A REVIEW OF THE TEXAS ECONOMY FROM THE OFFICE OF **GLENN HEGAR**, TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

SEPTEMBER 2015

FISCAL NOTES

ALSO INSIDE THIS ISSUE:



# 2015 Legislative Wrap-up

by Michael Gibson, Elizabeth Barrett and Bruce Wright


The 2015 legislative session that concluded on June 1 considered thousands of bills and passed more than 1,300 of them, including HB 1, the General Appropriations Act, a weighty budget document calling for $209.4 billion in state spending in the next two years.

The 2016-17 biennial budget is a fiscally prudent one, well beneath various spending caps built into state law.

In addition to HB 1, however, a number of other new laws will have significant impacts on our state's finances. In this issue, *Fiscal Notes* takes a look at a few of the most important ones.

## TAX RELIEF FOR TEXANS

From the start of the 2015 session, the state's leadership made it clear that meaningful tax relief would be a major priority. Two bills delivered on this promise.

### SENATE BILL 1: PROPERTY TAX RELIEF

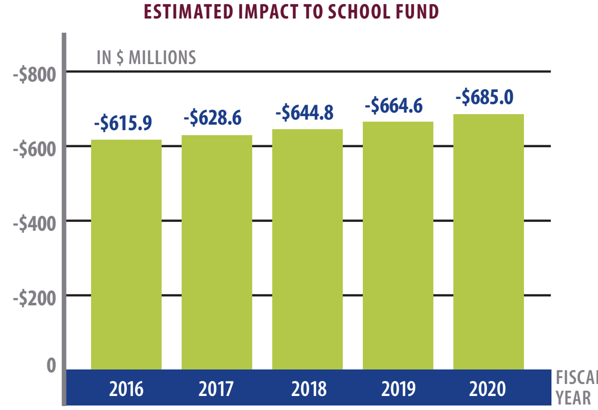
SB 1 will provide relief from school property taxes by increasing the amount of the residence homestead exemption — property value that can be excluded from tax — from $15,000 to $25,000. Thus a school district would tax a residence appraised at $200,000, for instance, at a value of $185,000 before SB 1 and $175,000 afterward.

Since the amount of the exemption is established in the state constitution, Texas voters will be asked in November to approve an amendment making the change.

Importantly, SB 1 *also* requires the state to make up for the loss in funding to school districts, which rely heavily on property tax revenues. According to the Legislative Budget Board (LBB), absorbing these losses will cost the state about $1.2 billion in the next two years, and more thereafter.

**FISCAL IMPACT OF SB 1: PROPERTY TAX RELIEF**

ESTIMATED IMPACT TO SCHOOL FUND




Source: Texas Legislative Budget Board

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# A Message from the Comptroller

Each session of the Texas Legislature considers thousands of bills that can impact people, businesses and institutions throughout our state, and the 2015 session that ended on June 1 was no different. In this issue of *Fiscal Notes*, we take a look at some of the most important new legislation concerning the state's finances.

From the taxpayers' viewpoint, possibly the most important actions of the session granted tax relief to homeowners and Texas businesses, with an increase in the homestead exemption from school property taxes (subject to voter approval in November) and a permanent 25 percent cut in franchise tax rates. I was glad to play a part as well, by identifying a series of outdated, difficult-to-administer taxes that could be eliminated. Eight of these taxes hit the chopping block at the end of the session.

Of course, the session addressed many other important topics, including education and transportation. Our lead article looks at these and other new laws that will affect how and why your tax dollars are spent.

We also look at credit rating agencies and the role they play in assessing the debt issued by our state and others. These credit ratings have a profound effect on the cost of borrowing, and happily Texas' ratings are excellent.

As always, I hope you enjoy this issue!

GLENN HEGAR
Texas Comptroller of Public Accounts


## THE GOOD FOR TEXAS TOUR

### A Report from Your CFO: The Financial State of the State

Join me for a discussion of the trends and issues affecting the state economy and your region. Understanding where we are today can help all of us ensure that we remain prosperous tomorrow. And that's good for Texas.

