

## Texas' Budget Challenge: Structural Changes Are Key To Avoid Persistent Deficits

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# Texas' Budget Challenge: Structural Changes Are Key To Avoid Persistent Deficits

## Overview

- The Texas Legislative Budget Board has recommended budget reductions of \$28.8 billion from 2010-2011 spending levels.
- Standard & Poor's believes there are potential credit implications for the underlying jurisdictions that may be affected by the budget reductions.
- In our view, Texas' very strong capacity to meet its debt service obligations will not be significantly diminished in the near term.

As the Texas Legislature continues its 140-day regular session, addressing the state's projected budget gap for the upcoming biennium will, we expect, rise to the top of the legislative agenda. Legislative estimates of the state's biennial budget gap vary depending on the method of calculation, ranging from a low of \$15 billion (8.2% of current biennial expenditures) assuming the current level of expenditures is maintained, to a high of \$27 billion (approximately 14.8% of current biennial expenditures) assuming that the existing level of services is maintained and the expected growth in student enrollment and Medicaid caseload is included, among other program increases that we expect.

In our opinion, addressing the budget gap will likely require meaningful legislative action and difficult cuts to many of the state's programs. Specifically, the Legislative Budget Board (LBB) has recommended \$8.8 billion in expenditure reductions from the current biennium, or a 9.9% reduction in general revenue-related spending. The recommended reduction for all state funds is \$28.8 billion, or approximately 15.4% below 2010-2011 spending levels. We view this level of cutbacks as high as a proportion of the state's budget, particularly for a state that, in our view, has a low level of government spending per capita. It is important to note that the LBB's initial recommendations do not include the use of the state's "rainy-day" fund, which the state comptroller projects will reach \$9.4 billion at the end of the current biennium.

From a credit perspective, the measures that the legislature adopts to address this budget imbalance are important, not just because of Texas' ability to preserve balanced budgets in the upcoming biennium, but also because we believe the legislature's fiscal policy choices to address the current budget imbalance could have long-term implications for the state's future budgetary performance. In addition, we believe the steps taken to balance the state's budget could have significant implications for the underlying governments and jurisdictions that rely on state transfers to fund their regular operations.

In our opinion, Texas' current challenges do not threaten the state's ability to meet its debt obligations in a meaningful way, particularly given the state's relatively low debt levels (Texas' issuer credit rating is AA+/Stable). As we cited in our recent commentary ("U.S. States And Municipalities Face Crises More Of Policy Than Debt", published Nov. 8, 2010, on RatingsDirect on the Global Credit Portal), we believe the crises that many states, including Texas, find themselves in are policy crises rather than questions of governments' continued ability to exist and function. They're more about tough decisions than potential defaults. This is because, for many states (including Texas), debt service holds a priority status relative to other obligations.

Indeed, we believe that many of Texas' current budget challenges are the result more of previous fiscal policy decisions that created structural budget deficits, than of a weak economy. We believe that state officials have the tools to correct these imbalances by adopting structural solutions that minimize the potential for persistent budget gaps to occur. We also believe that a balanced approach that includes both revenue enhancements and expenditure cuts has a higher potential of success in preserving the state's long-term structural budget balance than a strategy that relies solely on expenditure cutbacks.

Standard & Poor's Ratings Services has examined the potential implications of Texas' budget imbalance on the state's long-term budgetary performance, and believe that there are potential credit implications for the underlying jurisdictions that may be affected by the state's budget cuts.

## **Sources Of Budgetary Imbalance: Beyond The Recession**

In our view, Texas' current budget difficulties are only partially the result of lower revenues and a weaker economy. The comptroller's revenue estimate for the 2012-2013 biennium reflects a 2.9% reduction in general purpose available revenues relative to the current biennium. Although for fiscals 2012 and 2013 the state comptroller projects an increase in tax revenues of \$4.6 billion, or 7.4% relative to the current biennium, we believe this will likely not be sufficient to make up for the exhaustion of federal stimulus funds and projected increases in demand for services. We continue to believe that the Texas economy will recover faster than in most other states. (See "Lone Star State Recovery: Why We Think Texas Will Emerge From The Recession Faster And Stronger Than Most States" published Oct. 21, 2010, on RatingsDirect on the Global Credit Portal.) However, we think that the pace of growth is unlikely to be dynamic enough to avoid significant budget reductions or tax increases necessary to maintain budgetary balance, in our opinion.

In fact, we believe that the primary source of the state's budget imbalance is not slower revenue growth, but rather, built-in budget imbalances that simply become more evident during periods of economic decline or slow revenue growth. Chief among these potential sources of persistent imbalances is education funding. As we have said for the past four years, the school finance reforms that the legislature approved in 2006 created a long-term source of budget pressure for the state, in our opinion.

This legislation required school districts to reduce local school district property tax rates by one-third. The state committed itself to fill the revenue gap that this created. The legislature also approved several tax measures designed to provide the state with funds to offset the cost of property tax relief legislation. These measures, however, have been insufficient, in their current form, to fully cover the increase in expenditures related to property tax relief. In addition, we believe that the mismatch between when the state collects its franchise tax and other revenues and when most of the transfers to schools have to be made will likely increase the pressure on the state's cash flow. If the timing of transfers to schools remains unchanged, the state comptroller's office projects that Texas' temporary cash shortfall in the early part of the fiscal year could grow to approximately \$14 billion by fiscal 2013. In fact, the state's temporary cash shortfall in 2010 reached \$10.8 billion (14.3% of annual expenditures)--almost double the amount of 2009 and the highest level of the past seven years.

