Center for Public Policy Priorities

The center is a 501(c)(3) non-partisan, non-profit policy research organization committed to improving public policies and private practices to better the economic and social conditions of low- and moderate-income Texans.

The center pursues this goal through independent research, policy analysis and development, public education, and technical assistance.

The Revised Texas Revenue Primer:
The Measure of Our Means

March 2003

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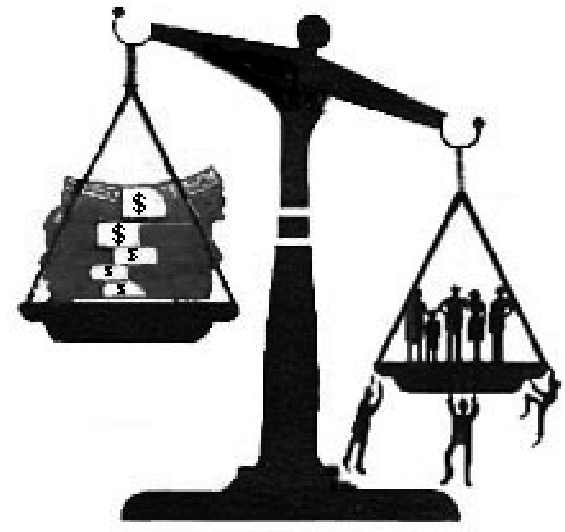

THE TEXAS REVENUE PRIMER

REVISED

The Measure of Our Means

March 2003

Center for Public Policy Priorities

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Foreword

Texans need to put more money into state government. Our state has a budget shortfall close to $15.6 billion, meaning it needs that much money on top of the comptroller's revenue estimate to do for the growing number of Texans next biennium what it did this biennium. This primer discusses ways to raise this money.

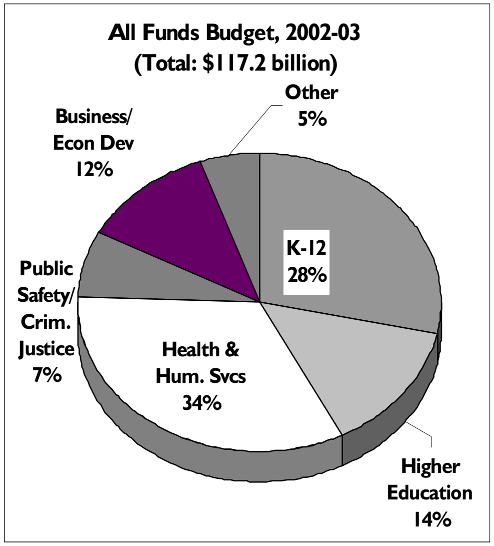
The state is short money partly because the economic downturn has slowed tax collections. The problem, however, goes beyond the economic downturn. Texas has a "structural deficit," meaning that because of what the state taxes, revenue is shrinking in relation to the economy, rather than growing with the economy. It is as if Texans make their money on the increasing sales of computer services, while running their state government with a tax on the declining sales of buggy whips. To eliminate this structural deficit, Texas must reform its tax system.

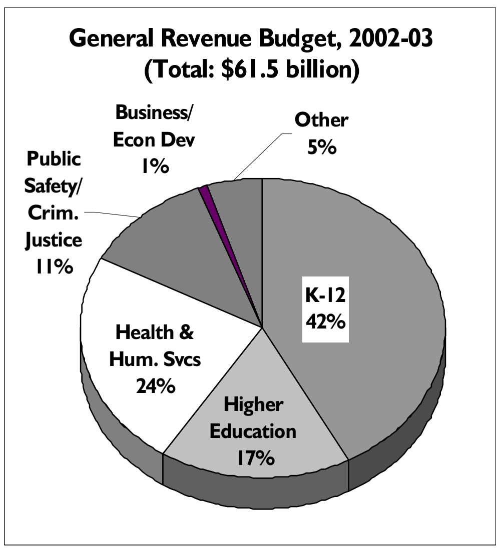
Texas also needs to reform its tax system to make it fairer. The state relies upon regressive taxes, meaning that the Texas tax system takes a much greater percentage of the income of low- and moderate-income families than of higher-income families. With the right mix of taxes, Texas could have a progressive tax system that both reflects and strengthens the Texas economy.

All but nine states include a broad-based personal income tax in their mix of taxes. In this primer, however, we do not discuss an income tax, because revenue from an income tax, which would require voter approval and time to implement, will not be available to fund the 2004-05 budget.

As the state budget is debated, it is important to recognize that the measure of our means is not the comptroller's revenue estimate, which is merely how much present tax laws would raise going forward, but is instead our collective wealth. The question then is how much of our collective wealth should we invest in Texas for our common good.

F. Scott McCown
Executive Director
Center for Public Policy Priorities





SOURCES: Legislative Budget Board, Legislative Budget Estimates for 2004-2005.

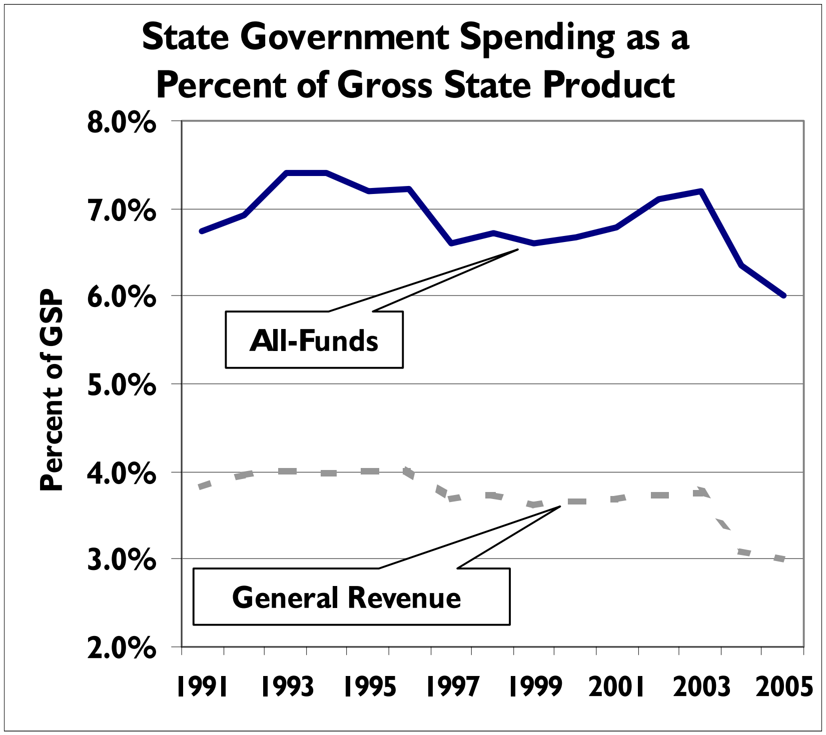
How Does the State Spend Its Money?

In 2002-03, Texas will spend just over $117 billion in total. The top chart shows the "all-funds" budget by major government function. "All-Funds" consists of $61.5 billion in General Revenue, $5.2 billion in General Revenue that is dedicated to certain programs, $37 billion in federal funds, and $13.4 billion in other dedicated revenue (such as State Highway Fund 6).

The bottom chart shows the state's General Revenue budget by major government function. **Public K-12** schools will receive 42¢ of every General Revenue dollar spent, and **higher education** will receive 17¢. **Health and human services** will account for 24¢ of every General Revenue dollar; a state dollar in this category more often than not draws down additional federal funds for Medicaid, the Children's Health Insurance Program, foster care, and other basic health and social services.

Public safety and criminal justice costs—primarily, the operation of state prisons for adult and youth offenders—take another 11¢ of every General Revenue dollar. **Business and economic development**, a significant part of the all-funds budget, receives hardly any General Revenue at all; most of the revenue in this area comes from federal and state highway money and federal employment, training, and child care grants. Other major uses of General Revenue include state employee health care and pensions.

The Legislative Budget Board estimates that 85% of General Revenue spending is controlled by the state constitution; federal or state law, regulations, and formulas; or court orders.



SOURCES: Legislative Budget Board, Legislative Budget Estimates for Fiscal 2004-2005; Staff Performance Report to the 78th Legislature; Comptroller of Public Accounts, Biennial Revenue Estimate, 2004-2005.

Is State Spending Too High or Too Low?

