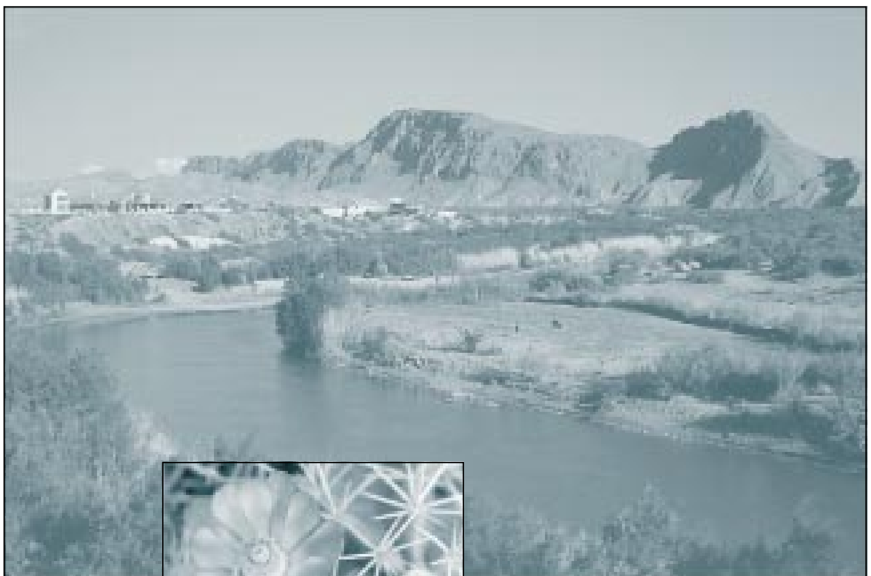
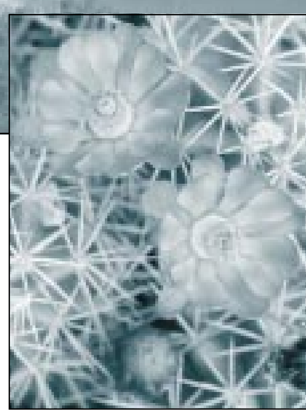
Introduction





OFFICE OF THE COMPTROLLER
TEXAS

February 27, 1998

The Honorable George W. Bush
Governor
State of Texas
State Capitol
Austin, Texas 78711

Dear Governor Bush:

The *Comprehensive Annual Financial Report* of the State of Texas for the fiscal year ended August 31, 1997, is submitted herewith. Responsibility for both the accuracy of the data presented and the completeness and fairness of the presentation rests with the Comptroller of Public Accounts. To the best of our knowledge, the information presented is accurate in all material respects and all disclosures necessary for a reasonable understanding of the state's financial activities have been included.

The reporting approach established by the National Council on Governmental Accounting in Statement 1 and endorsed by the Governmental Accounting Standards Board (GASB) has been utilized. This report is divided into five sections. (1) The Introductory Section provides information on the general contents of the report. (2) The Financial Section is composed of the auditor's opinion, the general purpose financial statements, and the combining individual fund and account group financial statements. (3) The Statistical Section provides various financial, economic and demographic data about the state. (4) A Schedule of Expenditures of Federal Awards has also been included for purposes of the Single Audit Act Amendments of 1996. (5) Supplementary Bond Schedules provide detailed bond information. A separate auditor's opinion is given on the bond schedules.

Reporting Entity

This report includes funds and account groups of various departments, agencies and other organizational units which are considered part of the State of Texas financial reporting entity. Criteria for determining the reporting entity and presentation of the related financial data is established by the Governmental Accounting Standards Board (GASB). The criteria includes legal standing and financial accountability. Other organizations that would cause the financial statements to be misleading or incomplete if they were excluded are also included in the reporting entity. Note 1 of the Notes to the Financial Statements provides detail on the financial reporting entity. A brief summary of the nature of significant component units and their relationship to the State of Texas is discussed in Note 22.

All activities which would generally be considered part of the State of Texas are included in this report. These activities provide a range of services in the areas of education, health and human services, public safety and corrections, transportation, natural resources and recreation, regulation, and general administrative services.

Financial Highlights and General Government Functions

Assets

The assets of the State of Texas have increased 45.8% from fiscal year 1994 with investments and cash and temporary investments comprising the highest total

Comparison of Total State Assets*

(In Millions)

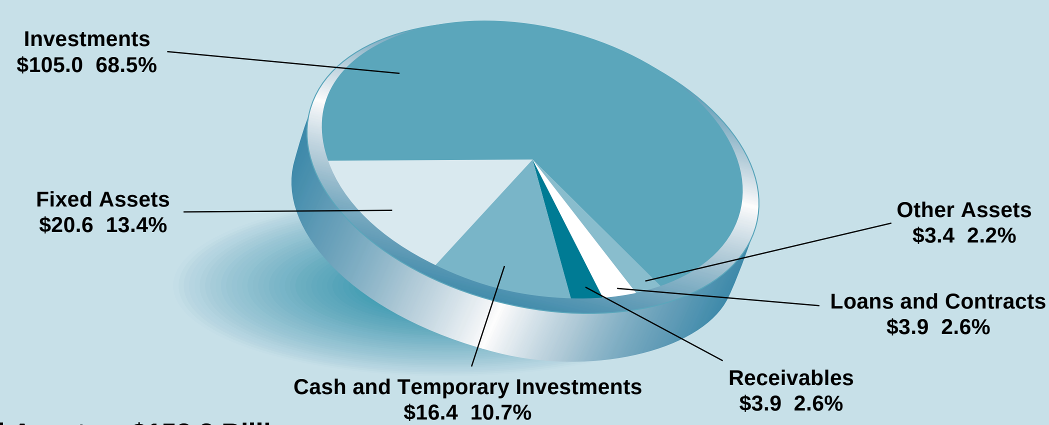
Account	1994 Amount	1995 Amount	% Change From 1994	1996 Amount	% Change From 1995	1997 Amount	% Change From 1996
Investments	$ 66,979.9	$ 68,870.2	2.8	$ 88,243.5	28.1	$ 105,009.6	19.0
Fixed Assets	16,604.9	17,675.0	6.4	19,383.0	9.7	20,609.1	6.3
Cash & Temporary Investments	11,853.1	11,999.5	1.2	14,053.6	17.1	16,377.1	16.5
Receivables	3,375.0	3,109.7	(7.9)	3,016.8	(3.0)	3,938.1	30.5
Loans and Contracts	3,545.8	4,027.4	13.6	3,412.1	(15.3)	3,924.2	15.0
Other Assets**	2,745.2	3,250.7	18.4	2,850.6	(12.3)	3,388.8	18.9
Total Assets	$ 105,103.9	$ 108,932.5	3.6	$ 130,959.6	20.2	$ 153,246.9	17.0

* This table includes primary government funds only.
For further information, refer to the Combined Balance Sheet.

** Other Assets also include Due From Other Funds, Interfund Receivables, Advances to Other Funds, Inventories, and all Restricted Assets.
It excludes the amounts shown in the General Long-Term Debt Account Group.

Total Assets – Primary Government

At August 31, 1997 (In Billions)*



Total Assets = $153.2 Billion

* Totals may not add due to rounding.

increase at 56.8% and 38.2% respectively over that same period. A portion of the increase is attributable to the implementation of GASB 28, relating to securities lending transactions. Refer to Note 3 for more details on securities lending transactions. Investments make up 68.5% of the assets of the state and have increased an average of 16.6% per year over the three year period.

Overall assets for the state were up by 17.0% over 1996, with all categories showing an increase. The largest increase in assets include investments, receivables and other assets. The 30.5% increase for receivables is partially due to a change in the classification of transactions among state agencies.

Liabilities

Liabilities represent obligations of the state at the end of the fiscal year. Total liabilities increased approximately $5.2 billion between August 31, 1994 and August 31, 1997. This is a three year increase of 17.9%.

