LEGISLATIVE BUDGET BOARD

Staff Performance Report

JANUARY 2005

SUBMITTED TO THE 79TH TEXAS LEGISLATURE

LEGISLATIVE BUDGET BOARD

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January 18, 2005

Honorable Governor of Texas
Honorable Members of the Seventy-ninth Legislature Assembled in Regular Session

Ladies and Gentlemen:

The Legislative Budget Board *Staff Performance Report to the 79th Legislature* is a report on the efficiency and operations of Texas state government. The report has been prepared in compliance with the provisions of Section 322 of the Texas Government Code.

The evaluation and audit processes established under the provisions of Section 322 are valuable tools to help the legislature identify and implement changes that improve state agency efficiency and performance. The results of these evaluations and reviews, coupled with ongoing assessments of agency progress towards the achievement of established performance targets contained in the General Appropriations Act, facilitate the accomplishment of state goals and objectives.

The *Staff Performance Report to the 79th Legislature* includes 67 separate analyses of state government efficiency and operations. These 67 analyses contain 120 recommendations that, if implemented, would produce an estimated $3.2 billion in savings, or revenue gains, to the General Revenue Fund during the 2006-07 biennium. Of this amount, approximately $1.3 billion of savings is incorporated in the introduced 2006-07 General Appropriations Bill. An additional $600 million in savings is achieved in the introduced 2006-07 General Appropriations Bill through other policy initiatives including holding funding for many services at 95 percent of the 2004-05 biennial spending level.

The savings recommendations that are not incorporated in the introduced 2006-07 General Appropriations Bill are offered as options for consideration by the legislature in conjunction with other policy deliberations. The recommendations related to benefits for state employees, for example, should be considered in light of available state revenue and goals for employee recruitment and retention. Savings will vary depending on how many recommendations are implemented, on budget decisions affecting the Employees Retirement System and the Teacher Retirement System, and the use of other budget savings strategies.

The analyses contained in the *Staff Performance Report to the 79th Legislature* are organized by functional area. Each analysis is designed to provide the reader with a clear understanding of the salient findings, concerns, and recommendations (if warranted) related to the issue or program that has been reviewed by Legislative Budget Board staff. When appropriate, the five-year fiscal impact of any recommendation(s) is discussed, and information is provided as to whether the recommendation(s) have been included in the introduced 2006-07 General Appropriations Bill.

The staff of the Legislative Budget Board appreciates the cooperation and assistance state agencies provided during the preparation of this report.

Respectfully submitted,

John O'Brien
Deputy Director

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ELIMINATE UNNECESSARY REPORTING REQUIREMENTS FOR STATE AGENCIES

By eliminating seldom used, duplicative, or unnecessary statutorily required reports, the state would reduce storage and labor costs. An effective process for eliminating unnecessary reports would require state agencies to affirm the continued usefulness of reports and would add automatic sunset language to statutes authorizing new reports. According to the Comptroller of Public Accounts, agencies and institutions of higher education are collectively required to produce 472 different reports each biennium, and the General Appropriations Act adds additional reporting requirements for agencies every two years. While requirements for reports specified in the General Appropriations Act must be renewed each biennium, most reports required by statute must be produced indefinitely. Furthermore, all reports generated by state agencies are subject to state retention and archival requirements. Eliminating redundant and unnecessary reports and the storage requirements resulting from their production would save valuable tax revenue for other purposes.

SIGNIFICANT CONCERNS

- State agencies are statutorily required to produce reports that have become unnecessary.
- There is currently no comprehensive process to identify and remove statutory requirements for reports that are duplicative or no longer useful.

RECOMMENDATIONS

- **Recommendation 1:** Amend the Texas Government Code to eliminate the Non-resident Bidder Report and the Training and Expense Report.
- **Recommendation 2:** Include a rider in the 2006–07 General Appropriations Bill that requires the Texas State Library and Archives Commission to produce the index of statutorily required reports, formerly produced by the Comptroller of Public Accounts, assessing each reports' usefulness.
- **Recommendation 3:** Consider adding an automatic expiration provision in any new statute requiring a report.

COMMENTS

State agencies and institutions of higher education must produce reports for public consumption, store them, and sometimes archive them under the principles of open government. No single report is expensive to produce, but with more than 200 state agencies producing 472 or more statutorily required reports biennially, the costs of producing, distributing, and storing documents add up. Reports can be resource-intensive to prepare and costly to retain, so reports that have outlived their usefulness should be eliminated. Figure 1 discusses some of the factors contributing to the costs of reporting.

FIGURE 1
FACTORS CONTRIBUTING TO THE COST OF PRODUCING, DISTRIBUTING, AND STORING STATUTORILY REQUIRED REPORTS

Availability of the information—Any difficulty in acquiring information increases the cost of producing the report;

Format—Publishing the report in electronic format on the agency's website usually costs less than producing and distributing hard copies;

Length and printing requirements—The number of pages, number of copies, type of paper, need for color, and detail in graphics all contribute to costs;

Internal record retention policies—Maintaining internal records accrues costs for state agencies; and

State record retention and archival policies—The average retention time for agencies is between 8 and 9 years, with some records kept as long as 50 years. Information storage, which requires additional imaging costs, is even more expensive and is only practical for documents intended for long-term storage. One cubic foot of paper documents costs $.185 to store at the Texas State Record Center each month but would cost nearly $64 to convert to electronic image and another $.88 to store electronically each month.

SOURCE: Legislative Budget Board.

The additional staff time and avoided printing and storage costs from eliminating reports cannot be precisely quantified. These costs are unlikely to be great enough for any single agency to be able to reduce staff. However, reducing reporting requirements would free up staff time for other tasks.

Legislative Budget Board (LBB) staff solicited input from state agencies through the State Agency Coordinating Council (SACC), Mid-Sized Agency Coordinating Council (MACC), and the Small State Agency Task Force (SSATF), and received recommendations for nine reports that could possibly be eliminated or consolidated. The two reports discussed in Recommendation 1 are good examples of

reports that are duplicative or have outlived their usefulness.

ELIMINATE UNNECESSARY REPORTS

Each of the following reports has outlived its usefulness. Recommendation 1 would eliminate these reports, reducing the administrative burden on all state agencies and cost to the state for storage and potential archiving.

- **Non-resident Bidder Report:** Texas Government Code § 2152.064 requires at least 181 state agencies to submit a Non-resident Bidder Report to the LBB in January and July of each year listing out-of-state contractors to whom a state agency has awarded a subcontract of $25,000 or more. The Non-resident Bidder Report collects information about out-of-state bidders on government contracts. The original statutory language was amended in the Seventy-eighth Legislature (2003) to exclude university systems and institutions of higher education from this requirement. As a result, the report does not provide complete information about the state's contracting activity with out-of-state vendors. The LBB has not received any requests for the information contained in this report.
- **Training and Expense Report:** Texas Government Code § 656.105 requires at least 181 state agencies to prepare and submit an annual report to the LBB detailing the amount of money expended for training by the agency in the preceding fiscal year. This report duplicates information that is already recorded in the state's accounting and budgeting systems and in each agency's annual financial report.

REQUIRE TEXAS STATE LIBRARY AND ARCHIVES COMMISSION TO PRODUCE "REPORT OF REPORTS"

There is no current comprehensive process to eliminate or consolidate duplicative or unnecessary statutorily required reports. The Comptroller of Public Accounts (CPA) each year produces the Required Reports Prepared by State Agencies and Institutions of Higher Education report (Report of Reports), which details the 472 statutorily required reports. The CPA originally began to compile the Report of Reports to assist the legislature regarding reporting requirements, but this guide has evolved into a tool to help state agencies and institutions of higher education identify statutory requirements for reports. The CPA states that the Report of Reports may not be comprehensive and encourages agencies to notify it of any new or omitted statutory reporting requirements. The Report of Reports makes no judgment about the continued usefulness of the reports it describes.

Recommendation 2 would require the Texas State Library and Archives Commission (TSLAC) to work with CPA to produce the Report of Reports. Furthermore, the goal of the Report of Reports should be expanded to include information from state agencies regarding the continued viability of statutorily required reports.

The mission of TSLAC includes preserving the record of government for public scrutiny and enhancing the capacity for achievement of individuals and institutions with whom it works. The Report of Reports, as an index of statutorily required reports encompassing all state agencies and institutions of higher education, falls within TSLAC's mission. TSLAC should be able to build upon CPA's work to ensure the completeness of the Report of Reports. Furthermore, TSLAC can create a process, potentially using forms, Web sites, and its contacts with records administrators in all state agencies and with SACC, MACC, and SSATF, to collect information regarding the continued usefulness of reports. Once TSLAC publishes the report, this information would become public record, thus allowing interested parties to recommend elimination of unnecessary reports or consolidation of duplicative reports.

The following rider should be included in the 2006–07 General Appropriations Bill for the Texas State Library and Archive Commission:

> **Report of Reports.** No later than June 1, 2007, the Texas State Library and Archive Commission, with the assistance of the Comptroller of Public Accounts, shall use funds appropriated above to prepare a complete and detailed written report indexing all statutorily required reports and providing detail about the preparing agency, title of report, legal authority, due date, recipient, and a brief description. The report shall provide indexes by (1) preparing agency, (2) title of report, and (3) report recipient, and the detail section shall be arranged by preparing agency. This report shall include an assessment from each receiving agency for each statutorily required report affirming or denying its continued usefulness to that agency. This report shall be provided to the Governor and the Legislative Budget Board and made available to the public.

The following rider should be included in the 2006–07 General Appropriations Bill for the Comptroller of Public Accounts:

> **Report of Reports.** The Comptroller of Public Accounts shall assist the Texas State Library and Archive Commission in assuming responsibility for

FIGURE 2
STEPS TAKEN BY OTHER STATES TO REDUCE UNNECESSARY REPORTS

California—The California Performance Review recommended sunset language for all current and future required reports in the California Education Code with a maximum life of two years, unless specifically identified for a different lifespan by the legislature. Another recommendation identified and eliminated duplicative reports.

Vermont—In January 2004, the State of Vermont Agency of Administration compiled a list of all statutorily required reports and recommended that state agencies identify obsolete reports.

Washington—The Web site of the Governor of the State of Washington lists eliminating unnecessary reports as a priority for government efficiency.

Florida—Florida's Office of Program Policy Analysis and Government Accountability has recommended eliminating unnecessary reports as a performance review component.

SOURCE: Legislative Budget Board.

the index of statutorily required reports previously published by the Comptroller.

INCLUDE SUNSET PROVISION FOR NEW REPORTS

Statutorily required reports currently remain in use until the laws requiring them are repealed by the legislature. Recommendation 3 suggests that the legislature add sunset language to the laws requiring all future reports to discontinue them after six years unless another termination point is specified by the legislature.

The legislature has included automatic expiration language in many areas of current statute. This recommendation would also align the statutory requirement for reports with the concept behind the sunset process for state agencies.

FISCAL IMPACT OF THE RECOMMENDATIONS

There is no significant fiscal impact from implementing these recommendations. It is assumed that TSLAC would be able to compile the Report of Reports and survey agencies about the usefulness of their reports using presently available resources. Because the process each agency uses to produce its statutorily required reports is unique, quantifying the staff time saved, printing costs, and storage costs saved by eliminating unnecessary reports cannot be specifically quantified. Eliminating unnecessary reports is unlikely to lead to reductions in staff, but eliminating superfluous reporting requirements would enable staff to spend time on more productive tasks.

The introduced 2006–07 General Appropriations Bill includes riders requiring TSLAC to assume responsibility for the Report of Reports and the CPA to assist TSLAC in preparing this report. There are no adjustments to appropriations based on these recommendations.

FEDERAL FUNDING ISSUES RELATED TO TEXAS HOMELAND SECURITY

From September 11, 2001 through August 30, 2004 Texas state agencies were allocated over $854.4 million in Federal Funds to improve the state's homeland security infrastructure. The following sections identify federal allocations to the state for homeland security and preparedness and detail associated state general revenue costs. Issues of concern include ongoing costs for administration, equipment, staff, maintenance, and training as Federal Funds are shifted or dissipate.

SIGNIFICANT FINDINGS

- The Texas Homeland Security Strategic Plan identifies port security, cargo container inspection, interoperability technology, and development of prevention strategies as ongoing costs required to strengthen the state's homeland security infrastructure.
- Federal appropriations for fiscal year 2005 changed funding levels of key homeland security programs. Texas allocations for National Homeland Security Grants for States are reduced by $37.0 million, and Hospital Preparedness Grants by $2.7 million. Urban Area Security Initiative Grants were increased by $11.6 million, and Texas will receive $3.0 million under the new federal Metropolitan Medical Response System Program.
- State agencies and institutions of higher education have requested $19.5 million in baseline General Revenue Funds for homeland security in the 2006–07 biennium, most of which has been requested by the Office of the Governor (for disaster assistance unrelated to terrorism), the Texas Alcoholic Beverage Commission and the Texas Engineering Extension Service.
- The Department of Public Safety has requested funding in fiscal years 2006 and 2007 for five homeland security related Exceptional Items. These items total $43.2 million in State Highway Fund 6 and $22.5 million in federal National Asset Seizure funds. The Exceptional Items are an Emergency Vehicle Operations Course, an In-Car Computer Project, the Criminal Intelligence Bureau's Texas Security Alert and Analysis Center, a Driver's License Reengineering Project, and a Driver's License Image Verification System.

SIGNIFICANT CONCERN

- The state may retain up to 20 percent of National Homeland Security Grants for States and Urban Area Security Initiative Grants for its own purposes, as well as 3 percent for administration, for a total estimated amount of $54.6 million for the 2006–07 biennium. In fiscal year 2004, the Texas Engineering Extension Service distributed 98 percent of all National Homeland Security Grants for States to local jurisdictions.

RECOMMENDATION

- The Department of Public Safety and the Texas Engineering Extension Service should examine whether homeland security related Exceptional Item requests for the 2006–07 biennium could be funded with Federal Funds.

COMMENTS

In fiscal year 2001 the governor established a task force on homeland security to conduct a survey and assessment of Texas' preparedness and security needs. The task force gave the state high marks for its overall security capabilities. In December 2001, the U.S. Congress passed the first homeland security appropriations legislation, which included funding to assist states with local security improvements. A state preparedness and needs assessment was conducted and a plan was submitted in fiscal year 2002 for federal approval. Federal distribution of homeland security funds to Texas state agencies began in March of 2002. State preparedness and assessment survey areas are listed in Figure 1.

STATE HOMELAND SECURITY PLAN REQUIREMENTS

Each state is required to maintain a federally approved homeland security plan. The first *Texas Homeland Security Strategic Plan* was completed in March of 2002. It addresses the coordinated and comprehensive use of state resources and federal funding to deter, detect, and respond to terrorism.

The *Texas Homeland Security Strategic Plan* lists four critical mission areas:

- intelligence and warning;
- protecting critical infrastructure;
- emergency preparation and response; and
- border security.

FIGURE 1
STATE PREPAREDNESS ASSESSMENT AREAS

- Command and Control
- Critical Infrastructure Assessment
- Continuity of Operations/Continuity of Government Plans
- Emergency Operating Plan
- Credible Threat Information
- Operational Coordination
- Communications
- Protective Action Recommendations
- Mutual Aid Plan, Public Information
- Training
- Exercises
- Laws and Authorities
- Health and Medical
- Facilities and Logistics
- Critical Infrastructure Mitigation
- Personnel Resources
- Equipment and Supplies

SOURCE: Office of the Governor.

Ongoing costs related to the four mission areas identified in the *Texas Homeland Security Strategic Plan* include cargo container inspection, port security, interoperability technology, and development of prevention strategies through surveillance and other methods. The plan also delineates clear lines of authority and communication for government officials, law enforcement, and emergency response personnel. Local security and preparedness assessments are an important tool in piecing the plan together and justifying Federal Funds for communities and the state as a whole. A total of 928 local security and preparedness assessments were completed as of June 2004. It is expected that 98 percent of local entities will be assessed by December 2004.

IMPLEMENTATION OF STATE HOMELAND SECURITY LEGISLATION

In 2003, the Seventy-eighth Legislature passed House Bill 9, which directs the state to prepare for all threats whether man-made, natural, or terrorist in nature. In addition, House Bill 9 established the Governor's Office of Homeland Security, a Director of Homeland Security, and a Critical Infrastructure Protection Council. The Director of Homeland Security is responsible for overseeing the Critical Infrastructure and Protection Council; state, federal and interstate relations; coordination of the State Homeland Security Strategic Plan; classified intelligence matters with state and federal law enforcement; liaison with councils of government; coordination with state administering agencies of state homeland security grants; and oversight of the Governor's Division of Emergency Management. Council membership consists of the governor or his designee and representatives from designated state agencies.

ENHANCEMENTS TO TEXAS HOMELAND SECURITY SINCE SEPTEMBER 11, 2001

Federal grants have made up the lion's share of funds expended for enhancements to Texas' homeland security preparedness, response capabilities, and security infrastructure since the events of September 11, 2001. Texas state agencies have been allocated over $854.4 million in new Federal Funds for fiscal years 2002 through 2004 (see Figure 2). As Figure 3 shows, three agencies account for 92.1 percent of Federal Funds allocated to Texas for homeland security.

The following are examples of how Federal Funds have been used in Texas for homeland security:

- Department of State Health Services (DSHS)—Texas received $171.5 million in Federal Funds from fiscal years 2002 through 2004 for Public Health Bioterrorism Preparedness and Response grants. Funds have been used to develop communications and information technology tools for the Health Alert Network and to enhance the capabilities of 10 biology labs statewide. Approximately $13.5 million was devoted to these purposes for areas along the Mexican border. The department has been allocated a total of $76.7 million in Hospital Bioterrorism Preparedness grants, of which $5.8 million has been distributed to hospitals in counties bordering Mexico.
- Department of Public Safety (DPS)—In fiscal year 2003, approximately $2 million in Byrne Law Enforcement grants was expended for counter-terrorism training, establishment of the Advanced Law Enforcement Rapid Response Training Center, and improvements to information technology infrastructure.
- Governor's Division of Emergency Management—The agency purchased and installed improved surveillance and information technology at Central Command Headquarters in Austin. It provided coordination, training and reference materials to Texas communities and first responders; coordinated and maintained several response and preparedness teams statewide; and enhanced the Texas Amber Alert Network, a warning system.

FIGURE 2
TEXAS HOMELAND SECURITY FEDERAL FUNDS BY STATE AGENCIES AND INSTITUTIONS OF HIGHER EDUCATION
(IN MILLIONS)

STATE AGENCY/INSTITUTION OF HIGHER EDUCATION	FY 2002	FY 2003	FY 2004	TOTAL
Texas Engineering Extension Service				
National Homeland Security Program				
Law Enforcement Terrorism Prevention			$25.9	$25.9
State Homeland Security			$87.4	$87.4
Citizen Corps			$1.8	$1.8
Equipment	$15.5	$83.7		$99.2
Training		$1.6		$1.6
Exercises	$0.7	$6.0		$6.7
Planning and Technical Assistance		$2.1		$2.1
Administration	0.4	$1.1		$1.5
Urban Area Security Initiatives				$0.0
Houston		$23.8	$19.8	$43.6
Dallas		$10.4	$12.1	$22.5
San Antonio			$6.3	$6.3
Trinity Rail			$0.8	$0.8
Alert Level Orange		$10.4		$10.4
Subtotal	$16.6	$139.1	$154.1	$309.8
The University of Texas Medical Branch at Galveston				
National Biocontainment Laboratory			$110.1	$110.1
Center for Biodefense and Emerging Infections			$48.3	$48.3
58 Research Grants			$70.9	$70.9
Subtotal			$229.3	$229.3
Department of State Health Services				
Public Health Bioterrorism Preparedness and Response	$54.0	$68.9	$48.6	$171.5
Hospital Bioterrorism and Emergency Response	$8.3	$35.1	$33.3	$76.7
Subtotal	$62.3	$104.0	$81.9	$248.2
Adjutant General's Department				
Airport Protection by National Guard	$17.2			$17.2
Subtotal	$17.2			$17.2
Department of Public Safety				
Byrne Criminal Justice Grants	$1.0	$1.2		$2.2
Local Law Enforcement Grants		$1.8		$1.8
State and Local All Hazards Emergency Operations		$4.8	$1.7	$6.5
Other		$1.9	$0.9	$2.8
Subtotal	$1.0	$9.7	$2.6	$13.3
Governor's Criminal Justice Division				
Byrne Criminal Justice Grants	$1.8	$6.5		$8.3
Subtotal	$1.8	$6.5		$8.3
The University of Texas at Austin				
10 Research Grants		$8.3		$8.3
Subtotal		$8.3		$8.3

(CONTINUED ON NEXT PAGE)

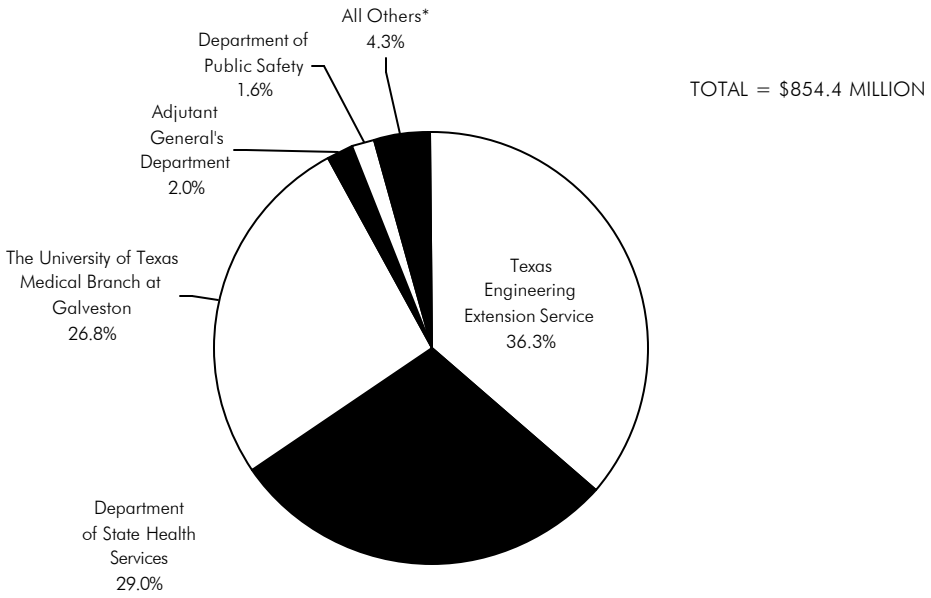
FIGURE 2 (CONTINUED)
TEXAS HOMELAND SECURITY FEDERAL FUNDS BY STATE AGENCIES AND INSTITUTIONS OF HIGHER EDUCATION (IN MILLIONS)

STATE AGENCY/INSTITUTION OF HIGHER EDUCATION	FY 2002	FY 2003	FY 2004	TOTAL
Texas Workforce Commission				
National Emergency Grants	$5.3	$0.9		$6.2
Subtotal	$5.3	$0.9		$6.2
Texas Commission on Environmental Quality				
Texas Biowatch Monitoring Program		$4.2		$4.2
Water Protection Counter Terrorism		$1.5		$1.5
Physical Security Equipment Grant	$0.2			$0.2
Subtotal	$0.2	$5.7		$5.9
The University of Texas at San Antonio				
Center for Information Assurance and Security	$2.5			$2.5
Information Assurance Scholarship Program	$0.2	$0.3		$0.5
Subtotal	$2.7	$0.3		$3.0
Texas Veterinary Medical Diagnostic Laboratory				
Network of Diagnostic Labs	$2.0			$2.0
Subtotal	$2.0			$2.0
The University of Texas Health Science Center at San Antonio				
Bioterrorism Training and Curriculum Development			$1.1	$1.1
Texas Medical Rangers			$0.1	$0.1
Subtotal			$1.2	$1.2
Texas Department of Agriculture				
Cooperative Agricultural Pest Survey Program		$0.3		$0.3
Subtotal		$0.3		$0.3
Texas Animal Health Commission				
Plant and Animal Disease Control and Care Grant		$0.3	$1.0	$1.3
Subtotal		$0.3	$1.0	$1.3
The University of Texas Health Center at Tyler				
Health Care Facilities and Other Construction		$0.2		$0.2
Subtotal		$0.2		$0.2
TOTAL	$109.1	$275.3	$470.1	$854.5

SOURCES: Legislative Budget Board and all the agencies listed.

- Texas Engineering Extension Service (TEEX)—During fiscal years 2001 through 2004, TEEX administered approximately $309.8 million in homeland security funds. Grants were distributed to local entities for training and equipping first responders, law enforcement officers in terrorism prevention, and Citizen Corps volunteers. TEEX also maintains Task Force 1, a rapid-response team for major emergencies and disasters. In cooperation with the councils of government, TEEX conducted 928 security and preparedness needs assessments in communities throughout the state.
- TEEX will also be administering Port Security Grants beginning in fiscal year 2005. The U.S. Department of Homeland Security announced a new round of Port Security Grants on September 13, 2004. According to the report, Texas will receive

FIGURE 3
TEXAS HOMELAND SECURITY FEDERAL FUNDS, FISCAL YEARS 2002–2004



AGENCY	FEDERAL FUNDS (IN MILLIONS)
Texas Engineering Extension Service	$309.8
Department of State Health Services	$248.2
The University of Texas Medical Branch at Galveston	$229.3
Adjutant General's Department	$17.2
Department of Public Safety	$13.3
All Others	$36.7

*All Others = Governor's Criminal Justice Division $8.3 million; The University of Texas at Austin $8.3 million; Texas Workforce Commission $6.2 million; Texas Commission on Environmental Quality $5.9 million; The University of Texas at San Antonio $3.0 million; Texas Veterinary Medical Diagnostic Laboratory $2.0 million; The University of Texas Health Science Center at San Antonio $1.2 million; Texas Department of Agriculture $0.3 million; Texas Animal Health Commission $1.3 million; and The University of Texas Health Center at Tyler $0.2 million.
SOURCES: Legislative Budget Board and all the agencies listed.

15 grants totaling $8.2 million for port security enhancements this fiscal year.

- Texas Department of Transportation (TxDOT)—In fiscal year 2002 the department expended $40.8 million in North American Free Trade Agreement transportation funds to improve border inspection facilities and other security concerns. Also, TXDOT recently announced that it has received an additional $28 million in discretionary funding from the U.S. Department of Transportation to enhance border security crossings and state inspection stations.

TEXAS FISCAL YEAR 2005 FEDERAL HOMELAND SECURITY ALLOCATIONS

In October 2004, Congress passed legislation affecting federal funding for homeland security. This legislation will require federal agencies to meet a list of conditions and obtain Congressional approval before spending money on new projects, such as the U.S. Visitor and Immigrant Status Indicator Technology (US-VISIT) program, an entry-exit program, and Secure Flight, a passenger-screening program. Funds cannot be spent on any future contracts with companies incorporated overseas. The new law also requires the U.S. Department of Homeland Security to

distribute grants to state and local governments according to strict deadlines.

Congress appropriated $33.1 billion in fiscal year 2005 for homeland security, $2.8 billion more than fiscal year 2004. However, Congress reduced fiscal year 2005 appropriations for National Homeland Security Grants for States, Public Health Bioterrorism Preparedness and Response Grants, and Hospital Bioterrorism Preparedness and Response Grants. Texas' estimated allocation for the grants is reflected in Figure 4, showing a $35.2 million decrease from fiscal year 2004.

Current National Homeland Security Grants for States funding formulas guarantee each state 0.75 percent of available funds. This set-aside accounts for 40 percent of Federal Funds to states, leaving only 60 percent to be distributed on the basis of population. This allocation methodology results in disparities on a per capita basis. For example, in fiscal year 2004, California received only $9.03 per capita in homeland security grants from the Office of Domestic Preparedness while Wyoming received $37.60 per capita. Texas ranked 44th in the nation, receiving $7.07 per capita.

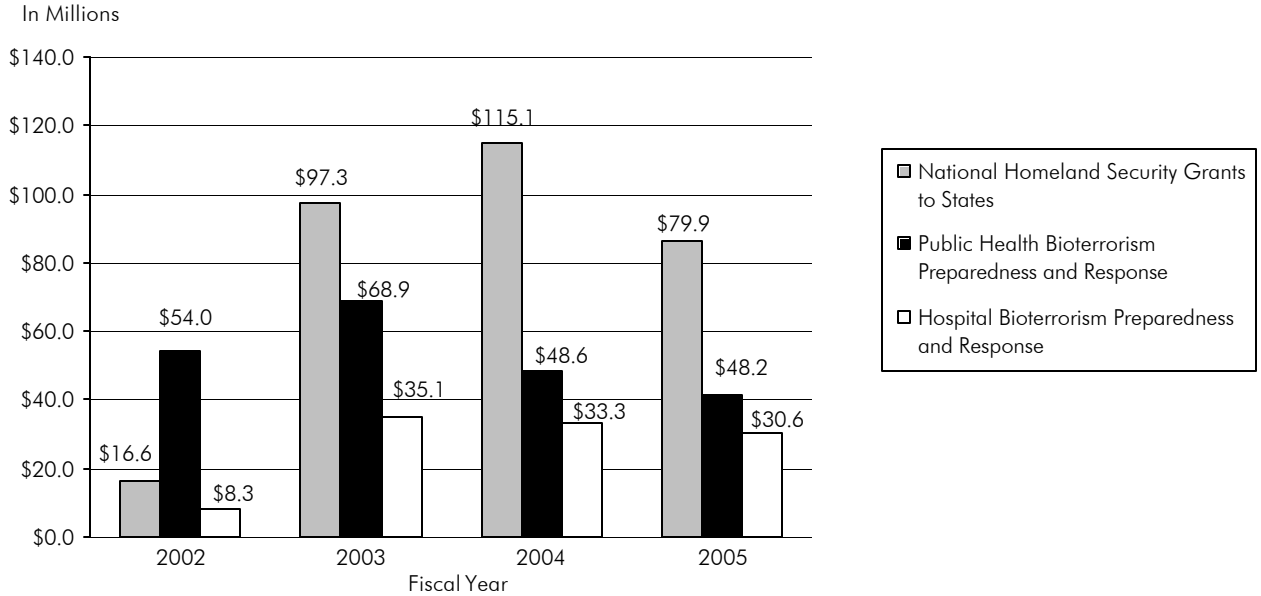
Congress shifted funding from National Homeland Security Grants for States to expand or enhance other programs, such as US-VISIT, which uses biometrics for fingerprint and photo identification, and increased Urban Area Security Initiative (UASI) grants for at-risk metropolitan areas.

MINIMIZING IMPACT ON STATE GENERAL REVENUE FUNDS AND OTHER FUNDS

Legislative appropriation requests for the 2006–07 biennium indicate that state agencies and institutions of higher education identified a total of $35.5 million in General Revenue Funds during the 2002–03 and 2004–05 biennia used for homeland security (see Figures 5 and 6). Included in this number is $15.5 million in unused Disaster Funds carried forward by the Office of the Governor. General Revenue–Dedicated Funds and other funding sources totaled $28.4 million over this time period. Some of these funds were expended before Federal Funds became available. Some were required because the expense did not meet guidelines for federal grant funding.

A total of $19.5 million in baseline General Revenue Funds is requested for the 2006–07 biennium, as well as $14.0 million in baseline General Revenue–Dedicated Funds and Other Funds. The DPS has requested funding for five homeland security related Exceptional Items for fiscal years 2006–07. The DPS requests, totaling $43.2 million in State

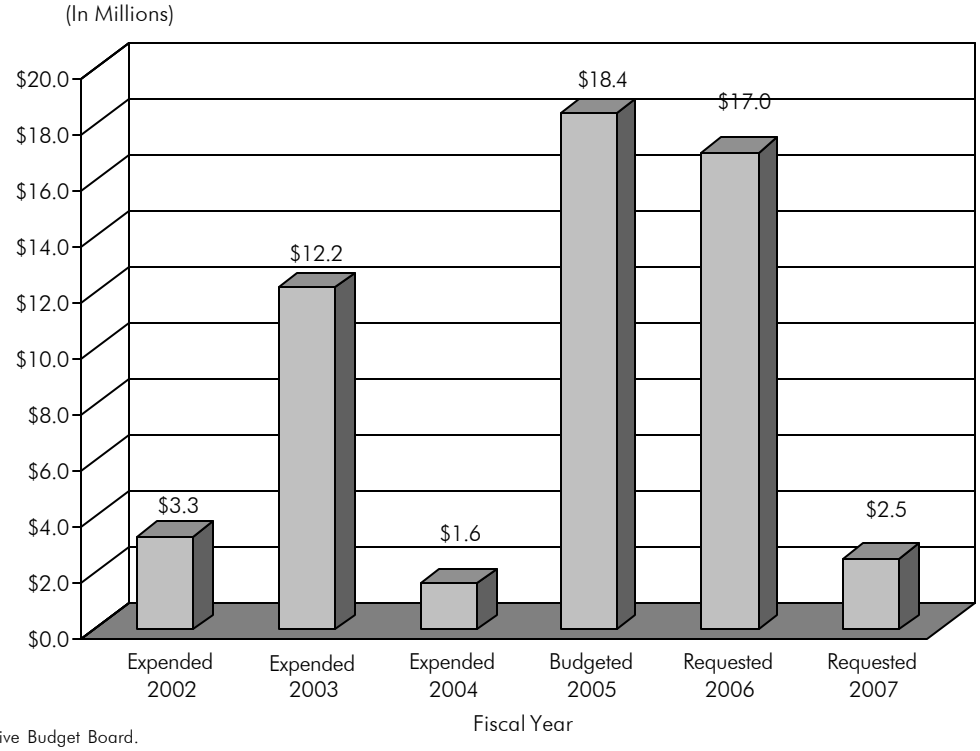
FIGURE 4
TREND OF SELECT FEDERAL FUNDS FOR HOMELAND SECURITY IN TEXAS FEDERAL FISCAL YEARS 2002 THROUGH 2005



NOTES: Fiscal years 2002 through 2005 all include the following grants: Citizen Corps Program; Law Enforcement Terrorism Prevention Program and State Homeland Security Program. Fiscal year 2005 includes $3.0 million for the new Metropolitan Medical Response System Program. Urban Area Security Initiative Grants are not included in this graph.

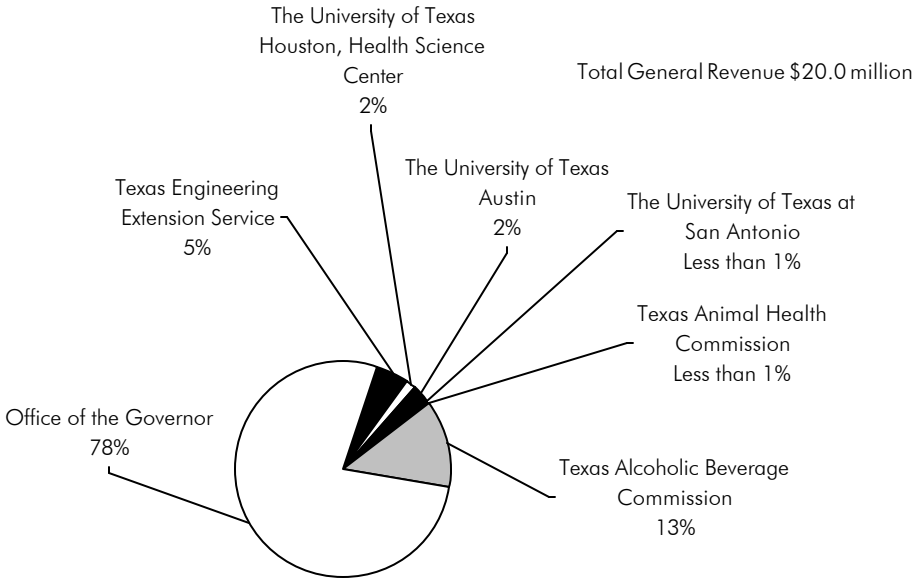
SOURCES: Federal Funding Information for States; the U.S. Department of Homeland Security.

FIGURE 5
GENERAL REVENUE FOR HOMELAND SECURITY



SOURCE: Legislative Budget Board.

FIGURE 6
DISTRIBUTION OF GENERAL REVENUE FOR HOMELAND SECURITY
FISCAL YEARS 2004 AND 2005



SOURCE: Legislative Budget Board.

Highway Fund 6 and $22.5 million in federal National Asset Seizure funds, may qualify for available federal National Homeland Security Grants for States. DPS' Exceptional Item requests would fund an Emergency Vehicle Operations Course, an In-Car Computer Project, the Criminal Intelligence Bureau's Texas Security Alert and Analysis Center, a Driver's License Reengineering Project, and a Driver's License Image Verification System.

Federal guidelines for State Homeland Security Grants and UASI grants permit states to retain up to 20 percent of the funds for state and local needs. Funds may be used for planning and coordination, infrastructure maintenance, training, equipment purchases, and replacement costs. The funding available to the state from these sources totals approximately $47.0 million for the 2006–07 biennium. The state may also retain up to 3 percent of total funds for administrative costs related to the grants. Funding available to the state for administrative costs is approximately $7.6 million for the 2006–07 biennium. The total from both grant resources over the course of the biennium is estimated at $54.6 million. These funds must be appropriated according to the State Homeland Strategic Plan and in accordance with federal guidelines. It is recommended that DPS and TEEX examine whether homeland security related Exceptional Item requests for the 2006–07 biennium could be funded with State Homeland Security Grants, UASI grants, or any other federal homeland security grants administered by the state.

MODIFICATIONS AND ADDITIONS TO TEXAS FEDERALLY FUNDED HOMELAND SECURITY PROGRAMS

Should Federal Funds for homeland security diminish over the years, state agencies may request state funds to maintain equipment, personnel, planning, and infrastructure originally acquired with federal dollars. As previously mentioned, recently passed federal appropriations for homeland security shift some funding into new or expanded programs and reduce others. Homeland security programs are new, and priorities change as requirements become more clearly defined. As the states and the federal government update or improve old security structures, they discover additional risks that need to be addressed to make the nation more secure. The focus of funding for the last three years has been on preparedness and response. Security experts are now advising the nation to turn its attention to prevention strategies. These new strategies will involve investments in a variety of technology and research categories, as well as improvements in surveillance techniques and mechanisms. The following initiatives provide examples of emerging investments in security planned for Texas:

- The Homeland Security National Center for Foreign Animal and Zoonotic Disease Defense, located at Texas A&M University, will receive $18 million over the next three years to partner with higher education, industry, and government to address potential threats to animal agriculture.
- The University of Texas Medical Branch at Galveston will receive over $110.1 million for construction and the purchase of equipment for one of two national, large-scale biological research facilities focusing on new and emerging disease threats. Also, the existing Center for Biodefense and Emerging Infectious Diseases received over $48 million for construction, equipment and research to develop medical countermeasures against viruses considered likely to be used as weapons by bioterrorists.
- On September 13, 2004, the U.S. Department of Homeland Security announced a new program for bus security. Texas will receive approximately $2.1 million in Federal Funds to be distributed among eight communities. The grants will be used for security equipment for public transportation vehicles and bus facility security enhancements.

The U.S. Congress is considering changes to the funding formula for states in both houses. The U.S. House of Representatives may require a 25 percent state match for National Homeland Security Grants for States. Both the U.S. House of Representatives and U.S. Senate are considering universal identification systems for all U.S. residents. State information and data technology systems would be required to meet minimum federal standards for the universal identification program, but funding to assist states in meeting the federal standards has not been authorized.

Unfunded federal mandates are also a possibility with homeland security. For instance on July 22, 2004, the president issued an executive order directing the federal government to address the safety and security needs of people with disabilities in emergency situations, including both natural and man-made disasters, such as floods, earthquakes, hurricanes, and acts of terrorism. The order creates the Interagency Coordinating Council on Emergency Preparedness and Individuals with Disabilities to oversee the implementation of policy. The council is expected to make recommendations to the executive branch in July 2005, but no funding has been allocated in the federal budget for implementation of the council's initiatives.

FISCAL IMPACT OF THE RECOMMENDATION

Texas agencies and institutions of higher education identified approximately $35.5 million in General Revenue Funds and $28.4 million in General Revenue–Dedicated Funds and Other Funds for homeland security purposes from fiscal years 2002 through 2005. Agencies and institutions of higher education submitted baseline requests of $19.5 million in General Revenue Funds and $14.0 million in General Revenue–Dedicated Funds and Other Funds for the 2006–07 biennium.

DPS is requesting funding in fiscal years 2006 and 2007 for five Exceptional Items totaling $43.2 million in State Highway Fund 6 and $22.5 million in federal National Asset Seizure funds, which may qualify for available federal National Homeland Security Grants for States. Over the 2006–07 biennium, the state could retain up to $54.6 million in federal Homeland Security grant funds that are currently distributed to local entities.

No provision to implement the report recommendation has been included in the introduced 2006–07 General Appropriations Bill.

IMPROVE COST-EFFECTIVENESS OF STATE-FUNDED AIR EMISSIONS REDUCTION PROGRAMS

Through better management and oversight of pass-through expenditures for improved air quality, the state could ultimately achieve savings in General Revenue–Dedicated Funds and perhaps increase the amount of credit the state is receiving for air quality-related spending. The Texas Emissions Reduction Plan, operated by the Texas Commission on Environmental Quality, and the Congestion Mitigation and Air Quality program, operated by local metropolitan planning organizations but funded mainly with Federal Funds provided through the Texas Department of Transportation, both provide substantial amounts of funding for projects aimed at reducing the amount of pollutants emitted by vehicles in areas deemed to be nonattainment for federal air quality standards.

Projects seeking funding through the Texas Emissions Reduction Plan program must demonstrate a minimum level of cost-effectiveness defined in statute for removing each ton of nitrous oxides, whereas Congestion Mitigation and Air Quality projects need only demonstrate that they will benefit air quality. Likewise, all Texas Emissions Reduction Plan projects contribute toward meeting obligations in the State Implementation Plan submitted to the U.S. Environmental Protection Agency to demonstrate the state's commitment to emissions reductions, whereas only a portion of Congestion Mitigation and Air Quality-funded projects receive any credit in the State Implementation Plan. Furthermore, there currently is no clear basis for comparison for cost-effectiveness between Texas Emissions Reduction Plan and Congestion Mitigation and Air Quality projects.

SIGNIFICANT CONCERNS

- Texas needs to be in compliance with the Federal Clean Air Act or could face sanctions by the Environmental Protection Agency. The exact criteria for being in compliance are somewhat uncertain at this time, because the U.S. Environmental Protection Agency is moving from a one-hour standard for defining acceptable ozone levels to an eight-hour standard. However, it does appear certain that Texas will continue to need to spend significant funds on measures, such as the Texas Emissions Reduction Plan and Congestion Mitigation and Air Quality, to reduce ozone levels through quantifiable nitrous oxide emissions reductions.
- Significant expenditures on emissions reductions are made by metropolitan planning organizations using federal Congestion Mitigation and Air Quality funds received by the Texas Department of Transportation (approximately $80 million to $100 million per year since the early 1990s). However, the portion of Congestion Mitigation and Air Quality expenditures going to projects achieving quantifiable emissions reductions in the State Implementation Plan is not clear.
- There are no cost-effectiveness criteria required for Congestion Mitigation and Air Quality project selection, as there are with the Texas Emissions Reduction Plan program. Furthermore, there is no clear basis of comparison for the cost-effectiveness of the two programs.

RECOMMENDATIONS

- **Recommendation 1:** Include a rider in the 2006–07 General Appropriations Bill that directs the Texas Department of Transportation to require all Congestion Mitigation and Air Quality-funded projects to achieve some credit within the State Implementation Plan.
- **Recommendation 2:** Include a common performance measure related to dollars spent per ton reduction in nitrous oxides in the 2006–07 General Appropriations Bill for the Texas Commission on Environmental Quality and the Texas Department of Transportation.
- **Recommendation 3:** Require the Texas Department of Transportation and the Texas Commission on Environmental Quality to collaborate on establishing cost-effectiveness guidelines for Congestion Mitigation and Air Quality projects and play a greater role in determining whether metropolitan planning organization spending plans maximize use of state funds in terms of population reductions.

COMMENTS

For the 2006–07 biennium, state agencies have requested more than a total of $670.0 million for strategies to

reduce air pollution in Texas. The bulk of that funding (more than $507.5 million) would come from two major pass-through programs: the Congestion Mitigation and Air Quality program (CMAQ), through which the Texas Department of Transportation (TxDOT) provides Federal Funds (an estimated $196 million for the 2006–07 biennium) to local governments in areas considered to be non-attainment for the federal ozone standard for a variety of road, bicycles paths, transit and vehicle programs; and the Texas Emissions Reduction Plan (TERP) program, through which the Texas Commission on Environmental Quality provides state fee funding (General Revenue–Dedicated TERP Account requested funding totals $311.1 million for the 2006–07 biennium) in the form of grants to private and public entities to retrofit and replace high polluting diesel engines.

The TERP program was created by the Seventy-seventh Legislature, 2001, for one imperative reason: to achieve credit in the Statewide Implementation Plan (SIP) for ozone reductions in the Dallas and Houston areas or face the possibility of sanctions against the state for failing to meet EPA standards. The program was set up with cost-efficiency requirements—only projects shown to achieve a reduction in pollution at a cost of less than $13,000 per ton of nitrous oxide per day removed from the air are eligible for funding. Recently, the agency has been able to achieve an average cost of around $6,000 per ton.

Texas began receiving CMAQ funding from the Federal Highway Administration in 1992. Since then, over $1.2 billion has been spent on a variety of projects, all of which must have some benefit to air quality. However, the CMAQ program does not require that cost-efficiency standards be used in determining project eligibility, nor is there any requirement that a project receive SIP credit. Therefore, a portion of the nearly $100 million per year Texas is receiving in CMAQ funds goes to projects achieving minimal quantifiable benefits to air quality and a level of SIP credit that appears low, based on the limited comparable data available, when compared to TERP levels.

The Federal Clean Air Act (CAA) requires Texas to meet certain air quality standards by limiting the amount of certain pollutants in the air. Those standards are administered by the U.S. EPA. Under the CAA, the TCEQ develops a SIP to address air quality. The SIP includes a set of rules to be implemented in "nonattainment" areas, or those areas exceeding EPA standards for particular air pollutants. In Texas, the major pollutants that cause areas to be considered "nonattainment" are known as "nitrous oxides" (NOx). NOx mixes with volatile organic compounds to form ground level ozone, which has been determined to cause or at least aggravate health problems among humans.

Prior to 2001, nonattainment was determined based on one-hour ozone readings. In that year, the EPA promulgated a new standard, based on readings over an eight-hour period. That new rule was challenged in court, and today the eight-hour standard remains in EPA rules, but has not been fully implemented. Texas thus currently operates under both systems.

Nonattainment areas are classified based on the extent to which they exceed air quality standards. The one-hour standard had the following classifications: marginal, moderate, serious, severe, and extreme. Under the eight-hour standard, a "nonattainment deferred" classification is added for areas with slightly better air quality than the marginal areas.

Under the one-hour standard, Texas had four nonattainment areas: Houston–Galveston–Brazoria, severe; Dallas–Fort Worth and El Paso, serious; and Beaumont–Port Arthur, moderate. Under the eight-hour classification, Houston–Galveston–Brazoria and Dallas–Fort Worth are considered moderate, while Beaumont–Port Arthur becomes marginal. Currently, the three areas that had been considered nonattainment under the one-hour ozone standard and continue to be considered nonattainment under the eight-hour standard have submitted SIPs to the EPA. Only one, Houston–Galveston–Brazoria, has had its SIP approved by the EPA. The Dallas–Fort Worth SIP has never been approved due to a lawsuit filed soon after it was submitted to EPA, and the EPA has never officially approved the Beaumont–Port Arthur SIP. Because these areas lack an approved SIP, they could face sanctions by the EPA. The Dallas–Fort Worth area, for example, could be subject to transportation nonconformity status as soon as June 2005.

Under the eight-hour standard, San Antonio has entered into an early action compact (EAC), a voluntary version of a SIP, resulting in their nonattainment designation being temporarily deferred. As near-nonattainment areas, Austin–San Marcos and East Texas (Tyler–Longview) also have entered into an EAC to prevent the area from being designated in the future as nonattainment. In addition, Corpus Christi and Victoria also are considered to be near-nonattainment. El Paso is a relative success story in that the area now met the one-hour standard and will be seeking a maintenance designation from the EPA. For a summary of EPA designations and SIP status for Texas areas, see Figure 1.

CONTROL STRATEGIES IN THE STATE IMPLEMENTATION PLAN

Strategies are implemented in nonattainment and near-nonattainment areas, as well as statewide, to improve air quality and to ensure that these areas will achieve or

FIGURE 1
EPA DESIGNATIONS FOR OZONE STATUS OF TEXAS AREAS

AREA	1-HOUR STANDARD	8-HOUR STANDARD	SIP STATUS
Austin–San Marcos	Near Nonattainment	Near Nonattainment	EAC[1]
Beaumont–Port Arthur	Moderate	Marginal	Approved SIP
Corpus Christi	Near Nonattainment	Near Nonattainment	None
Dallas–Fort Worth	Serious	Moderate	SIP Pending
East Texas (Tyler–Longview)	Near Nonattainment	Near Nonattainment	EAC[1]
El Paso	Serious	Attainment[2]	Approved SIP
Houston–Galveston–Brazoria	Severe	Moderate	Approved SIP
San Antonio	Near Nonattainment	Nonattainment Deferred	EAC
Victoria	Near Nonattainment	Near-nonattainment	None

NOTES:
[1] EAC= Early Action Compact
[2] El Paso remains nonattainment for PM-10 (particulate matter) under the 8-Hour Standard.
SOURCE: Texas Commission on Environmental Quality.

maintain attainment status. These strategies prescribe requirements that generally become stricter and more numerous as an area moves from one classification level to another. Areas in nonattainment areas also become eligible for funding from the Congestion Mitigation Air Quality (CMAQ) program administered by the Federal Highway Administration (FHWA). More funding is available to entities in the severe and serious categories than in the marginal and moderate categories.

According to the TCEQ, the Houston–Galveston–Brazoria area might be expected to achieve attainment status under a shortened timeline because its attainment status under the eight-hour standard would be moderate, rather than severe as under the one-hour standard. At the same time, the amount of CMAQ funding the state receives will likely be reduced, since the classifications for each area actually are improving under the eight-hour standard. This could result in the need for more drastic control measures, including a significant increase in the need for TERP expenditures.

Control strategies contained in the SIPs aim to reduce air pollution, and in most areas strategies focus on reducing nitrous oxides (NOx), the precursor to ground-level ozone. Each control strategy aims to achieve a targeted reduction in the number of tons of pollutants being emitted by identifiable "point" sources, such as industrial facilities, and by less identifiable "nonpoint" sources, such as vehicles, construction equipment, and lawn equipment.

The TCEQ estimates the number of tons of each pollutant, such as NOx or particulate matter, that each nonattainment area must eliminate through these control strategies, and the SIP includes a listing of each strategy and the expected number of tons in daily emissions. Control strategies in the SIPs submitted for Houston–Galveston and Dallas–Fort Worth did not originally achieve all of the reductions necessary for these areas to reach attainment status. The difference between the reduction in tons achieved by the SIP and the amount necessary for the area to reach attainment is known as the area's emissions "gap." The gaps in the Houston–Galveston–Brazoria and Dallas–Fort Worth SIPs were filled using credits from the Texas Emissions Reduction Plan (TERP).

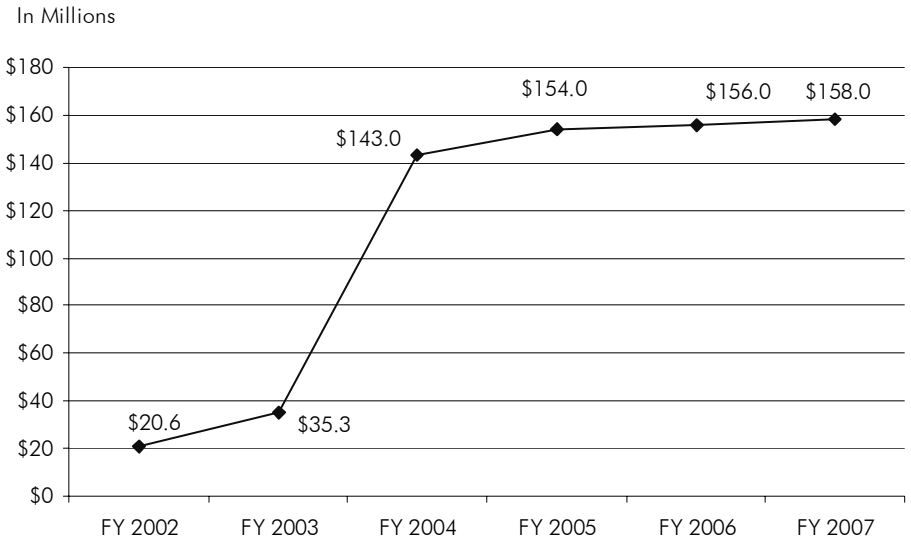
THE TEXAS EMISSIONS REDUCTIONS PLAN PROGRAM

Senate Bill 5, Seventy-seventh Legislature, 2001, created the TERP as an incentive-based program to achieve NOx reductions. The TERP program was modified by House Bill 1365, Seventy-eighth Legislature, Regular Session, 2003, and by House Bill 37, Seventy-eighth Legislature, Third Called Session. TERP programs receiving funding include a diesel engine reduction incentive program and a new technology research and development program. The diesel engine reduction incentive program is the only TERP program with a quantified NOx emissions reductions target contained in the SIP.

TERP funding comes from various fees on construction equipment, but the largest portion of TERP funding comes from a $15 to $25 fee paid when a vehicle title is transferred from one individual to another. Revenues to the TERP account in fiscal year 2004 totaled $143 million and are expected to increase to $158 million by fiscal year 2007. Figure 2 illustrates the level of TERP revenues from fiscal years 2003 through 2007.

Provisions in Texas Health and Safety Code, § 386.106, require that projects achieve emissions reductions of at least one ton of NOx per year for every $13,000 in assistance provided, or $4.7 million per ton of NOx reduced per day. By statute, 89.5 percent of all TERP

FIGURE 2
REVENUES TO THE GENERAL REVENUE–DEDICATED TEXAS EMISSIONS REDUCTION PLAN ACCOUNT NO. 5071



SOURCES: Comptroller of Public Accounts; Texas Commission on Environmental Quality.

funds must be spent on the diesel emissions grant program. TCEQ reports that in fiscal year 2004, the agency awarded a second round of grant awards consisting of $80.9 million. These projects had an average cost per ton of NOx removed of only $5,960, less than half of the statutory requirement. The TCEQ reports that demand for TERP funds exceeded the supply of funds available in the General Revenue–Dedicated TERP Account No. 5071 by over $275 million in the fiscal year 2004 grant funding cycle.

CONGESTION MITIGATION AND AIR QUALITY IMPROVEMENT PROGRAM (CMAQ)

The Federal Highway Administration (FHWA) administers the CMAQ as a funding source for transportation projects that will contribute to attainment of national air quality standards in nonattainment areas. Since 1992, Texas has received over $1.2 billion in CMAQ funds from FHWA. To this point, all of the CMAQ funds have been designated for projects in the state's four nonattainment areas under the one-hour ozone standard, with each area receiving an allocation of the funding based on population and a weighting factor determined by how severe the area's air pollution problems are. Figure 3 gives a breakdown of CMAQ apportionments by metropolitan planning organization (MPO) from 1998 to 2004.

All CMAQ projects require a 20 percent match, which is usually paid for by the local government entities, but TxDOT can also pay for the match requirement if the project is part of the state highway system, and recently TERP funds have been used as the required match.

There are various types of projects that are eligible for CMAQ funding, including, but not limited to the following:

- intersection and traffic flow improvements;
- hike and bike trails;
- programs for improved public transit;
- van pool programs;
- on road diesel engine retrofits and replacement programs (Clean Vehicles);
- alternatively fueled vehicle programs; and
- the construction of high-occupancy vehicle lanes.

In addition, all CMAQ projects must conform to an area's transportation improvement plan, and CMAQ funds may not be used to create or expand single occupancy vehicle capacity. In all cases, CMAQ projects must demonstrate some benefit to a region's air quality. Although the FHWA requires an annual report from each state quantifying emissions reductions from CMAQ projects, the FHWA does not require projects to receive credit in a SIP. One restriction on CMAQ projects is that they must benefit highway users (i.e., no off-road projects).

FIGURE 3
ANNUAL CONGESTION MITIGATION AND AIR QUALITY IMPROVEMENT PROGRAM APPORTIONMENT BY METROPOLITAN PLANNING ORGANIZATION (IN MILLIONS)

	FISCAL YEAR APPORTIONMENT						
DISTRICT	1998	1999	2000	2001	2002	2003	2004
Beaumont	$2.6	$3.3	$4.7	$5.1	$4.8	$3.5	$3.1
Dallas	$20.9	$27.4	$30.6	$33.4	$31.1	$23.7	$28.6
El Paso	$6.4	$8.2	$9.0	$9.9	$9.1	$6.2	$7.3
Fort Worth	$10.3	$12.9	$14.5	$15.8	$14.7	$10.9	$13.4
Houston	$35.4	$45.7	$50.1	$54.6	$50.8	$37.5	$46.0
Total	$75.0	$95.7	$109.0	$118.7	$110.5	$81.8	$98.5

SOURCE: Texas Department of Transportation.

METROPOLITAN PLANNING ORGANIZATIONS

TxDOT is the recipient of CMAQ funds in Texas. TxDOT delegates project selection to each area's metropolitan planning organization (MPO). TxDOT does not impose any additional criteria on MPOs in their selection process. As long as a project meets CMAQ guidelines, it is up to each local community to decide what type of projects it will fund and the order in which projects will be implemented. TxDOT has no requirement that projects receive any credit in the SIP. MPOs do generally pledge to TCEQ to achieve certain emissions reductions for purposes of the SIP, but those pledges are not necessarily tied to CMAQ funding.

The TCEQ works with TxDOT and MPOs to calculate emissions reductions resulting from CMAQ projects. Although TCEQ is the agency responsible for ensuring that regions in Texas attain air quality standards, TCEQ has no input into selection criteria by MPOs regarding CMAQ funding priorities. Although some CMAQ projects are selected that have substantial benefits to air quality, many projects fail to gain any credit toward the SIP.

MPOs are each responsible for a portion of SIP credit. Each makes a pledge to reduce a target number of tons per day (tpd) of NOx from two categories of projects: transportation control measures (TCM) and voluntary mobile emissions reductions program (VMEP). The H-GAC is responsible for coming up with measures to achieve a 10.6 tpd reduction in NOx for TCMs and a 7 tpd reduction of NOx for VMEP projects. The NCTCOG would be responsible for a 4.7 tpd reduction of NOx for TCMs and a 1.6 tpd to 4.6 tpd reduction for VMEP projects in the proposed Dallas–Fort Worth SIP. However, not all of these reductions are necessarily a result of CMAQ expenditures. Moreover, MPOs do not seem to track the amount of CMAQ spending that is contributing to the attainment of a specific amount of NOx reductions in the SIP.

The TCEQ has specific targets in the SIP for NOx reductions: 38.8 tpd in Houston–Galveston–Brazoria and 22.2 tpd in Dallas–Fort Worth, for example. In addition to the fact that TCEQ must require any TERP grant request to meet the $13,000 tpd statutory limit, all grant funds are specifically tied to a portion of the NOx reduction in the SIP. Every TERP dollar spent on grants therefore attributes to some quantifiable NOx reduction, while NOx reductions for projects funded by CMAQ remain unquantified.

Over the past several years, MPOs have been programming a greater amount of funding to the Clean Vehicles program, thereby funding projects that would also be eligible for TERP diesel emissions reduction grant funds. Presumably, these projects should be able to achieve cost-effectiveness results similar to TERP-funded projects, although data comparisons currently do not appear to be available. In addition, in some cases the amount of funds provided for such projects represents only a portion of CMAQ funding. For example, the North Central Texas Council of Governments (NCTCOG), the Dallas–Fort Worth area MPO, reports that of $122.2 million in CMAQ funds programmed for 2003, including funds from prior year's allocations, only $13.7 million was programmed for Clean Vehicles projects. In 2004, of over $100 million in programmed CMAQ funds, only $4 million was for the Clean Vehicles program.

The H-GAC reports that essentially all of its CMAQ funding, and even a portion of its non-CMAQ funding, for fiscal years 2005 and 2006 is going to the Clean Vehicles program. This demonstrates that the H-GAC is taking an aggressive approach to achieving NOx reductions. However, it is not clear what amount of SIP credit each project is receiving. Recommendation 1 would require that all

projects receiving CMAQ funding also receive SIP credit, and that the amount of SIP credit as it relates to each project be made clear. The following rider language to implement this recommendation could be included in the 2006–07 General Appropriations Bill:

> The Department of Transportation shall require that any project receiving Federal Funds from the Congestion Mitigation and Air Quality Improvement Program receive quantifiable credit in the State Implementation Plan (SIP) toward attaining attainment for air quality under the Federal Clean Air Act. In addition, each funded project shall have an amount of SIP credit tied to it, and TxDOT shall provide a report listing each project, the amount of credit each project will receive in the SIP, and the amount of CMAQ funds designated for each project to the Legislative Budget Board and Governor at least annually.

Since the project-by-project detail currently compiled by the H-GAC and NCTCOG currently uses a completely different methodology than the TCEQ in calculating the emissions reductions assigned to each project, it is virtually impossible to compare the cost-effectiveness of the CMAQ and TERP programs. Recommendation 2 would require both TxDOT and TCEQ to report on the cost-effectiveness of CMAQ and TERP expenditures, respectively, and that cost-effectiveness should be reported using a common methodology. Because TCEQ is responsible for ensuring compliance with the Clean Air Act for the state, and because TCEQ already has a performance measure for Average Cost Per Ton of Nitrous Oxides Reduced Per Year through Texas Emissions Reduction Plan Expenditures, a similar measure could be added to TxDOT's bill pattern in the General Appropriations Act. The TCEQ's proposed target for the efficiency measure for fiscal years 2006 and 2007 is $5,000, so a similar target is recommended for TxDOT with respect to CMAQ expenditures.

Because Federal CMAQ Funds appropriated to TxDOT and General Revenue–Dedicated TERP Funds appropriated to the TCEQ both are being spent to achieve a common goals—reduced air pollution and compliance with the Federal Clean Air Act—Recommendation 3 directs the two agencies to work more closely together on targeting funding to projects and categories of projects that each agency can fund while achieving the greatest benefits to air quality and SIP attainment at the lowest cost possible. The two agencies should work together to establish cost-effectiveness guidelines for CMAQ projects and play a greater role in determining whether MPO spending plans maximize use of state funds in terms of pollution reductions. If it is determined that one program is less cost-effective than the other at achieving NOx reductions, funding at the less cost-effective agency should be targeted toward more cost-effective project proposals. Any reduction in the need for General Revenue–Dedicated TERP Account funds would be a savings to the state.

FISCAL IMPACT OF THE RECOMMENDATIONS

None of the recommendations, if implemented, would have a significant fiscal impact during the 2006–07 biennium.

The introduced 2006–07 General Appropriations Bill includes a rider and a performance measure pursuant to Recommendations 1 and 2, respectively.

IMPROVE THE STATE'S MANAGEMENT OF PHARMACEUTICAL COSTS

Like other purchasers of prescription drugs, Texas continues to experience significant increases in the cost of prescription drug benefits. In spite of cost-containment strategies such as restricting formularies, negotiating with providers for favorable pricing, and increasing cost-sharing obligations for beneficiaries, the state's costs continue to rise. These trends are expected to continue as pharmaceutical manufacturers develop new drugs to manage acute and chronic illnesses, brand name prescription drug price growth continues to exceed the rate of inflation, and the population ages.

While the state has recently implemented a number of innovative methods aimed at controlling this cost growth, many of these initiatives have been focused on limiting utilization. Efforts to improve the way the state purchases prescription drugs have been limited by the fact that Texas, in general, manages its spending on prescription drugs in an uncoordinated manner. As a result, it is difficult for the state to take advantage of the combined purchase volume of its health benefit programs through consolidated pharmaceutical purchasing.

In an effort to enhance oversight of state cost-containment strategies and coordination of state pharmaceutical purchasing, the Seventy-seventh Legislature, 2001, created the Interagency Council on Pharmaceuticals Bulk Purchasing. This council is statutorily required, among other things, to analyze the practice of contracting with pharmacy benefit management vendors for services relating to the purchase of prescription drugs. Many states are considering consolidating their state contracting for pharmaceutical purchasing to leverage a larger pool for negotiations with pharmacy benefit managers. Texas, through the Interagency Council on Pharmaceuticals Bulk Purchasing, has had limited success in achieving consolidation of pharmaceuticals purchasing. Establishing a new Pharmaceutical Cost Management Office and giving it certain responsibilities with respect to drug purchasing would position Texas to effectively implement strategies to offset the growth in pharmaceutical costs.

SIGNIFICANT FINDINGS

- Texas health programs spent over $6 billion in the 2004–05 biennium on pharmaceutical purchasing and expect to spend more than $9 billion in the 2006–07 biennium.
- The Employees Retirement System, Teacher Retirement System, The University of Texas System, and Texas A&M University System each have separate contracts with pharmacy benefit managers with different terms.
- Other states have successfully formed intra- and interstate consolidated purchasing arrangements to enhance their ability to manage prescription drug costs.

SIGNIFICANT CONCERNS

- Despite recent cost-containment efforts, new strategies to control the increase in drug costs are needed to limit further shifting of cost increases to beneficiaries. Beneficiaries of certain Texas plans currently pay between 30 and 40 percent of drug costs.
- Texas manages its spending on prescription drugs in an uncoordinated manner and has had limited success in achieving consolidation of pharmaceutical purchasing. As a result, it is more difficult for the state to take advantage of the combined purchase volume of its health benefits program to negotiate the most favorable terms with pharmacy benefit managers and drug wholesalers.
- The Interagency Council on Pharmaceuticals Bulk Purchasing has encountered significant barriers to achieving its goals.
- Standardizing drug benefits may increase efficiency by streamlining administrative functions. This could lead to greater savings in state pharmaceutical purchasing.

RECOMMENDATIONS

- **Recommendation 1:** Amend the Interagency Council on Pharmaceuticals Bulk Purchasing statute to abolish the council, to create and fund a new Pharmaceutical Cost Management Office, and establish an advisory committee, comprised of representatives from all state drug-purchasing entities, to advise the Pharmaceutical Cost Management Office.

- **Recommendation 2:** Direct the Pharmaceutical Cost Management Office to implement and oversee a statewide pharmaceutical purchasing program.

COMMENTS

Prescription drug costs in various state programs continue to rise. State spending including beneficiary cost sharing on prescription drugs is expected to increase from more than $6 billion in the 2004–05 biennium to approximately $9 billion in the 2006–07 biennium. To address escalating costs, state entities have implemented a number of cost-containment strategies, including but not limited to restricting formularies, negotiating with providers for favorable pricing, and increasing cost sharing obligations for beneficiaries.

Entities that contract with the pharmacy benefit managers (PBM) have also implemented a number of cost-control measures. These measures include preferred drug lists (PDL) and prior authorization (PA). A PDL is a listing of prescription products selected by the Pharmaceutical and Therapeutics Committees of each drug plan as efficacious, safe, and cost-effective choices for the plan's beneficiaries. Medications that are not included on the PDL are usually available with the PA by the plan. Prior authorization requires physicians to obtain the plan's approval for obtaining drugs not on PDL by submitting request forms or by calling the plan.

PBM-type entities also negotiate terms that directly affect drug costs. This includes negotiation and review of the ingredient costs, determination of dispensing fees, and establishment of maximum allowable costs for similar medications in established drug classes. The plans can negotiate lower reimbursement fees to the pharmacies by narrowing pharmacy networks. Drug plans also encourage mail delivery of medications to beneficiaries. Drug plans can achieve significant cost reductions if more plan participants receive their medication through mail delivery because plans typically receive larger discounts from PBMs for mail-delivered medications.

In addition, to control increases in costs, health programs have established cost-sharing obligations for beneficiaries, which include deductibles, co-payments, and co-insurance. Plans establish different tiers for drugs depending on their preferred status. Some tiers require significantly higher co-payments, which encourages plan participants to consider other medications. As a result of implementing cost-sharing obligations, beneficiaries of certain Texas plans contribute between 30 and 40 percent of their prescription drug costs.

As another cost control measure, drug plans either require mandatory generic substitution or encourage it by making plan participants pay the difference between the brand and generic versions of the medication.

Texas' Medicaid program, which is similar in its structure to the entities that contract with the PBMs, has also implemented cost-control measures, which include PDL, PA, expanded drug utilization review (DUR), and supplemental rebates. The Medicaid program negotiates supplemental rebates on the drugs included on the PDL. The Medicaid Vendor Drug Program also negotiates prices reimbursed to pharmacies, but it does not require Medicaid recipients to pay a portion of the drug costs.

PDLs and other measures are not applicable to the entities that purchase pharmaceuticals directly from group purchasing organizations and wholesalers. Direct purchasing entities establish limited or close formularies to achieve savings. In addition, direct purchasing entities are researching whether they qualify to receive one of the most favorable pricing schedules negotiated by the federal government, which are known as 340B prices.

One factor that limits the effectiveness of cost-containment efforts is the fact that the state in general manages its multi-billion dollar pharmaceutical spending in an uncoordinated manner. Currently, prescription drug purchasing is administered under 10 different programs, managed separately by at least seven different state entities. Each program is focused on serving the specific needs of a different group, such as employees, retirees of state agencies and their dependents, employees of universities, and employees of public schools. In addition, prescription drugs are also provided to recipients of public assistance and the institutionalized and incarcerated populations of Texas.

While some savings have been achieved through these cost-containment efforts, the state's drug costs continue to rise. Effective enhancements to the coordination of state pharmaceuticals purchasing would result in greater savings.

INTERAGENCY COUNCIL ON PHARMACEUTICALS BULK PURCHASING

To address increasing pharmaceutical costs and the uncoordinated manner in which state programs purchase drugs, the Seventy-seventh Legislature, 2001, created the Interagency Council on Pharmaceuticals Bulk Purchasing (council) and required it to do the following:

- Develop procedures that member agencies must follow in the purchasing of pharmaceuticals unless the member agency can purchase the pharmaceuticals for a lower price than it can through the council.
- Designate one member agency to be the central purchasing agency for purchasing pharmaceuticals.

- Use existing distribution networks, including wholesale and retail distributors, to distribute the pharmaceuticals.
- Develop procedures under which the council may disclose information relating to the prices that manufactures or wholesalers charge for pharmaceuticals according to the category of pharmaceutical.

Council membership includes the Department of Health (TDH), the Department of Mental Health and Mental Retardation (MHMR), the Correctional Managed Health Care Committee (TDCJ), the Employees Retirement System of Texas (ERS), the Teacher Retirement System (TRS), the Health and Human Services Commission (HHSC), and the Texas Building and Procurement Commission (TBPC).

The council achieved its first objective by developing procedures that member agencies should follow in the purchasing of pharmaceuticals. These procedures were designed separately for entities that buy drugs directly from group purchasing organizations (GPO) or wholesalers, and entities that reimburse for the purchase of pharmaceuticals. Procedures for both types of entities required agencies to compare prices to determine which entities were receiving more favorable prices for the pharmaceuticals. Price comparison, if executed as it was intended, could position the member agencies to negotiate better prices for state programs.

Member agencies have regularly compared certain pricing information as directed by council procedures. However, because certain factors are not included in the pricing information compared, the utility of this practice is unclear. In particular, prices reported by agencies that use PBMs include only the average ingredient cost and dispensing fee and do not include the amount of rebate each agency has negotiated in its contracts, nor does this comparison takes into account other differences in each plan, such as administrative costs. This activity compares only the relative drug price and does not provide a comparison of drug costs.

The council has encountered barriers in comparing detailed pricing information due to confidentiality issues. Statutory provisions governing the council's price comparison activity prohibit the council or its members from disclosing the prices charged by a specific manufacturer or wholesaler for a specific pharmaceutical. Information made confidential by those provisions is also confidential while in the possession of a member agency, which prohibits a council member representing an agency from sharing that information with his or her agency. The interpretation of these provisions by the Office of Attorney General, in part, led to the HHSC Deputy Commissioner for Health Services in the letter to the Council of October 21, 2003 to state that the council's price information gathering activity is a "meaningless activity." As a result, HHSC has requested that the council work with stakeholders to recommend statutory changes that would improve the council's capabilities in this regard.

The council has not achieved its mandate to designate one member agency to be the central pharmaceutical purchasing agency for the state. The council reports that this requirement does not seem feasible and is not practical given the differences in populations served by each agency, the dissimilar structure of agency programs, and that no agency has the resources or expertise to manage pharmaceutical purchasing for all member agencies.

The council has proven to be beneficial to entities that directly purchase pharmaceuticals from GPOs or wholesalers, which include TDCJ and former TDH and MHMR. As directed by the council's procedures, TDH and MHMR were able to successfully negotiate a joint contract with a pharmaceutical wholesaler leveraging lower pricing based on their combined purchase volume. The council reported that the estimate of savings from the joint contract totaled $2.7 million in All Funds in fiscal year 2003. In addition, effective December 1, 2003, TDCJ joined with TDH and MHMR in its contract for pharmaceutical purchasing, achieving preferable terms based on the combined volume of business.

Overall, the council indicates that the procedures it has established provide an opportunity to improve the exchange of information among agencies, encourage interagency coordination in purchasing activities, identify best practices, and assist the legislature in evaluating agency pharmaceutical expenditures. However, efforts to aggregate statewide drug purchasing have been minimal, with the council's focus concentrated on savings for individual agencies. For example, little effort was made to achieve savings through joint contracting by entities that utilize PBMs.

In annual reports submitted in 2003 and 2004, the council recommended removal of the requirement to designate a central purchasing agency. The council is currently preparing its recommendations for the Seventy-ninth Legislature, 2005. Among the options considered by the council's members is the elimination of the council to be replaced with a non-governmental body.

STATE ENTITIES CONTRACTING WITH THE PHARMACY BENEFIT MANAGERS

The council helped direct purchasing entities to achieve savings from receiving a deeper discount rate from the pharmaceutical wholesaler McKesson Corporation. In

contrast, the council has done little to assess the potential to achieve savings through the consolidation of the PBM contracts for its own member agencies, ERS and TRS. In addition, there are at least two more state entities that contract with the PBMs, which are The University of Texas System (UT) and the Texas A&M University System (A&M). Neither of these entities participates in the work of the Council.

To provide drug benefits to the plan participants, ERS, TRS, UT, and A&M contract with PBMs for various services including establishment of a pharmacy network, claims administration, formulary management, manufacturer price, and dispensing fee negotiations.

All of these entities contract separately with a PBM for drug benefit administration for their beneficiaries. Contract terms are considered to be proprietary information; therefore, the state entities believed they were severely restricted from comparing the terms of the contacts with each other.

Figure 1 shows the PBMs contracting with the state entities, populations represented by each entity (not including health maintenance organizations), and the fiscal year 2004 drug expenditures of the plans and plan participants.

State health plans differ by method of finance, statutory requirements, population covered by the plans, and plan designs. The Medicaid program offers drug benefits as part of the state's public assistance program. Drug benefits provided through the Medicaid program have to meet the federal government's requirements.

Drug benefits in commercial plans, which include ERS, TRS, UT and A&M, differ based on each entity's determination of the plan design. The areas in which drug benefits differ between plans include drug formulary, copayment or

FIGURE 1
STATE PHARMACY BENEFIT MANAGER CONTRACTORS' PROFILES FOR FISCAL YEAR 2004

ENTITY	CONTRACTOR	EFFECTIVE DATE OF THE CONTRACT WITH THE PBM	NUMBER OF PEOPLE COVERED	FISCAL YEAR 2004 PLAN DRUG EXPENDITURES ALL FUNDS (IN MILLIONS)	PARTICIPANTS' COST SHARE FOR DRUGS IN FISCAL YEAR 2004 (IN MILLIONS)	TOTAL FISCAL YEAR 2004 DRUG COST (IN MILLIONS)
ERS	Medco Health Solution (Medco)	September 1, 1999–August 31, 2002; September 1, 2002, amended September 1, 2004	455,000	$246.4	$158.2	$404.6
TRS	TRS–Active Care: Medco	September 1, 2002	229,400	$98.8	$48.9	$147.7
	TRS–Care: (Medco through 9/1/04); Caremark	Medco: September 1, 2001, amended September 1, 2002 Caremark: September 1, 2004	180,000	$200.6	$83.9	$284.5
UT	Medco Health Solutions	September 1, 2003	97,000	$62.7	$26.3	$89.0
A&M	Eckerd Health Services	September 1 2001; Amended September 1, 2003	33,000	$21.5	$11.2	$32.7
Total for PBM-type entities			944,400	$630.0	$328.5	$958.5
Medicaid	Work done in-house.	HHSC solicited bids for PBM services, and is currently in the process of making determination.	2.8 million	$2,158.1	N/A	$2,158.1
Total with Medicaid			3.7 million	$2,788.1	$328.5	$3,116.6

SOURCES: Legislative Budget Board; Health and Human Services Commission; Employees Retirement System; Teacher Retirement System; The University of Texas System; Texas A&M University.

coinsurance, incentives for mail delivery of the drugs, and generic substitution requirements. Drug plans also differ in the tools used to manage drug utilization, such as PDL, PA, drug utilization (DUR) and disease-management programs, and drug pricing. These areas represent the basis for negotiations of contract terms between state entities and the PBMs.

DRUG BENEFIT TERMS FOR CONTRACTING STATE ENTITIES

In general, drug costs are determined by many components that are negotiated through contract terms. The primary negotiated components are ingredient costs and dispensing fees for the retail pharmacy portion and mail delivery portion, rebates, and various administrative fees associated with matters such as claims processing, disease-management programs, and meeting other requirements of clients.

The Legislative Budget Board (LBB) staff review of the contracts between state entities such as ERS, TRS, UT and A&M, showed that even though there are similarities in the contract terms for drug benefit, there are differences as well. Some state entities have deeper discounts on the ingredient costs side, while others pay slightly more for various administrative aspects of the drug coverage. Dispensing fees appear to be consistent in most cases across the board. In some cases, the participating pharmacy networks are different.

The literature indicates that entities contracting with the PBMs can negotiate flat and guaranteed rebates as well as market-share or tiered rebates. Flat and guaranteed rebate amounts or percentages do not change depending on the utilization, while market-share or tiered rebates increase with the increase in the utilization of the drugs. It appears that the four entities (ERS, TRS, UT, and A&M) negotiated similar guaranteed rebates. Guaranteed rebates require less verification from the plan's staff; however, there is little information about what types of rebates would benefit the state the most. In cases where guaranteed rebates differed, administrative costs differed as well.

Overall, even through it appeared that in some cases some plans were receiving better individual terms for drug cost components, it does not necessarily mean that these plans were receiving a better financial deal overall. To determine which contract is in the state's best interest would require analyzing each plan's drug utilization and purchasing methods (retail versus mail order utilization) in the context of each other plan's contract terms. This would require actuarial analysis.

Research suggests that larger plans may receive better financial terms from the PBMs; therefore, smaller plans could benefit from consolidation. A recent actuarial study looked at the cost-benefit analysis of consolidating the ERS and A&M health plans and concluded that the A&M Care prescription drug reimbursement was approximately 2 percent higher than the ERS arrangement.

ESTABLISHMENT OF THE PHARMACEUTICAL COST MANAGEMENT OFFICE

Recommendation 1 calls for the abolishment of the Interagency Council on Pharmaceuticals Bulk Purchasing and the establishment of a new independent Pharmaceutical Cost Management Office (office). The office could be administratively attached to ERS, which would provide administrative support and office facilities. The office could also be funded through ERS whereby ERS collects funds through interagency contracts from the 20 state agencies identified in the proposed contingency rider. At the same time, the office should be an independent entity and represent interests of the state as a whole and not those of a particular state entity. The Board of Trustees governing ERS should not have authority over the office. The executive director of the office should be appointed by the governor with the approval of the lieutenant governor and the speaker of the House of Representatives. The executive director would be responsible for hiring and managing a staff of five full-time employees.

In addition, Recommendation 1 creates an advisory committee comprised of representatives from state drug purchasing entities (which include former council member agencies), representatives of community centers for mental health and mental retardation, and representatives institutions of higher education. Other governmental entities should be invited to participate in the advisory committee.

Recommendation 2 directs the office to implement and oversee a statewide pharmaceutical purchasing program. Core responsibilities of the office should include the following:

- centralized review and approval authority over contracting;
- statewide purchasing and payment procedures;
- implementation and monitoring of cost-containment strategies;
- analysis of inter- and intrastate consolidation of contracting; and
- analysis of other pharmaceutical purchasing issues such as drug importation.

In executing the above responsibilities, activities of the office should include the following:

- Conduct inventory of the state-funded programs that purchase pharmaceuticals, analyze expenditures, and examine drug utilization trends.

- Review current purchasing and payment procedures at the state-funded program.
- Identify current cost-containment measures implemented by each plan.
- Identify additional cost-containment measures that would be beneficial to the plans and the state.
- Use approval authority over contracting for pharmaceuticals purchasing.
- Conduct a feasibility and cost-effectiveness drug importation study.
- Analyze interstate and intrastate consolidation of contracting for pharmaceuticals purchasing.
- Analyze cost-benefit and feasibility of implementing a single contract for the purchasing of prescription drugs for entities that contract with pharmacy benefit managers.
- Analyze the cost-benefit of standardizing various state prescription drug benefits to achieve additional savings.
- Analyze local governments' participation in the state purchasing arrangements.
- Report program activities to the Legislative Budget Board and the Governor's office on a semi-annual basis, with the first report to be submitted no later than February 28, 2006.

The office should determine the cost-benefit and feasibility of consolidating contracts for the entities that contract with PBMs for drug benefit management services. This analysis could include ERS, TRS, UT, A&M, and other governmental drug purchasers, such as Medicaid, CHIP, community mental health and mental retardation centers, and local governments. The analysis could be done via RFP or RFI and would enable the office to determine whether the state could achieve savings from a consolidated intrastate aggregate purchasing arrangement.

Such an analysis does not assume major changes to the existing structures of the entities. State entities selected for consolidated contracting could remain responsible for managing drug benefit programs for their beneficiaries and could continue to receive funding for programs under existing procedures. The office should be able to negotiate the terms of a contract for a majority of the programs that reimburse for medication through PBMs. In addition, state policy makers could have more access to comparable information relating to the pricing, arrangements, and cost-containment strategies of state programs.

Standardization of benefits across state plans should be contingent on the results of the analysis governing the establishment of a single contract for PBM-type entities. If feasible, the state could realize greater savings if benefits across state plans are made comparable, and if the tools utilized in those plans, such as PDL, PA, DUR, and pharmacy networks, among others, are standardized across the plans.

The office should be required to provide semi-annual reports on the activities and results of the studies to the Legislative Budget Board and the Governor's Office. The first report should be submitted no later than February 28, 2006.

If the recommendations were to be implemented, the Pharmaceutical Cost Management Office could be funded via the following contingency rider added to Article IX in the 2006–07 General Appropriations Bill:

Contingency Appropriation for Senate/House Bill XXXX: Pharmaceutical Cost Management Office

(a) Contingent upon enactment of Senate/House Bill XXXX, or similar legislation relating to establishment of a new Pharmaceutical Cost Management Office, the following shall take effect: The Employees Retirement System is hereby authorized to collect funds to be used by the Pharmaceutical Cost Management Office for a statewide pharmaceutical purchasing program through interagency contracts with the 20 state agencies identified by this section. A new strategy is hereby created in the Employees Retirement System's bill pattern, Statewide Drug Cost Containment, and funds received through interagency contract shall be deposited to the new strategy and appropriated to the Pharmaceutical Cost Management Office for the purposes of overseeing a statewide pharmaceutical purchasing program.

(b) Each agency identified by this section shall provide $50,000 for fiscal year 2006 via interagency contract by October 1, 2005, and $50,000 for fiscal year 2007 via interagency contract by October 1, 2006, to the Employees Retirement System to fund the Pharmaceutical Cost Management Office for the purpose of overseeing a statewide pharmaceutical purchasing program. If an agency has not executed the contract by the specified date, then the Comptroller of Public Accounts shall transfer the funds.

(c) The 20 state agencies having the greatest number of employees shall contract with the Employees Retirement System to fund the Pharmaceutical Cost Management Office for the purpose of overseeing a statewide pharmaceutical purchasing program. The State Auditor's Office and Employees Retirement System shall cooperate to identify the 20 state agencies with the greatest number of employees. Unless the State Auditor's Office and Employees Retirement System cooperatively identify other agencies to be substituted on the list of 20 agencies subject to this section, the 20 agencies subject to this section include:

1. Texas Education Agency;
2. Texas Health and Human Services Commission;
3. Texas Department of Transportation;
4. Department of Aging and Disability Services;
5. Texas Department of Criminal Justice;
6. Department of State Health Services;
7. Department of Family and Protective Services;
8. Texas Workforce Commission;
9. Texas Building and Procurement Commission;
10. Texas Department of Insurance;
11. Department of Public Safety of the State of Texas;
12. Office of the Attorney General;
13. Texas Commission on Environmental Quality;
14. Railroad Commission of Texas;
15. Texas Youth Commission;
16. General Land Office and Veteran's Land Board;
17. Parks and Wildlife Department;
18. Texas Lottery Commission;
19. Comptroller of Public Accounts; and
20. Texas Alcoholic Beverage Commission.

NATIONAL TRENDS IN CONSOLIDATING PHARMACEUTICAL PURCHASING

Many states are considering and pursuing aggregate or bulk purchasing approaches to increase bargaining power from larger populations and to receive greater discounts and rebates. In addition, the states can reduce their administrative expenses and standardize their benefits across programs, which can streamline the administration and provide the basis for even greater savings. There are several existing programs used by states to aggregate pharmaceutical purchasing. In general those models include interstate pooling of either Medicaid or commercial PBM-type contracts and intrastate consolidated purchasing arrangements for both commercial and Medicaid plans.

INTRASTATE POOLING OF PHARMACEUTICAL PURCHASING

While many states are studying the possible benefits from consolidating their contracts for PBM services, one state, Georgia, has achieved this consolidation. In 2000, Georgia's Department of Community Health (Department) executed a contract with the PBM, Express Scripts, for administration of the drug benefit for approximately 2.1 million beneficiaries covered through the Medicaid and CHIP program, Georgia's public employees' benefit program and drug benefit program for employees of higher education covered through the Board of Regents.

Public assistance programs and the public employees' benefit program are housed in the department, while the Board of Regents is a separate entity, which chose to join the statewide contract because of the benefits achieved by the consolidated contract.

Even though there is only one contract for all programs, the programs have different benefits, PDL, and PA rules, and each program makes a separate payment to the contractor for the services received. The plan that covers state employees went from using one PDL to working with two PDLs to offer a less expensive coverage option for the state employees.

The state's savings were expected to be up to $100 million (a one-time decrease) as a result of consolidating the contracts and running the drug programs through a PBM. Estimated savings can be attributed to a number of measures, including establishment of the PDL, PA, and DUR. Direct savings from consolidation are difficult to estimate because Georgia's programs went from covering drug benefits as a part of the medical benefit to managing drug benefits separately with selected cost-containment measures. However, Georgia's staff indicates that there are savings in the administrative costs associated with the management of the contract, benefits of shared knowledge, and advantages arising from the accessibility of

information to different programs that is necessary for the decision-making process.

Georgia's Auditor Office is expected to complete a review of the consolidated contracting effort in January of 2005. A portion of this audit will concentrate on the savings associated with the contract consolidation.

West Virginia created a Pharmaceutical Cost Management Council (PCMC) charged with finding ways to reduce prescription costs for every West Virginia resident. The bill that created the PCMC specified numerous strategies for cost reduction in drug purchasing to be researched by the PCMC, which include developing a pricing schedule based on the Australian and the U.S. federal government's prices (both for West Virginia alone and for the multi-state arrangement), investigating drug importation, and obtaining discounts for the uninsured and seniors.

The PCMC recommended consolidating drug purchasing by all state agencies in a cabinet-level Office of the Pharmaceutical Advocate (OPA). The OPA would have the buying power for a group of 500,000 beneficiaries that includes 298,000 Medicaid recipients and 205,000 public employees.

With regard to drug prices, the PCMC recommended using the Federal Supply Schedule (FSS) as a benchmark to determine how much the state is willing to reimburse for various medications. FSS prices are substantially lower than the prices offered by PBM organizations or drug manufacturers for the Medicaid program. In addition, the state could become a virtual wholesaler and require drug manufacturers with which it contracts to extend negotiated prices to the local pharmacies.

Illinois, by executive order of the governor, created the Special Advocate for Prescription Drugs. The Special Advocate is authorized to create a central purchasing program to review all contracts and programs at agencies that relate to the purchase of or payment for prescription drugs. Other duties and authority of the special advocate include the following:

- Develop and implement a policy for purchases and payments of prescription drugs.
- Negotiate for or coordinate the negotiation of contracts, reimbursement rates, and rebates.
- Review all existing contracts for prescription drugs and direct agencies to continue, freeze, or terminate those contracts.
- Combine any and all programs and contracts at the various agencies for purposes of negotiating reimbursement rates, rebates, or other terms.
- All state contracts related to the purchase of or payment for prescription drugs are subject to the approval of the special advocate.

INTERSTATE POOLING OF PHARMACEUTICAL PURCHASING

Efforts to combine and leverage a larger volume of business are not limited to consolidation within a state. There has been significant interest on the part of states in joining or forming interstate pooling programs to purchase prescription drugs in the hopes of achieving savings through increased market power, improved efficiency, and benefits management. A leading example of this effort is the drug purchasing pool named Rx Issuing States (RxIS).

In 2001, officials representing state employees, Medicaid programs, and senior programs from nearly 20 states participated in a pharmacy workgroup brought together to foster cooperation among states in addressing increases in prescription drug costs. Following this pharmacy workgroup, West Virginia joined together with Missouri, New Mexico, Delaware, and Ohio to form RxIS. Participating states issued a request for proposal and selected Express Scripts to act as the coalition's PBM. Several additional states considered joining RxIS but opted instead to remain with their then-current PBMs.

RxIS states sought in their contracts with a PBM to receive the full rebate paid by drug manufacturers while paying higher administrative fees to the PBM in what is referred to as an "administrative services only" contract. Each RxIS state has a separate contract with Express Scripts with a range of plan design options to choose from, the pricing of which is based on the pool's aggregate number of covered participants. In such arrangements, savings depend on the state's receipt of 100 percent of manufacturer rebates, and on leveraging enhanced bargaining power and reduced unit costs for services based on the volume of the combined pool.

In total, RxIS reportedly aggregates approximately 700,000 covered individuals. RxIS consists, primarily, of commercial (non-Medicaid) plans from each participating state, although West Virginia's State Children's Health Insurance Program (which is not administratively attached to the state's Medicaid program) also utilizes RxIS for drug benefits. Literature describing RxIS claims that savings from participating in the pool can come from the following:

- A pass through of 100 percent is possible for manufacturers' rebates, which could be greater than the increase in administrative fees. This type of rebate arrangement with a PBM is attributed, in part, to the collective bargaining power of states that issued the RFP.

- As drug costs escalate, so do rebates.
- Administrative fees are based on a sliding scale that correlates to the pool's volume—the greater the number of covered lives in a pool the lower per-unit administrative costs.
- The expansion of pools is expected to enhance the PBM's ability to negotiate with drug manufacturers for lower drug prices and higher rebates.
- Audit costs can be less if shared among participating states.

All states that participate in RxIS have reportedly experienced savings. West Virginia, representing approximately 30 percent of RxIS' covered lives, reportedly realized $7 to $8 million in net savings in the initial year and anticipates $25 million in savings over the first three years. Delaware, with approximately 104,000 covered lives, saved approximately $1.1 million by joining RxIS. Missouri, with approximately 100,000 covered lives, saved approximately $2 million in the initial year and now reports that in subsequent rebidding, it has left the RxIS pool but retained Express Scripts as its PBM.

ERS reviewed a sample RxIS contract in August of 2002 and compared it to ERS' current PBM contract. ERS indicates that the comparison showed the terms of ERS' contract to be more favorable in the areas of administrative fees, formulary management fees, mail service rates, rebates, and disease management fees.

The benefit of participation in an interstate pool aggregating covered lives is based on the theory that the greater the volume, the better the opportunity for enhanced negotiations with PBMs and drug manufacturers for more favorable contract terms. The challenge in joining or forming an interstate pool lies in navigating multiple state regulations and political interests and the time and will required to conduct the analysis and negotiations necessary to first, determine if savings can be achieved, and, second, execute a sound contract to deliver those identified savings.

The Minnesota Multi-state Alliance for Pharmacy (MMCAP), created in 1985, is a voluntary cooperative purchasing group, managed and operated by the Materials Management Division of Minnesota's Department of Administration. MMCAP was created to combine the purchasing power of its members to receive the best prices available for pharmaceuticals, hospitals supplies, and related products. MMCAP contracts with over 160 pharmaceutical manufacturers; its membership includes programs from 41 states. While no aggregate savings estimates are available for MMCAP, the National Conference of State Legislatures reports that the average discount is approximately 23.7 percent below average wholesale drug prices for brand name pharmaceuticals and 65 percent below average for generics.

Many states are following the developments in consolidated purchasing and are studying the possible benefits of joining and forming new pools. For example, in November of 2004, Indiana's State Budget Agency issued a report examining the feasibility, costs, and legal parameters of Indiana's participation in one of the intra- or interstate aggregate purchasing programs. The report discussed three multi-state prescription drug purchasing programs, and concluded that participation in a program of this type is feasible for Indiana.

In addition, because Indiana has already conducted an extensive request for proposal process as part of the establishment of an intrastate drug-purchasing program, the state is in the position to assess the benefits of such an arrangement. The assessment could be done through a review of the proposed financial and administrative terms and a comparison of the terms in the state's existing programs. Having detailed information as a result of the RFP places Indiana in an advantageous position for its decision-making process about consolidated pharmaceuticals purchasing.

FISCAL IMPACT OF THE RECOMMENDATIONS

Because the office is funded out of budgeted appropriations through interagency contracts with the 20 state agencies having the greatest number of employees, the estimated cost of Recommendations 1 and 2 would not have a fiscal impact on the introduced 2006–07 General Appropriations Bill. An estimated cost of $2 million for the 2006–07 biennium is based on the following assumptions:

- four to six full-time employees who have state purchasing and pharmaceutical expertise;
- budget for contracted services including legal, financial, actuarial, and pharmaceutical safety consulting services; and
- budget for travel and other overhead expenses.

Although it is reasonable to assume that significant savings would result from the implementation of statewide pharmaceutical purchasing program, the number of variables involved precludes a close approximation of the savings at this time.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations.

INCREASE CONSOLIDATION OF DATA CENTER SERVICES TO MAXIMIZE THE POTENTIAL FOR SAVINGS

Over the past decade, Texas has experienced some success in consolidating the management of data center services. Currently, data center service costs of major state agencies total approximately $447.0 million each biennium. Based on fiscal year 2004 totals, approximately $76.0 million of biennial data center service costs are managed in a consolidated manner within the state data center system. As a result, there remains significant opportunity for further consolidation to maximize potential savings. The Legislative Budget Board staff estimate that the state could potentially save $18.5 million in All Funds by the end of fiscal year 2010 from further consolidation of data center services. In addition, opportunities exist for institutions of higher education to consolidate the management of data center services. While some institutions of higher education use the state data center system for such services as business continuity planning, only one institution has consolidated fully within this system.

SIGNIFICANT CONCERNS

- According to the Department of Information Resources, state agencies and institutions of higher education continue to operate a significant number of data center facilities independent of the state data center system. As a result, the state continues to own a number of decentralized data centers in numerous locations with varying resource requirements, driving unnecessary overhead costs.
- Operational data available on independent data center services managed by state agencies and institutions of higher education is based on self-reported, mostly unverified data from surveys. While this data is useful in providing estimates concerning overall size and cost, it is not adequate for detailed strategic planning purposes because it is not reliably accurate, consistent, or detailed.

RECOMMENDATIONS

- **Recommendation 1:** The Department of Information Resources should recommend to the Seventy-ninth Legislature, 2005, a plan to consolidate the management of state agency data center services. This report should be submitted to the legislature no later than March 31, 2005 to facilitate legislative action.
- **Recommendation 2:** Include a rider in the 2006–07 General Appropriations Bill that requires each institution of higher education to conduct a detailed inventory of their data center services and report this information to the Department of Information Resources.

COMMENTS

In May 2004, the Department of Information Resources (DIR) issued a report, *A Foundation for Change*, outlining a strategy to maximize the value of the state's information technology resources. In the report, DIR identified the need for a shared technology infrastructure managed in a consolidated manner, including data center services.

As a key aspect of the state's technology infrastructure, data centers provide information technology services to state agencies and institutions of higher education. Generally, a data center is a centralized facility dedicated to the management of information resources including people, processes and technologies. Figure 1 provides a listing of typical data center services.

State data centers range significantly in size, scope and complexity. DIR classifies data centers based on the type and number of mainframes and servers, number of full-time-equivalents (FTEs), budgeted costs, and environmental modifications (e.g., installation of back-up power supply systems, raised flooring, and supplemental air conditioning). Figure 2 identifies the basic characteristics of each class of data center.

DATA CENTER CONSOLIDATION AND SAVINGS OPPORTUNITIES

Like other technology infrastructure, such as telecommunications, data center services are typically provided more efficiently and cost-effectively when managed in a consolidated manner. Consolidation provides for the optimization of technologies in one or more large, centralized data centers to achieve costs savings, improve performance, and mitigate risks.

Figure 3 depicts the common areas of consolidation when data center services are managed in a consolidated manner. For example, one of the benefits of data center service consolidation outlined in Figure 3 is the opportunity to merge storage systems using technologies such as storage area networks (SAN) and network attached storage (NAS) to achieve economies of scale and lowered cost of ownership.

FIGURE 1
TYPICAL DATA CENTER SERVICES

1. Operational Services
   a. Mainframe and server operations
   b. Production control
   c. Tape management
   d. Direct Access Storage Device (DASD) management
   e. Front-end systems operations
   f. Physical security operations
   g. Uninterrupted power supply management
   h. Print operations
2. Technical Services
   a. Operating system support
   b. Vendor application support
   c. Physical and logical database application support
   d. Operating system conversion
   e. Operating system upgrades
3. End-User Support Services
   a. Help desk
   b. Data security administration
   c. Product application training
   d. Server/workstation backup
   e. Server/workstation software distribution
4. System Management Services
   a. Disaster recovery planning
   b. Service level management
   c. Problem management
   d. Change management
   e. Recovery management
   f. Capacity management
   g. Requirements management
5. Business Continuity Management Services
   a. Off-site storage of data
   b. Cold-site availability
   c. Hot-site availability
6. Network Services
   a. Local area network management
   b. Wide area network management
7. Security Management Services
8. Email Management Services

SOURCE: Legislative Budget Board.

FIGURE 2
DATA CENTER CLASSIFICATIONS

TYPE	MAINFRAMES		SERVERS		FTES		ANNUAL BUDGET		MODIFICATIONS
Data Center Facility	≥ 1	or	≥ 50	or	≥ 6	or	≥ $1 million	or	High (2 or more modifications)
Concentrated Computing Facility	–		≥ 5 – 49	or	1 – 5	or	$50,000 – $999,999	or	Medium (1 modification)
Server Closet Facility	–		≥ 1 – 5		–	&	≤ $49,999		–

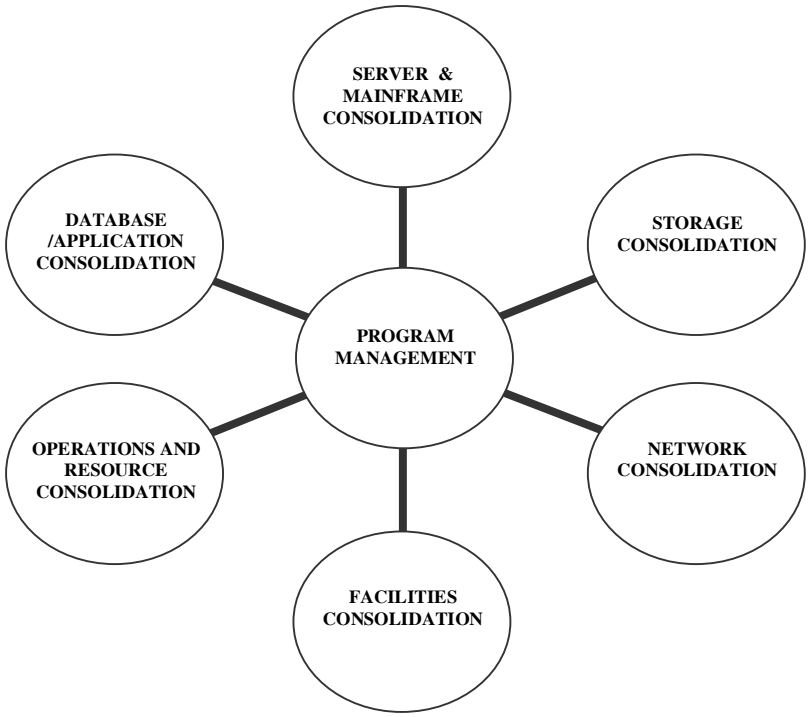
SOURCE: Department of Information Resources.

In addition to the savings gained in the areas outlined in Figure 3, data center service consolidation produces specific cost savings according to Gartner, Inc., a leading provider of analysis in the information technology industry, including the following:

- reduced hardware needs based on lower total requirements for data storage systems;
- lower software costs including greater discounts negotiated when purchasing systems from fewer suppliers and in larger average order sizes. For many larger-scale systems, the incremental cost for software decreases as systems get larger, and for smaller systems, a merger can reduce duplicate licensing;
- reduced facilities costs due to the need for less floor space including reduced rental expenses and lower power consumption; and
- reduced staffing needs in operations and systems support, help desk and network support, application development, and asset administration.

In another study, Gartner found that organizations can significantly reduce their total data center service budgets by implementing real-time infrastructure solutions including

FIGURE 3
DATA CENTER CONSOLIDATION SAVINGS OPPORTUNITIES



SOURCE: Accenture Data Center Offerings Presentation.

platform standardization, server rationalization, and archival and other automation tools. The study stressed, however, that cost savings will vary based on the proportion of mainframe versus server spending, and savings will be greatest in organizations with larger proportions of server costs that have not standardized platforms, implemented automation tools, or consolidated the way they manage their services.

DATA CENTER CONSOLIDATION NATIONAL TRENDS

Texas is not alone in its efforts to optimize information technology operations and reduce unnecessary costs through data center service consolidation. Many other states are planning or have already implemented consolidation initiatives including the following:

- California—California is considered a public sector leader in the consolidation of data center services with the establishment of the state's Teale Data Center serving over 200 state agencies and the Health and Welfare Data Center serving 11 of the largest human service agencies. Today, California is taking the next step in consolidation. It is merging these two large data centers into a state data center system by building a high-capacity, high-performance network between the two sites. This will facilitate further savings including server rationalization, which involves replacing the many smaller servers with a few larger ones operating multiple applications.
- Oregon—Oregon is in the process of consolidating its three major data centers and eleven smaller centers (representing 80 percent of the state's capacity) into a single data center, thereby reducing the cost of managing the state's mainframes, servers, storage systems, and networks. The governor estimates savings of between $10 million and $20 million per year.
- South Carolina—South Carolina projects $30 million in savings over a 10-year period through consolidation of 11 departmental data centers. While the evaluation assessment of the consolidation initiative projected an initial bump in costs in the first two years over the baseline cost, the state is already experiencing savings with second-year costs below the original baseline cost analysis.

As DIR focuses on developing an effective data center services consolidation strategy, it will be helpful to examine the different strategies that have been implemented in other states to increase savings in Texas.

THE STATUS OF DATA CENTER CONSOLIDATION IN TEXAS

Today, Texas has two data center facilities: one in San Angelo known as the State Data Center (SDC) and the other in Austin known as the Austin Disaster Recovery and Operations Center (ADROC). The operational vendor of these facilities provides data center services to state agencies, institutions of higher education, and other public sector entities in a consolidated manner. In fiscal year 2004, the state data center system served more than 50 different public sector entities in Texas.

Currently, approximately $38 million annually (fiscal year 2004) in data center services are provided in a consolidated manner by the operational vendor of the state data center system, including server and mainframe management services, business continuity planning services, seat management services, and other services such as application maintenance.

Figure 4 shows the state agencies with contracts for data center services provided in a consolidated manner.

In addition to the firm, fixed-price contracts for data center services provided at the SDC totaling approximately $29.0 million, there are over 30 time and material contracts for services such as business continuity planning and application maintenance services at ADROC, totaling approximately $1.5 million annually in fiscal year 2004. The operational vendor of the state

FIGURE 4
CONSOLIDATED DATA CENTER COSTS
ESTIMATED FISCAL YEAR 2004 (IN MILLIONS)

AGENCY	CONTRACT BEGIN DATE	CONTRACT END DATE	SERVICE TYPE	ESTIMATED FY 2004
STATE DATA CENTER SERVICES				
Texas Department of Criminal Justice	9/3/02	8/31/07	Mainframe Outsourcing	$6.3
Health and Human Services Commission	10/31/00	8/31/05	Client Server Outsource (TIERS)	$4.7
Office of Attorney General–Child Support Only	9/1/02	8/31/07	Data Center Outsourcing	$5.5
Health and Human Service Commission	9/14/01	8/31/04	Peoplesoft Application Support and Hosting	$2.7
Texas Education Agency	12/1/97	8/31/07	Mainframe Outsourcing	$2.7
Texas Workers' Compensation Commission	6/1/98	8/31/07	Mainframe Outsourcing	$2.1
Department of State Health Services	10/1/98	8/31/07	Mainframe Outsourcing	$2.2
Department of Public Safety	1/14/04	8/31/13	Client Server Outsourcing	$0.4
Texas Department of Transportation	12/1/01	11/30/04	Peoplesoft Production	$0.9
Texas Workforce Commission	9/1/03	8/31/04	Client Server Outsourcing	$0.5
Texas Department of Agriculture	9/1/02	8/31/07	Data Center Outsourcing	$0.3
Texas Alcoholic Beverage Commission	4/1/01	8/31/07	Data Center Outsourcing	$0.2
Texas Parks and Wildlife	6/22/99	8/31/07	Mainframe Outsourcing	$0.3
Texas Online	9/1/03	8/31/06	Facilities Support	$0.1
Angelo State University	12/1/97	8/31/07	Mainframe Outsourcing	N/A[1]
Total				$29.0
AUSTIN DISASTER RECOVERY OPERATIONS CENTER SERVICES				
Time and Materials Contracts				$1.5
NON-SITE BASED SERVICES				
Disaster Recovery and Seat Management				$7.5
TOTAL, CONSOLIDATED DATA CENTER COSTS				**$38.0**

[1] Angelo State University (ASU) receives services on an in-kind basis from the operational vendor.

SOURCES: Legislative Budget Board; Department of Information Resources.

data center system also provides non-site-specific services such as certain disaster recovery and seat management services in a consolidated manner. In fiscal year 2004, the estimated value of these services totaled $7.5 million.

Also, some agencies have executed individual contracts for data center services directly with the operational vendor of the state data center system. While these services are provided under contract to the state, they are not provided within the state data center system in a consolidated manner. Instead, they are provided under separate contract agreements at independently managed data center facilities. As a result, the state may be losing out on the benefits of economies of scale, reducing the potential for savings. The value of these contracts totaled $24.5 million in fiscal year 2004.

According to DIR, state agencies continue to operate and maintain many independent facilities providing data center services with some large agencies managing multiple facilities. As a result, the state continues to manage a number of decentralized data center facilities in numerous locations with varying resource requirements, driving unnecessary overhead costs.

Based on an analysis of financial data from the information technology detail (ITD) submitted with agency legislative appropriations requests (LARs), the estimated cost of independently managed data center services at major state agencies is $161 million annually.

In addition, DIR estimates that based on State Information Technology Asset Reporting (SITAR) operational data, state agencies operate at least 2,000 servers and almost 20 mainframe systems independent of the state data center system. Figure 5 displays a proportional breakdown of the costs associated with the different approaches utilized to manage data center services in the state.

Institutions of higher education also operate a significant number of independent data center facilities and manage at least 3,500 servers and more than 25 mainframe systems. These estimates are based on third-party surveys conducted in 2003 by EDUCAUSE, a technology in higher education nonprofit association. While the survey, which included over 40 Texas institutions of higher education, did not specifically focus on data center services, it did yield useful summary-level information on the extent of these services at institutions of higher education in Texas.

ADEQUACY OF REPORTED DATA FOR STRATEGIC PLANNING

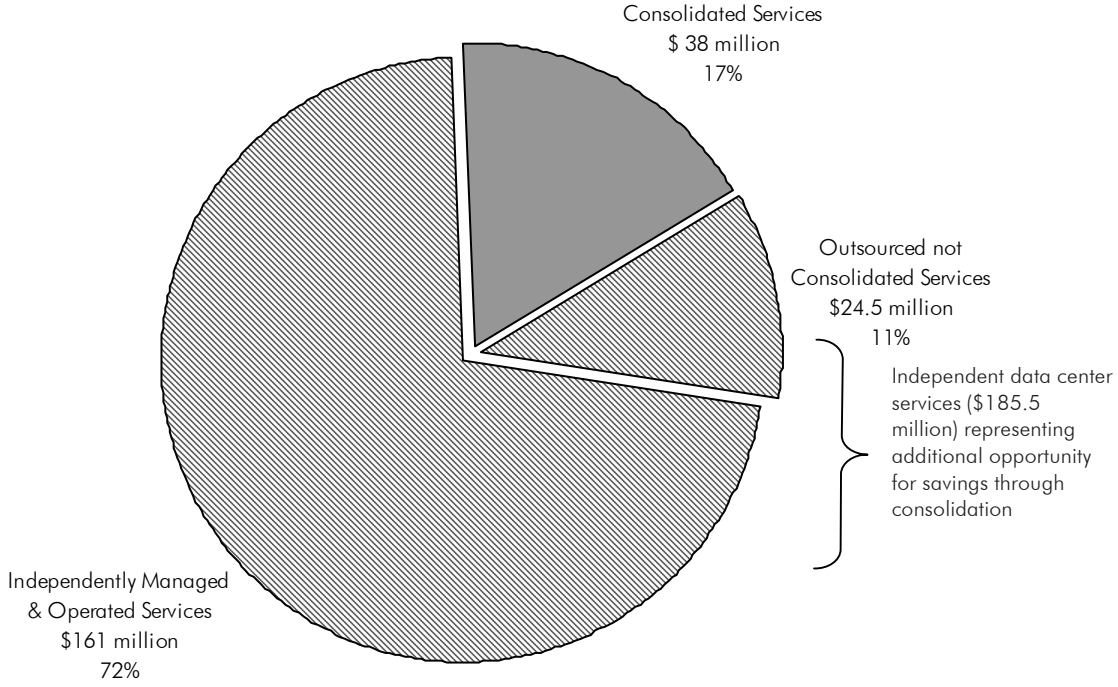
Operational data available on independently managed data center services is based on self-reported, mostly unverified surveys, such as SITAR and EDUCAUSE, that are aimed at collecting data relating to information technology services in general. While this data is useful in providing estimates concerning overall size and cost, it is not adequate for detailed strategic planning purposes because it is not reliably accurate or consistent. For example, it is not unusual for operational data from SITAR to be inconsistent with ITD financial data due to differences in methodologies. DIR has attempted recently to improve its knowledge base relative to the resources and costs associated with state agency independently managed data center services, by comparing data reported in SITAR and the ITD budget requests. However, DIR still lacks the detailed operational information required for the development and implementation of an effective data center service consolidation strategy and action plan.

While state agencies and institutions of higher education are required to complete the ITD budget request schedule as part of their 2006–07 LARs, the schedule is not intended to provide specific information about data center services. Instead, budget information is collected on Daily Operations, a budget category intended to provide a cost baseline of agency and institution ongoing information technology services. Daily Operations is subdivided into 10 elements shown in Figure 6. Five of these elements closely align with data center service costs: Email, local area network (LAN), wide area network (WAN), Security, and Operations.

Using the total ITD reported amounts for these five elements, Legislative Budget Board staff estimate that the state could potentially save at least $18.5 million in All Funds by the end of fiscal year 2010 from consolidating the management of data center services of major state agencies. Because of migration costs and considering a gradual transition for agencies, savings would likely not be realized in fiscal year 2006. This estimate is based on a 10 percent savings over a five-year period for major agencies currently managing independent data center services.

While this calculation provides an estimate of potential savings from further consolidation, the state needs more complete and consistent data concerning independent data center services to accurately determine the actual magnitude of savings resulting from consolidation and to develop an effective data center service consolidation strategy and action plan. In particular, the state needs more data concerning the location, types, platforms, applications, and the age and capacity of servers and mainframes, along with the costs and staffing needs that would be necessary for consolidating independent data center services within the state data center system.

FIGURE 5
COST SUMMARY OF STATE AGENCY DATA CENTER SERVICES, ESTIMATED FISCAL YEAR 2004



NOTE: Based on ITD fiscal year 2005 budget submissions of 24 major state agencies and reported contract expenditures.

SOURCE: Legislative Budget Board.

FIGURE 6
INFORMATION TECHNOLOGY DETAIL DAILY OPERATIONS ELEMENTS

1 Email	6 Off the Shelf Application Support
2 Web	7 Custom Application Support
3 LAN	8 Security
4 WAN	9 User Support
5 Financial/ Human Resources	10 Operations

SOURCE: Legislative Budget Board.

PLAN TO CONSOLIDATE STATE AGENCY DATA CENTERS

Recommendation 1 recognizes that while the state has achieved some success in consolidating data center services, cost savings have not been maximized due to the lack of a coordinated consolidation strategy. This recommendation would provide decision-makers with an action plan for consolidation based on demonstrable savings.

Therefore, DIR should complete its planned assessment of state agency data center services that are managed independent of the state data center system. DIR should report its findings to the Seventy-ninth Legislature by March 31, 2005. The report should address the following key issues:

- Identify all relevant operational details of each independently managed data center, including the location, types, platforms, applications, and the age and capacity of servers and mainframes.
- Identify the operational baseline costs of state agency data center services that are managed independent of the state data center system.
- Determine the magnitude of savings that will be realized through increased data center services consolidation.
- Provide a full estimate of resources needed to implement the strategy and action plan including the cost of equipment and professional services.

Further, the report should define a strategy and action plan for consolidating independently managed data center services within the state data center system, including detailed options for independent data center services consolidation, with measurable impacts and the savings

from each option. A similar report was originally required in Senate Bill 1701, Seventy-eighth Legislature, Regular Session, 2003. DIR is currently in the early stages of initiating this assessment and has identified funding in fiscal year 2005 for this initiative. Due to the importance of this assessment for legislative consideration, it is critical that agencies cooperate with DIR to ensure the successful completion of this assessment.

IMPROVE HIGHER EDUCATION DATA CENTER REPORTING

Recommendation 2 would provide decision-makers with information concerning the full size, scope, and cost of data center services managed by institutions of higher education and the potential savings of consolidating these services.

In particular, Recommendation 2 would require all institutions of higher education (as defined in Section 61.003 of the Education Code) to conduct a detailed inventory of their data center services and report this inventory to DIR. All institutions of higher education that are associated with university systems, shall report the inventory to DIR on a system-wide basis. The inventory should be reported in a format, at a level of detail and by a date determined by the DIR. Due to the importance of strong technology leadership in the higher education sector, the Chief Information Officer (or similar position) of the each institution or system (as applicable) shall approve and submit the inventory data to DIR. In order to ensure the validity of the data, it would be the responsibility of the internal auditor (or similar position) of each institution or system (as applicable) to verify that the reported data accurately captures the full size, scope, and cost of data center services managed by each institution or system. In addition, DIR may perform follow-up site visits in order to confirm the reported information. A strong knowledge base of the size, scope, and cost of data center services managed by institutions of higher education would facilitate improved strategic planning for comprehensive data center service consolidation in Texas, including data center consolidation within institutions of higher education or university systems.

Finally, DIR should investigate and report on the potential impact on higher education institution or university system data center service consolidation of the Texas Internet Grid for Research and Education currently being developed to allow universities to share high-performance computing, data storage, and visualization resources.

The following rider should be added to Article IX of the 2006–07 General Appropriations Bill to require this activity:

Higher Education Institution Data Centers.

(a) Each institution of higher education (as defined under § 61.003, Education Code) shall conduct a detailed inventory of all data center services regardless of data center service funding sources.

(b) The Chief Information Officer (or similar position) shall approve and submit the inventory in a format, at a level of detail and by a date determined by the Department of Information Resources (DIR), to DIR. In addition, to ensure the accuracy of the inventory data, the internal auditor (or similar position) of each institution or system (as applicable) shall verify that the inventory data reported captures the full size, scope, and cost of data center services of each institution or system based on the format and level of detail determined by DIR.

(c) All institutions of higher education are required to report this inventory to DIR. Institutions of higher education that are associated with university systems shall report the inventory to DIR on a system-wide basis.

(d) DIR may perform follow-up site visits in order to confirm the information reported by the institution or system.

(e) The results of the inventory and DIR's recommendations based on potential cost savings for data center service consolidation including consolidation within institutions or systems shall be submitted by DIR to the Legislative Budget Board and the Governor by September 1, 2006.

(f) DIR shall investigate and report to the Legislative Budget Board and the Governor by September 1, 2006 on the potential impact on higher education institution or system data center service consolidation of the Texas Internet Grid for Research and Education.

FISCAL IMPACT OF RECOMMENDATIONS

There is no significant fiscal impact associated with these recommendations. However, implementing the recommendations would increase the state's opportunities to achieve future savings, estimated to be at least $18.5 million in All Funds over five years, through data center service consolidation. This estimate is based on a 10 percent savings over a five-year period for major agencies currently managing independent data center services.

The introduced 2006–07 General Appropriations Bill includes the recommended Article IX rider requiring institutions of higher education to report data center services to DIR.

NEW USES FOR THE TEXAS DEPARTMENT OF INSURANCE'S OPERATING FUND ACCOUNT

Taxes, fees, and other income from the Texas Department of Insurance operations comprise the Texas Department of Insurance Operating Fund Account (Fund 36), which is dedicated to support the statutory purposes of the state agency. Fund 36, although self-leveling, has historically maintained a minimum balance of $11 million to $15 million. Some of that balance could be used for additional programs related to the fund's statutory purpose that contribute to reduced insurance premiums across the state, such as the Cancer Council and two of the programs under the Department of State Health Services. By funding these other programs through Fund 36, $18 million in General Revenue Funds in the 2006–07 biennium would be made available for other purposes.

SIGNIFICANT FINDINGS

- During each of the past four fiscal years, the Texas Department of Insurance's Operating Fund Account has had a minimum balance of at least $11.0 million. The Texas Department of Insurance estimates a $22.9 million balance for fiscal year 2005.
- The Texas Department of Insurance reports that its Operating Fund Account balance is necessary to cover agency operations in the event of a late transfer of maintenance taxes from the General Revenue Fund, a miscalculation of necessary premium fees, or other unforeseen needs (such as a mandated pay raise). However, such events have not necessitated the use of the balance in the past, and according to Texas Department of Insurance staff, the balance in the account has never been less than $10 million.
- The Texas Department of Insurance's Operating Fund Account is used to fund several other state agencies whose operations contribute to Texas Department of Insurance's goal of keeping insurance rates low.

SIGNIFICANT CONCERN

- The Texas Department of Insurance's Operating Fund Account balances could be used to replace General Revenue Funds for other programs within the account's statutory purpose.

RECOMMENDATION

- In the 2006–07 General Appropriations Bill, appropriate $18.0 million biennially from the Texas Department of Insurance's Operating Fund Account to the Cancer Council ($6.5 million) and the Department of State Health Services Environmental Health and/or Immunizations programs ($11.5 million).

COMMENTS

The Texas Department of Insurance's Operating Fund Account (Fund 36) consists of revenue collected from insurance companies, such as maintenance taxes collected by the Comptroller of Public Accounts and fees and reimbursements collected by the Texas Department of Insurance (TDI) and the Texas Commission on Fire Protection. The fees are directly deposited into Fund 36, but the maintenance taxes are first deposited into the General Revenue Fund and later transferred to Fund 36, generally in April of each year.

TDI keeps a minimum balance in Fund 36 to cover three months' operating expenses in the event of a late transfer of maintenance taxes from General Revenue Funds, a miscalculation of necessary premium fees, or other unforeseen needs, such as a mandated pay raise. This minimum balance typically ranges between $11 million and $15 million and has not fallen below $10 million since the creation of the fund in 1983, even in the context of mandated pay raises. TDI's appropriation is unaffected by fluctuations in the minimum balance. If TDI were to need a portion of the minimum balance for normal operating expenses, the transfer of maintenance taxes from the General Revenue Fund later in the fiscal year would return it to normal levels by the end of the year.

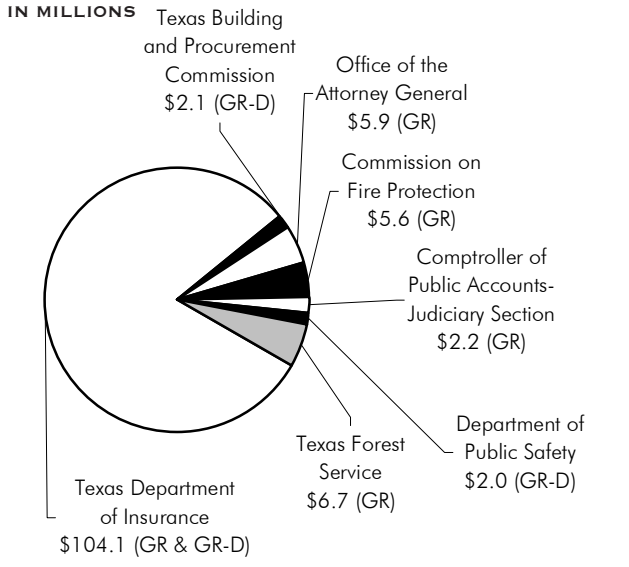
The most recent legislation affecting the minimum balance in Fund 36 was passed during the Seventy-sixth Legislature, 1999. Funds were transferred from Fund 36 to the Texas Forest Service (TFS), and a rider was adopted barring TDI from increasing maintenance taxes to cover expenditures to the TFS. Although TFS continues to receive funding from Fund 36, this rider was not carried through to the 2002–03 General Appropriations Act; and since fiscal year 2002, TDI's minimum balance has returned to its former substantial level. While there are statutory caps on premium fees and maintenance taxes, TDI's fees and taxes are well

below these caps, and the agency has significant room to increase the fees. In fact, maintenance tax rates decreased an average of 41 percent from fiscal year 2002 to fiscal year 2003.

As Figure 1 shows, appropriations from Fund 36 are currently designated for seven state agencies, some from Fund 36 as General Revenue–Dedicated Funds and some from the pre-transfer maintenance taxes in General Revenue Funds. In the 2004–05 biennium,

- TDI was appropriated $104.1 million to fund all operations as both General Revenue Funds and General Revenue–Dedicated Funds;
- the Texas Building and Procurement Commission was appropriated $2.1 million for its Facilities Operations strategy as General Revenue–Dedicated Funds;
- the Office of the Attorney General was appropriated $5.9 million from pre-transfer General Revenue Funds for its Legal Services strategy to compensate for legal services provided to TDI;
- the Commission on Fire Protection was appropriated $5.6 million from pre-transfer General Revenue Funds to completely fund all strategies and operations;
- the Judiciary Section, Comptroller's Department was appropriated $2.2 million from pre-transfer General Revenue Funds, which partially funded its Public Integrity Unit strategy for investigation and prosecution of insurance fraud cases;
- the Department of Public Safety was appropriated $2 million from General Revenue–Dedicated Funds in fiscal year 2004 (with the balance carrying forward in fiscal year 2005) for its Traffic Accident Records strategy to further develop and implement the Crash Records Information System; and
- the Texas Forest Service was appropriated $6.7 million for its Wildfire and Emergency Program strategy from pre-transfer General Revenue Funds, which, by rider, was designated for the Texas Wildfire Protection Plan.

FIGURE 1
FUND 36 ALLOCATION
2004–05 BIENNIUM



Total: $128.4 Million

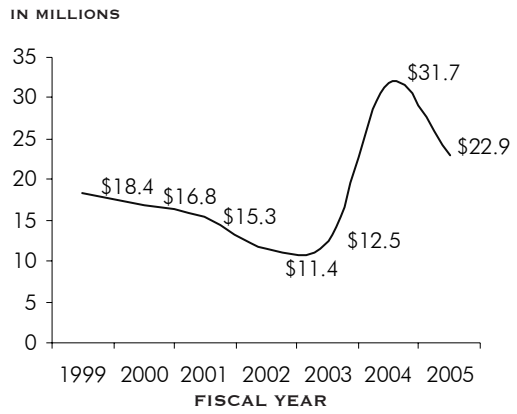
SOURCE: Texas Department of Insurance.

OTHER PROGRAMS RELATED TO FUND 36'S PURPOSE

While TDI is not required to keep a minimum balance, it maintains a minimum balance in Fund 36, generally between $11 million and $15 million, to cover unforeseen needs. The minimum balance fluctuates by year, and no appropriate minimum amount has been identified. Figure 2 shows the Fund's balance from fiscal year 2000 to fiscal year 2005.

The balance of Fund 36 could be used to replace all or some of the General Revenue Funds appropriations to other state programs meeting the statutory purpose of Fund 36. ("The money in the fund may be used for the purposes for which any of the money deposited in the fund is authorized to be used by law." Article 1.31A § 5, Insurance Code.) The General Appropriations Act is the only

FIGURE 2
FUND 36 MINIMUM BALANCE FOR FISCAL YEARS 1999–2005



SOURCE: Texas Department of Insurance.

legal authority for appropriations to agencies other than TDI and the tax administration function of the Comptroller of Public Accounts, which is authorized in Article 4.19, Insurance Code, to draw from Fund 36 to cover the costs of administrating the maintenance tax. For all other state agencies drawing funding from Fund 36, the authority in the General Appropriations Act aligns with the statutory purpose of the fund.

Research of insurance cost drivers found that cancer, environmental quality, and lack of vaccinations are leading contributors to healthcare costs. LBB analysis identified a state agency, the Cancer Council, and two Department of State Health Services programs, Environmental Health and Immunizations, that contribute to TDI's statutory mission "to work for the availability of quality insurance products for all Texans at reasonable prices and under reasonable terms and to strive to protect consumers' insurance assets." Appropriations to these agencies do not require additional statutory changes.

As shown in Figure 2, the projected minimum balance of Fund 36 for 2005 is $22.9 million. This recommendation would replace $18.0 million in General Revenue Funds for the identified programs from Fund 36 in the 2006–07 biennium. If fee and tax rates remain at current collection levels, this recommendation would leave TDI with a minimum balance of $4.9 million for unforeseen needs in the 2006–07 biennium.

The following rider language would prevent the increase of TDI's maintenance tax in the 2006–07 biennium to cover the new expenditures to the Cancer Council and the Department of State Health Services, although TDI would have the ability to increase taxes in later biennia to cover these expenses:

> **Maintenance Tax on Gross Premiums.** It is the intent of the legislature that during the 2006–07 biennium the Texas Department of Insurance shall not increase its maintenance tax on the gross premiums of any line of insurance to compensate for expenditures by the Cancer Council and Texas Department of State Health Services from the Texas Department of Insurance Operating Fund Account 0036 for the use of reducing insurance costs through preventative healthcare.

THE CANCER COUNCIL

The Cancer Council provides direct service grants to communities in an effort to reduce the incidence of cancer. According to a 2000 study in *The American Journal of Managed Care*, the cost of treatment for cancer patients at one major U.S. employer increased healthcare costs per employee by $224. The study concluded that "expenditures to reduce the incidence and severity of conditions indirectly associated with cancer may also reduce overall employer healthcare expenses." With this in mind, the Cancer Council's mission of "reducing the human and economic impact of cancer on Texans through the promotion and support of collaborative, innovative, and effective programs and policies for cancer prevention and control" aligns with the mission of TDI and the statutory purpose of Fund 36 to assist TDI's operations. An annual Fund 36 appropriation of $3.3 million in fiscal year 2006 and $3.2 million in fiscal year 2007 would end the Cancer Council's reliance on General Revenue funding for this purpose.

DEPARTMENT OF STATE HEALTH SERVICES

Two Department of State Health Services programs contribute to TDI's mission and the statutory purpose of Fund 36: Environmental Health and Immunizations. A 2002 report for Blue Cross Blue Shield found that environmental quality and immunization are two of the 10 leading health indicators that drive healthcare costs. Although the study points out that the influence of these health indicators were lower than expected, they are among factors that are likely to have recently increased in significance.

DEPARTMENT OF STATE HEALTH SERVICES ENVIRONMENTAL HEALTH

The goal of the Department of State Health Services Environmental Health program is to develop and implement comprehensive, uniform, and effective risk assessment and risk management programs in the areas of consumer products, occupational and environmental health, and community sanitation. The Department of State Health Services Bureau of Environmental Health includes the following divisions:

- Toxic Substances Control Division with programs addressing asbestos, environmental lead, and indoor air quality;
- General Sanitation Division, which regulates environmental health in schools, childcare facilities, youth camps, migrant labor housing facilities, public swimming pools, and public lodging facilities; and
- Product Safety Division, which licenses and regulates the manufacturers and retailers of hazardous or potentially hazardous consumer products.

All of these programs contribute to protecting the general public health and act to control incidence of illness, injury, or death, thus helping to reduce insurance rates. An annual Fund 36 appropriation of $3.2 million would replace the entire General Revenue Fund appropriation for the

Department of State Health Services Environmental Health program.

DEPARTMENT OF STATE HEALTH SERVICES IMMUNIZATIONS

The goal of the Department of State Health Services Immunizations program is to implement programs to immunize Texas residents. The mission of the Immunizations Division of the Department of State Health Services Bureau of Immunization and Pharmacy Support is to improve the quality and longevity of life for people in Texas by achieving and maintaining an environment free of vaccine-preventable diseases, which, the Division states, will add to the state's economic base by avoiding substantial healthcare costs. An Institute of Medicine report published in calendar year 2000 found that Texas, with a 73 percent immunization rate, is tied for the third-lowest immunization rate in the nation. An Institute of Medicine report published in calendar year 2003 stated that immunizations benefit not just the individual receiving the vaccine but also the community as whole by helping to reduce medical costs. The study further asserted that 11 percent of children age five and under and 76 percent of adults ages 18 to 64 are underinsured for immunizations. Avoiding healthcare costs through preventative medicine contributes to TDI's mission to work to keep insurance products at reasonable prices. In the 2006–07 biennium, the Immunizations program will receive $25.8 million from the General Revenue Fund annually. An appropriation of $2.5 million in 2006 and $2.6 million in 2007 from Fund 36 for this program would replace General Revenue Fund appropriation, which could be used for other purposes.

FISCAL IMPACT OF THE RECOMMENDATION

As Figure 3 shows, this recommendation would result in net savings of $18 million in General Revenue Funds and an equal net cost to General Revenue–Dedicated Funds in the 2006–07 biennium. It is assumed that the recommended rider would not continue in the 2008–09 biennium, allowing TDI to raise fees or maintenance taxes in subsequent years and increasing the amount available for certification.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBALE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE REVENUE GAIN/(LOSS) TO GENERAL REVENUE–DEDICATED FUNDS
2006	$9,000,000	($9,000,000)	$0
2007	$9,000,000	($9,000,000)	$0
2008	$9,000,000	$0	$9,000,000
2009	$9,000,000	$0	$9,000,000
2010	$9,000,000	$0	$9,000,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of this recommendation.

RECOVER CERTAIN STATE AGENCY OVERPAYMENTS TO VENDORS

Recovery audits identify and recover overpayments and lost vendor discounts. Recovery audits typically recover 0.1 percent of total expenditures in private industry and between 0.03 and 0.05 percent in the public sector. Auditors retain a percentage of the money recovered as payment for their work.

The federal government and other states have benefited from wide scale recovery audits, but Texas' use of them has been limited. In addition to recovering funds misspent, recovery audits provide recommendations to improve accounting processes and prevent future overpayments. By requiring state entities with more than $100.0 million in biennial expenditures of appropriated funds to undertake annual recovery audits, the state could recover up to $4.5 million in All Funds annually starting in fiscal year 2007. If this program first reviews expenditures from the three previous fiscal years in its first year of operation, fiscal year 2007 savings would be greater than collections in subsequent years.

SIGNIFICANT FINDINGS

- In the private sector, recovery audits typically find 0.1 percent of total expenditures in lost discounts or overpayments to vendors. In the public sector, this rate is between 0.03 and 0.05 percent. Recovery audit firms typically keep between 20 and 40 percent of recovered funds as payment.
- In the 2004–05 biennium, 45 state entities had expenditures of appropriated funds exceeding $100 million and spent more than $19 billion annually in All Funds on goods and services from vendors.

SIGNIFICANT CONCERN

- Based on recovery audit rates achieved by the federal government and other state governments, Texas potentially loses up to $9 million annually in All Funds through overpayments, lost discounts, and noncompliance with contracts.

RECOMMENDATIONS

- **Recommendation 1:** Include a rider in the 2006–07 General Appropriations Bill that requires the Comptroller of Public Accounts to negotiate and administer an umbrella contract with a third-party recovery audit firm or firms to be used by all state agencies.
- **Recommendation 2:** Amend Chapter 2101, Government Code to require those state entities with biennial expenditures from appropriated funds exceeding $100 million to participate in recovery audits unless exempted by the Comptroller of Public Accounts based on a low proportion of expenditures to vendors.
- **Recommendation 3:** Amend Article IX, Section 8.03, of the 2004–05 General Appropriations Act to appropriate 50 percent of recovered General Revenue Funds, General Revenue–Dedicated Funds, and Other Funds to each state entity that participates in the contracted recovery audit to pay the recovery audit firm and to use the balance for the original purpose for which the recovered funds were appropriated.

COMMENTS

Recovery auditing is the 30-year-old practice of reviewing information regarding expenditures for overpayments, lost discounts, and noncompliance with contracts over a specified period of time. Recovery audit firms look for erroneous invoices, discounts offered but not received, improper late penalties, incorrect shipping costs, and multiple payments for single invoices. In the private sector, recovery audit firms typically recover 0.1 percent of the business' volume in an audit and keep between 20 and 40 percent of their findings as payment. In addition to the recovered expenditures, recovery audit firms provide recommendations to reduce future overpayments and lost discounts by improving accounting and procurement procedures.

Public sector agencies have recently begun to contract with third-party recovery auditing firms. The U.S. Department of Defense (DoD) Defense Supply Center began a pilot recovery audit program in 1996 that identified $30.4 million in overpayments, of which the DoD was able to validate $17.9 million. By 2000, the DoD had recovered $5.3 million from vendors. Based on the success of this pilot, DoD started an agency-wide pilot program in 1998, and in fiscal year 2001, contractors returned $488.0 million in overpayments based on identified overpayments.

Congress mandated recovery auditing for federal agencies with the 2002 Defense Authorization Act. The Defense Authorization Act requires federal agencies with more than

FIGURE 1
OTHER STATES' EXPERIENCE WITH RECOVERY AUDIT FIRMS

Missouri: The Missouri Department of Administration has contracted with a recovery audit firm since 1998, and between fiscal years 1998–2003, the recovery audit firm identified and collected $3.5 million. Missouri's typical recovery audit starts at the end of a fiscal year and takes about a year to complete. Missouri has not had any legal problems with collection from overpaid vendors. As Missouri's accounts payable processes improve due to recommendations from the recovery audit firm, the focus of Missouri's recovery audit has shifted to Medicaid payments.

Delaware: The State of Delaware's recovery audit contract, which is about a year old, has resulted in recovery of $60,000 in overpayments from state purchases between fiscal years 2001 and 2003, with a recovery rate of 0.03 percent. The recovery audit firm has recommended that Delaware tie payments to purchase orders in its new accounting system.

North Carolina: North Carolina contracted with a recovery audit firm in 1999 and has audited expenditures, exempting medical services, back through 1996. North Carolina has recovered $4 million from 1996–2003, with a recovery rate of .05 percent.

California: The 2004 California Performance Review recommended that the state hire a recovery audit firm to audit its telecommunication expenses.

SOURCE: Legislative Budget Board.

$500 million in expenditures on goods and services to use recovery audits and authorizes the agencies to do the following:

1) return recovered money to the account it came from or to the general treasury,
2) pay the third-party recovery auditors, and
3) conduct management improvement programs to address the overpayment issues.

Texas has never required state entities to use recovery auditing on a wide scale. However, the Council on Competitive Government is in the process of negotiating a third-party contract to be overseen by the State Energy Conservation Office that would include recovery audits of all agencies' utility expenditures.

Current internal reviews of Texas expenditures include sample-based audits conducted by the Comptroller of Public Accounts (CPA) and the Texas Building and Procurement Commission (TBPC). As Figure 2 shows, post-payment audits conducted by the CPA can identify lost discounts or interest erroneously paid to vendors. Unlike recovery audits, however, they test a sample of expenditures rather than all of them. TBPC's procurement audits, on the other hand, investigate state payment processes for compliance with procurement statutes, rules, or procedures, and do not test for lost discounts, duplicate payments, or contract compliance.

In a memo of May 8, 2003, the federal Office of Management and Budget authorized the use of part of the money recovered from overpayments from federal programs for state and local governments to pay for contingency fee contracts with recovery audit firms. Each federal program has differing rules regarding whether a state may keep or must return the rest of the recovered payments.

The three recommendations are interdependent. Recommendation 1 requires the CPA to contract with a recovery audit firm or firms. Recommendation 2 amends statute to set the parameters of the recovery audit and to require state entities with expenditures exceeding $100 million to participate in recovery audits. Recommendation 3 deposits half of the recovered funds back into the state treasury and appropriates the remaining half of recovered funds to state entities to pay for the audit and to expend for the purposes of the original appropriation.

Recommendation 1 would require the CPA to negotiate and administer an umbrella contract with a recovery audit firm or firms for use by all state entities. The CPA is the best agency to negotiate and administer this contract because of its extensive experience administrating third-party umbrella contracts for the state and direct access to information from the Uniform Statewide Accounting System (USAS).

The following rider should be included in the bill pattern for Comptroller of Public Accounts in the 2006–07 General Appropriations Bill:

> **Recovery Audit.** The Comptroller of Public Accounts shall contract with a consultant or consultants during the 2006–07 biennium for the purpose of auditing expenditures for overpayments or lost discounts and to receive recommendations for improved accounting operations. Any reports submitted to the Comptroller of Public Accounts in connection with such a contract shall be submitted to the Legislative Budget Board, State Auditor's Office, and the Governor no later than seven days after receipt of the report by the Comptroller. No later than January 1, 2007, the Comptroller shall issue a report summarizing the findings to the Legislature.

Recommendation 2 would amend Chapter 2101, Government Code to require those state entities with greater than $100 million biennially in expenditures from appropriated funds to participate in contracted recovery audits unless exempted by the CPA based on a low proportion of expenditures to vendors. The new language in Chapter

FIGURE 2
DIFFERENCES BETWEEN CERTAIN INTERNAL STATE AUDITS AND THIRD-PARTY RECOVERY AUDITS

	COMPTROLLER OF PUBLIC ACCOUNTS POST-PAYMENT AUDIT	TEXAS BUILDING AND PROCUREMENT COMMISSION PROCUREMENT AUDIT
Purpose	Ensure compliance with expenditure documentation and processing requirements.	Ensure delegated and non-delegated payment processes comply with purchasing statutes, rules, and procedures.
Scope	Auditors review a random sample of purchases, travel expenses, payroll, state property accounting entries, and signature cards related to expenditures processed through USAS.	Auditors review a random sample of post-procurement purchasing and payment documentation and all pre-procurement documents for certain types of purchases.
Frequency	Post-payment audits are conducted annually, but the agencies audited are chosen through a risk assessment formula.	Post-procurement audits conducted once per agency each biennium; Pre-procurement audits are completed for research, service, and emergency purchases exceeding $25,000 and lease payments prior to payment by the comptroller.
How this audit differs from recovery audit	While post-payment audits can identify interest erroneously paid to vendors or lost discounts, these audits only test a sample of expenditures. Recovery audits typically use computer-assisted auditing techniques to audit all expenditures for these erros as well as duplicate payments.	Procurement audits focus on whether the proper procurement method was used and related requirements were complied with. These audits do not test for lost discounts, duplicate payments, or proper calculation of interest owed to vendors for late payment.

SOURCE: Legislative Budget Board.

2101 should specifically allow state entities to reimburse the recovery audit firm or firms from recovered funds.

Recommendation 3 would amend Article IX, Section 8.03, of the 2006–07 General Appropriations Bill to appropriate 50 percent of recovered General Revenue Funds, General Revenue–Dedicated Funds, and Other Funds to state entities on an individual basis. Each state entity would need to pay the recovery audit firm the contracted payment rate from the recovered funds but would be able to keep the remainder. This practice would provide an incentive for state entities with expenditures under $100 million biennially to voluntarily participate in recovery audits. Because recovery audit firms typically contract to keep between 20 and 40 percent of recovered funds, this practice would provide state entities with between 10 and 30 percent of recovered funds as an incentive to undertake recovery audits.

Figure 3 illustrates the process of appropriating recovered General Revenue Funds under Recommendation 3. Half would be deposited in the state treasury as unappropriated revenue in the authorized fund, which in this example would be General Revenue Fund 0001. The other half would be appropriated to the state entity. The state entity would pay the recovery audit firm the contracted percentage, and would be able to keep the remainder as a new appropriation with the same purpose as the original appropriation.

Section 8.03, as amended, would read as follows:

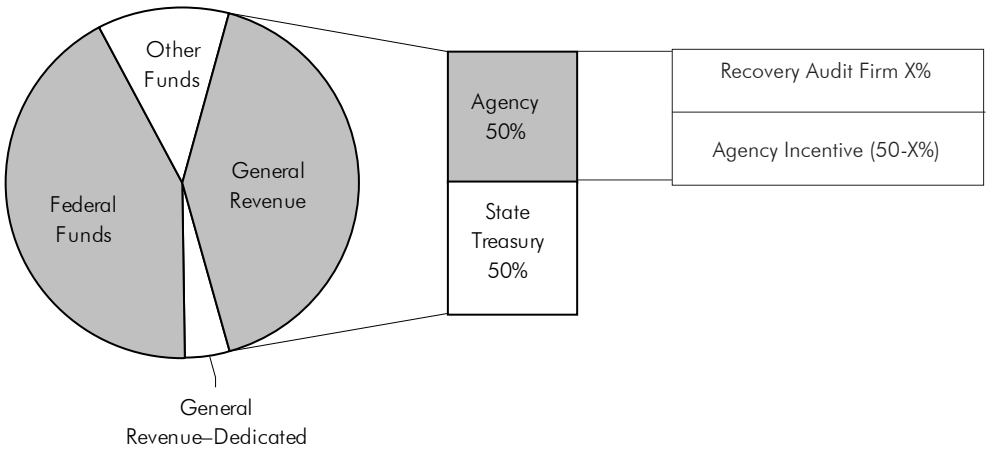
Sec. 8.03. Reimbursements and Payments.

(a) Except as provided in Subsection (f), any [~~Any~~] reimbursements received by an agency of the state for authorized services, including contractual agreements with a non-governmental source or any unit of government, including state, federal, or local government, refund of expenditures received by an agency of the state and any payments to an agency of the state government made in settlement of a claim for damages, are hereby appropriated to the agency of the state receiving such reimbursements and payments for use during the fiscal year in which they are received. Revenues specifically established by statute on a fee or service provided basis are not appropriated by this section and are available for expenditure by the collecting agency only if appropriated elsewhere in this Act.

(b)-(e) [no change]

(f) Fifty percent of the reimbursements, refunds, and payments of state funds received under Subsection (a) as a result of a recovery audit pursuant to Chapter 2101, Government Code shall be credited by the Comptroller to the agency's current appropriation items or accounts from which the expenditures of like character were originally made and such

FIGURE 3
RECOVERED GENERAL REVENUE



SOURCE: Legislative Budget Board.

funds are hereby appropriated to the agency in the fiscal year in which the funds are received. The remaining 50 percent shall be deposited in the state treasury as unappropriated revenues to the originating funds or accounts.

FISCAL IMPACT OF THE RECOMMENDATIONS

In the 2006–07 biennium, the estimated net savings of all recommendations would be $9.6 million to General Revenue Funds and $0.9 million to General Revenue–Dedicated Funds. Recovery audits typically start at the end of the fiscal year and take one year to complete, meaning that recovered expenditures are not collected until the fiscal year after the audit has been completed. Because of the time necessary to issue requests for proposals and negotiate contracts, the earliest any recovered revenue would be seen from this program would be in fiscal year 2007. However, recovery audits tend to start by reviewing several previous years. Consequently, if this program first reviews expenditures from fiscal years 2003 to 2005 in fiscal year 2006, fiscal year 2007 would realize greater collections than subsequent years.

Half of recovered General Revenue Funds, General Revenue–Dedicated Funds, and Other Funds would be returned to the state treasury, while the other half would be appropriated to the state entity, which would then need to pay the recovery audit firm's contracted percentage from its 50 percent allotment. Federal Funds would be returned to the state agency, which would pay the contracted percentage of the recovery audit firm, and would use the remainder or return it to the federal government, as provided in the rules of each federal program.

Figure 4 assumes a 0.04 percent recovery rate on all expenditures and that recoveries from fiscal years 2003 to 2005 would be collected in fiscal year 2007. Because the recovery audit collection rate in other states is between 0.03 percent and 0.05 percent of gross expenditures, the estimated cost savings for all three recommendations would be $13.5 million in All Funds in fiscal year 2007 and $4.5 million in each subsequent fiscal year. However, at the average private industry recovery rate of 0.1 percent, it is possible that Texas could realize savings up to $11.3 million annually in All Funds by instituting a system of recovery audits. As each Federal Funds program has its own rules regarding recovered expenditures, it is estimated that there would be no savings or revenue gain.

FIGURE 4
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE NET SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE NET SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE NET SAVINGS/ (COST) TO OTHER FUNDS
2006	$0	$0	$0
2007	$9,600,000	$900,000	$3,000,000
2008	$3,200,000	$300,000	$1,000,000
2009	$3,200,000	$300,000	$1,000,000
2010	$3,200,000	$300,000	$1,000,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill includes a rider directing the CPA to negotiate and administer an umbrella contract with a third-party recovery audit firm or firms to be used by all state agencies, as discussed in Recommendation 1. The introduced 2006–07 General Appropriations Bill also includes the Article IX rider language, as amended in Recommendation 3. If the statutory change in Recommendation 2 is implemented, the state would realize a $13.5 million in All Funds revenue gain in fiscal year 2007. Appropriations to each state agency would be on a contingency basis and are not reflected in the introduced 2006–07 General Appropriations Bill.

CHANGE POLICIES GOVERNING RETURN-TO-WORK RETIREES

Return-to-work retirees receive some benefits at higher rates than general state employees. First, more return-to-work retirees are eligible for benefit replacement pay than average state employees. Benefit replacement pay is a salary supplement created to offset a loss to employees when the state stopped paying a portion of an employee's social security taxes. Second, return-to-work retirees often receive longevity pay at a higher rate. Longevity pay awards employees with additional wages for increased years of service to encourage them to remain employed with the state. As a return-to-work retiree, an employee receives longevity pay and benefit replacement pay from two sources: (1) as an enhancement to their retirement annuity and (2) as part of their state employee compensation. Discontinuing longevity pay and benefit replacement pay for return-to-work state retirees would save the state up to $10.9 million in General Revenue Funds in the 2006–07 biennium.

SIGNIFICANT FINDINGS

- The number of return-to-work retirees has increased 716 percent from 469 in 1999 to 3,830 in August 2004.
- In fiscal year 2004, the average salary of a return-to-work retiree was $39,652 while the average salary of a general state employee was $32,681.
- In May 2004, more than half of all return-to-work retirees active in the state's workforce earned a post-retirement salary that was equivalent or greater than they earned before retirement.

SIGNIFICANT CONCERNS

- Return-to-work retirees benefit twice from benefit replacement pay and longevity pay, in their retirement annuity and in their compensation when they return-to-work.
- Return-to-work retirees are more likely to earn benefit replacement pay, longevity pay, and vacation leave at higher rates than the average state employee.