State Spending Growth

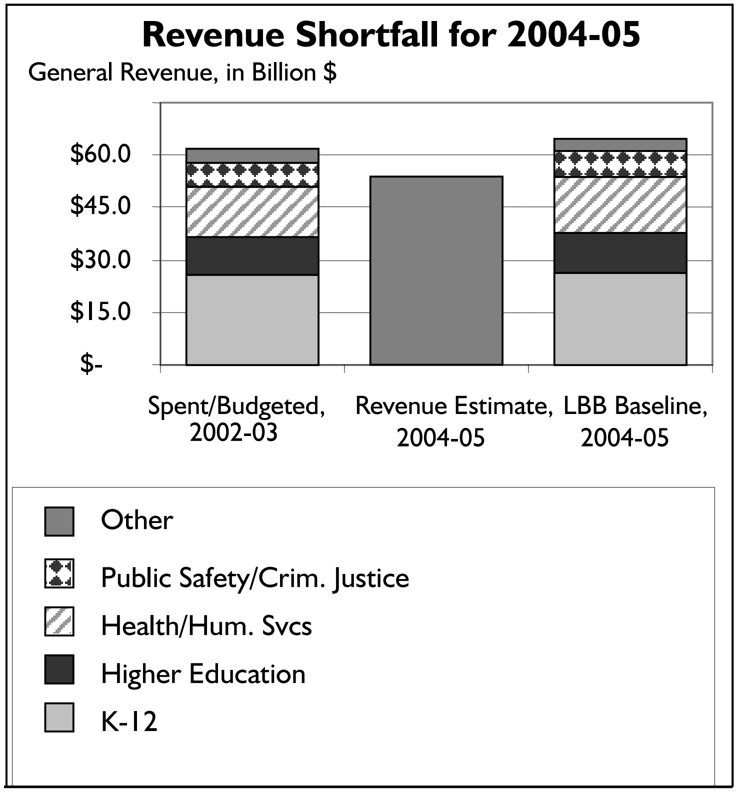
All-funds spending by Texas state government has been about 7% of the economy (as measured by Gross State Product) since 1991. Spending peaked in 1993-94 at 7.4% of GSP, fell slightly until 1997, and in 2000 began to grow again. By 2002, state spending was still not as big a part of the economy as it was in the early 1990s. General revenue spending has shown less fluctuation, averaging 4% through 1996, then dropping to about 3.7% through 2002. Data in the chart for years after 2002 are based on projections of revenue and spending by the Legislative Budget Board and Comptroller's office. If economic growth and spending are limited to amounts in the January 2003 revenue estimate, by 2005, total state spending will be only 6.0% of GSP. General Revenue spending will fall to 3.0% of GSP.

Another way to put state government spending growth in context is to adjust it for population growth and inflation, and to see which functions have grown the fastest. State government spending overall grew in adjusted terms by 2.8% annually on average in the 1990s, with the largest spending increases in public safety/criminal justice and natural resources. Since 1995, adjusted state spending has risen only 1.3% annually, with increases in education spending offset by cuts in spending by regulatory agencies, natural resources, health and human services, and public safety and criminal justice.

Comparisons to Other States

Information from the Census Bureau and the National Association of State Budget Officers consistently shows Texas at or near the bottom of the 50 states in state spending. In 2000, Texas ranked 50th in general per capita state spending and 49th in state taxes per capita. A decade ago, Texas ranked 50th in general per capita state spending and 46th in state taxes per capita. Per resident, all-funds state government spending in Texas is much lower than that of local governments or the federal government.

State aid per K-12 pupil rose in the late 1990s with a state-funded property tax homestead exemption increase and teacher pay raise, but has fallen again compared to other states, leaving a larger share of public school costs to be picked up by local property taxpayers. In the 2001-02 school year, state aid per K-12 student is only $3,186, putting Texas in 41st place nationally on this measure.



SOURCES: Legislative Budget Board, Legislative Budget Estimate; Comptroller of Public Accounts, Biennial Revenue Estimate

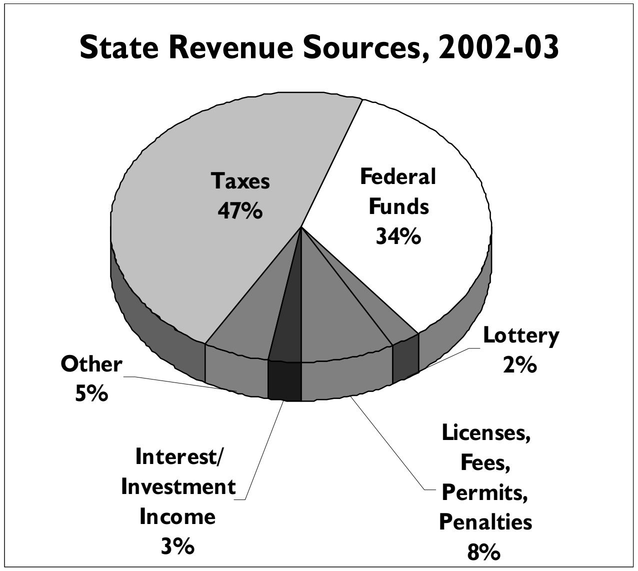
Without New Revenue, Can We Even "Tread Water"?

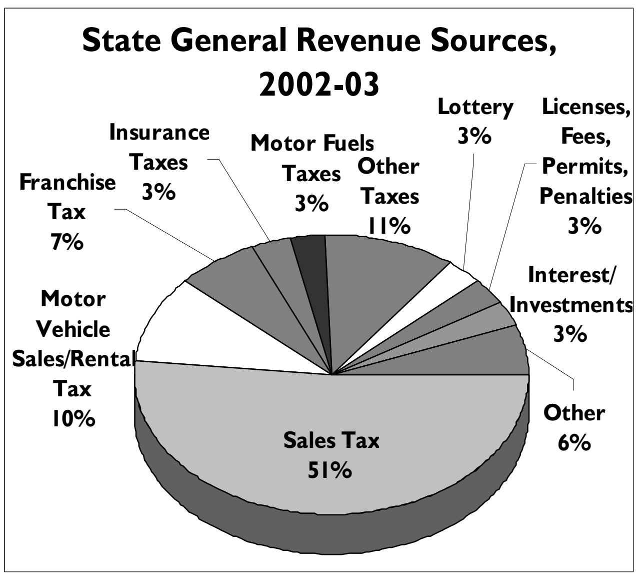
When the comptroller announced that the 2003 legislature would have only $54.1 billion in General Revenue for the next budget cycle, she also calculated that Texas faces a $9.9 billion shortfall for the 2004-2005 biennium. However, this shortfall estimate did not include funding for most of the growth in federally mandated programs, K-12 or university student enrollment increases and other population growth, or inflation in health care costs. It did include $1.25 billion for the new school district health insurance plan enacted in 2001, as well as $1.2 billion more needed for Medicaid shortfalls in 2003 and mandatory growth in the next budget cycle.

The Legislative Budget Board's 2004-05 Baseline Budget recommended a spending level of $64.6 billion in General Revenue, which results in a shortfall of $10.5 billion. The LBB budgets only $624 million in new GR for school district health insurance, but it does allow for a 7.5% annual increase in the cost of state employees' and teachers' health insurance plans. It has new funding for higher education enrollment growth, and for state debt service, but not for K-12 student growth (which costs another $1 billion).

CPPP's shortfall estimate of $15.6 billion is based on 2004-05 General Revenue spending of $69.7 billion, which would be enough to cover 2002-03 spending ($61.5 billion); pay for "current services" cost increases in health and human services ($2.6 billion) and the school district health plan ($1.25 billion); and adjust for population and inflation in all non-HHS programs ($4.3 billion).

Most of the 2002-03 General Revenue spending in the state budget is in the areas of education ($36 billion), health and human services ($14 billion), and prisons/public safety ($7 billion). Current state spending in these areas alone is $57 billion, which is more than the net amount of General Revenue projected to be available for the 2004-05 biennium. Some spending in these areas of the budget cannot be reduced without violating state or federal laws or constitutions.





SOURCES: Comptroller of Public Accounts,
Biennial Revenue Estimate, 2004-2005.

Where Does the State Get Its Money?

The top chart shows where the state gets its money. The bottom chart shows General Revenue sources only.

About 47% of all state revenue comes from taxes. Another 33% of state revenue comes from the federal government.

