Testimony of M. Ray Perryman Before the Texas Senate Finance Committee

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Madame Chair and Distinguished Members:

My name is M. Ray Perryman. I am President of The Perryman Group, an economic research and analysis firm based in Waco. I hold a BS degree in Mathematics from Baylor University and a PhD in Economics from Rice University. I have more than 30 years of professional experience and have built and continue to maintain an extensive set of models for the Texas economy. I am extremely involved in a wide variety of public policy issues, and have worked on numerous economic development initiatives throughout the world. I have frequently testified before the Texas Legislature on a wide range of issues related to the Texas economy. I have also assisted the State with forecasting and analysis related to budgeting and other issues on a *pro bono* basis since the early 1980s.

I appreciate this opportunity to offer a perspective on growth in State spending. I have studied economic and fiscal aspects of the Texas economy for about 35 years, both from public policy and private sector perspectives. In addition, examining these issues has been a crucial phase of the econometric modeling involved in producing my regular subscription forecast series, which has been released multiple times per year for more than three decades. A synopsis of my testimony today is simply that the future prosperity of Texas requires an innovative and forward-looking budgetary process that is not artificially constrained.

Preliminary Economic Projections

I will provide projections to assist in the next budget cycle at a later date when more data is available and there is a greater opportunity to observe and evaluate ongoing patterns in petroleum prices and other evolving information. I will, however, summarize our current forecasts for some of the relevant measures for budgetary planning.

Even with the end (at least for now) of the oil surge, the Texas economy continues to expand at a modest pace, with employment gains in most months. Many companies and communities across the state benefitted across a broad industry spectrum and secondary sectors from the increase in petroleum-related activity, and the sharp decline in oil prices and resulting scaling back of drilling and exploration have had a decidedly negative (though not catastrophic) effect on the Texas economy. The current downturn in the oil and gas segment has not created the disruption and devastation observed in the 1980s, with a primary reason for the state's continued success being the increasingly diverse nature of the economy.

Looking to the future, once crude oil prices recover (which is inevitable due to future global demand conditions), drilling activity in Texas will trend upward and be a catalyst for longer-term growth. My most recent short-term forecast indicates the Texas economy is likely to continue to outpace the US rate of growth over a five-year horizon. Real gross product is projected to expand at a 4.15% compound annual growth rate (CAGR) through 2020, representing total expansion of $347.1 billion. Almost 1.4 million net new jobs are forecast to be added during the next five years, a 2.12% CAGR. The expansion will be concentrated in the later years of the projection period, with 2016 being another relatively difficult year.

For personal income, I am anticipating reasonable growth, though not at the rate experienced during the oil surge. Growth in the Consumer Price Index (CPI) plus population is likely to expand at a substantially slower pace than personal income. Projections through 2020 in terms of annual percentage growth rates being discussed in the budgetary process are noted in the following table.

Projected Annual Growth Rates in Selected Indicators: Texas Personal Income by Place of Residence and the Consumer Price Index(CPI) + Population		
	Personal Income Percent Growth	CPI + Population Percent Growth
2016	3.98%	2.87%
2017	5.12%	3.41%
2018	5.84%	3.48%
2019	6.41%	3.51%
2020	6.32%	3.29%
Source: The Perryman Group		

I will now offer some brief analysis regarding the overall issue of spending limits, both conceptually and as it applies to the Texas economy at this time.

The Basic Economics of Artificial Spending Limits

Obviously, the responsibility of spending fiscal resources from taxpayers to provide public goods and services brings with it a fiduciary obligation to be efficient and effective in the use of these funds. Implicit in this dictum, however, is the expectation that adequate governmental functions will be available to sustain economic and social progress. This concept lies at the core of the social contract which forms the basis for much of the Western philosophical tradition on which the US political system is founded. In addition, this framework was essential to the evolution of capitalism and the rise of markets as the dominant force in organizing economic activity. In fact, Adam Smith and the "Classical" School that emerged in his wake rooted their analysis and precepts in the writings of the "Natural Law" philosophers, most notably John Locke.