RECOMMENDATIONS

- **Recommendation 1:** Amend Government Code, Chapter 659 to prohibit return-to-work retirees from receiving benefit replacement pay and longevity pay. By rider to the General Appropriations Bill, reduce agencies' appropriations by the amount of longevity pay and benefit replacement pay agencies would have paid to return-to-work retirees in the 2006–07 biennium.
- **Recommendation 2:** Amend Government Code, Chapter 661 to require retirees who return to state service to restart their years of service with the state at zero. This measure would ensure that return-to-work employees earn vacation at the same rate as employees with no years of service.

COMMENTS

During fiscal years 2002 and 2003, the state spent $156.8 million on benefit replacement pay (BRP) and $198 million on longevity pay. In fiscal years 2004 and 2005, 57 percent of BRP payments will be paid from General Revenue Funds. Return-to-work retirees contribute to this expense. On average, return-to-work retirees earn $140 a month in longevity pay, and 89 percent of them are entitled to receive BRP.

As described in Figure 1, state employees hired after August 31, 1995 are not eligible for BRP. As a result, the annual appropriation for BRP decreases each year as eligible employees separate from the state. Figure 2 shows the rate of decrease in the BRP expenditure for general state employees. BRP benefits employees with greater tenure, who are closer to retirement and often more likely to remain employed with the state. Therefore, it is estimated that the BRP expenditure will only decrease 9.8 percent in the 2006–07 biennium.

BENEFITS FOR RETURN-TO-WORK RETIREES

Return-to-work retirees benefit twice from BRP and longevity pay:

- BRP and longevity pay are part of the average salary the Employees Retirement System of Texas (ERS) uses to calculate the amount of an employee's retirement annuity.
- Eligible return-to-work retirees continue to receive BRP and longevity pay when they return to work for the state.

A typical state employee's retirement annuity is based on salary, years of service (or service credit), and a multiplier

FIGURE 1
WHAT ARE BENEFIT REPLACEMENT PAY AND LONGEVITY?

Benefit replacement pay was created in 1996 to replace the state-paid portion of an employee's social security tax for employees receiving that benefit at the end of fiscal year 1995. Benefit Replacement Pay of up to $1,026.86 each year provides supplemental compensation to eligible state employees based on their salaries. An employee retains BRP entitlement as long as he or she does not have a break in service from the state of 12 consecutive months. This eligibility requirement also applies to return-to-work retirees. Therefore, if a retiree who received BRP returns to work sooner than 12 months after retirement, the return-to-work retiree is eligible for BRP.

Longevity pay awards tenure. After three years of state service, employees receive $240 a year in longevity pay. For each additional three years of state service, longevity pay increases $240 a year until reaching a maximum of $3,360 a year at 42 years.

SOURCE: Comptroller of Public Accounts.

FIGURE 2
BENEFIT REPLACEMENT PAY SPENDING EACH BIENNIUM SINCE INCEPTION

BIENNIUM	MILLIONS OF DOLLARS FOR GENERAL STATE EMPLOYEES	DECREASE FROM PREVIOUS BIENNIUM
1996–97	$284.8	
1998–99	$224.6	21.1 percent
2000–01	$185.2	17.5 percent
2002–03	$156.8	15.3 percent
2004–05	$129.2	17.6 percent
2006–07	$116.6	9.8 percent

SOURCE: Legislative Budget Board.

(currently set at 2.3 percent). As salary or retirement service credit increases, the amount of the employee's retirement annuity increases. An employee's average salary is based on the employee's gross pay plus longevity, benefit replacement pay, and hazardous duty pay. Therefore, when a retiree returns to work, he or she benefits twice from BRP and longevity pay; once through increased retirement annuity and again as a payment included in employee compensation. State employee salaries and benefits continue to be one of the largest single state expenditures. Changes to employee benefits and cost-sharing arrangements should be considered in light of available state revenue and goals for employee recruitment and retention.

Recommendation 1 eliminates BRP and longevity pay to return-to-work retirees. The recommendation reduces the 2006–07 biennial estimated appropriation to the Comptroller of Public Accounts (Comptroller) for benefit replacement pay in all funds proportional to employees' salaries. Recommendation 1 also requires the Comptroller at the start of each fiscal year of the 2006–07 biennium to do the following:

- Identify the amount of longevity pay each agency would have paid to return-to-work retirees during the fiscal year.
- Reduce each agency's appropriations by the amount the agency would have paid in longevity pay to its return-to-work retirees' during the fiscal year.

Contingent upon the passage of appropriate legislation to prohibit return-to-work retirees from receiving benefit replacement pay and longevity pay, add the following rider in the 2006–07 General Appropriations Bill:

> **Return-to-work retirees.** Contingent on the passage of legislation by the Seventy-ninth Legislature, regular session eliminating benefit replacement pay and longevity pay payments to retirees who retire from the state and return to work for the state (return-to-work retirees):
>
> (a) The Comptroller shall identify:
>
> a. The number of return-to-work retirees receiving benefit replacement pay on September 1, 2005
>
> b. By agency, the number of return-to-work retirees receiving longevity pay on September 1, 2005, and
>
> c. By agency, the number of return-to-work retirees receiving longevity pay on September 1, 2006; and.
>
> (b) On September 1 of each year of the biennium, The Comptroller shall reduce each agency's fiscal year appropriation by the annual amount of longevity pay that would have been paid to return-to-work retirees employed by the agency during that fiscal year and by method of financing, as identified pursuant to Subsection (a).
>
> (c) On September 1, 2005, The Comptroller shall estimate the amount of benefit replacement pay that would have been paid to return-to-work retirees during the 2006–07 biennium by article of the General Appropriations Act and by method of financing and shall reduce biennial appropriations for benefit replacement pay to each article by that amount and by method of financing.

RETURN-TO-WORK RETIREE'S VACATION LEAVE

Return-to-work retirees have many years of state service and consequently earn more vacation leave than average state employees. Figure 3 shows the average salary, years of service, and vacation earned by the average return-to-work retiree versus the average state employee. A return-to-work retiree's years of service takes into account all years worked for the state—pre- and post-retirement. As a result, return-to-work retirees receive vacation leave at the same rate as they did before retirement. For example, an employee who retired with 23 years of service would return to state employment earning 15 hours per month of vacation, 50 percent more than the average state employee.

Also, when a return-to-work retiree separates from state employment the second time, the retiree is entitled to a lump-sum payment for unused vacation. Return-to-work retirees have a higher average salary and earn vacation at a faster rate than the average state employee, which causes their unused vacation leave reimbursement to be more expensive. Figure 3 compares the costs related to an average return-to-work retiree and an average general state employee. A lump-sum payment for one year vacation leave to the average return-to-work retiree is almost double the amount paid to an average employee if neither used any vacation leave for one year.

Recommendation 2 would amend statute to allow a return-to-work retiree to be treated like a newly hired employee. They would earn vacation leave at the "less than two year rate," or eight hours per month. This recommendation would require retirees to restart earning years of service based on each year of post-retirement employment.

FISCAL IMPACT OF THE RECOMMENDATIONS

Discontinuing longevity pay and benefit replacement pay for return-to-work state retirees would result in a net General Revenue Fund savings of $10.9 million and a net General Revenue–Dedicated Fund savings of $1.1 million in the 2006–07 biennium.

Figures 4 and 5 reflect the initial savings that would result from the implementation of Recommendation 1. Benefit costs must be proportional to an agency's funding sources; therefore, amounts reflected in Figures 4 and 5 are based on the proportionality of the funds used to pay employees salaries in fiscal years 2004 and 2005. The savings estimate is based on the projected number of return-to-work retirees that would likely be employed with the state in fiscal years 2006 through 2010. The savings would increase if state agencies hired retirees at a higher rate in the coming years. The cost savings estimate includes employees at state agencies, but excludes employees at institutions of higher education. Institutions of higher education pay BRP as part of an employee's salary not as a separate component of an employee's salary as it is paid to state employees. The changes in law would affect return-to-work retirees at institutions of higher education; therefore, the cost savings estimate is conservative. The estimate was based on data supplied by the Comptroller regarding the number of BRP and longevity pay eligible employees who retired from state employment during the first half of fiscal year 2004 and returned to work.

It is estimated that Recommendation 2 would avoid future costs by reducing the amount of the lump sum payment a return-to-work retiree would receive when he or she leaves state employment.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations.

FIGURE 3
COMPARISON OF ENTITLEMENTS RECEIVED BY RETURN-TO-WORK RETIREES AND AVERAGE STATE EMPLOYEES

AVERAGE RETURN-TO-WORK RETIREE	AVERAGE GENERAL STATE EMPLOYEE
$19.06 per hour	$15.71 per hour
23 years of state service	8 years of state service
15 hours of vacation a month	10 hours of vacation a month
$3,431 vacation payment	$1,885 vacation payment

SOURCE: Legislative Budget Board.

FIGURE 4
BENEFIT REPLACEMENT PAY COST SAVINGS

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$2,368,443	$249,310	$831,032	$706,378
2007	$2,555,090	$268,957	$896,523	$762,044
2008	$2,741,738	$288,604	$962,013	$817,711
2009	$2,928,386	$308,251	$1,027,504	$873,378
2010	$3,115,034	$327,898	$1,092,994	$929,045

SOURCE: Legislative Budget Board.

FIGURE 5
LONGEVITY PAY COST SAVINGS

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$2,873,524	$302,476	$1,008,254	$857,016
2007	$3,099,975	$326,313	$1,087,711	$924,554
2008	$3,326,427	$350,150	$1,167,167	$992,092
2009	$3,552,878	$373,987	$1,246,624	$1,059,630
2010	$3,779,329	$397,824	$1,326,080	$1,127,168

SOURCE: Legislative Budget Board.

ELIMINATE THE STATE CONTRIBUTION FOR RETIREES' DEPENDENT HEALTH INSURANCE PREMIUM

Healthcare costs and retiree populations are expected to increase in the next several years. The current policy of the state contributing 50 percent of the cost of general state retirees' dependent health insurance premium will cost $584.1 million in the 2006–07 biennium. This is a 24.5 percent increase over the 2004–05 biennium.

Research shows that many other government and private entities do not contribute to retirees' dependent health insurance premiums. Eliminating the state's contribution for health insurance premiums for retirees' dependents under age 65 would reduce the state's share of insurance costs by $121.2 million in All Funds during the 2006–07 biennium, $93.6 million of which is General Revenue and General Revenue–Dedicated Funds. It would reduce the estimated appropriations to the Employees Retirement System and the Higher Education Employees Group Insurance System for the 2006–07 biennium.

SIGNIFICANT FINDINGS

- In fiscal year 2004, 37 percent of retirees in the Employees Retirement System and the Higher Education Employees Group Insurance System covered dependents on their health insurance.
- Under TRS-Care, the health plan offered to retirees of the Teacher Retirement System, the state requires public education retirees to pay the entire healthcare premium for their dependents. However, the dependents' healthcare costs are indirectly subsidized by the state, school district, and member.

SIGNIFICANT CONCERN

- Based on historical trends, healthcare costs and the number of state retirees are expected to increase in each of the next several years. Insurance premiums have increased by 7 percent, more than twice the rate of inflation, since 2001 and retiree populations have increased by 5 percent each year during this same time period.

RECOMMENDATION

- Include a rider in the 2006–07 General Appropriations Bill requiring state and higher education retirees to pay 100 percent of the premium for dependent health insurance coverage for dependents under the age of 65.

COMMENTS

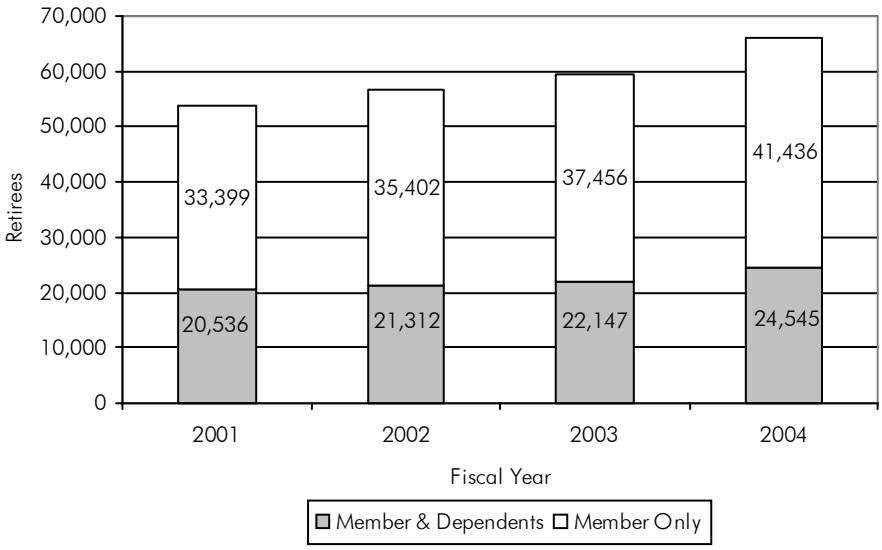
The state currently pays 50 percent of the total cost of health insurance premiums for spouses and dependents of its retirees. As shown in Figure 1, at the end of fiscal year 2004, there were 65,981 general state and higher education retirees who received their health insurance through the Employees Retirement System (ERS). Since 2001, as the number of retirees has grown, so has the number of retirees who include dependents on their health insurance. Figure 1 also shows that 24,545, or 37 percent, of retirees covered dependents on their health insurance in fiscal year 2004. Of the 24,545 retirees covering dependents, 13,005 retirees have dependents under age 65.

Legislative Budget Board staff estimate that the retiree population will grow by 5 percent annually in the coming years. As the number of retirees grows, so will the number of dependents enrolled in the state health plan. Historically, an average of 38 percent of retirees in the state health plan have added dependents to their insurance coverage. The approximate cost to the state for general state retiree and dependent health insurance premiums for fiscal year 2005 will be $246 million. This is a $24 million increase over the fiscal year 2004 level.

In addition to the growing number of retirees and their dependents, health insurance premiums have followed the same upward trend, and according to the National Conference of State Legislatures, health insurance premiums for family coverage have increased by 64 percent nationwide since 1999.

Texas state employee health insurance premiums have increased by an inflation-adjusted 7 percent from fiscal year 2001 to 2005. In fiscal year 2005, HealthSelect's premium increased by 5.1 percent, and the premiums for the participating HMO plans in ERS increased by an average of 12.6 percent over fiscal year 2004 rates. In 2004, ERS increased copayments, implemented tighter eligibility rules, and instituted a prescription drug deductible. While these measures reduced the rate of increase in healthcare and premium costs, they have not prevented the further increase in insurance premiums. Requiring retirees to contribute toward their dependent health insurance premium may help to reduce overall expenditures for retiree healthcare costs, and the practice is a cost-sharing measure used in other states and by major private employers. This recommendation would not affect dependents of

FIGURE 1
NUMBER OF RETIREES BY COVERAGE TYPE



SOURCE: Employees Retirement System.

deceased retirees since they already pay the full premium cost of their health insurance.

OTHER GOVERNMENT AND PRIVATE EMPLOYERS

Other states and major private employers have reduced health benefits for retirees and their dependents, and they have increased retiree contributions for health insurance premiums to mitigate increasing healthcare costs. As Figure 2 shows, few major private employers in Texas contribute to retiree dependent health insurance. In fact, Southwest Airlines, Motorola, IBM, Dell, and HEB (if over age 65) pay nothing for retiree dependent health insurance premiums. The contribution levels for other local government entities, like the cities of Dallas, Austin, and Houston and the counties of Dallas, Travis, and Harris vary significantly but range between 0 percent, as is the case in Travis County, and 65 percent (if age 65 or older) in Houston.

Figure 2 also shows the different levels of contribution that retirees pay for their dependents' health insurance premiums in Arkansas, California, Florida, and New York.

In line with what many other government and major private employers do, it is recommended that state and higher education retirees pay the entire premium for dependent health insurance coverage for dependents under the age of 65. The recommendation would be implemented by including rider language in the 2006–07 General Appropriations Bill for ERS and the Higher Education Employees. Additional language from the riders continued in the 2004–05 General Appropriations Act is underlined on the following page.

FIGURE 2
EMPLOYER CONTRIBUTION FOR THE HEALTH INSURANCE PREMIUMS OF DEPENDENTS OF RETIREES

EMPLOYER	EMPLOYER CONTRIBUTION FOR DEPENDENTS OF RETIREES
City of Austin, TX	50 percent
City of Dallas, TX	6 percent
City of Houston, TX	65 percent if age 65 or over
Dallas County, TX	30 percent if under age 65
Travis County, TX	0 percent
Harris County, TX	50 percent
Dell–TX	0 percent
HEB–TX	Variable if under age 65 and hired before 1972; 0 percent if age 65 or over
Motorola–TX	0 percent
IBM	Subsidy based on retirement date of retiree and Medicare status of dependent
Southwest Airlines–TX	0 percent
State of Arkansas	Up to 76 percent for dependent coverage if covered by Medicare*
State of California	at least 55 percent
State of Florida	0 percent
State of New York	75 percent
State of Texas	50 percent
Teachers Retirement System of Texas	0 percent

*Percentage paid varies by the type of health plan chosen and the cost of the insurance premium.

SOURCE: Employees Retirement System.

Employees Retirement System

5. **State Contribution to Group Insurance for General State Employees.** Funds identified above for group insurance are intended to fund:

   a. the total cost of basic life and health coverage for all active and retired employees;

   b. fifty percent of the total cost of health coverage for spouses and dependent children of all active ~~and retired~~ employees who enroll in coverage categories which include a spouse and/or dependent children;

   c. fifty percent of the total cost of health coverage for spouses and dependent children 65 years and older of all retired employees; and

   d. the additional cost of providing a premium structure comparable to the Children's Health Insurance Program (CHIP) for dependent children of state employees enrolled in the State Kids Insurance Program (SKIP).

Higher Education Employees

1. **State Contribution to Group Insurance for Higher Education Employees Participating in the Employees Retirement System Group Insurance Program.** Funds identified above for group insurance are intended to fund:

   a. the total cost of basic life and health coverage for all active and retired employees;

   b. fifty percent of the total cost of health coverage for spouses and dependent children of all active ~~and retired~~ employees who enroll in coverage categories which include a spouse and/or dependent children; and

   c. fifty percent of the total cost of health coverage for spouses and dependent children 65 years and older of all retired employees.

If the state were to eliminate the 50 percent contribution towards health insurance premiums for retiree dependents who are under age 65, it would realize $93.6 million in General Revenue and General Revenue–Dedicated Funds savings in the 2006–07 biennium and could reduce the appropriations to ERS-General State Employees, ERS-Higher Education Employees, the Texas A&M University System (A&M System), and the University of Texas System (UT System).

In addition to reducing state retiree health insurance expenditures, eliminating the state's share for health insurance premiums for retirees' dependents under age 65 would more closely align the state retirement systems of Texas. As part of TRS-Care, there is no policy in place that requires the state to contribute anything toward teacher retiree dependent health insurance premiums. However, the health insurance premium for dependents of TRS retirees is indirectly subsidized by the member, state, and school district. Therefore, while the member pays the full cost for dependent coverage, the premium is set at approximately half of the cost of market value, reducing the cost to the retiree. The current policy of the state paying half of the premium for general state retirees' dependents results in retirees' dependents under age 65 paying less than 40 percent of their healthcare costs. Requiring them to pay the full premium cost would result in them paying less than 75 percent of their healthcare costs.

In order to shield the state health plan from adverse selection, this recommendation proposes that the state continue its 50 percent contribution level for retirees' dependents aged 65 and older. Adverse selection, in the context of the health insurance industry, is a common concern among employers offering health plans for their employees. It occurs when the pool of members becomes saturated with less healthy plan members, causing costs to increase—those who need the coverage the most will stay, while those with fewer health problems will seek less expensive coverage and create an imbalance of healthy and unhealthy members. Contributing 50 percent of premium costs for dependents once they turn 65 would provide an incentive for healthy retiree dependents to continue their participation in the state health plan once they become eligible for Medicare.

FISCAL IMPACT OF THE RECOMMENDATION

This recommendation would result in a net General Revenue Fund savings of $75.4 million and a net General Revenue–Dedicated Fund savings of $18.2 million in the 2006–07 biennium.

As shown in Figure 3, eliminating the state's 50 percent contribution towards health insurance premiums for retirees' dependents under age 65 would save the state $121.2 million in All Funds in the 2006–07 biennium. This figure accounts for an annual 5 percent retiree population increase and applies current participation levels of members with different coverage types. The savings estimate also reflects the dependent population growth broken out by dependents over and under age 65.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COSTS) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COSTS) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COSTS) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COSTS) TO OTHER FUNDS
2006	$36,660,698	$9,052,243	$7,274,362	$6,183,208
2007	$38,773,732	$9,161,470	$7,638,455	$6,492,686
2008	$39,821,158	$9,275,936	$8,020,008	$6,817,007
2009	$40,964,824	$9,396,322	$8,421,294	$7,158,100
2010	$42,164,115	$9,522,563	$8,842,098	$7,515,783

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not include the savings noted in the fiscal impact table (Figure 3). The gain to the Trust Fund would come from retirees paying the entire health insurance premium for their dependents under 65. This gain could be used to offset retiree healthcare costs and, as a result, make available $75.4 million in General Revenue Funds.

FREEZE LONGEVITY PAY TO MAKE FUNDS AVAILABLE TO REWARD PERFORMANCE

State agencies seldom use merit pay to reward positive employee performance. On the other hand, the state provides longevity pay to all eligible employees regardless of their performance levels for their continued service to the state. It is uncertain whether compensation tools like longevity pay encourage positive employee performance. Yet, in the 2002–03 biennium, the state spent $198 million on longevity pay. At the same time this practice has been prevalent, the legislature has established several pay-for-performance programs to encourage better employee performance. Freezing longevity pay would make funds for pay for performance programs available to agencies to reward employees whose job performance exceeds expectations and would allow the state to more directly link compensation to professional achievement.

SIGNIFICANT FINDINGS

- State employees receive $240 a year in longevity pay for each three years of state service. Longevity pay reaches a maximum of $3,360 a year after 42 years with the state.
- Longevity pay cost the state approximately $99.4 million in All Funds in fiscal year 2004. The average eligible state employee receives $650 a year in longevity pay.
- The average tenure of employees is increasing. In fiscal year 2001, 36 percent of employees had 10 or more years of service while in fiscal year 2003, 38 percent had 10 or more years of service, which may be increasing the state's spending for longevity pay.
- Beginning September 1, 2001, the legislature removed the limitation from the General Appropriations Act on the amount agencies could expend for merit salary increases and promotions. In fiscal year 2003, 18 percent of eligible employees received some type of performance pay.
- The State Auditor's Office surveyed state agencies in November 2003 regarding their perceived usefulness of certain retention strategies. State agencies indicated that merit salary increases, one-time merit payments, and retention bonuses are three of the most useful strategies for retaining key employees.

SIGNIFICANT CONCERNS

- Longevity pay rewards tenure only and is awarded to each eligible employee regardless of performance or disciplinary standing.
- State agencies do not utilize the state's compensation programs because funding is limited.

RECOMMENDATIONS

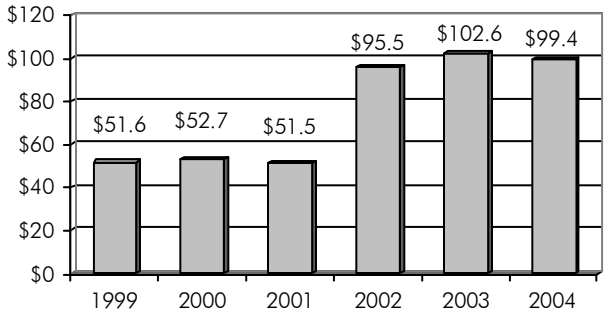
- **Recommendation 1:** Amend Government Code, Chapter 659, Subchapter D to allow employees to continue to receive longevity pay at their current rate until they terminate from state employment.
- **Recommendation 2:** Include a rider in the 2006–07 General Appropriations Bill that requires agencies to use funds made available from freezing longevity pay to reward positive employee performance.

COMMENTS

In the 2002–03 biennium Texas spent $198 million on longevity pay for state employees. Longevity pay is included in an agency's budget as part of salaries and wages and is not a separate appropriation like benefit replacement pay. Approximately 57 percent of the longevity pay expenditure is paid from General Revenue Funds because Texas requires employee benefit costs be proportional to an agency's funding sources.

The effect of longevity pay on the state's workforce is uncertain. In 2001, the legislature approved a substantial longevity pay increase nearly doubling the state's expenditure for longevity pay from $51.5 million in fiscal year 2001 to $95.5 million in fiscal year 2002, as shown in Figure 1. In November 2003, the State Auditor's Office sent a survey to all state agencies asking them to list the types of strategies they use for retention purposes and to rate those strategies' effectiveness. State agencies reported that merit salary increases, one-time merit payments, and retention bonuses are three of the most useful strategies for retaining employees. It is difficult to predict how the longevity pay expenditures will vary from year to year because different factors influence the number of employees receiving longevity pay. For example, the longevity expenditure decreased slightly in fiscal year 2004. The decrease may be attributable to the 8,489 employees who retired between August 2003 and August 2004. Many of those retirees were

FIGURE 1
ANNUAL LONGEVITY EXPENDITURE



SOURCE: Comptroller of Public Accounts.

highly tenured employees who receive longevity pay at a higher rate than the average state employee.

Figure 2 illustrates the various pay for performance programs available to award employees. Yet, state employee compensation issues are consistently at the forefront. House Bill 2914, Seventy-seventh Legislature, Regular Session, 2001, created the Employee Compensation System Evaluation Task Force to evaluate employee compensation and the strengths and weaknesses of the current merit system in Texas. In November 2002, the task force reported that a key tool to use for keeping high performing employees in state government is the effective implementation and sufficient funding of a pay-for-performance system. In the same bill, the legislature expressed its desire for agencies to ensure the expectations for an employee's performance are linked to agency goals and strategic plans. During the Seventy-seventh Legislature, Regular Session, 2001, the legislature removed the salary cap set in the General Appropriations Act (GAA), 2002–03 biennium that limited the amount agencies could spend on merit increases and promotions, a move which was certainly in the spirit of providing additional opportunities to reward positive employee performance.

The federal Office of Management and Budget published a Strategic Management of Human Capital plan for fiscal year 2005 setting forth management practices intended to make employees more aware of their roles in the organization. In federal fiscal year 2005, the federal government will make sure its employees understand how their work contributes to the achievement of the agency's mission and what is expected of them. Appraisal systems will make clear how employees will be evaluated and will distinguish between high and low performers. Implementing a performance appraisal system provides the necessary foundation

FIGURE 2
PAY FOR PERFORMANCE PROGRAMS IN TEXAS

The Legislature has provided avenues for agencies to award performance and retain staff. However, there are not specific appropriations to finance these programs.

Beginning June 2001, statute required agencies to implement a policy that ensured an employee's performance expectations were linked to the goals of the agency contained in its strategic plan. Statue authorizes performance to be awarded in these ways:

- Merit pay is like a raise, it increases an employee's monthly salary.
- One-time merit is like a bonus and is paid in one lump-sum. Both may be awarded every six months when an employee's job performance and productivity are consistently above what is normally expected or required.

To foster and award outstanding performance, productivity, and innovation, the General Appropriations Act (GAA) authorizes an agency to enhance an employee's compensation if the agency achieves or exceeds 80 percent of its key performance measures. The GAA also authorizes an agency to sign a retention bonus contract with an employee for up to $3,000 to guarantee an employee remains with the agency for the next year. The employee must be considered essential to operations to receive this bonus payment.

SOURCE: Legislative Budget Board.

for establishing pay for performance programs in the federal workforce. In the future, a federal employee's additional pay will be directly linked to his or her performance and achievements instead of simply longevity.

State employee salaries and benefits continue to be one of the largest single state expenditures. Changes to employee benefits and cost-sharing arrangements should be considered in light of available state revenue and goals for employee recruitment and retention. Recommendation 1 would amend Government Code, Chapter 659, Subchapter D to accomplish the following:

- freeze longevity pay at the rate employees are receiving it on August 31, 2005; and
- eliminate longevity pay for new employees and any employee who terminates from state employment.

Freezing longevity pay would stop the growth rate of the expenditure and should decrease the state's expenditure by $15.2 million in All Funds by 2010. Figure 3 reflects the costs the state would forgo in longevity pay by prohibiting future increases. The estimate assumes that freezing longevity pay will eliminate the 1 percent growth in the expenditure from fiscal year 2006 to fiscal year 2010. The avoided costs from the 2006–07 biennium would remain in agencies' budgets to award good employee performance. Employees receiving longevity pay on August 31, 2005 would continue to receive it at a frozen rate until they terminate from state employment. However, if an

FIGURE 3
PROJECTED COST OF LONGEVITY PAY WITH ANNUAL GROWTH FISCAL YEARS 2006–2010

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$572,409	$60,254	$200,845	$170,719
2007	$1,150,542	$121,110	$403,699	$343,144
2008	$1,734,457	$182,574	$608,581	$517,294
2009	$2,324,211	$244,654	$815,512	$693,186
2010	$2,919,862	$307,354	$1,024,513	$870,836

SOURCE: Legislative Budget Board.

employee eligible for the benefit were to have a one-day break in service, the employee would be ineligible to receive longevity pay if he or she were to return to state employment.

Recommendation 2 directs state agencies to use the longevity savings created when employees eligible for longevity pay leave state employment for merit pay and other pay-for-performance programs established by the legislature. It is reasonable to expect that the state's longevity expenditure would decrease at approximately the same rate as the benefit replacement pay expenditure because both decrease when employees terminate or retire. In the 2006–07 biennium, Recommendation 2 would make approximately $14.3 million available in All Funds to state agencies as a result of channeling the money no longer spent on longevity pay to pay-for-performance initiatives. This recommendation will not fully fund an employee performance or incentive program, but will allow agencies to strengthen the link between employee compensation and employee achievement.

Contingent upon the passage of legislation to implement Recommendation 1, the following rider should be included in the General Appropriations Bill for the 2006–07 biennium:

> **Performance Pay.** State agencies will retain appropriations made for salaries that become available from freezing longevity pay. State agencies shall use the longevity pay savings to award active employees for exceeding performance expectations. The employee performance payments may be made as a merit increase or another type of pay-for-performance authorized in statute or the General Appropriations Act, including authorized recruitment and retention bonuses.

FISCAL IMPACT OF THE RECOMMENDATIONS

There are no costs or savings associated with the two recommendations because agencies would retain funds made available from freezing longevity pay to fund pay-for-performance programs.

Statutory change is necessary to implement these recommendations. The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations.

IMPACT OF MEDICARE PRESCRIPTION DRUG BENEFITS ON STATE RETIREES

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 adds a new Part D to the Medicare law that provides for a voluntary prescription drug benefit program for Medicare-eligible citizens, most of whom are 65 or older. The law provides for an interim prescription drug card for certain seniors until December 31, 2005. On January 1, 2006, the full voluntary prescription drug benefit program goes into effect. It operates on a calendar year basis.

The provisions of Medicare Part D allow employers to receive a subsidy of roughly 28 percent for most of their expenditures for prescription drugs to encourage them to continue providing prescription drug coverage to their Medicare-eligible insurance plan participants. However, employers have other options. Texas can take advantage of the options with respect to its Medicare-eligible retirees. Significant cost savings are possible through alternatives for providing prescription drug coverage to retirees in the Employees Retirement System, Teacher Retirement System, Texas A&M University System, and The University of Texas System.

SIGNIFICANT CONCERNS

- Under current policies, the state retirement systems will spend $582.3 million in General Revenue Funds ($701.4 million in All Funds) in the 2006–07 biennium on prescription drug coverage for Medicare-eligible retirees.
- Across Texas state retirement systems, Medicare-eligible retirees will spend $363.9 million out-of-pocket, excluding payments toward premiums, on prescription drugs in the 2006–07 biennium. In fiscal year 2007, this will average $1,141 per person.
- The retirement systems could save $164.2 million in General Revenue Funds ($200.5 million in All Funds) in the 2006–07 biennium, without added expense to the retirees, by continuing current prescription drug coverage and claiming a subsidy from the federal government for 28 percent of expenditures on each retiree's annual drug costs between $250 and $5,000.
- The retirement systems could save $388.7 million in General Revenue Funds ($464.0 million in All Funds) in the 2006–07 biennium by eliminating prescription drug coverage and only paying the Medicare Part D premiums for retirees and their spouses.
- The retirement systems could save $233.6 million in General Revenue Funds ($279.2 million in All Funds) in the 2006–07 biennium by eliminating prescription drug coverage, paying the Medicare Part D premiums, and providing a payment of $600 for retirees to use for paying their deductible and copayments.
- The retirement systems could save $250.1 million in General Revenue Funds ($298.9 million in All Funds) in the 2006–07 biennium by eliminating prescription drug coverage and developing a cost-sharing plan to cover part of the Medicare Part D benefits. Payments would cover premiums, roughly half of the Medicare $250 deductible, and half of drug costs between $250 and $8,150.

RECOMMENDATIONS

- **Recommendation 1:** To reflect availability of the 28 percent subsidy for prescription drug costs from Medicare for Medicare-eligible individuals, appropriations to the state retirement systems should be reduced by $164.2 million in General Revenue Funds for the 2006–07 biennium.
- **Recommendation 2:** Consider eliminating prescription drug coverage for Medicare-eligible state retirees and dependents, and instead provide a portion of the costs for premiums, deductibles, and copayments for accessing Medicare Part D benefits.

COMMENTS

The Medicare Part D prescription drug program begins on January 1, 2006. Medicare-eligible individuals who choose to participate in the Medicare Part D program must pay a monthly premium (estimated at $35 for calendar year 2006 and adjusted annually for inflation) to a prescription drug plan (PDP) sponsor who offers a federally approved prescription drug plan. The participants have a $250 annual deductible, which is also adjusted each year to accommodate increased costs due to inflation. After the participant pays the deductible, Medicare will pay 75 percent of the cost of covered prescription drugs up to an initial coverage limit ($2,250 in calendar year 2006 and adjusted annually

for inflation). The program participant is then responsible for all prescriptions drug costs until they have reached an annual out-of-pocket threshold ($3,600 in calendar year 2006 and adjusted annually for inflation). The $3,600 in annual out-of-pocket cost includes the deductible but must be paid by an individual; payments by employers do not count toward the threshold. Once the annual out-of-pocket threshold is reached, Medicare provides catastrophic coverage, paying 95 percent of the cost of covered prescription drugs. Figure 1 gives an example of cost sharing for a person with annual prescription drugs costing $6,000.

Not all prescription drugs are covered under Medicare Part D. Drugs or classes of drugs excluded or optional under Medicaid (except for smoking cessation agents) are not covered. Exclusions include agents used for weight loss or weight gain, medications for the symptomatic relief of coughs and colds, prescription vitamins and mineral products, barbiturates, and benzodiazepines. Expenditures on these items do not count toward the individual's annual out-of-pocket threshold.

In addition, Medicare-eligible individuals with income under 150 percent of the federal poverty level—$1,211 per month for a single person or $1,626 per month for a couple in 2007—are entitled to a premium subsidy paid totally or in part by Medicare. They do not have to pay the annual deductible or they pay at a reduced level. Cost sharing is also eliminated or reduced.

Congress provided a subsidy to employers in order to encourage them to continue providing prescription drug coverage for Medicare-eligible retirees. Medicare will reimburse employers 28 percent of the cost of drugs for which Medicare allows payment under Part D for Medicare-eligible retirees and dependents. Covered costs include the ingredient costs (the cost of the drug itself) and the dispensing fee, but exclude administrative costs. In 2006, this subsidy is limited to covered costs between $250 and $5,000, and will be adjusted for inflation in future years. The subsidy amount is reduced by the amount of any price concessions, such as rebates or discounts, received on behalf of these retirees for covered drug costs.

On the other hand, the 28 percent subsidy is applied to the cost paid by the employer plus the direct cost paid by the retiree. For example, retirees at the Employees Retirement System (ERS) typically pay about 40 percent of the cost of prescription drugs. If an ERS retiree had $1,000 in prescription drug expenses in a year, the retiree would pay $400 and ERS would pay $600. Medicare would reimburse ERS 28 percent of $750 because the subsidy only applies to costs between $250 and $5,000. ERS would receive $210 or 35 percent of the $600 it paid. Aggregated over all costs and all retirement systems, the subsidy effectively reimburses retirement systems for 33 percent of their payments for covered drugs.

For the employer to get this subsidy, the retiree cannot be enrolled in a Part D prescription drug plan or a Medicare Managed Care plan with prescription drug coverage. In addition, prescription drug plans have to provide drug coverage at least equal to a standard set by Medicare.

CURRENT PRESCRIPTION DRUG COVERAGE FOR STATE RETIREES AND SPOUSES

As Figure 2 shows, in state fiscal year 2006 there will be about 168,000 Medicare-eligible retirees and spouses (also referred to as "participants") in the state retirement systems, excluding about 4 percent of retirees and spouses in Health Maintenance Organizations (HMOs). More than half of the 168,000 participants (55 percent) receive benefits through the Teacher Retirement System (TRS), about 35 percent through ERS, and the remaining 10 percent through the two university systems.

FIGURE 1
MEDICARE PART D COPAYMENTS FOR PRESCRIPTION DRUGS BY PAYER, CALENDAR YEAR 2006

RANGES OF DRUG EXPENDITURES	PARTICIPANT PAYS	MEDICARE PAYS		EXAMPLE: $6,000 IN ANNUAL PRESCRIPTION DRUG EXPENDITURES	
				PARTICIPANT PAYS	MEDICARE PAYS
$0 to $250	100%	0%	=>	$250	$0
$251 to $2,250	25%	75%	=>	$500	$1,500
$2,251 to $5,100	100%	0%	=>	$2,850	$0
$5,101 and over	5%	95%	=>	$45	$855
			Totals	$3,645	$2,355

NOTE: This example is for illustrative purposes only. Most people have annual prescription drug costs considerably lower than this. Ranges will be adjusted annually for inflation.
SOURCE: Legislative Budget Board.

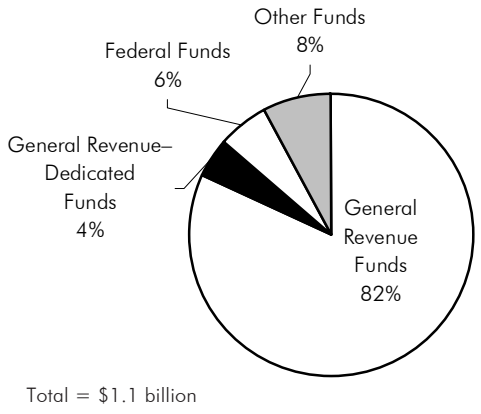
FIGURE 2
NUMBER OF MEDICARE-ELIGIBLE STATE RETIREES AND SPOUSES

	STATE FISCAL YEAR	
	2006	2007
Employees Retirement System	59,470	61,848
Teacher Retirement System	91,335	94,258
The University of Texas System	11,000	11,440
Texas A&M University System	5,781	5,840
Total	167,586	173,386

NOTE: Retirees and spouses participating in Health Maintenance Organizations (HMOs) are not included. HMO enrollees account for roughly 4 percent of all retirees and spouses, but enrollment is probably lower for people 65 and older.
SOURCE: Legislative Budget Board.

Under the current prescription drug plan for retirees, state retirement systems and participants are projected to spend $1.1 billion on prescription drugs for Medicare-eligible retirees over the 2006–07 biennium. Of this, $701.4 million is estimated to be retirement system funds, and the remaining $363.9 million is projected participant contributions. Of the $701.4 million, 83 percent ($582.3 million) is attributable to General Revenue Funds, and 4 percent ($30.4 million) is attributable to General Revenue–Dedicated Funds across all four systems (Figure 3).

FIGURE 3
PRESCRIPTION DRUG COVERAGE FOR MEDICARE-ELIGIBLE RETIREES AND SPOUSES BY METHOD OF FINANCE: 2006–07 BIENNIUM



SOURCE: Legislative Budget Board.

However, within each retirement system, the method of finance varies greatly. For example, General Revenue Funds make up 100 percent of system funds at TRS, yet only 60 percent of system funds at ERS. The remainder of the ERS System funding is made up of General Revenue–Dedicated Funds, 6 percent; Federal Funds, 15 percent; Highway Fund 6, 12 percent; and Other Funds, 6 percent.

Coverage of prescription drugs is included in the total healthcare premiums paid out of each system. However, retirement systems vary in the level of support to retirees and spouses. Participants' deductibles and copayments cover from 30 percent (at TRS) to 40 percent (at ERS) of total prescription drug costs. ERS and The University of Texas (UT) pay all of the premiums for retirees, but only half of the premiums for spouses and dependents. Premiums plus copayments cover all of the healthcare expenditures. At TRS and Texas A&M University (A&M), both retirees and spouses pay a premium, but the premiums plus copayments do not cover all of the healthcare expenditures. Deductibles for prescription drugs are in effect for ERS, UT, and A&M, but not for TRS. All systems use a three-tiered approach to copayments for prescription drugs, with staggered amounts for generic drugs, preferred name brand drugs, and other drugs.

Yearly estimates of the increase in the number of participants aged 65 and older range from 1 percent to 4 percent, depending on the retirement system. At the same time, estimates of the increase in the average cost of prescription drugs per Medicare-eligible person are approximately 15 percent per year.

STATE OPTIONS FOR SAVING GENERAL REVENUE FUNDS BY TAKING ADVANTAGE OF MEDICARE PART D

The new Medicare Part D prescription drug benefit has significant potential savings for Texas state retirement systems. Four options were reviewed and are presented here. Assuming no change in coverage from state fiscal year 2005 other than cost inflation and population growth, all of these options save General Revenue Funds compared with the estimated cost of retirement systems' prescription drug plans.

The analysis presented here does not account for the possibility that some retirees may have incomes under 150 percent of the federal poverty level. These retirees would pay less under Part D, and savings to the state retirement systems would be slightly higher than the analysis indicates. Furthermore, estimated costs or savings in agency administration are not included.

Option 1: Maintain the current systems, but secure the 28 percent drug subsidy from Medicare for prescription drugs provided to Medicare-eligible retirees (including covered Medicare-eligible spouses).

Option 2A: Eliminate prescription drug coverage to Medicare-eligible individuals and pay Medicare premiums, but provide no cost sharing.

Option 2B: Eliminate prescription drug coverage to Medicare-eligible individuals, pay Medicare premiums, and provide a fixed payment amount to retirees that would enable them to maintain the current average monthly per capita payment (based on ERS).

Option 2C: Eliminate prescription drug coverage to Medicare-eligible individuals and develop a cost-sharing plan to cover part of the Medicare Part D benefits. Payments could cover monthly Medicare premiums, roughly half of the $250 deductible, and half of drug costs between $250 and Medicare's limit for catastrophic coverage, without a significant increase in costs to participants.

The Medicare prescription drug program does not begin until January 1, 2006, and the analyses presented here assume that the current drug benefits will continue from September 1, 2005 to December 31, 2005.

Figure 4 sketches the types of costs associated with each option. It also includes estimates of the cost and change in cost per participant borne by the retirement system, participants, and Medicare. Figure 5 graphically presents the costs and changes in costs per participant for each option.

The cost estimates for Options 2A, 2B, and 2C assume identical prescription drug benefits for retirees and spouses. Currently, retirees and spouses have the same deductibles and copayments; however, state retirement systems' subsidies for healthcare premiums for the two groups are different. It is assumed that differences between retiree and spouse healthcare premiums will continue under any prescription drug option, with the prescription drug benefits being the same.

In many cases, the following analysis is based on the average impact on retirees and spouses across all the systems; but the systems have differing levels of benefits. The vast majority of TRS retirees are in TRS-Care III, which has no deductible and significantly lower copayments than the other systems. In addition, TRS has the most retirees, so a change to prescription drug coverage which is cost neutral to participants in general would tend to impact TRS retirees somewhat negatively but would provide cost advantages to all other participants.

Option 1: The retirement systems would maintain their current prescription drug benefits but take the steps necessary to get the 28 percent retiree drug subsidy from Medicare for prescription drugs provided to Medicare-eligible retirees (including covered Medicare-eligible spouses). Over the 2006–07 biennium, this option would save an estimated $164.2 million in General Revenue Funds, $2.2 million in General Revenue–Dedicated Funds, and $200.5 million in All Funds compared to the estimated cost for the biennium if no changes are made from the plan in place for state fiscal year 2005. Under this option, all cost savings accrue to the systems, and program participants continue to incur prescription drug costs at the same level as they currently do.

This option would be relatively simple to implement. As long as the prescription drug plans are actuarially equivalent to the "standard drug coverage" under Medicare Part D, retirement systems can continue their currently planned prescription drug programs and obtain the subsidy. This option allows considerable flexibility in establishing formularies, but the retirement systems or benefit coordinators will have to be able to separate medications that Medicare covers from prescription drugs that Medicare does not cover. In addition, if any participants are enrolled in Medicare Part D, they would need to be identified and excluded from claims for the 28 percent subsidy. Retirement systems must also be able to apportion rebates or other cost concessions to those attributable to the Medicare Part D populations' drug costs. Moreover, retirement systems will incur some administrative costs in applying for the subsidy, providing notices to participants, reporting to the federal Centers for Medicare and Medicaid Services (CMS), and maintaining records. These costs have not been included in the estimates presented here. Finally, the timing of the subsidy payments by Medicare under this option is uncertain. Medicare could delay paying the subsidy by raising questions about information provided to them by the retirement systems.

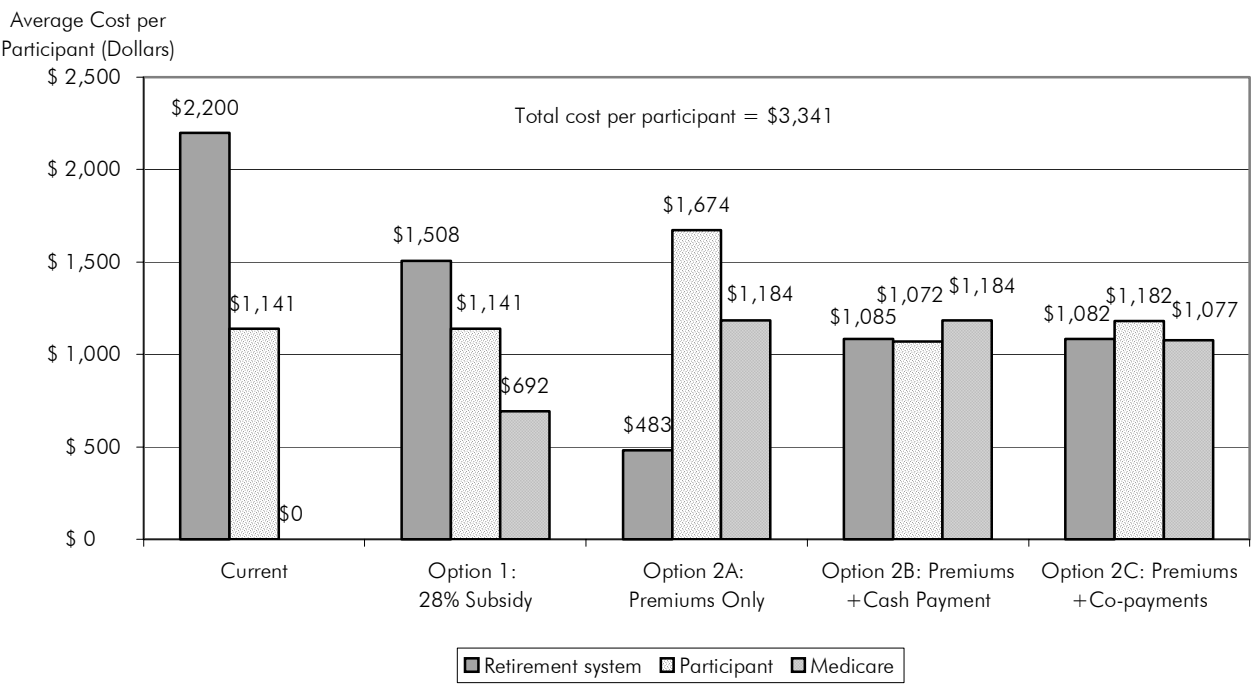
Option 2A: Retirement systems would eliminate prescription drug coverage for Medicare-eligible individuals, but systems would pay for Part D premiums (estimated at $35 per month in 2006) for retirees and spouses. Over the 2006–07 biennium, this option would save an estimated $388.7 million in General Revenue Funds, $7.8 million in General Revenue–Dedicated Funds, and $464.0 million in All Funds compared to the estimated cost for the biennium if no changes are made from the plan in place for state fiscal year 2005. Retirees and their covered spouses would incur an additional out-of-pocket cost of $171.3 million over the biennium if they participate in the Medicare Part D prescription drug program and incur prescription drug costs at current levels. This is equivalent to an increase of

FIGURE 4
ANNUAL COSTS PER PARTICIPANT ASSOCIATED WITH VARIOUS OPTIONS

PREMIUMS		DEDUCTIBLES		CO-PAYMENTS		CASH PAYMENT		2007 COSTS = ($3,341)		
SYSTEM	PARTICIPANT	SYSTEM	PARTICIPANT	SYSTEM	PARTICIPANT	SYSTEM	PARTICIPANT	SYSTEM	PARTICIPANT	MEDICARE
Current prescription drug coverage.										
100% of retiree's total health premium; 50% of spouse's total health premium	0% of retiree's total health premium; 50% of spouse's total health premium	$0	($50) except Teacher Retirement System	N/A	Varies by system and type of drug (generic, preferred,or other)	$0	$0	TOTAL COSTS		
								($2,200)	($1,141)	$0
Option 1. Claim 28 percent subsidy.										
Same as current		Same as current		Same as current		Same as current		TOTAL COSTS		
								($1,508)	($1,141)	($692)
								NET SAVINGS (COST)		
								$692	$0	($692)
Option 2A. Eliminate system drug coverage; systems pay Part D premiums.										
($420)	$0	$0	($250)	$0	(25% of $251–$2,250 100% of $2,251–5,100 5% above $5,100)	$0	$0	TOTAL COSTS		
								($483)	($1,674)	($1,184)
								NET SAVINGS (COST)		
								$1,717	($533)	($1,184)
Option 2B. Eliminate system drug coverage; systems pay Part D premiums and $600 cash payment.										
($420)	$0	$0	($250)	$0	(25% of $251–$2,250 100% of $2,251–5,100 5% above $5,100)	$600	$0	TOTAL COSTS		
								($1,085)	($1,072)	($1,184)
								NET SAVINGS (COST)		
								$1,115	$69	($1,184)
Option 2C. Eliminate system drug coverage; systems develop a cost-sharing plan for out-of-pocket expenses.										
($420)	$0	($100)	($150)	(50% of $2,251–$8,150)	(25% of $251–$2,250 50% of $2,251–8,150 5% above $8,150)	$0	$0	TOTAL COSTS		
								($1,082)	($1,182)	($1,077)
								NET SAVINGS (COST)		
								$1,118	($41)	($1,077)

NOTES: The description of current premium coverage is based on the Employees Retirement System and The University of Texas System; the Teacher Retirement System and Texas A&M System have a more complex premium-sharing plan. Medicare Part D premiums, deductibles and thresholds for copayments are subject to annual inflation. Retirees and spouses would also assume any costs associated with prescription drugs not covered by Medicare in Options 2A, 2B and 2C. Plan components (i.e., premiums, deductibles, copayments, and cash payments) are outlined for 2006; actual costs are based on 2007 to reflect a full year of expenditures.
SOURCE: Legislative Budget Board.

FIGURE 5
COMPARISON OF MEDICARE PRESCRIPTION DRUG OPTIONS COSTS PER PARTICIPANT, CALENDAR YEAR 2007



SOURCE: Legislative Budget Board.

over $500 per participant each year. About 82 percent of participants would have increases in out-of-pocket expenditures, with about 27 percent of the total paying an additional $1,000 or more for prescription drugs.

Option 2B: The retirement systems would eliminate prescription drug coverage for Medicare-eligible individuals, but would pay Medicare Part D premiums and provide a payment of $600 for retirees and their spouses to use for paying prescription drug copayments. Under this option, the total benefit paid by retirement systems in fiscal year 2007 would be $1,085 per participant. On average, this payment level allows retirees' annual per capita payment under their current plans to be maintained, resulting in a slight savings of $69 per participant in state fiscal year 2007 (see Figure 4). Over the 2006–07 biennium, this option would save an estimated $233.6 million in General Revenue Funds, $4.7 million in General Revenue–Dedicated Funds, and $279.2 million in All Funds compared to the estimated cost for the biennium if no changes are made from the plan in place for state fiscal year 2005. This option saves $69.5 million more in General Revenue Funds than claiming the 28 percent subsidy under Option 1.

While this option is relatively simple to implement, it raises a number of issues. Retirees with low drug expenses would have extra cash while those with medium-to-high drug expenses would have considerably higher out-of-pocket costs than they do under the current system. State retirement system funds now used to pay for healthcare would be available for people with low drug costs to use at their discretion. About 35 percent of participants would incur higher out-of-pocket costs under this option than they do under the current prescription drug programs, with 14 percent of the total seeing their out-of-pocket costs rise by over $1,000.

In addition, participants in ERS would fare better in terms of their current out-of-pocket costs at this payment level than participants in other systems. This is because ERS participants' current out-of-pocket costs for prescription drugs are higher than out-of-pocket costs in the other systems. Without prescription drug benefits or assistance with deductibles and copayments from the state retirement systems, participants' out-of-pocket costs rise dramatically. Since ERS participants are already paying a relatively high level of out-of-pocket costs, the $600 payment would result in their out-of-pocket costs, on average, going down by about $300. Similarly, participants at A&M would have a reduction in out-of-pocket costs of about $85. Participants at TRS, on the other hand, would see an increase in their out-of-pocket costs of about $100. UT participants would pay about the same.

Finally, a cash payment would be considered taxable income by the Internal Revenue Service. Therefore, the actual amount available for payment of prescription drugs is lower, the amount depending on the participant's tax bracket. For example, a person in the 15 percent tax bracket would only have $510 of the $600 cash payment to spend on prescription drugs. The cash payment would have to increase to $706 to result in $600 being available at the 15 percent tax level. At a payment of $706, General Revenue Fund savings would drop by $23.6 million to $210.0 million over the 2006–07 biennium.

Option 2C: The retirement systems would eliminate prescription drug coverage for Medicare-eligible individuals and develop a cost-sharing plan to cover part of the Medicare Part D benefits. Payments by the retirement systems would cover monthly Medicare premiums, roughly half of the $250 Medicare deductible, and half of drug costs between $2,250 and Medicare's limit for catastrophic coverage. Participants would pay the first $50 of the $250 deductible and half of the remaining $200 of the deductible. They would be responsible for the 25 percent copayment between $250 and $2,250 in total prescription drug costs, with Medicare paying the other 75 percent. Participants would then pay half of drug costs between $2,250 and Medicare's limit for catastrophic coverage, and 5 percent after they have paid the annual out-of-pocket threshold. Medicare would pick up the remaining 95 percent above the out-of-pocket threshold.

Over the 2006–07 biennium, this option would save an estimated $250.1 million in General Revenue Funds, $4.9 million in General Revenue–Dedicated Funds, and $298.9 million in All Funds compared to the estimated cost for the biennium if no changes are made from the plan in place for state fiscal year 2005. It would save $85.9 million more in General Revenue Funds than claiming the 28 percent subsidy under Option 1. Under this scenario, participants' costs for prescription drugs would increase an average of $41 per person in fiscal year 2007 over their payments in the current system. Almost 60 percent of participants would have higher out-of-pocket expenditures, but 37 percent of the total would pay less than $250 in additional costs, and only 4 percent would see their out-of-pocket costs rise by over $1,000. Out-of-pocket costs would be lower for almost 80 percent of ERS participants, and only 15 percent of ERS participants would face additional costs in excess of $25. The average out-of-pocket costs for ERS participants would be about $200 less than they are now.

Because only expenditures made by participants count toward filling the Medicare gap between $2,250 and the catastrophic level, the more the state retirement systems cover the gap, the higher the total drug expenditures must be to trigger Medicare's 95 percent catastrophic coverage level. Thus, the state retirement systems and participants are paying for drugs that Medicare would be paying for under Options 2A or 2B. With the retirement systems covering 50 percent of the costs in this gap, the gap expands to $8,440 in calendar year 2007 before Medicare catastrophic coverage is applied.

Option 2C is complex by necessity due to the complexity of the Medicare Part D structure. It would be confusing to participants, who would face different copayment levels depending on the total amount spent on prescription drugs. It would also require retirement systems or benefit managers to closely track total drug expenditures in order to verify correct payment. Nevertheless, every person participating in a Medicare Part D prescription drug program will face this complexity. Pharmacies and benefit managers will also have to deal with tracking drug expenditures related to Part D coverage, which could increase administrative costs.

Option 2C is equitable in the sense that payments by the state retirement systems are tied to the use of prescription drugs. State retirement system funds intended for healthcare will be spent on healthcare rather than discretionary spending, as they could be under Option 2B. In addition, this option is an efficient use of state retirement system funds because all of the benefits are used to purchase healthcare rather than some of them going to pay federal income taxes. While those with higher costs would pay more in total as they currently do, the state retirement systems would share the burden up to the point Medicare catastrophic coverage is reached.

Because the Medicare Part D program runs on a calendar year, Option 2C would be difficult to implement unless retirement systems also switch their prescription drug plans to a calendar year. Further, retirement systems may have difficulty modifying their health plans and automated systems in time to implement this option by January 1, 2006.

SUMMARY OF THE FISCAL IMPACT OF THE OPTIONS

Figure 6 provides the estimated costs to the state retirement systems for prescription drugs for the 2006–07 biennium under the current system, and includes net savings under each of the options described above. Figure 7 provides a comparative summary of the options.

Recommendation 1 indicates that funding for retirement systems should be reduced by the estimated amount of the 28 percent subsidy from Medicare. Figure 8 provides General Revenue Fund savings related to the the subsidy by retirement system.

FIGURE 6
COMPARISON OF OPTIONS FOR COVERING PRESCRIPTION DRUGS FOR MEDICARE-ELIGIBLE RETIREES BY METHOD OF FINANCE, 2006–07 BIENNIUM (IN MILLIONS)

		SYSTEMS' SAVINGS COMPARED WITH CURRENT COVERAGE			
FUNDING	CURRENT COST	OPTION 1: OBTAIN 28 PERCENT SUBSIDY	OPTION 2A: PREMIUMS ONLY	OPTION 2B: PREMIUMS + CASH PAYMENT	OPTION 2C: PREMIUMS + CO-PAYMENTS
General Revenue Funds	($582.3)	$164.2	$388.7	$233.6	$250.1
General Revenue–Dedicated Funds	($12.5)	$2.2	$7.8	$4.7	$4.9
Highway Fund 6	($25.2)	$9.3	$15.6	$9.5	$10.0
Federal Funds	($30.5)	$8.8	$18.9	$11.4	$12.1
Other Funds	($50.9)	$16.0	$33.0	$20.1	$21.9
All Funds	($701.4)	$200.5	$464.0	$279.2	$298.9

NOTES: The figure includes information for the Employees Retirement System, Teacher Retirement System, The University of Texas System, and Texas A&M University System. Numbers may not add due to rounding. Higher Education Systems' Other Funds are not appropriated.

SOURCE: Legislative Budget Board.

FIGURE 7
SUMMARY OF OPTIONS FOR COVERING PRESCRIPTION DRUGS FOR MEDICARE-ELIGIBLE RETIREES

	OPTION 1: OBTAIN 28 PERCENT SUBSIDY	OPTION 2A: PREMIUMS ONLY	OPTION 2B: PREMIUMS + CASH PAYMENT	OPTION 2C: PREMIUMS + CO-PAYMENTS
Implementation and operation	◆ Fairly simple	◆ Very simple	◆ Fairly simple	◆ Complex ◆ Requires close tracking tracking benefit managers
Impact on retirees, per person per year	◆ No impact	◆ $533 more paid on average ◆ 82 percent have some increase ◆ 27 percent have increases over $1,000	◆ $69 saved on average ◆ 35 percent have some increase ◆ 14 percent have increases over $1,000	◆ $41 more paid on average ◆ 58 percent have some increase ◆ 4 percent have increases over $1,000 ◆ 47 percent have increases under $250
Other considerations	◆ All state retirement systems' benefits are used for healthcare	◆ All state retirement systems' benefits are used for healthcare	◆ Allows discretionary spending ◆ Cash payment is taxed	◆ All state retirement systems' benefits are used for healthcare

SOURCE: Legislative Budget Board.

FIGURE 8
SAVINGS TO STATE RETIREMENT SYSTEMS FROM THE 28 PERCENT MEDICARE PART D SUBSIDY 2006–07 BIENNIUM (IN MILLIONS)

RETIREMENT SYSTEM	GENERAL REVENUE FUNDS
ERS	$39.3
TRS	$116.1
UT	$5.0
A&M	$3.7
Total, All Systems	$164.2

NOTE: Numbers may not add due to rounding.

SOURCE: Legislative Budget Board.

Recommendation 2 suggests consideration should be given to eliminating prescription drug coverage for Medicare-eligible retirees and dependents and providing a portion of the costs for premiums, deductibles, and copayments for accessing Medicare Part D benefits.

The information used in developing the estimates includes the cost of some drugs that are covered by the retirement systems but are not covered by Medicare Part D. It is estimated that 2 percent of prescription drug costs are for non-covered drugs. Costs under Options 2A, 2B, or 2C will be higher for state retirement systems that choose to continue coverage of these drugs. Additionally, the regulations for the Medicare Part D prescription drug program are not yet finalized. Final regulations could change some of the assumptions used to obtain the figures. Finally, removing retiree drug benefits from system coverage could have an impact on the costs of prescription drugs for remaining covered employees.

FISCAL IMPACT OF THE RECOMMENDATIONS

Figure 9 shows the five-year fiscal impact of claiming the 28 percent subsidy, by method of finance. Implementing this recommendation would save an estimated $164.2 million in General Revenue Funds and $2.2 million in General Revenue–Dedicated Funds during the 2006–07 biennium. Retirement systems would incur some administrative costs in applying for the subsidy, providing notices to participants reporting to the federal Centers for Medicare and Medicaid Services, and maintaining records. These costs have not been included in the estimates presented here.

The introduced 2006–07 General Appropriations Bill includes a reduction of $164.2 million in General Revenue Funds related to claiming the 28 percent subsidy from Medicare.

FIGURE 9
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS TO FEDERAL FUNDS	PROBABLE SAVINGS TO OTHER FUNDS	PROBABLE SAVINGS TO ALL FUNDS
2006	$65.8	$0.9	$3.5	$10.2	$80.4
2007	$98.3	$1.3	$5.3	$15.1	$120.0
2008	$116.8	$2.9	$7.0	$16.4	$143.1
2009	$139.1	$3.4	$8.4	$19.7	$170.5
2010	$165.5	$4.1	$10.0	$23.5	$203.1

NOTE: Higher Education Systems' Other Funds are not appropriated.

SOURCE: Legislative Budget Board.

IMPLEMENT A TIERED COINSURANCE PLAN FOR STATE EMPLOYEES

Participants in the Employees Retirement System HealthSelect health plan pay a flat coinsurance rate of 20 percent as their share of the cost of medical services in addition to other healthcare costs for which they are responsible, such as copayments and sometimes deductibles. As an alternative to a flat percentage rate, a tiered coinsurance plan would stipulate different coinsurance percentages for different levels of medical spending. Such a method would directly link the amount a participant pays for medical services to the cost of healthcare service received and more evenly distribute the cost of medical services according to each participant's consumption of medical services. Under a tiered coinsurance plan, participants have more incentive to be efficient purchasers of medical services, and when participants make cost-effective choices, both the state and the participant save money through equitable cost sharing. Tiered coinsurance could save the state approximately $38.8 million in General Revenue Funds and $4.0 million in General Revenue–Dedicated Funds in the 2006–07 biennium. As participants make more cost-effective choices about utilization, the savings would be greater.

SIGNIFICANT FINDINGS

- The average annual increase in Employees Retirement System health plan expenditures from fiscal year 1998 to fiscal year 2003 was 11 percent.
- The Employees Retirement System projects health plan expenditures to exceed $3 billion in the 2004–05 biennium.
- In fiscal year 2003, 7 percent of the participants in HealthSelect had annual medical benefits spending between $5,000 and $49,999, which accounted for 45 percent of the health plan's medical expenses.

SIGNIFICANT CONCERNS

- HealthSelect's current coinsurance structure limits a participant's coinsurance to $1,000 regardless of the cost of their medical expenses.
- Participants who account for the majority of the costs have less financial incentive to be efficient purchasers of medical services.

RECOMMENDATION

- Include a rider in the 2006–07 General Appropriations Bill to direct the Employees Retirement System to implement a tiered coinsurance plan to control healthcare costs and link the amount a participant pays for his or her medical services (excluding prescription drugs to his or her costs).

COMMENTS

Tiered coinsurance requires participants who spend more on healthcare to pay a larger portion of their expenses. As such, it motivates participants to shop for value, scrutinize bills for accuracy, and curb unnecessary utilization. Unlike flat rate coinsurance, tiered coinsurance more directly links the contributions of participants to their individual spending. Additionally, tiered coinsurance promotes a consumer approach to the use of medical services. It requires participants to pay a percentage of their healthcare expenses until their out-of-pocket spending reaches a maximum dollar amount. After the participant pays the maximum out-of-pocket amount established in the healthcare plan, the plan then covers 100 percent of any additional allowable costs.

Under the current HealthSelect coinsurance arrangement the Employees Retirement System (ERS) pays 80 percent of medical expenses and the participant pays 20 percent until the participant pays an out-of-pocket maximum of $1,000. Thereafter, the plan pays 100 percent. By contrast, a tiered coinsurance plan requires participants' out-of-pocket expenses to be more proportional to the amount of their medical spending. A tiered coinsurance would shift a proportionate amount of the cost of physician and medical services to participants, thus ensuring equitable cost sharing between the state and participants for healthcare expenses. Legislative Budget Board staff estimate tiered coinsurance would save $38.8 million in General Revenue Funds and $4.0 million in General Revenue–Dedicated Funds in the 2006–07 biennium. This cost savings estimate is based on the sample coinsurance plan in Figure 1. The sample tiered coinsurance plan is applicable to medical spending up to $200,000 annually. It also limits an individual's coinsurance maximum and provides reduced coinsurance rates for employees who qualify for low-income family subsidies for insurance.

Ninety-two percent of participants in the ERS health plan had less than $5,000 in medical claims in fiscal year 2003. Once a participant satisfies the coinsurance maximum of $1,000, his or her coinsurance contribution responsibilities stop. For example, if a participant spends $5,000, his or her contribution is $1,000. If a participant spends $49,000, his or

FIGURE 1
SAMPLE TIERED COINSURANCE PLAN

TIER	MEDICAL SPENDING RANGE	EMPLOYEE COINSURANCE
Tier 1	$1 – $5,000	20 percent
Tier 2	$5,001 – $10,000	10 percent
Tier 3	$10,001 – $40,000	5 percent
Tier 4	$40,001 – $80,000	2 percent
Tier 5	$80,001 – $200,000	1 percent

SOURCE: Legislative Budget Board.

her contribution is still $1,000, and the state is required to pay the other $48,000.

As healthcare costs continue to rise, employers have fewer cost-saving options. Decreasing network size and negotiating lower contract fees with providers are exhaustible options. At some point, employers must consider changes to benefit plans or the modification of cost-sharing arrangements through increasing the following for participants: deductibles, coinsurance amounts, and other plan out-of-pocket costs. Raising deductibles adversely affects employees with low claims by requiring them to pay a large percentage of their individual spending. Texas employers are struggling to cope with the national trend of rising healthcare costs. The national expenditure for healthcare has nearly doubled since 1992, reaching approximately $1.6 trillion in 2002. The annual ERS health plan expenditure was $1.4 billion in fiscal year 2002 and $1.5 billion in fiscal year 2003.

ERS implemented several benefit plan design changes in fiscal year 2003, including changes to copayments, coinsurance, and eligibility for certain employee groups to address rising healthcare costs. ERS is currently estimating that those changes to the benefit plan will result in over $600 million in savings to the state in the 2004–05 biennium. Still, an increasing number of participants turned in medical claims over $50,000 in 2003. Furthermore, 7 percent of participants in HealthSelect had an annual medical benefit spending between $5,000 and $49,999, which accounted for 45 percent of the health plan's medical expenses. A tiered coinsurance plan would address higher cost claims and require the 8 percent of participants with claims over $5,000 to contribute more toward the cost of their medical claims.

If participants are required to pay greater out-of-pocket expenses, they will have more incentive to become involved in the selection of effective care providers and treatments. This involvement on the part of participants is likely to place additional pressure on hospitals and physicians to disclose information about costs and performance. Instead of controlling costs by limiting supply with managed care, employers could control costs by limiting demand for services, thereby producing a more consumer-driven approach to healthcare purchases. A consumer-driven approach to healthcare spending would put greater economic purchasing choices in the hands of the participants. If a participant's financial ability to access healthcare becomes a concern, the state could cap participant expenses at a percentage of the individual's income, thereby placing a limit on the burden to the sick according to their ability to pay.

A secondary benefit to implementing a tiered coinsurance plan is the cost avoidance resulting from decreased utilization. As participants make more cost-effective decisions, utilization decreases and savings increase. Under the current coinsurance arrangement (80/20), when a participant avoids a $100 out-of-pocket expense, the plan saves $400. The same cost avoidance in a tiered coinsurance plan from a participant in the upper tier would avoid $9,900 in costs to the state. While no additional savings from decreased utilization is quantified here, it is expected that more cost-effective choices by participants would result in greater savings to the plan.

Even if these savings are not fully realized through lower appropriations this biennium, they would be reflected in future trends. For example, if a participant avoids 10 percent of their healthcare costs, the plan would save 5.5 percent of its costs. This is because the current coinsurance arrangement only applies to approximately 40 percent of benefit expenditures and tiered coinsurance will affect about an additional 55 percent of benefit expenditures. If participants avoid 10 percent of their costs, the plan would be expected to save 10 percent of the costs now affected by the tiered coinsurance plan, which would be 5.5 percent. A 5.5 percent savings in plan costs would equate to a savings of about $150 million in All Funds in the 2006–07 biennium.

State employee salaries and benefits continue to be one of the largest single state expenditures. Changes to employee benefits and cost-sharing arrangements should be considered in light of available state revenue and goals for employee recruitment and retention. The recommendation proposes a tiered coinsurance plan as a feature of the HealthSelect healthcare plan in an effort to achieve more equitable cost sharing. Figure 1 provides an example of a tiered coinsurance design. The percentages in Figure 1's tiered coinsurance design distribute the cost of medical services more evenly among participants at all spending levels. An annual coinsurance maximum or lifetime coinsurance maximum may be adjusted to limit a participant's out-of-pocket contribution.

For the purpose of making the cost-sharing levels proportional to spending and to establish the most equitable rates possible, the recommendation requires ERS to identify the appropriate coinsurance percentages based on participant utilization and spending. In addition, ERS should consider a

similar distribution or compatible plan for non-network and out-of-area HealthSelect participants. The ERS Board of Trustees should develop the most suitable tiered coinsurance design. To implement the appropriate tiered coinsurance plan, the following rider should be included in the 2006–07 General Appropriations Bill:

> The Employees Retirement System shall implement a tiered coinsurance plan to control healthcare costs and link the amount a participant pays for his or her medical services (excluding prescription drugs) more closely to the amount the participant spends on healthcare. The Employees Retirement System should set the appropriate coinsurance percentages for the HealthSelect health plan based on participant spending. In developing the tiered coinsurance plan, the Employees Retirement System should consider adjusting the individual coinsurance maximum and the family coinsurance maximum with a reduced coinsurance maximum for employees who meet the eligibility criteria for the State Kids Insurance Program.

FISCAL IMPACT OF THE RECOMMENDATION

This recommendation would result in a net General Revenue Fund savings of $38.8 million and a net General Revenue–Dedicated Fund savings of $4.0 million in the 2006–07 biennium. The cost-saving estimate in Figure 2 is based on actual expenditures, the sample tiered coinsurance plan in Figure 1, and the following:

- HealthSelect in-network coinsurance percentages (medical only, do not apply to prescription drugs);
- annual, individual coinsurance maximum of $5,000;
- unlimited lifetime coinsurance maximum;
- annual, individual coinsurance maximum of $2,500 for employees whose annual salary is below $18,620; and
- continuation of the same cost trends throughout the projection period.

The appropriate tiered coinsurance plan may require adjustments to the range of medical spending in each coinsurance tier, the employee contributions for each tier, or the participants' annual or lifetime out-of-pocket maximum. However, a main characteristic of tiered coinsurance is the participants' ability to make more healthcare choices based on their own budgetary constraints. Cost sharing is necessary to manage the employer's burden of providing health insurance benefits. The proposed recommendation would lead to a cost-sharing structure to encourage participants to become informed consumers of physician and medical services. Figure 2 displays the direct savings that could be achieved from implementing the sample tiered coinsurance plan in Figure 1. Additionally, savings would increase as participants choose less costly services or use fewer services.

FIGURE 2
FIVE-YEAR FISCAL IMPACT
TIERED COINSURANCE PLAN

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$18,297,000	$1,926,000	$6,420,000	$5,457,000
2007	$20,577,000	$2,166,000	$7,220,000	$6,137,000
2008	$23,085,000	$2,430,000	$8,100,000	$6,885,000
2009	$25,878,000	$2,724,000	$9,080,000	$7,718,000
2010	$29,070,000	$3,060,000	$10,200,000	$8,670,000

SOURCES: Legislative Budget Board; Employees Retirement System.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of this recommendation.

OFFER AN INCENTIVE TO EMPLOYEES WHO OPT OUT OF THE STATE EMPLOYEE HEALTH INSURANCE PROGRAM

Currently, the state pays 100 percent of the cost of a full-time employee's employee-only premium for all general state employees and university employees in the Employees Retirement System Group Benefit Plan. The Texas Employees Group Benefit Act and the State University Employees Uniform Insurance Benefits Act allow employees to waive participation in the state health plans. The University of Texas System and Texas A&M University System inform employees of their option to waive participation in the health plan. By rider, the University of Texas System and Texas A&M University System have additional authority to provide a financial incentive to employees who waive participation in the system's health plan, but only when the employee has another source of health coverage. The Employees Retirement System does not provide an incentive to employees who waive basic insurance coverage.

Often, a state agency's benefits coordinator enrolls full-time employees in the Employees Retirement System Group Benefit Plan. These employees may not have the opportunity to decline the state's health benefits even though some may have another source of health coverage through a spouse or from prior military service. Requiring the Employees Retirement System to establish a process that provides an opportunity for all employees to waive participation in the group benefit plan and receive an incentive could save the state $8.3 million in All Funds during the 2006–07 biennium with a potential $4.7 million savings in General Revenue Funds.

SIGNIFICANT FINDINGS

- The University of Texas System and the Texas A&M System notify employees that they may elect not to participate in the system's health plan. Currently, 3 percent of eligible employees in the University of Texas System and 5 percent of eligible employees in the Texas A&M System have waived coverage in plan year 2004–05.
- The University of Texas System and the Texas A&M System provide a financial incentive equal to one-half of the employee-only premium to employees who waive participation in the system's health plan and provide documentation indicating they have health insurance coverage from another source.
- In October 2004, the Employees Retirement System's health plan administrator reported 3,242 state employees and retirees had the TRICARE military health plan as their secondary health coverage.

SIGNIFICANT CONCERNS

- Current statute allows an employee to waive participation in the basic health coverage provided by the Employees Retirement System, but employees are not necessarily informed of their option to waive the coverage.
- Military retirees are eligible for health insurance benefits under the TRICARE military health system. However, the federal government requires TRICARE beneficiaries who are enrolled in another comprehensive health plan like the Employees Retirement System Group Benefit Plan to use TRICARE as their secondary payer on medical expenses.

RECOMMENDATIONS

- **Recommendation 1:** Include a rider in the 2006–07 General Appropriations Bill that requires the Employees Retirement System to establish a process that provides an opportunity for employees and retirees who are members of the Group Benefit Plan to waive their participation in it.
- **Recommendation 2:** Amend Insurance Code, Chapter 1551 to authorize the Employees Retirement System to implement an incentive program for employees who waive basic insurance coverage. Inlcude a rider in the 2006–07 General Appropriations Bill and contingent appropriate statutory changes, that authorizes the Employees Retirement System to provide a $60 monthly incentive to employees who waive basic health coverage.
- **Recommendation 3:** Amend Insurance Code, Chapter 1551 to prohibit employees from waiving participation in the basic health insurance program unless the employee furnishes proof of alternate health benefit coverage.
- **Recommendation 4:** Require the Employees Retirement System to offer employees with military

health benefits the option to select a TRICARE supplement in lieu of participating in the basic health coverage provided by the state.

COMMENTS

The Texas Insurance Code, Chapter 1551 allows an employee to opt out of basic coverage; however, the statute does not require Employees Retirement System of Texas (ERS) to inform employees of their option to waive coverage. Part-time employees are indirectly informed of their option to waive coverage because they are responsible for a portion of their premium and must authorize their agency to withhold the premium amount from their pay.

OPTING OUT OF INSURANCE: THE ILLINOIS EXPERIENCE

In 2003, the state of Illinois added an opt-out provision to its group insurance program. Illinois was seeking a way to reduce healthcare costs that would have no direct impact on employees and would allow the state to maintain the integrity of the group insurance program. The state and the regional state employees association both supported the inclusion of an opt-out provision in the health plan. As of September 30, 2004, Illinois had 1,558 members in opt-out status, a little less than 1 percent of the 190,000 members covered by the state group insurance program. The opt-out provision allowed the state to save an estimated $3.2 million annually without negatively affecting employees. The opt-out provision was not a detriment to the State of Illinois group insurance program or the pool of insured. Recommendation 1 would require ERS to establish a process to provide an opportunity for employees and retirees who are members of the group benefit plan to waive their participation in the plan. Figure 1 shows how the opt-out provision would affect plan participants.

Both the University of Texas System and the Texas A&M System notify employees that they may elect not to participate in the system's health plan. Full-time employees who waive coverage and document health insurance coverage from another source are entitled to a financial benefit of $150.92 per month with the University of Texas System and $145.60 per month with the Texas A&M System. This amount is equal to one-half of the employee-only state contribution. Employees may use that money to pay for the cost of optional coverage, such as dental insurance and vision coverage. In plan year 2004–05, the University of Texas System had an opt-out rate of approximately 3 percent, and the Texas A&M System had an opt-out rate of approximately 5 percent of eligible participants. This incentive is authorized in the 2004–05 General Appropriations Act Rider 3 and Rider 4 page III-45, under Higher Education Employees Group Insurance Contributions.

Recommendation 2 would establish an incentive program for employees who opt out of basic coverage and requires ERS to provide a $60 monthly incentive to full-time employees and a porportional amount to part-time employees who opt out of the basic health coverage. The incentive amount could be applied to other optional coverage defined by ERS such as:

- optional term life;
- dental;
- voluntary accidental death and dismemberment;
- short-term disability; and
- long-term disability.

The Employees Retirement System has fewer optional coverage types and a greater number of plan participants than the university system health plans; therefore, the financial incentive is smaller than the amount provided by the university systems. At ERS, most optional coverage rates are based on salary, age, or both. If an average state employee were to purchase all the optional coverages that could be purchased with the incentive, the cost to the employee would range between approximately $55 and $67. The $60 incentive would allow full-time employees who opt out to enroll in most additional coverage types. Any amount not used for optional coverage would remain in the ERS fund.

A financial incentive to opt out could increase the savings to the state, as a result of more employees declining coverage in order to receive other benefits. As the number of participants waiving coverage increases, it is likely that total plan costs would decrease. Recommendation 3 would prohibit employees from waiving participation in the basic health plan unless the employee furnishes proof of alternate health benefit coverage. The incentive would only

FIGURE 1
HOW THE OPT OUT PROVISION WOULD AFFECT PARTICIPANTS

The election to opt out of the Group Benefit Plan would be voluntary. An employee who chooses to opt out of the employee-only benefit of the Group Benefit Plan may not enroll dependents in the plan. After an employee opts out of basic health coverage, there would be two ways to opt back in:

- during the annual summer enrollment period; or
- when a qualifying life event occurs, such as a change in marital status or employment status.

Those who opt back in to basic coverage during summer enrollment or after a qualifying life event would be subject to the current rules relating to evidence of insurability and any applicable provisions of the Health Insurance Portability and Accountability Act of 1996.

SOURCE: Legislative Budget Board.

be provided to employees who furnish proof of comprehensive health insurance to discourage employees from opting out of basic coverage without an alternate source of health insurance. The University of Texas System and Texas A&M University System have not experienced any negative effects to their insurance plans as a result of providing a financial incentive to employees who opt out of the plan.

The 2004–05 General Appropriations Act provides additional authority for the University of Texas System and the Texas A&M System to provide one-half of the employee-only state contribution to employees who waive basic coverage. To provide an incentive to waive coverage for general state and higher education employees, the following rider should be included in the 2006–07 General Appropriations Bill:

> **Incentive Program.** Active and retired employees are authorized to use $60 per month of the "employee-only" state contribution amount for optional insurance. Optional insurance for the employees participating in the group insurance program shall be defined under rules adopted by the Employees Retirement System. An active or retired employee participating in the group insurance program as defined by the Employees Retirement System pursuant to this rider may only use $60 per month of the employee-only state contribution if they sign and submit a document to their employer or the Employees Retirement System indicating the employee has health insurance coverage from another source.

RETIRED MILITARY EMPLOYEES

According to the U.S. Department of Veterans Affairs, Texas has one of the largest populations of military retirees in the United States. In October 2004, the Employees Retirement System's health plan administrator reported 3,242 state employees and retirees had the TRICARE military health plan as their secondary health coverage. This group of employees is eligible for health insurance benefits under the TRICARE military health system. However, the TRICARE program requires that when a beneficiary is enrolled in another health plan, the other plan is primary and TRICARE becomes secondary. Other public employers have begun to offer a TRICARE supplement to retired military employees in lieu of their health insurance plan in an effort to reduce healthcare costs. In fiscal year 2005, the monthly premium for employee-only health coverage was $315 per month while a TRICARE supplement costs about $60 per month. Recommendation 4 requires ERS to contract with a provider to offer a TRICARE supplement as an optional coverage to employees. Employees with health insurance coverage through TRICARE who waive participation in basic health coverage could apply their opt out incentive to the TRICARE supplement.

FISCAL IMPACT OF THE RECOMMENDATIONS

This recommendation would result in a net General Revenue Fund savings of $4.7 million and a net General Revenue–Dedicated Fund savings of $502,700 in the 2006–07 biennium. Recommendation 1 would require ERS to provide employees with an opportunity to opt out of the health plan and could save the state $8.3 million in All Funds during the 2006–07 biennium. State employee salaries and benefits continue to be one of the largest single state expenditures. Changes to employee benefits and cost-sharing arrangements should be considered in light of available state revenue and goals for employee recruitment and retention. The estimate in Figure 2 is based on Texas having an additional 1 percent of employees and retirees opting out of the health plan. It is difficult to be certain of how many employees have an alternative source for health coverage and would choose to opt out of the state's plan. In an effort to provide a fiscal impact, the cost savings presented assumes that Texas would continue to pay 100 percent of the employee-only premium and that the cost of the premium would remain constant. For the purposes of this estimate, the population in the ERS Group Benefit Plan is held constant and the amount of the incentive remains $60.

FIGURE 2
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$2,387,823	$251,350	$837,833	$712,158
2007	$2,387,823	$251,350	$837,833	$712,158
2008	$2,387,823	$251,350	$837,833	$712,158
2009	$2,387,823	$251,350	$837,833	$712,158
2010	$2,387,823	$251,350	$837,833	$712,158

SOURCE: Legislative Budget Board.

The recommendation would decrease the number of employees in the ERS Group Benefit Plan resulting in a savings to the General Revenue Fund through decreased appropriations for healthcare premiums. The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of this recommendation.

POTENTIAL SAVINGS FROM PRESCRIPTION DRUG IMPORTATION

Importation of certain drugs could result in significant savings to the state and the beneficiaries of state-supported prescription drug benefit programs. Depending on program design attributes, it is estimated that potential savings range between $455 million and $898 million in All Funds including beneficiary cost-sharing obligations in the 2006–07 biennium. Like other states that provide prescription drug benefits, Texas has experienced significant cost increases in recent years. These cost trends are expected to continue as pharmaceutical companies develop new drugs to manage acute and chronic illnesses, brand name prescription drug price growth continues to exceed the rate of inflation, and the population ages.

SIGNIFICANT FINDINGS

- Prescription drug costs continue to increase with overall spending by the state (All Funds including beneficiary cost sharing) expected to total almost $9.2 billion in the 2006–07 biennium.
- Analysis of actual expenditures for certain drugs shows that the state and beneficiaries of state-supported prescription drug benefit programs will pay an estimated $1.1 billion more in All Funds in the 2006–07 biennium when current prices are compared to prices of imported drugs.
- While drug importation promises potential savings, many factors will affect the actual savings that may be realized. Depending on program design attributes, it is estimated that potential savings range between $455 million and $898 million in All Funds in the 2006–07 biennium.

SIGNIFICANT CONCERNS

- While importing most prescription drugs violates federal law, an increasing number of jurisdictions nationwide are actively pursuing drug importation initiatives through a provision that allows citizens with valid prescriptions to import drugs for personal use.
- Questions concerning the permissiveness of drug importation cloud the issue. A number of federal initiatives in both the legislative and executive branches are focused on clarifying the issue.
- Drug importation raises safety concerns and may impact the business economics of retail pharmacies.

RECOMMENDATION

- Include a rider in the 2006–07 General Appropriations Bill directing the Employees Retirement System to conduct a detailed prescription drug importation cost-effectiveness and feasibility study, and require the 20 state agencies having the greatest number of employees to provide $12,500 each in the 2006–07 biennium to fund this study via interagency contract.

COMMENTS

Overall spending on prescription drugs (All Funds including beneficiary cost-sharing obligations) is expected to exceed $9.2 billion in the 2006–07 biennium. In spite of cost-saving strategies, such as restricting formularies, negotiating with providers for favorable pricing, and increasing cost-sharing obligations for beneficiaries, the state's costs continue to increase. For example, the Vendor Drug Program experienced an average cost-per-prescription increase of 30 percent in Medicaid between fiscal years 2001 and 2005. The cost increase would have been 43 percent if cost-saving measures, such as the preferred drug list initiative to shift the market to less expensive drugs, had not been implemented.

As Figure 1 shows, the state provides pharmacy benefits to different groups of beneficiaries including state employees, higher education employees, public education employees, recipients of public assistance, and institutionalized and incarcerated populations. The drug needs of these beneficiaries are managed by a variety of administrative agencies and institutions, which sometimes use a pharmacy benefits manager (PBM) to help coordinate benefits.

While Figure 1 shows prescription drug costs across all self-insured prescription drug benefit programs administered by state agencies and institutions, it does not show Health Maintenance Organization (HMO) costs for employee pharmacy benefits. Instead, these benefits are provided on a fully insured and integrated basis with other healthcare benefits managed by the HMOs. In all, 12 HMOs provide pharmacy benefits to approximately 8 percent of covered beneficiaries at the Employees Retirement System of Texas, 6 percent at the Teacher Retirement System, 35 percent at the University of Texas System, and 38 percent at the Texas A&M University System. HMO pharmacy benefit costs for the 2006–07 biennium are

FIGURE 1
PHARMACY BENEFIT PROGRAMS AND COSTS IN TEXAS (IN MILLIONS)

BENEFIT PROGRAM	ADMINISTRATIVE AGENCY OR INSTITUTION	PHARMACY BENEFIT MANAGER	PROJECTED TOTAL DRUG COST 2006–07 BIENNIUM[1]
Vendor Drug Program (Medicaid)	Health and Human Services Commission (HHSC)	None	$5,535.0
TRSCare & TRS ActiveCare	Teacher Retirement System	Caremark & Medco	$1,541.5
HealthSelect	Employees Retirement System	Medco	$1,146.8
Texas Children's Health Insurance Program	HHSC	None	$240.3
UTSelect	University of Texas System	Medco	$233.2
Community Healthcare Centers	Department of State Health Services (DSHS)	None	$191.7
Mental Health	DSHS	None	$103.2
A&M Health Benefit Program	Texas A&M University System	Eckard Health Services	$85.5
Correctional Managed Healthcare	Texas Department of Criminal Justice (TDCJ)	University of Texas (UTMB)	$77.0
Kidney Health Care	DSHS	None	$37.1
Children with Special Health Care Needs	DSHS	None	$8.8
TOTAL			$9,200.3

[1] Actual cost (All Funds including beneficiary cost-sharing obligations) and rebate information was obtained from each agency or institution for the period between September 2003 and May 2004. 2006–07 biennial projections include expected cost growth rates and the impact of the Medicare Part D prescription drug benefit. Vendor Drug Program totals are based on agency forecasted costs.
SOURCE: Legislative Budget Board.

expected to total approximately $136 million, or less than 5 percent of total state employee, retiree, and dependent pharmacy benefit costs.

DRUG IMPORTATION SAVINGS TO TEXAS

In order to assess the state's potential cost savings of drug importation, actual prices and expenditures incurred between September 2003 and May 2004 by the state; and beneficiaries of state-supported prescription drug benefit programs for certain drugs were analyzed. Eighty-eight highly utilized brand name prescription drugs deemed suitable for importation from Canada comprise the drugs used in this review to assess potential cost savings.

These drugs were selected based on a drug importation study conducted by the Office of Special Advocate for Prescription Drugs (OSAPD) for the State of Illinois. In order to be deemed suitable for importation by the OSAPD, drugs had to meet the following criteria:

- Patient safety—Any drug that could not be transported safely or used by the patient in a safe manner was excluded.
- Drug safety—Any drug that was not approved by the Federal Drug Administration (FDA) for use in the United States was excluded.
- Urgency of need—Any drug that the patient could not reasonably wait for was eliminated, including all antibiotics.
- Controlled substances—All controlled substances were excluded.
- Cost—Any drug that was more expensive in Canada including almost all US generic drugs was excluded.

The pricing component of this analysis focused on comparing unit costs and utilization for certain drugs to unit prices for these drugs. Prices for different strengths and package sizes of each brand name prescription drug were analyzed, comprising over 200 individual medications. State costs were benchmarked against prices available on the Minnesota Rx Connect website. This resource, developed by the Minnesota Department of Human Services, provides a channel for obtaining prescription drugs from Canada.

As Figure 2 indicates, the state and beneficiaries of state-supported prescription drug benefit programs will spend an estimated $3.3 billion on drugs suitable for importation in the 2006–07 biennium. If imported, the same set of drugs would cost an estimated $1.9 billion, reflecting a $1.4 billion cost difference. When the loss of approximately $321 million in manufacturer rebates is considered, the total estimated cost difference is almost $1.1 billion in All Funds for the 2006–07 biennium.

It is important to note that the estimated cost difference between the current drug cost and the imported drug cost after rebates ($1.1 billion) does not equate directly to

FIGURE 2
COSTS FOR DRUGS SUITABLE FOR IMPORTATION FROM CANADA
2006–07 BIENNIUM (IN MILLIONS)

BENEFIT PROGRAM	STATE DRUG COST[1]	IMPORTED DRUG COST[1]	MANUFACTURER DRUG REBATES	COST DIFFERENCE	PERCENTAGE DIFFERENCE
Vendor Drug Program (Medicaid)	$1,888.7	$1,055.0	$264.3[2]	$569.4	30%
TRSCare & TRS ActiveCare	$729.5	$437.6	$28.8	$263.2	36%
HealthSelect	$489.0	$292.1	$18.9	$178.0	36%
UTSelect	$97.9	$59.1	$3.9	$34.9	36%
Texas Children's Health Insurance Program	$47.3	$26.0	$3.3	$18.0	38%
Department of State Health Services[3]	$32.3	$19.6	$1.3	$11.4	35%
A&M Health Benefit Program	$27.4	$16.4	$0.5	$10.5	38%
Kidney Health Care	$9.0	$6.7	$0.0	$2.4	26%
Correctional Managed Healthcare	Savings on subset of drugs suitable for importation[4]			$0.9	-
Children with Special Health Care Needs	$0.8	$0.5	$0.0	$0.3	43%
TOTAL	$3,321.1	$1,912.4	$320.9	$1,088.9	Average: 33%

[1] Actual cost (All Funds including beneficiary cost-sharing obligations) and rebate information was obtained from each agency or institution for the period between September 2003 and May 2004. Imported drug cost based on prices quoted in June 2004. 2006–07 biennial projections include expected cost growth rates and the impact of the Medicare Part D prescription drug benefit.
[2] Manufacturer drug rebates for Medicaid do not include supplemental rebates.
[3] Department of State Health Services (formerly MHMR) analysis excludes four brand name prescription drugs potentially suitable for importation since these drugs are more costly if imported than current pricing. The drugs excluded are Prevacid, Protonix, Aricept, and Advair Diskus.
[4] TDCJ qualifies for 340B drug pricing status which requires manufacturers to sell covered outpatient drugs at a price determined by a federal statutory formula. As a result of this status, imported prices are not lower in most cases than the current prices paid by TDCJ.
NOTE: The cost difference and potential savings of importation at the 43 Community Healthcare Centers could not be estimated within the scope of this study due to a lack of available data on specific drug spending patterns.
SOURCE: Legislative Budget Board.

potential cost savings to the state of drug importation. In order to assess potential cost savings, many factors must be considered. Quantifiable factors that should be considered include the following:

- Participation rates—The level of participation in any mail order importation program will significantly affect the potential savings. The participation rate may be influenced through incentives such as reduced copayments.
- Method of Finance (MOF)—Each prescription drug benefit program administered by the state is financed differently. Depending on the MOF, the state may be required to share the savings with other financing sources. For example, in the Medicaid program, the state contributes 39 percent of the actual cost while the federal government contributes 61 percent. As a result, savings in this program will accrue to the state and federal government in the same proportion as the MOF.
- Impact on Medicaid and state employee benefit programs of the Medicare Part D Prescription Drug Benefit—Medicare Part D will shift a portion of the cost burden for prescription drugs for elderly Medicaid eligible recipients (the so-called dual-eligible population of Medicaid) and retired state employees from the state to the federal government. The Medicare Part D benefit will start to take effect in the beginning of calendar year 2006.

In addition to quantifiable factors, other considerations that will require further analysis in order to estimate their impact on costs or savings include the following:

- implementation and ongoing administrative costs of an importation program;
- impact of legal questions surrounding importation on participation rates;
- expanded importation options such as the European Union, where generic as well as brand name prescription drugs may be less expensive;
- ability of foreign supply to meet U.S. importation demand; and

- impact on current contracted relationships between the state, drug suppliers, and pharmacy benefit managers (PBM).

In order to estimate potential cost savings to the state, the Legislative Budget Board staff analyzed two scenarios for illustrative purposes. Scenario 1 assumes that all prescription drug benefit programs will be included in an importation program, while Scenario 2 assumes that Medicaid and the Children's Health Insurance Program will not be included in such a program. Each scenario focuses on estimating the impact of quantifiable factors on potential savings and assume the implementation of a comprehensive importation mail order program based on the brand name drugs included in this review, stable currency exchange rates, reliability of supply and current manufacturer pricing. This scenario analysis, however, does not estimate the impact of other costs or savings considerations that require further analysis to quantify, such as programmatic implementation costs and expanded importation options.

SCENARIO 1: ALL PROGRAMS POTENTIAL SAVINGS

By implementing a drug importation program with the following attributes, the potential savings are estimated to total almost $898 million in All Funds in the 2006–07 biennium:

- mandatory mail order participation by public assistance beneficiaries (e.g., Medicaid and CHIP beneficiaries); a 75 percent participation rate is assumed;
- a 19.25 percent cost shift in fiscal years 2006 and 2007 from the Medicaid prescription drug program to the new Medicare Part D prescription drug benefit program, which will be federally funded;
- a 5 percent to 8 percent average cost shift in fiscal years 2006 and 2007 from the state employee prescription drug benefit programs to the new Medicare Part D prescription drug benefit program, which will be federally funded; and
- voluntary mail order participation by employees, retirees, and other beneficiaries of state-supported prescription drug benefit programs; it is estimated that a 90 percent participation rate could be achieved through a share of savings incentive structure such as reduced or waived copays and deductibles.

A significant obstacle in implementing this scenario is the lack of an enforcement mechanism for the state in the Medicaid program. Since most beneficiaries receive benefits without paying any copays or deductibles, the state has less leverage to encourage or penalize noncompliance. In addition, other federal rules relating to the state's management of the Medicaid and CHIP programs may complicate implementation.

Figure 3 summarizes the composition of potential savings by benefit program and funding source.

SCENARIO 2: NON-PUBLIC ASSISTANCE PROGRAMS POTENTIAL SAVINGS

By implementing a drug importation program with the following attributes, the potential savings are estimated to total almost $455 million in All Funds in the 2006–07 biennium:

- no participation by most public assistance beneficiaries;
- a 5 percent to 8 percent average cost shift in fiscal years 2006 and 2007 from the state employee prescription drug benefit programs to the new Medicare Part D prescription drug benefit program, which will be federally funded; and
- voluntary mail order participation by employees, retirees, and other beneficiaries of state-supported prescription drug benefit programs; it is estimated that a 90 percent participation rate could be achieved through a share of savings incentive structure.

This scenario would be less complex to implement since it would focus primarily on state agency, higher education, and public education employees. In addition, these groups are already utilizing prescription drug mail order programs for their maintenance drug needs. Current mail order participation rates for the prescription drugs in this review range between 50 and 70 percent.

Figure 4 summarizes the composition of potential savings by benefit program and funding source.

STATE AND FEDERAL DEVELOPMENTS

An increasing number of governmental entities nationwide are actively facilitating drug importation so that their citizens, employees, retirees, dependents, and other beneficiaries can obtain prescription drugs at a lower cost. At least 18 states and eight municipalities are considering importation or are acting to import less expensive brand name prescription drugs for their public assistance and employee benefit programs. See Figure 5 for a listing of importation initiatives that other jurisdictions are planning or implementing.

FIGURE 3
ALL PROGRAMS SAVINGS ESTIMATE
2006–07 BIENNIUM (IN MILLIONS)

	POTENTIAL SAVINGS BY FUNDING SOURCE				
BENEFIT PROGRAM	FEDERAL FUNDS	BENEFICIARY FUNDS	OTHER FUNDS	GENERAL REVENUE FUNDS	TOTAL
Vendor Drug Program (Medicaid)	$260.5	$0.1	$0.0	$166.5	$427.1
TRSCare	$0.0	$43.6	$59.9	$62.3	$165.8
TRS ActiveCare	$0.0	$20.3	$56.9	$0.0	$77.2
HealthSelect	$20.0	$62.5	$22.1	$55.7	$160.3
UTSelect	$0.0	$8.8	$13.8	$8.8	$31.4
Texas Children's Health Insurance Program	$9.6	$0.3	$0.0	$3.7	$13.5
Department of State Health Services	$3.7	$0.0	$0.7	$5.8	$10.3
A&M Health Benefit Program	$0.0	$3.3	$2.8	$3.3	$9.4
Kidney Health Care	$0.0	$0.02	$0.0	$2.1	$2.1
Correctional Managed Healthcare	$0.0	$0.0	$0.0	$0.8	$0.8
Children with Special Health Care Needs	$0.1	$0.0	$0.0	$0.2	$0.3
TOTAL	$293.8	$138.9	$156.2	$309.5	$898.4

SOURCE: Legislative Budget Board.

FIGURE 4
NON-PUBLIC ASSISTANCE PROGRAMS SAVINGS ESTIMATE
2006–07 BIENNIUM (IN MILLIONS)

	POTENTIAL SAVINGS BY FUNDING SOURCE				
BENEFIT PROGRAM	FEDERAL FUNDS	BENEFICIARY FUNDS	OTHER FUNDS	GENERAL REVENUE FUNDS	TOTAL
Vendor Drug Program (Medicaid)	$0.0	$0.0	$0.0	$0.0	$0.0
TRSCare	$0.0	$43.6	$59.9	$62.3	$165.8
TRS ActiveCare	$0.0	$20.3	$56.9	$0.0	$77.2
HealthSelect	$20.0	$62.5	$22.1	$55.7	$160.3
UTSelect	$0.0	$8.8	$13.1	$9.5	$31.4
Texas Children's Health Insurance Program	$0.0	$0.0	$0.0	$0.0	$0.0
Department of State Health Services	$3.7	$0.0	$0.7	$5.8	$10.3
A&M Health Benefit Program	$0.0	$3.3	$2.6	$3.5	$9.4
Kidney Health Care	$0.0	$0.0	$0.0	$0.0	$0.0
Correctional Managed Healthcare	$0.0	$0.0	$0.0	$0.8	$0.8
Children with Special Health Care Needs	$0.0	$0.0	$0.0	$0.0	$0.0
TOTAL	$23.7	$138.5	$155.4	$137.8	$455.3

SOURCE: Legislative Budget Board.

According to the Council of State Governments, states and municipalities are primarily using three models in designing drug importation programs including the following:

- **Acting as brokers:** Government acts as a broker between foreign distributors and consumers. In this arrangement the state compiles a list of medications it deems most appropriate for importation, negotiates with foreign wholesalers for the best price, and imports the drugs to a central repository for distribution to local pharmacies. The advantage of this approach is the state's enhanced ability to monitor the safety of imported medications. For instance, the plan may include random testing of imported medications at state laboratories or universities. There are disadvantages as well, such as potentially greater responsibility and administrative costs.

- **Contracting directly with foreign drug suppliers:** Government contracts directly with foreign suppliers. The Springfield, Massachusetts city government, for example, has contracted with a Canadian company to allow city employees, retirees, and their dependents to import maintenance prescription medications via mail order from Canada. Beneficiaries send their prescriptions to the company, which fills them at participating Canadian pharmacies and sends the drugs directly to the buyers and bills the city. The city is waiving copayments to encourage participation.

- **Establishing websites to assist citizens, employees, and other beneficiaries to find lower drug prices at foreign pharmacies:** Government establishes a state-sponsored Web site to help consumers find safe and legitimate Canadian online pharmacies. This option may reduce the state's responsibility and reduces administrative costs. Seven states—Illinois, Missouri, New Hampshire, Minnesota, Wisconsin, Rhode Island, Kansas, and North Dakota—operate such Web sites. Some states pursuing this option offer financial incentives, such as copayment waivers to beneficiaries for switching to Canadian online pharmacies for their prescription drug needs.

While importation of prescription drugs from foreign countries generally violates one or more provisions of the Federal Food, Drug, and Cosmetic Act (FFDCA), the FDA has used significant enforcement discretion to allow importation of certain drugs for personal use. Congress enacted this law in 1938 to create a closed drug distribution system, which helps ensure that the domestic drug supply is safe and effective. However, the personal use enforcement discretion demonstrated by the FDA, allowing citizens with a valid U.S. prescription to import a 90-day supply of drugs for personal use, has diminished the legal clarity of this issue.

Federal policy on the subject may change in the future. In May 2004, U.S. Health and Human Services (HHS) Secretary Tommy Thompson stated he would recommend that the President not stand in the way of drug importation legislation that results from ongoing deliberations in the U.S. Senate. Several bills are pending in Congress to permit drug imports from Canada and elsewhere on a commercial scale, including three Senate bills (S. 2493, S. 2328, S.2307) that seek to legalize drug importation from Canada and possibly other countries in the European Union. They are similar to a House bill (H.R. 2427), which passed the house last year (by a vote of 243–186) allowing drugs to be imported from 25 industrialized nations. If a drug importation bill passes, more states and localities may pursue drug importation soon.

In addition, Secretary Thompson appointed a 13-member federal task force, which held public hearings to gather testimony from consumers, pharmaceutical manufacturers, pharmacists, health care providers, and other involved groups over the summer to examine the issue of drug importation. A report was released in December 2004.

In May 2004, 18 state attorneys general (AGs) wrote to Secretary Thompson urging him to adopt a procedure to allow states to import prescription drugs. In their letter, the AGs proposed a drug importation procedure with three elements:

- Allow states to be appointed as licensed wholesalers, or allow them to contract with licensed wholesalers for the importation of FDA-approved prescription drugs from Canada;

- Provide for states to work with Health Canada (the Canadian equivalent of HHS) and the FDA to inspect Canadian pharmacies and exchange drug plant inspection information; and

- Require drugs to be manufactured in FDA-approved facilities and imported into the United States from Canada in their original packaging, with provision for labeling and tracking of drugs.

Figure 5 provides a listing of drug importation initiatives being planned or implemented in other jurisdictions.

SAFETY AND ECONOMIC CONCERNS

Safety concerns over drug importation have been at the forefront of the FDA's objections to the importation of prescription drugs into the U.S. from foreign sources.

FIGURE 5
NATIONAL IMPORTATION INITIATIVES (AS OF OCTOBER 1, 2004)

STATE/LOCAL GOVERNMENT	PHASE	MODEL	EXPECTED ANNUAL SAVINGS
Illinois	Operating www.I-saverx.net	State has set up a Web site and is contracting with Canadian and European wholesalers to import certain prescription drugs. Illinois program includes Wisconsin, Kansas, and Missouri partnering in the program. May expand to provide all Illinois residents with lower priced imported drugs.	State Programs: $94 million to $112 million; Total State: $1.9 billion
Kansas	Operating www.I-saverx.net	Partnered with Illinois, Missouri, and Wisconsin in I-Saverx importation initiative.	Not available
Minnesota	Operating www.minnesotarxconnect.com (citizens) www.advantage-meds.com (employees)	Phase 1: Establish Web site for citizens to import drugs from Canada. Pharmacies are certified by the state as safe. Phase 2: Establish Web site for employees, retirees and dependents to import drugs from Canada. Pharmacies are certified by the state as safe. Phase 3: Assist local pharmacies to set up import programs (Planned).	Savings from Phase 2: $180 a year per drug
New Hampshire	Operating www.nh.gov/governor/prescription	Phase 1: Establish Web site for citizens to import drugs from Canada. Pharmacies are certified by the state as safe. Phase 2: State will purchase Canadian drugs for the Department of Corrections, retired state workers, and mental illness drugs for Medicaid patients (Planned).	Not available
Missouri	Operating www.I-saverx.net	Partnered with Illinois, Kansas, and Wisconsin in I-Saverx importation initiative.	Not available
North Dakota	Operating governor.state.nd.us/prescription-drug.html	Establish Web site for citizens to import drugs from Canada.	Not available
Rhode Island	Operating www.state.ri.us/rirx	State-sponsored Web site provides link to Wisconsin's Web site. Also, legislation allowing pharmacies operating in Canada to be licensed in Rhode Island will become effective 1/15/05.	Not available
Wisconsin	Operating www.I-saverx.net	Establish Web site for citizens to import drugs from Canada. Pharmacies are certified by the state as safe. Partnered with Illinois, Kansas, and Missouri to jointly import drugs from Canada, UK and Ireland.	$70 million to $140 million
Connecticut	Planning	A pilot program allowing the state's ConnPace drug program for low-income elderly and disabled residents to purchase prescription drugs from Canadian pharmacies.	Not available
Iowa	Planning	State-sponsored Web site provides a link to Canadian pharmacies.	Not available
Kentucky	Planning	The State Auditor submitted a report to the Legislature recommending drug importation to lower prescription drug costs for employees and Medicaid beneficiaries.	$107 million
Maryland	Planning	The Maryland Legislature passed an importation bill in the 2004 session. SB 167 requires the state Department of Health and Mental Hygiene, by November 1, 2004, to seek approval of a waiver from the FDA to operate a Canadian Mail Order Plan to purchase and import prescription drugs from Canada and to certify the safety and efficacy of the imported prescription drugs. The bill authorizes the health and mental hygiene secretary to include enrollees and recipients of other state prescription drug programs in the mail order plan.	Not available
Massachusetts	Planning	State-run pharmacy benefits manager will advise residents in purchasing drugs from Canada, but will not serve as intermediary.	$9 million for employees, $1.4 for the State
Michigan	Planning	State-sponsored Web site provides a link to Canadian pharmacies.	Not available
Ohio	Planning	State-sponsored Web site provides a link to Canadian pharmacies.	Not available

(CONTINUED ON NEXT PAGE)

FIGURE 5 (CONTINUED)
NATIONAL IMPORTATION INITIATIVES (AS OF OCTOBER 1, 2004)

STATE/LOCAL GOVERNMENT	PHASE	MODEL	EXPECTED ANNUAL SAVINGS
Vermont	Planning	State-sponsored Web site provides a link to Canadian pharmacies.	Not available
West Virginia	Planning	State-sponsored Web site provides a link to Canadian pharmacies. Also, the legislature recently passed HB 4084 (2004): West Virginia Pharmaceutical Availability and Affordability Act which establishes a state-sponsored prescription drug discount card program for residents. It also provides that the state shall "explore the feasibility of using or referencing the federal supply schedule or Canadian pricing. Requires the state to 'investigate the feasibility of purchasing prescription drugs from Canada,' including feasibility of serving as a wholesale distributor of prescription drugs in the state."	Not available
California	These bills passed in the legislature were vetoed by the Governor (9/30/04)	Several bills are under consideration: AB 1957 would require the California State Board of Pharmacy to establish a Web site by July 1, 2005 to help California residents safely buy prescription drugs at reduced prices. Another bill (SB 1144) would permit the state General Services Department to purchase pharmaceuticals from authorized Canadian pharmacies or sources, as well as existing in-state sources, for use with state hospitals and prisons. It also adds Canada to a required progress report on bulk and discount purchasing that is due February 1, 2005. SB 1149 would require the State Board of Pharmacy to collect and publish information concerning suppliers of dangerous drugs that are located and operating outside of the United States and have violated safe shipment, handling and processing standards. Finally, SB 1333 authorizes the Department of Health Services to reimburse a pharmacy that provides to a Medicaid or AIDS Drug Assistance Program beneficiary a prescription drug that was purchased from a Canadian pharmacy.	Not available
Burlington, VT	Operating	BurlingtonMeds is an optional mail-order program designed for city employees and their dependents. Participants who order a 90-day supply of medication from Canada receive copayment waivers.	$100,000 to $200,000
Montgomery, AL	Operating	A voluntary mail-order program to obtain Canadian drugs for city employees and retirees	$500,000
Springfield, MA	Operating	Springfield Meds contracts with CanaRx Services Inc. (a Canadian online pharmacy) to allow public employees, their dependents, and city retirees to import maintenance prescription medications via mail order from Canada. To encourage participation, there is no copay.	$2 million
Portland, ME	Operating	The city has set up an alternative drug benefit (Portland Meds) providing mail ordered prescription drugs from Canada.	$100,000
Boston, MA	Planning	Pilot program for city employees and retirees beginning July 2004	$1 million
Cambridge, MA	Planning	Pilot program for city employees and retirees	Not available
Oak Creek, WI	Planning	Program for city employees and retirees	$100,000
Palm Beach County, FL	Planning	Program for city employees and retirees	$175,000

SOURCES: Legislative Budget Board; Trends Alert: Critical information for state decision-makers, Prescription Drug Importation, Council of State Governments (June 2004) and Prescription Drug Importation (2004-R-0463), Office of Legislative Research – Connecticut General Assembly, June 2004.

According to the FDA, many drugs obtained from foreign sources that appear to be the same as U.S.-approved prescription drugs are, in fact, of unknown quality. The following are the primary risks that concern the FDA:

- lack of confidence in manufacturing practice standards of non-FDA-approved facilities that produce drugs;
- increased concern over counterfeit drugs ordered online from pharmacies that misrepresent the nature and origin of drugs;
- risks associated with using untested medications, that while approved by foreign governments, have not received FDA approval;
- concerns over unsupervised patient usage of certain drug therapies that usually require close medical supervision to monitor the onset of potential side-effects; and
- issues with inadequate labeling and labels printed in foreign languages, increasing the potential that important dosage or side-effect information will not be communicated effectively to the consumer.

In addition to these safety concerns, drug importation raises potential liability issues. In the current closed distribution system, liability for harm resulting from defects with prescription medications typically falls to the manufacturer. However, under a drug importation program set-up by a state or local governmental entity, it is unclear which party may bear the burden of liability.

Finally, drug importation may also impact the business economics of retail pharmacies. While dispensing fees (i.e., the fee collected by a pharmacist for dispensing prescription drugs) typically represent a small portion of drug costs, a potential reduction in this revenue source due to increased utilization of mail order systems may impact retail pharmacies. However, the magnitude of the impact due to lost prescriptions and other incidental sales is difficult to assess within the scope of this review. Also difficult to assess is the impact that potential cost savings to the state and consumers could have on the local economy. These are important considerations that should be included in a detailed importation feasibility analysis. Some jurisdictions have attempted to minimize the potential impact on retail pharmacies and at the same time enhance patient safety by including a "Primary Care Pharmacist Model" in planned importation programs. Under this proposed model, a retail pharmacy would coordinate patients' drug purchases from foreign sources and would be compensated on a transaction basis.

INTERAGENCY CONTRACT FUNDING FOR PRESCRIPTION DRUG IMPORTATION STUDY

As this analysis illustrates, drug importation is a complex issue with both significant potential cost savings and risks. In order to enhance the state's capacity to realize cost savings and minimize risks, it is recommended that the ERS conduct a detailed drug importation cost-effectiveness and feasibility study.

In order to implement and fund this recommendation, the following rider should be added to Article IX of the introduced 2006–07 General Appropriations Bill:

Interagency Contract Funding for Prescription Drug Importation Study.

(a) The Employees Retirement System is hereby authorized to collect funds to be used as provided by this section through interagency contracts with the 20 state agencies identified by this section. A new strategy is hereby created in the Employees Retirement System's bill pattern, Statewide Drug Cost Containment, and funds received through interagency contract shall be deposited to the new strategy and spent for the purposes as provided in this section.

(b) Each agency identified by this section shall provide $12,500 for fiscal year 2006 via interagency contract by October 1, 2005 to the Employees Retirement System for the purpose of conducting a detailed prescription drug importation cost-effectiveness and feasibility study. If an agency has not executed the contract by the specified date, then the Comptroller of Public Accounts shall transfer the funds. The Employees Retirement System is required to report the results of this study to the Legislative Budget Board and Governor by March 1, 2006.

(c) In conducting this study the Employees Retirement System shall analyze and report on the following:

1. Safety of managed prescription drugs importation
2. Feasibility and cost-savings by method of finance of prescription drug importation for each drug purchasing program administered by state agencies and institutions of higher education including but not limited to the Health and Human Service Commission, Teacher Retirement System, Employees Retirement System, Department of State

Health Services, Department of Aging and Disability Services, Texas Department of Criminal Justice, University of Texas System, Texas A&M University System

3. Prescription drug importation operating models utilized by other jurisdictions and make recommendations on the most feasible and cost-effective model for Texas
4. Opportunities to integrate Texas pharmacists in the state's efforts to increase the affordability of safe prescription drugs
5. Federal statutory developments that may impact Texas' ability to implement a prescription drug importation program
6. All potential foreign sources of safe, lower cost prescription drugs

(d) The 20 state agencies having the greatest number of employees shall contract with Employees Retirement System for the purpose of funding a detailed prescription drug importation cost-effectiveness and feasibility study in fiscal year 2006. The State Auditor's Office and Employees Retirement System shall cooperate to identify the 20 state agencies with the greatest number of employees. Unless the State Auditor's Office and Employees Retirement System cooperatively identify other agencies to be substituted on the list of 20 agencies subject to this section, the 20 agencies subject to this section include:

1. Texas Education Agency;
2. Texas Health and Human Services Commission;
3. Texas Department of Transportation;
4. Department of Aging and Disability Services;
5. Texas Department of Criminal Justice;
6. Department of State Health Services;
7. Department of Family and Protective Services;
8. Texas Workforce Commission;
9. Texas Building and Procurement Commission;
10. Texas Department of Insurance;
11. Department of Public Safety of the State of Texas;
12. Office of the Attorney General;
13. Texas Commission on Environmental Quality;
14. Railroad Commission of Texas;
15. Texas Youth Commission;
16. General Land Office and Veteran's Land Board;
17. Parks and Wildlife Department;
18. Texas Lottery Commission;
19. Comptroller of Public Accounts; and
20. Texas Alcoholic Beverage Commission.

FISCAL IMPACT OF THE RECOMMENDATION

The funding mechanism defined in the rider provides for the 20 state agencies having the greatest number of employees to provide $12,500 each to fund this study via interagency contract. The design of this mechanism is based on the assumption that the agencies that will enjoy the bulk of the potential savings from a reduction in prescription drugs costs should fund this study. Since these agencies will transfer funds to ERS from budgeted appropriations, this recommendation does not have a fiscal impact on the General Appropriations Bill.

The estimated cost of $250,000 for the 2006–07 biennium for this recommendation is based on the following assumptions:

- three full-time employees who have state purchasing and pharmaceutical expertise;
- budget for contracted services including legal, financial, actuarial and pharmaceutical safety consulting services; and
- budget for other overhead expenses.

The introduced 2006–07 General Appropriations Bill includes a rider requiring ERS to study the feasibility of drug importation and requires interagency contracts to fund this work.

REDUCE THE 12-MONTH BENEFIT REPLACEMENT PAY ELIGIBILITY GRACE PERIOD

Benefit replacement pay was created in 1996 to replace a benefit the state provided to employees which paid a portion of an employee's social security tax. The Benefit Replacement Pay program includes a grace period provision, which allows individuals to leave state employment and remain eligible to receive the benefit if they return to work for the state within one year. Its appropriation for the 2002–03 biennium totaled $156.8 million for general state employees. Reducing the grace period to 30 days would decrease the state's Benefit Replacement Pay expenditure by approximately $367,000 in General Revenue Funds, which would be available for other purposes in the 2006–07 biennium.

SIGNIFICANT FINDINGS

- 66,491 or about half of full-time employees at state agencies receive Benefit Replacement Pay.
- Eligible employees typically receive a benefit amount of $1,026 each year, costing the state $156.8 million in All Funds during the 2002–03 biennium.

SIGNIFICANT CONCERN

- Employees and return-to-work retirees remain eligible to receive Benefit Replacement Pay if they return to work for the state within one year of their termination date, which prolongs the program and increases the cost of providing the benefit.

RECOMMENDATION

- Amend Government Code, Chapter 659 to reduce the Benefit Replacement Pay eligibility grace period from one year to 30 days.

COMMENTS

Before 1996, state employees received a benefit called "state-paid social security." State-paid social security provided additional compensation to employees by paying the employee portion of the social security contribution in lieu of an across-the-board salary increase. The Seventy-fourth Legislature, 1995, repealed the provisions relating to state-paid social security. Beginning January 1, 1996, Benefit Replacement Pay (BRP) took effect to offset a loss of compensation to employees. Employees hired after the change in law took effect were not eligible for BRP. BRP, a payment of up to $1,026 each year, provides supplemental compensation to eligible state employees based on their salaries. An employee retains BRP entitlement as long as he or she does not have a break in service from the state of 12 consecutive months. This eligibility requirement also applies to return-to-work retirees.

In the 2002–03 biennium, BRP cost the state $156.8 million in All Funds. In the 2004–05 biennium, 57 percent of BRP payments will be paid from General Revenue Funds. Figure 1 shows the declining rate of decrease in the BRP expenditure for general state employees. Because BRP-eligible employees have greater tenure, they often have more incentive to remain with the state until retirement. As a result the BRP expenditure is projected to decrease only 9.8 percent in 2006–07, which is significantly less than its rate of decrease in previous biennia. Reducing the eligibility grace period would help offset this trend.

At present, employees remain eligible for BRP as long as they have been away from state employment for less than a year. Another benefit, vacation leave, is withdrawn sooner than one year. The law requires employees be paid for any unused vacation time 30 days after they leave state employment. Implementation of this recommendation would cause employees to lose BRP eligibility 30 days after terminating their employment with the state.

State employee salaries and benefits continue to be one of the largest single state expenditures. Changes to employee benefits and cost-sharing arrangements should be considered in light of available state revenue and goals for

FIGURE 1
BENEFIT REPLACEMENT PAY SPENDING EACH BIENNIUM SINCE INCEPTION (IN MILLIONS)

BIENNIUM	EXPENDED IN ALL FUNDS	DECREASE FROM PRIOR BIENNIUM
1996–97	$284.8	
1998–99	$224.6	21.1 percent
2000–01	$185.2	17.5 percent
2002–03	$156.8	15.3 percent
2004–05	$129.2[1]	17.6 percent[1]
2006–07	$116.6[2]	9.8 percent[2]

[1] Budgeted
[2] Estimated
SOURCE: Legislative Budget Board.

employee recruitment and retention. Adopting the recommendation would accelerate the decrease in BRP spending, which is only achieved through loss of eligibility. Figure 2 shows the total cost savings that would result from amending Government Code, Chapter 659 to reduce the BRP eligibility grace period to 30 days.

FISCAL IMPACT OF THE RECOMMENDATION

This recommendation would reduce the 2006–07 appropriation for BRP by $367,575 in General Revenue Funds and $38,692 in General Revenue–Dedicated Funds. The estimate is based on the number of state employees who returned to work in fiscal year 2004 and received BRP, but who would have been ineligible under this recommendation. The fiscal estimate is based on only general state employee costs. Institutions of higher education include BRP in the salary of eligible employees and do not make the payment under a separate expenditure code; therefore, BRP amounts are not identifiable. The change in policy would affect all eligible state employees and eligible state-paid judges as those terms are defined in Government Code, Chapter 659.121.

FIGURE 2
FIVE-YEAR FISCAL IMPACT
BENEFIT REPLACEMENT PAY SAVINGS

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$183,787	$19,346	$64,487	$54,814
2007	$183,787	$19,346	$64,487	$54,814
2008	$183,787	$19,346	$64,487	$54,814
2009	$183,787	$19,346	$64,487	$54,814
2010	$183,787	$19,346	$64,487	$54,814

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill recommends a $116.6 million All Funds appropriation for Benefit Replacement Pay. This recommendation would reduce that appropriation by $644,868 in All Funds. The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of this recommendation.

REDUCE THE STATE CONTRIBUTION FOR EMPLOYEE HEALTH INSURANCE

Over the five-year period between fiscal years 1998 and 2003, All Funds expenditures associated with insurance coverage for general state employees and retirees served by the Employees Retirement System's group insurance program increased 68 percent. The agency anticipates that state health insurance costs will continue to increase; in fact, it is projected that appropriations will have to increase by 27 percent to maintain the current premium contribution policy in the 2006–07 biennium. To contain this cost increase, the state should reduce its contribution for active employee insurance coverage from 100 percent to 90 percent. This would result in a General Revenue Fund and General Revenue–Dedicated Fund savings of $101.4 million for the next biennium (excluding certain higher education funding). Reducing the state contribution for employee coverage to less than 100 percent is consistent with the contribution policy adopted by most large employers nationwide.

State employee salaries and benefits continue to be one of the largest single state expenditures. Changes to employee benefits and cost-sharing arrangements should be considered in light of available state revenue and goals for employee recruitment and retention.

SIGNIFICANT CONCERN

- To maintain the current group insurance premium subsidy, it will cost the state $260 million more in General Revenue Funds during the 2006–07 biennium than it did in the 2004–05 biennium to maintain the current contribution policy. This represents a 27 percent increase, which under current policy will be borne by the state alone.

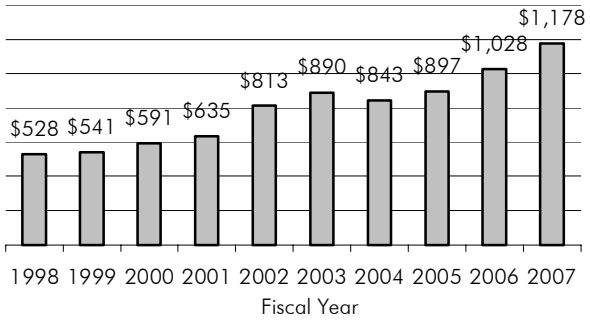
RECOMMENDATION

- Lower the state's group insurance contribution for basic health and life insurance from 100 percent to 90 percent for active employees whose total household income is greater than 200 percent of the federally determined poverty level.

COMMENTS

Even though the Seventy-eighth Legislature, 2003, required the Employees Retirement System (ERS) to implement significant changes in order to reduce state insurance contributions from what they would have been, the underlying trend in healthcare costs continues to affect health insurance premiums. This trend has and will continue to play a role in the upward cost of employer insurance contributions. For historical reference, fiscal year 1998 group insurance expenditures for general state and higher education employees cost $528 million in All Funds. By fiscal year 2003, this expenditure had grown to $890 million, a 68 percent increase. Figure 1 displays this trend in expenditure growth.

FIGURE 1
EXPENDITURE HISTORY ERS INSURANCE STATE EMPLOYEES CONTRIBUTION EXPENDITURES* ALL FUNDS (IN MILLIONS)



* Fiscal years 2005–07 are projected spending estimates.
SOURCE: Employees Retirement System.

RECENT EFFORTS TO CONTROL HEALTH INSURANCE COSTS

In order to contain the growth in state contributions for group insurance, the Seventy-eighth Legislature, 2003, required ERS to make several changes in its overall plan design. These changes were intended to address a $715.5 million employee group insurance cost increase projected by ERS at the beginning of the 2003 regular session. The benefit design changes included increasing deductibles and copays for employees, as well as changing the eligibility for retiree health benefits.

REDUCING FUTURE CONTRIBUTION COSTS

The state currently subsidizes all of the employee-only premium and half of the additional cost of covering dependents. Continuation of this premium subsidy policy is projected to cost the state $465 million in All Funds, and

$260 million in General Revenue Funds for the 2006–07 biennium. This represents a 27 percent increase in expenditures over the 2004–05 biennium.

Keeping with the nationwide trend toward reduced employee-only contributions among large employers and because of the significant cost increase anticipated for the 2006–07 biennium, the recommendation would reduce the state's employee contribution to 90 percent for active employees (not retirees). In order to offset the impact of such a change on lower-paid employees, the recommendation would reduce the state employee contribution from 100 percent to 90 percent of the premium just for employees whose total household income is greater than 200 percent of federally determined poverty levels. This approach aligns with the eligibility for premium subsidies under the State Employee Kids Insurance Program (SKIP), which also uses a 200 percent of poverty threshold for employees covering dependents.

LARGE EMPLOYER CONTRIBUTIONS FOR EMPLOYEE HEALTH INSURANCE

Requiring employees to contribute to their personal health insurance coverage is typical among large employers. The 2003 Employer-Sponsored Health Plan survey by Mercer Human Resources Consulting found that most large employers that offer health plans similar to the one provided by the Employees Retirement System (ERS) require employee contributions for personal coverage. Approximately 90 percent of the large organizations surveyed by Mercer required employees to contribute to their own coverage.

According to the Mercer study, among these employers that required personal coverage contributions, the average employee's contributions was 24 percent of the total cost of insurance, indicating that employers generally covered 76 percent of the employee-only contribution. Among large government employers, the average employee contribution was 23 percent in 2003.

The Kaiser Family Foundation's report, "Employer Health Benefits, 2004 Summary of Findings," also indicates that large private employers usually subsidize significantly less than 100 percent of the employee's premium. The report indicates that the average large private firm contributes 85 percent.

CONTRIBUTIONS AMONG LARGE TEXAS PRIVATE EMPLOYERS AND GOVERNMENTAL ENTITIES

Figure 2 shows information from a May 2004 ERS document that compares the contribution percentages paid by employees of selected large private employers in Texas, as well as local and state governmental entities. The contribution levels for all plans except ERS relate to employer preferred provider plans, which are similar to HealthSelect.

As depicted in Figure 2, eight major employers require employees to contribute to their coverage, and six of them require contributions exceeding 10 percent of the premium—Dell, Motorola, HEB, City of Dallas, IBM, and Texas A&M. Employee contributions to health insurance premiums under these six plans range from the City of Dallas at 39 percent and Dell at 32 percent, to IBM and Motorola, both at 13 percent.

FIGURE 2
COMPARISON OF ERS HEALTHSELECT EMPLOYER CONTRIBUTIONS AND WAITING PERIOD TO OTHER MAJOR PLANS
FISCAL YEAR 2004

EMPLOYER	EMPLOYEE ONLY CONTRIBUTION	WAITING PERIOD
ERS HealthSelect	100%	90 days
UT System	100%	90 days
Texas A&M System	88%	90 days
City of Austin	100%	0 days
Travis County	100%	0 days
City of Houston	91%	90 days
Harris County	100%	3 full months
City of Dallas	61%	0 days
Dallas County	95%	1 full month
HEB	80%	0 days
SW Airlines	100%	30 days
IBM	87%	0 days
Motorola	87%	0 days
Dell	68%	0 days

SOURCE: Employees Retirement System.

According to an article in the *San Antonio Express-News*, the Texas-based financial services and insurance firm USAA will require employees to contribute 10 percent of their health insurance premiums beginning in 2006.

Reducing the state's contribution for active employee insurance is therefore consistent with the policy of many large employers nationwide, as well as several large Texas employers. Some may argue that the state must continue the current contribution policy in order to be competitive with other employers. However, the surveys mentioned above indicate a widespread pattern of employees sharing the cost of health insurance with their employers.

RIDER PROVISIONS FOR REDUCING THE CONTRIBUTIONS

The following rider provisions, and amendments to the Texas Insurance Code, would implement the recommendation. Amendments to the Insurance Code are necessary to authorize the state insurance programs to have premium subsidies that vary depending on an employee's salary.

Employees Retirement System (Article I of the General Appropriations Act)

5. State Contribution to Group Insurance for General State Employees. Funds identified above for group insurance are intended to fund:

   a. ninety percent of the total cost of the basic life and health coverage for all active ~~and retired~~ employees whose total household income is greater than 200 percent of appropriate federal poverty thresholds; or

   b. the total cost of the basic life and health coverage for other active employees whose total household income is less than 200 percent of appropriate federal poverty thresholds, and for all retired employees; and

   c. ~~b.~~ fifty percent of the total cost of health coverage for the spouses and dependent children of all active and retired employees who enroll in coverage categories which include a spouse and/or dependent children;

Higher Education Employees (Article III of the General Appropriations Act)

1. **State Contribution to Group Insurance for Higher Education Employees Participating in the Employees Retirement System Group Insurance Program.** Funds identified above for group insurance are intended to fund:

   a. ninety percent of the total cost of the basic life and health coverage for all active ~~and retired~~ employees whose total household income is greater than 200 percent of appropriate federal poverty thresholds; or

   b. the total cost of the basic life and health coverage for other active employees whose total household income is less than 200 percent of appropriate federal poverty thresholds, and for all retired employees; and

   c. ~~b.~~ fifty percent of the total cost of health coverage for the spouses and dependent children of all active and retired employees who enroll in coverage categories which include a spouse and/or dependent children;

EMPLOYEE IMPACT

Figure 3 indicates the impact the recommendation would have on active state employees with incomes above $18,620. The unadjusted cost equals a flat 10 percent of the HealthSelect fiscal year 2005 annual premium. The adjusted cost reflects the savings associated with using the state's premium conversion, or TexFlex, program for payment of the 10 percent contribution. Premium conversion results in savings because employees pay for insurance with pre-tax dollars. The adjusted cost, therefore, would depend on the employees' marginal income tax bracket.

FIGURE 3
EMPLOYEE IMPACT
REDUCE CONTRIBUTION TO 90 PERCENT–BASED ON FISCAL YEAR 2005 PREMIUM

MARGINAL INCOME TAX BRACKET	ANNUAL UNADJUSTED EMPLOYEE COST	ANNUAL ADJUSTED EMPLOYEE COST
$18,620 - $28,400	$378.67	$321.87
$28,400 - $68,800	$378.67	$284.00
$68,800 - $143,500	$378.67	$272.64
$143,500 - $311,950	$378.67	$253.71

SOURCE: Legislative Budget Board.

FISCAL IMPACT OF THE RECOMMENDATION

The following fiscal impact information (Figure 4) indicates savings of $96.2 million in General Revenue Funds and $22.5 million in General Revenue–Dedicated Funds in the 2006–07 biennium would result from implementation of the recommendation.

The savings estimate was calculated using:

- the fiscal year 2005 employee-only monthly premium of $315.56 (for HealthSelect); no increase in the premium cost is assumed;
- the number of active state employees who have health insurance through ERS (including higher education employees) as of October 2004; no increase in the number of employees covered is assumed;
- an adjustment to account for part-time employees, assuming that about 14 percent of the population are part-time employees; this adjustment reduced the savings by the same percentage; and

- waivers for employees with annual state salaries less than 200 percent of the federal poverty level. The Health and Human Services Commission currently determines eligibility for the State Kid's Insurance Program through a contract with a third-party vendor. A similar eligibility determination process would need to be established to qualify state employees who apply for an exemption to paying 10 percent of their healthcare premium. This administrative cost would reduce the savings shown in Figure 4.

FIGURE 4
FIVE-YEAR FISCAL IMPACT
REDUCE CONTRIBUTION TO 90 PERCENT GENERAL STATE AND HIGHER EDUCATION EMPLOYEES

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$48,381,497	$11,314,886	$8,761,240	$7,447,054
2007	$48,381,497	$11,314,886	$8,761,240	$7,447,054
2008	$48,381,497	$11,314,886	$8,761,240	$7,447,054
2009	$48,381,497	$11,314,886	$8,761,240	$7,447,054
2010	$48,381,497	$11,314,886	$8,761,240	$7,447,054

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any savings as a result of these recommendations. The ERS Trust Fund, as well as the University of Texas Sytem and Texas A&M University System health plans, would gain revenue from employees paying 10 percent of the cost of active employee insurance coverage. This revenue gain could be used to offset employee healthcare costs and, as a result, make $96.2 million of General Revenue Funds available in the 2006–07 biennium.

REQUIRE STATE RETIREES UNDER THE AGE OF 65 TO PAY A PORTION OF THEIR HEALTH INSURANCE COSTS

The cost of health benefits for state retirees increased 36 percent from fiscal year 2001 to fiscal year 2003. In the 2002–03 biennium, healthcare for retirees covered by the Employees Retirement System cost the state $652 million in All Funds.

State retirees age 65 or older are eligible for Medicare and pay a federal insurance premium for Medicare Part B. The state is the primary provider of health insurance coverage for its retirees under age 65, but when a retiree reaches age 65, Medicare becomes the primary health insurance provider and the state becomes the secondary. Requiring retirees under age 65 to pay to the state the equivalent of the Medicare Part B premium would reduce the General Revenue Funds required for retiree healthcare coverage by $59.7 million and $14.3 million of General Revenue–Dedicated Funds in the 2006–07 biennium. If implemented, retirees would contribute $78.20 per month, or approximately 25 percent of the fiscal year 2005 premium for members only.

SIGNIFICANT FINDINGS

- The state retiree population is expected to grow by 5 percent each year for the next few years.
- Health insurance premiums are also expected to continue to increase. Premiums for retirees have increased by 7 percent each year since 2001. This is more than twice the rate of inflation.
- Under TRS-Care, a health plan offered to retirees of the Teacher Retirement System, the state requires public education retirees to pay a premium towards their health insurance. This is also true of several other states, major employers, and non-state government entities in Texas.

SIGNIFICANT CONCERN

- The increasing number of state retirees coupled with rising insurance premiums call for the consideration of strategies to share the increased cost of health insurance between retirees and the state.

RECOMMENDATION

- Require state and higher education retirees under age 65 to pay the state the equivalent of the Medicare Part B premium as their share of health insurance premiums.

COMMENTS

The state currently pays 100 percent of its retirees' health insurance premiums regardless of their age. In fiscal year 2004 there were 65,981 general state and higher education retirees who received their health insurance through the Employees Retirement System (ERS). Forty-four percent, or 29,134, were retirees under the age of 65, which does not include retirees of the Texas A&M System (A&M System) or the University of Texas System (UT System).

The state's retiree population under ERS is projected to grow 5 percent in each of the next several years. This means that there will be an additional 1,457 general state and higher education retirees under age 65 in fiscal year 2005. Historically, plan members within this age range contribute to higher healthcare costs. The All Funds cost to the state for retiree and retiree dependent health insurance will be approximately $246.6 million in fiscal year 2005. This is a $24 million increase from the estimated fiscal year 2004 figure of $222.6 million.

Healthcare costs are also expected to continue to increase. In fiscal year 2001, total healthcare plan expenditures for general state and higher education retirees equaled $258 million. By fiscal year 2003, healthcare costs grew by 36 percent, or $92 million.

CURRENT RETIREE HEALTH INSURANCE PREMIUMS

State retirees under age 65 do not pay a premium for their health insurance coverage, while those 65 and older must assume financial responsibility for their primary health insurance. Prior to reaching age 65, Medicare benefits are not typically available. ERS must, therefore, recognize medical expenses that will shift to Medicare at age 65. For fiscal year 2004, Legislative Budget Board staff estimate that the state paid $105 million from All Funds to cover the cost of member-only health insurance premiums for general state and higher education retirees under age 65.

In calendar year 2005, retirees age 65 or older will pay $78.20 monthly for Medicare Part B insurance coverage to the federal government. Under current ERS rules, the state does not require retirees to purchase Medicare coverage; however, the state plan is the secondary provider of health coverage regardless of whether the retiree has Medicare coverage or not. Therefore, if a Medicare-eligible retiree does not purchase Medicare, the retiree, and not the state insurance, is responsible for the portion of the claim that

would otherwise have been paid by Medicare. Nevertheless, in this situation the state insurance, while secondary, is still provided to the retiree at no cost.

Retirees of the Teacher Retirement System under the age of 65 are required to pay a variable premium based on the retiree's years of service and the program in which the retiree participates. Beginning in fiscal year 2005, these retirees are required to pay an additional amount of premium equal to the Medicare Part B premium.

OTHER STATES' CONTRIBUTIONS TOWARD RETIREE HEALTH CARE PREMIUMS

Other states and major private sector employers have reduced health benefits for retirees and increased retiree contributions for health insurance premiums to help defray healthcare expenses. As Figure 1 shows, few major employers in Texas contribute to retiree health insurance. In fact, Southwest Airlines, Motorola, and Dell pay nothing for retiree health insurance premiums.

Since 1998, the number of states that pay the full cost of their employees' healthcare premiums has decreased from 22 to16. Thirty-four states require their retirees to pay all or a part of their health insurance premium. Figure 2 shows the different contributions that states make for the health insurance of their retirees in Arkansas, California, Florida, and New York.

FIGURE 1
EMPLOYER CONTRIBUTION FOR RETIREE HEALTH INSURANCE PREMIUMS AS OF MAY 2004

MAJOR EMPLOYERS IN TEXAS	EMPLOYER CONTRIBUTION
Austin	80 percent with 20 years of service
Dallas	15 percent
Houston	55 percent if under age 65; 65 percent if age 65 or over
Dallas County	30 percent if under age 65
Travis County	84 percent
Harris County	100 percent
Teacher Retirement System	Variable- Medicare Part B equivalent to 100 percent (based on years of service)
HEB	Variable if under age 65 and hired before 1972; 0 percent if age 65 or over
Southwest Airlines	0 percent
IBM	Subsidy based on retirement date and Medicare status
Motorola	0 percent
Dell	0 percent
State of Texas (ERS)	100 percent

SOURCE: Employees Retirement System.

FIGURE 2
STATE CONTRIBUTION FOR RETIREE HEALTH INSURANCE PREMIUMS IN FIVE STATES AS OF FISCAL YEAR 2004

STATE	STATE CONTRIBUTION
Arkansas	Up to 32 percent for individual coverage and up to 26 percent for individual coverage if covered by Medicare
California	65 percent to 100 percent for individual coverage*
Florida	0 percent
New York	90 percent
Texas (ERS)	100 percent

* Percentage paid varies by the type of health plan chosen and the cost of the insurance premium.
SOURCE: Legislative Budget Board.

A recent study conducted by the Kaiser Family Foundation and Hewitt Associates found that 91 percent of the 408 firms surveyed require retirees to pay a portion of their premium. It also found that the retiree's share for health insurance increased by 19 percent between 2002 and 2003. Even in the context of the trend of reductions in employer contributions for retirees' health insurance, 86 percent of the firms indicate that they are very likely to increase the portion that retirees are required to contribute to their health insurance premiums in the next three years due to rapidly increasing premiums.

REQUIRING RETIREES TO PAY THE EQUIVALENT OF MEDICARE PART B PREMIUMS

The recommendation would require retirees under age 65 to pay for a portion of the cost of their healthcare premium. As the number of state retirees and the cost of health insurance continue to increase, the financial burden on the state is also increasing. Higher healthcare costs and the limited contributions of other government and commercial entities to retiree health insurance are reasons for state retirees in Texas to be required to pay for a portion of their healthcare premiums.

The recommendation would provide the state with an option for offsetting the rising cost of healthcare. Implementation of this recommendation would allow a reduction in the appropriation for retiree group insurance for ERS and the Higher Education Employees Group Insurance. The recommendation would be implemented by including rider language in the 2006–07 General Appropriations Bill for ERS and the Higher Education Employees. Additional language from the riders continued in the 2004–05 General Appropriations Act is underlined on the following page.

Employees Retirement System

5. **State Contribution to Group Insurance for General State Employees.** Funds identified above for group insurance are intended to fund:

   a. the total cost of basic life and health coverage for all active ~~and retired~~ employees;

   b. the total cost of basic life and health coverage for retirees age 65 or older;

   c. levels of health insurance cost sharing between the state and retirees in such a manner that retirees under age 65 who are not eligible for Medicare will contribute the equivalent of the Medicare Part B premium towards their health insurance premium;

   d. [~~b.~~]fifty percent of the total cost of health coverage for spouses and dependent children of all active and retired employees who enroll in coverage categories which include a spouse and/or dependent children; and

   e. [~~c.~~]the additional cost of providing a premium structure comparable to the Children's Health Insurance Program (CHIP) for dependent children of state employees enrolled in the State Kids Insurance Program (SKIP).

Higher Education Employees Group Insurance Contribution 1. State Contribution to Group Insurance for Higher Education Employees Participating in the Employees Retirement System Group Insurance Program. Funds identified above for group insurance are intended to fund:

   a. the total cost of basic life and health coverage for all active ~~and retired~~ employees; ~~and~~

   b. the total cost of basic life and health coverage for retirees age 65 or older;

   c. levels of health insurance cost sharing between the state and retirees in such a manner that retirees under age 65 who are not eligible for Medicare will contribute the equivalent of the Medicare Part B premium towards their health insurance premium; and

   d. [~~b.~~]fifty percent of the total cost of health coverage for spouses and dependent children of all active and retired employees who enroll in coverage categories which include a spouse and/or dependent children.

FISCAL IMPACT OF THE RECOMMENDATION

This recommendation would result in a net General Revenue Fund savings of $59.7 million and a net General Revenue–Dedicated Funds savings of $14.3 million in the 2006–07 biennium. If implemented, the state's contribution for retiree health insurance would be reduced by the equivalent of the Medicare Part B premium and would offset a portion of ERS's-general state and higher education, A&M System's, and UT System's appropriation requirement for retiree health insurance coverage for all state retirees who receive health insurance.

The amounts in Figure 3 take into account the federally projected Medicare Part B premium for each of the years noted below. The number of retirees is assumed to increase at 5 percent per year and to have the current percentage of retirees under age 65.

FIGURE 3
FIVE-YEAR FISCAL IMPACT
RETIREES UNDER 65 PAYING A MEDICARE PART B PREMIUM EQUIVALENT

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$28,926,096	$7,092,664	$5,793,178	$4,924,201
2007	$30,811,436	$7,225,183	$6,234,907	$5,299,671
2008	$32,519,041	$7,404,931	$6,834,067	$5,808,957
2009	$34,281,308	$7,590,433	$7,452,406	$6,334,545
2010	$37,171,109	$7,789,359	$8,115,494	$6,898,170

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not include the savings noted in the fiscal impact table shown above. The gain to the Trust Fund would come from retiree's under age 65 paying a portion of their health insurance premium. This gain could be used to offset retiree healthcare costs and, as a result, make available $59.7 million in General Revenue Funds.

DECREASE ADMINISTRATIVE ALLOWANCE FOR COLLECTION OF GASOLINE TAX

Current statute allows suppliers, distributors, and importers of gasoline to retain, as a group, 2 percent of the revenue generated by the tax to cover the administrative costs of processing and paying the tax. This percentage has not been adjusted since fiscal year 1971, yet Texas' tax rate on gasoline has quadrupled in the last 30 years, and domestic motor fuel consumption has increased by 76.6 percent during the same period of time. Adjusted for inflation, gasoline distributors and suppliers retained approximately $30.0 million as a result of the allowance in 1972 and will retain $48.0 million in each year of the 2006–07 biennium, even though the widespread use of computers for accounting purposes has reduced administration costs. In this context, the 2 percent share of the tax presently retained by suppliers, distributors, and importers seems unjustified. Reducing the administrative allowance for the gasoline tax to 1 percent would generate $12.1 million in additional revenue for the Available School Fund and $36.2 million for the State Highway Fund in the 2006–07 biennium.

SIGNIFICANT CONCERN

- Over the past 30 years, the 2 percent of the state gasoline tax retained by suppliers, distributors, and importers to cover administrative costs has become excessive in the context of a quadrupled tax rate and a dramatically increased rate of domestic motor fuel consumption.

RECOMMENDATION

- Amend Chapter 162 of the Tax Code to reduce the administrative allowance for collection of the gasoline tax to 1 percent for suppliers, importers, and distributors, with three-fourths of the allowance provided to distributors.

COMMENTS

Motor fuels taxes consist of the state's consumption taxes on gasoline, diesel fuel, and liquefied gas. The state's revenue from these taxes results from a combination of total consumption and the tax rate. Adjusted for inflation, in fiscal year 1972, Texas collected $1.6 billion in motor fuels taxes. By fiscal year 2003, the state collected $2.8 billion in motor fuels tax receipts.

The tax on gasoline was first enacted in fiscal year 1923 at a rate of one cent per gallon. The tax rate was raised to 4 cents per gallon in fiscal year 1941, then to 5 cents per gallon in fiscal year 1955, 10 cents per gallon in fiscal year 1984, 15 cents per gallon in fiscal year 1986, and finally 20 cents per gallon in fiscal year 1991.

According to the U.S. Census Bureau, total U.S. domestic motor fuel consumption has increased from 92.3 billion gallons in 1970 to 163 billion gallons in 2001. This increase represents a 76.6 percent increase over this 30-year time period. Specifically in Texas, the Federal Highway Administration reports that consumption has increased from 10.3 billion gallons in 1992 to 14.5 billion gallons in 2002. This growth represents a 41 percent increase.

ADMINISTRATIVE ALLOWANCE

Article VIII, Section 7-a of the Texas Constitution dedicates three-fourths of the revenue from motor fuels taxes to uses related to the state highway system. The remaining one-fourth is dedicated to the Available School Fund. Motor fuels tax receipts are collected each month and deposited in the General Revenue Fund. After the Comptroller of Public Accounts (comptroller) makes required deductions and refunds (Section 162.502 of the Tax Code), the receipts are allocated to the Available School Fund and the State Highway Fund.

However, the administrative allowance on motor fuels taxes is separated from the state's tax revenue before it is deposited with the comptroller. The administrative allowance is allowed to remain with suppliers, distributors, and importers of motor fuels taxes in exchange for their timely submission of the taxes to the state treasury.

The first statutory provision outlining the allowance in relation to the gasoline tax (House Bill 8, Forty-seventh Legislature, Regular Session, 1941) set it at 1 percent of revenues collected and indicated it was "to cover losses and the expense of collecting the tax levied herein." The allowance was raised to 1.5 percent of revenues collected in the 1950s, when the statutory language indicated it was "for the expense of collecting, accounting for, reporting, and handling such motor fuel and the taxes collected." In fiscal year 1971, the allowance was raised to 2 percent of revenues collected and has not been raised since. The statute was amended in fiscal year 1981 to indicate the allowance was "for expenses of collecting, accounting for, reporting, and remitting the tax collected and for keeping records." Current statute now indicates the allowance is "to cover administrative expenses."

FIGURE 1
DEFINITIONS OF SELECTED GAS TAX COLLECTION TERMS

Bulk transfer / terminal system means the motor fuel distribution system consisting of refineries, pipelines, marine vessels, and terminals.

Distributor is a person who acquires motor fuel from a supplier or another distributor and who makes sales at wholesale or retail.

Importer is a person that imports motor fuel into Texas.

Rack means a mechanism for delivering motor fuel from a refinery, terminal, marine vessel, or bulk plant into a transport vehicle, railroad tank car, or other means of transfer.

Supplier is a person that is subject to the general taxing jurisdiction of Texas, registered with the federal government for transactions in motor fuel in the bulk transfer / terminal distribution system, and is a position holder in motor fuel in a terminal or refinery or a person who receives motor fuel under a two-party exchange.

