SPECIAL EDITION
SEPTEMBER/OCTOBER 2018
FISCAL NOTES
AN EXAMINATION OF GROWING STATE OBLIGATIONS — AND WAYS TO MITIGATE THEIR EFFECT ON STATE FINANCES.
A REVIEW OF THE TEXAS ECONOMY FROM THE OFFICE OF **GLENN HEGAR**, TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

LONG-TERM OBLIGATIONS
AND THE TEXAS LEGACY FUND


The chambers of the Texas State Senate

When the Texas Legislature convenes in January 2019, it will be in familiar territory: grappling with tight fiscal constraints on the state's budget.

Lawmakers will face a shortfall in the current two-year budget, which covers services through Aug. 31, 2019. Estimated at about $4 billion, the budget gap includes Medicaid expenses of more than $2 billion and costs from Hurricane Harvey that could total as much as $1 billion or more. In addition to reconciling this shortfall, the Legislature must craft a working budget for the next two fiscal years, in answer to literally thousands of competing demands for funding.

Beyond the immediate fiscal challenges, however, Texas faces *long-term* financial obligations in key areas that include state employee pensions, health care benefits for retired teachers, the state's prepaid tuition plan and deferred maintenance for state-owned buildings. These obligations, too often forgotten in the daily concessions and compromises of the budget process, are growing year by year. If they're not addressed, Texas will face larger program expenses in the future — and may face a credit downgrade that could drive up the state's borrowing costs.

Texas currently enjoys the highest ratings provided by the major credit agencies, but two of them, Moody's and Standard & Poor's, have pointed to the state's persistent underfunding of state employee pensions as a major concern.[1] Seven states have suffered downgrades due to pension system shortfalls.

Texas' expanding economy — the state added 394,500 jobs in the year ending in August 2018, and is enjoying historically low unemployment — has yielded some additional funds to help plug budget gaps. In July, Texas Comptroller Glenn Hegar increased his estimate of unappropriated revenue available for the current biennium by nearly $2.7 billion, thanks

CONTINUED ON PAGE 3

A Message from the Comptroller

Early next year, the Texas Legislature will begin the arduous process of putting together a budget for the state's next two fiscal years. They'll have to juggle a host of competing demands, most of them seeming equally urgent. As always, there'll be deals, debates and demonstrations on the Capitol steps.

As a former legislator, I know that writing the budget is like building an enormously complex puzzle — while hoping you have enough pieces. The exercise is always difficult, and it commands most of the Legislature's attention until it's complete.

As Texas comptroller, however, I've tried to draw our lawmakers' attention to another financial issue — one sometimes overlooked in the grind of budget writing. I'm talking about a series of *long-term* obligations the state faces, such as state employee pensions, retired teachers' health care benefits, the state's prepaid tuition plan and deferred maintenance for aging state-owned buildings.

These obligations must be met, sooner or later, and the longer we wait the more money they'll require. A number of states have found out about their spiraling costs the hard way, by having their credit ratings lowered — which raises the cost of borrowing and imposes even *deeper* difficulties.

Two years ago, our office issued a report on long-term obligations during the 2017 legislative session. This report updates its predecessor with new information, but the message remains the same: the state should begin paying down these obligations as soon as possible if we're to maintain its financial health.

We've proposed a way to begin addressing this problem through what we call the *Texas Legacy Fund* — a permanent endowment for the state, created from a portion of the state's rainy day fund, which generates investment earnings specifically for addressing long-term obligations. The plan is discussed in detail in this report.

Right now, the Texas economy is riding high. But all of us know that ups and downs are inevitable. Now's the perfect time to tackle some of the thorniest issues facing the state. The sooner we start, the less it will cost us in the long run.

GLENN HEGAR
Texas Comptroller of Public Accounts

Note: This report contains estimates and projections that are based on available information, assumptions and estimates as of the date of the forecasts upon which they are based. Assumptions involve judgments about future economic and market conditions and events that are difficult to predict. Actual results could differ from those predicted, and the difference could be material.

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Texas Comptroller Glenn Hegar

to higher-than-anticipated state tax collections. In particular, oil production tax collections rose by nearly 57 percent through July compared to last year; natural gas production tax collections rose by 45 percent. Collections for the sales tax, the most important state tax, were up 10 percent.

The strong economy provides another reason for the state to address its long-term financial obligations while it can. If the economy slows down or energy prices decline — and both will, eventually — lawmakers will have even fewer resources to deal with these challenges.

Comptroller Hegar presented an initial report on the causes, costs and consequences of the state's long-term obligations for the 85th Legislature that convened in 2017. He also described a proposal to help meet these costs by investing the state's savings more strategically, an idea now called the Texas Legacy Fund.

This update to that report presents the latest data available and discusses noteworthy legal changes and policy options for addressing our key long-term obligations. While they differ in size, scope and urgency, their consequences are similar: The longer the state waits to address them, the greater their ultimate costs will be.

I. STATE EMPLOYEE PENSION FUNDING

The Employees Retirement System of Texas (ERS) manages several pension plans with $29 billion in assets serving nearly 542,000 active and retired public employees and their dependents.[2] These include:

- the *ERS plan* (sometimes called the "Employee Class plan") for state employees, elected state officials, law enforcement officers and custodial officers — the largest plan the agency administers;
- the *Law Enforcement and Custodial Officer Supplement Retirement Fund*, which provides additional retirement benefits for these employees, who also belong to the ERS plan; and
- the *Judicial Retirement System of Texas Plans 1 and 2*, for judges, justices and certain court commissioners (the state replaced Plan 1 with Plan 2 in 1985).[3]

The ERS plan is a defined benefit plan (DBP) — a mandatory plan offering set monthly payments based on years of service and the employee's highest salary, a type increasingly rare in the private sector. Both state and employee contributions made throughout working careers are invested to guarantee specific payments upon retirement.

Investment returns, generated primarily by bonds, stocks, private equity and real estate, accounted for 64 percent of the plan's revenue between 2003 and 2016.[4] Although both the state and its employees contribute, the state as plan provider bears the investment risk.