Comparison of Total Liabilities*

(In Millions)

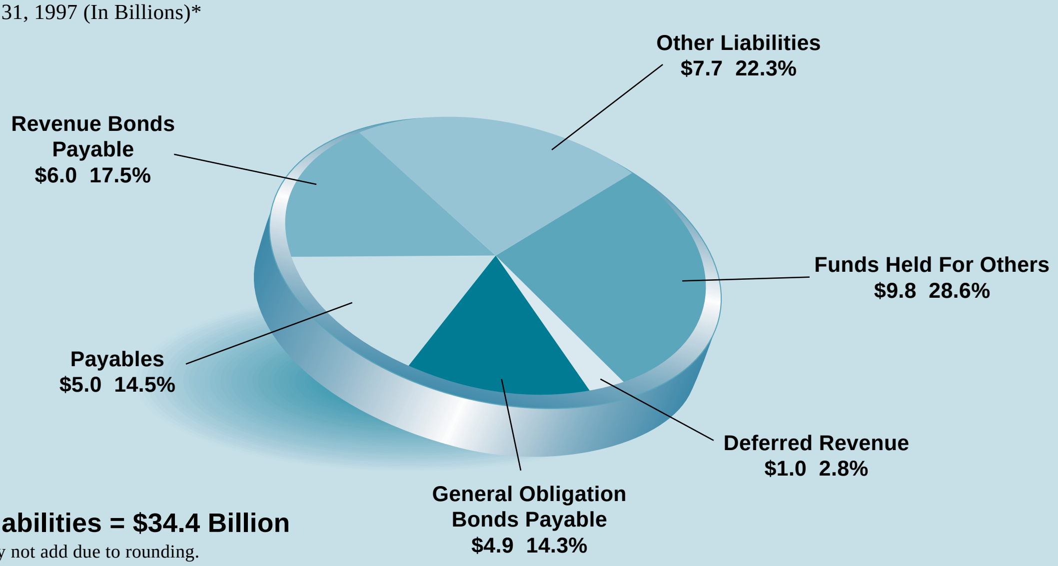
Account	1994 Amount	1995 Amount	% Change From 1994	1996 Amount	% Change From 1995	1997 Amount	% Change From 1996
Payables	$ 4,303.6	$ 4,002.1	(7.0)	$ 5,006.2	25.1	$ 4,983.0	(0.5)
Deferred Revenue	758.2	1,046.7	38.1	951.3	(9.1)	974.8	2.5
Revenue Bonds Payable	6,009.1	5,508.6	(8.3)	5,302.0	(3.8)	6,001.1	13.2
General Obligation Bonds Payable	3,963.1	4,569.5	15.3	4,962.2	8.6	4,931.2	(0.6)
Funds Held for Others	9,492.7	7,334.9	(22.7)	8,694.3	18.5	9,831.5	13.1
Other Liabilities**	4,633.4	4,084.6	(11.8)	5,531.5	35.4	7,667.5	38.6
Total Liabilities	$ 29,160.1	$ 26,546.4	(9.0)	$ 30,447.5	14.7	$ 34,389.1	12.9

* This table includes primary government funds only. For further information, refer to the Combined Balance Sheet.

** Other Liabilities includes Accruals Between Funds, Notes and Loans, Restricted Payables, Employee's Compensable Leave, Capital Lease Obligations, Obligations/Reverse Repurchase Agreements, Obligations/Securities Lending, and Claims and Judgments.

Total Liabilities – Primary Government

At August 31, 1997 (In Billions)*



Total Liabilities = $34.4 Billion

* Totals may not add due to rounding.

Total liabilities increased 12.9% or $3.9 billion from 1996. Implementation of GASB 28 resulted in the recording of a liability for over $4.3 billion for obligations under securities lending. This amount is offset by a corresponding investment asset as noted above. Excluding this $4.3 billion increase, there is a net decrease in liabilities. The TexPool Fund accounted for $291.9 million of the increase in Funds Held for Others. The TexPool Fund liability is offset with an increase in investments.

Revenue and General Obligation Bonds issued by the State of Texas accounted for 31.8% of the debt. Additional information relating to bonds can be found in Note 6.

Fund Balance and Retained Earnings

Fund balances and retained earnings for the past four years and the changes over the last three years are shown below.

Comparison of Total Fund Balances and Retained Earnings*

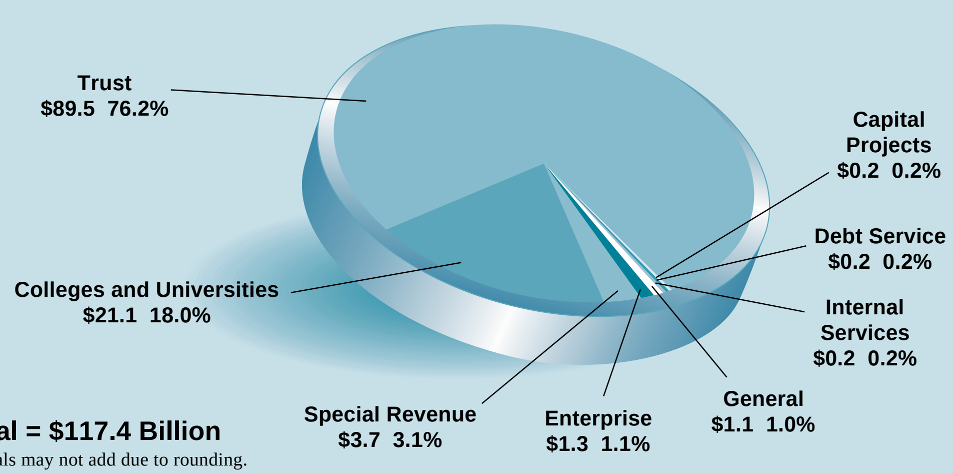
(In Millions)

Account	1994 Amount	1995 Amount	% Change From 1994	1996 Amount	% Change From 1995	1997 Amount	% Change From 1996
General	$ 587.3	$ 693.9	18.2	$ 375.0	(46.0)	$ 1,135.1	202.7
Special Revenue	3,244.8	3,628.8	11.8	3,455.8	(4.8)	3,735.9	8.1
Debt Service	196.2	200.1	2.0	292.0	45.9	206.9	(29.1)
Capital Projects	739.4	285.3	(61.4)	250.4	(12.2)	226.0	(9.7)
Enterprise	851.1	1,073.0	26.1	1,115.6	4.0	1,263.2	13.2
Internal Service		199.9		236.8	18.5	248.7	5.0
Trust	53,004.7	57,936.0	9.3	74,268.9	28.2	89,463.6	20.5
Colleges and Universities	17,482.6	18,366.2	5.1	19,687.7	7.2	21,133.8	7.3
Total Fund Balances and Retained Earnings	$ 76,106.1	$ 82,383.2	8.2	$ 99,682.2	21.0	$ 117,413.2	17.8

* This table includes primary government funds only.
For further information, refer to the Combined Balance Sheet.

Fund Balances and Retained Earnings – Primary Governments

At August 31, 1997 (In Billions)*



Total = $117.4 Billion

* Totals may not add due to rounding.

The General Fund had a fund balance increase of $760.1 million. Revenue increased significantly, with the largest increase of $1.2 billion in tax revenue. The Debt Service Fund decreased $85.1 million or 29.1% from 1996. Most of the decrease was in the Public Finance Authority Escrow G.O. Bond Fund.

Pension funds accounted for $14.6 billion of the $15.2 billion increase in fund balance for the trust funds. The majority, $12.2 billion, is due to the net appreciation in fair value of investments.

Revenues

Revenues for governmental fund types and expendable trust funds totaled $41.9 billion in fiscal year 1997, an increase of 4.1% over fiscal year 1996. The various sources and the changes from last year are shown below.

Tax revenues, accounting for 52.6% of the total revenue, are the major source of revenue for the State of Texas. The state collected $22.1 billion in taxes for fiscal year 1997, an increase of $1.2 billion, or 5.7%,

Comparison of Revenue by Source*

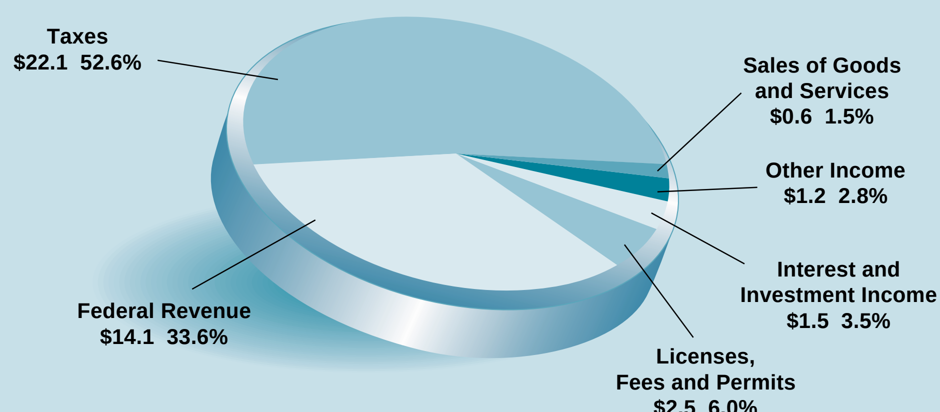
(In Millions)

Account	1994 Amount	1995 Amount	% Change From 1994	1996 Amount	% Change From 1995	1997 Amount	% Change From 1996
Taxes	$ 19,160.8	$ 19,857.4	3.6	$ 20,870.4	5.1	$ 22,069.9	5.7
Federal Revenue	9,074.1	13,991.2	54.2	14,128.8	1.0	14,099.3	(0.2)
Licenses, Fees and Permits	2,425.0	2,319.0	(4.4)	2,578.6	11.2	2,494.1	(3.3)
Interest and Investment Income	1,155.4	1,236.3	7.0	1,136.7	(8.1)	1,482.9	30.5
Land Income	8.8	7.9	(10.2)	10.1	27.8	13.2	30.7
Sales of Goods and Services	503.0	547.4	8.8	516.6	(5.6)	635.7	23.1
Other Income	1,604.2	1,448.1	(9.7)	1,043.8	(27.9)	1,153.7	10.5
Total Revenues	$ 33,931.3	$ 39,407.3	16.1	$ 40,285.0	2.2	$ 41,948.8	4.1

* This table includes primary government funds only. For further information, refer to the Combined Statement of Revenues, Expenditures, and Changes in Fund Balances - All Governmental Fund Types, Expendable Trust Funds, and Discretely Presented Component Units.

