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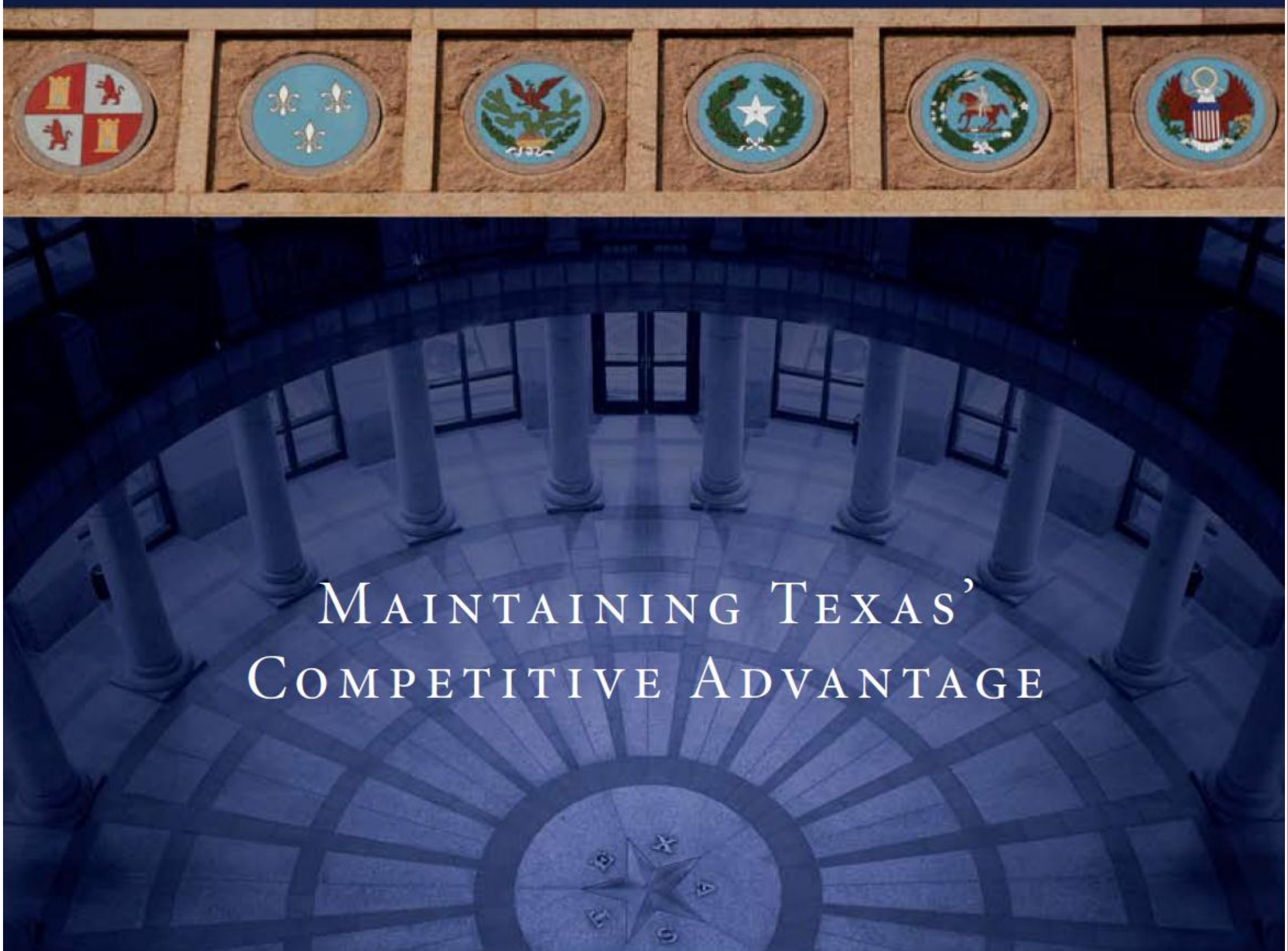