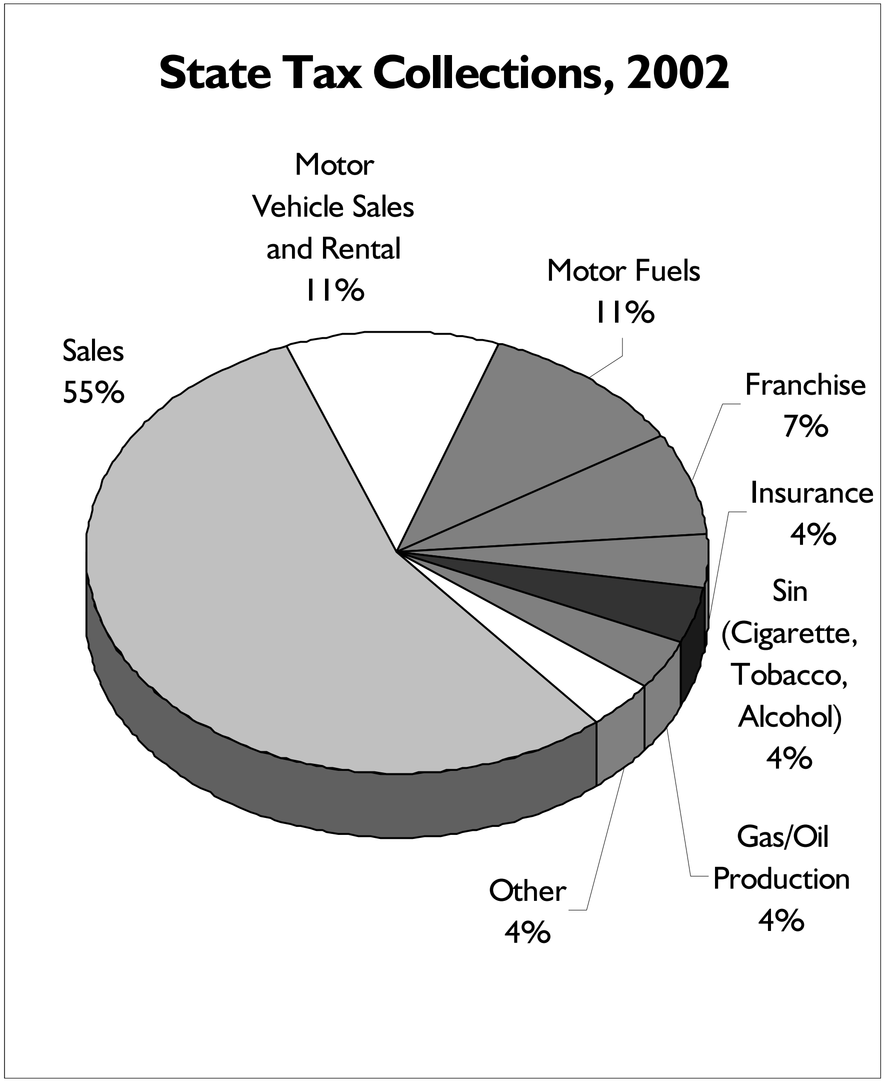
General Revenue spending is much more dependent on taxes, which make up 85 percent of all General Revenue funds.

The lottery generates only 2% of all state revenue. After subtracting for expenses, including prizes, however, in 2002 the lottery produced $820 million, down from $1.2 billion in 1997. This net amount pays for less than a week of public school each year.

According to the January 2003 Biennial Revenue Estimate, the state is expected to take in $111.0 billion from all sources in 2002-03. (The state budget for 2002-03 is $117.2 billion. The difference between the revenue estimate and the budget is mostly cash left over from 2001, which the state carried forward to fund the 2002-03 budget. The state will not have any cash left over from 2003 to fund 2004-05.)

General Revenue in 2002-03 is expected to total $56.3 billion.

For 2004-05, the comptroller estimates that $114.2 billion in total funds will be available. Net general revenue in 2004-05 will amount to only $54.1 billion.



SOURCES: Comptroller of Public Accounts, Annual Cash Report 2002.

What Taxes Does the State Collect?

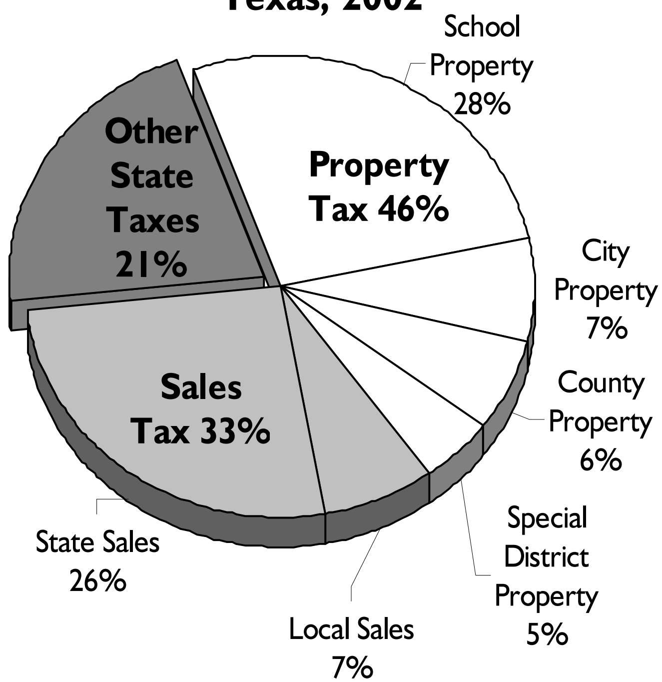
This chart looks at the 47% of state revenue that comes from taxes.

The state is heavily dependent on the sales tax, which supplied 55% of all state tax revenue in 2002. The sales tax has produced the majority of state tax revenue every year since 1988.

The motor-vehicle sales tax, which is technically a separate tax from the general sales tax, was the second largest source of state tax revenue in 2002. Starting in 2003, it is expected to rank in third place, behind the motor fuels taxes.

Sales taxes and other taxes linked to consumption—the motor-fuels taxes on gasoline and diesel, and "sin taxes" on cigarettes, tobacco, and alcohol—account for over 80% of state tax revenue.

Taxes initially paid by business, including the corporate franchise tax, the tax on insurance premiums, oil and gas production taxes, and other taxes, provide the rest of state tax collections.



SOURCES: Comptroller of Public Accounts, Annual Property Tax Report - Tax Year 2001; Annual Cash Report 2002.

What State and Local Taxes Do Texans Pay?

This chart looks at combined state and local taxes from the point of view of the taxpayer—what taxes does the average Texas family pay?

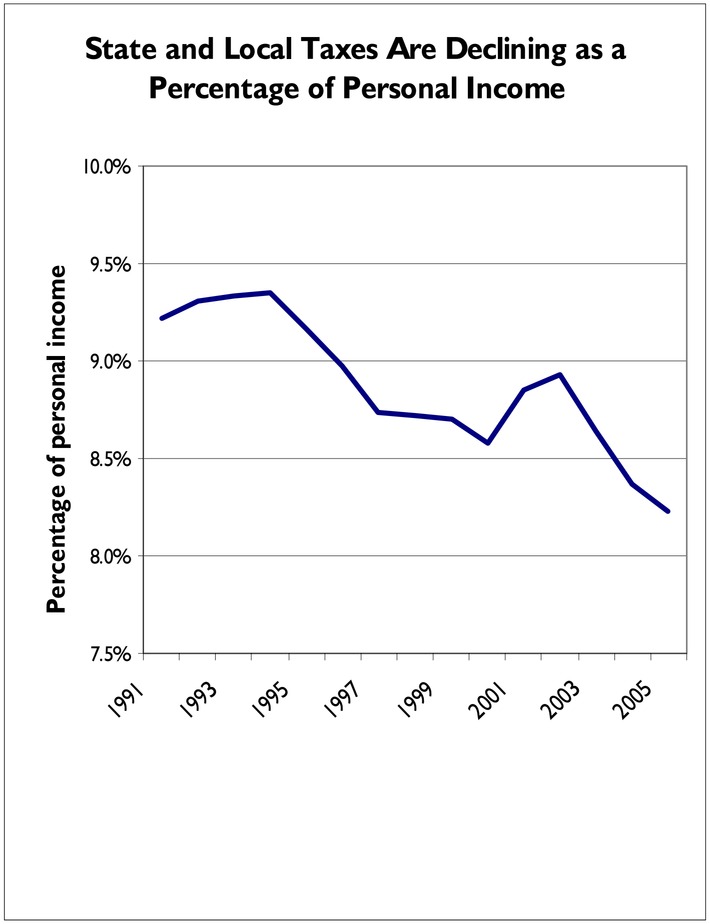
More than three-quarters of all state and local taxes paid by Texas taxpayers go to just two taxes—the property tax and the sales tax. The property tax is the largest tax paid by the average Texas family. About three-fifths of property taxes go to support local school districts; the rest goes to cities, counties, and special districts (e.g., community colleges, hospital districts, water districts).

The state sales tax of 6¼% accounts for most sales taxes collected. Cities, counties, transit authorities, and other local taxing units may levy a sales tax of up to another 2% combined, for a total maximum sales tax of 8¼%.

All other state taxes, including the motor-vehicle sales tax, corporate franchise tax, and taxes on gasoline, cigarettes, and alcohol, make up less than one-quarter of all state and local taxes paid in Texas.

Although Texas has a very low combined state and local tax burden, ranking 40th among the 50 states, it ranks 9th in sales tax per capita and 15th in property taxes per capita.

Looking at it another way: Texas has a very low state tax burden—49th of the 50 states in state taxes per capita. But Texas has a very high local tax burden because the state "pushes down" to the local level funding obligations such as public education. Texas ranks 15th in local taxes per capita.



SOURCES: Personal Income and State Taxes from Texas Comptroller of Public Accounts, Annual Cash Report, various years; Local Taxes from Texas Comptroller of Public Accounts, Annual Cash Report and Annual Property Tax Report, various years.

How Are State and Local Taxes Changing?

A major failing of the Texas state and local tax system is its inability to keep up with the growth of the state economy, thus creating a "structural deficit."

