

TEXAS PUBLIC POLICY FOUNDATION

Solving the Third-Party Payer Problem in Texas' Public Education Systems



Increasing Education Efficiency Through Parental Choice

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Center for Educational Freedom
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Solving the Third-Party Payer Problem in Texas' Public Education System

Increasing Education Efficiency Through Parental Choice

by Bill Peacock, VP Research

Executive Summary

There are two systems of K-12 education operating in Texas today—the public and the private. For the most part in Texas, these two systems operate separately. Unlike many other states, Texas doesn't have a private school choice program that allows students to attend private schools using money from the public system.

However, from a constitutional perspective, these two systems need not be separate. The mandate in the Texas Constitution that the Legislature “make suitable provision for the support and maintenance of an efficient system of public free schools” requires public funding of education, but does not mandate government delivery of education. In fact, when considered in terms of economic efficiency, it is desirable that these two systems interact.

The current bifurcated system is extremely inefficient. Nowhere is this inefficiency more apparent than when it comes to the third-party payer feature that currently dominates the public system. Just like in our health care system, the design bug in Texas' third-party payer education system is that the consumer of education services is not the one paying most of the costs. The result is that providers in a third-party system have little incentive to compete on either quality or price.

The most effective reform in recent years for improving efficiency in health care has been Health Savings Accounts (HSAs). Likewise, the solution to the third party pay problem in education may well be Education Savings Accounts (ESAs). An ESA would put consumers—parents—in charge of the education of their children. Parents could tailor educational services to the unique needs of their child by selecting from one or more of a variety of services such as private schools, online learning, tutoring, curricula, textbooks, etc. Parents could even save unused funds for college. Additionally, Texas should remove the restrictions that arbitrarily separate public schools from private schools and homeschooling and introduce elements of parental choice within the public schools.

Increasing the economic efficiency of Texas' “system of public free schools” through these simple yet transformative measures will accomplish the constitutionally directed “general diffusion of knowledge [that is] essential to the preservation of the liberties and rights of the people” and provide all Texas school children a higher quality education and significantly increased economic opportunity.

Key Points

- There are two systems of K-12 education operating in Texas today—the public and the private. However, from a constitutional perspective, these two systems need not be separate.
- The current bifurcated system is extremely inefficient. Nowhere is this inefficiency more apparent than when it comes to the third-party payer feature that currently dominates the public system.
- The solution to the third party pay problem in education may well be Education Savings Accounts (ESAs). An ESA would put consumers—parents—in charge of the education of their children.
- With ESAs, parents could tailor educational services to the unique needs of their child by selecting from one or more of a variety of services such as private schools, online learning, tutoring, curricula, textbooks, etc.

The Development of Texas' Centralized, Inefficient System of Public K-12 Education

As mentioned, there are two systems of K-12 education operating in the Texas today—the public and the private. The great majority of students attend public schools. The Texas Education Agency reports that there were 5,151,925 students enrolled in Texas public schools in 2013-14 ([ix](#)); in 2010, there were only 317,485 private school students in Texas ([Ewert, 21](#)). The public system consists of districts, charter schools, and service centers, all created through legislative action, and funded with tax revenue. The private system consists of two main subsystems: private schools and homeschooling, funded largely by parents and charitable contributions.

For the most part in Texas, these two systems operate separately. Unlike many other states, Texas doesn't have a private school choice program that allows students to attend private schools using money from the public system. Additionally, part-time enrollment in the public system is generally not allowed so students in the private system can't cross over to the public system to take a few classes. The closest Texas comes to crossing over between the two systems is through charter schools, where nonprofit entities are allowed to operate public schools.

However, from a constitutional perspective, these two systems need not be separate. In fact, when considered in terms of economic efficiency, it is desirable that these two systems interact. The mandate in the Texas Constitution that the Legislature “make suitable provision for the support and maintenance of an efficient system of public free schools” requires public funding of education, but does not mandate government delivery of education. Kent Grusendorf explains the original intent of the term “public free schools” in the Texas Constitution:

Critical to understanding original intent is the fact that “public” did not mean government-operated schools as we think of the term today; instead it only meant “open to the public” like a restaurant or store which is open to the public. And “free” meant that poor students were entitled to attend regardless of ability to pay ([1](#)).