Terminal is a motor fuel storage and distribution facility supplied by pipeline or marine vessel, and from which motor fuel may be removed at a rack.

Two-party exchange means a transaction in which motor fuel is transferred from one supplier to another under an exchange agreement.

SOURCE: Tax Code, Chapter 162.

According to the comptroller's January 2003 report of tax exemptions and incidence, the allowances for the gasoline tax are estimated to amount to $48 million per year in the 2006–07 biennium.

Opponents to a reduction in the administrative allowance for gasoline distributors and suppliers argue that the current 2 percent allowance does not fully reimburse for the costs of collecting the tax. However, according to a 1999 survey commissioned by an industry association, while the allowance was not sufficient to cover the costs of some suppliers and distributors, 48 percent of those surveyed said they had costs that were less than the allowance. Furthermore, in addition to the allowance, distributors keep the interest earned on pre-deposited tax revenues.

Suppliers deposit taxes to the state treasury, which are due on the twenty-fifth day of the month following the month in which the tax accrued. Distributors and importers can defer paying their taxes to suppliers until two days before this date. This allows them to keep it for almost one month before giving it to the supplier who then remits it to the comptroller. During this time period, the collected funds can earn interest or realize other earnings from temporary use. In the same 1999 study, they found that the median amount earned by respondents from the use of the pre-deposited funds was $2,130 per year.

An electronic transfer must be used to make payments. Distributors who make these payments on a timely basis may keep 1.75 percent of the total taxes due to cover their administrative expenses. Suppliers and importers are then allowed to deduct an additional 0.25 percent from their tax payment, if they too are timely. Figure 2 illustrates the collection process for a single distributor, supplier, and the state treasury.

FIGURE 2
TAX COLLECTION PROCESS

	DISTRIBUTOR	SUPPLIER	STATE TREASURY
Total Tax	$1,000.00	$1,000.00	$1,000.00
Percent Retained	1.75	0.25	98.00
Amount Retained	$17.50	$2.50	$980.00

SOURCE: Legislative Budget Board.

The text of the gasoline tax provisions relating to allowances follows:

Sec. 162.113. REMITTANCE OF TAX TO SUPPLIER OR PERMISSIVE SUPPLIER; ALLOWANCES.

(e) A licensed distributor or licensed importer who makes timely payments of the gasoline tax imposed under this subchapter is entitled to retain an amount equal to 1.75 percent of the total taxes to be paid to the supplier or permissive supplier to cover administrative expenses.

Sec. 162.116. INFORMATION REQUIRED ON SUPPLIER'S AND PERMISSIVE SUPPLIER'S RETURN; CREDITS AND ALLOWANCES.

(b) A supplier or permissive supplier that timely pays the tax to this state may deduct from the amount of tax due a collection allowance equal to two percent of the amount of tax payable to this state.

Sec. 162.119. INFORMATION REQUIRED ON IMPORTER'S RETURN; ALLOWANCES.

(b) An importer of gasoline that timely files a return and payment may deduct from the amount of tax payable with the return a collection allowance equal to two percent of the amount of tax payable to this state.

The report recommendation would require changes to sections 162.113, 162.116, and 162.119 of the Tax Code. Amendments to the above-mentioned sections would reflect the reduction in the administrative allowance for collection of the gasoline tax to 1 percent for suppliers, importers, and distributors, with three-fourths of the allowance provided to distributors.

PREVIOUS RECOMMENDATIONS TO REDUCE OR ELIMINATE THE ALLOWANCES

In July 1991, the comptroller's Texas Performance Review (TPR) recommended eliminating the allowances available for the filers of motor fuels tax reports. At that time, the estimated gain to the Available School Fund would have been approximately $8 million per year and the gain to the State Highway Fund would have been approximately $23 million per year.

In January 1993, the comptroller's TPR recommended eliminating filing allowances related to the sales tax, alcoholic beverage excise tax, and the hotel/motel tax, as well as the motor fuels taxes. That recommendation was estimated to bring approximately $50 million more into the General Revenue Fund per year, as well as $11 million for the Available School Fund and $32 million for the State Highway Fund.

House Bill 2458, Seventy-eighth Legislature, Regular Session, 2003, as introduced, would have reduced the administrative allowance to 0.5 percent, split equally between suppliers and distributors. However, the committee substitute for the bill returned the allowance amount to 2 percent, as it was in previous statute, split 1.75 percent to distributors and 0.25 percent to suppliers.

ADMINISTRATIVE COST ALLOWANCES IN OTHER STATES

Twenty-four states have some kind of allowance to cover the administrative costs of collecting and reporting motor fuels taxes to their respective treasuries. Based on 2002 data, five of the top ten states, ranked by gross motor fuel tax collections, provide some form of administrative allowance. Figure 3 summarizes this information.

FIGURE 3
YEAR 2002 MOTOR FUEL TAX COLLECTIONS AND ALLOWANCES

STATE	GROSS TAX COLLECTIONS (IN THOUSANDS)	DEDUCTIONS FOR EXPENSES (IN THOUSANDS)	STATUTORY PERCENT
California	$3,237,098	$0	0.0%
Texas	$2,891,176	$45,810	2.0%
Florida	$1,765,079	$2,280	0.2%
Pennsylvania	$1,685,367	$4,569	0.5 - 2.0%
New York	$1,537,111	$0	0.0%
Ohio	$1,462,478	$31,323	2.0 - 3.0%
Illinois	$1,313,901	$20,250	1.75 - 2.0%
North Carolina	$1,276,097	$0	0.0%
Michigan	$1,099,976	$0	0.0%
Wisconsin	$876,303	$0	0.0%

SOURCE: Federal Highway Administration.

Florida provides an allowance of 0.2 percent for suppliers if they are timely in their tax payments and split the allowance evenly with purchasers. Ohio allows an allowance of up to 3 percent, although in addition to administrative costs this amount covers actual losses of fuel resulting from handling losses. In Illinois, timely suppliers or distributors may take a 1.75 percent allowance for record-keeping and tax collection costs. This rate was lowered from 2 percent, effective June 30, 2003.

In some cases, states gradually reduce the allowance as the amount of tax increases. For example, Pennsylvania provides a 2 percent allowance on taxes up to $50,000, 1.5 percent on taxes between $50,000 and $75,000, 1 percent on taxes between $75,000 and $100,000, and 0.5 percent on taxes over $100,000.

As an alternative to an across-the-board administrative allowance reduction, Texas could use a similar model to the one being used in Pennsylvania. Based on annualized gasoline tax collections from February 2004 to September 2004, gradually reducing the allowance as the amount of tax increases could yield the state $68 million in All Funds savings for the 2006–07 biennium.

FISCAL IMPACT OF THE RECOMMENDATION

This recommendation would result in a net General Revenue Fund gain of $12.1 million in the 2006–07 biennium. In January 2003, the comptroller estimated the 2 percent gasoline tax allowances at $48.1 million in fiscal year 2006 and $48.5 million in fiscal year 2007. Figure 4 reflects the fiscal impact resulting from reducing the total administrative allowance to 1 percent. The gain to General Revenue is for the Available School Fund. The gain to Other Funds is for the State Highway Fund. Since the recommendation will not increase the state's taxes on motor fuels, it is assumed that no additional federal highway funds will be available to the state should the recommendation be implemented.

FIGURE 4
FIVE-YEAR FISCAL IMPACT
PROPOSED ALLOWANCE REDUCTION

FISCAL YEAR	PROBABLE GAIN/(LOSS) FROM GENERAL REVENUE FUNDS	PROBABLE GAIN/(LOSS) FROM OTHER FUNDS
2006	$6,012,500	$18,037,500
2007	$6,062,500	$18,187,500
2008	$6,062,500	$18,187,500
2009	$6,062,500	$18,187,500
2010	$6,062,500	$18,187,500

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not include the revenue gain noted in the fiscal impact table shown in Figure 4. The $12.1 million in General Revenue Funds would be additional monies that would be deposited into the Available School Fund within the General Revenue Fund.

ELIMINATE THE PERMANENT RESIDENT EXCEPTION TO THE HOTEL OCCUPANCY TAX

The state levies a hotel occupancy tax on hotel guests. Businesses and individuals who occupy a hotel room for 30 or more consecutive days are considered permanent residents and are exempt from the hotel tax. Corporations and individuals who enter into written lease agreements with hotels for the continuous lease of rooms for more than 30 days benefit from this exemption.

In fiscal year 2004, the state collected $238.9 million in hotel tax revenue. Without the permanent resident exception for individuals and corporations, the General Revenue Fund would have received $6.9 million more in revenue for that same period. Eliminating this exception would require amending Chapter 156 of the Tax Code to repeal the clause that exempts businesses and individuals who have the right to use or possess a hotel room for at least 30 days without interruption of payment from paying the hotel tax. Implementing this recommendation could provide an additional $14.2 million in General Revenue and General Revenue–Dedicated Funds for the 2006–07 biennium.

SIGNIFICANT CONCERN

- The state forfeits $6.9 million in General Revenue and General Revenue–Dedicated Funds annually as a result of corporations and individuals taking advantage of the 30-day, long-term stay exemption.

RECOMMENDATION

- Amend Chapter 156 of the Tax Code to repeal the permanent resident exception to the hotel occupancy tax.

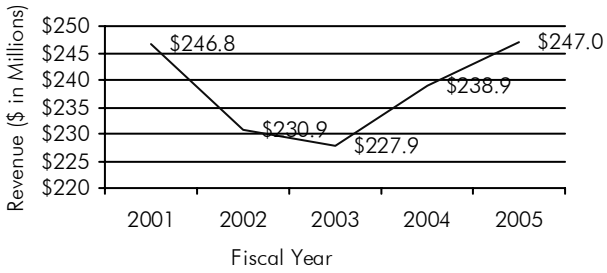
COMMENTS

At present, the hotel occupancy tax is imposed at a 6 percent rate. The state hotel tax applies to room rental charges for periods of less than 30 continuous days by the same person. Cities and counties are also allowed to levy their own hotel taxes. According to state statute, a city's hotel tax rate may not exceed 7 percent, and a county's hotel tax rate must be between 2 and 7 percent. However, if local governments choose to levy a hotel tax, the combined state, county, and city hotel occupancy tax may not exceed 15 percent. In fiscal year 2004, approximately 400 cities and 48 counties in Texas levied local hotel occupancy taxes.

The hotel occupancy tax is collected by the hotel providing the service and sent to the Comptroller of Public Accounts on a monthly basis. Section 156.251 of the Tax Code provides that, "The revenue from the tax imposed by this chapter shall be deposited in the state treasury to the credit of the general revenue fund." By statute, one-twelfth of the revenue generated by the tax is used for the purpose of promoting tourism in the state. One-third of the revenue generated by the tax from hotels in eligible coastal municipalities is allocated to those municipalities for the maintenance of their public beaches. One percent of the revenue generated can be deducted and withheld by the hotel as reimbursement for the cost of collecting the tax.

While state hotel tax revenue has increased steadily for the last two years, as Figure 1 shows, it has not returned to its early 2000 levels. Hotel tax revenues decreased from $247 million in fiscal year 2001 to $228 million in fiscal year 2003. According to the comptroller, hotel tax revenues are projected to grow to $247 million in fiscal year 2005.

FIGURE 1
HOTEL OCCUPANCY TAX REVENUE



NOTE: 2005 revenue figure is a projection.
SOURCE: Comptroller of Public Accounts.

Section 156.101 of the Tax Code provides that a "person" with the right to use or possess a hotel room for at least 30 consecutive days without interruption of payment is not required to pay the state hotel occupancy tax. In the context of the law, the term "person" also includes businesses. Approximately 83 percent of hotel tax exemptions are claimed by businesses such as consulting firms, airlines, trucking companies, and railroads that often benefit greatly when they rent entire blocks of hotel rooms for more than 30 consecutive days. The permanent resident exception to the hotel occupancy tax is the only clause in Chapter 156 of the Tax Code that grants a tax exemption to corporations and private individuals. Other exemptions

to the hotel tax are allowed for state and federal entities, non-profit organizations, religious institutions and for institutions of higher education.

HOTEL TAXES IN OTHER STATES

Ten states presently have hotel occupancy taxes. The tax rates range from 4 percent in Montana to 12 percent in Connecticut. Also, the period of time after which guests become exempt from paying state hotel occupancy taxes varies from a typical period of 30 days to as much as six months, which is the case in Florida.

As is the case in Texas, the majority of states allow their local governments to impose and collect hotel taxes, which is also the case for states such as California that do not levy state hotel occupancy taxes. In California, local and county jurisdictions tax hotel guests at rates up to 14 percent, comparable to Texas' combined 15 percent hotel tax rate.

REPEAL THE PERMANENT RESIDENT EXCEPTION

Chapter 156 of the Tax Code should be amended to repeal the permanent resident exception to the hotel occupancy tax. In fiscal year 2004, an estimated $117.0 million in hotel receipts were not taxed due to the permanent resident exception. This translates into a $6.9 million loss in tax revenue for the state. The majority defrayed costs to businesses. If this recommendation is approved and the tax exemption repealed, corporations and individuals would be required to pay the hotel occupancy tax regardless of length of stay.

This recommendation would have little impact on private individuals as a group because they typically represent a small portion of the guests who stay for continuous periods of more than 30 days. Furthermore, this recommendation would not eliminate other hotel tax exemptions currently allowed for federal and state employees on official business, non-profit organizations, religious institutions, and public or private institutions of higher education, entities for which an exemption makes their costs more manageable.

FISCAL IMPACT OF THE RECOMMENDATION

This recommendation would result in a net General Revenue Fund gain of $13.1 million and a net General Revenue–Dedicated Fund gain of $1.2 million in the 2006–07 biennium. Revenue from the hotel occupancy tax is projected to grow in the next few years. The revenue gain was derived by taking a sample of hotels in Texas that claim large amounts of exemptions and by calculating the portion of their gross receipts that is exempt due to the permanent resident exception. The fiscal impact in Figure 2 assumes a growth rate of 2 percent in taxable receipts per year, which is equal to the current rate of inflation. Figure 2 shows one-twelfth of the revenue resulting from eliminating the permanent resident exception as General Revenue–Dedicated for the promotion of tourism as required by statute. The 1 percent administrative allowance retained by taxpayers is also reflected in the savings calculation. Figure 2 does not reflect the deduction from the revenue generated from the hotel tax that would be allocated to coastal municipalities because there are so few that receive this dedicated hotel tax revenue. As such, the impact on the state revenue gain is insignificant.

FIGURE 2
FIVE-YEAR FISCAL IMPACT
PROPOSED TAX EXEMPTION ELIMINATION

FISCAL YEAR	PROBABLE REVENUE GAIN/(LOSS) TO GENERAL REVENUE FUNDS	PROBABLE REVENUE GAIN/(LOSS) TO GENERAL REVENUE–DEDICATED FUNDS
2006	$6,479,789	$589,072
2007	$6,609,385	$600,853
2008	$6,741,573	$612,870
2009	$6,876,404	$625,128
2010	$7,013,932	$637,630

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not include the revenue gain noted in the fiscal impact table shown above.

REDUCE THE INTEREST RATE PAID ON TAX REFUNDS

In 1999, the Seventy-sixth Legislature required the state to pay interest on tax refunds at an interest rate equal to the prime rate plus 1 percent. However, the interest rate paid on tax refunds is greater than the rate of return on deposits in the state treasury. For example, in fiscal year 2003, the prime rate plus 1 percent was 5.25 percent, whereas the average yield for the state treasury was 2 percent. The state should reduce the interest rate paid on refunds to taxpayers who voluntarily overpay their taxes to the average yield earned on funds in the state treasury. By doing this, the state could avoid spending approximately $22.4 million in General Revenue Funds for interest payments during the 2006–07 biennium.

SIGNIFICANT CONCERN

- The state pays a higher rate of interest to taxpayers on tax refunds than it earns on funds in the state treasury.

RECOMMENDATION

- Section 111.064 of the Texas Tax Code should be amended to change the interest rate paid on tax refunds for voluntary overpayments to the average yield earned on funds in the state treasury. Refund claims filed on or after September 1, 2005 should earn interest at the reduced rate regardless of when the tax was paid.

COMMENTS

The primary taxes collected by the state are sales tax, franchise tax, minerals tax, and motor vehicle sales tax. The Comptroller of Public Accounts is responsible for collecting most taxes and fees, auditing taxpayer records to determine compliance, and educating the taxpayer about the tax requirements. Taxes and fees can be due monthly, quarterly, or yearly. It is the responsibility of the vendor to file a tax return and pay its taxes by the due date. Likewise, if the vendor overpays the amount of tax it owes, it is responsible for filing a refund claim with the comptroller.

Section 111.104 of the Texas Tax Code directs the comptroller to provide refunds to taxpayers when taxes are erroneously collected. Refunds are either a result of a voluntary overpayment or a protest payment. The most common voluntary overpayment occurs when a tax-exempt organization fails to present its approved exemption when making purchases and therefore is required to pay sales tax. This results in an overpayment of taxes, and in order to receive a refund, the organization must seek a tax refund from the vendor who originally collected the tax. The vendor may refund the tax to the organization and make an adjustment on the vendor's next tax payment to the comptroller, or the vendor may issue an "assignment of right" to the organization to collect the refund directly from the comptroller. Another type of refund that occurs is a protest payment. A protest payment is made when the taxpaying organization contends the tax or fee is not legal; yet, Section 112.051 of the Tax Code still requires the taxpayer, under protest, to pay the tax by its due date pending disposition of any legal challenge.

In either case, if the comptroller determines that the tax was erroneously collected, the tax is refunded with interest. Section 111.064 of the Tax Code directs the comptroller to pay interest on tax overpayments for the period beginning 60 days after the due date of the tax payment and ending on the date the comptroller determines the money is owed to the taxpayer. The interest rate paid on all tax refunds is prime rate plus 1 percent. The prime rate used for each year is the prime rate published in the Wall Street Journal on the first business day of each calendar year.

The recommendation suggests the interest rate paid to taxpayers for voluntary overpayments should be reduced to the average yield earned on state funds in the state treasury. Figure 1 provides a comparison forecast of the average yield to be earned on state funds and the average prime rate plus 1 percent for the corresponding fiscal years. During the 2006–07 biennium, the state will pay, on average, an

FIGURE 1
INTEREST RATE COMPARISON FORECAST

FISCAL YEAR	AVERAGE YIELD ON STATE DEPOSITS FORECAST	PRIME RATE PLUS ONE FORECAST	DIFFERENCE
2006	2.8%	6.3%	3.5%
2007	3.3%	6.4%	3.1%
2008	3.6%	7.1%	3.5%
2009	4.0%	7.2%	3.2%
2010	4.6%	9.3%	4.7%

SOURCE: Comptroller of Public Accounts.

interest rate that is 3.3 percent more than what it will earn on state deposits. If the interest rate paid to taxpayers for voluntary overpayments were reduced to the average yield earned on funds in the State treasury, the state would no longer be penalized by voluntary overpayments made by taxpayers.

However, for those who pay under protest, the interest rate should remain the prime rate plus 1 percent. These taxpayers were required by the state to pay tax they contended to be unlawful and therefore did not make a voluntary overpayment.

FISCAL IMPACT OF THE RECOMMENDATION

By implementing this recommendation, the state could avoid spending approximately $22.4 million in General Revenue Funds and $70,000 in General Revenue–Dedicated Funds for the 2006–07 biennium. Figure 2 provides a break down of the total savings by fund type.

FIGURE 2
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COST)TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/ (COST)TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/ (COST) TO OTHER FUNDS
2006	$10,345,829	$32,205	$1,003,819
2007	$12,027,025	$37,468	$1,166,009
2008	$12,240,134	$38,101	$1,186,670
2009	$11,035,550	$34,352	$1,069,887
2010	$12,548,488	$39,061	$1,216,565

SOURCE: Legislative Budget Board.

Voluntary tax overpayments are refunded from the same fund accounts into which the original payments were deposited. Interest payments on voluntary tax overpayments are also provided from the corresponding fund or account. In order to obtain the potential savings by fund type, expenditures for each fund are averaged for fiscal years 2002 to 2004. Figure 3 provides an average of the expenditures for each fund type.

The average for each fund type shown in Figure 3 is multiplied by the difference between the forecasted prime rate plus 1 percent and the forecasted average yield on state funds for fiscal years 2006 to 2010 shown in Figure 1. This new figure is then divided by the corresponding prime rate plus one percent to obtain an estimated savings in General Revenue Funds, General Revenue–Dedicated Funds, and Other Funds. Because the comptroller will make refund payments to taxpayers on claims filed prior to September 1, 2005, fiscal year 2006 estimates allow for a three-month transition for payments to be made at the higher interest rate.

FIGURE 3
AVERAGE ANNUAL INTEREST EXPENDITURES FOR FISCAL YEARS 2002–04

General Revenue Fund	$24,833,987
General Revenue–Dedicated	$77,291
Other Funds	$2,407,245

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of the recommendation.

REQUIRE REAL ESTATE SALES PRICE DISCLOSURE AND IMPLEMENT A REAL ESTATE TRANSFER FEE

Texas relies heavily on property taxes to fund local government in the state, yet Texas is one of only 15 states that does not have mandatory real estate sales price disclosure. Mandatory sales price disclosure would provide the local appraisal districts with an important tool to appraise real property. In a 2003 survey, chief appraisers of local appraisal districts estimated that mandatory disclosure would add $18.8 billion of taxable value to the tax rolls.

State aid to school districts is based, in part, on district wealth per student. In general, if taxable property value increases, state aid to school districts decreases. Therefore, increases in appraised value realized from mandatory real estate sales price disclosure could result in significant savings to the state. Savings to the state would begin in fiscal year 2008 with savings for that year estimated at $19 million. Savings would increase to $64 million in fiscal year 2009, $110 million in fiscal year 2010, and $135 million each fiscal year thereafter. During the four-year period encompassing fiscal years 2007 to 2010, school districts would experience a cumulative net gain of $135 million.

Closely related to the local appraisal process is the annual property value study conducted by the Comptroller of Public Accounts. The study measures the validity and uniformity of local appraisals to ensure that state aid is distributed fairly among school districts. The study is currently funded with general revenue. Imposing a real estate transfer fee could provide a net gain of $9.9 million to the General Revenue Fund in the 2006–07 biennium. This revenue could be used to fund a portion of the cost of the property value study.

SIGNIFICANT CONCERNS

- The absence of accurate real estate sales price information leads to increased costs to the state in aid to school districts.
- The state appropriates approximately $6 million per year from the General Revenue Fund to finance the annual property value study conducted by the Comptroller of Public Accounts. A nominal property transfer fee collected in conjunction with sales price disclosure could be used to fund the study.

RECOMMENDATIONS

- **Recommendation 1:** Amend Chapter 22 of the Tax Code to require real estate sales price disclosure.
- **Recommendation 2:** Amend the appropriate statute to impose a $35 fee on each real estate transfer in the state.

COMMENTS

The lack of real estate sales price information leads to increased costs to the state in aid to school districts because of the link between local school property tax appraisals and state funding of public schools.

The Texas Constitution prohibits the state from imposing a state property tax, but the local property tax is the largest source of revenue for local governments in the state. Cities, counties, special districts, and school districts impose property taxes. Property taxes are administered locally and are based on property values determined by local appraisal districts.

LOCAL APPRAISAL

The state is divided into 253 appraisal districts. (The appraisal districts follow county boundaries, except for the Potter–Randall appraisal district, which encompasses two counties.) The appraisal districts are governed by local boards, and each district has a chief appraiser. Each appraisal district is charged with determining the market value and taxable value of property in that district. State law requires appraisal districts to reappraise each taxable property at least once every three years, but many appraisal districts reappraise annually.

The most frequently used method of appraisal, the market data comparison method, uses sales price data to establish the market value of property. This process is dependent on the availability of accurate sales price data. Texas does not have mandatory real estate sales price disclosure. In the absence of mandatory disclosure, appraisal districts use various sources of voluntarily disclosed or purchased sales price data, such as multiple-listing-service data, in the appraisal process. While adequate sales information is frequently available on low-priced and mid-priced residential properties, chief appraisers have testified that insufficient price data are available on nonresidential properties and high-priced residential properties.

In a survey conducted by the Comptroller of Public Accounts in 2003, chief appraisers estimated that $18.8 billion in property value would be added to the tax rolls if the state enacted a mandatory disclosure statute. Total school district taxable value for 2003 was $1,057.9 billion; therefore, the $18.8 billion in estimated property value increases represents 1.8 percent of total 2003 school district taxable value.

Chief appraisers indicate that they tend to be conservative in their appraisals when they lack adequate sales price data. They also cite the low rate of taxpayer appeals as evidence of conservative appraisals. In 2003, 9.1 million appraisal notices were sent out by appraisal districts but only 751,290 protests were filed.

THE COMPTROLLER'S PROPERTY VALUE STUDY AND HOW VALUE IS DETERMINED FOR SCHOOL FINANCE PURPOSES

Government Code, Section 403.302, requires the state comptroller to conduct an annual property value study (PVS). The primary purpose of the study is to ensure the proper distribution of state aid to school districts.

The study is carried out by the Property Tax Division (PTD) of the comptroller's office. In the PVS, the PTD estimates the taxable value of property in each school district. To accomplish this estimate, property is generally divided into the following categories: single-family residential; multi-family residential; vacant lots and tracts; acreage at market value, and farm and ranch improvements; acreage at productivity value; commercial real property; oil, gas, and other minerals; utility real and tangible personal property; and commercial personal property.

The PTD estimates the value of property in each of these categories in each school district by appraising a representative sample of the properties in each category in each school district. Most of the appraisals are done by the market data method. Sales data used by the comptroller include data from the appraisal districts, data from multiple listing services, and voluntary disclosures by property owners. When insufficient sales data are available in a property category, the comptroller conducts field appraisals. The PTD appraises only a sample of the properties in each appraisal category in each school district, whereas the appraisal districts appraise all properties.

The PTD matches its appraisals for each of the sample properties to the local appraisal value for each of the sampled properties. Through statistical analysis, the PTD uses the relationship between PTD values and local values on the sample properties to estimate market value of property in each school district and ultimately to estimate the taxable value of property in each school district.

The outcome of the PVS determines what appraised property values will be used in the distribution of state aid to each school district. As illustrated in Figure 1, if the local appraised value is equal to or greater than 95 percent of the PVS estimated value for a school district, local value is judged to be valid and is used to calculate state aid to that school district. If the local appraisal district value for a school district is less than 85.5 percent of the PVS value, the PVS value is used to calculate state aid to that district. If the local appraisal district value for a school district is between 85.5 percent and 95 percent of the PVS value, and the local value was valid in the two previous years, the school district is given a grace period of up to two years during which state aid is calculated based on local value. If the local appraisal district value for a school district is between 85.5 percent and 95 percent of the PVS value, and the district is not eligible for the grace period, the school district's state aid is calculated based on PVS values. (In a few districts the margin of error of the PVS is greater than 5 percent. For those districts the margin of error of the study rather than 5 percent is used as the standard for validity.)

As Figure 1 illustrates, the distribution of state aid to most school districts is based on local appraisal district values. There are 1,031 school districts in the state. However, some school districts cross appraisal district lines, making the total number of school district/appraisal district combinations 1,049. The comptroller evaluates each school district/appraisal district combination separately. The comptroller

FIGURE 1
VALUE USED IN SCHOOL FINANCE FORMULA

LOCAL VALUE	DISTRICTS	VALUE USED	AGGREGATE TAXABLE VALUE OF THOSE DISTRICTS ($ BILLIONS)
More than 5 percent higher than PVS value	30	Local	2
Up to 5 percent higher than PVS value	304	Local	95
100 percent of PVS value	2	Local	Less than 1
At least 95 percent but less that 100 percent of PVS value	648	Local	932
In grace period	54	Local	22
Received State Values	11	PVS	5
Total	1,049		1,058

NOTE: PVS = Property Value Study.

SOURCE: Legislative Budget Board

certified local values in 1,038 of the 1,049 districts in the 2003 PVS. The districts for which local values were certified account for over 99 percent of total school district taxable value in the state.

State aid is distributed to each school district based, in part, on district property value per student. All else being equal, the higher the district property value the less state aid a district receives. For the overwhelming majority of school districts, any increase in local appraised value from mandatory disclosure would result in an increase in local revenue to the district, and after a one-year lag, a corresponding reduction in state aid to that district.

REAL ESTATE TRANSFER FEE

A study conducted by the National Conference of State Legislatures in 2001 indicated that 36 states impose some form of state real estate transfer tax or fee.

Texas does not collect a state transfer tax or fee. However, under Local Government Code, Section 118.011, counties collect a real property records filing fee of $3.00 for the first page of a real-estate-related document, $2.00 for each additional page or attachment, and $0.25 for each name in excess of five that must be indexed. The county real property records filing fee applies to various real estate transactions, not just property transfers.

According to the Real Estate Center at Texas A&M University, 214,375 multiple-listing-service, residential housing sales were reported in calendar year 2003. The average annual number of multiple listing service housing sales for the last five years has been 196,645. A real estate transfer fee of $35 would generate approximately $7 million per year.

ADMINISTRATION OF PRICE DISCLOSURE AND TRANSFER FEES

Mandatory sales price disclosure and a real estate transfer fee would both be administered at the county level. The real estate transfer fee would be collected by the county clerk at the time the clerk collects the local real property records fees under Local Government Code, Section 118.011. The sales price disclosure information would be sent directly to the appraisal district at the time the sale is closed. The appraisal districts would then provide the sales information to the comptroller. Tax Code, Section 5.07(c) already requires each appraisal district to provide the comptroller with information concerning the sale of real property in the district.

The statute requiring sales price disclosure suggested by Recommendation 1 should contain sufficient safeguards to protect the confidentiality of the sales price information.

FISCAL IMPACT OF THE RECOMMENDATIONS

Recommendations 1 and 2 would result in a net General Revenue Fund gain of $9.9 million in the 2006–07 biennium. Recommendation 1 would amend the Tax Code to require all buyers of real property to disclose the sales price to the local appraisal district. According to the comptroller's fiscal note estimate on House Bill 1779, Seventy-eighth Legislature, Regular Session, 2003, appraisal districts reported that as much as $18.8 billion could eventually be added to tax rolls under some form of mandatory disclosure. For purposes of the estimate of fiscal implication shown in Figure 2, it is assumed that 50 percent of that value, or $9.4 billion, would be added over a four-year period beginning in fiscal year 2007. State aid to school districts is based on prior year property values; therefore, state savings would begin in fiscal year 2008. The statewide average tax rates for school districts, counties, and cities were applied to the estimated property values to calculate the fiscal impact. In fiscal year 2011 and each fiscal year thereafter, the General Revenue Fund savings are estimated to be $135.0 million.

FIGURE 2
FISCAL IMPLICATION OF IMPLEMENTING MANDATORY REAL ESTATE SALES PRICE DISCLOSURE

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE GAIN TO SCHOOL DISTRICTS	PROBABLE GAIN TO CITIES	PROBABLE GAIN TO COUNTIES
2006	$0	$0	$0	$0
2007	$0	$19,000,000	$5,000,000	$7,000,000
2008	$19,000,000	$45,000,000	$17,000,000	$23,000,000
2009	$64,000,000	$45,000,000	$29,000,000	$39,000,000
2010	$109,000,000	$26,000,000	$36,000,000	$49,000,000

SOURCE: Legislative Budget Board.

Recommendation 2 would amend statute to impose a $35 real estate transfer fee on the buyers of real property. The estimate of fiscal implications in Figure 3 uses the five-year average of annual residential sales of 196,645 (adjusted by 5 percent to reflect sales of commercial properties and housing sales not captured by the multiple listing services) and assumes a January 1, 2006 effective date. The estimate assumes that the $35 fee would initially be collected by the counties and remitted to the comptroller for deposit to the

General Revenue Fund. It is also assumes that the counties would retain $2.50 of each fee to defray administrative cost. The estimate of administrative cost to the Comptroller of Public Accounts in fiscal year 2006 is based on the comptroller's estimate of administrative cost for House Bill 1667, Seventy-eighth Legislature, Regular Session, 2003, which would have imposed a fee administered in a similar manner.

FIGURE 3
FISCAL IMPLICATION OF IMPLEMENTING A REAL ESTATE TRANSFER FEE

FISCAL YEAR	PROBABLE GAIN/(LOSS) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE REVENUE GAIN TO COUNTIES
2006	$3,355,000	($121,000)	$258,000
2007	$6,710,000	$0	$516,000
2008	$6,710,000	$0	$516,000
2009	$6,710,000	$0	$516,000
2010	$6,710,000	$0	$516,000

SOURCE: Legislative Budget Board.

FIGURE 4
FISCAL IMPLICATIONS OF MANDATORY SALES PRICE DISCLOSURE AND IMPLEMENTING A REAL ESTATE TRANSFER FEE

FISCAL YEAR	PROBABLE GAIN/ (LOSS) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS /(COST) TO GENERAL REVENUE FUNDS	PROBABLE GAIN TO SCHOOL DISTRICTS	PROBABLE GAIN TO CITIES	PROBABLE GAIN TO COUNTIES
2006	$3,355,000	($121,000)	$0	$0	$258,000
2007	$6,710,000	$0	$19,000,000	$5,000,000	$7,516,000
2008	$6,710,000	$19,000,000	$45,000,000	$17,000,000	$23,516 ,000
2009	$6,710,000	$64,000,000	$45,000,000	$29,000,000	$39,516,000
2010	$6,710,000	$109,000,000	$26,000,000	$36,000,000	$49,516,000

SOURCE: Legislative Budget Board.

The fiscal impact of the recommendations is not included in the introduced 2006–07 General Appropriations Bill.

RESTRICT LATE PROPERTY VALUE ADJUSTMENTS

Property value appraisals are a key component used in the public school finance model. In general, the property value appraisal process begins on January 1 and ends July 1 of the following year when the comptroller certifies the "final" property values to the commissioner of education. Historically, property values did not change significantly after "final" certification. In recent years, however, the amount of late property value adjustments has grown significantly, and updates to the "final" property values have extended the property value appraisal process from 18 months to several years. Increases in property value adjustments made after "final" certification result in additional costs to the Foundation School Fund appropriations. If increases are made after the related appropriation year end, the costs are paid from future Foundation School Fund appropriations. Several key deadlines, exemption periods and extensions could be revised to reduce late property value adjustments and the related expense to the Foundation School Fund.

SIGNIFICANT CONCERNS

- Late property value adjustments have collectively caused a significant negative fiscal impact. For calendar year 2001, property values have been adjusted downwards by approximately $4.6 billion, or 0.5 percent, from the "final" certification, resulting in additional costs to the state of approximately $60 to $70 million. For calendar year 2002, property values have been adjusted downwards by approximately $2.4 billion, resulting in additional costs of $30 to $40 million. It is anticipated that the calendar year 2002 values will continue to decline, significantly, adding to the costs. Late adjustments for calendar years 2003 and 2004 are not available.

RECOMMENDATIONS

- **Recommendation 1:** Amend the Property Tax Code to change the time limit for corrections to appraisal rolls that affect tax liability (other than corrections to homestead exemptions) from five years to one year after appraisal review board approval for residential property. Eliminate these corrections for non-residential property.
- **Recommendation 2:** Amend the Property Tax Code to reduce the deadline for filing late homestead exemptions from one year after the taxes become delinquent to the actual date taxes become delinquent so that final certification includes homestead exemptions filed late.
- **Recommendation 3:** Amend the Property Tax Code to eliminate the automatic extension provision for rendition statements.
- **Recommendation 4:** Amend the Government Code to limit audits of a school district's total taxable value and audits of related revisions to the annual property study to one year after the final certification of property values. Provide an exception to this rule for school districts that have paid large tax refunds as the result of a lawsuit settlement. In these instances, an audit would be allowed for three years after final certification.
- **Recommendation 5:** Amend the Education Code to require payments to school districts for changes in property values that result from a significant lawsuit settlement made after the related appropriation year expires to be paid out evenly over five years, rather than all at once.
- **Recommendation 6:** Amend the Property Tax Code to require taxpayers who litigate a non-residential appraisal valued over $1 million and ultimately are not successful to pay the attorney fees resulting from the case for the appraisal district.

COMMENTS

In Texas, each school district is authorized to levy and collect local property taxes to support public education in their districts. Two main variables impact the property tax amount: tax rates and property values. School districts contract with one or more appraisal districts to determine local property values. Once the appraisal district provides the property values, school boards set the tax rate based upon the needs of the school district and the amount of appraised property values.

Each district submits its local property value to the comptroller's office. It is the comptroller's responsibility to determine the amount of property values to be used in the calculation for state aid to the school districts from the Foundation School Fund.

TIMELINE FOR PROPERTY VALUES

The time line for the appraisal process can be separated into three major categories:

- Appraisals performed by the local appraisal districts;
- the property value study preformed by the comptroller's office; and
- the appropriation and distributions of funds based upon those property values.

Local appraisal districts are responsible for certifying property values in their districts and reporting those values to the comptroller's office. The comptroller's office in turn analyzes and studies those values as well as other data and provides property values to the commissioner of education to be used to distribute funds to the school districts. The appropriations and distributions are initially based on estimated property values and are later updated with actual values. Figure 1 provides a summary of the timeline.

TYPES OF LATE PROPERTY VALUE ADJUSTMENTS

The "final" property value may be updated after certification to the commissioner of education for several reasons, including successful taxpayer lawsuits, statutorily authorized extensions or exemptions, and audits of the property value study. Some provisions have been recently authorized such as an extended deadline for freeport exemption. Other provisions, such as the right to appeal property value appraisals to district court, are long established, but are utilized more frequently.

Following is a list of the types of adjustments with related recommendations. A summary of adjustments, other than judicial remedies, as well as the legislative history is provided. Figure 2 lists other significant types of adjustments.

Corrections of appraisal roll after ARB approval (Section 25.25, Tax Code) - The appraisal review board may change the appraisal roll to correct different types of errors: (1) clerical errors or other inaccuracies that affect a property owner's liability for a tax; (2) multiple appraisals of a property in a single tax year; (3) the inclusion of property that does not exist, either in the form described on the appraisal roll or at the location described on the appraisal roll; (4) one-third over-appraisals; or (5) joint motions on incorrect value.

FIGURE 1
APPRAISAL PROCESS TIMELINE
2001 TAX YEAR, 2002–03 SCHOOL YEAR

APPRAISAL DISTRICTS/ TAXING ENTITIES	PROPERTY VALUE STUDY	APPROPRIATIONS/EXPENDITURES
Property Value Appraisal — January 2001 to May 2001	Field appraisals — January 2001 to December, 2001	Estimate of 2001 Property Values — October 2000
Appraisal Protests — June 2001 to July 2001	Desk Audits — October 2001 to January 2002	Revised Estimate of 2001 Property Values — March 2001
Tax Rate Assessments and Liability Calculations — August 2001 to October 2001	Determination of Property Value — January 2002	General Appropriations Act — May 2001
Tax Collections — October 2001 to January 31, 2002	Protests of Property Value Study — May 2002 to July 2002	Distributions — August 2002 to August 2003
Updates to District Appraisal Records — August 2001 to August 2003	Appeals — July 2002	Settle-up — September 2003 to August 2004
	Certification of Property Values to Commissioner of Education — July 2002	Audit Adjustments — indefinitely
	Updates to Property Value Study — August 2002 to July 2005 or later for certain changes	

SOURCE: Texas Property Tax Code.

FIGURE 2
SUMMARY OF OTHER SIGNIFICANT LATE PROPERTY VALUE ADJUSTMENTS INCLUDED IN STATUTE

Late Application for Religious Organization Exemption (Section 11.433, Tax Code)—A qualified religious organization may request an exemption up to five years after the taxes on the property are imposed. The religious organization is not qualified for the exemption if it paid taxes before an application is filed.

Late Application for School Exemption (Section 11.434, Tax Code)—A qualified school may request an exemption up to five years after the taxes on the property are imposed. The school is not qualified for the exemption if it paid taxes before an application is filed.

Late Application for Charitable Organization Exemption (Section 11.435, Tax Code)—A qualified charitable organization may request an exemption up to five years after the taxes on the property are imposed. The charitable organization is not qualified for the exemption if it paid taxes before an application is filed.

Application for Exemption of Certain Property Used For Low-income Housing (Section 11.436, Tax Code)—An organization that acquires qualified low or moderate income housing may request an exemption up to 30 days after the acquisition date. Before an organization acquires a property, the organization may request the chief appraiser to provide a preliminary determination of whether the property would qualify for a low or moderate income housing exemption. The chief appraiser must provide the determination within 45 days.

Exemption for Cotton Stored in Warehouse (Section 11.437, Tax Code)—Allows a cotton storage warehouse operator to claim a freeport exemption under section 11.251 for cotton stored in the warehouse on behalf of all the cotton owners if the cotton will be transported outside the state. Since a freeport exemption may be granted late, this exemption may also be granted late. The warehouse operator only has to apply for the exemption once. However, the chief appraiser may require the operator to file a new application to confirm current qualification.

Exemption for Cotton Stored in Warehouse (Section 11.437, Tax Code)—Allows a cotton storage warehouse operator to claim a freeport exemption under section 11.251 for cotton stored in the warehouse on behalf of all the cotton owners if the cotton will be transported outside the state. Since a freeport exemption may be granted late, this exemption may also be granted late. The warehouse operator only has to apply for the exemption once. However, the chief appraiser may require the operator to file a new application to confirm current qualification.

Late Application for Veteran's Organization (Section 11.438, Tax Code)—A qualified veteran's organization may request an exemption up to five years after the taxes on the property are imposed. The veteran's organization is not qualified for the exemption if it paid taxes without protest before an application is filed.

Late Application for Disabled Veteran (Section 11.439, Tax Code)—A qualified disabled veteran may request an exemption up to five years after either the taxes were paid or the date the taxes became delinquent.

Late Application for Freeport Exemption (Section 11.439, Tax Code)—A qualified property owner may request a freeport exemption after the filing deadline if it is filed before the appraisal review board approves the appraisal records. If the late application is approved the property owner is liable for a 10 percent penalty.

Portable over 65 Tax Freeze (Section 11.26g, Tax Code)—A proportional amount of the school tax freeze for persons 65 and over can be transferred to a new residential homestead. A homeowner requests transfer of the freeze when he applies for a homestead exemption on the new home. Since a homeowner may file for a late exemption, the tax freeze may also be applied late.

Prorated Taxes for Certain Charitable Organizations (Section 26.11, Tax Code)—In 1993, the legislature provided a methodology for prorating taxes on property acquired by charitable organizations that use the property to provide low-income housing. The amount of taxes owed is based on the number of days that property was owned by the previous owner. In 1997, the legislature extended the provision to community housing development organizations (CHODO) that provide low-income and moderate-income housing. Since a charitable organization may file for a late exemption, the taxes may also be prorated at a later date.

Calculation of Taxes for Residence Homestead of Elderly Persons (Section 26.112, Tax Code)—Persons 65 years or older are eligible for an exemption on their residence for the entire year in the year that the person becomes eligible.

Prorating Taxes on Property Acquired by Nonprofit Organizations (Section 26.113, Tax Code)—In 1997, the legislature provided a methodology for prorating taxes in the year property qualifies for a nonprofit organization exemption based in part on the date the property becomes eligible. Since a nonprofit organization may file for a late exemption, the taxes may also be prorated at a later date.

Late Protest based on Failure to Deliver Notice (Section 41.411, Tax Code)—In 1995, the legislature authorized a property owner to file a late protest, after the normal deadline but before the delinquency date, if the ARB has not delivered or provided a notice as required by law. If the ARB finds that the notice was required but not delivered, it must hear any protests regarding the property that the property owner cares to present.

Approval of Appraisal Records by Board (Section 41.12, Tax Code)—Appraisal review boards must complete substantially all timely filed protests, determine all timely filed challenges, and approve the appraisal roll by July 20. However, 5 percent or less of the total appraised value of all other taxable properties may remain outstanding.

SOURCE: Texas Property Tax Code.

The authority to correct appraisal rolls was granted in calendar year 1979. Initially, a chief appraiser was allowed to change the appraisal roll at any time to correct data that did not affect the tax liability. In addition, the appraisal review board or its equivalent could change the appraisal roll at any time to correct clerical errors that affected tax liability or to correct multiple appraisals of a property. The chief appraiser had to certify each change within five days after the date of the change.

In 1985 the provision was amended to require the appraisal review board to hear a request of both the property owner and the chief appraiser (joint motion) to correct a substantial error. The hearing had to be requested before the taxes became delinquent. A property owner who filed a motion under this section had to comply with the payment requirements in place when the motion was filed.

In 1989, this provision was amended to limit corrections, which affected tax liability or multiple appraisals to three years. This time limit was extended to five years by the Seventy-second Legislature in 1991. In addition, the Seventy-second Legislature authorized changes to remove property that did not exist in the form or at the location described in the appraisal roll. Finally, the Seventy-second Legislature added restrictions to the provision (initially added in 1985) requiring a hearing for substantial changes other than clerical errors, multiple appraisals, or removing certain property that did not exist. Under the amended provision, either the property owner or the chief appraiser may make the motion for a hearing. The error may be corrected only if the appraised value exceeds the correct value by more than one-third. It cannot be changed if the property owner protests the appraisal, or if the appraisal was established under a written agreement. If the appraisal is not changed under this provision, the property owner or the chief appraiser may file suit to order a change in the appraisal within 45 days.

In 1993, the legislature required the Appraisal Review Board to correct an appraisal error if the motion was made jointly by the property owner and the chief appraiser before the taxes became delinquent. In addition it authorized the transfer of remedies to a new property owner when the property is transferred during a tax year.

In 1997, the legislature authorized the chief appraiser to change the appraisal roll at any time to correct a clerical error or other inaccuracy that did not increase the tax liability. (Previously these corrections were limited to clerical errors that did not affect tax liability.) Also in 1997, the legislature authorized the property owner to request a hearing, if the property owner and the chief appraiser had not agreed to a correction, for certain changes within 15 days. This provision does not apply to corrections for clerical errors or other inaccuracies, multiple appraisals or non-existing property.

Recommendation 1 would amend the Property Tax Code to limit corrections, which affect tax liability under this provision from five years to one year after appraisal review board approval for residential property changes other than homestead exemptions, and eliminate the provision for non-residential property.

Late-filed homestead exemptions (Section 11.431, Tax Code)—Homeowners may file for a homestead exemption up to one year after the delinquency date—usually February 1 of the following year. For example, a homeowner could file for a calendar year 2001 homestead exemption until February, 2003. Homeowners who are 65 or older or disabled may apply for the exemption no later than one year after their 65th birthday or one year after the delinquency date, whichever is later.

This extension was added in 1981 and applies to each tax year that begins on or after January 1, 1982. Section 11.431 was adopted in response to an attorney general ruling which said that the former April 1 cut-off date for applications could not operate to deny a constitutionally granted over 65 homestead exemption, but a taxpayer could be stopped from claiming the exemption if he waited so long to apply that his delay made it administratively impractical to grant it.

Recommendation 2 would amend the Property Tax Code to reduce the deadline for filing late homestead exemptions from one year after the taxes become delinquent to the dates taxes become delinquent to ensure final certification includes all homestead exemptions filed late.

Filing Date for Rendition Statement (Section 22.23, Tax Code)—A taxpayer is required to file a rendition statement by April 15. The taxpayer may request an extension, and the chief appraiser must grant the extension to May 15. The taxpayer may request an additional 15-day extension for good cause with the chief appraiser's approval.

This provision was amended in 1981 to require the rendition statements to be delivered to the chief appraiser after January 1 and before May 1 unless a chief appraiser extended the deadline to May 15 for good cause. In 1985 the deadline was reduced to April 1, and an automatic extension until May 30 was added. In 1993, the deadline was moved to April 15 and the automatic extension provision was removed. In 2003, the legislature added a provision, which requires the chief appraiser to extend the deadline to May 15 if a property owner requests one.

Recommendation 3 would amend the Property Tax Code to eliminate the automatic extension provision for rendition statements.

Audits of Total Taxable Value (Section 403.302 (h), Government Code)—The commissioner of education or a school district may request the comptroller to audit the total taxable value of a school district and revise the annual property study finding. The request for audits must be filed by the third anniversary of the final certification of the values or within one year of change to the appraisal roll made under Section 25.25 or 42.41, Tax Code.

This section was first added in 1995. It required the comptroller to conduct an annual study, defined the methodology to be used, defined taxable value, and allowed for audits by the comptroller. In 2003, the request for audit was limited to corrections and changes in a school district's appraisal roll made after preliminary certification. It also required the audit request to be filed no later than three years after the final certification or one year after a change to the appraisal roll made under Section 25.25 or 42.11, Tax Code.

Recommendation 4 would amend the Government Code to limit these audits to one year after the final certification of property values, with an exception for school districts that have paid large tax refunds as the result of a lawsuit settlement. In these instances, an audit would be allowed for three years after final certification.

Judicial Review (Chapter 42, Tax Code)—A property owner may appeal an appraisal review board decision to district court. The chief appraiser must adjust the appraisal roll based on the final determination.

Recommendation 5 would amend the Education Code to require payments to school districts for changes in property values as a result of a significant lawsuit settlement made after the related appropriation year expires to be paid out evenly over five years. This recommendation should even out the impact of large settlements.

Recommendation 6 would amend the Property Tax Code to require taxpayers who litigate a non-residential appraisal and lose to pay attorney fees for the appraisal district. This recommendation should reduce the number of lawsuits and the related property value changes.

ANALYSIS OF 2001 AND 2002 LATE PROPERTY VALUE ADJUSTMENTS

For calendar year 2001, property values have been adjusted downwards by approximately $4.6 billion or 0.5 percent from the "final" certification. This adjustment includes: (1) a reduction in market values of $1.9 billion: (2) an increase in exemptions of $1.1 billion and (3) an increase in other deductions, such as freeport exemptions, of $856 million. For calendar year 2002, property values have been adjusted downwards by approximately $2.4 billion or 0.2 percent, including a $1.3 billion reduction in market values and an increase in state exemptions of $856 million. Figures 3, 4 and 5 include a comparison of the calendar year 2001 property values certified to the Texas Education Agency commissioner in July 2002 to the calendar year 2001 property values calculated in September 2003 and in September 2004. Figure 6 includes a detailed comparison of the calendar year 2002 property values certified to the Texas Education Agency Commissioner in July 2003 to the calendar year 2002 property values calculated in September 2004.

FISCAL IMPACT OF THE RECOMMENDATIONS

The fiscal impact of the recommendations can not be determined. However, it is anticipated that, if implemented the recommendations would reduce late property value adjustments and the related expense to the School Foundation Program.

None of the recommendations are reflected in the introduced 2006–07 General Appropriations Bill.

FIGURE 3
2001 PROPERTY VALUES

	JULY 2002 SELF REPORTS	SEPTEMBER 2003 SELF REPORTS	$ DIFFERENCE	% DIFFERENCE
Market Value	$1,098,326,057,956	$1,097,440,561,200	($885,496,756)	-0.08%
Less State Exemptions	($72,859,794,344)	($73,912,267,687)	($1,052,473,343)	1.44%
Less Other Deductions	($20,531,761,434)	($21,505,235,172)	($973,473,738)	4.74%
Less Value Loss to 10% Cap	($14,113,980,929)	($14,114,152,657)	($171,728)	0.00%
Less Value Lost to Elderly Tax Freeze	($21,651,566,140)	($22,023,261,229)	($371,695,089)	1.72%
Net Taxable Value for School Tax	$969,168,955,109	$965,885,644,455	($3,283,310,654)	-0.34%

SOURCE: Comptroller of Public Accounts.

FIGURE 4
2001 PROPERTY VALUES

	SEPTEMBER 2003 SELF REPORTS	SEPTEMBER 2004 SELF REPORTS	$ DIFFERENCE	% DIFFERENCE
Market Value	$1,097,440,561,200	$1,096,419,682,383	($1,020,878,817)	-0.09%
Less State Exemptions	($73,912,267,687)	($73,963,033,907)	($50,766,220)	0.07%
Less Other Deductions	($21,505,235,172)	($21,387,711,145)	$117,524,027	-0.55%
Less Value Loss to 10% Cap	($14,114,152,657)	($14,111,259,006)	$2,893,651	-0.02%
Less Value Lost to Elderly Tax Freeze	($22,023,261,229)	($22,008,078,969)	$15,182,260	-0.07%
Net Taxable Value for School Tax	$965,885,644,455	$964,949,599,356	($936,045,099)	-0.10%

SOURCE: Comptroller of Public Accounts.

FIGURE 5 (DIFFERENCE IS SUM OF DIFFERENCES IN FIGURES 3 AND 4)
2001 PROPERTY VALUES

	JULY 2002 SELF REPORTS	SEPTEMBER 2004 SELF REPORTS	$ DIFFERENCE	% DIFFERENCE
Market Value	$1,098,326,057,956	$1,096,419,682,383	($1,906,375,573)	-0.17%
Less State Exemptions	($72,859,794,344)	($73,963,033,907)	($1,103,239,563)	1.51%
Less Other Deductions	($20,531,761,434)	($21,387,711,145)	($855,949,711)	4.17%
Less Value Loss to 10% Cap	($14,113,980,929)	($14,111,259,006)	$2,721,923	-0.02%
Less Value Lost to Elderly Tax Freeze	($21,651,566,140)	($22,008,078,969)	($356,512,829)	1.65%
Net Taxable Value for School Tax	$969,168,955,109	$964,949,599,356	($4,219,355,753)	-0.44%

SOURCE: Comptroller of Public Accounts.

FIGURE 6
2002 PROPERTY VALUES

	JULY 2003 SELF REPORTS	SEPTEMBER 2004 SELF REPORTS	$ DIFFERENCE	% DIFFERENCE
Market Value	$1,160,076,781,511	$1,158,754,182,994	($1,322,598,517)	-0.11%
Less State Exemptions	($75,446,337,142)	($76,303,211,527)	($856,874,385)	1.14%
Less Other Deductions	($16,776,968,666)	($16,747,225,274)	$29,743,392	-0.18%
Less Value Loss to 10% Cap	($14,152,209,212)	($14,156,203,158)	($3,993,946)	0.03%
Less Value Lost to Elderly Tax Freeze	($25,235,713,611)	($25,332,920,335)	($97,206,724)	0.39%
Net Taxable Value for School Tax	$1,028,465,552,880	$1,026,214,622,700	($2,250,930,180)	-0.22%

SOURCE: Comptroller of Public Accounts.

FACTORS CONTRIBUTING TO THE HIGH COST OF MEDICAID

Medicaid, a state and federal program to provide healthcare to low-income persons, has certain characteristics that result in challenges to state budgets. These include federal mandates in terms of clients served, services provided, and other program characteristics. States, including Texas, have explored various cost-containment mechanisms over the past several years.

SIGNIFICANT FINDINGS

- Medicaid comprises a large and quickly growing proportion of state expenditures.
- The federal government requires that the state cover certain groups, which in Texas results in coverage of a large number of clients.
- The federal government requires coverage of many services for a state to participate in the Medicaid program.
- States have made efforts to contain the costs of the program in recent years. Texas adopted measures in most of the possible categories of cost containment during the previous biennium.

COMMENTS

Congress established the Medicaid program in 1965 under Title XIX of the Social Security Act. Medicaid is a federal-state partnership to provide healthcare to certain low-income persons. The federal government provides matching funds in accordance with a formula based on the relationship between a rolling three-year average of the state's per capita income to the nation's per capita income. There are no predetermined caps on the amounts a state may draw down using the matching formulas. States must identify state, often General Revenue Fund, resources as match for the federal dollars. The federal government sets many parameters of the Medicaid program, but states are allowed some flexibility. States must adopt and have approved by the federal government a state plan, which identifies populations served and various details of the services provided.

The Medicaid program accounts for a significant portion of Texas' state expenditures. Approximately $29 billion in All Funds was appropriated for the Medicaid program during the 2004-05 biennium out of the $118 billion in All Funds appropriated for state expenditures. Medicaid made up about 25 percent of the total. All Funds expenditures for Medicaid have grown by 90 percent during the period from fiscal year 1994 through 2003. In comparison, the state budget in All Funds grew 65 percent during the same period. Texas tax revenues, including sales tax, oil and gas production taxes, corporate franchise taxes, and alcohol and tobacco consumption taxes, grew by only 44 percent during the same period. The economic pressure resulting from these trends challenges state policy makers to identify resources to fund the Medicaid program.

CONTINUED GROWTH IN THE MEDICAID PROGRAM

As a condition of participating in the Medicaid program, the federal government requires that states serve any person who seeks assistance and meets certain criteria. The criteria are generally related to the person's age and family income and are sometimes relative to participation in another federal program such as Supplemental Security Income (SSI). Figure 1 identifies the categories of persons entitled to Medicaid coverage under federal law. For example, children through age 18 in families with incomes at or below 100 percent of the Federal Poverty Level are generally eligible for Medicaid. Younger children to age six are eligible for Medicaid if they are in families with incomes at or below 133 percent of the Federal Poverty Level (FPL). Figure 2 illustrates the equivalent annual average incomes at various percentages of the Federal Poverty Level and for families of various sizes.

In light of Texas' large population and these categories that mandate eligibility based on age and family income, a large number of children and a relatively high proportion of persons in low-income categories in Texas qualify for Medicaid.

- High Proportion of Low-Income Individuals. Texas has both a large population and a large number of low-income persons. According to the U.S. Bureau of the Census, in 2000, 3.1 million Texans out of a population of 20.9 million persons, or 15.4 percent, fell below 100 percent of the Federal Poverty Level. Nationally, 12.4 percent of the people in the United States have incomes at or below 100 percent of the Federal Poverty Level. The size of the Texas population and its percentages of persons at or below the poverty level require Texas to cover a great number of people in order to participate in the Medicaid program.

FIGURE 1
CATEGORIES OF PERSONS ENTITLED TO MEDICAID COVERAGE IN FEDERAL LAW

- Low-income families with children, as described in Section 1931 of the Social Security Act, who meet certain of the eligibility requirements in the State's AFDC plan in effect on July 16, 1996.
- Supplemental Security Income (SSI) recipients (or in States using more restrictive criteria—aged, blind, and disabled individuals who meet criteria which are more restrictive than those of the SSI program and which were in place in the State's approved Medicaid plan as of January 1, 1972).
- Infants born to Medicaid-eligible pregnant women. Medicaid eligibility must continue throughout the first year of life so long as the infant remains in the mother's household and she remains eligible, or would be eligible if she were still pregnant.
- Children under age 6 and pregnant women whose family income is at or below 133 percent of the Federal poverty level. (The minimum mandatory income level for pregnant women and infants in certain States may be higher than 133 percent, if as of certain dates the State had established a higher percentage for covering those groups.) States are required to extend Medicaid eligibility until age 19 to all children born after September 30, 1983 (or such earlier date as the State may choose) in families with incomes at or below the Federal Poverty Level. This phases in coverage, so that by the year 2002, all poor children under age 19 will be covered. Once eligibility is established, pregnant women remain eligible for Medicaid through the end of the calendar month in which the 60th day after the end of the pregnancy falls, regardless of any change in family income. States are not required to have a resource test for these poverty level related groups. However, any resource test imposed can be no more restrictive than that of the AFDC program for infants and children and the SSI program for pregnant women.
- Recipients of adoption assistance and foster care under Title IV-E of the Social Security Act.
- Certain Medicare beneficiaries.
- Special protected groups who may keep Medicaid for a period of time. Examples are: persons who lose SSI payments due to earnings from work or increased Social Security benefits; and families who are provided 6 to 12 months of Medicaid coverage following loss of eligibility under Section 1931 due to earnings, or 4 months of Medicaid coverage following loss of eligibility under Section 1931 due to an increase in child or spousal support.

SOURCE: U.S. Centers for Medicare and Medicaid Services.

FIGURE 2
2004 HHS POVERTY GUIDELINES (FEDERAL POVERTY LEVELS-FPL)

SIZE OF FAMILY UNIT	73% FPL	100% YEARLY FPL	125% FPL	133% FPL	150% FPL	185% FPL	200% FPL	220% FPL	225% FPL	235% FPL	300% FPL
1	6,796	9,310	11,638	12,382	13,965	17,224	18,620	20,482	20,948	21,879	27,930
2	9,118	12,490	15,613	16,612	18,735	23,107	24,980	27,478	28,103	29,352	37,470
3	11,439	15,670	19,588	20,841	23,505	28,990	31,340	34,474	35,258	36,825	47,010
4	13,761	18,850	23,563	25,071	28,275	34,873	37,700	41,470	42,413	44,298	56,550
5	16,082	22,030	27,538	29,300	33,045	40,756	44,060	48,466	49,568	51,771	66,090
6	18,403	25,210	31,513	33,529	37,815	46,639	50,420	55,462	56,723	59,244	75,630
7	20,725	28,390	35,488	37,759	42,585	52,522	56,780	62,458	63,878	66,717	85,170
8	23,046	31,570	39,463	41,988	47,355	58,405	63,140	69,454	71,033	74,190	94,710
For each additional person	2,321	3,180	3,975	4,229	4,770	5,883	6,360	6,996	7,155	7,473	9,540

NOTES: 1. SSI eligibility is at 73 percent of FPL. 2. CHIP eligibility is up to 200 percent of FPL.
SOURCES: U.S. Department of Health and Human Services; Department of Aging and Disability Services.

- High Proportion of Low-Income Families with Children. According to the U.S. Bureau of the Census, in 2000 there were around 600,000 families below the poverty level in Texas. This represented 12 percent of the families in the state. Nationally, 9.2 percent of families fall below the poverty level.
- High Proportion of Children and Growth in the Number of Children. Texas has a relatively young population. Children make up a larger share of the population in Texas than in other states. The proportion of adults who are of child-bearing age is also larger in Texas than in other states. In addition, Texas receives a net in-migration each year, both from other states and from other countries. The combination of growth from new births and migration leads to higher population growth in Texas compared to the U.S. as a whole. For instance, between 1992 and 2002, Texas grew by 23.4 percent,

compared to the U.S. average of 13.1 percent during the same period. Rapid growth in younger cohorts means that the number of children Texas must serve in the Medicaid program will likely grow each year.

To illustrate the sheer size of the Texas Medicaid program, it pays for approximately one of every two births in Texas.

In addition, the Medicaid program is projected to provide coverage during some portion of the year for approximately one out of three children under age 19 in Texas from fiscal year 2005 forward.

COVERED POPULATIONS AND SERVICES

For the 2004–05 biennium, the state of Texas is serving primarily mandated or entitlement populations. As shown in Figure 3, some groups served by Texas above the federally mandated levels are pregnant women and infants and nursing home and waiver clients. The state serves pregnant women up to 185 percent FPL. The federal requirement is that states serve up to 133 percent FPL. During fiscal year 2005, the Health and Human Services Commission (HHSC) restored coverage for pregnant women up to 185 percent of FPL from the fiscal year 2004 level of 158 percent of FPL. Another group Texas serves beyond the federal requirement is persons in nursing facililties. Texas serves up to 300 percent of Supplemental Security Income (SSI), or 218 percent FPL. The federally mandated minimum is SSI, which is approximately 73 percent or 74 percent FPL. Figure 3 shows categories of clients served in Texas acute care programs above federally mandated minimums.

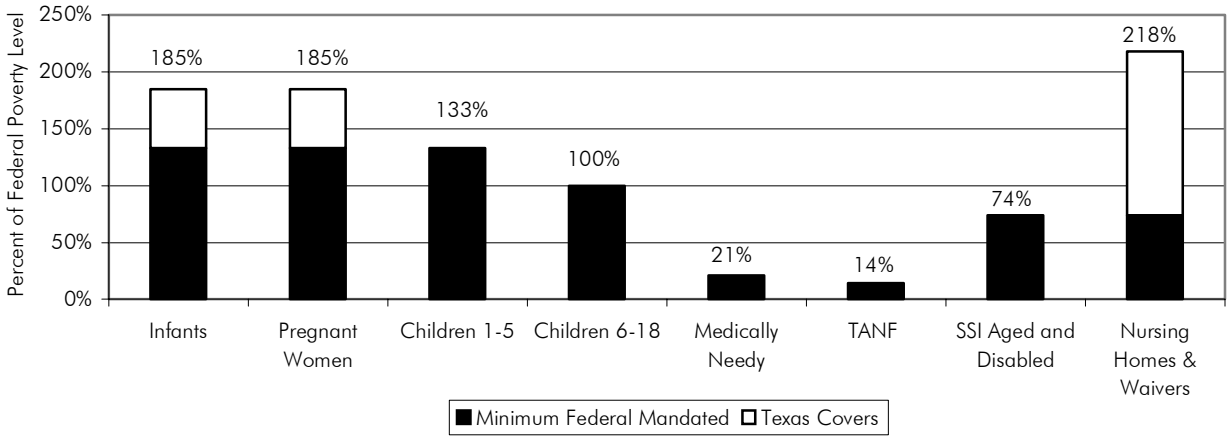
Serving both mandated and some optional populations results in a large number of clients for the Texas Medicaid program. Figure 4 shows recent growth in the Medicaid program. The average monthly number of recipient months approaches 2.5 million in fiscal year 2003, and children comprise a large part of the total caseload.

As a condition of participating in the Medicaid program, states must offer a number of basic services.

According to the federal Center for Medicare and Medicaid Services (CMS), states participating in the Medicaid program must provide the following services to most categorically needy populations:

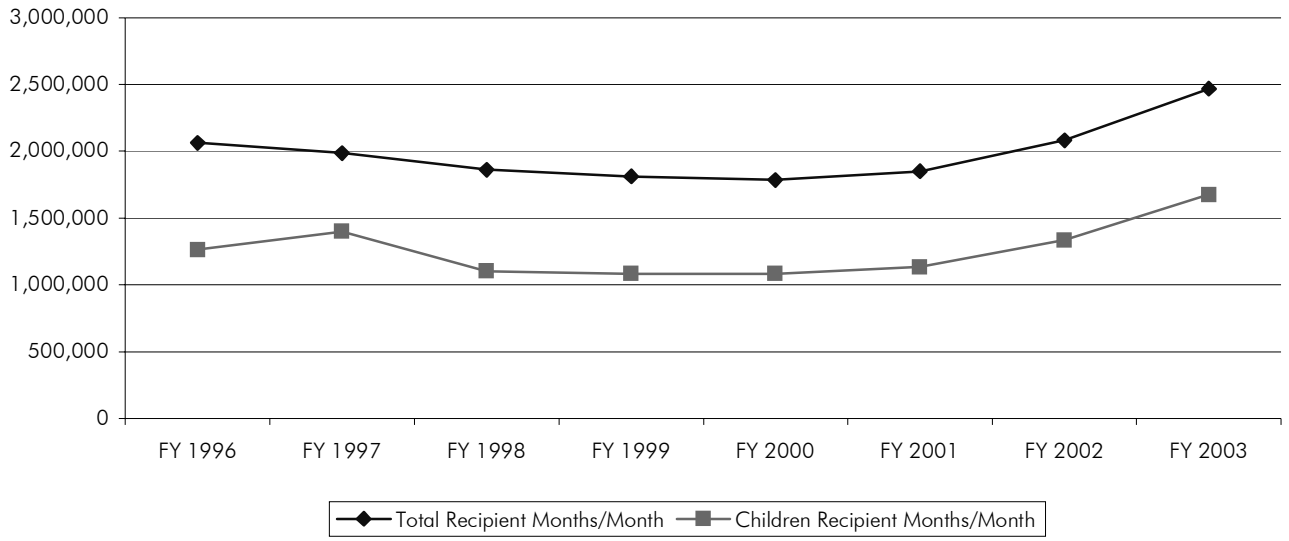
- inpatient hospital services;
- outpatient hospital services;
- prenatal care;
- vaccines for children;
- physician services;
- nursing facility services for persons aged 21 or older;
- family planning services and supplies;
- rural health clinic services;
- home healthcare for persons eligible for skilled-nursing services;
- laboratory and x-ray services;
- pediatric and family nurse practitioner services;

FIGURE 3
MEDICAID ELIGIBILITY IN TEXAS



NOTE: The Health and Human Services Commission restored coverage for Pregnant Women up to 185 percent of FPL retroactive to September 1, 2004.
SOURCE: Health and Human Services Commission.

FIGURE 4
GROWTH IN MEDICAID, TOTAL AND CHILDREN'S GROUPS



SOURCE: Health and Human Services Commission.

- nurse-midwife services;
- Federally Qualified Health-Center (FQHC) services, and ambulatory services of an FQHC that would be available in other settings; and
- Early and Periodic Screening, Diagnostic, and Treatment (EPSDT) services for children under age 21.

States may also receive federal matching funds to provide certain optional services. Following are the most common of the 34 currently approved optional Medicaid services:

- diagnostic services;
- clinic services;
- Intermediate Care Facilities for the Mentally Retarded (ICFs/MR);
- prescribed drugs and prosthetic devices;
- optometrist services and eyeglasses;
- nursing facility services for children under age 21;
- transportation services;
- rehabilitation and physical therapy services; and
- home- and community-based care to certain persons with chronic impairments.

For children, Medicaid requires that states provide essentially any medically necessary service. The specific requirement is that medical treatment must be provided for conditions or medical needs identified through the Early and Periodic Screening Diagnosis and Treatment program, also known in Texas as Texas Health Steps. This results in a generous benefit package for children, who make up approximately two-thirds of the Medicaid caseload. For children with special medical needs, coverage can include such additional services as private-duty nursing or durable medical equipment, such as wheelchairs. These services are generally paid through the Texas Medicaid Comprehensive Care Program (CCP) for children. In Medicaid, adults would generally only receive these services through a "waiver" program. Insurance plans in the private market face some "mandated benefits" but generally have more flexibility in limiting services through exclusions, limitations on amount, duration, scope, and lifetime maximum expenditures.

An example of Medicaid coverage in Texas exceeding mandated benefits is the Vendor Drug Program. Prescription drugs are an optional benefit, but if the state provides prescriptions, the federal government requires that states maintain "open formularies" in order to benefit from the drug rebate program. The concept of an open formulary means that a Medicaid recipient is entitled to receive any FDA-approved drug prescribed by his or her physician.

The Texas Medicaid program is implementing a "preferred drug list" in an attempt to contain costs, pursuant to House Bill 2292, Seventy-eighth Legislature, 2003. The preferred drug list will require prior authorization for products not on the preferred drug list. The approach is an attempt to guarantee continued access to prescription drugs for clients while securing some of the cost advantages of limited formularies for the state.

LONG-TERM CARE SERVICES

Medicaid is also a significant provider of long-term care. This can include institution-based care, such as nursing home care for low-income persons, institution-based care for persons with mental retardation, or community-based care for low-income seniors or persons with disabilities.

Long-term care tends to be more expensive on an average monthly basis than acute care. Long-term care includes services necessary to meet a client's needs related to activities of daily living, such as bathing and eating. Moreover, most clients receiving long-term care services also receive acute care services through Medicaid.

The entitlement in Medicaid tends to be for institution-based care. This may be related to Medicaid's history of providing services based on a medical model. In 1981, the federal government began authorizing home- and community-based "waiver" programs in order to offer long-term care services in the community instead of institutional environments. These are referred to as Section 1915(c) waivers, after the section in Title XIX of the Social Security Act that created the program. States are given some flexibility, including limiting the number of clients served. However, states must follow certain rules established by the federal government to document and assurances that the average per capita expenditures for waiver assistance do not exceed the average per capita expenditures that would have been made for services if the waiver had not been granted.

Names of community-based waiver programs operating in Texas, currently operated by the Department of Aging and Disability Services (DADS), include the following:

- Community Based Alternatives (CBA);
- Community Living Assistance and Support Services (CLASS);
- Medically Dependent Children's Program (MDCP);
- deaf/blind multiple disabilities; and
- Texas Home Living and Home and Community Based Services (HCS).

Figure 5 summarizes long-term care programs in Texas Medicaid by entitlement or nonentitlement basis and shows whether the program is operated on a community or institutional basis.

FIGURE 5
SELECTED TEXAS-OPERATED, LONG-TERM-CARE PROGRAMS, BY INSTITUTION OR COMMUNITY-BASED PROGRAM AND ENTITLEMENT OR NON-ENTITLEMENT STATUS

	ENTITLEMENT	NON-ENTITLEMENT
Institution	Nursing Home	
	Intermediate Care Facility-Mental Retardation	
Community	Primary Home Care	Community-Based Alternatives (CBA)
	Day Activity Health Services	Community Living Assistance and Support Services (CLASS) Deaf/Blind
		Home and Community Based Services (HCS) and Texas Home Living

SOURCE: Legislative Budget Board.

Because Medicaid is designed as a safety net program to serve very low-income, elderly, and disabled persons, the program serves more high-needs persons than the average commercial health insurance provider. A recent study concluded that the higher apparent cost of providing medical care in Medicaid is eliminated if the differences in disability or "limitations" of its clientele are taken into consideration. The paper argues that the Medicaid program serves a much larger proportion of persons with disabilities than private insurers, and it is the costs to provide needed services to those clients that result in higher per person expenditures than might be seen in comparable private coverage.

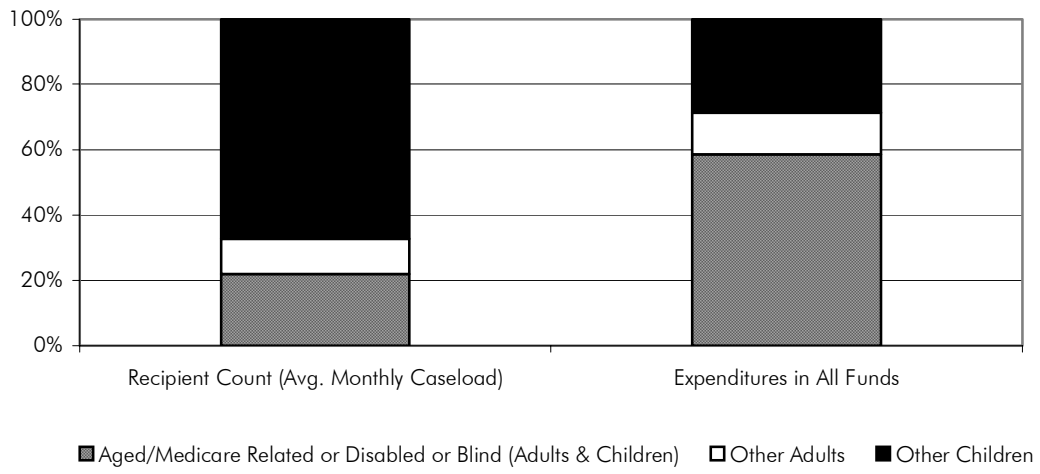
The largest group of clients in the Texas Medicaid program is children. However, although aged and disabled people make up a smaller percentage of clients, they account for the majority of expenditures, as indicated in Figure 6.

DIFFICULTY IN PREDICTING MEDICAID EXPENDITURES

In order to participate in the Medicaid program, each state must serve all persons determined to be eligible and offer those persons medically necessary services in accordance with the state's federally approved state plan. Therefore, states cannot budget fixed amounts for Medicaid services.

It can be difficult to predict the number of persons who will apply for and be determined eligible for Medicaid. First, the number of persons eligible for Medicaid services appears to be influenced by trends in the economy, particularly the unemployment rate. Therefore, accurate

FIGURE 6
RELATIVE WEIGHT OF CHILDREN VERSUS OTHER CLIENTS
PERCENTAGE OF CLIENTS COMPARED TO PERCENTAGE OF EXPENDITURES



SOURCE: Department of Aging and Disability Services.

predictions of the number of clients can be affected by whether an accurate prediction of economic trends is available at the time a forecast is made.

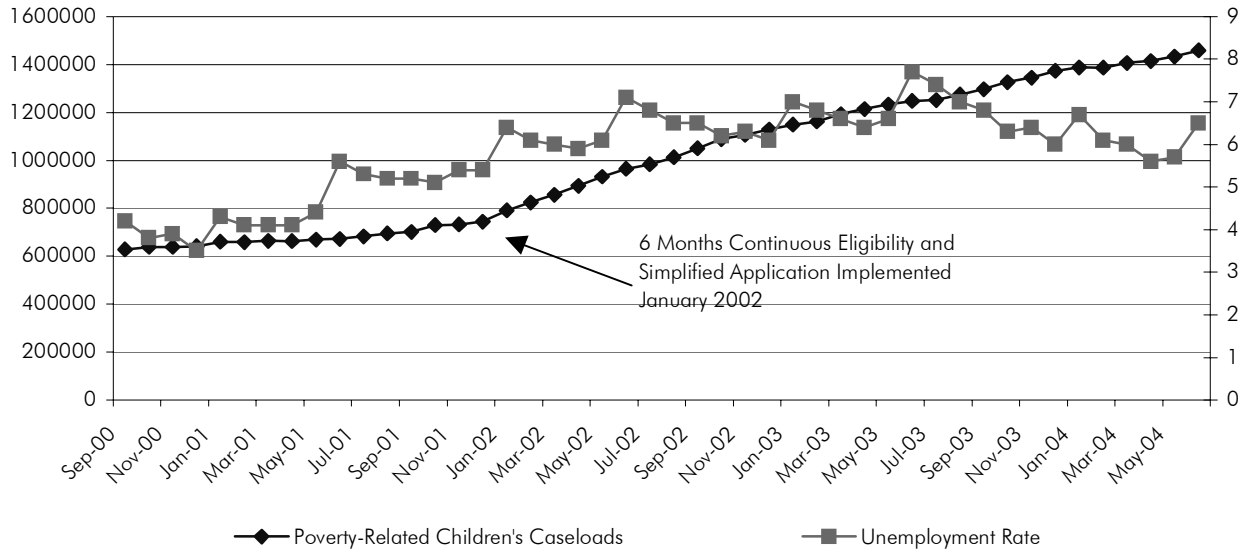
A second factor making accurate predictions difficult is any policy change affecting eligibility. During the Seventy-seventh Legislature, 2001, legislation was enacted that authorized six months of continuous eligibility for children's groups and simplified application procedures. Previously, there was no guarantee of continued eligibility for children, and they could lose eligibility if their parents' income or asset status changed. The changes were expected to increase caseloads in children's groups, so performance targets adopted by the legislature reflected an increase in the number of children to be served and their length of stay in the Medicaid program.

A third factor complicating accurate projections is the interrelationship between changes in Medicaid policy regarding and the economy of the state. The changes to Medicaid children's eligibility were implemented at the same time the state and nation experienced a downturn in the economy and increased unemployment. Higher rates of unemployment are likely to increase Medicaid caseloads. If one or both parents lose employment, family incomes are reduced. More families may fall within Medicaid income eligibility levels if family incomes are sufficiently reduced. Both the simplified application and the six months of continuous eligibility were implemented in January of 2002. Figure 7 shows two poverty-related children's groups with the unemployment rate superimposed over the caseload growth. When estimates were made of caseload impacts of continuous eligibility, it was not known that unemployment would increase significantly at approximately the sametime.

A fourth complicating factor with regard to Medicaid projections is the lag between the time agencies prepare their legislative appropriations requests and the legislative session. Due to the time necessary to process claims, there is a lag in receiving final data in Medicaid programs. "Completion factors" are often applied to data to adjust incomplete data to make budget projections. However, during preparations for the Seventy-ninth Legislature, 2005, some agencies utilized data points from as far back as October or December of 2003 to make projections for needs in the 2006–07 biennium. Data points are the data fed into statistical models to make projections. The more complete the data utilized and the shorter the term of the projection, the more likely the projection is to be accurate.

A problem with using "older" rather than "newer" data is that changes in trends in the intervening period are not reflected in the appropriations requests of the agencies. From a technical perspective, quantitative models used to forecast caseloads are much more likely to be close to the actual caseload for the period when the forecast is for a shorter term. If data used for forecasts are as old as

FIGURE 7
GROWTH IN CHILDREN'S MEDICAID AND TEXAS UNEMPLOYMENT RATE FISCAL YEARS 2001–2004



SOURCES: Health and Human Services Commission; Texas Workforce Commission.

December of 2003, and the forecast is being made for dates out to August of 2007, the projection period is for 44 months, or more than three and one-half years in the future. Agencies often supply updated caseload and cost data to funding committees during the legislative session to ensure committees have the most recent data and forecasts possible.

Predictions regarding the costs of services are also complicated. National projections regarding growth in medical inflation, particularly inflation in drug costs, have been outstripped by the actual growth in these items during the last several years. Health economists attribute the significant increases to factors such as the aging of the population, the influence of the media on consumption of health/pharmaceutical services, but particularly to continuing innovations in the health field. The costs of the Medicaid program are directly affected by these factors, as well.

STATE ACTIONS TO CONTAIN COSTS OR REDUCE EXPENDITURES IN MEDICAID

States experienced rapid growth in Medicaid expenditures in the context of declines in state revenues during the last several years. States have taken a variety of approaches to addressing the resulting economic pressures, including reducing coverage to optional populations, decreasing optional services, making changes to the Medicaid delivery system, making reductions in payments to hospitals and physicians or other providers, instituting cost sharing requirements, and making changes to Medicaid administration. The Kaiser Commission on Medicaid and the Uninsured has produced several 50-state surveys to summarize the approaches states have taken. According to the most recent survey, all 50 states and the District of Columbia adopted actions to control Medicaid spending in fiscal year 2004, and all states planned to implement some measures to contain costs in 2005.

Some states have responded to increased Medicaid expenditures by reducing coverage for optional populations. Many of those states covered more categories of optional populations than Texas. Coverage for the pregnant women category in Texas was reduced from 185 percent to 158 percent during fiscal year 2004 but was restored to 185 percent FPL retroactive to September 1, 2004.

The state legislature has discretion over the number of clients served in Medicaid Home and Community-Based waiver programs, such as those operated by the Department of Aging and Disability Services. Additional savings can be produced by not allowing new clients to enter the program as other clients leave it.

In the last budget cycle, Texas adopted various measures to counteract increased costs. For instance, certain optional services (health counseling, mental health services, hearing aids, and eyeglasses) were eliminated for adult clients. Approaches adopted by other states and reviewed by Texas included additional limits on the monthly number of

prescriptions or hospital days. In the long-term care arena, there were reductions in the maximum hours of service per week for clients served in the community. Service hours for using a combination of agency funds and State Fiscal Relief funds.

Another significant approach to cost containment was the institution of a preferred drug list in the prescription drug program. The Health and Human Services Commission began implementing a preferred drug list during fiscal year 2004, phasing in categories of drugs as they were evaluated by the Pharmaceutical and Therapeutics Committee. Prior approval is required for medications not on the preferred drug list. Supplemental rebates offered by the pharmaceutical manufacturers were part of the savings measures incorporated into the new approach.

The Health and Human Services Commission also contracted for a study to evaluate savings through further expansion of managed care in Texas. According to the agency, additional sites of STAR+PLUS, an acute-care and long-term care model, are planned for the 2006–07 biennium, along with statewide expansion of the Primary Care Case Management acute-care model.

Texas made reductions in payments to providers, including hospitals and physicians, during the last legislative session. The payments were partially restored in fiscal year 2004 using State Fiscal Relief dollars and many were again partially restored in fiscal year 2005 using funds identified by the Health and Human Services Commission, including State Fiscal Relief dollars.

Cost sharing, wherein a client contributes to the payment for care, is generally seen as a control on utilization or encouragement towards proper utilization. The federal government places limits on the groups of clients for whom cost sharing can be imposed and the amount of cost sharing. Generally, cost sharing cannot be imposed for children, pregnant women, or institutionalized clients. Medicaid cost sharing was discussed during the last legislative session, but it has not been implemented.

Fraud is sometimes cited as a possible source of over-expenditure in Medicaid. Texas added staff to investigate Medicaid fraud at the Office of the Attorney General and established an Office of Inspector General at HHSC to combat potential Medicaid fraud.

The combination of these approaches and an infusion of additional federal funds in the form of an enhanced matching ratio helped the state to partially address higher than expected Medicaid expenditures during the 2004–05 biennium.

CHANGING THE FEDERAL MATCHING FORMULA

Some states, including Texas, have raised issues relating to the formula of the Federal Medical Assistance Percentage, or FMAP, the Medicaid match rate. The formula is based upon the ratio of the state's per capita personal income over the previous three years in relationship to national per capita personal income over the same period. It has been argued that a formula that took into consideration the percentage of a state's population in poverty might be more advantageous for Texas. Any changes in formula, however, would have some states gaining and some losing. At present there appear to be no pending proposals at the federal level that would help Texas.

CHANGING THE STRUCTURE OF THE MEDICAID PROGRAM

Different proposals have been offered as long-term solutions to funding Medicaid. Some approaches that would effect structural changes in the Medicaid program include moving to a block grant approach, having the federal government take budgetary responsibility for dual eligible Medicare/Medicaid clients, and eliminating the Medicaid program entirely.

Over recent years, there has been some discussion at the federal level about instituting a block grant for Medicaid. However, proposals identified to date appear to not be advantageous to Texas, in that they offer a fixed grant amount but still require that mandatory populations be served. The flexibility often offered by the block grant proposals is limited to optional populations. The proposals have included enhanced federal amounts to states in the first few years with subsequent reductions in federal funding. Some states could take advantage of this approach by potentially amending optional coverages. However, since Texas has large and growing numbers of persons who fall within the mandatory populations, receipt of a fixed grant, even if increased in the first few years, would create even more acute budget problems for the state.

There are large numbers of Medicaid clients who are low-income Medicare recipients. Depending on the type of client, the Medicaid program can pay for the client's Part A or Part B Medicare premiums. In Medicare, Part A premiums cover hospital and Part B physician and other services. There are also low-income Medicare beneficiaries called full-dual eligibles, which means that all cost sharing under Medicare and even services through the Medicaid program that are not provided under Medicare are covered by the states' Medicaid programs. The states receive matching funds at the Medicaid match rate for these services. It government took full budgetary responsibility for these low-income Medicare recipients.

Some groups have argued for the elimination of the current Medicaid program in favor of medical savings accounts and additional tax credits for low-income persons to purchase health insurance. There do not appear to be proposals currently in Congress to accomplish this. There would need to be more detail available on how such a proposal would be implemented in order to evaluate potential impact on the Texas budget.

IMPACT OF POLICY CHANGES TO THE CHILDREN'S HEALTH INSURANCE PROGRAM (CHIP)

Since fiscal year 2000, the Children's Health Insurance Program has provided health insurance to Texas children under the age of 19 in families with incomes up to 200 percent of the Federal Poverty Level. The Seventy-eighth Legislature, 2003, enacted certain changes to eligibility and benefits for the Children's Health Insurance Program through House Bill 2292 and House Bill 1, the General Appropriations Act (GAA) for the 2004–05 biennium. This review analyzes the caseload and fiscal impacts of the policy changes enacted by the Seventy-eighth Legislature, 2003, compared to the impacts assumed in the 2004–05 General Appropriations Act.

SIGNIFICANT FINDINGS

- During fiscal year 2004—as policy changes were implemented—the number of children served (caseload) in the Children's Health Insurance Program declined by approximately 147,000 or 29 percent. The average monthly cost per child also declined. However, the program did not achieve fiscal year 2004 performance targets for caseload and average monthly costs, as established by the 2004–05 General Appropriations Act.
- The Health and Human Services Commission estimates a supplemental need in the Children's Health Insurance Program of $78.5 million in General Revenue Funds for the 2004–05 biennium. The regular appropriation for the Children's Health Insurance Program for the 2004–05 biennium was $807.9 million All Funds, including $286.7 million from the General Revenue Fund.
- Premium copayments are a significant contributing factor to the supplemental need. The Health and Human Services Commission's projections for premium copayment revenue for 2004–05 are significantly lower than the 2004–05 appropriation. Additionally, unanticipated costs resulted from not receiving a waiver of a federal cost-sharing requirement and from not disenrolling recipients for nonpayment of premium copayments.
- Without a statutory change, continuous eligibility will revert to 12 months as of September 1, 2005. House Bill 2292 authorized six months of continuous eligibility for the 2004–05 biennium but reestablished 12 months of continuous eligibility for fiscal year 2006.

COMMENTS

The Seventy-eighth Legislature, 2003, enacted several changes to the Children's Health Insurance Program (CHIP) through House Bill 2292. CHIP continues to serve all eligible children up to 200 percent of the Federal Poverty Level ($37,700 for a family of four), including children funded entirely by the state without the participation of the federal government (Legal Immigrants and School Employee Children). Figure 1 summarizes selected policy changes, implementation dates, and the statutory direction provided to the Health and Human Services Commission (HHSC).

ASSETS TEST

House Bill 2292 authorized HHSC to establish eligibility standards regarding the type and dollar value of allowable assets for a family whose gross income is above 150

FIGURE 1
SELECTED CHIP POLICY CHANGES ENACTED BY THE SEVENTY-EIGHTH LEGISLATURE, 2003

POLICY CHANGES	HOUSE BILL 2292	IMPLEMENTED
Assets Test	Authorized	August 2004
Elimination of Income Disregards	Required	November 2003
Increased Premium Copayments	Authorized	October 2003 Suspended November 2004
Elimination of Benefits: (Vision, Dental, Hospice, Chiropractic, Behavioral Health, Skilled Nursing, and Tobacco Cessation)	Authorized	Eliminated September 2003; mental health and substance abuse partially restored February 2004, retroactive to September 2003
90-day Waiting Period for All Enrollees	Required	October 2003
Six-month Continuous Eligibility Period	Authorized	January 2004 Sunsets September 1, 2005

SOURCE: Legislative Budget Board.

percent of the Federal Poverty Level. In August 2004, an assets test was applied to new applicants and renewals whose eligibility was undetermined as of the 24th of the month. The caseload impact of the assets test occurred in October 2004. To be eligible for CHIP, the assets of a family with gross income above 150 percent of the Federal Poverty Level may not exceed $5,000 in countable liquid assets and excess vehicle value combined (Figure 2). Certain liquid assets and vehicles are exempted from the calculation of assets.

FIGURE 2
COUNTABLE LIQUID AND VEHICLE ASSETS

LIQUID ASSETS	EXCESS VALUE OF VEHICLES
Countable Liquid Assets include: Cash on hand; cash value of of checking and savings accounts; money remaining from the sale of a homestead, and cash value of stocks, bonds, and savings certificates.	**Countable Vehicles include:** Operable and licensed automobile, truck, motor-cyle, SUV, van, boat, or motor home (including campers and RVs). **Excess Value of Countable Vehicles:** The excess of $15,000 for the highest valued vehicle plus the excess of $4,650 for each additional vehicle, if no exemptions are applied.

SOURCE: Health and Human Services Commission.

According to HHSC, the process of developing rules and procedures for the assets test contributed to its delayed implementation. As a result, no savings were realized in fiscal year 2004 from the assets test.

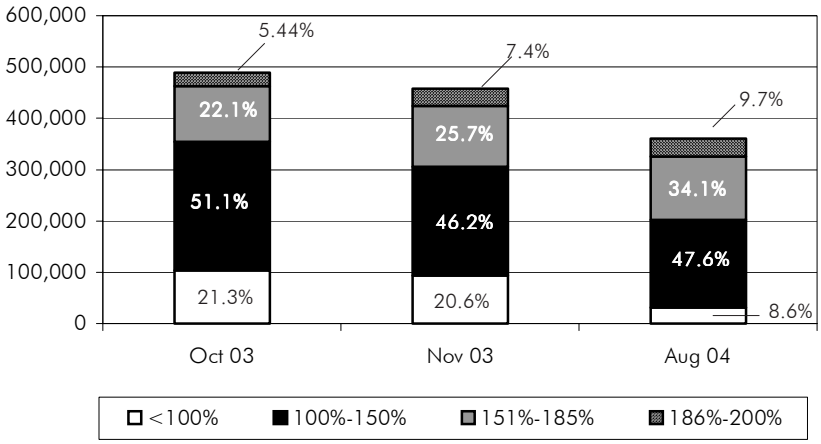
ELIMINATION OF INCOME DISREGARDS

Prior to the enactment of House Bill 2292, eligibility for CHIP was based on a family's net income (gross family income reduced for expenses for work and dependent care). Reductions were allowed for up to $120 per employed person, $200 per child under two years of age, $175 per person age two and older, and $50 for child support payments received by a CHIP household. Payments to dependents living outside a CHIP household were also disregarded from the determination of income. House Bill 2292 eliminated income disregards and based eligibility on gross family income before any payroll deductions. In November 2003, HHSC redetermined the eligibility of all existing enrollees and began determining the eligibility of new enrollees based on gross family income.

HHSC indicates the elimination of income disregards accounted for 16,170 (53 percent) of the November decline in total enrollment. In addition, there is an ongoing reduction in new enrollment due to the elimination of income disregards.

The elimination of income disregards also resulted in a shift in enrollment from the lower income groups (below 100 percent of the Federal Poverty Level) to the higher income groups (151-200 percent of the Federal Poverty Level) (Figure 3). This shift began in November but continued throughout fiscal year 2004. For most families,

FIGURE 3
CHIP ENROLLMENT BY PERCENT OF FEDERAL POVERTY LEVEL



SOURCES: Legislative Budget Board; Health and Human Services Commission.

gross income is higher than net income (gross income reduced for income disregards). Therefore, determining eligibility based on gross income shifts some families into a higher income group.

Between October 2003 and August 2004, the percentage of children in families with incomes below 100 percent of the Federal Poverty Level decreased from 21.3 percent to 8.6 percent, representing a 60 percent decrease. Conversely, the percentage of children in families with incomes above 150 percent of the Federal Poverty Level increased from 27.6 percent to 43.8 percent for a 59 percent increase. Beyond the elimination of income disregards, HHSC indicates that part of the decrease in enrollment in the lowest income group (below 100 percent of the Federal Poverty Level) may be because children transitioned to Medicaid. The number of children enrolled in Medicaid from CHIP is unknown. Medicaid eligibility criteria for children include an assets test and an exemption for certain family income (income disregards).

INCREASED PREMIUM COPAYMENTS FOR FAMILIES

House Bill 2292 authorized HHSC to establish cost sharing up to the maximum allowable levels under federal law. In October 2003, HHSC increased premium copayments for all income groups above 100 percent of the Federal Poverty Level (Figure 4). The largest increase was applied to the income group between 101 percent and 150 percent of the Federal Poverty Level, whose monthly premium copayments increased from $0 to $15. Prior to October 2003, this income group was assessed a $15 annual enrollment fee but no monthly premium copayments. Under federal law, total annual aggregate cost-sharing for a family may not exceed 5 percent. Additionally, federal law prohibits enrollment fees, premiums, or similar charges that exceed the maximum monthly charges allowed under Medicaid and cost-sharing that exceeds a nominal amount for families with incomes below 150 percent of the Federal Poverty Level.

FIGURE 4
MONTHLY PREMIUM COPAYMENTS PER FAMILY

	PRE-HOUSE BILL 2292	POST-HOUSE BILL 2292
At or below 100% FPL	$0	$0
101% to 150% FPL	$0	$15
151% to 185% FPL	$15	$20
186% to 200% FPL	$18	$25

SOURCE: Health and Human Services Commission.

Following the premium copayment increases, the number of families noncompliant with cost-sharing requirements increased. Under HHSC policies, families who do not make premium copayments for three months are disenrolled from CHIP. HHSC delayed disenrolling children for nonpayment of premium copayments for all of fiscal year 2004 to provide notice to families of the premium copayment increases and the disenrollment policy. In August 2004, the governor requested that HHSC further delay the disenrollment of children planned for August. The governor also requested that HHSC explore linking additional benefits to the payment of premium copayments. As of November 1, 2004, HHSC temporarily suspended the collection of monthly premium copayments for all enrollees.

The projection for premium copayment revenue for the 2004–05 biennium in HHSC's 2006–07 legislative appropriations request is $56.5 million lower than its 2004–05 biennial appropriation of $88.0 million (Figure 5). HHSC's 2006–07 Legislative Appropriations Request assumes no premium copayment revenue in fiscal year 2005 due to the suspension of premium copayments. In addition to the nonpayment and suspension of premium copayments, it is possible that the projection for the 2004–05 General Appropriations Act (GAA) assumed higher monthly premium copayments for each income group than were adopted.

FIGURE 5
PREMIUM COPAYMENT COLLECTIONS (IN MILLIONS)

	FISCAL YEAR 2004	FISCAL YEAR 2005	BIENNIAL TOTAL
Appropriated	$44.0	$44.0	$88.0
Estimated Collections/ Expenditures	$31.5	$0.0	$31.5
Uncollected/Unexpended Revenue	$12.5	$44.0	$56.5

SOURCES: Legislative Budget Board; Health and Human Services Commission.

Another factor contributing to the supplemental need is the assumption in the 2004–05 GAA that a waiver of a federal cost-sharing requirement would be approved for the biennium. Federal law requires the use of premium copayment revenue to reduce the federal share and state share of expenditures in the CHIP program. The GAA assumed premium copayments could be used for the state share of expenditures only and thus assumed more in Federal Funds than was allowable. In June 2004, HHSC submitted a concept paper for a waiver of this requirement.

The proposed waiver committed the state to maintain current eligibility and enrollment policies, to not increase cost-sharing, and to fully fund the state-funded groups for the time the waiver was in effect. In September 2004, the Centers for Medicare and Medicaid Services notified HHSC that the applicable provision of federal law can not be waived. The cost of not receiving a waiver is estimated to be $22.8 million in General Revenue Funds for fiscal year 2004. There may be additional costs in fiscal year 2005, depending on the amount of premium copayment revenue collected.

RESTRUCTURED BENEFITS PACKAGE

House Bill 2292 allowed for the restructuring of CHIP benefits by eliminating the requirement that CHIP benefits be equivalent to the basic plan for active state employees and provide the minimum coverage recommended in 1998 by interim committees of the legislature. Effective September 2003, vision, dental, mental health, substance abuse, chiropractic, skilled nursing facilities, tobacco cessation, and hospice benefits were eliminated from the benefits package. In February 2004, HHSC partially restored mental health and substance abuse benefits retroactive to September 2003. Figure 6 compares the mental health and substance abuse benefits offered in CHIP prior to and after September 1, 2003.

In January 2004, HHSC estimated the cost of partially restoring mental health and substance abuse benefits at $5.3 million in General Revenue Funds for the 2004–05 biennium. This estimate does not include the cost of retroactivity and was based on 2004–05 GAA caseload targets.

90-DAY WAITING PERIOD FOR ALL NEW ENROLLEES

Prior to the 2004–05 biennium, children with health insurance at any time in the 90 days before applying for CHIP were subject to a waiting period of 90 days from the last day of coverage in order to prevent "crowd out." Crowd out is the substitution of publicly funded health insurance for privately funded health insurance. Exemptions from the 90-day period included involuntary loss of health insurance, good cause as determined by HHSC, or because available insurance was unaffordable (exceeded 10 percent of net income). House Bill 2292 extended the waiting period to all CHIP enrollees and continued existing exemptions from the waiting period. Additional exemptions from the waiting period are allowed for participation in a CHIP premium assistance program and for children disenrolled for nonrenewal who renew the following month. Children not exempted from the waiting period must wait 90 days from application until enrollment. The waiting period begins on the first day of the application month, if the child applies by the fifteenth day of the month; otherwise, the waiting period begins the first day of the following month.

The 90-day waiting period was applied to new applicants beginning October 1, 2003. As a result, new enrollment was lower from October 2003 to January 2004. In January 2004, new enrollment increased when the waiting period ended for 3,800 children who applied in October 2003.

SIX-MONTH CONTINUOUS ELIGIBILITY PERIOD

House Bill 2292 authorized HHSC to provide six months of continuous eligibility in CHIP instead of 12 months. Beginning in January 2004, enrollees in their sixth or twelfth month of coverage were required to renew. Additionally, all new enrollees received six months of continuous eligibility.

As a result of six months of continuous eligibility, there was an increase in the number of renewals, nonrenewals, and attempted renewals in fiscal year 2004, as more children were due for renewal each month. The increase in

FIGURE 6
CHIP MENTAL HEALTH AND SUBSTANCE ABUSE BENEFITS

PRIOR TO SEPTEMBER 1, 2003	AFTER SEPTEMBER 1, 2003
Mental Health	Mental Health
45 days annual inpatient services	30 days annual inpatient services
60 days annual outpatient limit	30 days annual outpatient limit
Substance Abuse	Substance Abuse
14 days annual detoxification and stabilization services	5 days annual limit on inpatient detoxification and stabilization services
60 days of inpatient services per episode	30 days annual limit for inpatient services
Outpatient Services (up to six months per episode)	30 annual outpatient visits

NOTE: This represents the major benefit changes. Some exceptions may apply.
SOURCE: Health and Human Services Commission.

nonrenewals and attempted but unsuccessful renewals contributed to higher total disenrollment in fiscal year 2004, which when combined with lower new enrollment due to other policy changes resulted in a decline in total enrollment. As of July 2004, the change to six months of continuous eligibility was fully implemented. However, the impact will continue due to higher numbers of children due for renewal. Without a statutory change, continuous eligibility will revert to 12 months as of September 1, 2005 pursuant to House Bill 2292.

CASELOAD CHANGES AND PROGRAM COSTS

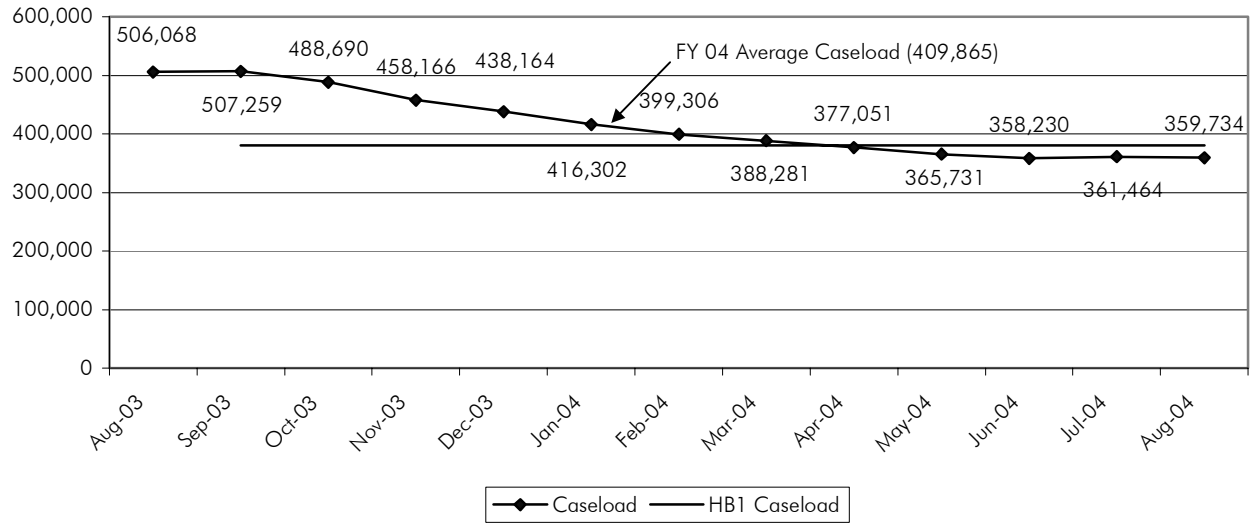
The policy changes enacted by the Seventy-eighth Legislature, 2003, had a significant impact on CHIP caseloads, costs, and revenues. Policy changes such as the elimination of income disregards, 90-day waiting period, six-months continuous eligibility, and the assets test combined to reduce caseloads by 147,525 between September 2003 and August 2004 (Figure 7). It is noteworthy that while total CHIP enrollment declined during fiscal year 2004, the total number of children enrolled in Medicaid and CHIP combined increased between fiscal year 2003 and fiscal year 2004. The number of children who moved from CHIP into Medicaid is unknown.

Despite the caseload decline, the average monthly caseload for fiscal year 2004 exceeded the 2004–05 GAA target by 29,262. This is in part because the implementation of some policy changes was delayed in fiscal year 2004. In its most recent caseload projections, HHSC projects to achieve the 2004–05 GAA caseload target for fiscal year 2005 (Figure 8).

Additionally, the average monthly cost exceeded the 2004–05 GAA target in fiscal year 2004. However, HHSC projects in its 2006–07 Legislative Appropriations Request to achieve the GAA target for fiscal year 2005 (Figure 8). According to HHSC, vendor drug costs, the partial restoration of mental health and substance abuse benefits, and the restoration of half of the 5 percent rate reduction are contributing to higher than projected average costs. Unanticipated costs also resulted from the denial of a waiver of a federal cost-sharing requirement and the decision to delay disenrollment for nonpayment of premium copayments.

The combination of higher than projected caseloads and costs and lower than projected premium copayment revenue helps to explain the estimated $78.5 million biennial supplemental need in General Revenue Funds in CHIP. In addition to the supplemental need, the Seventy-ninth Legislature, 2005, will face decisions regarding continuous eligibility and premium copayments. A statutory change is required to continue six months of continuous eligibility, which expires September 1, 2005. Additionally, HHSC has not indicated when premium copayments will be reinstated.

FIGURE 7
NUMBER OF CHILDREN ENROLLED IN CHIP – AUGUST 2003 THROUGH AUGUST 2004



SOURCE: Health and Human Services Commission.

FIGURE 8
2004–05 GAA TARGETS COMPARED TO HHSC PROJECTIONS

	FISCAL YEAR 2004			FISCAL YEAR 2005		
	GAA	ACTUAL	DIFFERENCE	GAA	HHSC PROJECTIONS	DIFFERENCE
Caseloads	380,603	409,865	29,262	346,818	346,179	(639)
Costs	$88.54	$95.71	$7.17	$91.27	$91.27	$0

NOTES:
Caseloads—Average monthly number of children served.
Costs—Average monthly cost per child.
SOURCES: Legislative Budget Board; Health and Human Services Commission.

CLOSE OUT ISSUES RELATED TO TEXAS' MEDICAID CONTRACT WITH THE NATIONAL HERITAGE INSURANCE COMPANY

Texas' contract with the National Heritage Insurance Company for Medicaid claims payment ended in December 2003. Financial summaries from the contractor were reviewed by Legislative Budget Board staff to identify any funds remaining in the Risk Stabilization Reserve and to ensure the Health and Human Services Commission made appropriate adjustments to expended/budgeted amounts. This report addresses the remaining outstanding issues with reporting and expenditures from Medicaid funds held by the contractor.

SIGNIFICANT FINDINGS

- At this time, there appear to be no state or federal funds remaining at the National Heritage Insurance Company related to the state's Medicaid contract.
- The Health and Human Services Commission has reduced its estimated 2004–05 biennial supplemental need for the Medicaid program by $154.2 million in General Revenue Funds, related to nonpayment of premiums to avoid increasing the Risk Stabilization Reserve balance.

SIGNIFICANT CONCERNS

- Adjustments and changes to claims cost made in the final National Heritage Insurance Company Financial Summary, prepared after the contractor was no longer responsible for claims processing, remain unverified.
- Health and Human Services Commission forecasting staff forecast on an incurred basis; the agency's budget staff produce estimates on a cash basis.

RECOMMENDATIONS

- **Recommendation 1:** Include rider language in the 2006–07 General Appropriations Bill that directs the Health and Human Services Commission to contract with an independent audit entity to audit the close out of the contract with the National Heritage Insurance Company to ensure no funds are due to the state.
- **Recommendation 2:** Include rider language in the 2006–07 General Appropriations Bill that directs the Health and Human Services Commission to provide, as part of the agency's monthly financial reports, an explanation of those adjustments made to translate actuarial forecasts of incurred claims into budgeted/expended amounts on a cash basis for the Medicaid program.

COMMENTS

The National Heritage Insurance Company (NHIC) was Texas' Medicaid claims administrator, responsible for processing Medicaid claims from 1976 until December 2003. NHIC acted as an insurance agent, receiving premium payments from the state and paying claims from those funds. In 2003 the contract was awarded to Texas Medicaid and Healthcare Partnership (TMHP), and on January 1, 2004 TMHP assumed responsibility for the processing of Medicaid claims. TMHP acts as a fiscal agent for the state's Medicaid program, processing claims and receiving payment from the state when those claims are finalized.

Under the arrangement with NHIC, the state paid a premium each month for each fee-for-service Medicaid recipient and NHIC in turn paid the claims for those recipients. Each month NHIC submitted a financial summary to the Health and Human Services Commission (HHSC). A list of selected elements included in these summaries and their descriptions appears in Figure 1.

NHIC had no responsibility for claims payments after December 31, 2003. NHIC provided a financial summary on January 15, 2004 for the period ending December 31, 2003. Analysis of this financial summary indicated NHIC might owe the state a refund of up to $200.6 million in All Funds, $77.7 million in General Revenue Funds.

NHIC calculated the excess of benefit premium incurred over benefit cost incurred as (Premium Payments + Estimated Premiums Incurred But Not Paid) – (Total Claim Payments + Total Estimated Incurred Liability). Any Risk Stabilization Reserve (RSR) adjustments started from this base. The amount remaining after adjustment is the RSR balance. There was a $25.0 million minimum balance in the RSR while the contract with NHIC was active. Any amounts in excess of $25.0 million were to be refunded to the state in the form of premium credits. According to the December 2003 NHIC Financial Summary, the RSR

FIGURE 1
SELECTED ELEMENTS CONTAINED IN NHIC'S FINANCIAL SUMMARIES

ELEMENT TITLE	DESCRIPTION
Premium Payments	Dollar amount paid to NHIC by the state
Estimated Premiums Incurred But Not Paid	Estimate of premium payments due to NHIC, but not yet paid by the state
Claim Payments	Dollars paid out by NHIC for claims, including any adjustments
Estimated Incurred Liability	Estimate of dollars still to be paid by NHIC for claims not yet submitted and/or processed for services that have already occurred
Risk Stabilization Reserve (RSR) Balance	Excess of premiums (paid and incurred) over claim payments and incurred liability, plus or minus any adjustments to the RSR
RSR Adjustments	Adjustments to the RSR including interest credits, refunds to HHSC, and risk charges

SOURCE: Legislative Budget Board; National Heritage Insurance Company.

balance was $48.9 million in All Funds, $44.4 million for fiscal year 2003 and $4.5 million for fiscal year 2004.

Additionally, the December 2003 NHIC Financial Summary continued to estimate incurred liability as far back as fiscal year 1990. However, beginning in January 2004, claims are processed by TMHP; TMHP is responsible for all claims, regardless of date of service and including those claims for which a premium was previously paid to NHIC. Therefore, NHIC should have no incurred liability.

From fiscal year 1977 to fiscal year 2004 NHIC was paid premiums totaling $47.0 billion in All Funds. NHIC in turn made total claim payments of $44.4 billion in All Funds. The difference of $2.6 billion in All Funds is excess premium payments. This amount is reduced by $2.4 billion in All Funds for refunds already made to the state agency and other adjustments to the RSR, including $53.1 million in All Funds in risk charges retained by NHIC. The remaining $200.6 million in All Funds is the total amount of funds that were remaining at NHIC, including the $48.9 million in All Funds in the RSR. Excluding the RSR balance, $151.8 million in All Funds was being held by NHIC for incurred liability. This $151.8 million is equal to NHIC's Estimated Incurred Liability less Estimated Premiums Incurred But Not Paid.

The $48.9 million in All Funds ($18.9 million in General Revenue Funds) in the RSR and the $151.8 million in All Funds ($58.8 million in General Revenue Funds) being held for incurred liability could have been due back to the state (an estimated $77.7 million in total General Revenue Funds). However, according to HHSC, NHIC does not owe the state any additional refunds. According to HHSC's analysis, there was a deficit in fee-for-service of $66.6 million in All Funds and a balance due of $71.2 million in All Funds in managed care. These amounts were combined, and the net positive amount of $4.6 million in All Funds was refunded to the state in May 2004.

HHSC provided an additional NHIC Financial Summary detailing adjustments and costs through January 31, 2004. This document shows additional Claim Payments of $25.6 million in All Funds for fiscal year 1995 and $4.3 million in All Funds for fiscal year 2001. According to notes in the report, these amounts were added by NHIC to reconcile the financial summary to the general ledger. Additionally, the report shows Net Cost Adjustments Paid for fiscal year 2004, in January 2004, of $237.4 million in All Funds. (Note: The NHIC financial summaries do not state what is accounted for in the Net Cost Adjustments Paid entry, but historically these amounts have reduced the total claim payments amount.) Together these amounts total a $267.3 million in All Funds increase in costs over what was reported in the December 2003 NHIC Financial Summary, and reflect adjustments made after the December 31, 2003 close of the contract. These costs are the difference between the estimated $200.6 million in All Funds remaining at NHIC on December 31, 2003 and the $66.6 million in All Funds deficit reported by HHSC.

Prior to the close of the NHIC contract, HHSC implemented a plan to avoid increasing the RSR balance and to spend down the existing balance. The agency withheld premium payments from November and December 2003 totaling $418.4 million in All Funds ($154.2 million in General Revenue Funds), which would have increased the balance in the RSR. Additionally, $220.5 million in All Funds, for services typically paid by NHIC from the RSR and then reimbursed by the state, were not reimbursed in order to spend down the RSR balance. Most of these claims were processed by NHIC in November and December 2003, although a small amount of claims were from October 2003. These services included payments for the following: Qualified Medicare Beneficiaries, Texas HealthSteps (Medical, Dental, and Comprehensive Care Program), Cost Reimbursed (primarily Undocumented Aliens and Federally Qualified Health Centers), and Title XIX Family Planning. This resulted in a $220.5 million in All Funds reduction to the RSR balance. This represented the majority of the $237.4 million in All Funds cost

adjustment in the January 2004 NHIC Financial Summary. The remaining $16.9 million in All Funds of the cost adjustment included the following: $6.6 million in All Funds in various fees and claims costs identified during the closeout reconciliation; $9.9 million in All Funds in provider accounts receivable, now to be recouped by TMHP; and $0.3 million in All Funds transferred to TMHP for additional hold payments, claims processed by NHIC and funded but put on hold prior to release of a check.

Adjustments and additions to claims cost made in the final NHIC Financial Summary, after the close of the contract, have not been verified. Of particular concern are the additional Claim Payments of $25.6 million in All Funds for fiscal year 1995 and $4.3 million in All Funds for fiscal year 2001. There should have been no additional claims cost after the close of the contract. All adjustments made in January 2004 were made by NHIC and they have not been verified. Using data provided by HHSC in its monthly data submission, the amounts not reimbursed by the state could not be duplicated. An audit of the closeout of the contract could alleviate any concerns over the possibility of funds remaining at NHIC. Specifically, the audit should include verification of increased claims cost for past fiscal years, and of the $237.4 million in All Funds cost adjustment.

Recommendation 1 would modify the rider related to the Risk Stabilization Reserve in the 2006–07 General Appropriations Bill to read as follows:

> **Risk Stabilization Reserve.** Out of funds appropriated above, the agency shall contract with an independent audit entity to audit the closeout of the Medicaid claims payment contract with the National Heritage Insurance Company (NHIC). In lieu of pursuing a contract and at the discretion of the State Auditor, the State Auditor's Office may conduct the audit. Special attention shall be paid to those adjustments made after December 31, 2003, when NHIC was no longer responsible for processing claims. The scope of the audit shall be provided to the Legislative Budget Board and the Comptroller of Public Accounts 45 days prior to the start of the audit. All findings shall be reported to the Governor, the Legislative Budget Board and the Comptroller within 30 days of completion of the audit. ~~Upon termination of a contract with the fiscal agent or insurance carrier for purchased health insurance, or change to another fiscal arrangement,~~ The state's share of ~~the~~ any identified unexpended balance in the risk stabilization reserve and/or trust account, or of other funds owed to the state, shall be deposited into the General Revenue Fund and such funds are not appropriated to the Health and Human Services Commission.

Further, HHSC forecasting staff forecast costs on an incurred basis. Their forecast of fiscal year 2004 included full premium payments through December 2003 and full cost of claims for services provided January to August 2004. Budget staff, however, produce estimates on a cash basis. This results in a need to adjust the cost forecast to align it with budgeted and/or expended amounts. For fiscal year 2004, budget staff correctly reduced expenditures in the premium strategies by $220.5 million in All Funds to reflect the fact that premium payments made to NHIC were used to fund other strategies. However, they failed to adjust for the nonpayment of premiums to NHIC in either the Fiscal Year 2004 Operating Budget or the 2006–07 Legislative Appropriations Request. This resulted in an overstatement of supplemental need. HHSC has since corrected this, reducing their estimate of supplemental need by the $418.4 million All Funds ($154.2 million in General Revenue Funds) not paid to NHIC. In order to ensure future adjustments are properly made and accounted for, HHSC should establish a procedure for routinely adjusting forecasts and reporting these adjustments to the Legislative Budget Board.

Recommendation 2 would modify the rider related to other reporting requirements in the 2006–07 General Appropriations Bill to include the following:

> **Other Reporting Requirements.**
>
> c. Monthly Financial Reports. The Health and Human Services Commission shall submit the following information to the Legislative Budget Board and the Governor on a monthly basis:
>
> (4) Narrative and tabular explanation of adjustments made to translate actuarial forecasts of incurred claims into budgeted/expended amounts on a cash basis for the Medicaid program.

FISCAL IMPACT OF THE RECOMMENDATIONS

There is no significant fiscal impact from Recommendations 1 and 2. Recommendations 1 and 2 have both been incorporated in the introduced 2006–07 General Appropriations Bill.

ALLOW ADDITIONAL GENERIC DRUG SUBSTITUTION

The administrative rules of the Texas State Board of Pharmacy prevent pharmacists from substituting generic drugs for a number of brand-name prescriptions. In Texas, generic drug substitution is governed by the U.S. Food and Drug Administration's *Approved Drug Products with Therapeutic Equivalence Evaluations*. This publication (commonly called the "Orange Book") identifies drug products approved on the basis of both safety and effectiveness. Drugs approved only on the basis of safety as well as those with active ingredients in existence before the passage of the federal Food, Drug, and Cosmetic Act of 1938 have been exempted from the Food and Drug Administration's evaluation process and are not listed in the Orange Book. As a result of the Texas State Board of Pharmacy's administrative rules, these drugs are not available for generic substitution in Texas.

In fiscal year 2004, Texas spent approximately $3.0 billion on prescription drug benefits for employees and beneficiaries of state medical programs. This amount is expected to increase to an estimated $3.5 billion in fiscal year 2005. To combat the increasing cost of prescription drugs, 11 states have mandated generic substitution of prescription drugs. This policy is discretionary for the other 39 states, including Texas.

In addition, 34 states allow generic substitution of drugs not included in the Orange Book. Allowing generic substitution of these drugs in Texas would reduce the state's expenditure for prescription drugs for Medicaid by at least $9.9 million in All Funds in the 2006–07 biennium. Approximately $3.9 million of this amount could be saved for the General Revenue Fund.

SIGNIFICANT FINDINGS

- The Orange Book provides states with a list of all prescription drug products approved by the Food and Drug Administration for safety and effectiveness as well as therapeutic equivalence determinations for multi-source prescription products. In most cases, multi-source prescription drugs are pharmaceutical equivalents available from more than one manufacturer.
- Pharmaceuticals that contain active ingredients introduced prior to the passage of the Federal Food, Drug, and Cosmetic Act of 1938 are "grandfathered in" by the Food and Drug Administration and do not have to go through the Food and Drug Administration evaluation process. As a result, these drugs are not listed in the Orange Book; nevertheless, time and human experience have proven them to be valuable medications.
- Non-Orange Book drugs can be well-known drugs, such as Children's Tylenol Suspension, Pedialyte Solution, and Tussi-12D Suspension.
- The Food and Drug Administration regulates manufacturing of all drugs, including those not evaluated in the Orange Book.
- Some Texas state health programs have begun to encourage substitution of generic drugs not included in the Orange Book for patients who have recently used certain generic equivalents but were later prescribed brand-name products. However, these pilot programs require that physicians re-prescribe the medication as the generic prior to pharmacists substituting these drugs.
- Thirty-four states allow generic substitutions beyond the drugs listed in the Orange Book. In these states, pharmacists can choose generic versions of brand-name drugs not listed in the Orange Book by matching active ingredients, dosage form, and dosage strength.

SIGNIFICANT CONCERN

- The Texas State Board of Pharmacy's (Pharmacy Board's) current administrative rules restrict substitution of generic drugs to the equivalencies listed in the Orange Book. Therefore, pharmacists cannot always substitute cost-effective generic alternatives for Texas state employees and program beneficiaries.

RECOMMENDATION

- The Texas Pharmacy Board should change its administrative rules to allow the substitution of generic drugs that are not evaluated in the Orange Book.

COMMENTS

In 1938 the U.S. Congress passed the Food, Drug and Cosmetic Act. This legislation required drug manufacturers

to provide scientific proof that new products could be safely used before introducing them to the market. The law "grandfathers in" drug products that contain active ingredients that were on the market prior to 1938, allowing them to be manufactured and sold in the United States without going through the approval process required for new products.

All drug products with active ingredients introduced after 1938 have been required to go through the New Drug Application Process (NDA) before they are marketed. The data that drug manufacturers have collected during clinical tests have to be included as a part of the application information. As the Food and Drug Administration (FDA) states in its description of the NDA, "The documentation required in an NDA is supposed to tell the drug's whole story, including what happened during the clinical tests, what the ingredients of the drug are, the results of animal studies, how the drug behaves in the body, and how it is manufactured, processed and packaged." Generic drugs go through the Abbreviated New Drug Application (ANDA), which is somewhat less rigorous than NDA. Even though pre-1938 drugs did not have to go through NDA or ANDA, the manufacturing of these drugs is still regulated by the FDA.

USE OF THE ORANGE BOOK

States implement different measures to control the costs of prescription drugs. Many of these measures encourage substituting less expensive drugs for those commonly prescribed. To provide assistance to all states, in 1978 the FDA established a single list of all prescription drug products that are approved by the FDA for safety and effectiveness. This list also contains therapeutic equivalence determinations for multi-source prescription products. Figure 1 describes what drugs are considered to be therapeutic equivalents based on the FDA determination.

The final version of the list was published in 1980. Enacted in 1984, the Drug Price Competition and Patent Term Restoration Act required the FDA to make the list of approved drugs publicly available and required that list to be updated monthly. The *Approved Drug Products with Therapeutic Equivalence Evaluations* publication, or Orange Book, is updated monthly and therefore satisfies this requirement.

In the preface to the Orange Book, the FDA emphasizes that the publication is a guide to substitution, which gives advice to the professionals, but does not constitute a federal mandate regarding which drugs to use during substitution or which drug products to avoid. The publication also states that the exclusion of certain drugs from the Orange Book does not necessarily mean that these drug products are not safe or effective, or that these products are not therapeutically equivalent to other drug products.

FIGURE 1
THERAPEUTIC AND PHARMACEUTICAL EQUIVALENTS

Drug products are considered to be therapeutic equivalents only if they are pharmaceutical equivalents and can be expected to have the same clinical effect and safety profile when administered to patients under the conditions specified in the labeling.

"Pharmaceutical equivalents" are drugs that

- contain the same amount of active ingredient,
- are of the same dosage form,
- are identical in strength or concentration, and
- use the same route of administration.

SOURCE: U.S. Food and Drug Administration.

As the Orange Book stresses, exclusion of certain drugs from the Orange Book means only that the FDA has not evaluated the safety, effectiveness, and quality of the drug product.

Drugs not evaluated in the Orange Book can be well-known drugs. For example, Children's Tylenol Suspension, Pedialyte Solution, Panafil Ointment, Accuhist DM Pediatric Syrup, and Tussi-12D Suspension are drugs that are not included in the Orange Book.

ENSURING THE QUALITY OF DRUGS

To ensure drug quality, the federal government has adopted multiple rules and standards for drug manufacturers. Manufacturers have to meet requirements of the Current Good Manufacturing Practice (CGMP) regulations. The FDA Center for Drug Evaluation and Control states that these regulations make sure that a product is safe for use and that it has the ingredients and strength the manufacturer claims it to have.

The FDA has not evaluated drugs with active ingredients in existence prior to 1938, thus there is no proven evidence that non-Orange Book generic drugs have the same clinical effect as non-Orange Book brand name drugs. However, even when drugs approved in the Orange Book are substituted with equivalent drugs, there may be some small effects of the substitution. Drugs that are evaluated in the Orange Book and have been determined to be equivalent to other drug products still might differ in shape, color, flavor ingredients, and preservatives as well as other characteristics. As one example, the Orange Book states there may be decreased patient acceptance because of flavor.

The Orange Book also points out that the FDA evaluation of the drugs in no way relieves practitioners of their professional responsibilities in prescribing and dispensing

such products with due care and with appropriate information to individual patients. States that do not limit generic substitution to the drugs evaluated in the Orange Book give final discretion regarding substitution to pharmacists.

SURVEY OF OTHER STATES

The results of the National Association of Boards of Pharmacy's most recent survey show that 16 states (including Texas) report that they use only the Orange Book as the basis for generic substitution. The other 34 states allowed additional generic substitution at the time of the survey.

Legislative Budget Board (LBB) staff surveyed 11 states to confirm that the states do allow substitution of drugs not evaluated in the Orange Book to determine the basis for states' use of substituted drugs and to estimate savings related to additional substitution. Survey results are summarized in Figure 2.

Pharmacists in all states use the Orange Book as the basis for generic substitution. Furthermore, states with regulations similar to Texas have rules stipulating that pharmacists may substitute only products that are rated therapeutically equivalent in the Orange Book.

States that do not specify the source for drug substitution require the products to contain identical amounts of the active ingredients contained in brand-name drugs. No state that allows substitution of non-Orange Book drugs based on the pharmacists' discretion reported considering limiting drug substitutions to those listed in the Orange Book. One state responded that the Orange Book excludes too many drugs that may be equivalent to more costly brand-name products. None of the states surveyed could provide estimated savings from additional generic substitution.

STATUS OF NON-ORANGE BOOK DRUGS CAN CHANGE

If the FDA has concerns about the quality of a drug not evaluated in the Orange Book, it can require an assessment of the medication. For example, in 1997, the FDA required all of the levothyroxine drugs used in thyroid treatment to go through a new drug application process, even though they were initially excluded from evaluation because they existed prior to NDA requirements. The FDA required the evaluation process for these drugs because of stability and potency problems. If drug manufacturers refuse to comply with an FDA request for evaluation, the FDA can take the products off the market. The evaluation process can be lengthy. In the case of levothyroxine drugs, the FDA evaluation process took approximately five years.

TEXAS UTILIZATION OF NON-ORANGE BOOK DRUGS

LBB staff surveyed state agencies that purchase or reimburse for drugs to estimate utilization of non-Orange Book drugs in Texas. Figure 3 shows the estimated amount Texas state agencies spent on these drugs during fiscal year 2004. Note that the cost difference of $11.5 million between brand and generic drugs as depicted in Figure 3

FIGURE 2
OTHER STATES' RESPONSES

STATE	BASIS FOR DETERMINING EQUIVALENCY OF DRUGS	ALLOW SUBSTITUTION OF DRUGS NOT INCLUDED IN THE ORANGE BOOK	HOW LONG ADDITIONAL SUBSTITUTION HAS BEEN ALLOWED
Arizona	Orange Book	No	N/A
California	United States Adopted Names (USAN)	Yes	Not Answered
Florida	Pharmacists' professional judgment	Yes	Since approximately 1979
Maine	Orange Book or Equivalent	No	N/A
Michigan	State statute – must be generically equivalent	Yes	1978
Minnesota	Pharmacists' professional judgment	Yes	Since approximately 1974
New Mexico	Orange Book	No	N/A
Ohio	State statute[1]	Yes	1981
Oregon	Orange Book[2]	Yes	1987
Texas	Orange Book	No	N/A
Virginia	Orange Book	No	N/A
Washington	Orange Book and the pharmacists' discretion	Yes	1979

NOTES:
[1]The drug used in substitution should contain identical amounts of the active ingredients.
[2]The statute does not stipulate the required source.
SOURCE: Legislative Budget Board.

FIGURE 3
PROGRAM EXPENDITURES FOR NON-ORANGE BOOK DRUGS IN FISCAL YEAR 2004 AND POTENTIAL COST DIFFERENCE FROM GENERIC SUBSTITUTION

STATE ENTITY			FISCAL YEAR 2004 EXPENDITURE FOR BRAND NAME DRUGS NOT EVALUATED IN THE ORANGE BOOK	POTENTIAL EXPENDITURE IF GENERIC SUBSTITUTION ALLOWED	COST DIFFERENCE (ALL FUNDS)
Health and Human Services Commission (HHSC)*		Medicaid	$35,363,165	$25,340,680	$10,022,486
		Children's Health Insurance Program	$1,542,759	$1,457,371	$85,388
A&M System Health Plan		Plan Participants	$331,192	$175,900	$155,292
ERS–Health Select		Health Plan	$562,307	$307,751	$254,556
		Plan Participants	$601,801	$316,220	$285,581
TRS	TRS-Active Care	Health Plan	$ 398,820	$305,923	$92,897
		Plan Participants	$349,064	$228,274	$120,790
	TRS Care	Health Plan	$ 556,680	$ 289,979	$266,701
		Plan Participants	$ 424,883	$249,034	$175,849
UT Health		Health Plan	$ 153,148	$124,752	$28,396
		Plan Participants	$115,937	$77,319	$38,618
Total for State Programs (Medicaid and CHIP) and Health Plans					$10,750,424
Total for Plan Participants					$776,130
Total					$11,526,554

*HHSC provided cost data for non-Orange Book drugs after calculating rebates for these drugs.

SOURCES: Legislative Budget Board; Employees Retirement System; Teacher Retirement System; The University of Texas; Health and Human Services Commission; Texas A&M University System.

does not equate directly to potential savings to the state programs and plan participants. Assumptions made to estimate the savings are described in the Fiscal Impact section at the end of this paper.

The records of the Employees Retirement System (ERS), the Teacher Retirement System (TRS), Texas A&M University, and The University of Texas (UT) do not include expenditures for non-Orange Book drugs in health maintenance organizations (HMOs). The drug expenditures information contained herein is based on LBB staff's compilation of a list of drugs not included in the Orange Book. Because no complete list of non-Orange Book drugs exists, some expenditures for non-Orange Book drugs may not be reflected, which makes this list a conservative estimate of current expenditures.

Cost difference varies among programs. Differing factors include drug utilization, cost difference between brand and generic drugs, and price of drugs established by each program. For example, in the Medicaid program, the drugs that have significantly contributed to the large cost difference between brand names and generics are drugs that prevent dehydration, reduce fever, and suppress cough. However, utilization rates for these drugs may differ in other programs.

The Medicaid program had the highest utilization of non-Orange Book drugs in fiscal year 2004. This is due, in part, to the various over-the-counter medications covered by Medicaid, many of which are not included in the Orange Book. Expenditures for drugs not included in the Orange Book for state programs other than Medicaid in fiscal year 2004 are relatively low. For example, in fiscal year 2004 the Texas Department of Criminal Justice spent $47,013 on non-Orange Book, brand-name drugs, and the Texas Department on Mental Health and Mental Retardation spent approximately $23,000. The Texas Department of Health did not identify expenditures for drugs not evaluated in the Orange Book.

Figure 3 shows that if additional generic substitution had been allowed, state programs and health plans could have saved $10.8 million (All Funds) in fiscal year 2004, and plan participants could have saved approximately $0.8 million. Recommendation 1 would require the Pharmacy Board to revise Title 22, Part 15, Chapter 309 of the Texas Administrative Code to allow substitution of the generic drugs that are not evaluated in the Orange Book.

Allowing the substitution of drugs not evaluated in the Orange Book does not imply that the substitution will be required. Based on the state law set in § 562.008 of the

Texas Occupations Code, a pharmacist cannot substitute drugs if a prescriber indicates on the prescription that the prescribed brand is medically necessary. Furthermore, if a prescriber does not indicate a preference, the pharmacist, based on his or her professional judgment and the patient's history, may decide that the substitution is not in the best interest of the patient.

Entities that contract with pharmacy benefit managers were able to provide data related to prescriptions in cases in which brand names were medically necessary per the physicians' instructions. Such cases are known as "dispense as written" (DAW) prescriptions. Prescriptions with the DAW indicator were not included in the analysis of the cost difference for ERS, TRS, UT, and A&M.

FISCAL IMPACT OF THE RECOMMENDATION

The recommendation in this report would result in a net General Revenue Fund savings of $3.9 million in the 2006–07 biennium. LBB staff calculated the fiscal year 2004 cost difference for state entities based on allowing additional drug substitutions. Because non-Orange Book drugs are not used extensively in other programs, the fiscal impact below represents savings to the state for the Medicaid program only. For example, in fiscal year 2004 ERS could have saved $116,078 in General Revenue Funds by allowing additional generic substitution, and TRS-Care savings could have been $136,018 in General Revenue Funds. UT savings in General Revenue Funds from additional generic substitution could have been approximately $11,074 in fiscal year 2004.

Actual savings could differ from estimates for a number of reasons. Each non-Orange Book, brand-name drug may have several generic versions available for substitution. The Health and Human Services Commission (HHSC) estimated its cost of generic drugs based on the average of the generic drugs costs. Substitution based on the lowest generic version's price could add an additional $2.7 million to the cost difference between brand-name drugs and their generic versions in the Medicaid program.

To estimate the savings in the Medicaid program shown in Figure 4, LBB staff

- used the cost difference for the Medicaid program from Figure 3;
- assumed a 1 percent reduction for prescriptions where brand-name drugs would be medically necessary; and
- assumed that substitution would take place only in 50 percent of all prescriptions.

These assumptions are consistent with Medicaid prescribing practices. LBB staff did not assume an increase in the cost of non-Orange Book drugs in fiscal years 2006 through 2010 because non-Orange Book drugs are a small subset of the total prescription drug pool, and the rate of cost increase for these drugs is unknown. The savings would be shared between the General Revenue Fund and Federal Funds.

FIGURE 4
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE NET SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE NET SAVINGS/(COST) TO FEDERAL FUNDS
2006	$1,934,841	$3,026,290
2007	$1,934,841	$3,026,290
2008	$1,934,841	$3,026,290
2009	$1,934,841	$3,026,290
2010	$1,934,841	$3,026,290

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations. To realize savings shown in Figure 4, the Pharmacy Board would need to change its administrative rules to allow additional generic substitution, and HHSC's General Revenue Fund appropriations for Vendor Drug Program would need to be reduced by $3.9 million.

CONSIDER ESTABLISHING A MULTI-STATE MEDICAID DRUG PURCHASING POOL

Many states are facing budget difficulties due, in part, to persistent escalating healthcare costs. In 2002 prescription drug spending represented 11 percent of national healthcare spending and was also one of the fastest growing components of spending, experiencing double-digit percentage growth in each of the last eight years. In Texas, drug costs represent approximately 21 percent of the total Medicaid expenditures. In fiscal year 2004, the Health and Human Services Commission spent $2.2 billion on drugs for 2.8 million Medicaid recipients. The Health and Human Services Commission projects a 19.7 percent increase in drug expenditures for the Medicaid program from fiscal year 2004 to fiscal year 2005.

States are considering a variety of cost-control measures to reduce expenditures or at least to slow the increase in spending. Texas implemented a number of cost-containment strategies after the Seventy-eighth Legislative Session. For example, House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, required the Medicaid Vendor Drug Program to establish a Medicaid preferred drug list, which according to the commission, would lead to $150.8 million in savings. Other cost-control measures implemented include supplemental rebates, prior authorization, drug utilization review, and generic drug substitution.

Other states, especially those that have smaller Medicaid populations, are looking beyond state lines to control spending. In April of 2004, the U.S. Department of Health and Human Services approved the first multi-state Medicaid drug pooling arrangement. This arrangement allowed five states initially (currently seven states) to pool their collective purchasing power to gain greater discounts on prescription drugs for Medicaid recipients.

Texas currently does not participate in a multi-state drug purchasing agreement. If Texas joined a drug pool that increased supplemental rebates by 1 percent of total drug expenditures, savings in the Medicaid program would be an estimated $25.8 million annually in All Funds beginning in fiscal year 2007.

SIGNIFICANT FINDINGS

- According to the U.S. Centers for Medicare and Medicaid Services, states that participate in multi-state arrangements are able to negotiate with drug manufacturers for lower drug prices while still maintaining control over their individual drug selection and utilization structures.
- Currently, seven states participate in the one federally approved multi-state drug pool. This pool includes more than 2.6 million beneficiaries with drug purchases exceeding $2 billion annually. Reported savings for participating states average 1.3 percent of total Medicaid prescription drug spending.
- Texas has more beneficiaries covered by the Medicaid program than the states in this drug pool combined. As a result, any multi-state drug pool would likely benefit from Texas' participation.
- Many states are exploring potential benefits of establishing multi-state programs.

SIGNIFICANT CONCERNS

- Texas, like other states, continues to experience significant increases in healthcare costs. Cost-containment measures such as multi-state drug purchasing pools can help slow cost increases for pharmaceutical drugs.
- The new federal Medicare Part D prescription drug benefit, effective January 2006, could reduce the state portion of the revenue from supplemental rebates by $37.9 million in the 2006–07 biennium.
- Establishing or joining a multi-state purchasing arrangement can require extensive preparation, including conducting analysis, negotiating with other states, issuing requests for proposals, and receiving approval of the federal government.

RECOMMENDATIONS

- **Recommendation 1:** By rider, require the Health and Human Services Commission to conduct an analysis to determine the benefit of establishing or joining a Medicaid multi-state, drug-purchasing pool and to report results of the finding to the Governor's Office and the Legislative Budget Board by January 15, 2006.
- **Recommendation 2:** Require the Health and Human Services Commission through a statutory change to Chapter 531, Government Code, to establish or join a Medicaid multi-state, drug-purchasing pool beginning in fiscal year 2007,

contingent on the results of the analysis and with the approval of the Legislative Budget Board and the Governor's Office.

COMMENTS

Under sections of the Social Security Act and as specified by the U.S. Centers for Medicare and Medicaid Services (CMS), states can establish preferred drug lists (PDLs) and decide which drugs can be placed on prior authorization (PA) lists to help reduce prescription drug costs. In addition, states can request CMS approval to enter into agreements with drug manufacturers for supplemental rebates on drugs used in Medicaid programs. Drug manufacturers are generally willing to provide states with supplemental rebates in addition to regular vendor drug rebates negotiated by the federal government, provided that their drugs are placed on PDLs and excluded from the PA requirement. A number of states have already established agreements with drug manufacturers for supplemental rebates. House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, required the Health and Human Services Commission (HHSC) to develop supplemental rebate agreements with drug manufacturers to reduce the cost of prescription drugs for the Medicaid program.

States with large Medicaid populations are typically in a more advantageous position when negotiating supplemental rebates. Some states with a smaller number of Medicaid beneficiaries have begun to look outside their borders to maximize the savings from cost-containment measures.

On April 22, 2004, the U.S. Department of Health and Human Services (HHS) approved a plan by five states to pool their collective purchasing power to gain greater discounts on prescription drugs for their Medicaid programs. This pooling initiative, known as the National Medicaid Buying Pool (NMBP), originally included the following states: Michigan, Vermont, Nevada, Alaska, and New Hampshire. According to HHS, this measure gives states participating in the multi-state arrangement an opportunity to decrease their costs by negotiating lower drug prices with drug manufacturers. The ability to purchase drugs at lower costs can improve a state's ability to continue providing critical medications to Medicaid beneficiaries. In September 2004, HHS approved plans of Minnesota and Hawaii to join the NMBP.

States that participate in the NMBP expect to achieve savings from a combination of cost-containment measures, but especially from the reduction of drug costs due to supplemental rebates. Pooling across states can lead to larger discounts on drugs that overlap in state PDLs. This is because the greater the total volume and utilization of a particular drug, the more likely that more favorable terms can be obtained from drug manufacturers in the negotiation for supplemental rebates.

Figure 1 shows statistics related to the states participating in NMBP. This data is from a number of sources including a survey of states performed by the Legislative Budget Board staff, Kaiser Family Foundation data, and Atlantic Information Services, Inc. data.

In addition, information received directly from selected states suggests that the savings from joining the pool could be higher than the estimates included in Figure 1. For example, Alaska's representatives indicated that the state could decrease Medicaid drug costs by $10 million from increased supplemental rebates and other cost containment measures.

Prior to joining the NMBP, states were at different stages of implementing cost-containment measures. For example, Michigan and Vermont were among the first states to implement PDLs and establish supplemental rebates. Other states were either in the process of establishing PDL, PA, and supplemental rebate agreements, or did not yet have supplemental rebate programs in place.

Also, some of the states in the pool already had contracts with the First Health Services Corporation (First Health), the pharmacy benefit administrator for the NMBP, prior to joining the multi-state arrangement. Other states had to issue a request for proposal, and states that awarded the contract to First Health as a result of the bidding process could request to join the existing multi-state pool.

An important consideration for the states that joined the NMBP was to decide whether they wanted to establish a single, multi-state Pharmacy and Therapeutics (P&T) committee, single PDL, and PA list, or to allow each state to maintain its independent drug evaluation process. Single PDL and PA could lead to larger cost reductions because the states would have the same concentrated utilization of drugs on the PDL to leverage in negotiations for supplemental rebates. States joining a multi-state pool with pre-existing, cost-control mechanisms, such as PDL and PA, may not necessarily experience the additional savings directly associated with those mechanisms that are realized by those states that did not have such mechanisms prior to joining. States that have already implemented cost-control measures, such PDL and PA, could still achieve significant savings by joining a purchasing pool through the collection of additional supplemental rebates obtained through enhanced negotiations with drug manufacturers.

STATES' ARRANGEMENT IN THE NATIONAL MEDICAID BUYING POOL

Currently, states that participate in the NMBP maintain their own PDL and P&T committees to evaluate drugs and

FIGURE 1
ESTIMATED SAVINGS FROM NATIONAL MEDICAID BUYING POOL

	MINNESOTA	MICHIGAN	HAWAII	NEVADA	VERMONT	ALASKA	NEW HAMPSHIRE	TOTAL
Fiscal Year 2004 Estimated Savings	$14 million	$8 million	$4.1 million	$1.9 million	$1 million	$1 million	$250,000	$30.25 million (1.3 percent of total expenditures)
Number of Beneficiaries Represented (as of federal fiscal year 2000)	596,700	1.36 million	202,900	158,500	147,800	109,000	110,200	2.68 million
Annual Medicaid Drug Expenditures in 2002	$700 million	$1.1 billion	$101 million	$78.8 million	$115 million	$70 million	$80.6 million	$2.245 billion

SOURCE: Legislative Budget Board.

determine which ones can be placed on the PDL and PA lists. Participating states report that their PDLs are similar to a large extent, but differences are needed to meet the unique needs of the population in each state's program.

States differ not only in the drug selection process but also in program policies. For example, some states collect drug co-payments from Medicaid beneficiaries while others do not. However, all states receive the same supplemental rebates negotiated by First Health.

CENTERS FOR MEDICARE AND MEDICAID SERVICES POSITION ON MULTI-STATE POOLS

Once a state decides that it wants to join the NMBP or similar multi-state Medicaid purchasing arrangement, the state has to submit a State Plan Amendment (SPA) to the CMS. The SPA has to demonstrate that the state considered a number of factors showing that care and services to the Medicaid population are provided in the best interest of those covered by the program. CMS requests that each state's PDL include drugs that are needed by different portions of the Medicaid populations, including those with the most serious health conditions, such as HIV/AIDS, mental disorders, and other conditions for which individual reaction to drugs might vary. States also have to establish a timely process for reviewing the requests for drugs placed on the PA lists.

CMS is supportive of multi-state pooling arrangements because, according to federal agency, they allow states to decrease their drug costs while permitting them to maintain control over drug selection and utilization structure.

However, CMS has indicated that there would be a limit on the number of states allowed to join this pool because the effectiveness of the pool would decrease at some point. CMS has encouraged states to look at other vendors that could establish new pools to disperse the market share to other pharmacy benefit administrators. CMS believes that states would benefit from supplemental rebates negotiated in a competitive environment.

Representatives from different states and the contractor that negotiates supplemental rebates indicate that the larger the population being represented by the pool, the more effective the pool is likely to be at reducing costs. According to First Health, the contractor that negotiates supplemental rebates for the NMBP, supplemental rebates for drugs increase as the population covered increases, up to at least nine million people. However, the inclusion of competing drugs from the same drug class could impact supplemental rebates from drug manufacturers.

OPTIONS FOR COST CONTAINMENT

The Texas Medicaid program covers approximately 2.8 million Texans who receive health and drug benefits. Texas has a larger population in its program than all the states in NMBP combined. Because Texas currently utilizes several cost-control methodologies, combining its population with the existing NMBP likely would not benefit Texas to the same extent that it would benefit the other states in the pool. By joining NMBP, Texas Medicaid program could achieve savings from additional supplemental rebates negotiated as a result of the increase in the number of

beneficiaries represented by the pool. Texas should consider joining an existing pool or establishing a new multi-state pool and exploring several options for identifying other states to cooperate with:

- **Option 1:** Texas Medicaid staff could analyze the potential for cooperation with states with populations similar in size to Texas and that have the same contractor for managing supplemental rebates. This option would give the state the opportunity to establish a multi-state drug purchasing arrangement without a new bidding process.
- **Option 2:** Staff in the Medicaid program could also analyze PDL selection and drug utilization in the states that have a different contractor but are similar in drug utilization and size. If it is determined that the state would benefit from cooperating with states with a different contractor for supplemental rebates, the Texas Medicaid program and the selected state, or states, would have to issue a RFP for a new supplemental rebate management vendor. The states would have to work through a number of administrative issues that include evaluation of the existing PDLs, work of the P&T committees, and application to CMS for establishment of the multi-state arrangement among others.

Recommendation 1 requires HHSC to identify other states that could be included in a Medicaid multi-state drug pool. HHSC staff would have to analyze similarities of drug utilization in comparable states. If states do not have many common drugs included on the PDL, it is likely that they would not benefit from a pooling arrangement. In addition, recommendation 1 requires HHSC to report the results of the analysis to the Legislative Budget Board and the Governor's Office by January 15, 2006.

The following rider that requires HHSC to conduct an analysis to determine the cost-benefit and feasibility of a multi-state, drug-purchasing arrangement was added to the introduced version of the 2006–07 General Appropriations Bill:

> **Analysis of Multi-state Medicaid Drug Purchasing Pool.** Out of funds appropriated above in Strategy B.2.2 Medicaid Vendor Drug Program, the Health and Human Services Commission shall conduct an analysis to determine the cost-benefit and feasibility of establishing or joining a multi-state Medicaid drug-purchasing pool. Analysis shall include the identification of other states with which pooling of Medicaid drug purchasing provides the greatest opportunity to achieve savings in Texas. The Commission shall report the results of this analysis to the Legislative Budget Board and the Governor not later than January 15, 2006.

HHSC may not be able to quantify the amount of savings the Medicaid program could achieve prior to establishing or joining a multi-state arrangement because the savings will depend on the negotiations with drug manufacturers. Currently, the HHSC staff estimates that supplemental rebates reduce drug expenses by approximately 6 percent. In the 2006–07 biennium, supplemental rebates are expected to decrease due to the implementation of the Medicare Part D prescription drug benefit. Based on the estimate for supplemental rebates in fiscal year 2005, state portion of the supplemental rebates will decrease by at least $37.9 million in the 2006–07 biennium. If Texas increases supplemental rebates by 1 percent as a result of entering into a multi-state drug pool, savings in the Medicaid program would total $25.8 million in All Funds annually. This level of savings is consistent with other states' experience in the NMBP.

Recommendation 2 calls for a statutory change to Chapter 531 of the Government Code to require HHSC to establish a Medicaid multi-state, drug-purchasing pool in fiscal year 2007 with the approval of the Legislative Budget Board and the Governor's Office, if analysis demonstrates that it would benefit Texas.

FISCAL IMPACT OF THE RECOMMENDATIONS

There is no significant fiscal impact associated with completing the recommended analysis. Existing HHSC staff would conduct the analysis to determine what arrangement would be most beneficial to Texas Medicaid program and proceed with the establishment of the multi-state arrangement with approval of the Legislative Budget Board and the Governor's Office on the state level and the CMS on the federal level.

The introduced 2006–07 General Appropriations Bill includes a rider authorizing HHSC to use appropriations to conduct the analysis to determine the cost-benefit and feasibility of establishing or joining a multi-state, drug-purchasing pool. The introduced bill does not include any other adjustments as a result of these recommendations.

EXPAND THE USE OF LESS COSTLY ALTERNATIVES FOR LONG-TERM CARE

According to the U.S. Census Bureau, 9.8 percent of the Texas population is 65 years and older. The U.S. Census also reports this segment of the Texas population grew by 355,956 persons from 1990 to 2000, a 20.7 percent increase over the course of the decade. Current trends indicate that aging and disabled Texans choose assisted living facilities, home-and community-based services, or adult day care facilities over nursing facilities for long-term care. Improved pharmaceuticals and medical technology contribute to the growth in home-based care by allowing individuals more flexibility in managing their illnesses or disabilities at home. The combination of a growing aged and disabled population, medical science, and technology improvements are changing the types of services and settings that Texans choose for their care.