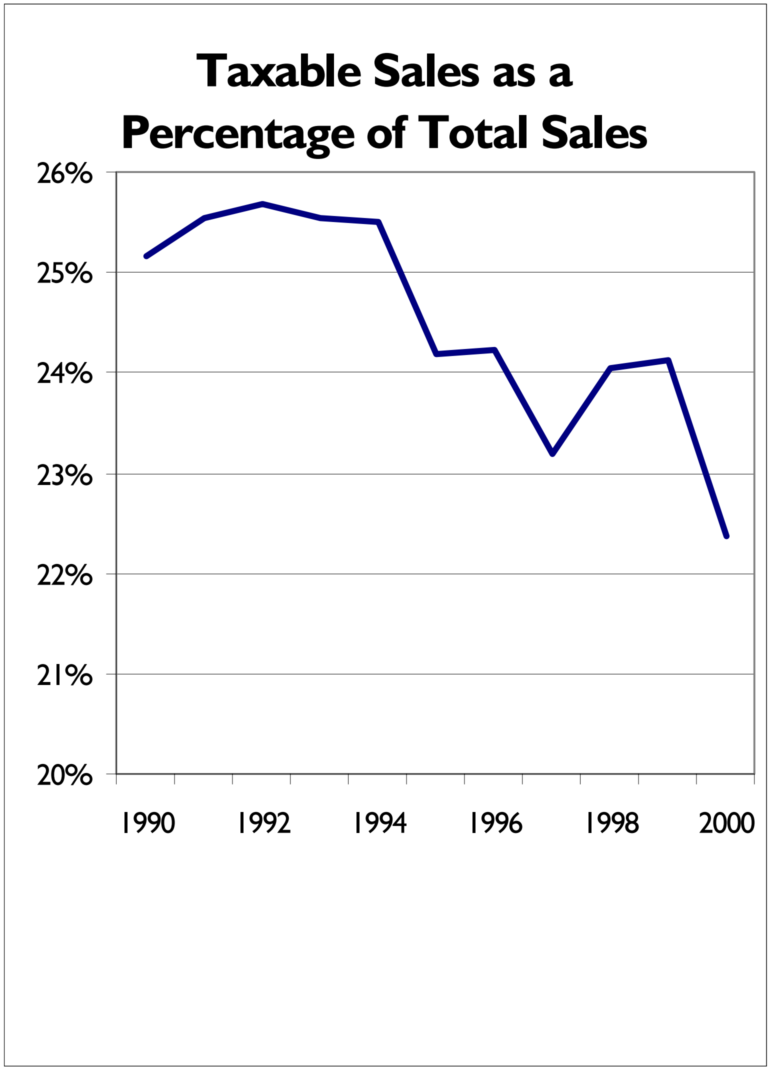
A tax system should be able to grow with the state's economy, generating additional revenue without increases in tax rates. Over the past decade, the Texas tax system has consistently fallen behind economic growth.

As the chart shows, since 1991, state and local tax revenue has fallen steadily as a percentage of statewide personal income—a standard measure of the size of a state's economy. Personal income reflects the ability of Texans to pay taxes. Growth in personal income also reflects a growing need for public services, since it relates to growth in population and inflation.

In the economic bust of the late 1980s, the state maintained revenue only by increasing tax rates. For instance, the state raised the sales tax rate from 4¼% in 1984, to 5¼% in January 1987, to 6% in October 1987, to 6¼% in 1990.

Although state tax rates have not increased since 1991, local school districts have raised school property tax rates consistently over this period, reflecting the state's pushing down of the obligation to fund education. The statewide average school tax rate per $100 of property value went from $1.07 in 1991 to $1.60 in 2001.

If state tax collections had remained at their 1991 proportion of personal income, the state would have an additional $15 billion in revenue in the 2004-05 biennium.



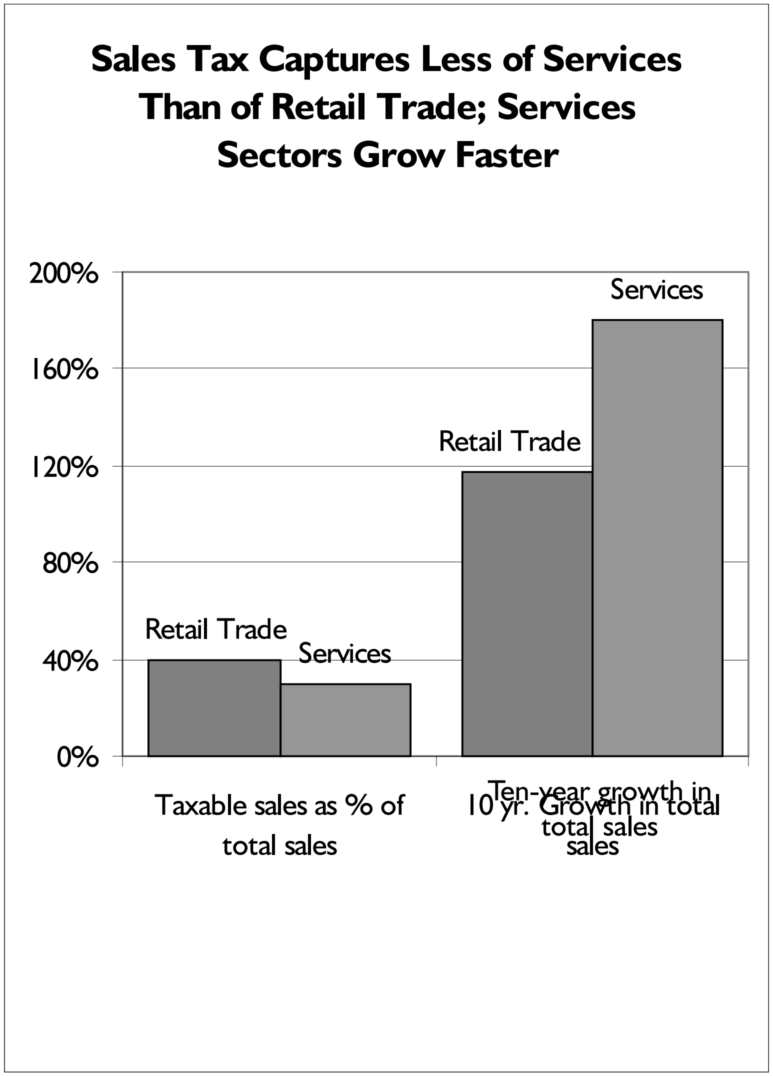
SOURCE: Unpublished data from Texas Comptroller of Public Accounts

How Are State Sales Tax Collections Changing?

A major reason that the Texas tax system cannot keep up with economic growth is its heavy dependence on the sales tax.

Over time, as the chart shows, the sales tax has applied to a shrinking percentage of all sales transactions in the state. Sales volume has grown faster than sales tax receipts.

Partly this reflects untaxed Internet and mail-order sales, but the larger problem is that the sales tax has not changed along with changes in the nature of the economy.



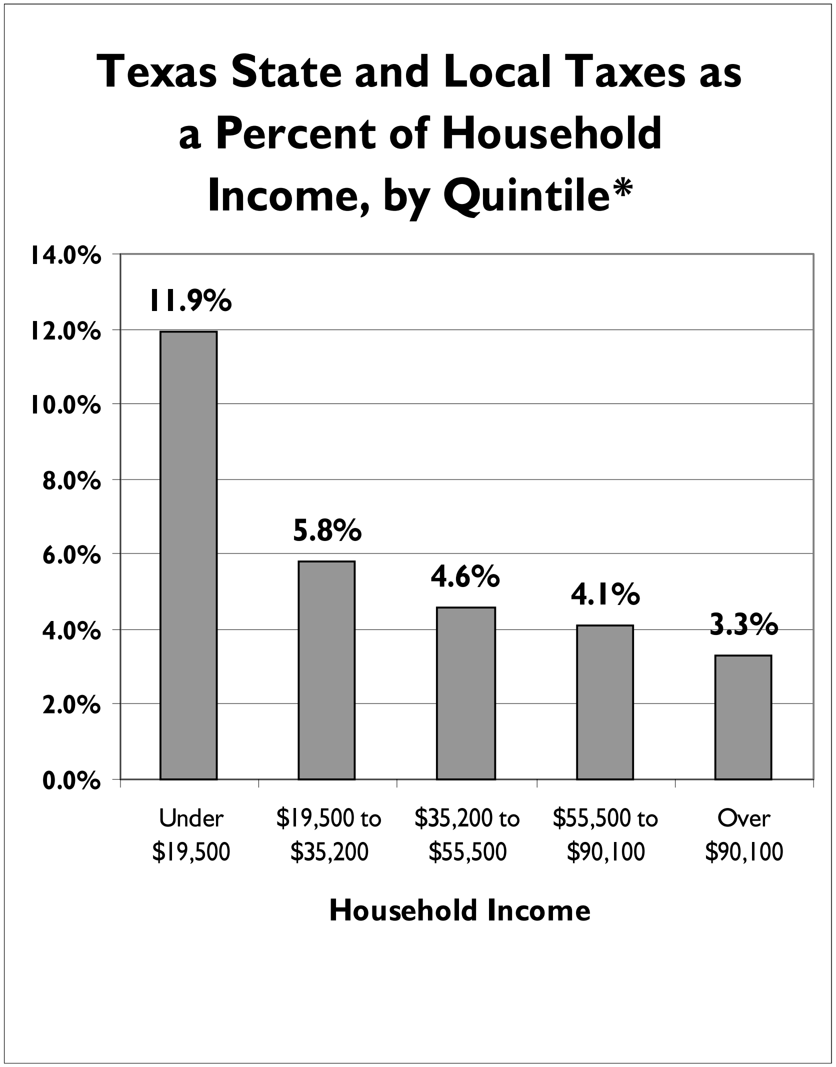
SOURCE: Unpublished data from Texas Comptroller of Public Accounts

Why Aren't Sales Tax Collections Keeping Pace?

