimulus funds for transportation, low-income housing and weatherization, employment programs, and unemployment compensation. Article 7 agencies could receive significant allocations of recovery funds for several programs, including:

- \$2.3 billion for highway and bridge construction and \$372 million in transit funds;
- \$530.1 million to help pay unemployment insurance benefits, provided the state makes certain legislative changes to the eligibility standards it uses to distribute benefits;
- \$345.9 million for weatherization of homes for qualified families;
- \$214.9 million for child-care assistance to low-income families and to improve child-care services in the state; and
- \$148.5 million for programs to enhance housing options for low-income individuals and families.

The state also is eligible to apply for competitive grant funding for highway construction, intercity high-speed rail, aviation improvements, and other programs.

HB 1 by Chisum, the 2008-09 general appropriations act (Art. 9, sec. 8.02) allows agencies to spend funds received from the federal government for a spending strategy or function already authorized in the act. This provision has been interpreted as allowing TxDOT to spend stimulus funds on highway planning and design, construction, or maintenance. The

federal Recovery Act requires that states give priority to projects that may be completed within three years and that are located in economically distressed areas as defined in federal law. On March 5, TTC approved allocating \$1.2 billion in stimulus funds for highway construction projects statewide. TTC also amended previous recommendations to spend \$500 million in stimulus funds for highway maintenance, adding 10 projects not authorized by a previous recommendation.

Budget drivers for business and economic development

Article 7 funding needs are influenced by factors related to the state's economic performance and workforce, such as congestion on major highways in metropolitan areas, road conditions, employment services and training, and the availability of affordable housing. Major weather events, such as hurricanes Katrina, Rita, and Ike, have affected Article 7 agencies, which have active roles in rebuilding roads, cleaning up debris, and helping relocated residents find housing and jobs. The state's employment rate also affects Article 7 appropriations because the TWC administers the state's unemployment insurance system, which distributes temporary benefits to unemployed individuals who have lost their jobs through no fault of their own.

Selected budget issues in business and economic development

Both the House and the Senate base budgets include a decrease of recommended appropriations to TxDOT of \$1.0 billion, or 5.8 percent, from the previous biennium. TxDOT has estimated current recommendations would leave no funds for authorizing new highway construction projects in fiscal 2010 because all available funds — along with a \$38 million shortfall not included in the recommendations — would be needed for already committed projects. The agency estimates that recommended appropriations would leave \$697 million for new construction in fiscal 2011, after reductions for funds committed to the Dallas area.

Appropriations also could include a transfer of funds for certain motor vehicle functions from TxDOT to a separate agency, in keeping with a Sunset Advisory Commission recommendation. This proposal would move functions related to vehicle titles and registration, the motor vehicle and motor carrier divisions, and automobile burglary and theft prevention to a new agency, the Texas Department of Motor Vehicles.

Restoring Fund 6 appropriations to highway construction. Several lawmakers have expressed an interest in eliminating diversions from Fund 6 to agencies and purposes not directly related to highway construction.

The 80th Legislature in 2007 appropriated \$1.95 billion, or 13.8 percent, of Fund 6 revenue to state agencies other than TxDOT. The largest share of this net amount, \$1.01 billion, went to the Department of Public Safety (DPS) for a variety of purposes. Another \$723.7 million was appropriated for benefits for employees of several state agencies, \$119.4 million to other agencies for a variety of purposes, and \$100 million to the Texas Education Agency (TEA) to buy school buses. Fiscal 2010-11 appropriations in both base budgets include \$984.8 million in Fund 6 revenue for DPS. The recommendations also would reduce appropriations from Fund 6 for TEA, medical transportation, and other purposes by \$254 million. The increase in Fund 6 appropriations for TxDOT would be accompanied by an equivalent reduction in general revenue funds recommended for the agency for debt service on bonds and other public securities.

In a letter to TTC Chair Deirdre Delisi, Gov. Perry, Lt. Gov. Dewhurst, and then-Speaker Craddick expressed an intent to work during the 81st legislative session to fund DPS with general revenue instead of motor fuels taxes. Gov. Perry reiterated his support for ending Fund 6 diversions to DPS in his January 2009 state of the state address.

Debate on redirecting diverted Fund 6 revenue to TxDOT could focus on whether doing so would constitute a de facto transfer of general revenue to

highway funding, and if so, whether this transfer is necessary or desirable in the context of limited general revenue funds.

Highway bonding authority. Fund 6 revenue bonds are projected to have \$1.4 billion remaining of \$6 billion capacity for fiscal 2010-11, and TMF bonds have an estimated remaining capacity of \$550 million out of \$6.4 billion for the next biennium. Appropriations for fiscal 2010-11 in both base budgets include \$2 billion in Fund 6 and TMF bonds combined, less than half the total bond proceeds appropriated for fiscal 2008-09. While bond capacity has diminished, debt service for these bonds has increased. Recommended fiscal 2010-11 appropriations include \$1.5 billion in debt service on previously issued Fund 6 and TMF bonds.