Maintaining Texas' Competitive Advantage

The Joint Final Report of the TCCRI Economic & Workforce Development and Transportation Task Forces

January 2011

The Texas Conservative Coalition Research Institute | txccri.org

MAINTAINING A COMPETITIVE ADVANTAGE:

A JOINT REPORT OF THE TCCRI ECONOMIC AND WORFORCE DEVELOPMENT TASK FORCE AND THE TCCRI TRANSPORTATION TASK FORCE

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There may be some policy recommendations or statements of philosophy that individual members are unable to support. We recognize and respect their position and greatly appreciate the work of everyone involved in the organization.

ABOUT TCCRI TASK FORCES

The Texas Conservative Coalition Research Institute's Task Forces are the backbone of the Institute's research and education efforts. Based on the conservative principles of limited government, individual liberties, free enterprise, and traditional values, the Institute's Task Forces develop legislative leaders and sound public policy ideas by bringing together legislators, experts, industry leaders, and stakeholders in a unique forum that fosters discussion and debate among public and private sector leaders. This approach has proven to be very successful.

THE 2009-10 ECONOMIC AND WORKFORCE DEVELOPMENT TASK FORCE

Chaired by State Senator Craig Estes (R-Wichita Falls) and State Representative Tan Parker (R-Flower Mound), the TCCRI Economic and Workforce Development Task Force met throughout the 2009-10 Interim. The Task Force was convened to review the state's economic climate and business tax structure and to recommend reforms aimed at enhancing Texas' competitiveness and creating a robust job market.

The Task Force also reviewed recent workers' compensation insurance reforms, in order to recommend policies necessary to ensure that both workers and employers continue to have access to coverage through a free market.

THE 2009-10 TRANSPORTATION TASK FORCE

Chaired by State Senator Mike Jackson (R-La Porte) and State Representative Linda Harper-Brown (R-Irving), the TCCRI Transportation Task Force studied the state's current transportation financing structure in the light of debates over the adequacy of revenues flowing to the State Highway Fund.

The Task Force discussed whether new transportation revenues are necessary or appropriate, with the goal of balancing needed revenues against the negative economic impact of raising taxes or creating new sources of revenue.

Note: The recommendations of each Task Force are the work of that Task Force alone. The Economic & Workforce Development Task Force did not directly address transportation issues, and the transportation recommendations in this document do not reflect the work of the Economic & Workforce Development Task Force. Similarly, the Transportation Task Force did not directly address Economic & Workforce Development issues, and those recommendations do not reflect the work of the Transportation Task Force.

MAINTAINING A COMPETITIVE ADVANTAGE:

FINAL REPORT OF THE TCCRI ECONOMIC AND WORKFORCE DEVELOPMENT TASK FORCE

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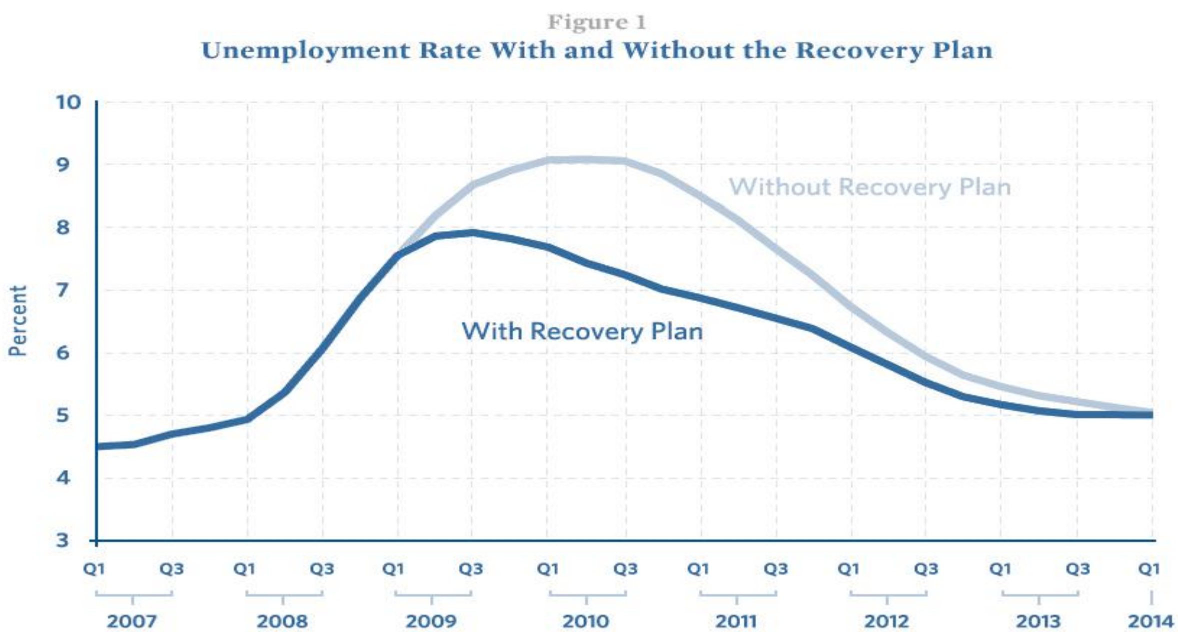
1. Introduction: Maintaining a Competitive Advantage

Texas is consistently ranked as one of the top states in the nation for job creation[i], economic growth[ii], and business climate[iii]. While the global economy has slumped, and a financial crisis has gripped the nation, Texas has performed relatively well due in large part to its relatively positive tax climate (though property taxes remain a major problem), lighter regulatory burden than many other states, and a steadfast commitment to economic growth and development.

Indeed, while the federal government has wasted hundreds of billions of dollars on economic "stimulus" programs, Texas has shown that the free market, small government approach to economic development is both more effective *and* less costly to taxpayers. The Obama Administration claimed its stimulus package had "saved or created" 640,000 jobs (at a cost of hundreds of thousands of dollars per job) as unemployment continued to skyrocket throughout 2009 and 2010. The stimulus spending failed even by the measures imposed by the Obama Administration, whose own projections suggested that the unemployment rate would stay below nine percent:



Source: "The Job Impact of the American Recovery and Reinvestment Plan," Office of the President-Elect, January 10, 2009.

In spite of these projections, unemployment rose higher than 10 percent over the course of 2009 and 2010, and even today stands at 9.4 percent[iv], a full 2.5 points higher than was projected with enactment of the stimulus. These failures are not lost on the American public: CNN polling shows that three out of four Americans believe that at least half of the $787 billion in stimulus spending was wasted.[v]

The stimulus was a failure because government spending and taxation do not create wealth-generating jobs. Private sector jobs can be created and the overall economy strengthened by reducing the tax burden on all businesses, fundamentally reforming and reducing the property tax (which will be the subject of another TCCRI report), and continuing to invest in a modern transportation infrastructure. These approaches can help Texas retain its position as the number one job creator in the nation, and provide a contrast to the failed big-government approach undertaken by the Obama Administration and several other states such as California, New York, and Illinois.

Indeed, Illinois, for example, is increasing its state income tax by 67 percent and the state corporation tax by 45 percent in response to its 51 percent state budget shortfall, prompting the Tax Foundation to note that:

> Not only did the [corporation tax] rate hike move Illinois from having the 21st highest overall corporate tax rate among the 50 states to having the fourth-highest, it also raised the average corporate tax rate for the nation as a whole, thus inching the U.S. closer to Japan as having the highest corporate tax rate among the leading industrialized nations.[vi]

The proof that Texas' approach is sound is in the numbers. Data from the Pew Center on the States confirms that Texas has a net domestic migration rate of 19.1 per 1,000, ranking 15th in the nation, while states like California, New York, and Illinois all have negative net domestic migration rates. Furthermore, the Pew Center reports that one-third of domestic migrants to Texas have a college degree or higher,[vii] which demonstrates that Texas is attracting a skilled and educated workforce. To ensure continued future growth, the Legislature should review the current tax structure to look for opportunities for improvement. While the nation's economic downturn may be a crisis for many states, it is also an opportunity for Texas to stand out as a beacon for economic growth.