Nonetheless, while the drafters of the Texas Constitution did not call for the two separate systems that we have today, the bifurcation of the public and private systems of education developed as proponents of public education, such as Horace Mann and John Dewey, touted the public

benefits that could be derived by a system of universal, free public schools. Cubberly writes, “No one did more than [Mann] to establish in the minds of the American people the conception that education should be universal, non-sectarian, and free, and *that its aim should be social efficiency, civic virtue, and character* [emphasis added], rather than mere learning or the advancement of sectarian ends” (167). Similarly, Warde noted that Dewey believed the products of public education would be “creative, well-adjusted equalitarians [who] would make over American society in their own image.”

In today's economic terminology, such broad societal benefits are known as positive externalities. The general concept of externalities is there are times when either certain costs or benefits of a transaction between parties “spill over” to those who are not parties to the transaction. When a cost spills over, i.e., a cost is imposed on a third party, it is a negative externality. When a third party benefits from a transaction, it is a positive externality. Another term for describing such an occurrence is public good.

One might think that little harm can come from a positive externality. But according to welfare economics, when a positive externality exists, society won't get enough of the activity in question because the parties involved will produce “too little” of it since they don't take into account the benefits to the rest of society (Callahan). According to this analysis, society should subsidize activities, such as public education, that produce positive externalities because the benefits from the externalities outweigh the costs of the taxation. To capture the benefits of the positive externalities then associated with education, the writers of the Texas Constitution established a publicly subsidized system of free public schools.

However, determining whether something produces a positive externality, i.e. a public benefit, requires that one somehow measure the benefit, or utility, that is received by all the parties involved, including the third parties. And the evolution of the public portion of Texas' education system into a stand-alone, monopolistic system of public schools renders such determinations problematic. Indeed, modern economic theory calls into question the economic efficiency of how public education is being delivered in Texas today.

Lionel Robbins criticized the original basis of the concept of externality because “as utility is not measurable, it is invalid to compare levels of utility between different people”

(Callahan). Since it is impossible to actually measure the benefits derived from Texas public schools today, the only way to determine how efficiently they deliver their benefits is through consumer choice, i.e., the value provided by the schools ought to be able to be measured by how much of the services they offer is being purchased or consumed by the parents and students they are designed to serve. Supporting this line of reasoning, Murray Rothbard pointed out “it is only through preference demonstrated in action that we can gauge what actors really value, and that to try to deduce values from mathematical formulas, without the evidence of action, is a hopeless cause” (Callahan). However, the monopolistic aspects of today’s public schools create a situation where consumer choice is largely meaningless. In such a situation, one cannot use the notion of positive externality to claim that the public school system is economically efficient, i.e., offers a public benefit, just because people use it. In fact, the opposite could be the case; it is likely many people use the public school system not because it is a net positive benefit to society, but because they get to benefit personally from what others are paying for.

Texas has spent hundreds of millions of dollars over the years trying to overcome what is in fact an insurmountable problem of determining the economic efficiency of the public schools. At one time, determining the cost of an education was all the rage. Texas implemented one estimator of differential costs into statute in 1991—the cost of education index; it hasn’t been changed since. Internal studies, outside research, and about every means have been tried to come up with at least an estimate of what it costs—or more precisely, should cost—to educate a student in public schools. However, during the most recent round of school finance litigation from 2011-2014, the judge asked every superintendent who testified how much it costs to educate a child. None could answer the question.

More recently, accountability has been the focus of the Legislature. Measures were put in place to determine quality of the education being offered by school districts and schools and how well each individual student was learning. These have included the Texas Assessment of Knowledge and Skills tests, the Financial Accountability Rating System of Texas, the State of Texas Assessments of Academic Readiness tests, and the federal No Child Left Behind law. All of these efforts, however, met with strong resistance from school districts and the public. Not surprisingly, it turns out that everyone has a different idea of what students should learn and how well the system is

doing in delivering the learning to each student. Imposing top-down accountability measures satisfied very few. In reality, in Texas’ educational system there is no way to conduct a cost-benefit analysis. Schools simply spend what they have available based to a large extent on political pressures from various interest groups. It is impossible to accurately gauge the outputs of the system. This is a natural outcome of today’s poorly designed, inefficient system.