State Revenues by Source
Governmental Fund Types and Expendable Trust Funds

For The Year Ended August 31, 1997 (In Billions)*



Total Revenues = $41.9 Billion

* Totals may not add due to rounding.

over the previous year. Texas' sales tax is the largest single revenue producer for the state. Bringing in almost $11.3 billion for fiscal year 1997, sales tax accounted for about 51.1% of total tax collections. Sales tax, franchise tax, motor fuels tax, and motor vehicle sales taxes were the primary contributors to the increase in tax collections.

Federal revenue in 1997 reflects a decrease of 0.2% as compared to 1996. This decrease of $29.5 million is due to a monetary federal fund increase of $295.2 million netted against a food stamp decrease of $324.7 million.

Expenditures

Expenditures for governmental fund types and expendable trust funds were $39.4 billion in fiscal year 1997, an increase of 1.0% over fiscal year 1996. State

Comparison of Expenditures by Function*

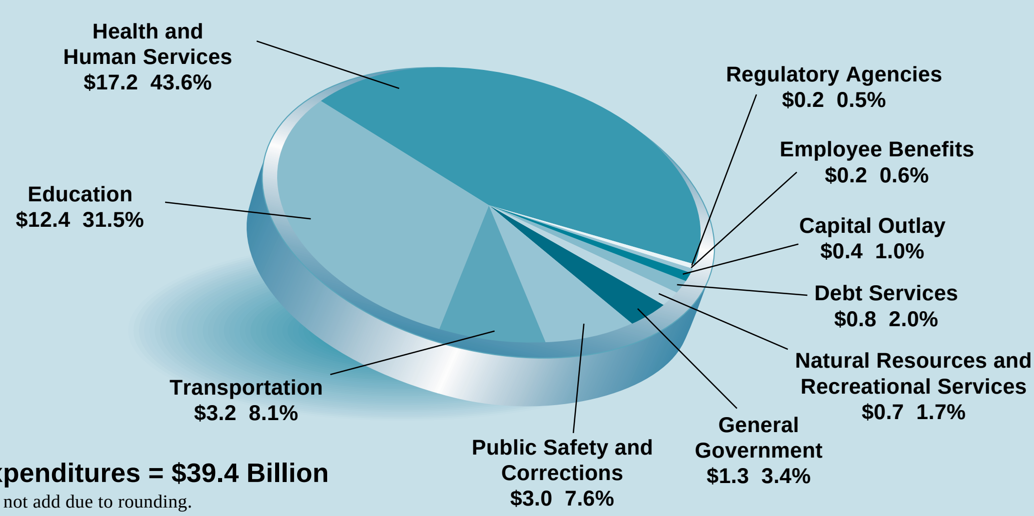
(In Millions)

Account	1994 Amount	1995 Amount	% Change From 1994	1996 Amount	% Change From 1995	1997 Amount	% Change From 1996
General Government	$ 1,079.7	$ 1,597.4	47.9	$ 1,313.9	(17.7)	$ 1,345.7	2.4
Education	9,370.3	11,540.4	23.2	11,872.1	2.9	12,429.5	4.7
Employee Benefits	1,002.7	209.7	(79.1)	225.9	7.7	245.9	8.9
Health and Human Services	13,858.3	16,651.2	20.2	17,271.9	3.7	17,192.8	(0.5)
Public Safety and Corrections	2,496.6	2,618.4	4.9	2,748.3	5.0	2,978.1	8.4
Transportation	2,888.0	2,965.3	2.7	3,535.9	19.2	3,194.1	(9.7)
Natural Resources and Recreational Service	514.5	590.3	14.7	594.5	0.7	675.0	13.5
Regulatory Agencies	240.0	227.3	(5.3)	213.7	(6.0)	214.3	0.3
Debt Services	687.9	1,006.6	46.3	744.6	(26.0)	771.1	3.6
Capital Outlay	1,002.0	1,082.6	8.0	499.1	(53.9)	379.8	(23.9)
Total Expenditures	$ 33,140.0	$ 38,489.2	16.1	$ 39,019.9	1.4	$ 39,426.3	1.0

* This table includes primary government funds only. For further information, refer to the Combined Statement of Revenues, Expenditures, and Changes in Fund Balances - All Governmental Fund Types, Expendable Trust Funds, and Discretely Presented Component Units.

Comparison of Expenditures by Function

For The Year Ended August 31, 1997 (In Billions)*



Total Expenditures = $39.4 Billion

* Totals may not add due to rounding.

government expenditures by function and the changes from last year are shown on the previous page.

Texas' largest expenditure was for health and human services. In fiscal year 1997, $17.2 billion, or 43.6%, of the total expenditures were for health and human services. There was a decrease of $79.1 million, or 0.5%, less than fiscal year 1996. The $79.1 million reflects a decrease of $324.7 million in the food stamps program and an increase of $245.6 in other areas.

The second largest expenditure, education, was $12.4 billion, or 31.5% of the total. This was an increase of 4.7%, over 1996. Transportation and capital outlay both reflect a 1997 decrease over 1996 of $341.8 and $119.3 million respectively.

Proprietary Operations

Proprietary funds include enterprise and internal service funds. Fund equity of the state's enterprise funds increased $147.6 million over 1996. This increase is attributable to the Texas Water Development Board showing a $107.7 million increase and the Texas Turnpike Authority with a $25.8 million increase.

The Internal Service Fund includes employees life, accident, and health insurance benefits. The fund ended the year with a fund balance of $248.7 million, an increase of $11.9 million.

Pension Funds

The state contributes to six pension plans: Teachers Retirement System (TRS), Employees Retirement System (ERS), two Judicial Retirement Systems (JRS), and the Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECO). The state also administers, but to date has not been required to contribute to, the Fire Fighters' Pension Commission (FPC).

Fund equity of the state's pension funds increased from $62.9 billion in fiscal year 1996 to $77.5 billion in fiscal year 1997. Of the $14.6 billion increase, net appreciation in fair value of investments accounted for $12.2 billion.

Fund Balances of Colleges and Universities

Fund balances of colleges and universities increased $1.4 billion, or 7.3%, over fiscal year 1996. Revenues and other additions, expenditures and other deductions, transfers, and fund balances of colleges and universities for the past four years and the changes over the last three years (expressed in millions) are shown on the following pages.

Economic Outlook

THE TEXAS ECONOMY

Low Inflation and Low Unemployment at the Same Time

Texas and the nation enjoyed both low inflation and relatively low unemployment in 1997. An often-cited J-curve economic theory says that low inflation and low unemployment should not coexist, but for now, Texas and the U. S. are enjoying an economy that is performing better than this increasingly suspect theory says it should. The nation added more jobs in 1997 than the European Community added in the last decade, and Texas was responsible for more than its share, having created more jobs than all states except California, and added them at a rate faster than all but ten states.

