Texas Public Policy Foundation

Spending

Legislator's Guide to the Issues 2017-18

Conservative Texas Budget

The Issue

The 2015 Texas Legislature started with the state's coffers overflowing with cash from a robust economy. Instead of discussing how much to spend, state officials discussed how much to cut taxes. This novel concept should be the starting point every legislative session.

That Legislature went on to make great strides by passing a conservative budget, defined as an increase by no more than the key metric of population growth plus inflation, $4 billion in tax and fee relief, and billions of dollars left unspent, including more than $10 billion in the state's rainy day fund.

These prudent fiscal decisions helped keep the size and scope of government from crowding out the productive private sector—the best economic stimulus—during a slowing economy.

Appropriations of $209.1 billion for the 2016-17 budget period increased 4.3% from the previous biennium. The Conservative Texas Budget Coalition deemed this a conservative budget because it was below the key metric (population growth plus inflation) of 6.5% during the previous two fiscal years. This conservative budget must be the first of many given past excessive trends that have led to a total budget that is 11.8% above this key metric since the 2004-05 budget.

Along with the 2015 Legislature, legislators practiced some budget constraint in the 2003 and 2011 legislative sessions when they passed budgets that increased by less than this key metric. However, in 2005 and again in 2013, spending by subsequent Legislatures increased substantially, erasing all of the gains from previous sessions.

Given the current economic climate, there looks to be less tax revenue available than last session, so it may be easier for the 2017 Legislature to pass another conservative budget. However, there will likely be proposals to appropriate more from the state's rainy day fund for various budget areas, thereby increasing the budget by more than this key metric when the focus should be on spending less to lower Texans' tax burden.

The 13 member organizations of the Conservative Texas Budget Coalition recommend that the Legislature pass the second consecutive conservative budget that's below population growth plus inflation so that legislators will be good stewards of taxpayer dollars.

By achieving this, Texas will better deal with potentially deep downturns and other economic circumstances. This provides Texas with the best opportunity to remain a free market bastion for Texans to achieve their hopes and dreams, and a model for others to follow.

SPENDING LIMITS FOR 2018-19 BUDGET

$147.5 BILLION *state funds*

$218.5 BILLION *all funds*

4.5% *increase* *(pop. + Infl.)*

ABOVE 2016-17 SPENDING

www.conservativetexasbudget.com

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The Facts

- Texas' total state budget growth is up an estimated 11.8% above the pace of compounded population growth plus inflation since the 2004-05 budget.
- The 2015 Legislature passed a conservative Texas budget below population growth plus inflation.
- Keeping spending and taxes low is the best path for Texans to achieve more prosperity.

Recommendations

- Adopt a second consecutive Conservative Texas Budget.
- Increase the 2018-19 total budget by less than the estimated increase in the rate of population growth plus inflation based on actual data for fiscal years 2015 and 2016.
- Pass a 2018-19 budget that increases by no more than 4.5% for a maximum total budget of $218.5 billion or state (non-federal) funds of $147.5 billion.

Resources

The 2018-19 Conservative Texas Budget by Talmadge Heflin and Vance Ginn, Texas Public Policy Foundation (June 2016).

The Real Texas Budget: Why Texas Needs to Ratchet Down Spending Growth by Talmadge Heflin, Bill Peacock, and Vance Ginn, Texas Public Policy Foundation (June 2016).

TEL It Like It Is: Why Texas Needs Spending Limit Reform by Talmadge Heflin and Vance Ginn, Texas Public Policy Foundation (Dec. 2015).

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Economic Stabilization Fund

The Issue

Oil and natural gas production may have recently slowed, but the more productive wells remain online as production has not declined as much as expected through mid-2016. For several years, the oil and gas production boom contributed to a large increase in severance taxes that primarily fund the Economic Stabilization Fund (ESF).

The ESF is broadly considered the state's "rainy day fund" or "savings account" that was put in place with passage of a constitutional amendment in 1988. The ballot language that Texans approved was "The constitutional amendment establishing an economic stabilization fund in the state treasury to be used to offset unforeseen shortfalls in revenue." However, there is no language in the constitution or statute identifying a specific purpose for the ESF. Regardless, the ballot language sold to Texas seems to be clear that this money is to fill unexpected revenue shortfalls. More clarity of the purpose of the fund is warranted.

Recently, the ESF balance has been used to fund various expenditures. The constitution requires a three-fifths vote in each house to close a revenue gap and a two-thirds vote in each house to use it for any other reason. In 2013, $1.8 billion in ESF dollars were appropriated to fully fund education in the 2012-13 biennium. Texans approved amendments in 2013 to take $2 billion from the ESF to pay for water projects and in 2014 that directed a portion of severance taxes to the State Highway Fund (SHF) instead of going in the ESF. According to the latest provision, a committee determined the ESF minimum balance to be $7 billion in 2015, allowing for $1.7 billion to be transferred to the SHF.