Yet, as Grusendorf noted, this type of inefficiency wasn’t built into Texas’s system of public schools as originally designed. The Texas Constitution doesn’t require that the public schools be an inefficient, stand-alone system designed to overwhelm private education. This is borne out by looking at the origins of public schools in Texas around the time the 1845 and 1876 versions of the Texas Constitution were written. Frederick Eby provides a glimpse into this past:

The method of school organization adopted in the new law [of 1876] was as simple and as loose as it could possibly be. . . . (1) It gave to parents the greatest latitude in determining for themselves the kind of education they desired for their children and the character of teacher they wished to employ. (2) There was no restriction to the number of children necessary to constitute a school community. . . . (3) The parents could enjoy the use of the state school fund, together with the minimum of state interference. Moreover, it lodged the responsibility of educating the children upon the parents, where, as they believed, it belonged. . . . Additionally, students were not restricted by geographic boundaries.

In fact, the community schools developed under this system were much like charter schools today—but with less regulation—and were also supplemented with a private school voucher system (Grusendorf, 3).

The Battle Over Controlling Texas Public Education—and its Money

The original open intent and design of an efficient “system of public free schools” in Texas didn’t last. The bifurcation into two systems of education—public and private—essentially operating inefficiently in isolation from the other increased as unions and associations for public school teachers, administrators, and board members sought to gain monopoly control over education in Texas as well as its funding.

Education groups haven't always favored a monopolistic system of public schools, though. Dr. William Carey Crane, the first president of the Texas State Teachers Association (TSTA), was actually "in favor of the New York State plan of school organization which permitted the use of state funds for the support of private and denominational institutions of learning" (Eby). Of course, today, the TSTA and most of other public school unions are adamantly opposed to any type of school choice. For instance, during the most recent legislative session, the TSTA wrote that school choice proponents "want to milk money from [public schools] for their own privatization schemes, such as private school vouchers, corporate charters or online learning courses" (TSTA).

The desire by education groups to control public education funding doesn't stop at opposing private school choice. Texas has long had a form of public school choice, the Public Education Grant, where students can take their public funds and move to another public school. But if that school is in another district, the student has to have permission from the district she wants to attend school in (Texas Education Agency 2014b). Districts have not widely embraced this type of choice either.

Additionally, union control of the education system has been exhibited through the support by education groups and school districts of "exclusive consultation" where one education group gets to represent all school district employees in conversations with the district despite Texas' general ban on collective bargaining for public employees (Greer). Education groups and districts also seek to further their monopoly over public education through educator certification. Though there are exceptions, most educators—both teachers and administrators—have to have attained certain levels of education and training to teach in the public schools. This ensures that most of the employees in public school have been through the education mills at public universities. What it doesn't allow is a person with years of expertise and knowledge in specific fields but without certification to teach students. Additionally, the ban on part-time enrollment in public schools ensures that there is minimal interaction between the two systems that might loosen the grip of the education establishment on the system.

The reason for this protectionist approach to public education is quite clear. Loss of control of the system by the education groups would bring about loss of control of the money in the system. All aspects of spending are highly

controlled in the current system to the benefit of stakeholders, rather than consumers.

One example of this is the teacher salary schedule. Unlike virtually all other public employees in Texas, and for the most part only matched in the private sector by employees working under union contracts, educators are compensated through restrictive salary schedules. Compensation under these schedules is generally based on years of service and levels of education, so teachers don't get paid on how well they do their jobs; they get paid on how long they can stick around, and how much schooling they can work in during their summer vacations. So a good teacher with five years of experience will get paid much less than a bad teacher with 15 years of experience. That doesn't make any sense unless you run a teacher's union under a government-subsidized monopoly that is inherently inefficient, increases costs, reduces quality, and is, as a result, populated with a lot of poor quality teachers who rely on the union to get them pay raises every year they don't deserve. In such a case, maintaining control over the system would be the first (and only) priority. This would also be the case for administrators and board members whose positions (and salaries, in the case of administrators) are secured through control of the system.