While the central challenge of the 2011 legislative session will be to again balance the budget without raising taxes, conservative legislators must keep their eyes on the bigger picture. Conservative policies are what have kept Texas' economy head and shoulders above the rest of the nation. Continuing a conservative path is crucial.

Ensuring that the state's tax climate remains strong is imperative and can be achieved by reducing the negative effects of the margins tax on Texas businesses. At minimum, conservative legislators should consider making the $1 million revenue exemption permanent and protect all businesses from one of the worst aspects of the tax, namely high compliance costs.

Texas must also continue to have sensible production of its natural resources – oil, gas, coal, uranium and wind – that has buoyed the state through most of its modern history. The Barnett Shale and wind development are the latest success stories, and many others are on the horizon (such as the Eagle Shale Formation in South Texas). This stands in stark contrast to other states like California that have discovered the impossibility of shutting down natural resource development while trying to remain economically competitive. Legislators must ensure that this type of economic development can continue to drive the state's economy: any attempts to raise taxes on business – producers of oil or natural gas (and especially high-cost natural gas, such as shale gas), for instance – must be resisted.

Looking beyond tax policy, the Legislature must also continue to recognize that a strong business climate and a robust job market also depend on creating a positive environment in which businesses can operate. The state has many tools at its disposal to attract businesses and to create jobs in Texas. Economic development incentive programs have an important role to play in the future economic development of the state, provided that they are conducted in a fair and transparent manner, and include “claw back” provisions that keep the state whole from a revenue perspective in the event that the expected economic activity is not attained. In addition, continuing to strengthen Texas’ system of workers’ compensation will further sharpen the state’s competitive edge over other states. Continuing to push for deregulation in certain markets is another key, which will be discussed in future TCCRI reports to the 82nd Legislature.

There has been much debate about transportation funding in Texas, and the Legislature must continue to focus on maintaining and developing a transportation infrastructure that is an asset, not a burden for the state. Other than sensible tax and regulatory policy, transportation infrastructure is the best means to continue economic growth. Ensuring that all tax revenues collected for transportation projects are spent on transportation projects is the first step in this process.

Texas has performed strongly over the last decade or more, but the state cannot afford to stand still. If the states are indeed laboratories of public policy, Texas is effectively in direct competition with the rest of the nation to attract businesses, people, and capital to the state. This document is intended to provide recommendations that will strengthen Texas’ competitive edge, and keep the state moving forward even as the rest of the nation struggles through the aftermath of an economic crisis.

2. Improving Texas' Business Tax Structure

While this Task Force report devotes special attention to the rate of the natural gas severance tax and the scope of the Margins Tax, it is important that the Legislature be vigilant against proposed tax increases of any kind to address the budget shortfall for the 2012-2013 biennium. Raising taxes would create obstacles to economic growth at a time when Texas and the country as a whole most need it. Furthermore, as TCCRI outlined in "Blueprint for a Balanced Budget," the budget can be balanced without raising taxes. Therefore, the Legislature should avoid the temptation to increase the tax burden on businesses and individuals in order to address the budget shortfall, while striving to treat all taxpayers fairly and consistently.

2a. The Margins Tax

The new Margins Tax was implemented in order to raise the additional revenue that is necessary to fund reductions of school district property tax rates.