The Medicaid program known as State of Texas Access Reform + PLUS, a managed, long-term-care pilot program in Harris County, has been successful in holding down costs. The Health and Human Services Commission reported in September 2004 that, when compared to Medicaid fee-for-service programs in Texas, State of Texas Access Reform + PLUS saved $23.2 million in General Revenue Funds during the 2004–05 biennium.

SIGNIFICANT FINDINGS

- The number of clients residing in Texas nursing facilities decreased more than 7 percent from 1999 through 2003. Assisted living facility residents in the Texas Medicaid program increased by more than 51 percent from 1999 through 2003.
- Clients receiving adult day-care services increased in Texas by more than 53 percent from 1999 through 2003.
- To meet consumer demand, over 257 new home- and community-based provider agencies opened in Texas from 2001 to 2003.
- The Health and Human Services Commission is planning an expansion of State of Texas Access Reform + PLUS from one to eight urban areas beginning in September 2005. The commission estimates the expansion will save approximately $73.0 million per year in General Revenue Funds once the program is fully developed. Assuming a phase-in of the expansion in fiscal year 2006, savings in General Revenue Funds would total an estimated $109.5 million for the 2006–07 biennium.

SIGNIFICANT CONCERN

- The Texas long-term care client caseload makes up less than 20 percent of Medicaid recipients but represents approximately 59 percent of costs for the entire state Medicaid budget.

RECOMMENDATION

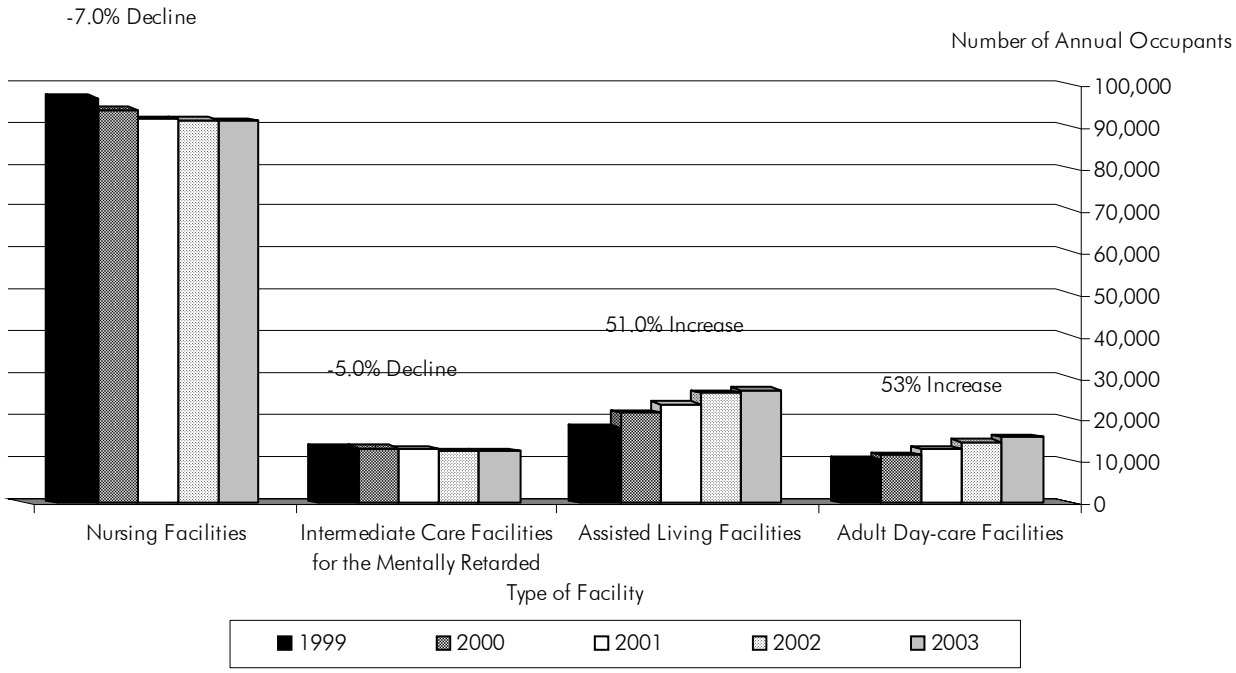
- Expand the less costly State of Texas Access Reform + PLUS managed long-term care program during the 2006–07 biennium and adjust appropriations to the Health and Human Services Commission and the Department of Aging and Disability Services for the 2006–07 biennium to reflect a savings of $109.5 million in General Revenue Funds.

COMMENTS

A June 2004 report from the Texas State Data Center at The University of Texas at San Antonio states that the population of persons 65 years of age or older was approximately 2.1 million in 2000 and predicts that it could grow as high as 8.2 million by 2040, an increase of more than 295 percent. According to U.S. Census data for the year 2000, persons in Texas age 65 and older made up nearly 10 percent of the state's population. The growth in alternative health care services and the increased demand for them have forced states to look for solutions and cost savings using nontraditional models.

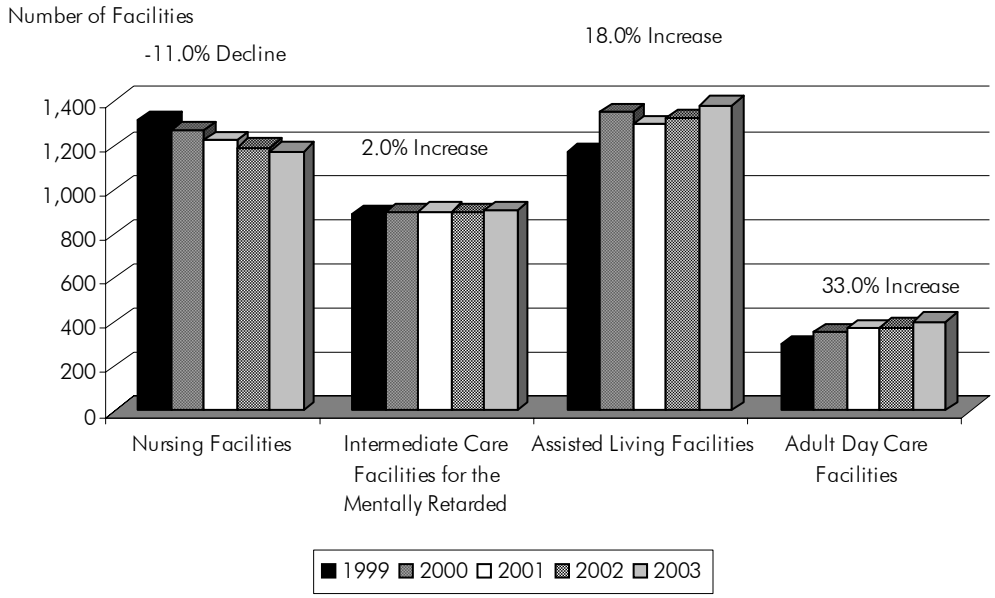
According to the Department of Aging and Disability Services' (DADS) Long-term Care Facilities Report for fiscal year 2003, the number of clients residing in Texas nursing facilities decreased 7 percent from fiscal years 1999 to 2003, while the number of clients residing in assisted living facilities or receiving adult day care increased 51 percent and 53 percent, respectively, during the same period (see Figure 1). The decline in nursing facilities operating in Texas is shown in Figure 2. The number of nursing facilities decreased 11 percent from fiscal years 1999 to 2003, while assisted living facilities increased 18 percent, and the number of adult day-care facilities rose 33 percent. Also, in order to meet consumer demand, the number of home- and community-based service agencies increased from 1,833 agencies in fiscal year 2001 to 2,090 agencies in fiscal year 2003.

FIGURE 1
LONG-TERM CARE OCCUPANT UTILIZATION TREND, FISCAL YEARS 1999 THROUGH 2003



NOTE: Figure reflects percentage increase or decrease in annual occupant utilization.
SOURCE: Department of Aging and Disability Services.

FIGURE 2
LONG-TERM CARE FACILITY TRENDS, FISCAL YEARS 1999 THROUGH 2003



NOTE: Chart reflects percentage decline or increase over a five-year period.
SOURCE: Department of Aging and Disability Services.

These trends correspond with changing health service requirements of the aged and disabled population in Texas as well as changes in program policy and structure at the state level. The trends reflect consumer-driven choices by aged and disabled persons who prefer to avoid institutionalization and live as independently as possible for as long as possible. Healthcare equipment and communication technology have made these options possible and continue to drive demand for consumer-driven alternatives to nursing home care. Several states encourage assisted living to reduce costs and serve as a substitute for nursing home care to persons who prefer more independent living. The average cost per person per month is approximately $1,083 for assisted living services in the Texas Medicaid program. Figure 3 compares services for various types of long-term care facilities.

FIGURE 3
SERVICE COMPARISON OF LONG-TERM CARE FACILITIES

TYPE OF SERVICE	SERVICES PROVIDED
Nursing Facilities	Facilities provide diagnosis, treatment and care, room and board. Clients may receive three consecutive therapeutic leave days.
Intermediate Care Facilities for the Mentally Retarded (ICF-MR)	Facilities provide diagnosis, treatment, and rehabilitation of persons with mental retardation. Clients receive 10 therapeutic leave days per year.
Assisted Living Facilities	Assisted living provides personal care, food, and shelter in one or more facilities. Assisted living services enhance a person's ability to age in place in a residential setting while receiving increasing or decreasing levels of services, as the person's needs change.
Hospice	Facilities provide nurse visits, home health aide visits, medical equipment, supplies, and appliances. Coverage is for two 90-day periods and one 30-day period with additional periods as necessary.

SOURCE: Department of Aging and Disability Services.

HOME- AND COMMUNITY-BASED SERVICES AND CONSUMER-DIRECTED CARE

Community care programs provide services in or out of the home to the aged and disabled populations as alternatives to institutionalization. Some services have waiting lists, and some are available only in certain parts of the state. DADS manages community-based services for approximately 70.6 percent of long-term-care program clients. Medicaid waiver services, which provide an array of services designed specifically for targeted groups of individuals, are limited to a fixed number of clients. Long-term-care clients in community-based services increased 6.2 percent from fiscal year 2000 through 2004. Figure 4 reflects trends in long-term-care caseloads for community-based services. Figure 5 describes the array of services available in the community.

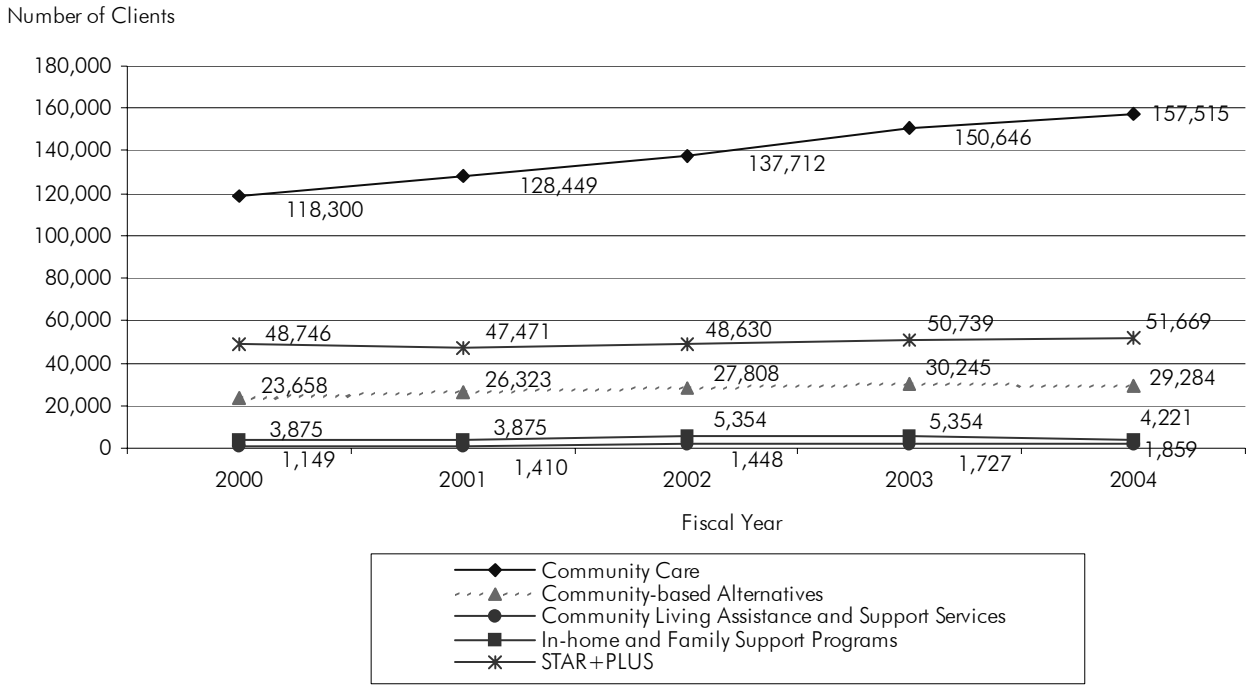
Consumer-directed services were authorized as a Medicaid service in Texas by Senate Bill 1586, passed by the Seventy-sixth Legislature, 1999. Texas entered the era of consumer-directed services in October 2002, after the Centers for Medicare and Medicaid Services approved the state's plan, which allows disabled persons to receive vouchers for home- and community-based services. Services are provided through six different DADS programs, and funding is provided by three sources: General Revenue Funds; Federal Medicaid Funds; and Social Services Block Grant Funds. Figure 6 lists the six programs in Texas that offer consumer direction as an option and identifies the funding mechanisms for each.

Prior to the implementation of the consumer-directed services program, the Health and Human Services Commission (HHSC) had already started implementation of a long-term care reform plan. The plan, called "Promoting Independence," was originally delivered to the Texas Legislature in January 2001. Phase one required educating nursing home residents about community-based alternative programs, collecting basic data on nursing home residents, training department staff, and making the general public aware of the new community options program. Phase two, implemented from September 2001 to September 2003, included recruiting and training relocation workers, developing an assessment tool and identification system, starting a data tracking system, and developing a community education program. Phase three provided preadmission screening in rehabilitation centers and hospitals to inform clients of community-based alternative programs. HHSC has formed a workgroup to evaluate quality of care, utilization, and cost-effectiveness of the program. HHSC is expected to report the workgroup's findings in fiscal year 2005.

COSTS FOR PROVIDING LONG-TERM-CARE SERVICES

Long-term care has historically been the largest expenditure within the Medicaid program. Although the long-term care population makes up less than 20 percent of the Medicaid caseload, in fiscal year 2003, DADS reported $8.1 billion in Medicaid expenditures from All Funds for long-term care, which is approximately 59 percent of the entire Medicaid budget (see Figure 7). The National Association of State Budget Officers and the National Governors

FIGURE 4
AVERAGE MONTHLY CASELOADS FOR SELECTED LONG-TERM CARE COMMUNITY-BASED SERVICES FISCAL YEARS 2000 THROUGH 2004



SOURCE: Department of Aging and Disability Services.

FIGURE 5
COMPARISON OF HOME- AND COMMUNITY-BASED CARE PROGRAMS

TYPE OF SERVICE	SERVICES PROVIDED
Home Health Services	Nurse visits; home health aide visits; medical equipment, supplies and appliances; physical and occupational therapy; speech pathology; and audiology services.
Adult Day-care	Adaptive aids; adult foster care; assisted living; nursing services; home-delivered meals, medical care;attendant care, medical supplies; home modifications; respite care; therapies; and emergency response.
Targeted Case Management	Coordination of necessary medical, social, educational care, and other services.
Community-based Alternatives	Adult day-care; adaptive aids; adult foster homecare; assisted living; nursing services; home-delivered meals; medical care; attendant care; medical supplies; home modifications; respite care; therapies; and emergency response.
Community Living Assistance and Support Services	Adaptive aids; medical supplies; case management; minor home modifications; occupational therapy; personal assistant services; physical therapy; respite care; speech pathology services; specialized therapy; psychological services; and nursing services.
Program of All-inclusive Care for the Elderly (PACE)	Inpatient care; outpatient medical care; specialty services (including dentistry and podiatry); social services; in-home care; meals; and transportation.
Home-and Community-based Services	Minor home modifications; medical, surgical, therapeutic, diagnostic, and other health services; counseling and training programs; attendant care; respite care; transportation services; room and board costs incurred by the client or family members during evaluation or treatment; and other approved disability-related services.

SOURCE: Department of Aging and Disability Services.

FIGURE 6
PROGRAMS AT DADS OFFERING CONSUMER-DIRECTED SERVICES

PROGRAM	FUNDING SOURCE
Community-based Alternatives	General Revenue Funds and Federal Medicaid
Community Living Assistance and Support Services	General Revenue Funds and Federal Medicaid
Deaf-Blind-Multiple Disability Waiver	General Revenue Funds and Federal Medicaid
Primary Home Care	General Revenue Funds and Federal Medicaid
Consumer Managed Personal Assistance	General Revenue Funds and Federal Social Services Block Grant
In-home and Family Support Programs	General Revenue Funds

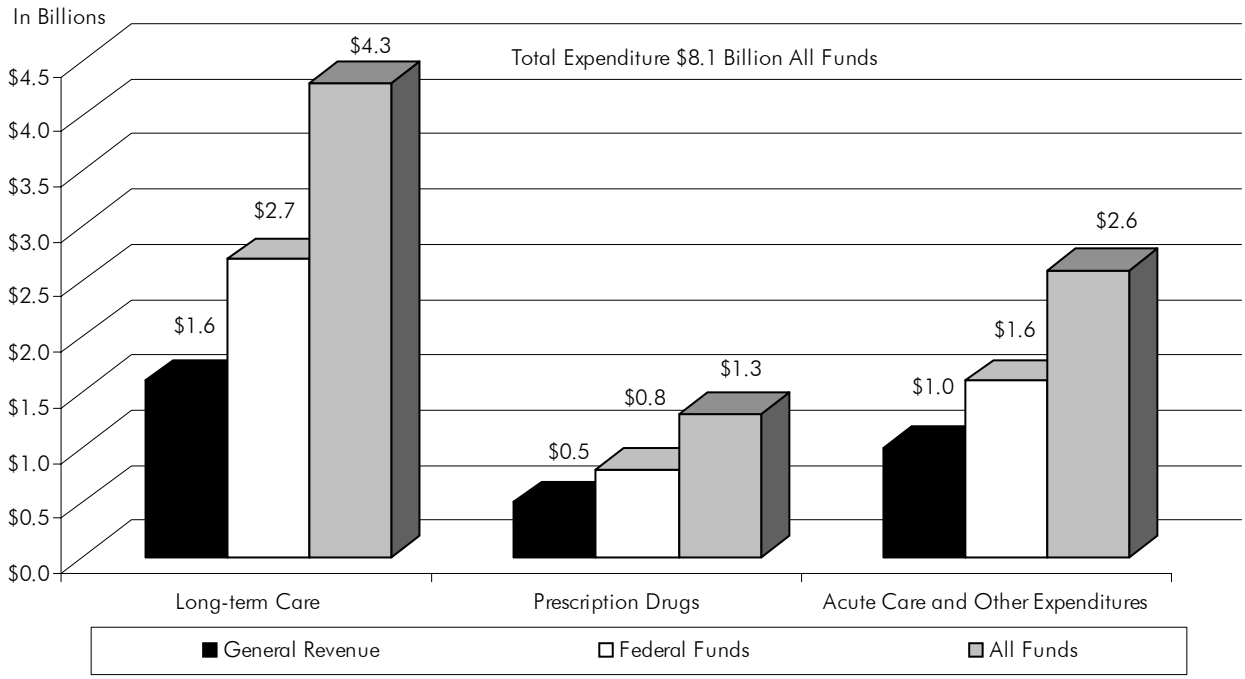
SOURCE: Health and Human Services Commission.

Association report that Medicaid costs increased by an average of 8 percent, faster than any other area of state spending in fiscal year 2003. Program and service costs in long-term-care facilities and community-based care vary depending on a variety of factors, including services provided, age and degree of illness or disability of the target population, and the availability of health professionals and healthcare assistants. A comparison of costs related to various long-term-care services is provided in Figure 8.

THE SUCCESS OF STAR+PLUS

Among the more successful of Texas' long-term-care programs is the State of Texas Access Reform + PLUS program (STAR+PLUS), the state's managed long-term care program, which is operated by HHSC. Implemented in fiscal year 1998, STAR+PLUS is a Medicaid pilot project, integrating delivery of acute and long-term-care services through a managed-care system. In April 2004, HHSC reported the Harris County caseload to be over 59,000 members. The program includes all Medicaid medical and supportive services, paying a fixed amount per person per month and contracting with commercial managed-care plans. Community-based alternative services are expected to be incorporated in the plan in the 2006–07 biennium.

FIGURE 7
MEDICAID LONG-TERM CARE EXPENDITURES FOR THE AGED AND DISABLED POPULATION FISCAL YEAR 2003



SOURCE: Department of Aging and Disability Services.

FIGURE 8
SELECTED PERFORMANCE MEASURES, DADS LONG-TERM CARE PROGRAM
FISCAL YEARS 1999 THROUGH 2004

	EXPENDED			ESTIMATED	
TYPE OF SERVICES	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
Nursing Facility Clients (monthly average)	64,630	65,016	64,447	65,541	66,786
Average Monthly Cost of Care	$1,954	$2,051	$2,317	$2,313	$2,196
Hospice Clients (monthly average)	2,074	2,648	3,077	3,576	3,995
Average Monthly Cost of Care	$1,783	$1,860	$2,079	$2,093	$2,082
Percentage of Long-term Care Clients Served in Community Settings	64.4%	66.6%	68.4%	70.0%	70.6%
Community Care Clients (monthly average)	118,300	128,449	137,712	150,646	157,515
Average Monthly Cost of Care	$614	$645	$690	$739	$657
Community-based Alternatives Clients (monthly average)	23,658	26,323	27,808	30,245	29,284
Average Monthly Cost of Care	$1,062	$1,124	$1,191	$1,269	$1,223
Community Living Assistance and Support Services (monthly average)	1,149	1,410	1,448	1,727	1,859
Average Monthly Cost of Care	$2,364	$2,634	$2,634	$2,634	$2,634
In-home and Family Support Program Clients (monthly average)	3,875	3,875	5,354	5,354	4,221
Average Monthly Cost of Care	$140	$140	$140	$140	$79
STAR+PLUS Aged and Medicare-eligible Clients (monthly average)	26,765	26,359	27,312	27,844	29,097
Average Monthly Cost of Care	$234	$159	$177	$200	$183
STAR+PLUS Disabled and Blind Clients (monthly average)	21,981	21,112	21,318	22,895	22,572
Average Monthly Cost of Care	$672	$657	$652	$666	$642

SOURCE: Department of Aging and Disability Services.

The program requires two waivers from the federal government:

- A 1915(b) waiver allows the state to limit client choice of providers and to mandate that certain Medicaid clients participate in managed care. The federal government also waives the requirement that state Medicaid policies apply uniformly to all Medicaid clients in the state.
- A 1915(c) waiver allows the state to limit home and community-based services to certain Medicaid clients who would otherwise require nursing home or other forms of institutionalized care.

An independent evaluation of the program's first two years of operation from February 2000 to January 2002 found cost savings of about $93 per member per month, a 17 percent savings when compared to fee-for-service, long-term care. During the Seventy-seventh Legislative Session in 2001, a variety of Medicaid workgroup recommendations were introduced to reform Texas Medicaid in Senate Bill 1156. Among the recommendations was a proposal to expand STAR+PLUS to other areas of the state.

The fiscal year 2003 encounter data of STAR+PLUS from participating health plans showed an increased use of preventive and support services, including a 32 percent increase in attendant care and a 38 percent increase in adult day-care. The Institute for Child Health Policy completed a study of STAR+PLUS in 2003 and reported a 28 percent reduction in hospital admissions, reduced emergency room visits, high customer satisfaction levels, and good quality of care. This study also showed high ratings in customer satisfaction and quality of care. Members rated their health management organizations 8.2 on a 10-point scale.

In fiscal year 2004, the program's projected average cost per person per month was approximately $183 for persons dually eligible for Medicare and Medicaid, and $642 per person per month for disabled and blind persons. HHSC reported in September 2004 that, when compared to

Medicaid fee-for-service, long-term-care services, STAR+PLUS saved $23.2 million in General Revenue Funds in the 2003–04 biennium. These cost savings reflect a 6.5 percent savings over Medicaid fee-for-service costs in Harris County.

Beginning in fiscal year 2005, HHSC plans to expand STAR+PLUS to seven additional urban areas: Bexar, Dallas, El Paso, Lubbock, Nueces, Tarrant, and Travis. Forecasting assumptions from HHSC indicate that expansion of STAR+PLUS will increase its client population by approximately 214,874 persons in fiscal year 2006 (over 38.2 percent of the eligible long-term-care population). Acute care funds will be combined with funds for community support services, and a discount of 6 percent will be applied to guarantee a savings to the state. Based on HHSC estimates, a fiscal analysis of the STAR+PLUS expansion assumes a savings of approximately $73 million per year in General Revenue Funds in a mature program. The Legislative Budget Board estimates savings of $36.5 million in fiscal year 2006 and $73.0 million in fiscal year 2007 for a total of $109.5 million for the biennium. It is recommended that appropriations for HHSC and DADS in the introduced 2006–07 General Appropriations Bill be adjusted to reflect these projected savings.

DEMAND FOR DIRECT SERVICE HEALTHCARE WORKERS

A major factor that will impact long-term-care policy and funding in coming years is a shortage of staffing. According to a study conducted in 2004 by the Health Policy Institute of Georgetown University and the Kaiser Commission on Medicaid and the Uninsured, national statistics show that 78 percent of adults receiving long-term care at home rely on unpaid help, 8 percent on paid assistance, and 18 percent on a combination of paid and unpaid help. Families are an important part of any long-term-care program, even when services are purchased. Long-term care is hands-on assistance provided by skilled persons who assist people who need help with fundamental daily activities such as bathing or eating over a significant period of time. This type of assistance is labor intensive and is provided by family, friends, and volunteers, as well as hired personnel.

The U.S. Bureau of Labor Statistics predicts a 39 percent growth in direct service worker occupations over the next 10 years. Aging baby boomers are only a part of the reason for this phenomenon. A recent federal program called the Demonstration to Improve the Direct Service Community Workforce provided grant recipients the opportunity to develop and implement pilot programs that offer strategies for the recruitment and retention of direct-care service workers. It will be critical for the state to work with the public and private sectors to insure that the supply of paid and volunteer caregivers meets the demand. Figure 9 shows a summary of suggestions from the demonstration projects provided by the Centers for Medicare and Medicaid Services.

FIGURE 9
RECRUITMENT AND RETENTION STRATEGIES FOR DIRECT SERVICE CAREGIVERS

- Health insurance for workers
- Career ladder programs or incremental step increases
- Training and education programs
- Supervisory training
- Normal fringe benefits such as vacation
- Providing culturally competent services such as language classes and childcare
- Assistance with transportation, especially in rural areas

SOURCE: The Centers for Medicare and Medicaid Services.

WHAT OTHER STATES ARE DOING

Minnesota has one of the most ambitious long-term-care efforts in place. During fiscal years 2002 and 2003 the Minnesota Legislature passed legislation creating a new comprehensive framework for the state's long-term-care system. Reforms established in 2003 include a plan to create health insurance options, such as the inclusion of long-term care in Medicare supplemental plans. Another initiative is a family care program whereby families receive incentives to provide care or pay for care through special loans.

The Minnesota Legislature appropriated $183 million for long-term-care reforms in fiscal years 2002 and 2003. Of that amount, $108 million provided cost-of-living increases for employees of nursing facilities and continuing care providers. More than $75 million was invested in expanding home- and community-based service options. Increased spending was partially offset by reducing the number of nursing home beds by 5,100.

Maine reformed its long-term care program in fiscal years 2001and 2002 to reduce state costs in acute long-term care and nursing facilities. Clients once fearful of ending up in nursing homes enrolled in the new program to receive services in their own homes. Demand for the program outstripped resources, despite a reduction in nursing home bed use. The high demand for consumer-directed and home-based care caught state officials off guard, and the program had to be re-engineered to properly screen client access to care at various levels in the continuum of care.

According to the 2000 census, Maine has a small population of 1.3 million and has one of the fastest growing elderly populations in the country, with 14.4 percent of its population aged 65 and older. Medicaid spending for long-term care in Maine was $411 million in fiscal year 2001,

accounting for approximately one-third of all Medicaid spending in the state. Between 1995 and 2001 Maine expanded its use of Medicaid's home-and community-based waiver program to reduce reliance on institutional care. During that time the percentage of public, long-term-care funding devoted to these facilities decreased from 84 percent to 61 percent. To gain control on over capacity and costs, Maine adopted new certificate of need rules on September 1, 2004. These rules place new restrictions on the certification of hospital swing beds, licensed nursing home beds, and the construction, development or establishment of any new, expanded, or replaced nursing facility. Hospice programs, assisted living facilities, and home healthcare programs are exempted from the new rules.

FISCAL IMPACT OF THE RECOMMENDATION

The STAR+PLUS, long-term care managed-care pilot has demonstrated the ability to contain costs better than traditional fee-for-service models, reflecting $23.2 million in General Revenue Fund savings in the 2004–05 biennium. HHSC estimates that $73.0 million per year in General Revenue Funds could be saved in a mature program by expanding STAR+PLUS to other urban areas of the state. This fiscal analysis assumes that the expansion would be phased in during fiscal year 2006 at a rate to achieve $36.5 million in General Revenue Fund savings for that fiscal year (see Figure 10).

FIGURE 10
FIVE-YEAR FISCAL IMPACT OF THE STAR+PLUS EXPANSION

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS
2006	$36,500,000	$56,350,000
2007	$73,000,000	$111,700,000
2008	$73,000,000	$111,700,000
2009	$73,000,000	$111,700,000
2010	$73,000,000	$111,700,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill reflects $109.5 million in General Revenue Fund savings provided for by the report recommendation.

EXPAND THE USE OF THE LONG-TERM CARE QUALITY ASSURANCE FEE

Texas, like other states, faces challenges to fund and sustain health programs for the elderly and disabled. Despite recent implementation of healthcare cost-control strategies, the cost for treatment of the elderly population in long-term care continues to rise. Texas' Medicaid spending in 2003 totaled approximately $15 billion. The majority of Medicaid expenditures provide care for the aged and disabled population. Medicaid payments for acute care of the aged and disabled totaled $2.6 billion in fiscal year 2003. Medicaid payments for long-term care of the aged and disabled totaled $4.3 billion in fiscal year 2003, $1.7 billion of which consisted of payments to Texas nursing facilities. Approximately two-thirds of nursing home patients in Texas are Medicaid recipients, not including those patients (known as "dual-eligibles") that receive both Medicare and Medicaid.

The quality assurance fee is presently assessed on public and private intermediate care facilities for the mentally retarded. If the assessment is allowed to expire in 2005, approximately $103 million in General Revenue–Dedicated Funds and $155 million in Federal Funds will be lost in the 2006–07 biennium, requiring replacement of state revenue to maintain services.

Expanding the assessment of the quality assurance fee to include nursing homes and accessing additional federal matching funds with the new revenue could provide relief from the fiscal constraints facing long-term care and the Medicaid program in Texas. Based on a model considered in 2001, the net biennial revenue estimate from a 6 percent assessment on nursing home gross receipts would yield approximately $347.5 million, after taking into account the state's share of a Medicaid rate offset. If all of the net nursing home quality assurance fee funds were to be used as state match, an additional $533.9 million in Federal Funds could be obtained in the 2006–07 biennium.

SIGNIFICANT FINDINGS

- The quality assurance fee currently levied on public and private intermediate care facilities for the mentally retarded sunsets on September 1, 2005, and without legislative action, will expire on that date.
- At least 33 states currently levy a provider tax on nursing homes. Assessments on nursing homes have been the most frequently imposed provider tax in the previous two years. The number of states enacting assessments on nursing homes has doubled during that period.

SIGNIFICANT CONCERNS

- Expiration of the quality assurance fee assessment in fiscal year 2005 would result in a revenue loss in the 2006–07 biennium and would require a replacement of General Revenue Funds to maintain current services.
- Texas does not currently assess the quality assurance fee to nursing homes. Applying the quality assurance fee to nursing homes in Texas at a rate of 6 percent of gross receipts could generate approximately $347.5 million in the 2006–07 biennium, after taking into account the state's share of a Medicaid rate offset. Approximately 94 percent of the revenue would come from assessments on the gross receipts of nursing homes participating in the Medicaid program.

RECOMMENDATIONS

- **Recommendation 1:** Continue the quality assurance fee currently levied on public and private intermediate care facilities for the mentally retarded. Doing so would require amendment of § 252.209, Health and Safety Code, relating to legislative review and expiration.
- **Recommendation 2:** Consider expanding the quality assurance fee to nursing homes. Such an expansion would require a statutory change.

COMMENTS

Texas currently levies a provider tax in the form of the quality assurance fee (QAF) on intermediate care facilities for the mentally retarded (ICF-MRs), including community mental health and mental retardation centers, and facilities administered by the Department of Aging and Disability Services (DADS) (state schools). Provisions governing the application of the QAF in Texas, first enacted in Senate Bill 1839, Seventy-seventh Legislature, 2001, can be found at Subchapter H, Chapter 252, Health and Safety Code. Key provisions of the statute are as follows:

- requires the Health and Human Services Commission (HHSC) to set the quality assurance fee for

each day in an amount that produces annual revenue less than or equal to 6 percent of a facility's total annual gross receipts;

- provides that the QAF is an allowable cost for reimbursement under the Medicaid program (This means that providers may report the assessment to the state as a cost eligible for reimbursement by Medicaid.);
- authorizes HHSC, subject to legislative appropriation and state and federal law, to use money in the quality assurance fund, together with any federal money available to match that money;
  - to offset expenses incurred to administer the QAF;
  - to increase reimbursement rates paid under the Medicaid program to facilities or waiver programs for persons with mental retardation; or
  - for any other health and human services purpose approved by the governor and Legislative Budget Board.
- prohibits the increased Medicaid reimbursement paid to a facility to be based solely on the amount of the QAF paid by that facility unless authorized by certain federal provisions; and
- requires the Seventy-ninth Legislature to review the operation and effectiveness of Subchapter H and provides that, unless continued by the Seventy-ninth Legislature, the subchapter and the QAF expire September 1, 2005.

COST OF QAF EXPIRATION

DADS reports that $20.9 million in QAF revenue was collected in fiscal year 2002, $51.1 million in fiscal year 2003, and $51.9 million in fiscal year 2004. DADS projects QAF revenue in the amount of $54.7 million in fiscal year 2005, when collections are projected to exceed appropriation by $5.5 million.

QAF funds are currently used to finance ICF-MR and state school services. Approximately $98.4 million in QAF revenue is appropriated to the Texas Department of Mental Health and Mental Retardation for the 2004–05 biennium, and $100.9 million is recommended for appropriation to DADS in the introduced version of the 2006–07 General Appropriations Bill. Those funds would be used to draw down $155.0 million in Federal Funds. Expiration of the QAF assessment in 2005 would result in a revenue loss of $258.0 million in All Funds in the 2006–07 biennium and would require replacement of General Revenue Funds to maintain current services. Approximately 99 percent of ICF-MR patients are Medicaid recipients. A reduction in appropriations for these services could significantly impact ICF-MR providers. Recommendation 1, the continuation of the QAF assessment to ICF-MRs and state schools, would have the positive fiscal impact summarized in Figure 1.

APPLYING THE QAF TO NURSING HOMES

Assessment of the QAF to nursing homes was contemplated at the time of the original enactment of the fee in Texas. Several bills considered by the Seventy-seventh Legislature, 2001, provided for the assessment of the QAF to nursing homes.

Based on an assessment of 6 percent on the gross receipts reported by nursing facilities (a 6 percent assessment is the threshold used in the federal hold harmless test and the assessment contemplated in Texas in 2001), estimated funds collected from expanding the QAF to nursing homes

FIGURE 1
CONTINUATION OF THE ICF/MR AND STATE SCHOOL QUALITY ASSURANCE FEE

FISCAL YEAR	PROBABLE REVENUE GAIN/ (LOSS) TO GENERAL REVENUE–DEDICATED FUNDS (QUALITY ASSURANCE)	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE–DEDICATED FUNDS (QUALITY ASSURANCE)	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS
2006	$51,500,000	($50,400,000)	$77,800,000	($77,800,000)
2007	$51,500,000	($50,500,000)	$77,200,000	($77,200,000)
2008	$51,500,000	($50,500,000)	$77,200,000	($77,200,000)
2009	$51,500,000	($50,500,000)	$77,200,000	($77,200,000)
2010	$51,500,000	($50,500,000)	$77,200,000	($77,200,000)

SOURCE: Legislative Budget Board.

could total approximately $226 million a year. Of those funds, approximately 94 percent of the revenue would come from assessments on the gross receipts of Medicaid-participating nursing homes.

For the purpose of estimating the fiscal impact of Recommendation 2, it is assumed that the assessment, like the current QAF, would be designated as an allowable cost. Therefore, revenue collected would be reduced by the state share of an adjustment to nursing home reimbursement rates to be paid back to providers to cover the cost of the fee associated with Medicaid patients (Medicaid rate offset). Based on that assumption, approximately $132.8 million is reimbursed to Medicaid-participating facilities in fiscal year 2006, $52.2 million in state funds, and $80.6 million in Federal Funds. The resulting net biennial revenue estimate from the assessment of the QAF to nursing homes is approximately $347.5 million, after reducing for the state's share of the above Medicaid rate offset.

If all of the $347.5 million net nursing home QAF funds were to be used as state match, an additional $533.9 million in Federal Funds could be gained in the 2006–07 biennium. Recommendation 2, the expansion of the QAF assessment to nursing homes, would have the positive fiscal impact summarized in Figure 2.

WHAT OPPONENTS AND PROPONENTS SAY

At the center of the debate is state establishment of nursing home reimbursement rates for services provided to Medicaid patients. The repeal of the federal Boren Amendment in 1997 removed the requirement that state nursing home reimbursement rates be "reasonable and adequate" and instead allowed for a "public process" requirement, including publication of proposed rates and calculating methodologies for review and comment by providers and beneficiaries. (In Texas, HHSC is granted broad authority to set rates in accordance with HHSC rule, applicable state and federal law, economic conditions, and available levels of appropriated state and federal funds.)

States argued that the prior provision tied their hands, forcing them to spend too much on nursing homes at the expense of other services. Nursing homes argued that without the requirement, state budget pressures, not the cost of care, would be the driving force in determining reimbursement rates. While states focus on managing difficult economic conditions, including implementation of cost-control measures and benefit and eligibility reductions, the nursing home industry faces rising costs due to mandated staff training and ratios, increased salaries and benefits to hire and retain quality staff, and high liability insurance costs, among other issues.

States that have imposed nursing home provider taxes have generally done so to provide relief to the nursing home industry in a time of Medicaid cutbacks. Proponents argue the following:

- The revenues and enhanced federal matching assistance are necessary for nursing homes to meet the actual costs of providing care to Medicaid recipients.
- Increased funding allows nursing homes to improve the quality of care they provide through, among other measures, increased staffing and training to meet standards set by both state and federal regulations.
- Evidence suggests that lower Medicaid payment rates are associated with poorer nursing home quality and diminished access to nursing home care for Medicaid recipients.

Opponents argue that provider taxes place an unfair burden on nursing homes that serve a small number of

FIGURE 2
ASSESSMENT OF QAF TO NURSING HOMES

FISCAL YEAR	PROBABLE REVENUE GAIN/ (LOSS) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS (MEDICAID RATE OFFSET)	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS (MEDICAID RATE OFFSET)	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS (MEDICAID RATE OFFSET)
2006	$226,200,000	($52,200,000)	$80,600,000	($80,600,000)
2007	$226,300,000	($52,800,000)	$80,800,000	($80,800,000)
2008	$226,300,000	($52,800,000)	$80,800,000	($80,800,000)
2009	$226,300,000	($52,800,000)	$80,800,000	($80,800,000)
2010	$226,300,000	($52,800,000)	$80,800,000	($80,800,000)

SOURCE: Legislative Budget Board.

Medicaid patients. Arguments asserted by opponents include the following:

- Private-pay patients and the nursing homes with few or no Medicaid patients share the burden of the tax, but they argue that little or nothing is returned to them through increased Medicaid reimbursements.
- Burdening patients using personal assets and income to pay for nursing home care hastens them towards Medicaid eligibility, thereby increasing the roles of state and federally assisted patients.
- Provider tax mechanisms, although legal, unduly shift the balance of the financial burden for the Medicaid program to the federal government.

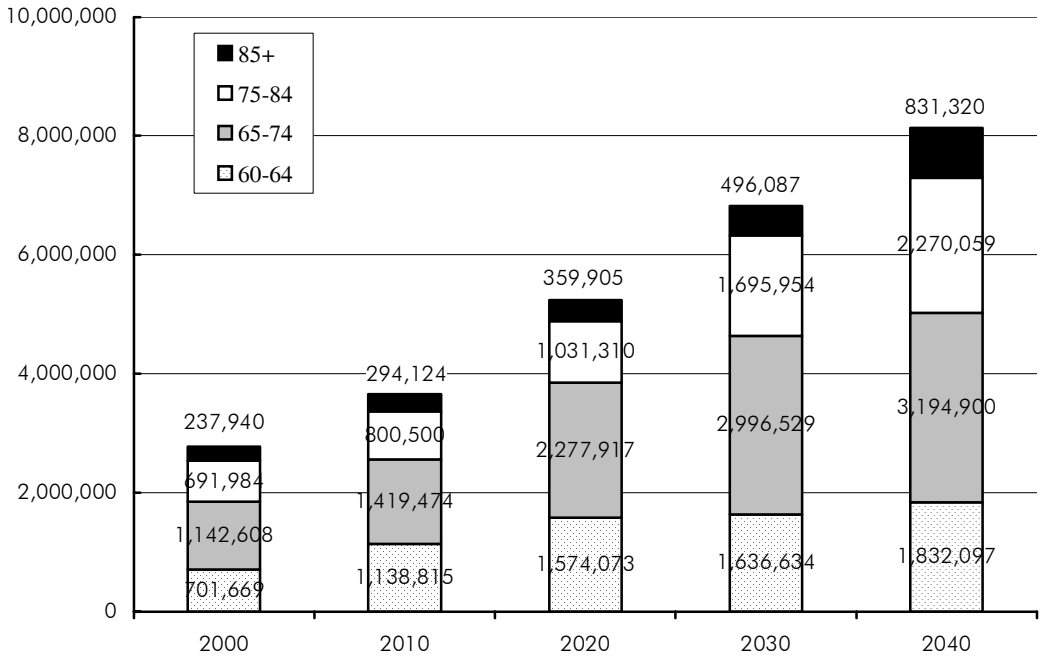
THE IMPACT OF DEMOGRAPHICS

According to the Kaiser Commission on Medicaid and the Uninsured, 12 million elderly and disabled people are receiving Medicaid benefits nationwide. In 2003, there was an average of approximately 90,000 patients in all licensed nursing facilities in Texas. Based on recent figures, approximately two-thirds of these patients were Medicaid recipients, not including Medicaid and Medicare dual eligibles. The average number of patients receiving care in the approximately 58 non-Medicaid-participating facilities is estimated at roughly 5,900. These facilities are not required to submit cost reports. Non-Medicaid-participating facilities and others serving a small number of Medicaid patients would not directly benefit from the use of provider tax revenue used to increase reimbursement rates.

While the population in Texas nursing facilities has decreased in recent years, there has been an increase in the cost of care. In 1999, the average daily cost of care per client was $83.19. In 2002, the cost increased by 19 percent to $99.25. The cost of providing long-term care to the aged and disabled is projected to continue rising.

Demographic data shows that the baby boomers will begin reaching retirement age in 2011. The elderly population in Texas is expected to double in the next 25 years. As this segment of the population grows, so will the demand for long-term care. The United States population of people 65 and older will grow from 13 to 21 percent by 2030. In 2020, baby boomers will be in their mid-80's, an age when the elderly population is most likely to need long-term care. In 2000, Texans 85 years or older totaled 237,000. By 2040, this population is expected to increase approximately 249 percent to 831,000. This significant change in population makeup will have a great impact on the healthcare infrastructure and economy of the state. (See Figure 3.)

FIGURE 3
DISTRIBUTION OF THE 60-PLUS POPULATION IN TEXAS BY AGE GROUP, 2000–2040



SOURCE: Texas Demographics: Older Adults in Texas, April 2003, Texas Department on Aging.

TRENDS IN STATE AND FEDERAL MEDICAID AND LONG-TERM CARE EXPENDITURES

On average, Medicaid expenditures, including All Funds, make up 21 percent of a state's budget. In Texas, approximately $15 billion or 25 percent of the budget was spent on Medicaid in 2003. Medicaid payments to Texas nursing facilities in 2003 totaled $1.7 billion in All Funds.

In 2001, national spending for nursing home care was $99 billion, 48 percent of which ($47.5 billion) was paid by Medicaid. In 2003, while the elderly made up only 9 percent of the 52.4 million Medicaid recipients, they accounted for 26 percent of federal Medicaid expenditures. Inversely, children accounted for 48 percent of the Medicaid population nationwide and accounted for 19 percent, or $44.7 billion of Medicaid expenditures.

In Texas, 20 percent of Medicaid recipients are aged or disabled, yet they account for over 62 percent of Medicaid expenditures. In contrast, children make up 59 percent of the Medicaid recipients but account for only 25 percent of Medicaid expenditures. Clients with disabilities, as well as the aged, generally have greater needs and utilize institutional and other long-term care services. (See Figure 4.)

FEDERAL PROVIDER TAX PROVISIONS AND STATE ACTION

A provider tax, such as the QAF, is a tax, fee, or assessment required of a healthcare provider by a state. States may use revenues from provider taxes, under the limited circumstances specified in federal law, to pay the state share of Medicaid spending. Some states seek to combine provider tax revenues with state fund appropriations to increase federal matching funds.

Federal Medicaid provisions relating to the permissible use of state provider taxes are in the Social Security Act (act) and the Code of Federal Regulations (C.F.R.). States seeking to implement a provider tax must do so in accordance with § 1903(w) of the act (42 U.S.C. 1396(b)(w)), which sets forth limitations on the use of provider taxes to obtain federal financial participation (FFP) under Medicaid, and with 42 C.F.R 433, Subpart B, the federal regulations pertaining to those provisions of the act.

The two primary requirements for the permissible use of provider tax revenue are as follows:

- The tax must be "broad-based," a tax that is imposed with respect to a permissible class of items or services on all providers in that class; and
- The tax must be "uniform," a tax that is imposed with respect to a permissible class of items or services at the same rate for all providers.

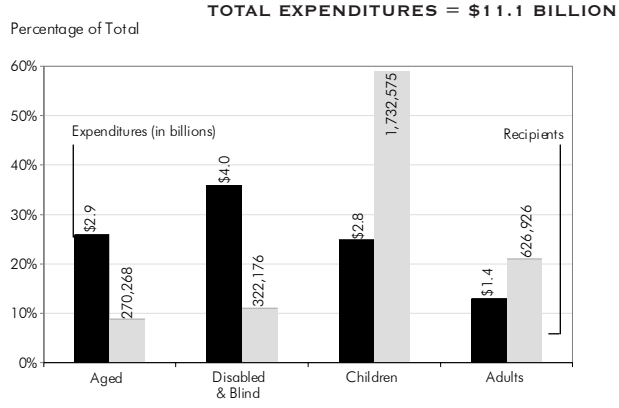
For example, a nursing home provider tax cannot specifically exclude certain providers who have only private pay (no Medicaid) clients or charge them a lower tax.

To be considered uniform, a provider tax cannot provide for credits, exclusions, or deductions that result in the return of a portion of the tax to the provider, with the net result being that the tax is not generally redistributive and the amount of the tax is directly correlated to Medicaid payments. Likewise, a provider tax is not considered to be uniform if it holds taxpayers harmless for the cost of the tax. Taxpayers are considered to be held harmless if any of the following apply:

- The state provides for a non-Medicaid payment to those providers or others paying the tax, and the amount of the payment is positively correlated to either the amount of the tax or to the difference between the Medicaid payment and the total tax cost;
- All or any portion of the Medicaid payment to the taxpayer varies based only on the amount of the total tax payment; or
- The state provides for any payment, offset, or waiver that guarantees to hold taxpayers harmless for all or a portion of the tax.

For example, the structure of the assessment cannot protect a subgroup of providers by ensuring that they will be compensated by either increased reimbursements or

FIGURE 4
TEXAS MEDICAID RECIPIENTS AND SPENDING, BY ELIGIBILITY CATEGORY
FEDERAL FISCAL YEAR 2002



NOTES: Total unduplicated recipient count = 2, 951,945. Unduplicated count of people enrolled in Medicaid is a larger number than an average monthly caseload number. The Adults category includes any beneficiaries than can be matched to an eligibility category within the same fiscal year.
SOURCE: Department of Human Services.

other funding methods for the full amount of their tax assessment. Federal regulations provide for a hold-harmless test on which a state can pass if the tax on each healthcare class produces revenues less than or equal to 6 percent of the taxpayers' revenues.

Federal provisions do, however, provide for the opportunity to seek a waiver of either or both of the broad-based and uniformity requirements if the net impact of the tax is found to be generally redistributive and the amount of the tax is not directly correlated to Medicaid payments. States that receive waiver approval may levy taxes that are not broad-based or uniform without a reduction in federal financial participation (FFP). The provisions for the application and approval of waivers from these requirements consist of several mathematical calculations designed to measure the impact of the assessment levied. If the tests applied to the proposed assessment meet the waiver calculation requirements and the assessment is found to be generally redistributive, federal regulations provide for automatic approval of waiver requests.

While there are no regulations on states' use of provider tax revenues, states seeking to use these funds as state Medicaid match that fail to meet provider tax requirements suffer a reduction in FFP. The act requires the federal government, for the purposes of determining a state's FFP, to reduce the total amount expended as medical assistance under the state's Medicaid plan by the sum of any revenues received by the state via a provider tax that does not meet federal requirements.

STATES IMPLEMENT NURSING HOME PROVIDER TAXES

States first began to implement provider taxes in the mid-1980s. While the bulk of those early provider taxes involved hospitals, other provider types were also involved including ICF-MRs, nursing homes, and physicians.

In the past two years, nursing homes have become the fastest growing provider tax assessment imposed by states, with the number doubling in that time. At the beginning of fiscal year 2003, 14 of the 21 states with provider taxes included assessments on nursing homes. During fiscal years 2003 and 2004, states imposed 28 new provider taxes. As of July 2004, 33 states impose provider taxes on nursing homes. Several additional states have recently considered enactment of a provider tax on nursing homes, hospitals, and health maintenance organizations.

Key distinctions between state enactments of provider taxes include the following:

- method and rate of the assessment;
- establishment of a defined account to hold provider tax revenues;
- dedication of the funds or designation of activities on which revenues can be used;
- prohibitions on passing the tax onto clients or from itemizing the tax in the bill for care;
- exemptions from the assessment of the tax; and
- dissolution of the assessment under certain circumstances or expiration of the tax.

Generally, states dedicate their provider tax revenues to their overall Medicaid budgets, to provider rate increases, or to cover shortfalls in their overall state budget.

While federal regulations provide for the enactment of provider taxes, the federal government scrutinizes provider tax structures for adherence to requirements in state plan amendments and waiver applications. Several states have encountered difficulty in seeking federal approval of provider tax structures, typically relating to efforts to exempt certain providers.

Colorado: Enacted provider tax in 2003.

- Enactment exempted providers that do not receive Medicaid payments and that are owned by a governmental entity, requiring the state to seek federal approval of a waiver of the broad-based requirement.
- The federal government did not approve the waiver because it had the effect of holding that exempted group harmless.
- Colorado repealed the tax in 2004.

Georgia: Enacted provider tax in 2003.

- Georgia reportedly began collecting its tax before receiving federal approval.
- In the spring of 2004, Georgia did receive approval for the use of provider tax revenues after the state withdrew its plan to exempt nursing homes that have few or no Medicaid patients, a violation of federal regulations.

Among the several states that have submitted requests for waiver of provider tax requirements, at least two, to date, have been successful: North Carolina and Oregon.

North Carolina: Enacted provider tax in 2003.

- Requires the Secretary of Health and Human Services to implement the program according to federal regulations.
- Establishes a two-tiered assessment based on patient days.

- Medicare beds and continuing care retirement communities (CCRC) exempted with waiver approval.
- Received federal approval of waivers of both the broad-based and uniformity requirements, finding that the net impact of the tax is generally redistributive and that the amount of the tax is not directly correlated to Medicaid payments.

Oregon: Enacted a provider tax in 2003.

- Sets forth assessments on four provider types, including nursing homes.
- Requires the Director of Human Services to set the rate to raise an amount equal to six percent of the annual gross revenue of all facilities, excluding revenue from exempted facilities.
- Provides that $12.5 million of the net tax revenue will be transferred to the general funds during 2003–05.
- Received federal approval of waiver for exemption of CCRCs and a state veterans home.

The recent federal approval of waivers in North Carolina and Oregon are significant developments. At the time Texas enacted its QAF, many believed that the federal government would not approve application for waivers relating to provider taxes. While provided for in the regulations, approval was considered unachievable and was, for the most part, not pursued by Texas at that time. Several other states currently have waiver applications relating to provider taxes pending.

Texas' healthcare assistance programs face funding challenges. Continuation of the current QAF assessment on ICF-MRs provides policymakers a clear step towards cost avoidance. Allowing its expiration will place significant additional strain on already limited resources. Additionally, the increasing number of nursing home provider taxes enacted and the federal approval of provider tax waivers in North Carolina and Oregon illustrate the viable opportunity for states to generate additional revenue to assist in funding long-term care. For these reasons, expansion of Texas' QAF assessment on to nursing homes merits consideration.

FISCAL IMPACT OF THE RECOMMENDATIONS

Recommendations 1 and 2 would result in a net gain of $347.5 million in General Revenue Funds and $2.1 million in General Revenue–Dedicated Funds in the 2006–07 biennium. Figures 5 and 6 summarize the positive fiscal impact of both Recommendations 1 and 2. Combined, the recommendations represent a net gain of $349.6 million in All Funds for the 2006–07 biennium, not including the potential to draw down additional Federal Funds if net revenue is used in Medicaid payments.

FIGURE 5
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE REVENUE GAIN/ (LOSS) TO GENERAL REVENUE FUNDS (NURSING HOMES)	PROBABLE REVENUE GAIN/(LOSS) TO GENERAL REVENUE–DEDICATED FUNDS (ICF-MR QUALITY ASSURANCE)	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS (COMBINED)
2006	$226,200,000	$51,500,000	$158,400,000
2007	$226,300,000	$51,500,000	$158,000,000
2008	$226,300,000	$51,500,000	$158,000,000
2009	$226,300,000	$51,500,000	$158,000,000
2010	$226,300,000	$51,500,000	$158,000,000

SOURCE: Legislative Budget Board.

FIGURE 6
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS (NURSING HOME MEDICAID RATE OFFSET)	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE–DEDICATED FUNDS (ICF-MR QUALITY ASSURANCE FUND)	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS (COMBINED)
2006	($52,200,000)	($50,400,000)	($158,400,000)
2007	($52,800,000)	($50,500,000)	($158,000,000)
2008	($52,800,000)	($50,500,000)	($158,000,000)
2009	($52,800,000)	($50,500,000)	($158,000,000)
2010	($52,800,000)	($50,500,000)	($158,000,000)

SOURCE: Legislative Budget Board.

As previously noted, the fiscal impact of Recommendation 1 has been built into the introduced version of the 2006–07 General Appropriations Bill. The estimate of revenue that would be collected from the continuation of the assessment of the QAF to ICF-MRs and state schools exceeds the $100.9 million recommended for appropriation to DADS in the 2006–07 biennium by $2.1 million. Collection of ICF-MR and state school QAF funds to support this appropriation requires a statutory change.

The introduced 2006–07 General Appropriations Bill does not include any appropriation of funds collected from the assessment of the QAF to nursing homes, as considered by Recommendation 2. Therefore, implementation of Recommendation 2 via statutory change represents a net positive fiscal impact of $347.5 million in the 2006–07 biennium.

IMPROVE COLLECTION OF VENDOR DRUG REBATES

All states that provide drug benefits to Medicaid beneficiaries receive rebates from drug manufacturers on drugs used by the Medicaid program. In 2003, the Texas State Auditor's Office reported that the Health and Human Services Commission had not properly accounted for all the outstanding prescription drug rebate revenue owed to the state. The auditors identified $20.7 million of uncollected rebates from calendar year 2001 but were unable to quantify outstanding amounts from prior years due to incomplete and inaccurate data in the agency's prescription drug information system. The auditors recommended ways to identify these uncollected amounts. However, the Health and Human Services Commission has not fully implemented these recommendations, and therefore it has not identified all outstanding balances.

Additionally, the Health and Human Services Commission is not collecting rebates for all drugs dispensed in physicians' offices to Medicaid clients. The agency could collect an estimated $12 million in All Funds in rebates on these drugs in the 2006–07 biennium if the Medicaid information system were configured to collect the necessary data from physicians.

SIGNIFICANT CONCERNS

- The Health and Human Services Commission has not determined the amount of outstanding rebates for the period from 1991 through first two quarters of calendar year 1995.
- According to the Health and Human Services Commission's data, the agency has not collected $17.3 million in outstanding vendor drug rebates, or related interest, for the period from the third quarter of calendar year 1995 through calendar year 2003. Since the agency has not fully implemented the State Auditor's recommendations for determining the amount of outstanding rebates for that period, the accuracy of reported outstanding rebate balances cannot be ensured.
- The Health and Human Services Commission reports that it has collected almost all outstanding rebates for calendar year 2001. However, since the agency has not fully reconciled collections to billings, some rebates may still be outstanding.
- The Medicaid Management Information System does not collect information on drugs administered in physicians' offices, and therefore the Health and Human Services Commission cannot collect all rebates on these drugs.

RECOMMENDATIONS

- **Recommendation 1:** The "Performance Reporting for the Prescription Drug Rebate Program" rider for the Health and Human Services Commission should be amended in the 2006–07 General Appropriations Bill to require the agency to estimate the rebates and interest owed to the state by drug manufacturers for the period from 1991 through second quarter of calendar year 1995 and report the estimated balances no later than August 31, 2006 to the Legislative Budget Board, State Auditor's Office and the Governor's office.
- **Recommendation 2:** Include a rider in the 2006–07 General Appropriations Bill that requires the Health and Human Services Commission to modify the Medicaid Management Information System to collect the National Drug Code data necessary for the state to calculate and collect rebates for physician-administered medication in the 2006–07 biennium. The agency should consider the cost-benefit of requiring physicians to submit National Drug Code data for physician-administered drugs from prior years.
- **Recommendation 3:** Reduce the Health and Human Service Commission's General Revenue Fund appropriation for Vendor Drug program by $4.7 million for the 2006–07 biennium, and increase Vendor Drug Rebates–Medicaid method of finance by the same amount. Rebates collected on physician-administered drugs should be appropriated for purposes consistent with the use of the Vendor Drug Rebates–Medicaid specified in the General Appropriations Act.

COMMENTS

The federal Omnibus Budget Reconciliation Act of 1990 established the Medicaid drug rebate program. This program enables states that provide drug benefits to the Medicaid population to receive a rebate from each drug

manufacturer whose drugs are used in the program. Acting on behalf of the states, the U.S. Center for Medicare and Medicaid Services (CMS) enters into rebate contracts with each drug manufacturer choosing to participate in the Medicaid program. Approximately 520 pharmaceutical companies participate in the rebate program. As part of the contract agreement, drug manufacturers are required to submit to CMS a list of all covered outpatient drugs and to report average manufacturer price and Medicaid best price for each drug. CMS calculates the unit rebate amount based on the manufacturers' prices and sends this information to the states. States calculate the rebate owed by the drug manufacturer based on the unit rebate amount and number of units for each drug used by the Medicaid program, and bill drug manufacturers on quarterly basis. To ensure that all rebates are collected, state Medicaid offices need accurate drug utilization data.

Drug manufacturers have 38 days to either pay the invoice sent by the state or to dispute the utilization data if they believe that it is inaccurate. While manufacturers are required to pay the undisputed portion of the rebate, they do not have to pay the disputed portion until the data discrepancy issues are resolved. Manufacturers have to provide notification to the states explaining the basis of the dispute. States and manufacturers use dispute resolution and other mechanisms to resolve disagreements about outstanding rebates. Disputes over rebate amounts owed go back to the beginning of the program, which was established in 1991. Many states have experienced difficulties in calculating and collecting outstanding rebates.

OUTSTANDING DRUG REBATES IN TEXAS' MEDICAID PROGRAM

In Texas, the Heath and Human Services Commission (HHSC) is responsible for collecting drug rebates. The HHSC collects rebates through its Vendor Drug Program. The state share of revenue from drug rebates is appropriated to the agency, while the federal share is returned to the federal government. In the 2004–05 biennium, state share of the revenue from drug rebates is expected to reach more than $400 million.

In 1995, HHSC established an automated system for drug manufacturers' billing, the Pharmacy Rebate Information Management System (PRIMS). Only some records for the period prior to the third quarter of calendar year 1995 have been recently entered into the system. As a result, the HHSC does not have accurate and complete information on outstanding rebates. Drug manufacturers will likely continue to dispute the agency's claims for outstanding rebates unless HHSC is able to support its assumptions for outstanding balances with accurate utilization data.

OUTSTANDING REBATE BALANCES PRIOR TO 1995

In April 2003, the State Auditor's Office (SAO) reported that, according to the HHSC data, outstanding rebates for the years before 1995 totaled $9.1 million. The HHSC could not adequately support this estimate; therefore, the SAO recommended that the agency recreate invoices and reconcile them with payments and credits. The SAO recommended that the HHSC consider hiring a third party or temporary staff to complete this work.

The HHSC agreed with the recommendation and responded that it would enter all pre-PRIMS payment and invoice data, complete reconciliation, and correct errors. The agency stated that once this payment-posting project was completed, PRIMS should be able to identify all outstanding rebates.

Since June 2004, HHSC hired nine temporary employees, but it later decreased the number to seven. The temporary employees entered approximately 129,000 line items out of the approximately one million line items necessary for determining the outstanding balances. HHSC staff reviewed 103 invoices associated with the 129,000 line items and was able to identify approximately $610,000 in outstanding rebates, not including interest.

The temporary employees worked for five months at a cost of $95,788. The HHSC staff estimates that it would cost an additional $345,000 to complete the data-posting project. Collection of the outstanding rebates just for the 103 invoices tested would cover costs for posting all remaining line items.

Posting the remaining line items would not only allow the agency to collect outstanding rebates, but the work would also provide more accurate data in the system used to bill for Vendor Drug and other programs' rebates. As of October 22, 2004 the HHSC system showed $83.8 million in outstanding rebates for the pre-1995 period. HHSC staff states that this is a significant overstatement of the actual outstanding balance. Entering all payment information and correcting unit measurements in PRIMS would allow the agency to develop more reliable estimates of outstanding drug rebates owed to the state.

OUTSTANDING REBATE BALANCES AFTER 1995

The SAO report also concluded that HHSC had not properly accounted for all outstanding prescription drug rebate revenue owed to the state after 1995. The auditors found that agency's PRIMS contained inaccurate data. The SAO concluded that while PRIMS data for outstanding balances was unreliable, there were indications that a significant amount of rebate revenue remained outstanding.

The SAO recreated an outstanding rebate balances in PRIMS for only one of the six years for which the system

had data. As of May 2002, the auditors reported that $20.7 million in rebates remained uncollected from calendar year 2001.

Rider 47 of the General Appropriation Act (GAA) for the 2004–05 biennium requires the HHSC to report on a quarterly basis to the Legislative Budget Board (LBB) and the Governor's Office outstanding rebate balances for a number of programs including Medicaid. The rider requires the HHSC to report outstanding balances, adjustments, interest, and collections for each year for which the prescription drug rebates program has collected rebates and also on a cumulative basis for all years.

The HHSC did not submit the report in fiscal year 2004. In October 2005, the HHSC provided LBB staff with updated rebate data for calendar year 2001. Figure 1 shows how much the HHSC reports has been collected and how much in rebates and interest remains outstanding.

FIGURE 1
CALENDAR YEAR 2001 OUTSTANDING DRUG REBATES

Original Rebate Balance Billed to Drug Manufacturers	$288,582,302
Pricing and Utilization Adjustments	$14,091,406
Value as of 9/30/04	$302,673,708
Collections through 9/30/04	$301,920,005
Outstanding Principal as of 9/8/04	$817,756
Outstanding Interest as of 9/8/04	$819,748

SOURCE: Health and Human Services Commission.

The HHSC did not fully implement the SAO recommendation that it produce detailed information for all adjustments made since the initial rebate billings. Without this detailed information, it is not possible to determine whether the agency has identified all outstanding rebates for calendar year 2001.

Based on the HHSC data, as of November 22, 2004, outstanding rebates in the Medicaid program for the period from the third quarter of calendar year 1995 through calendar year 2003 were $17.3 million. This includes the reported $817,756 from calendar year 2001 but does not include interest that has accumulated on outstanding rebate balances. The HHSC can also collect interest for amounts due from the date of initial billing.

During the 2004–05 biennium, Medicaid benefits were reduced to address the escalating costs of the Medicaid program. Collecting vendor drug rebates and ensuring that the state has accurate drug utilization data could enable the state to return more revenue to the Vendor Drug Program.

Recommendation 1 would amend the HHSC rider 47 "Performance Reporting for the Prescription Drug Rebate Program" from the 2004–05 biennium to require the agency to estimate the rebates and interest owed to the state by drug manufacturers for the period from 1991 through the second quarter of calendar year 1995. In addition, the rider would require HHSC to report the estimated balances to the Legislative Budget Board, State Auditor's Office and the Governor's office no later than August 31, 2006.

The amended rider is included in the General Appropriations Bill for the 2006–07 biennium:

~~47~~ 41. **Performance Reporting for the Prescription Drug Rebate Program.** The Commission shall report on a quarterly basis the following information to the Legislative Budget Board, the State Auditor's Office and the Governor's Office: the outstanding prescription drug rebate balances for the Medicaid, CHIP, Kidney Health, and Children with Special Health Care Needs programs. The report shall include rebate principal and interest outstanding, age of receivables, and annual collection rates. The reports shall specify amounts billed, dollar value of pricing adjustments, dollar value of utilization adjustments, and dollars collected. The Commission shall report these data on each year for which the Prescription Drug Rebate program has collected rebates and also on a cumulative basis for all years. In addition, the Commission shall provide no later than August 31, 2006 a separate report to the Legislative Budget Board, State Auditor's Office and the Governor's Office detailing the outstanding Medicaid prescription drug rebates and interest balances for the period from 1991 through the second quarter of calendar year 1995 in the format specified above.

In order to fully comply with this rider, the Commission should address data integrity issues related to the calculation of outstanding balance, cited in the State Auditor's Office report number 03-029 An Audit Report on the Health & Human Services Commission Prescription Drug Rebate Program. (HHSC-Rider 47)

OBTAINING MEDICAID REBATES FOR PHYSICIAN-ADMINISTERED DRUGS

In April 2004, the federal Office of the Inspector General (OIG) of the U.S. Department of Health and Human Services reported that many states are not collecting all rebates on physician-administered drugs.

To receive rebates, states must identify drugs by their National Drug Codes (NDCs). This practice enables drug manufacturers to verify utilization of their products by each state's Medicaid program. Most states, however, use Healthcare Common Procedure Coding System (procedure codes) to identify physician-administered drugs and have not developed crosswalks to match NDCs to procedure codes.

States that established crosswalks as of 2001 requested $23 million in rebates on these drugs. The OIG report found that in 2001, Medicaid could have added millions of dollars to its rebate savings if every state had collected rebates for all single-source and 40 multiple-source, physician-administered drugs. The majority of savings was from single-source drugs. As of March 2003, 24 states, including Texas, did not collect rebates on any physician-administered drugs. The study indicated that states' savings in a single year could exceed the one-time costs of implementing system changes needed to collect rebates for these drugs.

Single-source drugs in most cases have only one NDC, which enables the states to more easily match it to a procedure code. Multiple-source drugs are manufactured by different drug companies under different names, which makes it more difficult to match procedure codes to exact NDCs.

The OIG reported that 17 states collected rebates on physician-administered drugs in 2001, and only a few states collected rebates on all drugs administered in the physicians' offices. Medicaid information systems in these states use NDCs for physicians' billing, which enables the states to bill drug manufacturers without establishment of a crosswalk from procedure codes to NDCs.

According to the numbers included in the OIG report, Texas spent more than $35 million for physician-administered drugs in 2001 and did not collect any rebates. Based on the numbers in the report, Texas could have collected rebates of $5,322,837 for single-source, physician-administered drugs in 2001. Additionally, Texas could have collected rebates of $750,305 for selected multiple-source, physician-administered drugs.

CURRENT DEVELOPMENTS IN TEXAS MEDICAID REBATE BILLING ON PHYSICIAN-ADMINISTERED DRUGS

The HHSC does not require physicians to submit NDCs for drugs administered in their offices, even though this information is readily available to the physicians. The HHSC reports that it started billing drug manufacturers for single-source drugs in June 2003. The agency bills for rebates on single-source drugs only because it cannot identify specific NDCs from procedure codes for multi-source drugs.

Based on the HHSC data, in fiscal year 2003 the Medicaid program reimbursed physicians $62.4 million for physician-administered drugs, of which approximately $41.7 million was spent on single-source drugs. In fiscal year 2004, the amount reimbursed for medication administered in physician offices was $73.5 million, of which approximately $23.3 million was for single-source drugs. The decrease in the expenditures for single-source drugs can be partially explained by the increase in number of drugs for which patents expire, which allows other drug manufacturers to introduce multi-source drugs. The HHSC reports it has collected $17 million in All Funds in rebates on the single-source drugs used in fiscal years 1991 through 2004.

If the agency's MMIS could match all procedure codes with NDCs, it could bill drug manufacturers for rebates on all drugs administered in physicians' offices for an additional $12 million in All Funds for drugs administered by the physicians in fiscal years 2006 and 2007. The HHSC can bill drug manufacturers for rebates on drugs utilized in the past. However, the agency will not have the NDC data for prior years. If physicians would provide the NDC data for 2003 through 2005, the HHSC could bill drug manufacturers for $12.1 million more in All Funds.

Recommendation 2 would require the HHSC to use up to $500,000 in General Revenue Funds to make the necessary changes to MMIS to enable it to receive NDCs to bill for rebates on all physician-administered drugs. Based on the agency's estimates, it could cost HHSC up to $4 million in All Funds to implement program changes to MMIS. The agency also suggests that the estimated federal matching rate for the system change would be 90 percent and HHSC would have to contribute 10 percent of the project costs.

HHSC would also need to change its reporting requirements for the physicians who provide services to the Medicaid population in fee-for-service and primary care case management models. There may be additional administrative burden for physicians to be able to submit NDCs. However, it appears that private organizations are already moving in this direction. At least one Health Maintenance Organization (HMO) requires its physicians to submit NDCs necessary for reimbursement determination.

Recommendation 3 would reduce HHSC General Revenue Fund appropriation for Vendor Drug program by $4.7 million for the 2006–07 biennium, and would increase Vendor Drug Rebates–Medicaid method of finance by the same amount. In addition, the recommendation specifies that rebates collected on physician-administered drugs should be appropriated for purposes consistent with the

use of the Vendor Drug Rebates–Medicaid specified in the General Appropriations Act.

The following rider that requires HHSC to make necessary changes to the system and shows reduction in the appropriated funds was included in the introduced 2006–07 General Appropriations Bill.

56. C**ollection of Rebates on Physician Administered Prescription Drugs.** From the funds appropriated above in Strategy B.2.2. Medicaid Vendor Drug Program, the Health and Human Services Commission shall use up to $500,000 in General Revenue to make necessary changes to the Medicaid Management Information System to collect rebates on single-source and multi-source physician administered drugs. The appropriations to the Commission made above for the Medicaid Vendor Drug Program have been reduced by $2,366,092 in General Revenue for fiscal year 2006 and $2,378,728 in General Revenue for fiscal year 2007 and the method of finance Vendor Drug Rebates–Medicaid have been increased by these same amounts. Additional rebates collected on physician-administered drugs are appropriated to the Commission for purposes consistent with the use of the Vendor Drug Rebates–Medicaid specified elsewhere in this Act.

FISCAL IMPACT OF THE RECOMMENDATIONS

Recommendation 3 would result in a net General Revenue Fund savings of $4.7 million in the 2006–07 biennium. Recommendation 1 requires the HHSC to complete data entry of rebate billings and collections prior to 1995 and to reconcile PMIS for rebate billings and collections after 1995. While there would be some cost associated with hiring temporary employees to assist with this effort, the collection of outstanding rebates should more than offset this cost. Until this recommendation is implemented, the amount of outstanding rebates cannot be accurately estimated.

The fiscal impact in Figure 2 reflects the amount of additional rebates the HHSC can collect once MMIS has the capability to accept NDCs for physician-administered drugs as called for in Recommendation 2.

The following assumptions were made to calculate this amount:

- The rebates rate for single-source drugs is 30 percent of drug expenditures and 10 percent for multiple-source drugs. These percentages are based on the federal OIG methodology.
- There is a 20 percent increase in expenditures for physician-administered drugs between 2004 and 2007 that reflects a number of factors including utilization and price increase.
- Proportions of single-source and multi-source drugs in fiscal year 2005, 2006 and 2007 are equal to proportions for these drugs in fiscal year 2004.
- No impact of the new Medicare Part D prescription drug benefit effective January 1, 2006 is assumed because this report analyzed rebates on drugs administered by physicians. Visits to physicians for beneficiaries eligible for both Medicare and Medicaid programs are already reimbursed by Medicare Part B. Therefore, the Medicaid program reimburses physicians for drugs dispensed in their offices for beneficiaries eligible for Medicaid program only.

In addition, the fiscal impact figure shows the reduction in the General Revenue Funds called for in Recommendation 3. The reduced General Revenue Funds amount is equal to the estimated rebate amount that HHSC will be able to collect on multi-source drugs.

FIGURE 2
FIVE-YEAR FISCAL IMPACT OF COLLECTING REBATES ON PHYSICIAN-ADMINISTERED DRUGS

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE GAIN/(LOSS) TO GENERAL REVENUE FUNDS (VENDOR DRUG REBATES REVENUE– STATE SHARE)	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS (VENDOR DRUG REBATES REVENUE– STATE SHARE)
2006	$2,366,092	$2,366,092	($2,366,092)
2007	$2,378,728	$2,378,728	($2,378,728)
2008	$0	$2,378,728	($2,378,728)
2009	$0	$2,378,728	($2,378,728)
2010	$0	$2,378,728	($2,378,728)

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill includes a rider authorizing HHSC to use up to $500,000 in General Revenue Funds out of appropriated funds for the Medicaid Vendor Drug Program to make changes to the MMIS. The introduced bill also incorporates a $4.7 million reduction in General Revenue Funds from Medicaid Vendor Drug Program that is expected to be offset by the increase in the state share of the drug rebate revenue.

IMPROVE COMPREHENSIVE REHABILITATION SERVICES FUNDING

The Department of Assistive and Rehabilitative Services' Comprehensive Rehabilitation Services program provides services to survivors of traumatic brain injury and spinal cord injury in Texas. The program is funded solely through General Revenue–Dedicated Funds deposited to the Comprehensive Rehabilitation Fund (Account No. 107). The fund was established by Senate Bill 195, Seventy-second Legislature, 1991, which dedicated traffic conviction fines to comprehensive rehabilitation services provided by the Texas Rehabilitation Commission. The Comprehensive Rehabilitation Services program was established by rule, and current rules were adopted in the Texas Register in 1993. In the 2004–05 biennium, appropriated funding from the Comprehensive Rehabilitation Fund totals $20.8 million.

This report discusses the history of revenues dedicated to the Comprehensive Rehabilitation Services program. This report also makes recommendations regarding subrogation receipts collected by the agency and reallocation of Comprehensive Rehabilitation Services Funds previously used for administration.

SIGNIFICANT FINDINGS

- The revenue source for the Comprehensive Rehabilitation Fund has changed substantially twice since its creation.
- The amount of revenue collected for the Comprehensive Rehabilitation Fund from court-related fines levied on offenders has fluctuated through the 13 years the fund has been dedicated to Comprehensive Rehabilitation Services. The appropriation of funds is capped in a rider, and the agency cannot spend additional revenue collected.
- House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, identified certain circumstances in which the Comprehensive Rehabilitation Fund can be used for general governmental purposes. However, none of the stipulations in House Bill 2292 for this to occur have been met to date.
- Subrogation receipts collected in relation to Comprehensive Rehabilitation Services cases are currently not appropriated to the Comprehensive Rehabilitation Services program. It is estimated that $50,000 in subrogation receipts is collected annually from reimbursements to the Comprehensive Rehabilitation Services program.
- Historically, some General Revenue–Dedicated Funds have been allocated to the agency's administration strategies. Shifting the General Revenue–Dedicated Funds to the Comprehensive Rehabilitation Services strategy and client services is more closely aligned with the intent and dedicated status of the funds.
- An estimated 225 additional clients can be served in the 2006–07 biennium, as compared to the number projected by the agency to be served in the 2004–05 biennium, if all recommendations are implemented.

SIGNIFICANT CONCERN

- Some portion of revenues (generated through court fees and fines) dedicated to the Comprehensive Rehabilitation Services program and subrogation receipts collected in relation to Comprehensive Rehabilitation Services cases are not allocated to the Comprehensive Rehabilitation Services program. Individuals eligible for services are waiting for available funding, and time is of the essence in procuring services for individuals with traumatic brain injury and spinal cord injury.

RECOMMENDATIONS

- **Recommendation 1:** Rider language should be included for the Department of Assistive and Rehabilitative Services in the 2006–07 General Appropriations Bill that appropriates subrogation receipts from Comprehensive Rehabilitation Services cases to the Comprehensive Rehabilitation Services program.
- **Recommendation 2:** In the 2006–07 General Appropriations Bill, $343,207 in General Revenue–Dedicated Funds otherwise appropriated for administrative costs at the Department of Assistive and Rehabilitative Services during each year of the biennium should instead be appropriated for Comprehensive Rehabilitation Services in Strategy B.3.4.

- **Recommendation 3:** The total projected amount of revenue estimated by the agency to be generated during the 2006–07 biennium should be appropriated to the Comprehensive Rehabilitation Services program in the 2006–07 General Appropriations Bill. Appropriations should continue to be limited to the amount of revenue the agency projects will be collected.

COMMENTS

Comprehensive Rehabilitation Services (CRS) is a program of the Department of Assistive and Rehabilitative Services (DARS). House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, consolidated four health and human services agencies into DARS: the Interagency Council on Early Childhood Intervention (ECI), the Texas Commission for the Deaf and Hard of Hearing (TCDHH), the Texas Commission for the Blind (TCB), and the Texas Rehabilitation Commission (TRC). The Texas Rehabilitation Commission provided services intended to assist individuals with disabilities to achieve employment through programs such as Vocational Rehabilitation, as well as independent living services for individuals with disabilities and comprehensive rehabilitation services for individuals with spinal cord and traumatic brain injury. Former TRC programs, including CRS, are now housed in DARS Division of Rehabilitative Services.

Senate Bill 195, Seventy-second Legislature, 1991, created the Comprehensive Rehabilitation Fund. This act dedicated a stream of funding, originally from fines assessed for traffic violations such as not wearing a motorcycle helmet or driving while intoxicated, to the CRS fund in the state treasury. The purpose of the Comprehensive Rehabilitation Services program is "to provide payment for an initial period of comprehensive medical rehabilitation services for individuals with traumatic spinal cord injuries and/or traumatic brain injuries; outpatient services for individuals with traumatic spinal cord injuries and/or traumatic brain injuries; and post-acute services for persons with traumatic brain injury" (Texas Administrative Code, § 107.1201), using funding from the Comprehensive Rehabilitation Fund.

To qualify for the CRS program, an individual must demonstrate a traumatic spinal cord injury and/or traumatic brain injury, and a reasonable expectation the CRS program will be of benefit in improving functioning in the home and community. Other eligibility criteria are listed in Figure 1. Eligibility is assessed by vocational rehabilitation counselors as part of assessment procedures for DARS Division of Rehabilitative Services (DRS) programs. If, during the course of services, an individual becomes eligible for another DRS program, the sponsorship of that individual is to be shifted immediately to that program.

The scope of services available is limited to a maximum of the following: 90 days inpatient comprehensive medical rehabilitation; 120 hours outpatient comprehensive rehabilitation; six months for post-acute brain injuries services; and post-closure services on a limited basis. There are also limitations on services related to the time of onset of injury. For inpatient services, no more than one year may have elapsed since the onset of injury at the time of referral to the program. For outpatient services, no more than two years may have elapsed, and for post-acute services, there is no time limitation. For examples of services provided through the CRS program, see Figure 1.

The number of individuals served through the CRS program is dependent upon available funding. In fiscal year 2004, the agency served 458 clients in Comprehensive Rehabilitation Services at an average cost of $18,858 per client. DARS estimated in September 2004 that 278

FIGURE 1
ELIGIBILITY CRITERIA AND SERVICES PROVIDED FOR THE COMPREHENSIVE REHABILITATION PROGRAM

ELIGIBILITY CRITERIA	SERVICES PROVIDED
◆ Traumatic spinal cord and/or brain injury ◆ Reasonable expectation of benefit ◆ At least 16 years of age ◆ Citizen or immigrant alien of United States ◆ Resident of Texas for at least six months or family member resident for six month ◆ Not eligible for another DRS program ◆ Willing to accept treatment ◆ Medically stable to participate	◆ Rehabilitation nursing ◆ Physical and occupational therapy ◆ Psychological/neuropsychological services ◆ Orthotic and prosthetic devices ◆ Drugs, medical supplies, and equipment ◆ Speech-language pathology therapy ◆ Cognitive therapy ◆ Social services ◆ Personal assistant services
SOURCE: Texas Administrative Code § 113.2.	SOURCE: Texas Administrative Code § 107.1207.

individuals with brain or spinal cord injury are waiting to receive services through the CRS program.

REVENUE SOURCE LEGISLATIVE HISTORY

The revenue source for the Comprehensive Rehabilitation Fund has changed substantially twice since its creation. Initially the CRS fund received 100 percent of traffic fees and fines dedicated to it, which was changed through legislation to 12.37 percent of court fees and fines for special services. The most recent legislative change lowered the allocation to the CRS fund to 5.3218 percent of consolidated court costs (see Figure 2). For the purposes of this report, "consolidated court costs" refers to the revenue source composed of consolidated court fees and fines levied upon conviction established by House Bill 2424, Seventy-eighth Legislature, Regular Session, 2003.

Dedication of traffic conviction fees and fines to the Comprehensive Rehabilitation Fund was initially codified as Article 102.081 of the Code of Criminal Procedure by Senate Bill 195, Seventy-second Legislature, 1991.

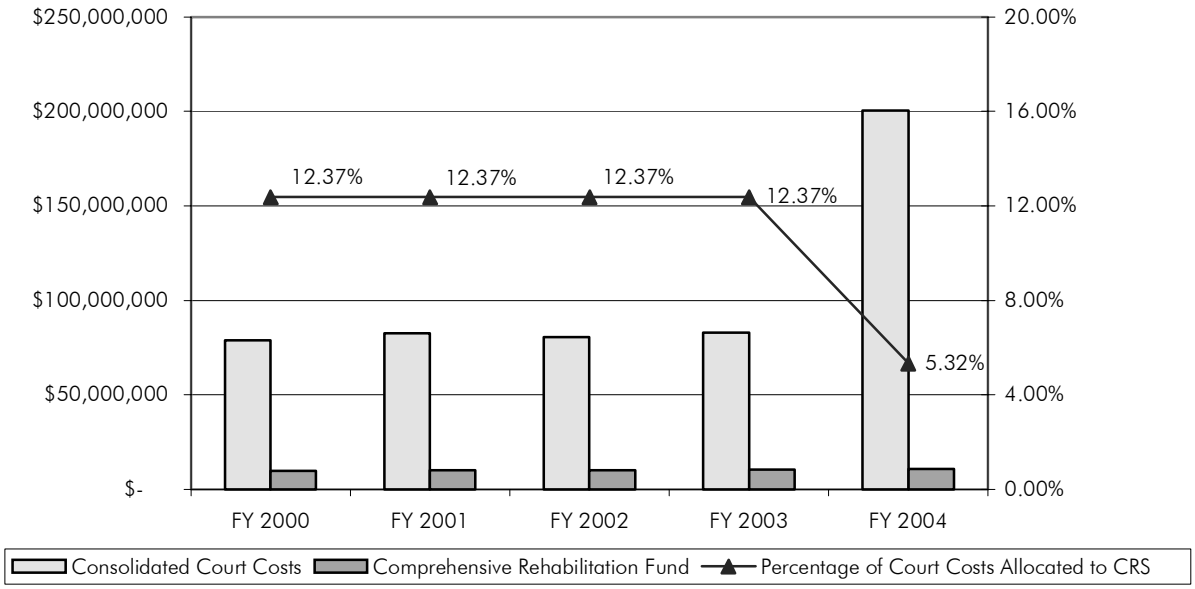
Article 102.081 was repealed by House Bill 2272, Seventy-fifth Legislature, 1997. This bill created Article 102.075 of the Code of Criminal Procedure requiring individuals convicted of certain offenses under the Penal Code to pay "court costs for special services." Article 102.075 specifies the amounts of fees and fines to be paid depending on the class of offense and allocates the revenue generated under this article to several accounts. The CRS Fund was allocated 12.37 percent of the revenue collected under Article 102.075.

Article 102.075 was repealed by House Bill 2424, Seventy-eighth Legislature, Regular Session, 2003, effective January 1, 2004. This bill amended Subtitle C, Title 4, Local Government Code to add Chapter 133. Chapter 133, § 133.102 consolidates fees and fines paid on conviction to the Comptroller of Public Accounts, raising the amounts of the fines and fees assessed as court costs (see Figure 3).

House Bill 2424 also added several new funds as beneficiaries of the revenue and lowered the CRS fund share to no less than 5.3218 percent. The bill also directs the comptroller to allocate the revenue based on historical data so the funds will receive, "to the extent practicable," the same amount the fund would have received without the consolidation of fees. This provision indicates the amount of money each fund receives should not differ significantly from historical collections, and this appears to be supported by the comptroller's revenue projections for the consolidated court costs (fines and fees).

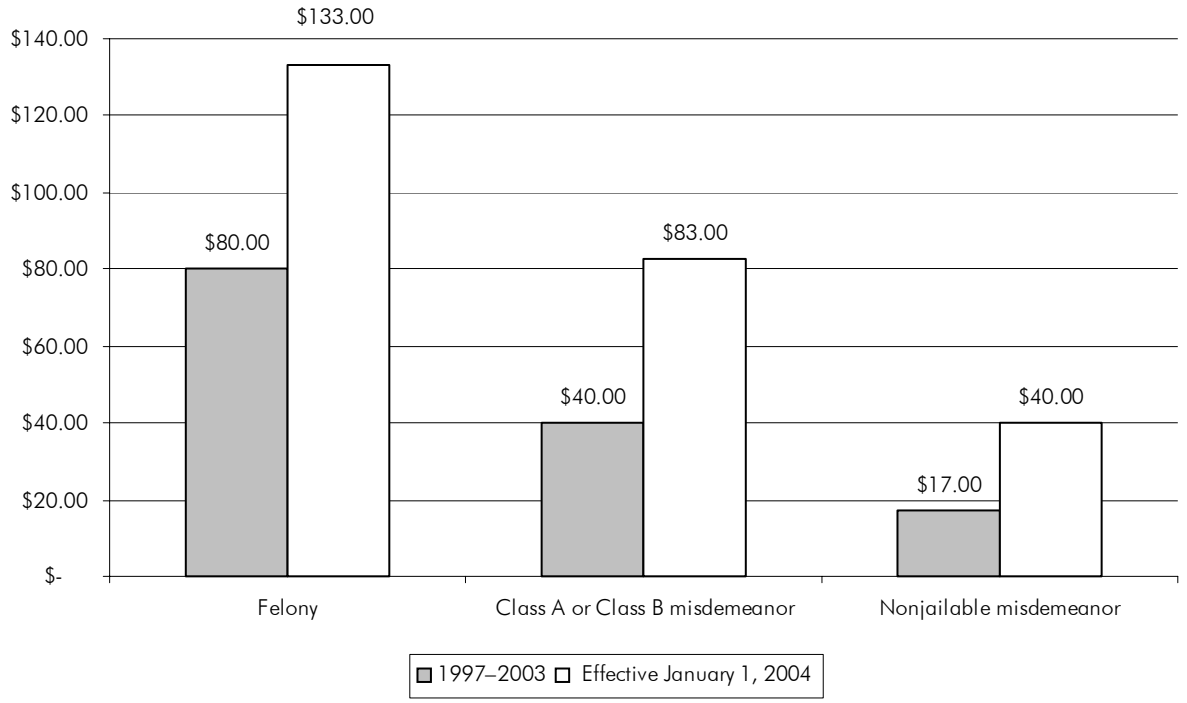
Although the revenue source and percentage of court fees and fines allocated to the CRS fund have changed several times, the actual amount of revenue collected by CRS has continued to increase.

FIGURE 2
CONSOLIDATED COURT COSTS AND COMPREHENSIVE REHABILITATION FUND
FISCAL YEARS 2000–2004



SOURCE: Comptroller of Public Accounts.

FIGURE 3
CONSOLIDATED COURT COSTS (FEES AND FINES)
1997–2004



SOURCE: Article 102.075, Criminal Code of Procedure (abolished); Chapter 133 § Local Government Code.

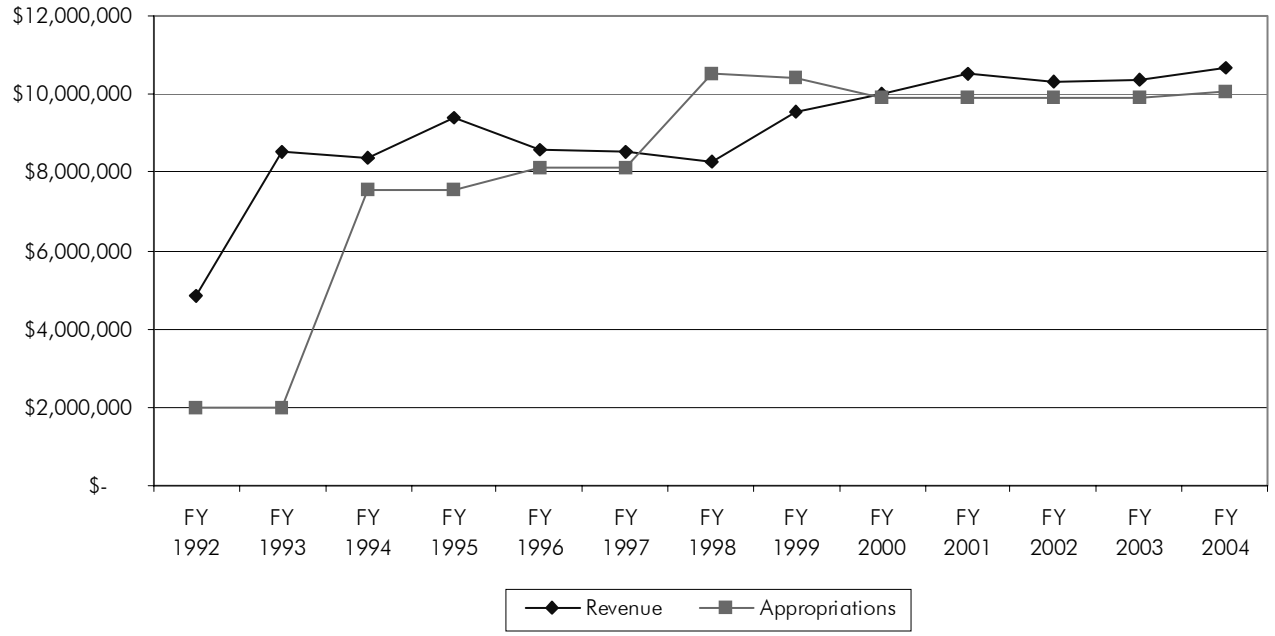
COMPREHENSIVE REHABILITATION FUND COLLECTIONS AND APPROPRIATIONS

Collections from the consolidated court costs (fines and fees) allocated to the Comprehensive Rehabilitation Fund fluctuate from year to year based on the overall collections from the consolidated court costs (fines and fees). The revenue source, consolidated court costs (fines and fees), has also fluctuated from fiscal year 2000 to fiscal year 2004. In addition to legislative changes in the composition of the revenue source, other external factors impacting collections could include crime and conviction rates.

Rider 6, "General Revenue Fund Dedicated: Comprehensive Rehabilitation Revenue," was added to the Texas Rehabilitation Commission bill pattern by the Seventy-seventh Legislature, 2001, in the General Appropriations Act for 2002–03. In addition to specifying that the unexpended balance of the account is included in the method of finance for the CRS program, the rider confirms that the amounts are statutorily dedicated to CRS and may not be used for any other purposes.

The Seventy-seventh Legislature, 2001, provided an estimated appropriation through Rider 6, General Appropriations Act (GAA) 2002–03, allowing revenues above the appropriated amounts to be spent on the CRS program. This allowed TRC to expend all General Revenue–Dedicated Fund collections, including any accumulated balance. In fiscal year 2002 the agency expended more than the estimated appropriation for this strategy under the authority of Rider 6. In fiscal year 2003, expenditures were lower than the estimated appropriation in the GAA. There were three reductions to the CRS fund in fiscal year 2003: consolidation related transfers to the Health and Human Services Commission; a reduction by House Bill 7, Seventy-eighth Legislature, Regular Session, 2003; and a reduction of almost $300,000 pursuant to Article II Special Provisions, Sec. 21, General Appropriations Act, Seventy-seventh Legislature, 2001. Previously, there was no rider for the CRS program and the appropriations were at times higher than the revenue and in other years lower than the collections (see Figure 4).

FIGURE 4
REVENUE AND APPROPRIATIONS FOR COMPREHENSIVE REHABILITATION SERVICES
FISCAL YEARS 1991–2004



SOURCES: Legislative Budget Board; Comptroller of Public Accounts.

The Seventy-eighth Legislature, Regular Session, 2003, capped the appropriation for the 2004–05 biennium. Amounts collected above the amount specified in Rider 6 remain in the Comprehensive Rehabilitation Fund and are only available for the CRS program (unless the House Bill 2292 provision detailed below is applied); however, the agency cannot spend the money unless it is appropriated.

HOUSE BILL 2292, SEVENTY-EIGHTH LEGISLATURE, REGULAR SESSION, 2003

Advocates for Comprehensive Rehabilitation Services have recently expressed concern that House Bill 2292 removes the dedication from the Comprehensive Rehabilitation Fund.

House Bill 2292, § 2.117 amends Human Resources Code, § 111.060, which establishes the Comprehensive Rehabilitation Fund in the state treasury, to identify circumstances in which funds in the CRS fund, Account No. 107, can be used for general governmental purposes.

House Bill 2292, § 2.117 (d) provisions 1 and 2 refer to the same circumstances necessary for the legislature to make an appropriation from the Economic Stabilization Fund (Rainy Day Fund), identified in the Texas Constitution, Article 3, § 49.g:

1. if the comptroller certifies there is a shortfall in a current biennium (it is our understanding this certification is most likely to occur when the comptroller releases the Biennial Revenue Estimate [BRE]; however, this could also be done at a different time); or
2. if the comptroller estimates in the BRE that there will be less revenue for a succeeding biennium than for the current biennium.

However, the Texas Constitution, Article 3, § 49.g specifically states that an appropriation must be made from the Economic Stabilization Fund, whereas House Bill 2292, § 2.117 (d) provisions 1 and 2 do not specifically require an appropriation. It is our understanding that in either of these two circumstances, an appropriation from the CRS fund would have to be made in order for funds to be taken out of Account No. 107 and the balance depleted. Without an appropriation, these two provisions appear to be duplicative of Government Code 403.095, Use of Dedicated Revenue, which allows the comptroller to use the balances of the account for the purpose of certification, without actually reducing the balance of the account.

House Bill 2292, § 2.117 (d) provision 3 states that if the Legislative Budget Board (LBB) determines a state fiscal emergency exists and determines money from the Comprehensive Rehabilitation Fund is needed for general governmental purposes, then the money may be used for general governmental purposes. In this scenario, the LBB would specifically identify the CRS fund as a source of funding; whereas, in the first two provisions if the circumstances identified were to occur, the CRS fund would automatically become available for general governmental purposes. This authority is already available to the LBB under Government Code, Chapter 317. If the LBB determination of a state fiscal emergency occurred during a regular legislative session, an appropriation could be made from the fund for another purpose.

Since none of the three circumstances identified in House Bill 2292 have yet occurred, the funds in Account No. 107 currently remain dedicated to the CRS program.

COLLECTION AND APPROPRIATION OF SUBROGATION RECEIPTS

Subrogation receipts at DRS (formerly TRC) are collected by the agency through cost-recovery legal action related to rehabilitation services provided by the agency. Costs may be recovered from personal insurance, from another person for personal injury caused by negligence or wrongdoing, or other sources.

Rider 3 in TRC's bill pattern directs all subrogation receipts collected by the agency to be deposited into the Vocational Rehabilitation (VR) strategy. This rider for 2004–05 is an estimated appropriation. In the agency's legislative appropriations request for the 2006–07 biennium, an additional $1 million above appropriated amounts in subrogation receipts is shown as estimated for fiscal year 2004.

The agency has determined that about 10 percent of the money recovered in subrogation is from CRS cases. Based on the 10 percent estimate provided by the agency, of amounts expended or budgeted for fiscal years 2003 through 2005, $205,000 may have been collected from CRS cases.

As suggested by Recommendation 1, Rider 3 should be amended to appropriate subrogation receipts collected on behalf of CRS clients to the CRS program and continue to direct subrogation receipts collected in relation to the VR program to the VR strategy. Based on the agency's 2006–07 legislative appropriations request, the amount of subrogation receipts that could be directed to the CRS program is approximately $100,000 per biennium. This redirection would allow DARS to serve five additional clients in the CRS program in 2006–07.

RECOMMENDED RIDER REVISION

The following revision to the agency rider appropriating subrogation receipts is incorporated in the introduced appropriations bill for the 2006–07 biennium.

> **Appropriation: Subrogation Receipts.** Included in amounts appropriated above in Strategy ~~A.1.1~~B.3.1, Vocational Rehabilitation - General ~~Services~~ and Strategy B.3.4 Comprehensive Rehabilitation, are subrogation collections received during the ~~2004–2005~~ 2006–07 biennium~~, $500,000 annually~~. Appropriations included in Strategy B.3.1. above, $450,000 in each fiscal year of the biennium, are from subrogation receipt collections from Vocational Rehabilitation cases. Appropriations included in Strategy B.3.4 above, $50,000, in each fiscal year of the biennium, are from subrogation receipt collections from Comprehensive Rehabilitation cases. ~~Amounts~~Subrogation receipts collected above the amounts ~~$500,000~~ appropriated in each strategy in each year are hereby appropriated to the agency for client services in the ~~Vocational Rehabilitation~~ program from which the subrogation collections were generated (estimated to be zero).

ALLOCATION OF COMPREHENSIVE REHABILITATION GENERAL REVENUE–DEDICATED FUNDS

Historically, some General Revenue–Dedicated Funds have been allocated to the agency's administration strategies through the General Appropriations Act. For fiscal years 2006 and 2007, the agency is requesting approximately $326,050 annually in CRS General Revenue–Dedicated Funds for administrative costs (95 percent of the 2004–05 base). If these funds were appropriated for direct client services, the increased funds allocated to the CRS strategy would allow certain individuals currently waiting for services to be served with the dedicated funding.

As previously mentioned, eligibility is determined for the CRS program through the vocational rehabilitation counselors. No administrative costs produced by the CRS program have been tied to Program Support (Goal D). Administrative costs for this program are covered through Strategy B.3.1, Vocational Rehabilitation–General. As suggested in Recommendation 2, the agency's administrative strategies should be reduced by $343,207 in General Revenue–Dedicated Funds for each year of the 2006–07 biennium, in addition to other administrative reductions. Allocating all General Revenue–Dedicated Funds to the Comprehensive Rehabilitation strategy and appropriating 100 percent of the 2004–05 funding level will allow approximately 34 more clients to be served in the 2006–07

biennium. This new allocation would align more closely with the dedicated status of the funds.

Recommendation 3 further proposes that the strategy be appropriated the full amount of revenue collections projected by the agency for the 2006–07 biennium. Recommendation 2 and 3 are incorporated in the introduced 2006–07 General Appropriations Bill.

The recommended performance target for cost-per-client for the 2006–07 biennium is $20,000, an increase of 6 percent from the fiscal year 2004 actual performance. Appropriating the full amount of Comprehensive Rehabilitation funding estimated to be available, as well as subrogation receipts, will enable the agency to serve an estimated 1,046 clients in the 2006–07 biennium. This is an increase of 225 over the 821 clients the agency projects to serve during the 2004–05 biennium. According to advocates, treatment for traumatic brain and spinal cord injury is likely to be more effective when it is received in a timely manner. There are no FTEs or administrative objects of expense associated with this strategy; all funding is used for client services.

FISCAL IMPACT OF THE RECOMMENDATIONS

There is no significant fiscal impact from Recommendations 1, 2, and 3. All three recommendations from this report are incorporated in the introduced 2006–07 General Appropriations Bill. Recommendations of this report are made in order to promote efficient use of state funds and direct dedicated funding to needed services.

IMPROVE THE BUSINESS ENTERPRISES OF TEXAS TRUST FUND AND BENEFITS PLAN

The Business Enterprises of Texas program provides and maintains employment opportunities for blind and visually impaired individuals in the field of food service and vending in public and private facilities, and is administered by the Department of Assistive and Rehabilitative Services.

The Seventy-sixth Legislature, 1999, established the Business Enterprise Program Trust Account No. 5043 as a trust fund in the state treasury for the retirement and benefits program for Business Enterprises of Texas managers.

SIGNIFICANT FINDINGS

- The revenues and expenditures of the Business Enterprises of Texas Trust Fund fluctuate from year to year, as does the interest earned on the account.
- A consultant draft report on developing a request for proposal to administer the benefits plan provides relevant insight into current operations of the plan as well as the potential for future changes.
- The Business Enterprises of Texas Trust Fund is both a trust fund and a General Revenue–Dedicated Fund account. The balance of this trust fund account is not included in the biennial revenue estimate and is not used for certification of the budget.

SIGNIFICANT CONCERNS

- Although authorized to in 2001, the Department of Assistive and Rehabilitative Services has not yet contracted with a professional management service to administer the Business Enterprises of Texas Trust Fund benefits plan.
- The cash balance of the Business Enterprises of Texas Trust Fund is declining as revenue and interest earnings have not been sufficient to offset authorized expenditures in recent years.
- Potentially, certain trust fund benefits plan options under consideration by the Business Enterprises of Texas managers may conflict with existing statute.
- Historically, concerns about the "cost" to the General Appropriations Act by appropriations from the Business Enterprise Program Trust Fund have been raised during the legislative appropriations process.

RECOMMENDATIONS

- **Recommendation 1:** The Department of Assistive and Rehabilitative Services should work with Business Enterprises of Texas managers to identify any statutory changes, if necessary, to allow the managers to alter the trust fund benefits plan.
- **Recommendation 2:** Maintain 100 percent of the 2004–05 biennial level of funding for the Department of Assistive and Rehabilitative Services' Business Enterprises of Texas Trust Fund strategy in the 2006–07 General Appropriations Bill.

COMMENTS

The Business Enterprises of Texas (BET) program is administered by the Department of Assistive and Rehabilitative Services (DARS). House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, consolidated four health and human services agencies into DARS: the Interagency Council on Early Childhood Intervention (ECI), the Texas Commission for the Deaf and Hard of Hearing (TCDHH), the Texas Commission for the Blind (TCB), and the Texas Rehabilitation Commission (TRC). The Commission for the Blind provided services intended to assist blind and visually impaired individuals to achieve employment through programs such as Vocational Rehabilitation, as well as independent living services, services for blind and visually impaired children, and the Business Enterprises of Texas.

The federal Randolph Sheppard Act (20 U.S.C. Section 107) and state law (Human Resources Code, Title 5, Chapter 94) provide DARS (formerly TCB) with statutory authority for BET. The Randolph Sheppard Act gives priority to blind and visually impaired business managers to operate cafeterias, vending machine operations, snack bars, gift shops, and sundry stores on federal property, and state law extends this priority in Texas to state property. DARS acts as the state licensing agency in Texas, providing training and employment opportunities to eligible individuals. BET program operations are funded through General Revenue–Dedicated Account No. 492, which collects revenue from "state unmanned vending" (vending machines not assigned to BET managers and located on state property), and federal Vocational Rehabilitation (VR) funds.

The Randolph Sheppard Act provides that funds set aside from net proceeds of vending facilities may be used for limited purposes, including "retirement or pension funds, health insurance contributions, and provision for paid sick leave and vacation time, if it is determined by a majority vote of blind licensees." The Randolph Sheppard Act does not stipulate how such retirement and benefits plans shall be implemented but allows the state licensing agency (DARS), with the active participation of the State Committee of Blind Vendors, to design the plan.

The BET retirement and vacation plan is funded through the BET Trust Fund, General Revenue–Dedicated Account No. 5043, which was created by House Bill 1400, Seventy-sixth Legislature, 1999. The plan currently maintains individual accounts for members and allocates plan revenues to fund expenses, vacation and retirement benefits, and individual accounts. Vacation benefits are distributed annually as a lump-sum payment, and members can choose between quarterly payments, annuity payments, or lump-sum payment of account balances for retirement benefits.

House Bill 1161, Seventy-seventh Legislature, 2001, authorized the agency to contract with a professional management service to manage the trust fund, effective June 15, 2001; however, the agency has yet to contract for plan management.

REVENUES AND EXPENDITURES OF BET TRUST FUND

Revenue deposited into the BET Trust Fund, General Revenue–Dedicated Account No. 5043, is generated from "federal unmanned vending." These revenues are produced from vending machines located on federal properties throughout Texas that are not assigned to BET managers and are subcontracted to private entities. The commissions paid by these private entities are deposited into the BET Trust Fund pursuant to Human Resources Code, Section 94.016. Interest that accumulates on the cash balance of the trust fund also accrues to the account and fluctuates due to timing and interest rates. In fiscal year 2001 the interest earned was 5.6 percent; in fiscal year 2004 interest totaled 1.5 percent (see Figure 1).

Funds deposited to the BET Trust Fund are used for retirement and vacation benefits for BET managers. The four allowable uses of these funds identified by statute are the following:

- payment of quarterly benefit distributions to retirees under current and prior plans;
- payment of vacation pay benefits to managers;
- equalization payments to vendors from competing vending machines as required by the Randolph Sheppard Act; and
- payment for yearly actuarial services related to trust fund balances.

Any remaining funds are dedicated to the individual accounts of participants in the current retirement plan. The agency is required by Rider 9 in the General Appropriations Act for the 2004–05 biennium in the bill pattern of the Commission for the Blind (now DARS) to report quarterly to the Legislative Budget Board, the Governor, and the comptroller on revenues and expenditures of the BET Trust Fund.

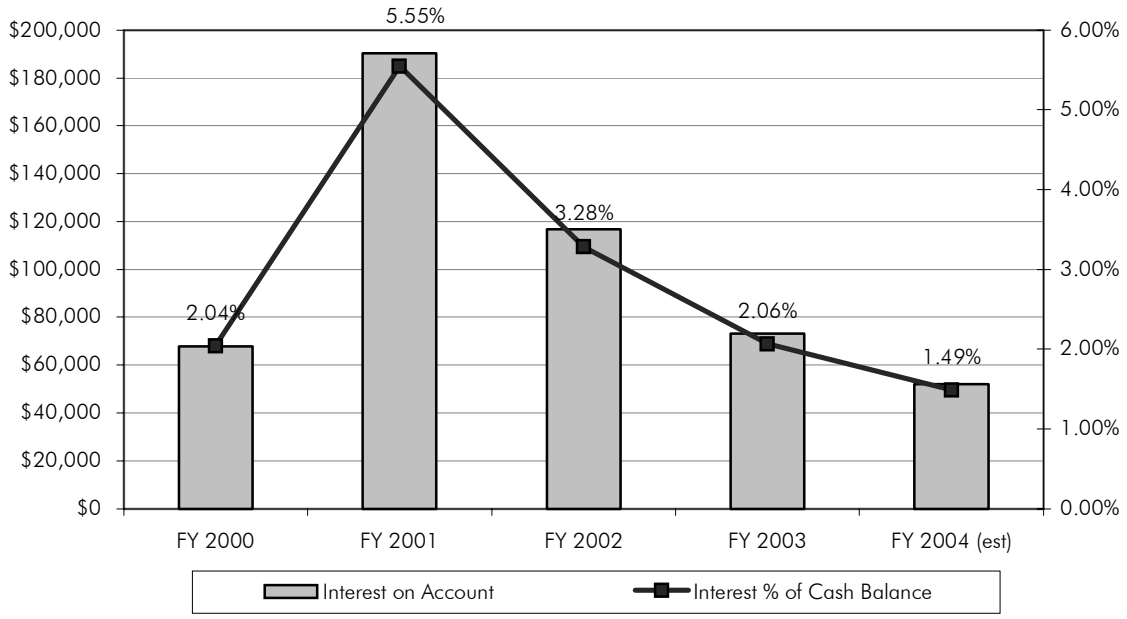
Rider 9 appropriates the agency "any amounts in addition to the amount identified in Strategy B.1.3 Business Enterprises of Texas Trust Fund, necessary to make retirement and benefits payments in conformity with the Randolph-Sheppard Act (20 USC, § 107) and Human Resources Code, § 94.016," giving the agency an estimated appropriation for this account and the related strategy (see Figure 2).

The BET Trust Fund appropriation for each year of the 2002–03 biennium was $360,000. The BET Trust Fund appropriation for each year of the 2004–05 biennium is $410,000. Expenditures exceeded estimated appropriations in fiscal years 2003 and 2004.

The agency uses factors such as historical payments for retiree and manager benefits, projections of retirement eligibility, manager annual incomes and tenure, and review of equalization and actuarial payments to forecast expenditures for the BET Trust Fund. However, fund revenues and expenditures do not always correspond. In fiscal years 2003 and 2004, expenditures exceeded revenues (see Figure 3); consequently, the agency drew against the trust fund balance. According to DARS, payment of lump-sum benefits upon the death of a participant is one example of an unpredictable factor that can affect the expenditures of the agency.

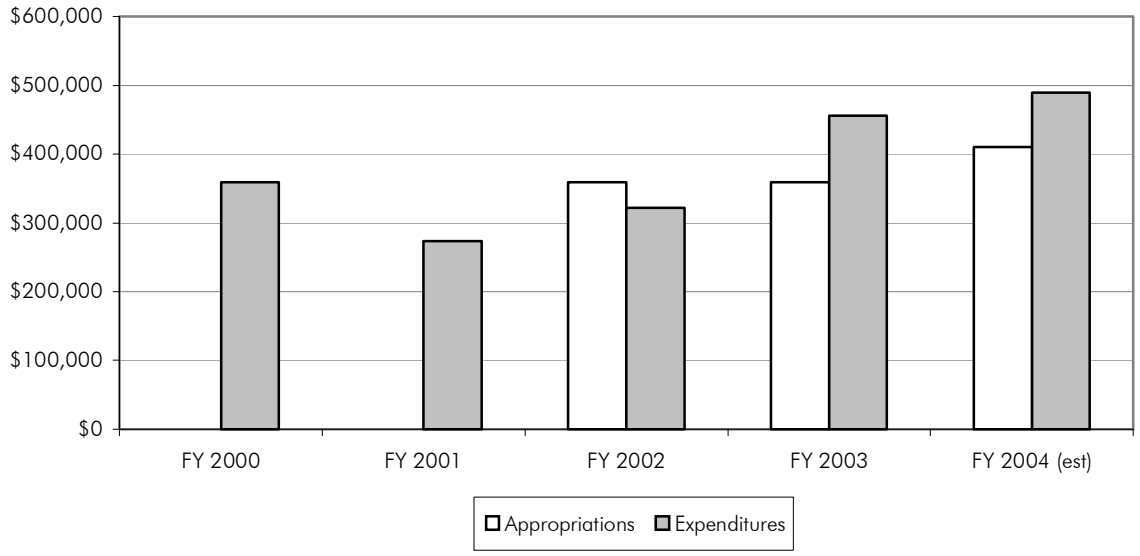
As of the end of fiscal year 2004, the cash balance of the BET Trust Fund was almost $3.5 million. Amounts appropriated from the BET Trust Fund above the revenue collected are appropriated from the cash balance of the account. The cash balance rose from fiscal year 2000 to fiscal year 2002 but has declined in subsequent years as expenditures have exceeded revenues (see Figure 4) accompanied by declining interest, as discussed above (Figure 1). This recent pattern in the revenues and expenditures of the BET Trust Fund is identified as a concern by this report, as the trust fund and benefits plan requires fiduciary responsibility by the state to be insured.

FIGURE 1
AMOUNT AND PERCENT INTEREST EARNED ON BUSINESS ENTERPRISES OF TEXAS TRUST FUND
FISCAL YEARS 2000–2004



SOURCES: Comptroller of Public Accounts; Department of Assistive and Rehabilitative Services.

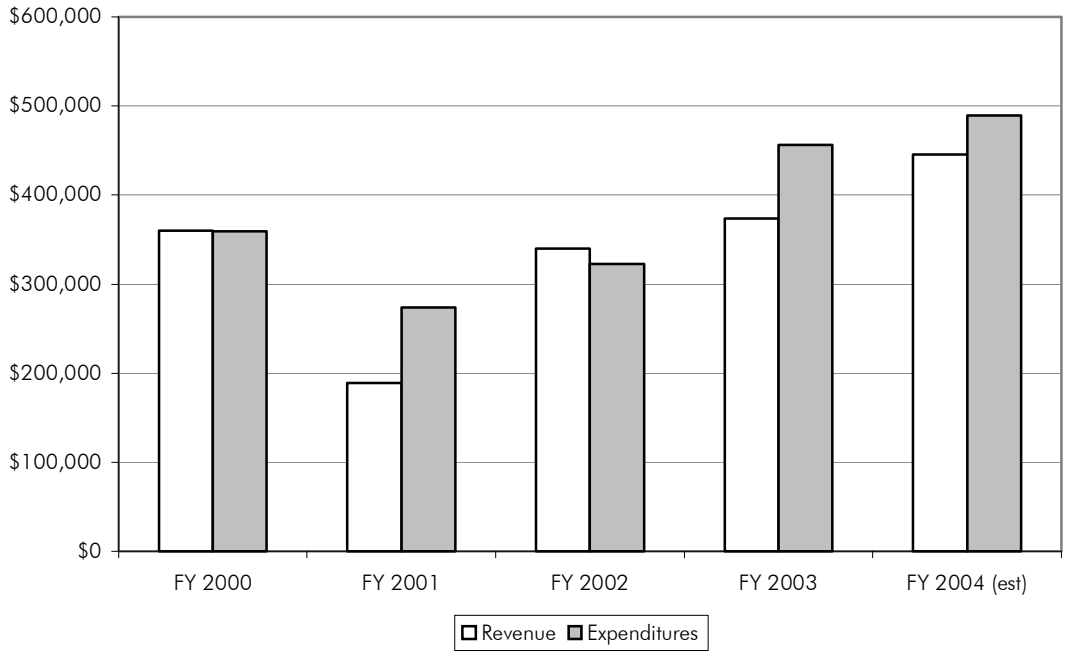
FIGURE 2
BUSINESS ENTERPRISES OF TEXAS TRUST FUND APPROPRIATIONS AND EXPENDITURES
FISCAL YEARS 2000–2004



NOTE: There was no separate appropriation for the BET Trust Fund in the 2000–01 biennium.

SOURCES: Legislative Budget Board; Comptroller of Public Accounts; Department of Assistive and Rehabilitative Services.

FIGURE 3
BUSINESS ENTERPRISES OF TEXAS TRUST FUND REVENUE AND EXPENDITURES
FISCAL YEARS 2000–2004



SOURCES: Comptroller of Public Accounts; Department of Assistive and Rehabilitative Services.

HOUSE BILL 1161: CONTRACT WITH A PROFESSIONAL MANAGEMENT SERVICE

The Seventy-seventh Legislature, 2001, authorized the Commission for the Blind (now DARS), via House Bill 1161, to contract with a professional management service to administer the BET Trust Fund. This initiative was undertaken with the assumption that if a professional management service managed the retirement fund, it would increase the profit to the fund, thereby providing a more secure retirement funding source for BET managers. The agency is not required by the legislation to enter a contract.

DARS has yet to contract with a professional management service to administer the BET Trust Fund, a concern identified in this report. House Bill 1161, Seventy-seventh Legislature, 2001, had an effective date of June 15, 2001. According to the agency, the BET Trust Fund is unique in that it provides actual retirement benefits to the BET managers. The agency reports that other states providing benefits related to retirement are more likely to issue a cash benefit to managers for investment in individual retirement accounts (IRAs) or other retirement savings selected by the individual managers. According to the agency, the complex aspects of the current benefits plan operations necessitated working with a consultant to implement House Bill 1161.

In May 2004 the agency awarded a contract to the consulting firm Escalade in Austin to develop a request for proposal (RFP) for management services. According to the terms of the contract, Escalade will do the following:

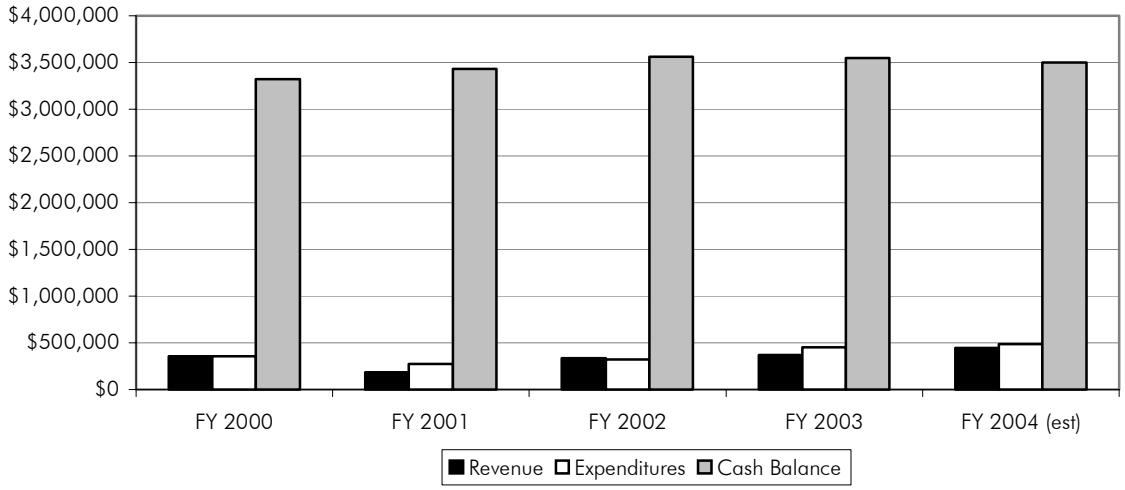
- conduct research to explore trust fund administration options in accordance with federal law (90 days);
- present options for management of the fund to the BET managers, who will vote on the options and choose one (120 days); and
- write the RFP and related specifications (90 days).

According to this timeline the RFP for management services should be finalized by March 2005.

The draft report by the consultant highlights significant aspects of the BET benefits plan operations, including the following:

- A trend exists that indicates increasing allocation of vacation benefits as a percentage of contribution revenue, which may eventually result in fewer dollars being available for retirement savings.
- The Department of Assistive and Rehabilitative Services, as plan Administrator, "provides a notable

FIGURE 4
BUSINESS ENTERPRISES OF TEXAS TRUST FUND REVENUE, EXPENDITURES, AND CASH BALANCE
FISCAL YEARS 2000–2004



SOURCES: Comptroller of Public Accounts; Department of Assistive and Rehabilitative Services.

degree of support of Plan operations" at no charge to the plan. The draft report states that DARS support includes the utilization of DARS personnel and absorption of administrative costs by DARS.

- As the assets of the plan increase, support demands will also increase and require greater work hours and specialized professional expertise from DARS.

Possible changes to the plan proposed in the draft report are as follows:

- distribution of net contribution revenue to plan members, allowing roll-over of accumulated individual balances to tax-advantaged arrangements (IRA or other retirement plan), either through a complete or partial termination of the plan; and
- outsourcing the pension administration requirements, as authorized by House Bill 1161.

As previously stated, the BET managers will vote on the option they prefer after being presented with the different options by the consultant. Potentially, certain options under consideration by the BET managers may conflict with existing statute. Therefore, Recommendation 1 is that DARS should work with BET managers to identify any statutory changes that may be necessary.

A provision was added to Rider 9 by the Seventy-eighth Legislature, Regular Session, 2003, requiring quarterly reports to the Legislative Budget Board and the Governor on the management of the BET Trust Fund. These reports are to include "deposits to the fund, the recommendations of the fund manager regarding investments, performance of investments, and an actuarial analysis of projected disbursements." The agency reports they are unable to provide reports on the management of the BET Trust Fund until House Bill 1161 is fully implemented and a fund manager is selected.

BUSINESS ENTERPRISES OF TEXAS TRUST FUND ACCOUNT CLASSIFICATION

Historically, concerns about the "cost" to the General Appropriations Act by appropriations from the Business Enterprise Program Trust Fund have been raised during the appropriations process. This report attempts to clarify the classification of the account and if it is used to certify the budget.

According to the Comptroller's Office, Business Enterprise Program Trust, General Revenue–Dedicated Account No. 5043, is a trust fund. The BET Trust Fund was established through House Bill 1400, Seventy-sixth Legislature, 1999, and set up in the state treasury. House Bill 3084, or the "funds consolidation bill," also a product of the Seventy-sixth Legislature, included the Business Enterprise Program Trust as an account in the General Revenue Fund exempted from loss of dedication, establishing the account as a General Revenue–Dedicated Fund.

The balance of this trust fund account is not included in the biennial revenue estimate and is not used for certification of the budget. The Comptroller's Office compares this to other General Revenue–Dedicated Fund accounts not used for certification, such as the Compensation to Victims of Crime account. Appropriating funds to the Business Enterprises of Texas Trust Fund strategy (B.1.5) should not be considered a "cost" to the General Appropriations Act. Therefore, Recommendation 2 is to maintain the 2004–05 level of funding for the trust fund, as the appropriation is estimated and the General Revenue–Dedicated Fund does not count as a "cost" to the General Appropriations Act. This recommendation is incorporated in the introduced 2006–07 General Appropriations Bill.

The BET Trust Fund, providing a benefit plan for BET managers who are blind and visually impaired, shows fluctuating revenues, interest earned, and expenditures. The cash balance of the BET Trust Fund is declining as revenue and interest earnings have not been sufficient to meet authorized expenditures in recent years.

DARS has not yet contracted with a professional management service to administer the BET Trust Fund benefits plan. House Bill 1161, Seventy-seventh Legislature, 2001, had an effective date of June 15, 2001. A consultant report on developing a request for proposal to administer the benefits plan provides relevant insight into current operations of the plan as well as potential future changes.

The BET Trust Fund is both a trust fund and a General Revenue–Dedicated account. The balance of this trust fund account is not included in the biennial revenue estimate and is not used for certification of the budget.

FISCAL IMPACT OF THE RECOMMENDATIONS

There is no significant fiscal impact for Recommendations 1 and 2. Recommendation 2 is incorporated in the introduced 2006–07 General Appropriations Bill. Recommendations of this report are made in order to promote efficient use of state funds and direct dedicated funding to needed services.

MONITOR STATE FUNDS USED FOR THE GIVEBACK PROVISION OF THE 2003 FEDERAL MEDICARE ACT

The U.S. Congress passed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on December 8, 2003. Among other provisions, the legislation provides outpatient prescription drug coverage to Medicare enrollees. When the federal government assumes the cost of these expenditures, state governments will be required to contribute toward the cost of providing prescription drugs to persons who are eligible for both Medicaid and Medicare. Texas should monitor these expenditures in order to ascertain the effects of this legislation on the state budget. This paper will examine a specific provision of the Medicare bill, Sec.103 Medicaid Amendments (b), which contains language describing this phased-down state contribution. This provision is variously known as the "giveback," "takeback" or "clawback" provision. For consistency, "giveback" shall be used in all references to this provision throughout this analysis.

SIGNIFICANT CONCERNS

- Medicaid programs, funded with state General Revenue Funds and Federal Funds, currently pay for outpatient prescription drugs for recipients who are dually-eligible for Medicaid and Medicare. However, effective January 1, 2006, the Medicare program, funded primarily with Federal Funds, will pay for outpatient prescription drugs for these dual-eligible recipients.
- States will be required by federal law to send General Revenue Funds to the federal Medicare Prescription Drug Account in the form of giveback payments as a phased-down state contribution toward the costs of these drugs.
- If a state chooses not to send in required payments, its federal Medicaid matching payments will be reduced by the amount of non-payment, plus interest.
- State savings may be offset by increases in Medicaid enrollment, reduced leverage in negotiating prescription drug rebates, and the use of 2003 as a base year to calculate savings, prior to savings realized through the implementation of the preferred drug lists.

RECOMMENDATIONS

- **Recommendation 1:** Include in the 2006–07 General Appropriations Bill a strategy, Medicare Federal Giveback Provision, in the bill pattern for the Health and Human Services Commission to track state General Revenue Fund expenditures for this provision.
- **Recommendation 2:** Include in the 2006–07 General Appropriations Bill a new method of finance, Medicare Giveback Provision, to track these state General Revenue Fund expenditures apart from other Medicaid funds.

COMMENTS

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA) provides that beginning in January 2006, the federal government will provide optional coverage of prescription medications for Medicare recipients through drug plans. This benefit is known as "Part D." An important piece of the Medicare legislation affecting state budgets is federal coverage of the outpatient drug expenditures currently made by state Medicaid programs on behalf of "full dual-eligible" enrollees. The term full dual-eligible refers to people receiving Medicare who have access to the state's full range of Medicaid benefits. Texas and the federal government pay for Medicaid benefits according to a roughly 40 percent/60 percent state/federal split. The Part D benefit will result in the federal government assuming some of the costs of drug expenditures that are currently being borne by state governments for dual-eligible recipients. However, states will continue to finance much of the prescription drug costs for dual-eligibles in the form of payments to the federal Medicare Prescription Drug Account. Recommendation 1 suggests including a line item in the bill to track this expense. Strategy B.2.3, Medicare Federal Give Back Provision has been included in the Health and Human Services Commission budget structure in the introduced 2006–07 General Appropriations Bill to reflect these expenditures. Recommendation 2 specifies that a new method of finance, Medicare Giveback, should be included to track these General Revenue Fund expenditures. This method of finance has been included in the introduced version of the 2006–07 General Appropriations Bill, as this will allow for easy reference when calculating all state expenditures for the Medicaid program. There are no federal matching funds associated with these state expenditures. These "giveback" payments are known in statute as "phased-down state contributions" and are discussed in detail below.

DUAL-ELIGIBLE ENROLLEES

The term "full dual-eligible" refers to enrollees who are eligible for both Medicare and the state's full range of Medicaid benefits. For a single adult, dual-eligibility generally means his or her income is at or below the Medicaid income limit and that he or she is 65 years or older, is disabled, or has end stage renal disease. Data show that more than 70 percent of dual-eligibles have annual incomes below $10,000 compared to 13 percent of all other Medicare beneficiaries. In calendar year 2002, dual-eligible enrollees in the United States accounted for 14 percent of all federal Medicaid enrollees. However, this group comprised 42 percent of total expenditures. Research shows dual-eligibles are more likely to be in fair or poor health compared to other Medicare beneficiaries. As a result, states paid approximately $7 billion for the cost of prescription drugs for dual-eligibles in 2002. Texas had 363,000 dual-eligible enrollees in 2002. The estimate of Texas' drug expenditures in 2002 for this group is $654 million. This breaks down to about $150 per recipient per month. In general, it appears that prescription drugs are a cost which dual-eligible recipients may not be able to manage without the financial assistance provided by state and federal governments.

MEDICARE "GIVEBACK" PROVISION

Under the MMA, states must provide a phased-down contribution, or "giveback," toward the federal government's cost of outpatient prescription drugs for dual-eligibles. The calculation of this monthly giveback involves several factors (see Figure 1), including the state share of 2003 per capita expenditures (PCE) for covered Part D drugs for full dual-eligibles multiplied by a federally-determined growth factor; the number of dual-eligibles enrolled in a Part D Plan in the month for which payment is made; and a phased-down percentage for the year, specified in statute (see Figure 2).

FIGURE 1
CALCULATION OF THE GIVEBACK

1/12th X State share 2003 per capita expenditures, inflated X # Dual-eligibles X Phased Down Percent

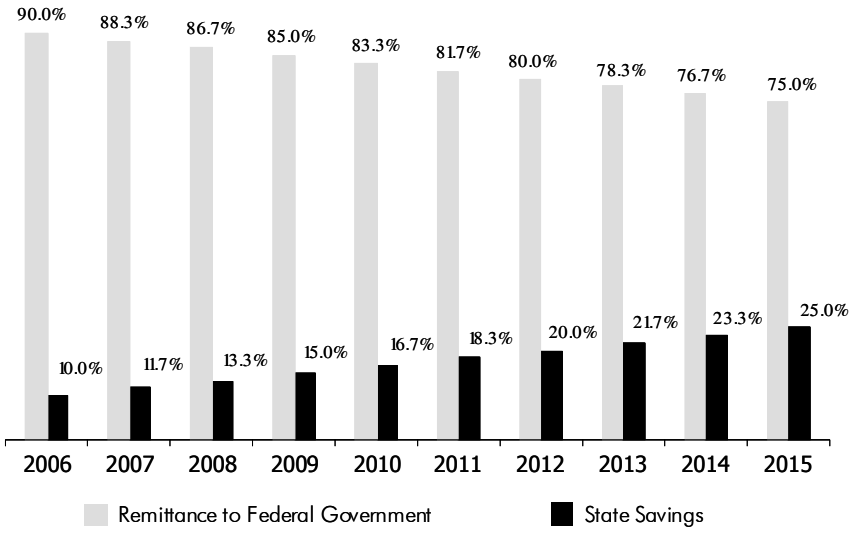
SOURCE: Legislative Budget Board.

The Health and Human Services Commission's estimate of the giveback is $175.0 million for fiscal year 2006 and $290.3 million for fiscal year 2007. The significant difference between years results from the rollout of Part D coverage starting January 1, 2006. Only eight months are included in the first year.

POTENTIAL COSTS TO TEXAS

There may be additional costs to the state in implementing the MMA. First, there may be an increase in the number of persons receiving Medicaid assistance. The MMA specifies that certain Medicare beneficiaries may apply for low-income subsidies (financed by Medicare) to help pay the

FIGURE 2
PHASE-IN OF STATE REMITTANCE RELATED TO DUAL-ELIGIBLES PERCENTAGE SAVINGS



SOURCE: Legislative Budget Board.

Part D premium, deductible, and cost-sharing obligations. Some people who apply for this subsidy may be determined eligible for Medicaid benefits such as long-term care, health services not covered by Medicare, and the Medicare premium assistance program. These newly determined dual-eligibles would be an additional cost to Medicaid.

Secondly, federal law does not allow states to claim federal Medicaid matching funds for the costs of drugs that could be provided to those dual-eligible recipients who are not enrolled in a Part D plan. Furthermore, with some limited exceptions, states would be responsible for the costs of drugs they provide that are not covered by a dual-eligible's prescription drug plan formulary. Should the state choose to cover drug costs of dual-eligibles not enrolled in Part D, or to provide coverage for drugs not included on participants' formularies, additional expenditures would be required. Third, the state may incur administrative costs related to outreach and enrollment in a Part D plan, including processing of eligibility for the low-income subsidies financed by Medicare available to certain dual-eligibles who enroll in Part D. Fourth, states will receive fewer rebates from prescription drug manufacturers since their overall drug expenditures will be reduced. Finally, the use of calendar year 2003 as the base year to calculate the giveback will not fully reflect savings initiatives begun in fiscal year 2004, such as the preferred drug list and disease management.

FISCAL IMPACT OF THE RECOMMENDATIONS

The Legislative Budget Board staff's estimate of the cost of drugs that will now be covered by Medicare is $670.2 million in General Revenue Funds for the 2006–07 biennium. Based on the giveback formula, the Health and Human Services Commission (HHSC) estimates that Texas will return $465.3 million to the federal government during the 2006–07 biennium. The net savings, after adjusting for reduced manufacturer rebates, is approximately $166.0 million. The giveback funds reside in Health and Human Services Commission's Strategy B.2.3, Medicare Federal Give Back Provision in the introduced 2006–07 General Appropriations Bill.

The introduced 2006–07 General Appropriations Bill includes $3,790.1 million in All Funds for Strategy B.2.2, Medicaid Vendor Drug Program and $465.3 million in All Funds for Strategy B.2.3, Medicare Federal Give Back Provision, for a total of $4,255.4 million in prescription drug expenditures.

PREVENT LOSS OF FEDERAL SUBSTANCE ABUSE BLOCK GRANT FUNDS

There are two main requirements for a state to receive the full federal Substance Abuse Prevention and Treatment Block Grant allotment: proof of a maintenance of effort to maintain non-federal funding at the average of the previous two years, and compliance with Synar Amendment provisions that require states to pass and enforce laws regarding the sale of tobacco products to individuals under the age of 18. During fiscal years 2003 and 2004, the Texas Commission on Alcohol and Drug Abuse received approximately $137.7 million in Substance Abuse Prevention and Treatment Block Grant Federal Funds each year. The economic conditions in the state at the time required reductions in state agency appropriations. Because of the reductions to Texas Commission on Alcohol and Drug Abuse's General Revenue Funds used for the federally required maintenance of effort, the agency and the state were unable to meet one of the two main requirements for the Substance Abuse Prevention and Treatment Block Grant. In an effort to prevent this from happening in the future, the Department of State Health Services should be encouraged to accurately account for all funds used for maintenance of effort, and the agency should review whether current appropriated funds could be used for Substance Abuse Prevention and Treatment Block Grant requirements without affecting services.

SIGNIFICANT FINDINGS

- Federal law requires states receiving Substance Abuse Prevention and Treatment funding to maintain a certain level of non-federal funding. This level of funding, known as "maintenance of effort," is one of the two main requirements for a state to receive the full allotment of Substance Abuse Prevention and Treatment Block Grant funds.
- Compliance with the Synar Amendment, which requires states to pass and enforce laws regarding the sale of tobacco products to individuals under the age of 18, is also a requirement for receiving the federal substance abuse block grant.

SIGNIFICANT CONCERNS

- Texas did not meet the non-federal funding requirement for "maintenance of effort" for the Substance Abuse Prevention and Treatment Block Grant in fiscal year 2003.
- If a federal waiver is not granted, Texas' allotment of Substance Abuse Prevention and Treatment Block Grant Federal Funds could be reduced by approximately $10 million in subsequent fiscal years.

RECOMMENDATIONS

- **Recommendation 1:** Include a rider in the 2006–07 General Appropriations Bill for the Department of State Health Services requiring the agency to provide an explanation and accounting of all funds used for Maintenance of Effort.
- **Recommendation 2:** The Department of State Health Services should review current appropriated funds and evaluate if any funds could be used toward the maintenance of effort requirement of the Substance Abuse Prevention and Treatment Block Grant without a reduction in the agency's service levels.

COMMENTS

The Texas Commission on Alcohol and Drug Abuse (TCADA) was formally merged with the Department of Health and the mental health component of the Department of Mental Health and Mental Retardation to form the Department of State Health Services (DSHS) on September 1, 2004. Most components of TCADA were placed under the Mental Health and Substance Abuse Services division at that time. The new agency was established pursuant to House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, which reorganized all health and human service agencies. TCADA had been the principal state agency designated by the governor to receive Substance Abuse Prevention and Treatment (SAPT) Block Grant federal funds. After the establishment of the DSHS, the governor designated DSHS as the principal state agency for activities authorized under the federal Public Health Service Act Section 1921. Section 1921 provides for the allocation of funding to states for planning, carrying out, and evaluating activities to prevent and treat substance abuse and other related activities.

There are two main requirements for a state to receive SAPT block grant funding: (1) maintain average non-federal expenditures over the previous two-year period, a commitment known as maintenance of effort (MOE) and (2) be in compliance with the Synar Amendment provisions

pertaining to passage and enforcement of laws regarding the sale of tobacco products to individuals under the age of 18.

MAINTENANCE OF EFFORT REQUIREMENT

Federal law requires states receiving SAPT funding to maintain prescribed levels of non-federal funding. This level of funding, known as maintenance of effort, is one of the two main requirements for a state to receive the full allotment of Substance Abuse Prevention and Treatment (SAPT) Block Grant funds.

To meet the MOE requirement of the SAPT Block Grant, a state needs to show maintenance levels of non-federal funding for the programs outlined under the grant. The MOE is based on the average non-federal expenditures of the previous two years. For example, if a state provides non-federal funding of $27.5 million in fiscal year 2001 and $27.9 million in 2002, the MOE for fiscal year 2003 is $27.7 million. A state needs to provide a minimum of $27.7 million for the current fiscal year of the block grant (average of the previous two fiscal years) to receive the full allotment and avoid a reduction to the block grant.

PENALTIES FOR NONCOMPLIANCE

If a state is found to be in noncompliance with the Section 1930 requirement regarding the average non-federal funding, the Secretary of the U.S. Department of Health and Human Services can grant a waiver of the MOE requirement or reduce the state's SAPT Block Grant allotment dollar for dollar by the amount not maintained by the state.

Due to funding transfers, TCADA had sufficient General Revenue funding to meet the fiscal year 2004 SAPT MOE requirement. However, Texas did not meet the MOE requirement for fiscal year 2003. The state has appealed the federal decision to deny a one-time waiver of the MOE requirement. If the appeal is unsuccessful, the federal allotment to the state for fiscal year 2005 could be reduced by $9.8 million. This could significantly reduce the number of Texans provided drug and alcohol services.

TCADA, having previously been designated the principal agency for SAPT Block Grants, was appropriated the non-federal funds required under federal law in the form of General Revenue Funds shown in Figure 1. General Revenue funding for employee benefits can also qualify for use in the MOE requirement.

REDUCTION IN 2004–05 FUNDING

The economic conditions in Texas in fiscal years 2002 and 2003 resulted in revenue collections that were not adequate to support the previously adopted budgets for fiscal year 2003. Consequently, the Seventy-eighth Legislature, Regular Session, 2003, enacted House Bill 7, which reduced fiscal

FIGURE 1
TCADA APPROPRIATIONS
SAPT BLOCK GRANT AND GENERAL REVENUE
GENERAL APPROPRIATIONS ACT

FISCAL YEAR	APPROPRIATED GENERAL REVENUE FUNDS	FEDERAL FUND ALLOTMENT
2001	$ 27,256,268	$ 127,289,421
2002	$ 27,299,576	$ 132,649,226
2003	$ 17,722,583 *	$ 133,331,132
2004	$ 17,214,474	$ 137,162,139
2005	$ 27,214,474	$ 137,162,139**

* House Bill 7 reduced General Revenue by $9,576,994 (from $27,299,577).
** Estimated appropriation assumed in the GAA.
SOURCE: Legislative Budget Board.

year 2003 General Revenue and General Revenue–Dedicated appropriations to all state agencies. The commission's fiscal year 2003 General Revenue Fund appropriation of $27.3 million was reduced by $9.6 million (Figure 3) with the passage of House Bill 7. The reduction reduced the General Revenue Funds available for the calculation of the MOE for fiscal year 2004. Targeted client levels at TCADA for fiscal year 2003 were maintained by using available SAPT federal funds carried forward from fiscal year 2002. In addition to the reduced level of General Revenue Funds available in fiscal year 2003, the commission was appropriated $17.2 million in General Revenue Funds for fiscal year 2004, approximately $10.0 million less than in fiscal years 2002 and 2005.

The reduction in General Revenue Funds for fiscal year 2003 and the decreased appropriation in fiscal year 2004 undermined the state's ability to meet the SAPT MOE requirement for both fiscal years. Any General Revenue Funds amount below the average of the previous two years could trigger a dollar for dollar reduction in SAPT federal funds in subsequent years. Potentially, the SAPT allotment for fiscal year 2003 could have been reduced by approximately $9.8 million, and the allotment for fiscal year 2004 could have been reduced by $6.5 million for a total of $16.3 million over the two-year period (Figure 2). It was estimated that the number of clients affected by the reduction would be approximately 6,300 in fiscal year 2003.

The Commission on Alcohol and Drug Abuse and the Health and Human Services Commission (HHSC) requested a waiver from the MOE requirements for fiscal year 2003 from the U.S. Department of Health and Human Services Department (USHHS). This request would have

FIGURE 2
MAINTENANCE OF EFFORT REQUIREMENTS FOR THE SAPT BLOCK GRANT AND APPROPRIATED GENERAL REVENUE

	EXP 2001	EXP 2002	EXP 2003	EST 2004	BUD 2005
General Revenue Appropriation to TCADA/DSHS	$ 27,256,268	$ 27,299,576	$ 27,299,577	$ 17,214,474	$ 27,214,474
Other GR Appropriations for SAPT*	$ (165,066)	$ 2,107,378	$ 744,949	$ 228,294	$ 183,059
HB 7 adjustments	$ -	$ -	$ (9,576,994)	$ -	$ -
Adjusted GR appropriation	$ 27,091,202	$ 29,406,954	$ 18,467,532	$ 17,442,768	$ 27,397,533
MOE Requirement			$ 28,249,078	$ 23,937,243	$ 17,955,150
Over/(Short)			$ (9,781,546)	$ (6,494,475)	$ 9,442,383

*Includes General Revenue appropriated for employee benefits for TCADA/DSHS workers.
SOURCE: Department of State Health Services.

the effect, if granted by the Secretary of the USHHS, of exempting the state from a reduction in the SAPT Block Grant for fiscal year 2003.

As provided by federal law, the secretary has 120 days to respond after the state makes the waiver request. Additional information on the state's economic condition during fiscal years 2002 and 2003 was transmitted with the waiver request. After additional interaction with staff from TCADA and the HHSC, the secretary denied the waiver request, although the ruling is currently being appealed.

To address the lower level of General Revenue Funds at TCADA for fiscal year 2004 as well as the uncertainty of the state's request for a waiver of the MOE requirement, HHSC sought a way to mitigate the potential reduction in SAPT Block Grant Funds. The proposed solution was to move $5.0 million in General Revenue Funds from fiscal year 2005 to fiscal year 2004 and to transfer $1.6 million in General Revenue Funds to TCADA for fiscal year 2004. The HHSC proposal was adopted, and the resulting adjustments are shown in Figure 3.

After the adoption of the changes in General Revenue Funds and the denial of the waiver, the only reduction in the SAPT Block Grant would be related to fiscal year 2003. Although the MOE requirement did not change for fiscal year 2004, the General Revenue Funds available to be used toward the MOE requirement increased by $6.6 million in fiscal year 2004, as indicated in Figure 4. The increase put the state in compliance with the fiscal year 2004 and 2005 MOE requirements.

As stated in Recommendation 1, the following rider should be included in the introduced 2006–07 General Appropriations Bill that requires an accounting and an explanation of all funds used in the calculation of the MOE.

__. **SAPT Maintenance of Effort Calculation.** The Department of State Health Services shall submit by September 1 of each year of the biennium to the Legislative Budget Board and the Governor a detailed analysis of all funds used for the calculation of the Substance Abuse Prevention and Treatment

FIGURE 3
ADJUSTED GENERAL REVENUE EXPENDITURES RELATED TO THE SAPT BLOCK GRANT

	EXP 2001	EXP 2002	EXP 2003	EST 2004	BUD 2005
General Revenue Funds Appropriation	$27,256,268	$27,299,576	$27,299,577	$17,214,474	$27,214,474
Other GR	($165,066)	$2,107,378	$744,949	$228,294	$183,059
House Bill 7 adjustment	0	0	(9,576,994)	0	0
HHSC approved adjustments*	0	0	0	5,000,000	(5,000,000)
HHSC approved adjustments*	0	0	0	1,600,000	0
Adjusted GR appropriation	$27,091,202	$29,406,954	$18,467,532	$24,042,768	$22,397,533

*September 2004.
SOURCE: Department of State Health Services.

FIGURE 4
MAINTENANCE OF EFFORT REQUIREMENTS AFTER HHSC ADJUSTMENTS

	EXP 2001	EXP 2002	EXP 2003	EST 2004	BUD 2005
General Revenue Funds Appropriation	$27,256,268	$27,299,576	$27,299,577	$17,214,474	$27,214,474
General Revenue Funds and all other non-federal funds	$ 27,091,202	$ 29,406,954	$ 18,467,532	$ 24,042,768	$ 22,397,533
MOE Requirement			$ 28,249,078	$ 23,937,243	$ 21,255,150
Over/(Short)			$ (9,781,546)	$ 105,525	$ 1,142,383

SOURCE: Department of State Health Services.

Block Grant Maintenance of Effort requirement for fiscal years 2005, 2006, and 2007. The report shall be in a format prescribed by the Legislative Budget Board and shall be accompanied by any supporting documentation detailing the sources and methodologies utilized in the calculation.

The "detailed analysis" that the rider requires would identify all non-federal funds used in the calculation of the MOE and provide an evaluation of future matching needs for the MOE requirement.

Recommendation 2 directs the DSHS and the HHSC to review all state funding used for substance abuse prevention and treatment in all state agencies to assure that the state is maximizing the fund matching available for the SAPT Block Grants.

STATE SYNAR COMPLIANCE

In addition to the MOE requirement for the SAPT Block Grant, a state must comply with the Synar Amendment. The Synar amendment, Section 1926 of the federal Public Health Service Act, was named after the late Oklahoma Senator Mike Synar. The amendment requires states to pass and enforce laws regarding the sale of tobacco products to individuals under the age of 18.

The Synar amendment requires the following of each state:

- Enforce such laws in a manner that can reasonably be expected to reduce the extent to which tobacco products are available to individuals under the age of 18;
- Conduct annual random, unannounced inspections to ensure compliance with the law. These inspections are to be conducted in such a way as to provide a valid sample of outlets accessible to youth and are used to determine the inspection failure rate (Figure 5);
- Develop a strategy and timeframe for achieving an inspection failure rate of less than 20 percent of outlets accessible to youth; and
- Submit an annual report detailing the state's activities to enforce the law, the overall success the state has achieved during the previous fiscal year in reducing tobacco availability to youth, how inspections were conducted and the methods to identify outlets, and plans for enforcing the law in the coming fiscal year.

Pursuant to the federal Synar requirements, the Seventy-fifth Legislature, 1997, passed Senate Bill 55 (Health and Safety Code 161). Provisions of the senate bill became effective on September 1, 1997.

TEXAS' COMPLIANCE EFFORTS

Senate Bill 55, Seventy-fifth Legislature, 1997, was passed with provisions providing for compliance with federal requirements. Pursuant to the Synar Amendment under Section 1.01, Subchapter H, Sec. 161.088(e), Health and Safety Code of Senate Bill 55, the Comptroller of Public Accounts has primary responsibility for administration and enforcement of the state law and preparing information required by section 1926 of the federal Public Health Service Act for submittal by the governor to the Secretary of the United States Department of Health and Human Services.

The comptroller may enter into interagency contracts with other state agencies, and those agencies may assist the comptroller in the administration and enforcement of the subchapter. The comptroller has an interagency contract with TCADA that outlines each agency's responsibility to ensure compliance with the Synar amendment provisions.