**Glenn Hegar** Texas Comptroller of Public Accounts

To see the schedule for the Comptroller's visits around the state this fall, please visit **texasahead.org/regionalrpts.**

### HB 32: FRANCHISE TAX RATE REDUCTION

HB 32 cuts the state's franchise or "margin" tax rate by 25 percent, and could save businesses across the state up to $1.3 billion in fiscal 2016 alone. The franchise tax, the state's main business tax, accounted for about 9.3 percent of all Texas tax collections in 2014, or more than $4.7 billion. The bill will reduce state revenues by nearly $2.6 billion during the 2016-17 biennium, mostly from the state's Property Tax Relief Fund.

**FISCAL IMPACT OF HB 32: FRANCHISE TAX RATE REDUCTION**

| FISCAL YEAR | ESTIMATED REVENUE LOSS FROM PROPERTY TAX RELIEF FUND 304 | ESTIMATED LOSS TO GENERAL REVENUE FUND |
|---|---|---|
| 2016 | -$1,268,483,000 | -$160,000 |
| 2017 | -1,291,384,000 | 0 |
| 2018 | -1,286,313,000 | 0 |
| 2019 | -1,310,256,000 | 0 |
| 2020 | -1,328,712,000 | 0 |

Source: Texas Legislative Budget Board

## TAX REPEALS

At the beginning of the 2015 session, Comptroller Glenn Hegar identified several outdated tax laws and recommended their repeal to ease the tax burden on business and make tax administration more efficient. Ultimately, the 2015 Legislature repealed:

- service fee on alcoholic beverages served on commercial planes and trains
- bingo gross rentals tax
- controlled substances tax
- state inheritance tax
- regulatory tax and fee assessment on the production of crude oil
- sulphur production tax
- fireworks tax
- liquefied gas tax*

* Note: compressed and liquefied natural gas delivered directly to vehicle fuel tanks remain taxable.

The minor taxes and fees repealed represent a revenue cost of only about $17.4 million in the 2016-17 biennium — an amount that will be more than made up by redeploying Comptroller resources to enforce other Texas taxes.

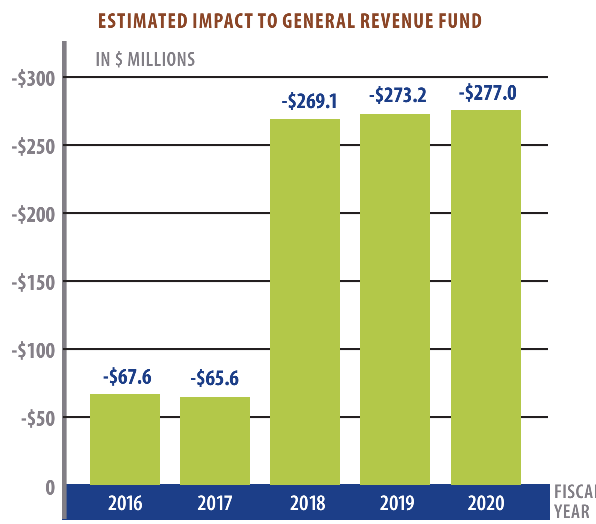
## GRANTS FOR PREKINDERGARTEN

Governor Greg Abbott cited early education as one of five emergency items facing the 2015 Legislature. One successful bill supported by the governor, HB 4, establishes the High Quality Prekindergarten Grant Program to provide up to $130 million in 2016 and 2017 for state grants to support pre-k programs in public schools and open-enrollment charter schools.

School districts (and charters) can receive this funding for students who are four years old as of Sept. 1 of each year. The grant amounts, to be determined by the state's commissioner of education, can reach up to $1,500 per student per school year.