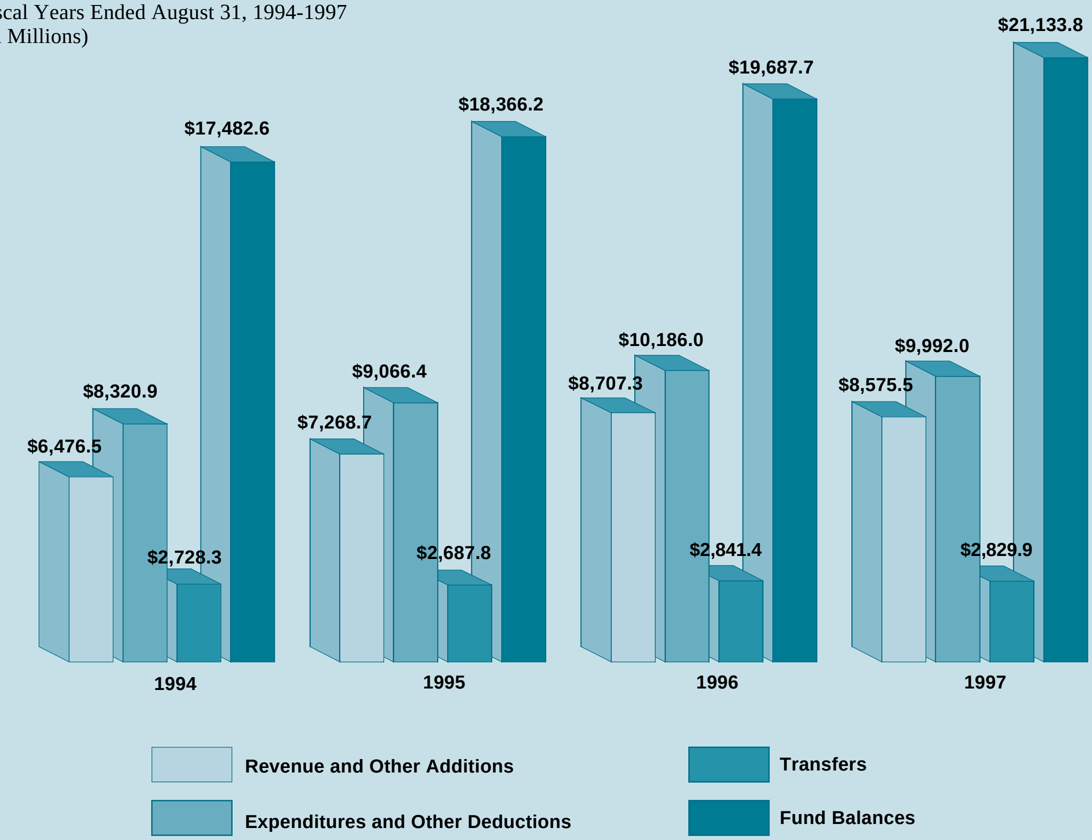
Texas' year-to-year job growth rate for non-farm employment was 2.6 percent in 1997. The nation has been closing the gap of Texas' advantage, but not because Texas has been slowing. Over the 1990-96 period, U. S. employment growth averaged an increase of 1.5 percent a year, while Texas added new jobs at the rate of 2.6 percent a year. In 1997, the nation's nonfarm employment total grew 2.3 percent. Service-producing industries, particularly in financial and communications services, were the primary driving force behind the growth in U. S. employment.

Several record-breaking positives illustrate the strength of the Texas economy in 1997. Over the twelve months ending in January 1998, long-term interest rates fell about one percentage point, to record low levels since the market selling of the nation's 30-year bonds began in 1977. This allowed mortgage rates to decline and boosted the state's housing permits to their highest level since before Texas' 1986 recession. Good job-market gains, low inflation, the best real per capita income growth in over a decade, a stock market addicted to rising prices, and low unemployment have coalesced to yield the highest rate of consumer confidence in 28 years, and a record high for the West South Central states since the regional survey began in 1981.

The Texas Economy will be Healthy, but will Slow a Bit

In short, the good economic times are expected to continue over the next two years, with the Comptroller's Fall 1997 forecast seeing just a slight slowing from the 4.2 percent increase in real gross state product in 1997. Weakness in Asian currency markets may shave a bit off Texas' growth, since our exports will be more expensive to consumers in Asia, while Asian imports will be cheaper for Texans. Still, the Asian nations hardest-hit by a financial crisis in early 1998 comprise a market which is small relative to

Comparison of Total Revenues, Expenditures, and Fund Balances – Colleges and Universities
Fiscal Years Ended August 31, 1994-1997
(In Millions)



Comparison of Revenues and Other Additions, Expenditures and Other Deductions, Transfers, and Fund Balances – Colleges and Universities

(In Millions)

Account	1994 Amount	1995 Amount	% Change From 1994	1996 Amount	% Change From 1995	1997 Amount	% Change From 1996
Revenues and Other Additions	$ 6,476.5	$ 7,268.7	12.2	$ 8,707.1	19.8	$ 8,575.5	(1.5)
Expenditures and Other Deductions	8,320.9	9,066.4	9.0	10,186.0	12.3	9,992.0	(1.9)
Transfers*	2,728.3	2,687.8	(1.5)	2,841.4	5.7	2,829.9	(0.4)
Fund Balances**	$ 17,482.6	$ 18,366.2	5.1	$ 19,687.7	7.2	$ 21,133.8	7.3

* Transfers include mandatory transfers, and transfers from and to the state's General Revenue Fund.

** Further detail is provided on reservations and designations of fund balances and retained earnings in Note 13 of the "Notes to the Financial Statements."

Texas' overall world trade.[1] The impact on Texas of Asian problems is expected to be relatively small.

Inflation is tame. Broad-based producer prices declined 1.2 percent in 1997, consumer prices rose at the slowest rate (1.8 percent) since 1965, and most of the increase in per capita wages is, at least for now, being offset by gains in productivity per worker. The Comptroller's most recent economic forecast expects inflation to pick up a bit, but rise by a mild 2.5 percent in 1998 and 2.9 percent in 1999.

Employment growth in 1997 slowed slightly, after peaking at 3.6 percent in 1994 and declining in each subsequent year. The subsequent declines may not sound particularly positive, but a certain degree of moderation helps infrastructure and environmental progress to keep up with the growth. The state's 2.6 percent employment growth for 1997 reflected a moderately robust economy. Productivity growth has been strong and inflation has been so low (1997 was the second-lowest year since 1970) that the increase in 1997's real gross state product exceeded that of 1993, 1994, and 1996, despite those years having faster employment growth.

This pattern of a gradually slowing employment growth rate is expected to continue over the next two years. Partly because fewer people are now entering the ages of their "working years" and partly because of an anticipated national slowdown, statewide employment growth is expected to slip to 2.4 percent in 1998 and 2.0 percent in 1999. Despite these modestly slower employment gains, real GSP growth rates will remain almost constant (from 4.2 percent in 1997 to a forecasted 3.9 percent in 1998), as productivity gains and low inflation allow real output to remain robust.

Consumer confidence in November 1997 reached another record high. At 140.0, the index for the West South Central States reached its highest level since the survey began in 1981.

INDUSTRY HIGHLIGHTS – 1998 AND 1999 OUTLOOK

Mining at the Peak

Although the overall economic outlook is rosy, mining (including oil and gas) is one major industry in which employment declines are expected over the next two years.

[1] Korea accounted for 2.7 percent of Texas exports in 1996. Indonesia accounted for 0.8 percent. These two nations, in combination with Japan and China (including Hong Kong and Taiwan) accounted for less than 15 percent of total Texas exports.

As forecasted, the Texas mining industry added jobs in 1997, after declining by nearly 28,000 over the previous five years. From November 1996 to November 1997, the state added back about 6,300 mining jobs, for an increase of 4 percent. However, energy prices are not anticipated to stay high enough to prolong recent job gains.

Unfortunately for Texas oil exploration in the near-term, the long-awaited return of oil and gas job growth has run most of its course. Production quotas by nations in the Mideast were increased at the beginning of 1998, even after most of the producers already were exceeding their quotas, producing a glut in world oil supplies. Supply and demand considerations will put downward pressure on energy prices and eventually choke off growth in the state's mining employment, leading to mild net job losses in 1998 and 1999. These are forecast to be about 2,000 jobs a year statewide, amounting to a little over one percent annually in 1998 and 1999.

The lack of expected job growth in mining should not be interpreted to mean that there will be little economic activity in the state's mining sector. In terms of real gross product, the value of Texas oil and gas is expected to grow at up to 1 percent a year over the next two years. Oil and gas exploration can be profitable at lower oil and gas prices and with fewer employees, because technological improvements reduce the number of workers necessary to achieve the same level of production.

Apartment Construction on the Rise

Like mining, the state's construction industry added 4 percent employment growth over the past year, but unlike mining, this represented a mild slowdown from previous years. Construction had three years of job growth exceeding six percent a year, so the recent robust 4 percent growth rate actually represents quieter times. Still, housing permits reached their highest level since the mid-1980s, to an annualized level of 123,000 during the first ten months of 1997. The increase in action centered around multi-family housing units, where permits rose 42 percent through the first ten months of 1997, while single-family permits declined 2 percent.

Overall housing permits are expected to slow slightly, to 2 percent growth in 1998 and 1 to 1.5 percent in 1999, as net migration drops back from its recent torrid pace of about 175,000 net migrants annually. Migration into Texas will be at a somewhat slower rate of 140,000 a year in 1998 and 1999, so the growth of residential and nonresidential construction will subside a bit.

Texas Manufacturing Employment—Now Second among the States

A decade ago, six states—California, New York, Ohio, Pennsylvania, Michigan, and Illinois—had more manufacturing employees than Texas. In early 1998, with 1.08 million jobs in this sector, Texas supplanted Ohio, after which there were more Lone Star manufacturing jobs than in all states except California. Of the ten largest states, half of them suffered net losses in manufacturing jobs in 1997. But Texas, with a 1.6 percent increase in manufacturing jobs, ranked second among the ten largest states in the rate of manufacturing job growth.

