



Budget Balancing Act: Health and Education Stretch Texas Resources

By Jason Saving

ABSTRACT: Texas legislators confront a key challenge: how to make much-needed investments in health, education and transportation without sacrificing the fiscal structure that has propelled the economy over the last few decades.

Just three years ago, following the Great Recession, Texas found itself in dire fiscal straits. Legislators convening to write the 2012–13 biennial budget were confronted with a shortfall exceeding \$20 billion.¹ They closed the gap, which amounted to 10 percent of their original spending plan, through a combination of spending reductions and revenue increases.

As a result, the 2012–13 budget fell in dollar terms—an unusual occurrence (*Chart 1*). The ensuing debate centered on the sources of Texas’ funding and how that money is spent. There were suggestions that education, health and transportation expenditures not be reduced—without fully taking into account what proportion of the budget they consume or whether it was even possible to undertake significant cuts without touching those areas.

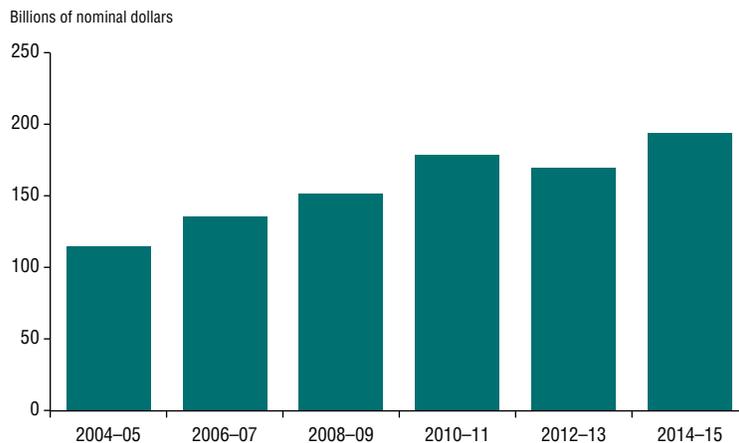
Others, looking at funding sources, noted that many of the taxes levied by

the state, such as on energy and alcohol, held up reasonably well during the difficult economic times. But, they wondered, are the taxes that remained reasonably strong during the recession representative of where the state gets most of its revenue?

At the midpoint of fiscal 2014, a steadily improving economy has substantially bolstered the state’s fiscal outlook.² Total spending reached a new high (though still lower than 2010–11 on a per capita basis) and state revenue has grown at a robust pace.

Revenue has risen faster in Texas than in most of its large-state counterparts—though less than in California, which is finally emerging from a much deeper recession than Texas experienced (*Chart 2*). Overall, the state’s 8 percent revenue growth is nearly double the 4.2 percent rate for the rest of the nation, underscoring that the Texas fiscal situation not only is improving but is doing so at a more rapid pace than in the rest of

Chart 1 Fiscal Pressures Caused Rare Decline in 2012–13 Budget



SOURCE: Texas Comptroller of Public Accounts.

the country.

Still, the recent uptick doesn't preclude that austerity may once again be required sometime in the future. Through good times and bad, legislators confront a key challenge: how to make much-needed investments in health, education and transportation infrastructure without sacrificing the lean and efficient fiscal structure that has helped the state's economy to outperform the nation over the last few decades.

Moreover, within the budgetary calculus, the sales tax is a particularly important revenue source, and education

and health services (together accounting for three-quarters of state spending) are key recipients whose size invariably makes them targets for spending cuts.

Tax Revenue Sources

The state imposes a variety of taxes and fees—including a cement production tax, a fireworks tax and a coastal protection tax—most of them unfamiliar to the average Texan. But not all state taxes are created equal; the sales tax is vastly larger than other levies (*Chart 3*).

The Limited Sales and Use Tax, introduced in 1961, imposed a 2 percent

levy on most retail purchases, although like today, there were exemptions for certain goods, such as groceries, whose taxation would disproportionately impact the poor. This was done in an effort to make the sales tax more progressive than it would otherwise be. The current statewide rate of 6.25 percent was authorized in 1990.