At the end of fiscal 2017, the ERS Retirement Trust Fund had $26.4 billion in assets. Its accrued liability, however — the total amount needed to meet all future pension obligations on the books — totaled $37.6 billion, resulting in an $11.3 billion *unfunded actuarial accrued liability*, or UAAL (**Exhibit 1**).[5] This

EXHIBIT 1

ERS TRUST FUND ACTUARIAL VALUATION AS OF AUGUST 31, 2017

Actuarial Value of Assets	$26.4 billion
Actuarial Accrued Liability	$37.6 billion
Unfunded Actuarial Accrued Liability	$11.3 billion
Funded Ratio	70.1%

Source: Employees Retirement System of Texas

unfunded liability has been rising steadily. The UAAL rose by $10 billion between 2007 and 2017 and by $2.5 billion between 2016 and 2017 alone.[6]

The financial status of a pension fund such as the ERS trust fund is reflected in its *funded ratio*, its assets divided by its liabilities expressed as a percentage. A fully funded plan, then, would have a funded ratio of 100 percent or more.

Traditionally, a pension plan was considered actuarially sound with a funded ratio of 80 percent or greater; today, however, actuaries and credit rating agencies increasingly consider a variety of factors in assessing a fund's health, including the size of its obligations, its funding policies and its investment strategies.[7]

At the end of fiscal 2017, the ERS plan's funded ratio was 70.1 percent, down from 75.2 percent a year before (**Exhibit 2**). The ratio has fallen steadily since 2000.[8]

A pension plan's financial status also can be gauged by its *funding period*, the time required for the plan to become fully funded based on characteristics such as contribution rates and benefits offered. In fiscal 2016, the funding period was 35 years. At present, the ERS plan's funding period is "never" — meaning that, based on current actuarial assumptions and contribution rates, it will *never* have enough money to pay for the current and future retirement benefits it owes.[9]

CHALLENGES FACING ERS

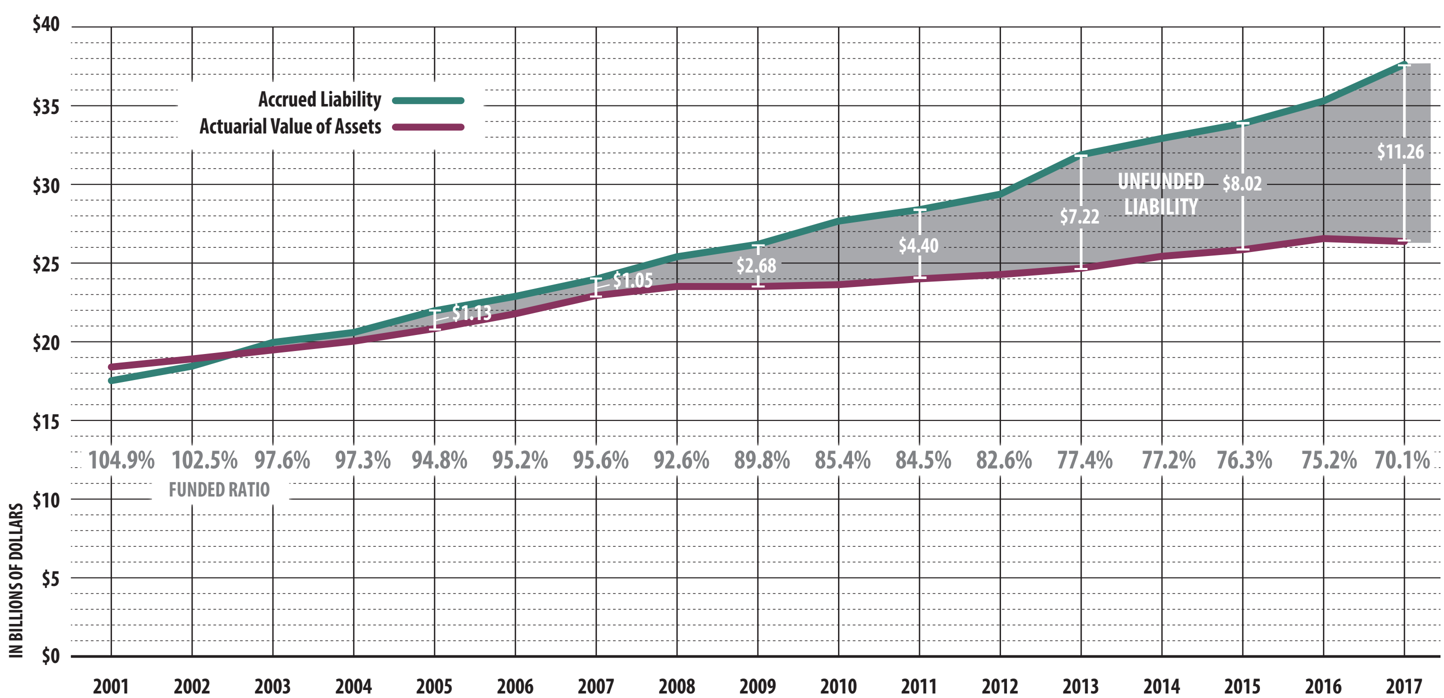
Several factors are making the ERS pension fund's future viability uncertain, including:

- *unrealistic investment return assumptions.* ERS' investment return assumption remained at 8.0 percent from 1994 to 2016; it was lowered to 7.5 percent in 2017 to more accurately reflect expected long-term returns. Even so, over time the ERS' *actual* investment returns averaged 5.5 percent for the last 10 years and 6.4 percent for the last 20 years.[10]

  The updated return assumption, however, will further reduce the ERS plan's funded ratio and, if future state and employee contributions continue at their current level, completely deplete the fund by 2084.[11]

EXHIBIT 2

ACTUARIAL VALUATION HISTORY OF ERS PENSION PLAN, FISCAL 2001-2017



Source: Employees Retirement System of Texas

- *inadequate state and employee contributions*. Since 2016, the state has contributed an amount equal to 10 percent of payroll to the ERS plan annually (including a 0.5 percent contribution from individual state agencies), while employees contribute 9.5 percent of their salaries (**Exhibit 3**).[12] The Texas Constitution limits the state's contribution to 10 percent, well below the national median of 12.95 percent. Conversely, the employee contribution rate is well *above* the national median of 6 percent (for state pension plans with members who also are enrolled in Social Security).[13]