In our opinion, the shift in education funding to a source that closely tracks the economic cycle (state general purpose funds) from a relatively stable one (local property taxes) could continue to significantly pressure the state budget, in particular during periods of economic decline. In our view, the state's budget imbalance is likely to reappear or persist beyond the upcoming biennium unless other sources of revenue or additional budgetary

flexibility are identified to fill this growing funding gap.

## **Impact Of Potential Budget Cuts**

In its initial budget recommendation, the LBB has identified initial budget reductions that are likely to affect a variety of state services and programs as well as underlying governments that rely on state funding for a significant portion of their revenues. Some of these reductions--and our opinion of their potential credit implications--include the following:

### **Reducing the state's contribution to the Teachers Retirement System to 6% from 6.6% (\$254.8 million)**

However, this proposal would require statutory change to take place. In addition, it includes a reduction in the state's contribution for retiree health insurance to 0.5% from 1%. This cut would also require legislative action. While other states have relied on reductions to their pension contributions as a budget management tool, we believe that this approach has the potential to create long-term structural budget imbalances by effectively increasing the future burden that pension liabilities have on the state's budget.

### **Reduction of school finance formula entitlements**

The state estimates certified revenue for the state's Foundation School Program to be \$9.3 billion below the amount required to fund the school finance formulas under current law. This widening gap in school funding is primarily the result of rising enrollment and declining property values, which affect school district revenues, as well as the absence of approximately \$3.3 billion in federal stimulus funds that will not be available in the upcoming biennium. The identified gap would result in an estimated 13% reduction in state and local education entitlements. We expect that the cut in entitlement funding is likely to increase the number of school districts that declare financial exigency. We believe that the credit impact of reduced state appropriations will vary by district and will largely depend on the districts' ability to adjust overall expenditures to the tight revenue environment. In addition, the impact on our ratings on school districts in general will partially depend on our assessment of potential additional legislation, adopted during the remainder of the session, that identifies new sources of school funding or additional budgetary flexibility.

### **Reduction of Medicaid funding**

The budget proposal also includes an assumption of a 10% reduction in the provider rates (for total savings of about \$3.8 billion), and an improvement in the Federal Medical Assistance Percentage (FMAP) funding levels of approximately \$1 billion. However, the initial recommendation does not include funding to serve the projected increase in the caseload (estimated to have an impact of \$1.7 billion in general revenue funds), and to replace the \$4.3 billion in federal stimulus funds from the temporary increase in FMAP funding.

### **Higher education funding**

The initial budget proposal calls for approximately \$1.2 billion in cuts to higher education spending. These include general formula reductions as well as community college-related funding. In addition, the initial proposal does not include any funding for projected enrollment growth. We believe that the proposed cuts to higher education will not affect all issuers equally. We expect that highly rated institutions, such as the University of Texas (AAA/Stable) and Texas A&M (AA+/Stable), would be less affected, given their significant revenue diversity and ability to generate revenues from tuition and fees, ancillary businesses, research, and investment income, which in our view allows them to withstand substantial declines in state appropriations. However, some of the public universities, particularly the smaller systems, receive a larger proportion of their funding from the state. We believe that these institutions

could have a more difficult time offsetting the decline in state appropriations and thus could have negative financial consequences. The proposed budget also includes a reduction in funding to all community colleges, which would total about \$145 million over the next two years. Since fiscal 2009, most community colleges have been able to absorb cuts in state appropriations through enrollment growth and tuition increases. While reductions to state appropriations are common during economic downturns, this is the first time that a proposal suggests completely defunding a college. Under the House's initial proposal, four community colleges would not receive any state appropriation funding over the two years of the biennium because the LBB found that these colleges had not grown in contact hours between 1990 and 2010. Three of the four community colleges: Brazosport College (BBB+/Stable), Borger Junior College (BBB/Stable), and Odessa College (A-/Stable) have revenue bonds that are rated by Standard & Poor's. For these three community colleges, state appropriations comprise a significant 30% of their revenue base. We do not believe that these institutions have the practical ability to raise tuition or increase enrollment significantly to offset the lack of state funding and therefore, such cuts could also have severe rating consequences.

## **Structural Solutions Are Key**

We believe that Texas' officials face a difficult set of alternatives to balance the upcoming biennial budget. Our ratings analysis will focus on the degree to which state officials adopt a budget that emphasizes the achievement of structural solutions. The degree to which these emphasize the use of one-time sources of revenue, such as the depletion of the state's "rainy day" fund, or the deferral of required contributions to address future liabilities, such as the state's retirement obligations, could shape our view of the state's expected future budget performance and liquidity, which can be a limiting credit factor.

Despite Texas' significant budget challenges, we do not believe that the state's very strong capacity to meet its debt service obligations will be significantly diminished in the near term. In our opinion, the state has a strong track record of closing sizable budget gaps that have emerged during prior economic cycles. In addition, the state's debt levels remain very low relative to those of other states and, in our view, are likely to remain low given existing voter-approved authorizations for future debt. We project debt service costs for the upcoming biennium to remain at approximately \$1.6 billion or 2.05% of biennial general revenue expenditures, a figure we consider to be low.

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