SENATE COMMITTEE ON FINANCE

INTERIM CHARGE
RECOMMENDATIONS
TO THE
82nd LEGISLATURE

JANUARY 2011
The Honorable David Dewhurst  
Lieutenant Governor of the State of Texas  
Capitol Building, Room 2E.13  
Austin, Texas 78701

Dear Governor Dewhurst:

The Senate Finance Committee is pleased to submit its final interim report with recommendations for consideration by the 82nd Legislature.

Respectfully submitted,

Senator Juan "Chuy" Hinojosa,  
Vice Chair

Senator Bob Deuell

Senator Kevin Eltife

Senator Eddie Lucio, Jr.

Senator Jane Nelson
Senator Dan Patrick

Senator Florence Shapiro

Senator John Whitmire

Senator Kel Seliger

Senator Royce West

Senator Tommy Williams

Senator Judith Zaffirini
Dear Chairman Ogden:

Thank you for your dedication and leadership as Chair of Senate Finance. I consider it an honor to have served with you for the past eight years, and I am confident that with your leadership and depth of knowledge Senate Finance will again produce an effective budget that operates within our means.

The report includes numerous recommendations that will improve the financial health and well-being of our state, and for that reason, I am happy to sign it. I am pleased with recommendations that seek to limit public spending and that aim to shed light on debt at all levels of government.

However, I must note a few concerns. While I support the goal of increased taxpayer participation in the tax-rate setting process, I am not confident that a 4% revenue cap for cities and counties that requires voter approval to exceed the cap is the best method to achieve this. Lowering the appraisal cap would be popular among my constituents, but I want to examine all options for replacing revenue lost to that reduction. Finally, I agree that the Legislature needs to explore options to address funding needs of nursing facilities. However, I have been and remain opposed to a quality assurance fee.

Again, thank you for your and your staff's time and effort to produce this report, and I look forward to a productive legislative session.

Sincerely,

Robert F. Deuell, M.D.
Texas Senate, District Two
January 31, 2011

The Honorable Steve Ogden
Chairman, Senate Finance Committee
P.O. Box 12068
Capitol Station
Austin, Texas 78711

Dear Chairman Ogden:

Thank you for your leadership and hard work on the important issues before the Senate Finance Committee this interim. The committee considered many issues that will be critical to the future of the State.

The reports prepared by committee staff provide an outstanding background on the topics examined. The proposed recommendations set out a positive course for discussion during the coming session. While I endorse most of the proposals made, I am not necessarily committed to all of the recommendations. My signature on these reports is a reflection of my support for an ongoing discussion of these topics, however, I do find it necessary to outline my specific concerns regarding the recommendations related to Chapter 313, Tax Code.

Because of the current challenges facing the state budget, I concur that the issues raised in the report on Chapter 313 need to be carefully evaluated. The economic development opportunities for many of the communities impacted by these types of agreements are few and far between. Any public policy discussion on the topic must take into account these limited opportunities.

Again, thank you for your hard work. I look forward to a productive session.

Yours very truly,

Robert Duncan
January 31, 2011

The Honorable Steve Ogden
Chairman, Senate Finance Committee
Capitol Extension, Room E1.036
P.O. Box 12068
Austin, Texas 78711

Dear Chairman Ogden:

I want to thank you for your leadership throughout this interim. The hard work and dedication that you and your staff have shown during the interim committee hearings are greatly appreciated. As you are aware, several of our colleagues in the Senate Finance Committee have voiced a number of concerns with some of the recommendations that are being suggested in the interim report. Although I share these concerns, I signed the report because I am engaged in the committee process and fully believe in the spirit of cooperation. Consequently, I write this letter to clarify my signature and to note that my participation in the signing of the committee report should not be interpreted as wholehearted agreement with the report's recommendations.

Generally, it appears that several overlapping policy themes guided the development of some of the recommendations, including but not limited to: shifting the burden of funding needed programs to locals; providing preference to some individuals/entities over others; and, limiting growth of available revenue/spending. Respectfully, I cannot agree to recommendations that adhere to such a policy direction. Overall, matters such as shifting the funding required to support Tuition Revenue Bonds (TRBs) to be paid by local tuition, lowering the homestead exemption to cover the cost of a decreased appraisal caps, and limiting growth of available revenue/spending are among some of the recommendations that provide me great concern. As you are aware, the Lower Rio Grande Valley is a fast growing region that lacks critical resources and thus is in need of increased services and assistance from the state. Since several of the recommendations may engender policies that run counter to the needs of my constituency, I hope that you can appreciate my reservations. For brevity, I have included a brief synopsis of some of the reservations that I have with the report's recommendations.

The recommendations that relate to Higher Education Funding are of great concern to me. Shifting the burden to our local institutions by requiring them to pay TRBs by local tuition revenue will unnecessarily cause undue harm to these institutions and likely raise the cost of tuition for our constituency. This is especially true for fast growing institutions that are currently doing a balancing act of struggling to keep up with their enrollment growth while attempting to
keep their tuition affordable so that low income students -- who are struggling to pay for college -- are not priced out of their education. Although the recommendation attempts to mitigate the serious problems that the policy engenders (by having the local tuition support requirement being "phased in") the foreseeable and immediate consequences of such a policy would be detrimental to our higher education institutions. As our Committee was informed during the interim hearings, having the state fund the debt service for our TRBs provides institutions better ratings than they would ever hope to receive if they did not have the full-fledged, financial support of our state. Taking away this state funding, albeit phased-out as the recommendation suggests, would have the unintended consequence of costing our constituents millions of dollars more in TRB debt service due to less favorable rates and would needlessly increase tuition to exorbitant levels. In light of the budget shortfall and the fact that institutions will be receiving less money from the state in the years to come, I fear that low-income and working families will feel the brunt of this recommendation.

Recommendations relating to the Property Tax System are also troublesome. In particular, the proposal to reduce the current $15,000 homestead exemption in an amount necessary to offset the cost of lowering the appraisal cap to 5% is of grave concern. It is reasonable to conclude that this "reduction to offset" recommendation would benefit property owners who are located in wealthier, newer areas or locations that are becoming more "modern/trendy" since it would restrict the growth in their property taxes. The interim report hints at this conclusion when it reports that reducing the appraisal cap from 10% to 5% "would benefit homeowners that have increasing property values."

Although a select few with increasing property values would receive a financial windfall by this recommendation, the cost of carrying out this policy would be unfairly shouldered by those whose tax bill would be increased. Since homestead exemptions lower the value of the property that is actually taxed locally, lowering the exemption will correspondingly increase a person's property tax bill (since of a homeowner's property's value will be taxed). Thus, every other homeowners' tax obligation will increase as the result of the "reduction to offset" policy that "would benefit homeowners that have increasing property values."

Additionally, the recommendation fails to provide any safeguards to most Texas homeowners that would ensure that their homestead exemption would not be completely eviscerated by the policy that assists those with "increasing property values." As noted in the interim report, lowering the appraisal cap would mean that there will be lower ad valorem taxes available to local school districts and there would be a need to "offset" the loss of this local tax revenue. This is especially problematic since the report fails to specify how much the homestead exemption would have to be reduced to cover the cost of lowering the appraisal cap. Rather, the report simply recommends reducing the homestead exemption to "an amount necessary to offset the cost of lowering" the appraisal cap to 5%. Although the benefit of this recommendation would enrich some, in practice, the cost of this policy could disproportionately hurt some Texans on low, fixed incomes who are in older or poorer neighborhoods.

Correspondingly, the Property Tax System recommendations that pertain to providing tax breaks to private property lessors of charter schools and, in the alternative, provide facility funding to charter schools is yet another example of unjustly favoring one entity/group at the expense of
others. As you are aware, over the last several sessions, I have maintained that the state should take a statesman-like position of comprehensively addressing the needs for facility funding of our public schools. The State of Texas has yet to come close to realizing this goal, and yet these two recommendations provide preferential treatment to charter schools at the expense of our public education system. Rather than provide public tax dollars to private entities that lease to charter schools, or alternatively, enrich charter schools with a windfall financial gain of state facility funding assistance, the state must comprehensively address the needs of public schools in terms of facility funding. I fear that because charter schools will be competing for the same facility funding dollars that property poor districts will be competing for, school districts like those that I represent will come out of the short end of the recommendation that simply entitles more entities to receive assistance from our ever-shrinking taxpayer dollars.

With regard to student success programs in Higher Education Funding, I agree that the state must allocate financial aid dollars in an efficient and effective manner so that a greater number of young Texans may realize their goal of higher education. However, any review of student success initiatives, especially that of TEXAS Grants, must consider the original purpose of these programs: to support those students who face the greatest barriers to pursuing higher education. Simply changing the way monies are spent does not equal greater efficiency if the original goal remains unmet.

The border delegation is in agreement that recommendations that call for limiting the growth of services and spending is increasingly troublesome to those of us who represent fast growing regions that lack critical resources and are in need of greater state assistance. Overall, I wholeheartedly believe mechanisms should not be erected that strap future Legislatures and policy makers to arbitrary numbers set today. Additionally, rather than limiting state supported debt, revenue and services, the state needs to have the flexibility to grow, adjust and react to any emergency or need that may arise in the future. In order to better serve the constituency that we represent as elected officials, at best, fiscal policy and spending need to be flexible to the evolving needs of our constituency and not stagnant to an arbitrary time or figure. At worst, limits in spending should be carried out by policy formulas that take into consideration factors such as the level of need, growth and profile of Texas' population. To do something otherwise may be a disservice to the constituency that we all represent.

Although the aforementioned amount to some, but not necessarily all, of my reservations to the report's proposed recommendations, please accept my signature as one that signifies that I agree that the finance appropriation process must continue to move forward and that I stand ready to debate the policy proposals that are developed from these recommendations.

Sincerely,

Eddie Lucio, Jr.
Senator, District 27
February 1, 2011

The Honorable Steve Ogden
Chairman
PO Box 12068
Austin, Texas 78711

Dear Chairman Ogden:

Thank you for the opportunity to review the interim study reports by the Senate Finance Committee and comment. The Senate Finance Committee dedicated a great deal of time studying many important issues and I happy to add my signature to this report. However, I wish to express my concern with a couple of recommendations.

My first concern is related to the recommendation that the franchise tax be changed to more closely match revenue projections. As a Texas Senator, I understand the budget reality that we face this session. The demands being placed on the Property Tax Relief fund are growing while the franchise tax revenue continues to generate less revenue than expected. However, I am fully aware that the revised franchise tax has resulted in a dramatic tax increase on many in the business community. It is my hope that any changes to the franchise tax would make the current burden more equitable and improve the ability to comply.

The committee’s report on property tax issues included several excellent proposals that would ease the property tax burden on Texans across the state. It is my hope that we can continue to rely less on property taxes in general and let Texans set their own tax burden through a consumption based model. Thank you again for your work and I look forward to serving with you on this important committee.

May God bless,

DAN PATRICK
Senator ★ District 7
Harris County
Bunker Hill Village
Hedwig Village
Hilshire Village
Houston
Humble
Hunters Creek Village
Jersey Village
Katy
Pinney Point Village
Spring
Spring Valley
Tomball
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1 Materials presented to the Committee can be found at: [http://www.senate.state.tx.us/75r/Senate/commit/c540/c540.htm](http://www.senate.state.tx.us/75r/Senate/commit/c540/c540.htm)
Cancer Prevention and Research Institute of Texas
EXECUTIVE SUMMARY

In 2007, the citizens of Texas authorized a significant commitment of public dollars to cancer research and prevention through the Cancer Prevention and Research Institute of Texas (CPRIT)--$3 billion, financed through general obligation bonds and distributed in increments of up to $300 million per year in grants to individuals and institutions. CPRIT began making awards in fiscal year 2010, and the Texas Senate Finance Committee (the Committee) was tasked by the Lieutenant Governor with reviewing the Institute's grant making processes for efficiency and effectiveness. The Committee found that CPRIT benefits from a small and very qualified staff, including nationally renowned individuals in key leadership roles. Its grant making process follows the best practices of similar organizations elsewhere in the state and in the country. However, there is room for improvement.

First, the Institute is required to maintain escrow balances sufficient to cover future disbursements on active grants, which results in Texas acquiring new debt before it is needed. Changing this requirement would produce savings for the State. Second, current reporting requirements do not ensure that comprehensive and consolidated information is available to each new Legislature to aid in appropriations decisions. Third, existing conflict of interest provisions leave open the possibility that donations made to the CPRIT Foundation to supplement the salaries of executive-level staff could influence grant awards decisions. Also, current clawback provisions could be enhanced, especially on commercialization awards, to improve grant performance. Fourth, Legislative intent regarding standards for intellectual property agreements and priorities for use of the resulting revenue is not clear. Furthermore, the Institute lacks flexibility in the type of awards it can make when compared to the Texas Emerging Technology fund, which is authorized to make loans and equity investments.
Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to grant making processes at the Cancer Prevention and Research Institute of Texas:

Issue 1: Escrow Requirement

1. Amend Chapter 102, Section 102.257 of the Texas Health and Safety Code to allow (but not require) the escrowing of multi-year grant awards, and amend Texas Government Code, Section 1232.122 to allow TPFA to stagger issuance of debt for CPRIT grants.

Issue 2: Information Flow to the Legislature

2. For even numbered years, maintain reporting requirements as specified in Sections 102.052 and 102.053 of the Texas Health and Safety Code, with an amended (added) deadline of the last day of February for CPRIT's annual public report for the previous fiscal year.

3. For odd numbered years, further amend Sections 102.052 and 102.053 of the Texas Health and Safety Code to require that by the last day of February, the Comptroller, CPRIT, and the Texas Public Finance Authority shall collaborate to produce a consolidated biennial report for presentation to the Governor and the Legislative Budget Board. The report should include CPRIT's public reports and independent financial audits, and the Comptroller's evaluations of those audits and related recommendations, for the previous two fiscal years, as well as total debt service requirements on currently outstanding CPRIT debt and debt service projections under several issuance scenarios.

Issue 3: Conflict of Interest and Clawback Provisions

4. Amend Texas Health and Safety Code, Chapter 102, Section 102.251 to require disclosure in the event that the Executive Director's list of grants recommended for funding differs from the recommendations submitted to him or her by the reviewing committee(s).

5. Consider repealing the authority provided in Texas Health and Safety Code, Chapter 102, Section 102.056 allowing salary supplements for executive-level staff.

6. Broaden allowable (optional) clawback provisions as stated in Texas Health and Safety Code, Chapter 102, Section 102.255(b)(2) to include a return of funds if grant recipients fail to deliver on benefits projected in grant applications, such as jobs created and products commercialized.
Issue 4: Intellectual Property Agreements and Revenue Sharing

7. Amend *Texas Health and Safety Code*, Chapter 102, Section 102.201(c) to allow the Cancer Prevention and Research Fund to be used for payment of debt service on CPRIT bonds, and for loans (including convertible loans), equity investments, warrants, or other instruments, subject to appropriation.

8. Consider amending Article III, Section 67(e) of the Constitution to authorize CPRIT to award funds financed through its constitutional bonding authority for loans (including convertible loans), equity investments, warrants, or other instruments.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with studying grant making processes at the Cancer Prevention and Research Institute of Texas (CPRIT):

*Monitor the Cancer Prevention and Research Institute of Texas grant making process to ensure that funds are spent efficiently and effectively.*

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas, on May 12, 2010 to consider invited testimony provided by James Mansour (CPRIT Board Chair) and Bill Gimson (Executive Director). The Committee solicited public testimony as well, however none was given.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

BACKGROUND

In 2007 voters passed an amendment to Texas' constitution authorizing up to $3 billion in General Obligation bonds to support the Cancer Prevention and Research Institute of Texas (CPRIT), limited to $300 million per year with no bonds issued after August 31, 2020. The General Appropriations Act (GAA) of the 81st Legislature appropriated to CPRIT approximately $448.2 million for the 2010-2011 biennium, almost all of which was general obligation bond

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1 Codified by *Texas Health and Safety Code*, Chapter 102, Section 102.254.
proceeds. That amount included approximately $15.5 million for operations and $432.7 million for grants. In fiscal year 2010, CPRIT received about 1,100 proposals, performed about 8,500 full reviews, and made 155 awards to 43 institutions and organizations totaling about $216 million. The agency expects to fully award its available grant funds in fiscal year 2011.

Article III, Section 67 of the Texas Constitution; Texas Health and Safety Code, Chapter 102; and Texas Administrative Code, Title 25, Chapters 701-704 set various requirements on the agency and its grants. The following list highlights those provisions most relevant to the Finance Committee's interim charge:

- CPRIT must maintain an escrow fund balance sufficient to cover future payments on active grants.\(^3\)

- The Institute must complete an annual public report and independent financial audit for review by the Comptroller.\(^4\)

- Grant recipients must show matching funds equal to at least half of their grant amount\(^5\), every grant must include an intellectual property agreement likely to produce revenue for Texas, and grant contracts may include certain clawback provisions.\(^6\)

- The Executive Director is required to submit to the Oversight Committee a list of grants recommended for funding that is "substantially based" on recommendations from the reviewing committee(s). These recommendations must be followed unless there is a two-thirds vote within the Oversight Committee to override.\(^7\)

- The institute may supplement the salary of senior staff members from gifts, grants, donations, or appropriations.\(^8\)

- Indirect costs are limited to 5% of the award amount; funds spent on facility purchase, construction, remodel, or renovation are limited to 5%; and the amount CPRIT can award in cancer prevention and control grants is limited to 10% of available grant funds.\(^9\)

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\(^2\) An additional $1.9 million in bond proceeds was transferred to the Department of State Health Services to enhance the infrastructure of the Texas Cancer Registry, in accordance with Article IX, Sect. 17.42 of the General Appropriations Act.

\(^3\) Texas Health and Safety Code, Chapter 102, Section 102.257.

\(^4\) Texas Health and Safety Code, Chapter 102, Sections 102.052 and 102.053.

\(^5\) Texas Constitution, Article III, Section 67,(i).

\(^6\) Texas Health and Safety Code, Chapter 102, Section 102.255.

\(^7\) Texas Health and Safety Code, Chapter 102, Sections 102.251 and 102.252.

\(^8\) Texas Health and Safety Code, Chapter 102, Section 102.056.

\(^9\) Texas Health and Safety Code, Chapter 102, Section 102.203.
Under these constitutional and statutory requirements, CPRIT makes multiple types of awards under three broad categories--research, prevention, and commercialization--using competitive peer review processes patterned primarily after those of the National Institutes of Health, the American Cancer Society, and the Komen Foundation. Appendix A shows the number and size of review committees in each area. As indicated, CPRIT's grant making process utilizes the expertise of over 150 individuals.

The following summarizes the peer review process for research and prevention grant applications.

**Figure 1: Peer Review Process for Research and Prevention Grants**

The upper portion of Figure 1 reflects a triage process intended to decrease the volume of applications advanced to full review. Research grants are screened primarily on the basis of scientific soundness. Due to the lower volume of applications received, prevention grants are triaged solely on the basis of completeness. In both categories, applications chosen for advancement are referred to a single review panel for scoring by three area experts. Once scores have been assigned, the panel meets to discuss the results and recommend applications for...
consideration by the Scientific Review Council or the Prevention Review Council, as appropriate. These councils finalize recommendations to the Executive Director, who creates the final list of awards for announcement by the CPRIT Oversight Committee. CPRIT's peer review process ensures that funded research grants have been examined and discussed by about 20 area experts prior to approval. In the case of prevention grants, this number is around 10.

Commercialization applications undergo a separate review process based on scientific, legal, and business criteria.

**Figure 2: Due Diligence Steps for Commercialization Grants**

Source: CPRIT

CPRIT's initial administrative review is primarily for completeness, and the Commercial Review Council (CRC) makes an initial review based on commercial viability. Three reviewers score the application on this criterion; the CRC then meets to select applications to go to scientific review by a special panel selected from among all CPRIT scientific reviewers. For those grants scored highly on both commercial and scientific grounds, the CRC continues with the intellectual property and legal review, and a deeper examination of business and commercial
components of the application. Based on the results, the full council meets to make its initial recommendations for funding to CPRIT. After remaining due diligence steps, the Executive Director presents funding recommendations to the Oversight Committee for approval. As Figure 2 indicates, commercialization grants are periodically reviewed and considered for further funding based on achievement of various milestones.\(^{10}\)

At present, CPRIT benefits from maintaining a small and very qualified staff, including nationally renowned individuals in key leadership roles. CPRIT's grant making process follows the best practices of similar organizations elsewhere in the state and in the country. However, the Senate Finance Committee identified several areas deserving attention.

**ISSUES AND RECOMMENDATIONS**

**Issue 1: Escrow Requirement**

Chapter 102, Section 102.257 of the *Texas Health and Safety Code* requires CPRIT to maintain an escrow balance sufficient to cover future disbursements on approved grants. Because the agency's grants are funded with general obligation debt, this provision (the "escrow requirement") can result in the State issuing debt before it is actually needed. The 2010-2011 Sunset Staff Report on CPRIT recommended removing the escrow requirement and amending Texas Government Code, Chapter 1232, Section 1232.122 to give the Texas Public Finance Authority the ability to stagger issuance of debt for CPRIT grants. Sunset staff estimated this recommendation would save about $31 million in the 2012-2013 biennium, and the Commission adopted the recommendation.

There are multiple sides to this issue, however. First, while removing the escrow requirement would allow Texas to push debt service costs on CPRIT bonds into the future, it

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\(^{10}\) Additional information on CPRIT's grant review processes can be found on the agency's website: [http://www.cprit.state.tx.us/](http://www.cprit.state.tx.us/).
would not necessarily reduce the overall cost to the State. Based on the time-value of money, deferring payments may be in the State's interest, but that depends on debt issuance and management patterns, and interest rates and other market trends that cannot be predicted. Second, CPRIT is not strictly observing the escrow requirement anyway, instead holding bond proceeds in the State Treasury where they may be perceived as an unencumbered "pot of cash" rather than monies dedicated toward contractual grant obligations. Third, removing the escrow requirement leaves open the possibility that CPRIT could surpass the $300 million annual limit for bond issuance, if obligations from multiple years' grant awards "pile up" in a given fiscal year. Whether or not the limit is actually surpassed, CPRIT could find itself of having to choose which types of grants to award (for example, single year versus multi-year) based on staying within the cap, rather than which applications hold the most promise. Fourth, it may be more beneficial to the state to have both options rather than to choose one over the other. Having the flexibility to issue the bonds in the present and hold the proceeds in escrow or delay issuance until the funds are needed would be helpful in managing the State's budget, making it easier to navigate difficult economic times through deferrals while front loading the debt when the economy is strong or interest rates are low.\footnote{Note that because the vast majority of CPRIT bonds are taxable, there is little to no arbitrage risk associated with holding bond proceeds in escrow.}

The Committee recommends that the Legislature:

1. Amend Chapter 102, Section 102.257 of the \textit{Texas Health and Safety Code} to allow (but not require) the escrowing of multi-year grant awards, and amend Texas Government Code, Section 1232.122 to allow TPFA to stagger issuance of debt for CPRIT grants.

