TEXAS PUBLIC POLICY FOUNDATION
Testimony

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Testimony before the House Select Committee on Fiscal Stability

by The Honorable Talmadge Heflin
Director, Center for Fiscal Policy

Chairman Otto and Members of the committee,

My name is Talmadge Heflin and I am the director of the Center for Fiscal Policy at the Texas Public Policy Foundation. Thank you for the opportunity to testify today and share our thoughts on the fiscal and economic challenges facing our state.

By most accounts, the next legislative session looks to be one of the more difficult in recent memory. A growing chorus of tax and budget experts are warning that the state's projected budget shortfall could range as high $15 billion for fiscal 2012-13, coming largely as a result of the recessionary drop in state revenues, recurring expenditures created by the stimulus and a surge in the cost of health care. If these shortfall estimates hold true, it will be the first time since the 2003 legislative session that the Legislature will have had to tackle a budget challenge of this size and scale.

Complicating the state's budget situation is the fact that any major fiscal decision—i.e., raising taxes or cutting spending—is likely to have an impact on Texas' fragile economic recovery, for better or worse. And with economic conditions as uncertain as they are these days, the Legislature must take special care when bridging the shortfall so as not to endanger the state's prospects.

In spite of these challenges, however, the Texas Public Policy Foundation believes that, with the right approach, the Legislature can successfully balance the budget and protect the state's budding recovery at the same time. Listed below are several of the Foundation's recommendations to accomplish these goals.

Mitigating the Effects of the Current Economic Recession

In the upcoming 2011 legislative session, state lawmakers will be faced with an array of complex budget and economic decisions that will affect the lives of more than 24 million Texans. Without a principled, well-thought out approach to work through these issues, the Legislature will have an overly difficult time developing a budget that is both balanced and promotes economic growth.

However, with the following recommendations the Legislature can lay the foundation for a fiscally responsible, economically vibrant Texas.

Adopt a zero-based budgeting process. During the last legislative session, the Legislature commendably adopted a growth rate within the expected rate of population growth plus inflation. While a similar feat next session would be equally praiseworthy, a more conservative approach is needed this time given the present economic and fiscal conditions.

Specifically, the Legislature should consider adopting a zero-based budgeting process for 2012-13. Start with zero and build the budget from the ground up. Give first priority to the bare essentials that the constitution calls for, then the essentials within the statues, if you have the money. If you don't have the money, change the statue. Only then do you move to the additional items on the agencies prioritized list of other needs. Implementing this process will have several positive effects.

First and foremost, using this approach for the 2012-13 budget cycle would protect Texas taxpayers and the state's economy from the effects of any new, major tax increases.

900 Congress Avenue
Suite 400
Austin, TX 78701
(512) 472-2700 Phone
(512) 472-2728 Fax
www.TexasPolicy.com

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Secondly, this would help arrest the growth of state spending which has trended well above the recommended limit of population growth plus inflation. According to the Foundation's research, All Funds appropriations between fiscal years 1990 and 2009 have increased from $20.7 billion to $82 billion, a growth of 296 percent. By contrast, the sum of population growth plus inflation, as measured by the Consumer Price Index, increased by only 110 percent over the same period—resulting in a discrepancy of nearly 3 to 1.

Finally, this process would demonstrate to Texas taxpayers, many of whom have had no other recourse than to cut household spending, that the state is willing to practice an equally responsible form of budgeting. The state's leadership is already wisely demonstrating this point by calling on agencies to reduce their request for the next budget by 10 percent.

Eliminate unnecessary agencies and programs, consolidate where possible. Much like a household that rids itself of luxury items when income falls, the Legislature should strive to identify state agencies that have become redundant, have outlived their purpose, or should have never been created in the first place and eliminate them.

Two obvious agencies that fit the bill: the Commission on the Arts and the Historical Commission. Were the Legislature to eliminate these agencies outright at their current funding levels, taxpayers could save $115 million in All Funds appropriations.

Consolidating overlapping state agencies is another effective means of saving taxpayer money. One idea that has not yet been researched in-depth, but looks promising, is the elimination of the Texas Alcoholic Beverage Commission (TABC) and the consolidation of its duties into the Texas Department of Public Safety. An approach like this could save tens of millions, as TABC was appropriated nearly $90 million in FY 2010-11.

Prevent any tax increases. Over the past several years, Texas has become well-known for its limited government, low tax governance philosophy—one that has served it well.