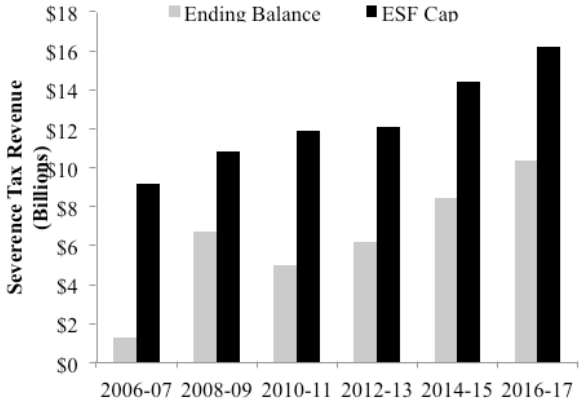
Despite these one-time and ongoing expenditures of severance taxes accumulating in the ESF, the Texas Comptroller projects that the ESF balance will increase 23% to $10.4 billion at the end of the 2016-17 budget cycle. Considering that the ESF balance cannot exceed 10% of general revenue funds excluding interest and investment income in the previous budget cycle, the cap this period is $16.2 billion. The chart below shows that ESF dollars are likely to rise to the largest cap share of 64% compared with only 14% at the end of the 2006-07 period.

It is critical that lawmakers understand that this is a one-time resource to the state. If this money is spent each session, the ESF will quickly dwindle and the state's credit rating will be at risk, particularly if the amount goes below 5% of general revenue-related funds.

Given a potentially tight budget next session, there will be calls to use ESF dollars as the amount grows larger. Using one-time funds to pay for ongoing expenditures only delays needed difficult decisions that should be made with general revenue funds, while simultaneously depleting one-time funds that should be used for future emergencies, budget stabilization, or tax relief.

Put differently, no reasonable person would advise a household who is spending more than their monthly income to tap their savings account to pay for a lifestyle beyond their means. If we wouldn't advise that for a family, then why would we collectively, as a state, advise that for our government?

Oil and Natural Gas Production Tax Revenues Reach Closer to the ESF Cap



Source: Legislative Budget Board

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The Facts

- The rainy day fund is expected to grow by $2 billion by the end of FY 2017.
- If the fund reaches $10.4 billion as projected, the ending balance would be a record high and reach closer to the cap of $16.2 billion.
- Using one-time funds to pay for ongoing expenses is poor public policy.

Recommendations

- Determine the desired purpose of the ESF and put it in law. Ideally, the ESF balance should be spent only on stabilizing the budget or tax relief; not on ongoing expenses.
- One option would be to create a fund to place excess ESF dollars or savings from budget cuts to return dollars to taxpayers by temporarily lowering the state's sales tax rate (Sales Tax Reduction (STaR) Fund).
- At a minimum, lawmakers should preserve an ESF balance equal to 5% of the general revenue-related funds each budget cycle but should consider conservative options, especially tax relief, with the rest.

Resources

Overview of the Economic Stabilization Fund, Legislative Budget Board (April 2016).

Why States Save, The Pew Charitable Trusts (Dec. 2015).

Preserve Texas' Rainy Day Fund in These Uncertain Economic Times by Chuck DeVore, Texas Public Policy Foundation (Oct. 2012).

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Public Pension Reform

The Issue

Recent analyses documenting the imminent threat posed by unfunded state pension liabilities contributed to several reforms by the 2013 Texas Legislature, including raising the retirement age and increasing contribution rates, to the two largest state pension systems—Teacher Retirement System (TRS) and Employees Retirement System (ERS). The 2015 Legislature raised the ERS member contribution rate to 9.5% to improve its solvency.

While these are positive first steps, these pension systems should be changed from defined benefit to defined contribution plans to make them sustainable long term for beneficiaries and not burden all Texans with higher taxes.

For decades, state and local officials have overpromised on and underfunded government-run retirement plans, resulting in the accumulation of trillions of dollars in unfunded liabilities across the nation. Unfunded liabilities are the difference between promised benefits to future retirees and money available to fund those benefits. In fact, one study pegged total unfunded state and local pension liabilities nationwide at more than $4.7 trillion—or almost $15,000 per American.

In Texas, state and local governments employ 14% of workers. Most of them have a defined benefit pension plan that promises a regular payment to retirees regardless of contribution. Volatile annual rates of return and fewer contributors paying for more beneficiaries are exhausting these plans, leaving them with mounting, unsustainable liabilities.

The Pension Review Board (PRB), the state agency charged with overseeing Texas' state and local retirement systems, shows that among the 93 systems monitored by the agency, unfunded liabilities topped $60 billion in early 2016. That is an increase in pension debt of $2.7 billion since June 2015 and an increase of $7.7 billion compared with two years prior.

The funded ratio—a measure of a plan's current assets as a share of its liabilities—averaged 80% across all plans. It is generally agreed that a funded ratio of 80% or more signifies a firm financial footing, something that many of Texas' systems are on the brink of falling below.

Looking at these plans' amortization periods also hints at trouble. The PRB's guidelines for actuarial soundness recommend that a plan's amortization period ideally range between 15 and 25 years. However, 56 of the 93 plans exceeded that target in early 2016. Over a longer time horizon, fewer plans are able to achieve the recommended amortization period. A 2014 PRB report compares the financials of Texas' 93 monitored plans in 2000 and 2013. The report finds that in 2000 roughly 46%, or 43 of the 93 plans, had amortization periods at or above 25 years. By 2013, however, that figure had grown to 65%, or 60 of the 93 plans.