**Issue 2: Information Flow to the Legislature**

Information flow to the public and to the Legislature is another area of with room for improvement. CPRIT's governing statute requires an annual public report, an annual
independent financial audit, and a review of the audit by the Comptroller (*Texas Health and Safety Code*, Chapter 102, Sections 102.052 and 102.053). There is no statutory deadline for CPRIT's annual public report; deadlines for the annual independent audit and Comptroller review are set by statute and Comptroller policy. Unaudited financial reports are due by November 20th (set by statute), with audited reports due by December 20th (by rule). The Comptroller's review of CPRIT's financial report will be issued along with the Comprehensive Annual Financial Review (by rule), which is issued on or before the last day of February (by statute). The first review, for fiscal years 2009 and 2010, will be published in February of 2011. CPRIT's public report must be submitted to the Governor and the Legislature; the audited financial report must be submitted to the Comptroller, and the Comptroller's review is to be publicly available.\footnote{Note that the Comprehensive Annual Financial Review, along with which the CPRIT review will be issued, is only required to be submitted to the Governor, though it is available to the public online.}

There are no specific reporting requirements regarding current debt service obligations on CPRIT debt or projected debt service on future issuances, though the Texas Public Finance Authority (TPFA) is able to provide this information to the Governor and Legislature upon request.

The magnitude of the investment in cancer research and prevention committed by the citizens of Texas is substantial ($3 billion), as are the associated debt service requirements (potentially reaching $500 million per biennium). The speed at which the debt is issued--and the impact on the state budget and the broader fiscal condition of Texas--are set by the appropriations process. Thus, the need for more comprehensive, consolidated information each odd numbered year is great, while less so in even numbered years. That need includes information on how different issuance scenarios will affect debt service requirements several
years into the future, for example if the Legislature opts to appropriate the maximum of $300 million per year over several years, or a lesser number such as the current $225 million.

The Committee recommends that the Legislature:

2. For even numbered years, maintain reporting requirements as specified in Sections 102.052 and 102.053 of the Texas Health and Safety Code, with an amended (added) deadline of the last day of February for CPRIT's annual public report for the previous fiscal year.

3. For odd numbered years, further amend Sections 102.052 and 102.053 of the Texas Health and Safety Code to require that by the last day of February, the Comptroller, CPRIT, and the Texas Public Finance Authority shall collaborate to produce a consolidated biennial report for presentation to the Governor and the Legislative Budget Board. The report should include CPRIT's public reports and independent financial audits, and the Comptroller's evaluations of those audits and related recommendations, for the previous two fiscal years, as well as total debt service requirements on currently outstanding CPRIT debt and debt service projections under several issuance scenarios.

**Issue 3: Conflict of Interest and Clawback Provisions**

CPRIT has implemented several common conflict of interest protections, as required by statute and developed by rule. All grant application reviewers are from outside the State of Texas, and by Section 702.11 of the Texas Administrative Code must recuse themselves in the event of a conflict of interest. Texas Health and Safety Code, Chapter 102, Subchapter C also details circumstances in which Oversight Committee members should be removed. However, when taken together, Chapter 102, Sections 102.056, 102.251, and 102.252 leave open the possibility of several important conflicts of interest. Section 102.056 allows for salary supplements for executive-level staff from external sources. At present, the CPRIT Foundation supplements the salaries of the Executive Director and the Chief Scientific Officer out of donations to the Foundation. Donors primarily include CPRIT Oversight Committee members, however other institutions and individuals can and do make donations. Sections 102.251 and 102.252 require the Executive Director to submit to the Oversight Committee a list of grants...
recommended for funding that is "substantially based" on--not necessarily equivalent to--recommendations from the reviewing committee(s). The Director's recommendations must be adopted unless there is a two-thirds vote within the Oversight Committee to override. Thus, the possibility exists that the Director (or, to a lesser extent, the Chief Scientific Officer) could inject influence into the award process that favors an institution that has made donations to the foundation that supplements his or her salary. Additional disclosure requirements may help ensure the purity of the awards process.

CPRIT grants come with not just social, but economic expectations as well, especially commercialization awards. Expected economic benefits include job creation or relocation of jobs to Texas--recipients must already be located in Texas, or be willing to move a substantial portion of their operations here--and revenue sharing through intellectual property agreements. Section 102.255 of Texas Health and Safety Code, Chapter 102, authorizes CPRIT to include some clawback provisions in its grant contracts if expectations are not met. For example, the contracts may stipulate that the State retains a lien on capital improvements built with awarded funds, entitling it to repayment and/or a share of profits if the improvement is sold. Also, CPRIT contracts may require funds to be repaid if grant money is spent for purposes other than those for which they were awarded. These provisions are common to other grant making bodies, however the Texas Enterprise Fund, which also makes grants intended to bring economic benefits to the state, has the ability to request repayment of funds if actual job creation falls short of projections. Similarly enhanced clawback authority at CPRIT, especially for commercialization grants, could increase the likelihood that Texas will see economic benefits from its investment. For example, clawback provisions could be expanded to cover situations in which recipients fail to deliver the proposed benefits, such as jobs created or products commercialized.
The Committee recommends that the Legislature:

4. Amend *Texas Health and Safety Code*, Chapter 102, Section 102.251 to require disclosure in the event that the Executive Director's list of grants recommended for funding differs from the recommendations submitted to him or her by the reviewing committee(s).

5. Consider repealing the authority provided in *Texas Health and Safety Code*, Chapter 102, Section 102.056 allowing salary supplements for executive-level staff.

6. Broaden allowable (optional) clawback provisions as stated in *Texas Health and Safety Code*, Chapter 102, Section 102.255(b)(2) to include a return of funds if grant recipients fail to deliver on benefits projected in grant applications, such as jobs created and products commercialized.

**Issue 4: Intellectual Property Agreements and Revenue Sharing**

Every grant contract at CPRIT must include an intellectual property agreement (*Texas Health and Safety Code*, Chapter 102, Sections 102.255 and 102.256). The latitude given to CPRIT in crafting these agreements leaves open the possibility that the return to the State could be out of sync with the magnitude of its investment. It seems logical that if the State provides funding covering X% of the expenditures required to develop a new technology or product, then the State should receive X% of future profits on the development. However, identifying the appropriate percentage can be both challenging and controversial. CPRIT generally defaults to 10%; however there are no specific requirements in its governing statute that provide Legislative intent and/or ensure the return to Texas is commensurate with its investment.

CPRIT also lacks the flexibility given to the Texas Emerging Technology Fund (ETF) in the types of awards it can make. The ETF has the ability to make loans or take an equity position in companies receiving awards, while CPRIT is limited to grants with intellectual property and revenue sharing provisions. Broadening CPRIT's authority to include loans, convertible loans, equity investments, and warrants has the potential to maximize the return on Texas' investment in cancer research and prevention, and could also help address the first issue.
discussed in this section. This type of change would require amending Article III, Section 67(e) of the Constitution, which governs CPRIT bond proceeds and explicitly states that the proceeds are to be distributed as "grants." Given the amount of dollars in question, and the fact that no major commercialization projects have yet been completed, any constitutional amendment should be thoroughly considered and debated before being sent to voters for approval.

As for the fate of revenue received on intellectual property agreements, *Texas Health and Safety Code*, Chapter 102, Section 102.201 directs patents, royalties, license fees, and other income into a dedicated account in the General Revenue Fund (the Cancer Prevention and Research Fund). It also specifies that the account may only be used to pay for research and prevention grants, the purchase of facilities, and the implementation of the Texas Cancer Plan. That section does not prioritize uses for revenue or otherwise express Legislative intent, and also excludes some worthwhile possibilities. For example, allowing funds to be used to pay debt service on CPRIT bonds could enhance the fiscal health of the state and reduce the long-term debt burden associated with the Institute. In addition, revenue to this account is not subject to the constitutional limitations described above and therefore could be more easily used for loans, convertible loans, equity investments, and warrants. Furthermore, because the use of the dedicated fund is subject to appropriation, each successive Legislature could specify whether any balances and new revenue are used for grants, loans, operations, debt service, or held for budget certification purposes.

The Committee recommends that the Legislature:

7. Amend *Texas Health and Safety Code*, Chapter 102, Section 102.201(c) to allow the Cancer Prevention and Research Fund to be used for payment of debt service on CPRIT bonds, and for loans (including convertible loans), equity investments, warrants, or other instruments, subject to appropriation.
8. Consider amending Article III, Section 67(e) of the Constitution to authorize CPRIT to award funds financed through its constitutional bonding authority for loans (including convertible loans), equity investments, warrants, or other instruments.
APPENDIX A: CPRIT REVIEW COMMITTEES

**RESEARCH GRANTS**

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<thead>
<tr>
<th>Review Committees:</th>
<th>Scientific Review Council (SRC):</th>
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<tr>
<td>• 8 Committees</td>
<td>• 7 Members:</td>
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<tr>
<td>• 130 Reviewers</td>
<td>Clara Bloomfield, M.D.</td>
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<tr>
<td></td>
<td>Sanjiv &quot;Sam&quot; Gambhir, M.D., Ph.D.</td>
</tr>
<tr>
<td></td>
<td>Tyler Jacks, Ph.D.</td>
</tr>
<tr>
<td></td>
<td>William Kaelin, Jr., M.D.</td>
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<td></td>
<td>Richard Kolodner, Ph.D.</td>
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<tr>
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<td>Charles Sherr, M.D., Ph.D.</td>
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<td>Everett Vokes, M.D.</td>
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**PREVENTION GRANTS**

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<td>• 28 Reviewers</td>
<td>Lawrence W. Green, Dr.P.H.</td>
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<td>Nancy L. Lee, M.D., LLC</td>
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**COMMERCIALIZATION GRANTS**

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<td>Ray Cosan</td>
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<td>Casey Cunningham, M.D.</td>
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<td>Kapil Dhirgra, M.D.</td>
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<tr>
<td></td>
<td>Cynthia Doerr, M.D.</td>
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<td></td>
<td>Todd M. Fruchterman, M.D., Ph.D.</td>
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<td></td>
<td>Phyllis Gardner, M.D.</td>
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<td>Jack Gellosky, M.D.</td>
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<td>Bruce D. Given, M.D.</td>
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<td>Evan Melrose, M.D.</td>
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<td></td>
<td>Andrew Nat, Jr.</td>
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<td>Robert Young, M.D.</td>
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Rural Hospitals, Hospital Financing, and Nursing Facilities
EXECUTIVE SUMMARY

During the 81st interim, the Senate Committee on Finance (the Committee) held a hearing to review the capacity, infrastructure, and funding of rural hospitals and the potential closure of rural nursing facilities. The Committee recommends the Legislature consider directing studies to better evaluate the current landscape and directing the Texas Health and Human Services Commission (HHSC) to change the Medicaid reimbursement methodology for acute care hospitals and nursing facilities to link payment with quality and reduce cost.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to hospital financing and nursing facilities.

Issue 1: Rural Hospitals

1. Direct the Texas A&M School of Rural Public Health or a similar institution to research access to quality trauma care and to recommend improvements in utilizing the Rural Health Facility Capital Improvement Fund, 911 Funds, EMS and Trauma Funds, Tobacco Settlement Funds, and the System Benefit Fund.

2. Direct HHSC to conduct a comprehensive study of access, population density, and utilization trends across all health care facilities in rural areas and provide correlation and comparison tools to evaluate the potential need for additional funding to sustain healthy networks of health care.

3. While steps can be taken to begin improving rural facilities, the Legislature should also continue to explore additional options to increase access to care in rural Texas.

Issue 2: Medicaid Hospital Financing

4. Direct HHSC, through the Texas Medicaid Program, to change the inpatient payment system to incentivize efficiency and quality and to achieve a shared savings program.

Issue 3: Nursing Facilities

5. Direct HHSC and DADS to make changes to Medicaid nursing facility reimbursements to further link payment to quality and to incentivize efficiencies, low-cost settings, and health outcomes.
6. Direct HHSC and DADS to pursue a Medicare and Medicaid Waiver to demonstrate how combined financing for acute and long term care services, especially for dual eligible individuals, can save tax dollars and improve health outcomes.

7. Explore all options to address funding needs for nursing facilities, including the potential for a quality assurance fee.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with conducting a review of rural hospitals and developing a recommendation to address capacity, infrastructure and service delivery problems. The Committee included inpatient payment systems and the capacity and funding of nursing facilities in the charge. The Committee met in accordance with the following interim charge as follows:

*Review the capacity of rural hospitals, rural hospital infrastructure, and the statewide impact of services provided by rural hospitals. Make recommendations for funding options to help communities that do not have adequate resources to replace aging infrastructure and consider the creation of a rural hospital infrastructure support program similar to the courthouse preservation fund.*

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas, on July 7, 2010, to consider invited and public testimony.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

**Issue 1: Rural Hospitals**

Texas rural public hospitals increasingly face market competition, aging buildings, and diminishing capital resources. Congress passed the Hill-Burton Act in 1946 which created funding programs for local communities to construct and to renovate hospitals, nursing facilities and other health care facilities. In return for these funds, the providers agreed to offer discounted
and free care in the community. According to research by Jeanette Harlow, $4 billion in funding was invested in the construction of over 6,900 buildings.\(^1\) Congress has not appropriated any additional funding to this program since 1997. As a result, many rural facilities have become more dependent on state and local government funds.

According to the presentation provided by the Texas Comptroller of Public Accounts, there are 134 hospital districts in the State of Texas imposing a property tax. (Appendix A: CPA presentation) One hundred six of the districts are in rural counties. Hospital districts also impose a sales and use tax. Of these that charge a sales and use tax, nine are at the two percent cap imposed by tax law and thereby cannot increase their tax rate and revenues without another taxing entity decreasing a corresponding percentage. Adding further burden, twelve rural counties, as defined by the Texas Department of Rural Affairs (TDRA), have at least two hospital districts collocated within the county, and twenty-four rural counties have at least two hospital facilities. Therefore, many rural hospitals and hospital districts face increased competition for patients and for tax dollars.

Additional aid for rural hospitals also comes from the Texas Department of Rural Affairs’ (TDRA) Permanent Fund for Rural Health Facility Capital Improvement, from the Department of State Health Services’ (DSHS) EMS and Trauma Funds as well as from the Tobacco Settlement Permanent Trust when counties administer Indigent Health Care Programs. TDRA offers a low interest loan and grant program to aid rural hospitals with facility improvements. In 2009, the General Appropriations Act appropriated $2,037,000 annually for the biennium for this program. It was anticipated that this funding would benefit 36 rural hospitals annually. DSHS was appropriated various amounts from EMS and Trauma accounts, and under Rider 24 fund awards must have a concentration on rural facilities. According to the

presentation by Texas Organization of Rural and Community Hospitals (TORCH), a new program with new funding would better meet the growing need for hospital replacement and rebuilding activities and more adequately address the critical need in aging, rural facilities. A new reimbursement structure that invests capital in quality hospitals would incentivize the establishment of quality care networks. The Committee recommends a study be conducted by the Texas A&M School of Rural Public Health or a similar institution to research access to quality trauma care and recommend improvements using the Rural Health Facility Capital Improvement Fund, 911 Funds, EMS and Trauma Funds, Tobacco Settlement Funds, and the System Benefit Fund.

The Texas Health and Human Services Commission (HHSC) reviewed and analyzed rural hospital utilization data from the 2008 Annual Survey of Hospitals, which is conducted by the American Hospital Association, the Texas Hospital Association, and DSHS. HHSC found that average annual utilization for a Texas rural hospital is 63 Inpatient Admissions, 240 Inpatient Days and 396 Emergency Department Visits per 1,000 Persons in the county. HHSC further concluded that the average percentage of bed days occupied is 28.9 percent. (Appendix B: HHSC presentation)

HHSC compiled a listing of hospital districts which have either reached the two percent cap on sales and use taxes or have a tax base of $750 million or less. For-profit hospitals were included in the compilation (see Appendix B). According to this data, 33 of 49 hospitals had below average percentages of bed days occupied, and 22 of the 49 had below average emergency department visits. The utilization trends seem to indicate that there are more rural facilities with bed capacity than there are people in need of rural hospital services. The Committee recommends HHSC conduct a comprehensive study of access, population density, and utilization
trends across all health care facilities in rural areas and provide correlation and comparison tools to evaluate the potential need for additional funding to sustain healthy networks of health care. Urgent care centers and free standing emergency rooms were not included in any of the data for this report as they are relatively new to the health care landscape. While steps can be taken to begin improving rural facilities, the Legislature should also continue to explore additional options to increase access to care in rural Texas.

The Committee recommends the following in regard to rural hospitals:

1. Direct the Texas A&M School of Rural Public Health or a similar institution to research access to quality trauma care and to recommend improvements in utilizing the Rural Health Facility Capital Improvement Fund, 911 Funds, EMS and Trauma Funds, Tobacco Settlement Funds, and the System Benefit Fund.

2. Direct HHSC to conduct a comprehensive study of access, population density, and utilization trends across all health care facilities in rural areas and provide correlation and comparison tools to evaluate the potential need for additional funding to sustain healthy networks of health care.

3. While steps can be taken to begin improving rural facilities, the Legislature should also continue to explore additional options to increase access to care in rural Texas.

**Issue 2: Medicaid Hospital Financing**

Under the Texas Medicaid program, inpatient hospital expenditures account for over $2.2 billion or 11.4 percent of total Medicaid expenditures. Acute care hospitals are reimbursed for services using the a Standard Dollar Amount (SDA) prospective payment methodology coupled with a group of defined procedures known as Diagnosis Related Groups (DRGs). Under this methodology, all hospitals have an individual SDA that rewards inefficiency and volume rather than outcomes, wellness, prevention, and efficiency. Rural hospitals, children's hospitals, and state-owned teaching hospitals are reimbursed using a methodology authorized by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Most rural hospitals are paid the greater of the prospective payment system rate or a cost-reimbursement amount. The differences in
these reimbursement methodologies have protected rural facilities from diseconomies of scale and sustained them in rural communities. They have provided a premium to maintain access to care and to support the needed trauma network in rural Texas. For FY 2009, HHSC expects to pay $67.2 million in cost settlement charges to rural hospitals, $9.5 million to children's hospitals, and $8.7 million to teaching hospitals. Similarly, the formula for rural hospitals, children's hospitals and teaching hospitals provides no incentive nor reward for the provider to seek high quality, low cost care.

Over the years additional funding allocations have been created to address various needs of all hospitals including the Rural Health Facility Capital Improvement Fund, EMS and Trauma Funds, Tobacco Settlement Funds, add-on payments for certain procedures, outlier payment adjustments for outlier patient populations, Disproportionate Share payments, and Upper Payment Limit sums. So while these current methodologies have tried to meet the increased demands of the Medicaid population needs since 1987, the whole system of funding and financing for hospitals has evolved into a system that is inefficient and out of date. Hospital financing needs to be reevaluated and reformed to include a new methodology to adjust payments to hospitals for inefficient or excessive use of tax dollars and allow for funds to be reallocated to facilities achieving better health outcomes for a lower cost. Therefore, the Committee recommends the Legislature direct HHSC to develop and to implement a new model to reimburse acute care hospitals and to include an adjustment in payments to hospitals for inefficient or excessive use of tax dollars. Any adjustment in the payment system should take into account issues related to high cost, high needs populations and access to care, including access to care in rural areas. The new model should also align incentives and include a shared savings which could be reinvested in high quality, low cost providers.
The Committee recommends the following in regard to Medicaid hospital financing:

4. Direct HHSC, through the Texas Medicaid Program, to change the inpatient payment system to incentivize efficiency and quality and to achieve a shared savings program.

**Issue 3: Nursing Facilities**

Texas rural nursing facilities are also facing increased financial pressure as more individuals choose to reside in the community in lieu of moving into a nursing home. As a result, persons choosing to live in a nursing home are increasingly in need of higher acuity services that are more expensive. While the current Medicaid reimbursement rate accounts for varying levels of need, it should also include incentive payments for high quality, efficient providers.

According to the presentation by the Department of Aging and Disability Services (DADS), the State of Texas has 1,196 nursing facilities with 131,807 beds licensed under Medicaid for state fiscal year 2010. (Appendix C: DADS presentation) The Texas occupancy rate, which includes both public and private payers, is 65.7 percent, which is a loss of 5.4 percent since 2009. (See chart below) As a result, there are 45,197 unoccupied beds across all nursing facilities. Unoccupied beds pressure the system and further cause cost shifting to make-up for potential revenues and costs of maintaining empty beds.
Rural nursing facilities must cautiously develop and maintain their patient mix. Some nursing facilities may be able to offset losses with higher reimbursement rates from Medicare and private pay clients. However, Medicare’s coverage is typically limited and tied to a person’s discharge from a hospital. Due to this correlation, there is added pressure related to hospital discharge planning and nursing facility placement, as providers compete for higher reimbursement rates. Medicaid-only nursing facilities have been increasingly harder to maintain and could face increased risks of potential closure. For rural nursing facilities, the threat is greater when a community lacks a hospital discharging patients and when community population is stagnant or possibly declining. Across Texas 70 percent of nursing home residents have Medicaid as their payer. As noted in provider testimony, business models are challenged by this large percentage. While some providers have found a way to balance and cost shift, some
nursing facilities face the threat of closure. In 2009 seven facilities closed. Contradictory to this trend, 30 new facilities opened the same year.

Texas Medicaid is projected to pay $2 billion annually this biennium for nursing home care. The Legislature has increased the funding for nursing facility care, and recently the Medicaid reimbursement methodology was adjusted to account for the varying levels of acuity. The total cost of nursing facility care to the Medicaid program grew 10 percent in 2009 and was projected seven percent for 2010. While the cost increases, the number of people services decreases. This negative correlation, noted in the graph below, between total cost and total number served garners concern.

HHSC should make changes to further link payment to quality and incentivize efficiencies not just volume and acuity. Outcome based payments produce savings for the payer and incentivize quality care for consumers while holding providers accountable. Savings could be reinvested in providers and weighted for capital improvements or quality. Additionally HHSC and DADS should pursue a Medicare and Medicaid Waiver to demonstrate how combined financing for acute and long term care services, especially for dual eligible
individuals, can save tax dollars and improve health outcomes. Quality based indicators, like a nursing facility's hospital admission and readmission rates related to potentially preventable conditions, such as dehydration, would provide a basis to demonstrate with ease how an outcome based payment could lead to larger savings when patients experience improvement in quality and health outcomes across all settings. Finally, the Legislature should continue to explore all options to address funding needs for nursing facilities, including the potential for a quality assurance fee.

The Committee recommends the following in regard to nursing facilities:

5. Direct HHSC and DADS to make changes to Medicaid nursing facility reimbursements to further link payment to quality and to incentivize efficiencies, low-cost settings, and health outcomes.

6. Direct HHSC and DADS to pursue a Medicare and Medicaid Waiver to demonstrate how combined financing for acute and long term care services, especially for dual eligible individuals, can save tax dollars and improve patient outcomes.

7. Explore all options to address funding needs for nursing facilities, including the potential for a quality assurance fee.
SB643, DOJ Settlement Agreement, and Section 48
EXECUTIVE SUMMARY

During the 81st interim, the Senate Committee on Finance (the Committee) held a hearing to monitor the Department of Aging and Disability Services' (DADS) implementation of Senate Bill 643, the Department of Justice (DOJ) Settlement Agreement, and Special Provisions, Section 48 of the General Appropriations Act. The Committee commends the work done this biennium to reshape the system of care and recommends continued improvement and new efforts to create a sustainable system to provide services to individuals with intellectual and developmental disabilities.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to Medicaid funding for persons with intellectual and developmental disabilities.