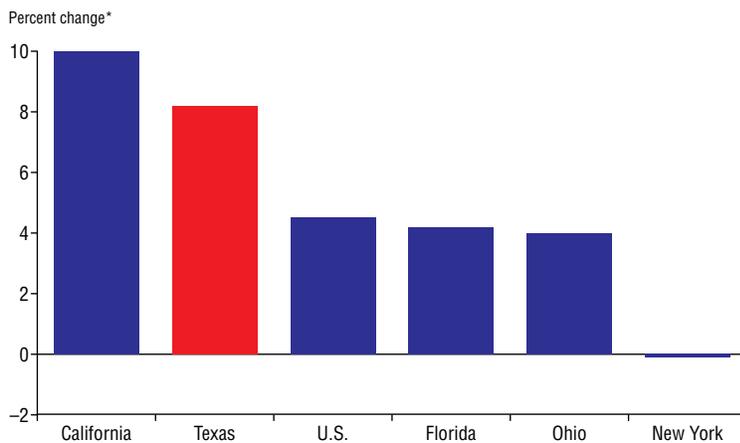
The sales tax accounted for 54.3 percent of all state tax revenue in 2013, the last year for which complete data are available (*Chart 4*). Over the last seven years, that proportion has changed only slightly, starting at 54.8 percent of revenue in 2007 and remaining within 3 percentage points since.

Economists generally find that people's consumption is more stable than their income from year to year. Income can fall to zero when someone is laid off, but food, clothing and shelter are still purchased. Thus, levies such as the income tax tend to swing dramatically with the business cycle, tumbling during downturns and recovering just as dramatically during recoveries.

The second-largest state tax revenue source is the franchise tax, a business assessment on gross receipts. The tax, a form of which dates back to the 19th century, is essentially a payment for the right to conduct business. Firms are taxed on their total revenue minus their wage or merchandise costs (whichever is greater) up to a maximum of 70 percent of their revenue. While initial discussions called for all but the smallest of businesses to be taxed, the current incarnation exempts the first \$1 million in revenue, which removes the bulk of enterprises from the reach of the franchise tax.

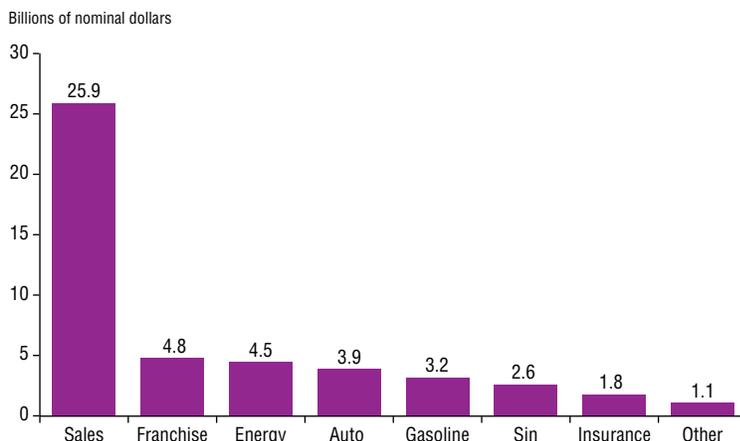
The franchise tax is commonly confused with a corporate income tax. But there is an important difference—firms that lose money can still owe franchise tax if their revenue is high enough, whereas a money-losing firm would not generally incur an income tax liability. Yet the franchise tax is also not a straight tax on revenue because of the deductions it allows for compensation or merchandise costs. The state Supreme Court has provided legal clarification about the franchise tax, ruling that it is not a corporate income tax despite certain similari-

Chart 2 Texas Revenue Growing Faster than National Average



*First half of FY2014 compared with first half of FY2013.
SOURCE: Rockefeller Institute.

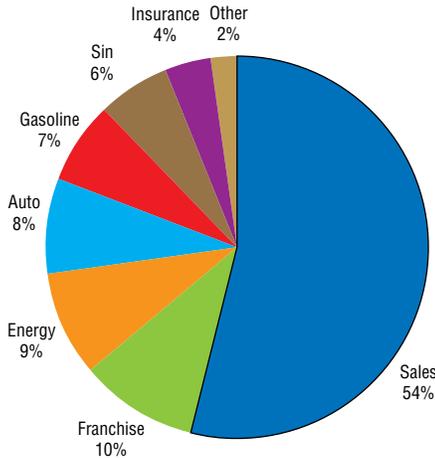
Chart 3 Sales Tax Top Source of Texas Tax Revenue



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

Chart 4

Sales Tax Larger Than All Other State Taxes Combined



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

ties—an important distinction in Texas, whose constitution bans individual and corporate income taxation.