As noted in the Foundations prior research,* the economic performance in the 10 states with the lowest tax burdens,† which includes Texas, exceeded the economic growth in the 10 states with the highest tax burdens. In addition, overall economic growth as measured by residents' total personal income has been significantly higher in the low-tax states. Not surprisingly, stronger economic growth led to more jobs and higher population growth in the low-tax states as more people choose to relocate to the states with lower taxes, as seen in Table 1.

As a general rule, states with lower average tax burdens experienced higher average growth in personal income, while the states with higher average tax burdens experienced lower average growth in personal income. In short, the size of the tax burden matters. High tax burdens discourage economic growth while low tax burdens encourage economic growth.

Texas clearly benefits from its current tax system with a relatively low tax burden—which makes it imperative that the state reject any attempts to increase taxes further.

Promote pro-growth policies of low taxation and minimal and predictable regulation. By most every indication, the state's economy and employment situation are recovering. The Legislature should continue down the path that led us to this position, and resist the temptation of following Washington's lead by trying to meddle in everything, and instead maintain and enhance an environment where the free market can flourish.

Thus far, the state's adherence to pro-growth policies has paid dividends. Here are just a few of the state's accomplishments.

- In the newest *Forbes* rankings, Texas is tied for first for the most number of Fortune 500 company headquarters (57).
- According to the latest round of employment statistics, Texas has added jobs every month this year, bringing total employment gains in 2010 to 168, 900.
- Texas is the world's 11th largest economy.
- Texas was recently declared "America's Top State for Business" by CNBC.

According to most economic and fiscal indicators, Texas is weathering the current recession well, especially when compared to other populous states, like California.

Case Study: Texas v. California. States fiercely compete with one another: they compete for jobs, they compete for businesses, and they compete for people. The results of this economic competition have real implications for future state

*For more information, please refer to the Texas Public Policy Foundation's research study *Enhancing Texas' Economic Growth through Tax Reform.*

†For the purposes listed above, a state's "tax burden" is defined as total state and local taxes as a percentage of personal income.

TABLE 1: STATE AND LOCAL TAX BURDEN VS. 10-YEAR ECONOMIC PERFORMANCE
(2007 STATE & LOCAL TAX BURDEN VS. ECONOMIC PERFORMANCE BETWEEN 1997 AND 2007, UNLESS OTHERWISE NOTED)

	2007 S&L Tax Burden	Personal Income Growth	Population Growth	Net Domestic In-Migration as a % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate
South Dakota	$87.40	76.0%	5.2%	-1.8%	14.5%	3.2%
Tennessee	$88.99	63.6%	11.9%	4.3%	9.6%	5.2%
Alabama	$90.44	61.6%	6.1%	0.8%	8.0%	3.5%
New Hampshire	$90.51	73.0%	13.2%	6.0%	15.9%	3.4%
Colorado	$94.00	88.5%	21.9%	5.1%	19.5%	4.4%
Missouri	$98.48	56.6%	7.8%	1.3%	7.3%	4.8%
Texas	$99.49	87.2%	20.6%	2.1%	20.8%	5.0%
Oklahoma	$100.21	70.1%	7.2%	0.1%	13.8%	3.9%
Oregon	$101.10	65.0%	14.3%	4.7%	16.0%	5.4%
Georgia	$102.50	78.1%	23.8%	6.4%	15.7%	4.7%
10 States with Lowest Tax Burden	$95.31	72.0%	13.2%	2.9%	14.1%	4.4%
10 States with Highest Tax Burden	$132.31	59.5%	5.5%	-2.3%	12.9%	4.4%
Connecticut	$119.41	61.6%	5.6%	-3.1%	5.6%	4.3%
Wisconsin	$121.73	59.8%	6.8%	0.6%	10.3%	4.7%
West Virginia	$123.38	46.3%	-0.4%	-0.5%	8.2%	4.8%
Rhode Island	$125.32	60.5%	5.8%	-1.9%	11.8%	5.3%
Alaska	$131.39	52.6%	9.8%	-3.9%	19.4%	6.8%
Hawaii	$133.05	46.9%	6.5%	-6.5%	16.5%	2.6%
Maine	$134.56	62.6%	6.3%	3.7%	13.1%	4.6%
Wyoming	$140.43	86.0%	5.0%	-2.0%	23.9%	3.2%
Vermont	$143.29	64.9%	5.8%	1.0%	11.9%	3.5%
New York	$150.52	53.8%	3.9%	-10.1%	8.3%	4.5%

Source: Texas Public Policy Foundation, "Enhancing Texas' Economic Growth through Tax Reform"

economic performance. States with strong competitive environments have flourishing economies while states with weak competitive environments have struggling economies.