Issue 1: Department of Aging and Disability Services

1. Direct DADS to continue census management initiatives to improve community access, individual choice, and the State Supported Living Centers.

2. Direct DADS to pursue methods to continue to reshape the community and state system of care for individuals with intellectual and developmental disabilities and to develop fiscal sustainability as well as consumer centered services. Some ideas which should be considered include modifications to the financial eligibility standards; the potential need for a new assessment tool; waiver amendments or a new waiver application to create a tiered model; a new benefit design which begins with entitlement services, such as Primary Home Care, and progresses to additional wrap-around services; changes to optional services covered; and an expansion of consumer directed services.

Issue 2: Department of Family and Protective Services

3. Direct DFPS, DADS and HHSC to jointly produce a cost benefit analysis to compare cost and outcomes, including lengths of stay, for children with an intellectual and developmental disability under the care of DFPS and like children in a DADS program. This analysis should include information related to creating a sustainable model for both DADS populations and DFPS children and consider adding a long term care benefit to the Star Health model to provide care for intellectually and developmentally disabled children.
Issue 3: Health and Human Services Commission

4. Direct HHSC and DADS to further consider modifications to the financial eligibility standards across programs, a tiered model with various caps, one to six bed group homes, payment reform, new waivers or waiver amendments, and improved utilization of lower cost programs, such as Texas Home Living, and to begin implementing concepts which achieve a more sustainable long-term system.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with monitoring the implementation of Senate Bill 643, the Department of Justice Settlement Agreement, and the Section 48 contingency appropriation. The Committee met in accordance with the following interim charge as follows:

Monitor the Department of Aging and Disability Services (DADS) implementation of SB 643, emergency legislation relating to Texas' state supported living centers (SSLCs), implementation of Special Provisions relating to All Health and Human Services Agencies, Section 48, Contingency Appropriation for the Reshaping of the System for Providing Services to Individuals with Developmental Disabilities, and implementation of the United States Department of Justice (DOJ) Settlement Agreement terms.

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas, on August 18, 2010, to consider invited and public testimony.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

Issue 1: Department of Aging and Disability Services

DADS Commissioner Chris Traylor presented information to the Committee regarding the current implementation of Senate Bill 643 and the Department of Justice Settlement Agreement terms and conditions. Mr. Traylor started the update by introducing the new Assistant Commissioner for State Supported Living Centers (SSLCs), Chris Adams, whose
position was directed and created in SB 643. They both presented and discussed the successful implementation of criminal history background checks, fingerprinting of employees, and random drug testing. With increased education and awareness on all staffing levels, DADS successfully implemented these new requirements. Surveillance cameras were also required by legislation to increase security and safety of residents and staff. Cameras should be installed in all SSLCs by January 2011. Numerous allegations of abuse and neglect have been dismissed when the video footage cleared the allegation. There have also been instances where employees have been turned in by the video monitors for inappropriate behavior, which might have gone unreported previously. Mr. Traylor also presented the plan for Mexia SSLC to become a forensic center for high-risk alleged offenders and to specialize units to better and more effectively care for individuals referred by the court.

At the time of the hearing, the DOJ had visited all SSLCs and concluded baseline reviews. The baseline reports establish a foundation for improvement, which DADS and the DOJ both want to resolve, such as recruiting and maintaining aids in the Austin SSLC. Additionally DADS staff and DOJ monitors want to work together and improve the homes for residents.

Alongside the funding and legislation involved in SB 643 and the DOJ Settlement, Special Provisions, Section 48 focused on improving access to needed services in the community and encouraging individuals and families to seek appropriate levels of care in the community while reducing the overall census of Texas SSLCs, through census management. Section 48 provided 5,936 HCS slots, 1,890 CLASS slots and six DBMD slots for new clients to enroll in services. These additional slots were provided to alleviate the intense pressure of a growing interest list for the HCS program and to provide DADS some flexibility to reshape the system of
care. Slots were prioritized for persons seeking to move out of a SSLC, persons at-risk of immediate enrollment in a SSLC, and children aging out of foster care.

As directed in Section 48, DADS implemented census management tools and initiatives. Primarily through education and awareness, residents of SSLCs have sought community placement options. As of October 1, 2010, 216 residents and his/her family or legal guardian were preparing to move out from a SSLC into the community. DADS, with staff and leadership at each SSLC, has worked to create a home-like environment for residents while also working to increase education and awareness for residents wanting to move into the community. For example, Mexia SSLC has a home in the community where residents can go live for a week off campus. This is a unique educational and preparation tool for transitioning residents. Though not addressed at length in the hearing, DADS reported additional information to support a declining overall census in SSLCs. By the end of FY 2010, DADS reported a census of 4,337 residents, a decline from the approximate census of 4,800 residents during the 81st Legislature when this provision was authored. DADS projects a continued declining trend while assuming there could be increased admissions as well. Specifically DADS is experiencing a bit of a phenomena at the Mexia SSLC where they are reporting increases in both their admissions rate and in community placements rate. DADS deducts this increase in the admission rate is due to the unique population at Mexia SSLC. A higher number of alleged offenders are being referred and admitted. However, with shorter average lengths of stay, it is expected the census can be maintained or continue to decline. The Committee recommends DADS continue census management initiatives to improve community access, individual choice and the SSLCs.

Additional pressure built up this past year in community programs as the interest lists' growth outpaced the large investment of funds to increase the number of funded slots. At the
time of the hearing, 3,183 additional people were in the HCS program, which has ramped up over the biennium. However, 5,350 more people have signed up on the HCS interest list. On average, 71 percent of individuals on the HCS interest list, which had 45,756 persons on it in August 2010, will be eligible and enroll in the program under the current rules. With the interest list growing faster than the number of people the HCS program can serve and the number of persons on the interest list eligible and in need of services, the need to reshape the community system is more urgent in order to have a sustainable program to serve this population long term. To further explain the current imbalance, the table below displays how enrollment and cost factors contribute to the unsustainable current system.

<table>
<thead>
<tr>
<th>Cost Comparison by Program*</th>
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<td>Non-Residential</td>
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<td>Texas Home Living</td>
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<tr>
<td>Avg. Monthly Cost</td>
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<td>Current Enrollment</td>
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*Rider 31 Cost Comparison Report: FY 2009 costs and enrollment numbers are used.

**Rider 31 Cost Comparison Report provides Average Number of Consumers served per month.

The state currently serves the most number of individuals in the community without residential benefits through the more expensive HCS waiver program, instead of the Texas Home Living waiver program. The chart also reflects that for persons in need of the residential services component in the community, the HCS program, again, is the more expensive residential option over the Community ICF/MR. The SSLCs are noted in the table as the most expensive non-community, residential option. Of all program options for individuals with intellectual and developmental disabilities, SSLCs, as indicated the Rider 31 Comparison of
Consumers by Level of Need (LON), provide the greatest percentage of care to consumers who need the Extensive (LON 8), Pervasive (LON 6), and Pervasive Plus (LON 9) services. This is a factor contributing to the higher average monthly cost for SSLC residents.

Commissioner Traylor and the Committee also discussed other methods for persons to receive services. DADS reported that 23 percent of the 45,756 persons on the HCS interest list in August 2010 are currently receiving some type of service and support through a DADS program. Therefore, due to the imbalance between cost and enrollment and the conglomeration of services, the Committee recommends DADS pursue methods to reshape the community and state system of care for individuals with intellectual and developmental disabilities. DADS should consider modifications to the financial eligibility standards; the potential need for a new assessment tool; waiver amendments or a new waiver application to create a tiered model with various caps; a new benefit plan which begins with entitlement services, such as Primary Home Care, with additional wrap-around services provided through a waiver type program; changes to optional services offered; and an expansion of consumer directed services to develop fiscal sustainability as well as person centered services.

Section 48 also directed the transfer of the case management function from the HCS provider to the local Mental Retardation Authorities (MRAs). This transfer created a more competitive service delivery model and implemented checks and balances to ensure more consumer involvement while also increasing consumer safety as coordinators visit the provider group home to follow up with consumers. The average number of transfers from one provider to another was 164 per month in 2009. In 2010, transfers increased to 334 and 235 in the month just prior to and the first month of the new model implementation. Though this data is not conclusive because not all consumers have been through the planning process with their service
coordinator, the increase in transfers may indicate that HCS clients feel more freedom to choose and/or to change providers than they did prior to the transfer.

The Committee recommends the following in regard to DADS:

1. Direct DADS to continue census management initiatives to improve community access, individual choice, and the State Supported Living Centers.

2. Direct DADS to pursue methods to continue to reshape the community and state system of care for individuals with intellectual and developmental disabilities and to develop fiscal sustainability as well as consumer centered services. Some ideas which should be considered include modifications to the financial eligibility standards; the potential need for a new assessment tool; waiver amendments or a new waiver application to create a tiered model; a new benefit design which begins with entitlement services, such as Primary Home Care, and progresses to additional wrap-around services; changes to optional services covered; and an expansion of consumer directed services.

Issue 2: Department of Family and Protective Services

The emergency legislation regarding SSLCs also directed the Department of Family and Protective Services (DFPS) to investigate abuse and neglect allegations in SSLCs. Under Section 48 provisions, 120 HCS slots were prioritized for children aging out of foster care. At the time of the hearing, 882 children in foster care had intellectual and developmental disabilities, and 142 children resided in residential treatment facilities. Because of the overlap and growing need for combined services for children in Child Protective Services and children aging out of foster care with an intellectual disability, the Committee recommends DFPS, DADS and HHSC jointly provide a cost benefit analysis to compare cost and outcomes, including lengths of stay, for children with an intellectual and developmental disability under the care of DFPS and like children in a DADS program. This analysis should include information related to creating a sustainable model for both DADS populations and DFPS children and consider adding a long term care benefit for intellectually and developmentally disabled children to the Star Health managed care model.
The Committee recommends the following in regard to DFPS:

3. Direct DFPS, DADS and HHSC to jointly produce a cost benefit analysis to compare cost and outcomes, including lengths of stay, for children with an intellectual and developmental disability under the care of DFPS and like children in a DADS program. This analysis should include information related to creating a sustainable model for both DADS populations and DFPS children and consider adding a long term care benefit to the Star Health model to provide care for intellectually and developmentally disabled children.

**Issue 3: Health and Human Services Commission**

Section 48 provisions directed the Health and Human Services Commission (HHSC) and the Department of Aging and Disability Services (DADS) to jointly design a captitated and/or non-capitated model of service delivery for intellectually and developmentally disabled individuals which could be initiated in a pilot program. HHSC contracted with Health Management Associates (HMA) to facilitate a study, stakeholder meetings, and recommendations. HMA reported they would produce a report discussing four state models, Arizona, Michigan, Wisconsin and Vermont, and three possible options for a pilot, non-capitated enhanced care management at an MRA, fully-capitated IDD managed long term care program, and fully-capitated IDD managed care program. HMA conducted stakeholder forums in Fort Worth, El Paso, Longview, and Austin.

HCS, CLASS and Texas Home Living waivers currently cost the state approximately two billion dollars per biennium. Savings associated with capitated rates, better coordination of services and care, and increased care management in the Medicaid program have typically been at least five percent. At the hearing, HHSC reported that a cost benefit analysis would be included in the report, which was expected in December 2010, but it was not available at the time of this report. Based on information and concepts shared in the forums and at the hearing, other worthwhile ideas such as modifications to the financial eligibility standards, a tiered model, one to six bed group homes, payment reform, new waivers or waiver amendments, and improved
utilization of lower cost programs, such as Texas Home Living, were not ideas within HMA’s purview. Therefore, the Committee recommends HHSC and DADS consider these additional ideas and begin implementing concepts which achieve a more sustainable system.

The Committee recommends the following in regard to HHSC:

4. Direct HHSC and DADS to further consider modifications to the financial eligibility standards across programs, a tiered model with various caps, one to six bed group homes, payment reform, new waivers or waiver amendments, and improved utilization of lower cost programs, such as Texas Home Living, and to begin implementing concepts which achieve a more sustainable long-term system.
Texas Tomorrow Fund
EXECUTIVE SUMMARY

During the 81st interim, the Senate Committee on Finance (the Committee) reviewed the relevant information pertaining to the Texas Tomorrow Fund (the Fund).

On March 24, 2010, the Committee heard invited and public testimony on this topic. Testimony was provided by representatives of the Office of the Comptroller of Public Accounts (the CPA) and the Higher Education Coordinating Board (the HECB). The CPA reviewed the four prepaid tuition and college savings plans administered by that office and the HECB discussed the role of exemptions and waivers. Various public institutions of higher education across Texas provided written testimony outlining the impact of the Fund on their campuses.

As of the actuarial valuation of August 31, 2009, the Fund had $1.6 billion in assets and $2.2 billion in liabilities. The unfunded liability of the Fund is $605.5 million with the projected cash depletion date being 2018.

Like other state funds, the market value of the Fund varies due to changes in the global economy; therefore, it can be expected that the unfunded liability will also vary. An updated actuarial valuation will be available in early 2011. Any legislative action should take into consideration the updated actuarial valuation.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard the Texas Tomorrow Fund:

1. Provide guidance to the Office of the Comptroller of Public Accounts on the refund policy with the focus on prevention of abuse.

2. As revenue becomes available, the State should provide annual contributions to the Fund to partially amortize the projected unfunded liability.
PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with studying the Texas Tomorrow Fund:

Examine the Texas Tomorrow Fund and its impact on institutions of higher education. Assess current and future costs, the ability of institutions to absorb the costs, and make recommendations for ensuring a sound fiscal approach to managing the fund for the future.

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas, on March 24, 2010, to consider invited testimony provided by the Office of the Comptroller of Public Accounts, the Higher Education Coordinating Board and various institutions of higher education. The Committee solicited public testimony on the interim charge in a public hearing in Austin, Texas, on March 24, 2010.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

The Texas Tomorrow Fund (the Fund) was established by House Bill 1214 in 1995. Opening in 1996 as the state's first prepaid college tuition program, the Fund "was developed to cover the cost of tomorrow's college tuition and required fees at today's prices at Texas public colleges and universities". In November 1997, Texas voters passed Proposition 13, a constitutional amendment that guaranteed the Fund with the full faith and credit of the State of Texas. The Fund was closed to new enrollment in 2003 after the legislature authorized tuition deregulation that same year. The Fund has been formally renamed the Texas Guaranteed Tuition Plan.

1 http://www.texas tomorrowfunds.org/ accessed on 08/12/10
On February 15, 2007, Comptroller Combs sent notification to the Governor, Lt. Governor and Speaker expressing her concern with the actuarial soundness of the Texas Tomorrow Fund. In that letter, she estimated the Fund may have an unfunded liability between $1.74 billion and $3.31 billion by 2029.

On May 12, 2009, in an attempt to address a portion of the estimated shortfall, the Texas Prepaid Higher Education Tuition Board (the Board), which oversees the Fund voted to change the refund policy of the plan effective November 1, 2009. Previously, refunds were paid based on the contributions plus earnings determined by the rate of tuition inflation over the life of the contract, minus fees. The rule change eliminated the earnings provision. Refunds would now be based on the contributions, minus fees. It was estimated this would reduce the cost to the Fund by between $60 million and $80 million. The Board, through letter, informed contract holders of this change on August 24, 2009, and advised them of the contract's 60-day opt out provision that allowed them to cancel their accounts and receive a refund based on the existing rule before the new rule went into effect.

Under the original refund policy, a financial incentive existed for a contract holder to hold the contract for the maximum allowable time, 10 years after the beneficiary's graduation from high school before seeking a refund. Under this scenario, contract holders were using the contract as an investment tool and realizing an investment return equal to tuition inflation. As of August 31, 2010, the Fund had paid out approximately 31,700 refunds on voluntary cancellations, including $133.5 million paid to account holders in earning based on tuition inflation over the life of their contracts. The new refund policy eliminated the incentive to use the contract as an investment tool, thereby improving the actuarial soundness of the fund without negatively impacting contract holders or institutions of higher education. This decision returned
the Fund to its constitutional purpose as a trust fund dedicated to the payment of tuition and fees for higher education.

Upon the Board's announcement of the new refund policy, Comptroller Combs received multiple letters from various members of the Texas State Legislature stating their objection and asking the Board to reconsider this recent rule change.

On October 30, 2009, Comptroller Combs sent a letter to the Governor, Lt. Governor and Speaker of the House notifying them that the Board would reconsider the recently changed refund policy at a public meeting on November 5, 2009. In the letter, she stated, "it will be my recommendation to the Board that any changes to the refund policy be postponed until the Legislature has the chance to meet and fund a solution. I strongly urge an interim study be conducted for this critical issue."  

On November 5, 2009, the Board voted to reinstate the original refund policy and allow any contract holder who cancelled an account between August 18, 2009, and December 31, 2009, to reinstate their contract without penalty.

On March 24, 2010, the Committee heard testimony on Charge #5 relating to the Texas Tomorrow Fund. Invited testimony included Martin Hubert on behalf of the CPA and Dan Weaver on behalf of the HECD. During this hearing, the CPA provided an update on the Fund. At that time, it was projected that the Fund's cash will be depleted by 2018 and the total unfunded liability is estimated to be $1.67 billion by 2031.

The CPA attributed the deficit to tuition increases being greater than the assumed amount and investment returns being less than the assumed amount. With respect to tuition increases, the Fund originally assumed tuition rates would increase significantly between 1997 and 1999 by at least 16 percent, but would return to level growth of 8.5 percent per year after 2003. Between

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2 CPA letter 10/30/09
1997 and 2009, the Fund experienced a compounded tuition increase of 8.64 percent. The actuarial gains and losses associated with tuition inflation since the inception of the fund contributed $2 million to the unfunded liability. With respect to investment returns, the Fund originally assumed an 8 percent investment return. Between 1997 and 2009, the Fund experienced a compounded investment return rate of 4.5 percent. As a result, almost 70 percent of the deficit is attributed to the investment return assumption not being realized. In every year since 2006, the Board has updated the investment return assumption based on the most current information. Currently, an investment return of 6.3 percent is assumed for 2010.

The CPA provided 3 scenarios to fund the projected deficit:

- State contributions of $88.7 million per year for 10 years
- State contributions of $65.5 million per year for 15 years
- State contributions of approximately $200 million per year after the Fund depletes in 2018

The CPA advised the Committee that these projections were based on assumptions. Therefore, if tuition increases are lower than actuarial assumptions or investment returns are higher than actuarial assumptions, the projected deficit would decrease.

The HECB provided testimony about the impact of the Fund on institutions. Statute requires institutions to forgive the difference between the tuition rate at an institution of higher education and the rate the Fund provides. For senior college plan contracts, which account for 93 percent of the contracts sold, the Fund provides to a Texas public institution of higher education the lesser of the actual tuition and required fees or the state-wide weighted average tuition and required fees as determined by the Board based on annual surveys completed by the Texas public institutions. The state through the general academic formula "reimburses" institutions of higher education for the statutory tuition that was not
collected, but does not reimburse institutions for the designated tuition that is not collected. No such reimbursement mechanism exists for the community colleges. The HECB quantified the amount of forgone tuition and fees to be $15 million for fiscal year 2009.

Various institutions of higher education provided written testimony on the impact of the Fund on its campus. Generally, institutions recognized the benefit of this program to students but warned of budgetary constraints placed on an institution caused by forgoing tuition. Those responses are provided in the appendix.

An updated actuarial evaluation of the Fund will be available in early 2011 that will capture any changes that occurred with the Fund as of August 31, 2010.

The Committee recommends to the Legislature:

1. Provide guidance to the Office of the Comptroller of Public Accounts on the refund policy with the focus on prevention of abuse.

2. As revenue becomes available, the State should provide annual contributions to the Fund to partially amortize the projected unfunded liability.
Higher Education Funding
EXECUTIVE SUMMARY

During the 81st interim, the Senate Committee on Finance reviewed the relevant information pertaining to the funding of Higher Education, specifically formula funding, student success efforts, research and capital funding.

The state currently has in place an appropriate structure for funding the teaching mission of institutions of higher education. Formula funding has been used to encourage and reward institutions of higher education to focus on increasing enrollment, while the performance incentive funding was established as the structure to encourage increased degrees awarded.

The state could improve student success by increasing the merit criteria of the TEXAS Grant program and utilizing the performance incentive funding as the mechanism to equitably distribute funds for academic resources and student services.

Research and capital funding could also be improved by utilizing a more efficient capital funding structure and by requiring institutions of higher education to report on the outcomes of their research.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to Higher Education funding:

1. As revenue becomes available, performance incentive funding should be utilized to encourage the desired outcomes of the state.

2. As revenue becomes available, performance incentive funding should be utilized as the mechanism to deliver funding to improve student success in lieu of special item funding.

3. A rider should be included in the General Appropriations Act directing the Higher Education Coordinating Board and institutions of higher education to analyze existing student success programs that have a positive impact of student performance, establish "best practices" and determine the cost to provide those services.
4. A rider should be included in the General Appropriations Act requiring the recipients of state funded research grants to report on the outcomes of that research in addition to the expenditure amounts.

5. The Legislature should not authorize any additional tuition revenue bonds under the current structure. Any future bonding authority should be either general obligation bonds approved by the voters or tuition revenue bonds that are repaid with tuition. Furthermore, the Legislature should direct the HECB to study a more efficient model to address the capital funding needs at institutions of higher education during the interim.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with studying higher education funding:

Study and make recommendations regarding formula funding and its impact on the cost of attendance and methods of financing higher education institutions, including funding differences for pharmacy and nursing programs; research funding; performance funding; and funding for institutions that face capacity student enrollment. Specifically address the following:

- Methods of financing capital projects at higher education institutions, including the levels of deferred maintenance on the ability to offer basic instructional services, and the methods used to finance deferred maintenance projects. Recommend alternatives for providing a structured and recurring funding mechanism more suited to the state’s fiscal capacity and institutional needs.

- Supplemental funding for structured programs that are essential for student success and for meeting the goals of Closing the Gaps, including those that provide concentrated student academic and personal support services for universities that enroll a high proportion of non-traditional or at-risk students. Study and make recommendations regarding the quality and effectiveness of academic advising, focusing on resources, staff development, and impact on time-to-degree.

The Committee met pursuant to the aforementioned interim charge in two public hearings in Austin, Texas, on June 23, 2010 and August 4, 2010 to consider invited testimony provided by the Higher Education Coordinating Board (HECB), various institutions of higher education and the Joint Admission Medical Program Council. The Committee solicited public testimony on the interim charge in two public hearings in Austin, Texas, on June 23, 2010 and August 4, 2010.
The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

Issue 1: Formula Funding

Each of the three classifications of higher education institutions receives its primary state support through individual distribution formulas based on student enrollment. These are generally referred to as formula funding. Formula funding provides the basic funding for institutions of higher education to educate students. In the past few years, increasing attention has been placed on using formula funding as a tool to encourage additional desired outcomes at community colleges and general academic institutions. The current structure of formula funding rewards institutions of higher education for enrollment, the participation component of Closing the Gaps.