In other words, from their very origins, capitalism and free markets existed in a framework which presumed a limited, but major role for government in the economy. In fact, to the surprise of many, Adam Smith wrote at length about public health and safety, education, care for the indigent, infrastructure, and most other items that are within the purview of the modern public sector. (I explored this phenomenon in detail in my academic writings several years ago, but only offer this this summary to provide context.)

One of the hallmarks of effective capitalism is the flexibility to respond as conditions change and signals are transmitted through the interplay of the forces of supply and demand. The ability to adjust wages, prices, quantities, production processes, and technologies is the very essence of how economic progress occurs. While the complexities of modern society inevitably result in some obstacles and others are rightfully deemed appropriate on grounds other than economics, such obstructions should only be imposed when essential. Because artificial spending caps impose limits on the ability to respond properly to market signals, they should generally be avoided. This basic premise certainly does not suggest that government outlays should be excessive; in fact, efficiency demands just the opposite. It simply means that the amount of spending should be determined by the economic conditions of the time rather than by a straitjacket that can generate counterproductive outcomes and forestall innovation in meeting public needs.

Specific Considerations Related to the Proposed Spending Caps

At present, of course, the increase in State spending each biennium is limited to projected percentage growth in personal income. I understand that consideration is being given to a lower cap based on the combined growth in the Consumer Price Index (CPI) and population. Thus, it is worthwhile to briefly explore these concepts. In its most basic terms, the growth in personal income derives from (1) increases in population (primarily working age individuals in the labor force, but others as well); (2) escalation in prices, as returns to factors of production typically adjust to inflation (though not perfectly so in terms of both timing and magnitude); and (3) gains in productivity which are normally reflected in the compensation to the factors of production owned by individuals (substantially but by no means exclusively labor resources).

On the other hand, the CPI plus population growth measure captures only the first two of these elements and makes no allowance for the requirements associated with productivity. Both of these approaches are problematic for a variety of reasons.

The income measure accounts for the major components that give rise to both increased private sector activity and the need for supporting public goods and services. Thus, as a general proposition, growth at the same level as income should, over time, approximately equal the expanding needs for public goods and services. A problem arises, however, in that an appropriate increase on average is, by definition, one that will be high in some years and low in others. An artificial cap precludes this normal ebb and flow in legitimate fiscal needs. Moreover, the premise that this average rate of increase is likely to be generally appropriate presumes that the current level of spending is adequate. There is substantial evidence that State spending in Texas is failing to meet pressing needs. (I will explore this issue in somewhat more detail below.) If that is the case, then any cap will pose difficulties in the process of "catching up."

The CPI + population growth limit brings additional challenges in that it ignores the fact that gains in productivity, which are essential to long-term economic success, require increases in both public and private capital. In essence, it omits one of the three components of income growth noted above. As one example, analysis by my firm and numerous others has concluded that approximately 20%-25% of the growth experienced within the US in the past 60 years could not have occurred in the absence of the Interstate Highway system. As congestion continues to increase and generate losses in efficiency and productivity, it constrains the returns that can be received on private investment. Similarly, It is well known and widely demonstrated that public investments in education are critical to increasing productivity and supporting private-sector growth; this pattern only intensifies as evolving technology and global competition places a greater emphasis on an effective and well-prepared workforce. The CPI + population growth constraint precludes the possibility of productivity-oriented public outlays, which are essential for long-term success.

Even it if were determined that such a measure were to be implemented, the CPI measure of inflation is improper for this purpose. The CPI is compiled from a monthly survey by the US Bureau of Labor Statistics and measures changes in prices based on the typical purchasing patterns of urban households. Its value can be (and often is) materially affected by variations in volatile items such as gasoline prices, downward cost trends in items such as consumer electronics, and fluctuations in housing costs. Significantly, its components have little in common with the spending patterns of State government. In fact, the major areas of public spending have historically increased at a level well above that of the CPI. Over the past ten years, for example, the CPI had increased by 21.4% (17.6% in the two Texas cities included in the CPI sample), while the increases in prices for infrastructure construction (47.7%), medical services (38.3%), educational services (41.7%), and governmental services (32.7%) have been much more pronounced. Thus, the use of the CPI as part of a cap formula would likely result in a substantial deterioration of public goods and services over time.