Many factors impact a state's competitive environment. A number of these factors—such as climate, natural resources, or geographical location—do not change. State economic policies (i.e., tax, expenditure, and regulatory policies) vary across states and across time within a state and have significant implications for a state's economic prospects. For this reason, state economic policies are crucial economic competitive metrics.

In a head-to-head comparison of Texas and California, the evidence, as laid out in the following Table, speaks for itself. The economic environment in Texas has significant advantages over California. The implications of this competitive advantage are clear; Texas' economic prospects are bright and the Texas economy will significantly outperform California's. Put another way: In a heavyweight competition between Texas and California, Texas wins!

Adopt a sustainable debt policy. While the Foundation cannot recommend any one model policy per se—since each circumstance has its own uniqueness—I would recommend that the Legislature consider some well-established principles surrounding debt policy, including:

- ***Avoid using long-term debt to finance current operations or to capitalize expenses.*** Operating expenses should be completely covered through the current-year budget. Capital debt should not be used as a credit card to pay for recurring expenses.

- ***Avoid using long-term debt for anything other than capital projects that cannot be financed from current revenue***

Competitive Event	California	Texas	Winner
Taxes on Consumption			
State Sales Tax Rate	**7.25%**	6.25%	
Sales Tax Burden per $1,000 of Personal Income	**$28.06 (32nd)**	$28.64 (34th)	
Overall Tax Environment			
Overall Tax Burden	$118.33	$99.49	
Personal Income Tax Progressivity	$33.58	$0.00	
Recent Legislated Tax Changes per $1,000 of Personal Income	+$0.29	-$4.35	
Number of Tax Expenditure Limits	2	1	
Regulatory Environment			
State Liability System (PRI U.S. Tort Liability Index Rank)	34th	18th	
State Minimum Wage	$7.50	$5.85	
Average Workers' Compensation Cost	$4.13	$2.84	
Right-to-Work State	NO	YES	
Education Freedom Index Score	2.11 (14th)	2.32 (7th)	
Government Spending Policies			
Total Expenditures per Capita	$9,448.26	$6,652.11	
Average Growth in State Government Expenditures	7.04%	5.96%	

Source: Texas Public Policy Foundation, "Competitive States: Texas v. California"

sources. Capital debt should only be used for large one-time expenses, such as building infrastructure or other projects that have a lifespan over several decades.

- ***Retire 25 percent of the principal within five years and 50 percent within 10 years.*** This policy encourages repayment of debt in the shortest possible time without creating an undue hardship on taxpayers.

- ***Bonds should only be re-issued (for the purpose of interest rate savings) under limited circumstances.***

- ***Avoid variable-rate and back-loading and balloon repayment schedules.*** Level or declining repayment schedules incur less interest cost. Delayed repayment schedules, typically used in an over-optimistic expectation of strong long-term growth of the tax base, incur greater interest cost. Delayed or back-loaded repayment schedules also lock future taxpayers into unnecessarily high debt repayment taxes. Variable-rate debt, dependent upon external rates and indices, is arguably a form of speculation.

- ***Encourage maximum use of competitive bidding process to issue debt.*** Competitive bidding can reduce interest costs, and it avoids questions of unfairness and favoritism in the debt underwriter selection process.

- ***Limit capital fund investment instruments to reliable sources.*** In order to maximize bondholder safety, investments should be limited to U.S. government securities or fully insured bank certificates of deposit (CDs).

Maintaining the state's AAA credit rating is an important piece of the Legislature's future fiscal decisions.

Maintain a predictable regulatory environment. A predictable and onerous-less regulatory environment is critical to maintaining the state's economic competitiveness and keeping the cost of government to a minimum. Some recommendations offered by the Foundation in past concerning this area include:

- ***Don't play favorites:*** Regulations should be put in place for the purpose of protecting consumers, not restricting the marketplace or driving out competitors.

- *Reduce regulatory risks and burdens:* The greater the regulatory burden and risk, the less likely businesses and investors will be able to access capital at a reasonable price.