The HECB has been one of the more vocal organizations on this effort, arguing that the current system needs a component that rewards institutions of higher education for graduating more students, the success component of Closing the Gaps. Institutions of higher education share in that concern but do not support using formula funding as that tool; they argue funding intended to increase the number of degrees awarded should be delivered through a separate funding structure.

In 2009, the Legislature established performance incentive funding as the funding structure to achieve increased degrees awarded. While the Committee believes that state funding should be distributed in a manner that best rewards institutions for achieving the desired outcomes, formula funding is not the most appropriate structure. Instead the Committee believes the most appropriate funding structure is performance incentive funding.
The Committee recommends to the Legislature:

1. As revenue becomes available, performance incentive funding should be utilized to encourage the desired outcomes of the state.

**Issue 2: Student Success**

In addition to the concept of adding a success component to formula funding, the state has other options to help increase student success, thereby seeing more students graduate. One strategy proposed by the HECB would increase the rigor of the merit criteria of the TEXAS Grant program. The proposal, commonly referred to as the "Priority Model", would require institutions of higher education to prioritize the awards among those students who meet two of four proposed merit criteria. The four criteria include taking an advanced academic program in high school, meeting the Texas Success Initiative Assessment thresholds, achieving a "B" grade point average and achieving a class rank within the top one-third.

The HECB analyzed the 2003-2009 cohort data and found that recipients of a TEXAS Grant who met the more rigorous criteria graduate at twice the rates as those who did not. The conclusion drawn from this data indicates that increasing the academic rigor of this program, the state would more efficiently and effectively utilize State financial resources since more of the students served would graduate.

Another strategy utilized by institutions of higher education is to provide academic resources and student services aimed at retention and graduation. No formula is currently utilized that distributes state funds for the purpose of increasing student success. Many institutions receive direct state support through special item funding but at differing degrees.

The Committee believes that due to the scarcity of funds, financial aid should be allocated in the most efficient and effective manner so to increase the number of students graduating. Additionally, any funds provided to institutions of higher education to support
student success programs should be awarded through the performance incentive funding structure, rather than through special item support.

The Committee recommends to the Legislature:

2. As revenue becomes available, performance incentive funding should be utilized as the mechanism to deliver funding to improve student success in lieu of special item funding.

3. A rider should be included in the General Appropriations Act directing the Higher Education Coordinating Board and institutions of higher education to analyze existing student success programs that have a positive impact of student performance, establish "best practices" and determine the cost to provide those services.

**Issue 3: Research**

The state has also placed significant emphasis on increasing the research presence at general academic institutions, most notably by the creation of the Emerging Technology Fund, the Cancer Prevention Research Institute of Texas and the passage of House Bill 51 in 2009.

While the Committee heard testimony on the volume of research conducted due to these programs, members questioned whether research grants were awarded to proposals that would generate the greatest benefit to the state. No empirical evidence was provided on the outcomes.

The Committee recommends to the Legislature:

4. A rider should be included in the General Appropriations Act requiring the recipients of state funded research grants to report on the outcomes of that research in addition to the expenditure amounts.

**Issue 4: Capital Funding**

The current system for funding capital needs for institutions of higher education is reliant on the authorization of tuition revenue bonds (TRBs). As of 2009, institutions of higher education have issued $8.5 billion of TRB debt with an annual debt service of $300 million. TRBs do not require voter approval as they are legally backed by institutional revenue. However, they are similar to general obligations bonds since the Legislature has consistently
appropriated general revenue to reimburse the institutions for the debt service. The current process of authorizing TRBs leads to an inefficient system. The system should be improved by adding predictability, allowing for long term planning and more scrutiny of the project requests. Therefore, the Committee believes the state should refrain from authorizing any additional debt for facilities until a more efficient system can be created over the interim.

The Committee recommends that the Legislature:

5. The Legislature should not authorize any additional tuition revenue bonds under the current structure. Any future bonding authority should be either general obligation bonds approved by the voters or tuition revenue bonds that are repaid with tuition. Furthermore, the Legislature should direct the HECB to study a more efficient model to address the capital funding needs at institutions of higher education during the interim.
Disaster Recovery Funding
EXECUTIVE SUMMARY

This report will review the allocation and expenditure of specific federal, long-term disaster recovery funds for Hurricanes Ike and Dolly. Therefore, this report will primarily focus on what is known as long-term Community Development Block Grant funds for disaster recovery (CDBG-DR).

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to the administration and delivery of long-term disaster recovery funding:

1. State officials in the executive branch should request US Congressional reform of disaster recovery housing funds similar to the approach taken to reform the Stafford Act.

2. State agencies responsible for distributing CDBG-DR funds should communicate with HUD as promptly as possible, follow all federal directions promptly, and request waivers early to avoid considerable delays.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with providing oversight of hurricane disaster funding. The Committee met in accordance with the following interim charge as follows:

Study the impact of recent hurricanes for which a federal disaster declaration was issued on local economies. Examine the basis for the distribution of federal dollars for hurricane cleanup across the state. Review past methods of distribution, including those involving the Texas Department of Housing and Community Affairs and the Office of Rural Community Affairs. Develop policy and statutory recommendations to ensure that the system of distribution is effective to address needs of the various regions of the state in the event of future disasters. Provide effective budget oversight of state agencies that received appropriations as a result of hurricane damage.

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas, on April 28, 2010, to consider invited testimony provided by the Department of Public Safety's Department of Emergency Management (DEM), Legislative Budget Board
(LBB), State Comptroller's Office (SAO), the Texas Department of Rural Affairs (TDRA, formerly known as Office of Rural Community Affairs), and the Texas Department of Housing and Community Affairs (TDHCA). The Committee solicited public testimony on the interim charge in a public hearing in Austin, Texas, on April 28, 2010.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

Hurricane Dolly made landfall in South Texas on July 23, 2008. Hurricane Ike struck the Texas coast less than two months later, on September 13, 2008. Once again, Texas experienced two consecutive storms in the same year, just like the year 2005 with Hurricanes Katrina and Rita. Other state reports and audits have identified challenges in the distribution of short-term recovery funds for Hurricanes Dolly and Ike and long-term recovery funds for Katrina and Rita. The Governor's Commission on Recovery and Renewal addressed short-term Dolly and Ike recovery funds. The Texas Sunset Advisory Commission and the State Auditor's Office both made recommendations for long-term housing funding for Hurricanes Katrina and Rita. Due to the timing of this report and the fact that long-term disaster recovery funding for Dolly and Ike has not yet been formally addressed, the focus of this interim report deal with long-term aid for the victims of Hurricanes Dolly and Ike.

CDBG-DR funds are long-term grants that supplement other disaster grants such as those of FEMA, the Small Business Administration, and the U.S. Army Corps of Engineers. CDBG-DR funds are not to be confused with regular, or annual, CDBG funds, which assist with non-disaster related housing and infrastructure needs. CDBG-DR funds are authorized under the Robert T. Stafford Act, defined by the Housing and Community Development Act, and
distributed by the U.S. Department of Housing and Urban Development (HUD). Corresponding Texas agencies overseeing the distribution of CDBG-DR funds are the Texas Department of Rural Affairs (TDRA) and the Texas Department of Housing and Community Affairs (TDHCA).

In total, Congress appropriated approximately $3.1 billion of CDBG-DR funds to Texas through the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act, Public Law 110-329 (2008). HUD divided the $3.1 billion into two rounds of funding. The Texas Governor designated TDRA the lead agency for distributing Hurricane Dolly and Ike funds while TDHCA was the lead agency for the delivery of Hurricanes Katrina and Rita funds.

HUD approved Round 1 Dolly/Ike funding in May 2009 without dispute. The agency, transitioning in leadership due to a new President, issued the guidelines and waivers for fund distribution 6 months following Congressional appropriation of CDBG-DR funds. To speed up the process, TDRA submitted its Action Plan one month before the guidelines had been published. HUD approved and distributed Round 1 Dolly/Ike funds to Texas.

The distribution of Round 2 of Dolly/Ike funding has easily posed the greatest challenge of all other recent Texas hurricane funds appropriated from the federal government combined. Hurricane Ike is the third most destructive hurricane to hit the United States in terms of monetary damage.

TDRA's director concluded that the allocation of funding to the state was unfair because the FEMA data had been incomplete. According to the executive director of TDRA, FEMA was unable to conclude its work in South Texas before it was called upon to address the damage from Hurricane Ike. TDRA claimed that the Round 2 Dolly/Ike allocation excluded portions of East Texas that had been affected by Hurricane Ike and neglected to distribute enough funds to South Texas. Constituents in both South and East Texas agreed with these findings. By Round 2 of
Dolly/Ike funding, the state and HUD began a protracted debate, which resulted in the costly
delay of $1.7 billion in aid to Texans affected by Hurricanes Dolly and Ike.

For the distribution of Round 2 of Dolly/Ike funds TDRA hired consultants to advise the
agency on its own fund allocation formula. TDRA hired a consultant company, HNTB, to devise
a formula to replace HUD-approved FEMA data and formula. The consultant company's
recommendations were problematic and deviated substantially from federal guidelines. TDRA
submitted an application, or Amended Action Plan, for Round 2 Dolly/Ike funding to HUD that
was vastly different than what the federal agency expected and requested.

By the time the Committee met in April 2010, fair housing advocates filed a complaint
with HUD against the state of Texas. The complaint related to the application of Round 2
Dolly/Ike funding. Complainants argued the funds were used against the intent of Congress, and
TDRA needed a more methodical approach to distributing funds.

Once the complaint was filed and HUD denied the Round 2 of Dolly/Ike funding, the
state's Action Plan was amended many times to address the concerns of fair housing advocates.
This struggle continues at the submission of this report. In order for HUD to accept the
Amended Action Plan by TDRA, all parties had to be signatories to a conciliation agreement.

HUD's reasons for rejecting TDRA's Amended Action Plan for Round 2 Dolly/Ike funds
hinged on many of the reasons cited in the complaint; improper public feedback procedures,
failure to comply with federal law and standards, failure to distribute the funds with a proper
method of distribution, and failure to update the state's Analysis of Impediments to Fair Housing
Choice (AI).

While the secretary of HUD waived some CDBG restrictions for the purpose of disaster
recovery, the Conciliation Agreement replaced some of these restrictions and added more
conditions to the funds. The agreement makes a number of specifications which include complainant oversight for steps in the fund distribution process. Additionally, the agreement allow advocates to oversee the revision of the state's AI document. The Conciliation Agreement divides Round 2 Dolly/Ike funding into two phases. The first phase involves the AI revision specifically for areas affected by Hurricanes Dolly and Ike. According to Section II.A.3.5 of the Conciliation Agreement, with a few exceptions, "neither TDHCA nor TDRA shall commit or expend any Hurricane Recovery Funds prior to HUD's acceptance of phase 1 of the updated AI, or January 1, 2011, whichever is earlier..." To date, HUD has not received phase 1 of the updated AI. The Conciliation Agreement also specifies that each allocated area may receive the lesser of either 33% of the area's total allocation under the Revised Action Plan Amendment or $258 million.

The AI is the basis for how all CDBG funds are distributed. Traditionally, AIs are updated after each census, when HUD releases the instructions in the federal registry. Texas has one currently, but it has not been updated since 2003. AIs must be updated to reflect large demographic shifts. Texas has experienced a large influx of population in the last decade which will earn it four additional congressional seats. Under HUD guidelines, TDHCA is expected to update the AI periodically, especially following large demographic shifts, such as the kind Texas has experienced.

Complicating matters, HUD has not yet released instructions for the latest AI, and census data will not be fully published until February 2011. In order for Texas to receive Round 2 Dolly/Ike funds, all of the information in the AI must be rewritten for Dolly- and Ike-affected areas. Eventually, the AI for the rest of the state will have to be updated as well. The conciliation agreement requires that the full AI be completed on a schedule, which may require it
to be quickly replaced if HUD fails to issue new AI guidelines in a timely manner. This document is currently being assembled by TDHCA, consultants, fair housing advocates, and some COG directors. It will have consequences for rural public infrastructure projects as well as the prioritization of annual CDBG funds to the entire state.

For these reasons, the Committee recommends that the state advocate for simplifying the specifications of CDBG-DR funds. Disaster recovery fund distribution is fundamentally at odds with regular CDBG funding because the latter involves a high level of community planning, development, and the creation of new housing choices for low income recipients, whereas disaster funds exist for the timely rehabilitation and reconstruction of existing structures. Therefore, the committee recommends encouraging federal statutory changes to long-term disaster recovery funds either by creating a categorically new type of fund (not CDBG) or by creating permanent "waivers" in statute that ease the restrictions of CDBG-DR funds in a way that reflects the intent for these funds to be distributed in a timely manner. State officials, appointed by the Texas Governor, have participated with the U.S. Senate Subcommittee on Disaster Recovery in discussions to reform the Stafford Act and short-term recovery fund distribution. The state should consider a similar participation in the reform of CDBG-DR funding.

Of course, state agencies can always do more to distribute funds more quickly and improve procedures that involve federal compliance. Federal restrictions such as avoiding recipient duplication of benefits, executing environmental clearance, enforcing contractor standards, and determining applicant eligibility are extremely important to the process but could be simplified. However, the delivery of Round 2 Dolly/Ike funding has been delayed over a year and a half in part because the state initially failed to follow federal guidelines. Early discussions
with HUD, taking time to fully comply with federal procedures, an updated and compliant AI, and appeals for additional waivers would have gone a long way to eliminate the unnecessary delays faced by hurricane victims still suffering from a storm that occurred almost two and one half years ago.

The Committee recommends that the Legislature:

1. State officials in the executive branch should request US Congressional reform of disaster recovery housing funds similar to the approach taken to reform the Stafford Act.

2. State agencies responsible for distributing CDBG-DR funds should communicate with HUD as promptly as possible, follow all federal directions promptly, and request waivers early to avoid considerable delays.
## APPENDIX A: FUNDING ALLOCATION TO STATE AGENCIES

(as of December 2010)

<table>
<thead>
<tr>
<th>Hurricanes</th>
<th>CDBG Rounds</th>
<th>Agency Administering Funds</th>
<th>Total Funds Appropriated</th>
<th>Total Funds Obligated/Awarded</th>
<th>Total Amount Spent</th>
<th>Percentage Spent</th>
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<td>Katrina/Rita Round 1</td>
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<td>TDHCA</td>
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<td>Dolly/Ike Round 1</td>
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<td>TDHCA</td>
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Note: TDHCA's and TDRA's Total Amount Spent updated with totals as of 12/31/10. TDHCA has transferred all remaining balances for Rita Round 1 and a percentage of current Rita Round 2 balances to the Maximization Fund, which utilizes unexpended Rita Round 1 and Round 2 local and infrastructure funds to provide housing assistance to additional households affected by Hurricane Rita. (Remaining Rita Round 2 balances reflect activity that has not yet been reimbursed.)
Public Debt
EXECUTIVE SUMMARY

Public debt and debt-like obligations at all levels of government is a subject that has recently drawn considerable attention. This is due in part to a growing awareness of the magnitude and speed of increases to public debt, and questions over the sustainability of that trend. The Texas Senate Finance Committee (the Committee) was charged by the Lieutenant Governor with examining the issue. The Committee found that Texas enjoys a strong position relative to many other states in terms of debt burden and debt management practices. The State's prudent fiscal policies have enhanced that position and helped Texas weather the storm of the recent economic recession and financial crisis. However, the Committee identified several concerns within four broad content areas: public debt and debt-like obligations, credit ratings and bond market access, limitations on debt and voter approval requirements, and interest rate swaps.

State-level public debt at the end of state fiscal year 2010 was $38.0 billion\(^1\), and public debt at all levels of government was $268.8 billion\(^2\). These amounts have risen significantly over the previous decade, driven largely by revenue-supported debt. Texas remains well below the Constitutional Debt Limit (5%) in terms of issued debt (1.36%) but less so when authorized but unissued debt is included (4.1%). In addition to obligations officially classified as debt, the state has incurred about $66.9 billion in potential liabilities and commitments that in many respects impact the financial health of the State as if they were debt, with the risk increasing during challenging economic times. These include pass-through and toll equity agreements through the Texas Department of Transportation, pre-paid tuition plans at the Comptroller's department, bond guarantees through the Permanent School Fund, the Existing Debt Allotment,

\(^1\) Texas Bond Review Board Annual Report 2010
\(^2\) Source: Municipal Advisory Council of Texas materials, September 2010.
and General Revenue-Dedicated account balances. The Committee's recommendations will help to preserve and enhance the prudence of Texas' fiscal policies at the state and local level.

In terms of credit and bond market access, Texas enjoys a strong position relative to many other states—including AA+, Aaa, and AAA ratings at Standard and Poor's, Moody's and Fitch (respectively)—although several important contributors to Texas' credit rating will be on the forefront during the 82nd legislative session. Local issuers of public debt are recovering from a period of severe stress in the municipal bond market that in some cases led local entities to rely more heavily on the State as a credit enhancer or de facto bond insurer. While this relationship does benefit municipal issuers with relatively low risk to the State, it could ultimately have negative implications to the fiscal health of the State and its credit rating. The Committee's recommendations are intended to formalize certain fiscal policies that have enhanced the State's credit rating, and to encourage the same at the local level.

Limitations on the amount of state and local debt and voter approval requirements primarily come from the Texas Constitution and statutes; home rule city charters; Attorney General opinions, rules, and bond council letters; and contract provisions. While the Attorney General conducts a legal review of all proposed public securities, the Finance Committee found room for improvement in oversight and tracking, and provision of public information on certain kinds of debt. First, there is no single or primary repository of comprehensive local debt information within the State or local governmental apparatus, such as amount of debt outstanding, types of issuances, or amount of annual debt service. There are also no specific requirements for voter education prior to bond elections (in terms of the existing debt or fiscal implications of the proposed issuance). Second, several types of public securities require little or no voter approval, and/or have scant limitations on the amount of outstanding debt of that type.
an issuer can acquire. These include certificates of obligation, Tuition Revenue Bonds, tax revenue anticipation notes, pension bonds, and city/county state highway system bonds. The Committee's recommendations in this area will improve voter education on and involvement in public debt matters as well as tracking and oversight of public securities.

Interest rate swaps are examples of financial instruments called derivatives that are used by issuers of debt to manage interest cost and mitigate certain kinds of risk. If all goes as planned, the issuer benefits by achieving below-market interest rates, and the counterparty profits off the spread between interest rates it pays and those it receives. However, public funds are exposed to termination risk, rollover risk, credit risk, basis risk, and tax risk, and it is possible that the issuer will ultimately pay more than it would have issuing more traditional debt. Six years of data show the State has generally paid more than the counterparty through swap agreements, however this does not reflect how the State's borrowing costs compare to what it would have paid if issuing traditional fixed- or variable-rate debt. Current criteria for which public entities can enter into interest rate swaps and other derivatives help restrict their use to larger, "sophisticated" issuers; however reporting, monitoring and oversight, and aggregation of statewide swap data for local issuers could be enhanced, as per the Committee's recommendations.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to public debt in Texas:

**Issue 1: Total Public Debt and Debt-Like Obligations**

1. Take a conservative approach in determining the speed at which currently authorized but unissued debt should be issued.

2. Require the Bond Review Board to add two new sections to its annual report, applicable only to even numbered years (those preceding a legislative session), that
would: (1) track certain debt-like obligations and liabilities, including but not limited
to pass-through financing and toll-equity agreements, pre-paid tuition plans, bond
guarantee programs, and the existing debt allotment; and (2) provide a more
comprehensive and detailed look at the status of local debt in Texas.

3. Require TxDOT to track all potential liabilities in its annual financial statements.

4. Restrict growth in pass-through agreements, toll-equity agreements, and loan
 guarantees at TxDOT, for example by setting a maximum dollar amount that can be
devoted to these purposes and/or amending TxDOT's Rider 63 in the General
Appropriations Act to remove the requirement that TxDOT issue at least as many pass
through agreements in the current biennium as in the previous.

5. Repeal bond authorizations over ten years old and consider repealing "dormant"
authority at the Department of Agriculture for the Farm and Ranch Finance Program
and the Texas Agricultural Finance Authority. Consider including expiration dates in
future bond authorizations.

6. Phase in a requirement that TRBs be paid from tuition revenue and reduce
appropriations for this purpose accordingly.

7. Consider setting a cap on revenue-supported debt at the state level.

8. Study gradual, multi-year approaches to reduce and/or spend down General Revenue-
Dedicated (GR-D) account balances, for example by transferring some percentage of
balances to undedicated General Revenue, converting some accounts to designated
General Revenue subject to appropriation (rather than separate dedicated accounts),
expanding uses of large GR-D accounts, or by capping the amount of new revenue into
GR-D accounts (while leaving revenue sources intact).

**Issue 2: Credit Ratings and Bond Market Access**

9. Identify and eliminate the current structural deficit.

10. Create standing subcommittees, workgroups, or select committees to monitor the
State's credit position and make recommendations for its enhancement.

11. Consider requiring municipal issuers of public debt to issue in each odd numbered
year a three-year credit enhancement plan based on the strengths and weaknesses
identified by relevant credit rating agencies, and to make that plan publically available.

**Issue 3: Limitations on Debt and Voter Approval Requirements**

12. Designate the Texas Bond Review Board (BRB) as the State's repository of detailed
local debt information. Require the BRB to establish a searchable database available
to voters statewide that includes definitions of relevant financial terms and information
on current debt burden at the state and local level. Require voter notification of the database prior to bond elections. Allow the BRB to contract with the Municipal Advisory Council of Texas to fulfill these requirements and increase the BRB’s appropriation as needed to achieve this recommendation.

13. Repeal Chapter 107, Section 107.003 of the *Local Government Code*, authorizing the sale of pension obligation bonds, or set voter approval requirements or election petition window parameters for such sales.

14. Consider creating voter approval requirements or election petition window parameters for city/county highway system bonds; consider the same action for tuition revenue bonds insofar as general revenue is appropriated to reimburse associated debt service.

15. Study the impact of: (1) setting a cap on the maximum amount of outstanding certificates of obligation (COs) and maximum amount of outstanding tax revenue anticipation notes (TRANs) with maturity dates over one year; (2) requiring voter approval of all COs and any TRAN with a maturity date over one year; and (3) extending the CO election petition window to sixty days, and establishing an election petition window of thirty days for all TRANs with maturity dates over one year.

16. Study options for increasing reporting requirements and oversight for COs, TRANs, pension bonds, and city/county highway system bonds.

**Issue 4: Interest Rate Swaps**

17. Require legal review by the OAG of any interest rate swap agreement, at the state or local level, regardless of when it is initiated.

18. Require local issuers that use swap agreements to report information on those agreements to the Bond Review Board (BRB)--identical to the information provided by state-level entities--on an annual basis, and require the BRB to include high-level summary information on swaps at the local level in its annual report. Increase the BRB’s appropriation as needed to fulfill this recommendation.

19. Require state agencies to report on the market interest rate available at the time of initiating a swap, compared to the interest rate achieved by the swap.

20. Study the impact of: (1) setting limits on termination provisions, for example preventing counterparties from terminating without cause, and (2) limiting the types of swaps and other derivatives that can be used by state entities (for example to pay-fixed, receive-variable interest rate swaps) or further limiting who can utilize derivative instruments.
PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with studying public debt at all levels of government in Texas:

Review and make recommendations regarding existing and future public debt at all levels of government in Texas, including independent school districts, cities, other local governments and the Texas Guaranteed Tuition Plan.