In its *Neeley v. West Orange-Cove CISD* decision (176 S.W. 3D 746 (TEX. 2005)), the Texas Supreme Court held that because independent school districts lacked "meaningful discretion" over property tax rates the "public school finance system violates Article VIII, section 1-e of the Texas Constitution." Article VIII, section 1-e reads, "no State *ad valorem* taxes shall be levied upon any property within this State."

In other words, although the Texas Constitution prohibits the imposition of a statewide property tax, because so many school districts were taxing at or near the $1.50 rate cap imposed by the Legislature, the Supreme Court declared that the school district property tax was, in effect, an unconstitutional statewide property tax. As a result of the Supreme Court's 2005 decision, the Legislature had to reform the public education finance system to ensure that public schools could continue to receive funding after June 1, 2006.

The plan that the 79th Legislature implemented required school districts to lower their M&O (maintenance and operations) tax rates such that the tax could no longer be considered a statewide property tax. In order to fund the loss of revenue that school districts would suffer when they lowered their tax rates, the Legislature enacted the new Margins Tax and reformed the motor vehicle sales and use tax and cigarette and tobacco taxes. All additional revenues generated by these reforms are dedicated to the Property Tax Relief Fund, and are statutorily directed to school districts to pay for property tax relief.

How the Margins Tax Works

The Margins Tax replaced the Texas Franchise Tax, which was paid at the greater of 0.25 percent of taxable capital or 4.5 percent of earned surplus, but contained a range of loopholes that allowed businesses organized as partnerships or non-corporate associations to avoid paying the tax. The Margins Tax is levied on adjusted gross receipts at a rate of 1 percent for all businesses except those primarily engaged in retail or wholesale trade, which are taxed at 0.5 percent. The tax closes many of the loopholes afforded by the previous Franchise Tax, and is applied to corporations, limited liability companies, partnerships (other than those comprised entirely of natural persons), business trusts, professional organizations, business associations, and joint ventures. Some legal entities, such as sole proprietorships, are still exempted from the Margins Tax.

A business that is required to pay the Margins Tax must calculate its "taxable margin," which is the least of the following three amounts:

- Total revenue (adjusted gross receipts) minus the cost of goods sold; or
- Total revenue minus compensation paid (capped at $300,000 per employee and excluding payments made to independent contractors); or
- Total revenue multiplied by 70 percent.
- Taxpayers with annual total revenue of $10 million or less can elect to use the E-Z computation method to calculate their tax liability: Total revenue times a rate of .00575 percent.

When the tax was enacted, businesses with total revenue of $300,000 or less were exempted from paying the tax, as were businesses that calculated their tax liability to be less than $1,000. In 2007, the Legislature also added a sliding scale of tax discounts to benefit small businesses having total revenue of greater than $300,000 but less than $900,000. The discounts ranged from 80 percent of the tax due for taxpayers in the lowest bracket ($300,000-$399,999 in total revenue) to 20 percent of tax due for those in the highest bracket (total revenue of more than $700,000 but less than $900,000).

In 2009, the Texas Legislature enacted House Bill 4765 (81R), which temporarily created a $1 million revenue exemption for the 2010 and 2011 tax years. As a result of this legislation, businesses with revenue below $1 million in 2010 or 2011 will owe no franchise tax for those years. HB 4765 also established a new permanent revenue exemption of $600,000 that will take effect in 2012. From 2012 onward, all businesses with annual revenue below $600,000 will owe no franchise tax to the state.