In 2015, TRS, the state's largest pension fund, had unfunded obligations totaling $33 billion, or $22,592 per member, and ERS, the second largest fund, had unfunded liabilities totaling $8 billion, or $32,126 per member. Assuming an overpromised 8% annual rate of return, the actuarial funded ratio for TRS is 80% and ERS is 76%, meaning that these are at or below the 80% threshold considered actuarially sound.

State pensioners have also been aging as baby boomers continue to retire leaving fewer contributors paying for more beneficiaries. According to the State Budget Crisis Task Force, the ratio nationwide of active public employees to retirees has fallen from 7-to-1 in 1950 to less than 2-to-1 today, putting more pressure on pension investment losses. A similar decline burdens Texas' pensions.

Lower rates of return and an aging population make pension reform in Texas vital. Modifications like those passed in 2013 and 2015 have bought some time for the plans, but these adjustments do little to change the long-term cost trajectory. Much more substantive changes are needed to retain solvency.

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Moving Texas' public pension systems away from the defined benefit system and into a defined contribution model would restore sustainability in the system, benefitting both the taxpayers and state employees. Defined contribution plans put the power of an individual's future in their own hands instead of depending on the uncertain fortune of government-directed defined benefit plans.

The Facts

- The state's two major retirement systems, TRS and ERS, are at or below the adequate actuarial funded ratio of 80%.
- Texas' retirement system is legally liable to pay defined benefits totaling 10 to 20 times what state employees paid into the system—if investing returns drop or benefits are increased, taxpayers would be on the hook for the added exposure.
- Defined contribution systems are more sustainable than defined benefit plans since they are, by definition, fully-funded, which is why the private sector is moving in this direction.

Recommendations

- Freeze enrollment in the current defined benefit system and enroll newly hired or unvested employees in a 401(k)-style defined contribution pension plan.
- Implement either a hard or soft freeze of the system for vested employees.
- Replace current employee health care plans with Health Savings Accounts.

Resources

"A Solution to Our Public Pension Problem" by Vance Ginn and James Quintero, *Forbes* (May 2, 2016).

Now is the Time for Pension Reform by Sarah Curry, State Budget Solutions (Aug. 2015).

Keeping the Promise: State Solutions for Government Pension Reform by Senator Dan Liljenquist, American Legislative Exchange Council (Sept. 2013).

Reforming Texas' State and Local Pension Systems for the 21st Century by Arduin, Laffer & Moore Econometrics, Texas Public Policy Foundation (April 2011).

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Sales Tax Reduction Fund

The Issue

The 2016-17 state budget of $209.1 billion funds education, health care, and all other areas of the budget. This budget is up 68.5% since the 2004-05 budget. However, the key measure of estimated compounded population growth plus inflation is up only 51% in that period. Had the budget followed this key measure since the 2004-05 budget, Texans would be paying $22 billion less in taxes and achieving greater prosperity.

Fortunately, the 2015 Legislature passed a budget that increased by 2.9% above the previous biennium's spending level, which was less than this key measure, but there is much more work to do. One way to continue correcting past excesses is to cut ineffective budget items.

While members attempt to reduce the amount of spending on specific programs by offering budget amendments in the appropriations process, this normally does not lead to an overall reduction in spending. Such amendments simply set aside the money cut from one program and make it available for members to appropriate for other purposes, which interested parties earnestly seek.

To resolve the incentive to spend every available dollar, a mechanism should be created that allows dollars cut from one area of the budget to be transferred to a special fund that allows legislators to actually reduce the bottom line of the budget. Dollars in the fund would accumulate until the appropriations bill is adopted. The Texas Comptroller would then determine the rate decrease and temporary period of reducing the broadest based and easiest to administer state tax (sales tax) such that the Fund is depleted. After the determined period, the tax rate would automatically revert to its original level.

The broadest, most visible, and easiest to administer tax in Texas is the state's sales tax. Therefore, this mechanism is called the Sales Tax Reduction (STaR) Fund. The many influential members of the American Legislative Exchange Council's Tax and Fiscal Policy Task Force passed a version of it last year as model legislation. A summary of the Tax Reduction Fund language follows:

> *"The Tax Reduction Fund is a special fund that consists of money transferred to it by the legislature and any interest earned on money in the fund that can be used to temporarily reduce a state's tax rate. The goal of the Tax Reduction Fund is to lower the bottom line of the budget by transferring funds that may be available in the budget that would otherwise be spent and returning those dollars to taxpayers by reducing the broadest state tax."*

After the STaR Fund is created, it could be funded by: 1) Legislators appropriating dollars that are from a budget surplus or saved dollars from less spending on state programs; and 2) Funds in excess of the Economic Stabilization Fund's (ESF) cap may flow directly into it rather than back into general revenue.

For the 2016-17 biennium, the Texas Comptroller calculates an ESF cap of $16.2 billion. Although the balance will likely fall below the cap at roughly $10.4 billion by the end of fiscal 2017, the cap could be reached in the near future.

With the potential of a tight budget next session, legislators will be challenged with scrutinizing every dollar in the state's budget to restrain the size and scope of government. Instead of spending these excess funds, a better choice is to restrain government spending and provide sales tax relief; however, the difficulty for legislators to attempt to do this starts in the appropriations process.