The grant program is funded only for the 2016-17 biennium; additional appropriations would be needed to continue the program in 2018 and beyond. The following LBB estimate assumes complete use of the grant funding in 2016 and 2017, and thereafter, a renewal of the program and participation by three-quarters of all eligible students at the maximum available rate. Some administrative costs are included as well.

**FISCAL IMPACT OF HB 4: HIGH QUALITY PREKINDERGARTEN GRANT PROGRAM**




Source: Texas Legislative Budget Board

## STATE CONTRACTS

The 2015 session opened amid a flurry of news reports concerning poor management of state agency contracts, making legislation to tighten the process a near-certainty. SB 20, which becomes effective on Sept. 1, includes several measures intended to enhance state contracting.

One concerns the Texas Comptroller's vendor performance tracking system, which collects agency feedback on vendors after contract completion or termination. SB 20 enhances this process by requiring the Comptroller to assign vendors "grades," based on agency input, ranging from A to F. The Comptroller's office will establish rules on how a vendor's rating will affect its eligibility to continue contracting with state agencies. The performance tracking system and new rating information will be made available to the public on the Comptroller's website, **Comptroller.Texas.Gov.**

CONTINUED ON PAGE 4

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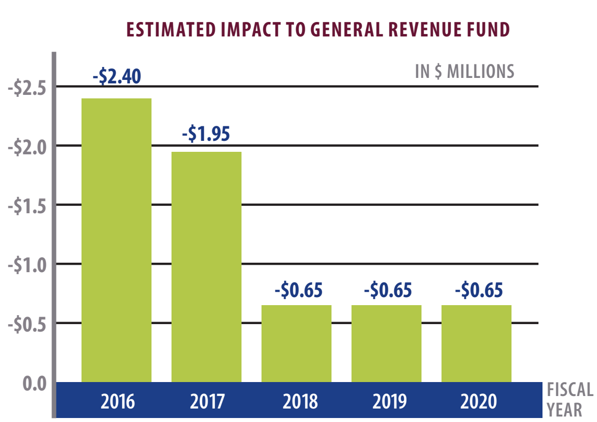
SB 20 also changes the data collection process for the state's centralized accounting and payroll/personnel system (CAPPS). Before SB 20, agencies using CAPPS' financial tools *could* submit data on contracts to the system; now they *must* provide specific contract data to CAPPS, including statements of work, financial information and summaries of the processes used to award each contract. At present, 10 state agencies use CAPPS-Financials; by the end of fiscal 2017, the Comptroller's office anticipates that about 50 agencies will be using CAPPS for their financial system, accounting for 87 percent of all state agency spending.

The bill also requires the State Auditor's Office to consider auditing Health and Human Services Commission contracts that exceed $100 million annually. Still other SB 20 transparency measures include required posting of contract information on state agency websites; increased ethics training; and a two-year prohibition on any vendor employment of former state workers who participated in purchases made with that vendor. The bill also outlines updated policies and procedures for higher education contracts.

Moreover, the Comptroller's office and Governor's Office will work together to study the feasibility of consolidating state purchasing functions and reducing the number of vendors that work with the state.

According to LBB, the sheer number of state contracts and vendors in Texas makes it difficult to "cost" this bill. The agency also notes that the vendor rating system may lead to protests and lawsuits, but these cannot be quantified because the Comptroller has not yet adopted rules and evaluation criteria for the ratings. LBB's cost estimates assume higher administrative costs for the revised vendor performance tracking system and additional legal assistance at the Comptroller's office, as well as additional agency costs associated with posting contract information online.

**FISCAL IMPACT OF SB 20: ENHANCED CONTRACTING MEASURES**




Source: Texas Legislative Budget Board

**DUE TO INCREASED POPULATION GROWTH AND ONGOING MAINTENANCE AND CONSTRUCTION NEEDS, INCREASED TRANSPORTATION FUNDING WAS A CRITICAL GOAL OF THE 2015 SESSION.**

## TRANSPORTATION

Texas has long taken pride in the nation's most extensive roadway system. Due to increased population growth and ongoing maintenance and construction needs, increased transportation funding was a critical goal of the 2015 session.