The TCADA entered into an interagency contract with Southwest Texas State University (now Texas State University) to conduct the random unannounced inspections of retailers selling tobacco products. The comptroller and the Department of Health (now the Department of State

FIGURE 5
TIMING OF INSPECTION REQUIREMENTS

STATES WHOSE LEGISLATURE MET IN 1993 AND 1994: YEAR FOR IMPLEMENTING REQUIREMENT	REQUIREMENT	STATES WHOSE LEGISLATURE DID NOT MEET IN BOTH 1993 AND 1994: YEAR FOR IMPLEMENTING REQUIREMENT
1994	Conduct reasonable number of random, unannounced inspections	1995
1995	Conduct reasonable number of random, unannounced inspections	1996
1996 and all subsequent fiscal years	Conduct random, unannounced inspections using probability sample	1997 and all subsequent fiscal years

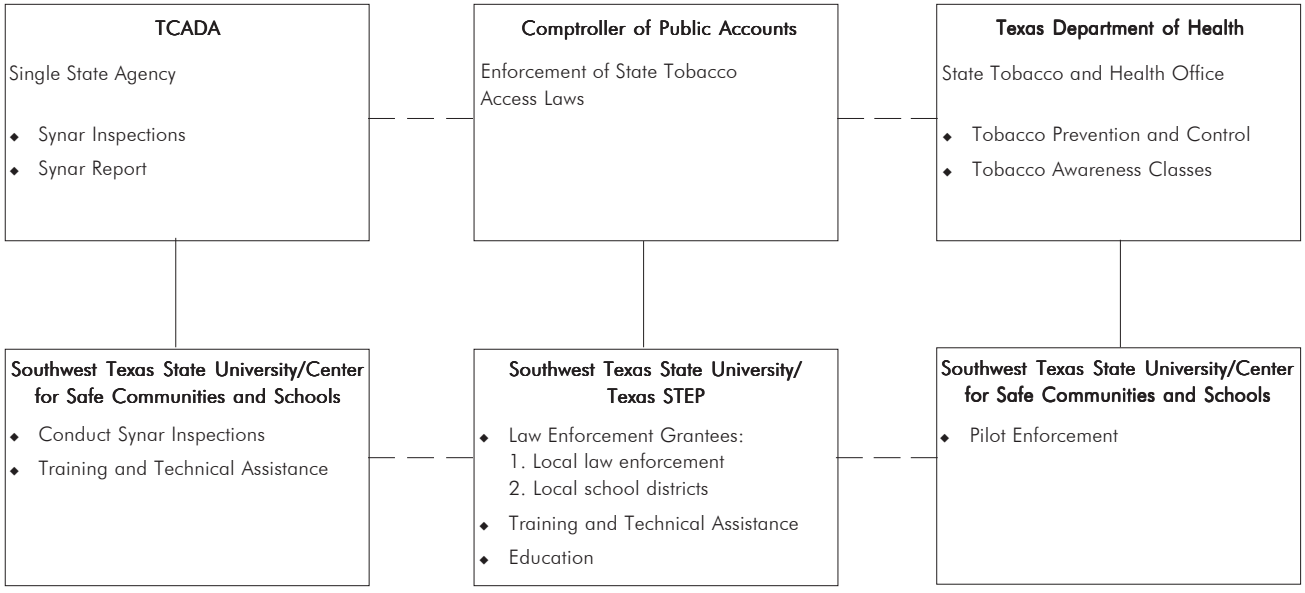
SOURCE: Legislative Budget Board.

Health Services) also have contracts with Texas State University for services (Figure 6). Additionally, under §161.088 the comptroller is directed to make block grants to counties and municipalities to be used by local law enforcement agencies to enforce the law and shall rely, to the fullest extent possible, on local law enforcement agencies to enforce the subchapter.

FISCAL IMPACT OF THE RECOMMENDATIONS

Because of the nature of the recommendations, there is no discernible fiscal impact for the 2006–07 biennium. The recommended rider has been included in the introduced 2006–07 General Appropriations Bill.

FIGURE 6
TEXAS SYNAR INTERGOVERNMENTAL RELATIONSHIPS
FEDERAL FISCAL YEAR 2003



SOURCE: Department of State Health Services.

REDUCE THE NEED FOR EMERGENCY ROOM UTILIZATION IN THE MEDICAID PROGRAM

Medicaid clients use the emergency room for conditions that could be treated in a primary care setting, such as a doctor's office or clinic. Treatment for these non-emergent conditions in the emergency room costs more than if this care had been delivered in a primary care setting. Redirecting clients with non-emergent conditions from the emergency room to the primary care setting could result in potential cost savings of $82.2 million per year. In an effort to reduce Medicaid expenditures, the Texas Health and Human Services Commission should establish a pilot program in one of the Primary Care Case Management service areas to test implementation of quality initiatives designed to reduce non-emergent use of the emergency room.

SIGNIFICANT FINDINGS

- During a one-year period, there were 599,798 emergency room visits in which non-disabled, low-income families, children, and pregnant Medicaid clients in Texas received treatment for non-emergent conditions.
- The total direct cost of treating non-disabled, low-income families, children, and pregnant Medicaid clients with non-emergent conditions in the emergency room was $115.9 million during a one-year period. If Medicaid clients who received non-emergent care in the emergency room had instead been seen by their primary care provider, the estimated cost for treating these clients would have been $33.7 million. Thus, the potential cost savings from redirecting clients with non-emergent conditions from the emergency room to the primary care setting is $82.2 million per year.
- Medicaid managed care has implemented strategies to encourage appropriate utilization of Medicaid services, including proper use of the emergency room. For example, all clients enrolled in managed care receive primary care and obtain referrals to specialty care from their primary care provider.

SIGNIFICANT CONCERN

- Despite managed care strategies, Medicaid clients continue to use the emergency room for non-emergent conditions.

RECOMMENDATIONS

- **Recommendation 1:** Include a rider in the 2006–07 General Appropriations Bill authorizing the Texas Health and Human Services Commission to spend up to $394,250 in General Revenue Funds and an amount of Federal Funds estimated to be $605,750 to establish a pilot program in one of the Primary Care Case Management service areas to test implementation of quality initiatives designed to reduce non-emergent use of the emergency room.
- **Recommendation 2:** Include a rider in the 2006–07 General Appropriations Bill requiring the Texas Health and Human Services Commission to conduct a study to test the effectiveness of a pilot program established to reduce non-emergent use of the emergency room and Medicaid costs and submit a report to the Legislative Budget Board and the governor by November 1, 2006.

COMMENTS

Medicaid, financed with both federal and state funds, is a healthcare program for low-income families, the elderly, and persons with disabilities. Individuals who receive Temporary Assistance to Needy Families (TANF) and Supplemental Security Income (SSI) are automatically eligible for Medicaid. Texas also provides Medicaid coverage to the following optional eligible groups: pregnant women up to 185 percent of the federal poverty level (FPL), infants up to 185 percent of the FPL, and children and pregnant women whose income exceeds Medicaid eligibility limits, but who do not have the resources required to meet their medical expenses. This report focuses on services provided to non-disabled, low-income families, children, and pregnant Medicaid clients. For purposes of this report, these clients are referred to as TANF and TANF-related Medicaid clients.

Texas Medicaid acute services have historically been delivered through a traditional fee-for-service model through which providers receive a fee for services performed. House Bill 7 enacted by the Seventy-second Legislature, 1991, created the first Medicaid managed-care pilot programs in Texas. Currently, Medicaid acute services are delivered through fee-for-service and two managed-care

models: the fully capitated Health Maintenance Organization (HMO) model and the Primary Care Case Management (PCCM) model. While HMOs assume full financial risk for enrollees, PCCM primary care providers (PCPs) receive a $3 per member per month case management fee, and claims are paid on a fee-for-service basis. TANF and TANF-related clients participate in Medicaid managed care on a mandatory basis and SSI and SSI-related clients on a voluntary basis. Figure 1 shows the number of TANF and TANF-related clients ever enrolled in each of the Medicaid delivery models during a one-year period. There is duplication across the model types because clients may have switched model types during the time period.

FIGURE 1
TANF AND TANF-RELATED CLIENTS BY MEDICAID DELIVERY MODEL (DECEMBER 2002 TO NOVEMBER 2003)

MEDICAID DELIVERY MODEL	NUMBER OF TANF AND TANF-RELATED MEDICAID CLIENTS
Fee-for-Service	2,487,751
Managed Care: Primary Care Case Management	478,850
Managed Care: Health Maintenance Organization	1,086,166

SOURCE: Health and Human Services Commission.

The Seventy-eighth Legislature, Regular Session, 2003, directed the Health and Human Services Commission (HHSC) to provide Medicaid services through the most cost-effective model(s) of managed care. Upon completing an actuarial assessment of the cost-effectiveness and feasibility of managed care expansion within the state's Medicaid program, HHSC is scheduled to expand managed care to all areas of the state during the 2006–07 biennium.

USE OF THE EMERGENCY ROOM FOR NON-EMERGENT CONDITIONS

Studies show that Medicaid enrollees have a higher rate of emergency room (ER) use than Americans with private insurance, the uninsured, and Medicare enrollees. In some cases, Medicaid clients use the ER for non-emergent conditions that could be treated in a primary care setting, such as a doctor's office or clinic. As shown in Figure 2, there were 599,798 ER visits in which TANF and TANF-related Texas Medicaid clients received treatment for non-emergent conditions during a one-year period (December 1, 2002 through November 30, 2003).

FIGURE 2
NON-EMERGENT USE OF THE EMERGENCY ROOM AMONG TANF AND TANF-RELATED MEDICAID CLIENTS (DECEMBER 2002 TO NOVEMBER 2003)

MEDICAID DELIVERY MODEL	NUMBER OF NON-EMERGENT ER VISITS
Fee-For-Service	334,100
Managed Care: Primary Care Case Management	103,279
Managed Care: Health Maintenance Organization	162,419
TOTAL	599,798

SOURCE: Health and Human Services Commission.

This report defines non-emergent conditions as those conditions that do not require treatment within 24 hours. The diagnostic codes used to indicate a non-emergent condition were chosen based on a literature review and in consultation with physicians at the University of Florida's College of Medicine. The list of codes excludes diagnoses in which there were differences of opinion among physicians about whether the condition could possibly require treatment in less than 24 hours.

A typical ER visit may result in physician fee(s), a hospital department fee, and billings for ancillary diagnostic services (e.g., x-rays and laboratory tests). As shown in Figure 3, the total direct cost of non-emergent ER use for Texas TANF and TANF-related Medicaid clients was $115.9 million during a one-year period (December 1, 2002 through November 30, 2003). This cost includes physician fees, hospital fees, and ancillary diagnostic services for non-emergent care in the ER. This cost does not include prescriptions and return outpatient visits that may be associated with the ER visit.

POTENTIAL SAVINGS FROM REDIRECTING CLIENTS WITH NON-EMERGENT CONDITIONS TO THE PRIMARY CARE SETTING

Redirecting clients with non-emergent conditions from the emergency room to the primary care setting could result in significant savings to the state. As shown in Figure 4, if TANF and TANF-related Medicaid clients who received non-emergent care in the ER were diverted to their PCP, the estimated cost for treating these clients in this setting would have totaled $33.7 million during a one-year period (December 1, 2002 through November 30, 2003). This cost estimate includes a physician reimbursement fee and an average amount for ancillary diagnostic tests. Physician reimbursement fees listed in the Texas Medicaid 2004 Physician Fee Schedule range from $11.73 to $87.83 depending on whether the client is new or established and the level of the visit. The physician reimbursement fee used

FIGURE 3
DIRECT COST OF NON-EMERGENT EMERGENCY ROOM USE FOR TANF AND TANF-RELATED MEDICAID CLIENTS (DECEMBER 2002 TO NOVEMBER 2003)

MEDICAID DELIVERY MODEL	PHYSICIAN FEES	HOSPITAL FEES	ANCILLARY DIAGNOSTIC SERVICES	TOTAL
Fee-For-Service	$11,530,618	$44,104,131	$11,449,101	$67,083,850
Managed Care: Primary Care Case Management	$3,955,687	$15,151,608	$3,140,614	$22,247,909
Managed Care: Health Maintenance Organization	$5,108,468	$20,102,299	$1,416,258	$26,627,025
TOTAL	$20,594,773	$79,358,038	$16,005,973	$115,958,784

SOURCE: Health and Human Services Commission.

FIGURE 4
POTENTIAL ANNUAL COST SAVINGS FROM REDUCING NON-EMERGENT EMERGENCY ROOM USE FOR TANF AND TANF-RELATED MEDICAID CLIENTS (DECEMBER 2002 TO NOVEMBER 2003)

	MEDICAID DELIVERY MODEL			
ITEM	FEE-FOR-SERVICE	MANAGED CARE: PRIMARY CARE CASE MANAGEMENT	MANAGED CARE: HEALTH MAINTENANCE ORGANIZATION	TOTAL
Total direct cost of non-emergent ER use	$67,083,850	$22,247,909	$26,627,025	$115,958,784
Estimated direct cost of treating clients with non-emergent conditions diverted from the ER to their PCP	$21,311,733	$6,189,410	$6,210,867	$33,712,010
Potential Cost Savings	$45,772,117	$16,058,499	$20,416,158	$82,246,774

SOURCE: Legislative Budget Board.

for this estimate was $29.52—the median cost for an outpatient visit provided to established patients and the most frequently paid procedure code for outpatient established office visits for PCCM and fee-for-service clients.

As shown in Figure 4, the estimated potential cost savings from redirecting TANF and TANF-related Medicaid clients with non-emergent conditions from the ER to their PCP could total $82.2 million per year. The savings estimate was determined by subtracting the cost of providing care to clients through PCP appointments from the total direct cost of non-emergent ER use. If the cost of treating clients with primary-care treatable urgent conditions (i.e., treatment is required within 24 hours) in the ER were included, the potential cost savings could be greater.

METHODS TO DECREASE NON-EMERGENT USE OF THE EMERGENCY ROOM

The primary strategy used to encourage appropriate utilization of Medicaid services is implementation of managed care within the Medicaid program. Studies show that Medicaid enrollees use the ER for non-emergent care for various reasons. As shown in Figure 5, Medicaid managed care has implemented several strategies to reduce non-emergent use of the ER not used in the fee-for-service delivery model.

Increasing access to after-hour appointments in the primary care setting has been identified as a method to reduce non-emergent use of the ER. Yet, access to routine after-hour appointments in the primary care setting remains limited across all Medicaid HMOs. As shown in Figure 6, the percentage of PCPs in HMOs that offer routine after-hour appointments ranges from 6.8 percent to 37.9 percent. Similar data for fee-for-service and PCCM PCPs is not available.

IMPLEMENT A QUALITY INITIATIVE PILOT PROJECT

Despite efforts to encourage appropriate utilization of Medicaid services, Medicaid clients continue to use the emergency room for non-emergent conditions. Recommendation 1 directs HHSC to establish a pilot program in one of the PCCM service areas to test implementation of quality initiatives designed to reduce non-emergent use of

FIGURE 5
MEDICAID MANAGED CARE STRATEGIES TO REDUCE NON-EMERGENT USE OF THE EMERGENCY ROOM

REASON FOR NON-EMERGENT ER USE	STRATEGIES	MEDICAID DELIVERY MODEL		
		FEE-FOR-SERVICE	MANAGED CARE: PRIMARY CARE CASE MANAGEMENT	MANAGED CARE: HEALTH MAINTENANCE ORGANIZATION
Lack of doctors who will accept Medicaid patients	Enrollees are required to have a PCP.		X	X
Limited availability of primary care appointments	PCP is required to provide or arrange for urgent care within 24 hours after the request.		X	X
	PCP is required to provide 24/7 telephone access.		X	X
Lack of nurse triage lines to direct clients to appropriate care settings	Nurse triage lines are available 24/7.		X	X
Lack of parental knowledge about childhood illnesses, when to seek emergency care, and available alternatives to the ER	Enrollees receive member handbooks that provide information on appropriate use of the ER and definitions of an emergency.		X	X
Lack of access to after-hour care in a primary setting.	*There is no requirement for PCPs' routine office hours to include after-hour appointments.*			

SOURCES: Seton Healthcare Network; Health and Human Services Commission.

FIGURE 6
PERCENTAGE OF PRIMARY CARE PROVIDERS THAT OFFER ROUTINE AFTER-HOUR APPOINTMENTS

MEDICAID DELIVERY MODEL	PERCENT OF PCPS
Fee-for-Service	Data Not Available
Managed Care: Primary Care Case Management	Data Not Available
Managed Care: Health Maintenance Organization	
Amerigroup	37.8
Community Health Center	8.2
CommunityFirst	25.3
El Paso First	11.2
FirstCare	6.8
Parkland	36.6
Superior	37.9
Texas Children's	32.4

SOURCE: Health and Human Services Commission.

the emergency room. HHSC should implement a quality initiative that includes public awareness efforts aimed at educating Medicaid clients about appropriate ER use and, at a minimum, one of the following strategies:

- Provide an additional per member per month quality enhancement fee to primary care providers and/or an administrative entity for the purposes of implementing quality initiatives to reduce non-emergent use of the emergency room.
- Provide higher reimbursement to PCPs who extend their routine office hours to include evenings and weekends.
- Contract with urgent care clinics to provide after-hour care.
- Develop a case management program targeted to clients who use the ER for non-emergent conditions.
- Implement another option designed to reduce non-emergent ER use determined by HHSC.

HHSC should implement the pilot program in a PCCM service area the agency determines is the most feasible. The Southeast Region managed care service area, comprised of Liberty, Hardin, Orange, Jefferson, and Chambers counties,

is one potential option. The Southeast Region is the only area that currently operates only the PCCM managed-care model and is expected to continue to operate only this model during the 2006–07 biennium. The HMO delivery model was not recommended for the pilot program because HMOs assume full financial risk for their enrollees and thus have an incentive to decrease non-emergent ER use. The fee-for-service delivery model was not recommended for the pilot program because the managed-care expansion will require all TANF and TANF-related clients currently in fee-for-service to enroll in PCCM or HMO depending on their geographic location. HHSC will need to determine if a Medicaid State Plan Amendment and/or federal waiver is needed to implement Recommendation 1.

The following rider could be included in the introduced 2006–07 General Appropriations Bill to implement Recommendation 1 and Recommendation 2:

Texas Health and Human Services Commission

57. Medicaid Quality Initiative Pilot Project. Out of funds appropriated above in Goal B, Medicaid, the Health and Human Services Commission is authorized to spend up to $394,250 in General Revenue Funds and an amount of Federal Funds estimated to be $605,750 for the biennium to establish a pilot program in one of the Primary Care Case Management service areas to test implementation of quality initiatives designed to reduce non-emergent use of the emergency room. The pilot program shall include public awareness efforts aimed at educating Medicaid clients about appropriate use of the emergency room and, at a minimum, one of the following: higher reimbursement to primary care providers who extend their routine office hours to include evenings and weekends; contracts with urgent care clinics to provide after-hour care; a case management program targeted to clients who use the emergency room for non-emergent conditions; an additional per member per month quality enhancement fee to primary care providers and/or an administrative entity for the purposes of implementing quality initiatives to reduce non-emergent use of the emergency room; or other option designed to reduce non-emergent use of the emergency room determined by the Commission. The Commission shall submit a workplan by September 1, 2005, to the Legislative Budget Board and the Governor that details the quality initiative(s) to be implemented by the Commission. The Commission shall conduct a study to test the effectiveness of the pilot program at reducing non-emergent use of the emergency room and Medicaid costs and submit a report to the Legislative Budget Board and the Governor by November 1, 2006.

FISCAL IMPACT OF THE RECOMMENDATIONS

Recommendations 1 and 2 would not impact the General Revenue Fund or the General Revenue–Dedicated Fund in the 2006–07 biennium. Recommendation 1 directs HHSC to establish a pilot program in one of the PCCM service areas to test implementation of quality initiatives designed to reduce non-emergent ER use. This recommendation would be implemented using up to $394,250 in existing General Revenue Funds and an amount of Federal Funds estimated to be $605,750 for the 2006–07 biennium. The estimated FMAP for state fiscal year 2006 (i.e., 60.68) was used to estimate General Revenue Funds and Federal Funds for state fiscal year 2006, and the estimated FMAP for state fiscal year 2007 (i.e., 60.47) was used for state fiscal year 2007. The estimated cost is based on the following assumptions:

- The amount expended is equivalent to $0.83 per member per month.
- The pilot project is implemented in the Southeast Region managed care service area.
- The number of TANF and TANF-related Medicaid clients enrolled in PCCM in the Southeast Region is 50,096 (based on enrollment data from December 2002 through November 2003).

The cost to implement Recommendation 1 may be all or partially offset by potential cost savings from redirecting clients with non-emergent conditions from the ER to their PCP.

Recommendation 2 directs HHSC to conduct a study to test the effectiveness of the pilot program at reducing non-emergent use of the ER and assess cost savings. It is estimated that this recommendation would have no significant fiscal impact because the evaluation of the pilot program could be conducted by HHSC using existing resources.

The introduced 2006–07 General Appropriations Bill includes a rider authorizing HHSC to use appropriations to implement a Medicaid quality initiative pilot project. The introduced bill does not include any other adjustments as a result of these recommendations.

USE LOCAL FUNDS TO DRAW DOWN FEDERAL FUNDS FOR GRADUATE MEDICAL EDUCATION

Graduate Medical Education is a partnership between medical schools and teaching hospitals to train resident physicians. The direct cost of Graduate Medical Education includes residents' stipends and benefits, salaries and benefits of faculty who supervise residents, program administrative staff, and facility overhead costs. States have the option to support Graduate Medical Education through their Medicaid programs and to receive matching Federal Funds.

Texas has chosen to pay a portion of direct Graduate Medical Education costs by making payments to teaching hospitals through the Medicaid program. Fourteen of the 64 teaching hospitals that receive Medicaid payments for Graduate Medical Education are public hospitals funded in part by local, county, or state tax dollars. In addition to federal and state funds, these hospitals use other funds to cover Graduate Medical Education costs. Federal law allows public hospitals to transfer allowable funds to the state to be used as the non-federal share for the Medicaid program. Using allowable funds from public teaching hospitals as the non-federal share for Medicaid Graduate Medical Education would save $10.0 million per year in General Revenue Funds and generate an additional $46.8 million per year in Federal Funds.

SIGNIFICANT FINDINGS

- The Texas Medicaid program uses a formula to determine the amount of Medicaid funds that can be allocated to Graduate Medical Education. This amount, referred to as the Medicaid Graduate Medical Education cost, totaled $102.6 million in state fiscal year 2003 for 64 teaching hospitals.
- Medicaid Graduate Medical Education payments to teaching hospitals do not necessarily equal Medicaid Graduate Medical Education costs because payments are restricted by available appropriations. Teaching hospitals receive a percentage of available appropriations equal to their share of the total Medicaid Graduate Medical Education cost.
- Graduate Medical Education funding in the 2004–05 biennium was contingent on the receipt of excess unclaimed lottery proceeds. The comptroller estimates that approximately $32.0 million in excess unclaimed lottery proceeds will be available to draw down federal Medicaid matching funds in state fiscal year 2005. This may result in a distribution of approximately $81.8 million in state and federal funds to all teaching hospitals in state fiscal year 2005.
- Teaching hospitals use funds that are not dedicated specifically to Graduate Medical Education to cover Graduate Medical Education costs. A study from the Texas Higher Education Coordinating Board estimates that 11 of the 14 public teaching hospitals spent $275.8 million in non-Graduate Medical Education hospital funds in fiscal year 2003. Of this amount, $99.3 million represents the portion of direct costs associated with hospitals' Medicaid patient load.
- With certain exceptions, federal law allows states to use intergovernmental transfers to obtain allowable funds from public teaching hospitals for use as the non-federal share for Medicaid Graduate Medical Education.

SIGNIFICANT CONCERN

- Public teaching hospitals use a significant amount of hospital funds to support Graduate Medical Education that are currently not leveraged with federal Medicaid matching funds.

RECOMMENDATION

- Amend the "Graduate Medical Education" rider for the Texas Health and Human Services Commission in the 2006–07 General Appropriations Bill to authorize the agency to use intergovernmental transfers of allowable funds from public teaching hospitals as the non-federal share for the Medicaid Graduate Medical Education program. The rider should require the agency to develop a payment methodology that allocates funds for Medicaid Graduate Medical Education to all public and private teaching hospitals, and mitigates negative fiscal impacts on contributing hospitals and other state funding.

COMMENTS

Graduate Medical Education (GME) is a combined effort among medical schools, teaching hospitals, and sometimes private foundations, to train resident physicians. Teaching

hospitals and ambulatory clinics provide the patient care opportunities for resident training. The teaching portion of the residency program is usually directed by medical school faculty or managed through a consortia arrangement of local practicing physicians who serve as faculty for specific residency programs.

Most residency programs in Texas are sponsored by medical schools (416 programs); however, a few programs are sponsored by foundations or teaching hospitals (52 programs). In the context of a residency program, "sponsorship" is a term related to national accreditation and reflects who maintains the residency program's curricula. Residency programs are required to seek and maintain accreditation so their residents may qualify for state licensure and specialty board certification.

Regardless of who "sponsors" a residency program, medical schools and teaching hospitals both incur GME costs. Medical schools and teaching hospitals enter into agreements with each other that detail how costs will be shared. The details of the agreements vary depending on the specific medical school and teaching hospital involved. However, in most cases, teaching hospitals compensate residents while medical schools compensate faculty physicians. Both types of entities have administrative expenses tied to GME. In general, funds are shifted between medical schools and teaching hospitals in order to pay for direct GME costs.

A study conducted by the Texas Higher Education Coordinating Board (THECB) in August 2004 estimated a statewide expenditure of $925.6 million for GME in fiscal year 2003 supported by revenues from 25 teaching hospitals and eight medical schools. This figure includes revenue sources dedicated specifically to GME and non-GME revenue sources, including the following: Medicare, Medicaid, state and local government funds, clinical practice plans, patient care revenues, local hospital district taxes, hospital reserves, private grants, donations, and Disproportionate Share Hospital funds. The data reported by the 25 teaching hospitals represent expenses related to training nearly 70 percent of Texas' resident physicians.

MEDICAID GME FINANCING

Medicaid, financed with both federal and state funds, is a healthcare program for low-income families, the elderly, and persons with disabilities. The federal government matches each state's Medicaid spending at a set rate that varies by state. This rate is called the Federal Medical Assistance Percentage, or FMAP. Each state's matching rate is determined by a formula set forth in federal law. The FMAP for Texas is estimated to be 60.68 for state fiscal year 2006 and 60.47 for state fiscal year 2007.

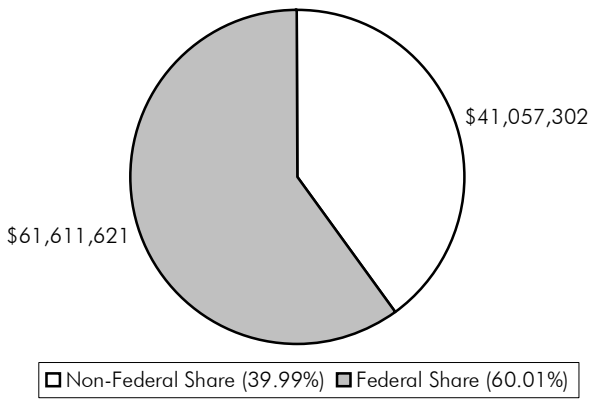
States have the option to support GME and to receive matching Federal Funds through the Medicaid program. Most states elect to provide some level of support for GME, primarily through Medicaid payments to teaching hospitals. Since 1986, Texas has chosen to support GME under its Medicaid program.

The Texas Medicaid program uses a formula similar to Medicare to determine the amount of Medicaid funds that can be allocated to GME. The Medicaid GME formula is applied to each hospital that reports GME expenses and includes a fixed rate per resident, the number of residents, and the percent of Medicaid patient days excluding nursery days (i.e., Medicaid patient load). The amount determined by the formula, referred to as the Medicaid GME cost, totaled $102.6 million in state fiscal year 2003 for 64 teaching hospitals.

Medicaid GME payments to teaching hospitals do not necessarily equal Medicaid GME costs because payments are restricted by the amount of appropriations available to be used as match. Teaching hospitals receive a percentage of available appropriations equal to their share of the total Medicaid GME cost. As shown in Figure 1, funding the entire Medicaid cost in state fiscal year 2003 would have required a non-federal share of $41.0 million to draw down $61.6 million in federal Medicaid matching funds.

Prior to the 2004–05 biennium, the Texas Legislature appropriated General Revenue Funds as the state match for Medicaid GME. However, GME funding in the 2004–05 biennium was made contingent upon the receipt of additional unclaimed lottery proceeds in excess of what was estimated by the comptroller in the Biennial Revenue

FIGURE 1
TOTAL MEDICAID GME COST FOR STATE FISCAL YEAR 2003



SOURCE: Texas Health and Human Services Commission.

Estimate. According to the comptroller, $11.3 million in excess unclaimed lottery proceeds is available from state fiscal year 2004, but the Health and Human Services Commission (HHSC) has not expended these funds as of November 2004. An estimated $20.7 million is expected to be available for state fiscal year 2005. These combined funds (i.e., $32.0 million) may be used to draw down federal Medicaid matching funds and result in a distribution of $81.8 million in state and federal funds to all teaching hospitals in state fiscal year 2005.

However, the Medicaid State Plan as of November 2004 caps Medicaid GME payments for state fiscal year 2005 based on $20 million in excess unclaimed lottery proceeds. It is uncertain if HHSC will expend the additional $12 million estimated to be available because this action would require an amendment to the Medicaid State Plan. If HHSC does not amend the Medicaid State Plan, the $20 million may be used to draw down federal Medicaid matching funds and result in a distribution of $51 million in state and federal funds to all teaching hospitals in state fiscal year 2005.

USE OF LOCAL REVENUE TO FUND MEDICAID GME

Teaching hospitals use funds to cover GME costs that are not dedicated specifically to GME (i.e., non-GME hospital funding sources). A study from THECB estimates that 11 of the 14 public teaching hospitals spent $275.8 million in non-GME hospital funds to support GME in fiscal year 2003. These funds may include the following types of revenue:

- local hospital district taxes;
- hospital reserves;
- patient care revenues; and
- Disproportionate Share Hospital funds.

Of the $275.8 million, Legislative Budget Board staff estimated that $99.3 million represents the portion of non-GME hospital funds used to fund GME that are associated with the hospitals' Medicaid patient load. This estimate was determined by applying each hospital's Medicaid patient load to the amount of non-GME hospital funds reported by the hospital for fiscal year 2003.

Federal law explicitly permits states to derive the non-federal share for Medicaid from public funds other than state general revenues. Furthermore, federal law allows states to accept intergovernmental transfers (IGTs)—fund exchanges between different levels of government—from public teaching hospitals funded in part by local, county, or state tax dollars. At least three states—California, South Carolina, and Utah—use IGTs to help pay for Medicaid GME.

There are, however, restrictions on the types of funds that can be transferred from public hospitals and used as the non-federal share. For example, certain types of provider taxes and donations cannot be used as the non-federal share of Medicaid expenditures. As a result, some portion of the $99.3 million may include types of ineligible revenue. Recommendation 1 would direct HHSC to use IGTs of allowable funds from public teaching hospitals as the non-federal share for the Medicaid GME program.

Based on the 2003 Medicaid GME cost and the estimated FMAPs for 2006 and 2007, the maximum annual amount of funds the state could use to draw down federal matching funds is $40.3 million in 2006 and $40.5 million in 2007 as shown in Figure 2. Assuming that adequate amounts of allowable funds are available, public teaching hospitals could transfer these amounts to the state as the non-federal share for Medicaid GME. These funds would generate $62.2 million in 2006 and $62.0 million in 2007 in federal Medicaid matching funds. Assuming a distribution of $51.0 million in state and federal funds to all teaching hospitals in fiscal year 2005, this recommendation would result in a net gain of $11.2 million in GME payments in fiscal year 2006 and $11.0 million in state fiscal year 2007.

Increasing Medicaid GME payments to teaching hospitals may have an impact on a hospital's funding from other programs such as disproportionate share (DSH) and upper payment limit funding streams. These concerns, however, relate to the potential for negative effect at the individual hospital level and not at the state level. For example, implementation of Recommendation 1 would not affect, in

FIGURE 2
SUMMARY OF PROPOSED MEDICAID GME FUNDING: FISCAL YEARS 2006 AND 2007

	2006	2007
Total Annual Medicaid GME Cost (est.)	$102.6 million	$102.6 million
Hospital Funds Used as Non-Federal Share (est.)	$40.3 million	$40.5 million
Federal Funds Distributed to All Teaching Hospitals (est.)	$62.2 million	$62.0 million
Aggregate Net Gain in GME Payments from 2005 (est.)	$11.2 million	$11.0 million

SOURCE: Legislative Budget Board.

the aggregate, the amount of available federal funding for Texas' DSH program because the state's allocation is a fixed amount. HHSC should develop a payment methodology that allocates funds for Medicaid GME to all public and private teaching hospitals, and mitigates negative fiscal impacts on contributing hospitals and other state funding programs. HHSC may need to amend the Medicaid State Plan to implement Recommendation 1.

The following amended rider would implement the recommendation:

Texas Health and Human Services Commission

~~48~~31. **Graduate Medical Education.** ~~Any amounts collected and deposited into General Revenue Object 3963 in the General Revenue Fund during the 2004-05 biennium above the amounts contained in the Comptroller of Public Accounts Biennial Revenue Estimate are hereby appropriated to the Health and Human Services Commission for the purpose of making Graduate Medical Education allocations in the Medicaid Program. Amounts appropriated by this provision are not to exceed $40 million for the biennium. This funding does not go into effect if appropriations or allocations from appropriations are made for this purpose in Article IX, Appropriation of State Fiscal Relief Federal Funds.~~ The Health and Human Services Commission is authorized to spend up to $80.9 million in Appropriated Receipts–Match for Medicaid and an amount of Federal Funds estimated to be $124.4 million for the biennium out of Strategy B.2.1. Cost Reimbursed Services, for Graduate Medical Education payments to teaching hospitals, contingent upon receipt of allowable funds from public teaching hospitals to be used as the non-federal share for Medicaid Graduate Medical Education. Appropriated Receipts–Match for Medicaid shall be the only source of funds used for the non-federal share for Medicaid Graduate Medical Education. The Commission shall develop a payment methodology that allocates funds for Medicaid Graduate Medical Education to all public and private teaching hospitals, and mitigates negative fiscal impacts on contributing hospitals and other state funding.

FISCAL IMPACT OF THE RECOMMENDATION

The recommendation would result in a net General Revenue Fund savings of $20 million in the 2006–07 biennium. The recommendation proposes using allowable funds from public teaching hospitals as the non-federal share for the Medicaid GME program. As shown in Figure 3, this recommendation would result in a savings of $10 million per year in General Revenue Funds. This probable savings assumes $20 million in excess unclaimed lottery proceeds available for Medicaid GME during the 2004–05 biennium.

The fiscal impact uses the Medicaid GME cost for state fiscal year 2003 (i.e., $102.6 million) as an estimate for annual Medicaid GME costs for state fiscal years 2006 through 2010. The estimated FMAP for state fiscal year 2006 (i.e., 60.68) was used to estimate Appropriated Receipts–Match for Medicaid and Federal Funds for state fiscal years 2006, and the estimated FMAP for state fiscal year 2007 (i.e., 60.47) was used for state fiscal years 2007 through 2010. Based on these assumptions, using allowable funds from public teaching hospitals as the non-federal share for the Medicaid GME program in state fiscal years 2006 through 2010 would result in the following:

- a revenue gain to Appropriated Receipts–Match for Medicaid when allowable funds are transferred from public teaching hospitals to the state;
- a cost to Appropriated Receipts–Match for Medicaid when Medicaid GME payments are distributed to teaching hospitals;
- a revenue gain to Federal Funds when the transferred funds from public teaching hospitals are used to draw down additional Federal Funds; and
- a cost to Federal Funds when Medicaid GME payments are distributed to teaching hospitals.

FIGURE 3
FIVE-YEAR FISCAL IMPACT OF USING LOCAL FUNDS FOR MEDICAID GME

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE REVENUE GAIN/(LOSS) TO APPROPRIATED RECEIPTS–MATCH FOR MEDICAID	PROBABLE SAVINGS/ (COST) TO APPROPRIATED RECEIPTS–MATCH FOR MEDICAID	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS	PROBABLE SAVINGS/ (COST) TO FEDERAL FUNDS
2006	$10,000,000	$40,369,421	($40,369,421)	$46,867,153	($46,867,153)
2007	$10,000,000	$40,585,025	($40,585,025)	$46,786,655	($46,786,655)
2008	$10,000,000	$40,585,025	($40,585,025)	$46,786,655	($46,786,655)
2009	$10,000,000	$40,585,025	($40,585,025)	$46,786,655	($46,786,655)
2010	$10,000,000	$40,585,025	($40,585,025)	$46,786,655	($46,786,655)

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill includes a rider authorizing HHSC to use up to $80.9 million in Appropriated Receipts–Match for Medicaid and an amount of Federal Funds estimated to be $124.4 million for Medicaid GME. Removing this rider would eliminate appropriations for Medicaid GME.

USE SYSTEM BENEFIT FUND REVENUE AS STATE MATCH FOR MEDICAID

The Seventy-sixth Legislature, 1999, created the System Benefit Fund to provide a discount on electric bills to low-income customers in deregulated electric-market areas. Through this program, beneficiaries of Medicaid and food stamps in deregulated electric-market areas automatically receive a credit on their utility bills. In fiscal year 2004, this credit averaged $13.16 per month per customer.

Unlike most state expenditures for assistance to low-income individuals, expenditures from the System Benefit Fund are not used as match for Federal Funds. The Public Utility Commission projects a System Benefit Fund balance of $117.1 million at the end of fiscal year 2005. This balance is expected to increase to $268.1 million by the end of the 2006–07 biennium. By appropriating part or all of the System Benefit Fund for the Medicaid program, the state could draw up to $616.2 million in additional Federal Funds for the 2006–07 biennium or replace up to $400.5 million in General Revenue Funds that could be used for another purpose.

SIGNIFICANT FINDINGS

- Annual expenditures for discounts to low-income electric customers declined from $149.7 million in fiscal year 2003 to $60.3 million budgeted for fiscal year 2005.
- During fiscal year 2004, the number of low-income customers receiving discounts declined from 792,954 in September 2003 to 302,140 in August 2004.
- In April 2004, 58.2 percent of low-income electric customers received medical benefits paid by Medicaid.
- The Medicaid program grew from $7.0 billion (All Funds) in fiscal year 1994 to $15.0 billion in fiscal year 2003. The average monthly cost of providing Medicaid services (not including prescription drugs or long-term care) rose 31.5 percent from fiscal year 1999 to fiscal year 2003. Medicaid caseloads grew from 1.8 million in fiscal year 1999 to 2.5 million in fiscal year 2003.

SIGNIFICANT CONCERN

- Most state expenditures for assistance programs for low-income clients are leveraged with Federal Funds. System Benefit Fund expenditures for discounts to low-income electric customers are an exception. Redirecting these funds to the Medicaid program could generate Federal Funds or free up General Revenue Funds to be available for other purposes.

RECOMMENDATIONS

- **Recommendation 1:** Consider amending Section 39.903(e) of the Utilities Code to designate medical assistance for low-income individuals as the first priority use of the System Benefit Fund, which could replace General Revenue Funds or be used to expand Medicaid benefits, generating additional Federal Funds.
- **Recommendation 2:** Consider appropriating $254.1 million from the System Benefit Fund projected balance for Medicaid programs in the 2006–07 General Appropriations Bill, which could replace General Revenue Funds or be used to expand Medicaid benefits, generating additional Federal Funds.

COMMENTS

The Seventy-sixth Legislature, 1999, passed Senate Bill 7, which deregulated the electric market in many areas of Texas and created the System Benefit Fund (SBF). To generate revenue for the SBF, Senate Bill 7 directed the Public Utility Commission (PUC) to set a nonbypassable collection fee at a rate up to 65 cents per megawatt hour on all customers of retail electric providers, excluding electric customers of municipally owned utilities and electric cooperatives. House Bill 3318 and House Bill 3378, Seventy-eighth Legislature, Regular Session, 2003, modified the SBF from a trust fund in the state treasury to a General Revenue–Dedicated account exempt from post-certification excess balance reduction. This allows the SBF to carry its ending balance forward into the next biennium.

Under current state law, the SBF may be used for discounts to low-income electric customers, customer education programs, administrative expenses, energy efficiency programs targeted to low-income customers, and losses to the Foundation School Fund attributable to electric restructuring. In the 2004–05 biennium, SBF was appropriated to cover only the low-income electric customer discount, customer education programs, and administrative

costs. The discount rate that low-income customers receive can range from 10 percent to 20 percent. The discount is available in deregulated areas, which according to the Sunset Advisory Commission's *Staff Report on the Public Utility Commission* (April 2004) account for 85 percent of demand for electricity in the state. Through this program, beneficiaries of Medicaid and food stamps in deregulated electric markets automatically receive a credit on their utility bill. The average monthly benefit for SBF recipients in fiscal year 2004 was $13.16.

ELIGIBILITY FOR UTILITY ASSISTANCE

Eligible low-income electric customers are those whose income is not more than 125 percent of the Federal Poverty Level (FPL) or those who receive food stamps or Medicaid benefits. In calendar year 2004, 125 percent of the FPL equates to an annual income of $19,075 for a family of three. Low-income electric customers are automatically enrolled in the program if they are Medicaid or food stamp clients, but they may self-enroll in the program if they are not Medicaid or food stamp recipients but fall within 125 percent of FPL. Figure 1 compares the various income limits for the low-income discount.

The low-income discount administrator, LIDA, which is a third-party vendor, identifies automatic enrollees through tape matches using data from the Health and Human Services Commission and retail electric providers. LIDA further certifies eligibility of self-enrollees. Figure 2 reveals that in April 2004, 35.3 percent of eligible low-income electric customers were food stamp-only clients, 49.8 percent were Medicaid clients, and 8.4 percent were low-income Medicare clients whose out-of-pocket costs for accessing Medicare benefits are paid by the Medicaid program. The remaining 6.5 percent were self-enrolled. Medicaid paid medical benefits for 58.2 percent of low-income electric customers at that time.

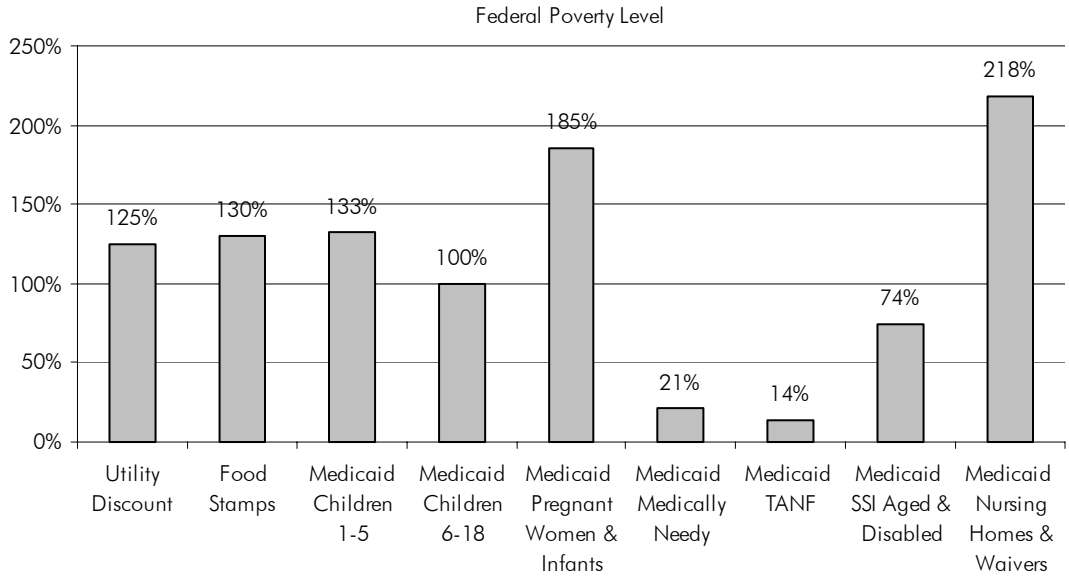
STATUS OF THE SYSTEM BENEFIT FUND

Figure 3 illustrates that the SBF balance is projected to increase to $117.1 million by the end of the 2004–05 biennium and climb to $268.1 million by the end of the 2006–07 biennium. Disbursements from the SBF for utility discounts have decreased from $149.7 million in fiscal year 2003 to $60.3 million budgeted for fiscal year 2005.

There are a number of factors contributing to this decline in disbursements:

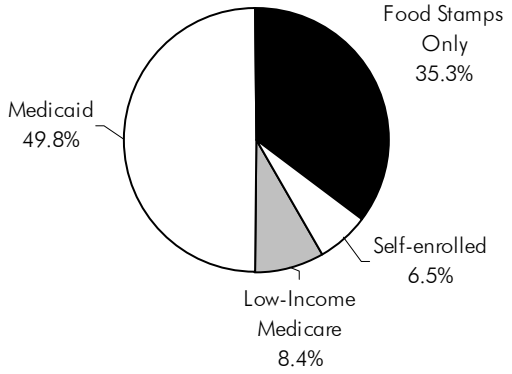
- In September 2003, PUC decreased the low-income discount rate from 17 percent to 10 percent to avoid exceeding its appropriation.
- Prior to fiscal year 2004, the LIDA established client eligibility annually, but now verifies enrollment in Medicaid and food stamps on a monthly basis.
- Clients who apply for enrollment in the discount program based on having income under 125 percent of the FPL must now provide documentation of

FIGURE 1
INCOME LIMITS FOR UTILITY ASSISTANCE
FISCAL YEAR 2004



SOURCE: Legislative Budget Board.

FIGURE 2
ELIGIBILITY CATEGORY OF CUSTOMERS RECEIVING UTILITY DISCOUNT
APRIL 2004



SOURCE: Legislative Budget Board.

income (rather than simply declaring it), and clients remain eligible for seven months.

- In April 2004, the PUC began enforcing the definition of "customer" by limiting it to the person in whose name the electric service is billed. Prior to this time, if any member of a family were a Medicaid or food stamp recipient, the household received a discount. Because there are a significant number of children who are eligible for Medicaid but whose parents are not, the number of clients receiving the discount declined further.

As the result of these changing conditions and requirements, Figure 4 shows that over the course of fiscal year 2004, the number of customers receiving the discount declined from 792,954 in September 2003 to 302,140 in August 2004.

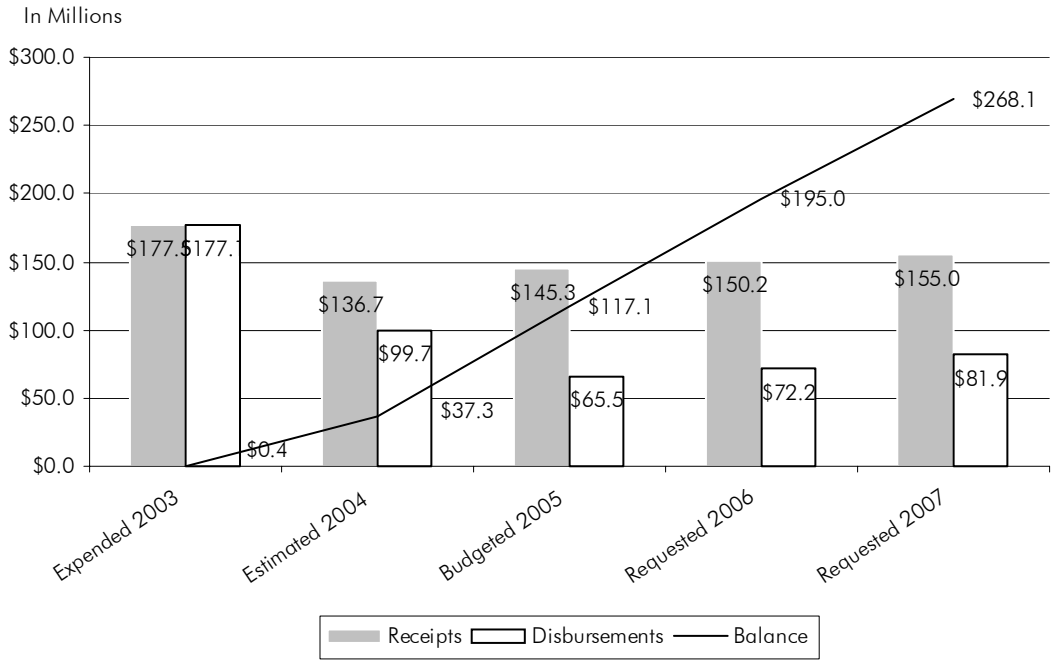
DEMAND FOR MEDICAID SERVICES

As Figure 5 illustrates, over the last decade the budget for Texas' Medicaid program grew from $7 billion in All Funds in fiscal year 1994 to $15 billion in fiscal year 2003. The state share of these costs fluctuates slightly each year, but in fiscal year 2003 the match rate was 40 percent. Medicaid is an entitlement program, meaning that the state must provide medical services to all eligible clients.

Figure 6 demonstrates that despite a number of cost control strategies implemented during the last few years, the average monthly cost of providing Medicaid services (not including prescription drugs or long-term care) rose from $161.07 in fiscal year 1999 to $192.59 in fiscal year 2003. This is a 31.5 percent increase.

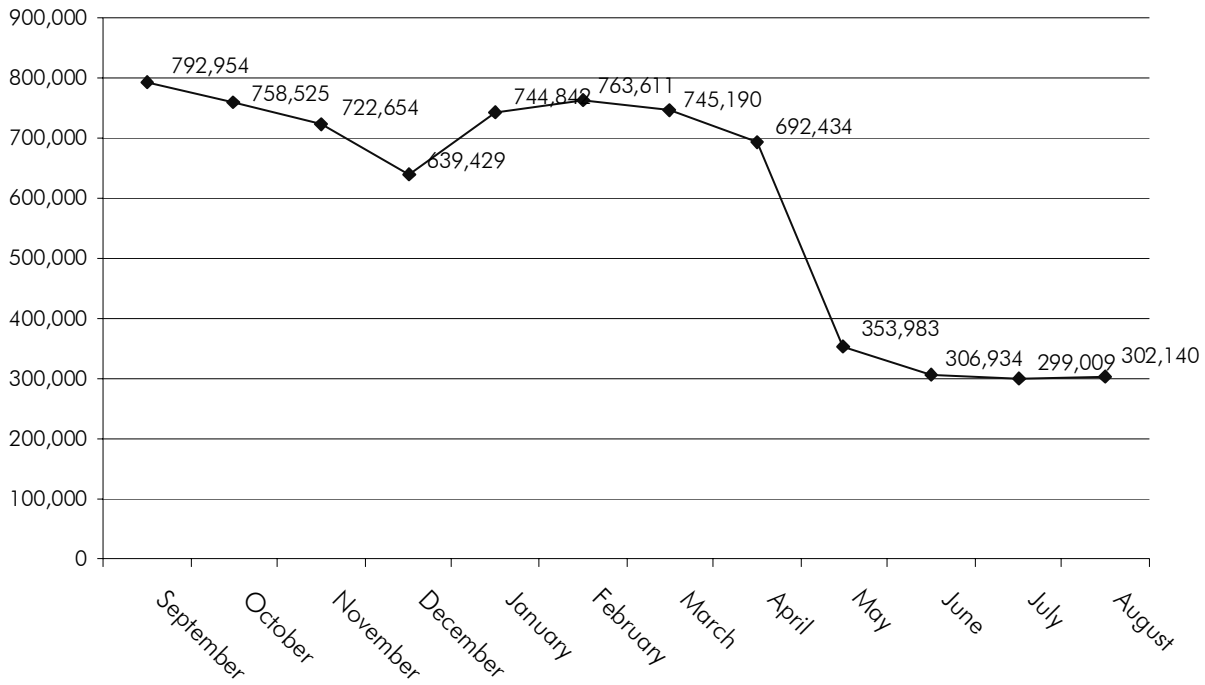
In addition, prescription drug expenditures for the Medicaid program increased from $0.9 billion in fiscal year 1999

FIGURE 3
GROWTH OF THE SYSTEM BENEFIT FUND, FISCAL YEARS 2003 TO 2007



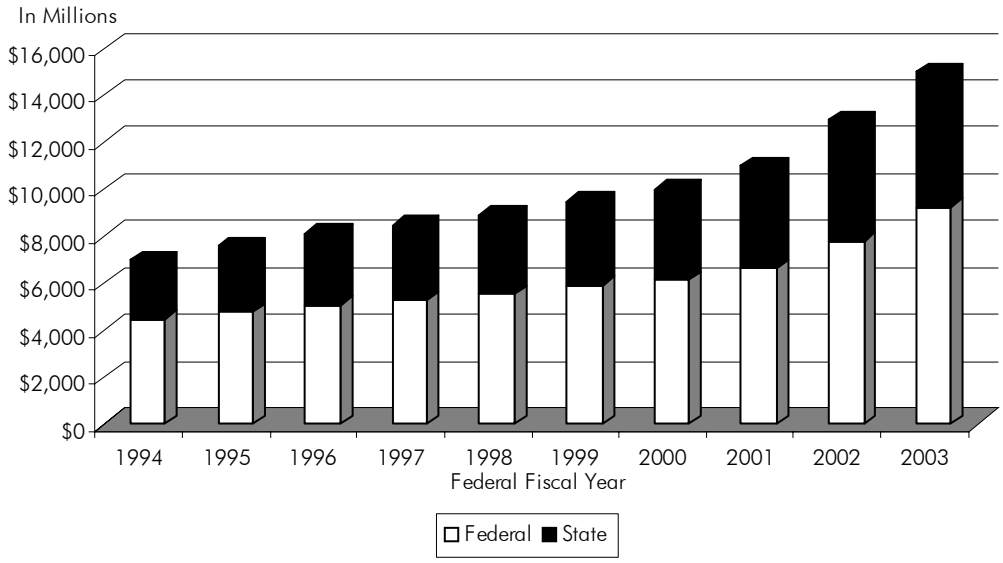
SOURCE: Public Utility Commission.

FIGURE 4
LOW-INCOME CUSTOMERS RECEIVING UTILITY DISCOUNT
FISCAL YEAR 2004



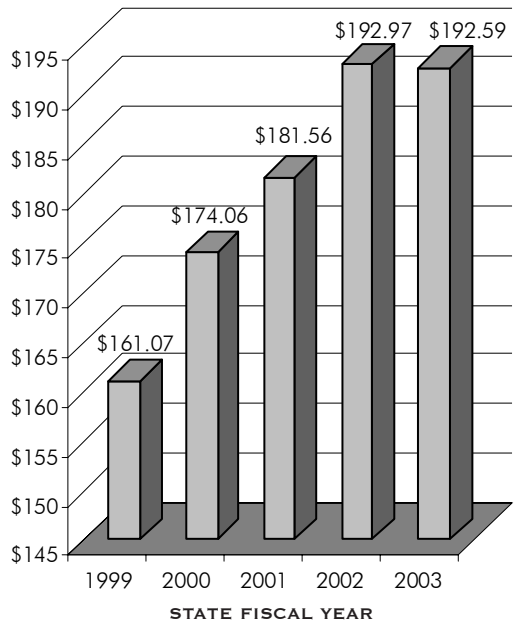
SOURCE: Public Utility Commission.

FIGURE 5
GROWTH IN TEXAS MEDICAID PROGRAM



SOURCE: Legislative Budget Board.

FIGURE 6
AVERAGE MONTHLY COST FOR MEDICAID CLIENTS



SOURCE: Legislative Budget Board.

to $1.9 billion in fiscal year 2003. Over this time period the number of claims for prescriptions grew 36.4 percent, and the average cost per claim rose from $37.70 to $55.77, a 47.9 percent increase.

Figure 7 shows that even though the eligibility criteria for Medicaid did not expand over this time period, Medicaid caseloads grew from 1.8 million in fiscal year 1999 to 2.5 million in fiscal year 2003.

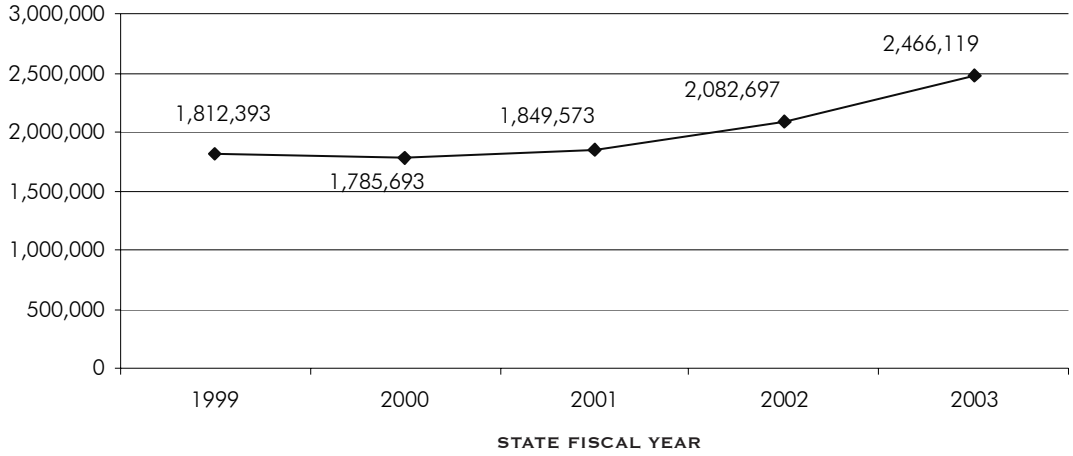
LEVERAGING SYSTEM BENEFIT FUNDS

By allowing the SBF to be used for Medicaid programs, Texas would leverage greater benefits per each state dollar spent. Unmatched by federal spending, the SBF buys only one dollar of benefit for each dollar spent. If the SBF were allocated to the Medicaid program, Texas would realize $2.50 in benefits for each dollar spent. However, to realize a gain in Federal Funds, the SBF expenditures would need to be allocated for Medicaid services outside of ongoing Medicaid costs.

Recommendation 1 would amend Section 39.903(e), Utilities Code to designate medical assistance for low-income individuals as the first priority in the list of purposes for the SBF. Recommendation 1 would further appropriate all funding currently designated for the low-income electric customer discount to Medicaid programs. The PUC projects $154.1 million in expenditures from the SBF in 2006–07 biennium, of which $146.4 million is intended for the low-income discount program. The remaining $7.7 million is for PUC administration, Office of Public Utility Counsel administration, and customer education. This recommendation would use the $146.4 million to fund medical assistance to low-income individuals and would continue to fund the remaining $7.7 million as currently requested. To fund customer education and administrative and other expenses but not the low-income discount program, these expenses would need to be the second priority use in the statutory list of SBF purposes.

Recommendation 2 would appropriate the remaining fund balance in the SBF for Medicaid services. The SBF could be used to replace $254.1 million in General Revenue Funds as a match for Medicaid or to expand Medicaid benefits. Fiscal year 2006 would start with the higher

FIGURE 7
NUMBER OF MEDICAID RECIPIENTS



SOURCE: Legislative Budget Board.

balance remaining from fiscal years 2004–05, but subsequent years would rely on the projected balance for each year.

Recommendations 1 and 2 together would appropriate all SBF fees, less those for customer education and administrative and other expenses, to medical assistance for low-income individuals.

FISCAL IMPACT OF THE RECOMMENDATIONS

In the 2006–07 biennium, Recommendation 1 would either result in net savings of $146.4 million in General Revenue Funds if used as a match for Medicaid or generate a net revenue gain of $224.8 million in Federal Funds if used to expand Medicaid benefits. Recommendation 2 would either result in net savings of $254.1 million in General Revenue Funds if used as a match for Medicaid or generate a net revenue gain of $391.3 million in Federal Funds if used to expand Medicaid benefits.

Figure 8 shows the additional Federal Funds that would result from implementing Recommendation 1 by funding Medicaid services outside of ongoing Medicaid costs. This would generate $224.8 million in Federal Funds in the 2006–07 biennium.

Figure 9 shows the impact of implementing Recommendation 2 by using General Revenue–Dedicated Funds for Medicaid services outside of ongoing Medicaid costs, which would generate an additional $391.3 million in Federal Funds in the 2006–07 biennium. In Figure 9, fiscal year 2006 would start with the higher balance remaining from fiscal years 2004–05, but subsequent years would rely on the projected balance for each year.

As Figure 10 shows, if Recommendations 1 and 2 together were used for expanding Medicaid benefits, the appropriation of this funding would generate $616.1 million in Federal Funds for the 2006–07 biennium. If the legislature were to instead replace General Revenue Funds, the savings to General Revenue Funds would be $400.5 million in the 2006–07 biennium.

FIGURE 8
FIVE–YEAR FISCAL IMPACT TO ALL FUNDS, RECOMMENDATION 1

FISCAL YEAR	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS
2006	$105,500,000
2007	$119,300,000
2008	$131,300,000
2009	$144,400,000
2010	$158,800,000

SOURCE: Legislative Budget Board.

FIGURE 9
FIVE–YEAR FISCAL IMPACT TO ALL FUNDS, RECOMMENDATION 2

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS
2006	($189,300,000)	$292,200,000
2007	($64,800,000)	$99,100,000
2008	($61,300,000)	$93,800,000
2009	($57,200,000)	$87,400,000
2010	($52,300,000)	$79,900,000

SOURCE: Legislative Budget Board.

FIGURE 10
FIVE–YEAR FISCAL IMPACT TO ALL FUNDS

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE REVENUE GAIN/LOSS) TO FEDERAL FUNDS
2006	($189,300,000)	$397,700,000
2007	($64,800,000)	$218,500,000
2008	($61,300,000)	$225,100,000
2009	($57,200,000)	$231,800,000
2010	($52,300,000)	$238,800,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations. Recommendation 1 would require a statutory change to use the revenue appropriated to the low-income discount from the System Benefit Fund to expand Medicaid benefits or to replace General Revenue Funds. This appropriation in the introduced 2006–07 General Appropriations Bill is $146.4 million.

The introduced 2006–07 General Appropriations Bill does not include any appropriation of remaining System Benefit Funds. Recommendation 2 suggests using this balance either to replace General Revenue Funds or to expand Medicaid benefits. As with Recommendation 1, these actions would require a change in current law.

USE TRAUMA FUNDS TO DRAW DOWN FEDERAL FUNDS

House Bill 3588, enacted by the Seventy-eighth Legislature, 2003, created the Designated Trauma Facility and Emergency Medical Services Account to provide funding for Texas' trauma-care systems. Approximately 96 percent of the deposits to this account support a portion of the uncompensated trauma care provided by eligible state trauma facilities. Payments sent to eligible state trauma facilities for uncompensated trauma care are currently allocated in a manner that does not draw down Federal Funds.

By accessing Federal Funds through the recommendations described below, payments to hospitals for uncompensated trauma care could be increased by $20.9 million, while potentially saving the state $138.1 million in General Revenue Funds in the 2006–07 biennium.

SIGNIFICANT CONCERN

- Because Designated Trauma Facility and Emergency Medical Services Account funds are not leveraged to draw down Federal Funds, Texas is missing an opportunity to increase overall payments to hospitals for uncompensated trauma care and save General Revenue Funds.

RECOMMENDATIONS

- **Recommendation 1:** Amend Chapter 780, Health and Safety Code, to divide the trauma facility portion of the Designated Trauma Facility and Emergency Medical Services Account into three sub-allocations: a portion to the Department of State Health Services for payments to hospitals for uncompensated trauma care; a portion to the Health and Human Services Commission to be used as state match in Medicaid payments to hospitals for uncompensated trauma care; and a portion to the General Revenue Fund.

- **Recommendation 2:** Direct the Health and Human Services Commission to develop a methodology for payments to hospitals for uncompensated trauma care so as to mitigate negative fiscal impacts on other state funding, and to ensure these trauma funds are distributed in a manner consistent with the purposes of the Designated Trauma Facility and Emergency Medical Services Account.

COMMENTS

As of October 2003, there were 460 acute-care hospitals in Texas. Sixty-four percent of these were located in metropolitan areas, accounting for 84 percent of the 57,000 acute-care beds in the state. Medicaid payments to Texas hospitals totaled $3.4 billion in fiscal year 2002.

The Seventy-first Legislature, 1989, enacted House Bill 18 directing what is now the Department of State Health Services (DSHS) to develop and implement a statewide emergency services and trauma-care system, designate trauma facilities, and develop a statewide trauma registry. The Texas Board of Health (board) later adopted rules for the implementation of that system. In doing so, the state was divided into 22 trauma service areas (TSAs). The board's action also provided for the formation of a regional advisory council (RAC) for each TSA. RACs are voluntary entities composed of representatives from hospitals, emergency medical services (EMS) providers, and the general public. Each RAC is responsible for the development and implementation of a regional trauma plan including injury prevention, communications, pre-hospital and facility triage criteria, ambulance and patient diversion policies, and planning for trauma facility designation and the identification of the lead trauma facility for each TSA.

Texas' statewide trauma system is administered by the Bureau of Emergency Management (BEM) at DSHS. The designation of a trauma facility is governed by DSHS rules. The BEM recommends designating a facility as a trauma center to the commissioner of health based on certain criteria. Varying levels of designation are based on facilities being able to provide a certain level of care and their role in serving the needs of their TSAs. Figure 1 summarizes key characteristics of each trauma facility designation level and the number of facilities in Texas at each level, as of September 1, 2003.

DESIGNATED TRAUMA FACILITY AND EMERGENCY MEDICAL SERVICES ACCOUNT

The Designated Trauma Facility and Emergency Medical Services Account (designated trauma account) was established by House Bill 3588, Seventy-eighth Legislature, Regular Session, 2003, to provide funding for designated trauma facilities, county and regional emergency medical services, and trauma-care systems.

FIGURE 1
TRAUMA FACILITY DESIGNATION LEVELS

	NUMBER OF FACILITIES
Basic (level IV) trauma centers provide resuscitation and stabilization and arrange for the transfer of trauma victims to a higher-level trauma facility when medically necessary.	130
General (level III) trauma centers provide resuscitation, stabilization, and assessment of injury and either treat the trauma victim or arrange for appropriate transfer to a higher level trauma facility. Level III centers can also serve as the lead trauma facility for a particular TSA.	37
Major (level II) trauma centers may provide trauma care for any patient with major trauma injuries but refer to level I centers for certain trauma procedures. Level II centers must actively participate on the appropriate RAC and submit data to the state trauma registry.	9
Comprehensive (level I) trauma centers provide complete trauma care for every aspect of even the most severe injuries, take the lead in developing prevention strategies, provide educational programs for trauma care providers and the general public, conduct trauma research, and include a teaching facility. Level I centers must actively participate on the appropriate RAC and submit data to the state trauma registry.	12
Total	188

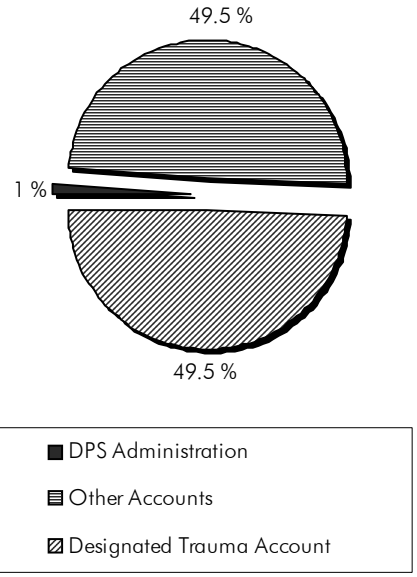
SOURCE: Texas Legislative Council.

Funds deposited to the designated trauma account come from two revenue sources: the driver responsibility program (DRP), which provides for surcharge assessments for certain or habitual traffic violation convictions; and a $30 state traffic fine relating to traffic offense convictions. Of the funds collected, 49.5 percent of DRP and approximately one-third of $30 state traffic fines are deposited into the designated trauma account. Figures 2 and 3 illustrate deposits made to the designated trauma account.

The Seventy-eighth Legislature, 2003, appropriated $108 million for use during fiscal year 2004 and $161.3 million for fiscal year 2005 to DSHS from the designated trauma account based on estimates of revenue generated by DRP and $30 state traffic fines. However, due to initial delays in collecting revenues, actual deposits to the designated trauma account in fiscal year 2004 totaled only $19.3 million, of which $18.2 million was allocated to hospitals in the first distribution in August 2004.

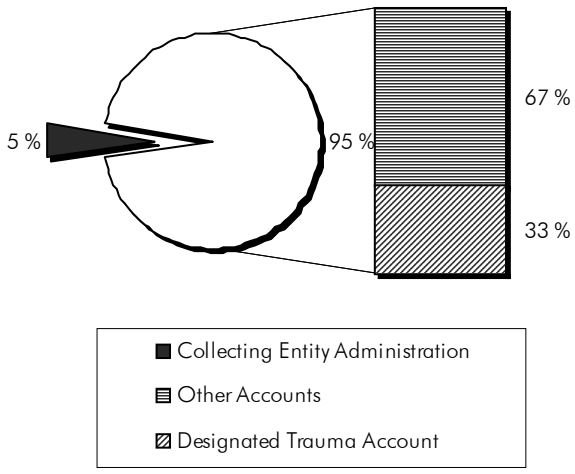
Because both DRP and state traffic fines are generated from violations and convictions, the rate of collection and resulting available revenue can vary from the estimate of potential revenue. Collection rates have a direct impact on the amount of funds available for appropriation and on the estimate of the fiscal impact of the recommendation. The estimates of designated trauma account deposits shown in Figure 4 are based on a collection rate of 65 percent for $30 state traffic fines and DPS's estimated collection rate of 66 percent for DRP.

FIGURE 2
DRIVER RESPONSIBILITY PROGRAM REVENUE



SOURCE: Legislative Budget Board.

FIGURE 3
$30 STATE TRAFFIC FINE REVENUE



SOURCE: Legislative Budget Board.

Additionally, Chapter 780 of the Health and Safety Code governing the designated trauma account expires September 1, 2007. Provisions relating to the collection of $30 state traffic fines also expire at that time. While the provisions in current statute relating to DRP do not expire, the portion of DRP funds allocated to the designated trauma account would not continue because of the expiration of Chapter 780. Without amendment of these provisions, new revenues collected for deposit to the designated trauma account will not be available for the 2008–09 biennium. Figure 4 summarizes the estimated funds that would be deposited to the designated trauma account under current provisions.

FIGURE 4
ESTIMATE OF FUNDS TO BE DEPOSITED TO THE DESIGNATED TRAUMA ACCOUNT

FISCAL YEAR	PROJECTED DEPOSITS FROM DRP	PROJECTED DEPOSITS FROM STATE TRAFFIC FINES	PROJECTED TOTAL DEPOSITS AVAILABLE
2006	$124,500,000	$30,600,000	$155,100,000
2007	$174,900,000	$30,600,000	$205,500,000
2008	$0	$0	$0
2009	$0	$0	$0
2010	$0	$0	$0

SOURCE: Legislative Budget Board.

CURRENT DISTRIBUTION OF DESIGNATED TRAUMA ACCOUNT FUNDS

Current statute distributes the funds deposited to the designated trauma account as follows: an initial $500,000 is set aside for an extraordinary emergency reserve; of the remaining funds, 96 percent is allocated to fund a portion of the uncompensated trauma care provided by designated trauma facilities and those hospitals actively pursuing trauma designation; 2 percent goes to EMS providers; 1 percent goes to RACs in the trauma system; and 1 percent is allocated for administrative costs at DSHS.

Following the creation of the designated trauma account, DSHS worked with stakeholders to develop administrative rules and policies for the use of account funds. The board adopted final rules governing the designated trauma account on July 1, 2004. Major provisions of the rules governing allocation include the following:

- definition of uncompensated trauma care and the methodology for determining associated costs;
- calculation of shares of available funds allocated to hospitals;
  - 15 percent shared equally among all eligible applicants up to $50,000 each;
  - 85 percent based on a pro-rata share of total uncompensated trauma care reported by eligible hospitals;
- provisions for the return of funds if a hospital does not maintain designation;
- support of the development of physician incentive plans by hospitals; and
- specification of the distribution methodology for the remaining allocations.

Figure 5 illustrates the current distribution from the designated trauma account.

In addition to the 188 designated trauma facilities, House Bill 3588 provided eligibility for designated trauma account funding to certain hospitals in active pursuit of trauma designation (actively seeking designation, or ASD). Under this provision, an additional 71 hospitals were eligible to apply for designated trauma account funds. In July 2003, 234 trauma facilities applied and were eligible for funding from the designated trauma account. According to DSHS, the total cost of the uncompensated trauma care provided in calendar year 2003 by the 234 facilities was approximately $222 million. Figure 6 provides a breakdown of the cost of uncompensated trauma care provided by each designated trauma level and the number of facilities at each level.

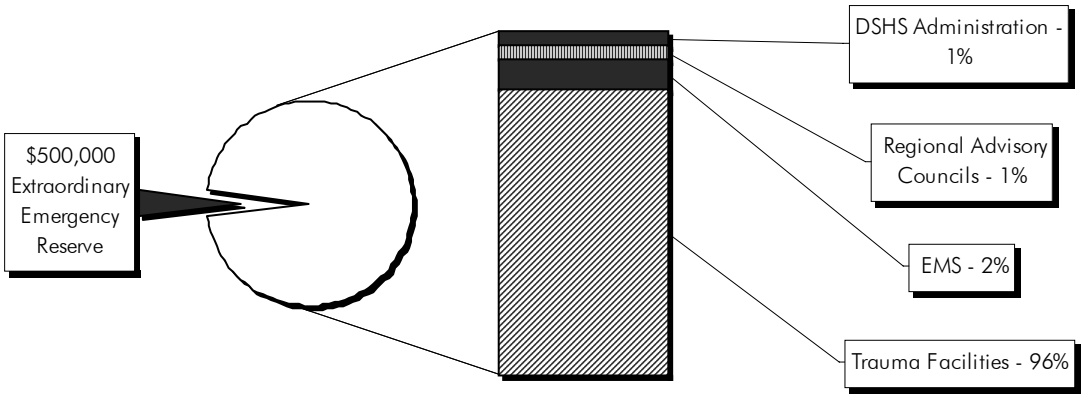
Among the funds initially distributed, level I and II designated trauma facilities experienced 73 percent of the uncompensated trauma care costs and received 69 percent of the hospital allocation; level III and IV designated trauma facilities experienced 23 percent of the costs and received 26 percent of the hospital allocation; and ASD facilities experienced 4 percent of the costs and received 6 percent of the hospital allocation.

According to DSHS figures, Parkland Health and Hospital System experienced the highest uncompensated trauma-care cost at approximately $30.4 million or 13.7 percent of the total uncompensated trauma-care costs reported. Parkland received a designated trauma account payment of approximately $2.3 million. One facility, DeTar Hospital North, reported no uncompensated trauma-care costs and received a designated trauma account payment of approximately $11,687, the minimum allocation to any facility that applied and was found to be eligible for funds.

LEVERAGE FUNDS THROUGH MEDICAID PAYMENTS

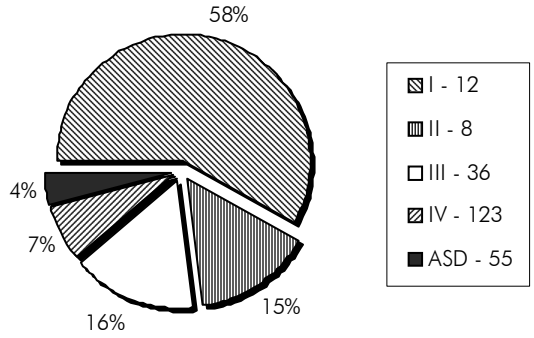
In the 2004–05 biennium, funds in the designated trauma account were appropriated to DSHS to make payments as

FIGURE 5
CURRENT ACCOUNT DISTRIBUTION



SOURCE: Legislative Budget Board.

FIGURE 6
UNCOMPENSATED TRAUMA CARE BY LEVEL OF DESIGNATION, CALENDAR YEAR 2003
$222 MILLION



SOURCES: Legislative Budget Board; Department of State Health Services.

directed by statute. These funds were not leveraged to draw down Federal Funds. If a portion of those funds were channeled through the Medicaid program, a jointly funded state-federal program administered by the Health and Human Services Commission (HHSC), the designated trauma account funds could count as state match and draw down a federal matching share. The federal share is determined by the Federal Medical Assistance Percentage (FMAP). The projected FMAP for state fiscal year 2006 is 39.32 percent state share and 60.68 percent federal share. In dollar terms, for every $1 the state spends, the federal matching share is $1.54. Leveraging state funds to draw down Federal Funds provides an opportunity to reduce dependence on General Revenue Funds and to increase funding for uncompensated trauma care.

Recommendation 1 would require a portion of designated trauma account funds to be directed to hospitals through Medicaid payments. Figure 7 outlines the hospital payment methodology used in Texas.

Recommendation 1 would amend Chapter 780, Health and Safety Code, to channel a portion of the designated trauma account funds through the Texas Medicaid program administered by HHSC. This new allocation could then be used as state match so that those funds are leveraged to

FIGURE 7
MEDICAID PAYMENT METHODOLOGY TO TEXAS HOSPITALS

Texas reimburses hospitals for inpatient hospital services provided to persons covered by Medicaid using a prospective payment system. A prospective payment system sets payments for hospital inpatient services based on a patient's diagnosis prior to the provision of services. Calculation of hospital payments are derived from three basic elements: the diagnosis related group (DRG), the DRG relative weight, and the standard dollar amount (SDA).

- The DRG system consists of the codes hospitals must use to identify the diagnosis of a patient for billing purposes.
- After assigning a DRG, a relative weight for the particular DRG is derived by dividing the average of all paid claims for a given DRG by the average of payments for all DRGs.
- The SDA is a factor that approximates the hospital's standardized average cost of treating a Medicaid inpatient admission based on audited cost reports and paid claims data. Components of the SDA include a measure of the severity of patients served by a hospital and the strain on hospital resources caused by those patients.

SOURCE: Legislative Budget Board.

draw down Federal Funds. Implementing Recommendation 1 would also require a state plan amendment and amendment of the Texas Administrative Code.

This strategy would require HHSC to adjust the formula used to calculate hospital payments to direct the designated trauma account funds toward uncompensated trauma care provided by hospitals. For example, the hospital-specific SDA could be amended to incorporate a weighted factor for the amount of uncompensated trauma care provided by a facility. Recommendation 2 would direct HHSC to mitigate negative fiscal impacts on other state funding that could result from the reallocation of designated trauma account funds, and to ensure funds are distributed in a manner consistent with the purposes of the designated trauma account funds.

For the purpose of estimating the potential fiscal impact of Recommendation 1, the following allocation of funds is assumed: 30 percent of the trauma facility portion would continue to be allocated directly to eligible hospitals through DSHS, equally or in proportion to the amount of uncompensated trauma care provided by each facility; 30 percent would be allocated to HHSC for use as state match in Medicaid payments to hospitals; and the remaining 40 percent would be directed to the General Revenue Fund. Figure 8 illustrates this distribution.

According to the methodology described above, in the 2006–07 biennium 30 percent or $103.5 million in designated trauma account funds would be allocated to DSHS. Thirty percent would be allocated to HHSC to be used as state match to draw down Federal Funds. The HHSC allocation would result in payments to hospitals in the amount of $262.5 million in All Funds, made up of $103.5 million in designated trauma account funds and $159.0 million in Federal Funds. The remaining 40 percent or $138.1 million would be directed to the General Revenue Fund.

Based on the example, leveraging a portion of designated trauma account funds through Medicaid payments would result in an increase in payments to hospitals for uncompensated trauma care in the amount of $20.9 million in the 2006–07 biennium compared to the unleveraged allocations in current law, while at the same time saving the state $138.1 million in General Revenue Funds. The increase in hospital payments for uncompensated trauma care corresponds to the difference between the gain in Federal Funds and savings in General Revenue Funds. Figure 9 illustrates this example distribution of the trauma facility allocation.

If Recommendation 1 were to be implemented, designated trauma account funds could be appropriated to HHSC and DSHS via the following contingency rider added to the Special Provisions Relating to all Health and Human Services Agencies in the 2006–07 General Appropriations Bill:

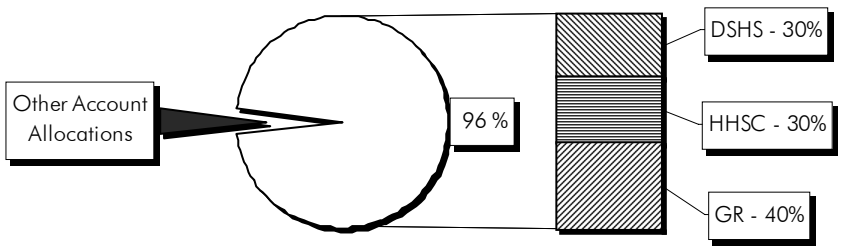
Sec. XX Contingency Appropriation for Senate/House Bill XXXX. Contingent upon enactment of Senate/House Bill XXXX or similar legislation relating to the suballocation of the trauma facility portion of funds from the Designated Trauma Facility and Emergency Medical Services Account 5111 (DTFEMSA), the following shall take effect:

a. Appropriations to the Department of State Health Services made above in Strategy B.3.1 EMS and Trauma Care System from the DTFEMSA are hereby reduced to $0 in fiscal year 2006 and $0 in fiscal year 2007.

b. The Department of State Health Services is hereby appropriated:

   i. An amount not to exceed $500,000 in fiscal year 2006 and $500,000 in fiscal year 2007 from deposits to the DTFEMSA in each fiscal year of the 2006–07 biennium, to maintain a

FIGURE 8
EXAMPLE DISTRIBUTION OF TRAUMA ALLOCATION



SOURCE: Legislative Budget Board.

FIGURE 9
EXAMPLE DISTRIBUTION OF FUNDS LEVERAGED THROUGH MEDICAID PAYMENTS

	DSHS ALLOCATION 30%	HHSC ALLOCATION 30%	MATCHING FEDERAL FUNDS EARNED	MATCHING FEDERAL FUNDS EXPENDED	GENERAL REVENUE ALLOCATION 40%
2006	($44,500,000)	($44,500,000)	$68,700,000	($68,700,000)	$59,400,000
2007	($59,000,000)	($59,000,000)	$90,300,000	($90,300,000)	$78,700,000
Total	($103,500,000)	($103,500,000)	$159,000,000	($159,000,000)	$138,100,000

SOURCE: Legislative Budget Board.

reserve for extraordinary emergencies as directed by Section 780.004(b), Health and Safety Code;

ii. Thirty percent of the trauma facility portion of funds, as defined by Section 780.004(c), Health and Safety Code, deposited to the DTFEMSA in each fiscal year of the 2006–07 biennium, estimated to be $44,500,000 in fiscal year 2006 and $59,000,000 in fiscal year 2007, after any amount necessary to maintain the extraordinary emergency reserve above. In accordance with Chapter 780, Health and Safety Code, these funds shall be used to fund a portion of uncompensated trauma care provided by certain facilities; and

iii. The remaining allocation of funds, as defined by Sections 780.004(d) – (f), deposited to the DTFEMSA in each fiscal year of the 2006–07 biennium estimated to be $6,200,000 in fiscal year 2006 and $8,200,000 in fiscal year 2007, after any amount necessary to maintain the extraordinary emergency reserve above.

c. The Health and Human Services Commission is hereby appropriated 30 percent of the trauma facility portion of funds, as defined by Section 780.004(c), Health and Safety Code, deposited to the DTFEMSA in each fiscal year of the 2006–07 biennium, estimated to be $44,500,000 in fiscal year 2006 and $59,000,000 in fiscal year 2007, and the matching Federal Funds in fiscal years 2006 and 2007. In accordance with Chapter 780, Health and Safety Code, these funds shall be used in state Medicaid reimbursement rates to fund a portion of uncompensated trauma care provided by certain facilities.

HHSC and DSHS have considered several methods of allocation from the designated trauma account that would draw down Federal Funds including:

- allocating designated trauma account funds to designated teaching hospitals through Medicaid graduate medical education;
- allocating designated trauma account funds to enhance the payments for certain Medicaid codes that pay for trauma services;
- allocating designated trauma account funds to enhance Medicaid payments to disproportionate share hospitals (DSH) for trauma services; and
- allocating designated trauma account funds to use as state match for a trauma upper payment limit.

HHSC and DSHS report two primary issues relating to implementing a leveraging strategy. First, strategies considered might change the amounts individual hospitals receive from the designated trauma account, particularly if the strategy is based on the proportion of Medicaid clients served by a facility. If a hospital has a low percentage of Medicaid clients, an adjustment to its Medicaid rate may not cover its uncompensated trauma care costs. Therefore, these facilities are more likely to benefit from an allocation to DSHS, which is maintained in Recommendation 1. Facilities with a high percentage of Medicaid clients are more likely to benefit from an allocation to HHSC.

Second, new funding allocations may have an impact on a facility's funding from other programs such as DSH and upper payment limit funding streams and may impact the net distribution of those funds as well.

Both of these issues, however, relate to the potential for negative impact at the individual facility level and not at the state level. For example, implementation of the recommendations would not impact, in the aggregate, the amount of available federal funding for Texas' DSH program because the state's allocation is a fixed amount. Uninsured costs at DSH hospitals, which totaled approximately $2.1 billion in fiscal year 2002, far exceed amounts reimbursed by Medicaid.

While leveraging strategies may reduce state funds provided to some hospitals, leveraging designated trauma account

funds through Medicaid provides an opportunity to increase overall payments to hospitals and to save state General Revenue Funds. Recommendation 2 would direct HHSC to mitigate negative fiscal impacts on other state funding programs that could result from the reallocation of the trauma funds and to ensure that designated trauma account funds are distributed in a manner consistent with the goals of the designated trauma account. Ultimately, the extent of the fiscal impact on facilities is dependent on the percent of funds in each allocation and on the methodology used to implement the HHSC allocation.

FISCAL IMPACT OF THE RECOMMENDATIONS

Recommendations 1 and 2 would result in a net gain of $138.1 million in General Revenue Funds in the 2006–07 biennium. As described above and illustrated in Figure 9, leveraging a portion of designated trauma account funds through Medicaid payments would result in an increase in payments to hospitals for uncompensated trauma care in the amount of $20.9 million in the 2006–07 biennium. Figure 10 summarizes the fiscal impact of Recommendation 1 in relation to the unleveraged allocations in current law. It is assumed that Recommendation 2 could be achieved using current staff resources and would not result in additional cost.

The introduced 2006–07 General Appropriations Bill includes a recommended appropriation of $63.6 million in designated trauma account funds to DSHS for the biennium. Based on current estimates of revenue, which exceed the amounts recommended for appropriation above, implementation of Recommendations 1 and 2 would increase the designated trauma account funds directed to DSHS by approximately $55.3 million, for a total of $118.9 million for the 2006–07 biennium. The recommendations would also direct new allocations in the amount of $262.5 million in All Funds to HHSC and $138.1 million in designated trauma account funds to the General Revenue Fund for the 2006–07 biennium.

As noted previously, the estimates of revenue deposited to the designated trauma account (as shown in Figure 4) are based on estimated collection rates for both the $30 state traffic fines and DRP. Estimates of revenue deposited to the designated trauma account in the Comptroller of Public Accounts' Biennial Revenue Estimate (BRE), published January 10, 2005, differ from those used in this report. In the BRE, the estimate of revenue deposited to the designated trauma account is $139.8 million for the 2006–07 biennium, approximately 61 percent or $221 million less than the estimate of revenue used in this report.

FIGURE 10
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE REVENUE GAIN/(LOSS) TO GENERAL REVENUE FUNDS	PROBABLE REVENUE GAIN/(LOSS) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE–DEDICATED FUNDS	PROBABLE REVENUE GAIN/(LOSS) TO FEDERAL FUNDS	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS
2006	$59,400,000	($59,400,000)	$59,400,000	$68,700,000	($68,700,000)
2007	$78,700,000	($78,700,000)	$78,700,000	$90,300,000	($90,300,000)
2008	$0	$0	$0	$0	$0
2009	$0	$0	$0	$0	$0
2010	$0	$0	$0	$0	$0

SOURCE: Legislative Budget Board.

ALIGN ADVANCED PLACEMENT PROGRAM FUNDING WITH THE PROGRAM'S STATED GOAL

Initiated in 1993 by the Seventy-third Legislature to recognize and reward students, teachers, and schools that demonstrate success in achieving the state's educational goals, the Texas Advanced Placement/International Baccalaureate (AP/IB) Incentive Program provides funding that lowers the cost of student AP and IB examinations, provides teacher training and equipment grants, and rewards secondary school campuses based on student performance on AP/IB examinations. A provision in the 2004–05 General Appropriations Act states that the goal of the AP/IB incentive program is to make such courses available on as many campuses as possible. However, one of the incentives, campus awards, tends to be granted to the same campuses each year. This incentive only serves to recognize the same level of achievement each year and does not encourage the expansion of advanced placement programs to new campuses or school districts.

SIGNIFICANT CONCERN

- Campus incentive awards represent an unnecessary allocation of Advanced Placement Incentive award funding because the same campuses tend to receive incentive awards each year from the Texas Education Agency.

RECOMMENDATION

- Reduce funding for Advanced Placement/International Baccalaureate incentive awards by $6.8 million in General Revenue Funds.

COMMENTS

High schools, colleges, universities, and the College Board cooperate to jointly administer the Advanced Placement program, which began in the 1950s. Typically colleges and universities award credit for advanced placement examination scores of 3 or above, with a 5 the maximum score. Developed by the International Baccalaureate Organization, the International Baccalaureate program is a comprehensive two-year curriculum for high school students ages 16–19. Students scoring in the 4–7 range on IB examinations typically receive college credit.

The Texas Education Agency's (TEA) Advanced Placement/International Baccalaureate Incentive (AP/IB) Program began in 1993 to recognize and reward students, teachers, and schools that demonstrate success in achieving the state's educational goals. Under Subchapter C of the Texas Education Code, six different incentives may be awarded to schools, teachers, and students; however, in the past the legislature has provided funding for only four of them:

- Teacher training reimbursements of up to $450 per teacher to attend advanced placement or International Baccalaureate staff development courses.
- Campus awards of $100 for each student who qualifies for college credit or advanced placement. This per-student award is typically reduced to match legislative funding; for example, it was limited to $60 per student in fiscal year 2000.
- Examination subsidies of $30 per eligible student, that reduce the $77 cost per advanced placement exam to $47. In addition, financially needy students receive a combined $42 fee reduction from non-state sources that lowers their exam cost to $5. An eligible student is one who is recommended by his or her teacher or principal to take the test.
- One-time $3,000 campus equipment grants for providing a college-level advanced placement or International Baccalaureate course awarded to schools based on student financial need.

Legislative appropriations for the AP/IB Incentive Program increased from the 1996–97 biennium to the 2002–03 biennium, but have decreased this biennium. As indicated in Figure 2, the legislature allocated substantially more in the 2002–03 biennium than any other period. Until the 2004–05 biennium, the legislature appropriated $2 million out of the Gifted and Talented allotment in the Foundation School Program, with the remainder appropriated out of the General Revenue Fund. Current appropriations come entirely from the General Revenue Fund.

The TEA allocates appropriations for the incentive program in a way that provides for the four separate awards explained above plus a variety of activities designed to improve course instruction and expand access to AP/IB curriculum. These activities range from special AP/IB course textbooks to curriculum for pre-AP/IB courses for middle school students and outreach to underrepresented student groups. As indicated in the Figure 3, allocations for exam subsidies, teacher training, and campus awards have increased while the agency has reduced allocations for

FIGURE 1
TEXAS ADVANCED PLACEMENT/INTERNATIONAL BACCALAUREATE PROGRAM PARTICIPATION

School district and student participation in the AP/IB program has shown remarkable growth between school years 2000 and 2003:

- The number of eleventh and twelfth grade students taking AP/IB exams increased from 52,109 to 80,601;
- The number of high school campuses with AP/IB examinees increased from 879 to 1,124 over this three-year period.

FIGURE 2
BIENNIAL APPROPRIATIONS FOR ADVANCED PLACEMENT/INTERNATIONAL BACCALAUREATE INCENTIVE PROGRAM

BIENNIUM	APPROPRIATIONS
1996–97	$2,000,000
1998–99	$3,000,000
2000–01	$21,000,000
2002–03	$34,000,000
2004–05	$27,000,000

SOURCE: Legislative Budget Board.

auxiliary activities in response to reductions in appropriations. The agency allocates about 40 percent of total incentive funding, or $4 to $5 million per year, to campus incentive awards.

CAMPUS INCENTIVE AWARDS AND PROGRAM EXPANSION

The 2004–05 General Appropriations Act contains a provision related to the Texas Education Agency's appropriation which states that the goal of the AP/IB incentive program is to make such courses available on as many campuses as possible. This goal implies that the TEA should allocate resources in a way that assists school districts so that most of their campuses provide a broad array of AP/IB courses. However, an analysis of school district campus awards indicates that the same campuses tend to receive campus awards year after year. In fiscal year 2003, of the 602 campuses that the TEA selected for campus incentive awards, 91 percent had received such awards in the two prior fiscal years.

Conversely, two other funded incentive awards, examination and teacher training subsidies, act as catalysts for new campuses and students to participate in the AP and IB programs. The examination subsidy makes the two tests affordable, thereby allowing a growing number of students to take them. Between fiscal years 2000 and 2003, the number of students taking either the AP or IB examinations increased by 55 percent. Teacher training subsidies also encourage the spread of advanced placement by allowing educators to attend professional development workshops that impart knowledge regarding AP and IB curriculum. TEA shifts allocations for teacher training among school districts each year, according to its own award data. Between fiscal years 2000 and 2002, only half of the school districts that received teacher training funds had been awarded such funding in the prior two years.

FIGURE 3
ALLOCATIONS FOR ADVANCED PLACEMENT/ INTERNATIONAL BACCALAUREATE INCENTIVES

	FY 2002	FY 2003	FY 2004
AP/IB Exam Subsidy	$4,011,510	$4,517,180	$6,150,000
Campus Awards	$4,166,829	$4,256,700	$3,422,500
Teacher Training	$1,274,789	$1,367,123	$2,100,000
Equipment Grants	$884,499	$0	$0
subtotal, Incentives	$10,337,627	$10,141,003	$11,672,500
AP/IB materials, misc. services, administration	$4,140,486	$5,691,357	$1,751,378
Lapse/Budget Reduction	$1,021,886	$2,667,640	$76,122
Total, AP/IB Funding	$15,500,000	$18,500,000	$13,500,000

SOURCE: Texas Education Agency.

Campus awards, however, represent an unnecessary appropriation because they do not support the goal of spreading AP and IB programs to the maximum number of campuses. Advanced placement programs at these school districts would continue without campus awards because they represent a low level of funding, about $6,600 per district, for the 628 districts that received them in fiscal year 2002. To address this concern, future appropriations for the AP/IB Incentive Program should not include funding for campus awards, but should instead focus on teacher training and examination subsidies.

FISCAL IMPACT OF THE RECOMMENDATION

The result of the recommendation, as indicated in Figure 4, is to reduce AP/IB incentive funding to the Texas Education Agency by $6.8 million for the 2006–07 biennium. This is the amount of funding provided by the Texas Education Agency to campus awards in the 2004–05 biennium.

FIGURE 4
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$3,422,000
2007	$3,422,000
2008	$3,422,000
2009	$3,422,000
2010	$3,422,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill includes a $6.8 million reduction in General Revenue Funds pursuant to the recommendation.

CONTINUE THE $500 PASS-THROUGH FOR PUBLIC EDUCATION EMPLOYEES

The Seventy-seventh Legislature, 2001, created a compensation supplement or pass-through, which public education employees can apply towards health insurance, healthcare, or direct compensation. The Seventy-eighth Legislature, Regular Session, 2003 reduced the $1,000 pass-through to a maximum of $500 for certain full-time employees. Without legislative action, the maximum amount will revert back to $1,000 annually for the 2006–07 biennium. Estimates provided by the Teacher Retirement System indicate that an additional $650 million in General Revenue Funds over the 2004–05 level will be needed to provide a $1,000 pass-through amount in the 2006–07 biennium. If the legislature is interested in providing a pass-through equal to what school district employees typically contribute to their flexible healthcare spending accounts, a $500 annual maximum is adequate, and the legislature could save $650 million in General Revenue Funds by continuing the current pass-through levels of $500 for full-time employees, $250 for part-time employees, $0 for professional employees, along with a 90-day waiting period for new employees.

SIGNIFICANT CONCERN

According to the Teacher Retirement System's legislative appropriations request for the 2006–07 biennium, providing an annual $1,000 pass-through to all active employees, without a 90-day waiting period, would cost the state General Revenue Fund $650 million more than 2004–05 expenditures, or a 125 percent increase.

RECOMMENDATION

- The Insurance Code should be amended to continue the 2004–05 pass-through levels of $500 annually for full-time employees, $250 for part-time employees, no supplement for professional employees, and a 90-day waiting period for new employees.

COMMENTS

The pass-through, referred to in state statute as "compensation supplementation" is an appropriation of money from the state General Revenue Fund to the Teacher Retirement System (TRS). The TRS transfers this money to school districts, which pass it through to school district employees. This transfer of money occurs monthly, but under state law it could occur more or less frequently during a state fiscal year (e.g. annually, semiannually, or weekly). According to House Bill 3343, Seventy-seventh Legislature, 2001, which created the statewide teacher health insurance program known as "Active Care" (Texas Insurance Code, Chapter 1580), if an employee is covered by a school district's cafeteria plan, then his or her pass through money must be deposited into that plan. Once deposited into the cafeteria plan, the money can be applied to any combination of (1) a flexible spending account for discretionary healthcare expenses permissible under the federal cafeteria plan law, (2) health insurance coverage, or (3) supplemental compensation. If the employee is not covered by a cafeteria plan, then the pass-through must be paid as supplemental compensation, which the Texas Insurance Code indicates is in addition to the compensation the employee would have received or did receive in the prior year. The state Insurance Code defines a "cafeteria plan" as a healthcare plan authorized by Section 125, Internal Revenue Code, and its subsequent amendments (referred to in this report as the federal cafeteria plan provisions).

The annual pass-through amount has undergone certain changes since House Bill 3343, the teacher health insurance bill, was enacted. During fiscal year 2003, the first year that pass-through funds were distributed, the pass-through amount was $1,000 for each active employee of a school district, charter schools, and education service centers. However, during the 2003 regular session, the legislature passed an omnibus public education bill, House Bill 3459, which reduced the pass-through to $500 per full-time employee, $250 per part-time employee, and eliminated it entirely for professional employees. Under TRS rules, a full-time employee is an active TRS member working 30 or more hours each week; part-time employee is an active TRS member working less than 30 hours each week; and professional employees are defined as campus administrators and central administrators.

House Bill 3459 also established a 90-day waiting period before a new public education employee may receive the pass-through. However, the same bill requires that the policy of providing a $1,000 pass-through for all school district employees without a 90-day waiting period will resume in fiscal year 2006.

SUPPLEMENTAL COMPENSATION FOR HEALTHCARE

According to staff at the Texas Association of School Boards, less than half of school district employees currently participate in cafeteria plan healthcare or dependent care reimbursement accounts authorized under the federal cafeteria plan law. Those employees who do participate typically deposit somewhere between $300 to $500 a year to their healthcare reimbursement accounts. House Bill 3257, Seventy-eighth Legislature, Regular Session, 2003, which would have created health savings accounts into which the pass-through would have been deposited, indicated legislative interest in focusing the pass-through on saving for healthcare costs. If the legislature is interested in appropriating a pass-through amount equal to what school district employees tend to deposit in their flexible healthcare accounts, then a $1,000 pass-through is two or three times the amount public school employees tend to contribute on their own.

Consideration should be given to continuing the 2004–05 pass-through policy. To implement this recommendation both state law and related appropriations would stipulate an annual $500 per full-time, $250 per part-time, $0 for professional employee pass-through, and a 90-day waiting period for new employees. TRS rider 9 of the 2004–05 General Appropriations Act would need to be amended as follows to eliminate aspects of the rider that relate to the minimum effort state subsidy, which did not receive an allocation of funding from TRS in fiscal year 2005; and deferral of the August 2005 payment of the pass-through until September 2005 (i.e., the next biennium). As the current rider indicates, the legislature clearly intended to eliminate funding for the minimum effort state subsidy beginning with fiscal year 2005. Deferral of the twenty-fourth monthly payment was a one-time delay that shifted the August 2005 pass-through payment to September 2005 (i.e. the next fiscal biennium).

9. **School District Employee Pass-Through.** The amounts appropriated in Strategy A.3.1, Active Health, for active school district employee health benefits are to be used to provide an annual compensation supplement (pass-through) of $500 for all full-time employees, and $250 for all part-time employees, except that no contributions shall be provided for the category of employees referred to as "professional staff" by the Teacher Retirement System. An employee is not eligible to receive the pass-through contribution until the 90th day after the date the employee is employed by the entity. ~~The Teacher Retirement System is authorized to allocate the last month's fiscal year 2005 payment of the pass-through in September, 2005. Also, out of the fiscal year 2004 appropriation in Strategy A.3.1, Active Health, no more than $27,000,000 may be used to provide a minimum effort transition subsidy (referred to as "state assistance for meeting minimum effort" in Article 3.50-9, Texas Insurance Code). No appropriation is provided for this purpose in fiscal year 2005.~~

The legislature can consider returning the pass-through to the $1,000 level as part of deliberations on school finance.

FISCAL IMPACT OF THE RECOMMENDATION

The recommendation to continue the current pass-through amounts of $500 and $250, as well as the 90-day waiting period, would save the state General Revenue Fund about $650 million, compared to projected costs for the 2006–07 biennium. Implementation of the recommendation would require changes to current law.

FIGURE 1
FIVE-YEAR FISCAL IMPACT
CONTINUE CURRENT PASS-THROUGH POLICY

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$323,200,000
2007	$327,060,000
2008	$329,512,950
2009	$331,984,297
2010	$334,474,179

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill assumes continuation of the $500 pass-through and the 90-day delay in eligibility for new employees. The introduced 2006–07 General Appropriations Bill places funding for the pass-through in the Foundation School Program at the Texas Education Agency.

EARLY CHILDHOOD CARE AND EDUCATION IN TEXAS

Congress is reauthorizing the Head Start Program and may create a demonstration program for state-administered programs, combining funds from Head Start, state-funded preschool, and child-care funds into a uniform early childhood care system with a focus on education. Texas may be selected to participate in the demonstration. This report examines the issues and implications of the federal proposal and provides a comprehensive view of early childhood care and education in Texas.

SIGNIFICANT FINDINGS

- If selected to participate in the state demonstration program, Texas would be required to coordinate and combine Federal Funds for Early Reading First, Even Start, and Title I, Part A funds used for preschool with state pre-kindergarten programs and Head Start funds ($946.5 million All Funds in fiscal year 2004). Texas would have the option to combine the Child Care and Development Fund ($468 million All Funds in fiscal year 2004) with Head Start funds.
- States would have the option to either meet the Head Start program performance standards for the entire combined program or for each child served in the combined program that is funded with federal Head Start funding. The Head Start program performance standards require medical and dental examinations for all enrolled children.
- The proposed state demonstration project would require participating states to at least maintain state and local funding levels for early childhood education.
- There could be a significant fiscal impact if Texas participated in the state demonstration program and selected the option to meet the Head Start program performance standards for the entire combined program.

COMMENTS

The 2000 U.S. Census counted 19.2 million children under the age of five throughout the country. Texas had the second largest child population in the United States, with more than 1.6 million children under five years old, which accounts for 8.5 percent of the total U.S. population under the age of five. Of the 1.6 million children, about 30 percent are either three- or four-year-olds. Based on the census' population estimates, the number of children under five years old in Texas will have increased to 1.8 million by 2003.

According to Census 2000 data, 53 percent of Texas children under age six have both parents working or have a single parent in the workforce. About 45 percent of three- and four-year-olds in Texas were enrolled in school in the year 2000. An August 2004 study by the National Institute for Early Education Research indicates education rather than child care was the primary motivation for parents to send their children to preschool. Texas children can enter kindergarten in public schools if they are five years old as of September 1 of the school year.

There is a Texas Essential Knowledge and Skills (TEKS) curriculum for kindergarten. The kindergarten TEKS curriculum identifies the skills and concepts that five-year-olds are expected to master by the completion of the kindergarten year. Although there are no assessments for kindergarten students, the Texas Assessment of Knowledge and Skills (TAKS) is administered annually beginning in grade three.

Several federal and state early childhood care and education programs serve children under the age of five. Figure 1 shows number of children participating in federal and state programs that serve children under the age of five. State agencies such as Texas Education Agency (TEA), Texas Workforce Commission (TWC), and Texas Department of Assistive and Rehabilitative Services (DARS) provide

FIGURE 1
NUMBER OF PARTICIPATING CHILDREN FOR EARLY CHILDHOOD CARE AND EDUCATION PROGRAMS IN TEXAS, FISCAL YEAR 2003

PROGRAM	CHILDREN
Head Start/Early Head Start	67,764
TEA Pre-kindergarten	157,498
TEA Even Start	11,020
TEA Special Education—Preschool	40,607
DARS Special Education—Infants and Toddlers	20,286
TWC Child Care	112,015

NOTE: Participants in TWC Child Care represent the number of children served per day.

SOURCE: Legislative Budget Board.

services to these children under the age of five. The following section provides a comprehensive review of these programs.

HEAD START PROGRAM AND EARLY HEAD START PROGRAM

The Head Start program, administered by the U.S. Department of Health and Human Services (HHS), is a federal program that has provided comprehensive early childhood development services to low-income children since 1965. Head Start programs have the overall goal of increasing the school readiness of young children in low-income families. Head Start programs provide preschool classes as well as health, nutritional, social, and other services to improve the conditions of children at risk of not succeeding in later school years. The Head Start program emphasizes the involvement of families and the local community to address specific needs of communities. Parents of enrolled children are provided support services such as parenting education, health education, emergency or crisis intervention, adult education, housing assistance, and transportation.

Head Start programs only serve preschool age children (three- and four-year-olds). Children are eligible to participate in Head Start if they are from low-income families as measured by the federal poverty level (FPL). Figure 2 provides the eligibility requirements for Head Start, along with other federal and state early childhood care programs. Children whose families participate in the Temporary Assistance for Needy Families (TANF) program or the Supplemental Security Income (SSI) program are automatically eligible to enroll in Head Start programs. Head Start programs must offer no less than 10 percent of total enrollments to children with disabilities.

Unlike other federal funding for social services that are distributed to states, HHS awards Head Start funds directly to local grantees. HHS reserves a portion of Head Start funds for set-aside provisions mandated by federal legislation. Set-aside provisions reserve funds for transition-to-school grants; research, demonstration, and quality assurance activities; Indian and migrant Head Start programs; and services for children with disabilities. The remaining Head Start funds are allocated to states based on a formula that includes a hold harmless provision that guarantees each state its allocation from fiscal year 1998 (adjusted for inflation), and an allotment based on the number of children under age five living in poverty.

When Congress reauthorized the Head Start program in 1994, the Early Head Start program was created to provide comprehensive services to low-income families with children from birth to age three and to pregnant women. Early Head Start services include quality early education; home visits; parent education; parent-child activities; comprehensive health services, including services to women before, during and after pregnancy; nutrition; and case management and peer support groups for parents. Family income is one key factor in determining eligibility. Early Head Start programs may elect to target their services to a particular population to best meet the unique needs of families and children in their community. In addition, Early

FIGURE 2
ELIGIBILITY REQUIREMENTS FOR EARLY CHILDHOOD CARE AND EDUCATION PROGRAMS

PROGRAM	AGE	INCOME	OTHER
Head Start	3 to 4	Up to 100% FPL	At least 10% of enrollment must target children with disabilities.
Early Head Start	0 to 3 and Pregnant Women	Up to 100% FPL	At least 10% of enrollment must target children with disabilities.
Pre-kindergarten	3 to 4	Up to 185% FPL	Homeless children and children unable to speak and comprehend English do not have to meet income requirement.
Even Start	0 to 7		Families must have low level of adult literacy or English language proficiency or other need-related indicators.
Special Education—Preschool	3 to 5	None	Children must have a disability and educational need.
Special Education—Infants and Toddlers	0 to 3	None	Children must have a disability or developmental delays.
Child Care and Development Fund	0 to 13 or up to 19 if disabled or under court supervision	Up to 85% of state median income ($48,115 for a family of four in fiscal year 2004)	Children must reside with a parent who is working or attending job training or an educational program, or are in need of protective services.

NOTE: Income for a family of four would be $18,850 at 100 percent FPL in calendar year 2004.

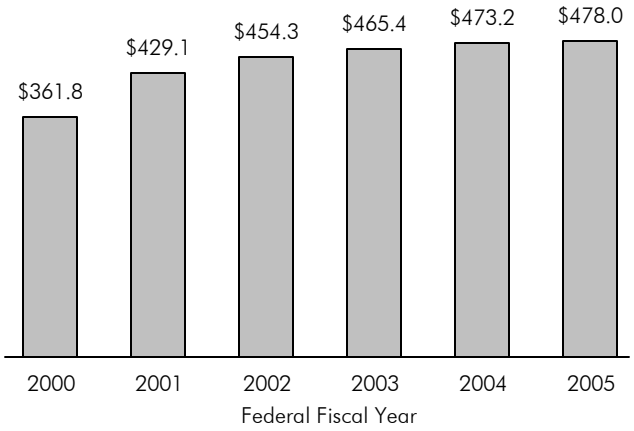
SOURCE: Legislative Budget Board.

Head Start programs must make at least 10 percent of their enrollments available to children with disabilities who are eligible for Part C services under the Individuals with Disabilities Education Act in their state.

Head Start programs served over 900,000 children throughout the country during fiscal year 2003. Texas Head Start programs served over 67,000 children during fiscal year 2003 (7 percent of the national total). Local grantees are provided flexibility to operate Head Start programs, resulting in a variety of program options. Head Start programs operate full and part-time day programs mostly during the school year. In Texas, 73 percent of children enrolled in Head Start attended full-day programs five days a week in fiscal year 2003, compared to 46 percent for all enrolled children in the country.

From fiscal year 1998 to fiscal year 2005, federal funding for Head Start and Early Head Start grew by more than one-third, from $4.4 billion to $6.8 billion. For fiscal year 2005, an estimated $478 million in Head Start and Early Head Start funding will be distributed to Head Start programs in Texas (see Figure 3). In its first year, federal funding nationally for Early Head Start programs totaled $106 million to support 68 programs, which served more than 18,000 children. By fiscal year 2004, over $655.5 million had been allocated to support 708 Early Head Start programs that served more than 62,000 children. Compared to other states, Texas receives the second largest allocation of Head Start and Early Head Start funds. Local grantees must provide 20 percent of the total cost of the Head Start program.

FIGURE 3
HEAD START AND EARLY HEAD START PROGRAMS FEDERAL FUNDING TO TEXAS (IN MILLIONS)



SOURCE: U.S. Department of Health and Human Services, Administration for Children and Families; Federal Funds Information for States.

THE CHILD CARE AND DEVELOPMENT FUND

The federal Child Care And Development Fund (CCDF) provides assistance to low-income families in need of child care while parents work or attend job training or educational programs. The CCDF is composed of several parts:

- Discretionary funds are allocated to states based on the number of children below the age of five, the number of children receiving assistance through the School Lunch Program, and state per capita income. Texas' award was $206.7 million in fiscal year 2004. There are no match or maintenance of effort (MOE) requirements.
- Mandatory funds are allocated to states based on historical expenditures for child care in the former Aid to Families with Dependent Children (AFDC) program. Texas' allocation for fiscal year 2004 was $59.8 million. There are no match or MOE requirements.
- Matching funds are allocated to states based on the proportion of children under age 13 residing in the state. To be eligible for matching funds, at a minimum states must maintain the historical spending level for child care in the former AFDC program. The federal match rate is the Federal Medical Assistance Percentage, or FMAP (60.22 percent in fiscal year 2004). Texas' allocation was $125.1 million in fiscal year 2004.

At least 4 percent of the CCDF must be used to improve child-care quality and availability, including activities such as consumer education, resource and referral services, provider grants and loans, monitoring and enforcement of requirements, training and technical assistance, and improved compensation for child-care staff.

TWC administers the CCDF and allocates child-care funding to the 28 local workforce development boards. The state meets its MOE and matching requirements through a combination of General Revenue Funds at TWC, state pre-kindergarten expenditures, and local funds. A portion of the CCDF ($31.7 million including estimated employee benefits in fiscal year 2004) funds child-care regulation and child care for children receiving services at the Department of Family and Protective Services.

TEMPORARY ASSISTANCE FOR NEEDY FAMILIES

The Temporary Assistance for Needy Families (TANF) program provides assistance to families with needy children so that children can be cared for in their own homes; promotes job preparation, work, and marriage; strives to reduce and prevent out-of-wedlock pregnancies; and encourages the formation and maintenance of two-parent

families. TANF is a block grant, based on the historical level of federal spending on related programs. States with high population growth and low benefit levels receive supplemental funds. Bonuses are awarded for achievements in reducing out-of-wedlock births and clients' job entry and success rates.

At a minimum, states must maintain spending at 80 percent of state expenditures in fiscal year 1994 on related programs (or 75 percent if the state meets national work participation standards). As a component of the state's TANF MOE, there is a minimum MOE related to child care ($34.7 million per year).

States may transfer up to 30 percent of the block grant to the CCDF, minus transfers to the Social Services Block Grant (SSBG), which are limited to 10 percent of the TANF grant. In fiscal year 2004, $2 million in TANF transferred to the SSBG was used for child care at TWC.

EARLY READING FIRST

The No Child Left Behind Act (NCLB) authorized a new program, Early Reading First. This competitive grant program provides funds to support efforts to enhance the oral language, cognitive, and early reading skills of preschool-age children—especially those from low-income families—through strategies, materials, and professional development that are grounded in scientifically based reading research. Congress appropriated $74.5 million in fiscal year 2003 to fund Early Reading First projects across the country. Of this amount, a total of $13.9 million was awarded for five Early Reading First projects in Texas.

EVEN START

The U.S. Department of Education distributes Even Start funds to support local family literacy projects that integrate early childhood education, adult literacy, parenting education, and interactive parent and child literacy activities for families with parents and their children. Even Start programs operate year-round and provide staff training and support services such as child care and transportation, when unavailable from other sources, to enable participation in education activities. Eligibility for children is from birth through age seven. Teen parents and their children from birth through age seven also are eligible. The parents served through the Even Start program must be eligible for services under the Adult Education and Family Literacy Act. Priority is given to families most in need of services.

Even Start funds are distributed to states based on each state's relative share of Title I, Part A funds. TEA is responsible for the administration of the Even Start program. Since August 2003, Texas LEARNS, housed in the Harris County Department of Education, has been providing grant management functions, program assistance, and other statewide support services to Texas Even Start providers. Texas' allocation for Even Start was $20 million in fiscal year 2004.

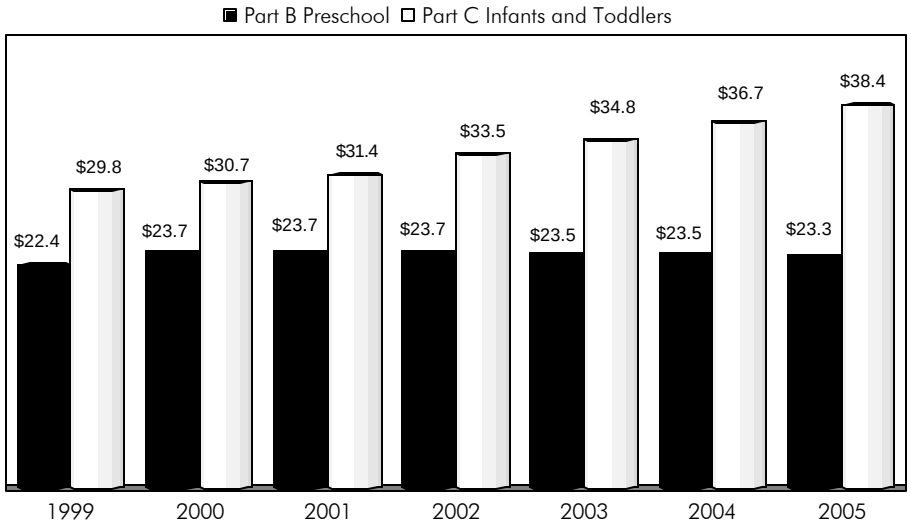
INDIVIDUALS WITH DISABILITIES EDUCATION ACT PROGRAMS

Individuals with Disabilities Education Act (IDEA) funding is awarded to state education agencies to meet the excess costs of providing special education and related services to children with disabilities. Part B, Section 619 Preschool Grants provide special education and related services for children with disabilities aged three through five. School districts may provide the following: special instruction, development and implementation of individual education plans, assistive technology devices, audiology, counseling services, early identification and assessment, medical services for diagnosis or evaluation, and therapies. These funds are distributed based on a formula. States receive a base amount (equal to fiscal year 1997 amounts), and of the funds exceeding the base amounts, 85 percent are allocated according to the number of children aged three to five and 15 percent according to the number of children aged three to five living in poverty. Texas' allocation for Part B, Section 619 Preschool Grants was $23.5 million in fiscal year 2004, and an estimated 40,000 preschool children in Texas received special education and related services. Figure 4 shows the growth in federal funding in Part B, Section 619 Preschool and Part C programs since fiscal year 1999.

DARS receives Federal Funds for another component of IDEA: Part C, relating to early childhood intervention programs for infants and toddlers with disabilities. The federal regulations regarding Part C of IDEA, as amended in 1997, indicate that the purpose of Part C is to provide financial assistance to states to maintain and implement a statewide, comprehensive, coordinated, multidisciplinary, interagency system of early childhood intervention services for infants and toddlers with disabilities and their families.

Texas' allocation for Part C program was $36.7 million in fiscal year 2004. IDEA, Part C funds are awarded based on a state's share of children, ages zero to two years in the general population (according to the most recent satisfactory data determined by the U.S. Secretary of Education). The Part C program has no matching requirements, but states must meet a MOE requirement. Texas meets its Part C MOE requirement through a combination of General Revenue Funds at DARS ($31.3 million in General Revenue Funds in fiscal year 2004) and Foundation School Funds transferred through an interagency contract from TEA ($12.9 million in fiscal year 2004). The Part C program funds screening and assessment for developmental delays. Part C services are provided in the home and in community

FIGURE 4
FEDERAL FUNDING TO TEXAS FOR PART B AND PART C OF THE INDIVIDUALS WITH DISABILITIES EDUCATION ACT



NOTE: Federal fiscal year 2005 estimated.

SOURCE: U.S. Department of Education.

settings with children who do not have delays. DARS currently supports 62 local programs that provide comprehensive services such as service coordination, vision services, speech-language therapy, physical therapy, and occupational therapy. DARS provides services directly or offers access to them. Providers include mental health and mental retardation centers, school districts, education service centers, and private nonprofit organizations. DARS also maintains a child find system that identifies eligible infants and toddlers. In fiscal year 2003, a total of 20,286 children in Texas received comprehensive services.

TITLE I, PART A SUPPORTED PRESCHOOL PROGRAMS

School districts may support preschool programs with their federal allocations of Title I, Part A Grants to Local Educational Agencies. Eligibility requirements for preschool programs funded by Title I, Part A, limit services to children at risk of not meeting challenging state standards, children from birth through five years of age, and children who participated in Head Start or Even Start. Children do not have to be eligible for Head Start to be served by Title I, Part A preschool programs. Texas served 167,822 preschool children with Title I, Part A funds during the 2003–04 school year.

Title I, Part A funds may be used for the following activities: (1) creating a new preschool at the district or school level; (2) expanding an existing preschool (e.g. those funded by other federal and state programs) by increasing enrollment, time, or services; and (3) improving the quality of existing preschool programs. Title I, Part A funds may also be used to provide preschool participants with comprehensive services. School districts are allowed to use a portion of Title I, Part A funds in a targeted assistance school to address health, nutrition, and other social services of preschool children. However, school districts must complete a comprehensive needs assessment and make certain that funding is not available from other public or private sources. The U.S. Department of Education requires that Title I, Part A preschool programs coordinate with other preschool programs providing educational services. Specifically, a school district's Title I, Part A plan must describe how it will coordinate and integrate services under Title I with other educational services such as Even Start, Head Start, Early Reading First, and other preschool programs, including its plans for the transition of children in those programs to elementary school programs.

TEXAS PRE-KINDERGARTEN PROGRAM

There are 41 states that provide some form of state funding to support pre-kindergarten programs. The Sixty-eighth Legislature, Second Called Special Session, 1984, established the Texas pre-kindergarten program (Pre-K). The purpose of the Pre-K program is to develop the skills necessary for success in the regular curriculum, including language, mathematics, and social skills. The Texas Pre-K

program serves three- and four-year-olds who are considered at risk. Figure 2 listed additional eligibility requirements. School districts must offer a Pre-K program if at least 15 eligible four-year-old children are identified.

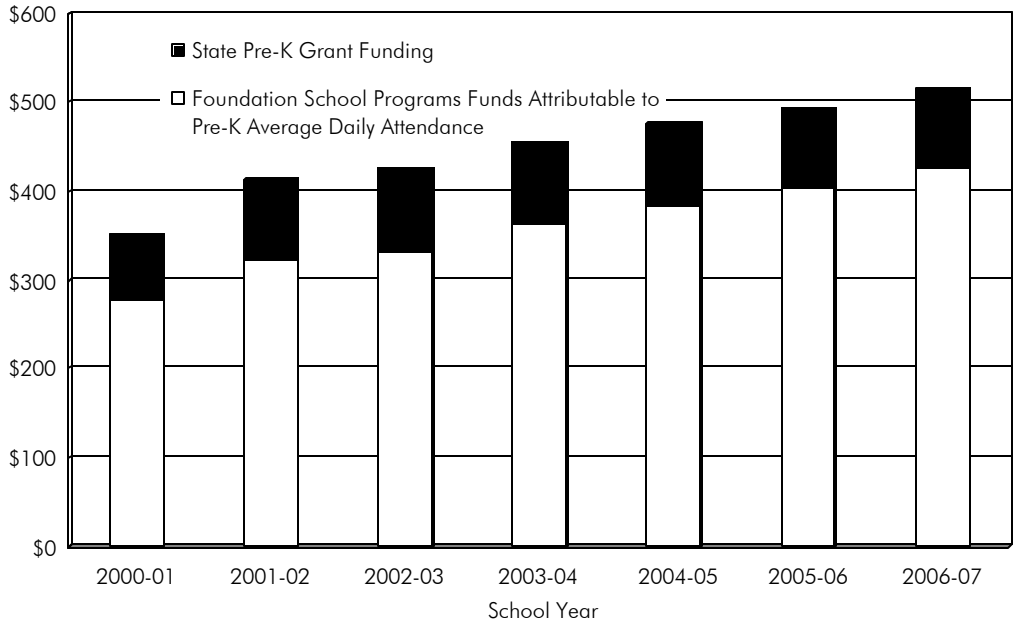
Texas funds Pre-K programs through the Foundation School Program (FSP). FSP funding is calculated and distributed on the basis of district-level aggregates. TEA estimates that $64.0 million in 2003–04 FSP funding can be attributed to Pre-K average daily attendance. In addition, state funding is available through the Pre-kindergarten Expansion Grant program. This program is designed to allow school districts and charter schools to apply to TEA for grants to expand existing half-day Pre-K programs to a full day, or establish new Pre-K programs at campuses which previously did not operate such a program. A total of $90 million in General Revenue Funds was awarded to 283 school districts in fiscal year 2004. Figure 5 shows FSP and Pre-kindergarten Expansion Grant funding for the last three school years and estimated funding for the school years 2004–05, 2005–06, and 2006–07. Texas school districts served 157,498 Pre-K students during the 2002–03 school year. According to a study by the National Institute for Early Education Research, Texas has the largest Pre-K program in the U.S. (in terms of the number of children served); in the percentage of all 4-year-olds served (43 percent), it ranks third behind Oklahoma and Georgia.

Pre-K programs operate during the school year (nine months). School districts have the option of contracting for services with other community organizations. In 1995, the Texas Legislature prohibited the adoption of TEKS for Pre-K programs. TEA currently provides only voluntary curriculum guidelines and encourages school districts not to exceed a student/teacher ratio of 22:1. Texas Pre-K program teachers must be certified and hold a kindergarten endorsement (coursework in early childhood education). The Seventy-sixth Legislature, 1999, amended the Texas Education Code to permit ineligible children to participate in Pre-K programs if the parents pay tuition.

COMPARISON OF TEXAS HEAD START PROGRAMS WITH NATIONAL GUIDELINES

All Head Start programs must follow the federal Head Start program performance standards with regards to addressing low-income children's health, social, and educational needs. The Head Start program requires that every enrolled child must be screened for any vision, hearing, behavior, language, social, cognitive, and emotional problems within 45 calendar days of enrollment. In fiscal year 2003, 87 percent of Head Start enrolled children nationally received medical screens; 24 percent of these children were assessed as needing treatment, and 89 percent of these children received follow-up medical treatment. Although 88 percent of enrolled children received medical screens through

FIGURE 5
TEXAS STATE FUNDING FOR PRE-KINDERGARTEN PROGRAM (IN MILLIONS)



SOURCE: Texas Education Agency.

Texas Head Start programs, only 12 percent of these children were assessed as needing treatment.

Head Start programs also must address the dental care of enrolled children. Nationally, 77 percent of Head Start children (preschool only) received a dental exam in fiscal year 2003; 28 percent of these children were diagnosed as needing dental treatment, and 77 percent of children needing dental treatment received treatment. Seventy-nine percent of enrolled children (preschool only) in Texas Head Start programs received a dental exam during this same period of time. Of the Texas Head Start enrolled children examined, 23 percent were diagnosed as needing treatment and 84 percent of this set of children received treatment.

Within 90 calendar days of a child's enrollment, Head Start programs must determine whether families have an ongoing source of continuous, accessible healthcare. If a child does not have a source of healthcare, Head Start programs must assist families in securing a source. During fiscal year 2003, 89 percent of children served by Head Start programs had health insurance. Of these children with health insurance, 71 percent were enrolled in the Medicaid Early and Periodic Screening, Diagnosis and Treatment (EPSDT) program or the Children's Health Insurance Program (CHIP). Texas Head Start programs, during this same period, reported that 82 percent of enrolled children had health insurance. The primary insurance for these children was the EPSDT program (72 percent), followed by private insurance (13 percent), and the CHIP program (10 percent).

The 1998 Head Start reauthorization required that by September 30, 2003, at least half of all Head Start teachers in center-based programs must have an associate's, bachelor's, or advanced degree in Early Childhood Education or a degree in a related field, with preschool teaching experience. In fiscal year 2003, 57 percent of Head Start teachers had at least an associate's degree. Texas Head Start programs reported in fiscal year 2003 that almost 84 percent of their teachers met the required qualifications.

HEAD START REAUTHORIZATION

The president has proposed significant changes to the Head Start program. In the fiscal year 2004 president's budget, the administration proposed that states be allowed to run the Head Start program. States would be able to combine Federal Funds from the Head Start Program, Early Head Start program, Title I, Part A preschool funding, IDEA, Preschool Grants, and the CCDF program with state-funded preschool programs. The president also proposed that the U.S. Department of Education administer the Head Start program instead of the U.S. Department of Health and Human Services. The fiscal year 2005 president's budget did not include the proposal to have states manage the Head Start program. However, the president did propose to implement nine pilot programs that would coordinate the Head Start, state preschool programs, and federal child-care-related programs to improve preschool performance.

The authorizing legislation for the Head Start program expired at the end of fiscal year 2003. Congress has continued funding for the Head Start program through its annual appropriation process. The U.S. House passed a Head Start reauthorization bill on July 25, 2003. The School Readiness Act of 2003 (House Bill 2210) reauthorizes the Head Start program through 2008 and amends the program to include components of the president's Head Start proposal. The U.S. House passed a provision that would require 50 percent of Head Start teachers to have a bachelor's degree or advanced degree in early childhood development by the year 2008. In addition, within three years of enactment, House Bill 2210 would require all Head Start teachers hired in center-based programs after enactment have an associate's degree or higher in early childhood education.

House Bill 2210 would allow eight states to participate in state demonstration programs. These qualified states would receive allocations of Head Start funding to coordinate Head Start with state early education programs. In order for a state to be qualified, it would need to meet the following criteria: (1) have an existing state-supported public Pre-K program; (2) have its standards for school readiness aligned with kindergarten through 12th grade; (3) have prior year state and local spending on Pre-K programs and Head Start programs at a level of at least 50 percent of Head Start federal funding (excluding Early Head Start); and (4) have an established means of inter-agency coordination and collaboration. Local Head Start grantees in selected states would continue to receive funds from the state for at least three years. States would have to provide a 5 percent match and meet an MOE requirement. House Bill 2210 would require states to combine Early Reading First, Even Start and state Pre-K programs. A state would be allowed to combine Head Start funds with CCDF.

Two Head Start reauthorization bills were introduced in the Senate the fall 2003. Only one bill has been reported out of committee, Senate Bill 1940, the Head Start Improvements for School Readiness Act. There are differences between the House Bill 2210 and Senate Bill 1940. The most significant difference is that Senate Bill 1940 does not include the option of states administering Head Start programs. It is likely that the president's budget for fiscal year 2006 will again address the coordination of early childhood care and education. The U.S. Senate might consider Senate Bill 1940 or a different reauthorization bill in the upcoming 109th first session.

FISCAL IMPACT TO TEXAS

House Bill 2210 would require states to meet all of the requirements to be selected as one of the state demonstration programs. Texas might be selected to be one of the eight state demonstration programs. As described earlier, Texas has an existing state-supported system of public Pre-K. Texas would meet the requirement of having state and local funding for preschool programs at least 50 percent of the Head Start funds allocated to the state. State funding alone was $454 million in fiscal year 2004 compared to Texas' Head Start programs' fiscal year 2004 allocation of $473.2 million. There would also be a 5 percent ($23.7 million) cash or in-kind match for states selected to be one of the eight state demonstration programs. Texas state and local funding levels for early childhood education programs would have to be maintained.

Qualified states must have existing standards for school readiness that are aligned with state kindergarten through twelfth grade. TEA developed curriculum guidelines for preschool programs, but school districts are not required to follow these guidelines. In 1995, the legislature prohibited adoption of TEKS for Pre-K. Texas would be required to meet the teacher qualification standards for the Head Start program proposed by House Bill 2210. Fifty percent of Head Start teachers would have to have a bachelor's degree or advanced degree in early childhood development by 2008. In addition, all Head Start teachers hired in center-based programs after enactment would be required to have an associate's degree or higher in early childhood education. Texas would have to follow Head Start program requirements regarding maximum class ratios. Participating states in the Head Start demonstration program would have the flexibility to use Head Start funds for any authorized Head Start purpose.

Texas would be required to coordinate and combine federal funding for Early Reading First, Even Start, Title I, Part A preschool, with state Pre-K and Head Start funds. Figure 6 shows the amount of funding for these federal and state programs that could be combined with Head Start funds. Texas would also have the option to combine CCDF funding with Head Start funds. One state agency would have to be designated the lead state agency. Currently, these programs are administered by TEA and TWC with different types of providers (school districts and child-care providers). States would have the option to meet the Head Start program performance standards for the entire combined program or for each child served in the combined program that is funded with federal Head Start funding. There would be a significant fiscal impact if Texas were selected and chose to meet the Head Start program performance standards for the entire combined program. As mentioned before, the Head Start program has specific requirements to screen children for vision, hearing, behavior, language, social, cognitive, and emotional problems.

The upcoming 109th First Session of Congress in January 2005 may reconsider the president's proposal to allow states to combine funds from Head Start, state-funded preschool, and child-care funds into a uniform early childhood care system with a focus on education. Congress may reconsider whether all states would be offered this option or create a demonstration program for select states.

FIGURE 6
EXPENDITURES FOR EARLY CHILDHOOD CARE AND EDUCATION PROGRAMS IN TEXAS
FISCAL YEAR 2004

PROGRAM	STATE REVENUE (IN MILLIONS)	FEDERAL FUNDS (IN MILLIONS)
Head Start/Early Head Start		$473.2
TEA Pre-kindergarten	$454.0	
TEA Even Start		$19.3
TEA Special Education—Preschool		$23.4
DARS Special Education—Infants and Toddlers	$44.2	$31.7
TWC Child Care	$70.0	$398.0

NOTE: Head Start/Early Head Start awarded directly to local grantees.

SOURCE: Legislative Budget Board.

ENSURING THE INTEGRITY OF THE CLASS-SIZE WAIVER PROCESS

In 1984, the Texas Legislature required that class size be limited to 22 students per teacher in kindergarten through fourth grade (Texas Education Code § 25.112). The legislature authorized the commissioner of education to grant exceptions, or waivers, to the class-size limitations if the commissioner found that the limits created an undue hardship on a school district. Exceptions to class-size limitations are valid for only one semester at a time, and the commissioner is prohibited from granting exceptions for more than one semester at a time. The class-size limitations do not apply to the last 12 weeks of a school year for most districts or to physical education or fine arts classes. Reporting and data collection governing class-size waivers are not being properly enforced; procedural changes are in order to correct deficiencies in these areas.

SIGNIFICANT FINDINGS

- The Texas Education Agency approves a class-size waiver for an entire district, not at the campus or class level; one district receives one waiver. Due to this method of granting waivers, class-size waiver data does not accurately reflect the number of classrooms that exceed class-size limitations.
- In 2003, the Legislative Budget Board staff recommended that the Waiver Unit implement Internet-based waiver submission and link the Waiver Unit data to the Public Education Information Management System database. The Waiver Unit cites denial of funding the reason these recommendations have not been implemented, estimated at $250,000 in General Revenue Funds to update the Waiver Unit's database in order to institute these two recommendations.

SIGNIFICANT CONCERNS

- The Waiver Unit's database is outdated and lacks the ability to support (1) a link to the Public Education Information Management System database, (2) an Internet-based waiver application, and (3) student data at the classroom level.
- There are school districts in Texas that have been using class-size waivers for over 20 consecutive semesters; and while a compliance plan must be submitted and each campus must show annual gains, districts are not denied waivers and do not suffer any consequences that might motivate the districts to take action on the problem.

RECOMMENDATIONS

- **Recommendation 1:** Include a rider in the 2006–07 General Appropriations Bill directing the Texas Education Agency to collect class-size data from each district receiving a class-size waiver, update the Waiver Unit's database to support a link with the Public Education Information System database, and implement an Internet-based waiver application to reduce data errors and improve efficiency.
- **Recommendation 2:** The Texas Education Agency should adopt rules to ensure that campuses are addressing the issues cited in their compliance plan that influence their need to request waivers for multiple consecutive semesters.

COMMENTS

The purpose of the class-size waiver provision of House Bill 72, Sixty-eighth Legislature, 1983, was to promote a higher level of student achievement. The supporters of this original bill were particularly concerned with numerous educational studies demonstrating the importance of smaller class sizes for students in the first few grades. Opponents of the original bill were concerned that the ratio set was not low enough. However, both supporters and opponents agreed that Texas classes needed to be smaller.

APPLICATION PROCESS AND REASONS FOR CLASS-SIZE WAIVERS

To determine compliance with the class size requirements, districts are required to conduct a class enrollment survey no later than a date specified by the commissioner each semester. Districts having classes in excess of the set limit must submit a class-size waiver request to the Waiver Unit no later than a date specified by the commissioner each semester.

For a waiver request to be granted, the district must show that the 22-student limit presents an undue hardship on the district. The commissioner of education, by way of the Waiver Unit, then uses the following criteria to determine undue hardship:

(1) The district is unable to employ qualified teachers;

(2) The district is unable to provide educational facilities;

(3) The district has budgeted for a class-size ratio of 22:1 in kindergarten through grade 4, but one or more campuses experience enrollment shifts that result in no more than one section per grade level, increasing to a maximum of 24:1; or

(4) A combination of the above reasons.

On the request form, the district must cite one reason for each campus, even through there may be multiple grade levels and classrooms utilizing waivers. This makes it difficult to quantify and identify the actual reason each grade level or classroom is in need of a waiver. For spring 2003, over 60 percent of campuses cited the reasons that they were unable to employ qualified teachers and/or that they were unable to provide educational facilities.

Regardless of the reason cited by the district, it must document its effort to alleviate the existing hardship and must submit a compliance plan, including a schedule for completion, approved by the local board of trustees. In a guidance letter issued October 5, 2004 by the commissioner, a new option was outlined that would allow the local school board to relinquish its oversight of class-size waiver requests to the superintendent, leading to the board being bypassed for approval on all future waiver requests by the district. The letter also provided another reason that districts may request class-size waivers. The commissioner would allow a district to be exempt from class size requirements for the first 10 percent of the K–4 classes in a district if its affected by high student mobility rates (as confirmed by PEIMS data). While the commissioner withdrew the October 2004 guidance letter with the two new options after much opposition by teacher organizations and publicity by the media, the commissioner is now seeking to employ both of these measures through the formal rule-making process.

Under Texas Education Code § 25.113, a district that is granted an exception from class-size limits must provide written notice of the exception to the parent or guardian of each student affected by the exception. The Waiver Unit does not have a method in place to ensure that these notices are delivered to the parents of the students affected by the granting of the class-size waiver. Underscoring the problem is the Waiver Unit's current reliance on media coverage to alert it to any problems in the class-size waiver system. If the parents of the affected children are not given proper notice of their children's classroom conditions, it is less likely that the media, and subsequently TEA, will know of any problems needing to be resolved.

WAIVER DATA COLLECTION AND REPORTING

The Waiver Unit grants class-size waivers at a broad, school district level. By granting waivers at the district level and by maintaining data at the district and campus levels rather than at the class level, there is no practical way of knowing how many classrooms are in excess of the 22:1 student-to-teacher ratio. A single class-size waiver granted to a district covers every classroom in that district and is only reported as one waiver. As a result, it is difficult to evaluate compliance with a law designed to have an impact at the class level when the Waiver Unit collects and maintains data at the district level. In addition, while the district's accountability is considered during the class-size waiver approval process, individual campus or classroom accountability could be suffering due to overflow classrooms and is not considered during the approval process. As a result of waivers being granted at a district level, legislators and other stakeholders do not have an accurate account of the impact of class-size waivers on actual class sizes in Texas.

According to the Waiver Unit, for school year 2003–04 Texas had an average of 1,562 classrooms each semester with more than 22 students. However, because the Waiver Unit grants a class-size waiver to a district and not per classroom, the data is reported as 148 waivers, rather than 1,562 classrooms (see Figure 1).

FIGURE 1
DISTRICT CLASS-SIZE WAIVERS APPROVED

SCHOOL YEAR	NUMBER OF DISTRICT WAIVERS APPROVED BY THE STATE WAIVER UNIT	CAMPUSES COVERED BY WAIVERS BY SEMESTER		TOTAL # OF CLASSROOMS IN EXCESS OF 22:1 RATIO	
		FALL	SPRING	FALL	SPRING
1993–94	115	**	**	**	**
1994–95	114	591	621	1944	2065
1995–96	105	447	466	2333	2392
1996–97	202	430	461	2464	2244
1997–98	207	577	696	2458	3158
1998–99	185	702	742	3335	3312
1999–2000	169	511	507	2505	2318
2000–01	145	512	522	2191	2626
2001–02	142	502	495	2726	2281
2002–03	145	425	486	1723	1753
2003–04	148	465	441	1693	1432

Notes: Total number of districts statewide is 1,261.
Total number of elementary campuses statewide is 4,245.
** Data unavailable.
SOURCE: Texas Education Agency.

Figure 2 illustrates the number of class-size waivers granted over a 10-year period by classroom and by grade. Although this shows the number of classrooms in excess of the 22:1 ratio, the Waiver Unit data does not accurately report the number of children actually affected by waivers. It is a significant concern that the agency cannot accurately monitor the extent to which the class-size waiver is affecting classroom size.

WAIVER UNIT DATABASE OUTDATED

In 2001, a TEA internal audit of the State Waiver Unit found numerous data entry errors and waiver applications that were never processed. The auditor's recommendations include the following:

- Implement routine crosschecks for verifying accuracy of database input prior to filing the waiver; and
- Provide Internet-based data-entry by the school districts to improve processing turnaround. This structure would include drop-down boxes to reduce data-entry errors and would require districts to provide a history of waivers specific to the school district.

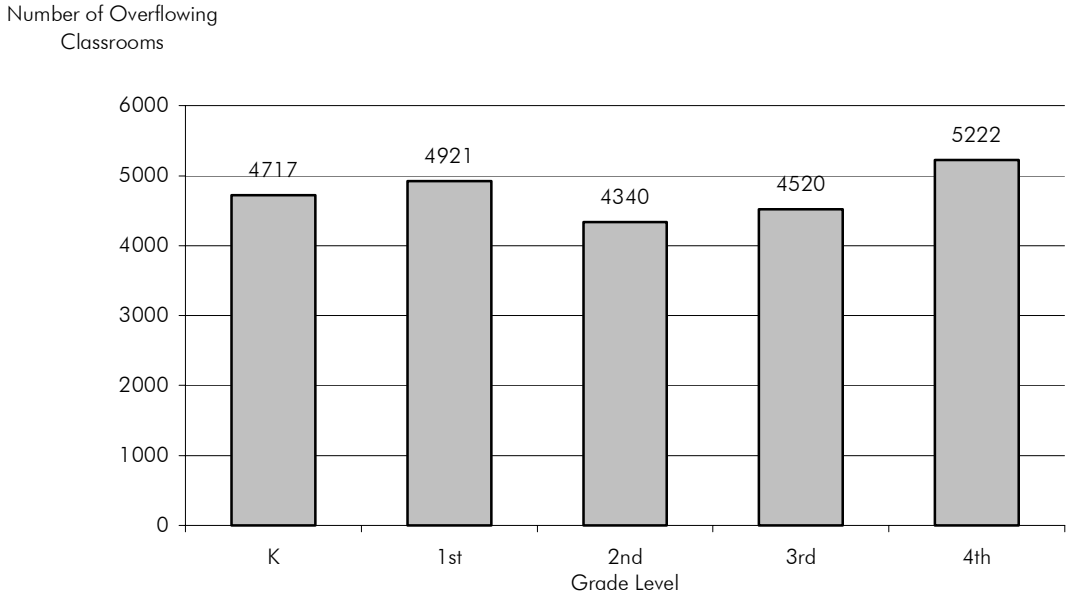
A follow-up audit by TEA was completed in December of 2002, and it was reported that all recommendations were implemented and considered closed. However, although drop-down boxes were added to assist in verifying accuracy of data, changes did not include the implementation of Internet-based data entry as recommended by the audit. The Waiver Unit attributes this to the fact that their database must first be upgraded, and the funding for this initiative has been denied by TEA management.

The Waiver Unit enters each district's waiver application information into the Wavier Unit database. An Internet-based application process would reduce duplication of work and ensure that the data maintained and used by the Waiver Unit is the most accurate and current data available. By then linking the Waiver Unit's database to the Public Education Information Management System (PEIMS), the Waiver Unit would then be able to validate the data submitted by the school district and facilitate the unit's ability to detect districts that have failed to apply for a waiver and are in violation of the class-size waiver law. It is a significant concern that the databases are not linked and that the Waiver Unit manually inputs each district's application.

CONSECUTIVE WAIVERS

According to TEA correspondence with school administrators, when a district requests a class-size waiver for two consecutive semesters, the district must "initiate a public notification" to ensure that the community is aware of the requests. This notice must describe the steps the district is

FIGURE 2
WAIVERS GRANTED OVER 10 YEARS BY CLASSROOM, BY GRADE (1994–2004)



NOTE: Waivers per semester were averaged to obtain an estimate of the number of classrooms affected each year.
SOURCE: Texas Education Agency.

taking to reduce the need for continued class-size waivers. A district requesting a class-size waiver for a third or subsequent semester is required to hold a meeting for parents and community members at each campus covered by the waiver request to discuss the continued need for the waiver and the specific steps that will be taken to bring the district into compliance. For districts that request a class-size waiver for more than four consecutive semesters, commissioner's rules require that student performance be considered in the decision to grant a waiver. A district requesting a waiver for the fifth or subsequent consecutive semester must show that all campuses covered by the waiver achieved annual gains in performance for all students, and for each student group on each state assessment administered, unless the student group is performing at the "recognized" or "exemplary" level on each assessment. For a district requesting a class-size waiver for the seventh or subsequent semester at any campus, the local school board of trustees must hold a public hearing addressing the continued need for a class-size waiver at one or more campuses.

It is unclear how TEA is enforcing these rules. Several districts have been granted class-size waivers for more than twenty consecutive semesters; even while these districts' accountability ratings either remained the same or declined. It is a significant concern that there are no guidelines within statute or the Texas Administrative Code (commissioner rules) that address the content of a compliance plan, which the districts must submit with each waiver request, or the time limit that a school district has to become compliant with the class-size limitation guidelines. The agency has indicated that the commissioner is in the process of developing new rules and that this issue is part of the planning process. Figure 3 demonstrates the locations of districts granted waivers for eight to 10 plus consecutive semesters, and Figure 4 lists the ten districts with the largest number of classrooms requiring waivers over the past ten years in Texas.

As illustrated in Figure 3, four districts have utilized waivers for over twenty consecutive semesters. In the Houston Independent School District (ISD), there is an employee whose sole responsibility is to monitor the individual schools, develop the compliance plan, and request waivers from TEA. The class-size wavier was originally developed as a short-term solution for school districts to give them a semester to address an issue that was prohibiting the district from adhering to the state class-size waiver statute. The waiver was not developed to be a part of the ongoing operations in large school districts.

There are no consequences, other than the possibility of receiving negative publicity from the media or teacher organizations, when a district fails to file for a waiver. Therefore, to avoid having twenty consecutive semesters, some schools do not file for a semester, even though they have overflow classrooms, in order to avoid the consecutive semester guidelines described above. For example, Dallas ISD has requested waivers for eight consecutive semesters. This does not mean that prior to those eight, all of their classrooms were within the 22:1 ratio, but conversely, that they failed to apply for a waiver one semester. In order to hold districts accountable and to ensure that they are addressing the issues influencing their constant need for class-size waivers, actions such as making class-size waivers part of TEA's Accountability Rating System or publishing the number of waivers per semester within regional or statewide reports may be considered.

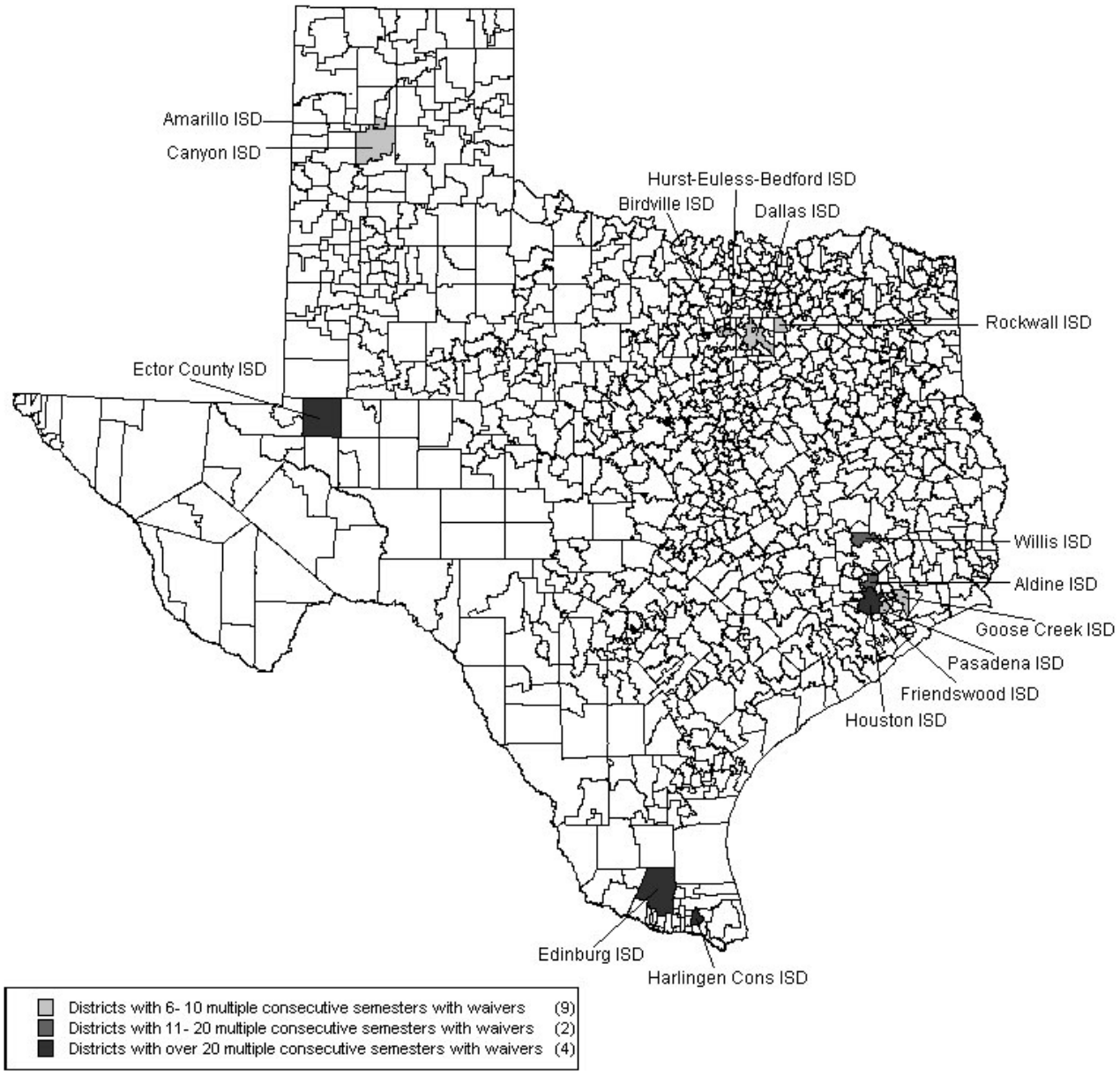
CONCERNS AND RECOMMENDATIONS

Recommendation 1 would include a rider in the General Appropriations Bill directing the TEA to collect class-size data from each district receiving a class-size waiver, update the Waiver Unit's database to support a link with the PEIMS database, and implement an Internet-based waiver application. By collecting class size student data from schools and linking the Waiver Unit database to PEIMS, the agency would be able to better estimate how many students are being affected by class-size waivers, and the ability to crosscheck information between the databases and identify non-compliant districts. The Internet-based waiver application would further the efficiency of the agency and reduce data errors due to manual transfer of information. The rider would be as follows:

> Out of funds appropriated to Strategy B.3.4, Information Systems - Technology, the agency shall allocate funds as necessary to provide an Internet-based system to allow school districts to submit waiver requests and related information electronically to the agency. The agency shall collect class-size waiver data at the district, campus and classroom level. The data collected by this system shall be linked with the Public Education Information Management System (PEIMS) to facilitate data accuracy, waiver monitoring and analysis.