A valuable way to reduce spending levels through the appropriations process is to include taxpayers as one of the funding constituents. With excess past spending and a rising amount available in the ESF, a priority must be to reduce the bottom line of the budget such that the good tax climate that has resulted in great economic prosperity in Texas will continue.

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The Facts

- The current appropriations process, in the House, does not allow for funds cut on programs to reduce the bottom line of the budget. Instead, these funds are available to be appropriated on other programs.
- The Texas Comptroller projects that the ESF will be roughly $10.4 billion by the end of 2017, reaching towards the cap of $16.2 billion, and could reach it in the near future.
- By including taxpayers as a funding constituent, more funds available by reducing the bottom line of the budget can be used to provide tax relief.

Recommendations

- Create the STaR Fund in 2017 to provide a means in 2019 and beyond for reducing the bottom line of the budget while returning those dollars to the taxpayers by temporarily reducing the state's sales tax rate.
- By appropriating dollars that were earmarked for budget growth directly into the STaR Fund along with excess dollars in the ESF to provide a temporary reduction in the state's sales tax rate, legislators can restrain the growth of government.

Resources

Tax Reduction Fund—Model Legislation, American Legislative Exchange Council (Sept. 2015).

Protecting Texas Taxpayers: the Sales Tax Relief Fund by Talmadge Heflin and Vance Ginn, Texas Public Policy Foundation (April 2014).

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State Debt

The Issue

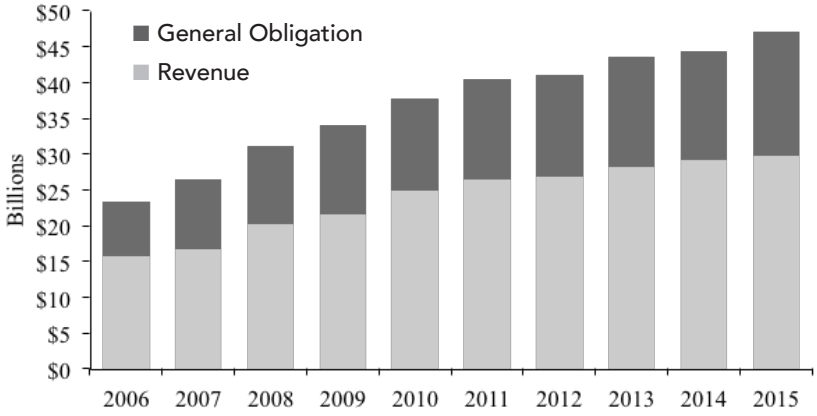
Contrary to the massive budget deficits the federal government is able to accumulate, the Texas Constitution forces state legislators to be more frugal by adopting a balanced budget. Though legislators cannot spend more than expected revenue, they can issue debt through voter-approved bond proposals for items like transportation projects, cancer research grants, and other initiatives.

Since all debt must be repaid from either the general revenue (GR) fund or specific revenue sources, more state debt results in burdening Texans with higher taxes. While new debt for these initiatives may be deemed necessary, legislators should limit increasing debt and make the cost more transparent so that Texans understand the burden on current and future generations.

In the past, the Texas Comptroller's office has taken beneficial steps in this direction by providing valuable information on the its website texastransparency.org. However, legislators should do more by passing legislation making it mandatory to include not only the principal cost of debt (debt outstanding) but also the total cost with interest payments (debt service outstanding).

From fiscal years 2006 to 2015, the chart shows that total state debt outstanding increased by an astounding 102% to $47.1 billion, according to the Texas Bond Review Board. This translates into an increase of 53% to about $1,700 owed by every man, woman, and child in the Lone Star State. Of the total state debt outstanding, there are two types: general obligation (GO) debt and non-general obligation debt—also known as revenue debt.

Texas State Debt Outstanding for Fiscal Years 2006 to 2015



Source: Texas Bond Review Board

As defined by the Comptroller, general obligation debt "is legally secured by a constitutional pledge of the first monies coming into the State Treasury that are not constitutionally dedicated for another purpose" and "must be approved by a two-thirds vote of both houses of the legislature and a majority of Texas voters." This debt may be issued in installments as determined by the legislatively appropriated debt service or by the issuing agency or institution and often has a 20 to 30 year maturity with level principal or level debt-service payments. Over the last decade, general obligation debt has increased by 130% to $17.3 billion.

Also noted by the Comptroller, revenue debt "includes debt that is secured by a specific revenue source and some lease purchase obligations. Generally, non-general obligation debt does not require voter approval and is not considered 'debt' limited by the Texas Constitution." Revenue debt has increased by 88.7% to $29.8 billion during the last decade.

If these trends continue, Texans will be burdened with even higher taxes and fees. A good metric of the state debt burden on each Texan is debt-per-capita. Using the latest ranking available for state debt per capita in 2013 by the Tax Foundation, Texas had the sixth lowest state debt per capita burden. Of the top five most populous states, the three most debt-ridden states are New York, Illinois, and California, which all tend to enact liberal policies.

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As a percentage of unrestricted general revenue for the previous three years, the constitutional debt limit (CDL) for debt service payable is 5%. The Texas Bond Review Board shows that debt service on outstanding debt is 1.38% and debt service on outstanding debt and on authorized but unissued debt is 2.65%, which both fall below the CDL at the end of 2015.