- *Protect property rights:* Eminent domain remains a problem and a threat to businesses around the state and makes the state less attractive to outside companies looking to relocate.

- *Reduce land-use regulations:* Zoning is becoming a burden in some areas of the state, thereby reducing the ability of businesses to freely expand and prosper.

- *Reduce reliance on federal funds:* The greater the acceptance of federal funds, the less autonomy state lawmakers have to craft their own policies and the higher state spending becomes due to Maintenance of Effort requirements.

Promote greater government transparency. When most people think about the benefits of financial transparency—the timely, meaningful, and reliable disclosure of government budget and spending information—they tend to think of the intangibles: educating the public, knowledgeably engaging their elected officials, and so on. But a growing body of evidence is beginning to show that transparency has a much more concrete benefit: saving money.

As a result of the Texas Comptroller's efforts to post detailed spending information online as well as conducting a top-to-bottom review of her agency's expenses, the Comptroller's transparency efforts have "saved taxpayers a projected $10 million" over the last few years. A pretty good return on investment considering the initial cost for Texas' spending website, *Where the Money Goes*, was $310,000.

Transparency's money-saving ability extends beyond just that example though—state and local governments have also been able to see big savings from TexasSmartBuy, an online ordering system that leverages the state's purchasing power to boost competitiveness among vendors and cut costs. In the short time that TexasSmartBuy has been up and running, Texas' state and local governments, as well as the taxpayers who support them, have seen "over $50 million in annually reoccurring savings."

And there are numerous other "success stories" out there detailing how governments in Texas are benefitting financially from their transparency efforts, be it by reducing open records requests, saving on printing, or other ways. So the next time you think about how transparency may benefit you, just think about all the money you could be saving.

The Fallacy of the Structural Deficit Argument

A common misconception about Texas state government is that in good economic times revenues are not able to keep pace with the cost of government, thereby creating a situation some have come to describe as a structural deficit. I would take exception with this analysis for two reasons.

First, the last several years of economic growth before the economic downturn, revenues were keeping pace with government needs. In fact sizable fund balances were available at the end of each fiscal year. The shortfalls began only after the economy began to cool.

Secondly, the supposed structural deficit is an indication that government spending is too high, not that state revenues are too low. If the spending increases faster than the revenue in good economic times that is a spending problem.

What we do have is a cyclical deficit, less revenue than it takes to maintain the spending level we are currently enjoying because of the economic downturn. Just as a family that finds their income unexpectedly reduced has to cut their spending, so does the state. The family and state may have a saving account, but it is unwise to spend all of the savings before cutting spending since the time of reduced income may be uncertain. That is why we recommend the Legislature use the rainy day fund very sparingly.

Recap of Recommendations

Budget & Spending

- Control state spending by making the 2012-13 budgeting process zero-based.

- Eliminate unnecessary state agencies and programs and consolidate where possible.
  - Fund agencies based on constitutional mandates, followed by statutory requirements.
  - Fund only those programs that return a greater value to the taxpayer than the program's cost.
  - Avoid duplication of services by focusing on programs that are not provided by local governments or the private sector.

- Adopt a sustainable debt policy.
  - Avoid using long-term debt to finance current operations or to capitalize expenses.
  - Avoid using long-term debt for anything other than capital projects that cannot be financed through current revenue.

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    - Retire 25 percent of the principal within five years and 50 percent within 10 years.
    - Bonds should only be re-issued (for the purpose of interest rate savings) under limited circumstances.
    - Avoid variable-rate and back-loading and balloon repayment schedules.
    - Encourage maximum use of competitive bidding process to issue debt.
    - Limit capital fund investment instruments to reliable resources.

- Promote greater government transparency.
    - State has saved almost $10 million through the Comptroller's transparency efforts.
    - State and local governments have realized $50 million in annually recurring savings through Texas Smart Buy.

Taxes & Regulations

- Prevent any tax increases.
    - Keep Texas state and local tax burden low.
    - A direct correlation between low taxes and economic growth.
- Maintain a predictable regulatory environment.
    - Don't play favorites.
    - Reduce regulatory risks and burdens.
    - Protect property rights.
    - Reduce land use regulations.
    - Reduce reliance on federal funding.

Economy

- Promote pro-growth policies.
    - Policies have helped create an environment where Texas now leads in Fortune 500 company headquarters, job creation, and business-friendly image.

Thank you for your time and I look forward to answering any questions you may have. ✯