Senate Joint Resolution 5 calls for a constitutional amendment that would dedicate some state sales tax and motor vehicle sales tax revenues to the State Highway Fund; the resolution will go before Texas voters on Nov. 3, 2015. If voters approve this amendment, in fiscal 2018 and thereafter the Comptroller will credit to the Highway Fund up to $2.5 billion annually from net sales tax revenue that exceeds the first $28 billion of revenue collected.

Beginning in fiscal 2020, the Comptroller will also transfer to the Highway Fund 35 percent of each year's net revenue from the motor vehicle sales tax that exceeds the first $5 billion collected. The funds must be used for building and maintaining public roadways, acquiring rights of way or repaying bonds issued for highway improvement projects.

This bill will have a negative impact on the General Revenue Fund, the usual destination for these tax revenues, but a positive one on the State Highway Fund. A relatively small cost in fiscal 2016 represents the funds needed to publish the resolution to be put before voters.

**FISCAL IMPACT OF SJR 5: INCREASED HIGHWAY FUNDING**

| FISCAL YEAR | ESTIMATED REVENUE LOSS FROM GENERAL REVENUE FUND | ESTIMATED REVENUE GAIN TO STATE HIGHWAY FUND |
|---|---|---|
| 2016 | -$118,681 | $0 |
| 2017 | 0 | 0 |
| 2018 | -2,500,000,000 | 2,500,000,000 |
| 2019 | -2,500,000,000 | 2,500,000,000 |
| 2020 | -2,932,104,000 | 2,932,104,000 |

Source: Texas Legislative Budget Board

For more information on specific bills of the 2015 Legislature, visit the Texas Legislature online at **www.capitol.state.tx.us.**

# Texas and the Credit Rating Agencies

by Elizabeth Barrett and Bruce Wright

## DETERMINING THE COST OF STATE BORROWING

Most of us find out, sooner or later, that our personal credit rating is important, generally when we start buying big-ticket items. Your credit rating can dictate how much you pay for a house or car, or even whether you can buy it at all.

State governments have credit ratings as well, and in their case the stakes are considerably higher; they spend and borrow billions of dollars each year, and even minor changes in their ratings can have multimillion-dollar impacts on their cost of borrowing.

Texas law authorizes state agencies to issue certain forms of debt to support state projects. This is primarily long-term general obligation debt — bonds backed by the "full faith and credit" of the state government — as well as some short-term debt including Texas Tax and Revenue Anticipation Notes (TRANs). (Texas will not be issuing TRANs this year due to the strength of its cash position.)

Every July, the Comptroller and a team of agency staff members visit the rating agencies to provide information intended to help them determine ratings for the upcoming year. At these meetings, the rating agencies obtain updates regarding the state's economic condition, recent legislative actions and other matters related to its long-term credit rating.

Texas has the highest available credit ratings from the nation's major agencies.

### RATING BASICS

The nation's major rating agencies, Moody's, Fitch and Standard and Poor's (S&P), issue ratings that characterize the state's ability to repay debt.

The rating agencies provide investors with assessments of the "creditworthiness" of potential investments and the risks involved. And their opinions have dollars-and-cents implications, since they affect the cost of borrowing.

A bond or other debt instrument, after all, is a form of IOU, and more highly rated borrowers usually pay lower interest costs — also called the "risk premium" — based on the assumption that they're more likely to be able to pay principal and interest when the debt becomes due. Many institutions, moreover, invest *only* in bonds the rating agencies judge to be "investment grade."

Moody's, Fitch and S&P use similar but different methods to determine each state's credit rating, based on factors such as the state's economic and financial policies, its financial management practices and recent legislation affecting the state's finances. The agencies' ratings are accompanied by a commentary outlining the strengths and weaknesses that led to the rating. These debt ratings are reviewed at least annually and updated as the rating agencies deem necessary.