This relatively good management of state debt provided Texas' AAA rating from all three major rating agencies since 2013. Although things look good on the surface, debt service will cut into spending on other programs and may lead to even higher taxes on Texans, slowing economic growth and individual prosperity.

Unfortunately, debt outstanding does not tell the whole story. While Texas has done relatively well managing its debt principal, debt service outstanding over the life of debt outstanding is substantially higher than the $47.1 billion. The Texas Bond Review Board notes that total debt service outstanding is $77 billion—63% more than the reported principal amount.

A grey area regarding debt is tuition revenue bonds (TRB). TRBs are obligations of the university systems that issue them and do not count against the state's debt limit because tuition revenue is pledged to service them. However, the Legislature has a practice of servicing them with general revenue. Over the next five years, Texas' state government is expected to spend nearly $1.4 billion in general revenue funds on debt service for the most recent round of TRBs, according to the Legislative Budget Board. With such a large sum of taxpayer dollars going to support these bonds through general revenue, the following question needs to be addressed: Should they be classified as general obligation bonds and require Texas voters to approve them?

By controlling spending, prioritizing debt payments, and increasing debt transparency, Texans can have a better sense of whether state lawmakers are being good stewards of their tax dollars.

The Facts

- From FY 2006 to 2015, total state debt outstanding increased by 102% to $47.1 billion.
- Total debt outstanding per capita in Texas increased over the last decade by 53% to about $1,700 per person.
- The Bond Review Board notes that total debt service outstanding, which includes principal and interest owed, is $77 billion, or roughly $2,800 per Texan.

Recommendations

- Scrutinize all budget areas by implementing zero-based budgeting because excessive spending may result in more debt.
- Prioritize debt to consider in which order it should be paid if given the opportunity for early retirement.
- Pass legislation that provides ballot box transparency by making it mandatory to include not only the total principal cost of debt but also the total cost with interest payments and how taxes will be affected.

Resources

$15,000 Owed by Every Texan for State and Local Debt by Vance Ginn and Kiara Pillay, Texas Public Policy Foundation (April 2016).

Overview of State Debt and Other Liabilities, Legislative Budget Board (March 2016).

Debt Affordability Study, Texas Bond Review Board (Feb. 2016).

Debt at a Glance, Texas Comptroller of Public Accounts (Sept. 2013).

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Tax and Expenditure Limit

The Issue

Texas has done better economically and fiscally than most states during the past 15 years. However, one area that still needs improvement is consistently controlling the state's budget growth. Since all government spending must ultimately be paid for by taxation, limiting budget increases is essential for a competitive economy that supports prosperity.

The 2016-17 total budget of $209.1 billion is up 68.5% since the 2004-05 budget. Comparatively, the key metric of population growth plus inflation compounded over time is up an estimated 51% during this period. Adjusting the total budget for this key metric shows that total budget growth is up 11.8% above the pace of compounded population growth plus inflation since the 2004-05 budget. This excessive increase has burdened Texans with higher taxes and fees to sustain elevated spending levels and slowed economic growth.

While historically the Legislature has occasionally passed conservative budgets that increase by no more than this key metric, Texas needs to keep past costly budget cycles from repeating. This can be accomplished by passing a stronger statutory spending limit whereby the current weak limit can be traced back to three design flaws:

- **The current limit covers less than half of the budget.** In Article VIII, Section 22(a) of the Texas Constitution, the only appropriations subject to the spending limit are those derived from "state tax revenues not dedicated by this constitution," which is about 45% of the 2016-17 total budget. By not capping more than half of the budget, legislators are left with perverse incentives to move money outside the cap by dedicating funds and resort to accounting gimmicks.
- **The current measure is not a reliable indicator for the budget's growth rate.** The Texas Constitution requires that the limit be based on the growth in the state's economy—statutorily identified as personal income growth. Research finds that this measure's instability leads to costly fiscal volatility and uncertainty.
- **The budget limit relies on a projected measure of economic growth.** Since several groups submit estimates of personal income growth to the Legislative Budget Board in November before a regular legislative session for the next two fiscal years (i.e., each fiscal year is from September 1 to August 31), the projections are for about 33 months. The difficulty of accurately predicting this growth rate leads to large discrepancies between actual and projected growth rates that are never corrected later.

The Facts

- Texas' total state budget growth is up an estimated 11.8% above the pace of compounded population growth plus inflation since the 2004-05 budget.
- Solving the state's budgeting difficulties will require bold leadership guided by a principled approach, similar to that outlined in the Real Texas Budget.
- The current spending limit is weak because it excludes a majority of the budget, is based on the estimated growth of future personal income, and can be avoided rather easily by lawmakers.

Recommendations

- Pass a conservative spending limit that makes the following statute changes to Section 316 of the Government Code:
  - Apply the limit to Texas' total government budget.