  In all but one year since 1998, moreover, the state has failed to make the *actuarially sound contribution* (ASC) — that is, the contribution needed to fund the cost of future benefits and eliminate the UAAL over a finite period.[14]
- *demographic pressures*. In the last two decades, the number of active contributing members in the ERS plan has fallen by 10 percent, while the number of retirees and survivor beneficiaries (such as spouses) has risen by 64 percent. Thus, fewer active members are contributing toward the plan while an increasing number of members draw benefits without contributions from salary.[15] Longer lives are increasing this fiscal pressure; the average U.S. life expectancy rose by nearly 10 years from 1960 to 2016.[16]

LEGISLATIVE ACTIONS

From 2009 to 2015, the Texas Legislature passed various laws addressing the ERS plan's growing unfunded liability by increasing employee contributions (in 2009 and 2015); raising the minimum retirement age (in 2009); increasing the length of the service period used to determine the final average salary, and thus the pension payment (in 2009 and 2013); and making other adjustments.[17]

The most recent legislation concerning ERS operations — Senate Bill 301, approved in 2017 — strengthens the ERS board's oversight of "alternative investments," such as private equities, private real estate or hedge funds. In recent years, these alternatives (as opposed to more traditional public equities) have represented a rapidly increasing share of ERS' investments. The new law also requires the ERS board of trustees to approve any individual alternative investment above $100 million and requires a vote to be taken in public. Finally, the law requires ERS to study and adopt new actuarial assumptions once every four years, rather than every five.[18]

POLICY OPTIONS

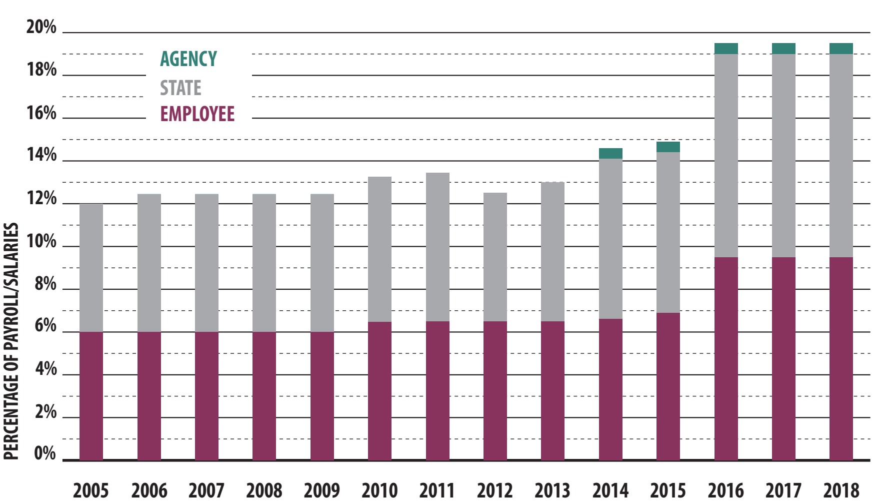
Despite recent legislation, the financial health of the ERS plan continues to decline. Any change to government pension plans can involve significant challenges and may have unforeseen consequences.

Proposed options to improve the funding status of the ERS plan include:

- *increasing contributions*. Increasing member contributions would improve the ERS fund's financial health, but would not be popular with enrollees. Increasing the state contribution rate requires a constitutional change unless the governor declares an emergency.[19]
- *making a one-time payment*. In the absence of further plan changes or major economic disruption, a substantial

EXHIBIT 3

ACTUAL CONTRIBUTION RATE COMPONENTS, 2005-2018



Source: Employees Retirement System of Texas

appropriation to the fund could significantly reduce the ERS plan's unfunded liability and establish a desirable funding period. Such a one-time payment also would help the fund earn higher returns. It would not, however, prevent the UAAL from rising again in subsequent years if the state does not begin meeting the ASC.[20] A lump-sum payment, moreover, might be limited by the spending cap of 10 percent of payroll.

- *dedicating an additional, ongoing state revenue source to the ERS plan.* An additional revenue stream diverted to the ERS plan could help address its increasing unfunded liability.
- *reducing benefits offered to current and/or future hires.* Options include increasing the retirement age; raising the number of working years required to become pension-eligible (currently, at least five or 10 years of service depending on the initial hiring date); or reducing the multiplier that determines the size of annuities. As already noted, the Legislature has taken similar actions several times in the last decade.

Although such actions would help stabilize the plan, they might cause high-performing workers to seek employment elsewhere, thereby reducing the overall quality of the workforce. They also could cause a "rush to retirement" among those at or near retirement age, which would reduce contributions and damage the plan's solvency.[21]

- *changing the ERS plan to a defined contribution or hybrid plan.* Most private employers offer defined contribution plans (DCPs), such as 401(k) plans, generally contributing a specific amount to employee retirement without guaranteeing a specific payment *at* retirement. The employee is at least partly responsible for managing the investment, if only by selecting among various retirement investment plans offered.[22] In recent years, at least 10 states have adopted hybrid plans.[23] These plans typically involve mandatory contributions to both a DBP and a DCP, distributing the risk between employee and employer. The DBP component provides a guaranteed monthly annuity, while the DCP component provides employees some control over their investment portfolios.[24]

THE BENEFIT MULTIPLIER

In Texas, retired state employees' monthly annuities are calculated as follows:

YEARS OF SERVICE X BENEFIT MULTIPLIER X FINAL AVERAGE MONTHLY SALARY = RETIRED EMPLOYEE'S MONTHLY ANNUITY

The current multiplier for regular employees in the main ERS plan is 2.3 percent. It's been in effect since fiscal 2002.

Source: Employees Retirement System of Texas

II. HEALTH CARE BENEFITS FOR RETIRED TEACHERS

The Teacher Retirement System of Texas (TRS) administers two health care benefit programs: the Texas School Employees Uniform Group Health Coverage Program (TRS-ActiveCare) for current public school employees and their dependents and the Texas Public School Retired Employees Group Benefits Program (TRS-Care) for retirees and their dependents. This overview addresses TRS-Care.