The Committee met pursuant to the aforementioned interim charge in public hearings in Austin, Texas, on March 10, 2010 and March 24, 2010 to consider invited testimony provided by representatives of the Bond Review Board, the Legislative Budget Board, the Office of the Attorney General, the Texas Public Finance Authority, the Texas Department of Transportation, the Texas Department of Agriculture, the Higher Education Coordinating Board, the Veterans Land Board, the Texas Water Development Board, the University of Texas Investment Management Company, the Municipal Advisory Council of Texas, and Standard and Poor's (S&P's). Public testimony was offered by Bill King, resident of Houston; and Dalton Smith, investment banker.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

The Committee identified four issue areas, each with its own background and recommendations, discussed below.

Issue 1: Total Public Debt and Debt-Like Obligations

In its fiscal year (FY) 2010 annual report, the Texas Bond Review Board (BRB) showed total state-level outstanding debt of $38.0 billion as of August 31, 2010, up 77.5% since FY2005. At the local level, outstanding debt was $174.6 billion, an increase of 58.5% over the same
period. The BRB's total of $212.5 billion in state and local debt in Texas comes in lower than the figure from the Municipal Advisory Council of Texas (MAC), which tracks a more comprehensive set of obligations. The MAC estimated total public debt at all levels of government in Texas to be $268.8 billion at the end of FY2010. State appropriated debt service for FY2010-2011 was $2.7 billion, excluding tuition revenue bonds (TRBs), which is a 266% increase since FY2000-2001. Appropriations for TRBs were $649.9 million, up 217% over the same period.

These figures indicate a significant and rapid increase in public debt in Texas over several biennia. At the state government level, much of the increase has come in the revenue-supported category (up 137.3% since FY2005). Tying debt to a revenue source does help to mitigate risk, but does not alleviate the financial burden on Texas citizens. At the local level, most of the increase in outstanding debt is of the tax-supported type. Total public debt is likely to continue increasing, in part due to recent federal legislation that created new bonding authority and special tax treatment for existing bonding authority, encouraging the issuance of more debt in the near term.

The State remains significantly below the constitutional debt limit in terms of issued debt (1.36%), however less so (4.1%) when the $16.3 billion of authorized but unissued debt is included. Among the authorized but unissued debt, recently approved cancer research and prevention bonds ($3 billion originally authorized; $2.55 billion left to be appropriated), and transportation bonds ($5 billion originally authorized; at least $3 billion left to be appropriated) will add significant sums to outstanding debt and debt service payable over the next two to three decades. However, the fact that the State is below the Constitutional Debt Limit indicates some additional capacity to authorize new bonds. The Higher Education Coordinating Board and

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Water Development Board, along with multiple agencies that issue bonds through the Texas Public Finance Authority, will seek such authority in the near future. Meanwhile, some outstanding authority may never be used. For example, the Legislative Budget Board identified $287 million in authority over ten years old, and the Department of Agriculture has $500 million in authority for the Farm and Ranch Finance Program and the Texas Agricultural Finance Authority that lies dormant due to changes in these programs.

If Texas exceeds its constitutional debt limit due to declining revenue or increasing debt service, the State is not required to rapidly pay-down outstanding debt. Furthermore, the State can continue to issue previously authorized but unissued debt. The impact of exceeding the limit is that there can be no new authorizations until the debt ratio falls back below the limit. Note, in recent years issuing previously authorized but unissued debt has improved (rather than hurt) the ratio calculation because the BRB makes conservative interest rate assumptions when projecting debt service obligations on currently unissued bonds, generally overestimating compared to actual interest rates obtained when the bonds are sold.

In addition to liabilities officially categorized as "public debt", Texas acquires debt-like obligations through contractual agreements and bond guarantee programs, and these obligations have the potential to significantly impact the State's fiscal health in difficult economic times. First, the Texas Department of Transportation (TxDOT) provides pass-through financing and toll equity agreements as a part of certain road construction contracts. In pass-through financing agreements, local communities fund upfront project and construction costs, and then receive reimbursement from TxDOT based on road usage. Each project has a minimum and maximum annual reimbursement and a maximum aggregate repayment amount. Pass through financing could proliferate in the future, since TxDOT's Rider 63 in the General Appropriations Act

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requires at least as many agreements in the current biennium as in the previous. The terms of toll equity contracts can vary significantly; the figure used in Table 1 (below) refers to potential loans to the North Texas Tollway Authority if available financing is insufficient to cover construction costs on two specific projects.

Second, the Texas Guaranteed Tuition Plan is a pre-paid tuition program operated by the Texas Comptroller of Public Accounts, which is currently experiencing an unfunded liability. This program is discussed in detail in a separate Finance Committee report. Third, the State uses the corpus of the Permanent School Fund to guarantee local school debt, thereby increasing issuing entities' bond rating and decreasing their borrowing costs. The current amount of the Permanent School Fund guarantee is approximately double the actual corpus of the fund, which may be a significant financial risk to the State, however no district benefitting from the guarantee has ever defaulted. Fourth, through the Existing Debt Allotment—essentially a guarantee on local tax revenue, subject to appropriation—the State provides aid to school districts to assist with debt service payments. The actual aid provided through the Existing Debt Allotment has historically hovered around ten percent of the total outstanding debt service eligible for the program, however this could increase as needs in school districts struggling with tight budgets increase. Lastly, General Revenue-Dedicated (GR-D) funds are statutorily limited to specific uses, however most account balances are available for budget certification. While this does not mean that the funds are actually expended for purposes other than intended, it does have implications on future spending. In the FY2010-11 biennium, GR-D account balances used in budget certification totaled $3.7 billion (4.5% of general revenue expenditures). All other things held equal, spending down these balances in the future would require general revenue spending
reductions of a like amount or statutory change to expand eligible uses of GR-D accounts. The larger the balances grow, the more difficult this becomes.

Table 1 gives the maximum obligation the State could experience in each of the areas discussed above.

Table 1: Public Debt-Like Obligations

<table>
<thead>
<tr>
<th>Agency or Fund</th>
<th>Description of Obligation</th>
<th>Maximum Obligation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texas Department of Transportation</td>
<td>Pass-Through Financing Agreements</td>
<td>$2.2 billion⁵</td>
</tr>
<tr>
<td>Texas Department of Transportation</td>
<td>Toll Equity Projects - potential loans</td>
<td>$6.5 billion⁶</td>
</tr>
<tr>
<td>Texas Guaranteed Tuition Plan</td>
<td>Unfunded liability (as of August 31, 2009)</td>
<td>$0.6 billion⁷</td>
</tr>
<tr>
<td>Permanent School Fund</td>
<td>Bond guarantee (as of FY2009 end)</td>
<td>$50.0 billion⁸</td>
</tr>
<tr>
<td>Existing Debt Allotment</td>
<td>State aid to school districts for debt service (FY2009 amount)</td>
<td>$3.9 billion⁹</td>
</tr>
<tr>
<td>General Revenue-Dedicated (GR-D) Account Balances</td>
<td>Dedicated revenue used in budget certification (FY2010-11 amount)</td>
<td>$3.7 billion¹⁰</td>
</tr>
</tbody>
</table>

**TOTAL**                                                                                      **$66.9 billion¹¹**

In sum, the Committee's findings place the total public debt and debt-like obligations at all levels of government in Texas between $325 billion and $350 billion. Careful management of existing debt and fiscal policy at the state and local level is essential to maintaining the financial health of the State and the financial wellbeing of its citizens.

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⁵ Source: Texas Department of Transportation materials presented at March 10, 2010 hearing. Includes all Commission-approved commitments (with or without executed agreements).
⁶ Source: Texas Department of Transportation materials presented at March 10, 2010 hearing.
⁷ Source: Legislative Budget Board materials presented at March 10, 2010 hearing.
¹⁰ Source: Legislative Budget Board materials presented to the House Select Committee on Fiscal Stability at May 26, 2010 hearing.
¹¹ Note that this figure is approximate, due to variations in when data are collected.
The Committee recommends that the Legislature:

1. Take a conservative approach in determining the speed at which currently authorized but unissued debt should be issued.

2. Require the Bond Review Board to add two new sections to its annual report, applicable only to even numbered years (those preceding a legislative session), that would: (1) track certain debt-like obligations and liabilities, including but not limited to pass-through financing and toll-equity agreements, pre-paid tuition plans, bond guarantee programs, and the existing debt allotment; and (2) provide a more comprehensive and detailed look at the status of local debt in Texas.

3. Require TxDOT to track all potential liabilities in its annual financial statements.

4. Restrict growth in pass-through agreements, toll-equity agreements, and loan guarantees at TxDOT, for example by setting a maximum dollar amount that can be devoted to these purposes and/or amending TxDOT's Rider 63 in the General Appropriations Act to remove the requirement that TxDOT issue at least as many pass through agreements in the current biennium as in the previous.

5. Repeal bond authorizations over ten years old and consider repealing "dormant" authority at the Department of Agriculture for the Farm and Ranch Finance Program and the Texas Agricultural Finance Authority. Consider including expiration dates in future bond authorizations.

6. Phase in a requirement that TRBs be paid from tuition revenue and reduce appropriations for this purpose accordingly.

7. Consider setting a cap on revenue-supported debt at the state level.

8. Study gradual, multi-year approaches to reduce and/or spend down General Revenue-Dedicated (GR-D) account balances, for example by transferring some percentage of balances to undedicated General Revenue, converting some accounts to designated General Revenue subject to appropriation (rather than separate dedicated accounts), expanding uses of large GR-D accounts, or by capping the amount of new revenue into GR-D accounts (while leaving revenue sources intact).

**Issue 2: Credit Ratings and Bond Market Access**

Texas enjoys a strong credit rating at all three of the primary rating agencies: AA+ at Standard and Poor's, and Aaa/AAA at Moody's and Fitch (respectively). This places Texas in a favorable position relative to many other states in terms of credit access, cost of issuance, and interest rates. The state's credit rating would need to drop by several degrees before it would
likely see a significant impact on borrowing costs. Standard and Poor’s, Moody’s, and Fitch cite multiple factors affecting Texas’ rating, including economic diversity, population growth, the poverty rate and medical needs of Texans, the state’s infrastructure requirements, the existence and management of the Economic Stabilization ("Rainy Day") Fund, constitutional spending limitations, and others. Several of these are unlikely to change in the near term, however the means by which the Legislature resolves current budgetary challenges and the potential implications of its decisions on future budgets could have an impact.

In terms of local debt, after a period of severe stress in the municipal bond market, stabilization of the financial sector and the Build America Bonds program helped to reignite local public finance. However, the last several years brought noteworthy changes. Tight credit markets and the near-disappearance of bond insurance placed significant pressure on municipal bond issuers, primarily leading to the delay or cancelation of capital improvement projects. However these pressures also caused some local entities to rely more heavily on the State as a credit enhancer or de facto bond insurer. Examples of this include the Permanent School Fund (PSF) bond guarantee program, pass-through financing, and toll equity agreements, discussed previously, and certain Texas Water Development Board (TWDB) loans in which municipal issuers sell their bonds to the TWDB rather than on the open market. These types of credit enhancement or de facto insurance do benefit municipal issuers with relatively low risk to the State, however if this activity continues to grow it could have negative implications to the fiscal health of the State and its credit rating.

Overall, Texas at the state-level has done well in the area of credit ratings and bond market access; however no categorical statements can be made in the case of local debt due to variations across cities, counties, and other districts. Legislative action could help to formalize
certain prudent fiscal policies that have enhanced the State's credit rating, and to encourage the same at the local level.

The Committee recommends that the Legislature:

9. Identify and eliminate the current structural deficit.

10. Create standing subcommittees, workgroups, or select committees to monitor the State's credit position and make recommendations for its enhancement.

11. Consider requiring municipal issuers of public debt to issue in each odd numbered year a three-year credit enhancement plan based on the strengths and weaknesses identified by relevant credit rating agencies, and to make that plan publically available.

**Issue 3: Limitations on Debt and Voter Approval Requirements**

Limitations on the amount of state and local debt primarily come from the Texas Constitution and statutes; home rule city charters; Attorney General opinions, rules, and bond council letters; and contract provisions. Most limitations take the form of maximum allowable tax rate or a maximum percentage of income/revenue that can be devoted to debt service. Texas statute requires the Office of the Attorney General (OAG) to review all proposed new public securities (bonds, notes, certificates of obligation, certificates of participation, or other instruments and obligations evidencing a proportionate interest in payments due to be paid by an issuer) and requires the OAG to approve the issuance provided the terms comply with applicable statute. The OAG does not make a financial or policy review of any public security. Voter approval requirements for state and local debt are found in the Texas Constitution and statutes, and home rule charters (unless they are in conflict with the Constitution or statutes). Tax and debt secured by ad valorem taxes generally require an election to approve either the amount of debt or the tax rate, depending on the issuing entity, though some types of debt do not require any voter approval.
Senate Committee on Finance, Interim Report on Public Debt in Texas

Of the Committee’s findings under this heading, two are of particular interest and potential concern. First, there is no single or primary repository of comprehensive local debt information within the State or local governmental apparatus, such as amount of debt outstanding, types of issuances, or amount of annual debt service. The Bond Review Board and Office of the Attorney General do maintain aggregated information and issuance history, however only a non-governmental entity—the Municipal Advisory Council of Texas, or MAC—maintains extensive and comprehensive data relating to the fiscal health of individual municipal issuers. The MAC provides this information in full to subscribers (primarily credit rating agencies, bond investors, and public entities), but only in part to non-subscribers such as the average voter. Hence, a Texas resident looking for quantitative information to help in voting decisions on local bond elections has no clear place to turn. What’s more, there are no specific requirements for voter education prior to bond elections (in terms of the existing debt or fiscal implications of the proposed issuance) that would result in the potential issuer providing the voter with the information he seeks.

Second, several types of public securities require little or no voter approval prior to issuance, and/or have scant limitations on the amount of outstanding debt of that type an issuer can acquire. There is no limitation on the par amount of certificates of obligation (COs) that can be issued, only the requirement that the issuer demonstrate ability to pay debt service. COs do not require voter approval, although they are subject to petition for election. Appropriately used, COs are issued to finance projects tied to a revenue source or to cover short-term financial needs, however they can also be abused. Tuition Revenue Bonds do not require voter approval because they are tied to a revenue source. However, they are similar to general obligations of the State, since the Legislature has consistently appropriated general revenue funds to pay debt service on
these bonds. In that sense, stricter voter approval requirements (or changes in how debt service is paid) may be warranted. Tax revenue anticipation notes, pension bonds, and city/county state highway system bonds require neither voter approval nor notification. Tax anticipation notes are used to manage cash flows; in the State's case, these notes have maturity dates of one year or less to ensure the note is secured by revenues within the same tax year. However, it is possible that actual tax collections will fall short of projections, resulting in spending that exceeds revenue, or that non-State entities may pledge tax revenue from more than one year into the future in order to achieve higher spending levels in the present. Pension obligation bonds are authorized in *Local Government Code* Chapter 107, Section 107.003, and can be issued to shore up pension funds facing unfunded liabilities. That section requires little in terms of reporting or oversight, and gives wide latitude in calculating unfunded pension liabilities. Hence, current guidance and oversight may be insufficient to guard against unnecessary use or even misuse. Similarly, wide latitude is given in the use and payment of city/county state highway system bonds.

The Committee recommends that the Legislature:

12. Designate the Texas Bond Review Board (BRB) as the State's repository of detailed local debt information. Require the BRB to establish a searchable database available to voters statewide that includes definitions of relevant financial terms and information on current debt burden at the state and local level. Require voter notification of the database prior to bond elections. Allow the BRB to contract with the Municipal Advisory Council of Texas to fulfill these requirements and increase the BRB’s appropriation as needed to achieve this recommendation.

13. Repeal Chapter 107, Section 107.003 of the *Local Government Code*, authorizing the sale of pension obligation bonds, or set voter approval requirements or election petition window parameters for such sales.

14. Consider creating voter approval requirements or election petition window parameters for city/county highway system bonds; consider the same action for tuition revenue bonds insofar as general revenue is appropriated to reimburse associated debt service.

15. Study the impact of: (1) setting a cap on the maximum amount of outstanding certificates of obligation (COs) and maximum amount of outstanding tax revenue
anticipation notes (TRANs) with maturity dates over one year; (2) requiring voter approval of all COs and any TRAN with a maturity date over one year; and (3) extending the CO election petition window to sixty days, and establishing an election petition window of thirty days for all TRANs with maturity dates over one year.

16. Study options for increasing reporting requirements and oversight for COs, TRANs, pension bonds, and city/county highway system bonds.

**Issue 4: Interest Rate Swaps**

Interest rate swaps are examples of financial instruments called derivatives that are used by issuers of debt to manage interest cost and mitigate certain kinds of risk. Through the swap arrangement, two “counterparties”—a debt issuer and a financial institution—agree to exchange interest payments based on fixed rates or market indices. The most common forms (about 99.5%) used by Texas issuers are pay-fixed/receive-variable and pay-variable/receive-variable.

In pay-fixed/receive-variable swaps, the issuer sells variable rate debt but synthetically fixes the interest rate through the agreement with the counterparty. The issuer does this by arranging to make fixed-rate payments to the swap provider, who makes variable-rate payments back to the issuer based on a specified market index expected to track the variable rates the issuer is obligated to pay on the outstanding debt. In pay-variable/receive-variable swaps the issuer also sells variable rate debt, but in this case makes variable-rate payments to the counterparty based on one market index while the counterparty makes variable-rate payments back to the issuer based on a different market index. The intent of this type of swap is for the issuer to synthetically convert the interest rate on taxable variable-rate debt to a tax-exempt variable rate.

If all goes as planned in these agreements, the issuer benefits by (synthetically) achieving below-market interest rates, and the counterparty profits off the spread between interest rates it pays and those it receives. However, there are risks involved to public funds, and it is possible that the issuer will pay more than it would have issuing traditional fixed-rate or variable-rate debt. Depending on the “Fair Value” of a swap at a given time, the issuer could owe the
counterparty a settlement if the swap is terminated ("termination risk"). Termination could also increase the issuer's exposure to fluctuations in variable interest rates ("rollover risk"). The counterparty could fail to fulfill its obligations ("credit risk") or the payments received could be less than required payments ("basis risk"). Lastly, federal tax laws or marginal tax rates could affect any tax-exempt, variable-rate bonds ("tax risk"). This and other information regarding types and uses of interest rate swaps by state entities can be found in the Bond Review Board’s Annual Report.

Chapter 1371 of the *Government Code* authorizes Texas issuers of public debt that meet certain criteria to enter into interest rate swaps and other derivatives. Senate Bill 968 (80th Legislature, Regular Session) tightened those criteria such that only large, "sophisticated" issuers could use these agreements, and established certain internal reporting requirements. SB968 did not include provisions specific to public reporting, monitoring, or aggregation of statewide swap data for local issuers. The BRB currently compiles information on active swaps entered into by state agencies, which as of the end of FY2010 included only the Veterans Land Board, the Texas Department of Housing and Community Affairs, the University of Texas System, and the Texas Transportation Commission (TxDOT). If an interest rate swap is included in the *initial* terms of a bond issuance, the OAG reviews and approves the agreement for compliance with applicable state law. However, neither the BRB nor the OAG has policy, financial, or contract management oversight authority of such agreements.

The Committee’s key findings regarding interest rate swaps are several. As of August 31, 2010, if all outstanding state-level swap agreements were terminated, state agencies would have owed about $557.2 million to counterparties. This is a significant increase over the same figure from 2009, largely due to persistently low market interest rates. However, due to Texas' strong
credit rating, state agencies are in an advantageous position that generally prevents counterparties from terminating swap contracts unless the State fails to make its payments. Six years of this type of data show that state agencies have consistently paid more than the counterparty through pay-fixed, receive-variable swaps, which represent about 72% of the swaps outstanding based on notional dollar amount. The state has generally, though not consistently, paid less than the counterparty through pay-variable, receive-variable agreements. While this gives the impression that interest rate swaps have not benefitted state issuers, mark-to-market data does not compare actual borrowing costs to what the agencies' expenses would have been without any swap agreement at all. This makes it difficult to establish whether swaps are benefiting state agencies, except anecdotally or by comparing interest rates at the time of issuance. State issuers employing swaps generally find them to be an important financial and risk management tool. It is more difficult to make judgments of the benefits or costs of swap agreements to local issuers, as individual and aggregate data is hard to come by. While the OAG registers swap agreements included in the initial terms of a local issuance, if such an agreement is entered into later during the repayment period, this isn’t always the case. The OAG generally neither sees nor approves the terms of the contract, and there are no specific requirements for public notification or approval. As such, additional data would be needed to state more definitively whether swaps are being safely and beneficially used by local issuers; it is possible that despite the added protections of SB968, local issuers may be entering into dangerously sophisticated financing agreements that deserve more public oversight and, potentially, approval requirements.

The Committee recommends that the Legislature:

17. Require legal review by the OAG of any interest rate swap agreement, at the state or local level, regardless of when it is initiated.
18. Require local issuers that use swap agreements to report information on those agreements to the Bond Review Board (BRB)—identical to the information provided by state-level entities—on an annual basis, and require the BRB to include high-level summary information on swaps at the local level in its annual report. Increase the BRB’s appropriation as needed to fulfill this recommendation.

19. Require state agencies to report on the market interest rate available at the time of initiating a swap, compared to the interest rate achieved by the swap.

20. Study the impact of: (1) setting limits on termination provisions, for example preventing counterparties from terminating without cause, and (2) limiting the types of swaps and other derivatives that can be used by state entities (for example to pay-fixed, receive-variable interest rate swaps) or further limiting who can utilize derivative instruments.
Limits on Public Spending
EXECUTIVE SUMMARY

The Senate Committee on Finance (the Committee) was charged with evaluating the impact of certain potential changes to limitations on public spending in Texas. The Committee found that although public spending has grown over the previous decade, current limitations are sufficient compared to the alternative suggested by the interim charge. However, requiring a transfer to the Economic Stabilization (Rainy Day) Fund when projected biennial revenue exceeds the weighted average of the previous two biennia could help smooth the growth and contraction of public spending and reduce total spending over time. Additionally, the Committee found that spending in areas not subject to current limitations has grown at a pace warranting further attention and potential action.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to public spending in Texas:

1. Consider amending Article III, Section 49-g of the Constitution to require in each new biennium the partial transfer of any projected general revenue above the weighted average general revenue of the previous two biennia.

