THE Neal Spelce AUSTIN LETTER

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Dear Client:

About three-dozen state governments are still facing big revenue shortfalls. Even the Texas Rainy Day Fund is now estimated to fall about a billion dollars short of the official estimate made earlier this year. And, California? Oh, my. Let's sort it out for you.

First of all, many of the hardest-hit states are going to be forced to rework their budgets in January and February. The problem: **this is halfway through their 2010 fiscal years**. Some of the states with the biggest holes to dig out of: Arizona, Virginia, Kentucky, New Mexico, Maryland, Colorado, Kansas – obviously a wide variety of economies.

Temporary **sales tax hikes** are being considered by Connecticut and Colorado. Hawaii is expected to **widen its income tax brackets**. Mississippi is considering **raising its gasoline tax**. Alabama is considering **cutting state police**. Several states are likely to **raise "sin" taxes on cigarettes and alcohol**.

California's well-publicized budget battles resulted in a budget this year that still contains a deficit north of a billion dollars. So, what effect did the budget cuts and tax hikes have in California? **Richard Reeves**, wrote a scathing commentary claiming **California is "crazy, mean and at war with itself**."

"The greatest public university in the world, home to dozens of Nobel Prize winners, has become **victim of a thousand cuts, and the students protesting tuition increases of more than 30% are trashing the buildings**," he reports. But his most telling observation came in the form of a direct quote from **Richard Mathies**, dean of the chemistry department at University of California, Berkeley.

"**Dismantling this institution, which is a huge economic driver for the state, is a stupendously stupid thing to do**, but that's the path the Legislature has embarked upon," Mathies told Reeves. Reeves said California's Chief Justice called the state "dysfunctional." So, what to do? Reeves said "No one in California has a clue."

Okay, what about Texas? As we noted above, the state's Rainy Day Fund was expected to **reach $9.1 billion at the end of the state's two-year budget cycle. Now the estimate has been reduced to $8.2 billion**. What's happening here? Check out the next item.

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Texas is projected to have an $8.2 billion "slush fund" at the end of its fiscal biennium in 2011. So if Texas runs short of money (and sales tax collections are down), it can simply tap the fund, right? Not so fast. It's not that easy.

The official name of the fund is the Economic Stabilization Fund, but everybody calls it the "Rainy Day Fund." **Back in 1988, Texas voters established the fund via a constitutional amendment with the state's 1986-1987 economic collapse still fresh in mind.** Money goes into the fund, via formulas, from oil and gas tax collections and any unencumbered surpluses. And it retains the interest it earns on fund balances.

Even though the fund has been tapped from time to time (most recently, in fiscal 2005), it has grown over the years. **The Rainy Day Fund now totals between $7 billion and $8 billion.** Quite a stash. And State Comptroller **Susan Combs** estimates it should surpass $8 billion by the end of this budget biennium.

But many of those who keep a watchful eye on state spending are warning that **Texas could face at least a $10 billion shortfall** when the next two-year budget is up for consideration. As you know, the Texas Legislature only meets once every two years and is not due back in Austin until January 2011. Who knows what may happen to the economy during the meantime?

One thing is certain, however: **Texas got about $13 billion of one-time money from the fed's economic stimulus package to finance the current budget. That money will go away in 2011.** So, those big bucks will need to be replaced, or programs eliminated and/or reduced – or both. Could the Rainy Day Fund be tapped to ease the budget pain?

Easier said, than done. **The constitution requires a legislative super-majority – a two-thirds vote of both the Texas House and Senate – to spend any Rainy Day Fund money.** If they line up as they have in the past, conservatives will not want to tap the fund, but liberals will push to spend at least a portion of it. And the voting margins are narrow in both the House and Senate.

Not that it will, but if the question ultimately boils down to **raising taxes or tapping the fund, you can look for the Rainy Day Fund to be drained.**

During the 2010 campaigns for the Texas House and Senate, and in general over the next 13 months before the next session of the Legislature convenes in Austin, you can look for some **trial tax balloons to be lofted – especially those that talk about adding various services and transactions to the already-existing sales tax.**

You see, legislators could then argue **they didn't really raise taxes, they just "closed some loopholes"** by placing those under the sales tax umbrella who have been "dodging paying their fair share" etc., etc. Lobbyists will have a field day. It will be interesting to watch.