TRS-Care is a self-funded program, initially established in 1985 through Chapter 1575 of the Texas Insurance Code.[25] As of April 2018, the TRS-Care program covered about 234,000 retirees, dependents and surviving spouses.[26]

PROGRAM SOLVENCY

TRS-Care funding is linked to active public school and charter school employee payrolls, *not* to actual health care costs. Due to rapidly rising health care prices and a contribution system that didn't change from 2005 to 2017, this funding has not kept pace with health care expenses.[27]

A November 2016 report by the Joint Interim Committee to Study TRS Health Benefit Plans projected that TRS-Care would incur a $1.3 billion to $1.5 billion shortfall in the 2018-19 biennium and a $4 billion to $6 billion shortfall for 2020-21.[28]

In response to the joint committee's recommendations, 2017 legislation:

- eliminated free coverage under TRS-Care (except for certain disability retirees enrolled during Plan Years 2018 through 2021), requiring members to contribute $200 per month toward their health insurance premiums;

- increased funding contribution rates for the state and school districts to generate an estimated $301.3 million in additional funding during the 2018-19 biennium;
- created a high-deductible health plan for enrollees not eligible for Medicare;
- created a Medicare Advantage plan and Medicare prescription drug plan for enrollees eligible for Medicare;
- allowed the system to provide other, appropriate health benefit plans to address the needs of enrollees eligible for Medicare; and
- allowed eligible retirees and their eligible dependents to enroll in TRS-Care when the retiree reaches 65 years of age, rather than waiting for the next enrollment period.[29]

TRS-CARE CONTRIBUTIONS

TRS-Care funding comes primarily from contributions made by active employees, school districts and the state, as well as retiree and dependent premiums and certain federal subsidies.

The 2017 legislative session increased the state's contribution from 1 percent of the salaries of all active public education employees to 1.25 percent, an increase that will generate an additional $167.4 million for the program during the 2018-19 biennium. It also increased school district contributions from 0.55 percent of payroll to 0.75 percent, to generate an additional $133.9 million in the same period **(Exhibit 4)**.[30] The contribution rate for active public education employees remained at 0.65 percent of payroll.

EXHIBIT 4

FORMULA FUNDING CHANGES FOR TRS-CARE

CONTRIBUTIONS	FISCAL 2017	FISCAL 2018
Active Employee	0.65%	0.65%
School District	0.55	0.75
State	1.00	1.25

Source: Texas Comptroller of Public Accounts

SUPPLEMENTAL FUNDING

At its creation in 1985, TRS-Care was expected to remain solvent for just 10 years, with the understanding that additional funding or benefit changes would be necessary to maintain the plan. Prior to the recent legislative changes to TRS-Care, however, the funding formula had not changed since 2005, requiring periodic supplemental appropriations to maintain benefits.[31]

In 2003, for instance, the Legislature appropriated $516 million from the Texas Economic Stabilization Fund (ESF) to maintain TRS-Care benefits. The program also received more than $487.1 million in supplemental appropriations from general revenue between 2003 and 2005. Since 2013, the Legislature has made supplemental appropriations to TRS-Care nearly annually (**Exhibit 5**). Most recently, the

EXHIBIT 5

STATE GENERAL REVENUE CONTRIBUTIONS FOR TRS-CARE, FISCAL 2003-2017 (IN MILLIONS)

Source: Teacher Retirement System of Texas

Legislature made a supplemental appropriation of $182.6 million for fiscal 2018 and then, during the 2017 special session, added another supplemental appropriation of $212 million to reduce the TRS-Care Standard plan deductible from $3,000 to $1,500 and reduce premiums for dependents.[32]

COST DRIVERS

The rising cost of health care is directly tied to the impact of chronic health conditions and increasing drug prices.

A small share of TRS plan participants accounts for a disproportionate amount of health care spending, largely due to chronic health conditions needing frequent care. Compared with the rest of the population, persons with chronic diseases such as diabetes have a much higher rate of emergency room visits, more frequent hospital admissions, longer hospital stays and higher readmission rates.

Price inflation among "specialty" medications — expensive new drugs generally under patent — also drives up costs. TRS-Care participants using specialty medications made up just 7.3 percent of all TRS-Care enrollees in fiscal 2017, but their specialty drugs accounted for 30.9 percent of all covered drug costs before rebates. For example, the amount TRS-Care spent on two specialty medications, Humira and Enbrel, rose by nearly 14.5 percent in fiscal 2017, even though the number of patients using them increased by less than 2 percent.

Even with the changes to the plan design and contribution rates, TRS' July 2018 Legislative Appropriations Request estimated that TRS-Care would need an additional $400 million to $600 million for fiscal 2020 and 2021 to maintain premiums and benefits at current levels. Subsequent contract negotiations reduced the projected need to an additional $240 million to $410 million.[33]

III. TEXAS GUARANTEED TUITION PLAN

The Texas Guaranteed Tuition Plan (TGTP), formerly called the Texas Tomorrow Fund™, is a prepaid tuition plan created in May 1995 and opened for enrollment in 1996. Texas voters approved a constitutional amendment in 1997 that guarantees the plan's benefits with the full faith and credit of the state.[34]

Fund participants could select contracts for public junior colleges, public universities or private colleges and universities and purchase them in a lump sum or through installments to lock in current tuition rates for the beneficiary's later use. The plan pays a different reimbursement rate per semester hour for each contract type.

The plan stopped accepting new contracts when the Texas Legislature deregulated tuition in 2003, in anticipation of significantly higher tuition rates. In all, the plan sold 158,442 contracts prior to closure. As of Aug. 31, 2017, it had 52,755 active contracts remaining.[35]

Of all contracts sold, 84.4 percent were "senior college plan" contracts, which pay an hourly reimbursement rate based on the weighted average amount of tuition (WAT) and schoolwide required fees for a semester hour at all Texas public four-year colleges and universities. Texas institutions charging above the WAT must waive the difference between the amount paid by the plan and the actual tuition and required fees, if greater.