The money at stake is significant. Texas taxpayers currently spend about \$61 billion a year on public K-12 education, up from \$38.44 billion in 2003-04. As of the 2012-13 school year, \$33.4 billion was spent on salaries (FAST). The average teacher in Texas makes \$49,692 for about nine months of work; the average professional support staff makes \$58,551; the average school administrator makes \$72,764; and the average central administrator makes \$94,630 (Texas Education Agency 2014c). And the number of educators and staff earning these salaries keeps growing. As of 2014, there were 334,510 teachers in Texas, a 70 percent increase from 1989. The 322,031 staff and administrators were up 78 percent since 1989. During the same time frame, students had only grown by about 60 percent (Texas Education Agency 2014c).

Examining the history of school finance lawsuits against the state further clarifies that money is at the center of the battle over control of the education system. Texas school districts have been suing the state on a regular basis since the 1980s over school finance demanding that more money be spent on the system—and thus on the salaries of those who work in the system. The school finance case recently decided by the Texas Supreme Court is at least the eighth major lawsuit over school finance since the late 1980s.

These education groups are aware that any kind of interaction with and competition from the private K-12 system would improve the efficiency of the public system, which would result in a reduction in the control of the education establishment over the public system. So they are opposed to anything that bridges the gap between the public and private systems. This opposition extends to even a privately-funded scholarship program made available to students living with the boundaries of San Antonio's Edgewood school system. The program helped drive improvement in Edgewood's standardized test scores and graduation rates (Diamond, 5). Yet the education establishment opposed this school choice program because, even though it was funded through private dollars, public schools are largely funded based on student attendance and one lost student results in less funding to the district.

Nowhere is this control more important than when it comes to the third-party payer feature that currently dominates the public system. The third-party payer's role in the design of the public system is a key aspect of maintaining control over the system—even as it makes it more inefficient for carrying out the constitutional mandate that Texas have an “efficient system of public free schools.” For if parents became empowered to direct educational funding, the control over funding and salaries currently vested in the education establishment would quickly deteriorate. It is to the third-party payer system this paper now turns its attention.

The Problem with Third-Party Payers

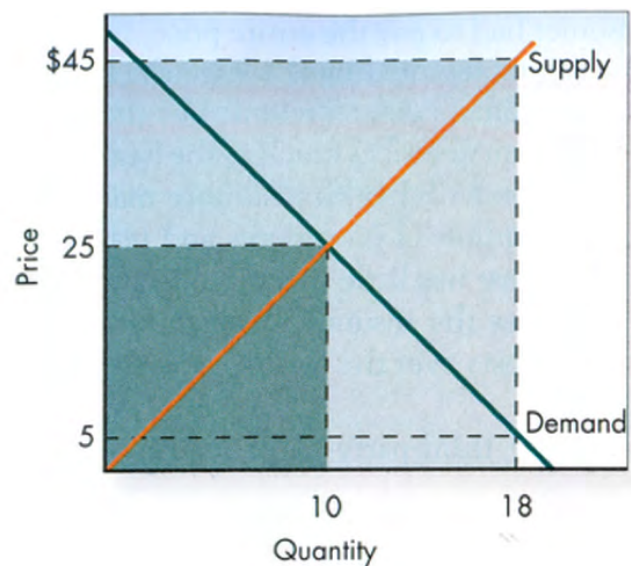
To understand the inefficiency of the third-party payer aspect of Texas' system of public education, it is useful to begin with an examination of the U. S. health care system. Many of the problems the country faces today in health care can be traced back to World War II, when America adopted wage and price controls in an attempt to control inflation brought about by the huge public expenditures made in the prosecution of the war. With companies unable to use cash benefits to lure and keep workers, they turned to noncash benefits like providing health care for their workers (Roy). Thus began the third-party payer system in health care.