Texas adopted a sales tax in 1961, when most sales involved goods—tangible items.

However, in the modern economy, the fastest growing sector involves services rather than tangible goods.

The sales tax applies to 40% of retail trade in goods, but only 30% of the sales of services. Over the past ten years, as the chart shows, sales of services have grown at a pace one and one-half times faster than the growth in retail trade in goods.



*Each bar represents approximately 1.6 million households

SOURCES: Texas Comptroller of Public Accounts,
Tax Exemptions and Tax Incidence, January 2003

Is the Texas Tax System Fair?

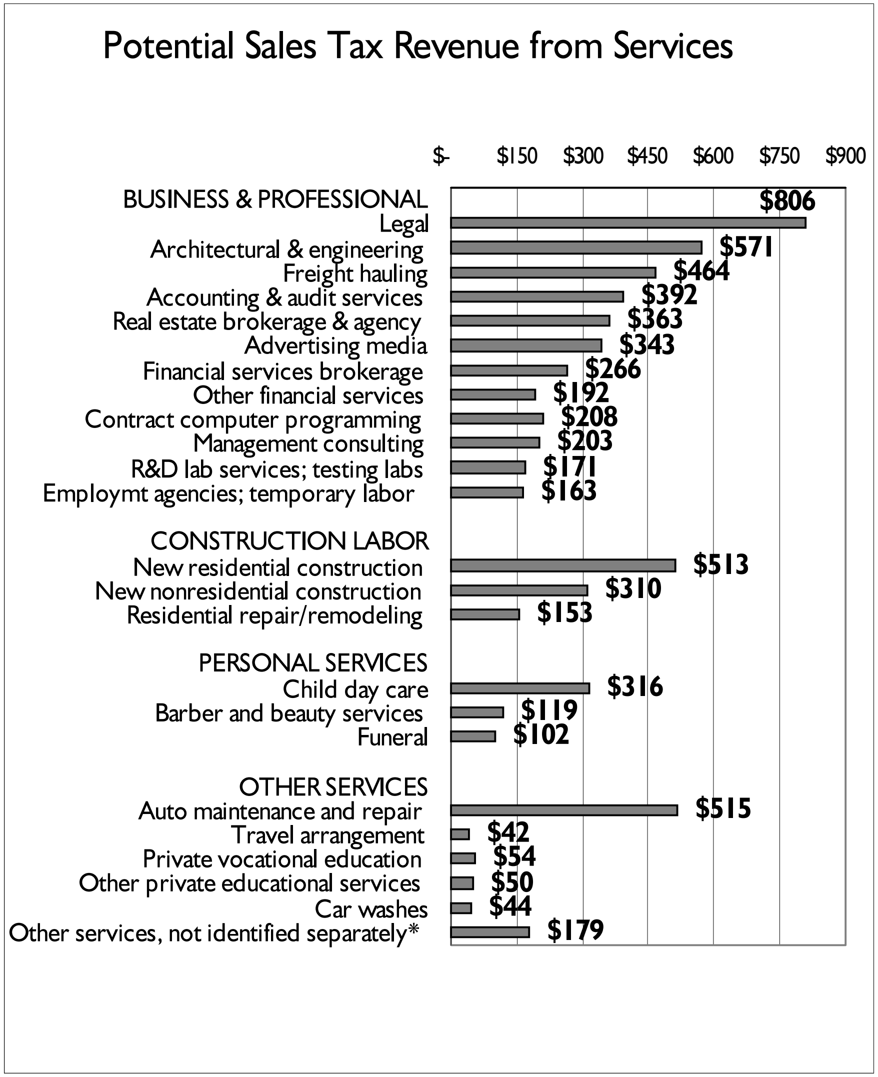
The Texas tax system is not fair because it places the heaviest burden on those least able to pay. Texas taxes are regressive, meaning they take a much greater percentage of the income from a low- or moderate-income family than from a higher-income family. Texas' state and local tax system is the 5th most regressive among the 50 states.

To see how regressive, look at the chart, which shows state and local taxes as a percent of household income.

The main cause is the sales tax, which is based on consumption. Consumption taxes are extremely regressive. For instance, an average family with an income under $19,500 pays 4.2% of that income in sales taxes, while a family with an income over $90,100 pays only 1.1% of its income in sales taxes.

The sales tax exempts groceries, residential utilities (gas, electric, water) and medicines. Even with these exemptions for necessities, however, the sales tax by its nature is still regressive.

Of course, there is a partial trade off between the disadvantages of regressivity for low-income Texans and the advantages of state spending on services for low-income Texans. For example, if the state spends tax dollars on programs for low-income Texans, such as children's health insurance, it mitigates some of the unfairness of regressive taxation, but only some. Far more low-income Texans will pay taxes than receive low-income services. In any event, between paying for services with a regressive or a progressive tax , a progressive tax is fairer. Texas needs—and can have—a tax system that raises adequate revenue and is fair to all Texans.



SOURCE: Texas Comptroller of Public Accounts, Tax Exemptions and Tax Incidence, January 2003

What Can the State Do to Modernize the Sales Tax?

The state could modernize the sales tax by expanding the sales tax to cover services that are currently untaxed, including most business and professional services.

The comptroller has estimated that taxing services (except medical and dental services) could raise $6.5 billion for 2004-05. The chart shows the largest exclusions in each category of services. These numbers may change if the comptroller updates these estimates.

Many of these exempt services are used largely by businesses and higher-income families—for example, legal services ($806 million), architectural and engineering services ($571 million), and freight hauling ($464 million).

Texas could broaden the base by making additional services subject to the sales tax and then lower the rate. Depending on the exact mix of services added to the base, the state could reduce the tax rate below the current 6¼%, still increase state revenue, and perhaps reduce regressivity.

What About the Corporate Franchise Tax?

The state's major business tax—the corporate franchise tax—covers only a fraction of the firms doing business in Texas. The franchise tax applies only to corporations and a similar business form called limited liability companies. Businesses that adopt other legal structures, such as partnerships, are not subject to the tax.

There are more than 60,000 partnerships in Texas. Most large law firms and medical practices operate as partnerships. Other large businesses also are partnerships exempt from the franchise tax. Extending the franchise tax to these businesses could generate hundreds of millions of dollars in additional revenue each year.

Whether or not the state requires more businesses to pay the franchise tax, the state must close a gaping franchise tax loophole. Here is the problem: Some corporations take advantage of a technique known as the "Delaware sub" to avoid paying the franchise tax. They create new subsidiaries in Delaware, which does not have a corporate tax. These subsidiaries become partners in a new limited partnership in Texas, which owns all of the assets of the original corporation. Because the law now provides that owning a limited partnership interest in a Texas partnership is not "doing business" in the state, the subsidiary that owns the limited partnership interest is not subject to the Texas franchise tax. The comptroller has estimated that closing this loophole could have increased franchise tax revenue by $143 million in 2002. The amount of lost revenue will grow by 40% a year as even more companies rush to take advantage of this loophole. The governor estimates that closing the loophole would raise $400 million in 2004-05.

Can Texas Improve Property Tax Collection?

The property tax, unlike the sales tax, has been able to capture a relatively stable percentage of total property value. Except for a large drop in 1997, when the state tripled the statewide homestead exemption for school districts, the proportion of reported property value that is lost to exemptions has not changed significantly. Thus, the way to get more revenue from the property tax is to ensure that each taxpayer pays what that taxpayer owes.

Of course, the property tax is a local tax, not a state tax, but to the extent the state "pushes down" the obligation to fund services, such as health care in county hospitals or public education in school districts, making each taxpayer pay what they owe in local taxes is important to meeting the state's needs.

Increasing the amount of taxable property value, by ensuring that all property is on the rolls and accurately valued, is particularly important to public schools. The state guarantees that local school districts can generate a certain amount of revenue per student for each penny of tax rate. Higher property values would produce more local revenue, reducing the need for state aid, thus freeing state money for increased spending on education or other state services, or for funding school property tax reductions.

The appraisal districts estimate that there is $36 billion in unreported business personal property in the state, which could generate $1 billion in school property taxes in 2004-05. By creating reasonable penalties to force businesses to report ("render") their personal property to appraisal districts, the state can increase collections.