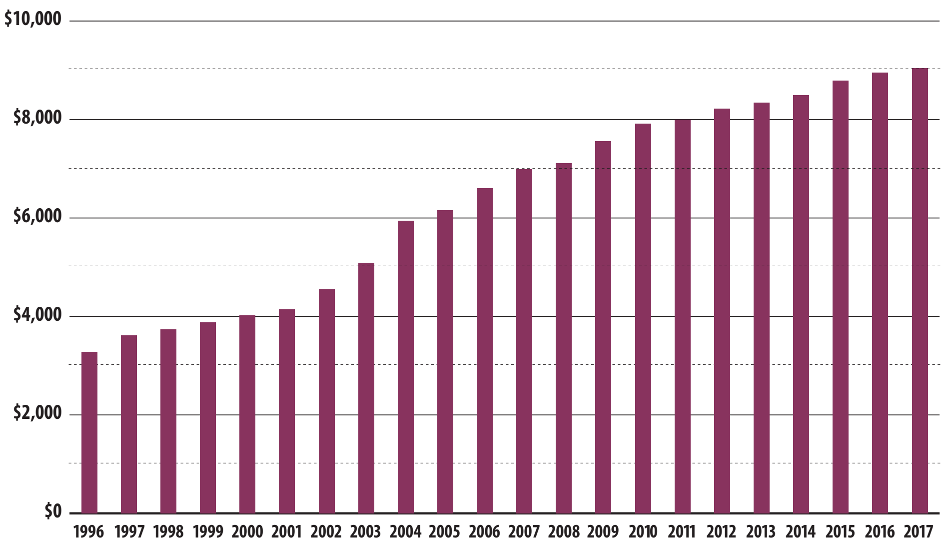
The Texas Prepaid Higher Education Tuition Board invests contract payments and uses the payments and interest earnings to pay college tuition and required fees for enrollees. The program has proven to be a significant benefit for participating students and their families, as the average cost of tuition and fees at Texas public colleges and universities has nearly tripled, even after adjustment for inflation, since the program began (**Exhibit 6**).[36]

LOOMING SHORTFALL

The TGTP's contract payments and investment earnings have failed to keep pace with the cost of tuition. By Aug. 31, 2017, the plan had an estimated unfunded liability of $613.8 million. According to actuarial projections, it could experience a cash shortfall as

EXHIBIT 6

AVERAGE ANNUAL TUITION AND FEES
AT TEXAS PUBLIC FOUR-YEAR COLLEGES AND UNIVERSITIES,
FISCAL 1996-2017



Source: Texas Higher Education Coordinating Board and Texas Comptroller of Public Accounts

early as 2020.[37] Since the program has a constitutional funding guarantee, any shortfall automatically triggers a draw on the state's general revenue.

Several actuarial assumptions used in setting prices for the plan's contracts didn't pan out. Tuition rose more than expected, while the fund's investments returned less than expected.

Furthermore, a provision of the program allows contract owners to cancel mature, paid-in-full contracts for a refund — when, for instance, a beneficiary did not attend college as expected, or received scholarships or other financial assistance that made the contract unnecessary — based on the *current* hourly reimbursement rate for their contract type, including earnings based on tuition inflation over the life of the contract. In fiscal 2017, earnings paid on these refunds totaled $26.4 million.

In 2009, the Texas Prepaid Higher Education Tuition Board considered a rule change to limit refunds to the amount contract holders paid in, less administrative fees, rather than basing them on the hourly reimbursement rate in effect at the time of cancellation.[38] Numerous contract owners expressed concern over this potential rule change to their legislative representatives, however, and it never took effect.[39]

PREPAID PLANS IN OTHER STATES

Texas isn't the only state to experience difficulties with prepaid tuition plans. Most states with such plans initially overestimated investment gains while underestimating tuition increases, just as Texas did. Of 22 states that once offered prepaid tuition plans, only 11 still have such plans open for new enrollment today. Of these, only four (Florida, Massachusetts, Michigan and Washington) guarantee their plans with the full faith and credit of the state.[40] The Private College 529 Plan, an independent prepaid tuition plan offered by nearly 300 private colleges and universities nationwide, also remains open for new enrollment.

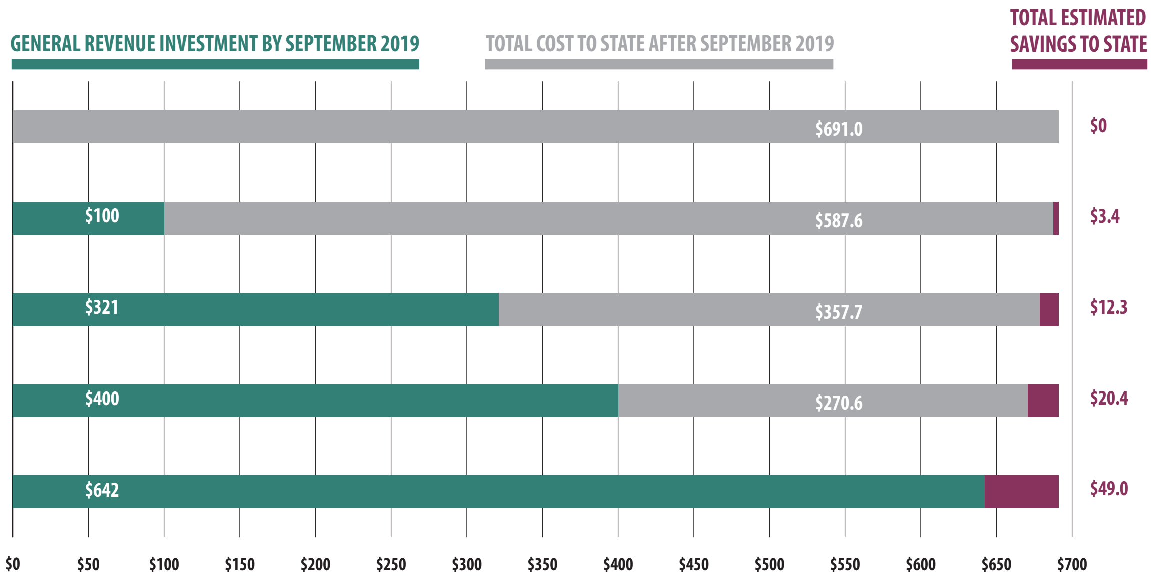
Most states that closed their prepaid tuition plans now administer other education savings plans instead. In Texas, the TGTP was replaced by a new prepaid plan, the Texas Tuition Promise Fund™ (see below).