The franchise tax accounted for 10.1 percent of state revenue—less than one-fifth the amount the sales tax provided in fiscal 2013. Franchise tax revenue has also exhibited volatility over time, falling to 8.5 percent of state revenue in 2007, though it has generally remained within a percentage point or two of its 2013 level.

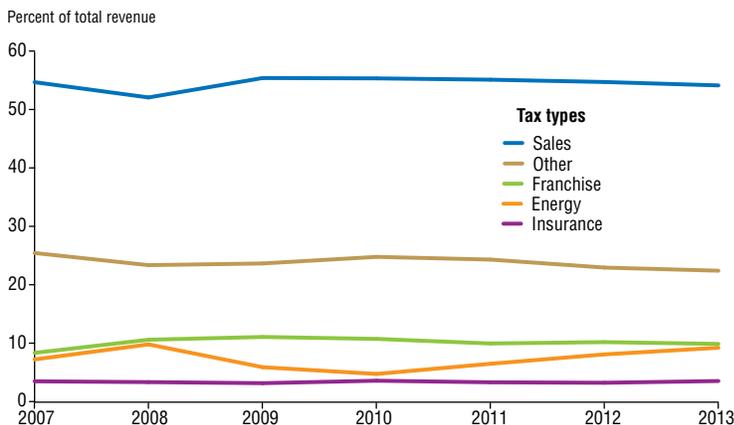
Next are the state’s energy taxes: a natural gas production tax and an oil production/regulation tax. Most striking is the degree to which these taxes swing

as economic conditions change. In the 2007–13 period, these levies ranged from a low of 4.9 percent of state tax revenue in 2010 to highs of 10 percent in 2008 and 9.4 percent in 2013 (*Chart 5*).

It isn’t surprising that oil and gas revenue would strengthen during a period of exceptionally strong energy production. However, the near doubling of its share of overall revenue illustrates the conundrum associated with narrow sectoral taxes: Revenue rises dramatically during good times for the sector but can fall just as dramatically, often when a state can least afford it. Even so, the contribution

Chart 5

Tax Trends Relatively Stable, Except for Energy



SOURCE: Texas Comptroller of Public Accounts.

of energy taxes to the state’s fiscal coffers remains modest.

Other state taxes include automobile taxes, the gasoline tax, “sin” taxes on alcohol and tobacco, insurance taxes and a grab bag of lesser levies such as the previously mentioned cement and fireworks taxes. These smaller sources collectively account for about one-quarter of state tax revenue.

Two other kinds of taxes provide no revenue for the state. The individual income tax—levied in 43 of the 50 states—has been banned in Texas since 1993 following a failed effort to introduce one. The second is the property tax, which school districts and other local government entities collect.³

Funding Education, Health Care

States provide many services for their residents, from operating state parks to staffing driver’s license offices. But the bulk of state spending in Texas—as in most other states—is devoted to health and education.

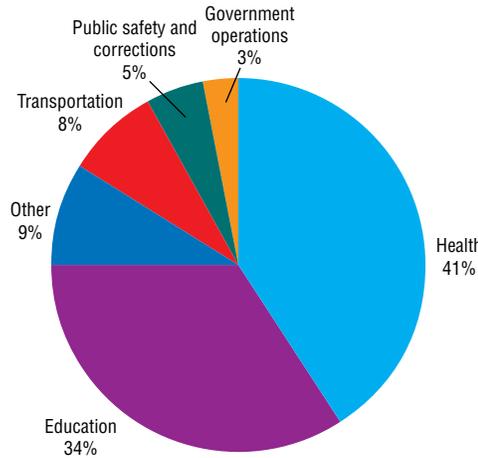
Health spending accounted for 41 percent of the state budget in fiscal 2013 (*Chart 6*). These expenditures flow primarily to Medicaid recipients, though they also include other programs such as the Children’s Health Insurance Program and some public hospital funding. Health outlays have expanded rapidly in recent years amid soaring medical costs and a state population growth rate that was double the nation’s. As late as 2007, health and education spending were roughly equal in Texas, but by 2013 health had grown 20 percent larger than education (*Chart 7*).

While health spending is a large and growing portion, Texas ranks last in the proportion of its residents with some form of health insurance coverage. To be sure, part of this stems from the state’s large undocumented population, which is more likely than citizens and legal residents to lack coverage. But part of it results from the exceptionally low income level at which Medicaid eligibility is cut off in Texas: just 20 percent of the federal poverty line, the second-lowest cutoff in the nation.