Recommendation 2 would require TEA to outline the compliance plan and the rules surrounding the multiple consecutive semesters within the commissioner rules. It is critical that districts develop a useful compliance plan to provide a guide for themselves as well as to provide an indicator to the state as to the status of the district and improvements made each semester. The agency has indicated that commissioner rules are in the development stages, and that this issue is part the planning process.

FIGURE 3
INDEPENDENT SCHOOL DISTRICTS WITH MULTIPLE CONSECUTIVE SEMESTERS WITH WAIVERS



SOURCE: Texas Education Agency.

FIGURE 4
TOP TEN DISTRICTS IN NUMBER OF CLASSROOMS REQUIRING WAIVERS OVER THE PAST 10 YEARS (1994–2004)

SCHOOL DISTRICT	CUMULATIVE # OF CLASSROOMS REQUIRING WAIVERS OVER THE PAST 10 YEARS
Houston ISD	21,422
Dallas ISD	5,548
Brownsville ISD	1,411
Killeen ISD	1,225
Aldine ISD	1,181
Edinburg ISD	1,062
North Forest ISD	715
Socorro ISD	690
Mesquite ISD	592
Ector County ISD	555

SOURCE: Texas Education Agency.

The procedures and policies currently in place within TEA's Waiver Unit hinder the proper reporting, enforcement, and original purpose of the class size provision. The data collection procedures and methodologies provide no accountability for actual class sizes, which was the original purpose of the law. Because of this, the Waiver Unit is unable to enforce the law or detect existing problems in the application of the law.

With the implementation of stricter quality controls on data collection and maintenance, the Waiver Unit can provide more useful information to parents, legislators, and policy makers. By implementing LBB staff recommendations, there would be a reduction in the duplication of data entry, a possible reduction in Waiver Unit administrative costs, and the assurance of more accurate and useful data. Once these improvements are implemented, the Waiver Unit can better monitor the application of the class-size limitation law that is intended to improve the achievement of all Texas school children.

FISCAL IMPACT OF THE RECOMMENDATIONS

Neither recommendation, if implemented, would have a significant fiscal impact. The introduced 2006–07 General Appropriations Bill includes a rider, pursuant to Recommendation 1, that directs the Texas Education Agency to collect class-size data from each district receiving a class-size waiver.

ISSUES RELATED TO THE TEXAS EDUCATION AGENCY'S PLAN TO RESTRUCTURE PUBLIC EDUCATION MONITORING

The Texas Education Agency monitors more than 1,200 local education agencies to ensure proper compliance with education laws and regulations throughout the public education system.

House Bill 3459, passed by the Seventy-eighth Legislature, Regular Session, 2003, prompted the Texas Education Agency to initiate a major overhaul of its local education agency monitoring system. The bill limited the agency's responsibilities for monitoring local education agencies' compliance with state law regarding education programs and processes. With the exception of special education, federally funded programs, and special accreditation investigations, the agency may monitor local education agencies only as necessary to ensure compliance with federal law, financial accountability, data integrity, and the assessment and accountability system.

Prior to the 2004–05 biennium, the Texas Education Agency's local education agency monitoring centered on an on-site compliance review of every local education agency approximately every five to eight years, enhanced by a data-driven risk analysis to identify local education agencies most likely to have potential compliance issues. However, over the years the Texas Education Agency embarked on additional monitoring functions, such as monitoring financial management and data quality. These functions existed as parallel, but not entirely coordinated, monitoring activities at the agency.

In response to House Bill 3459, the Texas Education Agency undertook a significant reorganization of its local education agency monitoring function. The agency established a plan to launch a new performance-based monitoring system sometime during the 2004–05 school year, with the 2003–04 school year as a transition period between systems. The performance-based monitoring system is intended to be a comprehensive, data-driven monitoring regime that abides by the mandates of House Bill 3459 through a focus on student performance and data quality indicators.

This review provides a description of the state's local education agency monitoring efforts prior to House Bill 3459 and the agency's new performance-based monitoring system.

SIGNIFICANT FINDINGS

- Prior to House Bill 3459, the Texas Education Agency's monitoring functions were not integrated and were labor- and resource-intensive. Monitoring was conducted primarily through costly on-site visits based either on a cyclical schedule by which every district would be visited in an eight-year period or through identification based on a system of risk-based indicators. Local education agency performance on student outcome-based indicators was not considered in selection for on-site visits.
- In an effort to move from process-based monitoring to results-based monitoring and in response to limitations imposed by House Bill 3459, the Texas Education Agency is developing a new, less resource-intensive, performance-based monitoring system. This system will rely on a set of data-driven performance indicators by which all local education agencies will be evaluated annually in the areas of program effectiveness, financial management, and data integrity. Local education agencies found to be "at risk" based on these indicators will be subject to a graduated schedule of intervention, ranging from an enhanced desk audit to on-site visits. Local education agencies will no longer be selected for review or intervention based solely on a cyclical rotation.
- During the 2003–04 school year, as the Texas Education Agency was transitioning between monitoring systems, it appears the agency conducted limited monitoring of local education agencies outside of special education.
- Implementation of performance-based monitoring—scheduled to launch toward the beginning of calendar year 2005—may also result in a diminished monitoring capacity in the 2004–05 school year, which could compound any adverse implications of the reduced monitoring in the 2003–04 transition year.
- Instituting a performance-based monitoring system introduces an inherent risk that performance-based measures based on aggregated data or averages could mask areas of noncompliance or ineffectiveness within campuses or districts.
- Instituting a performance-based monitoring system could produce an incentive for schools or districts to overlook noncompliant activities that are perceived

to have no negative impact or even a positive impact on measured objectives.

- The preliminary performance-based monitoring model relies heavily on raw test passing rates for its measures of student performance, which may lead the monitoring system to unfairly target local education agencies with disproportionate numbers of hard-to-educate students.

COMMENTS

Prior to passage of House Bill 3459, the Texas Education Agency (TEA) employed a nonintegrated, multi-pronged approach to monitoring based primarily on on-site visits. Eleven different divisions of the agency spent $8 million annually to monitor more than 150 different federal and state programs. During the 2000–01 school year, the agency conducted over 1,000 on-site visits in over 700 districts.

The primary focus of the monitoring methodology for program compliance and effectiveness was the District Effectiveness and Compliance (DEC) system of on-site visits to districts. Under this system, every local education agency (LEA) was scheduled for an on-site visit once during an eight-year cycle, during which a set of special student programs would undergo a comprehensive review with regard to the LEA's compliance with state and federal requirements, as well as its decision-making and planning process as it relates to the quality of services provided for all students, including those in special programs.

Special programs reviewed included bilingual education/English as a second language, career and technology education, federal title programs, gifted and talented education, optional extended year programs, and special education. Requirements for dyslexia services, prekindergarten notification procedures, and state compensatory education expenditures were also reviewed.

In support of or in lieu of on-site monitoring, TEA conducted risk assessments based on elements aimed at predicting the likelihood that an LEA would be ineffective or noncompliant with state or federal law. These risk assessments relied on two data-driven systems: the Program Analysis System (PAS) and the Special Education Data Analysis System (DAS). PAS includes elements related to special state and federal program areas, including bilingual education, compensatory education, and federal title programs. DAS includes elements related to special education. The PAS/DAS elements are risk-based rather than performance-based. The result of these assessments determined whether further intervention was warranted. Interventions ranged from requests for additional information to on-site visits.

For a given year, an LEA was selected for a DEC visit through one of four possible methods of identification: (1) PAS or DAS Review, (2) special education complaints, (3) adverse special education due process hearing results, or (4) identification based on the eight-year cycle during which every district would receive a single visit. While all LEAs in Texas were part of the DEC visit cycle, PAS and DAS were the primary systems used to identify additional districts for DEC visits.

In addition to DEC visits, TEA regularly conducted other forms of on-site monitoring, including Initial Onsite Reviews (IOR) of charter schools, "Needs Peer Review" visits to alternative education campuses, reviews of nonpublic facilities providing special education services on a contract basis, and other special reviews related to governance, equal employment opportunity, or other complaints. Two other divisions within the agency also performed primary monitoring functions: School Financial Audits and Grants Administration. Other TEA divisions conducted on-site reviews in program areas such as child nutrition, adult education, and charter schools.

HOUSE BILL 3459 MONITORING PROVISIONS

House Bill 3459 sharply limited TEA's compliance monitoring activities. With the exceptions of special education, federally required or federally funded programs, and special accreditation investigations, TEA may no longer monitor education program compliance by school districts, except with regard to the following: (1) compliance with federal law and regulations; (2) financial accountability, including compliance with grant requirements; and (3) data integrity of submissions to the Public Education Information Management System (PEIMS) and the assessment and accountability system.

Program areas that no longer fall under traditional compliance monitoring include bilingual education, compensatory education, gifted and talented education, career and technology education, kindergarten/prekindergarten programs, adult education, and disciplinary alternative education programs. House Bill 3459 makes the board of trustees in each school district and charter school the primary entities responsible for ensuring compliance with all requirements of these and other state education programs.

The language of House Bill 3459 only restricts the scope of the agency's monitoring activities. It does not prescribe a performance-based monitoring system.

MONITORING AFTER HOUSE BILL 3459

In the 2004–05 biennium, All Funds appropriations to TEA administration were reduced by 20 percent from the prior biennium. In order to operate effectively within these

FIGURE 1
EXCERPT FROM HOUSE BILL 3459, 78TH LEGISLATURE, REGULAR SESSION, 2003

Sec.7.027. LIMITATION ON COMPLIANCE MONITORING.

(a) … the agency may monitor compliance with requirements applicable to a process or program provided by a school district, campus, program, or school granted charters … and the use of funds provided for such a program … only as necessary to ensure:

(1) compliance with federal law and regulations;

(2) financial accountability, including compliance with grant requirements; and

(3) data integrity for purposes of:

(A) the Public Education Information Management System (PEIMS); and

(B) accountability under Chapter 39.

(b) The board of trustees of a school district or the governing body of an open-enrollment charter school has primary responsibility for ensuring that the district or school complies with all applicable requirements of state educational programs.

SOURCE: House Bill 3459, 78th Legislature, Regular Session, 2003.

reduced means, the agency underwent a reorganization, reducing their workforce by 25 percent. A major component of the reorganization was a consolidation of the monitoring function at the agency. The number of divisions with monitoring responsibilities was consolidated from eleven to three primary divisions, and positions working primarily on monitoring were likewise reduced by 79 full-time-equivalent (FTE) positions.

In response to both House Bill 3459 and agency budget cuts, TEA began developing a less resource-intensive, performance-based monitoring system to replace the DEC visits.

The cyclical DEC-based system, in which 130–165 districts were identified for an on-site visit each year, was a labor- and resource-intensive process for both TEA and LEAs. The agency presented a new performance-based monitoring system not only as a way to respond to the limitations of House Bill 3459 but also as an opportunity to adopt a new monitoring philosophy intended to shift the focus from process to results. The new system, according to TEA, would have a strong emphasis on data integrity, would focus on a coordinated approach to agency monitoring, and would feature a more creative application of sanctions and interventions.

PERFORMANCE-BASED MONITORING

Performance-based Monitoring (PBM) uses data and data analysis—particularly student performance data on the Texas Assessment and Knowledge and Skills (TAKS) tests, dropout/completion data, program participation data, and data quality—as the basis for the identification of LEAs at-risk of poor program performance. LEAs flagged as at-risk

FIGURE 2
PERFORMANCE-BASED MONITORING AS DEFINED BY THE TEXAS EDUCATION AGENCY

A "data-driven model to observe, evaluate, and report on the public education system at the individual student group, campus, district, regional and statewide levels across diverse areas, including: program effectiveness, compliance with federal and state law and regulations, financial management, and data integrity."

SOURCE: Texas Education Agency.

based on these data are subject to a set of graduated interventions, from an enhanced desk audit to a possible on-site investigation.

PBM aims to integrate data analysis from three different types of indicators into comprehensive evaluation. The types of indicators are: student performance, program effectiveness, and data integrity. Figure 3 shows a list of possible indicators in each of these areas using Limited English Proficiency programs as an example.

FIGURE 3
PERFORMANCE-BASED MONITORING INDICATORS EXAMPLE: LIMITED ENGLISH PROFICIENT (LEP) PROGRAMS

Student Performance	LEP TAKS passing rate and performance on Reading Proficiency Test in English (RPTE)
	LEP year-after-exit TAKS passing rate
	LEP dropout rate
Program Effectiveness	LEP TAKS participation rate
	LEP exemptions
	LEP graduates from the Recommended High School Program
	Highly-qualified teachers in LEP program
Data Integrity	Leaver/dropout code use analysis
	Excessive absences on assessments

SOURCE: Texas Education Agency.

An important feature of this system is that it places no new reporting requirements or burdens on LEAs by using data that is already collected in various formats. This serves the agency's goal of creating a monitoring system that is less resource-intensive for both the state and LEAs.

Although many data indicators cut across several programs, TEA intends to maintain individual program accountability. Evaluations will be structured to ensure that low performance in one program cannot be masked by high performance in another, or vice versa. To this end, the agency has identified specific program areas that will be subject to PBM review, listed in Figure 4.

FIGURE 4
FOCUS OF PERFORMANCE-BASED MONITORING IDENTIFICATION

PROGRAM

- Bilingual Education
- Special Education
- Career & Technology Education
- Title Programs Under No Child Left Behind (NCLB)
  - – Economically Disadvantaged Students (Title I, Part A)
  - – Migrant Students (Title I, Part C)
  - – Teacher Quality (Title II)
  - – Limited English-proficient Students (Title III)
  - – Safe and Drug-free Schools (Title IV)

DATA INTEGRITY

- Leaver/dropout records
- Assessments (excessive absences/exemptions)
- Discipline data (rate of disciplinary placements)

SOURCE: Texas Education Agency.

Figure 4 also identifies the key components of PBM's data integrity analysis. Data quality is of critical importance to a monitoring system like PBM that relies so heavily on LEA-reported data. Inaccurate or incomplete data in any program area will undermine the agency's ability to evaluate that program. As such, TEA plans to fully integrate data quality analysis into its PBM design.

In contrast to the DEC-based monitoring system, which targeted approximately one-eighth of LEAs annually according to an established cycle, under PBM the agency plans to conduct a basic performance review of every LEA each year. Based on this data analysis, a subset of LEAs will be identified as warranting further review. In addition to these LEAs, the agency plans to identify a few randomly selected LEAs for a more thorough review to assess the validity of its performance indicators on a continual basis.

Under PBM, monitoring activities reflect minimal interventions for LEAs that demonstrate strong student performance and program effectiveness. For LEAs identified as at-risk, other strategies that are more cost-efficient than on-site monitoring are used first. For example, LEAs may be required to submit and adhere to improvement plans based on the results of the performance analysis. When more intensive interventions occur, they are designed to emphasize local flexibility and to minimize the burden related to cost and labor for LEAs to the extent possible.

Specific levels of intervention and the performance thresholds that trigger them will be fully described when TEA officially launches the PBM system in the beginning of calendar year 2005.

House Bill 3459 took effect September 1, 2003 and effectively prohibited the DEC-based system of monitoring. Under that system, approximately 165 LEAs were scheduled to receive an on-site visit in school year 2003–04 as part of the eight-year cycle. Instead of undergoing the scheduled on-site review, these 165 LEAs participated only in the special education monitoring plan for school year 2003–04. Of the 165 LEAs, a limited number were to be identified for intervention based on risk levels as reflected in DAS. The Division of Special Education Monitoring implemented special education interventions.

In January 2004, TEA began developing proposed PBM core indicators. TEA launched the PBM data integrity committee in March 2004. This committee conducts audits of dropout records, absences, exemptions from state assessment, alternative assessments, and disciplinary alternative education programs (DAEPs). During the summer of 2004, TEA senior staff reviewed the proposed core indicators and data integrity indicators, and gathered input from stakeholders. Through the fall of 2004, TEA senior staff and stakeholders reviewed the overall framework for agency monitoring. The 2004–05 PBM manual was released in December 2004.

During the 2003–04 school year, TEA was no longer authorized to continue its old monitoring function but it had not yet completed the task of designing a new one. As a result, the school year became a transition period for state monitoring activity. The 165 LEAs scheduled for comprehensive, on-site DEC visits were instead reviewed remotely using a transitional set of performance indicators; "at risk" LEAs were then identified for a series of graduated interventions. A concern with this transition approach is that is seems unnecessarily limited; it is not clear why, since the DEC-based monitoring system had ended, the agency limited its transitional performance data-based review to those 165 LEAs instead of all of them.

Additionally, the PBM system is not scheduled for full implementation until the beginning of calendar year 2005. Another concern is that the timing of the launch of the new system will result in a diminished monitoring capacity in the 2004–05 school year, which could compound any adverse implications of the reduced monitoring in the 2003–04 transition year.

This report has highlighted some of the potential benefits of PBM: specifically, by shifting the monitoring focus from process to results, the system promises to be a less resource-intensive way of identifying areas in which LEAs are not providing adequate services to students. There are potential drawbacks to PBM as well. For example, the system produces an inherent risk that performance-based

measures based on aggregated data or averages could mask areas of noncompliance or ineffectiveness within campuses or districts.

Also, a performance-based monitoring system could produce an incentive for schools or districts to overlook noncompliant activities that are perceived to have no negative impact or even a positive impact on measured objectives.

Finally, there is a danger that a monitoring system based primarily on raw student performance will unfairly target LEAs that have a disproportionate share of hard-to-educate students. LEAs in this category may have well-run programs, but the socioeconomic status of its students may keep TAKS passing and graduation rates relatively low compared to other LEAs around the state.

One way to avoid this problem is to develop performance measures that focus on student progress from year to year rather than raw test scores and passing rates. TEA has recognized this issue and flagged it as a priority for the future development of PBM.

LIMIT CAREER AND TECHNOLOGY EDUCATION FUNDING TO HIGH-COST COURSES

School districts receive additional state funding to offer courses in career and technology education. This is a field that teaches occupational skills and knowledge. The "weighted allotment" for career and technology education funding is based on the assumption that these courses are more expensive to teach because they involve smaller class sizes or special equipment and supplies. However, not all courses that receive career and technology funding actually feature these two factors that would make them cost more than regular education courses.

In compliance with a rider in the 2004–05 General Appropriations Act, the Texas Education Agency eliminated seven career and technology courses from the list of courses that can generate additional weighted funding. The process used by the agency to identify courses for exclusion from weighted funding focused primarily on the Business Education subject area and did not review all career and technology subject areas. A broad analysis of career and technology courses determined that excluding 12 additional courses, from six subject areas, that are taught similarly to regular education courses could save the state General Revenue Fund about $7.1 million annually.

SIGNIFICANT CONCERN

- At least 12 secondary career and technology education courses are taught in a manner almost identical to regular education courses and as a result they can be excluded from the list of courses that require weighted funding under the career and technology allotment. A more comprehensive review of career and technology courses would likely identify additional courses that do not require weighted funding.

RECOMMENDATIONS

- **Recommendation 1:** Reduce the appropriation for the Texas Education Agency's Foundation School Program by $7.1 million in General Revenue Funds for each year of the 2006–07 biennium. This amount corresponds to the savings achieved by excluding 12 career and technology courses that do not require additional weighted funding.
- **Recommendation 2:** Include a rider in the 2006–07 General Appropriations Bill that requires the Texas Education Agency to conduct a comprehensive review of all career and technology courses currently eligible for weighted funding, and exclude courses that are taught in a conventional format from receiving additional weighted funding.

COMMENTS

The mission of career and technology education is to ensure that students master the skills and knowledge necessary for managing the dual roles of family member and wage earner (Texas Education Code § 29.181). The Texas Education Agency requires that school districts offer a secondary curriculum including career and technology courses in at least three of the following eight categories: career orientation, agricultural science, trade and industrial, family and consumer, technology education, marketing, health science, or business education (Texas Administrative Code § 74.3(b)(2)(I)).

CAREER AND TECHNOLOGY EDUCATION FUNDING

The state provided an estimated $500 million for career and technology education in fiscal year 2003. State funding is provided through two components of the Foundation School Program: the Tier 1 weighted allotment of 1.35 for each full-time-equivalent student, and the Tier 2 guaranteed yield. Funding for a district depends on the number of students taking career and technology courses. A formula is applied that converts career and technology students into full-time-equivalent students. A full-time-equivalent student (FTE) in this case is a hypothetical student taking 30 hours of career and technology coursework per week (six hours a day); for example, ten students taking a full year career and technology course translate to 1.67 FTEs (10 x (1/6 of a day)). A district's career and technology Tier 1 allotment is determined by the following formula:

Adjusted basic allotment x
Career and Technology full-time equivalents x
1.35 weight

Tier 2 funding is also affected by the number of career and technology FTEs because that data influences the number of students counted in weighted average daily attendance (WADA). A school district's WADA increases as the number of career and technology FTEs grows, which

increases the district's Tier 2 state aid. It is important to note, however, that not all school districts receive state aid through Tier 1 or Tier 2. A district that generates sufficient local funding, because of its property wealth, to meet its statutorily determined Tier 1 or Tier 2 funding needs will not qualify for state funding in the Foundation School Program.

STATE FUNDING AND COURSE COSTS

In 2001, a review of career and technology education funding performed by the Legislative Budget Board (LBB) determined that the Texas Education Agency (TEA) had directly contributed to the 42 percent growth in Texas' costs for this weighted allotment between fiscal years 1995 and 1999 by increasing the number of courses eligible for the career and technology weight. The report recommended that the TEA study the instructional arrangements of school district career and technology programs to identify courses that can be taught in a conventional academic setting (e.g., business law) and therefore do not require additional weighted funding.

In response to this recommendation, the Seventy-eighth Legislature, Regular Session, 2003, adopted a rider to the TEA appropriation requiring that the agency identify those courses least in need of the career and technology allotment and preclude school districts from receiving additional weighted funding associated with those courses. The agency identified only seven such courses, from a list of more than 400 career and technology courses. Agency correspondence indicates that the TEA focused on Business Education classes in this elimination process because the 2001 LBB review mentioned courses in that subject area that did not require weighted funding. The TEA estimates that reclassifying these courses will save $10 million per year in General Revenue Funds.

As reflected in Figure 1, the seven courses TEA excluded from allotment eligibility represent only 4 percent of the total career and technology student completions (75,960 student completions/1,819,600 total students). Also, savings from excluding the courses account for only about 2 percent of the total allotment-related state funding, based on fiscal year 2002 data. TEA staff indicated that the overall goal of this effort was to focus primarily on business education courses that do not require intensive instruction or extensive educational technology. The agency did not conduct a comprehensive review of all career and technology courses.

12 COURSES COULD BE EXCLUDED

Many of the courses that currently receive the career and technology allotment merit the 1.35 weight because of lower student-teacher ratios and higher expenses for equipment and supplies, but others do not. For example, business law courses can use the same instructional arrangement as regular academic classes.

FIGURE 1
COURSES EXCLUDED FROM THE CAREER AND TECHNOLOGY ALLOTMENT BY THE TEXAS EDUCATION AGENCY

COURSE	AREA	STUDENTS COMPLETING COURSE
1. Career Connections	Career Orientation	39,335
2. Introduction to Business	Business Education	27,245
3. Business Management	Business Education	4,769
4. Business Ownership	Business Education	2,500
5. International Business	Business Education	2,111
6. Career Investigation	Career Orientation	Data Not Available[1]
7. Business Venture	Business Education	Data Not Available[1]
Total Students Completing 7 courses:		75,960
All Career and Technology Student Completions:		1,819,600

[1]No data in the Public Education Information Management System for these two courses.

SOURCES: Legislative Budget Board; Texas Education Agency.

A broad analysis of career and technology courses revealed that at least 12 courses should not be included in the list of eligible classes. School district and TEA staff indicated that these courses are taught without small class sizes or expensive special equipment or supplies. Figure 2 shows that these courses are primarily introductions to certain fields, or they give students "life skill" information that can be provided without low class sizes or costly supplies and materials found in courses such as those for medical science or electronics. For example, in the business law course, students learn about legal issues facing modern corporations. However, the course description does not point to a need for special materials or small class sizes in order for the instruction to be effective.

It is estimated that excluding these courses from the career and technology weight could save Texas $7.1 million per year in General Revenue. This is based on calculating the total career and technology state allotment cost of these courses using the number of students who completed these courses in the 2002–03 school year.

Excluding these courses from receiving the career and technology allotment would not have a significant affect on the funding received by school districts. These 12 courses represent approximately 4,400 full-time-equivalent students, or 3 percent of total career and technology full-time-equivalent students, and 2 percent of estimated state career

FIGURE 2
COURSES THAT COULD BE EXCLUDED FROM THE CAREER AND TECHNOLOGY ALLOTMENT

	COURSE	AREA	ESTIMATED STATE SAVINGS
1.	Business Law	Business Education	$ 1,432,000
2.	Crime in America	Trade & Industrial	$ 967,000
3.	Career Studies	Career Orientation	$ 900,000
4.	Principles of Marketing	Marketing	$ 728,000
5.	Business Communication	Business Education	$ 728,000
6.	Entrepreneurship	Business Education	$ 580,000
7.	Family & Career Management	Family & Consumer	$ 426,000
8.	Retailing	Marketing	$ 356,000
9.	Family Health Needs	Family & Consumer	$ 321,000
10.	Banking & Financial Systems	Business Education	$ 268,000
11.	Courts & Criminal Procedure	Trade & Industrial	$ 221,000
12.	Intro-Criminal Justice Career	Trade & Industrial	$ 153,000
	Total Savings:		$ 7,080,000

SOURCES: Legislative Budget Board; Texas Education Agency.

and technology funding in the 2002–03 school year. To ensure that at least this level of savings occurs, the appropriation to the Foundation School Program for fiscal years 2006 and 2007 would be reduced by $7.1 million each year in General Revenue Funds (Recommendation 1). Figure 3 reflects the annual savings that would result from implementation of Recommendation 1.

Recommendation 2 would require the TEA to review all career and technology courses currently eligible for weighted funding to identify those that are be taught in without the use of high-cost factors such as small class size and special equipment. The review should indicate which courses would not be eligible for the 1.35 weight under this standard. The following rider should be included in the 2006–07 General Appropriations Act in order to require the agency to implement this recommendation:

> **Career and Technology Education Allotment Programs Eligibility.** Funds appropriated above in Strategy A.1.1, FSP–Equalized Operations, for the Career and Technology Education allotment shall not be used to provide weighted funding for programs identified by the Commissioner as least in need of the additional funding provided by the allotment. Courses to be excluded from weighted funding include, but are not limited to, Business Law, Crime in America, Career Studies, Principles of Marketing, Business Communication, Entrepreneurship, Family & Career Management, Retailing, Family Health Needs, Banking & Financial Systems, Courts & Criminal Procedure, and Introduction to Criminal Justice Careers.
>
> Additionally, it is the intent of the Legislature that no more than 10 percent of each school district's Foundation School Program Career and Technology Education allotment under the Texas Education Code § 42.154 may be expended for indirect costs related to the career and technology education programs.

In conclusion, implementation of the two recommendations would improve the efficiency of career and technology funding by focusing the allotment on actual high cost courses. The principle underlying these recommendations is that vocational courses that are taught in a standard lecture format should be treated as regular education classes for the purpose of determining school finance allocations, while courses that require costly supplies, equipment, or instructional methods should receive additional weighted funding.

FISCAL IMPACT OF THE RECOMMENDATIONS

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$7,080,000
2007	$7,080,000
2008	$7,080,000
2009	$7,080,000
2010	$7,080,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill includes a $14.2 million reduction in General Revenue Funds pursuant to Recommendation 1. The bill also includes the aforementioned rider to implement Recommendation 2.

REFORM THE STATE'S PROCESS OF PURCHASING PUBLIC SCHOOL INSTRUCTIONAL MATERIALS

During the Regular Session of the Seventy-eighth Legislature, 2003, as the state faced a large budgetary shortfall, the Texas Education Agency's funding request for instructional materials was $653 million for the 2004–05 biennium. This request, the highest ever for Texas, represented an increase of over 14 percent from the prior biennium and was double the appropriation for textbooks just three biennia earlier.

Ultimately, the legislature decided to provide partial funding for textbooks in the 2004–05 biennium, appropriating $404 million, deferring $145 million in purchases of some English as a second language and all career and technology education textbooks until the 2006–07 biennium, and implementing measures to reduce overall costs. This funding solution was a temporary one; while it helped the legislature through the 2004–05 budget crisis, it has compounded the funding demand of instructional materials for the 2006–07 biennium. The Texas Education Agency's funding request for the 2006–07 biennium is $718 million, and that amount assumes no purchases of new textbooks in the second year of the biennium.

The legislature's experience of funding textbooks for the current biennium combined with the consistently strong increases in the demand textbooks have placed on the state budget in recent years have brought into sharp focus several concerns about the process by which public education textbooks are priced and purchased in Texas. This report identifies and describes these concerns in detail and makes recommendations on ways the process can be improved and how the cost of instructional materials may be better managed.

SIGNIFICANT FINDING

- State funds dedicated for purchases of instructional materials have increased significantly over the last six biennia (1994–95 through 2006–07 requested), with average biennial increases in excess of 13 percent.

SIGNIFICANT CONCERNS

- Decisions on how much the state is expected to pay for textbooks are made and locked in two and three years prior to the legislative session during which the appropriations are made. The decision is made by the elected State Board of Education.
- The State Board's method for establishing a maximum cost—increasing the average catalog price of a textbook by 5 percent for each of the three years between proclamation announcement and purchase—is flawed and builds in unnecessary and excessive expense to the state's textbook purchase.
- School districts have no incentive to select textbooks with costs lower than the established maximum cost, because the state will pay the full amount up to the maximum cost.
- Without a school district incentive for cost containment there is no competitive incentive for textbook publishers to keep textbook costs low. As one might expect, publishers generally set their textbook prices at or very near the maximum cost allowed.
- A number of other textbook procurement policy changes—from a district distribution system based on enrollment trends to cooperation with other states—also offer the potential to slow the growth in the cost of instructional materials.

RECOMMENDATIONS

- **Recommendation 1:** The textbook procurement process should be overhauled to incorporate incentives for districts to select lower-cost textbooks. Two potential options for creating cost incentives are (1) to expand the textbook credit pilot program statewide or (2) to implement a new funding-based incentive system.
- **Recommendation 2:** The maximum cost calculation should be revised to reflect more reasonable estimates of inflationary pressures.
- **Recommendation 3:** Appropriate steps should be taken that have the potential to contain the cost of instructional materials, including the following: negotiating with publishers to purchase the printing rights for consumable materials; purchasing fewer books but distributing them more efficiently based on a 3-year average enrollment trend basis; and funding Braille and large-type textbooks with federal Individuals with Disabilities Education Act funds.
- **Recommendation 4:** A cooperative agreement should be established with the State Education

Departments of California and Florida to share information and strategies for keeping textbook prices low.

COMMENTS

The cost of instructional materials has exhibited strong and consistent growth over the last three biennia. Although the final appropriations for the 2004–05 biennium are $404 million, the Texas Education Agency's (TEA's) initial request of $653 million was double the $326 million appropriated just six years earlier.

Figure 1 shows appropriations for instructional materials since the 1992–93 biennium. With few exceptions, until the 2004–05 biennium the legislature appropriated the amount requested by the TEA. This pattern clearly broke during the Seventy-eighth Legislative Session, 2003, when a budgetary shortfall forced both cost-savings measures and a deferral of textbook purchases to the 2006–07 biennium. It should be noted that the Seventy-eighth Legislature also requested that the State Board of Education (SBOE) not schedule any textbooks for purchase in fiscal year 2007, to which the SBOE assented. Had the SBOE kept its prospective textbook adoption schedule, cost demands in the upcoming 2006–07 biennium easily would have exceeded $800 million.

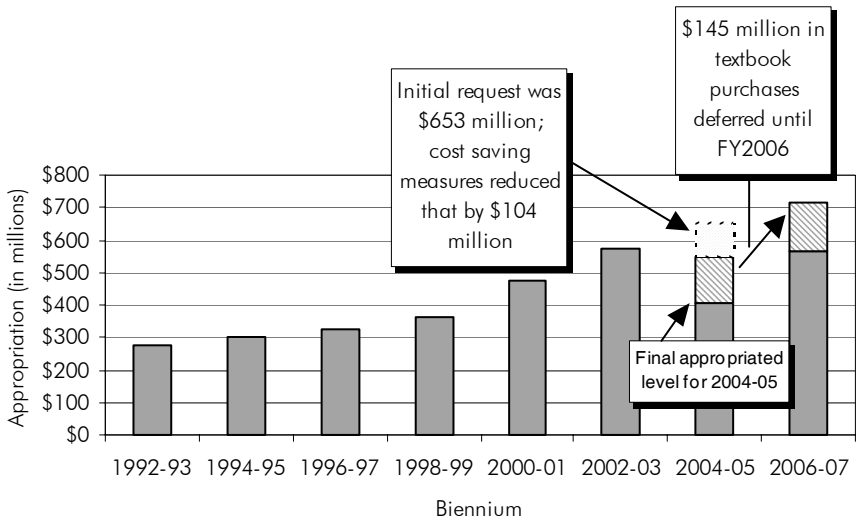
COST COMPONENTS OF INSTRUCTIONAL MATERIALS

To understand what has been driving these steady increases in instructional materials costs, it helps to know what the state is purchasing. As Figure 2 illustrates, there are three categories of costs: new textbooks, continuing contracts, and administration of the textbook division at the TEA.

Most discussions of instructional materials funding focus on the purchase of new textbooks which, for the 2006–07 biennium, account for over 73 percent of the TEA's budget request. The quantity and cost of the new textbooks in any given year is determined by the SBOE's adoption cycle, which schedules textbooks of particular subjects and grade levels for review, adoption, and purchase every six to nine years.

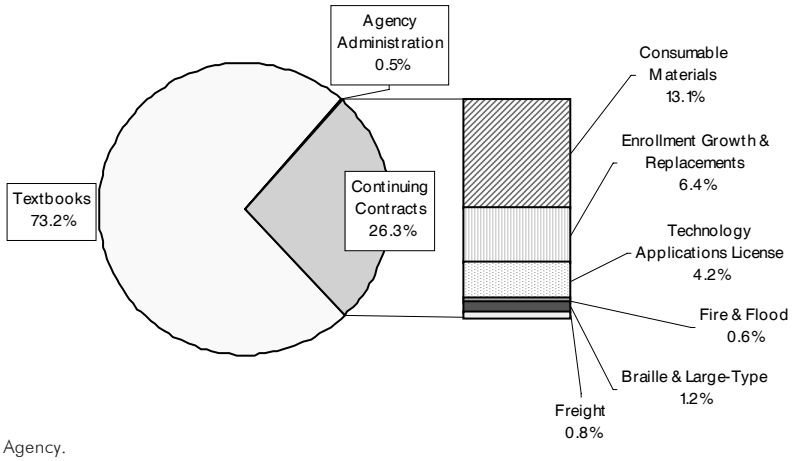
Less frequently discussed is a set of funding obligations collectively referred to as "continuing contracts," which represent over 26 percent of the 2006–07 budgeted cost. The largest among these are consumable materials, which are the workbooks and other complementary products designed to be used and thrown away at the end of a single year. Instructional materials funding also pays for additional copies of textbooks currently in use in school districts that are needed due to enrollment growth, to replace unusable and worn-out textbooks, and to replace books damaged or destroyed by natural disasters like fire and flood. Also, Braille, large-type, and audio books are purchased for students with visual or hearing impairments.

FIGURE 1
INSTRUCTIONAL MATERIALS APPROPRIATIONS, 1994–95 TO 2004–05, AND 2006–07 REQUEST



NOTE: Funding for 1992–93 and 1998–99 include amounts pre-paid in the last year of the prior biennium from balances in the State Textbook Fund.
SOURCE: Legislative Budget Board.

FIGURE 2
THE COST OF INSTRUCTIONAL MATERIALS: TOTAL 2006–07 BIENNIAL REQUEST - *$718 MILLION*



SOURCE: Texas Education Agency.

A new major continuing contract cost is annual license fees for the new technology applications products, which is a $30 million cost beginning in fiscal year 2007. Finally, costs for shipping the textbooks to districts are borne by the state, and administrative costs at the agency round out the funding for instructional materials.

INSTRUCTIONAL MATERIALS FUNDING

Texas is one of only a handful of states in which the state provides a specific appropriation that pays for nearly all school district instructional materials needs. Under the Texas Constitution, the state is required to provide free textbooks for all children attending Texas public schools (Figure 3).

The source of state funding for instructional materials is the State Textbook Fund, which is simply funds from the Available School Fund (ASF) in the amount of the textbook appropriation. The ASF comprises a distribution from the Permanent School Fund and one-quarter of the motor fuels and occupations tax revenue. Although the Texas Constitution speaks of the SBOE setting aside a sufficient amount of funds to purchase textbooks, the level of funding is determined by legislative appropriation.

FIGURE 3
THE TEXAS CONSTITUTION
ARTICLE 7, SECTION 3(B)

It shall be the duty of the State Board of Education to set aside a sufficient amount of available funds to provide free textbooks for the use of children attending the public free schools of this State.

THE ADOPTION PROCESS

Texas is one of 22 states with a process by which the state adopts a selected list of approved textbooks that districts may purchase with state funds. The Texas Education Code, Chapter 31, provides for the adoption of two separate lists of textbooks. Textbooks on the "conforming" list must meet manufacturing standards, be free from factual errors, and contain material covering each element of the Texas Essential Knowledge and Skills (TEKS) curriculum. The "nonconforming" list consists of books that meet manufacturing standards, are free from factual errors, and cover at least half (but not all) of the TEKS curriculum. Textbooks not making either list are rejected. State funds may be used to purchase any textbook on the conforming and nonconforming lists.

The SBOE begins the textbook adoption process by issuing a request for publishers to bid for new materials, called a *proclamation*. Proclamations identify the subject areas and grade levels scheduled to start the review, adoption, and purchase cycle, along with the maximum costs per book the state will pay for each subject area. The journey from the announcement of a proclamation to the purchase of the textbooks is a long one, generally taking three and one-half years. Accordingly, there is a four-year lag between the proclamation year and the school year in which the textbooks are purchased and used, as well as the fiscal year which contains the appropriations that pay for them. For example, Proclamation 2002, announced in the spring of 2002, identifies a set of textbooks that will make their way into schools in the 2005–06 school year and that will be purchased with fiscal year 2006 appropriations. Figure 4 shows the calendar for Proclamation 2002.

FIGURE 4
TEXTBOOK ADOPTION PROCESS—PROCLAMATION 2002

2002	Spring	Proclamation 2002 announced by SBOE. Maximum costs are established.
2002–03		Publishers develop materials.
2004	Spring	Publishers submit samples of materials for review.
	Summer	Panels review materials for coverage of TEKS, factual errors, and manufacturing specifications.
	Fall	Commissioner makes final recommendations to the SBOE regarding placement of materials on the conforming or nonconforming or rejection lists.
	Winter	SBOE adopts materials on the conforming and nonconforming lists, or rejects materials.
2005	Spring	Materials reviewed and selected by local school districts.
	Spring	**Legislature appropriates funds for textbook purchases for the 2006–07 biennium (proclamation 2002—and 2003 had it been issued).**
	Summer	Books are delivered to districts in time for start of 2005–06 school year.
2006		Proclamation 2002 textbooks are used in school year 2005–06 and paid for in fiscal year 2006.

SOURCE: Texas Education Agency.

In the intervening years between proclamation announcement and purchase, publishers develop the materials and then undergo a review process from panels appointed by the Education Commissioner. The SBOE then makes the final decisions as to whether each textbook is adopted and placed on the conforming, nonconforming, or rejected lists.

Local school boards are charged with establishing local policy for selecting new instructional materials. During the spring prior to the start of the school year in which the textbooks will first be used, school districts transmit book orders electronically to the TEA via the Educational Materials and Textbooks system, an internet-based system. The TEA verifies orders against enrollment data for each district, then submits them to be filled by the textbook publishers. The publishers generally wait for these orders before printing the books; the materials are then delivered to school districts during the summer months prior to the start of school. Publishers who fail to deliver books by the first day of school may be subject to administrative penalties. Finally, in the first few months of the fiscal year which corresponds with the school year, the TEA makes scheduled payments to publishers for the instructional materials.

INCREASING TEXTBOOK COSTS

This section examines the textbook adoption and purchase process described above for flaws that may be contributing to the continually increasing cost of instructional materials. However, it is important to recognize possible causes that have little or nothing to do with the way the state of Texas buys its public education textbooks.

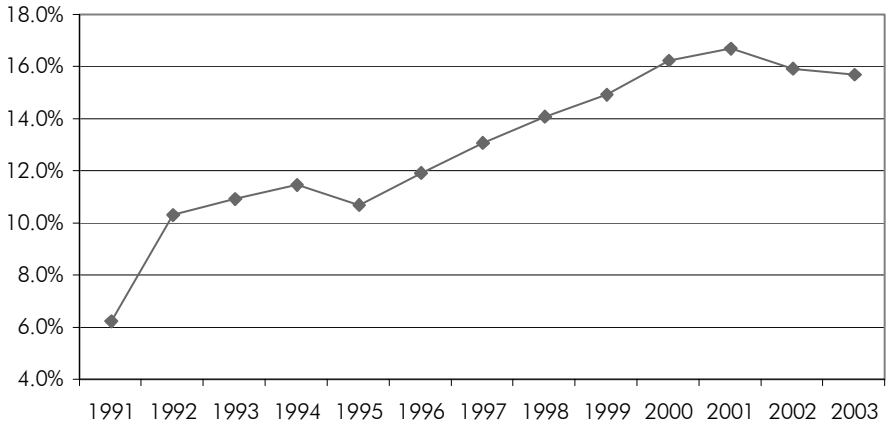
External Factors: First, it should be acknowledged that large annual increases in the cost of instructional materials over the last decade have not been limited to the state of Texas. Many states are grappling with rising textbook costs, the most recent being California, where the general assembly passed a bill this year addressing this problem. Nor is the issue limited to the public education realm; the spiraling cost of college textbooks has drawn national attention as well.

One suggested cause is the consolidation of the educational textbook publishing industry during the 1990s, in which the number of providers in the industry shrank from a dozen or so to primarily four: McGraw-Hill, Pearson, Harcourt, and Houghton-Mifflin. It is argued that such consolidation has stifled competition, driving up prices.

Textbook publishers counter that states have added significantly to the cost of producing textbooks by (1) adopting comprehensive and specific curriculum standards, (2) including requirements for state-specific information, limiting the feasibility of selling those books to markets in other states, and (3) erecting complicated and resource-intensive review and adoption procedures. The more complicated and demanding these procedures, the more opportunities a textbook has of running afoul of them, jeopardizing the large developmental costs already invested into the book. For Texas specifically, publishers point to the adoption of the new curriculum standards—the TEKS—in 1997. Publishers suggest that the costs of developing new textbooks that covered 100 percent of the TEKS elements (in order to be considered "conforming") was a key driver in higher textbook prices over the last few years.

Certainly these factors help explain the strong increases in textbook costs over the past decade. However, evidence suggests that during the years of strong growth in textbook costs in Texas (as well as around the country), the financial impact on textbook publishers was not neutral but rather quite positive. Figure 5 illustrates the operating profit margin of the five primary educational publishers in the industry over the last dozen years. As is evident, publishers

FIGURE 5
EDUCATIONAL PUBLISHERS' OPERATING PROFIT MARGIN



Average includes Harcourt, Houghton Mifflin, McGraw-Hill, Pearson/Simon & Schuster and John Wiley

SOURCE: Goldman Sachs Research estimates.

have improved their profit margins by 60 percent since the mid-1990s, a time period during which we witnessed both new curriculum standards and strong cost increases.

Internal Factors: Setting aside these factors, it is clear that there are several characteristics of the state's current system of pricing and purchasing textbooks that appear to be contributing to the escalating cost of instructional materials. This report identifies four key problems:

1. The SBOE, rather than the legislature, establishes the expected textbook costs borne by the state in future years. Proclamations, by establishing the number of subject areas and grade levels for which textbooks will be purchased and then by setting the maximum costs of these books, establish expected textbook costs for that adoption cycle. As discussed earlier, proclamations are determined and announced by the SBOE with little, if any, legislative input and are made two and three years prior to the legislative session during which the textbook appropriations are made. As a result, every session the Texas Legislature, the body which is responsible for balancing the costs of textbooks against other budgetary needs, faces textbook funding demands that it had little to no say in setting and which are difficult to change.

Past proclamations suggest that cost, while a peripheral concern, has not been a major factor in the design of the adoption cycle. Other concerns, such as ensuring that students have access to textbooks that are fully aligned with the TEKS in core curriculum subject areas as quickly as possible, have taken precedent. Proponents justify this by citing Texas' high-stakes system of testing and accountability. However, other proclamation practices, such as purchasing whole subject areas or all grades in a particular subject area in a single proclamation, do not possess the same urgency and may warrant reconsideration during years of tight state budgets.

While the composition of the proclamations certainly drives total annual textbook costs, it is not a sufficient explanation of the strong and consistent increases in costs of the last decade. A closer look at publisher prices over the same time period indicate that they have shown strong increases as well. Figure 6 gives an example: social studies textbooks for grades one through six were part of Proclamation 1994 and again in Proclamation 2000. During that six-year period, the average maximum cost for those books increased by 41 percent, for an annual growth rate of 5.9 percent.

FIGURE 6
SOCIAL STUDIES, GRADES 1–6 (INCLUDING SPANISH)

AVERAGE MAXIMUM COST		TOTAL	ANNUALIZED
PROCLAMATION 1994	PROCLAMATION 2000	PERCENTAGE INCREASE	PERCENTAGE INCREASE
$27.73	$39.07	40.9%	5.9%

SOURCE: Texas Education Agency.

The trend for social studies textbooks appears fairly representative of the overall trend during this time period, and a closer look at the data indicate that the state's policy of setting maximum costs for textbooks may be contributing to these cost increases.

2. The SBOE's method for establishing a maximum cost is flawed. The policy of assigning maximum costs to textbooks was adopted into law in 1995 by the Seventy-fourth Legislature in order to give both publishers and the legislature an idea as to what the state could be expected to pay for textbooks. The legislature left it up to the SBOE to determine the calculation of the maximum cost.

The SBOE adopted a calculation that takes the average of the publishers' catalog prices for the textbook in each subject area and grade, and increases it by 5 percent for each of the three years between proclamation announcement and purchase. This 5 percent inflation adjustment apparently was intended to account for increasing publisher production costs, particularly in the raw materials of paper and ink.

The problem with this methodology, however, is that it has effectively locked in 5 percent as the minimum annual growth in textbook prices, regardless of whether 5 percent is an accurate reflection of unavoidable textbook production cost pressures.

Indeed, 5 percent appears to have been an excessive inflationary adjustment over the last decade. This report analyzed increases in maximum costs for all textbooks that have been through two adoptions under the maximum cost system; specifically, textbooks adopted under Proclamations 1994 or 1995 that have been readopted in Proclamations 2000 through 2004. Figure 7 shows the average annual change in the maximum cost for these books and compares it to an array of items that arguably can be used as benchmarks of cost pressures.

The average annual increase in costs for textbooks over this time period has been 5.45 percent. As the figure shows, this greatly exceeds the cost pressures publishers have faced from increase in the price of the raw materials, which was a purported driver of the 5 percent maximum cost assumption: the producer price index for paper and printing ink increased only 1.1 percent during the same years. Similarly, a maximum cost inflation adjustment tied to the actual Consumer Price Index (CPI) would have yielded maximum cost increases of less than half of what occurred. Growth rates for broader indicators of public education spending—average teacher salaries and operating expenditures per pupil—are closer but still fall short of textbook cost increases.

These data suggest that the SBOE's policy of setting maximum textbook costs by growing publishers' catalog prices by 5 percent a year has built in unnecessary and excessive expense to the state's textbook purchases.

These problems with the maximum cost policy are important, but only exacerbate a more fundamental flaw in Texas' system of pricing and purchasing textbooks: the lack of incentives for school districts and publishers to contain costs.

3. School districts have no incentive to select textbooks with costs lower than the established maximum cost. Texas' constitutional guarantee that the state will provide free textbooks to all students in its public schools is admirable, but it does contribute to an unintended problem. Since the principle of local control, codified in the Texas Education Code Chapter 31, allows school districts to select which textbooks they want to use (albeit from state-approved lists); and because the state is constitutionally required to pay for whatever choice they make, districts have no financial incentive to consider cost in their selection. Indeed, since the state will pay up to the maximum cost for a textbook, there may be an incentive to districts to select books at or near the maximum cost under the assumption that by doing so the districts would get the most textbook "bang" for the state's buck.

During the Seventy-seventh Legislative Session, 2001, the legislature recognized this fundamental lack of market incentives and took a step to remedy it by establishing a textbook credit pilot program, which provides a financial benefit to districts that select textbooks priced below the maximum cost. However, this pilot program remains limited to 30 districts.

4. There is no competitive incentive for textbook publishers to keep textbook costs low. Without a school district incentive to select lower cost textbooks, it is no surprise that publishers generally set their textbook prices at or very near the maximum cost allowed.

Figure 8 compares the average publisher price of textbooks in the last three purchased Proclamations (1999, 2000, and

FIGURE 7
AVERAGE ANNUAL INCREASE IN TEXTBOOK COSTS—PROCLAMATIONS 1994–1995 TO PROCLAMATIONS 2000–2004, AND COMPARISON ITEMS

Textbooks—Maximum Cost	5.45%
Total District Operating Expenditures per Pupil	4.45%
Average Texas Teacher Salary	3.20%
Average Annual Inflation Rate (CPI)	2.43%
Average Annual Increase Producer Price Index—Paper plus Printing Ink	1.10%

SOURCES: Texas Education Agency; National Education Association; U.S. Bureau of Labor Statistics.

FIGURE 8
PUBLISHER PRICES COMPARED TO MAXIMUM COSTS, PROCLAMATIONS 1999–2001

PROCLAMATION	SUBJECTS	AVERAGE MAXIMUM COST	AVERAGE PUBLISHER PRICE	PUBLISHER PRICE, AS % OF MAX COST
1999	Science	$60.84	$59.86	98.4%
2000	Social Studies, Prekindergarten, Economics	$52.75	$53.17	100.8%
2001	Biology, English as a Second Language, Career & Technology, Technology Applications	$43.35	$41.39	95.5%
3-Year Average		**$46.73**	**$45.34**	**97.0%**

NOTES:
1. Analysis uses simple averages, which are not weighted for number of books purchased in each subject area.
2. Only textbooks adopted as conforming are included.
3. Analysis excludes teacher editions.
SOURCE: Texas Education Agency.

2001) to the average maximum cost established for those books. Over those three Proclamations, the publisher price averaged 97 percent of the maximum cost. In dollar terms, this represents an average publisher price of $45.34 per book compared to a $46.73 maximum cost, a difference of $1.39.

Because local school districts have little reason to consider cost in their textbook selection decisions, publishers feel no competitive pressure to keep the costs of their textbooks low. In fact, this absence of a market incentive has likely driven textbook prices up. Because they need not compete on price, textbook publishers attempt to win school districts as customers with "free" ancillary materials; that is, software and CD-ROMs, question sets, quizzes, and other supplemental materials or services, including teacher training. Of course, these items are not free, but rather their costs are factored into the price of the student textbooks and help to push their prices toward the maximum cost.

RECOMMENDATIONS FOR REFORM

To address the concerns identified above, this section describes recommendations for reforming the current textbook pricing and purchasing system in Texas, in order of importance.

Recommendation 1: The textbook procurement process should be overhauled to incorporate incentives for districts to select lower cost textbooks.

The combination of local control over textbook selection and state obligation to pay for those books has created a system that provides no benefit to school districts who are financially prudent with their textbook choices.

The Seventy-seventh Legislature, 2001, recognized this flaw and passed House Bill 623, which created the Textbook Credit Pilot Project (Texas Education Code § 31.1011).

This pilot awarded credits for textbooks to school districts that purchased textbooks below the established maximum cost. For the textbooks falling below the maximum cost, the dollar amount difference between the actual cost of the textbook and the maximum cost was split evenly between the district and the state. The district could use the credits toward the purchase of additional bound or electronic textbooks. The state's share of the savings reverts to the State Textbook Fund. This pilot ends after the current school year, and the enabling statute requires the TEA to deliver a report on the project to the Seventy-ninth Legislature, 2005.

Ten districts participated in the pilot during the 2002–03 school year, with an additional 10 joining in each of the next two years. The project had a promising start, with the 10 districts producing nearly $182,000 in cost savings below the maximum cost, representing a $91,000 savings to the state. However, in the two subsequent years state savings dropped to $63,000 despite the addition of 10 more districts, and to $7,300 from 30 districts in the final year of the project. The pilot districts realized little savings in the final two years mainly because they were choosing textbooks in subject areas in which prices differed little among publishers: they were all at or around the maximum cost. The lesson of the pilot project was that school districts would respond well to a financial incentive in their selection of textbooks, even though the pilot was too small to force textbook publishers to price their books more competitively.

As a solution, this report recommends that the Textbook Credit Pilot Project drop its pilot status and be expanded to all school districts and charter schools in the state. A clear signal from the Seventh-ninth Legislature, 2005, on the intent to make this a statewide program could affect the

textbook prices publishers will submit for Proclamations 2004 and 2005, impacting school years 2007–08 and 2008–09, and the 2008–09 state fiscal biennium.

While expanding the credit program statewide would be a major advance in instilling market incentives into the textbook procurement process in Texas, it is not without its shortcomings. First, districts may only spend credits they earn in the program on additional textbooks, which may be less of an incentive for districts to select low-cost textbooks than it could be if districts were allowed to use those credits on any district need. Second, the program reduces the state's textbook costs by one-half as much as it could, since 50 percent of the cost savings must be shared with districts in the form of credits.

To address these shortcomings, the state could implement, through a combination of statutory changes and administrative rules, an alternative incentive-based funding system. The following "90 percent allocation" system is offered as an example:

1. For each Proclamation, the maximum cost for each textbook is calculated and the total cost of each proclamation is determined. For example, assume Proclamation 2005 will cost $250 million.
2. Prior to school districts selecting which textbooks to purchase, the TEA divides the total proclamation cost among all districts based on expected enrollment levels, and an initial textbook allocation amount is calculated for each district.
3. Districts are then directed to select textbooks based on the assumption that the state's textbook appropriation will be 90 percent of this allocation. This would be a state savings of $25 million.
4. If a district can select enough low-cost textbooks that it does not spend all of its 90 percent allocation, the district may use the remaining funds for any purpose.
5. If a district's selection of textbooks costs more than the 90 percent allocation, the difference is paid for out of funds the district would receive through the Technology Allotment (which runs in excess of $120 million each year).

Possible benefits to a system like this include the following:

- It provides strong incentives to districts to select low-cost textbooks; districts face a loss of technology funds if their selection of textbooks exceeds the 90 percent allocation but gain all-purpose funds if their textbook selection falls below the 90 percent threshold. These district incentives should in turn translate into strong incentives for publishers to price their textbooks competitively.
- The state has the power to set a cost-savings target (10 percent in this scenario) and receive the full benefit of these cost savings.
- The state can maintain its constitutional obligation to fully fund textbooks by tapping the Technology Allotment as an emergency supplemental funding source.
- Based on the prices submitted by publishers, the cost-savings target can be lessened (if 10 percent is deemed too punitive) or increased (if it is deemed that more savings can be achieved). This applies to only the textbooks purchased in the first year of a biennium.

Potential drawbacks include the following:

- If publishers do not respond to the incentive to lower their textbook prices or if the cost-savings target is unrealistically high, this system will be punitive toward districts and achieve textbook cost savings only through a reduction in the Technology Allotment.
- Significant percentage point reductions in cost cannot be sustained in perpetuity; after one full adoption cycle of cost savings, expectations for future savings may be minimal.

Recommendation 2: The SBOE should revise the maximum cost calculation to reflect more reasonable estimates of inflationary pressures.

Regardless of whether the procurement process is changed to include district incentives for selecting lower cost textbooks, the SBOE's calculation of maximum cost needs revision. As discussed in this report, the current policy of increasing publishers' catalog prices by 5 percent for each of the three years between proclamation and purchase has overstated inflationary pressures on textbook costs and has built in unnecessary and excessive expense to the state's textbook purchases over the last decade.

The reliance on publishers' catalog prices as a base for the maximum cost is unfortunate but perhaps necessary absent another clear starting point. Easier to address is the 5 percent calculation; this assumption was based on cost increases in raw materials—primarily paper and ink—at the time the policy was adopted in the mid-1990s. As this report suggests, costs of these raw materials did not sustain those high rates of increase. Furthermore, it is not clear why the inflation adjustment should be based wholly on

raw material costs that, according to the publishers themselves, account for only around 7 percent of total textbook costs.

This report recommends that the SBOE abandon this static inflation assumption and instead apply projections of the national Consumer Price Index (CPI). This would cut the inflation adjustment approximately in half—the CPI has averaged 2.43 percent over the last 10 years—and should be updated regularly, fluctuating with changes in inflationary pressures. This could be accomplished through a change in the SBOE's administrative rules.

This recommendation should provide a more accurate and reasonable assumption about textbook price increases due to inflation. For example, had the CPI been used for the Proclamation 2002 textbooks scheduled for purchase in 2006, the maximum cost of those books would have been $351 million, a $27 million (7 percent) decrease from the current $378 million price tag.

Recommendation 3: Appropriate measures should be adopted that have the potential to contain the cost of instructional materials.

Smaller changes can be made to Texas' adoption process that may help contain the cost of instructional materials. The TEA could be directed by rider to enact the following potential cost-saving measures:

- The SBOE should seek "advice and consent" from the Legislative Budget Board and the Governor prior to the approval and announcement of each Proclamation regarding the number of textbooks scheduled for adoption and the accompanying total estimated maximum cost. Because the content of each Proclamation effectively establishes the textbook funding demand the legislature must deal with three years after the proclamation is announced, improved communication and coordination between the SBOE and the legislature at the time the proclamations are determined may prevent their cost from diverging significantly from legislative expectations.
- The TEA should explore the possibility of negotiating with publishers to purchase the printing rights for consumable materials. Consumable materials—estimated to cost $94 million in the 2006–07 biennium—represent a significant long-term cost to the state. The TEA should investigate whether savings could be achieved if the state acquired the rights to produce these materials itself. This may allow the state to use cheaper materials and print only a subset of the items on an as-needed basis.
- The TEA should not distribute surplus textbooks evenly across school districts, but rather according to expected need based on enrollment trends. The 2006–07 request for textbook funds represents a purchase of 105 percent of estimated statewide enrollment, with each district slated to receive the additional 5 percent to cover unanticipated enrollment growth. However, fast-growth, flat-growth, and negative growth districts can be predicted using enrollment trend data; and these surplus books can be distributed more efficiently based on projected need. Under such a distribution system, the state may be able to lower the number of surplus textbooks purchased, with each percentage point drop from the 105 percent assumption representing a $5 million biennial savings.
- Braille and large-type textbooks should be funded with federal Individuals with Disabilities Education Act (IDEA) funds. These instructional materials are estimated to cost $8.5 million in the 2006–07 biennium but are an allowable expense for IDEA Part B state-level discretionary funds. The TEA is expected to receive approximately $110 million in this type of IDEA Part B funds for the 2006–07 biennium.

Recommendation 4: The TEA should establish a cooperative agreement with California, and Florida to share information and strategies for keeping textbook prices low.

The states of Texas, California and Florida are the three largest "textbook adoption" states in the country and together represent over 27 percent of the nation's public school students and thus over one quarter of the national public education textbook market. As a result, decisions and policies made in these states regarding textbook content and pricing essentially dictate textbook content and pricing for the nation.

Given this potential market leverage, it is reasonable to assume that with a minimal level of communication these states could establish coordinated policies to attempt to contain textbook costs. However, currently there is very little communication and coordination between the state education agencies in these states.

A starting point can be the sharing of information regarding what publishers are charging each state for similar textbooks. Texas, California, and Florida, along with most other states, have a "most favored nation" clause regarding textbooks; specifically, publishers may not sell a textbook to Texas for a price higher than they are selling the same textbook to another state. However, analysis of textbooks and prices across the states are rarely conducted in order to

see if publishers are following this clause, and an agreement between the largest three "adoption states" could facilitate such analysis.

A consequence of the "most favored nation" clause is that one state may have a textbook policy which intentionally or unintentionally inflates textbook costs; publishers may then effectively "export" these higher costs to other states, because the original state's "most favored nation" clause forbids publishers from charging any other state less for their textbooks.

Cooperation between Texas, California, and Florida and the sharing of strategies for containing textbook costs may help identify instances where one state's policies are having negative nationwide consequences. Also, such coordination would give the states the ability to present a more united front to publishers, perhaps ensuring greater success in efforts to curb some expensive trends in public education instructional materials, such as the proliferation of the "free" ancillary materials that accompany textbooks. The TEA could be directed by rider to pursue such a cooperative agreement.

As the funding demand of instructional materials has grown sharply over the last few years, so has recognition that Texas' system of pricing and purchasing textbooks possesses serious flaws that have contributed to the escalating cost. During the current biennium, the TEA has been forced to enact some cost-savings measures in response to a reduced level of textbook appropriations. Interim committees in both chambers of the Texas Legislature are charged with finding ways to improve the state's delivery of instructional materials to students, including consideration of electronic and web-based materials. Finally, the SBOE has initiated a review of its policies regarding the establishment of textbook maximum costs.

FISCAL IMPACT OF THE RECOMMENDATIONS

Any overhaul of the current textbook procurement process, including actions specified in the report recommendations, would affect at the earliest Proclamation 2005 and thus not have a significant fiscal impact until the 2008–09 biennium. However, smaller reforms, including those identified in this report, may be pursued during the interim, enabling the state to move toward a more competitive and efficient textbook procurement process and potentially freeing millions of state dollars for other public education funding needs.

One cost-saving measure under Recommendation 3, that Braille and large-type textbooks be purchased with Federal IDEA Funds, has been included in the introduced 2006–07 General Appropriations Bill. This yields a savings to General Revenue Funds of $8.5 million for the 2006–07 biennium.

UPDATE ON THE NO CHILD LEFT BEHIND ACT

The No Child Left Behind Act (NCLB), which is the most current federal reauthorization of the Elementary and Secondary Education Act of 1965, was signed into law two years ago. This legislation sets the authorized funding levels for the main sources of federal aid to public schools. Congress determines the actual funding in the annual appropriation process. For fiscal year 2004, Texas received $1.9 billion in federal funding for programs authorized by the No Child Left Behind Act. In exchange for increased federal funding, states must strengthen the accountability framework established after the 1994 reauthorization of Elementary and Secondary Education Act and implement additional education reforms. This report provides an update on the No Child Left Behind Act, with an emphasis on teacher quality and adequate yearly progress provisions. This federal law established a number of requirements on both the state and local school districts, driving costs that are not within the control of the state.

SIGNIFICANT FINDINGS

- The U.S. Department of Education, as required for the first time by the No Child Left Behind Act, used the most recent census data to distribute fiscal year 2004 Title I, Part A Grants to Local Educational Agencies, to states. Texas' allocation increased by $92.2 million over the previous funding level to $1.1 billion in fiscal year 2004.
- The No Child Left Behind Act provides Federal Funds to assist states in the development and implementation of their assessments; Texas will receive approximately $22.7 million in each year of the 2006–07 biennium for this purpose. This amount does not cover the state's total expenses related to testing, which are anticipated to reach $61.0 million in fiscal year 2006.
- Even though Title I, Part A funds do not flow to all school districts, all public school teachers of core academic courses must be highly qualified by the 2005–06 school year. According to the Texas Education Agency, survey data indicate that 95.6 percent of teachers in Texas public schools met the No Child Left Behind Act's definition of "highly qualified" in their primary assignment at the end of the 2003–04 school year.

COMMENTS

Congress enacted the Elementary and Secondary Education Act (ESEA) in 1965 to assist states and school districts in meeting the educational needs of economically and educationally disadvantaged children. Title I, Part A of ESEA, authorizes the primary source of federal funding for elementary and secondary education. ESEA has been extended and amended several times since its enactment. Congress made significant changes to Title I, Part A when it passed a reauthorization of ESEA in 1994 to address concerns that increased federal funding was not significantly improving the academic achievement of disadvantaged students. States were required to develop challenging curriculum content and performance standards, assessments aligned with content standards, and accountability systems to assess student achievement. The ESEA set deadlines for states to comply with these requirements. Texas was one of the 19 states that received approval for meeting the 1994 ESEA requirements by the 2000–01 school year deadline.

Congress did not eliminate any of the 1994 ESEA requirements with the passage of the No Child Left Behind (NCLB) Act of 2001. The NCLB Act amended ESEA to add additional requirements such as increasing student assessments, collecting and distributing results of student achievement, ensuring highly qualified teachers in every classroom, and guaranteeing that all students are proficient in mathematics and reading by the 2013–14 school year. In addition, the NCLB Act specifically describes the actions states and local districts must take to aid Title I, Part A schools that fail to make progress in improving student achievement.

FEDERAL FUNDING FOR ELEMENTARY AND SECONDARY EDUCATION

The U.S. Department of Education distributes most of the federal funding to states on a formula basis for elementary and secondary education programs. The department distributes most of the grants to states in July from the appropriation for a fiscal year that started the previous year. For example, the funds appropriated in the fiscal year 2004 federal appropriations act are meant for the 2004–05 school year, or state fiscal year 2005. States have 27 months to draw down and expend the Federal Funds.

As a condition of receiving Federal Funds, some of the elementary and secondary education grants prohibit "supplantation," which means states may not supplant or replace state and/or local spending with Federal Funds. Congress includes these provisions to ensure that Federal Funds will not replace existing state and local funds for activities allowed by the federal programs. See Figure 1 for more information on supplanting.

FIGURE 1
SUPPLANTATION GUIDANCE

The U.S. Department of Education presumes supplanting has occurred in the following situations:

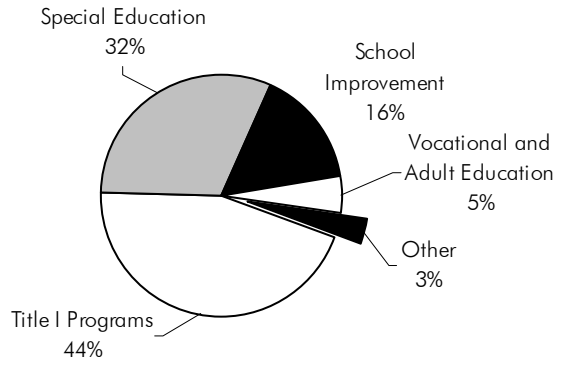
- The state education agency or local school district used Federal Funds to provide services that the state education agency or local school district was required to make available under other federal, state, or local laws.
- The state education agency or local school district used Federal Funds to provide services that the state education agency or local school district provided with non-Federal Funds in the prior year.
- The state education agency or local school district used Title I, Part A Grants to Local Educational Agencies or Part C (Migrant Education) funds to provide services for participating children that the state education agency or local school district provided with non-Federal Funds for children not served by these funds.

SOURCE: U.S. Office of Management and Budget.

Most federal programs require a state and/or local match. Match refers to cost-sharing requirements that accompany receipt of Federal Funds. There are no cost-sharing requirements for most federal elementary and secondary education programs. However, states and local school districts are subject to maintenance of effort (MOE) requirements for several elementary and secondary programs. MOE refers to a minimal level of state and local school district spending required as a condition of receiving Federal Funds. For example, to receive Title I, Part A funds, a local school district's overall spending (including state funds) for public education should not decrease by more than 10 percent from the preceding year.

In fiscal year 2005, Congress increased federal funding for elementary and secondary education programs by 2 percent ($544.6 million nationally) over the previous funding level of $35.2 billion. Most of the increase is attributable to financial assistance to school districts, allocated on the basis of students living in poverty and students in special education. Texas will receive $3.0 billion in federal funding in federal fiscal year 2005 ($79.3 million over the fiscal year 2004 funding level). Figure 2 displays the amounts of federal funding to Texas for various categories in federal fiscal year 2005. The categories of Title I Programs and Special Education account for 76 percent of the federal funding to Texas for elementary and secondary education programs. Federal grants awarded on a competitive basis directly to Texas school districts are not included in this total amount.

FIGURE 2
FEDERAL FUNDING TO TEXAS FOR EDUCATION
FEDERAL FISCAL YEAR 2005
TOTAL = $3 BILLION



NOTE: Other includes Language Acquisition State Grants, Education for Homeless Children and Youth, and State Grants for Incarcerated Youth Offenders. Amounts do not include Federal Funds awarded directly to school districts or awarded to higher education students. Vocational and Adult Education does not include Temporary Assistance for Needy Families funds.

SOURCE: Legislative Budget Board.

FEDERAL FUNDING FOR NCLB ACT PROGRAMS

Although Congress has increased federal funding nationally for NCLB Act programs by 56.9 percent since the legislation was enacted in 2002, appropriation levels for NCLB Act programs remain below the amounts authorized by the statute. For fiscal year 2005, Congress appropriated a total of $22.4 billion to NCLB Act programs, which is $8.8 billion below the authorized level of $31.2 billion. Three states, California, New York, and Texas, receive over 30 percent ($7.0 billion) of the total federal funding for NCLB Act programs.

Federal funding for NCLB Act programs distributed on a formula basis to Texas will be about $1.9 billion in fiscal year 2005. This federal funding level will be $24.3 million (1 percent) over the fiscal year 2004 funding level. A significant amount of the fiscal year 2005 increase can be attributed to Title I, Part A Grants to Local Educational Agencies. Title I, Part A Grants to Local Educational Agency will increase by $42.0 million over fiscal year 2004 funding level to $1.2 billion. Amounts for all the Title I programs are provided in Figure 3 along with fiscal year 2005 amounts for other NCLB Act programs.

FIGURE 3
ALLOCATIONS TO TEXAS FOR THE NO CHILD LEFT BEHIND ACT PROGRAMS
(IN MILLIONS)

PROGRAM	FY 2003	FY 2004	ESTIMATED FY 2005	CHANGE FROM FY 2004
Title I				
Grants to Local Educational Agency	$1,018.5	$1,110.7	$1,152.7	$42.0
Reading First Initiative	93.1	99.0	100.4	1.4
Migrant	57.8	57.9	57.4	(0.5)
Even Start	19.4	20.0	18.2	(1.8)
Comprehensive School Reform	18.7	19.5	17.7	(1.8)
Neglected and Delinquent	2.6	2.6	2.7	0.1
Language Acquisition State Grants	65.4	74.4	82.9	8.5
Mathematics and Science Partnerships	9.1	14.0	16.7	2.7
21st Century Community Learning Centers	45.5	85.0	87.3	2.3
Rural and Low-Income Schools	6.9	6.9	9.0	2.1
State Assessments	20.4	21.9	22.7	0.8
Community Service State Grants	4.1	0.0	0.0	0.0
Safe and Drug-Free Schools and Communities	37.1	35.0	34.9	(0.1)
Improving Teacher Quality	239.8	242.3	241.1	(1.2)
Fund for the Improvement of Education	5.8	6.0	0.0	(6.0)
Innovative Education Program Strategies	29.2	23.5	15.7	(7.8)
Educational Technology State Grants	55.8	59.4	42.9	(16.5)
Total	$1,729.2	$1,878.1	$1,902.3	$24.2

SOURCES: Legislative Budget Board; U.S. Department of Education.

TITLE I, EDUCATION FOR THE DISADVANTAGED

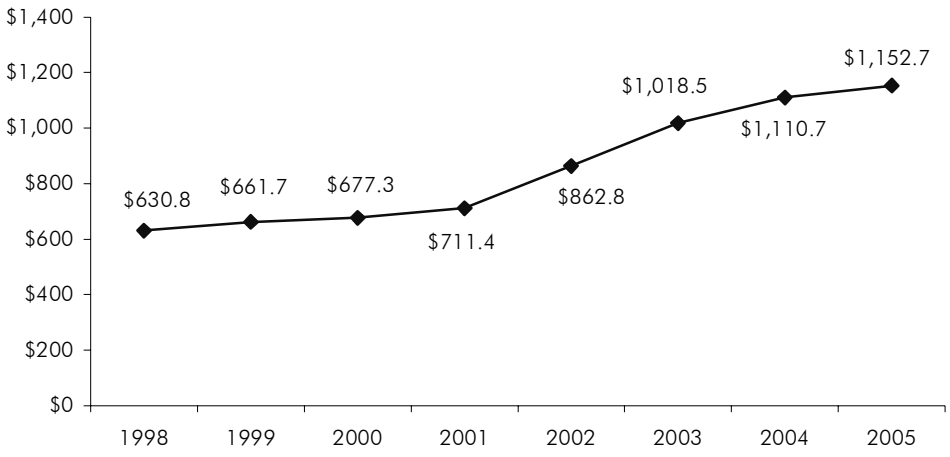
Title I, Part A of the NCLB Act provides federal funding to assist local school districts in providing supplementary educational services for disadvantaged children to meet state academic content and student achievement standards. Texas will receive $1.2 billion under Title I, Part A Grants to Local Educational Agencies, in fiscal year 2005. Congress has increased federal funding for this program for the past several years. Figure 4 shows the growth in Title I, Part A funds for school districts in Texas since 1998.

The formulas used to distribute Title I, Part A funds are important not only because of the significant amount of federal funding, but also because formulas of other NCLB Act programs are based on Title I, Part A allocations. The 1994 reauthorization of the ESEA provided that Title I, Part A Grants to Local Educational Agencies, be distributed based on four formulas (Basic, Concentration, Target, and Education Finance Incentive grants). The law required that any additional funds appropriated above 1995 amounts be allocated to school districts under the Target or Education Finance Incentive (EFI) formulas. Historically, however, Congress has appropriated funds using only two formulas (Basic and Concentration), which are based primarily on census poverty data and the cost of education in each state. Beginning with fiscal year 2002 appropriations, Congress directed the department to distribute Title I, Part A funds based on all four formulas. The EFI formula was modified by the NCLB Act to direct funds to schools based on the number of disadvantaged students, rather than the past formula, which was based partly on the state school-age population. The other three formulas had minor changes.

The NCLB Act also extended previous hold harmless provisions that had only been in place for Title I, Part A funding distributed with the Basic formula. The hold harmless provisions guarantee a percentage of prior year's funding to local school districts depending on the number of children living in poverty (child formula count). For Basic, Concentration and EFI grants, school districts with higher poverty rates get the higher percentages as follows:

- ninety-five percent of prior year's funds if child formula count makes up at least 30 percent of enrollment;

FIGURE 4
TITLE I FUNDS TO TEXAS FOR TITLE I, PART A: GRANTS TO LOCAL EDUCATIONAL AGENCIES (IN MILLIONS)



SOURCE: U.S. Department of Education.

- ninety percent of prior year's funds if child formula count makes up at least 15 percent of enrollment; and
- eighty-five percent of prior year's funds if child formula count is less than 15 percent of enrollment.

School districts must distribute Title I funds to schools with the highest percentages of children living in poverty. Schools must then focus Title I, Part A funded services on children who are failing or most at risk of failing to meet state academic standards, unless they are implementing a school-wide program. The NCLB Act lowered the poverty threshold for Title I, Part A school-wide programs from 50 percent to 40 percent of poverty. Schools in which disadvantaged children make up at least 40 percent of enrollment are now eligible to use Title I funds for school-wide programs that serve all children in the school.

The NCLB Act authorized $500 million annually for a new formula grant to states, Assistance for Local School Improvement. Congress has not appropriated funds for this program.

The Reading First Initiative (Title I, Part B, Subpart 1) replaced the Reading Excellence Act program and established reading programs for all children in kindergarten through third grade. Funds are provided to support the application of scientifically based reading research and the proven instructional and assessment tools consistent with such research for children in kindergarten through third grade. Congress appropriated $1.0 billion nationally in fiscal year 2005 for Reading First Initiatives; Texas' allocation will be $100.4 million. The NCLB Act also authorized the Early Reading First program (Title I, Part B, Subpart 2). This competitive grant program helps with early identification and intervention of reading failure among children. In fiscal year 2003, a total of $13.9 million was awarded for five Early Reading First projects in Texas.

Other Title I programs reauthorized by the NCLB Act that impact the Texas state budget include Even Start (Title I, Part B, Subpart 3), Migrant Education (Title I, Part C), the Neglected and Delinquent Children and Youth Program (Title I, Part D), and Comprehensive School Reform Demonstration (Title I, Part F). The NCLB Act made the most changes to the Migrant Education program. This legislation added a hold harmless provision to ensure that every state receives a base amount equal to fiscal year 2002 amounts. Beginning in fiscal year 2003, any additional funds above the fiscal year 2002 appropriation amount will be distributed to states based on a formula that includes (1) the count of migratory children, ages 3–21 years old, residing within the state, (2) the count of migratory children, ages 3–21 years old, receiving state services in the summer, and (3) each state's per-pupil expenditure. However, Congress for the past two fiscal years has not appropriated funding above the fiscal year 2002 amount for the Migrant Education program. The department has distributed funds to states based on fiscal year 2002 amounts. Texas will receive $57.4 million in fiscal year 2005 to help ensure that migratory children are not penalized in any manner by disparities among states in curriculum, graduation

requirements, state academic content standards, and student academic achievement standards.

IMPROVING TEACHER QUALITY

The NCLB Act authorized a new state formula grant program, Improving Teacher Quality, which combined the Eisenhower Professional Development state grants and Class-Size Reduction grants. The Improving Teacher Quality Program funds the preparation, training, and recruitment of high-quality teachers. Congress appropriated $2.9 billion in federal funding nationally in fiscal year 2005 for the Improving Teacher Quality Program. The formula for distributing these funds provides states with a base allocation equal to fiscal year 2001 Eisenhower Professional Development and Class Size Reduction grants. For additional funds, 35 percent is based on each state's population of children ages 5–17 years old, and 65 percent is based on each state's number of children ages 5–17 from families with incomes below the federal poverty level. Texas will receive an allocation of $241.0 million in fiscal year 2005. School districts are required to reserve no less than 5 percent and no more than 10 percent of their Title I, Part A funds for assisting teachers in meeting the highly qualified definition.

SCHOOL IMPROVEMENT PROGRAMS

The NCLB Act reauthorized other programs to assist states and local school districts in meeting the requirements of the legislation. The NCLB Act amended the 21st CCLC Program. Texas' local school districts used to directly apply to the federal government (approximately $17.7 million in fiscal year 2001 for Texas). Now states receive 21st CCLC funding based on each state's share of Title I Part A funds, and distribute funds to local school districts on a competitive basis. The 21st CCLC program funds community learning centers that provide academic enrichment opportunities for children, particularly students who attend high-poverty and low-performing schools to meet academic content standards, to expand enrichment activities that can complement regular academic programs, and to offer literacy and other educational services to the families of participating children. The 21st CCLC program's allocation to Texas increased to $85.0 million in fiscal year 2004 (an increase from the $39.5 million distributed in fiscal year 2003). Future increases to Texas may not be as significant due to the NCLB Act's complete conversion of all 21st CCLC program funding into a formula grants to states. For the past two years, the 21st CCLC formula grants to states increased as the portion for competitive grants decreased. Texas' fiscal year 2005 allocation for the 21st CCLC program is estimated to be $87.3 million.

The NCLB Act consolidated the Technology Literacy Challenge Fund with several competitive technology grants into a formula-based block grant, the Educational Technology Program. This program promotes innovative state and local programs using technology. States receive funds based on each state's current share of Title I, Part A funds. Texas' allocation for the Educational Technology State Grant will be $42.9 million for fiscal year 2005 (a loss of $16.5 million over the previous year).

The NCLB Act requires that the former Immigrant Education and Bilingual Education Programs be consolidated into the Language Acquisition State Grant Program when Congress appropriates $650.0 million or more for the two programs. Texas' fiscal year 2005 allocation will be $82.9 million. Prior to the NCLB Act, Texas received Immigrant Education Program funds based on a formula, and school districts were awarded Bilingual Education Program funds on a competitive basis from the federal government.

Federal funding for the Innovative Education Program will decrease by 33 percent or $98.1 million from the fiscal year 2004 funding level of $296.5 million. Texas fiscal year 2005 allocation for the Innovative Education Program is estimated to be $15.7 million (a decrease of $7.8 million from the previous year's funding).

Congress may consider legislation that could impact the distribution of Title I, Part A funds to Texas. The NCLB Act required the department to use the most updated Census data, when available, to distribute Title I, Part A funds. The department began using 2000 Census data to determine Title I, Part A allocations for fiscal year 2004. Even though Congress appropriated an overall increase to Title I, Part A funds, the department released fiscal year 2004 Title I, Part A allocations with decreases to 10 states. Congress did not include the Senate Appropriations Committee's provision in the Labor-Health and Human Services-Education Appropriations Act, that would have provided $71.6 million for states whose Title I allocations were less in fiscal year 2004 than in fiscal year 2003. Texas received $1.1 billion in fiscal year 2004, an increase of $92.2 million over fiscal year 2003. As a result, Texas would not have received any of the funds to bring states up to their prior year allocations.

FLEXIBILITY

Authorized as a demonstration program in 1994, the "Ed-Flex" program allowed select states to be exempted from certain federal requirements in exchange for enhanced accountability for student achievement. Under the demonstration program, Texas was one of the 12 states granted Ed-Flex authority for five years. The most commonly waived rules are the poverty threshold for Title I schoolwide programs and rules barring districts from serving lower-poverty schools. The Ed-Flex Partnership Act of 1999 amended the demonstration program and allowed any

state that meets new eligibility criteria to receive waiver authority. In fiscal year 2001, Texas' Ed-Flex status was extended for an additional five years.

The NCLB Act authorized a new flexibility authority, Transferability for State and Local Educational Agencies, that allows states and local educational agencies to transfer a portion of the funds received under certain federal programs to other specified programs to better address specific needs. Under this new flexibility authority, states are allowed to transfer up to 50 percent of non-Title I formula state activity funds not allocated to school districts. School districts are given the flexibility to transfer up to 50 percent of funds from the non-Title I programs without state approval. Non-Title I formula grants include Improving Teacher Quality, Educational Technology, Safe and Drug-free Schools, and Innovative Education. In addition, states can also transfer state activity funds from one other non-Title I program, the 21st CCLC Program.

A performance pilot project was also authorized for 150 school districts and seven states to participate in performance agreements to combine 100 percent of non-Title I funds (State Flexibility Authority Program and Local Flexibility Demonstration Agreements). As of this time, only the state of Florida has been approved to participate in the State Flexibility Authority Program. The Seattle Public School District is the first school district to receive approval for participation in the Local Flexibility Demonstration Agreement.

ASSESSMENT REQUIREMENTS

The NCLB Act requires each state to develop and administer a system of assessments to track student academic achievement on an annual basis. States are allowed to design their own tests, which must be aligned to state-established academic and achievement standards.

Starting in the 2004–05 school year, students in grades 3 to 8 must be tested in reading/language arts and mathematics, and once in high school. By the 2007–08 school year, students must be tested in science at least once in elementary (grades 3 to 5), middle (grades 6 to 9), and high school (grades 10 to 12). The NCLB Act directs states to use the results of these assessments as the basis for a statewide accountability system.

Texas has had little difficulty in meeting the assessment requirements of the NCLB Act. The state's experience with "high stakes" testing systems dates back to 1979 and the introduction of the Texas Assessment of Basic Skills (TABS) tests, which were a precursor of the current array of assessments called the Texas Assessment of Knowledge and Skills (TAKS). Indeed, the federal law regarding assessments was structured in large part on the Texas model.

There are, however, two areas in which the state will have to augment its testing to comply with federal law. To meet the requirement for a middle school science test by the 2007–08 school year, the TEA is currently developing an eighth grade TAKS science exam. The agency also is developing a plan to meet the NCLB Act requirement that limited- English-proficient (LEP) students must be tested for English language skills in reading, writing, listening, and speaking, starting in kindergarten. In exchange for flexibility to choose the method of instruction for these students, schools must test LEP students who have been in the U.S. for three years in English. The department has provided states the following two new policies concerning the assessments of LEP students:

- For up to two years, states are allowed to include LEP students who have attained English proficiency for LEP subgroup accountability measures.
- States have the option to not include in Adequate Yearly Progress (AYP) calculations the assessment results of LEP students' in their first year of enrollment in U.S. schools.

The NCLB Act provides Federal Funds to assist states in the development and implementation of their assessments; Texas will receive approximately $23 million in each year of the 2006–07 biennium for this purpose. This amount does not cover the state's total expenses related to testing, which are anticipated to reach $61 million in fiscal year 2006.

ACCOUNTABILITY—ADEQUATE YEARLY PROGRESS

Each state must create a definition of AYP toward a goal of 100 percent of students passing the reading/language arts and mathematics tests by the 2013–14 school year. Based on initial TAKS field test results from 2002, Texas determined the AYP standards for the 2002–03 and 2003–04 school years to be 46.8 percent for Reading/Language Arts and 33.4 percent for Mathematics. These standards will gradually increase over the next decade, reaching the goal of 100 percent passing in 2013–14. Figure 5 shows the AYP targets for the 2004–05 school year for all students and each student group.

All school districts are subject to AYP evaluation. Additionally, all Title I and non-Title I public school campuses, alternative education campuses, and open-enrollment charter schools are evaluated for AYP with a few exceptions; for example, new campuses, juvenile justice and disciplinary alternative education campuses, and campuses with no students in grades 3 to 8 or 10 are not subject to AYP.

FIGURE 5
ADEQUATE YEARLY PROGRESS TARGETS FOR THE 2004–05 SCHOOL YEAR FOR ALL STUDENTS AND EACH STUDENT GROUP

TARGETS	PERCENT
Percent Passing Reading	53.5
Percent Passing Math	41.7
Participation Rate	95.0
Graduation Rate (high school)	70.0
Attendance Rate (elementary and middle school—all students only)	90.0

NOTE: Adequate Yearly Progress target of graduation rate applies only to all student groups.

SOURCE: Texas Education Agency.

AYP performance requirements are met if the percent of students passing for all students and each student group summed across grades 3 to 8 and 10 in reading/language arts and mathematics meets or exceeds the AYP standard. Figure 6 shows what student groups are included in AYP evaluation.

FIGURE 6
ADEQUATE YEARLY PROGRESS PERFORMANCE IS

- All students
- African-American
- Hispanic
- White
- Economically disadvantaged
- Special education
- Limited-English proficient

SOURCE: Texas Education Agency.

The NCLB Act also establishes a standard for student participation in the testing system. To meet AYP, 95 percent of all students and each student group must be tested. This criterion is applied separately for reading/language arts and mathematics. Two other standards must be met for all students only: for high school students, a graduation rate of 70 percent, and for elementary and middle school students, an attendance rate of 90 percent.

Alternatively, a campus may achieve AYP for a student group by meeting an improvement standard. If any student group (or all students) does not meet the performance standard for reading/language arts and mathematics, that student group must show both (1) a 10 percent decrease in the percent not passing the standards on TAKS from the prior year and (2) any improvement on the graduation/attendance measure. Although student groups are not required to meet the graduation rate or attendance rate standard, they may be required to show improvement on the graduation rate or attendance rate to meet the performance gains criteria. In total, campuses and districts must meet up to 29 criteria in order to earn the "Meets AYP" rating. If a school or district fails to meet even one of these criteria, it earns the "needs improvement" rating and may be subject to a graduated set of school improvement sanctions.

SCHOOL IMPROVEMENT

If a campus or district fails to meet AYP on the same performance indicator for two consecutive years, that campus is identified for possible school improvement sanctions. Although all campuses and districts are evaluated for AYP, only campuses and districts that receive federal Title I, Part A funds are subject to the sanctions. In the 2002–03 school year, 98 percent of Texas school districts, 60 percent of regular campuses, and 78 percent of charter campuses are defined as Title I. In September 2004, the TEA released a list of 170 Title I schools and 29 charter schools that did not meet AYP standards in the same indicator for a second year. (See Figure 7 for overall ratings.) The campus sanctions are as follows:

Year 1—School Choice/Transportation. Schools that fail to meet AYP for the same measure for two or more consecutive years are in year 1 of school improvement. Parents must be notified of the school's status, and students must be offered the option of transferring to another public or charter school that has not been identified as needing improvement. The school district must provide transportation, using up to 20 percent of its federal Title I allocation. Also, at least 10 percent of these funds must be used for teacher training to directly address the student achievement problems that earned the school the "needs improvement" rating.

Year 2—Supplemental Services. Schools that fail to meet AYP for the same measure for three or more consecutive years are in year 2. In addition to the year 1 sanctions, the school must offer free after-school tutoring in the subject areas in which it failed to meet the AYP standard. The supplemental tutoring services may be offered by public or private providers, as determined by the student and parents, and the district must use up to 20 percent of its Title I funds to pay for the services.

Year 3—Corrective Action. One more year of failing to meet AYP earns a school year 3 status in which, in addition to the years 1 and 2 provisions, a school must take corrective actions, such as replacing staff, implementing new curricula, appointing an outside expert for consultation, or school internal reorganization.

FIGURE 7
ADEQUATE YEARLY PROGRESS RATINGS FOR DISTRICTS, CAMPUSES AND CHARTERS, 2002–03 SCHOOL YEAR

	DISTRICTS (NON-CHARTER)		CAMPUSES (NON-CHARTER)		CHARTER CAMPUSES	
	NUMBER	PERCENT	NUMBER	PERCENT	NUMBER	PERCENT
Meets Adequate Yearly Progress	1,001	96.3	6,121	81.9	141	54.2
Needs Improvement	37	3.6	498	6.7	65	25.0
Not Evaluated	1	0.1	854	11.4	54	20.8
Totals	1,039	100.0	7,473	100.0	260	100.0

SOURCE: Texas Education Agency.

Year 4—Restructuring. The final stage of school improvement involves the fundamental restructuring of a school, including reopening as a charter school, replacing the principal and staff, or turning school operation over to the state or private management company.

For schools and districts in School Improvement, meeting AYP for two consecutive years removes the campus from School Improvement status.

ONE PERCENT CAP ON SPECIAL EDUCATION ALTERNATIVE ASSESSMENT

Texas is unique among the states with regard to its assessment of special education students using the State-Developed Alternative Assessment (SDAA), which measures student performance in terms of growth against expectations established by the admission, review, and dismissal (ARD) committee.

However, for AYP the U.S. Department of Education ruled that students who are considered AYP proficient by virtue of either meeting ARD expectations on the SDAA and testing below enrolled grade level or meeting ARD expectations on a functional-based, locally determined alternative assessment (LDAA) may together comprise only 1 percent of the total students within each district. For Texas, however, the SDAA was designed as the preferred assessment for special education students; the vast majority of those students took the SDAA or LDAA in 2003, and these students represented 9 percent of all students tested statewide.

To address this issue, the TEA is developing a new version of the SDAA to be administered statewide in 2005. This new test will be more aligned with the TAKS, and the agency hopes to establish a grade-level-equivalent uniform passing standard that will satisfy the requirements of AYP.

HIGHLY QUALIFIED TEACHERS

By the end of the 2005–06 school year, all teachers in core academic subject areas must be "highly qualified." Figure 8 describes what subject areas the NCLB Act defines as core academic subjects. The NCLB Act considers teachers "highly qualified" if they have all of the following:

- at least a bachelor's degree;
- full and current state certification; and
- demonstrated subject-matter competency in each of the core subjects they teach.

FIGURE 8
NCLB CORE ACADEMIC SUBJECT AREAS (REQUIRING HIGHLY QUALIFIED TEACHERS)

English	Civics/government
Reading/language arts	Economics
Mathematics	Arts
Science	History
Foreign languages	Geography

SOURCE: Legislative Budget Board.

Additionally, teachers hired after the start of the 2002–03 school year to teach a core academic subject in a Title I program must be "highly qualified" when hired.

With respect to open-enrollment charter schools, the NCLB Act defers to state law regarding teacher certification. In Texas, charter schools are not required to employ certified teachers unless the teacher is assigned to teach in special education or bilingual educations programs, in which case the appropriate state certification is required.

In Texas, the State Board for Educator Certification (SBEC) sets state certification standards. SBEC requires teachers to have a bachelor's degree that includes education courses, or receive alternative certification from an approved program, as well as pass subject and grade-level exams, to receive a certificate. In 2004, SBEC eased alternative certification for high school teachers by allowing college graduates who pass the appropriate subject matter tests to teach grades 8 to 12 for two years without formal

certification. School districts are required to train these teachers during this period, after which the district may issue a permanent certificate. Teachers who use this new route to certification meet the NCLB Act definition of "highly qualified."

TEA has developed an extensive system for current teachers to demonstrate subject matter competence. This system, based on the NCLB Act's guidelines for a High, Objective, Uniform Standard of Evaluation, is referred to as HOUSE, and allows teachers to establish competency through a combination of classroom experience, college coursework, and relevant professional development.

According to TEA, survey data indicate that 95.7 percent of teachers in Texas public schools met the NCLB Act's definition of "highly qualified" in their primary assignment at the end of the 2003–04 school year. Despite this high degree of compliance, there are concerns regarding the feasibility of meeting the standard of 100 percent of teachers being "highly qualified," particularly in subject areas in which Texas schools face serious teacher shortages, including mathematics, science, bilingual education, and foreign languages.

In 2004, the U.S. Department of Education eased its rules for "highly qualified" teachers in several key areas, including science, rural, or multiple-subject teachers:

- Teachers in eligible small, rural, and isolated areas who are "highly qualified" in at least one subject will have until 2007 to become highly qualified in the additional subjects they teach.
- States may certify teachers in the general field of science, allowing teachers to demonstrate subject-matter competency through a "broad field" test or major, rather than for each specific subject area.
- Current multiple-subject teachers, particularly teachers in middle schools or special education, are not required to return to school or get a degree in every subject they teach but may demonstrate subject-matter competency through the HOUSE option.

The NCLB Act requires all new paraprofessionals hired after January 8, 2002, and working in a program supported with Title I, Part A funds, to have completed at least two years of college or otherwise meet a state or local standard of quality. Paraprofessionals hired on or before January 8, 2002, must meet this standard by January 8, 2006. All paraprofessionals, regardless of hiring date, must have earned a secondary school diploma or its equivalent.

Congress continued to raise federal funding for Part A Grants to Local Educational Agencies to Texas and will most likely continue increasing assistance to states in meeting the requirements of the NCLB Act. The NCLB Act added additional requirements to Texas, such as expanding student assessments, collecting and distributing results of student achievement, ensuring highly qualified teachers in every classroom by the 2005–06 school year, and guaranteeing that all students are proficient in mathematics and reading by 2014. According to TEA, survey data indicate that 95.6 percent of teachers in Texas public schools met the NCLB Act's definition of "highly qualified" in their primary assignment at the end of the 2003–04 school year. Texas has had little difficulty in meeting the assessment requirements of the NCLB Act. However, there are two areas in which the state will have to expand its testing to comply with the NCLB Act. The state's total expenses related to testing are anticipated to reach $61 million in fiscal year 2006.

USE STATE HIGHWAY FUNDS FOR PUBLIC SCHOOL TRANSPORTATION

In the 2002–03 school year, an average of 1.2 million Texas students rode school buses each day, an increase of 2 percent from the previous school year. Through the Foundation School Program, the state shares the cost of busing students with local school districts. The Foundation School Program is the primary tool for allocating state financial assistance to school districts.

State law allows that portion of the State Highway Fund not dedicated by the constitution for public roadways to be used for any function performed by the Texas Department of Transportation. One of the agency's functions is the provision of funds to encourage, foster, and assist in developing public transportation programs across the state.

Transporting students to school falls within many of the statutory definitions of public transportation already in the Transportation Code. However, this expenditure is currently funded from the General Revenue Fund. An annual appropriation of $50 million in State Highway Funds to fund a portion of the public school transportation program would make $100 million in General Revenue Funds available for other purposes in the 2006–07 biennium.

SIGNIFICANT FINDINGS

- The district entitlement for the public school transportation program during the 2002–03 biennium totaled $626.4 million ($307.8 million in 2002 and $318.6 million in 2003) from state and local revenues. The public school transportation entitlement for the 2004–05 biennium is estimated to be $602.0 million.
- For the 2004–05 biennium, the legislature appropriated $111.8 million from the State Highway Fund to pay for public transportation programs administered by the Health and Human Services Commission.

SIGNIFICANT CONCERN

- The State Highway Fund is not being used to support legitimate public transportation needs in state public schools.

RECOMMENDATION

- For each year of the 2006–07 biennium $50 million should be appropriated to the Texas Education Agency from the non-constitutionally dedicated revenue in the State Highway Fund to replace a portion of the Foundation School Program transportation allotment.

COMMENTS

The district entitlement for the public school transportation program during the 2002–03 biennium totaled $626.4 million ($307.8 million in 2002 and $318.6 million in 2003) from state and local revenues.

Public school transportation operating expenditures for the previous four school years (1999–2003) are shown in Figure 1. In the 2002–03 school year, the total transportation operating expenditure was $812.4 million, which includes the district entitlement for the public school transportation program. Over the last three years, the transportation operating expenditure has increased an average of 8 percent annually.

FIGURE 1
ACTUAL PUBLIC SCHOOL TRANSPORTATION OPERATING EXPENDITURES 1999 TO 2003

SCHOOL YEAR	ALL FUNDS	PERCENT CHANGE
1999–2000	$ 644,558,394	
2000–01	$ 688,924,510	6.9
2001–02	$ 732,156,076	6.3
2002–03	$ 812,405,269	11.0

SOURCE: Texas Education Agency.

The Texas Education Agency (TEA) distributes transportation money to school districts throughout the state. The distribution of entitlements to each school is based on a linear density factor determined by dividing the average number of regular eligible students transported daily by the approved daily route miles traveled. Transportation funding provides a mileage reimbursement rate for different linear density groupings. Figure 2 shows the current transportation allotment.

The Transportation Code requires the Texas Department of Transportation (TxDOT) to encourage, foster, and assist in the development of public transportation by working with local governments. The definition of public transportation in Section 456.001 (8) of the Transportation Code

FIGURE 2
PUBLIC SCHOOL TRANSPORTATION ALLOTMENT 2004–05 BIENNIUM

LINEAR DENSITY GROUPING	ALLOCATION PER MILE OF APPROVED ROUTE
2.40 and above	$1.43
1.65 to 2.40	1.25
1.15 to 1.65	1.11
0.90 to 1.15	0.97
0.65 to 0.90	0.88
0.40 to 0.65	0.79
up to 0.40	0.68

SOURCE: Texas Education Agency.

implicitly includes the transport of students to public school, providing one more opportunity to increase the level of public transportation service provided by TxDOT. In addition, Section 456.007 (b) allows the legislature to appropriate money for public transportation purposes from the portion of the State Highway Fund that is not dedicated by the constitution.

House Bill 2292, Seventy-eighth Legislature, Regular Session, 2003, required TxDOT to assume responsibilities for providing medical public transportation services previously provided by the Health and Human Services Commission. The appropriation for the 2004–05 biennium was $111.8 million from the non-constitutionally dedicated portion of the State Highway Fund to operate the program.

The appropriation of $50 million per year from the non-constitutionally dedicated revenue in the State Highway Fund to TEA to pay a portion of the state's share of the FSP's Transportation Allotment would make an equal amount of General Revenue Funds available for other purposes.

FISCAL IMPACT OF THE RECOMMENDATION

The recommendation would result in General Revenue Funds savings of $100 million in the 2006–07 biennium. The recommendation that the legislature appropriate $50 million annually from the State Highway Fund for the public school transportation program is based on a comparable level of funding appropriated to TxDOT for providing medical public transportation service to Health and Human Services Commission clients.

The implicit definition of the transport of students to public school in Section 456.001 (8) of the Transportation Code, coupled with Section 456.007 (b), would allow non-constitutionally dedicated revenue from the State Highway Fund to be applied toward a portion of the state's share of the cost by replacing a portion of General Revenue Funds. Figure 3 provides a five-year forecast on the fiscal impact.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO OTHER FUNDS
2006	$50,000,000	($50,000,000)
2007	$50,000,000	($50,000,000)
2008	$50,000,000	($50,000,000)
2009	$50,000,000	($50,000,000)
2010	$50,000,000	($50,000,000)

SOURCE: Legislative Budget Board.

The fiscal impact of the recommendation is included in the introduced 2006–07 General Appropriations Bill. The change in the method of finance section of TEA's bill pattern currently reflects the $50 million annual appropriation of non-constitutionally dedicated revenue from the State Highway Fund.

APPLY PROPORTIONALITY TO STATE CONTRIBUTIONS FOR PUBLIC COMMUNITY COLLEGE EMPLOYEE HEALTH BENEFITS

The state's requirement that employee benefits be paid in proportion to the funding source of salaries is a major cost-limiting factor in state appropriations. Texas could realize significant savings by applying proportionality to state employee health benefit contributions for public community colleges.

SIGNIFICANT FINDINGS

- The great majority of Texas public community colleges do not apply proportionality when requesting General Revenue Fund contributions for group health insurance.
- The fiscal year 2003 General Revenue Fund higher education group insurance appropriation for community colleges was over-funded by approximately 38 percent, or $50 million.
- Forty-four of the 50 community college districts were over-funded in excess of at least 15 percent in fiscal year 2003, including all of the 10 largest community college districts.

SIGNIFICANT CONCERNS

- Texas' public community colleges are the only entities receiving significant amounts of General Revenue Fund appropriations that have not historically adhered to state requirements on proportional cost sharing.
- Through the application of proportional cost sharing standards to community colleges, the state would save an estimated $106 million in General Revenue Funds in fiscal years 2006 and 2007.

RECOMMENDATIONS

- **Recommendation 1:** By requiring community colleges to follow the same standards of proportional cost sharing as are required of all other entities receiving state appropriations, reduce community colleges' General Revenue Fund appropriations for group health insurance by $106 million in the 2006–07 General Appropriations Bill for higher education group insurance.
- **Recommendation 2:** Revise the Article IX rider language in the 2006–07 General Appropriations Bill to include community colleges among the entities subject to proportionality cost-sharing provisions.
- **Recommendation 3:** A rider should be included in the 2006–07 General Appropriations Bill that directs the Comptroller of Public Accounts to develop a proportionality reporting framework in collaboration with the Legislative Budget Board that addresses community colleges' funding circumstances.
- **Recommendation 4:** A rider should be included in the 2006–07 General Appropriations Bill that directs the Legislative Budget Board to determine whether further savings to the General Revenue Fund may be realized by examining the available data on the state's proportional contributions to community college's optional retirement and teacher's retirement employee benefits.

COMMENTS

Prior to and during the Seventy-eighth Legislature, Regular Session, 2003, the issue arose whether the state's employee benefits contributions to public community colleges were based on the actual proportional share of salaries at community colleges paid with state funds. The legislature's policy of paying employee benefits costs only for those employees having salaries paid out of the General Revenue Fund remains a major cost-limiting factor in determining state appropriation levels. If there is noncompliance with such proportionality requirements, the state may be contributing General Revenue Funds in excess of its proportional obligation.

Two basic issues emerge when reviewing the applicability of proportionality to the proportional payments of state benefits to community colleges. Current rider language relating to proportionality in Section 6.11, page IX-35 of the 2004–05 General Appropriations Act, reads in part as follows:

Sec. 6.11 Salaries to Be Proportional by Fund.

(a) Unless otherwise provided, payment for salaries, wages, and benefits paid from appropriated funds, including "local funds" and "education and general funds" as defined in § 51.009 (a) and (c), Education Code, shall be proportional to the source of funds.

(b) Unless otherwise specifically authorized by this Act, the funds appropriated by this Act out of the General Revenue Fund may not be expended for employee benefit costs, or other indirect costs, associated with the payment of salaries and wages, if the salaries or wages are paid from a source other than the General Revenue Fund.

COMMUNITY COLLEGES' PERCEPTION OF PROPORTIONALITY REQUIREMENTS

The first issue revolves around whether proportionality applies to community colleges. The phrase, "Unless otherwise provided," in subsection (a) above relates to how community colleges have interpreted state requirements limiting their use of appropriations from the General Revenue Fund.

Education Code § 130.003(c) states that funds appropriated by the state to community colleges, "… shall be used exclusively for the purpose of paying salaries of the instructional and administrative forces of the several institutions and the purchase of supplies and materials for instructional purposes." Furthermore, Public Community/Junior Colleges Rider 3, Approved Elements of Expenditure, page III-214 of the General Appropriations Act, states that General Revenue Fund appropriations to community colleges "shall be limited to the payment of the following elements of cost: instruction, academic support, student services, institutional support, organized activities, and staff benefits associated with salaries paid from General Revenue." There is clear intent in statute and General Appropriations Act language to restrict how community colleges may expend General Revenue Fund appropriations.

While statute defines and limits community colleges' use of General Revenue Funds, it is not clear that this same statute necessarily exempts community colleges from complying with Article IX proportionality requirements. Because statute confines the use of General Revenue Funds for certain instruction and administration-related purposes, this source of funds can bear a disproportional share of salaries paid. But statute does not allow for state contributions to exceed the share of salaries paid through the General Revenue Fund. Thus, while community colleges' statutory restrictions on the use of General Revenue Funds result in the disproportion of salaries paid to fund sources, such restrictions do not preclude the proportionality of state funded benefits to state funded salaries. The issue then becomes how to determine the actual share of total salaries paid with General Revenue Fund appropriations.

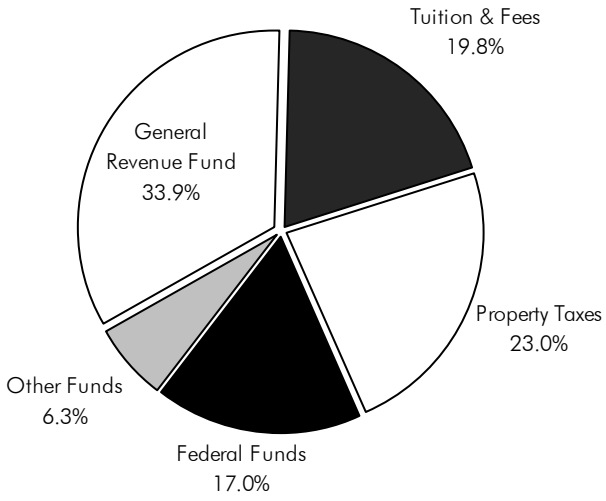
The above statute and rider language have been interpreted to imply that a given employee's eligibility for General Revenue Fund benefits contributions is determined not by the source of the employee's salary, but whether that given employee's job function conforms to one of the above "elements of cost." Under this interpretation, community colleges determine eligibility for state funded benefits according to whether an employee performs occupational functions that are legally eligible to be funded by General Revenue Fund appropriations.

No Texas entities other than community colleges receiving state appropriations use occupational function as a means to determine eligibility for state funded employee benefits contributions. Community colleges have used this method of reporting eligibility since they joined the Employees Retirement System in the early 1990s.

FUNDING SOURCES AND STRICT PROPORTIONALITY

The second issue to emerge from this review stems from the language in the General Appropriations Act (2004–05 Biennium) Article IX, General Provisions, Section 6.11(a) which states that proportionality applies to "appropriated funds." Of the five funding sources for community colleges (General Revenue Fund, tuition and fees, property taxes, Federal Funds, and Other Funds), the General Revenue Fund is the only revenue source appropriated by the state, unlike the practice for most other institutions of higher education, for which tuition and certain fee revenues are also appropriated. Figure 1 shows the three-year average percent share of each revenue source as a portion of total funding, based on data collected from each community college districts' annual financial report for fiscal years 2001 to 2003.

FIGURE 1
THREE-YEAR (FY 2001–03) AVERAGE OF ALL FUNDS REVENUE FOR COMMUNITY COLLEGES (AFR DATA)



SOURCE: Texas Higher Education Coordinating Board.

The rider language has been interpreted by many community colleges to imply that proportionality requirements do not apply to those funding sources falling outside the state appropriations process. Thus the combination of determining health benefits funding eligibility by occupational function and the longstanding view that proportionality does not apply to their non-appropriated funding sources has resulted in levels of state support for community college employee benefits that are out of proportion to state salary contributions.

A major obstacle in applying standards of proportional cost sharing to community colleges has been the lack of information available to the state regarding the use of community colleges' General Revenue Fund appropriations. Such information is indispensable in determining the extent of community colleges' compliance with state proportionality requirements. For example, while community colleges receive only 34 percent of their total funding from the General Revenue Fund, it does not necessarily follow that community colleges pay only 34 percent of their total salaries from that source.

Given statutory and rider language restricting community colleges' use of their General Revenue Fund appropriations for specific purposes, it may be the case that for practical purposes some community colleges expend all their state funds on salaries. However, prior to this year, community colleges were not required to submit any data to the state that would provide comprehensive information regarding their use of General Revenue Fund appropriations.

A new rider included in the General Appropriations Act (2004–05 Biennium), Rider 15, page III-216 required community colleges to submit a benefits proportional by fund report to the comptroller. These reports provided the legislature with a useful means to determine each community college's total General Revenue Fund income in relation to its total salary expenditures.

FOUR-STEP METHODOLOGY

Using data collected from each community college's fiscal year 2003 benefits proportional by fund report, this analysis follows a four-step methodology. The first step entails determining the relative share of total salaries paid with the General Revenue Fund. This allows observers to know the upper limit of General Revenue Fund contributions that may be used to pay employee salaries. For purposes of simplicity, this analysis assumes all General Revenue Fund dollars go toward paying the salaries of employees in occupational areas eligible for state contributions from this funding source.

The second step involves determining the actual state-funded and locally-funded portions of each community college's total group insurance plan (GIP) expenditures. The intent is to isolate what portion state contributions are paying of total GIP expenditures. The third step compares the percent of a community college's total salaries paid with the General Revenue Fund to its percent of employee GIP benefits paid with the General Revenue Fund.

The fourth step determines the difference between the share of GIP actually paid with the General Revenue Fund and the share of GIP that would be paid with General Revenue Funds if proportionality were to be applied. We assume that the state's share of employee benefits for each community college must not exceed the share of total salaries paid out of the General Revenue Fund. For example, if a community college pays 51 percent of its total salaries with its General Revenue Fund appropriations, only 51 percent of the college's total GIP should be paid from that source.

Thus, to determine the non-proportional GIP amount for each community college district, this analysis determined the difference between each college's total GIP expenditures as provided by the Employees Retirement System and the share of GIP that should be paid by the General Revenue Fund with the application of standards of proportional cost-sharing normally applied to state agencies. The methodology thus emphasizes sensitivity to the variation in specific degrees of overfunding among the individual community college districts. Figure 2 provides revised group health insurance contributions in light of each community college's degree of overfunding.

IMPLICATIONS FOR STATE FUNDING

A state funding concern emerges if it is determined that community colleges over-report their enrollment of employees whose salaries are paid with General Revenue Funds. If over one-third of the community colleges' reported enrollment for GIP benefits paid through the General Revenue Fund is not substantiated by the data, the legislature may realize savings by applying some measure of proportionality to how the state funds its contributions toward community college health benefits.

The extent of the savings to the General Revenue Fund may vary depending on how the legislature opts to fund higher education group insurance. For example, assuming adoption of the Legislative Budget Board's recommended funding levels for fiscal years 2006 and 2007, the state would reduce its contribution to the community colleges' group health insurance appropriation by approximately $106.0 million over the biennium. These savings are incorporated into the community college portion of LBB recommendations for higher education group insurance. As is shown in Figure 2, were the community college's group insurance recommendations calculated without consideration of their actual proportional benefits costs, the state's

FIGURE 2
COMMUNITY COLLEGES GROUP INSURANCE:
LBB STAFF RECOMMENDED AND PROPORTIONAL CONTRIBUTION AMOUNTS

	A 2006–07 GENERAL REVENUE RECOMMENDED (PRIOR TO PROPORTIONALITY)	B PERCENT OF COLUMN 'A' OVER-FUNDED	C REVISED 2006–07 GENERAL REVENUE RECOMMENDED A * B	D DOLLAR DIFFERENCE A - C
Alamo Community College	$22,235,238	49.7%	$11,190,146	$11,045,092
Alvin Community College	$3,005,998	40.2%	$1,797,661	$1,208,337
Amarillo College	$7,367,057	37.0%	$4,638,944	$2,728,113
Angelina College	$2,855,044	21.9%	$2,229,401	$625,643
Austin Community College	$12,453,019	54.1%	$5,714,518	$6,738,501
Blinn College	$5,920,186	5.9%	$5,570,011	$350,175
Brazosport College	$2,598,295	34.8%	$1,695,162	$903,133
Central Texas College	$5,265,438	47.9%	$2,742,745	$2,522,693
Cisco Junior College	$1,614,262	8.3%	$1,480,673	$133,589
Clarendon College	$905,612	7.3%	$839,334	$66,278
Coastal Bend College	$2,593,225	20.1%	$2,072,554	$520,671
College of the Mainland	$3,911,162	60.7%	$1,538,332	$2,372,830
Collin Cty Community College	$6,471,024	38.6%	$3,974,072	$2,496,952
Dallas Cty Community College	$28,581,273	38.9%	$17,449,543	$11,131,730
Del Mar College	$7,365,690	58.6%	$3,050,199	$4,315,491
El Paso Community College	$11,605,007	45.3%	$6,349,645	$5,255,362
Frank Phillips College	$1,032,700	31.6%	$706,205	$326,495
Galveston College	$1,748,789	33.8%	$1,158,395	$590,394
Grayson County College	$2,764,494	27.6%	$2,000,357	$764,137
Hill College	$1,884,228	15.6%	$1,590,828	$293,400
Houston Community College	$18,434,889	40.8%	$10,908,873	$7,526,016
Howard College	$2,980,322	1.4%	$2,939,802	$40,520
Kilgore College	$3,859,016	18.5%	$3,145,759	$713,257
Laredo Junior College	$5,450,076	40.4%	$3,249,845	$2,200,231
Lee College	$3,722,383	44.0%	$2,085,737	$1,636,646
McLennan Community College	$5,636,709	39.6%	$3,404,109	$2,232,600
Midland College	$3,746,837	43.5%	$2,115,545	$1,631,292
Navarro College	$2,762,472	21.5%	$2,169,256	$593,216
North Central Texas College	$2,490,456	19.5%	$2,004,169	$486,287
North Harris Montgomery Community College	$14,514,524	38.1%	$8,979,105	$5,535,419
Northeast Tx Community College	$1,779,351	29.6%	$1,252,821	$526,530
Odessa College	$3,934,721	43.3%	$2,232,816	$1,701,905
Panola College	$1,781,329	32.8%	$1,196,221	$585,108
Paris Junior College	$2,439,649	22.0%	$1,902,107	$537,542
Ranger Junior College	$850,964	53.8%	$392,951	$458,013
San Jacinto College	$13,003,309	34.6%	$8,507,763	$4,495,546
South Plains College	$6,181,330	29.8%	$4,337,107	$1,844,223
South Texas Community Col.	$7,731,697	31.9%	$5,265,934	$2,465,763
Southwest Texas Junior College	$2,646,566	40.2%	$1,582,422	$1,064,144
Tarrant County Junior College	$17,735,083	46.3%	$9,532,369	$8,202,714

(CONTINUED ON NEXT PAGE)

FIGURE 2 (CONTINUED)
COMMUNITY COLLEGES GROUP INSURANCE: LBB STAFF RECOMMENDED AND PROPORTIONAL CONTRIBUTION AMOUNTS

	A 2006–07 GENERAL REVENUE RECOMMENDED (PRIOR TO PROPORTIONALITY)	B PERCENT OF COLUMN 'A' OVER-FUNDED	C REVISED 2006–07 GENERAL REVENUE RECOMMENDED A * B	D DOLLAR DIFFERENCE A - C
Temple Junior College	$2,510,555	38.9%	$1,533,829	$976,726
Texarkana College	$3,164,957	16.7%	$2,636,578	$528,379
Texas Southmost College***				
Trinity Valley Community College	$3,089,523	9.9%	$2,782,214	$307,309
Tyler Junior College	$6,416,027	25.8%	$4,759,441	$1,656,586
Vernon Regional Junior College	$1,994,738	19.9%	$1,598,671	$396,067
Victoria College	$2,848,420	29.4%	$2,010,672	$837,748
Weatherford College	$2,515,942	37.0%	$1,585,943	$929,999
Western Texas College	$1,368,374	31.2%	$940,775	$427,599
Wharton County Junior College	$3,373,246	31.0%	$2,327,466	$1,045,780
Total	**$281,141,206**	**37.7%**	**$175,169,025**	**$105,972,181**

*** Texas Southmost College is excluded from this analysis because the institution's group insurance appropriation is made to The University of Texas System.
SOURCE: Legislative Budget Board.

General Revenue Fund contribution would be approximately $281.1 million. Applying proportional cost-sharing to community colleges would reduce this contribution by approximately 38 percent to $175.2 million for fiscal year 2006–07.

IMPLICATIONS FOR COMMUNITY COLLEGES

There is a range of possible responses to proportional state contributions for community colleges' health insurance benefits. Community colleges may opt to decline offering health coverage to certain categories of employees altogether. On the other hand, if community colleges prefer to maintain current employee coverage levels they may opt to pay the entire reduced state share using funds other than General Revenue Fund. Options falling between these responses would require a degree of cost sharing between the college and its covered employees. It is possible that some districts may create a separate and less costly health benefits plan to parallel the state plan and provide it to employees determined to be ineligible to receive state funded health benefits contributions.

It is also possible the reduction in state contributions for health benefits to community colleges need not become an absolute reduction to the amount of General Revenue Fund contributions to community colleges. For example, redirecting the savings through the community colleges' funding formula would mitigate the impact of the reduction by raising the state's share of nonrestricted General Revenue Fund appropriations to community colleges. Assuming LBB recommended funding levels for community colleges, this redirection would increase the share of nonrestricted General Revenue Funds appropriated to community colleges by approximately 7 percent.

It should be noted any increase in General Revenue Fund appropriations to the community colleges' funding formula might result in an increase in the total portion of salaries paid out of the General Revenue Fund. Assuming little or no growth in community colleges' other income sources, this potential shift in General Revenue Fund proportionality may increase state costs for future community college group health insurance appropriations.

FISCAL IMPACT OF THE RECOMMENDATIONS

The fiscal impact information in Figure 3 shows that an overall savings of $106 million in General Revenue Funds for fiscal years 2006 and 2007 would result from the implementation of proportional cost-sharing measures recommended in this report (Recommendation 1).

FIGURE 3
FIVE-YEAR FISCAL IMPACT
APPLY NORMAL STANDARDS OF PROPORTIONAL COST-SHARING TO PUBLIC COMMUNITY COLLEGES' HEALTH INSURANCE APPROPRIATIONS

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO LOCAL FUNDS
2006	$51,318,247	($51,318,247)
2007	$54,653,934	($54,653,934)
2008	$54,653,934	($54,653,934)
2009	$54,653,934	($54,653,934)
2010	$54,653,934	($54,653,934)

SOURCE: Legislative Budget Board.

The savings provided for by Recommendation 1 are incorporated into the introduced 2006–07 General Appropriations Bill. The Article IX rider language revision proposed by Recommendation 2 is incorporated into the introduced 2006–07 General Appropriations Bill. The rider language proposed by Recommendations 3 and 4 regarding the establishment of a proportionality reporting framework and the examination of other state appropriations to community colleges involving proportionality are not included in the introduced 2006–07 General Appropriations Bill.

CONTINUE TO LIMIT GENERAL REVENUE APPROPRIATIONS FOR TUITION REVENUE BONDS TO INTEREST ONLY

Tuition revenue bonds are used to finance construction of classroom facilities and other university buildings. Although the authorization and issuance of tuition revenue bonds is not contingent on an appropriation for related debt service, legislative practice has been to use General Revenue Funds to reimburse institutions of higher education for the cost related to debt service. Debt service is the amount of interest and principal required to pay a debt over a specified period of time.

Debt service appropriations for tuition revenue bonds in the 2002–03 biennium totaled $275.6 million. The Seventy-eighth Legislature, 2003, changed prior policy by appropriating tuition revenue bond debt service for interest only for tuition revenue bonds issued after March 31, 2003. As a result, debt service appropriations for tuition revenue bonds in the 2004–05 biennium totaled $261.9 million. This change represents a 5 percent decrease from the previous biennium.

By continuing to limit General Revenue Fund appropriations for tuition revenue bonds issued after March 31, 2003 to interest only, $57.7 million in General Revenue Funds would be available for other purposes in the 2006–07 biennium. Additionally, the universities have requested approximately $3.1 billion in their legislative appropriations requests for new tuition revenue bond authorizations. Thus, savings from limiting bond appropriations to interest only may change depending upon the number of universities that receive new tuition revenue bond authorizations.

SIGNIFICANT FINDINGS

- Universities, pursuant to the Education Code, Section 55.17, may pledge all or any part of their revenue funds to the repayment of bonds.
- For the 2006–07 biennium, institutions of higher education have requested $376.6 million in General Revenue Funds to cover debt service on tuition revenue bonds issued through the end of fiscal year 2005.

SIGNIFICANT CONCERN

- Total debt service for tuition revenue bonds issued after March 31, 2003 will exceed $131.6 million in the 2006–07 biennium. Although tuition revenue bonds are legally secured by an institution of higher education's tuition and fees, legislative practice has been to use General Revenue Funds to reimburse institutions of higher education for the cost related to debt service.

RECOMMENDATION

- Continue the policy during the 2006–07 biennium established via a rider in the 2004–05 General Appropriations Act that limits General Revenue Fund appropriations for tuition revenue bonds issued after March 31, 2003 to the payment of interest related to these bonds.

COMMENTS

Revenue bonds are legally secured by a specified revenue source. For example, tuition revenue bonds (TRBs) are legally secured by an institution of higher education's tuition and fees. TRBs are used to finance projects such as classroom facilities and other university buildings. Under Section 6, part 8.(b.) of the Special Provisions Relating Only to State Agencies of Higher Education, 2004–05 General Appropriations Act, no educational and general funds appropriated to any institution or agency named in Article III may be expended on auxiliary enterprises, unless specifically authorized in the General Appropriations Act. In other words, TRBs cannot be used for dormitories, food services, or athletics.

TRB AUTHORIZATION AND ISSUANCE

In order to issue TRBs, higher education institutions request projects in their legislative appropriations requests. The legislature has to authorize issuance of the bonds in legislation. Once an authorization is made, and after the university requests project and financing approval from its board of regents, the project is submitted to the Texas Higher Education Coordinating Board (THECB). The THECB reviews the project to determine whether the construction, rehabilitation, or repair meets the standards for cost, efficiency, and space use. The Bond Review Board then verifies funds are available to service the debt and the financing system is appropriate. Lastly, the attorney general reviews and approves the issuance of the bonds.

All institutions issue their own bonds except for Midwestern State University, Stephen F. Austin University, and Texas Southern University. The Texas Public Finance Authority

(TPFA) issues bonds for them. Although the authorization and issuance of TRBs is not contingent on an appropriation for related debt service, legislative practice has been to use General Revenue Funds to reimburse institutions of higher education for the cost related to debt service.

LEGISLATIVE PRACTICE REGARDING TRBS

Using General Revenue Funds to reimburse institutions of higher education for the debt service of TRBs has been the practice since 1971 when TRBs were first authorized in the amount of $185.0 million. In 1973, the Sixty-third Legislature authorized $57.5 million in TRBs. No additional authorizations were made between 1973 and 1991. In 1991, as part of the South Texas Border Initiative, the legislature authorized $60.0 million in TRBs. All these higher education institutions received debt service appropriations, even though universities, pursuant to the Education Code, Section 55.17, may pledge all or any part of their revenue funds to the payment of bonds.

TRB DEBT SERVICE

Debt service is the amount of interest and principal required to pay a debt over a specified period of time. The TRB debt service appropriation can only be used for paying debt service, and the appropriation lapses at the end of the biennium if not used for that purpose. Debt service appropriations for TRBs in the 2002–03 biennium totaled $275.6 million. The Seventy-eighth Legislature, 2003, under Section 51 of the Special Provisions Relating Only to State Agencies of Higher Education, changed prior policy by appropriating TRB debt service for interest only for TRBs issued after March 31, 2003. As a result, debt service appropriations for TRBs in the 2004–05 biennium totaled $261.9 million. This change represents a 5 percent decrease from the previous biennium.

For the 2006–07 biennium, institutions of higher education have indicated they will need $376.6 million in debt service appropriations for TRBs issued through the end of fiscal year 2005. Of that amount, $73.9 million is for interest on TRBs issued after March 31, 2003, and $57.7 million is for principal. The recommendation would continue the policy established by the Seventy-eighth Legislature, 2003, and limit General Revenue Fund appropriations for TRBs issued after March 31, 2003 to the payment of interest related to these bonds. The following amended rider under Section 51 of the Special Provisions Relating only to State Agencies of Higher Education, 2004–05 General Appropriations Act, could be used to implement this recommendation:

> **Debt Service Related to Tuition Revenue Bonds.** For tuition revenue bonds issued after March 31, 2003, it is the intent of the legislature that General Revenue appropriations for the ~~2004–05~~ 2006–07 biennium to institutions of higher education be used only for the payment of interest related to these bonds. ~~It is the intent of the legislature that General Revenue funding for these tuition revenue bonds could be used to pay principal and interest payments made during the 2006–07 biennium.~~

Continuing the policy established last biennium would make $57.7 million in General Revenue Funds available for other purposes in the 2006–07 biennium. Figure 1 lists each university system's estimate of the amount of debt service (principal and interest) appropriation universities will request for TRBs and shows the cost avoided per university system by limiting General Revenue Fund appropriations to interest only for TRBs issued after March 31, 2003 for the 2006–07 biennium.

FIGURE 1
REQUESTS FOR TRB DEBT SERVICE IN THE 2006–07 BIENNIUM BY UNIVERSITY SYSTEM

UNIVERSITY SYSTEM	DEBT SERVICE REQUIRED FOR TRBS ISSUED AFTER MARCH 31, 2003	INTEREST ONLY REQUIRED FOR TRBS ISSUED AFTER MARCH 31, 2003	POTENTIAL SAVINGS (DIFFERENCE BETWEEN TOTAL DEBT SERVICE AND INTEREST ONLY)
Texas A&M University System	$39,903,352	$17,510,552	$22,392,800
Texas Southern University	$5,498,153	$2,608,153	$2,890,000
Texas State University System	$4,291,435	$2,211,435	$2,080,000
Texas Tech University	$21,661,819	$12,361,819	$9,300,000
Texas Woman's University	$1,232,977	$617,977	$615,000
University of Houston System	$3,912,600	$2,172,600	$1,740,000
University of North Texas	$4,428,558	$2,023,558	$2,405,000
University of Texas System	$50,715,204	$34,425,204	$16,290,000
Total	$131,644,098	$73,931,298	$57,712,800

SOURCE: Individual universities and university systems.

Additionally, during the Seventy-eighth Legislature, 2003, TRBs totaling $268.9 million were authorized. While 76 percent (or $205.4 million) of those authorizations were appropriated debt service, according to the THECB, universities plan to request $3.1 billion in new TRB authorizations. Thus, savings may change depending upon the number of universities that request and receive new TRB authorizations. Figure 2 lists the new TRB authorizations requested by university system. It also shows authorizations that were approved during the 2004–05 biennium. In comparison, all of the universities that received authorizations in the 2004–05 biennium plan to request new TRB authorizations in the 2006–07 biennium.

FISCAL IMPACT OF THE RECOMMENDATION

The recommendation of paying interest only for post March 31, 2003 TRBs would result in a net General Revenue Fund savings of $57.7 million and would have no impact on General Revenue–Dedicated Funds for the 2006–07 biennium. Figure 3 shows the potential General Revenue Fund savings. The savings estimate is from the principal, or is the difference between total debt service requested for principal and interest and debt service required for the interest portion only on TRBs as calculated in Figure 1. The total biennial savings of $57.7 million reflects a $28.8 million savings per year for 2006 and 2007.

FIGURE 2
NEW TRB AUTHORIZATIONS BY UNIVERSITY SYSTEM

UNIVERSITY SYSTEM	AUTHORIZATIONS RECEIVED IN THE 2004–05 BIENNIUM	NEW TRB AUTHORIZATIONS REQUESTED FOR THE 2006–07 BIENNIUM
Texas A&M University System	$27,500,000	$684,431,987
Midwestern State University	$0	$10,395,000
Stephen F. Austin State University	$0	$67,250,000
Texas Southern University	$3,500,000	$109,560,000
Texas State Technical College System	$0	$0
Texas State University System	$27,000,000	$300,831,248
Texas Tech University System	$45,000,000	$89,750,000
Texas Woman's University	$0	$68,500,000
University of Houston System	$25,000,000	$340,524,785
University of North Texas System	$0	$165,500,000
University of Texas System	$140,900,000	$1,312,222,600
Total	$268,900,000	$3,148,965,620

SOURCES: Bond Review Board; Higher Education Coordinating Board.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO OTHER UNIVERSITY FUNDS
2006	$28,856,400	($28,856,400)
2007	$28,856,400	($28,856,400)
2008	$0	$0
2009	$0	$0
2010	$0	$0

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments for this recommendation. If the recommendation is implemented, TRB's appropriations would be reduced by $28.9 million per year for the 2006–07 biennium (as shown in Figure 3).

ELIMINATE OR REDUCE INSTITUTIONAL ENHANCEMENT APPROPRIATIONS TO HIGHER EDUCATION INSTITUTIONS

The Institutional Enhancement strategy contained in the 2004–05 General Appropriations Act is an appropriation for general academic institutions, two-year Lamar colleges, health-related institutions, and the Texas State Technical Colleges, that replaced multiple special items beginning with the 2000–01 General Appropriations Act. Unlike formula funding and tuition, which generate revenue in proportion to the number of students educated, Institutional Enhancement provides generic supplemental support unrelated to educational workload. Formula funding for general academic institutions—an objective, and equitable workload-based vehicle for allocating resources—has been given a declining percentage of total higher education funding; while the less equitable Institutional Enhancement supplement has received an increasing percentage of total higher education appropriations. Reducing appropriations for Institutional Enhancement would tie a greater proportion of higher education funding to objective formulas that are linked to educational workload. It would also make $203.7 million in biennial General Revenue Funds available for formula funding or other state services.

SIGNIFICANT CONCERNS

- At the same time that Institutional Enhancement appropriations as a percentage of higher education total funding for general academic institutions have increased from 4 percent to 6 percent, appropriations for formula funding have decreased from 77 percent to 73 percent.
- Institutions are using Institutional Enhancement for general operating costs, even though these costs are financed by other income streams, such as state formula funding and student tuition.
- Educational workload determines the income that institutions receive from formula funding and tuition. The total number of semester credit hours taken at an institution is a major factor in formula-based funding. Institutional Enhancement funding, on the other hand, has no relation to educational workload.
- Large institutions can exercise full tuition flexibility and have access to much greater financial resources than medium and small institutions; therefore, the need for Institutional Enhancement appropriations for large institutions should be examined more critically.

RECOMMENDATIONS

- **Recommendation 1:** Institutional Enhancement appropriations for the four largest general academic institutions in terms of enrollment and state appropriations—the University of Texas at Austin, Texas A&M University, University of Houston (main campus), and Texas Tech University—should be eliminated.
- **Recommendation 2:** Appropriations for all other institutions that received Institutional Enhancement funding in the 2004–05 biennium should be reduced by half in the 2006–07 General Appropriations Bill. The legislature should consider reallocating these savings, as appropriate, to other formula funding or other state services.

COMMENTS

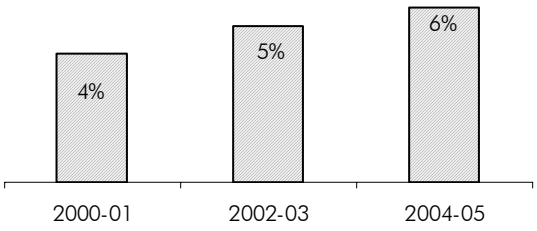
Institutions of higher education receive state appropriations from two general sources: formula and non-formula funding. Formula funding allocates state appropriations to institutions using objective variables, such as semester credit hours and predicted square feet of facilities. Non-formula funding is appropriated to Special Items, Institutional Enhancement, Capital Funds, staff benefits, Indirect Cost Recovery, and other items. About 73 percent of the All Funds appropriations to the general academic institutions comes from formula funding; non-formula funding makes up the rest.

INSTITUTIONAL ENHANCEMENT FUNDING

Institutional Enhancement appropriations represent a growing portion of total higher education state funding for the general academic institutions, the institutions to which most of this type of funding is allocated. The percentage of All Funds appropriations from Institutional Enhancement to the general academic institutions grew from 4 percent for the 2000–01 biennium to 6 percent for the 2004–05 biennium (see Figure 1).

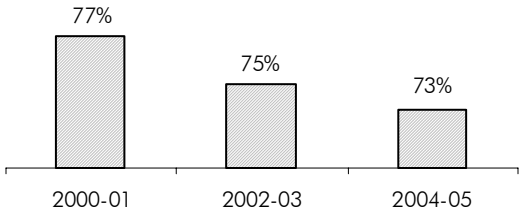
Over the six-year period that Institutional Enhancement funding has increased (fiscal 2000 to fiscal year 2005), formula funding as a percent of total state appropriations for the general academic institutions has decreased. Figure 2

FIGURE 1
GENERAL ACADEMIC INSTITUTIONS "ALL FUNDS" TOTAL APPROPRIATIONS FROM INSTITUTIONAL ENHANCEMENT (IN MILLIONS)



SOURCE: Legislative Budget Board.

FIGURE 2
GENERAL ACADEMIC INSTITUTIONAL "ALL FUNDS" TOTAL APPROPRIATIONS FROM FORMULA FUNDING (IN MILLIONS)



SOURCE: Legislative Budget Board.

shows that formula funding in the 2000–01 biennium accounted for 77 percent of total All Funds, and then shrank to 73 percent in the 2004–05 biennium. This decline is, in part, the result of increasing appropriations to Institutional Enhancement.

Institutional Enhancement is the result of an effort to consolidate certain special items that were once funded by formula funding, such as academic/research support. The Seventy-seventh Legislature, 1999, Regular Session, merged numerous special items for certain institutions into a new appropriation, Institutional Enhancement. Combined with an additional $2 million for most institutions, the first 2000–01 appropriation totaled $237.2 million for all institutions in biennial General Revenue Funds.

Many institutions received an additional $2 million more in the 2002–03 biennium. The south Texas and border institutions each received $3 million more for the 2002–03 biennium. On the other hand, those institutions that benefited significantly from "excellence" and research funds received no increase. Overall, the legislature appropriated about $66 million more for the 2002–03 biennium than it did in the prior biennium. In the subsequent regular session, the legislature distributed about $46.6 million in new money for the 2004–05 biennium based on each institution's share of non-formula funding, with total funding equaling about $350 million.

Cost data reported through the Legislative Budget Board's online budget system indicates that institutions receiving Institutional Enhancement funding tend to use that revenue and formula funding for the same type of expenditures—such as general operating costs, including faculty salaries and staff salaries. This overlap in funding is the reason that the legislature first merged various special items that could be supported by formula funding into the Institutional Enhancement appropriation.

ISSUES WITH INSTITUTIONAL ENHANCEMENT

It is reasonable to expect that providing funding for something as generic as operating costs would require some connection with institutional workload or performance. However, in the case of Institutional Enhancement funding, appropriations can be used for a variety of operating costs.

In contrast, formula funding and tuition revenue create income for institutions in proportion to their output. Certain funding formulas, such as the Instruction and Operations formula, allocate money equitably to institutions based on the number of semester credit hours they provide for their students in a given base period. In a similar manner, institutions generate tuition revenue by charging students on a semester credit basis. Institutional Enhancement, on the other hand, has no connection with semester credit hours, or any other educational workload factor. It no longer has the same justification that other special items have (supporting the unique mission of each institution), so its value to the state is questionable.

Under Recommendation 1, Institutional Enhancement funding for the four largest institutions (University of Texas at Austin, Texas A&M University, Texas Tech University, and University of Houston) would be eliminated. Under Recommendation 2, funding for the remaining institutions would be reduced by half.

In light of the ability the four large institutions have to adjust tuition, and their ability to use other sources of income (such as research-related funding), these institutions are better equipped to respond to a loss of appropriations than smaller institutions. As indicated in Figure 3, Institutional Enhancement appropriations represent less than 5 percent of total state appropriations for each of the four largest institutions. The same table also provides informa-

FIGURE 3
INSTITUTIONAL ENHANCEMENT APPROPRIATIONS AND REDUCTIONS
2004–05 APPROPRIATIONS

	2004–05 INSTITUTIONAL ENHANCEMENT APPROPRIATION	2004–05 TOTAL ALL FUNDS APPROPRIATION	INSTITUTIONAL ENHANCEMENT AS A PERCENT OF TOTAL APPROPRIATION	2006–07 RECOMMENDED REDUCTION
GENERAL ACADEMIC INSTITUTIONS				
Texas A&M University	$28,374,165	$591,585,129	4.8%	$28,374,165
Texas Tech University	$12,949,430	$318,925,990	4.1%	$12,949,430
UT Austin	$9,297,638	$757,326,265	1.2%	$9,297,638
University of Houston (main)	$6,941,250	$383,778,118	1.8%	$6,941,250
Subtotal, Four Largest General Academic Institutions	$57,562,483	$2,051,615,502	2.8%	$57,562,483
Texas A&M University–Corpus Christi	$17,018,415	$101,041,126	16.8%	$8,509,208
Texas A&M International University	$15,494,535	$72,133,433	21.5%	$7,747,268
UT Pan American	$14,966,798	$136,549,774	11.0%	$7,483,399
UT El Paso	$14,860,417	$168,630,294	8.8%	$7,430,209
Texas A&M University–Kingsville	$13,288,259	$85,383,353	15.6%	$6,644,130
Texas Southern University	$12,006,991	$130,368,366	9.2%	$6,003,496
Stephen F. Austin State Univ.	$11,719,032	$106,550,509	11.0%	$5,859,516
Texas Woman's University	$11,406,199	$115,145,310	9.9%	$5,703,100
UT Brownsville	$10,797,068	$45,141,448	23.9%	$5,398,534
UT San Antonio	$9,812,666	$192,785,707	5.1%	$4,906,333
UT Tyler	$9,426,116	$52,109,435	18.1%	$4,713,058
Sul Ross State University	$8,440,145	$33,899,975	24.9%	$4,220,073
Prairie View A&M University	$8,181,698	$118,358,447	6.9%	$4,090,849
Angelo State University	$7,564,766	$63,192,671	12.0%	$3,782,383
West Texas A&M University	$7,372,919	$67,701,806	10.9%	$3,686,460
UT Permian Basin	$7,172,433	$33,485,964	21.4%	$3,586,217
Sam Houston State University	$6,225,804	$119,240,479	5.2%	$3,112,902
UH–Downtown	$5,369,021	$67,477,097	8.0%	$2,684,511
Lamar University	$5,361,138	$86,145,025	6.2%	$2,680,569
Southwest Texas State Univ.	$5,307,508	$203,935,103	2.6%	$2,653,754
Tarleton State University	$4,843,135	$77,194,050	6.3%	$2,421,568
Midwestern State University	$4,730,308	$49,742,133	9.5%	$2,365,154
Texas A&M–Commerce	$4,605,339	$81,902,865	5.6%	$2,302,670
Sul Ross State University Rio Grande College	$4,590,170	$12,240,264	37.5%	$2,295,085
Texas A&M Univ. at Galveston	$4,344,299	$28,188,004	15.4%	$2,172,150
UH–Clear Lake	$4,222,542	$72,867,929	5.8%	$2,111,271
Texas A&M–Texarkana	$4,215,574	$21,203,164	19.9%	$2,107,787
UH–Victoria	$3,965,243	$27,013,044	14.7%	$1,982,622
UT Arlington	$3,277,645	$237,628,685	1.4%	$1,638,823
University of North Texas	$3,252,395	$270,587,371	1.2%	$1,626,198
UT Dallas	$3,045,290	$168,169,889	1.8%	$1,522,645
Subtotal, General Academics	**$304,446,351**	**$7,149,243,724**	**4.3%**	**$181,004,417**

(CONTINUED ON NEXT PAGE)

FIGURE 3 (CONTINUED)
INSTITUTIONAL ENHANCEMENT APPROPRIATIONS AND REDUCTIONS
2004–05 APPROPRIATIONS

	2004–05 INSTITUTIONAL ENHANCEMENT APPROPRIATION	2004–05 TOTAL ALL FUNDS APPROPRIATION	INSTITUTIONAL ENHANCEMENT AS A PERCENT OF TOTAL APPROPRIATION	2006–07 RECOMMENDED REDUCTION
TWO-YEAR LAMAR INSTITUTIONS				
Lamar University–Orange	$2,771,416	$14,289,976	19.4%	$1,385,708
Lamar University–Port Arthur	$2,741,104	$21,325,565	12.9%	$1,370,552
Lamar University Institute of Technology	$2,737,304	$20,634,883	13.3%	$1,368,652
Subtotal, Two-year Lamar Institutions	**$8,249,824**	**$56,250,424**	**14.7%**	**$4,124,912**
TEXAS STATE TECHNICAL COLLEGES				
Texas State Technical College–West Texas	$3,647,216	$24,912,957	14.6%	$1,823,608
Texas State Technical College–Waco	$3,263,904	$55,935,079	5.8%	$1,631,952
Texas State Technical College–Harlingen	$3,188,148	$38,121,585	8.4%	$1,594,074
Texas State Technical College–Marshall	$2,371,642	$9,195,126	25.8%	$1,185,821
Subtotal, Texas State Technical Colleges	**$12,470,910**	**$128,164,747**	**9.7%**	**$6,235,455**
HEALTH-RELATED INSTITUTIONS				
Texas Tech University Health Sciences Center	$9,000,000	$204,490,276	4.4%	$4,500,000
Texas A&M Health Science Center	$3,500,000	$132,425,801	2.6%	$1,750,000
UT Southwestern Medical Center at Dallas	$1,750,000	$310,327,706	0.6%	$875,000
UT Medical Branch at Galveston	$1,750,000	$1,009,995,556	0.2%	$875,000
UT Health Science Center at Houston	$1,750,000	$306,291,726	0.6%	$875,000
UT Health Science Center at San Antonio	$1,750,000	$287,341,804	0.6%	$875,000
UT M.D. Anderson Cancer Center	$1,750,000	$2,305,195,589	0.1%	$875,000
UT Health Center at Tyler	$1,750,000	$167,266,320	1.0%	$875,000
North Texas Health Science Center at Fort Worth	$1,750,000	$98,925,184	1.8%	$875,000
Subtotal, Health-related	**$24,750,000**	**$4,822,259,962**	**0.5%**	**$12,375,000**
Total, All Institutions	**$349,917,085**	**$12,027,754,110**	**7.3%**	**$203,739,784**

SOURCE: Legislative Budget Board.

tion on the recommended reductions to each institution. The legislature should consider reallocating these savings, as appropriate, to formula funding or other state services.

FISCAL IMPACT OF THE RECOMMENDATIONS

Implementation of the recommendations would result in General Revenue Fund savings of $203.7 million for the 2006–07 biennium, as indicated by Figure 4.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations but does reflect some reduction in total funding for Institutional Enhancement when compared to the 2004–05 base spending level.

FIGURE 4
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$101,869,892
2007	$101,869,892
2008	$101,869,892
2009	$101,869,892
2010	$101,869,892

SOURCE: Legislative Budget Board.

ELIMINATE THE TEACHING EXPERIENCE SUPPLEMENT FOR HIGHER EDUCATION

The Seventy-fifth Legislature, 1997, created the teaching experience supplement as an incentive for general academic institutions to use tenured and tenure-track faculty to teach undergraduate classes. The 2004–05 General Appropriations Act provides for an additional 10 percent to be added to the funding formula when tenured and tenure-track faculty teach undergraduate courses. However, the Texas Higher Education Coordinating Board's data concerning the faculty used for undergraduate courses and recent performance measures from the General Appropriations Act reporting on tenured and tenure-track professors in lower division courses both indicate that the percentage of courses taught by tenured and tenure-track faculty has in fact decreased since the supplement was implemented. Because the teaching experience supplement has not had the intended impact, the legislature should consider eliminating appropriations for it. This would make $70.5 million in biennial General Revenue Funds available for formula funding or other state services.

SIGNIFICANT FINDING

- Texas Higher Education Coordinating Board shows the percentage of tenured and tenure-track faculty teaching undergraduate semester credit hours decreased from 56 percent in the fall of 1998 to 51 percent in the fall of 2003.

SIGNIFICANT CONCERN

- Since the percentage of courses taught by tenured and tenure-track faculty has decreased since 1998, the teaching experience supplement represents an unnecessary allocation to the higher education funding formula because it does not achieve its purpose of increasing the percentage of undergraduate teaching hours provided by tenured and tenure-track faculty.

RECOMMENDATION

- The 2006–07 General Appropriations Bill should not include appropriations for the teaching experience supplement, thus reducing the General Revenue Funds contribution to the higher education funding formula by $70.5 million. The legislature should consider reallocating these savings, as appropriate, to other formula funding or other state services.

COMMENTS

General academic institutions of higher education are allocated most of their funding through formulas and supplements. The formulas are the instruction and operations formula and the infrastructure formula. The supplements are Teaching Experience Supplement (TES) and the small institution supplement. These formulas and supplements are direct appropriations from the General Revenue Fund and General Revenue–Dedicated Funds. In the 2004–05 biennium, approximately $3.1 billion was allocated to the instruction and operations formula, of which $97.0 million was for TES. Approximately $70.5 million of TES appropriations were from the General Revenue Fund and the remaining appropriations were General Revenue–Dedicated Funds, primarily from tuition and fees collected by the institutions.

The amount of funds appropriated to each institution from the instruction and operations formula is equal to the product of the number of semester credit hours (SCH), the program or level of a course, and the state rate, as shown in Figure 1. The program or level is a weight assigned to the particular discipline. For example, nursing is weighted more than liberal arts and upper division courses are weighted more than lower division courses. The state rate varies depending on the amount appropriated to the instruction and operations formula. TES adds an additional percentage increase to the instruction and operations formula.

FIGURE 1
INSTRUCTION AND OPERATIONS FORMULA

Instruction and Operations	semester credit hours x program/ level weight x rate
TES	semester credit hours x program/ level weight x TES x rate

SOURCE: Legislative Budget Board.

For the 2004–05 biennium, TES appropriations were about 3 percent of the total instruction and operations formula. The $70.5 million in General Revenue Funds appropriated to TES is distributed among Texas' 35 general academic institutions for the biennium. Figure 2 provides a breakdown of the General Revenue Funds appropriated to each institution for the 2004–05 biennium.