The problem with the third-party payer system is that the person receiving the health care services is not the one paying most of the costs. The typical system involves a small deductible that is only a fraction of the actual cost of the services provided. Therefore, many of the normal incentives that operate in a market are absent. Buff and Terrell observed, “Third-party payment, with its moral

hazard, has increased demand and thereby driven up prices” (75).

The moral hazard they refer to is the patient in a system who has every incentive to use medical services and little incentive to shop based on price; it really doesn't matter if an MRI is needed, much less whether it cost \$500 or \$5,000. On the other hand, free markets “restrain costs by providing incentives for the individual to use a given good or service only to the extent that its incremental value to that individual is greater than its incremental costs” (Sowell, 66). On the supply side, without consumers pushing them to increase efficiency, health care providers have little incentive to make the needed effort and investment to cut costs since they continue to attract patients no matter what they charge.

Figure 1: Costs in Third-Party Payer Markets



Source: Economics, by David Colander

Colander illustrates this problem in Figure 1:

In the normal case, when the individual demander pays for the good, equilibrium quantity is where quantity demanded equal quantity supplied—in this case at an equilibrium price of \$25 and an equilibrium quantity of 10. Under a third-party-payer system, the person who chooses how much to purchase doesn't pay the entire cost. Because the copayment faced by the consumer is much lower, quantity demanded is much greater.

In this example with a copayment of \$5, the consumer demands 18. Given an upward-sloping supply curve, the seller requires a higher price, in this case \$45 for each unit supplied to provide that quantity (119).

Similarly, over time the lack of price competition also leads to a lack of competition on quality. Yes, customers still want improved health outcomes, but in a third-party payer system, the lack of price competition reduces the transparency and communication of data about the quality of health care outcomes. Patients then don't have enough information to "shift demand (and therefore, revenue)" (Goodman, et al., 6). This combines with the fact that the third-party payer is often much more concerned about overall costs than the wellbeing of an individual patient. So the third-party payer starts limiting access to treatments as well as providers and customers become more locked in to certain providers, thereby, limiting supply. This exacerbates the problem caused by the lack of transparency about quality of health care outcomes. As a result, the providers become less and less concerned about the quality of treatment they provide. The outcome of the third-party payer system is, therefore, lower quality service at a higher cost, i.e., greater inefficiency.

The Third-Party Payer System in Texas Public Schools

The Texas public education system finds itself in the same situation today. The massive \$61 billion-a-year system is a complex web of inefficiency in large part for the simple reason that the people who use the schools, i.e., parents of school-age children, don't actually pay for the schools—at least not directly; and even what the users pay indirectly is generally a small portion of the total cost. Looking back to the example of health care, it is easy to see how the same inefficiencies have crept into public education under a third-party payer system.

On top of the problems inherent in a third-party payer system, the inefficiencies are enhanced when the third-party payer is the government. Anderson points to this effect when he notes "since 1970, the costs of Medicaid have risen 35 percent more, and the costs of Medicare have risen 34 percent more, per patient, than the combined costs of all health care in America apart from these two flagship government-run programs" (3).