Problems Created by the Margins Tax

Despite the Legislature's best intentions and the efforts of the 80th and 81st Legislatures to mitigate its negative effects, the Margins Tax is not without its flaws. The tax is complex, with businesses having a multitude of ways to calculate their liability and unclear rules pertaining to what can be excluded from from "total revenue" in adjusting their gross receipts and what items can be included in the deductions for either "cost of goods sold" or "compensation." While the Legislature's goal of reducing property taxes was—and is—laudable, raising taxes on business is by no means a perfect solution. No tax, even when it is levied on a business, is truly paid by a business. All business taxes are paid by individuals. As the Tax Foundation notes:

> Taxes affect business decisions, job creation and retention, plant location, competitiveness, and the long-term health of a state's economy. Most importantly, taxes diminish profits. If taxes take a larger portion of profits, that cost is passed along to either consumers (through higher prices), workers (through lower wages or fewer jobs), or share-holders (through lower dividends or share value). Thus a state with lower tax costs will be more attractive to business investment.[viii]

Although the Margins Tax was created in response to a court ruling, Legislators must ensure that this property tax rate reduction is not achieved at the expense of Texas businesses. An important way to achieve this is to keep the Margins Tax rate as low as possible so that the Texas business climate is not damaged as the Legislature strives to reduce property taxes.

The Margins Tax also introduced unitary combined reporting to Texas for the first time. Under the previous franchise tax, taxpayers filed on a separate entity basis. The Margins Tax, however, is imposed on the unitary group, which in and of itself has created additional confusion and ambiguity with regard to the entire tax regime.

It is also evident that the tax can be particularly damaging to small businesses for which margins are likely to be tight. Additionally, a business may also find itself owing taxes even if in a year when it does not record a profit.

In light of the deep cuts to the budget that are proposed elsewhere, the question arises whether it is advisable for the state to enact these tax law changes and forego revenue. The answer to this question depends on whether the economic activity created by these suggested changes to the tax law will offset or outweigh the lost revenue. While there is no easy way to evaluate this offset, it is worth noting that the incentive that is already part of the current law – the high-cost gas tax incentive – has generated economic benefits to the state at the same time natural gas taxes have contributed substantial amounts to the state treasury.

While the exact costs (in foregone tax revenue) of the proposed changes to the Margins Tax and the continuation of the high-cost gas incentive are not known, a general idea of the costs can be obtained by looking at certain proposed legislation and the accompanying fiscal notes from the last legislative session.

Some proposed changes to the Margins Tax during the 81st Legislative Session resemble those made in this report. For example, HB 720 proposed permanently increasing the revenue exemption amount from $300,000 to $1 million (adjusting for inflation each year), at an estimated revenue loss of $172 million over 2010-1011 (approximately $86 million annually). This report recommends making the $1 million exemption permanent; however, the annual forgone revenue should be less than that contemplated by HB 720 because the revenue exemption amount is already scheduled to rise to $600,000 in 2012 and beyond.

Similarly, excluding all flow-through funds from revenue (as suggested in this report) was proposed in the 81st Legislative Session in HB 3835. The fiscal note for that bill estimated that the state would forego approximately $900 million in revenue over the 2010-2011 period as a result.

Again, it is important to weigh this foregone revenue with the economic benefits of the suggested tax reforms, which include job creation, capital investment, decreased burdens on small business, and the multiplier effects of these benefits.

Recommendation: Consider lessening the impact of the Margins Tax through additional reforms.

If school district M&O taxes are further reduced by either dedication of surplus revenues or increased Sales and Use Tax revenues resulting from rate increases, closed exemptions, or both, legislators must consider options that could lead to the repeal of the Margins Tax.

In the meantime, the following policy proposals should be considered to lessen the negative impact of the Margins Tax on Texas' business climate:

- Making the $1 million revenue exemption permanent.
- Amending the Texas constitution to require a two-thirds vote of the Legislature to increase the Margins Tax rate.
- Constitutionally dedicate the new revenue generated by the Margins Tax to the Property Tax Relief Fund to prevent future diversions of these funds to other projects.
- Allow small businesses to include payments made to independent contractors as compensation in calculating the tax due.
- Allow businesses to carry forward losses from a 10-year period (currently, these are limited to those that were established under the previous Franchise Tax; taxpayers under the Margins Tax may not otherwise use net operating losses to reduce their tax liability).
- Exclude all flow-through funds from total revenue.