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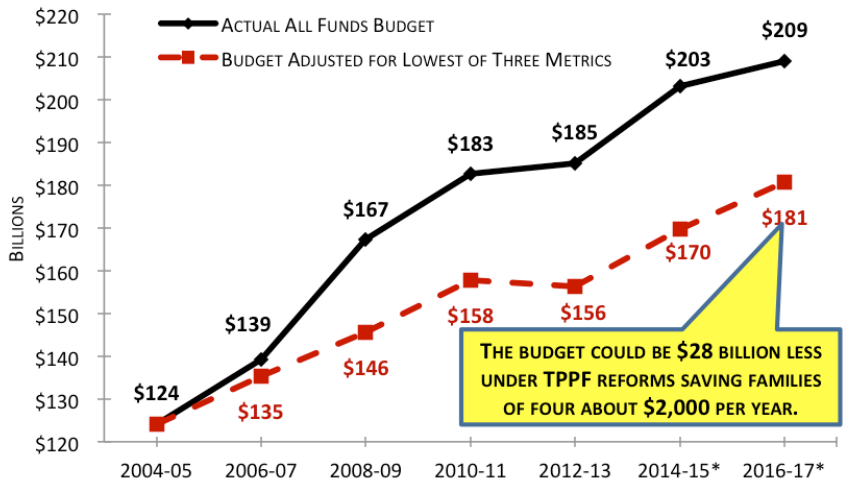
- Base the limit on the lowest growth rate of the Census Bureau's measure of state population plus the Bureau of Labor Statistics' measure of inflation for the consumer price index for all items, the Bureau of Economic Analysis' measure of total state personal income, or the Bureau of Economic Analysis' measure of total gross state product for the two fiscal years immediately preceding a regular legislative session when the budget is adopted.

- Put a constitutional amendment on the ballot to change Article VIII, Section 22(a), such that a supermajority vote of two-thirds in each chamber instead of a simple majority is required to exceed the spending limit.

The chart below presents the budget adjusted for these growth rates to consider what the budget would look like if the Legislature had implemented our recommended reforms in 2003 and followed them since the 2004-05 budget.

Texas' Government Budget Growing Faster Than Reformed TEL Since 2004-05



Notes: Budget data are the latest spending measures from 2004-05 to 2014-15 and appropriations for 2016-17. Adjusted budget estimates are calculated based on TPPF's recommended TEL reform.

Resources

The Real Texas Budget: Why Texas Needs to Ratchet Down Spending Growth by Talmadge Heflin, Bill Peacock, and Vance Ginn, Texas Public Policy Foundation (June 2016).

TEL It Like It Is: Why Texas Needs Spending Limit Reform by Talmadge Heflin and Vance Ginn, Texas Public Policy Foundation (Dec. 2015).

A Labor Market Comparison: Why the Texas Model Supports Prosperity by Vance Ginn, Texas Public Policy Foundation (Oct. 2015).

Reforming Texas' Tax and Expenditure Limit by Talmadge Heflin and Vance Ginn, Texas Public Policy Foundation (Jan. 2015).

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Transparency and Budgeting

The Issue

It is critical for legislators to appropriately account for spent tax dollars, eliminate state budget inefficiencies, and prove why each agency and program are necessary for Texas taxpayers to fund an efficient, limited government.

Today, the General Appropriations Act (GAA), the bill creating the state budget, is laid out using a strategy-based budgeting format that is almost impossible to track programs in the budget. To determine fiscal prudence by each agency, program-level specifics are necessary. The budget should be written with each agency's revenue and expense listed by program, as well as listing the revenue source next to each line item. Changing to a program-based budgeting format would simplify the process for the average taxpayer, leading to more transparency and a greater chance for weeding out inefficiencies. This would help hold the Legislature accountable for its budget practices and help educate and empower taxpayers in the process.

The budget should be available online in as close to real time as possible during the legislative process. Fortunately, the Legislative Budget Board (LBB) took steps to create an online application on their website after the 83rd Legislature that displays the state budget by program. Taxpayers can now search for program-level spending information, a short explanation of the program, and its statutory authorization. This application is a good first step, but currently the information provided is only informational and not frequently updated, particularly as the GAA moves through the legislative process.

Another issue is the current budgeting approach too often assumes that all previous expenditures are justified and necessary. Legislators then simply add automatic spending increases on the previous budget. This budget inertia is highly inefficient. A helpful tool to improve efficiency and increase budget transparency would be to implement zero-based budgeting.

Zero-based budgeting is a complete review of each agency's budget starting from scratch to determine the necessity of programs. This method requires an in-depth analysis that takes much time and effort, but it is well worth the cost to increase budget transparency and help legislators exercise greater budget-writing control.

In 2003, Texas faced a projected $10 billion shortfall. Governor Rick Perry sent the Legislature a budget with zeros next to each agency's line item and publicly stated that he would be against any budget that included a tax increase. The Legislature was asked to do the hard work of taking a detailed examination at what had become traditional spending patterns. Ultimately, the Legislature bridged the $10 billion budget shortfall by using a zero-based budgeting approach to eliminate inefficiencies within each agency and avoid raising taxes.

Essential to successfully performing zero-based budgeting is a review of all aspects of an agency or program, including its purpose, goals, and determined metrics to gauge success. Done correctly and often, zero-based budgeting would help restrain budget growth and therefore the government's footprint so taxes and fees can be lower than otherwise.

The Facts

- The current strategy-based budgeting format, which links appropriations to strategies and goals rather than programs, obscures government agency budgets.
- The LBB increased budget transparency by developing an online application offering the state budget by program after the 83rd Legislative Session.