Figure 2: Flow of Funds in Texas' Third-Party Payer Public Education System

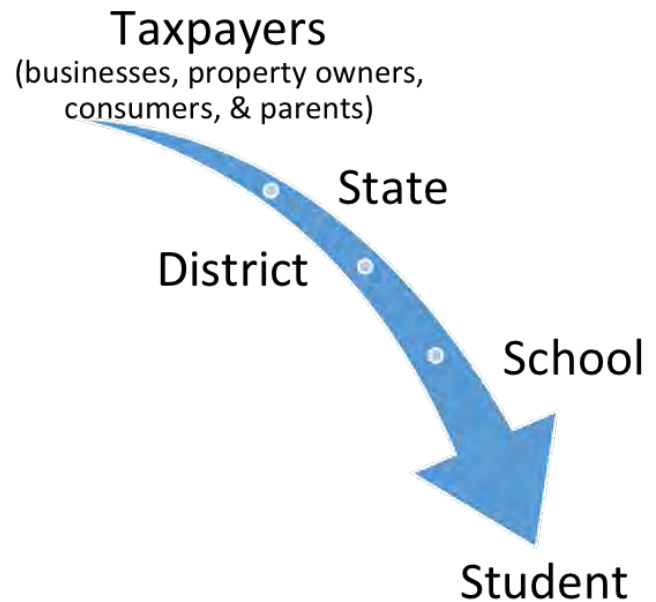


Figure 2 shows how Texas' system of public K-12 education functions as a third-party payer system with the government as the payer. Parents (as payers) are far removed from the providers (the public schools). Additionally, parents usually supply only a small portion of the funds needed to educate their children; the rest is paid by businesses, consumers, and property owners. Whatever the source of the funds, the money is paid to the schools by two different entities, the state and local school districts (the federal government also provides a limited amount of funds, but is omitted here for simplicity sake). The funds are further comingled and interchanged through the state's system of recapture. Thus some money paid by taxpayers in one school district is recaptured and used to pay for education in another district. After the state takes its cut of taxpayer money, it sends the rest to the local school district. Finally, the money is passed from the district to the schools, and is ultimately used to pay for the instruction of the students who are under the direction of parents as consumers.

The disconnect between parents as payers and consumers in the system is obvious. Because the role of parents as payers in the system is small and indirect they have little authority to demand accountability. As a substitute for the parents, taxpayers may attempt to demand accountability for their tax dollars from the state, the state may attempt to demand accountability from a district, and a district

may do the same from a school, but the information or outcomes they demand may not be what the parents are interested in. Even in situations where the state and school districts have attempted to provide parents the ability to move students to another school, i.e., public school choice, parents still lack the information and authority needed to shift demand, and revenue, outside of the system. Accountability in this system attempts to flow back up the funding stream toward the state, but it substitutes for direct accountability to consumers. An inefficient system that produces poor quality and high costs is the inevitable result.

The inefficiency of the current system is well documented. Terry Moe notes, "The Texas school system, like the school systems in every other state in the nation, is simply not organized to be effective or efficient. All these school systems are organized in ways that literally make no sense in terms of what is required to provide children with the best education possible" (1). Alan Parker further explains that "low-income students and parents are structurally unable to correct the system, having the least amount of political power and the least capacity to organize politically to correct the system" (7). Because of the lack of parental accountability and control inherent in a third-party payer system, parents have to resort to political means in an attempt to secure a quality education for their children. Not only is having to resort to political means highly inefficient economically, for many families is it also highly impractical; their limited ability to reshape the system often means that their children have little hope of receiving a quality education.

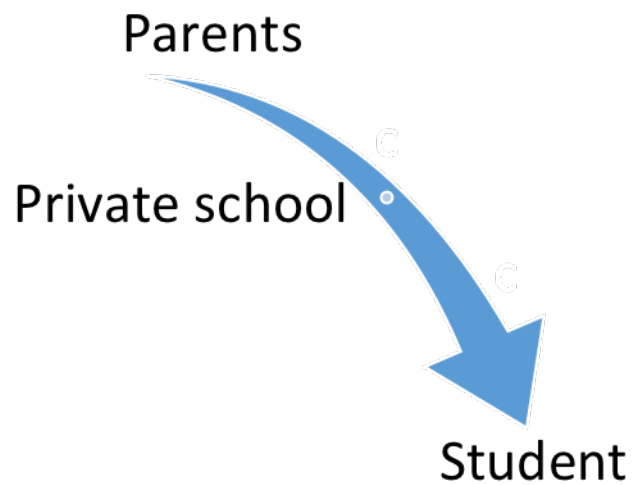
Texas' System of Private Education

As noted, more than 300,000 students are enrolled in private schools in Texas. Perhaps another 140,000 are home-schooled. While this is less than 10 percent of the number of students in public schools, it provides limited but still valuable competition to the state as the de facto monopoly education provider. The private system also provides an example of a more efficient model of education that can be used to inform the design of the public schools.