The state could also require disclosure of the sales price of all real estate transactions. Disclosure is required in 35 states; Texas is the only state highly dependent on property taxes that tries to function without knowing sales prices. To protect privacy, the law could make disclosure to the appraisal district confidential. Although no estimate has been made of the additional value that could be uncovered, there is no doubt that appraisal districts could better collect what is owed with mandatory sales price disclosure.

Should Tax Rates Be Increased?

Sales

The state sales tax generated $14.5 billion in 2002 with a tax rate of 6¼%; thus, small changes in the rate could produce large amounts of revenue. Each one-quarter cent increase in the rate would increase state revenue by about $1.1 billion per biennium. Of course, Texas already has one of the highest sales tax rates. As discussed earlier, however, if the base were broadened, the rate could actually be lowered below the current 6¼%, still produce more revenue, and perhaps lower regressivity, depending on the exact mix of sales and services taxed.

Cigarettes

The cigarette tax is 41¢ per pack, well below the national average of 61¢ per pack. Many states facing revenue problems in 2002 increased their cigarette taxes by amounts up to 70¢ a pack, with 13 states now taxing $1.00 or more per pack. Texas could generate nearly $200 million in the next biennium for a 10¢ increase in its cigarette tax rate. However, as the tax rises, more people may go out of state to buy cigarettes, or turn to the black market, or stop smoking, proportionately reducing the revenue gained from larger increases. A $1.00 per pack tax is estimated to raise $1.5 billion.

Gasoline

The state gasoline tax is currently 20¢ per gallon, up from 15¢ in 1991. Three-quarters of the tax goes to the State Highway Fund, and one-quarter flows to the Available School Fund. Raising the tax by a nickel would increase state revenue by about $1 billion in 2004-05. Changing the point of collection of the gasoline tax could raise $300 million over the biennium.

Any Other Ideas?

Estate tax

The Texas inheritance tax is linked to the federal inheritance tax, which is currently being phased out. Breaking the link between the state and federal taxes (“decoupling”) to maintain the current level of the state inheritance tax could increase the amount of revenue collected in 2004-05 by $380 million.

Green taxes

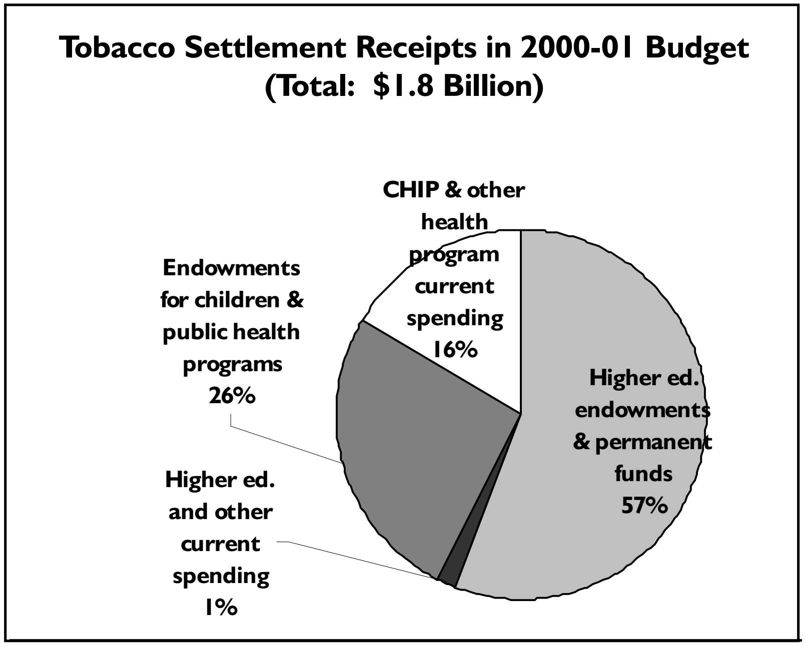
Just as the cigarette tax helps influence behavior and pay for the impact of that behavior, a tax on pollution and natural resource use could protect the environment and increase revenue. These “green taxes,” including a tax on coal use, a higher fee on highly polluting diesel fuels, and a tax on inefficient energy producers, could generate more than $900 million per biennium.

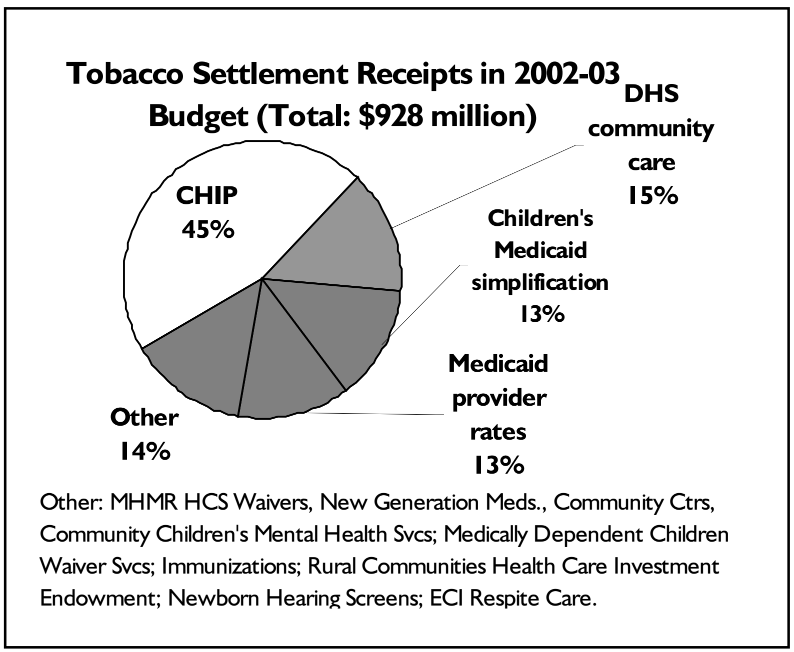
House Bill 1200 (2001)

House Bill 1200, enacted in 2001, allows school districts to grant property tax abatements under certain circumstances. Since the lost property tax revenue must be replaced with state aid under the school finance formulas, HB 1200 reduces state revenue that could be used to fund services. Because the effect of these long-term abatements is phased in, the cost increases over time. In 2004-05, these abatements will reduce state revenue by $49.8 million, but by 2008-09 the cost could reach nearly $1 billion. Repeal of this bill now could help prevent or reduce future budget crises.

Gross Receipts Tax

A gross receipts tax is levied on the total revenue of a business. All forms of business — including corporations, partnerships, and sole proprietorships — would pay the tax. Because of this broad tax base, tax rates could be relatively low. Different tax rates could apply to different types of business activity, such as manufacturing, retail, and services.





SOURCE: Legislative Budget Board, General Appropriations Act, 1999 and 2001

Should the State Sell Its Tobacco Settlement?

Selling the tobacco settlement raises a serious question about trading long-term benefits for a short-term gain.

In January 1998, Texas won a multi-billion dollar settlement from the tobacco industry. The bulk of the money comes to the state in annual, perpetual payments (starting in 1998 at $89 million and increasing gradually to $580 million) that, over the first 25 years of the agreement, are estimated to total $14.1 billion.

The actual future payments could be higher or lower, depending on factors in the settlement agreement that determine the size of the payment such as inflation and domestic tobacco sales and profits.

As seen in the top chart, the lion's share of tobacco settlement receipts appropriated in 1999 went to endowments, either for higher education ($1.0 billion) or for children's and public health programs ($475 million).

The 2002-03 budget treats the annual payments of tobacco settlement receipts as General Revenue. The bottom chart shows the use of the receipts. (Appropriations for 2002-03 from dedicated interest earned on the tobacco endowments total an additional $134.1 million.)

Some have proposed that Texas "securitize" part or all of its future tobacco settlement payments. Securitization replaces some or all of a state's annual payouts from tobacco product manufacturers with an immediate, but one-time, sum of money raised through a sale of public bonds or other financial securities backed by future receipts.

Securitization would provide a single, certain payment now, as opposed to periodic, uncertain payments in the future. Morgan Stanley has estimated that Texas could net $5.8 billion from the sale of 30 years' worth of tobacco settlement receipts (that may total $14.2 billion), assuming a future interest rate of 6½%. In other words, the Morgan Stanley analysis has the state getting about 41¢ per dollar of expected settlement receipts; other states have received as little as 24¢ on the dollar. Moreover, the price for tobacco bonds may fall further as other states offer bonds ahead of Texas.