TEXAS TUITION PROMISE FUND

In 2008, Texas opened a new prepaid tuition plan, the Texas Tuition Promise Fund, that differs from its predecessor in important ways. It's structured so it will never pay institutions or purchasers more in benefits than the amount purchasers contribute for tuition units, plus or minus net earnings or losses. Furthermore, it isn't guaranteed by the full faith and credit of the state, although Texas public colleges and universities must accept the amount transferred by the plan as payment in full for tuition and required fees for the hours covered by the units.

EXHIBIT 7

TEXAS GUARANTEED TUITION PLAN — IMMEDIATE INVESTMENTS PRODUCE GREATER SAVINGS: FIVE SCENARIOS (IN MILLIONS)



Source: Sherman Actuarial Services, LLC

POLICY OPTIONS

Texas could save as much as $49 million in general revenue by fully resolving the Texas Tomorrow Fund's unfunded liability before the end of fiscal 2019.[41]

In 2017, Sherman Actuarial Services, LLC, analyzed the TGTP at the request of the Legislative Budget Board. The company estimates the current TGTP shortfall at $642 million and projects that the plan's available cash for benefits will be depleted in March 2020, requiring annual general revenue appropriations until 2039, when all contracts are expected to be fulfilled.

In all, funding the plan on this "pay as you go" basis is estimated to cost the state $691 million beyond the plan's own earnings through 2039. A more substantial upfront investment in the next legislative session, however, could reduce the state's total costs substantially by generating additional investment earnings for the program (**Exhibit 7**). Paying the full current shortfall of $642 million in 2019, for instance, ultimately would decrease future costs to general revenue by $49 million.

IV. DEFERRED MAINTENANCE FOR STATE-OWNED BUILDINGS

Deferred maintenance refers to the postponement of maintenance activities (such as repairs, retrofitting or replacement) for buildings, equipment and systems due to a lack of sufficient funding. Deferring maintenance isn't uncommon in times of tight budgets, but a growing maintenance backlog can lead to inefficiencies, safety hazards, poor customer service and higher eventual costs.

The costs related to the state's deferred maintenance backlog reflect the compounding effect of postponement from one year to the next, similar to the interest on debt. When maintenance is postponed, repair and replacement costs become higher in future years due to the accelerated deterioration of known deficiencies, the accumulation of new problems and the rising cost of repair and construction.

State deferred maintenance projects often require several years to complete, yet their funding is appropriated on a biennial basis. New deficiencies can arise and the state of current deficiencies can change greatly between the development of an appropriation request and the beginning of a project. Unplanned budget spikes can result if a deferred maintenance item becomes an emergency.

Historically, Texas has funded deferred maintenance projects primarily through general revenue appropriations and the issuance of general obligation bonds. Funding for unplanned, emergency projects, by contrast, usually comes from the remaining balances of recently completed projects, interest earned on bond proceeds, utility appropriation balances and, most commonly, the diversion of funding from *planned* deferred maintenance projects.

In 2015, after years of deferring maintenance for state-owned buildings, Texas established a master plan for state facility maintenance and created a special fund to address deferred maintenance issues.[42]

FUNDING

In 2015, six state agencies were appropriated nearly $500 million for fiscal 2016-17 deferred maintenance projects (**Exhibit 8**). As of June 2018, more than $34 million of this amount (or 6.9 percent of the total) had not yet been spent or "encumbered" (slated for spending on specific projects).[43]

In 2017, the Legislature appropriated nearly $459 million of additional deferred maintenance funding to 11 agencies for fiscal 2018 and 2019.[44] In addition to general revenue and general revenue-dedicated funds, the 11 agencies also received more than $602 million from the ESF for health and safety repairs. Of this amount, $130 million was appropriated specifically for deferred maintenance projects, while $160 million was appropriated for "critical repairs" at state hospitals and living centers. The Texas Facilities Commission (TFC), which manages facilities for more than 100 state agencies, received $90 million from the ESF.[45]

As of June 2018, state agencies had reported more than $449 million of deferred maintenance needs for the 2018-19 biennium to the Joint Oversight Committee on Government Facilities (**Exhibit 9**).[46] As of that month, more than $15 million had been spent and $41 million was encumbered, leaving a total available deferred maintenance balance of $393 million.

HARVEY EFFECTS

Hurricane Harvey, which made landfall near the end of fiscal 2017, impeded a number of state deferred maintenance projects along the Texas coast. During

EXHIBIT 8

JUNE 2018 BALANCES, DEFERRED MAINTENANCE PROJECTS APPROVED FOR FISCAL 2016 AND 2017

	CURRENT ESTIMATED PROJECT BUDGET	FISCAL 2016 AND 2017: ENCUMBERED	FISCAL 2016 AND 2017: EXPENDED	REMAINING PROJECT BALANCE	PERCENT REMAINING
DEPARTMENT OF PUBLIC SAFETY	$38,778,877	$1,566,407	$22,386,298	$14,826,172	38.2%
TEXAS MILITARY DEPARTMENT*	19,559,181	3,598,556	15,960,625	0	0.0
TEXAS PARKS AND WILDLIFE DEPARTMENT	88,983,987	27,114,080	61,869,907	0	0.0
TEXAS DEPARTMENT OF CRIMINAL JUSTICE	67,380,574	12,519,249	54,861,325	0	0.0
TEXAS FACILITIES COMMISSION	217,156,348	126,972,112	70,598,080	19,586,156	9.0
TEXAS DEPARTMENT OF TRANSPORTATION	67,198,859	10,266,705	56,932,154	0	0.0
TOTALS	**$499,057,826**	**$182,037,109**	**$282,608,389**	**$34,412,328**	**6.9%**

* Facilities of the Texas Army National Guard, Texas Air National Guard and Texas State Guard.
Source: Texas Joint Oversight Committee on Government Facilities