Computers and electronics manufacturing—including semiconductors, computer assembly, telecommunications equipment, and software production—is at the root of this shifting importance of manufacturing in Texas' economic mix. High technology products have become a mainstay of Texas manufacturing, and these industries will have far more impact in the future on the cycles of the state economy. While once a small player in Texas' economy, the computer/electronics industry[2] now accounts for about 8 percent of Texas'

[2] Defined here as Standard Industrial Codes 3500-3699

gross state product and more than 40 percent of Texas' exports.

Orders for computers and electronics were somewhat weak at the beginning of 1998, but Texas' high technology industries still will grow and increase in employment concentration. The 6 percent annual employment boom of the mid-1990s appears to be over, however. Computers and electronics employment statewide will increase about 3 percent in 1998 and roughly 1 percent in 1999, if present trends play out as expected. High technology markets likely will experience several phases of market saturation over the next few years, indicating that the industry has left behind the heady booms of an emerging industry and is now becoming a mature economic player.

A survey of manufacturing purchasers, published as the Purchasing Managers' Index, expects almost no expansion of the manufacturing industry nationwide in the near future, so the modest gains forecast for Texas should continue to outperform the nation. Overall, durable goods manufacturing (such as fabricated metals, computers, and transportation equipment) will outpace nondurables (such as food processing, textiles & apparel, paper, and petrochemicals) in 1998 and 1999, continuing a five-year trend.

The state's petrochemical industry is expected to turn around five years of declining employment in 1998, with new plants in Chocolate Bayou, the Bayport area of Pasadena, and in Deer Park. Slow annual employment growth of 0.4 percent a year is anticipated in petrochemicals over the next three years, with proportionately greater increases in petrochemical production. Petroleum refining, following on the heels of recent strength in oil and gas exploration, will be on a temporary up-cycle stage after five years of declining employment. For the long-term, however, both petrochemicals and petroleum refining will decline in statewide employment concentration, along with the oil and gas exploration industry, as other manufacturing and service industries proliferate.

A moderating growth rate of construction is reflected in a less hasty demand for building products, and this will slow the brisk pace of lumber and wood manufacturing over the next two years. Lumber and wood manufacturing should expand jobs at about 3 percent a year in 1998 and 1999. The Comptroller's forecast expects virtually no growth in stone, clay, and glass manufacturing—and even the possibility of some retrenchment in the workforce.

SERVING THE GOODS

After a couple of years in which goods employment growth exceeded or equaled that of services, service-producing sectors will once again dominate Texas employment growth in 1998 and 1999. Nearly 90 percent of job growth in these two years will be in the service-producing, as opposed to goods-producing, industries.

Communications Lead TPU

Transportation, communications, and utilities (TPU) will take the award for the fastest rate of growth over the next two years, despite expected job losses in the utilities subsector. Both the fastest growing subsector of the Texas economy—communications—and the fastest declining subsector—public utilities—are lumped into the TPU category. But the outlook for each is markedly different. Communications (which includes telecommunications, cellular, and Internet communications) is expected to have an employment growth rate of 7 percent in 1998 and another 4 to 5 percent in 1999, for the fastest projected growth of an industry subsector. Public utilities, on the other hand, will be unlikely to add jobs over the next two years, because of uncertainty about a future in which various proposals for deregulation are being considered. Texas utilities are expected to see a 2.5 percent employment decline in 1998 and another 1.2 percent job decline in 1999.

Transportation will experience a couple of years of 3 to 4 percent employment growth, spurred on largely by rapid growth in Latin American export trade—which will boost total Texas exports about 9 or 10 percent annually, despite weakness in the prospect for exports to Asia.

Wholesale and Retail Trade will Mirror the State's Growth

Not every Texas industry is in a state of flux. In the "more of the same" category, wholesale and retail trade will continue to track the growth of the overall economy closely, with wholesale trade growing about a half-percentage point slower than retail trade. Retail trade is expected to parallel overall statewide nonfarm employment growth almost exactly. The number of retail trade jobs will grow by 2 to 2.5 percent annually in 1998 and 1999, adding about 35,000 jobs a year.

Texas retailers can expect sales to increase another 6.1 percent in 1998 and 6.9 percent in 1999. Less than 3 percent of this increase will be due to rising prices, implying real retail sales growth, after inflation, of 3.5 to 4 percent annually. This is a continuation of sales growth patterns seen through most of the 1990s, so for the individual retailer, a gradual slowdown in the state economy over the next two years could go mostly unnoticed. Home furnishings, general merchandise stores, and electronics will see the fastest nominal growth (about 9 percent a year), while the slower growth rates, which still exceed inflation, will be in food stores and automotive retailers (about 5 percent annually).

Consumer debt may be weighing down some consumer spending, as evidenced by slower retail sales in the second half of 1997, following on the heels of five-years of growth averaging 7.5 percent annually. Still, with high consumer confidence and positive economic fundamentals—including favorable interest rates, stock market profits, and a growing population—any belt-tightening by Texas consumers is expected to be slight.

A Positive Outlook (for Now) for Texas Banking

In the finance, insurance, and real estate industry (FIRE), banking will account for much of the job growth in 1998 and is likely to have its strongest year since the banking recession of the 1980s. Favorable interest rates may spawn an increase in home refinancing and the initiation of home equity lending will add to banks' already healthy fee income, allowing banks, savings institutions, and credit unions to see employment growth of 3 to 4 percent in 1998. Longer-term, however, the outlook for employment in financial institutions remains weak, due to ongoing consolidations and labor productivity increases, so job losses should resume in 1999 or 2000.

The Texas stock index rose an astounding 95 percent from November 1996 to November 1997, boosted mostly by valuations of high technology companies. Although this Texas index left the Dow Jones' laudable 23 percent gain in 1997 looking anemic, Texas still benefited less by stock gains than many states, owing to the state's relatively low concentration of investment firms. Real estate is expected to take a bit of a breather from its heady growth rates of nearly 3 percent annually in 1996 and 1997. Because the national economy has narrowed the performance gap with Texas, net migration to Texas is expected to taper off somewhat. So, although real estate is expected to continue moderate growth, real estate job growth may not exceed 1 percent annually over the next two years.

Services Are Poised to Be Back on Top

Services will once again capture the top spot as the fastest growing major (1-digit SIC) industry in

Texas, as judged by employment growth. Among its subsectors, business/repair/engineering services will outperform the other service sectors, and it is likewise expected to be second only to communications in anticipated job growth over the year. In 1999, it is forecast to surpass even communications to lead the pack of all Texas industries. Some private business and repair services, such as jet engine repair, may replace federal jobs lost when Kelly Air Force Base ceases operations.

The health services industry should expect job growth of 3 to 4 percent a year, which is considerably faster than the overall state economy. Growth is likely to center in home health care services, and although this will do little for higher-wage hospital employment, an aging population provides the demographic impetus for the health care industry to exceed overall state economic growth for the long term.

Government is Not the Place to Find a Job

All government sectors are expected to add jobs at a slower pace than the overall state economy, particularly in the federal civilian sector, which will post its eighth straight year of declining employment in Texas. This is due in part to general cutbacks in federal government employment nationwide and in part to the loss of civilian jobs with the closing of Kelly Air Force Base in San Antonio. In 1997, for the first time since 1970, the federal government budget recorded a surplus, aided by a strong economy and stock market, bringing in record personal tax revenue, a reining in of spending (largely defense cuts), and low interest rates which reduced federal debt payments. These positive fundamentals may allow some federal government hiring to resume after 1999.

State government employment will fare somewhat better in the short-term than the federal government, but job openings likely will grow at an anemic 0.2 percent in 1998. Local government is by far the largest source of government employment in Texas, comprising two-thirds of all Texas government jobs and being mostly in school districts. Local government experienced several years of rapid growth, but near-term finances of local governments will be affected by the declining growth of property taxes. This will allow job growth of only about one percent a year in 1998 and 1999.

IN SUMMARY: CONTINUED ECONOMIC HEALTH

In 1997, Texas real gross state product growth exceeded its 25-year annual average, having grown by 4.2 percent. Employment advanced, real per capita income grew at its fastest rate since 1984, and net migration continued to feed economic growth. As 1997 ended, record high consumer confidence and relatively low unemployment were reflected in healthy retail sales, another year of increasing housing sales, and a six percent increase in business incorporations. Texas exports and tourism continued to gain importance in the state's economy, revealing the ever-increasing role of interstate and global influences on the state.