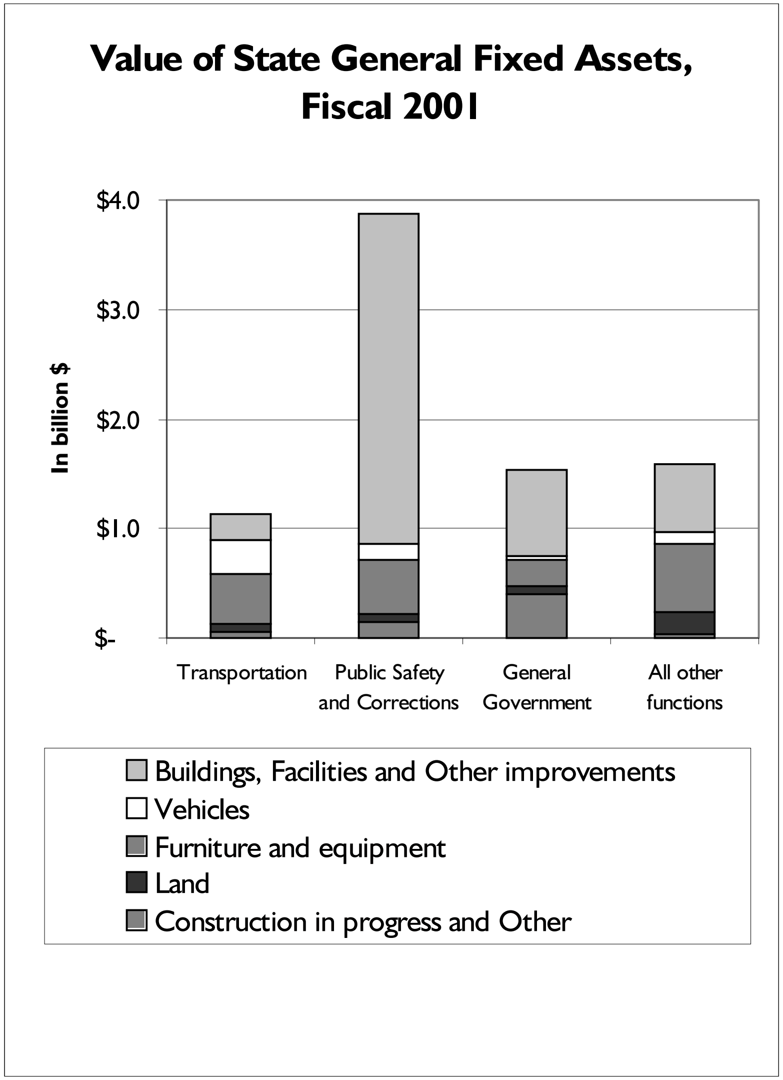
Whatever price Texas could get, selling tobacco bonds to balance the budget for one biennium would be like selling the goose that lays the golden eggs. The state is using tobacco settlement receipts for ongoing and growing programs such as CHIP, which under state law has first call on tobacco funds. How would Texas pay for these programs if the state sold its revenue stream?

Besides fast cash, proponents offer two other reasons to sell.

First, as a financial matter, they argue that selling shifts the risk from the state to the bond buyers that future payments might be smaller than anticipated due to a drop in domestic consumption of cigarettes or the bankruptcy of tobacco makers from litigation. (Of course, the price Texas could get for the bonds would be discounted for that risk.)

Second, as a policy matter, proponents for securitization argue that the state should not be relying upon the sale of tobacco to fund its budget, but should instead be discouraging smoking.

These two arguments have a serious potential technical flaw. Securitization does not necessarily eliminate or even reduce the risk to the state of decreases in future tobacco settlement payouts. Investment firms frequently buy a large share—but not all—of each future year's payouts, and stipulate in the securitization agreement that if payouts from the manufacturers turn out to be lower than expected, the reduction will be taken out of the share of the payout going to the state. Other securitization deals involve only the more certain first few years' worth of payments, leaving states with the risk of uncertain payments in the long term. Whether the state securitizes or not, if the state bears the risk of diminished payouts in the future, it will continue to have a stake in the sale of tobacco.

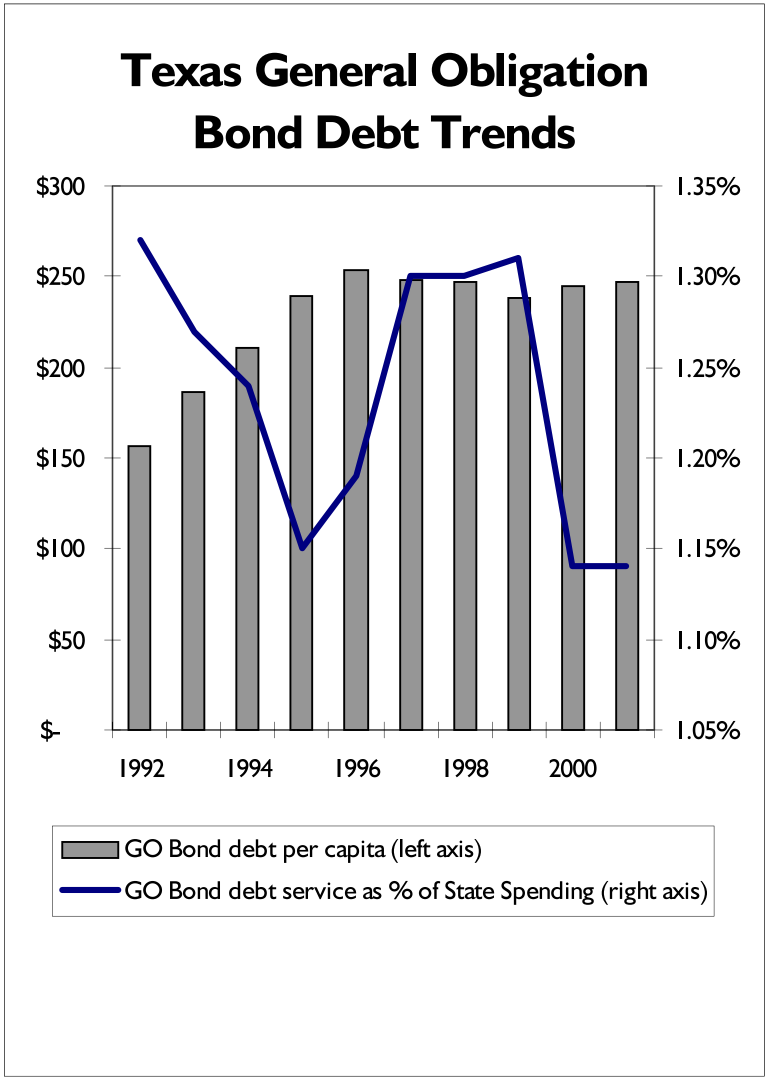


SOURCE: Texas Comptroller of Public Accounts, Consolidated Annual Financial Report for 2001

Are There Other Assets the State Can Sell?

States looking for money often consider selling valuable assets, such as college dormitories or public utilities. As with other one-time revenue, however, the sale of an asset does not create an ongoing revenue stream, and any revenue from that sale should be used only to pay one-time costs, or the structural budget problem gets even worse.

At the end of 2001, the state had about $8.1 billion in general fixed assets, including buildings; furniture and equipment; cars, boats, and planes; and other items of value. As seen in the chart below, though, almost half of the state's assets ($3.9 billion) are owned or overseen by criminal justice and public safety agencies. Most of this value, $2.9 billion, is in buildings (prisons).



SOURCE: Texas Comptroller of Public Accounts, Consolidated Annual Financial Report for 2001

Should the State Borrow?

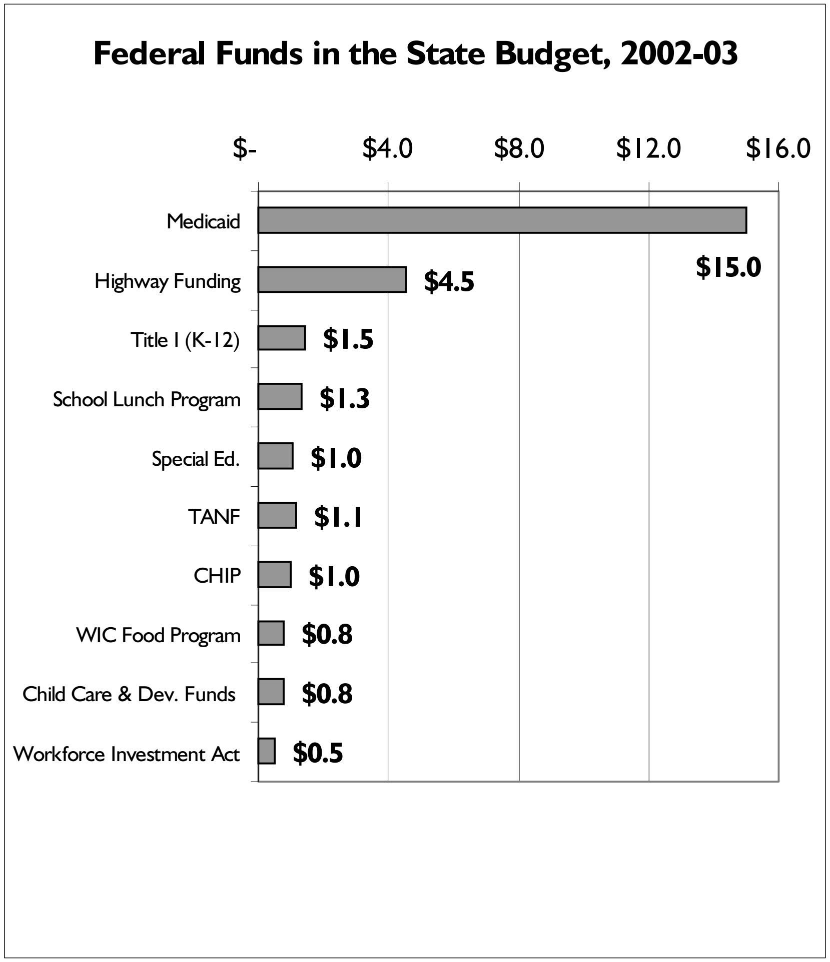
The Texas Constitution prohibits the state from enacting a budget that creates a deficit—a budget that spends more money than the comptroller estimates to be available over the biennium. But just as a family can borrow money to buy a home, the law does allow the state to incur debt for capital projects (such as buildings and other facilities) with a long life. Texas and 38 other states issue general obligation bonds to pay for major capital projects.