EXHIBIT 9

JUNE 2018 BALANCES, DEFERRED MAINTENANCE PROJECTS APPROVED FOR FISCAL 2016 AND 2017					
AGENCY	CURRENT ESTIMATED PROJECT BUDGET	FISCAL 2016 AND 2019: ENCUMBERED	FISCAL 2018 AND 2019: EXPENDED	REMAINING PROJECT BALANCE	PERCENT REMAINING
DEPARTMENT OF PUBLIC SAFETY	$12,000,000	$668,416	$384,047	$10,947,537	91.2%
TEXAS MILITARY DEPARTMENT*	10,303,638	1,459,178	540,680	8,303,780	80.6
TEXAS PARKS AND WILDLIFE DEPARTMENT	66,185,665	3,546,695	3,614,331	59,024,639	89.2
TEXAS DEPARTMENT OF CRIMINAL JUSTICE	41,996,216	8,095,662	3,274,498	30,626,056	72.9
TEXAS FACILITIES COMMISSION	90,000,000	11,037,884	401,839	78,560,277	87.3
TEXAS DEPARTMENT OF TRANSPORTATION	50,000,000	4,756,121	2,898,353	42,345,526	84.7
TEXAS HISTORICAL COMMISSION	6,350,000	2,322,701	2,052,656	1,974,643	31.1
STATE PRESERVATION BOARD	4,700,000	212,920	42,881	4,444,199	94.6
DEPARTMENT OF STATE HEALTH SERVICES	1,800,000	36,852	0	1,763,148	98.0
HEALTH AND HUMAN SERVICES COMMISSION – STATE HOSPITALS	79,059,077	5,255,557	1,540,033	72,263,487	91.4
HEALTH AND HUMAN SERVICES COMMISSION – STATE SUPPORTED LIVING CENTERS	74,567,911	3,538,609	285,675	70,743,627	94.9
JUVENILE JUSTICE DEPARTMENT	12,100,000	539,294	54,963	11,505,743	95.1
TOTALS	**$449,062,507**	**$41,469,889**	**$15,089,956**	**$392,502,662**	**87.4%**

* Facilities of the Texas Army National Guard, Texas Air National Guard and Texas State Guard.
Source: Texas Joint Oversight Committee on Government Facilities

an October 2017 hearing before the Texas Joint Oversight Committee on Government Facilities, several agencies detailed the challenges posed by Harvey's destruction and the need for flexibility in the use of deferred maintenance funds for Harvey-related repairs. In response, the committee asked agencies to notify it ahead of time before using deferred maintenance funding for recovery efforts.

The Oversight Committee chair emphasized that agencies should consider whether properties with deferred maintenance projects have a historical pattern of *repeated* damage from natural disasters. He also said the committee eventually should decide whether such properties — particularly those damaged as often as every three to five years — should continue receiving deferred maintenance funding.[47]

POLICY OPTIONS

One obvious source of additional deferred maintenance funding is the state's Economic Stabilization Fund. As noted above, the Legislature tapped the ESF for deferred maintenance funding in 2017.[48]

During that session, other bills related to use of the ESF for deferred maintenance were discussed. House Bill 1498, for instance, would have appropriated $500 million from the ESF for deferred maintenance and repairs at institutions of higher education. The bill didn't pass, however.[49]

V. LONG-TERM OBLIGATIONS AND THE TEXAS LEGACY FUND

Texas' long-term obligations *must* be addressed at some point, and the longer we wait, the higher their cost will be. Inaction will simply cause these problems to snowball, lowering the state's credit rating, raising our cost of borrowing and putting the state's financial stability at risk.

Most of the available strategies, however — such as raising member contributions, reducing benefits and increasing state debt — would create their own problems and may be unacceptable for many voters

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and lawmakers. And in tight budget times such as these, using general revenue to quickly retire these obligations simply isn't feasible.

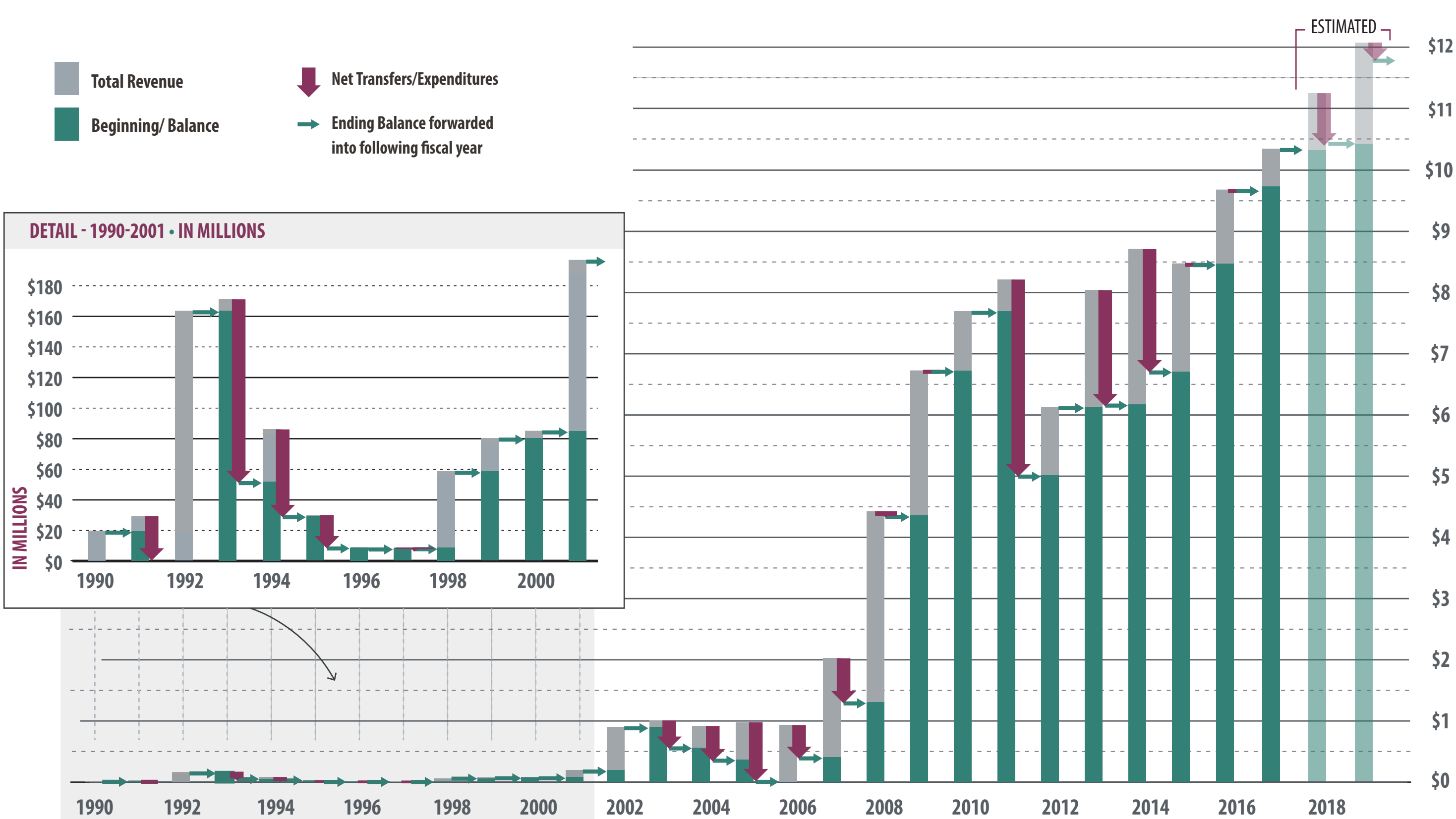
Fortunately, Texas has the tools it needs to begin addressing its long-term obligations, starting with its Economic Stabilization Fund — often called the "rainy day fund." At the end of fiscal 2017, the ESF balance was nearly $10.3 billion; barring any appropriations from the fund, it's expected to rise to nearly $11.9 billion by the end of fiscal 2019, an amount equal to about 11 percent of the state's total appropriations for fiscal 2019 (**Exhibit 10**).[50] It's the nation's largest reserve fund and the third largest as a share of annual state expenditures.[51]