Texas has advantages which will allow the state to continue outperforming the national economy, whether or not the national slowdown foreseen by many forecasters occurs in 1998. Although Texas' pace of economic growth will certainly be affected by the vicissitudes of the national economy, the state's economic advantages include a younger-than-average labor force, an excellent transportation and communications infrastructure, a central U. S. location, a mostly-pleasant winter climate, a relatively low cost of living[3], attractive real estate prices, and a relatively favorable tax structure. The WEFA Group forecasts the national economy to grow at about 2.5 percent a year in

[3] Every Texas city tracked by the American Chamber of Commerce Researchers Association had a cost of living below the composite national average.

1998 and 1999, while the Comptroller's most recent forecast expects the state economy to grow markedly faster, at a forecasted 3.9 percent annually in both 1998 and 1999.

The outlook is that employment growth will average over 2 percent annually in 1998 and 1999, that total personal income will rise about 6 to 7 percent a year, and that real per capita income, in 1997 dollars, will increase from $23,284 in 1997 to $24,160 in 1999, a growth rate exceeding inflation by nearly two percentage points each year.

Major Initiatives

Several issues were addressed by the 1997 Legislative Session. One of the issues was aimed at preventing teens and children from smoking. Legislation established training and educational programs for employees of tobacco retailers, teens and their parents. The state is also studying racial disparity in higher education in Texas. A report, due January 15, 1999, will examine student recruitment, admissions, retention, and financial aid.

Additional education legislation authorizes 100 open enrollment charter schools to be set up during 1998-1999 biennium. This is a major increase from the 20 now operating across Texas. It also allows students to receive public education grants or to attend different schools in their district if at least half of the school's student body has failed the Texas Assessment of Academic Skills test in two of the preceding three years.

Other legislation passed by the 1997 Legislature targeted management of water resources. It created a blueprint for drought planning, regulation of water rights, public information and financial and technical assistance. Provisions in the legislation include: 1) requiring water planning regions to submit a formal plan for maintaining water quality and quantity; 2) call for stricter oversight of diversion and reuse of water; 3) relaxing the conditions required to grant emergency authorizations; 4) designating conservation districts as the preferred entity to manage groundwater resources; 5) establishes a single financial assistance pool; 6) expands financial aid for public water systems to all community water systems; and 7) improves research, data collection, dissemination and access to natural resources data.

Property tax reform legislation allows use of $1 billion of the state's projected balance at the end of fiscal 1997 for increasing the basic homestead exemption from $5,000 to $15,000. This measure is estimated to save the average homeowner in Texas about $140 a year.

The Window on State Government Web Site now offers an electronic, interactive database to help reunite Texans with their abandoned bank accounts, safe deposit contents, and other valuable property that has been forwarded to the state under Texas' unclaimed property laws. Texas currently holds more than $700 million of unclaimed property. Last year, the state returned to owners $32.8 million in abandoned assets.

A unique health care atlas has been compiled by the Comptroller answering the most common questions asked by Texans. The atlas includes a wide range of information such as the number of people and their dependents covered by health insurance, the portion of the state's budget used to provide health care for poor Texans covered by Medicaid, and provisions used by hospitals to meet the growing demand for health care.

Cities, counties, schools and other local governments should realize substantial savings from the 1997 privatization of the state's TexPool Fund. TexPool participants will save approximately $1.5 million a year in fees under the new management of the fund.

Accounting System and Budgetary Controls

The state's financial statements for general government operations, expendable trust funds, and agency funds have been prepared on the modified accrual basis of accounting in conformity with generally accepted accounting principles (GAAP). Revenues are recognized when measurable and available to finance current expenditures; expenditures are recognized when the related liability is incurred. The proprietary, non-expendable trust, pension trust, and college and university funds are accounted for on the accrual basis. A summary of the state's significant accounting policies and other necessary disclosures are included in the notes to the financial statements.

The state's internal accounting controls provide reasonable assurance regarding the safeguarding of assets against loss from unauthorized use or disposal and the reliability of financial records for preparing financial statements. The concept of reasonable assurance recognizes that the cost of a control should not exceed the resulting benefit.

Budgetary control is exercised through expenditure budgets for each agency. These budgets are entered on the statewide accounting system after an appropriations bill becomes law. The appropriations become law after passage by the Legislature, the Comptroller has certified the amounts appropriated are within the amounts estimated to be collected, and the bill has been signed by the Governor. Controls are maintained first at the agency level, with additional control at the fund and appropriation level to ensure that expenditures are not made in excess of authorized limits. Further detail on budgetary accounting for the state is found in Note 1.

Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of monies are recorded in order to reserve that portion of the applicable appropriations, is employed for purposes of budgetary control and contract compliance. Encumbrances at year-end do not constitute expenditures or liabilities.

Debt Administration

During fiscal year 1997, Texas' state agencies and universities issued $1.5 billion in state bonds to finance new construction, housing, water conservation and treatment, and other projects. General obligation debt accounted for $326.6 million of the state bonds. This debt carries the full faith and credit of the state and can only be authorized by a constitutional amendment. The remaining $1.2 billion is due to new issuances of revenue bonds which are serviced by the revenue flows of individual entity projects.

Bonds retired were composed of $198.8 million in general obligation bonds and $284.6 million in revenue bonds during the year. There were also $157.0 million in general obligation bonds and $263.9 million in revenue bonds that were refunded. The total outstanding general obligation debt of the state after new issuances, retirements, and refundings as of August 31, 1997, was $4.9 billion. An additional $3.4 billion is authorized but has not been issued. The total of revenue bonds outstanding was $6.5 billion. An additional $2.0 billion was authorized but not issued. Bonded indebtedness is illustrated on the following page.

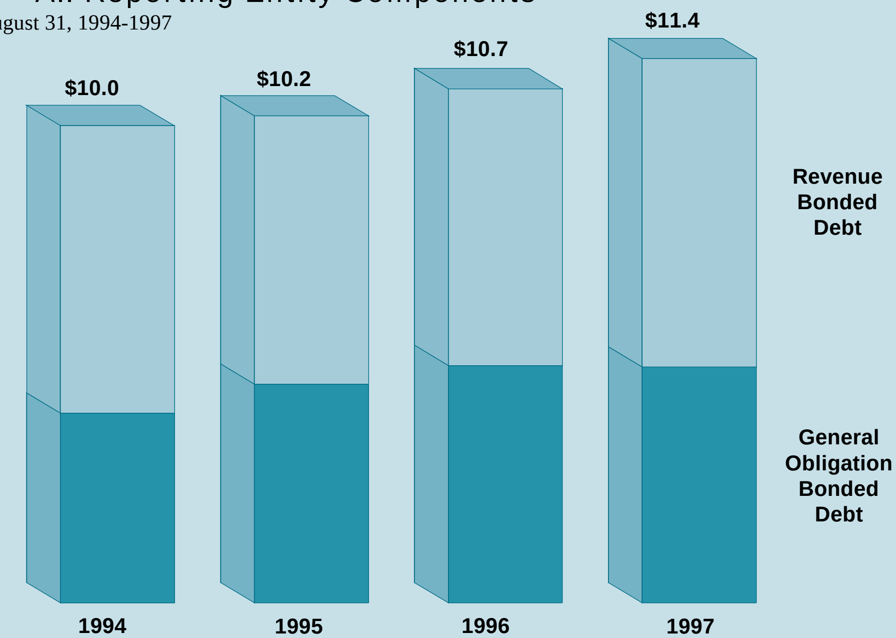
The state's general obligation bond issues are rated at Aa2 by Moody's Investors Service, AA by Standard & Poor's Corporation, and AA+ by Fitch Investors Service, as of August 31, 1997.

Cash Management

Funds deposited in the State Treasury are pooled for investment purposes. The Treasury is authorized to invest in time deposits, obligations of the United States, obligations of various federal credit organizations, repurchase agreements, reverse repurchase agreements, banker's acceptances, commercial paper, and mutual funds.