Unlike Texas' public system, most parents pay for the vast majority of their children's private school education. The money flows directly from the parents to the private schools, which then use the money to instruct the children, administer the schools, and provide for extracurricular benefits. Since the parents pay the money needed for education directly to the private school, they have significant control over every aspect of how the money is

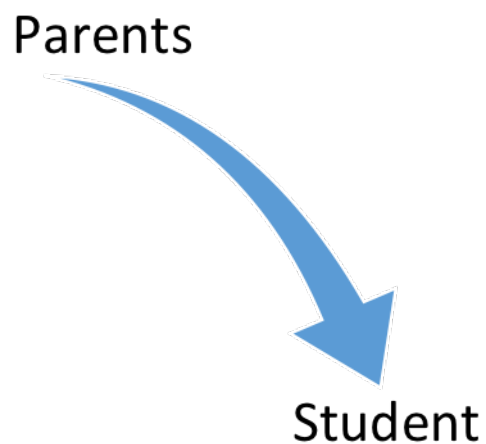
used. If too much money is going to extracurricular activities rather than to classroom instruction, parents usually have the authority to shift funds from one use to the other by demanding change in their current school or taking their student and their money to another school that better meets their needs.

Figure 3: Flows of Funds in Private Education



There are of course scholarships in the private system, but unlike tax dollars these charitable contributions are difficult to come by. The competition for the charitable contributions themselves and the use of them as scholarships limits the impact that these funds have on cost and quality. The result is a highly efficient system that allocates funds according to the desires of the consumers because the consumers are also the payers for most of the costs in the system.

Figure 4: Flow of Funds in Homeschooling



When it comes to homeschooling, parents still function as the payers and consumers. In fact, parents generally pay 100 percent of the cost. The system differs from that of private schools in that no exchange of funds takes place between the consumer and the provider. This is because the parents are both the consumers and the providers. All things being equal, this is the most efficient way to provide education; there is no third-party payer in this system and the parents have total control over all aspects of their children's education. Authority and accountability are self-contained in this system. Of course, all things are not equal, and the abilities and time that parents have available to provide their children with an education might lead them to choose private schools to educate their children. In economic terms, this is known as comparative advantage. Parents may find that they can provide a better quality education for their children at less cost by taking advantage of, for example, the superior ability of others when it comes to instruction.

Whether parents choose private school or homeschool, Texas' private K-12 education system is still highly efficient because the choice of how their children are being educated is being made freely by parents as consumers who in turn also act as the primary payer in the system. Consumer choice, accountability, and thus efficiency are maximized.

Solving the Third-Party Payer Problem in Texas

When it comes to health care, the primary approach taken to dealing with the problem of third-party payers has been health savings accounts (HSAs). The U.S. News and World Report explains how HSAs work:

Contributions made by a policyholder to a HSA are tax deductible, and contributions made by an employer are tax-free. Interest accrued in the HSA is also tax free, and the accounts are "portable," meaning they stay with you even if you change jobs or leave the workforce.

Individuals can withdraw money from a HSA without paying taxes to cover the cost of qualified medical expenses. But if the money goes toward nonmedical purposes, the amount is subject to income tax and an additional 20 percent tax, according to IRS rules.

Most importantly, unspent funds can remain in a HSA from year to year, unlike flexible spending accounts and health reimbursement accounts

that require consumers to spend or lose the money that was set aside each year. Plus, health savings accounts convert to typical individual retirement accounts once you reach retirement age.

"With a health savings account, the money stays with you even if you don't spend all of it during the year," Schopfer notes. "There is no pressure to 'use it or lose it,' which encourages people to be wasteful and get [health care services] they may not need." ([U.S. News and World Report](#))

By eliminating the use it or lose it aspect of the current third-party payer health care system, along with the emphasis on consumers using their own funds to pay for health care, HSAs offer a significant opportunity to improve wasteful, inefficient health care spending ([Canon, 4](#)).

Similar to HSAs, the solution to the pay problem in education may well be Education Savings Accounts (ESAs). An ESA would put consumers—parents—in charge of the education of their children. Parents could tailor educational services to the unique needs of their child by selecting from one or more of a variety of services such as: private schools, online learning, tutoring, curricula, textbooks, etc. Parents could even save unused funds for college.