The use of an unweighted population measure poses similar issues, as the demographics of Texas are changing in fundamental ways that are likely to result in more public resources per capita being required going forward. I will examine this issue in more detail in a subsequent section.

Finally, there are additional problems associated with any cap, particularly one that systematically assures underfunding governmental functions. First, there is a ratcheting down effect that occurs over time as business cycles occur. It is not uncommon for scarce resources during recessionary periods to necessitate cuts in fiscal spending. Once these reductions occur, they set a new and lower base to which a cap is applied, thus precluding the full restoration of needed funding in more prosperous times. In other words, the normal functioning of the business cycle is disrupted. In addition, innovation and long-range perspectives are restricted. For example, there are potential reforms in the funding in areas such as criminal justice, indigent health, and child protection that would generate dynamic cost savings and revenue enhancements well in excess of initial outlays. Such initiatives could be impossible to implement if total spending were under an artificial cap that was sufficiently restrictive. Other positive reforms that have been widely discussed (such as college affordability and property tax relief) might best be implemented by methods which involve additional State contributions. Any such efforts would be greatly complicated by a highly restricted spending limit.

In short, while fiscal efficiency and restraint is laudable and, indeed, necessary, its achievement through an arbitrary dictum is both analytically flawed and likely to generate many unintended and undesirable consequences. I will now explore the demographic patterns and current fiscal challenges confronting Texas in more detail.

Changes in the Texas Population

The Texas population will expand substantially by 2050. It will also be older and, most likely, sicker. Hispanics will be the majority, with the number of Asian Americans also growing fairly rapidly, while the number of non-Hispanic whites begins to shrink. Public schools in the state will need to accommodate nearly twice as many students, many of whom will be more difficult and expensive to educate. The implications for infrastructure, education, health care systems, and social services are profound and in need of immediate recognition and attention.

Growth in the population has two sources: the natural increase (births minus deaths) and net migration (both from other states and from foreign countries). The 1.0 migration scenario from the Office of the State Demographer and the Texas State Data Center (which presumes future

migration occurs at a rate equal to what occurred between 2000 and 2010) cannot be ruled out. With a diverse economy and the resulting job opportunities, the potential for a comeback in oil and natural gas, and other factors, we could see continued expansion at the 2000-2010 rate. If that happens, the population of Texas would reach 55.2 million in 2050, up from about 27.5 million as of the most recent Census Bureau estimate (July 2015).

While the 1.0 scenario is a possibility, the 0.5 scenario (reflecting net migration at a rate half of the 2000-2010 period) is probably more realistic. Under the 0.5 scenario, the Texas population would reach 41.3 million by 2050 (my dynamic model, which predicts migration based on economic performance, projects around 44.8 million, which is relatively close to the 0.5 scenario). The majority of counties are expected to grow, though a number of more sparsely populated areas are projected to decline. Much of the overall growth is expected to occur within the state's large, urban areas. The fastest growing counties will be those surrounding the urban counties of Harris, Dallas, Tarrant, and Travis. Hidalgo County is also among the fastest growing, and selected counties in the panhandle and along the border are also forecast to experience relatively rapid increases.

This population expansion will lead to a need for additional roadways, water supplies, and other infrastructure. Many of the major highways in the state are already in need of upgrading to handle current congestion, and adding millions of residents will exacerbate the problem. Although some progress has been made in terms of providing for the necessary funding, there is still work to be done. Similarly, while voters have approved additional funding for water supplies, more will be needed to ensure adequate fresh water is available in the future for both human and industrial use. These types of infrastructure enhancements do not happen overnight and require advanced planning and resource commitments.

The Texas population will also be aging. The age group expected to expand the most rapidly is the 65 and older category, which is expected to triple in size between 2010 and 2050. With nearly eight million 65+ persons projected in 2050 under the 0.5 migration scenario, the proportion falling into that age range will grow from just over 10% of total Texans in 2010 to more than 19% in 2050. Older persons generally require additional health care, as well as other social services in many cases.