In the following sections, we'll look at the yardsticks the rating agencies use to gauge Texas' financial health, and their current assessments of our state.

### MOODY'S RATINGS

**As of May 2015, Texas' long-term debt was rated Aaa with a stable outlook, the highest available rating.**

Moody's rates long-term debt outlook as (in descending order) Aaa, Aa1, Aa2, Aa3, A, Baa and below. The agency credits Texas with a diversified and fast-growing economy, low bond debt, conservative revenue forecasting and the presence of the state's Economic Stabilization Fund (its "Rainy Day Fund").

CONTINUED ON PAGE 6

**MOODY'S RATING CRITERIA**

| MOODY'S RATING CRITERIA | FACTOR WEIGHT | FACTOR ELEMENTS |
|---|---|---|
| **ECONOMIC STRENGTH** The economic profile of the state, with relative economic strengths and weaknesses | 20% | Per capita income versus U.S. average |
| | | Industrial diversity |
| | | Employment volatility |
| **GOVERNANCE** The quality of financial decision-making and financial policies | 30% | Financial best practices |
| | | Financial flexibility vs. constitutional constraints |
| **FINANCIAL STRENGTH** Financial structural balance produced by the decisions and practices of state policymakers | 30% | Revenues |
| | | Balances and reserves |
| | | Liquidity |
| **DEBT POSITION** The state's debt and long-term liabilities as part of its overall financial health | 20% | Bonded debt |
| | | Adjusted new pension liabilities |

Source: Moody's Investors Service

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Areas of concern Moody's cited in 2015 include a need for higher transportation and educational spending, as well as high poverty rates creating a need for services that may affect the state's long-term financial security.

## FITCH RATINGS

**As of August 2014, Fitch rated Texas' long-term debt at AAA with a stable outlook, its highest rating.**

Fitch rates long-term debt outlook as (in descending order) AAA, AA+, AA, AA-, A+, A, A-, BBB and below. It credits Texas for low debt, a diverse and growing economy and its Rainy Day Fund. Areas of concern include the cyclical nature of the Texas energy industry and additional long-term funding needs for transportation, schools and water.

### FITCH RATING CRITERIA

| FITCH RATING CRITERIA | FACTOR ELEMENTS |
|---|---|
| **DEBT AND OTHER LONG-TERM LIABILITIES** State debt and other long-term liabilities and their effect on affordability and flexibility | Debt ratios and trends |
| | Debt structure |
| | Future capital and debt needs |
| | Pension and other post-employment benefit funding |
| | Indirect risks and contingent liabilities |
| **ECONOMY** The economy's ability to yield the tax revenue needed to support ongoing operations and repay debts | Major economic drivers |
| | Employment |
| | Income and wealth |
| | Demographic factors |
| | Tax burden |
| **FINANCES** The state's financial resources and ability to meet short- and long-term goals | Revenue analysis |
| | Expenditure analysis |
| | Operating margin trends |
| | Fund balance and reserve levels |
| | Liquidity |
| **MANAGEMENT AND ADMINISTRATION** Management skills of state elected and appointed officials and staff | Institutionalized policies and budgeting practices |
| | Financial reporting and accounting |
| | Political, taxpayer and labor environment |
| | Revenue and spending limitations |

Source: Fitch Ratings

## FITCH CREDITS TEXAS FOR LOW DEBT, A DIVERSE AND GROWING ECONOMY AND ITS RAINY DAY FUND.

## STANDARD AND POOR'S RATINGS

**As of November 2014, S&P rated Texas' long-term debt at AAA, its highest rating.**

S&P rates long-term debt outlook as (in descending order) AAA, AA+, AA, AA-, A+, A, A- and BBB. Each factor is scored on a scale from 1 (strongest) to 4 (weakest); each metric is averaged and added for a composite score that translates into a rating.

S&P credits Texas with strong employment growth, effective revenue forecasting and cash management and low debt. Areas of concern include long-term budget issues, primarily due to public school funding.