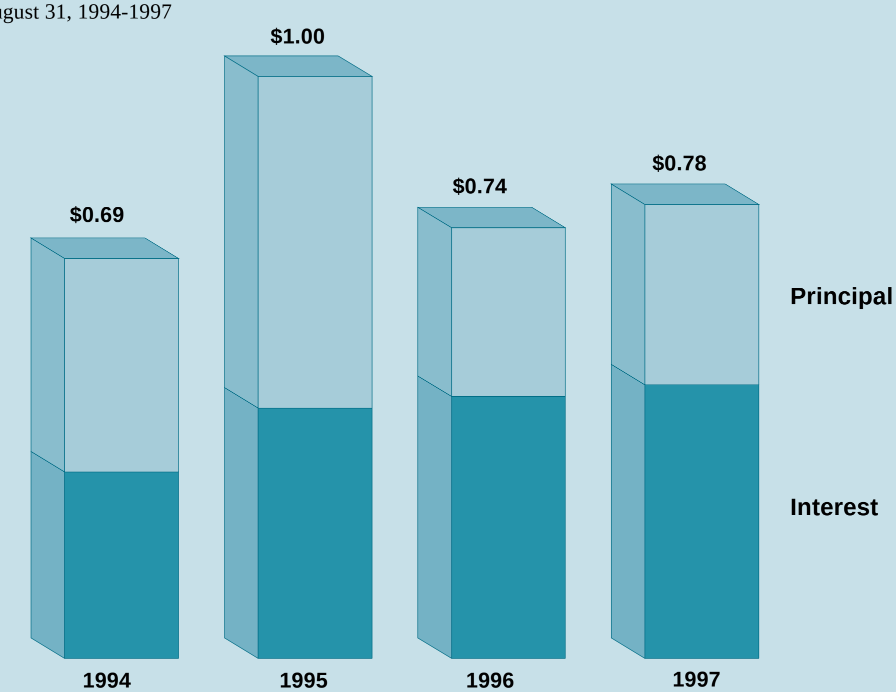
Outstanding General and Revenue Bonded Debt – All Reporting Entity Components

Fiscal Years Ended August 31, 1994-1997
(In Billions)



Debt Service Expenditures – Governmental Fund Types and Expendable Trust Types

Fiscal Years Ended August 31, 1994-1997
(In Billions)



During fiscal year 1997, the average investment portfolio consisted of the following:

Average Investment Portfolio*
(In Thousands)

Investment Type	Percent of Total	Average Amount Invested	Average Interest Rate
Now Accounts	0.2 %	$ 18,279.6	5.414 %
Time Deposits	4.0	321,161.7	5.320
Repurchase Agreements	32.1	2,594,655.4	5.436
U.S. Treas.& Agency Secur.	38.7	3,129,401.8	5.305
U.S. Treas. (Lottery)	13.5	1,088,473.6	**
Commercial Paper	13.6	1,097,972.0	5.563
Mutual Funds	3.7	297,394.6	5.289
Subtotal	105.8	8,547,338.7	
Reverse Repurchase Agreements	(5.8)	$ (465,166.3)	5.244
Total	100.0 %	$ 8,082,172.4	5.398 %

* The above numbers include primary government funds only.

** The yield for Lottery is not included in the average yield for the state since the investments are long-term and are held for lottery prize winners.

The state earned interest of $376.2 million on Treasury deposits in fiscal year 1997.

Risk Management

The state assumes substantially all risks associated with:

- Claims of state employees for unemployment compensation.
- Claims of state employees covered by the state self-insured health care plan, Health Select.
- Claims of covered employees for workers' compensation benefits.
- General tort claims that parties may file against the state, its officials, employees, or appointees.
- Liability claims against the state or its agencies due to conditions of property, vehicles, aircraft, or watercraft.

Independent Audit

The State Auditor has performed an audit in accordance with generally accepted auditing standards of the state's general purpose financial statements. His opinion has been presented in this report preceding the financial statements.

The State Auditor has also performed federal audit procedures necessary to meet the requirements of the federal Single Audit Act Amendments of 1996 and related OMB Circular A-133. A report on compliance with federal regulations will be issued separately in the 1997 Statewide Audit Management Letter.

Deloitte & Touche LLP has also performed an audit in accordance with generally accepted auditing standards of the state's Supplemental Bond Schedules. Their opinion has been presented in this report preceding the bond schedules.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a "Certificate of Achievement for Excellence in Financial Reporting" to the State of Texas for its Comprehensive Annual Financial Report for the fiscal year ended August 31, 1996. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The State of Texas has received a Certificate of Achievement for the last seven years (fiscal years ended August 1990 through 1996). We believe our current report continues to conform to the Certificate of Achievement Program requirements, and are submitting it to the GFOA.

We will continue to maintain a highly qualified and professional staff to make this certification possible.

Sincerely,

John Sharp

JOHN SHARP
Texas Comptroller of Public Accounts

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of Texas

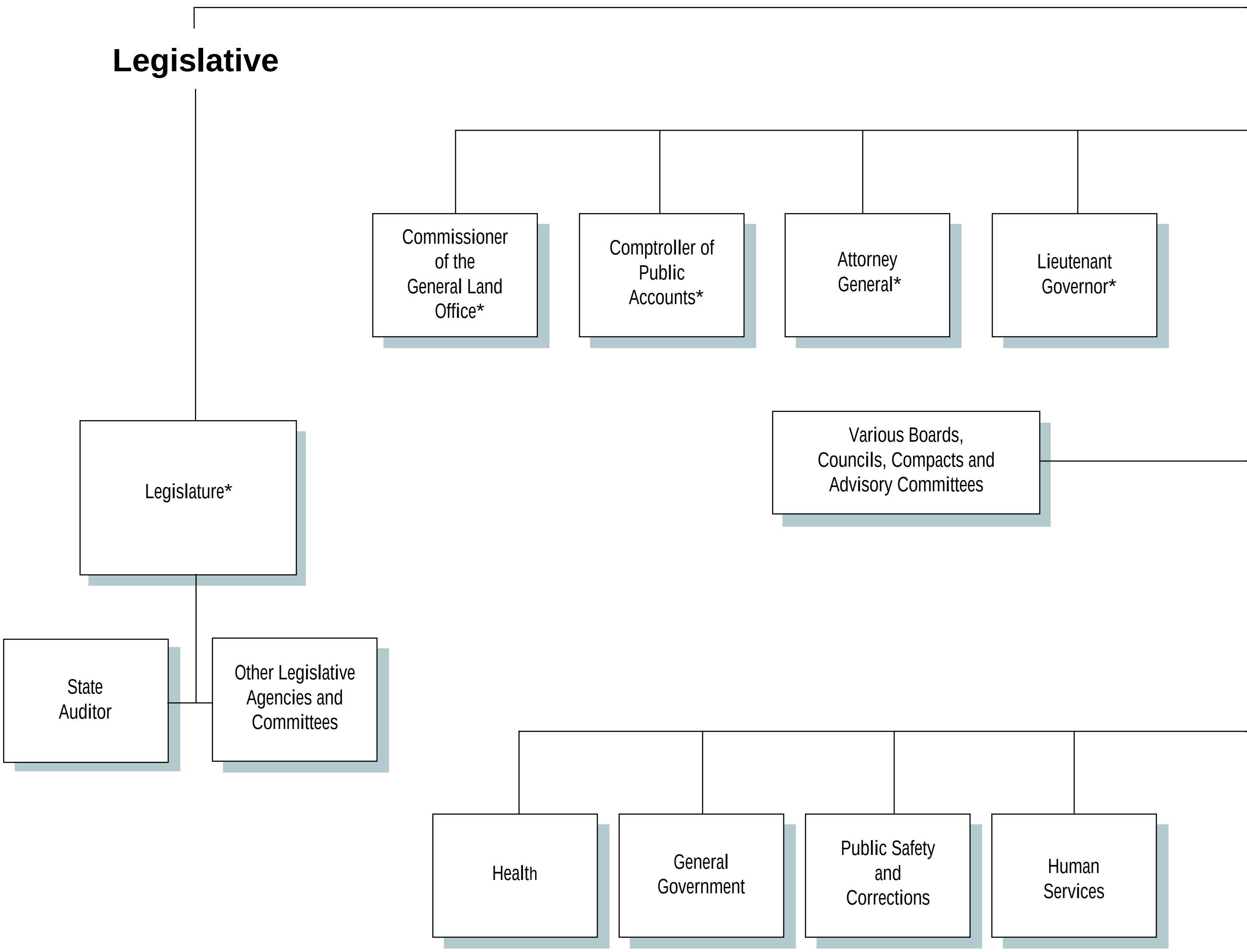
For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
August 31, 1996