Adding to the strain on health care and social services in the future is that obesity rates are expected to rise dramatically. The Office of the State Demographer projects that the Texas adult obesity rate will reach almost 37% as soon as 2030. Obesity is associated with a number of chronic health conditions including cardiovascular disease, diabetes, asthma, arthritis, and certain cancers. Diabetes rates have already been increasing markedly, with particularly alarming increases in younger adults. Health care needs will expand rapidly, straining capacity and resulting in a need for additional resources.

The public school system in the state will also be strained. School enrollment has been growing at a notable pace, with the Texas Education Agency (TEA) reporting that enrollment in Texas public schools increased from 4.4 million in 2004-05 to 5.2 million in 2014-15. Hispanic students account for the largest percentage of total enrollment in Texas public schools (52.0%), followed by White (29.0%), African American (12.6%), Asian (3.9%), and multiracial (2.0%) students. The percentage of students identified as economically disadvantaged is increasing and now stands at almost 59%; the proportion of students receiving bilingual or English as a second language instructional services is also rising. Texas school enrollment has been growing about six times the rate of the United States as a whole, and many school districts are struggling to keep up with the need for new capacity. The proportion of Hispanic students will continue to rise at a notable rate. The combination of rapidly increasing enrollment and its changing makeup, a chronically underfunded system, and rising educational requirements for success is daunting indeed.

Another aspect of the challenge is the fact that the fastest-growing groups of students are within racial/ethnic groups with fewer financial resources. Wealth varies notably by race and ethnicity. A study by the Federal Reserve Bank of St. Louis (using data from the Survey of Consumer Finances, which the Federal Reserve conducts every three years) reports that median family wealth for all families in 2013 was approximately $81,500. For non-Hispanic white families, the median was about $134,000, with just over $91,400 for Asians, $13,900 for Hispanics, and almost $11,200 for African-American families. The reasons for these variations include differences in age, education, tendency to own financial assets and a house, and debt, among others. Recent analysis by my firm illustrates that Hispanics only control 4.8% of the personal wealth in Texas.

In order for the Texas economy to continue to grow, the workforce must be prepared for the jobs of the future. Businesses cannot function without quality workers, and if Texas falls short in this area, economic development will be stifled. At the same time, individuals without marketable skills will find it increasingly difficult to find and keep quality jobs. While the Supreme Court of Texas recently ruled that the current school system in the state, which is among the worst in the country, meets the standard of adequacy in the Texas Constitution, the global economy of the future is a much more demanding arbiter.

Educational attainment is a primary aspect of being prepared for a job. Higher education and having a degree translate into to better pay and a lower likelihood of being unemployed, and enhancing the overall levels of higher education in Texas is a worthy goal. The state currently lags the nation in both the percentage of residents 25 and older with high school diplomas (81.6% in Texas and 86.3% for the US) and with bachelor's degrees or higher (27.1% in Texas

and 29.3% in the US). Worse, the gap is larger among younger age groups, indicating Texas will likely fall further behind if the pattern does not change.

Despite progress in encouraging college enrollment, affordability is clearly a problem for many families. When combined with the lack of financial resources for rapidly growing student populations, the issue becomes even more difficult. A recent survey indicates that 89% of Hispanic youth recognize the value of additional education beyond high school, yet 75% do not pursue further training due to financial constraints. Without sufficient resources for higher education, educational attainment in Texas will be negatively affected, raising the possibility of eroding standards of living and economic growth over time.

The Texas population is in the midst of sweeping change. While some of the patterns have been in place for decades, they are becoming more pronounced. There are significant implications for public policy, and the ability to address them will be notably limited if highly restrictive spending caps are implemented.