Education spending accounted for one-third (33.7 percent) of the state bud-

**Chart
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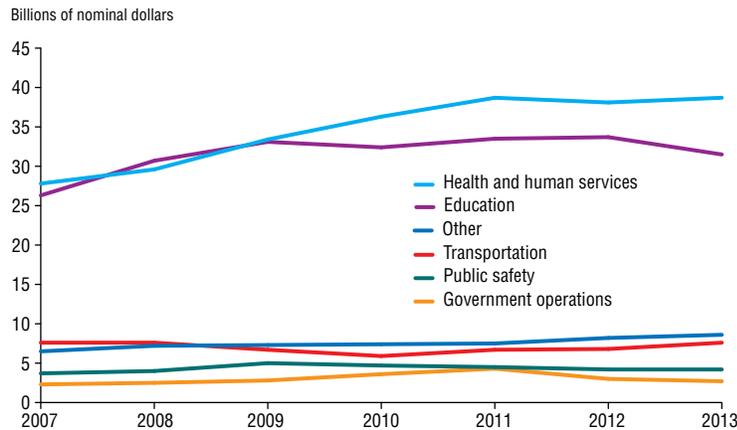
State Outlays Flow Mostly to Health and Education



NOTE: Data for 2013.
SOURCE: Texas Comptroller of Public Accounts.

**Chart
7**

Medicaid and Other Health Expenditures Make Up Largest Component of Budget



SOURCE: Texas Comptroller of Public Accounts.

get in fiscal 2013. This expenditure is split roughly evenly between K–12 education (which the state funds in conjunction with local school districts) and state colleges and universities.

Even with such a large share, Texas lags other states in per-capita education outlays. The National Education Association estimated that Texas ranked 46th among the 50 states in per student K–12 education spending in 2012–13.⁴ Yet educators were remarkably efficient using what they received, at least by some measures: Texas fourth-grade math test

results placed students 24th in the nation, with each ethnic group in the state outperforming its national peers on the exam.⁵

Transportation and infrastructure represents the third-largest Texas outlay, accounting for 8.1 percent of expenditures in 2013. This spending is primarily devoted to roads and bridges, which recently received a grade of C from the American Society of Civil Engineers—unexceptional though slightly above the national average of D+. An estimated \$4 billion per year in additional funding would

be needed to fully address infrastructure needs, implying any sustained rise in transportation spending would come at the expense of education or health care—areas where few believe existing needs are adequately met with current funding though they dominate the budget.⁶

Public safety and corrections—seen by many as the cornerstone of state government services—ranks fourth, at 4.6 percent of state expenditures. This broad category encompasses state law enforcement personnel, prisons and certain associated equipment and training.

Surprisingly, spending to operate the machinery of state government—the executive, legislative and judicial branches—collectively consumes only 2.9 percent of state expenditures. The remaining 9.3 percent is primarily devoted to employee benefits and natural resources and recreation, along with other smaller items.

Array of Additional Funds

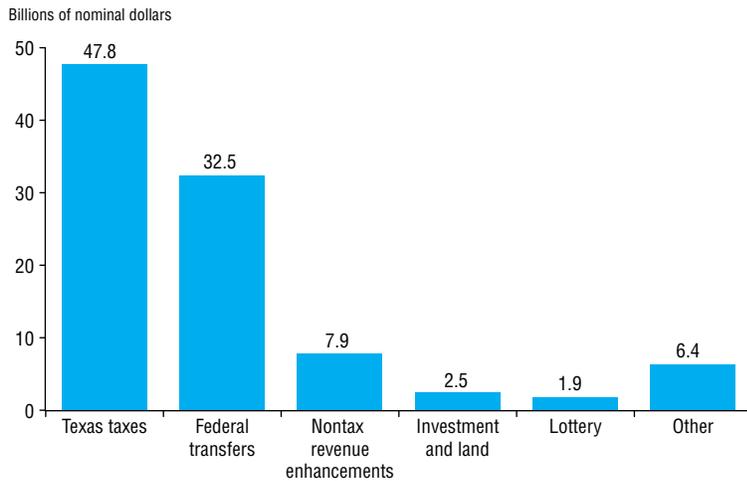
Texas collected \$47.8 billion in tax revenue in fiscal 2013. However, it spent \$93.6 billion during that period. An array of additional funds allows the state to comply with a balanced-budget requirement mandating estimated revenue equal projected expenditures.