Potential bond funding for highway projects also includes \$5 billion in general obligation bonds approved by voters through Proposition 12 (SJR 64 by Carona) in November 2007. While voters approved the constitutional amendment authorizing the bonds, the Legislature did not enact contingent legislation to authorize issuance of the bonds or appropriate the bond proceeds, so no Proposition 12 bonds have been issued. TxDOT's budget request for fiscal 2010-11 includes \$2.2 billion in general obligation bond appropriations for transportation planning and design, right-of-way acquisition, construction, and maintenance.

A number of lawmakers have expressed an intent to specify the dollar amount of Proposition 12 bonds that should be issued and for what purposes the bond proceeds should be appropriated. The language in the original proposition is sufficiently flexible to allow for a variety of transportation-related appropriations. Supporters of issuing more general obligation bonds say it would help finance desperately needed projects, while opponents say it would require future general revenue appropriations the state cannot afford to spend on debt service for highway funding when other state priorities without dedicated funding sources have a higher claim on general revenue.

Appropriations of toll revenue. Appropriations to TxDOT in both base budgets include \$1.4 billion

from a concession agreement paid by the NTTA for the development of SH 121. These funds, which account for 21.6 percent of recommended Fund 6 appropriations, excluding debt service and bonds, are dedicated by statute to be spent in TxDOT's Dallas district. Legislators this session may decide how to appropriate these funds for eligible projects and what measures should be taken to ensure that improvements completed with the funds are properly executed and documented. One possibility would be to distinguish these funds in the appropriations bill through a rider, a separate strategy, or other action to maintain the distinction between concessions fee revenue and other Fund 6 revenue.

Stimulus funds for Unemployment Insurance.

Texas could receive up to \$530.1 million in federal recovery funds for unemployment insurance (UI), a program funded by employers to provide compensation to qualified individuals who lost their jobs through no fault of their own. To be eligible for additional UI funds, the state would have to adopt legislation revising the state's UI program. To receive the first one-third of available funding — \$185 million — the state would have to adopt an "alternative base period" when determining eligibility for potential UI recipients. This change in effect would allow the most recent months of employment to be considered in benefit assessments, in contrast to current law, which recognizes employment history one full quarter before the date of application. In addition, the state would have to make two of the four following changes to receive the remaining two-thirds of the funds:

- grant eligibility to workers seeking part-time employment;
- expand compelling family reasons for loss of work to include spousal relocation without a waiting period (current state law requires a six to 25 week waiting period except in instances of spousal military relocation);
- extend benefits for individuals enrolled in state-approved employee training programs; and
- provide additional allowances for dependent children of at least \$15 per week.

Should the state choose not to implement these changes, it would forfeit supplemental federal funds for unemployment insurance.

Supporters of making the revisions to the UI system say they are necessary to correct outdated eligibility criteria, while opponents say the state should not encumber itself with ongoing financial obligations to secure a one-time funding windfall.

Regulatory Government

Article 8 includes agencies that regulate business professionals and service industries. The agencies vary in size and scope and include the Public Utility Commission (PUC), the Insurance and Banking departments, the Texas Medical Board, the Real Estate Commission, and the Racing Commission. The Department of Licensing and Regulation alone oversees 26 businesses, industries, trades and occupations, ranging from cosmetologists and barbers to mixed martial-arts fighters and tow truck operators. Thirty-one agencies under Article 8 regulate specific professions or industries: general professions and services (10), health care (10), financial services (five), insurance and workers' compensation (three), and utilities (two). The State Office of Administrative Hearings provides general administrative support.

Most Article 8 agencies obtain revenue from fees – typically for registration, licensing, and examinations – paid by the professionals and workers they regulate and from fines assessed to violators of agency rules and regulations. A few also derive revenue from sales of goods and services and through interagency contracts. Most Article 8 agencies raise fee revenue that is greater than their biennium budgets, and that excess is swept into general revenue funds for general purpose spending.

Both the House and the Senate base budgets would appropriate \$785.3 million for Article 8 agencies, less than 1 percent of the overall state budget. That appropriation would include \$360.3 million in general revenue funds and \$406.9 million in general revenue-dedicated funds. The 80th Legislature in 2007 increased appropriations for Article 8 agencies by \$199.4 million in fiscal 2008-09 from the previous biennium, but \$138.4 million (or 69.4 percent) of that increase came from restoring the use of the System Benefit Fund to assist low-income electric ratepayers.

The 80th Legislature enacted Sunset legislation that consolidated the Structural Pest Control Board into the Department of Agriculture and moved that agency's funding out of Article 8. Regulatory agencies under Sunset review this session include the Credit Union Department, Department of Insurance, Office of Public Insurance Counsel, Racing Commission, Residential Construction Commission, and Board of Tax Professional Examiners.

The Texas Medical Board is undergoing a limited review this cycle.

Selected budget issues for regulatory agencies

Using System Benefit Fund funds balances for budget certification. An ongoing budget concern has been excess revenue from licensing and other fees raised by Article 8 agencies being swept into general revenue funds and made available for other general purpose spending. However, some balances from fees and other special assessments are neither allocated for their original purpose nor appropriated for general fund spending. These unallocated balances are used by the comptroller for budget certification. One of the largest of these accounts is the System Benefit Fund, which contains revenue generated by an assessment collected from electric ratepayers and administered by the Public Utility Commission to assist low-income utility customers and fund education programs.