The ESF is a budget management tool designed to stabilize volatile revenue swings and to protect state finances against economic shocks and downturns. It's supported mainly by revenue from oil and natural gas severance taxes. The Legislature proposed the ESF as a constitutional amendment in 1987, after a period of massive budget shortfalls caused largely by cratering oil and gas markets. By dedicating a portion of severance taxes to the ESF, Texas could save during severance tax windfalls and use the proceeds to reduce the volatility of its budget.

The Legislature's original intent was to maintain a relatively small ESF in highly liquid investments for immediate use. The fracking boom of the last few years, however, poured billions into the fund, far more than is needed for immediate liquidity. Yet the bulk of it is still invested in short-term instruments currently yielding about 2.1 percent, not even enough to meet the current inflation rate (as of Aug. 31, 2018) of 2.7 percent. In effect, the state is losing purchasing power and leaving money on the table that could be raised through common, prudent investment strategies.

EXHIBIT 10

ESF TOTAL REVENUE, TOTAL EXPENDITURES AND ENDING BALANCES, FISCAL 1990-2019 (IN BILLIONS OF DOLLARS)



Source: Texas Comptroller of Public Accounts

In recent years, the Legislature has taken small steps to remedy this situation. The 2015 legislative session created the Texas Economic Stabilization Investment Fund (TESTIF), a portion of the ESF that the Comptroller can invest to achieve net returns that at least meet inflation.

The portion of the ESF that can be invested in this way is the amount exceeding a "sufficient balance" — the amount the state requires to be readily available in short-term investments. This balance is set by a joint House-Senate committee prior to each legislative session. The balance was set at $7.5 billion for the 2018-19 biennium.

As of May 31, 2018, the amount above the sufficient balance totaled more than $3.2 billion, and the cumulative return on this TESTIF portion was about 5.6 percent, or $72 million more than would have been earned if the total ESF balance had remained in the corpus of the fund, the Treasury Pool.[52]

THE TEXAS LEGACY FUND

There are, however, other ways the ESF could be used to benefit the state. The creation of an endowment fund from a portion of the ESF, for example, could produce billions in earnings for the benefit of future generations of Texans. Such investment funds and strategies are hardly novel — Texas and Oklahoma are the only "energy" states without such a plan, and in November, Oklahoma voters will vote on creating one for their state.

The Comptroller proposes that the ESF portion exceeding the sufficient balance be placed in a new *Texas Legacy Fund*. This fund would be invested for higher returns and its earnings would be used to retire long-term obligations, leaving the principal untouched. Texas already has many permanent funds that function in this way, including the Permanent School Fund, which generates earnings for public education, and the Permanent University Fund, which supports public colleges and universities.

Importantly, the Legacy Fund would not interfere with the ESF's original purpose of protecting state finances against economic shocks; any transfers to the Legacy Fund would occur *only* if the ESF is at the legislatively set sufficient balance.

The Comptroller also proposes that the more conservative TESTIF investment strategy be applied to the sufficient-balance portion of the ESF, so that the purchasing power of the entire ESF balance can be maintained.

Under this proposal, investment earnings from the Legacy Fund would be dedicated to addressing long-term obligations and other state priorities as defined by the Legislature. The Legacy Fund would be outside general revenue, so any appropriations from it would not count against the state's pay-as-you-go budget.

The Texas Legacy Fund would be managed by the Texas Treasury Safekeeping Trust Company, which is directed by the Comptroller. The trust company oversees $60 billion in assets including 14 separate endowment funds with assets totaling more than $4 billion, such as the Tobacco Settlement Permanent Trust Account and the National Research University Fund.

The sooner the state implements a stronger investment strategy, the more it will benefit. If, for instance, the state had invested the entire sufficient balance in 2017 in the same way that the TESTIF is invested, projections indicate it could have earned an additional $64 million during the 2018-19 biennium.

Over time, Legacy Fund revenue growth would accelerate dramatically. At present, the ESF contains $3.1 billion more than the sufficient balance. If it were invested today as the Legacy Fund, the state could be earning $111 million annually on that investment by 2020-21. In 10 years, annual distributions could hit $955 million, with a cumulative distribution to that point of nearly $3 billion.

Whether the Texas Legacy Fund is established or other proposals are enacted, Texas' budget challenges won't be resolved overnight. These proposed reforms represent long-term solutions f or long-term challenges, giving us the tools we need to systematically and aggressively chip away at our obligations and avoid potential credit downgrades. **FN**

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Texas Comptroller of Public Accounts
Publication #96-369,

SPECIAL EDITION – September-October 2018