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- Zero-based budgeting is a more thorough budget analysis than the current approach, making it a time-consuming process. However, the method holds promise as demonstrated in 2003 when Texas legislators, faced with a $10 billion budget shortfall, balanced the state budget without a tax increase.

Recommendations

- Convert from the current strategic-based budgeting format to a program-based budgeting format, as proposed in SB 827 during the 84th Legislature.
- Post budget information online throughout the budget process so that it will be available to Texans and legislators in near real time.
- Adopt zero-based budgeting for a portion of the budget each biennium to ensure taxpayers get the most value of the programs and agencies they fund, as proposed in HB 459 during the 84th Legislature.
- Lawmakers may consider applying this zero-based budgeting to about one-third of the budget every biennium so that each portion is reviewed every third biennium. For example, education in one biennium, health and welfare in the next, and then all other budget items.

Resources

The Real Texas Budget: Why Texas Needs to Ratchet Down Spending Growth by Talmadge Heflin, Bill Peacock, and Vance Ginn, Texas Public Policy Foundation (June 2016).

Testimony before the Senate Committee on Government Organization on Budget Transparency by Talmadge Heflin, Texas Public Policy Foundation (June 2014).

Testimony before the House Committee on Appropriations Subcommittee on Budget Transparency and Reform Regarding House Bill 98 by Talmadge Heflin, Texas Public Policy Foundation (April 2013).

Using Zero-Based Budgeting in Texas by Chuck DeVore, Texas Public Policy Foundation (May 2012).

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Transportation

The Issue

Years of rapid economic growth and a population growing at about double the national rate present Texas with infrastructure challenges. Working to mitigate these strains, Americans have been driving fewer miles per capita since 2006, as the Internet brings shopping, entertainment, and personal communications into homes.

The chart below shows that lawmakers boosted funding for the Texas Department of Transportation (TxDOT) over two sessions in 2013 and 2015. Proposition 1 resulted in $1.7 billion being allocated for transportation in 2015. However, due to lower oil and gas prices, Proposition 1 transfers are likely to be more modest than forecast. Proposition 7 amended the Texas Constitution to allocate revenue to the State Highway Fund from state sales taxes starting in 2018 and a portion of motor vehicle sales taxes in 2020. Further, some $1.3 billion in diversions out of the Fund 6 account for non-transportation purposes was ended in the 2016-17 budget.

House Bill 20 in 2015 contained several reforms of note. The most notable was requiring the Texas Transportation Commission (TTC) to implement performance-based planning to: generate metrics for the executive and legislative branches to measure performance; and prioritize projects using objective criteria. But the TTC was given wide latitude to ignore its project ranking criteria by allowing for discretionary funding decisions up to 10% of TxDOT's biennial budget. Since new project starts make up less than half of the overall TxDOT budget, granting 10% discretionary authority allows the TTC to ignore much of its own ranking process by allocating about 25% of spending on new projects that did not make the prioritized project list.

Transportation Budget Summary

	2014-2015	2016-2017	2018-2019
Proposition 1	$1.7 billion	$2.0 billion (est.)	$2.0 billion (est.)
Proposition 7	N/A	N/A	$2.3 billion (est.)
Ending Diversions	N/A	$1.3 billion	Continued
Total TxDOT Funding	$19.5 billion (exp.)	$23.1 billion (est.)	$24.0 billion (est.)

Design-Build Contracting

Design-build differs from traditional design-bid-build contracting in that, in the former, a contractor is responsible for designing and building the project while in the latter, a different party, usually the government, designs the project and then bids it out to a contractor to build. Design-bid-build typically results in a longer, more expensive process. In the six-year period ending in 2014, TxDOT awarded five design-build contracts totaling $3.85 billion. This method of procurement is estimated to have saved Texas taxpayers some $1.08 billion, or 22% of the total spent.

Further, according to a federal study, the national average time savings for project completion in a design-build contract versus a design-bid-build contract is approximately 14%. For example, the DFW Connector Project used design-build, shaving 28 months off the expected timeline versus the traditional bidding process. This saved $43 million in construction inflation while allowing 180,000 cars to use the DFW Connector earlier than they otherwise would have, saving about $60 million in commuter costs.

House Bill 20 raised the threshold of value for design-build contracts from $50 million to $150 million. Further, a design-build contract may not extend a maintenance agreement as part of the award for a term of longer than five years. This has the unintended consequence of discouraging designs and construction techniques that may cost more on the front-end and considerably less in maintenance costs on the back end—roads and bridges typically cost more to maintain over their lifetimes than to build in the first place.

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The Facts

- Texas restricts money and time saving design-build contracts to no more than three per year and no less than $150 million. Other large states do not have parallel restrictions.
- Per capita miles driven has been flat since 2006 and, when combined with increasing fuel efficiency, alternative-fueled vehicles, and inflation, this means the fuel tax becomes less capable of funding transportation, placing a greater reliance on other revenue sources.

Recommendations

- Remove limitations on design-build contracting by striking the yearly limit of three, eliminating the minimum size of $150 million, and striking the requirement for designs to be 30% complete before going out to bid.
- Remove the disincentives to propose long-lasting designs and construction techniques by allowing contractors to assume responsibility for maintenance beyond the current five-year limitation as part of the initial contract award.
- Additional spending on transportation, if any, should be included within Texas' tax and expenditure limitation and not be in the form of dedicated funds that do not count toward the spending limit.