### STANDARD AND POOR'S RATING CRITERIA

| STANDARD AND POOR'S RATING CRITERIA | FACTOR ELEMENTS |
|---|---|
| **GOVERNMENT FRAMEWORK** Government structure and political environment | Fiscal policy framework |
| | System support |
| | Intergovernmental funding |
| **FINANCIAL MANAGEMENT** State's ability to make sound and timely financial and operational decisions in response to fiscal and economic demands | Financial management assessment |
| | Budget management framework |
| **ECONOMY** A review to assess the state's overall economic fundamentals | Demographic profile |
| | Economic structure |
| | Wealth and income indicators |
| | Economic development |
| **BUDGETARY PERFORMANCE** State's financial condition based on audited financial statements | Budget reserves |
| | Liquidity |
| | Tax/revenue structure |
| | Revenue forecasting |
| | Service levels |
| | Structural budget performance |
| **DEBT AND LIABILITY PROFILE** Prioritization of debt service expenditures and other liabilities | Debt burden |
| | Pension liabilities |
| | Risk assessment for other post-employment benefits |

Source: Standard & Poor's Financial Services LLC

# State Revenue Watch

This table presents data on net state revenue collections by source. It includes most recent monthly collections, year-to-date (YTD) totals for the current fiscal year and a comparison of current YTD totals with those in the equivalent period of the previous fiscal year.

These numbers were current at press time. For the most current data as well as downloadable files, visit **TexasTransparency.org.**

**Note:** Texas' fiscal year begins on September 1 and ends on August 31.

## NET STATE REVENUE — ALL FUNDS EXCLUDING TRUST

(AMOUNTS IN THOUSANDS)

### Monthly and Year-to-Date Collections: Percent Change From Previous Year

| Tax Collections by Major Tax | JULY 2015 | YEAR TO DATE: TOTAL | YEAR TO DATE: CHANGE FROM PREVIOUS YEAR |
|---|---|---|---|
| **SALES TAX** | $2,412,934 | $26,341,939 | 6.19% |
| PERCENT CHANGE FROM JULY 2014 | 2.74% | | |
| **MOTOR VEHICLE SALES AND RENTAL TAXES** | 410,917 | 4,088,202 | 7.24% |
| PERCENT CHANGE FROM JULY 2014 | -0.87% | | |
| **MOTOR FUEL TAXES** | 296,606 | 3,139,427 | 3.86% |
| PERCENT CHANGE FROM JULY 2014 | 6.45% | | |
| **FRANCHISE TAX** | 19,970 | 4,505,157 | -1.51% |
| PERCENT CHANGE FROM JULY 2014 | -870.63% | | |
| **INSURANCE TAXES** | 563,097 | 1,828,215 | 7.82% |
| PERCENT CHANGE FROM JULY 2014 | 19.79% | | |
| **NATURAL GAS PRODUCTION TAX** | 75,764 | 1,180,432 | -30.16% |
| PERCENT CHANGE FROM JULY 2014 | -61.12% | | |
| **CIGARETTE AND TOBACCO TAXES** | 132,941 | 1,349,849 | 9.61% |
| PERCENT CHANGE FROM JULY 2014 | 5.01% | | |
| **ALCOHOLIC BEVERAGES TAXES** | 114,843 | 1,042,917 | 8.20% |
| PERCENT CHANGE FROM JULY 2014 | 23.79% | | |
| **OIL PRODUCTION AND REGULATION TAXES** | 229,388 | 2,677,635 | -23.52% |
| PERCENT CHANGE FROM JULY 2014 | -36.26% | | |
| **INHERITANCE TAX** | 0 | (3,817) | -33,166.90% |
| PERCENT CHANGE FROM JULY 2014 | N/A | | |
| **UTILITY TAXES**[1] | 88,170 | 424,002 | 0.66% |
| PERCENT CHANGE FROM JULY 2014 | -7.54% | | |
| **HOTEL OCCUPANCY TAX** | 49,125 | 475,691 | 8.64% |
| PERCENT CHANGE FROM JULY 2014 | 9.23% | | |
| **OTHER TAXES**[2] | 24,625 | 259,861 | 4.06% |
| PERCENT CHANGE FROM JULY 2014 | -20.53% | | |
| **TOTAL TAX COLLECTIONS** | **$4,418,383** | **$47,309,509** | **1.94%** |
| PERCENT CHANGE FROM JULY 2014 | -0.81% | | |