Michael McShane, a research fellow in education policy studies at the American Enterprise Institute, explains how ESAs can help develop a vibrant, competitive market in K-12 education:

ESAs present a viable solution to a fundamental challenge in the way that education is delivered in America. Rather than going to one location run by one organization for an entire day, parents can find the combination of programs and providers that best meets their child's needs. Perhaps they love their school but want their child to learn Mandarin; with money from their ESA, they can purchase an online program to teach the language. Perhaps they are in a rural area without access to AP or dual-enrollment courses, they can use the funds to pay for credit-granting online courses provided by universities.

Another advantage of ESAs is that they hold the promise of harnessing one of the newest innovations in education. Many of the country's top colleges and universities are offering Massive Open

Online Courses, and many of these MOOCs are free to attend and require only an inexpensive professionally administered exam to grant credit. Higher education advocates and entrepreneurs are trying to figure out the proper place for MOOCs in colleges and universities, but perhaps their most promising use isn't in higher education but in secondary education. High school students could use their ESA dollars to access these credit-bearing college courses, regardless of where they live ([McShane](#)).

McShane also explains how ESAs can lead to greater efficiency, i.e., higher quality at equal or lesser cost, in Texas' system of public education:

ESAs also address another big problem with education in this country: We don't know how much it costs to educate a student. We know how much we spend, but because public schools are funded in lump sums to districts—and even voucher, tax credit, and charter school allotments are lump sum “coupons” to purchase education—we see schools set their costs right at the government subsidy. As competition for state budget dollars increases with expanding Medicaid liabilities and looming pension obligations, cost-effective education becomes more important every year.

“Unbundling” education services through a flexible spending account model encourages all providers to compete on price. If parents know that whatever they do not spend on tuition they can spend on tutoring or save for college, they will evaluate schools based on the return on their investment. To date, private schools that participate in school choice programs are evaluated on one dimension: quality. With fungible dollars, these schools can be evaluated two dimensionally: on quality and price. This competition should serve to both increase quality and decrease price ([McShane](#)).

The unbundling of services through ESAs will encourage providers to compete on price and quality, which is exactly what is missing in the system thereby delivering what is required by the Texas Constitution—an efficient education system.

The source of funds for ESAs can be payments from the state and local schools, as well as from individual or charitable sources through the use of tax credits. The

most important design aspect of ESAs is to ensure that once money has been deposited into an ESA, there are few restrictions on how the money is used for educational purposes. The more restrictions on how parents use the money to provide an education for their children the higher the likelihood that ESAs lose their effectiveness in increasing efficiency and overcoming the problem of the third-party payer.

Reforming Texas' System of Public Education

Our analysis of the economic efficiency of both public and private education in Texas leads to some simple yet transformative principles for reforming Texas' “system of public free schools.” If Texas is going to correct the economic and educational inefficiencies of Texas public schools, the Legislature should:

- Reduce the inefficiency of payments in Texas' “system of public free schools” by providing education savings accounts for parents to use to pay for the education of their children in public, private, or homeschool settings.
- Remove the restrictions that arbitrarily separate public schools from private schools and homeschooling:
 - allow private school and homeschool students to attend public schools part time;
 - remove restrictions that centralize the control in Austin over the public provision of virtual education; and
 - expand the ability of private providers to use virtual education models to provide instruction for public school credit.
- Introduce elements of parental choice within the public schools, including:
 - give parents more authority to direct elements of their children's education, such as curriculum;
 - eliminate the artificial cap on the number of public charter schools to give parents more choice about where their children attend; and
 - decentralize decisions about educator pay and qualifications by eliminating the state's educator salary schedule and educator certification system. ★

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About the Author



Bill Peacock is the vice president of research and director of the Texas Public Policy Foundation's Center for Economic Freedom. He has been with the Foundation since February 2005. Bill has extensive experience in Texas government and policy on a variety of issues including, economic and regulatory policy, natural resources, public finance, and public education. His work has focused on identifying and reducing the harmful effects of regulations on the economy, businesses, and consumers.

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