Current Challenges

Several aspects of Texas infrastructure are strained, with negative effects on quality of life, safety, and potential for economic growth. Although expenditures for highway construction, maintenance, and right of way topped $5 billion last year, congestion remains a problem in urban areas due to rapid population and economic growth. Maintenance and safety enhancements are desperately required in many areas, but funding limitations preclude addressing all needs. If the roadways of Texas are not well maintained and expansion projects are not undertaken to help keep congestion under control, it will cost much more in the future, both in terms of additional outlays and (especially) lost productivity and efficiency. There has been some progress given additional funds allocated during recent legislative sessions, but $5 billion per year is simply insufficient given growing needs and miles of roadways.

Like many states, Texas is also facing a substantial unfunded pension problem. It is crucial to ensure we are setting enough money aside to deal with these obligations in the future. Again, while some progress has been made to correct part of the problem, the fact remains that recent budgets have provided for far lower contributions to retirement systems than called for by plan actuaries.

In the area of public education, Texas compares poorly in terms of per student spending. An analysis by the US Census Bureau ranked Texas near the bottom of all states, with spending

well below the US average. The National Education Association placed Texas at number 40 based on spending in K-12 public schools and average daily attendance. While methods, measures, and rankings vary, Texas clearly ranks at the lower end of the spectrum in terms of spending in public schools. Quality of education is directly related to individual success in the job market, and workforce preparedness drives the potential for economic growth. Investing in education is essential from an economic perspective irrespective of any legal proceedings, and changing demographics increase the need for adequate resources.

As is well known, Texas leads the nation in the percentage of residents without health insurance, which creates a notable strain on public hospitals and the overall health care complex. Multiple additional safety net programs are in crisis, including foster care and child protective services. Failing to provide adequate resources for these essential services can have devastating consequences for some of the State's most vulnerable residents. In addition, improving outcomes can reduce future needs for social services. My firm has examined the potential costs and benefits of investing in reducing child maltreatment, dealing with hunger, indigent health care, and redesigning the foster care system. In all cases, the overall fiscal gains to the State associated with effects such as the reduced need for future social services and improved productivity far outweigh the initial costs. The needed innovations, however, would be difficult, if not impossible to achieve in the face of arbitrary spending limits.

Concluding Comments

Spending by the State of Texas has been growing over time in the face of a rapidly growing economy and an expanding and evolving population, but not at a pace sufficient to keep pace with population and economic expansion. An analysis by the Kaiser Family Foundation ranked Texas 47 among all states in terms of per-capita State spending, illustrating the low level of outlays compared to most areas. This number is especially troubling given the large geographic area within the state, its complex and multi-faceted business complex, and its unique demographic challenges.

While excessive spending is clearly to be avoided, Texas has fallen critically behind in several areas. Keeping tax burdens low is laudable, but spending more now will avoid bigger problems down the road. In fact, if Texas does not catch up on unfunded pensions; restructure programs in crisis such as indigent health care, foster care, and child protective services; improve education at all levels, and make a dent in infrastructure shortcomings, the state will almost certainly face a future characterized by slower economic growth and the necessity of committing even more resources to public needs.

While I am a fiscal conservative, believe in government efficiency, and recognize and support the important fiduciary obligation to taxpayers, sufficient money must be available to operate and meet basic needs, as well as provide the framework in which future growth can occur. True and lasting fiscal restraint does not mean spending the least amount possible at any given moment with no regard for future consequences; it means adopting intelligent and prudent public resource commitments that promote the economic vitality that will sustain a "low tax" environment for decades to come. Conceptually, markets work best with the ability to respond to changing conditions in both directions and the limited portion of a market economy that properly belongs to government is no exception. When the economy is growing robustly, income levels typically respond with faster growth, and additional fiscal revenues become available. At the same time, economic growth tends to generate additional needs in terms of infrastructure and public services, while a strong job market attracts additional residents, which in turn increases the need for State resources. A forward-looking and innovative budgeting process accrues to the advantage of every Texan, both current and future.

I am grateful for the opportunity to offer this perspective. I sincerely appreciate all that each of you do for Texas and Texans and would be happy to answer any questions that you may have. If I can assist your efforts in any other way, please let me know.

Respectfully submitted,

M. Ray Perryman, PhD, President

The Perryman Group