FIGURE 2
TEACHING EXPERIENCE SUPPLEMENT
FISCAL YEARS 2004–05

	2004 GENERAL REVENUE	2005 GENERAL REVENUE	TOTAL
UT Arlington	$1,339,281	$1,345,392	$2,684,673
UT Austin	4,431,138	4,445,864	$8,877,002
UT Dallas	560,012	560,200	$1,120,212
UT El Paso	1,152,150	1,170,474	$2,322,624
UT Pan American	947,263	951,419	$1,898,682
UT Brownsville	310,475	313,494	$623,969
UT Permian Basin	197,258	198,032	$395,290
UT San Antonio	1,444,357	1,454,506	$2,898,863
UT Tyler	450,857	453,076	$903,933
Texas A&M University	4,005,521	4,020,358	$8,025,879
Texas A&M Univ. at Galveston	106,752	106,896	$213,648
Prairie View A&M University	736,326	738,046	$1,474,372
Tarleton State University	689,232	692,602	$1,381,834
Texas A&M University–Corpus Christi	812,220	817,073	$1,629,293
Texas A&M University–Kingsville	653,466	656,510	$1,309,976
Texas A&M International University	331,496	333,105	$664,601
West Texas A&M University	592,719	599,248	$1,191,967
Texas A&M–Commerce	481,578	483,824	$965,402
Texas A&M–Texarkana	106,813	108,667	$215,480
University of Houston	2,098,813	2,102,196	$4,201,009
UH–Clear Lake	319,500	320,288	$639,788
UH–Downtown	557,572	559,845	$1,117,417
UH–Victoria	163,518	163,964	$327,482
Midwestern State University	563,888	572,767	$1,136,655
University of North Texas	2,107,005	2,114,576	$4,221,581
Stephen F. Austin State Univ.	1,167,779	1,174,402	$2,342,181
Texas Southern University	536,230	536,463	$1,072,693
Texas Tech University	2,323,913	2,336,077	$4,659,990
Texas Woman's University	661,577	664,583	$1,326,160
Angelo State University	670,538	675,706	$1,346,244
Lamar University	981,337	987,656	$1,968,993
Sam Houston State University	1,314,527	1,321,576	$2,636,103
Texas State Univ.	2,080,377	2,090,910	$4,171,287
Sul Ross State University	191,580	192,411	$383,991
Sul Ross State University–Rio Grande College	68,345	68,653	$136,998
Total	$35,155,413	$35,330,859	$70,486,272

SOURCE: Legislative Budget Board.

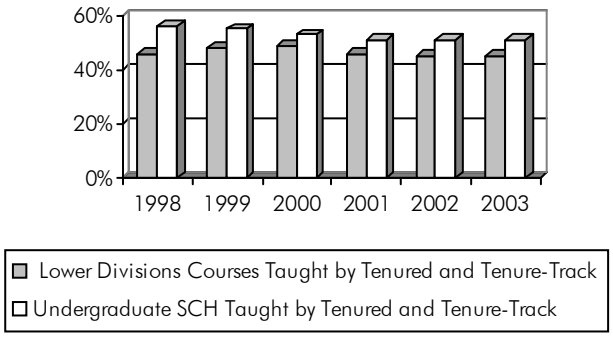
The Seventy-fifth Legislature, 1997, instituted TES to provide an incentive to general academic institutions to use their best-qualified educators for teaching undergraduate courses. This was predicated on the belief that the most knowledgeable, thus best qualified, faculty were tenured and tenure-tracked. Initially, TES added a 5 percent increase to the formula, and subsequently in fiscal year 2002, the weight was increased to 10 percent.

The current weight for TES remains at 10 percent, although the rider provision states that the legislative intent is to increase the weight to 50 percent. At the current weight, THECB data shows no increase in the percentage of tenured and tenure-track faculty teaching undergraduate SCH. As a result, the current reimbursement did not have the desired effect on the percentage of tenured and tenure-track faculty teaching undergraduate courses.

Additional duties of tenured and tenure-track faculty, such as student advising, committee meetings, and research, prohibit institutions from increasing the percentage of undergraduate courses taught by these faculty members. As a result, concerns are raised by educators about increasing the classroom time of tenured and tenure-track faculty because it will leave less time for these other functions. THECB's report, *Higher Education in Texas: 1998 Status Report*, stressed that research is vital for maintaining and increasing the expertise and knowledge of tenured and tenure-track faculty. Non-tenured faculty rarely perform these other duties in addition to their classroom instruction.

THECB data shows the percentage of tenured and tenure-track faculty teaching undergraduate semester credit hours decreased from 56 percent in the fall of 1998 to 51 percent in the fall of 2003. Furthermore, performance measures in the General Appropriations Act (GAA) reporting on the percent of tenured and tenure-track faculty used to teach lower division courses show, on average, an initial increase in the percentage of courses taught in 2000. This percentage has steadily declined since then (see Figure 3). Consequently, the recommendation is to eliminate TES because it has not achieved its purpose of increasing the percentage of tenured and tenure-track faculty teaching undergraduate courses.

FIGURE 3
PERCENT OF SEMESTER CREDIT HOUR TAUGHT BY TENURED AND TENURE-TRACK FACULTY



SOURCE: Legislative Budget Board.

FISCAL IMPACT OF THE RECOMMENDATION

If TES were eliminated from the higher education formula, the savings to General Revenue Funds would be $70.5 million for the 2006–07 biennium as shown in Figure 4. In the 2004–05 biennium, the state appropriated $97.0 million in General Revenue Funds and General Revenue–Dedicated Funds to TES of which $70.5 million are General Revenue Funds. The introduced 2006–07 General Appropriations Bill does not change the General Revenue appropriation for TES, and General Revenue–Dedicated Funds would continue to be allocated back to institutions through the instruction and operations formula.

FIGURE 4
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS /(COST) TO GENERAL REVENUE FUNDS
2006	$35,250,000
2007	$35,250,000
2008	$35,250,000
2009	$35,250,000
2010	$35,250,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of the recommendation.

LIMIT TUITION EQUALIZATION GRANTS TO PELL GRANT RECIPIENTS

Section 61.221 of the Texas Education Code authorizes the Texas Higher Education Coordinating Board to provide Tuition Equalization Grants to students enrolled at approved private universities or colleges. Tuition Equalization Grants' purpose is to maximize the use of the state's educational resources and facilities by offering need-based financial assistance to students to attend private institutions rather than public institutions. Lower-income families are identified as those eligible for federal Pell Grants. In fiscal year 2003, $39.5 million of the total annual Tuition Equalization Grant appropriation of $70.7 million was given to Pell Grant recipients. By limiting Tuition Equalization Grants to Pell Grant recipients exclusively, the state could maintain its current level of contribution to Pell and Tuition Equalization Grant recipients and save an estimated $31.2 million in General Revenue Funds annually.

SIGNIFICANT CONCERN

- The Texas Higher Education Coordinating Board does not award Tuition Equalization Grants solely to students with significant financial need. The legislature created Tuition Equalization Grants to encourage students who otherwise could not afford it to attend private universities and colleges.

RECOMMENDATIONS

- **Recommendation 1:** Amend the Tuition Equalization Grant eligibility requirement in Section 61.225 of the Texas Education Code to restrict Tuition Equalization Grant awards to federal Pell Grant recipients exclusively.
- **Recommendation 2:** The 2006–07 biennial General Revenue Funds appropriation to the Texas Higher Education Coordinating Board for Tuition Equalization Grants should be reduced by $62.4 million to provide Tuition Equalization Grant awards exclusively to Pell Grant recipients at its current level of contribution.

COMMENTS

In 1971, the Sixty-second Legislature created the Tuition Equalization Grants (TEG) program to encourage needy students to attend private universities and colleges by helping them pay the higher tuition. By diverting students to private institutions, the state lessens the expense of expanding the public college system and spends less money for each student diverted. TEG may not exceed an amount equal to 50 percent of the average state appropriation per student to public institutions. In fiscal year 2003, the state paid an average of $7,306 in All Funds to public institutions for each full-time-equivalent (FTE) student and paid a maximum of $3,653 per FTE student for TEG. However, the General Revenue Fund appropriation for an FTE student at a public university is $5,255; therefore, TEG is approximately 70 percent of the state's General Revenue Fund appropriations. To be eligible for TEG, a student must meet the following qualifications:

- be a Texas resident and/or national merit finalist;
- enroll on at least one-half time basis;
- be required to pay more tuition than is required at a public college or university;
- establish financial need;
- not be a recipient of any form of athletic scholarship;
- register for the Selective Service or be exempt from this requirement; and
- be required to pay more tuition than that of a public institution.

FINANCIAL NEED CALCULATION

TEG assistance is contingent on student financial need. Financial need is determined by subtracting the expected family contribution (EFC) from the cost of attendance. The EFC is obtained when a student/family completes the Free Application for Federal Student Aid (FAFSA). The EFC calculation takes into account a family's income and assets, but it also considers family size and extraordinary expenses, such as having another child in college. As a result, both middle and upper middle-income families may qualify for some type of need-based financial aid. Financial aid resources can vary greatly, ranging from gift aid to loans, with those having the greatest need qualifying for the federal Pell Grant. In addition to financial aid, families may apply for additional student loans that are not related to need. These loans are subject to the usual loan application process.

The cost of attendance is based on a nine-month period and includes tuition, fees, books, supplies, and living expenses. Because EFC is subtracted from the cost of

attendance to determine financial need, the more expensive the institution's tuition and fees are, the greater the need. Thus, a student attending a private institution will be eligible for more financial aid than a student attending a public university if the EFCs of the two students are equivalent.

According to the Texas Higher Education Coordinating Board (THECB), a family must show exceptional financial need to be eligible for a Pell Grant as shown in Figure 1. Since Pell Grant recipients have fewer college options, TEG awards can provide more choices to students by offering additional assistance. Furthermore, private institutions have additional sources of federal financial aid, such as the Leveraging Educational Assistance Program (LEAP) and the Special Leveraging Educational Assistance Program (SLEAP). These programs require the state to match federal funding at the rate of either one or two dollars per every federal dollar. Because TEG is state funded, THECB can use this program as match to leverage additional federal aid for students who attend private institutions.

FIGURE 1
FEDERAL PELL GRANT

The federal Pell Grant is an entitlement for those students who show exceptional financial need. Pell Grants are awarded to undergraduate students who have not earned a bachelor's or professional degree. To qualify, a student's EFC cannot exceed $3,850. The maximum amount of the Pell Grant is adjusted annually, so it varies from year to year. The minimum Pell Grant award is $200 and the maximum for the academic year 2003–04 is $4,050.

In contrast, students from families in the middle or greater income range have more choices about where to attend college. When such a student attends a private institution, the higher cost of attendance increases his/her eligibility for financial aid. According to THECB, middle-income families are more likely to borrow their EFC. THECB data indicates that these families have the ability to borrow more than the cost associated with attending a public institution. Though, according to a 2003 THECB financial aid report, "only 18 percent of students from these families attended a private institution. The vast majority of such students were attending public institutions."

Figure 2 shows the resources available to those receiving aid to meet their financial need and data on those who receive loans to replace part of their EFC for the 2002–03 academic year. Students receiving aid to meet their need, on average, are eligible for Pell Grants and still have unmet needs of $4,645; whereas, families who borrow the EFC are not eligible for Pell Grants and have approximately $8,000 surplus. The average yearly difference in cost between a private and public institution is $8,550.

FIGURE 2
STUDENTS RECEIVING AID

	STUDENTS RECEIVING AID TO MEET NEED	STUDENTS RECEIVING LOANS AT LEAST IN PART TO REPLACE FAMILY CONTRIBUTION
Average Cost of Attendance	$12,204	$14,379
Average Amount of Available Resources		
· Expected Family Contribution	$1,493	$11,669
· Waivers and Outside Aid	$172	$436
· Gift Aid	$3,066	$1,863
· Work Study	$118	$103
· Loans	$2,710	$8,327
Total Resources	$7,559	$22,398
Unmet Need	$4,645	$(8,019)

SOURCE: Texas Higher Education Coordinating Board.

To bridge this gap, TEG serves to provide more options to lower-income students by offering additional financial assistance so they may have the opportunity to attend private colleges. Therefore, in order to meet the goal of the TEG program, which is to maximize the use of existing educational resources by encouraging students to attend private institutions who otherwise could not afford it, TEG should be provided exclusively to those who are eligible for the federal Pell Grant program.

Recommendation 1 would restrict the use of the TEG to those students receiving the federal Pell Grant. Section 61.225 of the Texas Education Code should be amended to limit TEG to Pell Grant recipients.

FISCAL IMPACT OF THE RECOMMENDATIONS

Recommendation 2 would reduce the 2006–07 biennial General Revenue Fund appropriation to THECB for TEG by $62.4 million as shown in Figure 3.

Approximately 48 percent of those who receive TEGs are also awarded Pell Grants. Although the percentage of TEG provided to Pell Grant recipients fluctuates, the funding amount of $39.5 million has remained steady for the last two years. The annual TEG appropriation in the 2004–05 biennium is approximately $70.7 million, of which $39.5 million in TEG funds were awarded to federal Pell Grant recipients. The state could eliminate TEG funds to non-Pell Grant recipients and save $31.2 million annually.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$ 31,200,000
2007	$ 31,200,000
2008	$ 31,200,000
2009	$ 31,200,000
2010	$ 31,200,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill reduces TEG appropriations by $13.2 million from the 2004–05 appropriated amounts. Therefore, the additional 2006–07 savings from this recommendation would be $49.2 million.

STREAMLINE COLLEGE DEGREE SEMESTER CREDIT HOUR REQUIREMENTS

Concerns over the increasing cost of higher education and the growth in enrollment have led both public higher education institutions and the legislature to create incentives to encourage students to graduate in four years. However, the state's primary expense for higher education is based on the total number of semester credit hours attempted by each student. In essence, the more hours attempted, the more it will cost the state. Several factors contribute to an excessive number of semester credit hours attempted. Changing majors is reported most frequently as the reason why students take excessive hours to graduate. Institutional policies requiring additional semester credit hours and academic mandates set by the legislature also contribute to the increased number of hours required for a degree. The legislature can curtail the cost associated with excessive semester credit hours by capping state funding for bachelor's degrees to 15 percent above the degree requirement and establishing controls to limit excessive degree requirements without appropriate academic justification.

SIGNIFICANT CONCERNS

- Statutory mandates requiring courses in United States history and United States and Texas government (Section 51.301 and 51.302, Texas Education Code) contribute to a core curriculum length ranging from 42–48 semester credit hours. Institutions with core curricula longer than 42 semester credit hours correlate with longer minimum degree lengths. In addition, credit transfer problems occur between public and private or out-of-state universities as a result of these legislative mandates.
- There is no maximum degree length in Texas, which has led to a wide discrepancy in institutional requirements. Semester credit hour degree requirements can vary up to 25 hours for the same degree across the state. Several institutions have set the minimum for all degrees above 120 hours regardless of the discipline.
- On average, 9 percent of any given student cohort will take six years to graduate with an average of 167 semester credit hours. As a result, the current state law capping bachelor degree funding to 45 semester credit hours over the degree requirement only affects a small number of students and results in a negligible savings to the state.
- Many institutions have implemented programs that reduce time to degree, which may minimize an excessive number of semester credit hours.

RECOMMENDATIONS

- **Recommendation 1:** Section 61.822 of the Texas Education Code should be amended to require all public institutions to maintain a core curriculum between 36 and 42 semester credit hours.
- **Recommendation 2:** Remove Section 51.301 and 51.302 of the Texas Education Code that requires all state funded institutions to provide six semester credit hours of United States history and six semester credit hours of United States and Texas government.
- **Recommendation 3:** The Texas Education Code should be amended to set the maximum length for a bachelor's degree at 120 semester credit hours and direct the Texas Higher Education Coordinating Board to develop criteria to allow exceptions to this, such as academic best practices with respect to accreditation, certifications, and industry requirements.
- **Recommendation 4:** Amend Section 61.0595 of the Texas Education Code to cap state funding for a bachelor degree to 15 percent above the degree requirement.
- **Recommendation 5:** Universities and the Texas Higher Education Coordinating Board should be required to report key performance measures tracking semester credit hours to evaluate universities' successes in implementing programs that reduce students' time to degree completion and semester credit hours attempted to ensure that students would graduate under a 15 percent funding cap.

COMMENTS

The Seventy-fifth Legislature, 1997, mandated the Texas Higher Education Coordinating Board (THECB) to adopt rules establishing policies and procedures for the development, adoption, implementation, and evaluation of the

core curriculum. The core curriculum consists of 42 semester credit hours (SCH) of general education necessary to develop the essential basic competencies for all disciplines. Core courses are required for all students at each public institution regardless of their field of study.

Each institution's core curriculum must be designed to achieve the educational objectives specified in five basic component areas. A sixth component, referred to as an institution's designated option, allows institutions to include additional course work that is not included in the educational objectives of the other components, such as computer literacy or health and wellness. The following are the five basic components:

- communication (English, composition, speech);
- mathematics (logic, college-algebra, statistics, calculus or above);
- natural sciences;
- humanities/visual and performing arts (literature, philosophy, modern or classical language/literature and cultural studies); and
- social/behavioral sciences (includes legislatively mandated courses).

The minimum core curriculum is set at 42 SCH, but each institution can seek approval from THECB to offer additional courses. According to THECB, institutions have been provided a blanket approval to provide up to 48 SCH as long as the institutions do not adopt additional hours from the institution's designated option component.

Recommendation 1 states that the core curriculum should be reduced to a range from 36 to 42 SCH. Although the current length is 42 SCH, many schools continue to have a core curriculum of up to 48 SCH. The State of Florida has mandated its core curriculum to 36 SCH, and the Southern Association of Colleges and Schools (SACS) only requires a minimum core curriculum length of 30 SCH. An analysis of institutions with a core curriculum exceeding 42 SCH correlates with minimum degree length exceeding 120 SCH.

Sections 51.301 and 51.302 of the Texas Education Code require all state-funded institutions to provide six SCH of United States history (may include Texas history), and six SCH of United States and Texas government. These courses are included in the core curriculum. The United States history mandate was first enacted in 1955 and was recently amended in 1995 to allow students to receive credit through an advanced placement exam. The U.S. and Texas government mandate was first enacted in 1929 and was most recently amended in 1995 to also allow students to receive credit through advanced placement exams, and also provided exemptions to this requirement for military personnel.

The core curriculum statute requires institutions to transfer a completed core curriculum from one institution to another. As a result, THECB reports very few complaints relating to core course transfers among public institutions. However, transfer problems do exist between private, out-of-state, and public institutions. For example, in both out-of-state and private institutions, students are not required to take the legislatively mandated Texas government; therefore, students will sometimes complete other courses in general education required by the private or out-of-state institution and find they have not met the statutory requirement when transferring into a public institution in Texas.

Recommendation 2 suggests that the legislature consider removing Section 51.301 and 51.302 of the Texas Education Code requiring all state-funded institutions to provide six SCH of U.S. history and six SCH of U.S. and Texas government. Removing the legislative mandate would minimize transfer problems associated with core requirements between public institutions and private or out-of-state institutions. Furthermore, THECB data show the majority of students in Texas public higher education institutions attended high school in Texas where courses in Texas, United States, and world history, as well as government are also required (19, TAC, Chapter 74). This results in potentially needless repetition.

MAXIMUM DEGREE LENGTHS

SACS sets a minimum of 120 SCH for all bachelor's degrees. However, there is no such standard for limiting the maximum number of SCH institutions may request for a bachelor's degree. Many factors can contribute to the required hours for a degree, such as required certifications, industry requirements, and national academic accreditations. Therefore, the maximum number of hours required to obtain a degree may vary, but should not be unlimited.

In Texas, several institutions have set their minimum degree lengths to be over 120 SCH regardless of the field of study. For example, Angelo State University requires all students to complete 130 SCH for a degree, and Texas State University requires 128 SCH. A review conducted of the top 25 degrees granted in the state of Texas (which accounted for approximately 60 percent of the 2003 graduates) found that the degree lengths varied up to 25 SCH for the same degree. This analysis compared the same degree based on the federal standards printed in the 2000 edition of Classification Instructional Program.

Some states have sought to curtail the differences in the length of bachelor's degrees by setting a maximum standard. Florida and Georgia set the maximum degree length at 120 SCH. In order to exceed 120 SCH, an institution must seek prior approval from the state.

Recommendation 3 would establish a bachelor's degree maximum at 120 SCH with exceptions allowed based on criteria developed by the THECB. Texas implemented a similar process when the legislature capped funding for doctoral students at 99 SCH. Statute directed THECB to develop criteria for institutions to follow that would allow exceptions to the 99-hour cap. THECB reports that this program has been successful and the number of students exceeding the 99-hour cap significantly decreased.

FUNDING CAP FOR BACHELOR'S DEGREE

In 1997, the legislature passed a number of incentive programs to encourage students to graduate more timely, including the B-on-Time Program and Tuition Rebate Program. In addition to these incentives, the legislature also placed funding limits on SCH. For example, the state will not fund courses taken by students who take more than 45 SCH above the degree requirement, nor will it fund the same course attempted by a student for a third time. It is difficult to measure the effectiveness of these changes until an entire cohort passes through the educational system.

The standard for measuring student performance is to evaluate a particular cohort from their initial entrance into school for up to six years. Based on this methodology, approximately 9 percent of "full-time entering" students take six years to graduate with an average of 167 SCH. When considering only those in the cohort who graduate, 17 percent are taking six years to complete. Furthermore, since similar degree lengths can vary up to 25 SCH, the data suggest only a small number of students may exceed the 45 SCH cap. For example, if a student completes a 130 SCH degree, the state will pay up to 175 SCH, which exceeds the average number of SCH completed by students in six years.

Florida's Office of Program Policy and Analysis and Government Accountability recommended the Florida Legislature require students who take more than 115 percent of the SCH required for their degrees to pay the full cost of tuition for the additional hours. Therefore, students graduating with a 120 SCH degree would only be funded by the state to take up to 18 SCH over the degree requirement. Florida's data show that only 20 percent of students would be affected by such a policy, and the state could save approximately $30 million if it were implemented.

Recommendation 4 would reduce the funding cap for a bachelor's degree to no more than 15 percent above the degree requirement. Since THECB data suggest only 9 percent of the students take six years to graduate with an average of 167 SCH, only a small number of students would be affected by this change. However, to provide students opportunities to avoid reaching the cap, programs such as dual credit courses in high school, credit by exam, remedial courses, and private institution attendance should be exempt from this cap.

UNIVERSITY ACCOUNTABILITY

Universities should also share the responsibility of reducing the number of SCH attempted with students by implementing programs to ensure students can graduate within the funding cap. Many institutions have already implemented programs that reduce time to degree, which should help minimize the number of SCH. For example, the University of Texas at Austin implemented a flat-rate tuition plan consisting of charging one rate for 14 SCH regardless of how many hours more than 14 that a student actually takes. Texas Tech guarantees that every class needed to graduate will be available for the student by course substitutions and waivers. The University of Houston gives tuition discounts to students who take a class on a Saturday.

Recommendation 5 would require universities to report performance in reducing time to degree completion and SCH attempted by students. The Legislative Budget Board (LBB) will monitor university outcomes through key performance measures. Currently, the LBB collects six-year graduation rates as a key measure in the General Appropriations Act and will request to collect four-year graduation rates for the 2006–07 biennium. To measure the effectiveness of universities' use of incentives and the ability to advise students through its system, SCH key measures should be required of both universities and THECB in addition to the yearly graduation rates for the 2008–09 biennium. Example measures include tracking the percentage of students who graduate under the following conditions:

- with 120 SCH or equal to the degree requirement,
- within 15 percent of the degree requirement, and
- exceeding 15 percent of the degree requirement.

By implementing performance measures for universities and capping funding for students, both institutions and students can share in the responsibility to meet the goal of reducing both the time and SCH required for degree completion.

FISCAL IMPACT OF THE RECOMMENDATIONS

The above recommendations should be implemented with a new cohort of students; therefore, the savings to the General Revenue Fund cannot be realized until a new cohort completes the six-year cycle. Although there will be no immediate fiscal impact as a result of these changes, future cost avoidance can be estimated in order to appreciate the value of curtailing the number of SCH attempted by students.

Each year, approximately 3,940 students take six years to graduate with 167 SCH. Assuming their degree length is now a 120 SCH and they graduate within 15 percent of the degree requirement, the approximate reduction in the number of hours attempted by each student would be 30 SCH. A full-time-student equivalent (FTSE) is 30 SCH and is currently funded at $5,255 in General Revenue Funds. By multiplying the number of students with the FTSE appropriation, the potential savings is $20.7 million annually in General Revenue Funds. However, such savings would not be realized for at least six years; therefore, the immediate fiscal impact cannot be determined.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of the recommendations.

FUNDING ISSUES RELATED TO THE VISITING JUDGES PROGRAM

In view of budget shortfalls, the Seventy-eighth Legislature, Regular Session, 2003, determined that cuts to visiting judge appropriations were more practical than cuts to salaries and other expenses of elected, active judges and felony prosecutors. Additionally, while prior legislatures had provided estimated appropriation authority for the visiting judge program (i.e., unlimited appropriations), the Seventy-eighth Legislature, 2003, placed a cap on visiting judge funding levels.

The public, trial courts, appellate courts, and the legislature are all stakeholders in the effective administration of justice. Additionally, legislators have historically been sensitive to concerns expressed by the trial or appellate court judges and justices from their districts. Requests for the Seventy-ninth Legislature, 2005, to restore funding to the visiting judge program will likely originate from a variety of sources.

SIGNIFICANT FINDINGS

- Local costs for creating and maintaining a new district court vary across the state. Counties providing information for fiscal notes in the regular session estimated that maintaining a new district court would range between $22,285 (Caldwell County) and $1 million (Collin County) per fiscal year.
- Most visiting judges serving district courts are retired judges, whose average compensation is $98,547 annually, or 76 percent of the salary and benefits of a district judge ($129,365).
- Funding for visiting judges serving in district courts decreased by 56 percent between 2002–03 biennial expenditures and 2004–05 biennial appropriations.
- Prior to fiscal year 2004, visiting judges serving a half-day or less were entitled to a full day's pay. House Bill 3306, Seventy-eighth Legislature, 2003, authorized half-day pay for judges serving a half-day or less, and it is estimated that over the 2004–05 biennium this provision will save $0.9 million in visiting judge costs.
- Funding for visiting judges serving in appellate courts decreased by 84 percent between 2002–03 biennial expenditures and 2004–05 biennial appropriations. In the 2004–05 biennium, intermediate appellate court justices have $0.6 million available in General Revenue Funds to pay visiting judges, which is half of the $1.2 million in estimated leave time needed to substitute for the absence of active judges. Appellate justices are seeking $0.8 million in General Revenue Funds for the 2006–07 biennium, which would provide for two weeks annual leave, one week for continuing legal education, and one week of sick leave.

COMMENTS

The Seventy-eighth Legislature, Regular Session, 2003, reduced funding levels for visiting judges serving in district- and appellate-level courts from $21.9 million for the 2002–03 biennium to $7.3 million for the 2004–05 biennium. This represents a reduction of 67 percent between 2002–03 expenditures and 2004–05 biennial appropriations (see Figure 1).

Visiting judges are assigned to trial and appellate courts for a variety of reasons, including instances in which an active judge is disqualified in a case, recused in a case, on extended sick leave, or involved in a lengthy trial.

At the trial court level, the presiding judges of the nine administrative judicial regions assign visiting judges (see Figure 2). Trial court uses for visiting judges include adjudication of complex multi-district civil cases and management of the regular caseload of trial judges involved in high-profile capital cases. During the 2002–03 biennium, seven of the nine administrative regions used visiting judges on a full-time basis to hear drug, tax, foster care, or other specialty cases. Specialty courts operating in the seven regions during the 2002–03 biennium are shown in Figure 3.

The Office of Court Administration reports that during fiscal year 2003, visiting judges were paid for a total of 26,203 days in the administrative judicial regions. Assuming a full-time active judge is paid for 250 days during a fiscal year, visiting judge service was the equivalent of adding 110 full-time judges to the trial courts during fiscal year 2003.

At the intermediate appellate court level, the Chief Justice of the Supreme Court may assign a visiting judge at the request of the chief justice of an appellate court to help control backlogs of cases or to hear special dockets. Additionally, because appellate justices must hear cases in panels of three, appellate courts employing only three permanent justices must use a visiting judge when one justice must be disqualified or is recused from a case.

FIGURE 1
FUNDING FOR VISITING JUDGES (JUDICIARY SECTION, COMPTROLLER'S DEPARTMENT)

2004–05 APPROPRIATIONS FOR VISITING JUDGES		FY 2004	FY 2005	FY 2004–05
Strategy:				
A.1.2	Visiting Former Judges, Regions	$602,891	$602,891	$1,205,782
A.1.4	Visiting Retired Judges, Regions	$2,759,458	$2,759,458	$5,518,916
A.1.3	Visiting Former Judges, Appellate	$62,782	$62,783	$125,565
A.1.5	Visiting Retired Judges, Appellate	$236,181	$236,182	$472,363
Total 2004–05 Appropriated Amounts				$7,322,626
2002–03 EXPENDITURES FOR VISITING JUDGES		**FY 2002**	**FY 2003**	**FY 2002–03**
Strategy:				
A.1.1	Visiting Former Judges, Regions	$1,228,800	$1,228,800	$2,457,600
A.1.15	Visiting Retired Judges, Regions	$7,800,000	$7,934,425	$15,734,425
A.1.1	Visiting Former Judges, Appellate	$471,200	$471,200	$942,400
A.1.16	Visiting Retired Judges, Appellate	$1,238,300	$1,493,300	$2,731,600
Total 2002–03 Expended Amounts				$21,866,025

Percentage reduction between 2004–05 appropriations and 2002–03 expenditures is 67%.

SOURCE: Legislative Budget Board; Comptroller of Public Accounts.

FUNDING FOR VISITING JUDGE PAYMENTS

Texas has provided for the payment of visiting judges under the Government Code since 1927. In 1957 the legislature adopted a provision for compensating visiting judges similar to the provision in law today. Since the 1998–99 biennium, funding for visiting judge payments has fluctuated from a high of $10.3 million in fiscal year 1999 to a low of $8.7 million in fiscal year 2000, a year when 13 new district courts were created (see Figure 4). Between fiscal year 1998 and fiscal year 2003, cases pending per elected district court judge grew by 10.5 percent, even though visiting judges were employed. By contrast, during the same time period, cases pending per elected intermediate appellate court justice fell by 32.4 percent, in part spurred by a rider and funding provided in the General Appropriations Act for the 2000–01 biennium to reduce a backlog of cases at the Houston and Dallas courts.

Visiting judge proponents argue that the use of visiting judges is less expensive than the creation of new trial courts. A new trial court costs the state $129,365 each year for the salary ($101,700) and benefits ($27,665) of each new district judge. Local costs for creating and maintaining a new district court vary across the state. Counties providing information for fiscal notes during the regular session in 2003 estimated that maintaining a new district court would range between $22,285 (Caldwell County) and $1.0 million (Collin County) per fiscal year.

In contrast, a visiting judge in a district court is compensated at 85 percent of the salary of a district judge. A visiting retired judge is given additional compensation of 100 percent of the county supplement paid an active district judge. According to the comptroller, most visiting judges serving are retired judges, whose average compensation is $98,547, or 76 percent of the salary and benefits of a district judge. Visiting judges serve in existing courtrooms provided by local government, which precludes additional local expenses for supporting staff and facility overhead.

Visiting judges serving appellate courts are compensated at 100 percent of the salary of an active appellate justice.

LEGISLATION RELATED TO VISITING JUDGE PAYMENTS

House Bill 3296, passed by the Seventy-seventh Legislature, 2001, authorized payments to retired statutory county judges serving as visiting judges in county courts. An estimated $2.9 million was spent for this purpose in the 2002–03 biennium. The Seventy-eighth Legislature, Regular Session, 2003, amended the statute to revoke this Government Code provision in House Bill 3306 due to budget shortfalls. Excluding these one-time 2002–03 payments from the total $18.2 million expended for visiting judges in the judicial regions results in a reduction of 56 percent between 2002–03 expenditures and 2004–05 appropriations (see Figure 4). Additionally, House Bill 3306 provided that visiting judges serving for a half day or less are compensated at rates equal to one-half the amount the judge would

FIGURE 2
PRESIDING JUDGES AS OF SEPTEMBER 1, 2004

FIRST
John Ovard
133 N. Industrial Blvd.
Auxiliary Court 9, 5th Floor
Dallas 75207
214/653-2943

SECOND
Olen Underwood
301 North Main, 2nd Floor
Conroe 77301-5742
936/538-8176

THIRD
B. B. Schraub
County Courthouse
101 E. Court Street, Rm. 302
Seguin 78155-5779
830/379-8556

FOURTH
David Peeples
100 Dolorosa, 5th Floor
San Antonio 78205
210/335-2132

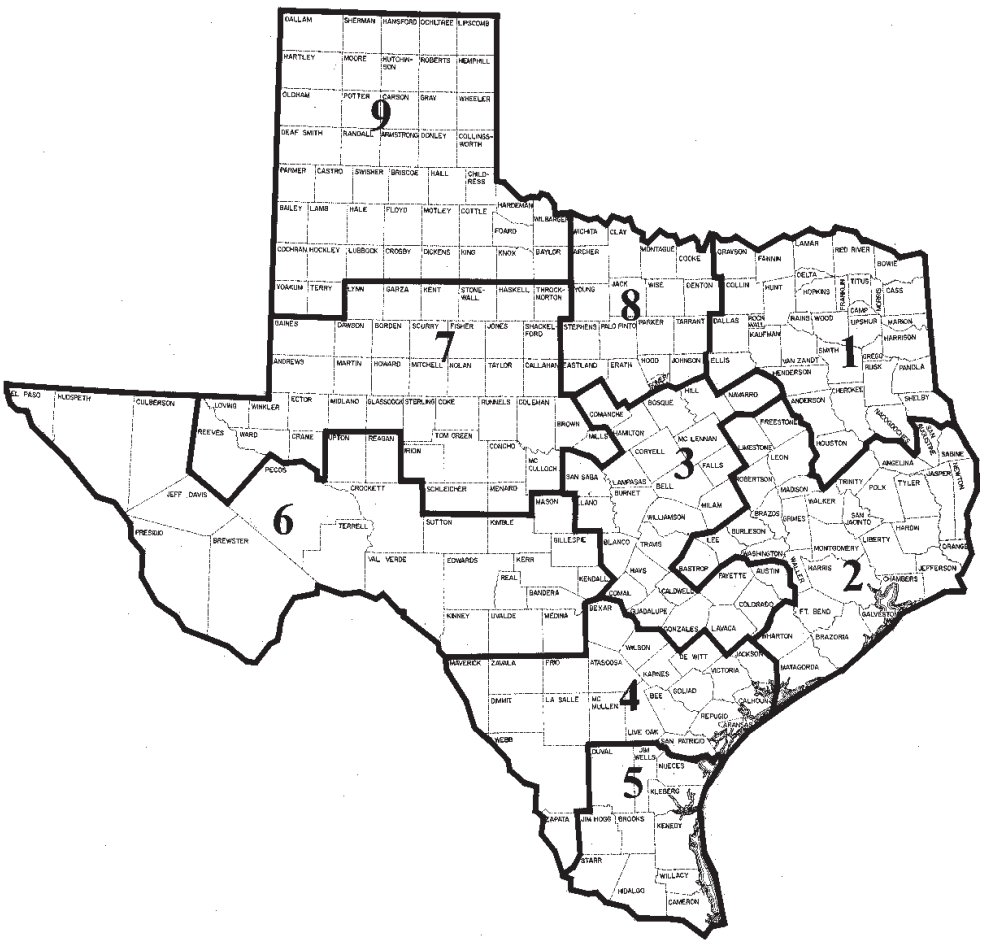
FIFTH
Darrell Hester
974 E. Harrison, 4th Floor
Brownsville 78520-7198
956/574-8160

SIXTH
Stephen B. Ables
700 Main
Kerrville 78028
830/792-2290

SEVENTH
Dean Rucker
200 W. Wall, Ste. 200
Midland 79701
432/688-4392

EIGHTH
Jeff Walker
401 W. Belknap, 5th Floor
Fort Worth 76196
817/884-1561

NINTH
Kelly G. Moore
500 W. Main, Rm 204W
Brownfield 79316
806/637-1329



Section 74.042, Texas Government Code, establishes nine administrative judicial regions in the state, with the presiding judge for each region designated by the governor.

The duties of a presiding judge include promulgating and implementing regional rules of administration, advising local judges on judicial management, recommending changes to the Supreme Court for the improvement of judicial administration, and acting for local administrative judges in their absence.

The presiding judge of each region convenes an annual conference of the district and statutory county court judges in the region to discuss the administration of justice and to adopt regional rules of administration. The presiding judge may assign active, senior, and former district judges and active, retired, and former statutory county court judges residing within the region to serve on a court as needed. A presiding judge may request that another presiding judge assign a judge from his region to sit in the region of the requesting judge.

The Chief Justice of the Supreme Court convenes an annual conference of the nine presiding judges to promote uniform administration of justice in the state. In addition, the Chief Justice is empowered to assign judges of one administrative regions for service in another region whenever such assignments are necessary for the prompt and efficient administration of justice.

SOURCE: Office of Court Administration.

FIGURE 3
SPECIALTY COURTS, 2002–03 BIENNIUM

First Administrative Judicial Region
- 2 drug courts (Dallas County)
- 1 child sex abuse court (Dallas County)
- 1 half-time child sex abuse court (Dallas County)
- 1 tax court and civil motion docket (Dallas County, 1.5 days per week for tax cases, 3.5 days per week for civil motions)
- 1 part-time protective order court (Dallas County, four days per week)
- 2 child protection courts to hear child abuse and neglect cases in rural areas

Second Administrative Judicial Region
- 2 criminal impact dockets to hear overflow criminal cases (Harris County)
- 1 drug court (Jefferson County)
- 1 family impact court to hear overflow family law cases (Harris County)
- 3 child protection courts to hear child abuse and neglect cases in rural areas
- 1 sexually violent predator civil commitment docket (Montgomery County)
- 1 part-time tax court (Montgomery County, approximately once a month)
- 1 part-time forfeiture and seizure court (Harris County, approximately once a month)
- 1 part-time Code of Criminal Procedure Sec. 11.07 writ dockets (various counties, as needed)
- 1 part-time probable cause docket (various counties, as needed)

Third Administrative Judicial Region
- 1 criminal impact court to assist with cases involving jailed defendants awaiting trials (Travis County)

Fourth Administrative Judicial Region
- 1 criminal impact court to assist the courts with criminal caseload (Bexar County)
- 1 jail court that hears statutory county court criminal cases, primarily pleas (Bexar County)
- 1 part-time drug court (Webb County, approximately two weeks per month)

Fifth Administrative Judicial Region
- 2 auxiliary courts to assist with heavy criminal caseloads (Hidalgo County)
- 1 jail court to assist with heavy criminal caseload (Nueces County)
- 1 jail/magistrate court to assist with heavy criminal caseload and magistrate duties (Nueces County)

Sixth Administrative Judicial Region
- 1 criminal impact court, primarily drug cases prosecuted by the county drug task force (El Paso County)
- 1 half-time tax court (El Paso County)

Eighth Administrative Judicial Region
- 1 full-time auxiliary court to assist the courts with criminal caseload (Tarrant County)

SOURCE: Office of Court Administration.

have been paid for a full day. In fiscal years prior to 2004, visiting judges serving a half day or less were entitled to a full day's pay. It is estimated that over the 2004–05 biennium this provision will save $0.9 million in visiting judge costs.

2004–05 GENERAL APPROPRIATIONS ACT RIDERS

The 2004–05 General Appropriations Act also includes four riders relating to visiting judge assignments. The Judiciary Section, Comptroller's Department bill pattern includes Rider 7:

> **Visiting Judges.** The appropriations made above to the Judiciary Section, Comptroller's Department for the use of visiting judges are determined on the assumption that each appellate judge or justice and each district judge will receive an average of three weeks annual leave and three days sick leave. Out of the amounts appropriated above for visiting judges in the nine administrative judicial regions, no less than $ 39,000 for the biennium has been provided for the purpose of visiting judge payments in cases for civil commitment of sexually violent predators. Additionally, out of the amounts appropriated above for visiting judges in the nine administrative judicial regions, no less than $1,266,261 for the biennium has been provided for the purpose of visiting judge payments in multi-district civil cases, capital cases, specialty criminal, civil, and family law cases, and other specialty cases as determined by the presiding judges of the nine administrative judicial regions.

The rider states that, except for specialty courts or cases, visiting judge funds should be used to provide personal leave time for elected, active judges. Concern that funding cuts would have a greater effect on caseloads in district courts than in appellate courts resulted in 2004–05 appropriations somewhat different than the leave time assumptions. The 2004–05 appropriation for visiting judge funds serving district courts totals $6.7 million, which exceeds estimated leave time by $1.3 million. In contrast, in 2004–05, intermediate appellate court justices have $0.6 million available to pay visiting judges, which is half of the $1.2 million in estimated leave time needed to substitute for the absence of active judges. Funding for visiting judges serving in appellate courts decreased by 84 percent between 2002–03 expenditures and 2004–05 appropriations. Appellate justices are seeking $0.8 million for the 2006–07 biennium, which would provide for two weeks annual leave, one week for continuing legal education, and one week of sick leave.

Rider 8, Transfers for Visiting Judges, allows the Judiciary Section to transfer funds as needed between amounts

FIGURE 4
COURT CASELOAD DATA AND VISITING JUDGE FUNDING LEVELS
FISCAL YEARS 1998–2005

	FISCAL YEARS							
	1998	1999	2000	2001	2002	2003	2004	2005
DISTRICT COURTS								
Number of District Courts	396	396	409	418	418	418	420	425
Visiting Judge Expenditures	8,174,186	8,307,109	6,744,306	8,096,417	7,582,061	7,716,486	3,362,349	3,362,349
Annual Percentage Change	4.0	1.6	(18.8)	20.0	(6.4)	1.5	(56.4)	-
Cases Added	696,314	723,837	746,370	754,081	789,024	841,794	-	-
Annual Percentage Change	(2.9)	4.0	3.1	1.0	4.6	6.7	-	-
Cases Disposed	698,239	698,700	725,183	739,027	743,342	792,254	-	-
Annual Percentage Change	(3.2)	0.1	3.8	1.9	0.6	6.6	-	-
Cases Pending (as of 8/31)	744,234	766,437	781,312	794,936	824,384	868,035	-	-
Annual Percentage Change	(0.2)	3.0	1.9	1.7	3.7	5.3	-	-
Cases Pending per Elected Judge	1,879	1,935	1,910	1,902	1,972	2,077	-	-
Annual Percentage Change	(0.4)	3.0	(1.3)	(0.4)	3.7	5.3	-	-
COURTS OF APPEALS (Intermediate Appellate Courts)								
Number of Courts of Appeals	14	14	14	14	14	14	14	14
Visiting Judge Expenditures	1,960,138	2,009,732	1,991,033	2,209,500	1,709,500	1,964,500	298,963	298,963
Annual Percentage Change	33.7	2.5	(0.9)	11.0	(22.6)	14.9	(84.8)	-
Cases Added	12,502	12,291	12,343	11,696	11,984	12,341	-	-
Annual Percentage Change	8.5	(1.7)	0.4	(5.2)	2.5	3.0	-	-
Cases Disposed	11,736	13,150	13,429	13,130	12,399	12,420	-	-
Annual Percentage Change	4.3	12.0	2.1	(2.2)	(5.6)	0.2	-	-
Cases Pending (as of 8/31)	11,575	10,723	9,690	8,294	7,977	7,876	-	-
Annual Percentage Change	7.1	(7.4)	(9.6)	(14.4)	(3.8)	(1.3)	-	-
Cases Pending per Elected Justice	145	134	121	104	100	98	-	-
Annual Percentage Change	7.4	(7.4)	(9.6)	(14.4)	(3.8)	(1.3)	-	-
TOTAL, Visiting Judge Expenditures for District and Appellate Courts	10,134,324	10,316,841	8,735,339	10,305,917	9,291,561	9,680,986	3,661,312	3,661,312
Annual Percentage Change	8.7	1.8	(15.3)	18.0	(9.8)	4.2	(62.2)	

NOTES: (1) Expenditure data for fiscal years 1998–2001 was extrapolated from Strategy A.1.1, District Judge Salaries, which prior to fiscal year 2002 included visiting judge payments for former judges. Estimates assume no vacancies in district judge positions. (2) Expenditures of $2.9 million authorized under HB 3296 for retired statutory county judges serving in county-level courts was excluded from the 2002–03 biennium. (3) Docket adjustments between pending cases reported at the end of the fiscal year (8/31), and pending cases reported at the beginning of the fiscal year (9/1) are not shown on this chart. Docket adjustments between fiscal year 1998 and fiscal year 2003 varied between -2.0 and 0.4 percent per year.
SOURCES: Legislative Budget Board; Comptroller of Public Accounts; Office of Court Administration.

appropriated for former and retired judges serving in trial courts upon the request of the presiding judges of the nine administrative judicial regions. Likewise, the rider allows the Judiciary Section to transfer funds as needed between amounts appropriated for former and retired judges serving in appellate courts upon the request of the Chief Justice of the Supreme Court.

The following two riders in the Office of Court Administration (OCA) bill pattern also relate to visiting judges:

Rider 9, Assistance to Presiding Judges of the Nine Administrative Judicial Regions, directs OCA to assist the presiding judges with seeking other funding sources for the visiting judge program.

Rider 10, Interagency Contract for Assigned Judges for Foster Care Courts, provides that OCA may reimburse the Judiciary Section, Comptroller's Department for visiting judges serving in Foster Care courts.

In fiscal year 2004, OCA provided the comptroller with a $125,000 interagency contract under Rider 10. In fiscal year

2005, OCA was reimbursed this same amount in interagency contracts from the Department of Family and Protective Services from federal funding for State Court Improvement projects. Finally, federal funding through the Criminal Justice Division of the Governor's Office for criminal-impact courts was considered a possible funding source during the legislative session. However, OCA reports that the agency has been unable to secure this type of funding for visiting judges.

Presiding judges and others in the administrative judicial regions have expressed concern that funding reductions for visiting judges will cause a backlog of cases. For fiscal year 2004, data from the Texas Jail Standards Commission indicate an increase in the pretrial felony population of 6 percent and an increase in the pretrial misdemeanor population of 10 percent. However, the direct cause of the increase in pretrial populations is difficult to prove and is likely the result of a combination of factors.

PREVIOUS REVIEWS OF THE VISITING JUDGE PROGRAM

The Seventy-seventh Legislature, 2001, recently considered the issue of visiting judge use at the trial court level. Rider 12 in the General Appropriations Act for the 2002–03 biennium directed the Texas Judicial Council to report on visiting judge use and criteria for determining the need to create additional district courts.

The resulting report, issued in October 2002, made several recommendations intended to assess the need for visiting judges and new district courts, including the following:

(1) The legislature should address judicial redistricting and consider removing overlapping geographic judicial districts;

(2) The legislature should address concurrent subject matter jurisdiction between district courts and county-level courts; and,

(3) The legislature should appropriate funding for a "judicial workload assessment" (weighted caseload study) for district courts.

In November 2002, the Senate Committee on Jurisprudence submitted an interim report to the Seventy-eighth Legislature, which included recommendations on assessing judicial workload, judicial redistricting, and the cost-effectiveness of the visiting judge program. The recommendations included the following:

(1) The legislature should not adopt new judicial districts until there has been an accurate assessment of judicial workload;

(2) The legislature should require the OCA to report additional data on visiting judge use;

(3) The senate should adopt rules for creating new district courts; and

(4) The legislature should require OCA to submit a report on jurisdictional conflicts between courts.

The recommendations in the two reports differ significantly in one key aspect. The Texas Judicial Council would have the legislature address judicial redistricting before conducting additional studies of judicial workload; however, the Senate Committee on Jurisprudence would have the OCA conduct additional statewide assessments of judicial workload before asking the legislature to address judicial redistricting. In summer of 2003, the presiding judges of the nine administrative judicial regions adopted a form to report reasons for visiting judge use to OCA.

RESIDENTIAL CONTRACT CARE AT THE TEXAS YOUTH COMMISSION

This report provides an analysis of residential contract care at the Texas Youth Commission. The agency's facility expansions to address population increases are described, and a general overview of residential contract-care services is provided. A cost estimate is developed for residential contract care funding for fiscal years 2006 and 2007, and cost savings relative to fiscal years 2004 and 2005 are calculated.

SIGNIFICANT FINDINGS

- Texas Youth Commission facility expansions have provided more bed space to address increased youth residential populations between 1995 and 2000. Institutional facility expansions should be completed in fiscal year 2005.
- Contract-care facilities provide bed space in a timely manner when youth populations increase over institutional bed capacity and provide specialized placement options for special-need populations within the Texas Youth Commission.

SIGNIFICANT CONCERN

- To address state budget constraints and recent population decreases, contract-care funding can be reduced in fiscal years 2006 and 2007 while still providing some secure and non-secure specialized program beds.

RECOMMENDATIONS

- **Recommendation 1:** In the 2006–07 General Appropriations Bill, reduce contract-care appropriations to fund an average of 232 beds for fiscal year 2006 and 300 beds for fiscal year 2007.
- **Recommendation 2:** Include in the 2006–07 General Appropriations Bill a rider that requires the Texas Youth Commission to fully utilize its institutional capacity before contract-care beds are utilized.

COMMENTS

Human Resources Code, Section 61.075, authorizes the Texas Youth Commission (TYC) to order a youth's confinement under conditions best designed for the youth's welfare and the interests of the public. To comply with this statutory requirement, TYC currently uses 14 institutional facilities, 9 halfway houses, and 23 contract-care facilities to house residential youth populations. These facilities provide direct supervision, housing, food, clothing, healthcare, security, education, and correctional treatment of the youths. TYC's residential bed capacity is made up of two types: state-operated beds (institutional facilities and halfway houses) and contract-care beds.

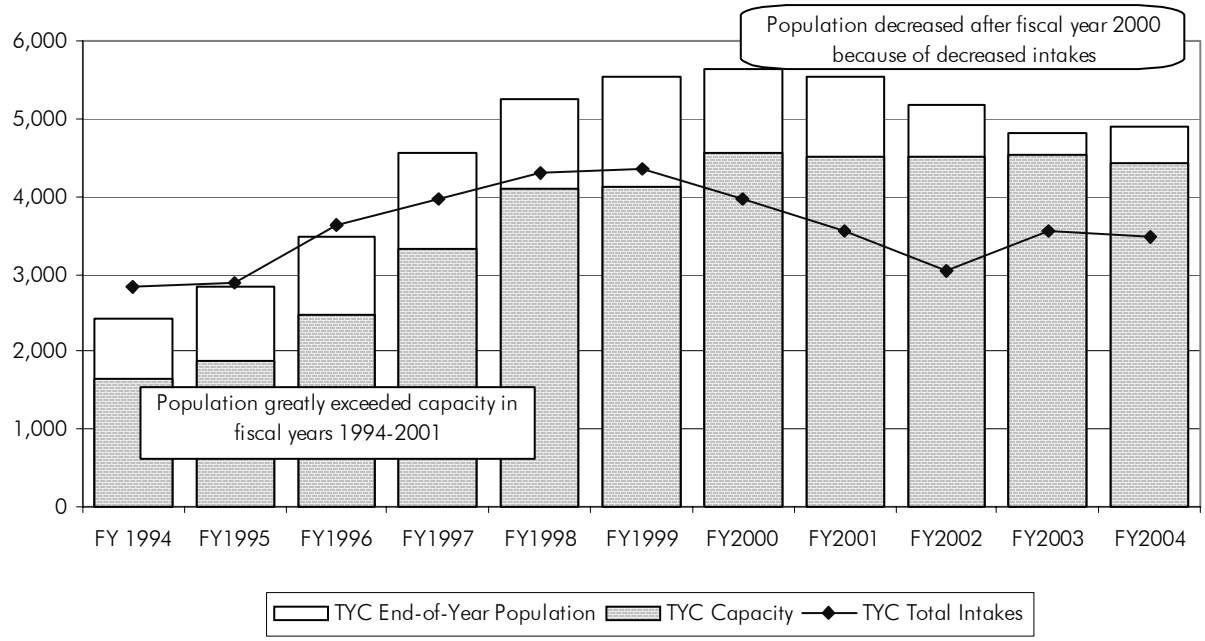
INCREASES IN TYC RESIDENTIAL POPULATIONS

The Youth Commission's activities and functions are directly affected by youth populations in the juvenile justice system. In fiscal year 1994, the juvenile justice system started to experience large population increases. Figure 1 shows TYC youth end-of-year residential populations versus state-owned bed capacity from fiscal years 1994 to 2004. In 1995, TYC's internal capacity was 1,880 beds, with private contractors providing an additional 943 beds. TYC end-of-year populations increased from 3,467 in fiscal year 1996 to 4,561 in fiscal year 1997, an increase of 32 percent in one year. Research by the Criminal Justice Policy Council (CJPC) showed increased populations were caused by a rise in new commitments to TYC. In reaction to the increased populations, the state began a series of facility expansions. By September 1998, CJPC projected a population of over 6,300 youths in TYC during fiscal year 2004.

During fiscal year 2000, TYC residential populations peaked. Since fiscal year 2000, fewer youths were sentenced to the juvenile justice system and there was a decrease in youth crime. During the Seventy-fifth Legislative Session, 1997, many modifications were made to the juvenile justice system, including the construction of local juvenile residential centers and increased community program services. In addition, tougher punishment guidelines were established.

The two factors that contribute the most to the overall TYC population are the number of intakes and lengths-of-stay in residential facilities. The total number of intakes includes new commitments, recommitments, parole revocations, and youths returned to residential programs by TYC. Length-of-stay is the amount of time a youth is required to participate in TYC residential programs. Before fiscal year 2000, intakes were increasing, and the length-of-stay decreased. After fiscal year 2000, there was a decrease in intakes and an increase in the length-of-stay. In fiscal year 2000 the average length-of-stay was 14.8 months, and in fiscal year 2004 the average length-of-stay was 17.4 months.

FIGURE 1
TEXAS YOUTH COMMISSION RESIDENTIAL POPULATION, CAPACITY, AND INTAKES



SOURCE: Texas Youth Commission.

FACILITY EXPANSIONS

Since 1995, six facilities have been added to the TYC system to accommodate population increases. This was accomplished in three ways: new construction, donations from the public, and the transfer of facilities from other state agencies. In 1995, the Al Price State Juvenile Correctional Facility was under construction, and the Sheffield Boot Camp was given to TYC by the Iraan School District. In 1995 and 1996, the Marlin Orientation and Assessment Unit and the San Saba State School were transferred from the Department of Criminal Justice (TDCJ). In 1997, the J.W. Hamilton State School was transferred from TDCJ, and the Victory Field Correctional Academy was transferred from the Department of Mental Health and Mental Retardation (now part of the Department of State Health Services). Because of population increases in TDCJ, the Hamilton facility was returned to that agency in 2003. In 1998, an expansion of TYC's Sheffield Boot Camp was initiated. Finally in 2000, the McLennan County State Juvenile Correctional Facility was under construction. Figure 2 details all TYC facilities including the 1995 facility expansions, when the facilities opened, and current bed capacity.

Facility expansion is a lengthy process (usually four to six years) requiring bond approval, construction, and operational planning. By the end of fiscal year 2005, all of the facility expansions should be operational. At the beginning of fiscal year 2006, TYC residential bed capacity (institutional and halfway houses) will be 4,576. The 1995 bed expansions totaled over $95 million and added 2,240 beds to TYC institutional bed capacity. The construction completed during the last 10 years has increased TYC's internal capacity to safely house youths, and if fully utilized, these expansions can limit the state's operational costs by reducing the need for contract-care beds.

CONTRACT-CARE FACILITIES

At the Marlin Orientation and Assessment Unit (MOAU), all youths are assessed for medical, educational, and specialized treatment needs. Diagnostic tests are performed and risk assessments are completed to determine which youths are at the greatest risk of recidivism and those who require participation in special programs. After assessment, the Centralized Placement Unit (CPU) reviews each youth according to classification, treatment needs, risk levels, gender, age, and special needs. CPU then reviews the priority ratings for the youths and places them in the program that

FIGURE 2
TEXAS YOUTH COMMISSION SECURE FACILITIES BY OPENING DATE

FACILITY	OPENED	BED CAPACITY
Corsicana Residential Treatment Center	1887	198
Gainesville State School	1916	340
Crockett State School	1951	264
West Texas State School (Pyote)	1967	240
Ron Jackson State Juvenile Correctional Complex Unit I (formerly Brownwood State School Unit I)	1969	348
Ron Jackson State Juvenile Correctional Complex Unit II (formerly Brownwood State School Unit II)	1969	112
Giddings State School	1972	376
Evins Regional Juvenile Facility (Edinburg)	1990	240
Al Price State Juvenile Correctional Facility (Beaumont – new construction)	1995	312
Marlin Orientation and Assessment Unit	1995	436
Sheffield Boot Camp (transferred from Iraan School District)	1995	128
San Saba State School (transferred from TDCJ)	1996	356
Victory Field Correctional Academy (Vernon)	1997	336
McLennan County State Juvenile Correctional Facility (Mart – new construction)	2000	672
Total TYC Institutional Capacity		4358

SOURCE: Texas Youth Commission.

they are required to complete (institutional or contract care). The average length-of-stay in a contract-care facility is six months. In fiscal year 2004, the average daily population of contract care was 608 youths, which is 12.5 percent of TYC's residential average daily population of 4,883.

Human Resources Code, Section 61.052, establishes a program for monitoring contracts for residential services at TYC. Contract-care facilities are a subcategory of TYC residential bed capacity that provide community-based programs in conjunction with governmental entities, such as counties, or private businesses. Currently, TYC has contracts with 23 separate entities comprising 14 facilities, 7 foster care homes, and 2 independent living programs. Figure 3 shows TYC's contract-care program locations, their security status, and the average daily populations of each facility as budgeted for fiscal year 2005. Contract-care facilities provide services to youths with specialized needs, divert low-risk youth from TYC institutions, and maintain additional bed capacity when populations increase unexpectedly.

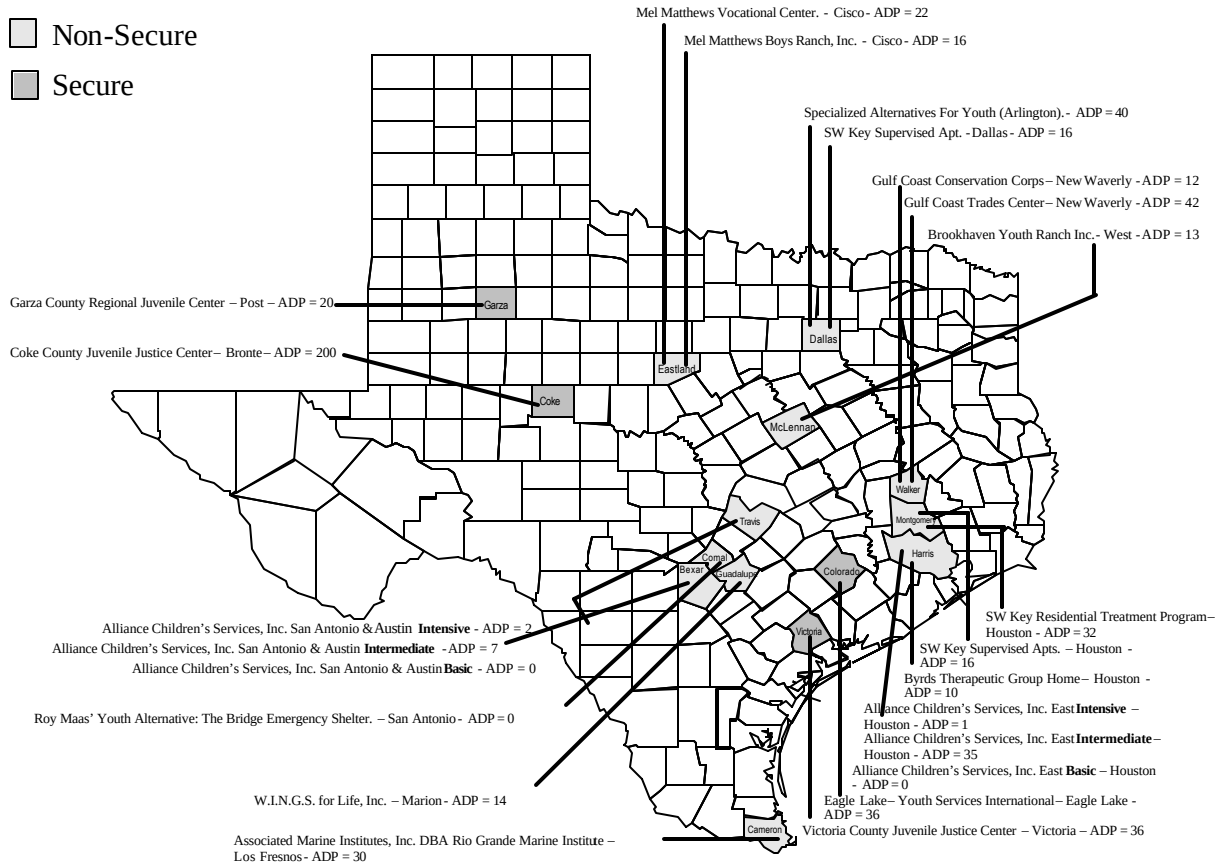
Contract-care facilities have different contract requirements depending on the services provided. Several contract programs are county-owned, and most of their youth residential population comes from TYC. Some examples of the specialized programs include the mother-baby program, pregnant girls, low-risk offenders, and youths without homes. Contract-care beds provide levels of security and specialized treatment services specific to the target population that TYC indicates it cannot provide in its own facilities.

REDUCTION OF CONTRACT-CARE EXPENDITURES IN FISCAL YEARS 2006 AND 2007

TYC facility expansions over the past 10 years were in response to increasing populations and limited internal bed capacity. The goal of the facility expansions was to increase internal capacity. Contract-care funding in fiscal years 2004 and 2005 is more than projected population demands in fiscal years 2006 and 2007. To address state budget constraints and youth residential population decreases, Recommendation 1 would reduce contract-care funding for fiscal years 2006 and 2007 while still providing some specialized program beds.

With facility expansions completed in fiscal year 2005, TYC's state-operated bed capacity (institutional and halfway houses) will be 4,576. Legislative Budget Board population projections from June 2004 indicate a need for an average of 4,808 beds during fiscal year 2006 and 4,876 beds in fiscal year 2007. Comparing the population projections to TYC's bed capacity, an average of 232 beds in fiscal year 2006 and 300 beds in fiscal year 2007 are needed in contract care to house the projected youth population that exceeds state-operated bed capacity.

FIGURE 3
TEXAS YOUTH COMMISSION FACILITIES
BUDGETED FISCAL YEAR 2005



NOTE: ADP = Average Daily Population.
SOURCE: Texas Youth Commission.

These reductions could result in a decrease of federal foster-care funds because of the loss of eligible foster-care beds in contract care. If TYC made reductions to contract-care beds not funded by foster-care dollars, the current estimate of federal foster-care funding would not change. Reductions in contract-care capacity would limit the types of treatment services that are available to TYC youth. Most of the remaining contract-care beds would be non-secure beds for specialized programs like the mother-baby program and transitional movement back into the community. Some of the services presently provided by contract care could be provided in TYC institutions. The variety of treatment services overall would be limited, but TYC would continue to have some specialized treatment facilities for youth requiring them.

UTILIZATION OF TYC'S INSTITUTIONAL CAPACITY

To implement Recommendation 2 and ensure the maximum utilization of available state residential capacity, the following rider should be included in the 2006–07 General Appropriations Bill:

> **Utilization of Existing Youth Commission Facilities.** It is the intent of the Legislature for the Youth Commission (TYC) to utilize existing TYC facilities to the maximum extent possible without overcrowding. Appropriations included above in Strategy A.1.3, Contracted Capacity, can be used for the purpose of contracting for additional capacity if the agency's residential population is over 100 percent capacity and agreements can be reached that are beneficial to the State.

FISCAL IMPACT OF THE RECOMMENDATIONS

As depicted in Figure 4, adoption of Recommendations 1 and 2 would produce an estimated savings in General Revenue Funds for the 2006–07 biennium totalling $24.2 million.

The Texas Youth Commission states that the contract cost per youth per day will increase during fiscal years 2006 and 2007 because the most severe cases will continue to receive contract-care treatment. Because of this, the estimate for the cost per youth per day for contract care is estimated to be $98.48 in General Revenue Funds in fiscal years 2006 and 2007. Applying this cost per day to the contract-care bed capacity and the days in the year yields an estimate of $8.3 million in General Revenue Funds for an average of 232 beds in fiscal year 2006 and $10.8 million in General Revenue Funds for an average of 300 beds in fiscal year 2007. Assuming that TYC will still be able to utilize $1.7 million in Federal Funds for contracted capacity each fiscal year, total funding in the contract-care strategy would equal $10.0 million for fiscal year 2006 and $12.5 million for fiscal year 2007.

FIGURE 4
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$13,535,887
2007	$10,622,142
2008	$0
2009	$0
2010	$0

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill reduces the Texas Youth Commission appropriations for contract care by $24.2 million from the 2004–05 appropriated amounts, and includes a rider requiring the agency to fully utilize its institutional capacity before contract-care beds are utilized.

FACILITY REPAIR AND REHABILITATION COSTS AT THE TEXAS YOUTH COMMISSION

This report provides information on facility repair and rehabilitation costs at the Texas Youth Commission. Facility expansions to address population increases are reviewed. The current status of facility repair and rehabilitation and Texas Youth Commission estimates for future facility repair and rehabilitation are outlined. The Texas Youth Commission future estimates are compared to a standard method of estimating maintenance and repair costs. Finally, the use of facilities management software for cost-effective facility repair and rehabilitation decisions is discussed.

SIGNIFICANT FINDINGS

- Texas Youth Commission facility expansions have provided 2,696 new institutional beds to address increased youth residential populations since 1995.
- Facilities repair and rehabilitation appropriations have ranged from $45.7 million in All Funds during fiscal years 1994–99 to $13.3 million during fiscal years 2000–05. Over the same time period, the agency's residential bed capacity has increased from 1,880 to 4,576, a 143 percent increase.
- Now that new facility construction is complete, the Texas Youth Commission plans to request $30 million in All Funds over the next six years for facilities repair and rehabilitation. The agency states that repair and rehabilitation needs have been deferred during facility expansions and new construction.
- Facilities management software could help the Texas Youth Commission make cost-effective facility repair and rehabilitation decisions. Until condition assessments are completed for the Texas Youth Commission facilities, the cost effectiveness of facility repair and rehabilitation cannot be determined.

COMMENTS

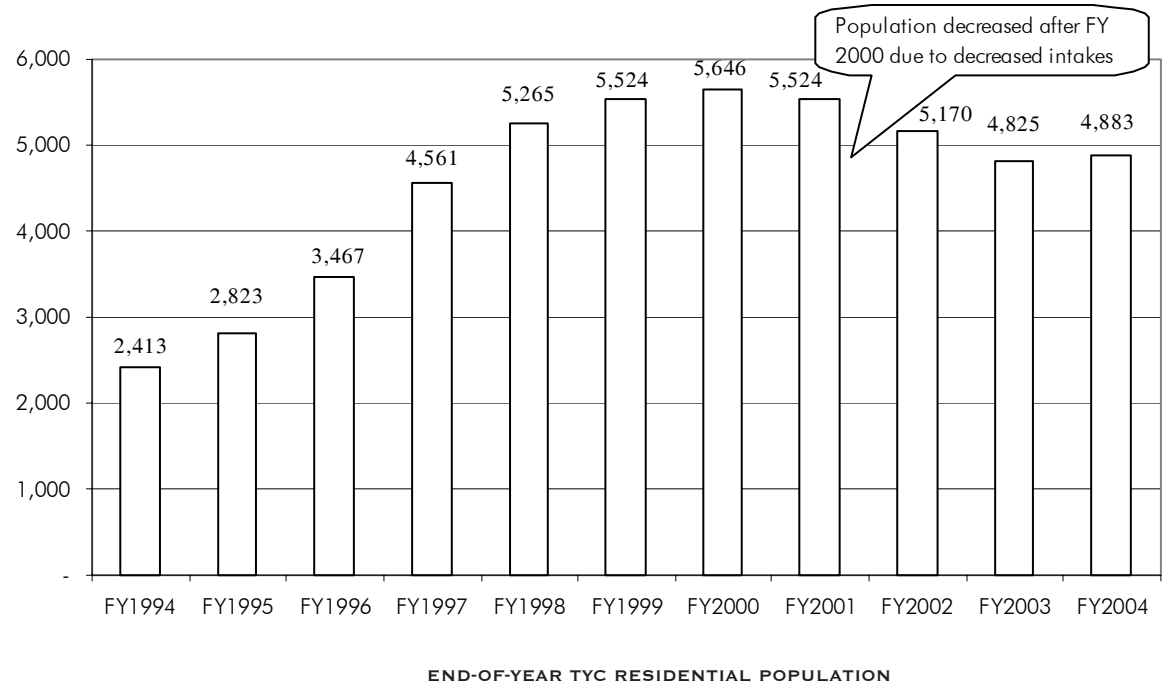
Human Resources Code, Section 61.075, authorizes the Texas Youth Commission (TYC) to order a youth's confinement under conditions designed for the youth's welfare and the interests of the public. To comply with this statutory requirement, the agency currently uses 14 institutional facilities, 9 halfway houses, and 23 contract care facilities to house the youth residential populations. These residential programs provide direct supervision, housing, food, clothing, healthcare, security, education, and correctional treatment for the youths.

YOUTH RESIDENTIAL POPULATION INCREASES AND FACILITY EXPANSIONS SINCE 1994

The agency's activities and functions are directly affected by populations in the juvenile justice system. In fiscal year 1994, the juvenile justice system started to experience large population increases. Figure 1 shows total TYC end-of-year residential populations from fiscal years 1994 to 2004. In 1995, TYC's internal capacity was 1,880 beds, with private contractors providing an additional 943 beds. TYC end-of-year populations increased from 3,467 in fiscal year 1996 to 4,561 in fiscal year 1997, an increase of 32 percent in one year. Research by the Criminal Justice Policy Council (CJPC) showed increased populations were caused by a rise in new commitments to TYC. To address the projected population increases, TYC began to expand its residential capacity. In September 1998, CJPC projected that over 6,300 youths would be confined in TYC residential facilities by fiscal year 2004.

Since 1995, six facilities have been added to the TYC system to accommodate population increases. This was accomplished in three ways: new construction, donations from the public, and the transfer of facilities from other state agencies. In 1995, the Al Price State Juvenile Correctional Facility was constructed, and the Sheffield Boot Camp was given to TYC by the Iraan School District. In 1995 and 1996, the Marlin Orientation and Assessment Unit and the San Saba State School were transferred from the Texas Department of Criminal Justice (TDCJ). In 1997, the J.W. Hamilton State School was transferred from TDCJ, and the Victory Field Correctional Academy was transferred from the Department of Mental Health and Mental Retardation (now part of the Department of State Health Services). Because of population increases in TDCJ, the Hamilton facility was returned to that agency in 2003. In 1998, an expansion of the TYC Sheffield Boot Camp was initiated. Finally in 2000, the McLennan County State Juvenile Correctional Facility was under construction. Figure 2 details all TYC facilities including the 1995 facility expansions, when the facilities opened, and current bed capacity. Figure 3 shows the distribution of TYC facilities throughout the state.

FIGURE 1
TRENDS IN TEXAS YOUTH COMMISSION RESIDENTIAL POPULATIONS



SOURCE: Texas Youth Commission.

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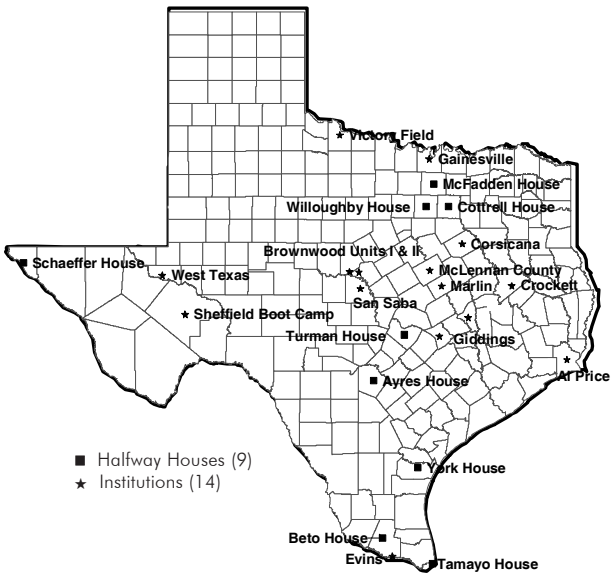
Total TYC Capacity		4358

SOURCE: Texas Youth Commission.

FIGURE 3
TYC FACILITY LOCATIONS



SOURCE: Texas Youth Commission.

By the end of fiscal year 2005, all of the facility expansions should be operational. At the beginning of fiscal year 2006, TYC residential bed capacity (institutional and halfway houses) will be 4,576. The bed expansions since 1995 cost over $95 million and added 2,696 beds to TYC's institutional bed capacity. The construction completed during the last 10 years has added internal capacity to house youths safely and limited the need for contract-care beds. TYC residential population projections from fiscal years 2006 through 2009 show modest population increases, and no additional facility expansions are planned at this time.

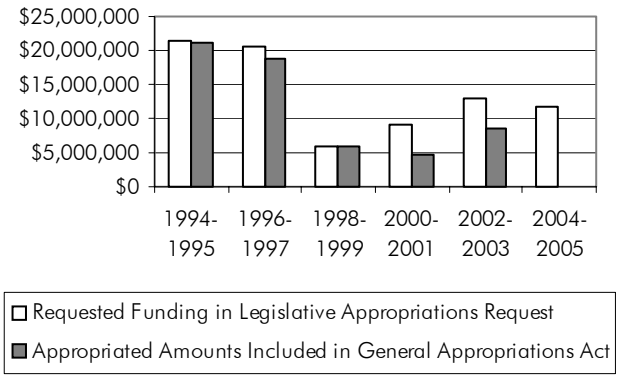
TYC FACILITY REPAIR AND REHABILITATION

In addition to the construction of new facilities, TYC's other major facilities' capital expenditures are for repair and rehabilitation of existing facilities. Human Resources Code, Section 61.048 gives TYC the authority to design, construct, equip, furnish, and maintain building and improvements at facilities under their jurisdiction. Repairs and rehabilitations are general repairs, replacements, improvements, and upgrades to existing buildings to maintain current building codes, standards, and operational levels. All 14 of TYC's facilities are used 24 hours a day, 7 days a week, 365 days per year. Seven of the 14 TYC facilities have buildings that are over 25 years old. Because of the constant use of buildings on each campus, repair and rehabilitation of existing facilities are important parts of TYC's budget.

The repair and rehabilitation of existing facilities can be divided into three categories: (1) utility, road, and site work, (2) roof replacements, and (3) rehabilitation of buildings and systems. Utility, road, and site work includes items such as natural gas, sewer, and water distribution systems, electrical work, drainage systems, and repairs to roads, parking lots, and sidewalks. Roof replacements include work to roofs, air vents, and gutters. Rehabilitation of buildings and systems includes structural and safety renovations, fire alarms, and security systems.

TYC received $55.0 million in All Funds for facility expansions from fiscal year 1994 to 1999. During that time, the agency requested $47.9 million for facility repair and rehabilitation costs and received $45.7 million. During the 2000–01 biennium, the agency received an additional $40.0 million for new construction and requested $9.1 million for repair and rehabilitation costs. They received all the requested funds for the new construction and were appropriated $4.8 million for repair and rehabilitation. During the 2002–03 biennium, TYC asked for $12.8 million for repair and rehabilitation costs, and was appropriated $8.5 million. In fiscal years 2004 and 2005, the agency requested $11.7 million for repair and rehabilitation and received no new appropriations for repair and rehabilitation costs. The appropriated amounts listed above do not include unexpended balances from prior biennia. Figure 4 compares TYC's requested repair and rehabilitation funding to appropriated funding from fiscal year 1994 to fiscal year 2005.

FIGURE 4
TEXAS YOUTH COMMISSION REQUESTED AND APPROPRIATED REPAIR AND REHABILITATION FUNDING



NOTE: Excludes unexpended balances from prior biennia.
SOURCE: Texas Youth Commission.

TYC FUTURE ESTIMATES FOR FACILITY REPAIR AND REHABILITATION

TYC plans to request more funding for repair and rehabilitation of facilities than in past years. Increases in youth residential populations and budget constraints have focused past efforts on the construction of new facilities and placed less emphasis on building repair and rehabilitation. TYC develops its facilities construction and repair and rehabilitation needs under a six-year capital improvement plan. Funding for repair and rehabilitation for the last six-year capital improvement plan (fiscal years 2000–2005) totaled $13.3 million. Funding requests for the next six-year capital improvement plan (fiscal years 2006–2011) are estimated at $30 million. TYC's fiscal year 2006–07 legislative appropriations request includes $9.9 million for the repair and rehabilitation of various facilities. This request includes $2.5 million in utility, road and site work, $2.8 million in roof repairs and replacements, and $4.6 million for rehabilitation of buildings and systems.

COMPARISON OF MAINTENANCE AND REPAIR COSTS

As a comparison, TYC's facilities repair and rehabilitation requests are compared to the Federal Bureau of Prisons' facility repair and rehabilitation methodology and the Texas Department of Criminal Justice's facilities repair and rehabilitation costs. Though the missions of the Federal Bureau of Prisons and the Texas Department of Criminal Justice are different from TYC, these adult correctional agencies also maintain an inventory of secure facilities.

The Federal Bureau of Prisons requests an annual appropriation for maintenance and repairs based on the replacement value of its facilities. In 1990, the Federal Building Research Board's Committee on Advanced Maintenance Concepts for Buildings prepared a report on ownership-maintenance and repairs of public buildings. This report recommended 2 percent to 4 percent of the aggregate current replacement value of those facilities (excluding land and major associated infrastructure) as appropriate budget allocations for routine maintenance. The report also stated that in the absence of specific information on which to base the maintenance and repair budget, this funding level should be used as an absolute minimum. Where neglect of maintenance has caused a backlog of needed repairs to accumulate, spending must exceed this minimum level until the backlog has been eliminated.

TYC estimates the aggregate current replacement value of its residential buildings and facilities at $370 million. Using the Federal Bureau of Prisons' method of estimating maintenance and repair costs, TYC's annual maintenance and repair costs would be between $7 million and $15 million. TYC's six-year capital improvement plan totals $30 million, an average of $5 million per year. Overall, TYC's capital budget plan falls below the bureau's recommended method for estimating maintenance and repair costs.

Parallels exist between the Texas Department of Criminal Justice (TDCJ) and TYC with respect to spending on maintenance and repair of facilities. First, TDCJ and TYC both have facilities that are more than 25 years old. Both agencies have also completed a period in which they expanded their facilities and are now requesting increased funding for maintenance and repairs. TDCJ has valued its facilities at more than $4 billion and has over 50 million square feet in more than 3,200 buildings that vary in age and life span. Ranging from brick and mortar facilities to metal buildings, the anticipated life span of TDCJ facilities ranges from 20 to 50 years, depending on the type of unit, quality of construction, intensity of use, climate, and other factors. For the 2004–05 biennium, TDCJ has expended or budgeted $72 million on major repairs to prison units. Spending for the 2004–05 biennium is higher than spending for major repairs to prison units in any previous biennium. Using the Federal Bureau of Prison's methodology and the relative values of each agency's facilities, TDCJ's ratio of maintenance and repair costs to facility replacement value is at 0.9 percent for the 2004–05 biennium. TYC's requested funding for the 2006–07 biennium yields a ratio of 1.35 percent. Both agencies are under the Federal Bureau of Prison's recommendation of 2 percent to 4 percent of the facility replacement value for repair and rehabilitation costs.

FACILITY MANAGEMENT SOFTWARE

Some public agencies such as TDCJ and the Texas Department of State Health Services have recently started to use facilities planning and management software to manage facilities repair and rehabilitation. The software contains a relational database in which all baseline facilities information is entered: mechanical, structural, electrical, safety code compliance, Americans with Disability Act compliance, architectural finishes, site improvements, and relevant infrastructures. This information is used to create quantitative benchmarks that allow cost-effective decisions on maintenance and repair investments.

To define targets and create benchmarks, a Facility Condition Index (FCI) is used. The FCI is a standard measure of the relative condition of a building. The FCI is recommended by both the National Association of College Business Officers and the Association of University Facility Officers. It is calculated by assessing the total value of facility deficiencies divided by the current replacement value of the building. For example, if a building with a replacement value of $1 million has $100,000 of existing deficiencies, the FCI is $100,000/$1,000,000 or 0.10. The higher the cost of fixing the deficiencies of the facility, the

higher the FCI value. Analysis of the benchmarks allows users to run "what-if" scenarios regarding the condition of facilities and the amount of money spent on maintenance and repairs. TYC should use facility management software to determine the amount of funds necessary for existing facility repairs for the next 10 to 15 years, to calculate whether facilities are becoming cost prohibitive to operate and repair, and to prevent the temporary closing of units due to structural failings.

TYC's facilities have been valued at more than $370 million, and the amount of money spent on maintenance and repairs has been relatively small. The buildings and infrastructure that support TYC's daily activities are aging and face growing repair costs. Now that the construction of facilities has slowed, TYC is in a position to spend more time and effort on repairing and maintaining its existing facilities.

Condition assessments have not been completed on TYC's 14 facilities. Little is known about the condition of all of TYC's facilities. Until TYC completes condition assessments on all its facilities and integrates the assessment information into a facility management software system, many questions regarding the repair or replacement of aging youth facilities will remain unanswered.

AGRICULTURAL OPERATIONS AT THE TEXAS DEPARTMENT OF CRIMINAL JUSTICE

Prisons in Texas have existed for 150 years and agricultural operations have been a major part of the Texas prison system since its establishment. Prior to 1991, the Texas Department of Criminal Justice operated under a legislative mandate to be as self-sustaining as possible; this mandate was fulfilled largely by agricultural and livestock operations. However, as Texas' prison population grew, it became apparent that purchasing certain products outside the system would be more cost-effective than producing them in-house. Furthermore, as policies regarding the treatment and rehabilitation of prisoners have changed, inmates now spend more time in school and vocational training and less time working in the fields. Does this mean that the agency is moving more toward purchasing products from outside producers thus de-emphasizing agricultural and livestock activities? Are there products that the agency is able to produce at a cost savings to Texas taxpayers? Additionally, are there less tangible benefits from agricultural and livestock operations that should be considered in deciding the future of the agency's agricultural and livestock operations? In order to answer these questions, the following areas are examined: the agency's current agricultural and livestock production, reasons for and against the agency's involvement in agricultural and livestock production, and an analysis of other states that have eliminated agricultural operations.

SIGNIFICANT FINDINGS

- The Texas Department of Criminal Justice operates and manages 145,337 acres located in 46 counties. The agency's Agribusiness Division employs over 316 full-time employees and utilizes over 5,800 offenders on 50 different prison units. The fiscal year 2004 expenditures for the Agribusiness Division were nearly $41 million in General Revenue Funds.
- The Texas Department of Criminal Justice produces about 20 percent of the food that is consumed at agency facilities.
- The Texas Department of Criminal Justice provides produce and human resources to maintain Texas food bank operations. The agency is paid a fee of approximately $100 per acre for its land, labor, and expertise to grow edible crops for 19 food banks across Texas.
- During the last 37 years, approximately 4,000 veterinarians have graduated from Texas A&M, all with hands-on, clinical experience related to the Texas Department of Criminal Justice's livestock operations.
- The Internal Audit Division of the Texas Department of Criminal Justice reported that cost-avoidance estimates reported in past cost analysis summary books might be inaccurate.
- Food industry giant Aramark has entered a year-long contract with the Texas Department of Criminal Justice to provide meals at a single prison unit for a daily cost of $2.43 per prisoner. The average daily cost per meal for the agency was $2.60 for fiscal year 2003.
- In fiscal year 2003, inmates performed over five million hours of labor in agricultural jobs.
- The states of Florida and Kentucky drastically reduced prison farmland operations but later resumed operations.

COMMENTS

The use of Texas prisoners for agricultural operations in order to make the prison system more self-sustaining dates back to 1854 when there were enough inmates to justify the construction of a cotton mill. Products from the mill were sold to the public, and eventually they were used to aid the Confederacy during the Civil War. In December 1865 the Thirteenth Amendment to the United States Constitution abolished slavery throughout the nation, which created a new demand for inexpensive farm labor. Two months following ratification of the Thirteenth Amendment, the Texas Legislature enacted legislation that established the Board of Public Labor and directed its members to secure contracts with private interests for the use of inmate labor. The result was a cheap source of labor for plantation owners. Texas prison inmates worked the large plantations of East Texas, raising cotton and corn, and tending livestock. The prison system, in another move to increase the prison's ability to be self-sustaining, purchased its first farm in 1885; and the number gradually grew to six prison farms by 1913.

FIGURE 1
TDCJ AGRIBUSINESS PRODUCTION LIST

FIELD CROPS	EDIBLE CROPS				LIVESTOCK
Alfalfa Meal	Apricots	Sweet Corn	Okra	Irish Potatoes	Swine
Corn	Green Beans	Cucumbers	Onions	Sweet Potatoes	Poultry
Cotton	Beets	Eggplant	Peaches	Pumpkins	Beef Cattle
Hay-Alfalfa	Blackberries	Garlic	Pears	Radishes	
Hay-Grass	Broccoli	Collard Greens	Peas	Yellow Squash	
Hay-Wheat	Cabbage	Mustard Greens	Pecans	Zucchini Squash	
Maize	Cantaloupe	Spinach Greens	Hot Peppers	Tomatoes	
Oats	Carrots	Lettuce	Sweet Peppers	Turnips	
Wheat	Cauliflower	Nectarines	Plums	Watermelons	

SOURCE: Texas Department of Criminal Justice.

Currently, the Texas Department of Criminal Justice (TDCJ) operates and manages 145,337 acres located in 46 counties in Texas. The TDCJ Agribusiness Division employs over 316 full-time employees and utilizes over 5,800 offenders in 50 different prison units.

CURRENT TDCJ AGRICULTURAL AND LIVESTOCK OPERATIONS

The agricultural operations of TDCJ include nine varieties of field crops and 36 varieties of edible crops (see Figure 1). For fiscal year 2003, nearly 23 million pounds of edible crops were produced and 78.3 million pounds of field crops were produced with field corn and hay grass accounting for nearly 75 percent of all field crop tonnage. Field crops are grown for feeding TDCJ livestock and any surplus field crops are sold to generate revenue.

TDCJ operates a number of processing plants that preserve raw foodstuffs. These plants include a beef processing plant (Potter County), a vegetable canning plant (Brazoria County), two feed mills (Anderson and Houston Counties), an alfalfa dehydrator (Brazoria County), and two cotton gins (Walker and Brazoria Counties) to produce cotton fiber. Cotton grown by TDCJ is used in its textile factories. Agriculture provides all of the horses and dogs used for securing prison units. The TDCJ Agribusiness Division also raises swine and cattle. Swine are shipped to the Michael Meat Packing Plant (Anderson County), where the animals are processed into pork products for prison consumption. While TDCJ Agribusiness maintains a large cattle operation, none of the beef is fed to inmates. All beef cattle are sold on the open market and TDCJ purchases low-cost beef trim, which it processes into ground beef for consumption. Crop production and livestock production are listed for fiscal years 2001 through 2003 in Figure 2.

TDCJ also has established a partnership with the Texas Association of Second Harvest Food Banks (TASHFB), an affiliate of Second Harvest, the largest charitable hunger relief organization in the United States. TDCJ provides a consistent source of quality produce and labor to maintain food bank operations. Of the vegetables sent to food banks from TDCJ, 80 percent are from prison farm operations, and the rest is from prison unit gardens. TDCJ is paid a fee of approximately $100 per acre for its land, labor, and expertise to grow edible crops for the 19 food banks across Texas associated with TASHFB. TDCJ's partnership with TASHFB has allowed offenders in TDCJ and adult probationers to contribute work to the food banks.

REASONS FOR TDCJ'S INVOLVEMENT IN AGRICULTURAL AND LIVESTOCK OPERATIONS

TDCJ's original reason for agricultural and livestock operations was an attempt to achieve self-sufficiency. Until 1991, TDCJ operated under a legislative mandate to be as self-sustaining as possible (See former Section 491.002, Government Code, which was derived from V.A.C.S. Art. 6166a, and which was repealed in 1991 by Ch. 16, § 10.01(a), Acts of the 72nd Legislature). In order to achieve that mandate, TDCJ made its own peanut butter, roasted its own coffee, and produced its own pancake syrup and cheese. In 1991, TDCJ had a population of 49,000 inmates, which has since grown by 101,000 inmates. In order for TDCJ to remain as self-sustaining today as it was prior to 1991, agricultural and livestock operations need to triple. Rather than take part in a massive agricultural expansion project as well as a massive prison construction project, the legislature removed the self-sufficiency mandate.

FIGURE 2
TDCJ FOOD AND FIBER PRODUCTION BY FISCAL YEAR

	FY 2001	FY 2002	FY 2003
Cotton	4,294,578 lbs.	4,690,802 lbs.	3,496,016 lbs.
Cotton Seed	5,181,734 lbs.	7,481,286 lbs.	5,454,628 lbs.
Corn	71,894,279 lbs.	54,934,465 lbs.	32,232,326 lbs.
Milo	18,226,227 lbs.	21,197,712 lbs.	10,750,314 lbs.
Wheat	94,592 lbs.	62,079 lbs.	1,696,179 lbs.
Hay-Wheat	433,800 lbs.	2,180,880 lbs.	338,780 lbs.
Hay Grass	20,587,820 lbs.	24,419,200 lbs.	26,434,940 lbs.
Hay-Alfalfa	645,040 lbs.	1,523,360 lbs.	1,378,120 lbs.
Alfalfa Meal	804,000 lbs.	510,400 lbs.	432,800 lbs.
Fresh Vegetables	20,343,824 lbs.	20,569,954 lbs.	22,992,995 lbs.
Canned Vegetables	344,747 cases	315,255 cases	352,369 cases
Pork Products	9,056,221 lbs.	8,054,241 lbs.	9,889,661 lbs.
Beef Products	13,059,504 lbs.	12,792,761 lbs.	12,083,418 lbs.
Finished Hogs	36,628 head	42,107 head	44,216 head
Horses-Foals	122 head	117 head	112 head
Dogs-Puppies	792 puppies born	696 puppies born	424 puppies born
Beef Cattle-Calves	6,184 calves weaned	6,672 calves weaned	6,463 calves weaned
Eggs	4,171,486 dozen	4,521,423 dozen	6,276,945 dozen

SOURCE: Texas Department of Criminal Justice.

Experience has shown that purchasing certain products from outside producers is more cost-effective than producing the products in-house. It is currently estimated that TDCJ's Agribusiness Division produces about 20 percent of the total food consumed in Texas prisons. In order to feed all inmates, TDCJ purchased $89 million in food products for its prison system in fiscal year 2003 according to the Comptroller of Public Accounts. Self-sufficiency is no longer an attainable goal for TDCJ; however, there are still a number of viable reasons for maintaining agricultural and livestock operations at TDCJ.

TDCJ MAY PRODUCE FOOD CHEAPER THAN PURCHASING FOOD AT MARKET PRICES

TDCJ is required by statute (V.T.C.A., Government Code § 497.112) to review its agriculture operations annually. The review must include a cost-effectiveness analysis of all agriculture programs and a determination as to whether it would be more economical to purchase agricultural products than to produce them. TDCJ has demonstrated for many years that the market value of the products produced by its Agribusiness Division is higher than the cost to the agency to produce the products. The

FIGURE 3
SUMMARY OF TDCJ AGRICULTURE COST AVOIDANCE BY CALENDAR YEAR (CY)

	CY 2000	CY 2001	CY 2002	CY 2003
Total Agriculture Costs to Agency	$ 43,631,014	$ 43,237,872	$ 49,146,553	$ 48,433,357
Average Market Value of Production	$ 54,500,526	$ 53,685,434	$ 53,682,675	$ 68,207,917
Cost Avoidance	$ 10,869,512	$ 10,447,562	$ 4,536,122	$ 19,774,560

NOTE: Cost Avoidance does not include land and mineral income.
SOURCE: Texas Department of Criminal Justice.

Agriculture Cost Analysis Summary for calendar years 2002 and 2003 indicated a cost avoidance of $4.5 million and $19.8 million respectively (see Figure 3). The market values of products are based on weekly prices published by the United States Department of Agriculture (USDA). Products that are not priced by the USDA are compared to the prices of wholesale distributors for comparable bulk amounts.

However, the TDCJ Internal Audit Division's 2002 Report on the Agribusiness Field Crops Program noted that Agribusiness did not keep adequate records, lacked formal policies and procedures, and did not reconcile the total expenditures and revenues reported in the Cost Analysis Summary Book to expenditures and revenues recorded in the TDCJ Business and Finance Division's Lonestars Accounting System. As a result, in the opinion of the Internal Audit Division, the reported cost avoidance in past Cost Analysis Summary Books may be inaccurate.

In July of 2004, the Internal Audit Division performed a follow-up audit of Agribusiness' recording of expenditures and revenues and found that expenditures and revenues still did not reconcile with the Lonestars Accounting System. TDCJ's Business and Finance Division is currently working with Agribusiness so that expenditures and revenues will reconcile with its Lonestars Accounting System. Revised figures for a cost-effectiveness analysis of all agriculture programs are expected in the near future but are not available at the time of this report. TDCJ has agreed to take remedial action in its cost accounting reports by December 31, 2004. Staff members of TDCJ have stated that inaccuracies cited in the internal audit are mainly the result of Agribusiness using an accounting system that is customized for agricultural and livestock operations, which is difficult to use in conjunction with the Lonestars Accounting System.

TDCJ INCURS LITTLE DIRECT MONETARY COST FOR EMPLOYING INMATES

Inmates must be guarded no matter where they are. Employing inmates in agricultural activities does not require TDCJ to incur significant additional security costs. There are also benefits derived from inmates working. Agricultural employment provides inmates with the potential for skills development, and an improved work ethic. Having inmates occupied lessens security tension in the cellblocks. Offenders are assigned specific tasks and are trained by agency staff members on specific job assignments. Training varies depending on the assigned job classification. Also, an offender's successful participation in the program hinges on a cooperative relationship between the TDCJ Agribusiness Division and TDCJ security operations. Of the 5,800 inmates that are reported to work in agricultural operations, 2,529 are employed full time. In Figure 4, statistics are provided to show agriculture-related hours worked by offenders for fiscal years 2001 through 2003.

Inmates in Texas are not paid for their labor, so stating a dollar value for inmate agriculture labor is speculative. However, based on the federal minimum wage rate of $5.15 per hour, TDCJ inmates performed labor in agriculture jobs valued at $25.9 million in fiscal year 2003.

TDCJ AGRICULTURAL OPERATIONS BENEFIT TEXAS FOOD BANKS

TDCJ serves as a partner to ten certified food banks and the partnerships have been beneficial to all parties involved. The food banks rely on TDCJ for manpower and crops. TDCJ estimates that in calendar year 2003, 965,502 pounds of vegetables were produced by TDCJ and sold to food banks for the cost of seed, fertilizer, and chemicals, resulting in a savings of $157,887 to Texas food banks. In its review of the TDCJ-food bank partnership, TDCJ's Research, Evaluation and Development (RED) Unit indicated that state jail offenders working in the partnership benefit by graduating to different levels of responsibility and to more highly skilled positions. Offenders start with the product recovery line, which consists of sorting food that is donated to the food bank. Later they can move up to more highly skilled positions such as forklift operator, inventory clerk, and dock coordinator. Some food banks are reliant on TDCJ manpower for their basic operations.

FIGURE 4
INMATE LABOR PERFORMED IN AGRICULTURE JOBS BY FISCAL YEAR (FY)

	FY 2001	FY 2002	FY 2003
Inmate labor hours in farm shops – Non-agriculture related	84,396 hours	107,078 hours	97,704 hours
Annual inmate labor hours performed in agriculture jobs	5,010,163 hours	4,923,850 hours	5,027,270 hours
Annual line force turn out	2,363,460 hours	2,165,800 hours	1,859,780 hours

SOURCE: Texas Department of Criminal Justice.

Without TDCJ manpower and crop production, food banks would serve fewer charitable agencies, such as day care centers, churches, senior citizen centers, and shelters.

TDCJ BENEFITS TEXAS A&M STUDY PROGRAMS

TDCJ and Texas A&M College of Veterinary Medicine have had a mutually beneficial relationship in agricultural and livestock production for 37 years through an interagency contract. TDCJ benefits from having access to the professional expertise of three full-time veterinary professors and approximately 20 faculty members in the Department of Large Animal Clinical Sciences. Texas A&M professors are able to provide TDCJ with livestock and production management expertise. The expertise provided by Texas A&M enables TDCJ to have a safe, consistent, and reliable food supply. TDCJ is able to help Texas A&M provide experience for entry-level veterinarians. Approximately 4,000 veterinarians have graduated from Texas A&M during the period of the interagency contract, all with hands-on clinical experience related to TDCJ's livestock operations. TDCJ livestock operations, unlike private livestock operations, allow Texas A&M to conduct research in the areas of antibiotic resistance, biosafety, preventative veterinary medicine, epidemiology, and reproduction. TDCJ's operations are widely distributed throughout the state which allows Texas A&M to study the effects of different environments on livestock production, knowledge that ultimately benefits all of Texas producers. The relationship also enables Texas A&M to procure extra grant money from the USDA. The arrangement between TDCJ and Texas A&M is the only one of its kind in the nation, and it has benefits that extend beyond the participating institutions.

OTHER STATES DRASTICALLY REDUCED PRISON AGRICULTURAL OPERATIONS BUT SUBSEQUENTLY DECIDED TO RESTORE THEM

The states of Florida and Kentucky nearly eliminated their prison agricultural and livestock operations in the 1980s. Both states subsequently reinstated their agricultural and livestock operations and now seek to expand them.

Florida—The Florida Department of Corrections (DOC) parallels TDCJ in many ways. Both correctional systems are large. Texas has the second largest prison population in America, and Florida ranks fourth. Both correctional systems date back to the Civil War, and both tried to remain self-sufficient through agricultural and livestock operations. Unlike Texas, the Florida DOC began to discontinue the use of thousands of acres of prison farms in the late 1970s and early 1980s. Florida became much more involved in job training and producing goods and services needed by government agencies. The new programs required the land that had been used for prison farming. However, in the mid 1990s Florida reversed this trend and decided to restore its prison agricultural operations. Two reasons were cited for the return to prison agriculture. (1) The work results in increased discipline, control, diminished tension, and greater safety in the institutions. (2) Increased agricultural production lowers the cost of providing meals to inmates.

Kentucky—In 1989, under the direction of Governor Wallace Wilkinson, Kentucky's Department of Corrections (DOC) ended all prison agriculture and livestock operations. Machinery was sold, and the farmland sat idle for two years until 1991, when the new governor, Brereton C. Jones, reinstated the operations. From 1991 until the present day, the Kentucky DOC has been in the process of rebuilding its agriculture and livestock operations. After selling off much of its equipment in 1989, the Kentucky DOC is still short on machinery for agriculture, canning, slaughtering, and dairy operations; but it is gradually acquiring more machinery as well as eliminating less cost-efficient operations. Officials with the Kentucky DOC state that it is difficult to assess how much cost avoidance is achieved through agricultural and livestock operations. Nevertheless, they see great value in occupying the time of inmates with work.

TDCJ AGRIBUSINESS BENEFITS SECURITY OPERATIONS

TDCJ breeds, raises, and trains its own security dogs and horses that help provide security to all of TDCJ's prison units. It is unlikely that any private entity could step in and assume operations regarding security dogs and horses on a 24 hour a day 7 day a week basis. Additionally, TDCJ allows its security dogs to be used by other law enforcement entities in the apprehension of escaped fugitives. During fiscal year 2004, TDCJ provided security dogs for tracking assistance on eighty-six (86) occasions to the Texas Rangers, the Texas Department of Public Safety, various county sheriff departments, local police departments, and the United States Border Patrol.

REASONS FOR REDUCED TDCJ INVOLVEMENT IN AGRICULTURAL AND LIVESTOCK OPERATIONS

TDCJ's Agribusiness Division lost $6.5 million through budget cuts in fiscal year 2004, resulting in the shutdown of farming operations at five prison units across the state and the curtailing of operations at another prison unit. TDCJ was able to compensate for the loss of farming land by leasing the 11,000-acre Buffalo Ranch near the community of Snook from the Texas General Land Office (GLO). Without the Buffalo Ranch, TDCJ would not have been able to produce the grain necessary for its livestock operations. However, according to TDCJ, future budget

cuts or even the elimination of agricultural operations could be imposed on TDCJ because of market factors, TDCJ's rehabilitation efforts, and correctional officer staffing levels.

LOSS OF FARM LAND DUE TO EXPLOSIVE SUBURBAN GROWTH

The Texas General Land Office (GLO) has been able to purchase land from state agencies, get it rezoned for development, and then either sell or lease the land to developers for much more than the purchase price to the GLO. TDCJ has ten prison units in the sprawling suburban area south of Houston (specifically Brazoria and Fort Bend counties). Fort Bend County is among the fastest growing counties in the United States, with a 57 percent growth rate from 1990 to 2000 according to the 2000 U.S. Census. Brazoria County, which lies further from Houston (see Figure 5), grew by 26.1 percent from 1990 to 2000. Land in both Fort Bend County and Brazoria County has become much more valuable for residential areas than it is for prison farmland. In order to maximize the state's return on land in the Sugar Land area, starting in September 2003 the GLO announced the sale of 2,000 acres from one of the prisons in the area. As of today, 86 percent of TDCJ's original farmland south of Houston has been sold.

The sale of prison farmland south of Houston begs the question whether it would be more cost efficient for TDCJ to sell other parcels of prison farmland rather than continue agricultural operations. According to the GLO, of all farmland owned by TDCJ, currently the only land of value to developers is the land in Fort Bend and Brazoria counties. Fort Bend County farmland is especially valuable. However, little prison farmland remains for development in the area south of Houston. Only 400 acres of prison farmland remains near Sugar Land, and it is necessary to serve as a buffer zone between the residents of Sugar Land and TDCJ's four prison units there. One-thousand acres of prison farmland remain in Brazoria County, but the GLO has said that it will take at least 10 years for Brazoria County to develop the 1,000 acres of prison farmland that it recently acquired from the GLO.

CHEAPER FOOD SERVICE FROM OUTSIDE PROVIDERS

Food-industry giant Aramark has entered a year-long contract with TDCJ to provide meals at a single prison unit for a daily cost of $2.43 per prisoner. The average daily food cost per prisoner for TDCJ in fiscal year 2003 was $2.60. It is important to note that TDCJ's fiscal year 2003 daily cost of $2.60 includes about five cents in fixed costs that would be paid by TDCJ regardless of who provides the meals. It is also important to note that TDCJ's average daily cost per meal in fiscal year 2003 was higher than what the cost will likely be for fiscal year 2004 because reduced amounts of food were served to inmates in 2004 and the inmate population was larger that year. At the time this report was produced, the average daily cost per meal was not available for 2004; however, in 2004 TDCJ implemented a new meal plan that eliminated desserts for inmates and reduced the amount of food served in meals. Also, the average inmate population for TDCJ in fiscal year 2004 was almost 1,400 higher than in fiscal year 2003. In calculating an average daily cost for food service, a smaller amount of food served in a year divided by a higher population will result in a decreased daily cost per prisoner.

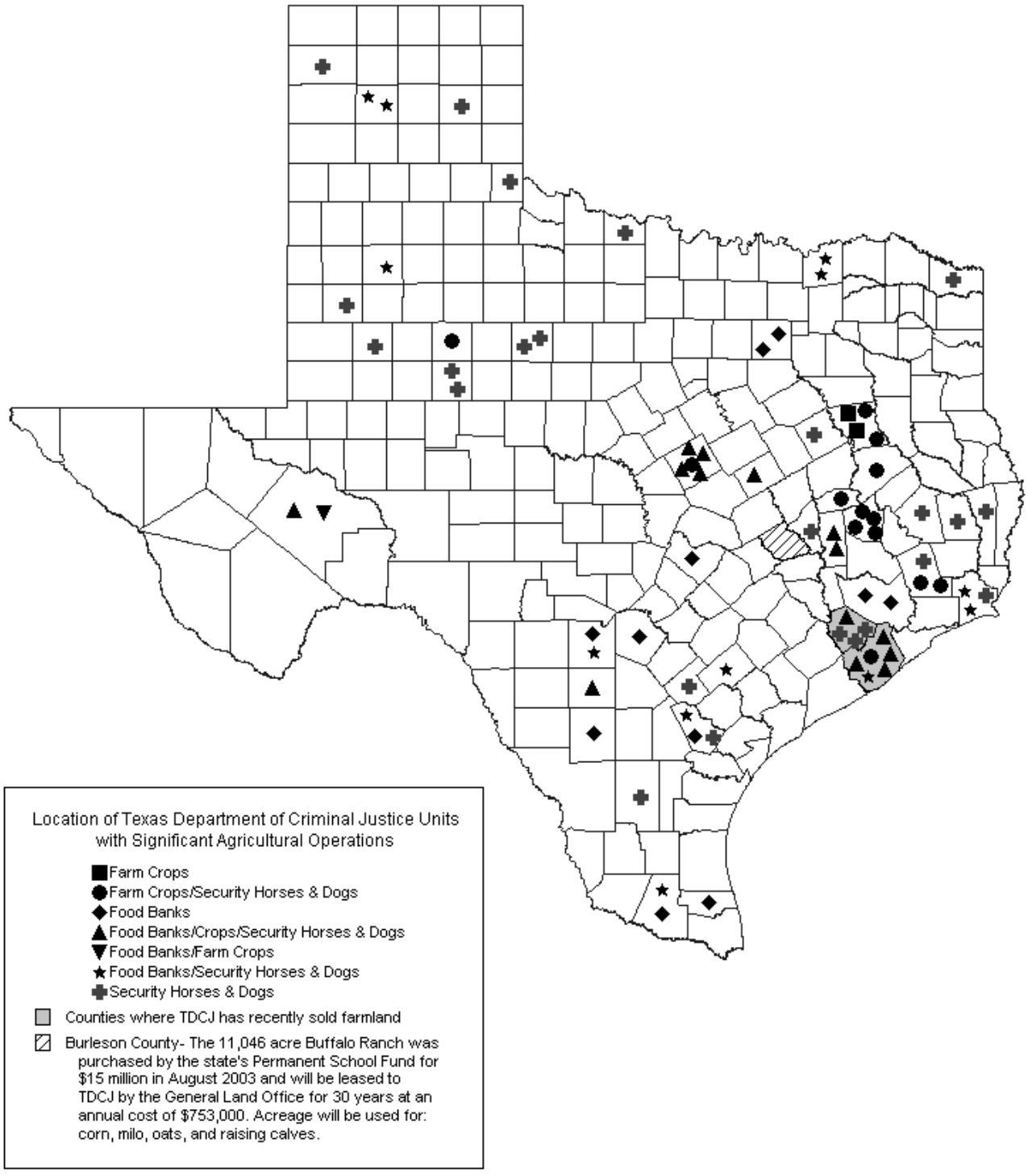
The year-long contract is a trial arrangement between Aramark and TDCJ. Aramark currently provides food services for inmates in Kansas, New Mexico, West Virginia, Kentucky, and Florida. In 2001, the state of Florida privatized its food service operations, and since that time Aramark has provided food to 120 Florida correctional locations. The average daily cost of meals provided to Florida inmates by Aramark was $2.55 in 2002–2003. A large private food provider can offer cost advantages when providing meals because it is able to purchase food in large quantities at very low prices. Aramark reports that it purchases $6 billion of food a year and is able to pay less per hamburger bun than McDonalds. As mentioned earlier, Florida also has prison agriculture and livestock operations. Florida also has inmates who work in food preparation. Aramark and the Florida DOC have arranged a five-year contract in which Florida inmates are able to lower food cost both by producing food and by preparing food at facilities.

Cost-effectiveness is a major factor to be considered when deciding to outsource food service, but security should also be considered. The food preparation and serving areas of prisons are potential locations for prison violence because for most inmates, mealtime is the highlight of their day. Poor food and poor delivery of food can result in inmate unrest and an unstable prison facility. For example, in Kansas, Aramark had to replace a private food provider that had problems in delivering food to prison inmates.

AGRICULTURAL SKILLS OF QUESTIONABLE VALUE IN PROVIDING JOB SKILLS TO INCREASE EMPLOYMENT OPPORTUNITIES AFTER RELEASE

The state of Texas has become increasingly urban and less rural since the early 1900s. According to the U.S. Census, the Texas population became primarily urban between 1940 and 1950, and 83 percent of Texans lived in urban areas as of the year 2000. The TDCJ inmate population is even more urban than the Texas population. Fiscal year 2002 data indicates that 91 percent of inmates released to parole

FIGURE 5
LOCATION OF TEXAS DEPARTMENT OF CRIMINAL JUSTICE UNITS
WITH SIGNIFICANT AGRICULTURAL OPERATIONS



SOURCE: Texas Department of Criminal Justice.

supervision were from urban counties, with nearly one in four parole releases to Harris County and nearly one in six to Dallas County. Training in agricultural operations is of questionable value in providing inmates with work skills to use when released. Nevertheless, the percentage of inmates working in full-time agricultural operations is similar to the percentage of people with the same occupation in the statewide workforce. On a regular basis 2,529 (1.7 percent) of TDCJ's offenders are directly assigned to agricultural operations. According to the 2000 U.S. Census, 2.7 percent of Texas' employed civilian population 16 years of age and older works in the agriculture-related industry. Little data exists on the post-prison success of offenders employed in TDCJ agricultural operations.

CORRECTIONAL OFFICER STAFFING VACANCIES MAKE AGRICULTURAL OPERATIONS UNRELIABLE

For the purpose of this report, correctional officer vacancies are defined as the number of correctional officer positions filled compared to the number of positions needed for ideal security levels as determined by TDCJ. In every month since June of 2000, TDCJ has had more than 2,000 vacant correctional officer positions. TDCJ has maintained necessary security levels, even when the number of correctional officer vacancies peaked at 3,407 in October of 2001. The shortage of correctional officers can have a negative impact on agricultural production. When units are understaffed, the offenders cannot work in the fields because field officers are used to cover officer shortages in the prison buildings. This substitution has caused vegetables not to be harvested at optimal times, negatively impacting production. To try to compensate, TDCJ's agribusiness and security operations are dealing with correctional officer vacancies by utilizing trusty squads, employees, and increased mechanical harvesting. Despite these provisions, a future downturn in correctional officer staffing levels would likely result in difficulties in future harvests.

DIFFERENT EMPHASIS ON TIME SERVED FOR TDCJ INMATES

As recently as the 1970s, inmates at TDCJ spent the first six months of their prison term working in the fields as part of a line force. Once the inmates completed their six months in the fields, they were then able to take classes, receive training, and undergo treatment. Today, the progression by inmates is much different. An inmate first spends from four to six weeks in a diagnostic facility before being transferred to a unit. Once in a unit, the inmate must wait several weeks before unit classification assigns the inmate to a particular task. In addition, inmates have to undergo counseling prior to release, which also removes them from participation in agricultural activities. Under the present system, inmates no longer work in the field to earn the right to receive training or treatment. They are now immediately eligible to take classes, receive training, or undergo treatment. As a result, TDCJ agriculture operations do not have the large, steady pool of workers it once had. Workers with short sentences are often eligible for release by the time they are trained and capable of contributing to agricultural operations.

SUMMARY

When Texas added 100,000 prison beds in the 1990s, a corresponding increase was not made in agricultural operations, making TDCJ's past legislative self-sufficiency mandate much more out of reach. TDCJ now grows only about 20 percent of its own food, which necessitates the purchase of approximately $89 million of food per year to meet the system's needs. Consequently, TDCJ to a large extent has already outsourced a large part of its food production to outside providers. The question now is whether it is cost-effective to continue TDCJ agribusiness functions.

The reasons against continued agricultural operations include: land may be more valuable for purposes other than farming, food service may be more cost efficient from outside providers, agricultural skills are of questionable value to releasees, and correctional officer vacancies coupled with TDCJ's evolving emphasis on how inmates serve their time do not meet the needs of traditional prison agricultural operations. However, it appears that TDCJ has already sold its land with development potential. It also appears that TDCJ produces food at long-term economical levels. Additionally, it appears that the number of inmates in full-time agricultural operations parallels the percentage of the Texas workforce in agriculture.

Also, beneficial relationships exist among TDCJ Agribusiness and Texas food banks and Texas A&M University. Texas food banks and Texas A&M would be negatively impacted by future decreases in TDCJ agricultural and livestock operations. TDCJ raises and trains its own security horses and dogs and it is unlikely that any private entity could assume operations regarding security dogs and horses. Finally, the states of Florida and Kentucky decided to eliminate their agricultural operations and are now in the process of restoring agricultural operations. Reasons stated for restoring agricultural operations for these states are: the work results in increased discipline and control, diminished tension, and greater safety in the institutions; and increased agricultural production lowers the cost of providing meals to inmates. The experiences of Florida and Kentucky also indicate that when a state makes the decision to get out of agriculture, it is a difficult decision to reverse.

IMPACT OF PRISON AND POPULATION DENSITY ON CORRECTIONAL OFFICER VACANCY RATES

Starting in February 2002, staffing levels for Texas Department of Criminal Justice correctional officers have improved. The agency attributes the improvement in correctional officer staffing to its officer recruitment and retention efforts and to an expanded career ladder for correctional officers with funds appropriated by the Seventy-sixth (1999) and Seventy-seventh (2001) Legislatures. However, a few areas in the state have been slower in showing improvement in correctional officer staffing levels, which is the focus of this review.

This review examines the relationship between the Texas Department of Criminal Justice correctional officer job vacancies and population density within commuting distance of prison units. First, the relationship between prison and population density and correctional officer vacancies is examined for the five-county area surrounding the cities of Huntsville and Palestine. To examine the area's staffing patterns in greater detail, population and correctional officer vacancies are examined for four of the units that have had continual difficulties in correctional officer staffing for the last three years. Next, other areas of Texas with a large number of prison units are contrasted with the Huntsville/Palestine area to isolate the effect of prison and population density on correctional officer vacancies.

For purposes of this report, prison unit staffing percentages and references to correctional officer vacancies are defined as the number of correctional officer positions filled compared to the number of positions needed for ideal security levels as determined by the Texas Department of Criminal Justice. The agency reports that all prison units have maintained necessary security levels, even when the number of correctional officer vacancies peaked in fiscal years 2001 and 2002. For an analysis of past correctional officer staffing levels at the agency, turnover rates for correctional officers, and an examination of what has been done to improve correctional officer staffing levels, see "Retention of Experienced Correctional Officers" in the *Staff Performance Report to the 78th Legislature.*

SIGNIFICANT FINDINGS

- The presence of a large population within 25 miles of a prison unit appears to reduce correctional officer vacancies. In the context of four units with correctional officer staffing problems in the Huntsville/Palestine area, the largest population within a radius of 25 miles is only 75,803. Conversely, for all of Texas' prison units the average number of persons living within a radius of 25 miles of each unit is 338,675, over four times larger than the Huntsville/Palestine area.
- The prison units identified in the five-county area around Huntsville and Palestine hold a combined prison population of 33,530 inmates, which is larger than 41 of the nation's individual state prison systems.
- According to a recent Texas Department of Criminal Justice staffing report, Brazoria County units are able to fill 89 percent to 93 percent of their authorized correctional officer positions while Coryell County units are able to fill 90 percent to 95 percent of their authorized positions. In contrast, 8 of the 12 Huntsville/Palestine area prison units are staffed below 90 percent with one unit staffed at 75 percent of authorized correctional officer positions.

COMMENTS

The number of correctional officer vacancies in Texas' prison units has decreased considerably in the last three years, with the number of vacancies decreasing from a high of 3,407 in October 2001 to a two-year low of 2,072 vacancies in March 2004. The number of vacancies peaked when many Texas correctional officers in the military reserves were called into active duty after the World Trade Center attack on September 11, 2001. Challenges to the Texas Department of Criminal Justice (TDCJ) associated with a shortage of correctional officers include reduced inmate and officer safety, reduced work by inmates caused by staffing-related unit lockdowns, and budget issues caused by the need to pay overtime wages to correctional officers. In its Audit Report on Correctional Officer Staffing at the Department of Criminal Justice, the State Auditor's Office (SAO) reported that in several of the prison units that they visited anecdotal evidence was provided that shake-downs and strip searches were not performed as prescribed by policy because of the shortage of correctional officers. TDCJ has employed a variety of

techniques to improve correctional officer retention and recruitment in an effort to reduce the shortage of correctional officers.

Knowledge about the causes of the shortage of correctional officers is important in order to understand future staffing levels of Texas' correctional system. The reasons behind the number of vacancies are complex and difficult to quantify. TDCJ officials often cite Texas' strong economy and low unemployment rate as a factor in driving up TDCJ's correctional officer attrition rate as well as cutting into the pool of applicants for correctional officer positions. In addition, the fact that being a TDCJ correctional officer is a dangerous and stressful occupation contributes to TDCJ's problem in keeping so many correctional officer positions filled. Unfortunately, the impact of the economy, the dangers involved in being a correctional officer, as well as professional suitability for the job are difficult to analyze empirically because of the lack of data related to specific reasons for people leaving TDCJ. The SAO collects agency turnover data, and included in the data is the reason for termination from the job. However, analysis of SAO data for TDCJ correctional officers indicates that the "catch-all" category of "Personal Reasons not Related to Job" has been the dominant reason for leaving employment since fiscal year 1998, making the analysis of specific reasons impossible.

Although system-wide staffing levels for TDCJ correctional officers have improved markedly over the last year, several areas have lagged behind the rest of the state in filling vacant positions, with the Huntsville/Palestine area being the most significant and the focus of this report because of its influence on the entire system. Although the Huntsville/Palestine area only accounts for 1 percent of Texas' population, it accounts for 25 percent of Texas' full-time authorized correctional officers, and 32 percent of TDCJ's correctional officer vacancies (see Figure 1).

LOCATION OF PRISON UNITS IN A FIVE-COUNTY AREA OF EAST TEXAS

The five-county area of East Texas bounded by Cherokee County to the north and Walker County to the south is the hub of Texas' correctional system. Most of Texas' oldest prison units and TDCJ's headquarters are located in this area. In its Inmate Monthly Report for the period ending July 31, 2004, TDCJ reported that the prison units identified in Figure 2 hold a combined prison population of 33,530 inmates. Figures from the Bureau of Justice Statistics indicate this regional population is larger than 41 of the nation's individual state prison populations. Population growth in the five-county area has lagged behind the state's population growth in the 1990s. U.S. Census Bureau data shows that Texas grew by 23 percent in the 1990s, but the five counties highlighted in Figure 2 grew by only 16 percent from 172,296 in 1990 to 199,651 in 2000.

PRISON UNITS WITH LARGEST NUMBER OF UNFILLED CORRECTIONAL OFFICER POSITIONS

Many of the units that have had the most vacant correctional officer positions are units that are located in the five-county area of East Texas identified in Figure 2. These units share two factors that contribute to the number of vacancies: (1) the units are located in an area where there is a heavy concentration of prison units; and (2) the units are located in an area where there is a relatively low population. The result is a local labor force that has been slower in filling correctional officer vacancies than other areas of the state that are larger in population and have fewer prison units.

In Figure 3, data for the 2000 U.S. census is used to determine the number of persons living within a 25-mile radius of four TDCJ units located in the five-county area of East Texas that have had comparatively large numbers of vacant correctional officer positions for the last several years. A radius of 25 miles is used because it approximates a reasonable commuting distance to each of the units. Of the four units shown in Figure 3, the average population within a radius of 25 miles is only 75,803. For all of Texas' prison units, the average number of persons living within a radius of 25 miles of each unit is 338,675. This average is affected by units in large urban areas, but even as an average it is considerably higher than the number of people living near the units in the five-county area of East Texas.

PRISON UNITS IN AREAS WITH A HEAVY CONCENTRATION OF CORRECTIONAL POPULATIONS

The Huntsville/Palestine area of Texas is not the only area of Texas with a heavy concentration of prison units. Coryell County (Gatesville) contains six prison units with a population of 8,124 inmates, and Brazoria County contains five prison units with an inmate population of 6,867. However, reports from TDCJ indicate that prison units in Coryell and Brazoria counties have not experienced the staffing vacancies that have been apparent in the Huntsville/Palestine area. According to a recent TDCJ staffing report, Brazoria County units are able to fill 89 percent to 93 percent of their authorized positions while Coryell

FIGURE 1
CORRECTIONAL OFFICER STAFFING AND VACANCIES, JULY 31, 2004

COUNTY	NUMBER OF UNITS	FILLED FULL-TIME CORRECTIONAL OFFICER STAFF	PERCENT FILLED	NUMBER OF VACANT POSITIONS
ALL TDCJ PRISONS	**103**	**23,127**	**92%**	**3,013***
FIVE-COUNTY AREA:				
Anderson	5	1,886	82	416
Cherokee	2	478	86	81
Houston	1	419	84	83
Madison	1	338	73	128
Walker	7	2,324	90	269
FIVE-COUNTY TOTAL	**16**	**5,445**	**85%**	**977**

*Estimated vacant positions before counting part-time correctional officers and unit-based training officers. On July 31, 2004, TDCJ reported 433 part-time correctional officers and an additional 936 training academy correctional officers that were undergoing unit-based training. The part-time correctional officers and training academy correctional officers are not reflected as staffed positions in the Figure 1 numbers.
SOURCES: Legislative Budget Board; Texas Department of Criminal Justice.

FIGURE 2
LOCATION OF PRISON UNITS IN A FIVE-COUNTY AREA OF EAST TEXAS

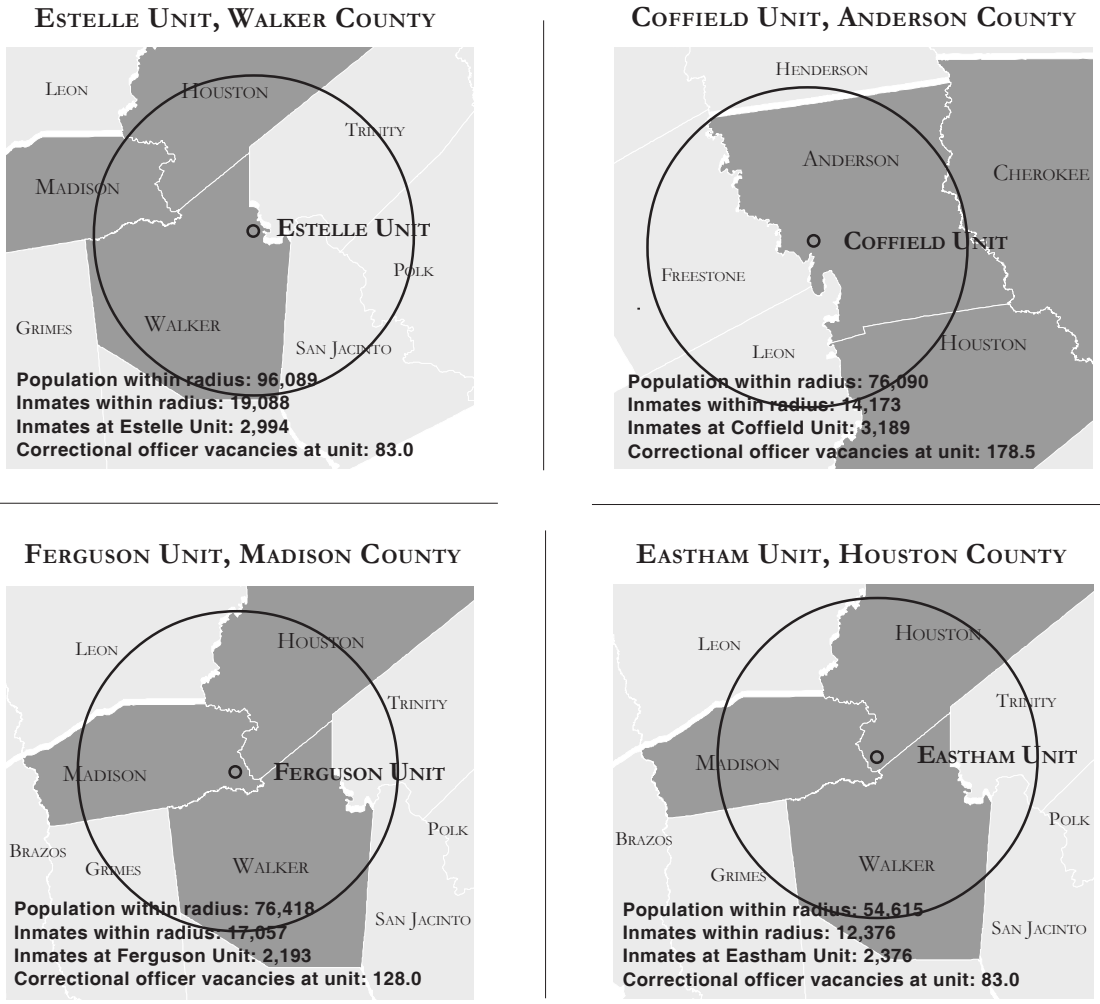
NOTE: Prison unit locations are approximate.
SOURCE: Texas Department of Criminal Justice.

County units are able to fill 90 percent to 95 percent of their authorized positions. In contrast, 8 of the 12 Huntsville/Palestine area prison units are staffed below 90 percent with one unit staffed at 75 percent of authorized correctional officer positions. Again, a critical difference in these three areas is the size of the population surrounding the prison units. As demonstrated in Figure 4, the Hughes Unit (Coryell County) has nearly 200,000 people living within a 25-mile radius, and the Darrington Unit (Brazoria County) has over 2 million people residing within a 25-mile radius.

STAFFING IMPROVEMENTS AND CHALLENGES

The problem of correctional officer vacancies is lessening as a result of various efforts by TDCJ and the legislature. TDCJ's officer recruitment and retention efforts, along with an expanded career ladder for correctional officers approved by the Seventy-sixth (1999) and Seventy-seventh (2001) Legislatures, have been responsible for improved correctional officer staffing. However, not all areas of the state have shown the same amount of improvement in correctional officer staffing. The Huntsville/Palestine area, where nearly 1,000 of TDCJ's correctional officer vacancies occur, lags behind other areas in the state in correctional

FIGURE 3
PRISON UNITS IN AREAS WITH HIGH CORRECTIONAL POPULATIONS AND LARGE NUMBERS OF UNFILLED CORRECTIONAL OFFICER POSITIONS, 25-MILE RADIUS

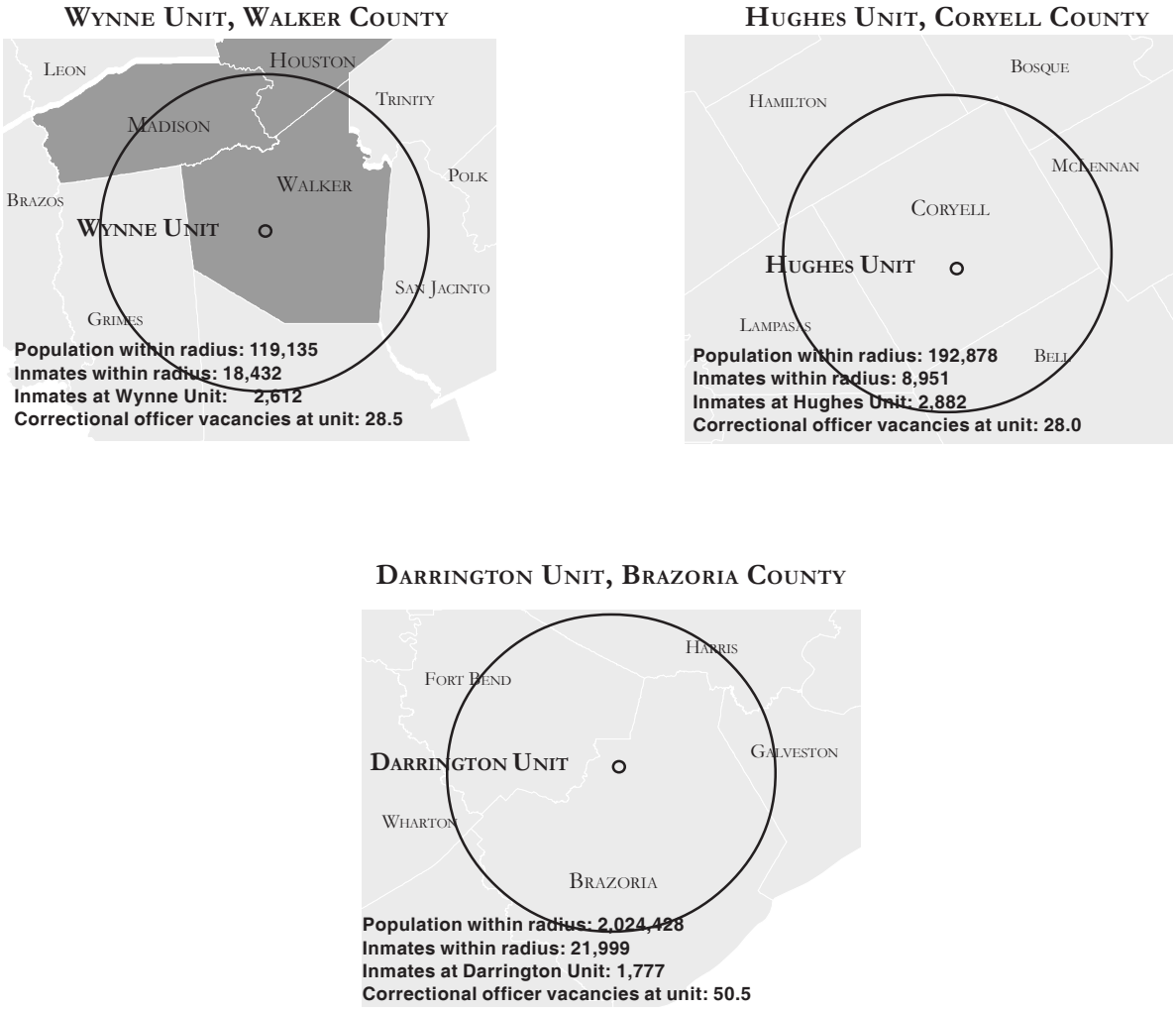


NOTE: Prison unit locations are approximate.
SOURCES: Legislative Budget Board; U.S. Census Bureau; Texas Department of Criminal Justice.

officer staffing. Prison units in the Huntsville area (Walker County units) have improved staffing rates from 78 percent to 90 percent in the last two fiscal years, but for the same time period, staffing rates for the five units in the Palestine area (Anderson County) have only improved from 78 percent to 82 percent.

The relationship of population to prison units is not anticipated to change significantly in future years. Population projections for the Huntsville/Palestine area indicate low growth rates when compared to other areas of Texas and the state as a whole. While correctional officer staffing rates for the Huntsville/Palestine area have improved in the last two years, the area still lags behind other parts of the state in correctional officer staffing. Since the Huntsville/Palestine area is such a dominant segment of TDCJ, its staffing rate will have a significant impact on TDCJ's staffing figures as a whole.

FIGURE 4
PRISON UNITS IN AREAS WITH HIGH CORRECTIONAL POPULATIONS, 25-MILE RADIUS



NOTE: Prison unit locations are approximate.
SOURCES: Legislative Budget Board; U.S. Census Bureau; Texas Department of Criminal Justice.

INCREASE THE NUMBER OF INMATES ELIGIBLE FOR MEDICALLY RECOMMENDED INTENSIVE SUPERVISION

Government Code, Section 508.146 prohibits sex offenders from being considered for medically recommended intensive supervision parole, which allows for the parole of offenders who no longer constitute a threat to public safety due to a medical condition. Because some inmates' offenses are violent, not all offenders who are permanently incapacitated may be considered for medically recommended intensive supervision.

Government Code, Section 508.146 should be amended to allow sex offenders who are permanently incapacitated (physically and/or mentally) to be considered for medically recommended intensive supervision. These offenders do not constitute a continuing threat to public safety. Allowing them to be released on medically recommended intensive supervision would reduce the state's share of providing for their medical care. For additional cost savings, the Texas Correctional Office on Offenders with Mental and Medical Impairments should consider improving its referral and screening process to identify a greater number of offenders eligible for medically recommended intensive supervision and to expedite the screening process.

SIGNIFICANT FINDINGS

- As of August 2004, the Texas Department of Criminal Justice had 150,714 incarcerated offenders, second only to the state of California.
- The Texas Department of Criminal Justice Correctional Managed Health Care reports that the most seriously ill offenders were hospitalized for an average of 107 days in fiscal year 2003. The average cost for this care was $1,020 per day.

SIGNIFICANT CONCERNS

- Sex offenders are not eligible for medically recommended intensive supervision. In fiscal year 2004, the Texas Department of Criminal Justice Correctional Managed Health Care reports that in its most extreme case it cost $1.5 million to care for a single sex offender who was permanently incapacitated.
- The medically recommended intensive supervision referral process is cumbersome. The University of Texas Medical Branch at Galveston and the Texas Tech University Health Sciences Center use one set of codes to track offenders' medical diagnosis while the Texas Department of Criminal Justice uses another to identify medically recommended intensive supervision candidates. As a result, some eligible cases may not be referred for medically recommended intensive supervision consideration, leaving eligible offenders incarcerated.
- The goal of the Texas Correctional Office on Offenders with Mental and Medical Impairments is to complete the medically recommended intensive supervision screening process within 30 days of an offender's referral. A Legislative Budget Board staff analysis found that the screening process took an average of 46 days in fiscal year 2004.
- The Texas Correctional Office on Offenders with Mental and Medical Impairments does not request an offender's board file (which is a compilation of inmate records used to determine parole eligibility) until after an interview with the offender is completed. This increases the time it takes to screen offenders for medically recommended intensive supervision release by 13 days on average.

RECOMMENDATIONS

- **Recommendation 1:** Amend Government Code, Section 508.146 to allow sex offenders who are permanently incapacitated (physically and/or mentally) to be considered for medically recommended intensive supervision. The Texas Department of Criminal Justice should be required to have a physician certify that the offender meets this eligibility requirement.
- **Recommendation 2:** The Texas Correctional Office on Offenders with Mental and Medical Impairments should develop an automated report for identifying offenders eligible for medically recommended intensive supervision. The agency should work with the University of Texas Medical Branch at Galveston and Texas Tech University Health Science Center to develop uniform diagnosis codes to identify offenders who may be eligible for release for medical reasons.
- **Recommendation 3:** To shorten the time required to recommend offenders for medically recommended intensive supervision release, the Texas

Correctional Office on Offenders with Mental and Medical Impairments should request the offenders' board file at the same time it assigns a caseworker to complete an interview of the offender.

COMMENTS

Between fiscal years 1998 and 2004, the Texas inmate population grew by 5 percent. According to Legislative Budget Board (LBB) staff projections, Texas' prison population will be 153,823 by the end of fiscal year 2007 and will exceed the Texas Department of Criminal Justice's (TDCJ) current operating capacity.

A January 1999 LBB Staff Report indicated that offenders are at high risk for poor health. Many offenders have never had regular checkups or proper treatment for medical conditions prior to incarceration. TDCJ Correctional Managed Health Care (CMHC) is constitutionally required to provide access to healthcare for all inmates, access to a licensed medical professional, and the right to care as prescribed by a licensed medical professional. Offenders are not eligible for Medicare or Medicaid while incarcerated; and private insurance usually does not cover incarcerated individuals, which means the state pays the full cost of treatment for all illnesses. Many offenders require restricted diets and have special medical needs, such as kidney dialysis. All of these factors result in high healthcare costs for offenders.

MEDICALLY RECOMMENDED INTENSIVE SUPERVISION ELIGIBILITY

In 1991, the Seventy-second Legislature established the Special Needs Parole program for prisoners who no longer constituted a threat to public safety due to a medical condition. This legislation facilitated their release from prison, upon approval by the Board of Pardons and Paroles (BPP), to a more cost-effective and appropriate treatment alternative. House Bill 772, Seventy-seventh Legislature, 2001, changed the program name to Medically Recommended Intensive Supervision (MRIS). The bill also added the option for the BPP to require offenders to submit to electronic monitoring and super-intensive supervision. Then House Bill 1670, enacted during the Seventy-eighth Legislative Session, 2003, excluded sex offenders and those offenders serving a sentence of death from MRIS consideration. The bill added offenders with aggravated convictions who have been diagnosed as terminally ill and/or require long-term care to the pool of MRIS candidates. Figure 1 lists the aggravated offenses currently eligible for MRIS consideration. Except as noted above, offenders who are elderly, physically handicapped, mentally ill, terminally ill, mentally retarded, or who require long-term care are currently eligible for MRIS release.

FIGURE 1
MRIS ELIGIBLE AGGRAVATED OFFENSES

The following aggravated offenses are eligible for MRIS consideration if the offender is terminally ill or requires long term care:

- Murder
- Capital Murder
- Aggravated kidnapping
- Aggravated robbery

Offenders serving a sentence of death cannot be considered for MRIS release.

SOURCE: Texas Code of Criminal Procedure Chapters 42 and 62.

As stated previously, statute prohibits sex offenders from MRIS consideration; and as a result, in fiscal year 2004, TDCJ CMHC reports that Texas spent $1.5 million to care for a single sex offender who was permanently incapacitated. Recommendation 1 would include sex offenders who are permanently incapacitated (physically and/or mentally) to the pool of eligible inmates for MRIS consideration. TDCJ would also be required to have a physician certify that the offender is debilitated or incapacitated and is severely restricted in the ability to self-ambulate and care for him/herself.

Few sex offenders would meet these requirements. LBB staff project that approximately 12 terminally ill sex offenders would be eligible for MRIS consideration annually during fiscal years 2006 to 2010. This projection is based on the average number of terminally ill sex offenders referred for MRIS consideration prior to the enactment of House Bill 1670. Due to their medical condition, these sex offenders would no longer pose a threat to public safety.

Releasing these offenders from prison would reduce the cost to the University of Texas Medical Branch at Galveston (UTMB) and Texas Tech University Health Science Center (TTUHSC) for inmate healthcare. These healthcare costs include the following:

- Hospitalization—TDCJ CMHC reports that the most seriously ill offenders were hospitalized for an average of 107 days in fiscal year 2003. The average cost for this care was $1,020 per day.
- Outpatient Care—TDCJ CMHC projects the fiscal year 2006 medical care costs for offenders age 55 or older to be $28.07 per day. Costs are assumed to increase at about 7 percent per year, reaching $37.48 per day in fiscal year 2010.

The cost savings in Figure 2 assume that UTMB/TTUHSC would avoid one year of medical treatment costs for the

FIGURE 2
COST SAVINGS

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS (CMHC)	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS (DADS)	PROBABLE NET SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS
2006	$765,717	($183,208)	$582,509	($282,733)
2007	$838,017	($199,535)	$638,482	($305,234)
2008	$782,026	($184,186)	$597,840	($281,754)
2009	$791,095	($184,186)	$606,909	($281,754)
2010	$800,835	($184,186)	$616,649	($281,754)

SOURCE: Legislative Budget Board.

sex offenders released on MRIS, and that this cost avoidance would include 54 days of hospitalization (half the number of hospital days of a seriously ill offender) plus 311 days of daily outpatient care per inmate. The savings estimate also assumes that these offenders would be eligible for Medicaid. The projected federal government portion of nursing home costs for Medicaid beneficiaries is 60.68 percent, and the state's portion is 39.32 percent for state fiscal year 2006. For state fiscal years 2007 to 2010, the projected federal government portion for nursing home costs is 60.47 percent, and the state's portion is 39.53 percent. As of May 2004, the average daily costs for nursing home care were $75.98. The Blind and Disabled Premium is estimated at $542.07 per month for fiscal years 2006 to 2010 and the Prescription Drug cost is estimated at $382.57 per month for fiscal years 2006 to 2010.

Figure 2 shows the medical costs avoided by the state by releasing permanently incapacitated sex offenders and the state's share of nursing home costs resulted in a net cost savings of $1.2 million in General Revenue Funds for the 2006–07 biennium.

To realize the cost savings shown above, the appropriations to TDCJ Correctional Managed Health Care would be reduced by the estimated costs for these offenders' healthcare. The appropriations to the Texas Department of Aging and Disability Services (DADS) would be increased to pay the state's share of Medicaid. Federal Funds would increase to pay for the federal government's share of nursing home costs.

IMPROVE THE MRIS REFERRAL PROCESS

Some ineligible cases may be referred to MRIS for screening, while some eligible cases may not be referred. Offenders are referred to the Texas Correctional Office on Offenders with Mental and Medical Impairments (TCOOMMI, formerly the Texas Council on Offenders with Mental Impairments) for MRIS screening from several sources including prison medical staff, daily hospital census reports, family members, other offenders, or attorneys/advocates. Figure 3 shows that a majority of offenders who are referred do not meet eligibility requirements. To help TCOOMMI identify eligible cases for MRIS release, TDCJ developed an automated report of offenders who have been diagnosed with certain medical conditions that could meet MRIS criteria.

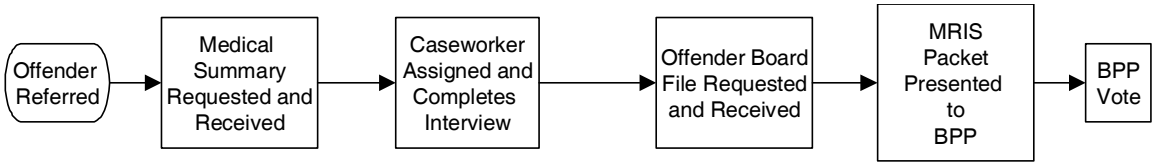
FIGURE 3
MRIS CASES REFERRED

Many offenders referred do not meet MRIS eligibility criteria. For example, in fiscal year 2004, 2,821 offenders were referred to TCOOMMI. Only 16 percent or 453 offenders met eligibility requirements and were presented to the BPP for parole consideration.

However, this report does not provide enough information to determine if an offender's medical condition meets MRIS eligibility criteria. For example, the report may list an offender as having AIDS, which is a terminal illness; but the report does not distinguish between the end stage of AIDS and the early stage of AIDS. While an offender with end stage AIDS may be bedridden, an offender with early stage AIDS may still be ambulatory. As a result, TCOOMMI must request an offender's medical summary to determine whether the offender meets MRIS eligibility criteria.

A 2002 TDCJ internal audit report also cited shortcomings in TDCJ's automated report. The internal auditors found that not all medical codes that might meet MRIS eligibility categories were included in TDCJ's automated report. Additionally, UTMB and TTUHSC use different codes from TDCJ to track offenders' medical diagnoses. This makes it difficult to screen offenders for eligibility using

FIGURE 4
TCOOMMI SCREENING PROCESS



SOURCE: Texas Department of Criminal Justice.

automated reports. As a result, TCOOMMI staff continues to review daily census reports and critical lists to identify offenders who might qualify for MRIS release. This increases the risk that some potentially eligible offenders may never be considered for MRIS release.

TDCJ's internal auditors sampled 209 offenders from TDCJ's automated report and found that only 22 percent of the potentially eligible candidates listed on TDCJ's automated report for MRIS release consideration had been screened by TCOOMMI. In fiscal year 2004, 15 percent of offenders approved for MRIS release were referred to TCOOMMI for consideration from parties outside the TCOOMMI process, such as family members and others.

Recommendation 2 would require TCOOMMI to develop an improved automated report to assist them in effectively identifying MRIS eligible offenders and to identify diagnosis codes to signal offenders eligible for release on MRIS.

EXPEDITE THE MRIS SCREENING PROCESS

Once an offender is referred, TCOOMMI staff must review the offender's board file to ensure he/she meets eligibility criteria and is not a threat to public safety. Figure 4 shows the TCOOMMI screening process.

TCOOMMI's goal is to recommend eligible offenders to the BPP within 30 days of receiving a referral. LBB staff analysis found that for fiscal year 2004, the average overall time for screening was 46 days.

Moreover, in fiscal year 2004 (through April 20, 2004) 100 offenders died while they were being reviewed for MRIS. LBB staff found that an offender's board file (which is a compilation of inmate records used to determine parole eligibility) is not requested until after an interview with the offender is completed. TCOOMMI reports that the primary reason for this practice has been refusals by offenders to be considered for MRIS. For this reason, TCOOMMI does not request offenders' board files until they have been interviewed and agree to be considered for MRIS. LBB staff analysis found that, on average, this lengthened the amount of time it takes TCOOMMI to screen offenders for MRIS release by 13 days.

Pursuant to Recommendation 3, TCOOMMI should request the offender's board file at the same time as it assigns a caseworker to complete an interview of the offender, if possible. This would reduce the MRIS screening time and expedite the MRIS process.

FISCAL IMPACT OF THE RECOMMENDATIONS

Amending Government Code, Section 508.146 to allow sex offenders who are permanently incapacitated (physically and/or mentally) to be considered for medically recommended intensive supervision would save $1.2 million in General Revenue Funds in the 2006–07 biennium. Figure 5 shows the medical costs avoided by the state from releasing permanently incapacitated sex offenders. The cost savings in Figure 5 assume that UTMB/TTUHSC would avoid one year of medical treatment costs for the sex offenders released on MRIS, and that this cost avoidance would include 54 days of hospitalization (half the number of hospital days of a seriously ill offender) plus 311 days of daily outpatient care per inmate. The savings estimate also assumes that these offenders would be eligible for Medicaid. Thus, the savings have been reduced by the state's share of Medicaid costs.

FIGURE 5
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO FEDERAL FUNDS
2006	$582,509	($282,733)
2007	$638,482	($305,234)
2008	$597,840	($281,754)
2009	$606,909	($281,754)
2010	$616,649	($281,754)

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not reflect any adjustments as a result of these recommendations.

IMPROVE MONITORING OF MENTALLY ILL OFFENDERS IN THE TEXAS CRIMINAL JUSTICE SYSTEM

During the last half century, the United States has undergone a shift in both mental health and criminal justice policy. The mental health system, once based primarily on institutional care, has shifted its emphasis to community-based treatment and support. Many mental health patients, through the aid of effective medications and rehabilitation models, have succeeded in living normal lives in the community. However, many people with mental illness are not receiving adequate care. In addition to limited resources resulting in a shortage of community mental healthcare services, many are unable to make and keep appointments at mental health centers. Various other issues, such as the lack of affordable housing for individuals with mental illness, co-occurring substance abuse problems, the stigma associated with mental illness, and the lack of stable employment contribute to the difficulties in providing effective community-based mental healthcare to all those who need it.

As a result, many people with mental illness end up homeless, cut off from services and likely to "decompensate," meaning to deteriorate mentally, and commit crime. To compound the issue, changes in criminal justice policy over the past two decades have increased the frequency, duration, and severity of the involvement of such individuals with the criminal justice system. Increased lengths of prison sentences for substance abuse crimes, as well as "zero tolerance" and "three strikes" laws, have all contributed to the growing nexus between mental illness and criminal justice nationwide. Consequently, individuals with mental illness are overrepresented in United States prisons. According to the United States Department of Justice, 16 percent of the U.S. prison and jail population has a mental illness, compared with 5 percent of the overall U.S. population.

SIGNIFICANT CONCERNS

- Many mentally ill offenders within the Texas Department of Criminal Justice are not being identified in county jails as mentally ill and as a result are not receiving appropriate treatment.
- Of the estimated 17,000 offenders in the Texas Department of Criminal Justice being treated for mental illness, approximately 14,000 receive some type of psychotropic medication. Medication noncompliance as a result of side effects of older medications may cause the symptoms of the offender's mental illness to reappear. When an offender's mental health deteriorates, so does his ability to function in a correctional setting. Behavioral issues can lead to disciplinary actions and administrative segregation. When a mentally ill offender is placed in segregation, he may further decompensate, making it more difficult for him to leave segregation. This compounding effect may mean more time in administrative segregation; greater loss of and inability to accrue good time; and subsequently, a longer time served—all of which are at a greater cost to the state.