Resources

Texas Highway Funding Legislative Primer, Legislative Budget Board (April 2016).

Texas Department of Transportation Annual Financial Report, FY 2015, Texas Department of Transportation (Dec. 2015).

The Road Forward: Improving Efficiency in Texas Transportation Spending by Chuck DeVore, Texas Public Policy Foundation (March 2015).

Texas Department of Transportation Annual Financial Report, FY 2014, Texas Department of Transportation (Dec. 2014).

Texas Public Policy Foundation

Spending

Legislator's Guide to the Issues 2017-18

Understanding Federal Funds

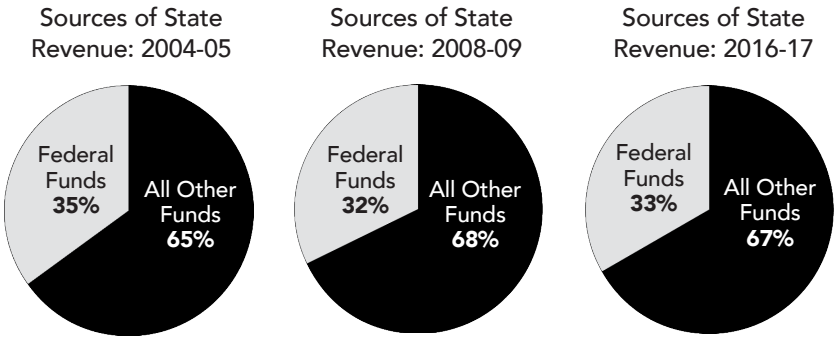
The Issue

Texas' dependency on federal funds, which includes grants, payments, and reimbursements from the federal government to state agencies, has remained around one-third of the budget during the past decade. This reliance threatens the state's financial stability and independence.

As a percentage of the 2016-17 budget, federal funds constitute approximately 33%, or $68 billion, of total appropriations. This is $726.2 million, or 1.1%, below federal aid for the 2014-15 budget.

Of the $68 billion in federal aid, Health and Human Services (Article II) was the biggest recipient with an estimated $43.2 billion, or almost two-thirds of the total. Appropriations supported by federal funds for general government functions (Article I) increased the most at 8% over the previous budget.

A valuable measure of state dependency on federal funds is the percentage of the budget from federal aid. The figures below show that federal aid went from 35% of the 2004-05 budget, declined to 32% in 2008-09, and then increased to its current share of 33%.



Source: Legislative Budget Board

This one percentage point increase in the share of federal aid from just a few budget cycles ago further burdens state legislators with more red tape and less independence from the federal government and burdens Texans in the process. From 2000 to 2013, this share averaged 33.9% in the Lone Star State, which ranks Texas as the 13th highest share nationwide with the national average of 30.3% according to the Pew Charitable Trusts.

Federal dollars per Texan increased 26% from $1,965 in 2004-05 to $2,475 in 2016-17. It is one thing for taxpayers to fund legislation that is passed by state lawmakers, but it is another thing entirely when so many state functions are directed and funded by those in Washington, D.C.

As more federal aid makes legislators more dependent on national policies, these policies crowd out the ability for state lawmakers to enact legislation that affects Texans. Specifically, growing federal aid dependency drives more state spending as legislators try to maximize federal funds, handicaps state decisions as lawmakers focus on federally funded programs and lose control of the growth of the budget, and slows economic growth and job creation as private sector funds are redistributed.

As Milton Friedman said, "There is no such thing as a free lunch." The common misconception that federal aid is free is not true. There are ample examples of ways that the federal government controls the choices made by the state and threatens fiscal federalism in the process.

With massive federal budget deficits and the national debt exploding, Congress must find ways to slow spending. This change would likely affect how much states receive in federal aid. With one-third of Texas' total budget funded by federal aid, legislators could face a serious fiscal imbalance.

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As written in the U.S. Constitution, states should be able to act as independent and sovereign entities. With more federal aid funding the state's budget, legislators lose their independence to act responsibly for their constituents and all Texans lose in the process.

The Facts

- Federal funds constitute approximately 33%, or $68 billion, of the 2016-17 budget.
- Federal funds per person went from $1,965 in 2004-05 to $2,475 in 2016-17, a 26% increase, burdening all Texans.
- From 2000 to 2013, the federal funds share of the budget averaged 33.9% in Texas, ranking Texas as having the 13th highest federal share nationwide.

Recommendations

- Prepare for the next federal budget crisis by identifying and measuring the cost of the mandates attached to federal funds.
- Evaluate the economic and fiscal impacts of a rising share of federal funds when writing the budget and minimize any increase in federal aid or reduce it.
- Rising federal aid funding for transportation and other state-level projects suggest legislators should consider ways to return more state dollars to fund projects without strings attached.

Resources

The Real Texas Budget: Why Texas Needs to Ratchet Down Spending Growth by Talmadge Heflin, Bill Peacock, and Vance Ginn, Texas Public Policy Foundation (June 2016).

Which States Rely the Most on Federal Aid? by Liz Malm and Richard Borean, Tax Foundation (Jan. 2015).

Budget Driver: Federal Funds by Talmadge Heflin, Texas Public Policy Foundation (Feb. 2010).