Texas received a total \$99 billion, with the federal government contributing \$32.5 billion (*Chart 8*). The federal sum represented 32.8 percent of state revenue, exceeding the sales tax’s 26.1 percent and dwarfing the other taxes Texas imposes. The majority of the federal money is earmarked for health (65.3 percent), education (17.9 percent) and transportation (8.8 percent), though a small amount comes in the form of grants for a variety of purposes.

Another significant source is what legislators sometimes call “nontax revenue enhancements”—assessments that raise money for the state but aren’t officially considered taxes. This category covers more than 200 revenue sources, including marriage and sport licenses, driver’s licenses and any surcharges for point penalties from traffic law violations, coin-operated (gambling) machine licenses and bingo prize fees, exam fees for teachers and boaters, combative sport

Chart 8

Federal Transfers Are Key Revenue Source for Texas



NOTE: Data for 2013.

SOURCE: Texas Comptroller of Public Accounts.

licenses (for boxers and martial artists) and fees for the use of state parks. Nontax revenue enhancements collectively contributed \$7.9 billion to state revenue in 2013—about as much as the franchise and gasoline taxes combined.

Other revenue sources available to the state include interest and investment income, lottery proceeds and land income, as well as the sale of certain goods and services to localities or the public. Combining these with the other revenue sources yields the state's \$99 billion in receipts during fiscal 2013.

Future Funding Challenges

Texas has become the nation's second-largest state, with 26.5 million residents and annual economic output (state gross domestic product) of \$1.53 trillion. The state has a large and complex set of revenue and expenditure sources that need to be understood as future tax and spending decisions are made. While expenditures flow to many areas, education and health care consume 75 percent of the state budget.

Looking to the future, lawmakers must keep a watchful eye over challenges facing Texas' main revenue source—the sales tax. The growing presence of Internet commerce and ongoing issues over sales tax collections on these transactions could disproportionately impact sales-

tax-reliant states such as Texas. Additionally, Texas' relatively high sales tax rate might potentially divert commerce to other states.

Then there is Medicaid. With the state opting out of Medicaid expansion under the Affordable Care Act (ACA), approximately 1.2 million Texans who would have received coverage under that program are unable to obtain it. However, it is also worth noting that Congress and the president explicitly excluded undocumented immigrants—a key group among the Texas uninsured—from ACA coverage.

Thus, states with high proportions of undocumented residents could expect to continue experiencing higher levels of uninsured regardless of the degree to which they embrace ACA (though the levels of the uninsured would obviously be lower with ACA than without). Moreover, Texas finds itself stymied by federal law in its efforts to make Medicaid more cost-effective, for example by implementing modest copayments to discourage casual use of Medicaid services. Efficiency measures like this would not reduce uninsured rates but could slow Medicaid cost growth and lessen state fiscal pressures.

Texas' population expansion is also an important issue. Realizing a population growth rate that exceeds the national

average is, all things considered, a blessing rather than a curse. But it is unclear whether education funding will be sufficient to keep pace with future employer demands. Population growth can also strain other state services such as health care, transportation and infrastructure, and criminal justice. Failing to properly address these needs could result in a less productive workforce, which would slow the state's future growth rate.

Seldom pointed out in this context, however, is the role played by Texas' low-tax, lightly regulated business environment in helping the state annually grow about a percentage point faster than the nation over the last four decades. The challenge that state lawmakers will increasingly confront is how to address mounting health and education needs, possibly requiring additional revenue, without sacrificing the tax and regulatory attributes that have helped the state's economy consistently grow faster than the nation's.

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Notes

¹ The Texas Legislature convenes in January of each odd-numbered year to write a budget for the following two fiscal years. Thus, it will convene in January 2015 to write the 2016–17 budget.

² The Texas fiscal year begins on September 1, so the midpoint would be March 1.

³ Because education funding is a joint state/local responsibility in Texas, it should be noted that local school property tax developments can still influence state tax allocation decisions.

⁴ "Rankings and Estimates: Rankings of the States 2013 and Estimates of School Statistics 2014," by NEA Research, National Education Association, March 2014.

⁵ Overall secondary education graduation rates in Texas remain very low relative to the national average.

⁶ For more information, see "Texas Transportation Needs Summary," by the 2030 Committee of the Texas Transportation Commission, February 2009.