RECOMMENDATIONS

- **Recommendation 1:** Every county jail, during its intake process, should be required to check each offender against the Department of State Health Services CARE system to determine if the offender has a history of mental health treatment, to report that finding on both the initial intake screening form and the Texas Uniform Health Status Update Form (if sentenced), and to transfer those forms with the offender if sentenced he or she is to the Department of Criminal Justice.
- **Recommendation 2:** The mental health screening instrument should be amended and standardized to include information on whether the CARE system was checked; any relevant mental health information should be included with the Uniform Health Status Update Form and transferred with the offender; and the rules and procedures of the Commission on Jail Standards should be amended to require the Commission on Jail Standards to include in its annual inspection of each jail a determination of each jail's compliance with the database check.
- **Recommendation 3:** A rider should be included in the 2006–07 General Appropriations Bill to require that the Department of State Health Services require local mental healthcare centers perform database matches for offenders in county jails.
- **Recommendation 4:** The Department of Criminal Justice should be appropriated $1.1 million each year of the 2006–07 biennium to conduct a pilot program of the Texas Medication Algorithm Project, including purchasing the prescribed

treatment regimens for approximately 350 offenders; tracking and making outcome measurements to determine the efficacy of adopting the Texas Medication Algorithm Project for a correctional population; and per rider reporting to the legislature; the Legislative Budget Board; and the Governor's Office of Budget, Planning and Policy the results of the project.

COMMENTS

The first step in addressing the dilemma presented by incarcerating mentally ill offenders is to identify those offenders as soon as they enter the criminal justice system. Early identification is essential for many reasons. Providing an early assessment for mental illness can provide valuable information about an offender, such as whether he has suicidal tendencies; whether he is taking psychotropic medication; and whether he poses a threat to himself, other offenders, or staff. It can minimize the occurrence of assaults on other offenders and correctional officers and hospitalization. Avoiding these potential difficulties can avoid costs in hospitalization and more intensive mental healthcare, as well as indirect costs such as lost personnel time and workers' compensation payments when correctional officers are injured. Additionally, it will aid the justice system in identifying those offenders who may not be competent for trial and provide valuable information for sentencing decisions will and probation caseload determinations.

For offenders entering the criminal justice system, this process should begin in the county jails. To better identify offenders with mental illness, each county jail should be required to screen each offender for mental illness as a component of its intake process. Since a majority of offenders with mental illness also have a dual diagnosis of mental illness and substance abuse, staff should screen for both issues at the initial screening. After the initial screening, offenders should continue to be monitored for symptoms of mental illness, as the effects of substance abuse can mask the presence of mental illness.

Although an initial mental health screening should be required, it should not be relied upon as the sole means of identifying offenders with mental illness. Screening tends to rely heavily on self-reports, which because of associated stigmas and altered mental states, may not provide the most accurate or comprehensive picture of an offender's mental health. To augment the screening process, staff should obtain and review all available healthcare records. Health and Safety Code, Section 614.017 complies with the federal regulations of the Health Insurance Portability and Accountability Act (HIPAA) and allows the sharing of mental health information of special needs offenders among health- and criminal justice-related agencies.

In Texas, the offenders' mental healthcare records are maintained in the Texas Department of State Health Services CARE database (formerly within the Department of Mental Health and Mental Retardation). Currently correctional managed healthcare, which provides the mental healthcare to offenders within correctional institutions in the Texas Department of Criminal Justice (TDCJ), provides mental healthcare to an average of 17,123 offenders with mental illness. However, when the Texas Correctional Office on Offenders with Medical and Mental Impairments (TCOOMMI) matched the records of all the incarcerated offenders against the CARE system, 33,012 offenders were found to be current or former state mental health clients. TCOOMMI also completed another recent study in which it reviewed, at random, 100 Texas Uniform Health Status Update Forms submitted by local jails at three different units within the correctional institutions division in TDCJ. These forms provide information on the offenders' physical and mental health and are required by the Commission on Jail Standards to be submitted for every offender sentenced to TDCJ. Of the 100 records reviewed, 15 had a mental health diagnosis noted (10 of these records had the same diagnosis that was found in the CARE system). The records were then checked against the CARE system which revealed that of the remaining 85, 29 additional offenders or 34 percent were found on the CARE system as former or current clients of the state mental healthcare system but had no mental health notation by the jail or the correctional institutions division. Of the offenders whose records were examined in this study, 44 percent had previously received state mental health services; whereas approximately 11 percent were receiving treatment for mental illness.

The PULHES system of medical classification, used by TDCJ and available for analysis by the Legislative Budget Board, classifies offenders on a four-point scale. Those with moderate mental disorders, including depression and schizophrenia are classified as a three and those who require continuous psychiatric supervision are classified as a four. Using the PULHES variables of three and four, at the end of fiscal year 2004, TDCJ had 10,303 mentally ill offenders. However, because correctional healthcare provided care to over 17,000 offenders, and over 33,000 had previously accessed state mental health resources, the PULHES variables appear to underestimate the number of mentally ill offenders in TDCJ.

To maximize early identification efforts and potential cost avoidance, each county jail, during the intake process, should be required to check each offender against the CARE system to determine if the offender has a history

of mental health treatment (Recommendation 1). The mental health screening instrument should be amended and standardized to include information on whether the CARE system was checked; any relevant mental health information should be included with the Uniform Health Status Update Form and transferred with the offender to TDCJ; the Commission on Jail Standards should include in its annual inspection of each local jail a determination of the jail's compliance (Recommendation 2); and local mental health centers should be required, by rider, to perform database matches for local jails (Recommendation 3). Currently, every contract that TCOOMMI has with local mental healthcare centers requires that the agency perform CARE database matches.

IDENTIFICATION OF MENTALLY ILL OFFENDERS IN THE DEPARTMENT OF CRIMINAL JUSTICE

The identification process, however, does not end with the county jails. During the intake process, trained staff in TDCJ's correctional institutions division look for observable signs of mental health problems; and all offenders, excluding those on death row, are screened using a mental health evaluation questionnaire. Results of the questionnaire are evaluated by a supervising psychologist to determine if further evaluation is needed. Also, medical personnel at the receiving unit review medical information and any medications sent to them by the county jails, and they observe the offenders to determine if any are in need of immediate referrals. Offenders who are determined to have psychological issues are referred to an associate clinical psychologist for further evaluation. A referral can also be triggered by either a sociological or medical referral through the normal intake process. The TDCJ classification division is notified of those offenders requiring mental health treatment, and the offender's diagnostic assessment becomes part of the offender's file to be used by unit classification staff and the mental health service providers at the offender's receiving unit.

When determining an offender's classification, correctional staff should consider an offender's psychiatric condition as well as his concurrent non-psychiatric medical conditions. There are costs and benefits to both housing mentally ill offenders at specialized units and housing them in the general population. Housing mentally ill offenders who can safely be included in the general population, so-called "mainstreaming," can aid in reducing the stigma of mental illness and provide corrections officials with greater administrative flexibility; but administrators should provide separate residential services for those with severe mental illness and a continuum of outpatient services for those who are housed in the general population. Mentally ill offenders within the general population, especially if their illness is undiagnosed or untreated, can decompensate more quickly than mentally ill offenders housed separately. When mentally ill offenders within the general population do decompensate, they are more likely to incur disciplinary infractions that lead to administrative segregation and subsequently, they decompensate even further and more quickly. Because of this potential and the changing needs of offenders with mental illness, staff should routinely reevaluate the housing assignments to ensure that the needs of each offender, whether in the general population or in an inpatient setting, are being met.

TDCJ considers the offender's mental health diagnosis when determining his unit, housing, and job assignments. This classification process is meant to ensure that each offender is placed in the appropriate institutional setting in which he can receive the appropriate supervision, treatment, education, and work opportunities consistent with the safety of the offender, the general population of offenders, agency staff, and the public at large. Within TDCJ, 74 facilities offer outpatient mental health services and four facilities offer inpatient services. Offenders are assigned to specific units based on their individual treatment, custody, education, and work needs as well as bed availability.

Once an offender is identified as having a mental illness, mental healthcare staff should develop a treatment plan for each offender. This plan should consider the offender's individual needs. In TDCJ, the offenders who have been determined to have psychological problems are referred to an associate clinical psychologist for an in-depth evaluation. The psychologists conduct clinical interviews, observe behavioral manifestations, conduct psychometric testing, and obtain medical information from other sources. After completing the investigation, the psychologists complete a diagnostic report and make recommendations for both long-term, routine care and services as well as any immediate psychiatric referrals. Depending upon the psychologists' recommendations, the offender may be referred to mental health treatment providers.

Unfortunately, offenders may not exhibit symptoms of mental illness until they have been incarcerated for a while. Also, an offender's mental illness status may change dramatically during incarceration. The incarceration experience itself, including the isolation, separation from family, and sometimes intimidation and victimization, can lead to severe depression or possibly even suicidal tendencies. It is also common for offenders' behavior to change as a result of new or different medications and withdrawal from drugs and alcohol. Offenders should be allowed to self-refer themselves for a psychiatric assessment. The staff needs to be aware of the symptoms of mental illness and have an effective referral process to ensure the offender's needs are addressed.

Within TDCJ, offenders are screened for mental illness with each unit change. Offenders who are in administrative segregation are evaluated by a mental health clinician after the first 30 days and every 90 days thereafter. Also, offenders in administrative segregation are evaluated five days a week by a nurse or mental health staff. Offenders returning from inpatient or special treatment facilities are evaluated within 72 hours of arrival at their receiving unit. Additionally, offenders may request an evaluation by submitting a sick-call request. Offenders may also be referred by medical or security staff, family members, advocates, or other offenders. When an offender is assessed to be critical, he is evaluated immediately, monitored through constant supervision, or moved to an inpatient facility if necessary. To warrant a transfer to one of the 1,570 inpatient psychiatric facility beds, the offender must exhibit symptoms of acute mental illness, such as psychotic symptoms, be at imminent risk of suicide, or be unable to function independently in the outpatient setting. Otherwise, an offender is seen by a mental health or medical clinician within 72 hours of referral. At most facilities, this initial evaluation is conducted by a mental health clinician. At some facilities the offender is triaged by nursing staff. If the initial examiner determines that a further evaluation is warranted, a referral is made to a psychotherapist, psychiatrist, psychiatric physician's assistant, or nurse practitioner. Follow-up appointments, usually held in an office setting but occasionally conducted at cell side, must be conducted within 14 days of referral.

PSYCHOTROPIC MEDICATION

In conjunction with other components of treatment, psychotropic medication can play an important role in the offender's treatment plan. Of the estimated 17,000 offenders in TDCJ being treated for mental illness, approximately 14,000 receive some type of psychotropic medication. Psychotropic medications include mood stabilizers, antidepressants, antipsychotics, and others. During fiscal year 2003, nearly three-quarters of the 96,480 prescriptions for antipsychotics were for typical antipsychotic agents, such as Haldol. These medications may cause side effects, such as tardive dyskinesia (involuntary movements), akathisia (body restlessness/inability to sit still), acute dystonia (spastic contraction of muscle groups) as well as hypotension (low blood pressure), tremors, and rigidity resembling Parkinson's disease, changes in the breath and heart rate, weight gain, insomnia, anxiety, and drowsiness. As a result of the side effects, an offender may refuse to take the medication.

Medication compliance is an issue in any mental health setting, and patients have the right to refuse any part of their mental health treatment, including medication. Within TDCJ, medication compliance is monitored by the treating mental health staff, and offenders are counseled to take the medication prescribed. With frequent noncompliance, the symptoms of the offender's mental illness may reappear, or a relapse may occur. When an offender's mental health deteriorates, so does his ability to function in a correctional setting. Behavioral issues can lead to disciplinary actions and administrative segregation. When a mentally ill offender is placed in segregation, he may further decompensate, making it more difficult for him to leave segregation. The compounding effect may mean more time in administrative segregation; greater loss of and inability to accrue good time; and subsequently, a longer time served—all of which are at a greater cost to the state.

However, newer generation medications, commonly known as "new gen meds," can be used to treat mental illness without most of the side effects of the typical agents. These medications are used less frequently in correctional settings than they are in the general community as a result of their higher costs. At TDCJ, only a quarter of antipsychotic medications prescribed are atypical or "new gen meds." The new gen meds included on the formulary are medications that may be prescribed if specific clinical criteria are met. According to the Consensus Project, coordinated by the Council of State Governments and in partnership with the Bureau of Justice Assistance and National Institute of Corrections, among other institutions, clinical evidence has shown that widespread availability of these medications produces the benefits of greater compliance with the patient's treatment plan and fewer hospitalizations. When applied to a correctional setting, the widespread use of new gen meds has the potential to produce significant long-term savings. The state could avoid the cost of hospitalizations and crisis management interventions while the offender is in custody, the cost of housing the offender in more costly segregation units, the cost of incarcerating the offender for larger percentages of his sentence, and the cost of medication and related medical expenses incurred during the offender's longer sentence length. Discharging an offender after having served his entire sentence, possibly even from administrative segregation, releases the offender with no supervision at all. Without supervision, there is no viable way to ensure that the offender receives treatment in the community, takes his medication, and avoids substance abuse and other criminal behavior. While a public safety concern, this lack of supervision also creates greater potential for recidivism and possible additional incarceration costs to the state.

Senate Bill 636, Seventy-seventh Legislature, 2001, required the Department of Mental Health and Mental Retardation (MHMR, now part of DSHS) to review the costs and

benefits associated with adopting the medication regimen, a specific formulary comprised of newer generation medications set out in MHMR's Texas Medication Algorithm Pilot Project (TMAP). Preliminary results of the study indicate that while costs can be approximated to a reasonable degree, a formalized pilot program is needed to better quantify the benefits that would result from adopting the TMAP regimen in a correctional setting. At the time of the study, it was estimated that to fully fund the TMAP program within TDCJ, an additional $16 million per year would be needed for additional prescription drug costs. Mental healthcare of offenders is often complicated by a dual diagnosis of substance abuse and mental illness. Since this dual diagnosis affects a large portion of the mentally ill offenders and previous medication studies have not yet validated the effectiveness or long-term benefits of the algorithm on this diagnosis, a pilot project is needed to determine the value that the algorithm would provide to this particular subpopulation.

To determine the effect that widespread use of new gen meds would have in a correctional setting, TDCJ should be appropriated $1.1 million each year of the 2006–07 biennium to conduct a pilot of the TMAP project (Recommendation 4). The project would provide funding for both purchasing the TMAP prescribed treatment regimens for approximately 350 offenders and the necessary tracking and outcome measurements to determine the efficacy of adopting TMAP for a correctional population.

MENTALLY ILL OFFENDERS IN ADMINISTRATIVE SEGREGATION

Another issue particular to the corrections setting is the use of administrative segregation with mentally ill offenders. The Correctional Managed Healthcare Committee reports that more than 2,000 offenders with a mental illness diagnosis are in either high security confinement or administrative segregation within TDCJ. This number represents 12 percent of the incarcerated mentally ill offender population currently receiving treatment for mental illness whereas 7 percent of the general population is confined in administrative segregation.

Using TDCJ's PULHES system of classification, at the end of fiscal year 2004, 946 mentally ill offenders or 9 percent of the total number of mentally ill offenders were housed in administrative segregation. While this is comparable to the 7 percent of the general population in administrative segregation, the number and percentage are lower than those provided by the Correctional Managed Healthcare Committee. Data constraints prevent determining the lengths of stay in administrative segregation and the resulting good time loss for mentally ill offenders, both of which contribute to longer times served and higher costs per day for time served in administrative segregation. During fiscal year 2003, 444 offenders or 29 percent of offenders qualifying as mentally ill (using the PULHES variables) were discharged after having served their entire sentence. Out of this number, 44 were discharged directly from administrative segregation, creating not only a public safety concern but also a considerable cost to the state. Of the offenders released during fiscal year 2003, those with a PULHES mental illness indicator served 10 percent more of their respective sentence than those without a mental illness indicator. Even though the PULHES system greatly underrepresents the number of offenders with mental illness, over $16 million in incarceration costs per year could be avoided if those offenders with mental illness scores of three and four served the same percentage of their sentences as those without mental illness indicators. Also, because offenders released on parole can qualify for Medicaid, the state could avoid the cost of psychotropic medication for those offenders.

Offenders in administrative segregation are reviewed by a mental health clinician after the first 30 days and every 90 days thereafter. In addition, a psychologist from the TDCJ health services division audits every segregation unit twice a year. The psychologist physically observes every offender confined in administrative segregation, interviews unit mental health and security staff for referrals of offenders, and interviews a sample of offenders in administrative segregation.

Treatment for mentally ill offenders confined in administrative segregation may differ from the treatment they would receive in the general population because of additional security restrictions for offenders who have exhibited violence toward the treatment staff. These offenders are usually excluded from group therapy. However, the offenders do have more frequent contact with mental health staff than their counterparts in the general population. Mental health staff perform weekly cell side rounds on all mentally ill offenders in administrative segregation. Also, the University of Texas Medical Branch (UTMB), which provides the medical and mental healthcare to the majority of incarcerated offenders through correctional managed healthcare, has an Administrative Segregation Intermediate Care Program (ASICP) to offer intensive outpatient mental health services to offenders who have had repeated admissions to the inpatient psychiatric facilities as a result of noncompliance with psychotropic medications. The program is an effort to aid these offenders in complying with prescribed treatment and in developing skills and behaviors required to function safely in the general population.

The effect of administrative segregation on mentally ill offenders varies. Some offenders' functioning may remain

static, some may improve, and some may decompensate. To avoid decompensation, the offenders may be assigned to the Program for the Aggressive Mentally Ill Offender (PAMIO). This 450-bed program at TDCJ's Clements Unit in Amarillo has two components: the primary PAMIO program, which focuses on reducing hostile aggression and self-injury for offenders in administrative segregation through medication, psychological treatment (counseling, group therapy, and behavior modification), and social treatment (in-cell activities, therapeutic group activities, and stress management); and the administrative step-down unit, which provides treatment to offenders with a history of frequent crisis interventions.

Offenders in any TDCJ facility statewide can be referred by mental health staff to the program. Acceptance to the program is based on the offender's administrative segregation custody level; presence of mental health disorders; and history of assaultive, predatory, or self-directed aggression. When an offender arrives at the primary PAMIO program, he undergoes a diagnostic evaluation from which a treatment plan is developed. His treatment is based on a system of behavioral levels in which each level has its own set of expectations and privileges. As an offender demonstrates compliance with treatment and medication plans and exhibits socially acceptable behavior, he moves up to the next level until he "graduates" from the program. Successful completion of the program generally takes 18 months. The goal of the program is to improve the offender's behavior so that he can be released from administrative segregation status.

Of the 450 beds in the program, 75 are dedicated to the step-down program, which is intended for offenders who are not seriously mentally ill but who are subject to frequent crisis interventions as a result of manipulative behavior or self-harm. Transfer to this program is not voluntary and is made by both mental health and TDCJ classification staff because of a history of crisis management issues with the offender. The unit has access to crisis intervention on site which reduces the need to move the offender. Therapeutic activities, such as aggression control, anger management, stress management, problem-solving, and coping skills, are provided to aid the offender in managing anger and impulsive or destructive behavior.

MENTAL HEALTH TRAINING

Another challenge in adapting the correctional system to meet the needs of mentally ill offenders is providing adequate training to affected staff. Training for corrections staff should be designed to enable the staff to identify offenders with mental illness problems; understand when it is appropriate to refer an offender for a mental health evaluation; improve the staff's ability to effectively communicate rules and procedures to offenders with mental illness; and provide basic information on related topics, such as the relationship between mental illness and violence, dual diagnoses, and psychotropic medication and its side effects. The training should also provide practical applications, such as suicide prevention, de-escalation techniques, and officer safety. TDCJ currently provides its correctional officers with one and one-half hours of pre-service training in mental health issues, two hours of training in suicide prevention, and one hour of in-service training in mental health issues/suicide prevention. The performance objectives of these trainings are to know how offenders access mental health services and how to refer them; to identify the types of treatment available and where the programs are located; and to identify characteristics of mental illness.

Training should be provided for parole board members and parole officers as well. Because parole board members come from a range of backgrounds and experiences, some may have experience with mental illness and others may not. It is important that each parole board member understands, in particular, the stigma of mental illness and the common association between offenders with mental illness and violence, which may cause the members to be hesitant to parole mentally ill offenders. Parole officers also come from a variety of backgrounds and have varying degrees of experience with mental illness. In addition to training similar to what the parole board members receive, parole officers should be aware of the availability of community mental health resources and alternatives to revocation. Parole officers should be able to identify when an offender is decompensating and when he is not complying with the terms of parole as a result of his inability to access mental health services.

It is particularly important that members of the parole board have sufficient knowledge and understanding of mental illness, the availability of community health services for parolees with mental illness, and adequate and reliable information regarding the history and treatment of each offender. Determining the risk level of an offender is central to the decision of whether the parole board releases an offender. Many releasing authorities, including the Texas Board of Pardons and Paroles, use parole release guidelines to steer and standardize the decision-making process. However, these guidelines typically address the general offender population without recognizing the special needs of mentally ill offenders. As an example, the Texas Board of Pardons and Paroles includes education and vocational and on-the-job training as factors to improve an offender's likelihood of release, but mentally ill offenders may be unable to participate in such activities. Even in states that do not utilize a system of discretionary parole, many use a

validated risk assessment tool to assess risk levels, yet no known risk assessment tool has been empirically validated to show the connection between mental illness and risk. Releasing authorities should be given access to the offender's mental health history and treatment plan and receive adequate training to ensure that a mentally ill offender's individual circumstances are taken into account when making the release decision.

RELEASE OF MENTALLY ILL OFFENDERS

Additionally, conditions of release must be reasonable, realistic, enforceable, and tailored to the individual offender's risks and needs. The parole board must ensure that the resources will be available in the community before making certain treatments and programs conditions of release. In Texas, the Board of Pardons and Paroles has the option of releasing the offender onto Medically Recommended Intensive Supervision (MRIS). A special mental health parole panel of three members considers special release conditions for qualifying offenders. To qualify, the offender cannot be convicted of a sex offense, and the board must determine that his mental illness played a role in his instant offense or his illness will adversely affect his ability to succeed after release. If approved, the offender is placed on a specialized caseload, and conditions of his release may include participation in a psychiatric/psychological evaluation, participation in mental health treatment, and compliance with medication. During fiscal year 2003, four mentally ill offenders were approved through MRIS. The parole board may also release an offender with mental illness to a specialized caseload through the regular parole or discretionary mandatory supervision process. However, of the more than 12,000 parolees who have received state mental health services, approximately 800 are on a specialized mental health caseload.

Another factor in the parole board's decision is its confidence in access to community-based mental healthcare resources. The Texas Correctional Office on Offenders with Medical and Mental Impairments (TCOOMMI) provides pre- and post-release care for special needs offenders released from institutions within TDCJ. When both the offenders and the appropriate community services are identified prior to release, and treatment and medication are made a condition of release a mentally ill offender's chance of reintegrating into society is increased. TCOOMMI has organized a regional continuity of care system in which offenders are immediately enrolled in services in the community to which they are paroled, thus, avoiding a break in service or medication.

Offenders with mental illness are overrepresented in the criminal justice system. Identifying, adequately treating, and providing effective medication for offenders with mental illness can improve and stabilize their lives, reduce recidivism, and avoid considerable long-term cost to the state.

FISCAL IMPACT OF THE RECOMMENDATIONS

The fiscal impact of the recommendations is $1.1 million in General Revenue Funds per year for fiscal years 2006 and 2007 to conduct a pilot program of the Texas Medication Algorithm Project (TMAP) to determine its effectiveness in a correctional setting. The pilot program would provide treatment regimens for approximately 350 offenders and the necessary tracking and outcome measurements to determine the efficacy of the program.

FIGURE 1
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS
2006	($1,100,000)
2007	($1,100,000)
2008	$0
2009	$0
2010	$0

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill does not include funding for this recommendation.

THE MILITARY IN TEXAS

The military in Texas consists of both state and federal military forces. The Texas Army National Guard, the Texas Air Force National Guard, and the Texas State Guard comprise the state military force, collectively known as the Texas Military Forces. The Texas National Guard serves a dual role and may be called into federal active service by the president, or state service, usually related to disaster relief, by the governor. Additionally, with 17 active military installations, over 113,000 active military personnel, and 37,000 civilian personnel, Texas has a strong federal military presence. Texas ranks third, behind California and Virginia, respectively, in the total number of federal active service and civilian personnel.

SIGNIFICANT FINDINGS

- The Texas Military Forces contribute to the state of Texas through many activities: such as, state active duty assistance, often in the form of natural disaster relief; assisting the federal government in homeland security; actively participating in the war on terror through worldwide deployments; training students in specialized youth education programs; and providing community assistance through the Texas State Guard.
- The federal military continues to have a strong presence in Texas. With 17 active military installations and over 113,000 active military service personnel, the U.S. Armed Services contribute to the economy and to local communities. Facing a new round of the federal Base Realignment and Closures process, the Seventy-eighth Legislature, Regular Session, 2003, passed legislation to better Texas' position to retain federal military installations.

COMMENTS

The Texas National Guard, as all state national guards, serves a dual role. The United States Constitution specifies that the president is commander-in-chief of the state militia when called into actual service of the United States and the governor of Texas serves as the commander-in-chief when the guard is called to state active duty.

STATE MILITARY PRESENCE

The guard is a first-line reserve component of the U.S. Army and Air Force and in that role may be called into active federal service by the president to provide military personnel for war, national emergencies, and at other times, if national security requires augmentation of active forces. The Texas National Guard air component also has the peacetime mission of supporting U.S. Air Force operations and airlift missions around the world as required. The size and structure of the national guard are established by the U.S. Congress; its composition and organization are determined by the Secretaries of the Army and the Air Force; and allocation of authorized number of guardspersons and federal funds is made to Texas by the federal National Guard Bureau.

The Texas Constitution makes the governor commander-in-chief at all times when the guard is not in active federal service. The guard may be ordered to active duty by the governor to provide trained and equipped military personnel to assist civil authorities in the protection of life and property and the preservation of law, order, and public safety in Texas. The governor appoints, with the advice and consent of the senate, the adjutant general. The adjutant general is the head of the Adjutant General's Department, the state agency that oversees the state activities of the Texas Military Forces. He is subordinate only to the governor in matters pertaining to the state military forces. The Texas Military Forces are comprised of the Texas Army National Guard, the Texas Air National Guard and the volunteer Texas State Guard. During fiscal year 2004, the Texas National Guard had approximately 16,800 members in the Texas Army National Guard and 3,200 members in the Texas Air National Guard.

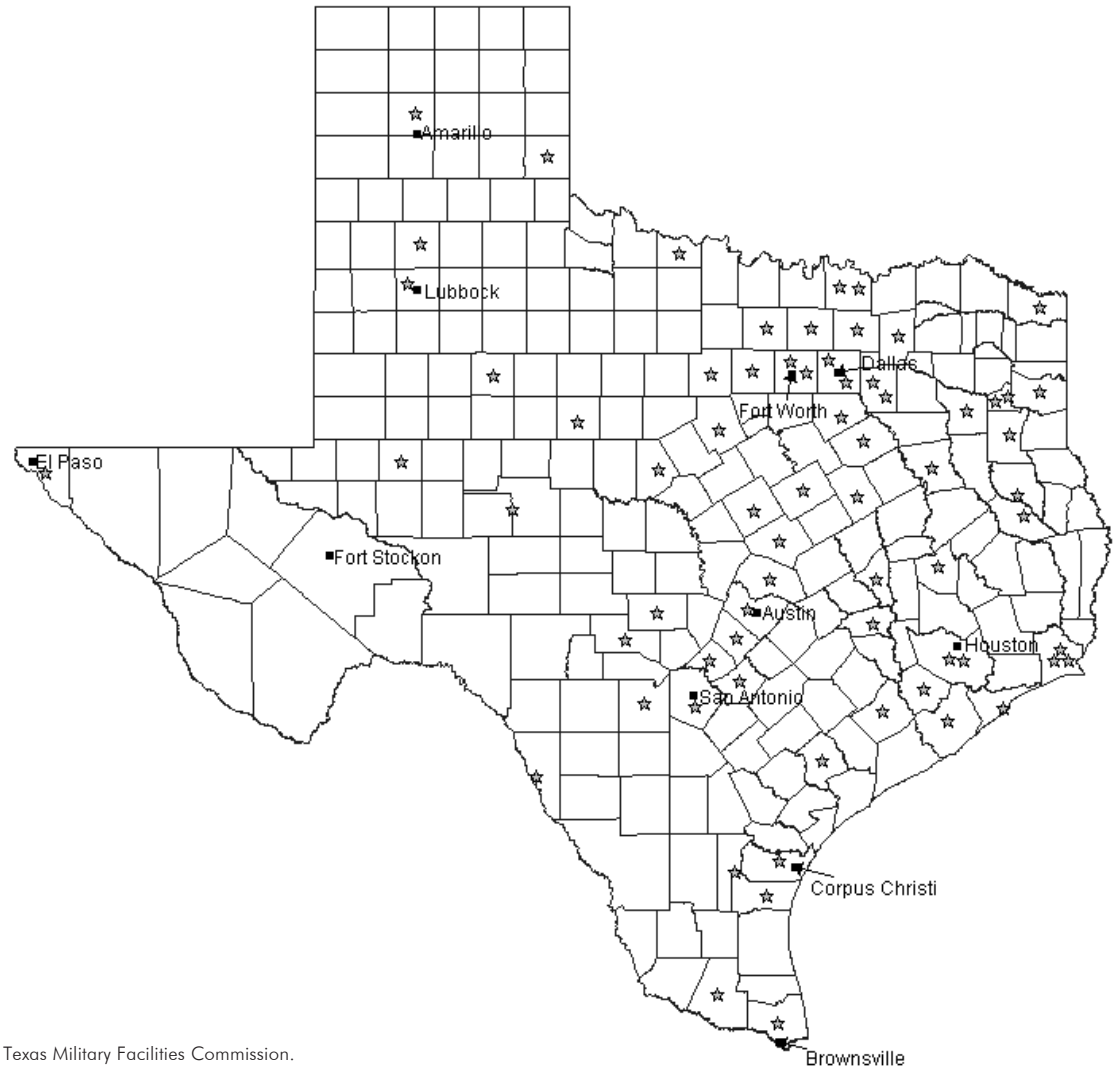
In addition to the funds appropriated to the Adjutant General's Department through Texas' General Appropriations Act, the department receives funds directly from the federal government. During state fiscal year 2004, the department received $416.5 million in federal direct funds. This funding is used not only to pay the salaries of the members of the national guard but also to support various federal operations such as airport security after September 11, 2001.

In addition to members of the Texas National Guard, the department also oversees the activities of the 1,600 members of the all-volunteer state reserve force, the Texas State Guard. The Texas State Guard provides trained and equipped individuals to supplement the Texas National Guard and replaces the Texas National Guard when that force is called into active service.

The Adjutant General's Department headquarters is located on Camp Mabry in Austin. The department rents state-owned national guard armories and other facilities statewide (see Figure 1) from the Texas Military Facilities Commission (TMFC). TMFC provides construction, maintenance, and repair of military facilities owned by the state and located on state property. The national guard uses 89 armories, 25 organizational maintenance shops, 19 training site facilities, and numerous other state-owned facilities (see Figure 2). The Adjutant General's Department also owns property and various federal armories throughout the state and is responsible for the maintenance, repair, and renovation of these facilities. Although it receives state appropriations each biennium for repairs of federal facilities, the federal and state share (ranging between 70/30 and 85/15) for building repair costs is determined by a master cooperative agreement between Texas and the federal National Guard Bureau.

The mission of the Adjutant General's Department is to provide mission-ready forces responsive to the community, state, and nation. As part of its state mission, the Texas National Guard participates in state active duty missions. These missions provide the state with assistance during times of emergencies, disasters, and special needs. During the past several years, the Texas National Guard has provided emergency response to numerous hurricanes and tropical storms on the Gulf Coast, floods in central and

FIGURE 1
LOCATIONS OF TEXAS NATIONAL GUARD ARMORIES



SOURCE: Texas Military Facilities Commission.

FIGURE 2
STATE MILITARY FACILITIES IN TEXAS

TYPE OF FACILITY	NUMBER OF FACILITIES
Armory	89
Organizational Maintenance Shop	25
Unit Training Equipment Site Building	4
Army Aviation Support Facility and Supporting Buildings	13
Armory Unit Storage Building	31
Vehicle Storage Building	9
Maintenance Training Bay	12
Storage/Warehouse	12
Administrative	2
Training Site Building	19
Miscellaneous (less than 1,000 square feet in size)	96
TOTAL Facilities	312

SOURCE: Texas Military Facilities Commission.

south Texas, snowstorms in north Texas, and wildfires across the state. In addition to natural disasters, the guard has also responded in times of specific need—providing additional security at the 2004 Superbowl in Houston and aiding in the Columbia shuttle recovery operation. The Adjutant General's Department is appropriated $1 million each fiscal year to perform state active duty missions as they occur. However, many missions, including many natural disaster-related ones and tasks such as the Columbia shuttle recovery operation, are reimbursed by the Federal Emergency Management Agency.

In addition to its primary state function of state active duty, the Adjutant General's Department also has several community-based functions. The Texas State Guard provides assistance to communities statewide through services such as security for local events, traffic and crowd control, searches for missing children, color and honor guards, and training support. The department also oversees two community-based education programs for at-risk students. The Starbase program, located at Ellington Field in Houston, teaches weeklong classes in practical math and science skills in a mentored environment. While attending the program, the elementary school students meet potential role models, such as astronauts, fighter pilots, and various members of the national guard.

The Adjutant General's Department also operates the Texas Seaborne ChalleNGe Program in Galveston. Each year this program provides six months of residential and 12 months of non-residential academic training for 200 high school students at risk of dropping out. In addition to obtaining a high school equivalent education, the students learn life skills, discipline, and motivation. The program is funded through a mix (65/35) of federal and state funding.

Following the September 11, 2001 tragedy, the Texas Military Forces have experienced a shift in mission. From immediate responses, such as a fighter escort of Air Force One and search, security, and rescue at Ground Zero to combat air patrols over major cities and security of 26 airports statewide, the Texas Military Forces' role in homeland security has expanded. Additional activities now include assisting the Federal Bureau of Investigation in the review of flight manifests, augmenting border patrol and customs services along the Mexican border and interceptor missions against unidentified aircraft entering U.S. airspace.

In addition the Texas National Guard has become more involved in the global war on terror. The Texas National Guard, as a reserve component of the U.S. Army and Air Force, may be called into active federal service by the president to provide military personnel for war, national emergencies, and at other times, if national security requires augmentation of active forces. The guard has been mobilized and deployed in support of the war on terror to 195 locations within the U.S., on coalition naval vessels, and in 38 countries, including Afghanistan and Iraq. Since September 11, 2001, over 10,000 Texas guardspersons have been mobilized. As of October 2004, over 4,000 have been deployed to Iraq and Afghanistan (500 are currently serving there) and 3,000 more are preparing for deployment. Texas National Guard duties include assisting in the training of the new Afghan National Army and flying night missions in Iraq.

To meet the demands of the growing involvement with both homeland security and the global war on terror, the Texas Military Forces are transforming their operations. The various state headquarters have been merged into a single, joint state headquarters to fuse the Texas Army and Air National Guards into one interdependent structure with consolidated functions and processes. Also, the very functions of the guard are being transformed. The 49th Armored Division of the Texas Army National Guard was recently reflagged as the 36th Infantry Division to provide a more agile, versatile, and deployable unit. Also, the Texas Air National Guard is putting new emphasis on information operations and an eventual transition to follow-on aircraft, including unmanned aerial vehicles. Finally, the Texas State Guard is transitioning into a trained joint force of specialists focused on homeland security, able to step in for the Texas National Guard as they are deployed.

FEDERAL MILITARY PRESENCE

In addition to the Texas Military Forces (Texas Army National Guard, Texas Air National Guard, and Texas State Guard), there is a strong federal military presence in Texas.

Texas is home to 17 active federal military facilities and 113,000 active duty service members, approximately 11 percent of all active duty service members. The federal military presence has a significant impact on the state economy. According to the Texas Military Preparedness Commission, military expenditures in Texas, including payroll and contracts, totaled $18.4 billion in federal fiscal year 2001. For federal fiscal year 2001, total payroll outlays totaled $8.8 billion (including reserve and national guard pay), and total military contracts were $9.5 billion.

U.S. ARMY INSTALLATIONS

Fort Hood is the U.S. Army's premier maneuver installation which enables the training and maintenance of combat-ready troops. The primary mission of the post is training and mobilizing units assigned to it and U.S. Army Reserve (non-active duty members of the federal military who may be called into active service) and national guard units. Fort Hood occupies 339 square miles of Bell and Coryell counties and is the only post in the U.S. capable of training two armored divisions. It is home to 42,000 soldiers, most of whom are members of the 3rd Infantry Division. The federal fiscal year 2003 budget for the post totaled $2.9 billion.

Fort Bliss is the site of the army's elite Air Defense Center. The primary mission of the post is to provide the nation's only Air and Missile Defense Center of Excellence to train and support the Air and Missile Defense Branch. Fort Bliss occupies 1.1 million acres in El Paso County and is the home of 15,000 soldiers and 7,000 civilian employees.

Fort Sam Houston is the home of the Army's Medical Command which manages the army's medical healthcare operations, administration, and clinical medical research. The installation, which occupies 3,150 acres in San Antonio, is home to 15,000 military and 8,000 civilian employees.

The primary mission of the Corpus Christi Army Depot is the repair and overhaul of rotary wing aircraft. The depot repairs and maintains helicopters for each branch of the service and employs 3,000 civilians and 11 military personnel.

The Red River Army Depot, located on 19,000 acres in northeast Texas in Bowie County, primarily provides maintenance for the Bradley fighting vehicle series. The depot employs 1,300 civilians and 7 military personnel.

The Lone Star Army Ammunition Plant is contiguous with and shares some services with the Red River Army Depot. The primary mission of the plant is to produce defense-related munitions. The plant employees 350 civilians.

U.S. NAVY INSTALLATIONS

Naval Air Station Corpus Christi is located on 2,500 acres in Corpus Christi (Nueces County). This installation is a premier flight training facility for the navy. Over 3,900 civilians and 2,500 military personnel are employed by the station.

The mission of Naval Air Station Kingsville, 30 miles southwest of Corpus Christi in Kleberg County, is primarily to train tactical jet pilots for the U.S. Navy and the Marine Corps. Total personnel for the station include 600 military personnel and 1,100 civilians.

Naval Station Ingleside is located on the northern shore of Corpus Christi Bay in San Patricio County. The primary mission of the base is to provide training, operations, and maintenance support to mine warfare forces. More than 3,500 personnel are assigned to the base.

Naval Air Station Joint Reserve Base Fort Worth provides training to both reservists and guardsmen while supporting joint service reserve training and operations. The station is located in Fort Worth (Tarrant County) and employs 1,500 civilian and 2,140 military personnel.

U.S. AIR FORCE INSTALLATIONS

Brooks Air Force Base in San Antonio is home to the 311th Human Systems Wing, which conducts aerospace medical research, and the Armstrong Research Site of the Air Force Research Laboratory. The base employs 600 military personnel and over 1,300 civilians.

Dyess Air Force Base is adjacent to Abilene in Taylor County. The base provides bombing, training, and combat support and hosts the 7th Bomb Wing (Air Combat Command) that operates 40 B-1B bombers. Military and civilian employees at the base total over 5,100.

Goodfellow Air Force Base is located east of San Angelo in Tom Green County. The base's primary mission is to develop and provide training in cryptology and intelligence for personnel of all the service branches. Over 500 civilians and 1,500 military personnel are employed at the base.

Lackland Air Force Base in San Antonio conducts the basic training of all enlisted recruits for the U.S. Air Force and provides healthcare and medical readiness at the air force's largest hospital. Over 20,000 military personnel and 6,000 civilians are assigned to the base.

Randolph Air Force Base, also in San Antonio, provides instructor pilot and flight fundamentals training and is home to the only Air Force Electronic Warfare Officer Training School. The base employs 4,200 military personnel as well as 4,600 civilians.

Laughlin Air Force Base, outside of Del Rio in Val Verde County, is the home of the 47th Flying Training Wing, which provides undergraduate pilot training for U.S. Air Force active duty, reserve and guard students. More than 1,900 civilian and 1,300 military personnel are employed by the base.

Sheppard Air Force Base provides technical and healthcare training to the U.S. Armed Services and NATO nations. The base is located north of Wichita Falls in Wichita County and employs 3,900 military personnel and 1,400 civilians.

BASE REALIGNMENTS AND CLOSURES

During the 1980s the U.S. Congress implemented the Base Realignment and Closures (BRAC) process as a means to increase the efficiency of the U.S. military. The Base Realignment and Closures Commission was formed to review recommendations from the U.S. Department of Defense. The commission is not required to accept all of the department's recommendations, but most bases recommended for closure are closed. The first BRAC round in 1988 mostly realigned bases. However, subsequent rounds of BRAC, in 1991, 1993, and 1995 involved the closing of many large bases within each service area. Since 1988 three major Texas military installations have been realigned, and seven, including Kelly and Bergstrom Air Force Bases, have been closed. Texas has lost about 14,600 jobs, military and civilian, as a result of previous BRAC rounds.

The process begins with the finalization of the criteria the commission will use to guide their BRAC decisions. Since a base closure will have a significant impact on the local economy, the criteria are designed to balance this negative effect with the needs of the military. In May 2005 the Secretary of Defense will submit recommendations for additional base realignments and closures to both the commission and Congress. In November 2005 the president must approve or disapprove of the final list of recommendations. If he does approve, the recommendations become legally binding and the actual process of base realignment and closures will begin with the 2006 federal fiscal year.

To improve Texas' posture for the 2005 BRAC process, Texas' Seventy-eighth Legislature, Regular Session, 2003, passed the following legislation:

- Senate Bill 652 combined the Office of Defense Affairs and the Texas Strategic Military Planning Commission into the Texas Military Preparedness Commission. The nine-member commission appointed by the governor was established to assist both existing defense-dependent communities in the prevention of base realignments and closures and those communities that have been already affected by BRAC. The commission also grants loans to communities for projects assessed to add military value to installations;
- Senate Joint Resolution 55 created the Texas Military Value Revolving Loan Account and permitted the sale of bonds for projects that benefit defense-related communities (the bonds were subsequently approved by voters in September 2003); and
- House Bill 591 mandated the Texas Education Agency to pursue reciprocity with other states to facilitate the transfer of military personnel and their dependents.

The military presence in Texas is strong. Both the Texas Military Forces and the federal military installations create a positive impact on the Texas economy and the local communities they serve.

ACHIEVE SAVINGS IN GENERAL REVENUE FUNDS BY EXPANDING THE USE OF WATER-RELATED FUNDS

The Water Development Board presently uses General Revenue Funds to pay for the cost of certain projects that could otherwise be financed with category-specific revenue from accounts in Other Funds. Furthermore, the agency presently has the ability to initiate new projects without sanction of the legislature and to continue projects conceived by legislatures many years in the past. Savings of up to $14.2 million in General Revenue Funds could be achieved during the 2006–07 biennium by replacing General Revenue Funds with these Other Funds.

SIGNIFICANT CONCERNS

- The brush control program of the Soil and Water Conservation Board and debt service for brush control projects and the saltcedar eradication program, currently paid with General Revenue Funds, could be paid using Other Funds from the Agricultural Water Conservation Account.
- General Revenue Funds are being expended by the Water Development Board for costs that could be financed through the Water Assistance Fund (Other Funds).
- The Water Development Board presently has the ability to initiate new projects and to continue possibly outdated projects without the approval or guidance of the legislature.

RECOMMENDATIONS

- **Recommendation 1:** For the 2006–07 biennium, use funds in the Agricultural Water Conservation Account to pay for the brush control program at the Soil and Water Conservation Board and to repay debt service on Agricultural Water Conservation bonds issued for brush control projects and saltcedar eradication programs in fiscal year 2003.
- **Recommendation 2:** For the 2006–07 biennium, use balances and revenues in the Water Assistance Fund to cover costs that would otherwise be paid using General Revenue Funds.
- **Recommendation 3:** Require the Water Development Board to request permission from the legislature to initiate new projects and to pursue only those projects initiated by previous legislatures that the Seventy-ninth Legislature, 2005, determines to remain priorities of Texas.

COMMENTS

Of the Water Development Board's 2006–07 Legislative Appropriations Request (LAR) of $72.0 million for the agency, $35.8 million, or 49.8 percent, is from General Revenue Funds (GR). The remaining $36.2 million is from non-GR funds: $8.1 million in Federal Funds; $23.8 million in Appropriated Receipts; $0.1 million in Interagency Contracts; $2.0 million from the Agricultural Water Conservation Fund; $2.2 million from the Water Assistance Fund.

The agency's 2006–07 LAR for Debt Service Payments for Non-self-supporting General Obligation Water Bonds includes a total request of $52.2 million, $38.2 million of which is from General Revenue Funds. Other Funds account for the remaining debt service funding, including $5.0 million out of the Economically Distressed Areas Bond Payment Account and $9.0 million out of the State Participation Program Bond Payment Account.

Outside of the State Treasury, the Water Development Board operates several different accounts, the largest of which are the Clean Water State Revolving Fund (CWSRF) and the Drinking Water State Revolving Fund (DWSRF). These accounts consist of state and federal contributions as well as repayments from local governments for the loan portions of these accounts. In addition, the agency has access to the funds from the Texas Water Resources Finance Authority (TWRFA), which derive from bond sales and refinancings. There are also several statutorily dedicated accounts inside the state treasury but outside of the General Revenue Fund, including the Agricultural Water Conservation Account and the Water Assistance Fund.

Because the agency has access to various accounts other than General Revenue Funds and those commonly used by other state agencies (e.g., Interagency Contracts and Appropriated Receipts), there is the potential to use some of these agency-specific funding sources to offset General Revenue Fund expenditures. Although each of these agency-specific accounts has statutory and/or constitutional designations for its use, there appear to be opportunities to use two of these accounts in ways that General Revenue Fund spending would otherwise be used during 2006–07.

POTENTIAL SAVINGS TO THE GENERAL REVENUE FUND FROM THE AGRICULTURAL WATER CONSERVATION FUND

In its 2006–07 LAR, the agency projects a balance of $16.2 million in the Agricultural Water Conservation Fund on August 31, 2005, with an additional $2.5 million in revenues from loan repayments accruing to the account during 2006–07. The majority of these funds were in the Agricultural Trust Fund (also "Other Funds") prior to September 1, 2003, until Senate Bill 1053, Seventy-eighth Legislature, Regular Session, 2003, consolidated that account and the General Revenue–Dedicated Agricultural Soil and Water Conservation Account into the Agricultural Water Conservation Account. Water Code, Section 18.899 specifies the use of funds in the Agricultural Water Conservation Account. These uses include grants and loans for conservation projects, agency costs in administering the agricultural water conservation program, and the repayment of debt service on bonds.

With over $16.0 million in balances in the Agricultural Water Conservation Account (Other Funds), there would be at least enough to cover the $5.4 million the agency projects would otherwise be spent in General Revenue Funds during the 2006–07 biennium to repay Agricultural Water Conservation Bonds. $16.0 million in General Obligation Bonds was issued pursuant to action by the Seventy-seventh Legislature, 2001, for brush control projects at the Soil and Water Conservation Board and saltcedar eradication projects at the Department of Agriculture.

The Soil and Water Conservation Board's LAR includes a request for $3.7 million for brush control projects in the agency's Water Conservation and Enhancement strategy. The vast majority of this money would be used to provide cost-share grants to landowners. These costs could also be paid using funds in the Agricultural Water Conservation Account, thereby saving an additional $3.7 million in General Revenue Funds. Using the Agricultural Water Conservation Account for both debt service on bonds issued for brush control and to pay ongoing costs of the Brush Control Program at the Soil and Water Conservation Board would result in a total General Revenue Fund savings of $9.1 million in the 2006–07 biennium (Recommendation 1).

POTENTIAL SAVINGS TO THE GENERAL REVENUE FUND FROM THE WATER ASSISTANCE FUND

The Water Assistance Fund (WAF) was created by the Sixty-seventh Legislature in 1981. Initially, $40 million was transferred to the WAF from the General Revenue Fund for water loan assistance, storage acquisition, research, and planning. Since the fund's inception, the legislature has directed additional funds, including General Revenue Funds and TWRFA proceeds, to the WAF for specific purposes and projects. The agency has maintained full access to funds in the WAF through riders in the General Appropriations Act (GAA) since the WAF's inception.

Revenues to the WAF have accrued from various sources over the years. The legislature has directed the agency to transfer balances from the TWRFA and from the General Revenue Fund on various occasions. One example of this, begun as a result of Senate Bill 1, Seventy-fifth Legislature, 1997, and the beginning of regional water planning activities, is the transfer of regional water planning funds from the General Revenue Fund to the WAF. Since the Seventy-sixth Legislature, 1999, between $7.0 million and $18.0 million each biennium has been transferred to the WAF, and another $7.4 million is requested for the 2006–07 biennium. Because such funds were originally appropriated out of the General Revenue Fund, such funds are subject to lapse.

In other cases, revenues accrue to the WAF in the form of repayments for specific loans authorized by the legislature. Examples of this include a $1.0 million loan to Fort Bend County and a $2.5 million loan to the Bexar Metropolitan Water District during the 1996–97 biennium and a $1.0 million loan for the Hueco-Bolson desalination project during the 2002–03 biennium. In these cases, General Revenue Funds were appropriated to make the loans; thus the funds were subject to lapse in the initial biennium in which they were appropriated. However, repayments accrue to the WAF where they become available for expenditure for any purpose the board deems necessary, as long as it complies with statutory restrictions for the WAF. These funds generally are not subject to lapse because the agency has always had appropriations authority to spend balances in the WAF through Rider 4, General Appropriations Act, Seventy-eighth Legislature, Regular Session, 2003.

Through the various loans that have been made from the WAF, the agency expects to receive a total of $1.8 million in loan repayments deposited back to the credit of the WAF during fiscal year 2004 to fiscal year 2007. The agency reports that virtually all of these funds have been "committed" to by the board, which means one of three things: a contract exists for the funds, the funds have been committed to by board resolution, or the funds have been "designated" for certain other projects. According to the agency, of the $30.7 million in cash in the WAF on July 31, 2004, $11.3 million in WAF funds were for "committed" projects still having no signed contract. Of this amount, $5.1 million is not expected to be under contract before the end of fiscal year 2005. Figure 1 provides a breakdown of funds in the WAF that are not yet encumbered but are expected to be spent prior to the end of fiscal year 2005. Figure 2 provides a breakdown of funds not anticipated to

FIGURE 1
FUNDS CURRENTLY NOT UNDER CONTRACT BUT EXPECTED TO BE ENCUMBERED PRIOR TO 8/31/05

PROJECT (BOARD RESOLUTION OR DESIGNATED)	AMOUNT	COMMENTS
Research and Planning, GAA, 78th Leg., Rider 2	$200,000	These funds are part of an overall $7.4 million General Revenue appropriation for Regional Planning Grants. This amount is reserved by the Board as a contingency amount to cover cost overruns at regional planning districts. If the funds do not get spent by the end of fiscal year 2005, they would become available in the WAF Account 480 in fiscal year 2006.
Financial Assistance to Unincorporated Communities, GAA, 76th Leg, Rider 15 and GAA, 78th Leg., Rider 19.	$400,000	The agency reports that these funds were designated for the Sand Branch community in Dallas County. The agency reports that negotiations continue with Dallas County, but no contract has been signed. If these funds are not spent by the end of fiscal year 2005, they would remain available in Account 480.
Colonia Self-Help, GAA, 71st Leg, Rider 5	$217,708	Board resolutions have been passed for several projects for Border Waterworks and Rensselaerville Institute, and contracts are expected to be in place by 8/31/05. If contracts are not in place, these funds would remain available in Account 480.
TWRFA–Playa Lakes, Board Resolution	$225,000	A total of $275,000 was originally allocated to Playa Lakes (GAA, 78th Leg., Rider 12), of which $50,000 is already under contract. A Board resolution has been approved for a contract with the University of Texas for an additional $50,000. The agency expects to execute that contract, and encumber the remaining $175,000, during fiscal year 2005.
Small Community Hardship Assistance, Board Resolution	$3,479,605	Small Community Hardship Assistance is a new program with demand exceeding funds available. The agency reports that all funds are expected to be encumbered prior to the end of fiscal year 2005.
TWRFA–Research and Facility Planning–Studies, Board Resolution	$829,050	The Board has approved resolutions for the following projects: Brazos River Authority, $50,000; Hamline University, $75,000; The University of Texas, $60,000 and $75,000; Texas A&M University–Texas Agricultural Experiment Station, $75,000; Texas Tech, $50,000; Alan Plummer Association, $75,000; GDS Associates Inc., $60,000; U.S. Geological Survey $29,700; and Jefferson County $239,350. An additional $40,000 is not designated for a specific project, but rather for agency program use.
Research & Facility Planning–Studies, GAA, 78th Leg., Regular Appropriations	$1,000,000	The agency expects to use these funds to cover costs in the Research and Planning Division that resulted from a shortfall in the amount of funds available to transfer from TWRFA in fiscal year 2005.
TOTAL, WAF Balance Not Under Contract But Expected To Be Prior to 8/31/05	$6,151,363	

SOURCE: Water Development Board.

be spent during 2005, although the agency has designated the majority of the funds for specific uses.

The legislature may direct the agency to use unencumbered funds in the WAF for any purpose it deems appropriate, as long as the use is authorized by statute. Allowable uses of WAF funding are generally limited to projects involving the provision of financial assistance to communities. However, there currently are expenditures the agency makes using General Revenue Funds that could be considered financial assistance and could thus be paid using the WAF. One example is the regional water planning activity. The agency is requesting $6.7 million in General Revenue Funds for this purpose during the 2006–07 biennium, but these costs could be paid using WAF proceeds instead, if the legislature determined that this use was a higher priority than projects otherwise receiving WAF "designation." At a minimum, the $655,715 in undesignated funds in the WAF could be used to reduce General Revenue Fund spending toward regional planning. If all funds which are not expected to be spent during fiscal year 2005 were redirected towards such expenses, a total of $5.1 million in General Revenue Fund savings could be realized (Recommendation 2).

FIGURE 2
FUNDS CURRENTLY NOT UNDER CONTRACT AND NOT EXPECTED TO BE ENCUMBERED PRIOR TO 8/31/05

PROJECT (BOARD RESOLUTION OR DESIGNATED)	AMOUNT	COMMENTS
EDAP Projects, 71st Leg., GAA, Rider 5	$1,823,023	These funds have been designated for Economically Distressed Areas Program (EDAP) by the Board, but they remain unencumbered. The funds were earmarked for facility planning, but the agency reports that until additional EDAP construction funding (agency LAR exceptional item request #1), no new facility plans will move forward.
TWRFA--Emergency Loans, GAA, 72nd Leg., Rider 4e	$440,000	These funds have been designated for use as emergency loans by the Board. However, demand has been less than expected for this program.
Rural Community Water & Wastewater Loan, Board Resolution	$1,350,000	The agency reports that the applicant pool for these loans is finding its needs are better met through the Rural Water Assistance Fund program. Agency staff currently is evaluating whether to consolidate these funds into another program serving rural and disadvantaged communities.
TWRFA--Board Discretionary (Board Resolution)	$845,818	The agency reports that these funds have been set aside by the Board to allow for increases to commitments and contracts already in existence and to fund other critical projects that arise.
Uncommitted Fund Balance	$655,715	Funds currently not designated for use.
TOTAL, WAF Balance Not Under Contract and Not Expected To Be Prior to 8/31/05	$5,114,556	

SOURCE: Water Development Board.

ENHANCED SCRUTINY OF THE WATER DEVELOPMENT BOARD'S USE OF OTHER FUNDS

Many of the designations for funding in the WAF are relatively old, dating as far back as the Seventy-first Legislature, 1989. Further, it appears that the agency does not systematically rescind its designation to projects no matter how long they are delayed. It is possible that funds could sit in the account waiting to be used for 10 to 20 years while other priorities of the state and agency go unmet. In addition, the agency essentially maintains full control of funds that accrue to the Water Assistance Fund from sources such as loan repayments, even though the original source of the money is often General Revenue Funds.

The Water Development Board, through Rider 6, General Appropriations Act, Seventy-eighth Legislature, Regular Session, 2003, was granted authority to spend any funds in the Agricultural Water Conservation Account with virtually no scrutiny from the legislature. Because these funds are also outside the General Revenue Fund, they also are not subject to lapse.

The agency has budgeted $10 million in fiscal year 2005 out of the Agricultural Water Conservation Account for a new program known as the Agricultural Water Conservation Demonstration Initiative Grant program. According to the agency's Web site, the program is intended to "expedite transfer of available technology to the farms and to develop comprehensive data, utilizing large-scale demonstration sites, to assess the cost-effectiveness of selected technologies, evaluate and determine the impact of implementation on crop productivity, impacts on reductions of irrigation water use, and impacts on available water supplies."

Although the decision to initiate and fund this new program is within the board's authority, the agency did not seek legislative approval or ask the legislature if it had another priority use for these funds. For instance, absent the agency's decision to use this $10 million for the demonstration initiative, the legislature could decide that these additional balances be used to fund brush control costs, including debt service, in 2008–09 and beyond.

Appropriations authority to the Water Development Board for funds in the Water Assistance Fund and the Agricultural Water Conservation Account should be provided through rider only for specific, identified projects during a given biennium (Recommendation 3). The agency would then need to request permission from the legislature to begin new projects, continue ongoing projects, and continue with projects initiated by previous legislatures

many years earlier. This would hold the agency more accountable for its spending and provide an opportunity to redirect funding based on legislative priorities rather than those of the agency. The language to be added to the appropriate rider providing appropriations authority for each respective account could resemble the following:

> The Water Development Board may only use funds in the Water Assistance Fund No. 480 on the following projects not to exceed the amounts listed during the 2006–07 biennium.

A listing of projects would follow with the names of the project and the estimated project cost. Funds associated with projects not continued would then be freed up for new projects or to pay ongoing agency costs. Moreover, implementation of recommendation three would result in funds in the WAF being treated similar to other state funds, which are subject to lapse and greater scrutiny by the legislature. To cover emergencies and unforeseen needs, a limited amount of funds from the WAF could be appropriated for such discretionary purposes each biennium.

Although the TWRFA, the CWSRF, the DWSRF, and the State Participation Program were all reviewed to determine whether balances were available for the legislature to consider for expenditure or limitation on expenditure, the only significant unencumbered balances offering opportunities for General Revenue Fund savings appear to occur with the Water Assistance Fund and the Agricultural Water Conservation Account. As programs change at the state and federal level, additional funding mechanisms outside the General Revenue Fund will continue to be monitored for additional opportunities.

FISCAL IMPACT OF THE RECOMMENDATIONS

As Figure 3 illustrates, implementation of the recommendations contained in this report could result in a savings in General Revenue Funds of $14.2 million during the 2006–07 biennium. This savings would be achieved by substituting $5.1 million in expected General Revenue Fund spending on regional planning activities with balances and revenues in the Water Assistance Fund. An additional $5.4 million could be saved by using funds in the Agricultural Water Conservation Account to pay debt service on brush control bonds instead of using General Revenue Funds. Finally, $3.7 million in General Revenue Funds could be saved by using funds in the Agricultural Water Conservation Account to pay costs of the brush control program at the Soil and Water Conservation Board rather than General Revenue Funds.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE SAVINGS/(COST) TO OTHER FUNDS
2006	$7,124,794	($7,124,794)
2007	$7,071,127	($7,071,127)
2008	$0	$0
2009	$0	$0
2010	$0	$0

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill includes $14.2 million in savings in General Revenue Funds as provided for by Recommendations 1 and 2.

MAXIMIZING FEDERAL FUNDS FOR TEXAS BEACHES

Texas receives less federal funding to address beach erosion than most states with shoreline both inland and coastal. From fiscal year 1995 to fiscal year 2004, the federal government distributed an estimated $1.1 billion in federal funding for beach erosion projects. The distribution to four states (New Jersey, Florida, New York, and Illinois) accounts for 68 percent or $758.5 million of the federal funding. Texas has received a total of $2.4 million for beach erosion projects. Additional funding is needed to protect the Texas coastline and maximizing federal funding should be explored.

SIGNIFICANT FINDINGS

- A review of the various federal agencies that fund coastal zone related programs determined that the U.S. Corps of Engineers' Continuing Authorities Program and projects specifically authorized by Congress are the primary source of federal funding available to states for beach nourishment projects that address coastal erosion. The U.S. Corps of Engineers is authorized to fund periodic beach nourishment projects beyond the initial construction for up to 50 years.
- The process to draw down federal funding to address beach erosion differs from most federal grant programs. The U.S. Corps of Engineers is authorized to partner with grantees through the Continuing Authorities Program and by federal legislation that specifically authorizes beach erosion control projects.
- The Corps of Engineers and Shore Protection: History, Projects and Costs study, completed by the Corps in May 2003, lists the 71 specifically authorized shoreline protection projects as of June 2002. According to this report, only two shoreline projects have been completed in Texas since the Corps first started them in 1950.

SIGNIFICANT CONCERN

- The current funding source for Coastal Erosion Planning and Response Program projects is primarily dedicated for another purpose, and its use does not comply with current state statute.

RECOMMENDATIONS

- **Recommendation 1:** Congress should be petitioned by the Texas Legislature to consider small beach nourishment projects as eligible projects for Pre-Disaster Mitigation grant funds.
- **Recommendation 2:** The General Land Office should examine strategies to maximize federal funding through the U.S. Corps of Engineers' Continuing Authorities Program.
- **Recommendation 3:** The General Land Office should seek legislation to amend the current statute to modify the interest cap and/or provide another dedicated revenue source to fund coastal erosion projects and contribute required state matches to maximize Federal Funds.
- **Recommendation 4:** The General Land Office should utilize the Coastal 2020 report to petition Congress to specifically authorize and fund beach erosion control studies and construction projects in Texas.

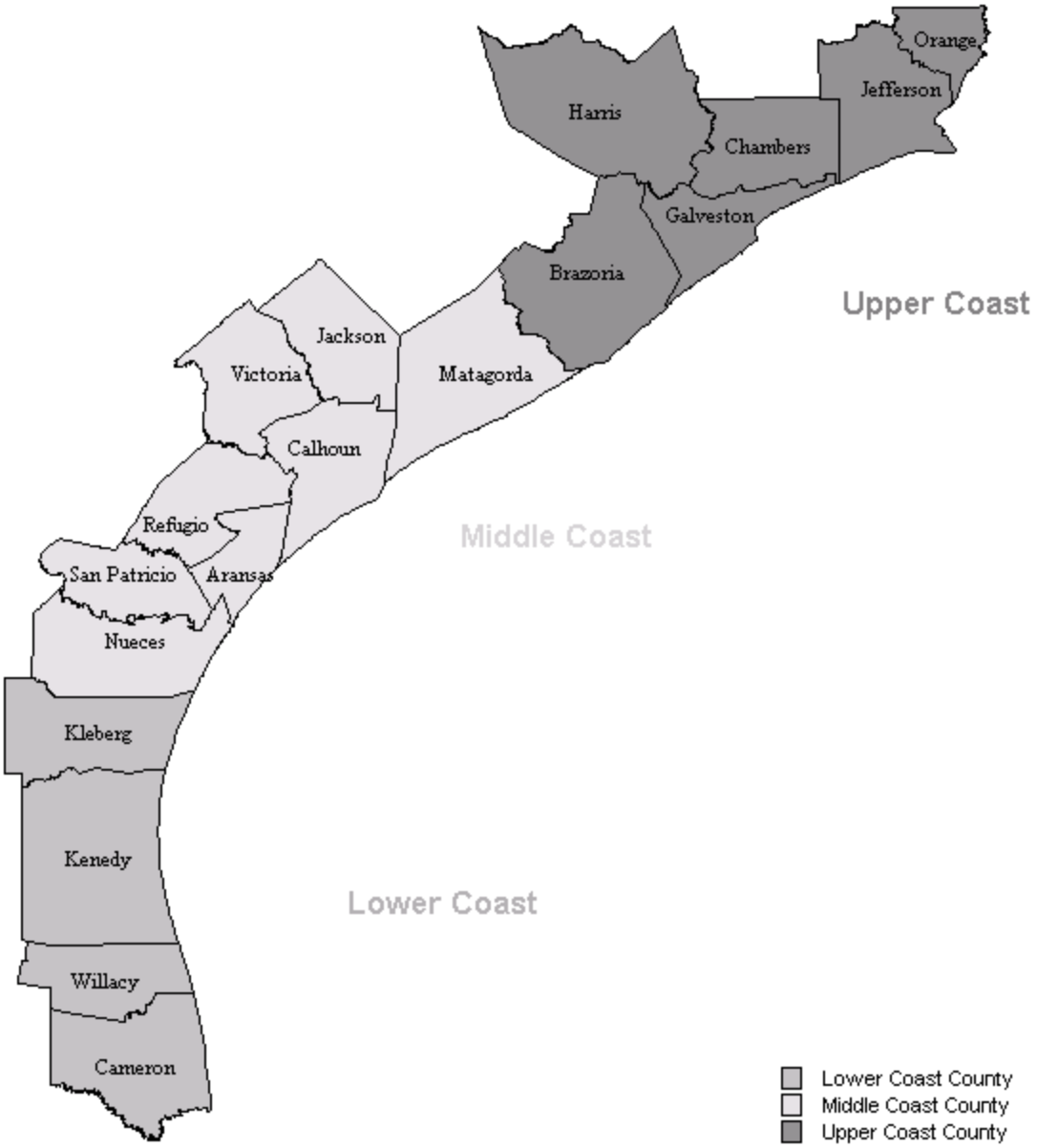
COMMENTS

In states bordering the Gulf of Mexico, large areas of coastal land have been eroded as a result of natural processes and human activities. According to a U.S. Geological Survey report published in 2004, about half of Texas beaches have been eroding at an average rate of 5.9 feet a year. Beach erosion is concentrated between Sabine Pass and High Island, southwest of the Galveston Island seawall, and along the peninsula. A growing coastal population, increased tourism activity, and land development on the Texas coast will continue to be pressures on Texas beaches and wetlands.

DEMOGRAPHICS AND ECONOMY OF TEXAS COASTAL AREAS

The Texas coastline stretches 624 miles along the Gulf of Mexico, from Orange County to Cameron County. For this report, the 18 counties falling under the jurisdiction of the Coastal Zone Management Act of 1972 (CZMA) are considered coastal (see Figure 1). Coastal zone counties include the following: Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Harris, Jackson, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Orange, Refugio, San Patricio, Victoria, and Willacy. According to the 2000

FIGURE 1
TEXAS COASTAL COUNTIES



SOURCE: Legislative Budget Board.

Census, 25 percent of Texas' population (5.2 million) lives in the coastal zone counties. Texas coastal counties' population grew by 16 percent over the 1990 Census count and is estimated to increase to about 6 million by 2010.

Tourism is a major industry in Texas and contributes to the economic development of coastal zone counties. Texas is one of the most visited states in the country (third to California and Florida). Tourism on the Texas coast has a significant impact on the Texas economy. In 2003, visitor spending in coastal zone counties accounted for 26.3 percent of the $33.5 billion spent by visitors to Texas. The coast's travel and tourism industry employed more than 126,000 people in 2003 and generated an estimated $193.5 million in local and $571.8 million in state tax revenues, for a total of $765.3 million.

BEACHES AND BARRIER ISLANDS

Texas has the third longest coastline in the country measuring 634 miles, about 480 miles of which are beach. Parallel to the beaches on the coastline are long, narrow strips of land called barrier islands. Barrier islands are mounds of sand deposited by waves and wind over a long period of time. There are 17 barrier islands that total 191,762 acres stretching along the coastline. Texas is similar to Alabama and Florida in that its sandy barrier islands are also close to the coastline. These landforms serve as a first line of defense against hurricanes and tropical storms.

BEACH NOURISHMENT

Several coastal states have implemented different types of projects under the overall categories of beach nourishment efforts to restore an eroding or lost beach or to create a new shoreline. Structural approaches to addressing beach erosion include construction of sea walls (wave resistant structures), revetments (wave protection structures placed on an existing sloping embankment), and jetties. Another approach to beach nourishment involves using large amounts of sand to widen beaches. This also provides an elevation to protect the upland area. According to the U.S. Geological Survey, beach nourishment is becoming the most frequently used method to address coastal erosion.

COASTAL ZONE MANAGEMENT PROGRAM

The passage of CZMA marked the first significant federal role in managing coastal areas. Congress authorized the Coastal Zone Management Program (CZMP) to ensure the protection and management of coastal areas. The CZMP is a voluntary program that provides federal funding and technical assistance (Sections 306 and 306a) to coastal states to prepare and implement state coastal management. The Seventy-second Legislature, 1991, passed the Coastal Coordination Act, which created the Coastal Coordination Council (CCC) and provided the framework for developing Texas' CZMP plan for federal approval.

The Texas Coastal Management Program (CMP) received Section 305 Federal Funds to develop its CZMP plan and continues to receive Section 306 and 306a funds to assist in managing and implementing the CZMP. Other CZMA programs include the Coastal Zone Enhancement Grants (Section 309) and the Nonpoint Source Pollution Control Program (Section 6217). CZARA established the Section 309 program to encourage states to develop programs in one or more of the following nine coastal zone enhancement areas: wetlands, public access, coastal hazards, cumulative and secondary impacts, energy and government facility siting, marine debris, ocean resources, special area management plans, and aquaculture. Figure 2 provides the matching requirements and the fiscal year 2004 federal awards for all CZMP programs.

Beginning in 1999, the Office of Ocean and Coastal Resource Management (OCRM) has interpreted congressional language to mean that projects funded with CZMP funds may not be capital-intensive and that Section 306a funds cannot be used to finance large-scale, erosion-prevention structures. OCRM's guidance policy for these

FIGURE 2
COASTAL ZONE MANAGEMENT ACT PROGRAMS

SECTION	PURPOSE	MATCH REQUIREMENTS	FEDERAL AWARD FISCAL YEAR 2004
306 and 306a	Coastal Zone Management Program Administration and Implementation	50 percent	$2.0 million
309	Program improvements to coastal programs in any of nine areas of national significance.	None	$0.5 million
6217	Nonpoint Pollution Control Program Administration and Implementation	50 percent	$0.3 million

SOURCE: National Oceanic and Atmospheric Administration, Office of Ocean and Coastal Resource Management.

funds indicates that beach nourishment or hard structure erosion control projects cannot be funded with Section 306a funds. However, OCRM does allow states to spend Section 306a funds for planning beach nourishment projects in certain limited instances. Small-scale shoreline stabilization structures are allowed for the redevelopment of deteriorating or underutilized urban waterfronts or ports to provide for increased public use and access. OCRM may approve planning activities for a beach nourishment project or nonstructural erosion control project if the project is on public land and the state CZMP can show there is a substantial public benefit related to the project, these benefits substantially outweigh the costs, there is a reasonable expectation that the project will last for a reasonable amount of time, the project is minor in scope and not capital-intensive, and the project meets other Section 306a requirements.

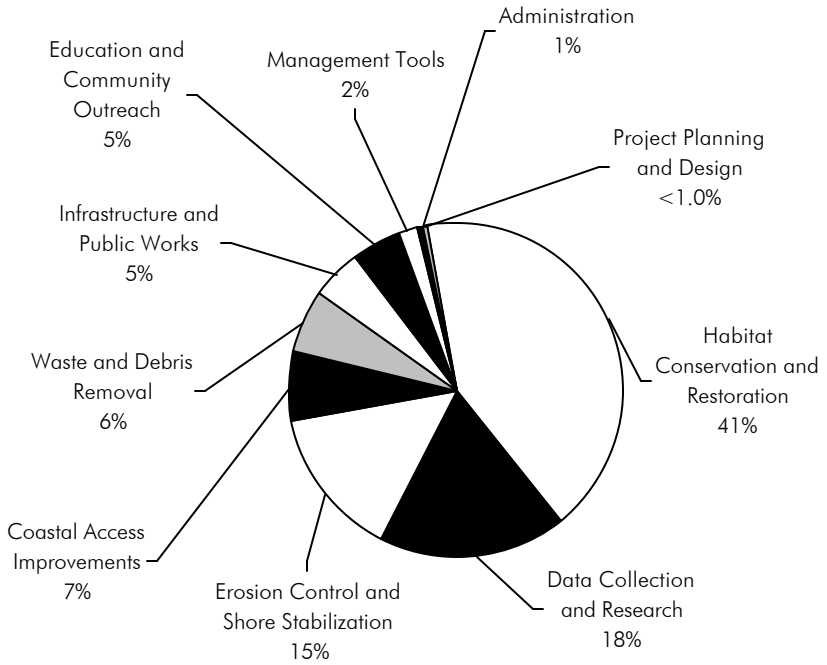
COASTAL IMPACT ASSISTANCE PROGRAM

Congress appropriated $150.0 million for the Coastal Impact Assistance Program (CIAP) in fiscal year 2001. This one-time appropriation was allocated to seven states to lessen the impacts of oil and gas production on the outer continental shelf and to protect coastal resources. Texas' allocation was a total of $26.4 million, with 35 percent ($9.2 million) flowing to local counties directly from the federal government. The General Land Office (GLO) and CCC managed the portion of funds retained by the state ($17.1 million). The GLO, CCC, and coastal counties funded 80 projects with CIAP funds and spent approximately 15 percent of these funds on erosion control and stabilization. Figure 3 displays the percent of CIAP funds spent by project type. About 15 percent of these funds were spent on erosion control and shore stabilization. Coastal beach associations have petitioned Congress to appropriate these funds in subsequent years. However, Congress has not appropriated funds for the CIAP program since fiscal year 2001.

BEACH MONITORING AND NOTIFICATION PROGRAM

Congress passed the Beaches Environmental Assessment and Coastal Health Act (BEACH Act) in October 2000. This BEACH Act authorized federal funding to states to develop and implement beach water quality monitoring and notification programs at recreational waters near beaches.

FIGURE 3
TEXAS COASTAL IMPACT ASSISTANCE PROGRAM PROJECT TYPES
FEDERAL FISCAL YEAR 2001, $26.4 MILLION



SOURCE: National Oceanic and Atmospheric Administration.

Congress appropriated $9.9 million in fiscal year 2004 for Beach Monitoring and Notification Program Implementation Grants. The distribution of these funds to the 38 eligible states is based on a formula, which considers three factors: (1) beach season length, (2) beach miles, and (3) beach use. Congress appropriated $2.0 million for fiscal year 2001 Beach Monitoring and Notification Program Implementation Grants, and increased the appropriation to $10.0 million in subsequent years. Texas has received about $0.4 million each year since fiscal year 2002 in BEACH Act funds. The Environmental Protection Agency requested that states report the total number of beaches and the number of beaches being monitored. Beaches are defined as discrete coastal recreation waters adjacent to a shore or similar points of access that are used by the public. GLO reported that 30 percent, or 50 of the 166 beaches in Texas are monitored. The GLO has used BEACH Act funds to expand the Texas Beach Watch Program that was supported with CMP funds.

HAZARD MITIGATION

Federal Emergency Management Agency's (FEMA's) Pre-Disaster Mitigation (PDM) grants support planning and projects to address natural hazards. FEMA reports that these plans and projects reduce overall risks to populations and structure and reduce reliance on funding from actual disaster declarations. For fiscal year 2003, Congress made $150.0 million available to fund the PDM grants. Each state receives approximately $0.2 million in PDM planning grant funds. FEMA distributes the remaining PDM funds on a competitive basis to eligible applicants, such as state emergency management agencies or similar state offices. Federal funding per project is limited to a maximum of $3.0 million. FEMA will contribute up to 75 percent of the total amount approved under the grant award to implement projects. At least 25 percent of the total eligible costs must be provided from a nonfederal source. Texas received a total of $10.0 million in PDM funds in fiscal year 2003 (see Figure 4).

Currently, PDM funds are available for minor structural hazard control or protection projects that may include vegetation management, storm water management, or shoreline/landslide stabilization. Congress may consider legislation that would allow small beach nourishment projects to be eligible for PDM grants. During the 108th Congress, House Bill 3804, The Beach Nourishment as Pre-Disaster Mitigation Act, was introduced to allow small beach nourishment or renourishment projects to be eligible for the PDM Grant funds. Recommendation 1 suggests that the Texas Legislature petition Congress to consider small beach nourishment or renourishment projects as eligible projects for PDM Grant funds.

FIGURE 4
PRE-DISASTER MITIGATION GRANTS AWARDED TO TEXAS FISCAL YEAR 2003 (IN MILLIONS)

GRANTEE	PROJECT TYPE	FEDERAL SHARE AMOUNT
City of Jersey Village Home	Residential Elevations	$1.5
Harris County Flood Control District	Residential Acquisitions	7.1
City of Conroe	Residential Acquisitions	0.9
Governor's Division of Emergency Management	Texas Multihazard Mitigation Plan	0.2
Governor's Division of Emergency Management	Management Costs and Technical Assistance	0.3
Total		$10.0

SOURCE: Federal Emergency Management Agency.

BEACH EROSION CONTROL PROJECTS

The U.S. Army Corps of Engineers (Corps) assists states with planning, designing, and managing water resource projects. The Corps is authorized to partner with states and local governments to protect coastal areas, including beaches and wetlands, from hurricanes and coastal storm damage. In the past, the Corps addressed beach erosion by implementing shoreline protection structures such as sea walls and revetments. Today the Corps focuses more on beach nourishment projects to replenish sand on beaches. The process to draw down federal funding to address beach erosion differs from most federal grant programs. The Corps is authorized to partner with grantees (referred to as sponsors) through two separate processes: (1) the Continuing Authorities Program (CAP) and (2) by federal legislation that specifically authorizes beach erosion control projects.

CONTINUING AUTHORITIES PROGRAM

The CAP authorizes the Corps to construct small beach restoration and protection projects not specifically authorized by Congress. CAP projects have specific criteria and cost-sharing requirements, and must follow the same project development phases as specifically authorized projects. Each project has a maximum federal share of costs ($2.0 million) and must not be dependent on additional improvements for successful operation. In fiscal year 2004 the state received $1.4 million in CAP funding to complete four coastal erosion projects. Recommendation 2 proposes that the GLO continue to explore strategies to maximize federal funding through CAP for small projects with the Corps.

SPECIFICALLY AUTHORIZED PROJECTS

The process for specifically authorizing projects involves sponsors requesting Congress to authorize and appropriate federal funding for two project development phases: (1) a needs assessment, and (2) project construction. The needs assessment component includes two studies: an initial reconnaissance study to determine if a feasible solution is likely, followed by a feasibility study to examine alternatives and to select the project that best meets national and local needs. The costs of the initial reconnaissance up to $0.1 million are completely funded by the federal government. Most feasibility studies' costs are shared equally between the federal government and the sponsor. Congress must appropriate funds for these studies in order for the Corps to complete the needs assessment.

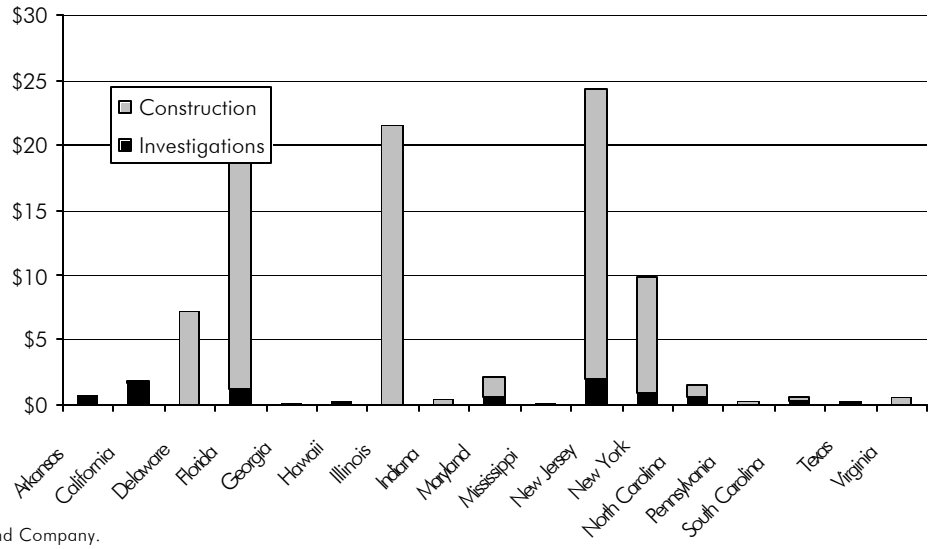
If the feasibility study determines that a Corps project should be completed, Congress must first authorize the project and then appropriate funds. Congress authorizes selected projects with the passage of the Water Resources Development Act every two years. These projects have a cost-sharing requirement of 35 percent. The Corps may then either operate and maintain the completed project or turn it over to a state or local partner. With beach nourishment projects, the cost-sharing agreement includes a federal commitment to share the ongoing costs of periodic renourishment, often over a period of 50 years.

Congress appropriated nationally an estimated $93.1 million in fiscal year 2005 for shoreline erosion projects and studies in 16 states. Florida, Illinois, and New Jersey were appropriated $66.9 million, or 72 percent of the total (see Figure 5). Congress earmarked about $0.4 million in federal funding in order to continue one feasibility study in Texas: the Sabine Pass to San Luis Pass project. The federal government and sponsors will share the $4.3 million cost of the feasibility study equally. The sponsors of this project are the GLO, Galveston County, and Jefferson County. Prior to this feasibility study, the Corps completed a reconnaissance study at a cost of $0.9 million for this project. The Corps has indicated that its fiscal year 2006 budget will request funding for a Texas statewide feasibility study.

The Corps of Engineers and Shore Protection: History, Projects and Costs study, completed by the Corps in May 2003, lists the 71 shoreline protection/coastal erosion projects specifically authorized by Congress as of June 2002. This study did not include the numerous small projects that fall under CAP. According to this report, only two shoreline projects have been completed in Texas since the Corps first started in 1950. The Galveston Seawall Structural project was completed in 1963 and cost an estimated $9.3 million. The Corpus Christi Beach project was completed in 1978 at a cost of $2.4 million.

The president's budget for fiscal year 2005 proposed to eliminate the federal contribution for periodic renourishment projects, work on beaches beyond initial beach nourishment. The Corps had notified states this new policy will be implemented in fiscal year 2005, unless Congress directs them otherwise. However, recently the

FIGURE 5
FEDERAL FUNDING FOR BEACH EROSION CONTROL PROJECTS
FEDERAL FISCAL YEAR 2005 (IN MILLIONS)



SOURCE: Marlowe and Company.

Corps has issued a notice that the new policy will not be implemented without congressional agreement.

COASTAL EROSION PLANNING AND RESPONSE ACT

To address erosion concerns along the Texas coast and provide funding for erosion control projects, the Seventy-sixth Legislature, 1999, enacted the Texas Coastal Erosion Planning and Response Act (CEPRA) with the passage of Senate Bill 1960. CEPRA is a coordinated effort of state, federal, and local entities to conduct beach nourishment, shoreline protection, and dune restoration projects and related studies. The GLO is the state agency that administers CEPRA.

Funding for CEPRA projects is a mix of state and local funds. Project partners must provide at least a 25 percent match for beach nourishment projects and a 40 percent match for shoreline protection and marsh restoration projects; however, one large-scale beach nourishment project can be conducted each biennium, using up to one-third of the biennial funding without a match requirement. A potential project partner may be any local government, state or federal agency, institution of higher education, or other public or private entity that submits a proposal to finance, study, design, install, or maintain an erosion response project. Projects are selected on criteria laid out in the original CEPRA legislation. Based on these scores the agency comes up with a priority list of projects. Most proposed projects range in scope from $0.5 million to $3.0 million. Figure 6 provides information on the first three cycles of CEPRA projects. CEPRA funding was decreased by more than half for the 2004–05 biennium.

LEVERAGING FEDERAL FUNDS FOR CEPRA PROJECTS

To date, the CEPRA program and the GLO have been somewhat successful at leveraging Federal Funds from the U.S. Fish and Wildlife Service and the Corps CAP Program. The state has not, however, been able to access the level of Federal Funds achieved by Florida and New Jersey. Unlike these other states, which have entered into many specifically authorized projects with the Corps, since the inception of CEPRA Texas has only entered into one such project—the Sabine Pass to San Luis Pass study. So far CEPRA has provided $600,000 to the project to offset the local share of study costs. When this study is complete, the state should be able to leverage $10.0 million to $15.0 million in Federal Funds for beach erosion control projects associated with this study. In order to leverage these funds, however, the project partners will have to be able to provide the required 35 percent state match of approximately $3.5 million to $5.3 million. According to GLO staff, the primary reason the state has not entered into more specifically authorized projects with the Corps is that state matching funds have not been available to qualify for major Corps projects. The GLO anticipates needing at least $10.0 million per biennium in CEPRA appropriations to be able to provide the necessary matching funds for new, specifically authorized projects in addition to other CEPRA projects. Appropriations for CEPRA projects have been decreasing since fiscal year 1999 and are currently $7.3 million for the 2004–05 biennium. There is the possibility that Congress will not provide funds in federal fiscal year 2005 for new, specifically authorized projects, but it is anticipated that the funding for these projects will be available in the coming fiscal years. To provide the necessary matching funds for projects associated with the Sabine Pass to San Luis Pass study and any future specifically authorized projects, which in turn could leverage millions in Federal Funds, the state needs a long-term, stable revenue source.

STATE REVENUE SOURCE

From fiscal year 2000 to fiscal year 2003, the revenue source for CEPRA projects was a $12.6 million biennial appropriation out of the General Revenue Fund and a $2.4

FIGURE 6
COASTAL EROSION PLANNING AND RESPONSE ACT (CEPRA) FUNDING CYCLES

			AMOUNTS APPROPRIATED (IN MILLIONS)	
LEGISLATIVE SESSION	CEPRA FUNDING CYCLE	NUMBER OF PROJECTS	GENERAL REVENUE	GENERAL REVENUE–DEDICATED COASTAL PROTECTION ACCOUNT NO. 027
2000–01 Biennium	Cycle 1	34	$12.6	$2.4
2002–03 Biennium	Cycle 2	41	$12.6	$2.4
2004–05 Biennium	Cycle 3	20	$0.0	$7.3

SOURCES: General Land Office and Veterans' Land Board.

million biennial appropriation out of General Revenue–Dedicated Coastal Protection Account No. 027. The Seventy-eighth Legislature, 2003, appropriated $7.3 million in General Revenue–Dedicated Coastal Protection Account funds and did not appropriate any General Revenue Funds for the 2004-05 biennium based on a proposal from the GLO substituting its General Revenue by General Revenue–Dedicated Coastal Protection Account funds as a means to comply with required budget reductions. The primary revenue stream for the General Revenue–Dedicated Coastal Protection Account is a two-cent-per-barrel fee on crude oil loaded or unloaded in Texas ports. This revenue stream was created primarily to fund oil spill prevention and response efforts; and according to statute, the General Revenue–Dedicated Coastal Protection Account appropriations for coastal erosion projects should not exceed the annual amount of interest income earned within this account. The GLO estimates the interest earnings to be $1.1 million for the 2004–05 biennium. The current appropriation for the 2004–05 biennium out of this account does not comply with statute. To comply with statute, future appropriations for coastal erosion projects would have to be drastically reduced. These projects would have to be funded out of the General Revenue Fund; statute would have to be amended modifying the interest cap; and/or another dedicated revenue source would have to be identified to fund these projects.

The House Committee on Land and Resource Management was charged to evaluate the need and possible strategies for alternative funding sources for coastal erosion and coastal hazard mitigation and report back to the Seventy-ninth Legislature. The committee held a hearing in August 2004 and has held several meetings since then with stakeholders, government relations staff, and representatives from industry to discuss various sources to fund current CEPRA projects and provide the state match for future specifically authorized projects.

The following are several options for alternative revenue streams identified in testimony to the committee:

- a two-cent assessment on oil and gas produced in coastal communities;
- a dockage fee;
- a fee on fuels and lubricants on ships;
- a fee on cruise ship departures;
- an additional surcharge on hotels and motels in coastal areas; and
- a fee on real estate transactions in coastal communities.

Recommendation 3 suggests that the GLO seek legislation that amends the current statute to modify the interest cap and/or provides another dedicated revenue source to fund current coastal erosion projects and to provide the state match necessary to maximize Federal Funds.

Five coastal states have a dedicated source of state revenue that funds beach erosion programs. Florida's program has been successful in drawing down Federal Funds to address beach erosion control due to its implementation of a source of state funding in 1964 to help offset local communities' share of project costs. The State of Florida's Beach Control Program is financed by a documentary stamp tax paid by individuals who record deeds or other instruments transferring interest in real property in the state. Over the past 10 years, 91 beach nourishment projects in Florida have been completed or are underway, involving 51 different local governments. According to the Florida Shore and Beach Preservation Association, funding for Florida beaches during 1992 through 2002 totaled $326 million ($122 million in federal funds, $90 million in local funds, and $114 million in state funds).

COASTAL TEXAS 2020

In order to address coastal issues, the GLO has developed "Coastal Texas 2020," an initiative to create a strategic plan, which will lay out strategies to address the environmental and economic challenges facing the Texas coast, provide suggestions for legislative changes, and propose funding mechanisms to address coastal erosion. To facilitate the work of Coastal Texas 2020, the coast has been organized into five regions, with an advisory committee for each region. These regional advisory committees will provide an avenue for input and feedback from all interested parties including recreational and resource user groups, homeowners associations, coastal land owners and developers, non-profit and public policy organizations, chambers of commerce, and convention and visitors bureaus for the Coastal Texas 2020 final report. Lists from the five regional groups will be compiled into one document and then based on cost estimates and project timeframes, the projects will be prioritized, and the data will be included in the final Coastal Texas 2020 report, which will be submitted to the Seventy-ninth Legislature in January 2005. Recommendation 4 suggests that the GLO should utilize the Coastal Texas 2020 report to petition Congress to specifically authorize and fund beach erosion control studies and construction projects in Texas.

Texas will continue to face coastal beach erosion due to natural hazards, growing coastal population, increased tourism activity, and land development on the Texas coast. Texas' funding source for Coastal Erosion Planning and Response Program projects is not stable and has been

decreased by more than half. Additional federal funding is needed to address coastal beach erosion. The Corps CAP program and projects specifically authorized by Congress are the primary source of federal funding available to states and local governments for beach nourishment projects. The recommendations proposed in this review suggest that the GLO continue to partner with the Corps through the CAP program and pursue specifically authorized beach erosion control projects according to the findings in the Coastal Texas 2020 report. In order to fund these future studies and projects, it is recommended that the GLO continue to explore alternative revenue streams to fund coastal erosion projects and contribute state matches for maximizing Federal Funds.

FISCAL IMPACT OF THE RECOMMENDATIONS

If needs assessments for specifically authorized Corps projects in the state are completed, Congress authorizes funding for these projects, and funding is available to contribute the required state match, the General Land Office could draw down additional Federal Funds—for example, $10 million to $15 million in Federal Funds for the Sabine Pass to San Luis Pass Project.

The introduced 2006–07 General Appropriations Bill includes a contingency appropriation out of the General Revenue–Dedicated Coastal Protection Account for erosion projects in excess of the interest cap contingent upon the Seventy-ninth Legislature adopting legislation modifying the present cap and revenue to the General Revenue–Dedicated Coastal Protection Account exceeding the Comptroller's revenue estimate.

ENHANCE THE ACCOUNTABILITY OF THE TEXAS ENTERPRISE FUND

The Seventy-eighth Legislature, 2003, capitalized the Texas Enterprise Fund for the 2004–05 biennium, with a $285 million appropriation from the Economic Stabilization Fund. The statutory purpose of the Texas Enterprise Fund is to promote economic development, job training programs, and business incentives. The fund is a deal-closing program intended to make sure that selected economic development or business projects occur in Texas and not in a competing state.

Although the fund is relatively new, the Office of the Governor (which administers the fund on behalf of the Governor, Lieutenant Governor, and the Speaker of the House of Representatives) has established procedures and controls for proposal evaluation and contract compliance. Ensuring that all future agreements require the full return of the state's investment would strengthen accountability and help to ensure the fund is used to effectively promote economic development and job creation in Texas.

SIGNIFICANT CONCERNS

- The Texas Enterprise Fund has controls to ensure fund recipients meet their performance targets. However, two agreements awarded in fiscal year 2004 could have included stronger provisions to hold recipients accountable for meeting job creation and investment goals.
- State law does not require the Office of the Governor to produce a report on the Texas Enterprise Fund's grant allocations, activities, or performance. As a result, the legislature and public do not have sufficient information to assess the performance of the activities financed by the fund.

RECOMMENDATIONS

- **Recommendation 1:** Amend Government Code, Section 481.078, to require that future Texas Enterprise Fund agreements withhold a reasonable percentage of the overall grant until certain performance targets are met.
- **Recommendation 2:** Amend Government Code, Section 481.078, to require that all future agreements include a provision that ensures the full return of the state's money when major goals, such as job creation and private investment, are not met by fund recipients.
- **Recommendation 3:** Amend Government Code, Section 481.078, to require that the Governor submit a Texas Enterprise Fund annual report that identifies all grant allocations, activities, and grantee performance.

COMMENTS

The Seventy-eighth Legislature, Regular Session, 2003, created the Texas Enterprise Fund to promote economic development, job training programs, and business incentives. For the 2004–05 biennium, the legislature appropriated $285 million from the Economic Stabilization Fund to the Texas Enterprise Fund, a dedicated account within the state's General Revenue Fund. The fund is administered by the Office of the Governor, Economic Development and Tourism division. This is a "deal-closing" fund, in the sense that state grants are negotiated and awarded to companies and other entities as an incentive to ensure that an economic development project will take place in Texas. According to the fund's enabling legislation, Government Code, Section 481.078, the Governor is authorized to negotiate and award grant money appropriated to the fund after obtaining permission from the Lieutenant Governor and the Speaker of the House of Representatives.

As shown in Figure 1, the Governor awarded $205.6 million in Texas Enterprise Fund Grants as of January 3, 2005, to 17 economic development projects. These projects are expected to create a combined total of 22,846 jobs. The total private investment is projected to be about $6.2 billion.

GRANT AWARD AND MONITORING PROCESS

The Economic Development and Tourism division of the Office of the Governor manages the process for determining whether a particular economic development project should receive a Texas Enterprise Fund grant. Figure 2 shows the overall award process. If division staff decide that a project may be worthy of a grant from the fund, it performs a preliminary analysis of the project. After the potential grantee has submitted an application, a more formal analysis is performed. Staff evaluates the project using various criteria: the ability to develop a Texas-based industry that functions effectively in the international market place, the impact of job creation on the local economy, the number of jobs created, the level of private investment, the level of capital improvements, the level of

FIGURE 1
TEXAS ENTERPRISE FUND GRANT ALLOCATIONS AND GOALS AS OF JANUARY 3, 2005

COMPANY	BUSINESS SECTOR	LOCATION	ENTERPRISE FUND GRANT	DIRECT JOB CREATION GOAL	PRIVATE INVESTMENT GOAL
Baylor College of Medicine–Bovine Gene Sequencing	Agriculture	Houston	$2.0 million	N/A	$51.0 million
University of Texas Dallas/ UT System/Texas Instruments	Semi-Conductor	Richardson	$50.0 million	1,000	$3.0 billion
Vought Aircraft	Aerospace	Dallas	$35.0 million	3,000	$598.0 million
Sematech	High-tech Consortium	Austin	$40.0 million	4,000	$190.0 million
Texas Energy Center	Energy Cluster	Sugarland	$3.6 million	1,500	$20.0 million
Home Depot	Retail	Austin/ New Braunfels	$8.5 million	843	$809.0 million
UT MD Anderson	Biomedical	Houston	$25.0 million	2,252	$55.0 million
Maxim Integrated Products	Semi-Conductor	San Antonio	$1.5 million	500	$90.0 million
Citgo Petroleum	Oil Refinery	Houston/ Corpus Christi	$5.0 million	820	$828.0 million
Cabela's	Sporting Goods	Fort Worth & Buda	$600,000	600	$70.0 million
Koyo Steering Systems	Manufacturing Auto Parts	Ennis	$333,000	200	$30.0 million
Superior Essex Communication	Telecommunications	Brownwood	$250,000	50	$7.6 million
LEARN & Tigre (Internet2)	Telecommunications	Statewide	$9.8 million	N/A	N/A
Huntsman	Chemicals	Odessa, Woodlands & Port Neches	$3.0 million	326	$227.0 million
Lee Container	Manufacturing	Nacogdoches	$300,000	105	$5.6 million
Countrywide Financial Corporation	Financial Services	Richardson	$20.0 million	7,500	$200.0 million
BP Chemical	Petrochemicals	League City	$750,000	150	$5.7 million
Totals			$205.6 million	22,846	$6.2 billion

SOURCE: Office of the Governor.

FIGURE 2
ENTERPRISE FUND MANAGEMENT PROCESS

SOURCES: Legislative Budget Board; Office of the Governor.

local involvement and support, competition for the project from outside Texas, and the financial soundness of the project. In addition, the division performs a cost-benefit analysis to determine whether state and local tax revenue over the life of the grant agreement is greater than the grant amount itself.

The Governor's office staff presents information and recommendations regarding a proposed TEF project to the Governor, Lieutenant Governor, and Speaker of the House of Representatives. These three officials decide which applicants will receive TEF awards, the amount of the awards, and the terms of each award agreement.

During negotiations with the applicant, staff develops a grant agreement that defines performance targets and penalties for non-attainment of these targets. Performance targets include the projected number of jobs created and the level of investment that must be attained within a specific time period. Specific penalties for failure to achieve these targets are also stipulated in the agreement.

After a decision to grant an award has been announced and an agreement between the state and the grantee has been signed, the Office of the Governor monitors the grant recipient's compliance with the agreement. The Governor's office staff periodically verifies that the grantee is spending state funds appropriately and is reaching the targets and goals stipulated in the agreement. Contract monitoring includes both site visits and review of certain financial documents, such as invoices for purchasing capital goods that contribute to the development of the project.

COMPARISON OF MAJOR STATE DEAL-CLOSING FUNDS

According to a fifty-state survey of deal-closing funds performed by the Texas Legislative Council in March, 2004, Texas is among eight states that have created deal-closing funds financed with state appropriations: Florida, Georgia, Louisiana, Maryland, North Carolina, Pennsylvania, Texas, and Virginia. One state, Georgia, uses tobacco settlement proceeds to finance its fund, while the others receive General Fund appropriations for this purpose. One state legislature, Maryland, did not appropriate money to its fund in 2004.

Distinguishing characteristics of these deal-closing funds include the following:

- There is competition with another state for the project;
- Grants are awarded to businesses, local governments or development authorities, or public institutions such as universities; and
- Grants are used to finance a variety of projects, including facility development, project infrastructure, research, or other technology development projects.

Figure 3 provides information about the five state deal-closing funds with the greatest appropriations: Georgia, North Carolina, Pennsylvania, Texas, and Virginia.

PERFORMANCE/EXPENDITURE MONITORING AND VERIFICATION OF GOALS

Under the performance evaluation systems in the five states, grant recipients must file annual or semi-annual reports indicating progress towards major goals such as creating jobs and achieving projected investment levels. North Carolina verifies job creation data from grant recipients reports by accessing data from the state's employment agency. Other states require recipients to certify the accuracy of information through signed affidavits.

In addition to using a compliance system, the Texas Governor's office also requires recipients to maintain segregated accounting records and documentation associated with grant funds, and submit annual compliance verification reports and/or year-end audited financial statements.

JOB CREATION TIMEFRAME REQUIREMENTS

The four major state deal-closing funds outside of Texas generally require companies to reach their job creation targets within three years or less. Georgia's Economic, Development, Growth, and Expansion (EDGE) Fund recipients are usually required through negotiations to produce a certain number of jobs within twelve months, while North Carolina generally requires recipients to meet their job creation targets within three years. The Pennsylvania fund sometimes allows large stable companies up to five years to reach their job creation targets.

The Texas Governor's office bases its job creation timeframe requirements on a variety of factors, including the stability of the company and the specific development aspects of the project. Timeframe requirements for existing projects vary from the target to create 1,500 jobs within four years by the Texas Energy Center, a start-up project awarded a $3.6 million grant, to a target to create 14,000 indirect jobs within ten years by the Sematech high-technology consortium that was awarded $40 million.

Flexibility in establishing the appropriate time period for compliance with Texas' job creation targets allows the governor's office to match the goal to the specifics of the project. However, long time periods with no intervening job creation milestone to gauge performance and address potential problems are a concern. Recommendation 1 would amend state law to require future agreements to withhold a reasonable percentage of the overall grant until certain performance targets are met.

FIGURE 3
COMPARISON OF MAJOR STATE DEAL-CLOSING FUNDS

	GEORGIA	NORTH CAROLINA	PENNSYLVANIA	TEXAS	VIRGINIA
Fund Name	EDGE Fund (Economic Development, Growth, and Expansion)	One North Carolina Fund	Opportunity Grant Program	Texas Enterprise Fund	Governor's Opportunity Fund (GOF)
Administrating Agency	One Georgia Authority	Dept. of Commerce	Dept. of Community and Economic Development	Office of the Governor, Economic Development and Tourism	Virginia Economic Development Partnership
Fund Created	2000	1993	1996	2003	1993
Funding	$25 million annual	$20 million annual	$50 million annual	$285 million biennial	$12 million annual
Published Guidelines or Internal Guidelines (not public)	Public Guidelines-Administrative Rules	Public Guidelines, not Administrative Rules	Public Guidelines	Internal Guidelines	Internal Guidelines
Content of Public Guidelines	Fund purpose, eligible recipients; eligible uses of grant; review of applications, awarding of funds, statement of funding conditions	Fund purpose, eligible recipients; eligible uses of grant; procedures for commitment, award, disbursement of funds, recipient reporting requirements, review procedure; award criteria; contract terms; disbursement of fund.	Fund purpose, eligible recipients; eligible uses of grant; minimum employment target; minimum investment-to-grant ratio; penalties for goal non-attainment; application procedures; application evaluation criteria.	Not applicable	Not applicable
Project Review Policy	Use a cost-benefit analysis, taking into account state & local tax revenue as benefit; community support; job creation, private investment; wage levels of new jobs, economic condition of community (economically disadvantaged sites receive priority ranking), and other factors.	Use a cost-benefit analysis only for grants over $1 million, taking into account state tax revenue only; must meet minimum job creation and private investment levels that vary depending on locality's population; wage levels of new jobs, economic condition of locality (fiscal stress of locality reduces local match requirement), and other factors.	Proposal evaluation takes into account job creation and private investment targets; wage levels of new jobs, economic condition of locality, and other factors.	Use a cost-benefit analysis, taking into account state & local tax revenue as benefit; community support; job creation, private investment; wage levels of new jobs, and other factors.	Use a cost-benefit analysis, taking into account state tax revenue only; must meet minimum job creation and private investment levels that vary depending on locality's population; wage levels of new jobs, economic condition of locality (fiscal stress of locality reduces local match requirement), and other factors.
Job Creation Timeframe	Typically require a certain number of jobs to be created within 12 months; no set timeframe in regulations or state law.	Typically 3 years	Typically 3 years	Varies depending on project scope.	Require localities to use agreement containing a maximum 30-month timeframe to reach job target.

(CONTINUED ON NEXT PAGE)

FIGURE 3 (CONTINUED)
COMPARISON OF MAJOR STATE DEAL-CLOSING FUNDS

	GEORGIA	NORTH CAROLINA	PENNSYLVANIA	TEXAS	VIRGINIA
Payment for Performance or Appropriate Spending	Grant draw-downs approved only on a reimbursement basis for appropriate expenditures.	Localities receive funds in 25% increments as 25% of new jobs created or other performance goals met	Grant draw-downs approved only on a reimbursement basis for appropriate expenditures, but may pay out grant in proportion to job target attained.	Higher risk projects required to show proof of job creation and appropriate spending for drawdowns. All projects required to show appropriate spending.	Provide full grant amount to locality at front-end of 30 month period.
Performance/ Expenditure Monitoring	Local development authority must file a semi-annual report indicating progress towards major goals such as job creation.	Locality obtain proof that grant funds are spent appropriately	In addition to reviewing invoices for grant draws, company must submit annual reports on job and investment levels at project for five years following final grant draw.	Periodic site and document reviews, interval of review depends on risk and length of project development period.	At 30 months from grant award date, locality must file report showing job creation and company investment performance.
Penalty for Not Attaining Goals	Penalties are negotiated between the locality and the company.	Penalties must be included in contract between the locality and the company.	Penalty of full grant plus up to 10% of the grant for not meeting job or investment targets.	Penalty depends on economic return on project; may be assessed on a penalty per job not attained basis.	Penalty proportional to failure to meet job and/or investment targets at 30 month end-of-contract date.
Verification of job creation or private investment	Rely on local development authority to verify reported information	Company must file wage record data to locality and state. State checks data against state employment agency data.	Company must certify to accuracy of job and investment data.	Check expense and annual reports against company records.	Rely on locality to verify reported information.
Report to Legislature; Public	No report to legislature required.	Quarterly reports to legislature.	No report to legislature required by law. Voluntarily submit annual report to legislature on fund grants and job creation goals.	No reporting requirement.	Biennial report to various legislative committees required. Report not released to the public.
Other Information	State law limits EDGE fund recipients to Georgia public entities. These are usually local development authorities, which own the improvements and lease them to the company.		Equitable distribution of awards throughout the state is a program goal.		Guidelines for internal use only. State law limits GOF grant recipients to Virginia public entities

SOURCES: Legislative Budget Board; Texas Legislative Council.

PENALTIES FOR NOT ATTAINING GOALS

All five states identified in Figure 3 require a penalty, also known as a "clawback," for grant recipients who do not reach the major goals of the grant agreement. North Carolina requires localities to include penalties for non-attainment of job creation targets and other major commitments. Pennsylvania guidelines indicate a penalty of up to 110 percent of the full grant amount for not operating at the project site for five years, or failure to create or retain the promised number of jobs or the promised level of private investment.

Texas requires a penalty for non-attainment of major elements of the grant agreement as well. However, one agreement did not mandate full return of the state's money

for non-attainment of these goals. The Texas Energy Center agreement provides for a maximum penalty of $2.7 million, compared to a grant amount of $3.6 million.

Recommendation 2 would require all future agreements to provide for full recovery of grant awards, plus any additional penalties the Office of the Governor deems appropriate.

PUBLIC REPORTS ON FUND ACTIVITIES

Only one of the four surveyed states has legal requirements for reports to document the use of grant money—North Carolina. North Carolina's governor is required to file a report on the One North Carolina Fund quarterly to the Joint Legislative Commission on Governmental Operations.

The legislation creating the Texas Enterprise Fund, House Bill 7, Seventy-eighth Legislature, Regular Session, 2003, did not include any requirement for a report on the funds activities or performance. Recommendation 3 proposes to amend state law to require an annual report that would inform the legislature and the public about Texas Enterprise Fund operations, allocations, number of projected and actual jobs created, and projected and actual private investment leveraged by the fund.

FISCAL IMPACT OF THE RECOMMENDATIONS

Actual performance or the results achieved by the entities awarded Texas Enterprise Fund grants cannot be reported yet because the fund only began operations in September 2003 and disbursed its first grant in March 2004. However, the Office of the Governor has established a system for evaluating, negotiating, and monitoring its grant proposals and agreements. Implementing the recommendations would provide stronger accountability for its performance. It is assumed that the Office of the Governor could implement these recommendations using available resources.

The introduced 2006–07 General Appropriations Bill does not change the fiscal impact of the recommendations.

IMPROVE FINANCIAL REPORTING BY THE TEXAS DEPARTMENT OF TRANSPORTATION

The size of the budget of the Texas Department of Transportation coupled with the significant new financial authority granted to the agency during the Seventy-eighth Legislative Session argue for improvements to the agency's financial reporting methods. Improvements are in order in three particular areas: (1) documentation of the cause and effect of current and anticipated fluctuations in the cash balance of the State Highway Fund, (2) notification of additional State Highway Fund receipts above those estimated in the General Appropriations Act, and (3) disclosure of capital budget projects for transportation items and acquisition of capital equipment and items.

SIGNIFICANT FINDINGS

- The State Auditor's Office has recommended improvements to the Texas Department of Transportation's current cash forecasting system to improve the accuracy of the forecasts and the presentation of this information to the legislature and the general public.
- In fiscal year 2004, the Texas Department of Transportation expects that $687.7 million more will be available in the State Highway Fund than was estimated in the 2004–05 General Appropriations Act.
- The Texas Department of Transportation's capital budget for the 2004–05 biennium is more than $105 million per year and is broken into only six general categories in the General Appropriations Act, within which the agency reports 79 separate projects. At present, the agency can transfer funds among these projects without notifying the Legislative Budget Board and the governor.

SIGNIFICANT CONCERN

- If improvements in the Texas Department of Transportation's financial reporting are not made, the existence of significant and valuable resources may not be known to the legislature at times when critical budget decisions are made.

RECOMMENDATIONS

- **Recommendation 1:** The Texas Department of Transportation's rider entitled, "Reporting Requirements," in the 2004–05 General Appropriations Act should be amended in the 2006–07 General Appropriations Bill to require detailed information in the monthly cash forecast of the State Highway Fund on the cause and effects of current and anticipated fluctuations in the cash balance. The rider should also require expenditure information to be reported at the same level as the agency's appropriation bill pattern strategies.
- **Recommendation 2:** A rider should be included in the 2006–07 General Appropriations Bill requiring the Texas Department of Transportation to notify the Legislative Budget Board and the Governor of additional State Highway Fund receipts above those estimated for the 2006–07 biennium. The rider should require the agency to wait before expending the funds, giving either office a chance to deny use of the funds or specify an alternate use.
- **Recommendation 3:** The capital budget rider for the Texas Department of Transportation in the 2006–07 General Appropriations Bill should be amended to include a list of all projects with at least a $2 million appropriation in one year under the heading, "Acquisition of Capital Equipment and Items." In addition, provide additional detail under the heading, "Transportation Items."

COMMENTS

The vast majority of the Texas Department of Transportation's (TxDOT) expenditures are from constitutionally dedicated revenue sources, both state and federal. However, the agency also has appropriations from the state's General Revenue Fund, from a General Revenue-Dedicated account, and several other sources. All of these fund sources are subject to the state's biennial appropriation process.

Discussing TxDOT's appropriation in testimony before the House Appropriations Committee on May 12, 2004, the agency's executive director noted that the legislature has given the agency "an unprecedented array of tools to address the growing demand and monetary constraints inherent in today's fiscal reality." The following are among those tools:

- the Texas Mobility Fund, which is a revolving fund that will be used to provide a method of financing for the state highway system; and

- the Highway Tax and Revenue Anticipation Note Fund, which will hold proceeds from the sale of notes issued to make up temporary shortfalls in the State Highway Fund.

In September 2003, Texas voters approved a constitutional amendment to allow the legislature to authorize TxDOT to issue notes or borrow money from any source to carry out its functions. The borrowing is limited to a period of two years and was intended to give the agency flexibility to deal with short-term cash flow problems. The legislation authorizing this activity limits the borrowing to amounts that do not exceed the average monthly revenue deposits to the State Highway Fund for the previous 12 months. As a result of the same amendment, TxDOT was given authority to issue bonds to pay for highway improvement projects. Implementing legislation limited those issuances to $1 billion per year and capped total issuances at $3 billion. These new authorities represent significant additional financial resources for TxDOT to finance its operations; and, as a result, the need for accurate and useful financial reporting on the fiscal health of the State Highway Fund is increased in proportion.

STATE HIGHWAY FUND CASH BALANCES

Recommendation 1 would amend TxDOT's "Reporting Requirements" rider contained in the 2004–05 General Appropriations Act (GAA). This rider requires the agency to submit a monthly revenue report to the Legislative Budget Board (LBB) and the Governor on state and federal funds received in the State Highway Fund. TxDOT issues a monthly Cash Forecast of the State Highway Fund No. 006 to meet this requirement. The report provides information about the fund's revenues and expenditures, although expenditures are summarized and are not reported at the level of TxDOT's appropriation bill pattern strategies.

A March 2003 audit by the State Auditor's Office (SAO) (Report Number 03-021) recommended several improvements to TxDOT's current cash forecasting system to improve both the accuracy of the forecasts and the presentation of this information to the legislature and the general public. Since TxDOT's construction and maintenance planning process relies on the cash forecast, these improvements would also help maximize funds available for transportation projects.

Following are the SAO's findings:

- TxDOT does not formally document its forecasting method to estimate future cash balances in the State Highway Fund. This increases the risk that forecasts will be inconsistent over time and that TxDOT may utilize incorrect methodologies when preparing the forecast.
- TxDOT does not formally document adjustments made to data used to forecast cash balances. This makes it difficult to determine whether the adjustments are appropriate or adequate.
- TxDOT has improved the format of the monthly cash forecast by including additional information, such as a reconciliation of the cash balances and information contained in the Uniform Statewide Accounting System. However, SAO recommended that information be included in the cash forecast that allows readers to understand the cause and effects of current and anticipated fluctuations in the cash balance.

TxDOT generally agreed with these findings and committed to making improvements suggested in the SAO report. As a result of the recommendation about format, TxDOT added a small narrative text box to its summary chart of the cash forecast. However, it only allows for one general statement about past trends and one statement about future trends. Specific information about large construction or maintenance projects is not provided in detail, nor is detailed information about fluctuations in funding patterns. For example, TxDOT has recently started using a new reimbursement method known as "tapered match" on projects they jointly fund with the federal government. TxDOT is now allowed to expend the federal share of a project's funding first and then spend the state portion near the end of the project, which has a significant impact on the cash balance. However, detail on how much this will affect the balance over time, or in what amount, is not currently provided in the forecast.

Another concern about the presentation of financial reporting for the State Highway Fund in the monthly cash forecast is that not enough information is presented about the expenditure assumptions used to prepare the forecast. Since expenditure information is presented in a summary manner, it is not possible to discern which of TxDOT's 18 appropriation strategies are affected by increases and decreases in projected spending. Including this level of detail would allow readers of the forecast to better understand TxDOT's assumptions and relate them to specific spending patterns over time.

Recommendation 1 would amend the "Reporting Requirements" rider in the 2004–05 General Appropriations Act to require improved reporting on these two points:

> Reporting Requirements. The Texas Department of Transportation shall provide a report to the department's border district legislators and to the respective metropolitan planning organizations on department's trade transportation activities in such border districts during the ~~2004–05~~2006–07

biennium. The department shall report annually no later than January 1, each year of the biennium. The report shall also be provided to the Governor and the Legislative Budget Board.

In addition, to other information that might be requested by the Legislative Budget Board, ~~The~~the Texas Department of Transportation shall submit to the Legislative Budget Board, in the format prescribed by the Legislative Budget Board, a monthly revenue report to the Legislative Budget Board and the Governor on state and federal funds received in State Highway Fund No. 006 as specified by the Legislative Budget Board. At any time, if the department becomes aware of any variances to estimated amounts appropriated above out of state and federal funds received in State Highway Fund No. 006, the department shall immediately notify the Legislative Budget Board and the Governor in writing specifying the affected funds and the reason for the anticipated change. The monthly revenue report shall include detailed explanations of the causes and effects of current and anticipated fluctuations in the cash balance. The level of detail requested in the monthly cash forecast shall be consistent with the recommendations prescribed by the March 2003 State Auditor Report number 03-021. In addition, the monthly cash forecast shall report expenditure information at the same level as the Texas Department of Transportation's appropriation bill pattern strategies.

ESTIMATING STATE HIGHWAY FUND RECEIPTS

TxDOT's appropriation in the GAA includes an estimation of the expenditures that will be made for its highway construction activities. This feature is included so that if revenues become available for this strategy—above the $2.8 billion already appropriated each year—the agency could expend those funds in a timely manner. According to TxDOT, $687.7 million in additional State Highway Fund revenues are estimated to be available for expenditure in 2004 using this authority. TxDOT believes this appropriation authority is critical. In particular, TxDOT argues that it avoids a situation in which additional funds are available but cannot be spent because the year's appropriation for highway construction and maintenance activities has already been exhausted.

In general, an agency's authority to transfer appropriations from one strategy to another is limited to 25 percent of the funds appropriated to the item from which the transfer is made (Section 6.08 of Article IX of the 2004–05 GAA). However, Rider No. 2 of TxDOT's bill pattern allows the agency to transfer as much money as it deems necessary between its contracted maintenance, right-of-way acquisition, and highway construction strategies. TxDOT is generally prohibited from moving money from any of these strategies into its other 15 strategies. (The one exception to this rule allows TxDOT to transfer an amount into its plan/design/manage strategy so long as it does not exceed 10 percent of that strategy. This transfer requires approval from the LBB and the governor.) In this way, the rider and the estimated appropriation feature work together to allow TxDOT to expend money that it receives above what was originally estimated, but only for contracted maintenance, right-of-way acquisition, and highway construction.

According to TxDOT's 2006–07 Legislative Appropriations Request, an additional $391.3 million in Federal Funds was made available to the agency in 2003. This money was appropriated to the agency in accordance with Article IX, Section 8.02, Federal Funds/Block Grants, of the 2002–03 GAA. The agency expects to use the same authority in 2004 to make an additional $382.8 million available for expenditure. In the 2004–05 biennium, other agencies are required to notify the LBB and the governor of the receipt of the funds, provide a written plan outlining the use of the funds, and wait 14 days before expending these funds in order to allow either of the two offices to disapprove the use of the funds.

In contrast to this requirement, TxDOT's Rider No. 35 does not provide the LBB or the Governor the opportunity to amend TxDOT's planned use of funds. Recommendation 2 would include a rider in the 2006–07 General Appropriations Bill that would alert the legislature of the availability of additional funds and would provide an approval process for the use of funds.

> **Additional Funds.** Except during an emergency as defined by the Governor, no appropriation of additional State Highway Funds may be expended by the Texas Department of Transportation unless:
>
> a. the Texas Department of Transportation submits a separate report within forty-five (45) days of the end of the second quarter of each fiscal year to the Legislative Budget Board and the Governor outlining any additional funds available above amounts estimated for the 2006–07 biennium, their anticipated uses and projected impacts; and
>
> b. the Legislative Budget Board and the Governor issue a written approval or specify an alternate use for the additional funds.

CAPITAL BUDGET INFORMATION AVAILABILITY

The GAA currently includes limited information about TxDOT's capital budget projects. Since TxDOT's capital budget is estimated at $211.3 million for the 2004–05 biennium, additional detail would lead to greater accountability and allow increased oversight. The GAA lists six categories within which TxDOT is limited to transferring capital budget funds during the biennium:

- acquisition of land and other real property;
- construction of buildings and facilities;
- repair or rehabilitation of buildings and facilities;
- acquisition of information resource technologies;
- transportation items; and
- acquisition of capital equipment and items.

The average appropriation for each of the six categories is $17.6 million per year.

Agencies are generally given authority in the 2004–05 GAA to move up to 25 percent of a particular capital budget item's appropriation to another capital budget item without notifying the LBB or the governor. This authority is limited so that the capital budget project receiving the additional funding may not increase by more than 25 percent of its appropriation. However, rider language in the 2004–05 GAA does not allow TxDOT to transfer additional appropriated funds to capital budget items without prior approval of the LBB or the governor.

TxDOT does report more detailed information to the LBB for its capital budget than what is included in the GAA. For example, the agency reports that 79 ongoing and future projects will be funded within the six categories. While the average appropriation for each project is $1.3 million per year, some individual projects have an appropriation as high as $15.9 million in one year. Within the acquisition of capital equipment and items category, the agency reports 35 projects. These include the acquisition of particular types of equipment used by the agency in highway maintenance and construction, such as dump trucks, motor graders, loaders, and asphalt maintenance equipment.

The GAA could include more details for capital budget projects exceeding certain dollar thresholds. Besides providing more information about these projects, including more detail would limit the amounts of funds TxDOT could transfer among projects.

For example, if projects with at least $2 million in expenditures in at least one year of the biennium were listed in the GAA, 29 entries would be included in TxDOT's 2004–05 capital budget. This would include one "roll-up" entry in each category that represents the costs for all projects in the category under $2 million. The average appropriation for each of these entries would be $3.6 million.

Approximately 45 percent of TxDOT's entire $100 million annual capital budget can be traced to the final category, acquisition of capital equipment and items. Applying the $2 million threshold methodology used above just to this last category, and outlining transportation items and leaving all projects in the first four categories "rolled-up," would mean that 16 entries would appear in TxDOT's bill pattern. Recommendation 3 would include detail in the capital budget rider to look like this:

	2004	2005
a. Acquisition of Land and Other Real Property	$1,350,000	$2,845,000
b. Construction of Buildings and Facilities	$5,170,330	$9,428,501
c. Repair or Rehabilitation of Buildings and Facilities	$17,365,500	$17,315,500
d. Acquisition of Information Resource Technologies	$26,403,255	$18,179,637
e. Transportation Items		
(1) Trucks, All Body Styles	$8,142,500	$9,971,193
(2) Automobiles	$483,437	$517,275
Total, Transportation Items	$8,625,937	$10,488,468
f. Acquisition of Capital Equipment and Items		
(1) Asphalt Maintenance Equipment	$3,102,446	$4,254,066
(2) Excavators	$2,466,198	$2,713,222
(3) Loaders	$4,048,660	$4,225,898
(4) Motor Graders	$6,537,226	$5,282,154
(5) Sweepers, All Types	$2,075,569	$1,850,596
(6) Clean Air Emissions	$2,542,550	$2,542,550
(7) Aerial Personnel Devices	$2,666,039	$1,771,269
(8) Trucks, Medium/Light Duty	$3,540,835	$3,876,064
(9) Trucks, Dump	$9,174,990	$10,569,828
(10) Other Acquisition of Capital Equipment and Items	$11,135,949	$9,729,629
Total, Acquisition of Capital Equipment and Items	$47,290,462	$46,815,276
	$106,205,484	$105,072,382

Implementing these recommendations would benefit the legislature and the general public by allowing for a better understanding of TxDOT's fiscal operations. More efficient reporting will not adversely affect TxDOT and may reveal additional and valuable financial resources for the state.

FISCAL IMPACT OF THE RECOMMENDATIONS

There is no significant fiscal impact from these recommendations. It is assumed TxDOT can fulfill the recommended reporting requirements using current resources.

The introduced 2006–07 General Appropriations Bill includes the riders needed to implement these recommendations. No other adjustments to the bill have been made.

REQUIRE EMPLOYERS TO SHARE HALF THE COST OF SKILLS DEVELOPMENT FUND JOB TRAINING

The Skills Development Fund was created by the Seventy-fourth Legislature, Regular Session, 1995, to provide customized job training to Texas employers. According to the Texas Workforce Commission, employers see the fund as a way of improving the productivity of their workforce. The job training grants from the fund flow to community colleges, which allows these colleges to become integral parts of their communities by working with local businesses. For the 2004–05 biennium, the legislature appropriated the Texas Workforce Commission $25 million in General Revenue Funds to operate the Skills Development Fund job training program.

Although this program does not require employers to share the cost of job training, many other states expect them to make a contribution—either in-kind or with cash. Requiring a cash contribution would give employers a greater stake in the outcome of job training and improve the program's cost-effectiveness by creating a public–private cost-sharing arrangement. Requiring a 50 percent match would save $12.5 million in General Revenue Funds for the 2006–07 biennium compared to 2004–05 appropriations.

SIGNIFICANT CONCERN

- Employers benefiting from the state-subsidized Skills Development Fund job training program are not expected to share the cost of this training. However, 14 out of 20 states providing some of the largest state appropriations for job training require employers to share a portion of the cost. Twelve of these states require employers to share half or more of the job training cost, either with cash or in-kind contributions.

RECOMMENDATION

- Amend the Texas Labor Code to require all employers benefiting from Skills Development Fund job training to pay for 50 percent of the cost of this service in cash. Employers would remit the required cash payment to the local community college, which acts as the fiscal agent for funds from the state.

COMMENTS

The Skills Development Fund (SDF) finances customized job training for businesses that partner with a community college to design programs for the creation of new jobs or to enhance the skills of current employees. The SDF was created by the Seventy-fourth Legislature, Regular Session, 1995, as part of House Bill 1863, the legislation that created the Texas Workforce Commission.

The disbursement and management of SDF grants are based on the following process. Partnerships are formed between a community college and one business or a consortium of two or more businesses from various industry clusters. The community college alerts the local Workforce Development Board of the grant proposal and then forwards the proposal to the Texas Workforce Commission (TWC). Once received, reviewed, and approved, grants are awarded, and contracts are written. The TWC then enters into a contract with the college. Under the contract, the college must serve as the fiscal agent, administer the contract, and submit periodic financial and performance reports to the agency.

For the 2004–05 biennium, the legislature appropriated $25.0 million to the Texas Workforce Commission to finance the SDF grant program. The volume of requests for training funds typically exceeds appropriations. In fiscal year 2003, the agency received requests from businesses totaling over $50.9 million. The agency's legislative appropriation request for the 2006–07 biennium includes $25.0 million based on 2004–05 appropriations plus an exceptional item request for $25.0 million in General Revenue Funds and one for $9.3 million in Other Funds. The budget recommendation appropriates $20.7 million for this program for the 2006–07 biennium, which is a reduction of $4.3 million from 2004–05 appropriations.

EMPLOYER MATCHING

The 20 states surveyed were chosen based on a March 2003 Texas Legislative Council survey. Since Texas provides one of the largest appropriations for this type of job training program, the states with the larger appropriations were chosen to survey for a better comparison. As indicated by Figure 1, of the 20 states that appropriate the greatest funding to their job training programs, 14 require employers to share the cost of such training with either an in-kind or cash contribution. Cost-sharing requirements range from 25 percent for Iowa to 75 percent for Arizona. The typical payment arrangement among 12 of these states is for the employer to pay for training costs up front and then obtain reimbursement from the state for actual costs.

FIGURE 1
COMPARISON OF KEY INFORMATION ON 20 STATES WITH THE HIGHEST FUNDING FOR JOB TRAINING PROGRAMS

STATE PROGRAM	2005 FUNDING (IN MILLIONS)	FUNDING SOURCE	EMPLOYER CONTRIBUTION	TYPE OF CONTRIBUTION	COSTS REIMBURSED DURING OR AFTER TRAINING PERFORMED?
Alaska State Training and Employment Program	$5.6 Million	Unemployment Insurance tax	No	N/A	Yes
Arizona Job Training Program	$7 Million	Complementary tax to unemployment insurance tax	Yes—50–75% (50% for existing workers; 75% for new hires)	Cash or In-kind	Yes
California Employment Training Panel	$27.6 Million	Complementary tax to unemployment insurance tax	Yes—50%	Cash or In-kind	Yes; payment begins 90 days after training completed
Georgia Quick Start Program	$14 Million	General Fund	No	N/A	No; costs are generally not incurred by employers
Illinois Employment Training Investment Program	$14.8 Million	General Fund	Yes—50%	Cash	50% in advance, 50% upon completion
Indiana Skills Enhancement Fund (SEF)	$16 Million	General Fund	Yes—50%	Cash or In-kind	Yes; paid in quarterly installments
Iowa Industrial New Jobs Training (260E)	$28.2 Million	Bonds	No	N/A	
Iowa Jobs Training Program (260F)	$4 Million	Bonds	Yes—25%	Cash	
Kansas Industrial Retraining Program (KIR)	$3.2 Million	Lottery fund (Shares funds with KIT)	Yes—50%	Cash	Yes
Kansas Industrial Training Program (KIT)	$3.2 Million	Lottery fund (Shares funds with KIR)	No	N/A	Yes
Kansas Investments in Major Projects and Comprehensive Training (IMPACT)	$11.2 Million	Bonds	No	N/A	No
Louisiana Incumbent Worker Training Program	$50 Million	Portion of unemployment insurance tax	No	N/A	Yes
Massachusetts Workforce Training Fund	$21 Million	Complementary tax to unemployment insurance tax	Yes—50%	Cash or In-kind	25% in advance; 50% in intervals during training; 25% upon final report
Michigan Economic Development Job Training	$10 Million	General Fund	Yes—30% (Employer contribution 30% for existing workers; 0% for new hires)	Cash or In-kind	Yes
Mississippi Workforce Education Program	$18 Million	General Fund	Negotiated but generally no	N/A	Yes
Missouri Customized Job Training Program	$8.5 Million	General Fund	Yes—50% (Though 50% match required, average award is $50,000)	Cash or In-kind	Yes
Missouri Job Training Retention Program (starts 7/1/05)	Estimated to be funded at $6 Million for the FY 2005–06	Bonds	Yes	Cash	No

(CONTINUED ON NEXT PAGE)

FIGURE 1 (CONTINUED)
COMPARISON OF KEY INFORMATION ON 20 STATES WITH THE HIGHEST FUNDING FOR JOB TRAINING PROGRAMS

STATE PROGRAM	2005 FUNDING (IN MILLIONS)	FUNDING SOURCE	EMPLOYER CONTRIBUTION	TYPE OF CONTRIBUTION	COSTS REIMBURSED DURING OR AFTER TRAINING PERFORMED?
Missouri New Job Training Program	$16 Million	Bonds	Yes	Cash	No
New Jersey Customized Training	$25 Million	Assessment of 0.10% of employers and 0.025% on employees	Yes—50%	Cash or In-kind	Yes
New York Strategic Training Alliance Program (STRAP)	$7 Million	General Fund	Yes—50%	Cash or In-kind	Yes
Ohio Investment Training Program	$25 Million	General Fund	Yes—50%	Cash or In-kind	Yes
Oklahoma Training for Existing Industry	$1.5 Million	General Fund	No	N/A	Yes
Oklahoma Training for Industry Program	$6.3 Million	General Fund	No	N/A	Yes
Pennsylvania Customized Job Training	$5 Million	General Fund	Yes—50%	Cash	No
Pennsylvania Incumbent Worker Training Fund	$5 Million	General Fund	No	N/A	Yes
Texas Skills Development Fund	$25 Million	General Fund	No	N/A	20% in advance; 60% dispersed in increments of 10 at various stages of training; final 20% upon completion and verification
Virginia New Jobs Program	$7.1 Million	General Fund (Funding shared for all VA Programs)	Yes—50%	Cash	Yes; payment begins 90 days after training completed
Virginia Retraining Program	$7.1 Million	General Fund (Funding shared for all VA Programs)	Yes—50%	Cash	Yes; payment begins 90 days after training completed
Virginia Small Business New Jobs Program	$7.1 Million	General Fund (Funding shared for all VA Programs)	Yes—50%	Cash	Yes; payment begins 90 days after training completed

SOURCE: Legislative Budget Board; Agencies in other states as listed.

Twelve states (or 60 percent of those states surveyed) require employers to share half or more of the job training costs through cash or in-kind contributions. Given this trend, requiring a 50 percent contribution from employers is appropriate. In-kind cost sharing typically involves providing training facilities and/or compensation during training. Of these 12 states, 4 states require a 50 percent contribution payable in cash only.

These four states cite two reasons to justify employer matching. First, it allows companies to show good faith through a tangible investment in the state's workforce. Second, a direct contribution makes these programs more efficient through public-private cost sharing.

The Skills Development Fund does not, however, require employers to share the cost of job training. Employers may provide in-kind matching, which usually takes the form of compensation for new or current employees during their training period, and/or the provision of job-training facilities. In fiscal year 2004, 38 of the 165 employers that benefited from SDF-financed training did not provide a contribution for this service.

The list of companies benefiting from SDF training in fiscal year 2004 includes large, well-established firms that could afford to share job training costs with the state. Twenty-six companies are listed on the Russell 1000, an equity index of 1,000 highly capitalized corporations; 26 companies are listed on the Forbes 2000, an inventory of the 2,000 largest U.S. corporations; and nine companies are listed on the comptroller's "Texas 100," consisting of the 100 largest publicly traded employers in the state (determined by their average number of workers). Thirty-one percent of the companies receiving SDF grants have 500 or more employees.

The recommendation addresses this concern by proposing to amend the Texas Labor Code to require all employers benefiting from Skills Development Fund job training to provide 50 percent of the cost of this training in cash. Exceptions or waivers to the matching requirement could be made for small businesses. In the instances where an employer provides the training rather than the community college, employers should finance the training up front and then obtain reimbursement from the state for actual costs. Adding this requirement would give employers a greater stake in the outcome of the training, and it would improve the cost-effectiveness of the program.

FISCAL IMPACT OF THE RECOMMENDATION

Implementing the recommendation of requiring an employer match of 50 percent would result in an estimated savings of $12.5 million in General Revenue Funds compared to 2004–05 appropriations. The recommendation would have no impact on General Revenue–Dedicated Funds during the 2006–07 biennium.

FIGURE 2
REQUIRE 50 PERCENT COST SHARING
FIVE YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/(COST) TO GENERAL REVENUE FUNDS
2006	$6,250,000
2007	$6,250,000
2008	$6,250,000
2009	$6,250,000
2010	$6,250,000

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill appropriates $20.7 million of General Revenue Funds for the Skills Development Fund. Therefore, the additional savings from implementing this recommendation is $10.3 million in General Revenue Funds for the 2006–07 biennium.

USE ADDITIONAL DONATED FUNDS TO DRAW DOWN FEDERAL FUNDS FOR CHILD-CARE SERVICES

Federal laws allow states to use privately donated funds as state match for federally supported child-care programs. Donated funds are not required to be transferred to the state. Instead, donating entities can certify eligible expenditures to the state and federal government, and the state can report these expenditures as its match for federal programs.

The Texas Workforce Commission is the primary state agency responsible for making sure that families eligible for child-care assistance receive it though various providers. Texas already uses donated funds certified by the Texas Workforce Commission and identified through local workforce boards as match for the federal Child Care and Development Fund. However, the Texas Workforce Commission could use additional private funds certified by other non-state entities as a state match for Federal Funds. For example, the Texas Alliance of Boys and Girls Clubs reports that its 275 clubs spent approximately $46.4 million in calendar year 2003 for child-care programs. Of this, the alliance estimates that at least $11.9 million was spent on children who meet eligibility requirements of the Child Care and Development Fund.

By using additional donated funds towards federal matching requirement, the Texas Workforce Commission's General Revenue Fund appropriation for the 2006–07 biennium could be reduced up to $15.7 million. The agency could also draw down an additional $17.1 million of available Federal Funds.

SIGNIFICANT CONCERN

- Texas is one of 13 states that already use donated funds as match for accessing federal Child Care and Development Funds. Some states use more sources of donated funds, and Texas could use additional donated funds to maximize federal assistance for child-care.

RECOMMENDATIONS

- **Recommendation 1:** The Texas Workforce Commission should determine whether entering into an agreement with a private entity, such as the Texas Alliance of Boys and Girls Clubs, to use certified private funds on terms acceptable to both parties complies with all federal and state regulations governing the use of privately donated funds as state match for federally supported child-care programs. The Texas Workforce Commission should report the results of its research to the legislature and the Legislative Budget Board by February 11, 2005.
- **Recommendation 2:** Contingent on the outcome of the determination made by the Texas Workforce Commission, the Texas Workforce Commission should enter into an agreement with the entity or entities selected to provide additional donated funds, which the state could then use as a portion of the state match requirements for the federal Child Care and Development Fund.
- **Recommendation 3:** If at least $23.8 million in certified private funds is available, reduce the Texas Workforce Commission's General Revenue Fund appropriations used to match Federal Funds for child-care by $15.7 million from 2004–05 appropriation levels in the 2006–07 General Appropriations Bill, and direct the Texas Workforce Commission to use the donated funds to access Federal Funds.

COMMENTS

The federal Child Care and Development Fund (CCDF) regulations allow states to use certified donated funds to meet state matching and maintenance of effort (MOE) requirements.

CCDF is the primary source of Federal Funds for child-care services for low-income families. CCDF consists of three sources of federal funds: mandatory funds, discretionary funds, and matching funds. Mandatory and discretionary funds have no matching requirements, while federal matching funds are available at the Federal Medical Assistance Percentage (FMAP). In fiscal year 2006, the FMAP for Texas is 60.68 percent. States can leverage allowable expenditures for child care with federal matching funds at the FMAP rate. Allowable state expenditures may include local and public funds, private donations, or certified private funds. Figure 1 shows federal requirements for use of public and donated private funds.

To receive matching funds, the state must obligate mandatory funds by the end of the fiscal year and expend its required MOE. The state's MOE has to be at least equal to the amount of the state's share of expenditures for fiscal year 1994 or 1995, whichever was greater. Each state has a

defined MOE amount, and for Texas it is $34.7 million each year. Texas uses pre-kindergarten expenditures made by the Texas Education Agency for 20 percent of the required state MOE amount.

FIGURE 1
FEDERAL REQUIREMENTS FOR PUBLIC AND PRIVATE FUNDS

Public Funds expended for child-care may be claimed as state expenditures when funds are:

- Appropriated directly to or transferred from another public agency to the lead agency, or certified by the contributing public agency as representing expenditures eligible for Federal match;
- Not used to match other Federal Funds;
- Not Federal Funds, or are authorized by federal law to be used to match other Federal Funds.

Privately Donated Funds expended for child-care may be claimed as state expenditures when funds:

- Are donated without any restriction, which would require their use for a specific individual, organization, facility or institution;
- Do not revert to the donor's facility or use;
- Are not used to match other Federal Funds;
- Are certified both by donor and by the Lead Agency as available and representing expenditures eligible for Federal match; and
- Are subject to audit requirements.

SOURCE: Title 45 of Code of Federal Regulation, Sec. 98.53.

CHILD-CARE PROGRAMS ADMINISTERED BY THE TEXAS WORKFORCE COMMISSION

The Texas Workforce Commission (TWC), the lead agency for the CCDF, funds child-care services provided to parents who meet local workforce development boards' (local boards) eligibility requirements for CCDF. Funding of child care, after school, and summer programs enables low-income parents and parents receiving Temporary Assistance for Needy Families (TANF) to work or to participate in the education or training programs they need in order to work. TWC does not directly contract with child-care facilities. Instead, TWC contracts with 28 local boards, which are responsible for planning, overseeing, and evaluating the delivery of all workforce training and services, including child-care services.

TWC allocates child-care funding in three programs: TANF Choices Child-care, Transitional Child-care for Families Working or Training for Work (Transitional child-care), and At-Risk Child-care for Families Working or Training for Work (At-Risk child-care). TANF Choices Child-care funding is provided to the TANF recipients, who often need child-care services to fulfill federal requirements regarding work participation. When TANF participants become employed, they can still receive child-care assistance for 12 months through Transitional child-care funding. Child-care services are provided through At-Risk child-care funding to low-income working families that receive little or no public assistance.

In the 2004–05 biennium, TWC budgeted $139.8 million in General Revenue Funds for child-care services, which draws $268.2 million in Federal Funds for child care. In addition, TWC relies on local boards to come up with local funds to use as match to leverage Federal Funds. Local match can be in the form of cash donations; however, 90 percent of local funds are in the form of certified donated funds.

Dependence on local match has increased in the last several years. In fiscal year 2003, local match was $13 million, and it increased to $19.6 million in fiscal year 2004. If local boards were unable to identify local match, the TWC would not be able to draw down Federal Funds.

OTHER STATES' EXPERIENCE

Federal law allows states to designate a single entity, state or non-state, to receive donated funds. The law specifies that donated funds from private entities do not have to be transferred to the state. Instead, the designated entity can certify that the expenditures took place for children that met criteria established in federal regulations. States develop their own methodologies for this certification process.

Several states have already established partnerships with private, non-profit organizations to certify private funds for matching purposes. This is a new approach, and not all states know how to implement it. In fiscal years 2002 and 2003, only five states, including Texas, were using donated funds to assist with matching dollars. In fiscal years 2004 and 2005, 13 states indicated their use of donated funds. For example, Nevada and Mississippi have designated non-state entities to receive donated funds. Mississippi has designated Barksdale Reading Institute, which is a privately funded non-profit foundation, to receive privately donated funds for CCDF match. A portion of funds expended by the institute for child-care services is utilized for CCDF match. Nevada has designated the Alliance of Boys and Girls Clubs to receive private funds. Even though the alliance certifies funds without receiving assurance that it will receive child-care funds from the state, Nevada established separate contracts with the Boys and Girls Clubs for child-care services.

USE OF DONATED FUNDS FOR MATCHING PURPOSES

Texas is one of a few states that have already been using private donations for matching purposes. Texas has established a slightly different approach than other states. Instead of designating a separate entity, TWC designated

itself as the entity that receives donations and is responsible for certification of these donated funds. In addition to existing contracts with 28 local boards, TWC could enter into agreements with additional non-state entities, such as the Texas Alliance for Boys and Girls Clubs, to expand the use of the donated funds. Figure 2 provides information about the alliance's programs.

The alliance estimates that its 275 Texas Boys and Girls clubs could certify at minimum $11.9 million annually in CCDF-eligible expenditures that could be used for matching purposes or CCDF MOE.

In each year of the 2004–05 biennium, TWC is appropriated $42.1 million in General Revenue Funds for CCDF matching funds. Each year TWC is also appropriated $27.7 million in General Revenue Funds for CCDF maintenance of effort.

In its legislative appropriations request (LAR) for the 2006–07 biennium, TWC requested $17.8 million in General Revenue Funds for the following exceptional items:

- $5.9 million to maintain 2004–05 funding levels for child-care services, and
- $11.7 million to draw down matching Federal Funds that would not be accessed during the 2006–07 biennium without additional matching funds.

In lieu of receiving General Revenue Funds for these exceptional items, TWC could use additional donated funds to maintain the 2004–05 biennial funding level and access Federal Funds available to the state.

MORE RESEARCH IS NEEDED TO ENSURE COMPLIANCE WITH FEDERAL AND STATE REQUIREMENTS

The alliance is requesting that $2.7 million of child-care funds be made accessible to its clubs across the state in exchange for certifying donated funds.

FIGURE 2
TEXAS ALLIANCE FOR BOYS AND GIRLS CLUBS

Mission—to inspire all young people, especially those from disadvantaged circumstances, to realize their full potential as productive, responsible and caring citizens.

- 93 Boys and Girls Club corporations in Texas
- Over 275 club sites in Texas
- Average attendance in Texas clubs—46,221 young people per day
- 2003 clubs collective expenses— $46,436,000

Core club programs include: character and leadership development, the arts, education and career development, health and life skills, sports, fitness, and recreation.

SOURCE: Texas Alliance of Boys and Girls Clubs.

The alliance's proposal to make its expenditures accessible to the state for federal matching purposes could potentially increase the administrative burden on the alliance for tracking CCDF eligibility requirements. Nevertheless, the alliance proposes a five-year period for state and alliance cooperation in accessing Federal Funds.

TWC needs to determine whether providing $2.7 million to the alliance complies with federal and state regulations. Federal regulations do not allow donated funds to revert to the donor's facility or use. It is possible the provision of the $2.7 million to the alliance would meet this requirement as long as the alliance does not certify the $2.7 million as donated funds to be used for federal match.

Based on federal and state regulations, if states contract with the entities that meet the description of center-based, group home, or family child-care providers, these providers have to be licensed and regulated by the applicable state entity. In Texas, the Department of Family and Protective Services licenses and regulates child-care providers. Only 16 out of 275 boys and girls clubs are currently licensed by the department. All other boys and girls clubs are exempt from licensing under "Neighborhood Recreation Program" status. Provisions of this exemption, including that the services are not structured to provide after-school child care, that the program does not collect compensation, and that children are free to join and leave the program at will may potentially contradict the description of the child-care services specified in federal regulations.

In addition, if TWC chooses to make a payment to the entity selected to certify additional donated funds, TWC should make sure that that the selection of the entity and the payment meet the state's contracting practices and provide the best value to the state. Therefore, TWC should consider using a competitive process to select a non-profit entity or entities to ensure that the selected entity represents the best interest of the state.

Recommendation 1 would require TWC to research whether contracting with a private entity, such as the alliance, for child-care services complies with federal regulations and state contracting practices. TWC should report the results of its research to the legislature and the Legislative Budget Board by February 11, 2005. Should the TWC determine that such an agreement is feasible, TWC should, as stated in the Recommendation 2, enter into an agreement with the appropriate entity or entities to use certified funds for matching purposes.

ADDITIONAL OPPORTUNITIES TO USE DONATED FUNDS FOR CHILD CARE

By entering into an agreement with an entity that could certify funds for matching purposes, TWC would be able to access all Federal Funds even if the General Revenue Fund

appropriations for 2006–07 biennium are less than 2004–05 funding levels. Recommendation 3 would reduce TWC's 2006–07 General Revenue Fund appropriations for child-care programs by $15.7 million compared to the 2004–05 biennium. This would require TWC to use at least $23.8 million in certified private funds as state match in the 2006–07 biennium.

The alliance estimates that the minimum annual amount for child care that could meet CCDF requirements is $11.9 million out of $46.4 million of the alliance's annual expenditures in 2003. The actual amount of qualified expenditures could be higher than $11.9 million, and the alliance reports it will start determining qualifying expenditures once the state indicates that cooperation is plausible.

There are also other options that would allow the state to use additional donated funds. The recommended option discussed in more detail in the fiscal impact section of this paper funds TWC's child-care programs (funded with General Revenue Funds for the Child Care and Development Funds and corresponding Federal Funds) at the 2004–05 service level. However, the state could use a different amount of donated funds and make a smaller reduction in the General Revenue Fund appropriation. This would allow the state to access more Federal Funds in the 2006–07 biennium and increase the number of children receiving services through the At-Risk child-care program.

In addition, there may be other programs where privately donated funds could be used to leverage Federal Funds. For example, of the $46.4 million expended by the alliance in 2003 for child-care services, only an estimated $11.9 million meets CCDF requirements. Other programs may have different eligibility requirements, and funds excluded from the CCDF certification could be eligible to be counted as match in these programs.

FISCAL IMPACT OF THE RECOMMENDATIONS

The recommendations would result in General Revenue Funds savings of $15.7 million in the 2006–07 biennium. The alliance estimates that the minimum annual amount for child care that could meet CCDF requirements is $11.9 million out of $46.4 million of the alliance's annual expenditures in 2003. This estimate is based on the eligibility requirements set forth in the federal regulations in Section 98.20 of Title 45 of the Code of Federal Regulation. Children must meet the following criteria to meet CCDF eligibility requirements:

- be under 13 years of age—approximately 72 percent of children served by the alliance in Texas meet this requirement;
- reside with a family whose income is at or below 85 percent of state median income—approximately 70 percent of children served by the alliance meet this requirement; and
- reside with a parent or parents who are working or attending a job training or educational program—approximately 80 percent of children served by the alliance meet this requirement.

The fiscal impact in Figure 3 assumes no increase in federal matching funds from fiscal years 2006 through 2010, but does assume using $22.9 million of additional Federal Funds that are currently available to the state. Once used, these funds would not be available in future years. The use of donated funds in future years could be expanded, should the federal government provide additional funds for child-care services.

This recommendation assumes a reduction in TWC General Revenue Fund appropriations used for matching federal funds for child-care programs in the amount of $15.7 million in 2006–07 biennium compared to the 2004–05 funding levels. If TWC uses $23.8 million of certified private funds, it can draw down approximately $46 million in Federal Funds. This reduction and the use of the certified donated funds would result in the same funding level for the child-care programs funded by General Revenue Funds for the Child Care and Development Funds and corresponding Federal Funds in the 2006–07 biennium as in the 2004–05 biennium. In addition, the TWC would still have access to $5.9 million in Federal Funds, which could be used in the 2008–09 biennium. To maintain the same level of services in the 2008–09 biennium as in the 2004–05 and 2006–07 biennia for the child-care programs funded by General Revenue Funds for the state match for the Child Care and Development Funds and corresponding Federal Funds, TWC would need $9.9 million in additional General Revenue Fund appropriations compared to the 2006–07 biennium. This is $5.9 million less than the amount in General Revenue Funds appropriated to TWC for child-care services in the 2004–05 biennium. The fiscal impact does not assume any payment to the entity or entities that would certify funds for matching purposes. Any amount paid to the certifying entity could decrease General Revenue Fund savings.

FIGURE 3
FIVE-YEAR FISCAL IMPACT

FISCAL YEAR	PROBABLE SAVINGS/ (COST) TO GENERAL REVENUE FUNDS	PROBABLE GAIN/(LOSS) TO FEDERAL FUNDS	PROBABLE GAIN/(LOSS) TO FEDERAL FUNDS FROM USING CERTIFIED DONATED FUNDS
2006	$7,873,544	($15,121,924)	$ 22,901,927
2007	$7,873,544	($15,121,924)	$ 22,901,927
2008	$2,938,841	($5,644,337)	$8,583,178
2009	$2,938,841	($5,644,337)	$8,583,178
2010	$0	$0	$0

SOURCE: Legislative Budget Board.

The introduced 2006–07 General Appropriations Bill reduces General Revenue Funds for Child Care and Development Fund appropriations by $4.2 million from the 2004–05 appropriated amounts. Therefore, the additional 2006–07 General Revenue Fund savings from these recommendations would be $11.5 million.