2. Study the impact of limiting the growth of appropriations from revenue other than tax revenue not dedicated by the Constitution, such as constitutionally dedicated tax revenue; fees, fines, and penalties; interest and investment income; and federal funds.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with evaluating the impact of certain potential changes to current limits on public spending in Texas:

Study the impact of changing the constitutional and statutory spending limit based on the sum of the rate of population growth and the rate of inflation. Examine what past biennial spending limits would have been, and what the next biennium’s limit might be, under a new definition. Consider the impact of exempting growth from federally mandated programs.
The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas, on May 12, 2010, to consider invited testimony provided by the Legislative Budget Board (LBB). Public testimony was provided by representatives of Americans for Prosperity and the Center for Public Policy Priorities.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

The Texas Constitution, Article VIII, Section 22(a) limits biennial growth in appropriations from tax revenue not dedicated by the Constitution to the estimated growth of the state's economy. This applies to taxes on general sales, motor vehicle sales and rental, franchises, cigarettes and tobacco, alcoholic beverages, inheritance, and hotel occupancy, and portions of taxes on motor fuels, insurance, natural gas, oil production and regulation, utilities, and other taxes. For fiscal years (FY) 2010-2011, $64.0 billion of the total $76.2 billion in General Revenue-Related collections available for appropriation were subject to the limit. As required by Government Code 316.002, prior to each legislative session the LBB adopts a projected growth rate based on personal income. The adopted rate can be positive or negative; in the last two biennia, the LBB has overestimated the actual growth rate by about 5% each time. A more restrictive spending limitation comes from Article III, Section 49a(b) of the Constitution, which caps appropriations at available cash and anticipated revenue based on the Comptroller's biennial estimate. This is commonly referred to as the "pay-as-you-go" requirement, and has kept Texas well within the budget growth limitation described above.

Public spending in Texas has nonetheless grown in the last decade. Appropriations of tax revenue not dedicated by the constitution have consistently increased, by factors ranging from...
1.0% (FY2008-2009 to FY2010-2011) to 30.7% (FY2006-2007 to FY2008-2009). The following chart shows appropriations in General Revenue-Related (General Revenue and General Revenue-Dedicated), Federal Funds, Other Funds, and All Funds (amounts in millions):

<table>
<thead>
<tr>
<th>General Revenue-Related</th>
<th>Federal Funds</th>
<th>Other Funds</th>
<th>All Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amt (mil)</td>
<td>%</td>
<td>Amt (mil)</td>
<td>%</td>
</tr>
<tr>
<td>FY2000-2001</td>
<td>$61,430</td>
<td></td>
<td>$27,704</td>
</tr>
<tr>
<td>FY2002-2003</td>
<td>$66,231</td>
<td>7.8%</td>
<td>$34,762</td>
</tr>
<tr>
<td>FY2004-2005</td>
<td>$63,546</td>
<td>-4.1%</td>
<td>$39,218</td>
</tr>
<tr>
<td>FY2006-2007</td>
<td>$69,749</td>
<td>9.8%</td>
<td>$48,304</td>
</tr>
<tr>
<td>FY2008-2009</td>
<td>$86,260</td>
<td>23.7%</td>
<td>$50,963</td>
</tr>
<tr>
<td>FY2010-2011</td>
<td>$87,003</td>
<td>0.9%</td>
<td>$65,534</td>
</tr>
</tbody>
</table>

Source: General Appropriation Acts of the 76th - 81st Legislatures

This growth in spending is due in part to Texas' strong economy over the last ten years, and in part to the fact that a large portion of the budget is not subject to the spending growth limitation. This includes such things as constitutionally dedicated tax revenue; fees, fines, and penalties; interest and investment income; and federal funds. For example, between FY2000-2001 and FY2010-2011, appropriations of federal funds increased 136.6% and Other Funds appropriations (which includes most fees, fines, and penalties) increased 229.9%. Over that same period, General Revenue-Related appropriations (most of which is subject to both the spending growth limit and pay-as-you-go limit) increased only 41.6%; this number drops below 20% if property tax relief passed by the 80th Legislature is excluded.

Changing the type of appropriations subject to the limit (for example, to include all non-federal spending) would require a constitutional amendment. However, changing the

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1 Despite this growth in FY2008-2009, Texas remained within the spending limit by $4.6 billion because the cap was adjusted upward by $14.2 billion to allow for property tax relief.
measurement of growth of the state's economy would require only a statutory change. The current measure--personal income growth--is generally considered to track the health of the economy, and is commonly used by other states in setting spending limits. An alternative approach of using the combined rate of inflation and population growth in effect freezes per capita spending, adjusted for inflation. This is more successful at stabilizing and slowing spending growth, but less common across the country because it is can be very restrictive and because the types of expenditures experienced by government do not generally grow at the same pace as inflation.

If the growth in public spending had been limited by the combined rate of population and inflation since FY2002-2003, Texas' pay-as-you-go requirement would still have kept the state below its limit, even more so if Medicaid appropriations are excluded, as illustrated in Figures 1 and 2.
### Figure 1: Spending Growth Under Current Limit vs. Hypothetical Population and Inflation Limit

**Article VIII, Section 22 Spending Limit**

<table>
<thead>
<tr>
<th>Biennium</th>
<th>Base Appropriations from Tax Revenue</th>
<th>Adopted</th>
<th>Current Article VIII Spending Limit from Tax Revenue Not Dedicated by the Constitution</th>
<th>Appropriations from Tax Revenue Not Dedicated by the Constitution</th>
<th>Amount Below the Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>44,795</td>
<td>14.09%</td>
<td>51,107</td>
<td>47,476</td>
<td>3,630</td>
</tr>
<tr>
<td>2006-07</td>
<td>49,933</td>
<td>11.34%</td>
<td>55,595</td>
<td>54,808</td>
<td>787</td>
</tr>
<tr>
<td>2008-09</td>
<td>54,808</td>
<td>13.11%</td>
<td>76,185</td>
<td>71,632</td>
<td>4,552</td>
</tr>
<tr>
<td>2010-11</td>
<td>71,632</td>
<td>9.14%</td>
<td>78,179</td>
<td>72,337</td>
<td>5,842</td>
</tr>
</tbody>
</table>

Note: FY 2007-11 appropriations include appropriations for property tax rate reductions. The FY 2008-09 spending limit includes an additional $14.2 billion authorized by Senate Concurrent Resolution 20, 80th Regular Session, for property tax rate reductions.

#### Appropriations Subject to Current Limit

**Limited by the Growth of Population and Inflation**

<table>
<thead>
<tr>
<th>Biennium</th>
<th>Base Appropriations from Tax Revenue</th>
<th>Population &amp; Inflation Growth Rate</th>
<th>Hypothetical Spending Limit</th>
<th>Appropriations from Tax Revenue Not Dedicated by the Constitution</th>
<th>Amount Below the Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>44,795</td>
<td>8.02%</td>
<td>48,389</td>
<td>47,476</td>
<td>913</td>
</tr>
<tr>
<td>2004-05</td>
<td>47,476</td>
<td>8.76%</td>
<td>51,636</td>
<td>49,933</td>
<td>1,703</td>
</tr>
<tr>
<td>2006-07</td>
<td>49,933</td>
<td>11.23%</td>
<td>55,542</td>
<td>54,808</td>
<td>734</td>
</tr>
<tr>
<td>2008-09</td>
<td>54,808</td>
<td>9.71%</td>
<td>74,319</td>
<td>71,632</td>
<td>2,686</td>
</tr>
<tr>
<td>2010-11</td>
<td>71,632</td>
<td>5.88%</td>
<td>75,844</td>
<td>72,337</td>
<td>3,507</td>
</tr>
</tbody>
</table>

Note: The growth of this hypothetical spending limit is limited to the growth of population and inflation. FY 2007-11 appropriations include appropriations for property tax rate reductions. The hypothetical FY 2008-09 spending limit includes an additional $14.2 billion authorized by Senate Concurrent Resolution 20, 80th Regular Session, for property tax rate reductions. This analysis does not consider what actions the legislature would have taken in response to this hypothetical spending limit. Historical growth rates are based on data from the U.S. Bureau of Economic Analysis. The FY 2010-11 growth rate forecast is based on the Comptroller's Fall FY 2009 Economic Forecast.

*Source: Legislative Budget Board*
Figure 2: Spending Growth Under Current Limit vs. Hypothetical Population and Inflation Limit, Excluding Medicaid Appropriation

**Hypothetical Spending Limit Excluding Medicaid Appropriations**

Limited by the Growth of Adopted Personal Income in $ millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Base Appropriations</th>
<th>Appropriations from Tax</th>
<th>Appropriations from Tax Not Dedicated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>from Tax Revenue Not Dedicated by the Constitution Excluding Medicaid</td>
<td>Revenue Not Dedicated by the Constitution Excluding Medicaid</td>
<td></td>
</tr>
<tr>
<td>2002-03</td>
<td>37,805</td>
<td>38,087</td>
<td>43,132</td>
</tr>
<tr>
<td>2004-05</td>
<td>38,807</td>
<td>39,398</td>
<td>43,398</td>
</tr>
<tr>
<td>2006-07</td>
<td>39,281</td>
<td>43,736</td>
<td>43,736</td>
</tr>
<tr>
<td>2008-09</td>
<td>42,920</td>
<td>62,738</td>
<td>56,772</td>
</tr>
<tr>
<td>2010-11</td>
<td>55,460</td>
<td>61,961</td>
<td>60,111</td>
</tr>
</tbody>
</table>

Note: This hypothetical spending limit excludes Medicaid appropriations, but includes appropriations for property tax rate reductions. The hypothetical FY 2008-09 spending limit includes an additional $14.2 billion authorized by Senate Concurrent Resolution 20, 80th Regular Session, for property tax rate reductions. This analysis does not consider what actions the legislature would have taken in response to this hypothetical spending limit.

**Hypothetical Spending Limit Excluding Medicaid Appropriations**

Limited by the Growth of Population and Inflation in $ millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Base Appropriations</th>
<th>Appropriations from Tax</th>
<th>Appropriations from Tax Not Dedicated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>from Tax Revenue Not Dedicated by the Constitution Excluding Medicaid</td>
<td>Revenue Not Dedicated by the Constitution Excluding Medicaid</td>
<td></td>
</tr>
<tr>
<td>2002-03</td>
<td>37,805</td>
<td>38,807</td>
<td>43,132</td>
</tr>
<tr>
<td>2004-05</td>
<td>38,807</td>
<td>43,398</td>
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</tr>
<tr>
<td>2006-07</td>
<td>39,281</td>
<td>43,736</td>
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</tr>
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<td>2008-09</td>
<td>42,920</td>
<td>56,772</td>
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</tr>
<tr>
<td>2010-11</td>
<td>55,460</td>
<td>60,111</td>
<td>60,111</td>
</tr>
</tbody>
</table>

Note: This hypothetical spending limit excludes Medicaid appropriations, but includes appropriations for property tax rate reductions. The growth of this hypothetical spending limit is limited to the growth of population and inflation. The hypothetical FY 2008-09 spending limit includes an additional $14.2 billion authorized by Senate Concurrent Resolution 20, 80th Regular Session, for property tax rate reductions. This analysis does not consider what actions the legislature would have taken in response to this hypothetical spending limit. Historical growth rates are based on data from the U.S. Bureau of Economic Analysis. The FY 2010-11 growth rate forecast is based on the Comptroller's Fall FY 2009 Economic Forecast.

Source: Legislative Budget Board
Based on these data, the Committee finds that the current methodology for restricting the growth of public spending is sufficient compared to the alternative methodology suggested by the interim charge. Furthermore, given current economic conditions, the question of how to calculate the spending growth limit is moot for the FY2012-2013 biennium: the pay-as-you-go requirement will prevail, and by a wide margin. However, the Committee identified two other matters deserving attention and possible action.

The first matter relates to the impact of current limitations on the growth and contraction of public spending. The present methodology leaves open the possibility of rapid spending growth during good economic times, when it may not be necessary; unwinding that growth when the economy slows presents a significant challenge. The existing approach also requires spending cuts, sometimes drastic ones, during recessionary periods, which is arguably when public spending is most needed. An alternative methodology that smoothes the growth and contraction of public spending could be more beneficial and effective.

The Legislature could require a transfer to the Economic Stabilization (Rainy Day) Fund in each biennium in which projected general revenue exceeds the weighted average of the previous two biennia; the amount of the transfer could be calculated as a percentage of the difference. For most biennia this would be a more restrictive limit than the current method because not all anticipated general revenue would be available for appropriation. Instead, the growth of spending would lag the growth in tax receipts. Meanwhile, the Rainy Day Fund would benefit from a more consistent source of revenue, providing the Legislature with greater flexibility in its use. When the economy is growing, the Legislature could appropriate some portion of the balance of the fund for such things as tax relief, targeted public investments, or other priorities, or leave it untouched. In recessionary biennia, or in the face of supplemental needs, the
Legislature would have another source for appropriations to sustain important programs and services and otherwise mitigate potential negative impacts on Texas citizens.

Thus, requiring a transfer to the Rainy Day Fund under certain conditions could slow the growth of general revenue spending during economic expansions and allow the Legislature room to lessen the contraction of spending during recessions. The result would be a more smoothed overall trend, with less dramatic peaks and valleys and less total spending over time.

The Committee recommends that the Legislature:

1. Consider amending Article III, Section 49-g of the Constitution to require in each new biennium the partial transfer of any projected general revenue above the weighted average general revenue of the previous two biennia.

The second matter deserving attention and possible action identified by the Committee has to do with which revenue sources are subject to the spending growth limit. As previously noted, the growth in public spending of certain revenue--such as federal funds, fees, fines, and penalties--has outpaced growth in spending of tax revenue not dedicated by the Constitution. Federal funds are often accompanied by matching or other requirements, and the impact on Texas citizens of fees, fines, and penalties can compound any economic challenges they face. While appropriations of these non-tax revenues are subject to the pay-as-you-go requirement, in this case the requirement is hollow insofar as federal funds are by definition limited to amounts available, and fees, fines, and penalties are easily raised. Under the current system, these revenue are not governed by the spending growth limit as is tax revenue not dedicated by the Constitution. As Table 2 shows, the rate of growth of appropriated federal and other funds exceeded the adopted personal income growth rate in most of the previous five biennia:
Table 2: Growth Rate of Appropriations of Federal and Other Funds Compared to Adopted Personal Income Growth Rate

<table>
<thead>
<tr>
<th>FY</th>
<th>Adopted Personal Income Growth Rate</th>
<th>Growth in Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Federal Funds</td>
</tr>
<tr>
<td>FY2002-2003</td>
<td>14.09%</td>
<td>25.48%</td>
</tr>
<tr>
<td>FY2004-2005</td>
<td>11.83%</td>
<td>12.82%</td>
</tr>
<tr>
<td>FY2006-2007</td>
<td>11.34%</td>
<td>23.17%</td>
</tr>
<tr>
<td>FY2008-2009</td>
<td>13.11%</td>
<td>5.51%</td>
</tr>
<tr>
<td>FY2010-2011</td>
<td>9.14%</td>
<td>28.59%</td>
</tr>
</tbody>
</table>

If appropriations of Federal Funds and Other Funds had been subject to the spending growth limit, spending patterns in these categories would have been significantly different.

The Committee recommends that the Legislature:

2. Study the impact of limiting the growth of appropriations from revenue other than tax revenue not dedicated by the Constitution, such as constitutionally dedicated tax revenue; fees, fines, and penalties; interest and investment income; and federal funds.
Property Tax
EXECUTIVE SUMMARY

The Senate Committee on Finance (the Committee) has identified and evaluated several potential improvements to Texas' property tax system including the varied topics of increasing public participation in the tax-rate setting process, property appraisal values, community housing development organization exemptions, real property interests in oil and gas, and ad valorem taxation of real property leased to a school.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to the property tax system:

**Issue 1: Increasing Public Participation in the Tax-Rate Setting Process and Ensuring Fairness in Appraisal Protests and Appeals**

1. Continue to monitor the effectiveness of past legislative mandates designed to increase public participation and fairness.

2. Consider a legislative proposal to promote transparency and simplify the local government tax rate setting process.

3. Consider requiring voter approval for city and county tax revenue increases of more than 4%.

**Issue 2: Property Appraisal Values**

4. Consider proposing a constitutional amendment to reduce the current $15,000 homestead exemption for school property taxes in an amount necessary to offset the cost of lowering the current 10% appraisal cap for residence homesteads to 5%.

**Issue 3: Community Housing Development Organization Exemptions**

5. Consider clarifying that community housing development organizations partnering with for-profit developers to develop multi-family properties must actually own the property to be eligible for an ad valorem tax exemption, due to concerns raised by recent legal challenges.

6. Alternatively, propose an amendment to the Texas Constitution that would allow for-profit entities in partnership with community housing development organizations to develop a multi-family property and receive an ad valorem tax limitation, even
though the CHDO is not the actual owner of the property, in exchange for offering extremely affordable rents for difficult-to-serve populations.

**Issue 4: Real Property Interests in Oil and Gas**

7. Continue to have the Comptroller's office prepare the market condition factors using the forecasted price for crude oil and natural gas but eliminate the requirement that the forecasts be based on "revenue estimating methodology" to enable the Comptroller's office to better focus on incorporating market value methodology in their estimates.

**Issue 5: Ad Valorem Taxation of Real Property Leased to a School**

8. Propose a constitutional amendment that would provide an ad valorem tax exemption specifically for private real property owners that lease their property to a charter school.

9. In the alternative, increase facility funding for charter schools. A legislative appropriation dedicated to charter school facility funding would be the most direct and measurable way to achieve this goal and an appropriation that has to be reauthorized every two years is easier to control and qualify based on changing circumstances.

**PROCEDURAL BACKGROUND**

The Senate Committee on Finance (the Committee) was charged with identifying and evaluating potential improvements to the property tax system. The Committee met in accordance with the following interim charge as follows:

*Identify and evaluate potential improvements to the property tax system. Consider and make recommendations relating to the following:*

- **Methods to increase public participation in the tax rate-setting process and ensure fairness in appraisal protests and appeals:**
- **Requirement that property appraisal values may not increase by more than inflation and/or population growth, or another amount to be determined by local taxing authorities, with a maximum cap of 10 percent:**
- **Exemptions provided to community housing development organizations to determine if changes are needed to ensure that the public benefits outweigh the revenue loss:**
- **Methods and procedures for determining a real property interest in oil or gas in place, as contained in Texas Tax Code Section 23.175, including how market-based data and market-based methodology could possibly be used to ensure fair, reliable, and equitable price forecasts of oil and gas**
interests. Analyze the need for the creation of an Oil and Gas Valuation Advisory Committee to assist in forecasting current calendar year statewide average prices for oil and gas; and

- The constitutional constraints and fiscal implications of exempting real property, leased to a school, as defined by Section 11.21 of the Tax Code, from ad valorem taxation

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin on April 14, 2010 and May 12, 2010 to consider invited testimony provided by the Texas Comptroller’s Office, Texas Association of Appraisal Districts, Texas Association of Counties, County Judges and Commissioner’s Association of Texas, registered professional appraisers, Texas Alliance of Energy Producers, Texas Oil and Gas Association, the Texas Charter School Association, and other industry professionals. The Committee solicited public testimony on the interim charge in a public hearing in Austin on the same dates.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

ISSUES AND RECOMMENDATIONS

The Committee identified five distinct issue areas, each with its own background and recommendations, discussed below:

Issue 1: Increasing Public Participation in the tax rate setting process and ensuring fairness in appraisal protests and appeals

Property taxes are local taxes, providing the main source of funding for local governments to use to pay for schools, streets, police and fire protection and other important services, paid by every Texas residential and business property owner unless otherwise exempt. Provisions regarding the "tax rate-setting process" are set out in Article VIII, Section 21 of the Texas Constitution:
• Notice must be given of the reasonable estimate of the taxes that will be imposed on a taxpayer’s property [Texas Constitution, Article VIII, Section 21(c)]

• Notice must be given of intent to consider tax increases. [Texas Constitution, Article VIII, Section 21(a)]

The statutory requirements for the tax rate setting process are commonly known as "Truth in Taxation" procedures and are found in Chapter 26, Tax Code. Increasing public participation in the tax rate-setting process and ensuring fairness in the appraisal system are enduring goals of the state, and the Comptroller's Property Tax Assistance Division assists taxpayers by publishing "truth in taxation" manuals annually and offering training for local taxing units concerning tax rate calculations and public notices.

Once a chief appraiser certifies to the tax assessor an estimate of the taxable value within the taxing unit, the taxing unit decides how much money the taxing unit will need to spend during the upcoming year. The unit then makes a calculation based on the taxable value to decide what the tax rate will need to be to produce the amount of revenue needed to finance the budget. A public hearing must be held on the proposed budget, and if the taxing authority requires tax revenue greater than the previous year, it must include the amount of the proposed increase in the notice of the budget hearing. While the actual tax rate depends on the budget adopted by the governing body, the effective tax rate is the rate the local government needs to generate about the same amount of revenue it received in the year before, on properties taxed in both years.

For cities, counties, and special districts, the rollback tax rate will raise about the same amount of tax revenue the local government spent in the previous year for day-to-day operations, plus an extra 8 percent increase for operating expenses and sufficient revenue to pay its debts in the coming year. If a local government wants to increase its property tax rate above the lower of
either the rollback rate or the effective rate, it is subject to special notification procedures such as newspaper publications and public hearings. Currently, the 8% rollback rate is a type of a revenue cap for taxing districts other than schools. If a local taxing unit adopts a tax rate higher than the rollback rate, a taxpayer can petition for an election to reduce the tax rate to the rollback rate. A successful election limits the unit's tax rate to the rollback rate.

For school districts, the rollback rate authorizes school districts to add four cents ($0.04) to the lesser of the compressed operating tax rate or the effective maintenance and operations (M&O) rate for their highest M&O rate. School districts then add their 2010 debt service rate for the final 2010 rollback tax rate. Section 26.08(a) of the Tax Code provides that if a school district adopts a tax rate that is higher than the rollback rate, school board trustees must hold an election to ask voters to approve the rate, unless the tax rate is intended to pay for responses to a natural disaster.

“Truth in Taxation” laws give taxpayers a voice in deciding their property tax rates, and the effects of legislative changes made during the 81st Regular Legislative Session are still being evaluated to determine whether the changes have had an effect on fairness and participation. The Comptroller's office provided testimony at the hearing to steps the Legislature took during the 81st Session to improve fairness in appraisal protest and appeals and improve public participation:

**Constitutional Amendments - 81st Legislature (Approved by voters in November 2009)**

- **Proposition 5: House Joint Resolution 36.** Authorized the creation of consolidated appraisal review boards [Article VIII, Section 18(c)]. Enabling legislation - House Bill 3611

- **Proposition 3: House Joint Resolution 36.** Authorized the Legislature to prescribe by general law:” administrative and judicial enforcement of uniform standards and procedures for appraisal of property for ad valorem tax purposes"[Article VIII, Section 23(b)] No enabling legislation.

IX - 5
• Proposition 2: House Joint Resolution 36. Authorized the Legislature to provide for the taxation of residence homestead property solely on the value as a residence homestead regardless if the use of the property is its highest and best use. Enabling legislation House Bill 3613

Statutory Changes - 81st Legislature

• House Bill 8: Required that the Comptroller conduct a biennial audit of all 256 county appraisal districts, and changed the school district property value study to a biennial schedule.

• House Bill 1038: Appraisal districts must consider foreclosed properties or properties that have declined in value because of the economy, in any of the three years preceding the tax year, in appraising residence homesteads.

• House Bill 2317: Continuing education course offered by the Comptroller's office for Appraisal Review Board members.

• House Bill 3611: Authorizes county appraisal districts the option to consolidate their appraisal review boards with other districts.

• House Bill 3612: Pilot program at State Office of Administrative Hearings as an alternative to judicial review.

• House Bill 3613: Market value of a residence homestead is not determined by the property's highest and best use.