| Revenue By Source | JULY 2015 | YEAR TO DATE: TOTAL | YEAR TO DATE: CHANGE FROM PREVIOUS YEAR |
|---|---|---|---|
| **TOTAL TAX COLLECTIONS** | $4,418,383 | $47,309,509 | 1.94% |
| PERCENT CHANGE FROM JULY 2014 | -0.81% | | |
| **FEDERAL INCOME** | 3,202,761 | 33,991,092 | 7.18% |
| PERCENT CHANGE FROM JULY 2014 | 15.01% | | |
| **LICENSES, FEES, PERMITS, FINES AND PENALTIES** | 902,532 | 9,004,296 | 15.16% |
| PERCENT CHANGE FROM JULY 2014 | 25.18% | | |
| **INTEREST AND INVESTMENT INCOME** | 252,189 | 1,349,809 | 13.40% |
| PERCENT CHANGE FROM JULY 2014 | 112.38% | | |
| **LOTTERY PROCEEDS**[3] | 172,993 | 1,758,605 | 0.67% |
| PERCENT CHANGE FROM JULY 2014 | 8.51% | | |
| **SALES OF GOODS AND SERVICES** | 14,002 | 402,316 | 65.35% |
| PERCENT CHANGE FROM JULY 2014 | -49.15% | | |
| **SETTLEMENTS OF CLAIMS** | 4,904 | 538,773 | -4.24% |
| PERCENT CHANGE FROM JULY 2014 | -318.25% | | |
| **LAND INCOME** | 72,544 | 1,410,763 | -17.44% |
| PERCENT CHANGE FROM JULY 2014 | -60.01% | | |
| **CONTRIBUTIONS TO EMPLOYEE BENEFITS** | 4 | 52 | -35.93% |
| PERCENT CHANGE FROM JULY 2014 | -24.47% | | |
| **OTHER REVENUE SOURCES** | 888,093 | 5,168,483 | 7.92% |
| PERCENT CHANGE FROM JULY 2014 | 31.99% | | |
| **TOTAL NET REVENUE** | **$9,928,405** | **$100,933,699** | **4.94%** |
| PERCENT CHANGE FROM JULY 2014 | 8.89% | | |

1- Includes public utility gross receipts assessment, gas, electric and water utility tax and gas utility pipeline tax.

2- Includes the cement and sulphur taxes and other occupation and gross receipt taxes not separately identified.

3- Gross sales less retailer commissions and the smaller prizes paid by retailers.

Note: Totals may not add due to rounding.

# FISCAL NOTES

Texas Comptroller of Public Accounts
Communications and Information Services Division
111 E. 17th St., Suite 301, Austin, TX 78774-0100

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## GLENN HEGAR

### Texas Comptroller of Public Accounts

*Fiscal Notes* is one of the ways the Comptroller's office strives to assist taxpayers and the people of Texas. The newsletter is a by-product of the Comptroller's constitutional responsibilities to monitor the state's economy and to estimate state government revenues.

*Fiscal Notes* also provides a periodic summary of the financial statements for the state of Texas.

Articles and analysis appearing in *Fiscal Notes* do not necessarily represent the policy or endorsement of the Texas Comptroller of Public Accounts. Space is devoted to a wide variety of topics of Texas interest and general government concern.



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Texas Comptroller of Public Accounts
Publication #96-369,
**September 2015**