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

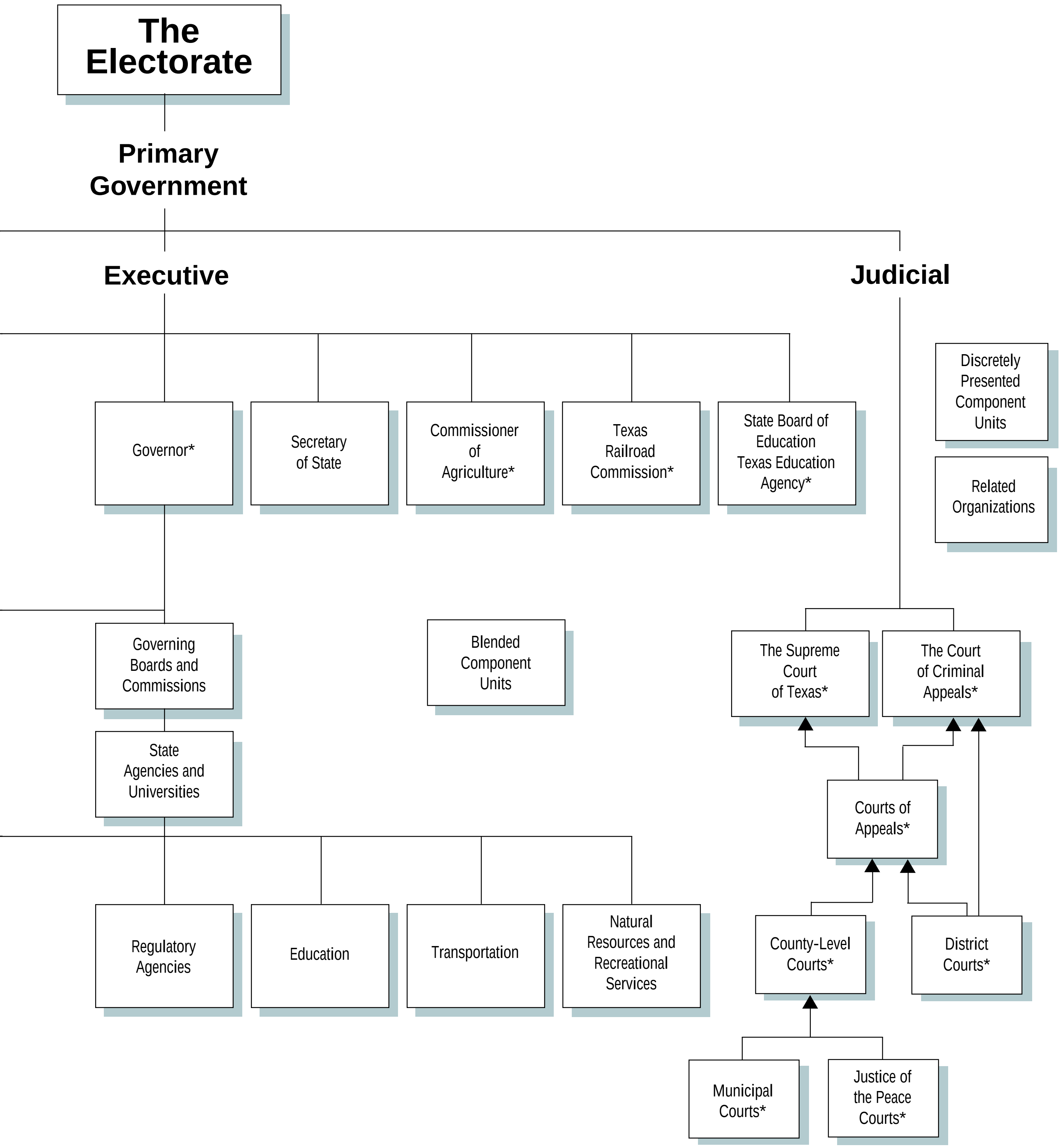
Linda K. Savitsky
President

Jeffrey L. Esser
Executive Director

Government Structure of Texas



*Elected Offices


The Electorate
Primary Government
Executive
Judicial
Governor*
Secretary of State
Commissioner of Agriculture*
Texas Railroad Commission*
State Board of Education Texas Education Agency*
Discretely Presented Component Units
Related Organizations
Governing Boards and Commissions
Blended Component Units
The Supreme Court of Texas*
The Court of Criminal Appeals*
State Agencies and Universities
Courts of Appeals*
Regulatory Agencies
Education
Transportation
Natural Resources and Recreational Services
County-Level Courts*
District Courts*
Municipal Courts*
Justice of the Peace Courts*

State of Texas
Comprehensive Annual Financial Report

State of Texas
Elected State Officials

Executive

George W. Bush
Governor

Bob Bullock
Lieutenant Governor

John Sharp
State Comptroller

Dan C. Morales
Attorney General

Garry Mauro
Land Commissioner

Rick Perry
Commissioner of Agriculture

Charles Matthews
Carole Rylander
Barry Williamson
Railroad Commissioners

Legislative

Lieutenant Governor, Bob Bullock, presides over the Senate

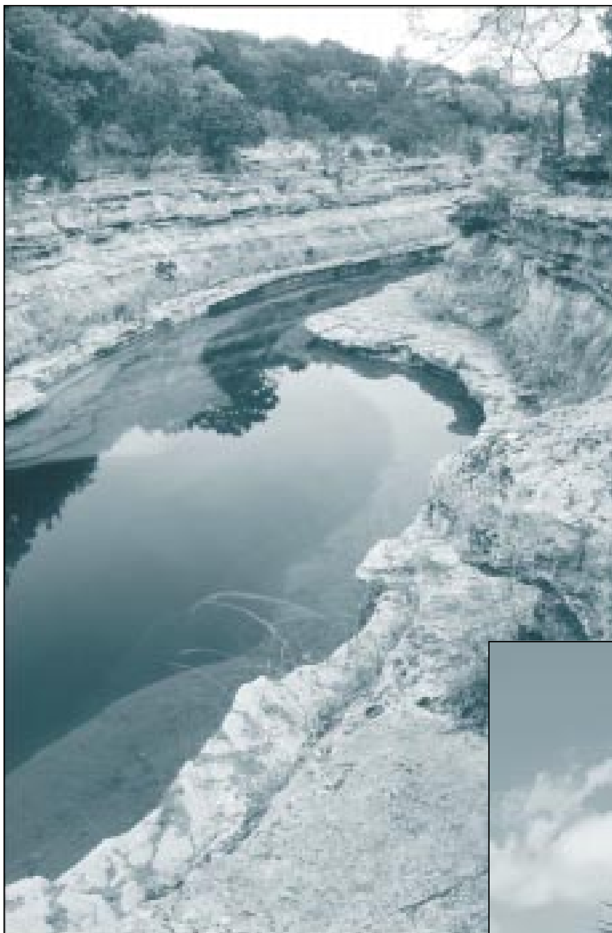
James E. (Pete) Laney
Speaker of the House of Representatives

Judicial

Thomas R. Phillips
Chief Justice of the Supreme Court

Michael J. McCormick
Presiding Judge, Court of Criminal Appeals

Financial Section



OFFICE OF THE STATE AUDITOR
TWO COMMODORE PLAZA
206 EAST NINTH STREET, SUITE 1900
AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA
State Auditor

INDEPENDENT AUDITOR'S REPORT

February 24, 1998

The Honorable George W. Bush, Governor
The Honorable John Sharp, Comptroller of Public Accounts
and
Members of the Legislature
State of Texas

Ladies and Gentlemen:

We have audited the general purpose financial statements of the State of Texas as of and for the year ended August 31, 1997, listed in the Financial Section of the Table of Contents. These financial statements are the responsibility of the State Comptroller of Public Accounts. Our responsibility is to express an opinion on these financial statements based on our audit.

The financial statements of the following entities and funds included in this report were audited by other auditors whose reports have been furnished to us. The Texas Department of Housing and Community Affairs, the Texas Turnpike Authority, the Texas Prepaid Higher Education Tuition Board, and the Texas Lottery Commission compose 59 percent and 96 percent of the assets and revenues, respectively, of the Enterprise Funds. Additionally, the Texas Guaranteed Student Loan Corporation, the Texas Workers' Compensation Insurance Fund, and the Texas Surplus Lines Stamping Office comprise 74 percent of the assets of the Proprietary Component Unit Funds. The Texas Local Government Investment Pool and the Employees Retirement System constitute 21 percent of the assets of the Trust and Agency Funds. Additionally, the Employees Retirement System makes up all of the Internal Service Fund. The Permanent University Fund makes up 67 percent of the assets of the College and University Endowment Funds. Our opinion, insofar as it relates to the amounts included for these entities and the Investment Pool, is based solely on the reports of other auditors.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the reports of other auditors, the general purpose

P.O. BOX 12067 AUSTIN, TEXAS 78711-2067 ● PHONE: (512) 479-4700 ● FAX: (512) 479-4884 ● INTERNET: http://www.sao.state.tx.us ● E-MAIL: auditor@sao.state.tx.us

financial statements present fairly, in all material respects, the financial position of the State of Texas as of August 31, 1997, and the results of its operations and the cash flows of the proprietary and nonexpendable trust fund types for the year then ended, in conformity with generally accepted accounting principles.

A significant change reflected in these statements affects comparability to prior financial statements. The Foundation School Fund has been consolidated into the General Fund from the Special Revenue Fund.

Our audit was made for the purpose of forming an opinion on the general purpose financial statements taken as a whole. The combining and fixed assets account group financial statements and the Schedules of Expenditures of Federal Awards are presented for purposes of additional analysis and are not a required part of the general purpose financial statements of the State of Texas. Such information has been subjected to auditing procedures applied in the audit of the general purpose financial statements and, in our opinion, based upon our audit and the reports of other auditors, is fairly presented in all material respects in relation to the general purpose financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we will issue a separate report on our consideration of the State's internal control structures and its compliance with laws and regulations.

The introductory section and the statistical and economic data section were not audited by us and, accordingly, we do not express an opinion thereon.

Lawrence F. Alwin, CPA
State Auditor