Some object to the state borrowing because then "the grandchildren" have to pay part of the debt. If the grandchildren are being raised in the family home and will ultimately inherit it, however, requiring them to pay part of the mortgage when they grow up is reasonable, particularly if it is the only way to provide them a decent home while they are children. For some long-term projects, borrowing is reasonable.

Historically, Texas debt has been low relative to state population and to state income, spending, and limits on the use of debt. The total amount of General Obligation bonds outstanding as of August 2001 was about $5.7 billion.

The law limits the amount of debt service that the state can pay in one fiscal year to 5% of the three-year average of unrestricted General Revenue. For the 2002-03 budget, Texas is well within this limit, with debt service on authorized bonds—whether or not they have actually been issued—estimated to be only 1.9% of undedicated GR.

In 2002, Moody's Investor Service assigned a rating of Aa1 to Texas for general obligation bonds, the second highest rating. Nine states got the highest rating (Aaa) including Delaware, which has the 6th highest state debt burden. Texas' lower rating probably has much to do with its structural deficit and little to do with the size of its debt.



SOURCE: Texas Health and Human Services Commission, Consolidated Budget Request for 2004-2005, and Legislative Budget Board, Texas Fact Book 2002

Can Texas Draw Down More Federal Dollars?

Federal funds are critical to Texas because they make up one-third of the state budget. Texas is more dependent on federal funds than most other states. In 2000, Texas ranked 14th highest in federal revenue as a percent of all state general revenue. Federal funds are also important to Texas because total federal spending on public services in Texas dwarfs spending by state and local governments combined.

Yet Texas does not fare well in the swap of dollars sent to Washington and dollars received from Washington, technically called "the terms of trade." The Tax Foundation estimates that in 2001, Texas received 92¢ in federal spending for each federal tax dollar that Texas taxpayers paid. In 2001, 35 other states and D.C. got more federal funds relative to taxes paid than Texas. Significantly, the terms of trade are growing worse. In 1991, Texas received 94¢ in federal spending for each dollar paid in federal taxes.

From 1996 to 2001, federal dollars to state and local governments in Texas have grown slower (42.9% total) than the national average (43.9%), mostly reflecting the state's poor utilization of Medicaid. Medicaid federal spending, the largest grant to state governments, grew by only 18.1% in Texas from 1996-2001—ranking Texas 46th—compared to 34.7% in the nation on average.

Texas needs a strategy to draw down more federal dollars. However, given the state match or state administrative costs required to draw down more federal dollars in many programs, the state cannot balance the 2004-05 budget with federal dollars.

How About the Rainy Day Fund?

In 1988, by constitutional amendment (Article 3, Section 49g), the state created the Economic Stabilization Fund, commonly called the "Rainy Day Fund." The state created the fund after experiencing the sharp decline in state revenue caused by the bust in oil and gas prices and the fall in property values in the mid-1980s.

The constitution requires that deposits to the fund be made under two circumstances: 1) when unencumbered General Revenue is left over at the end of a biennium, which has only happened once (in 1991), and 2) when the oil or gas production taxes collected in a fiscal year exceed the amount of those taxes collected in 1987. The legislature can also appropriate additional dollars to the Rainy Day Fund, but has never done so. The recent rapid growth in the Rainy Day Fund is due almost entirely to higher collections of natural gas taxes.

After the comptroller makes the oil and gas production tax transfer for 2004, the fund is projected to reach $1.2 billion. While the constitution does limit how big the Rainy Day Fund can become, the state is far below the limit, which is currently $5 billion.

The state has used the fund in the past. In 1991, the state used $29 million for the Foundation School Program. In 1993, the state authorized spending $197 million for criminal justice.

If Texas taps its reserves, the state will join the ranks of many other states that have done so. Of the 41 states that have a reserve fund, 30 have recently used it to reduce budget shortfalls.

Standard & Poor's commented on this trend, noting that tapping a Rainy Day Fund does not automatically reflect negatively on a state's creditworthiness. If done in combination with raising revenue and cutting spending, and accompanied by a plan to replenish the reserves, a state's use of a Rainy Day Fund is seen as part of a balanced approach. The Texas fund is automatically replenished, so use of the fund could easily be part of a balanced approach.

What About Local Governments?

The state is not alone in its budget shortfall. All across Texas, cities, counties, and districts face shortfalls. In addition to their traditional obligations, cities and counties are also being required to spend more on new homeland security efforts.

Any cuts in state funding merely shift the cost of providing services to these struggling local governments. For example, cutting Medicaid and the Children's Health Insurance Program shifts the cost of medical care to hospital emergency rooms run by cities and counties, paid for by local taxpayers without federal matching dollars.

Cities face another problem because they rely in part upon the sales tax. In 2002, the twenty largest cities in Texas collected $53 million less in sales taxes than they did in 2001. For 2003, Texas' four largest cities are reporting potential budget shortfalls totaling more than $200 million. Like the state, cities would benefit from expanding the sales tax to additional services.

What Is Best for the Economy?

In an economic downturn, the federal government can stimulate the economy through deficit spending, since the federal government does not have to balance its budget. Because our state government must balance its budget, however, the state's only choices in an economic downturn are to reduce spending or raise taxes. The question is which of these choices is best for the state's economy.

On balance, it is better for the economy to modestly raise state taxes than to reduce state spending.

To begin with, it is important to have a sense of proportion. A $6 billion annual tax increase would be less than 1% of our economy measured by Gross State Product. It is also less than 1% of our total Personal Income. Looked at another way, a $6 billion annual tax increase is $2.06 per day per Texas household. A tax increase of this size would not hurt the economy.

To the contrary, state spending is itself an important part of the economy. The state is both an employer and a major purchaser of goods and services. Much of the money spent by the state goes to salaries of teachers, state workers, and health care providers who put the money back into the economy by personal spending.

State spending also brings hundreds of millions of dollars into the economy through matching federal funds. Sometimes spending one state dollar will bring as much as four federal dollars. Reducing state spending will therefore result in the loss of significant support for the economy. For example, a recent economic analysis shows that just a 6% cut in Medicaid would result in the loss of 10,600 jobs and almost $1.1 billion in business activity in Texas.

Finally, reducing state spending damages our long-term economic prospects. While some claim that being a low-tax state makes us more competitive in attracting businesses, in fact, it is more important to businesses that a state have strong public and higher education systems that produce a good workforce. Indeed, where do high-wage businesses locate and expand within Texas? They do not go to poor communities with low taxes; they go to communities with good schools and other quality public services paid for by taxes.

In short, a modest tax increase to invest in Texas will yield a good return.

Conclusion

This final chart sums up the options we have identified. As we have shown, the state's revenue system is limited in how much it can raise at reasonable rates. The state needs to reform its tax system so that it raises adequate revenue, at reasonable rates, in a fair way. In the meantime, raising revenue can—and should—be part of balancing the budget for 2004-05. Among these options, the state can find a way to pay.

OPTIONS FOR RAISING REVENUE*

	Biennial Amount ($)	Discussed on Page No.
Current amount of revenue (biennial, 2002-03)	$111.0 billion	9
Extending the sales tax to services (except medical, dental)	$6.5 billion	23
Raising the cigarette tax (for a $1.00 increase per pack)	$1.5 billion	26
Tapping the Rainy Day Fund	$1.2 billion	38
Raising the sales tax (for each .25% increase)	$1.1 billion	26
Raising the gasoline tax (for each 5¢ increase per gallon)	$1 billion	26
Full reporting of business personal property to local appraisal districts (school property tax revenue)	$1 billion	25
"Green taxes"	>$900 million	27
Eliminating the "Delaware Sub" franchise tax loophole	$400 million	24
"Decoupling" estate tax	$380 million	27
Changing gasoline tax point of collection	$300 million	26
Extending the franchise tax to other forms of business (besides corporations and limited liability companies)	Hundreds of millions	24
Repeal of House Bill 1200: School district abatements	$49.8 million	27
Gross receipts tax	Unknown	27
Selling the tobacco settlement/other assets	One-time uncertain	29,33
Borrowing for capital projects	Unknown	35
Drawing down more federal dollars	Limited	37
Requiring disclosure of sales price of all real estate transactions (school property tax revenue)	Unknown	25

*These numbers may be updated as the comptroller's estimates are revised.

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