• Senate Bill 771: Expands binding arbitration and prohibits an appraisal district from increasing the value of a property in specific instances without substantial evidence.

The Methods Assistance Program (MAP) is the Property Tax Assistance Division's new initiative in response to House Bill 8, 81st Regular Legislative Session, requiring the Comptroller to conduct an extensive review of all appraisal district every two years ensuring standardized appraisal and operating procedures in appraisal districts throughout the state so that all taxpayers have the advantage of consistent and fair appraisal systems. Preliminary results for the first group of appraisal districts to undergo review have been released and any appraisal
districts with noted deficiencies are now working with the Comptroller's office to standardize and improve operations.

To promote transparency and simplify the local government tax rate setting process, the Legislature should consider streamlining the statutory provisions found in Chapter 26, Tax Code, simplifying the effective tax rate calculation, and providing new notices offering taxpayer assistance by the Property Tax Assistance Division of the Comptroller's office through a website and a toll-free number. In simplifying the effective tax rate calculation, it would be possible to eliminate all the adjustments and deductions that currently benefit taxing entities in the effective tax rate calculation, and focus instead on actual maintenance and operations levied in the prior year and taxable values in the current year. Current adjustments and deductions include: (1) reductions in levies created by the imposition of additional sales and uses taxes locally; (2) adjustments for deficiencies or excessive tax collections or refunds (3) deductions for late appraisal roll corrections and changes due to litigation (4) indigent health care and criminal justice expenditure adjustments, and (5) deductions for pollution control exemptions. Repealing many of the adjustments and deductions to values and levies that taxing districts are currently allowed would improve transparency and further reduce the complexity of the effective tax rate calculation for taxpayers. It could be possible to reduce the number of steps in the calculation from as many as 50 to 9, decreasing the complexity of the process; however, opposition from taxing entities may exist because of the repeal of these deductions.
Example of a Simplified Effective Tax Rate Worksheet

1. Last year's M & O tax levy $___________
2. Lost property levy $___________
   *Property not on current year's tax roll*
3. Adjusted M & O levy $___________
   *Line 2 - Line 1*
4. M & O levy on new property $___________
   *Last year's tax rate applied to all new property*
5. Current year's M & O tax levy $___________
   *Add lines 3 and 4*
6. Current year's total taxable value $___________
7. Effective M & O tax rate $___________/$100
   *Divide line 5 by line 6 and multiply by $100*
8. Debt service tax rate $___________/$100
9. Total effective tax rate $___________/$100
   *Add lines 7 and 8*

Officially instituting a 4% revenue cap and requiring voter approval for tax increases over that level in cities and counties would also improve taxpayer participation in the tax-rate setting process. Currently, if a county or city exceeds its 8% rollback rate, a de-facto type of revenue cap, a percentage of the registered voters must sign a petition requesting a rollback election. If the rollback election is successful, the city or county cannot raise the tax rate higher than the effective tax rate. Obviously, it would be much more difficult for cities and counties to raise taxes every year if their budgets were subject to an actual 4% revenue cap and voter approval was required to raise taxes over that level.
The Committee recommends that the Legislature:

1. Continue to monitor the effectiveness of past legislative mandates designed to increase public participation and fairness.

2. Consider a legislative proposal to promote transparency and simplify the local government tax rate setting process.

3. Consider requiring voter approval for city and county tax revenue increases of more than 4%.

**Issue 2: Property Appraisal Values**

It has been argued that because of increasing property values, today’s property owners continue to experience large property tax increases, and as economic growth continues, Texans may be priced out of their homes, businesses and communities due to rising taxes. Legislators have tried various solutions to try to satisfy a population upset over rising property taxes by utilizing and considering appraisal caps, revenue caps, more exemptions, higher exemptions, appraisal and oversight reforms. However, these options should be considered with the constraints of the many constitutional and statutory provisions governing the local property tax system. The Texas Constitution requires that taxation must be equal and uniform, and generally all property is taxable at its market value.

- All property must be taxed equally and uniformly. [Texas Constitution, Article VIII, Section 1-a]

- No single property or type of property should be taxed more than its fair market value. [Texas Constitution, Article VIII, Section 20.]

- The Texas Constitution provides certain exceptions, such as taxation based on productive capacity for agricultural and timber land. [Texas Constitution, Article VIII, Section 1-d-1]

- Exemptions must be authorized, either as constitutional requirements or exemptions permitted. [Texas Constitution, Article VIII, Section 1(b)]

Important constitutional exemptions that are currently authorized include:
The current 10% appraisal cap on residential property that was instituted in 1997. [Article VIII, Sec 1(i) of the Texas Constitution.]

Various other constitutional homestead exemptions include a $3,000 property tax exemption. [Article VIII, Sec 1-b(b) of the Texas Constitution.]

A $15,000 school district tax exemption of the appraised value of a residence homestead. [Article VIII, Sec 1-b(c) of the Texas Constitution.]

If disabled or age 65 and older there is an additional exemption from school district taxation of $10,000 of the appraised value of a residential homestead as well as a prohibition on increase in taxes imposed on the homestead for general elementary and secondary public school purposes while the property remains the residence homestead of the person or the person's spouse [Article VIII, Sec 1-b(d) of the Texas Constitution.]

Also a taxing unit may offer an exemption of up to 20 percent of a residential home value, with a minimum exemption of $5000. [Article VIII, Sec 1-b(e) of the Texas Constitution.]

Introducing a constitutional amendment to lower the 10% current appraisal cap for homestead property to 5% would be popular with residential property homeowners, and the reduction would benefit homeowners that have increasing property values and are concerned with being forced out of their homesteads due to rapidly escalating property taxes. However, a reduction in the 10% appraisal cap to 5% would reduce ad valorem tax revenues available to all local taxing districts, and the state would have to increase education funding to the Foundation School Program to make up for reductions in local school taxes. With the current shortage of additional available state revenues, to fund additional school ad valorem tax reductions during these challenging economic times, any constitutional amendment to lower the 10% current appraisal cap for homestead property would need to simultaneously reduce a current ad valorem exemption, such as reduction of the $15,000 school property tax exemption for all residence homesteads. The Comptroller’s "Tax Exemptions & Tax Incidence" report from February 2009, listed the final incidence of the general homestead exemption of $15,000 at over $1 billion dollars.
The Committee recommends that the Legislature:

4. Consider proposing a constitutional amendment to reduce the current $15,000 homestead exemption for school property taxes in an amount necessary to offset the cost of lowering the current 10% appraisal cap for residence homesteads to 5%.

**Issue 3: Community Housing Development Organization Exemptions**

Community Housing Development Organizations (CHDOs) are non-profit organizations that partner with other entities, including for-profit developers in the development of single family or multifamily affordable housing.

In 1997, the Legislature enacted a property tax exemption for housing properties owned by CHDOs in Section 11.182 of the Tax Code. In 2001, the Legislature amended the Tax Code to allow a CHDO to partner with a for-profit entity to build low income housing and allowed the for-profit entity to benefit financially from a property tax exemption. At that time, the Legislature did not delete the requirement that the CHDO must own the property, but the statute did not explicitly say that the partnership was entitled to the exemption in its own right. A separate section, Section 11.1825, Tax Code, further limiting the availability of the 2001 exemption, was passed in 2003 and applies to properties developed after January 1, 2004.

Since passage of the 2001 legislation, the legal interpretations regarding the exemption have been questioned, especially for properties developed before January 1, 2004, and due to recent appellate and Supreme Court decisions regarding both statutory and constitutional interpretation, partnership eligibility for the CHDO exemption is now determined differently across Texas' 254 counties.

In the case of CHDO multi-family affordable housing, there is active litigation over the denial of ad valorem tax exemptions for specific properties, creating a difficult financial situation for developers and costly litigation for appraisal districts. The litigation is based on the 2001
amendments that provided a property tax exemption for properties that were created by partnerships between developers and CHDOs to provide low income housing. Generally, the litigation centers on the statutorily required role of the CHDO in the partnership, and the fact that the Texas Constitution requires that a primarily charitable organization such as the CHDO both "own" and "use" the property. The statute does require that the CHDO be a general partner, but partnership law allows a general partner to have an insignificant ownership in the limited partnership, often with ownership at 0.1% of the partnership property, and many of the developer/CHDO limited partnerships were set up in this manner, and this ownership arrangement found in Section 11.182(e) of the Texas Tax Code is at the heart of the controversy.

Appraisal districts testified that they must deny property tax exemptions that do not meet constitutional or statutory requirements. Currently, several districts are now required to deny certain low income housing property tax exemptions due to recent court interpretations of CHDO ownership requirements found in Tax Code, Section 11.182(e), and Article VIII, Section 2(a) of the Texas Constitution. Currently, the availability of the CHDO ad valorem tax exemption may depend upon which Court of Appeals district in which a property is located. Two appellate decisions, Primrose¹ and Jim Wells,² call into question the legality of the property tax exemption partnership envisioned by the Legislature in Section 11.182(e), Texas Tax Code.

In both cases, the Texas Supreme Court denied the petition for review, and as a result, both appellate cases are now legal precedent in their district. In Primrose, a limited partnership sought an exemption for an apartment complex it owned in which the general partner in the limited partnership was a CHDO that owned only 0.01% of the limited partnership, but the court

held that unless the CHDO controlled a sufficient interest in the entire entity so as to be able to cause it to compel title to the property to itself, it could not be deemed to be the equitable owner of the property. A simple fix would seem to be simply to change the wording of Section 11.182(e) of the Tax Code, to specify that the general partner does not have to be a controlling equitable owner, but the Jim Wells decision has called into question the constitutionality of both Section 11.182 and Section 11.1825 of the Texas Tax Code. In Jim Wells, the District Court of Appeals disagreed that that Section 11.182(e) eliminated the requirement of ownership of an apartment complex by an exempt CHDO and allowed exemptions to be granted to “for profit” limited partnerships with CHDO general partners. The court found that the Legislature did not intend to expand the exemption eligibility requirements to “for profit” limited partnerships but only to impose additional restrictions on the exemption qualifications, and as such, CHDO exemptions are limited to non-profit CHDO entities which "own" apartment complexes. The court further held that this construction is required by Article VIII, Section 2 of the Texas Constitution which limits such exemptions to “institutions engaged primarily in public charitable functions” and Section 2(a) of the Texas Constitution allows property tax exemptions to only be given to charitable organizations that both "own" and "use" the property for charitable purposes.

Appraisal districts located in the court of appeals districts where Jim Wells and Primrose were decided are now bound to follow the respective appellate decisions. As a result, developers and charitable organizations involved in certain CHDO partnerships are concerned that many low-income housing partnerships, set up based on the tax exemption, will go into default if they no longer are entitled to receive an exemption. At this time, no properties have actually gone into bankruptcy because of the loss of an exemption, but there is a perceived threat that this will likely occur.
This spring, the Texas Comptroller’s Office took a survey of the 35 largest county appraisal districts in Texas for the tax years 2005-2009 and prepared the following chart for our April 14, 2010 hearing. For each of those years, over $2 billion in CHDO property was exempted from ad valorem taxation by those 35 districts. At a tax rate of $1 per $100 valuation in local school taxes lost, it could be estimated that this tax exemption costs the state approximately $20 million a year in revenues that the state sends to local school districts as a replacement for lost tax revenue. Over the past five years, Bexar and the Harris County appraisal districts have had the largest amount of CHDO property exempted in their districts; over $400 million of CHDO properties in each county are exempted from ad valorem taxation each year. As it is difficult for the state to verify that the public benefits outweigh the corresponding ad valorem tax revenue loss, the Legislature could consider requiring that tax incentives only be given to community housing development organizations that are proven to offer affordable rents, significantly below market rates.
## Comptroller Survey of Community Housing Development Organizations (CHDOs) 2005-2009

*Note: Zeros entered in the table below indicate that the district reported having no CHDOs.*

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<th>CAD Name</th>
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<th>2006 Total Value of Exemptions</th>
<th>2007 Total Value of Exemptions</th>
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*Source: Texas Comptroller's Office, April 14, 2010*
During the committee hearing, for-profit developers and community housing development organizations offered testimony about the importance of the continuance of the 2001 CHDO/for-profit developer partnership exemption and their belief that any litigation issues could be solved if the Legislature would clarify in Tax Code, Section 11.182(e) that it intends to exempt partnerships between a for-profit developer and its CHDO general partner, even though the CHDO does not actually own the property. However, due to recent litigation and the fact that both the Comptroller's office and appraisal districts have testified to the possibility of an inherent conflict between the Constitution and the Texas Tax Code, the Committee recognizes that if the Legislature simply clarifies Tax Code, Section 11.182(e), that action may not only be found unconstitutional, but also could be costly to local taxing districts that currently deny similar exemption requests. As an alternative, with evidence that CHDO partnerships consisting of property ownership by for-profit developers can provide significant assistance to low income renters, the Legislature could consider amending the Constitution to provide for reductions in the appraised value of CHDO properties in balance with the assistance offered. The Legislature could propose a constitutional amendment that would allow for a limited use appraisal for CHDO partnership properties in balance with a reduction in rental rates for low income renters. A limited use appraisal for CHDO properties could be similar to the reduced appraisals allowed for agricultural properties, and require strict controls on what type of rents are charged, with a focus on providing very affordable rents in exchange for an appraisal limitation to ensure that there is a measurable benefit to the property tax reduction offered to the low income housing developer in partnership with a CHDO. According to testimony provided in the hearing, benefit directed to properties that serve the more difficult to serve populations with rental rates
substantially below market, targeting at least 50 to 60% of average family median income is the most needed.

The Committee recommends that the Legislature:

5. Consider clarifying that community housing development organizations partnering with for-profit developers to develop multi-family properties must actually own the property be eligible for an ad valorem tax exemption, due to concerns raised by recent legal challenges.

6. Alternatively, propose an amendment to the Texas Constitution that would allow for-profit entities in partnership with community housing development organizations to develop a multi-family property and receive an ad valorem tax limitation, even though the CHDO is not the actual owner of the property, in exchange for offering extremely affordable rents for difficult-to-serve populations.

**Issue 4: Real Property Interests in Oil and Gas**

Beginning in 1993, Section 23.175 of the Tax Code required the valuation of oil and gas properties to take into account the average price of oil and gas for the prior calendar year. This method of appraising a real property interest in oil and gas, using a "look-back" methodology often caused appraisal values to lag behind in the case of a rising market, or in the case of a declining market, the valuations were artificially inflated. Then in 2007, Section 23.175, Tax Code was amended by House Bill 2982 (80R) to add a "forward looking" component, based on state severance tax revenue estimating methodology to the valuation formula used to appraise oil and gas properties. The legislation was intended to ensure more accurate and uniform appraisals throughout the state and smooth out the peaks and valleys of crude oil and natural gas prices in their effect on mineral valuations and ad valorem taxes. The fiscal note that accompanied House Bill 2982 (80R) projected there to be "no significant revenue implication" for switching to the revenue estimating methodology; however, the Texas Association of Counties and the County Judges' and Commissioners Association of Texas have expressed concern to the committee about the accuracy and effectiveness of the 2007 changes to the statute, requiring incorporation of
"revenue estimating" methodology. According to the associations, dramatically lowered valuations and the resulting revenue losses in local taxing districts, from the changed methodology in combination with a recently volatile oil and gas market, prompted their request that the Legislature investigate this subject.

The Comptroller’s Revenue Estimating Division releases a Crude Oil and Natural Gas Price Forecast each year to estimate the amount of oil and gas severance taxes that the state will receive in each upcoming fiscal biennium for budgetary planning purposes. Although the forecast is primarily used by the Comptroller to estimate projected state revenue from oil and gas production, it now is used to provide limitations on price increases in crude oil and natural gas property appraisals administered by local appraisal districts for property tax purposes. Currently, as illustrated by the statutory reference below, the calculation of mineral appraisals for ad valorem purposes now includes a comptroller’s market condition factor that is derived by dividing the Comptroller’s current calendar year statewide average price for oil or gas, as applicable, forecasted for revenue estimating purposes, by the preceding calendar year actual statewide average price for oil or gas.

Tax Code, Sec. 23.175. OIL OR GAS INTEREST. (a) If a real property interest in oil or gas in place is appraised by a method that takes into account the future income from the sale of oil or gas to be produced from the interest, the method must use the average price of the oil or gas from the interest for the preceding calendar year multiplied by a market condition factor as the price at which the oil or gas produced from the interest is projected to be sold in the current year of the appraisal. ....The comptroller shall calculate the market condition factor by dividing the comptroller's current calendar year statewide average price for oil or gas, as applicable, forecasted for revenue estimating purposes by the preceding calendar year actual statewide average price for oil or gas, as applicable....

The chief revenue estimator from the Texas Comptroller's office testified that the current methodology has been in place for three years, and the Comptroller's revenue estimating staff...
draws information from the U.S. Department of Energy and large economic forecasting entities such as Global Insights and Moody's, as well as "the strip" (NYMEX) to develop its revenue estimates.

During the hearing, the Texas Association of Counties expressed concern that the 2007 change to the statute has significantly impacted the tax base negatively in over 100 counties. The County Judges and Commissioners Association of Texas is concerned that counties often have to make up money that they lose on lowered valuations for oil and gas properties by shifting the burden to other taxpayers to meet revenue needs. They also explained that the state of Texas has in the past several years, since the methodology change, had to make up for lost school property tax revenues by putting more funding into school finance formulas and estimated that over $75 billion in taxable oil and gas revenues have been taken off the rolls over the past two years, creating about $660 million in lost school tax revenues that have to be made up by the state.

Certified appraisers also testified that the current use of revenue estimating methodology is not fair, equitable, or reliable, as in their opinions the Comptroller price forecasts are too conservative and may lead to appraised values which are under market value. Suggestions were made that the goal of the forecast should be to mimic the expectations of buyer and sellers in the marketplace as of the appraisal date; therefore, the words "revenue estimating methodology" should be removed from the statute.

The chart below was created, using estimates produced by the Comptroller's office for the hearing, to illustrate the impact of using both the current system and the old system of estimating oil prices for purposes of mineral property appraisal, in light of the recent price volatility in the market. Before the large spike in oil prices during calendar year 2008, both the old system and the current system of appraisal methodology seemed to be approximating the actual price, if on
the low side. Both estimates for calendar year 2008 are extremely low using either the current or old methodology, and in calendar year 2009, neither the current system or the old system closely approximated the actual price of oil, with the current system providing a low estimate and the old system providing an estimate that much higher than the actual price. However since 2003, it does appear that using the current system of methodology to estimate oil prices for purposes of mineral property appraisal would produce values consistently lower than the actual price.

![Estimation of Oil Prices for Purposes of Mineral Property Appraisal](image)

Oil and gas producers such as Texas Alliance of Energy Producers, the Texas Independent Producers and Royalty Owners (TIPRO), and the Texas Oil and Gas Association testified that they do not want to make any changes to the current system of estimating oil and natural gas prices for the purposes of mineral property appraisal. Producers agree that there has been more fluctuation in the valuation because the market has been extremely volatile and there is no longer a one-year lag. They also pointed out that the old methodology incorporated a one-year look-back, and was not based on actual market value. The industry groups recommend
waiting and looking at valuation results from 2010 and 2011 before making any more changes to the tax code.

The Committee was also asked in the interim charge to analyze the need for the creation of an Oil and Gas Valuation Advisory Committee to assist in forecasting current calendar year statewide average prices for oil and gas. On this subject, the oil producers testified that they are fearful that a formal advisory committee might create antitrust issues and price fixing allegations. In general, the oil and gas industry testified that they are satisfied that the Comptroller's staff does a good job making a forecast and they doubt that a formal advisory committee made up of stakeholders with necessary biases could do a better job. TIPRO also testified that the Legislature should be wary of quick fixes and should not use the NYMEX, to the exclusion of other factors, to estimate price.

The following chart, however, looks back over the last three years and charts the accuracy of crude oil prices published by the Comptroller's office using current "forecast" methodology compared to previous "look-back" methodology, actual average price and NYMEX future values. Looking at the data, it appears that the NYMEX futures price was closer to the "actual average price" than either the current "forecast price" or the price based on the "previous methodology" of the look-back approach. According to the data, the previous methodology for forecasting the future price crude oil, does not accurately approximate "actual average price," and the current Comptroller forecast based on "revenue estimating" methodology being consistently below actual market value for past three years.
According the next chart, presented by the Texas Comptroller's Office, both natural gas price forecasts by the Comptroller's office based on "revenue estimating" methodology for the past three years also do not appear to be extremely accurate, as compared to actual prices. However, the chart also shows that neither the current system nor the old system have produced or would have produced forecast that are extremely accurate compared to actual taxable prices.
## Comptroller Oil and Gas Chart - April 14, 2010 - Senate Finance Hearing

**Tax Code 23.175 -- Estimation of Oil and Natural Gas Prices for Purposes of Mineral Property Appraisal**

### Natural Gas

<table>
<thead>
<tr>
<th>Actual Prices (TAXABLE)</th>
<th>Calendar Year</th>
<th>Current System (TAXABLE)</th>
<th>VS. Actual Taxable Price</th>
<th>Old System (TAXABLE)</th>
<th>VS. Actual Taxable Price</th>
<th>Taxable Prices: Old System vs. New System</th>
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### Oil

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<th>Old System (TAXABLE)</th>
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</tbody>
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### NOTES:

1. With respect to prices, the term "taxable" refers to that portion which is subject to either the crude oil or natural gas production tax.
2. A calendar year covers the same time period as a tax year (for property tax purposes).
3. The Current System (that is, how Tax Code 23.175 currently operates) was instituted beginning with calendar/tax year 2008.
4. This analysis also shows what prices would have been if this method had been used in the years 2000 through 2007.
5. Similarly, the Old System refers to how Tax Code 23.175 operated prior to the legislative change (that is, calendar/tax year 2007 and before).
6. This analysis also shows what prices would have been if this method had been used in the years 2008 and after.
7. Prices used for the appraisal of mineral properties, such as those above, are only one factor customarily used in the appraisal of mineral properties. Other factors (not projected by the Comptroller's Office) can include production and cost of operating a property.

The ultimate goal should be to estimate the appraised value of oil and gas properties as close as possible to market value, per constitutional requirements. If the current "market condition factor" based on "revenue estimating methodology," used in the current valuation oil and gas appraisal formulas, continues to seriously underestimate or overestimate appraisals, it would be advised to allow the Comptroller's office to instead use a methodology that more closely approximating market value. While one option could be to incorporate a component such as the NYMEX futures contracts price for oil and gas, a better option is to change the parameters.

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of current law by removing the reference to "revenue estimating methodology;" thereby allowing
the Comptroller's office more latitude to choose the methodology to devise a market condition
factor that will bring values closer to market value.

The Committee recommends that the Legislature:

7. Continue to have the Comptroller's office prepare the market condition factors using the
forecasted price for crude oil and natural gas but eliminate the requirement that the
forecasts be based on revenue estimating methodology to enable the Comptroller's office
to better focus on incorporating market value methodology to their estimates.

**Issue 5: Ad Valorem Taxation of Real Property Leased to a School**

Currently, Article VIII, Section 2(a) of the Texas Constitution authorizes the Legislature,
by general law, to exempt from taxation .... "all buildings used exclusively and owned by
persons or associations of persons for school purposes..." meaning that the Texas Constitution
exempts all school property, public and private, both owned and used by a school from paying ad
valorem taxes.