In 1999, the 76th Legislature created the System Benefit Fund as a special trust fund, but it was made a dedicated account in the General Revenue Fund in 2001. In fiscal 2004-05 and fiscal 2006-07, the Legislature did not allocate System Benefit Fund funds for assistance for low-income electric customers, but instead held the money for certification of the budget because of projected budget shortfalls. In 2007, the Legislature appropriated \$82.9 million for fiscal 2008 and \$93.9 million for fiscal 2009 for low-income discounts, consumer education, and electric market oversight contracts.

The projected System Benefit Fund balance at the end of fiscal 2009 will be about \$503.9 million, and the LBB estimates the fund will accrue \$44.3 million in interest. In addition, the LBB projects that the assessment will generate \$294.5 million for the System Benefit Fund in fiscal 2010-11.

Both base budgets would appropriate \$186.9 million from the System Benefit Fund for fiscal 2010-11 for the low-income discount program to pay 10 percent of the

monthly electricity bills for low-income residents and for consumer education and electric market monitoring. With this level of appropriations, \$682.8 million would remain unallocated in the System Benefit Fund at the end of fiscal 2011.

About 86 percent of those who qualify for the low-income discount program are enrolled automatically when they receive Medicaid or federal assistance to buy food, with the remainder becoming eligible by providing other documentation on income and specific needs. Currently, the low-income discount provides for about a 15.5 percent rate reduction from May until September. The caseload grows by 1.5 percent each month, and more Texas utility customers would qualify for the discount should eligibility for Medicaid or to receive federal assistance to buy food be expanded through federal stimulus funding. The PUC projects that 548,000 will qualify for System Benefit Fund assistance in fiscal 2010 and 655,000 in fiscal 2011. If the appropriation is kept at the currently recommended level, the amount of discount for an individual ratepayer would drop to 10 percent of the monthly electric bill.

Legislators could decide whether to increase the fiscal 2010-11 appropriation from the System Benefit Fund to increase the discount for qualifying ratepayers or to provide assistance for the anticipated increase in the number eligible for the program. Additional money could be provided for other eligible, but unfunded, programs, such as weatherization. System Benefit Fund balances also could be retained for the comptroller's budget certification for fiscal 2010-11 or as a reserve for System Benefit Fund appropriations in future budgets.

Sunsetting the Texas Residential Construction Commission. In 2003, the 78th Legislature created the Texas Residential Construction Commission (TRCC), a nine-member commission appointed by the governor with the advice and consent of the Senate. TRCC registers industry members and provides information to homeowners. It acts as a resource for complaints by homebuyers and as a neutral review source on alleged post-construction defects. Both base budgets recommend an appropriation of about \$18 million for TRCC for fiscal 2010-11.

The Sunset Advisory Commission staff recommended abolishing the TRCC and repealing the Texas Residential Construction Commission Act. The staff estimated that sunseting TRCC would cost \$400,000 in fiscal 2010 and \$300,000 in fiscal 2011 because of the loss of excess TRCC revenue being transferred to general revenue funds to be appropriated for general purpose spending. On January 14, 2009, the Sunset Commission took no action on the staff recommendation and recommended the continuation of the agency, whose ultimate fate will be decided by the Legislature this session.

State regulatory response to economic crisis. The financial services agencies operating under Article 8 regulate a variety of financial institutions, including state-chartered banks and credit unions and non-bank institutions, such as pawn shops and motor vehicle sales finance companies. Other Article 8 regulators monitor the securities market and the solvency of insurance companies. The Finance Commission, which includes three financial services agencies, is requesting increased appropriations for higher financial examiner salaries and more staff to address growing problems in their industry. According to the financial services agencies, these resources are needed to achieve parity in salaries with similar regulatory agencies, such as the Federal Deposit Insurance Corporation. Unlike the financial regulatory agencies, the Texas Department of Insurance (TDI) did not initially request an increase for regulatory activities and offered proposed reductions in its budget.

Shortfalls in Racing Commission budget. Since the Texas Racing Commission began operating in 1988, it has depended on revenue from the pari-mutuel industry, including licensing and inspection fees and proceeds from the pari-mutuel handle, including proceeds from uncashed winning tickets. Competition from other forms of gambling in other states and illegal Internet wagering have contributed to an ongoing decline in Texas pari-mutuel handle, and the industry was affected by bankruptcies and hurricane damage to horse and greyhound tracks in 2008.

The Racing Commission faces a shortfall of more than \$675,000 for fiscal 2009. In addition to budget cuts and fee increases, the agency requested a Governor's

Emergency and Deficiency Grant of \$250,000. The commission otherwise may request supplemental appropriation items to make up for the shortfall.

Also, revenue from Racing Commission fees may not be available to meet the \$40.1 million budgeted for the agency in fiscal 2010-11.

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