Tough economic times generally trigger an outbreak of entrepreneurship. **And Texas is becoming more entrepreneur-friendly**.

This is the word from a non-partisan, non-profit small-business and entrepreneurship advocacy group, The Small Business & Entrepreneurship Council, based in Virginia. **It ranked Texas #3 in a national Index that was just released**. Texas was #6 in 2008. South Dakota and Nevada kept their hold on the #1 and #2 ranking. Following #3 Texas was Wyoming and Washington.

Texas is obviously the largest and most economically advanced of the Top Five. Factors considered in the rankings include **property rights**, **health care**, **energy costs**, **taxes**, **government spending and regulatory costs**.

A much-anticipated report this week reveals that the regional economy showed signs of improvement in the past six weeks.

The report is the highly-regarded "Beige Book" survey released by the Federal Reserve Bank of Dallas. It evaluates economic conditions throughout Texas and some surrounding states. **In the past six weeks**, **through November 2009**, **economic conditions** "**firmed**," reports the Fed.

> The report indicated that industries such as housing, energy, petrochemicals, high-tech manufacturing, staffing and paper showed signs of improvement. It indicated **a slow**, **but steady**, **recovery is underway**, **with some sectors such as commercial real estate lagging behind**. One issue not directly addressed, however, is the *rate* of recovery.
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> Industries that continue to report ***deteriorating*** **conditions include the aforementioned commercial real estate and financial services**. A *positive* development came from **staffing firms that noted they are experiencing more demand for contract workers**, and some hiring is occurring in the transportation service industry.

In the real estate sector, **new and existing home sales improved over the past six-week period**, but the level of activity throughout the region remains relatively weak. It noted that the real estate industry is waiting to see if the new home sales activity is related to the first-time homebuyer tax credits or part of a larger trend that would indicate improvement in the residential real estate sector.

Adding to the **difficulty of drawing a conclusion** is what we reported to you last week – the tax credit for first-time homebuyers has been extended for six months and the program has been expanded to include tax credits for longtime homeowners who want to buy another home. Look to the next item for a separate report on home sales specifically in the Austin metro area.

Austin's existing home sales data through October showed marked evidence of improvement.

This is the conclusion drawn by **Beverly Kerr**, the Austin Chamber's VP/Research, after analyzing the most recent data from the Austin Board of Realtors and the Real Estate Center at TexasA&M. She points out that **October's nearly 2,000 sales total is 38% above the number of homes sold in October 2007**.

Further, the Real Estate Center's **latest estimate for 2009 would put the year's total sales only 5.7% below 2008**. It's improving quickly. Just one month ago, this preliminary estimate pegged 2009's sales 7.5% short of 2008 and before that, the spread had been estimated at 8.5%.

> The number of homes with "for sale" signs in the front yard is also diminishing. "Austin's months of inventory on the market measure has shown steady improvement over the last several months," Kerr reported. At 6.1 months, it is up from 5.9 months a year ago, but it is ***below* the 7 or more months supply of homes for sale on the market during May, June and July of this year**.

What about home values/prices? Well, they're off a tad from a year ago. Austin's *average* sales price of $234,000 is down 2.3% from last October and the *median* price of $179,800 is down by 4.6%. However, **on an annual basis, the difference between 2008's *median* price and 2009's *median* price is expected to be only -0.9% — one of the nation's best marks**. The difference in the *average* home price is expected to be -3.2%.

For a perspective on "one of the nation's best marks," consider these figures: **The National Board of Realtors predicts the national 2009 *median* price will be 12.8% below 2008** and 22.2% below 2006. Conclusion: the Austin metro housing market is to be envied for preserving housing values through the national housing bubble and the subsequent recession.

Dr. Louis Overholster feels a phrase first uttered in 1927 when silent movies were turning into "talkies" – "Who the hell wants to hear actors talk?" — is just as appropriate during this age of political endorsements.

Sincerely

Neal Spelce

Editor/Publisher