_Texas Constitution, Article 8, Section 2 (a) OCCUPATION TAXES; EQUALITY
AND UNIFORMITY; EXEMPTIONS FROM TAXATION. (a) All occupation
taxes shall be equal and uniform upon the same class of subjects within the limits
of the authority levying the tax; but the legislature may, by general laws, exempt
from taxation public property used for public purposes; ....all buildings used
exclusively and owned by persons or associations of persons for school purposes
and the necessary furniture of all schools and property used exclusively and
reasonably necessary in conducting any association engaged in promoting the
religious, educational and physical development of boys, girls, young men or
young women operating under a State or National organization of like character;
.... and institutions engaged primarily in public charitable functions, which may
conduct auxiliary activities to support those charitable functions; and all laws
exempting property from taxation other than the property mentioned in this
Section shall be null and void.

However, if real property is leased to a private school, the owner is not eligible for a
property tax exemption on the school property. Often, the private school has to pay more in rent
payments because the land owner will add the cost of the property taxes into, or on top of the
As drafted, this interim charge focuses on the feasibility of exempting from property taxation, property under Tax Code, Section 11.21, owned by a private individual leased to a private school. There was, however, no interest in the actual focus of the charge before, during, or after the hearing, but there was significant interest from the committee members and the Texas Association of Charter Schools in exempting real property leased to charter schools from ad valorem taxation.

This charge explores the possibility of granting an ad valorem tax exemption for private property leased to a private school under Tax Code, Section 11.21. A private school would include schools as diverse as a Montessori school, and a private institution of higher education such as Rice, Howard Payne, or Abilene Christian. The director of the Comptroller's Property Tax Assistance Division testified that a constitutional amendment would be required to allow an ad valorem exemption for private owners of real property leased to a private school under Texas Tax Code Section 11.21. The director also explained that her office sent out a survey to the 50 largest appraisal districts to determine the financial impact of providing such an exemption, but reported that the appraisal districts were unable to provide any data to the Comptroller's office. No information was available because appraisal district records only list real property under the name of the owner/lessor and not the name of the private school/lessee.

No one publicly or privately expressed any support for a property tax exemption for private property leased to a private school, and there were no witnesses that appeared at the hearing in support of the idea. However, there was support at the hearing from several senators and the Texas Association of Charter Schools to provide for a property tax exemption for privately owned property leased to a charter school. Charter schools do receive state funds, and are a type of "public school," but they are ultimately controlled by private parties and are not
subject to many requirements that regular public schools must follow. Currently, any land/property owned by a private individual and leased to a charter school is subject to ad valorem taxation. Several senators were concerned that as charter schools are "public schools," any land that they lease from a private individual for school facilities, should receive a property tax exemption.

The Executive Director of the Texas Charter School Association testified that there is currently no state aid for charter school facilities; and as charter schools do not have local taxing authority, the cost for their facilities has to come out of the school's maintenance and operations funds. He proposed that the Legislature should provide a property tax exemption for landlords who lease space to charter schools. He argued that savings from property tax exemptions, could go towards funding more teachers, increased salaries, and better technology. He estimated that approximately 60 to 65% of campuses are leased, and that approximately 2.5 million in property taxes were paid by charter schools in 2007. It was his opinion that a property tax exemption for private property leased to a charter school could require voters to approve changes to the Texas Constitution. Also, according to the director of the Comptroller's Property Tax Assistance Division, if the state wants to allow leased charter school property to be tax exempt to a private owner, it would be best to get a legal opinion regarding whether a Constitutional amendment would be required.

It would uncomplicated to just statutorily designate that school property taxes paid by the owner of real property leased to a charter school, should be transferred by the school district to public open enrollment charter schools within the district to use for facility funding; However, a statutory designation would likely violate the requirement in Article VII, Section 3(e) of the Texas Constitution that the school taxes benefit only the district in which they are collected, as
charter schools are open enrollment schools. In sum, if the Legislature wants to allow the for-profit owner of property leased to a charter school to qualify for a property tax exemption, the most certain method to provide for the exemption would be to propose an amendment to the Texas Constitution. It also would be important to specify in the Constitution that the tax savings received by the private property owner be passed on in the form of rent savings to the charter school that is leasing the property.

Alternatively, the least complicated and most efficacious approach would be for the Legislature to appropriate funding for that purposeful enrichment of charter school facilities. An appropriation has the advantage that it must be revisited every biennium, while a new property tax exemption would reduce the already shrinking local ad valorem tax base, and exemptions seem to become invisible, costly, and enduring.

The Committee recommends that the Legislature:

8. Propose a constitutional amendment that would provide an ad valorem tax exemption specifically for private real property owners that lease their property to a charter school.

9. In the alternative, increase facility funding for charter schools. A legislative appropriation dedicated to charter school facility funding would be the most direct and measurable way to achieve this goal and an appropriation that has to be reauthorized every two years is easier to control and qualify based on changing circumstances.
Franchise Tax
EXECUTIVE SUMMARY

Although the Senate Committee on Finance (the Committee) was charged with reviewing the effect of business tax credits, the focus of the hearing primarily concerned the underperformance of the Franchise Tax.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action:

1. Recommend a budget rider or statutory change to direct the Comptroller's office or the Legislative Budget Board to research and review the effect that a business tax research and development credit would have on economic development in Texas.

2. Consider changes to current franchise tax law that would allow it to bring in revenues that matches more closely past revenue predictions and the anticipated costs of mandated property tax relief.

3. Consider proposing a constitutional amendment to clarify that a business entity doing business in Texas may be taxed for franchise tax purposes without regard to whether the business entity is organized as a corporation, limited liability company, limited liability partnership, limited partnership, professional association, or other organizational form in which the owners of the business entity receive liability protection by law.

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with reviewing the effect that business tax credits have on economic development in Texas. The Committee met in accordance with the following interim charge as follows:

Review the effect that Texas Business Tax credits, such as a research and development credit, have on economic development in Texas. Determine whether the costs of various tax credits would be adequately offset by the net increase in state sales tax and other revenues and jobs produced by each credit. Focus on businesses relocating to or from the State of Texas, the impact on the tax base, employment, and the overall economic condition of the state.
The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin on Wednesday, July 7, 2010 to consider invited testimony provided by the Texas Comptroller's Office. The Committee solicited public testimony on the interim charge in a public hearing in Austin, Texas, on that same date.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.

BACKGROUND

Starting with tax year 2008, Texas replaced its franchise tax based on the greater of net taxable capital or net taxable earned surplus, with a revised franchise tax based on a taxable entity's "margin." The transformation of the franchise tax began during the 3rd Called Session in 2006, when the Legislature revised the franchise tax by changing the tax base, lowering the rate, and extending participation to active businesses receiving state law liability protection. The changes to the franchise tax were intended to achieve two important goals. One goal was to close any tax planning loopholes and level the playing field for liability-protected active businesses. The second goal was to raise additional franchise tax revenues to fund legislatively mandated reductions in local property tax rates for both homeowners and businesses. The Property Tax Relief Fund (the Fund) was also created by the Legislature in 2006, and all increases in franchise tax revenues attributable to franchise tax changes were statutorily dedicated to the Fund to be used to pay for the state's increased responsibility for property tax relief in light of the approximately one third reduction in school maintenance property tax rates. The revision of the franchise tax resulted in many of the business tax credits that existed under the old franchise tax being eliminated, including a tax credit for business research and development.
ISSUES AND RECOMMENDATIONS

The original goal of this interim charge was to investigate the feasibility of reinstituting a research and development tax credit for the revised franchise tax. While it could be expected that availability of a franchise tax research and development tax credit would increase the levels of research and development done by Texas businesses, the committee did not discover definitive data regarding the costs and benefits of the credit. Due to the lack of a reliable cost/benefit analysis, and the fact that current revised franchise tax revenues are underperforming, conversations about reinstituting a research and development tax credit should be continued at a later time when more definitive financial data and sufficient tax revenues exist.

Additionally, before the Legislature considers reinstating a research and development franchise tax credit, there are several inherent concerns about the current revised franchise tax that need to be addressed. One concern is the underperformance of the tax. The tax was intended to raise additional tax revenues for the Property Tax Relief Fund to finance state’s obligations for school funding in light of the approximately one-third reduction in local school maintenance property tax rates that also occurred in 2006. The following chart shows the projected Property Tax Relief Fund revenues from the fiscal note for House Bill 3, 79th Legislature, 3rd Called Session (the legislation that revised the franchise tax). The projected additional revenue that the revised franchise tax would bring in, dedicated to funding local property tax rate reductions and sent to the Property Tax Relief Fund, is significantly higher than actual collections and current revenue estimates, with a shortfall of approximately $2 billion a year. Over the past four tax years, the differences between the original estimate and actual revenues are over $8 billion.
Franchise Tax Revenue to Property Tax Relief Fund ($Billions)
Projected at Passage of HB 3, 79th 3rd Called vs. Actual FY 2007-10 & BRE Estimated FY11

During the July 7, 2010 Senate Finance Committee hearing, the Texas Comptroller’s office provided testimony regarding significant issues surrounding the underperformance of the current franchise tax revenues, highlighting the fact that business owners are taking a much larger "Cost of Goods Sold" (COGS) deduction when calculating their taxable margins than the Comptroller’s office initially estimated. In a subsequent report, entitled, "The Business Tax Advisory Committee: Report to the 82nd Legislature," the Comptroller’s office reported that both the number of taxpayers that deducted COGS and the amount deducted by individual taxpayers taking COGS was higher than estimated, and explained that research by the Comptroller’s Revenue Estimating Division suggests that "the size of COGS was the most important revenue factor from the revised franchise tax underperforming the estimate."\(^1\) As the revised franchise tax COGS deduction is not based on the established federal income tax system, but is instead based on detailed and often industry specific statutory definitions, interpretations of the statutory provisions defining what costs qualify for "Cost of Goods Sold" deduction have

been interpreted in a manner that was unexpected by the Texas Comptroller's revenue estimating division. As a result of the detailed nature of the COGS definitions, some businesses may be interpreting the statute incorrectly, but as the revised tax is still relatively new, the Comptroller's office estimates that it will take several audit cycles to accurately examine the various interpretations of statute.

Additional concerns about the tax include whether it is too complicated, whether it is fair to tax a business on its "margin" instead of its net income, or whether certain provisions of the tax are constitutional. One option to reduce the complexity of the "taxable margin" calculation for Texas franchise taxpayers could be to require all businesses to calculate their franchise tax liability utilizing a method similar to the current EZ calculation found in Chapter 171.1016, Texas Tax Code. A revised EZ tax calculation, disallowing any "COGS" or compensation deductions, applied to all taxable business, could utilize a significantly lower EZ tax rate than the current rate of 0.575%. An EZ calculation also has the advantage of being more predictable for the state and less costly for taxpayers to utilize. Additionally, franchise taxpayers have complained that the revised franchise tax is unfair because a business can lose money and still have a tax liability.

Article VIII, Section 24 of the Texas Constitution prohibits the imposition of a tax on the net incomes of natural persons without a referendum. The Legislature understood this provision does not apply to the revised franchise tax because 1) a business entity may have negative net income and still owe tax, and 2) the tax is imposed on business entities, not natural persons. Nevertheless, to eliminate any lingering controversy that the revised Texas Franchise Tax violates the Article VIII, Sec.24(a) of the Texas Constitution's prohibition against "taxing a person's share of partnership and unincorporated associations income," the Legislature should
consider proposing a constitutional amendment to clarify that a business entity doing business in Texas may be taxed for franchise tax purposes without regard to whether the business entity is organized as a corporation, limited liability company, limited liability partnership, limited partnership, professional association, or other organizational form in which the owners of the business entity receive liability protection by law.

The Committee recommends that Legislature:

1. Recommend a budget rider or statutory change to direct the Comptroller's office or the Legislative Budget Board to complete an official cost benefit analysis on the effect that a Texas business tax research and development credit would have on economic development.

2. Consider changes to current franchise tax law that would allow it to bring in revenues that match more closely past revenue predictions and the anticipated costs of mandated property tax relief.

3. Consider proposing a constitutional amendment to clarify that a business entity doing business in Texas may be taxed for franchise tax purposes without regard to whether the business entity is organized as a corporation, limited liability company, limited liability partnership, limited partnership, professional association, or other organizational form in which the owners of the business entity receive liability protection by law.
Chapter 313, Tax Code
EXECUTIVE SUMMARY

The Texas Economic Development Act, Chapter 313, Tax Code, was created by the Legislature in 2001 and was initially promoted as an economic development tool for encouraging capital intensive businesses to build new facilities and create additional high-paying jobs in Texas. Over the past decade, the Act has been amended to allow additional types of business that typically do not create many jobs to qualify for the tax incentives offered under the program and even to make certain job creation requirements optional. In response to legislative concerns about the cost effectiveness of the Act, the Legislative Budget Board recently completed an Efficiency and Effectiveness Review of the Texas Economic Development Act, entitled "Improve the Administration of the Texas Economic Development Act." The review notes that benefits provided through the program have resulted in $158 million in state costs through fiscal year 2009, and that benefits are projected to cost the state $191 billion through the life of current projects. The review also expresses concern that the state's role in approving projects has been largely administrative, that there has been a decrease in emphasis on job creation, and that little analysis is ever done on the economic impact of proposed and current projects. In light of this, the Senate Finance Committee (the Committee) recommends that the program's enabling statute be modified to improve the administration of the act, to ensure that approved projects produce a positive cost benefit to the state, to limit the state cost of the program, and to end the practice of school districts receiving "payments in lieu of taxes," or PILTs.

Summary of Recommendations for the 82nd Legislature

The Committee recommends that the 82nd Legislature consider taking the following action in regard to Chapter 313, Tax Code:

1. Incorporate Legislative Budget Board staff suggestions to improve administration of the Texas Economic Development Act by giving the Comptroller's office the statutory

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authority to enter into and negotiate Chapter 313 agreements with the approval of the participating school district.

2. As the Legislative Budget Board review noted that there are significant challenges measuring the net benefit to the state, it is recommended that the Comptroller's office be given statutory authority to complete a cost benefit analysis on the financial impact of Chapter 313 project agreements.

3. In order to limit the amount of school funding the state must subsidize each year, consider placing a statutory limit on the total value of Texas Economic Development Act agreements that can be approved each year.

4. To avoid the appearance of school districts being paid to approve tax incentives, consider changing the statute to prohibit school districts from receiving "Payments in Lieu of Taxes."

PROCEDURAL BACKGROUND

The Senate Committee on Finance (the Committee) was charged with monitoring the efficiency and effectiveness review of Chapter 313, Tax Code (the Texas Economic Development Act) conducted by the Legislative Budget Board and analyzing the benefits to the state. The Committee met in accordance with the following interim charge:

Monitor the Legislative Budget Board effectiveness and efficiency review of Chapter 313, Tax Code. Consider whether tax provisions provide a net benefit to the state.

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin on Wednesday, July 7, 2010 to consider invited testimony provided by the Texas Comptroller's Office and the Legislative Budget Board. The Committee solicited public testimony on the interim charge in a public hearing in Austin on the same date.

The Committee extends its thanks to those who participated in the hearing, and assisted with or made presentations before the Committee.
BACKGROUND

The Chapter 313 Tax Code program, also known as the Texas Economic Development Act, was created by House Bill 1200 in 2001, by the 77th Texas Legislature. The Texas Economic Development Act authorizes school districts to enter into agreements with businesses to provide for lower property taxes (with appraised value limitations and tax credits) in exchange for the business's promise to build or improve business property and create additional jobs in the school district. While local school districts are responsible for entering into the agreements, the resulting loss in school property tax revenue will little or no impact at the local school district level, because any loss is largely offset by the state through additional state aid or reduced recapture. Over the years since enactment, the Legislature has made changes to Chapter 313 to relax job creation requirements and to expand the program to additional types of businesses. Additionally, while the cost of the benefits provided through the program are significant, there are few, if any limitations on the amount of tax benefits that the State of Texas is obligated to cover for these agreements, and the state's role in negotiating and approving projects is largely administrative. Recently, in response to the Legislature's request, the Legislative Budget Board Staff released a Texas State Government Efficiency and Effectiveness Report, entitled "Improve the Administration of the Texas Economic Development Act," that addresses many of the concerns with the Chapter 313 program and makes recommendations for improvement.

ISSUES AND RECOMMENDATIONS

The Texas Legislature enacted the Texas Economic Development Act to encourage Texas businesses to expand and create new jobs and to attract new businesses and jobs to Texas.
While the Act can be viewed as an important economic tool for the State of Texas, there are concerns with the operation and parameters of the tax incentive.

Since the creation of the Act, the Legislature has amended the Act to make some job requirements optional and to expand the types of projects that are eligible to receive a value limitation to include renewable energy projects, such as "wind farms." While renewable energy projects may offer significant benefits to the state, the projects typically do not create as many jobs as traditional manufacturing projects. Over the life of the value limitation agreement, these projects result in a significant loss of tax revenue per job created. The chart on the following page offers a summary of the number total projects by type, estimated total tax benefit per project type, the amount of total jobs promised, and the estimated tax benefit over the life of the project agreement.

Under Chapter 313, a school district enters into an agreement directly with a business to offer a local property tax incentive. However, because the state's school funding system compensates districts for the resulting revenue loss, it is the state treasury that ultimately funds the tax incentive. A school district may even negotiate "payments in lieu of taxes," or "PILTs," from the business receiving the special tax treatment. PILTs are typically set up so that the business rebates to the school district a dollar amount equal to part of the tax savings the business receives.
Which Projects Created Under Chapter 313 Get the Biggest Tax Break Per Job?

<table>
<thead>
<tr>
<th>Projects with School Property Tax Breaks</th>
<th>Estimated Total Gross Tax Benefit for Life of Project Agreements</th>
<th>Total Projects</th>
<th>Jobs Promised</th>
<th>Estimated Gross Tax Benefit per Promised Job over Life of Project Agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Renewable Electric Generation (Wind)</td>
<td>$712,376,734</td>
<td>63</td>
<td>446</td>
<td>$1,596,613</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>$801,192,532</td>
<td>28</td>
<td>4821</td>
<td>$166,188</td>
</tr>
<tr>
<td>Research and Development</td>
<td>$22,088,315</td>
<td>4</td>
<td>431</td>
<td>$51,249</td>
</tr>
<tr>
<td>Nuclear Electric Power Generation</td>
<td>$352,788,750</td>
<td>2</td>
<td>500</td>
<td>$705,578</td>
</tr>
<tr>
<td>Renewable Electric Generation (Non-Wind)</td>
<td>$21,277,159</td>
<td>1</td>
<td>41</td>
<td>$518,955</td>
</tr>
</tbody>
</table>

Source: Texas Comptroller of Public Accounts

Concerns with the Texas Economic Development Act program include the fact that the state has no explicit authority to administer or be a party to negotiations for incentives that are ultimately paid by the state, and the fact that the state has little control over the aggregate amount of local property taxes it must reimburse to school districts for business tax value limitations. Also of concern, is the fact that a school district can directly profit from a Chapter 313 agreement through the payment of a HLT, which is a gain to the district outside of the school finance system.

In response to these concerns, the 82nd Texas Legislature should consider incorporating the Legislative Budget Board (LBB) staff suggestions from their report entitled *Improve the Administration of the Texas Economic Development Act* to increase the efficiency and
effectiveness of the Act. One of the recommendations in the recent LBB review is to "amend the Texas Tax code to realign the roles and responsibilities of the state and of school district in a way that ensures program effectiveness, preserves appropriate taxing autonomy and provides greater consideration for the fiscal impact to the state." As such, the Legislature could propose improving administration of the Texas Economic Development Act by giving the Comptroller's office the statutory authority to enter into and negotiate Chapter 313 agreements with the approval of the appropriate school district. By changing the negotiating parties for a value limitation agreement to the business and the Comptroller's Office, with school district approval required throughout the process, the burden is shifted so that the Comptroller's office can apply consistent standards and requirements for all agreements, and individual school districts will no longer be burdened with the complex paperwork and negotiations required to qualify, initiate and administer a Chapter 313 agreement.

Another concern is that over the years the Act has been in existence, the Act has been amended to include new types of business projects which may not be cost efficient. Most of new projects incentivized are related to renewable energy instead of the capital intensive manufacturing ventures that were the original focus of the Chapter 313 program. While capital intensive manufacturing ventures tend to create large numbers of good paying jobs with benefits, there are fewer jobs associated with renewable energy projects such as "wind farms." The Comptroller's office is required by current law to conduct an economic impact evaluation of each proposed project, but an analysis of the fiscal impact to the state is not explicitly required or completed. An additional Legislative Budget Board recommendation from its recent report is to amend the Tax Code to make it the Comptroller's "authority and responsibility to evaluate the economic impact of proposed projects at both the state and local level more explicit." As the
Legislative Budget Board review noted, there are significant challenges measuring the net benefit to the state. Therefore, this committee recommends that that the Comptroller's office be given statutory authority to complete a cost benefit analysis on the impact of Chapter 313 project agreements under the Act to ensure that the use of state tax dollars to subsidize local Chapter 313 agreements is in the best interest of both the local area and the state as a whole.

Another concern with the program from the state's perspective is that there are currently no fiscal limits on the amount of property tax breaks that can be authorized by school districts under the Act. After a value limitation agreement is approved, a school district receives state funds to replace any ad valorem tax revenue that the school district loses as a result of the business tax breaks, and the state's liability for this program is unlimited. It is significant that the LBB's report highlights the fact that "benefits provided through the program resulted in $158 million in state costs through fiscal year 2009, and will cost $1.91 billion through the life of current projects." In order to limit the amount of school funding the state must subsidize each year, the Committee recommends placing a statutory limit on the total value of Chapter 313 agreements that can be approved each year.

Finally, during the interim charge hearing, the Committee discussed the concept of payments in lieu of taxes (PILTs), supplemental payments to a school district made by a business in exchange for the school district's approval of a tax limitation agreement for that business. While supplemental payments are not illegal, House Bill 3676, passed in the 81st Regular session, prohibited new Chapter 313 agreements from providing for supplemental payments to a district in excess of $100 annually per student in average daily attendance. Unfortunately, the entire premise of a PILT elicits the idea of the school district getting a "kickback," as the district is getting a direct benefit from a business that it has agreed to set-up with a tax value limitation,
with little or no ultimate cost to the school district. Therefore, the committee recommends prohibiting the practice of PILTs in connection with the Texas Economic Development Act.

The Committee recommends that Legislature:

1. Incorporate Legislative Budget Board staff suggestions to improve administration of the Texas Economic Development Act by giving the Comptroller's office the statutory authority to enter into and negotiate Chapter 313 agreements with the approval of the appropriate school district.

2. As the Legislative Budget Board review noted that there are significant challenges measuring the net benefit to the state, it is recommended that the Comptroller's office be given statutory authority to complete a cost benefit analysis on the financial impact of Chapter 313 project agreements.

3. In order to limit the amount of school funding the state must subsidize each year, consider placing a statutory limit on the total value of Texas Economic Development Act agreements that can be approved each year.

4. To avoid the appearance of school districts being paid to approve tax incentives, consider changing the statute to prohibit school districts from receiving "Payments in Lieu of Taxes."