2b. The Tax Incentive for High-Cost Natural Gas Production

In 1989, the Texas Legislature enacted a law to temporarily exempt "high-cost" natural gas production in the state from severance taxes.[ix] High-cost gas is defined partly by reference to a federal statute and partly by reference to the rules promulgated by the Railroad Commission of Texas (RRC). In turn, the RRC defines high-cost gas as natural gas which is produced from one of several specified sources, such as shale, tight sands, or coal beds.[x] The common trait of these sources is that they might be termed "unconventional" sources of natural gas that are difficult or expensive to develop ("unconventional" and "high-cost" natural gas are used interchangeably in this piece[xi]).

The exemption in the original statute has since been changed to a tax rate reduction. The tax reduction under the statute is calculated by multiplying the normal tax rate on natural gas production (currently 7.5 percent) by a ratio that involves the cost of drilling and completing a given well. The tax reduction applies to wells producing high-cost gas that were begun or completed after 1996. The reduced tax rate is effective for ten years or until the cumulative tax savings exceed 50 percent of the well's drilling and completion costs, whichever occurs first.

The importance of unconventional natural gas is projected to rise dramatically. An April 2009 New York Times article quotes industry sources as predicting that unconventional natural gas will comprise 53 percent of U.S. and Canadian natural gas supplies by 2020, up from 30 percent in 2000.[xii] The Federal Reserve Bank of Dallas in 2005 cited the Department of Energy's projection that unconventional gas will account for 44 percent of natural gas supplies in the Lower 48 states by 2025, up from 17 percent in 1990 and 35 percent in 2003.[xiii] Whatever the exact numbers may be, it is clear that natural gas production through unconventional means is a fast-growing component of the energy sector.

In keeping with its role as a leader in the nation's energy sector, Texas has been at the forefront of unconventional natural gas production. High-cost gas drilling has accounted for much of the development in Texas over the last decade, including the Granite Walsh, Barnett, Eagle Ford, Haynesville, and Bossier shale plays. As the Federal Reserve Bank of Dallas noted in its 2005 report:

> What . . . areas of hot drilling activity have in common is unconventional gas reserves—the Barnett shale near Fort Worth, the Cotton Valley and Bossier sands in East Texas, and other tight sands in the western Anadarko Basin of the Panhandle. Together they are instrumental in pushing the Texas rig count to recent high levels.

According to the U.S. Energy Information Administration, in 2009 Texas accounted for a remarkable 57.5 percent of the United States' shale gas (a type of high-cost natural gas) production.[xiv]

The development of the high-cost gas industry has had pronounced economic benefits for Texas. In 1999, the Texas Railroad Commission stated that "[t]he high-cost gas incentive has pumped more than $40 billion into our state's economy since it was initiated in 1989."[xv] Eric Potter, a director of the Bureau of Economic Geology at the University of Texas at Austin, has estimated that the Barnett shale play alone will generate $100 billion for the Texas economy.[xvi] Notably, this increased economic activity includes impressive job creation; for example, the RRC in October 2007 credited the Barnett shale play with creating over 55,000 permanent jobs.[xvii]

In addition to creating jobs and spurring capital investment, high-cost gas production-- like all natural gas production-- benefits the state treasury. For example, for fiscal year 2009, the state collected over $725 million in gas production taxes.[xviii] In addition, the state's Economic Stabilization Fund (the "Rainy Day Fund") is funded in large part by oil and gas production taxes. In 2004, when the Comptroller transferred $594.5 million into the fund to bring the balance up to $878.1 million, she credited a "surge" in natural gas severance taxes.[xix] By the close of the 2010 fiscal year, the fund had swelled to $7.7 billion.[xx] The Comptroller estimates that the fund will rise to $9.4 billion by 2013.[xxi]

Continuing the high-cost gas incentive costs the state would likely cost the state more than $1 billion annually in foregone revenue, since in 2006 the Comptroller reported the cost of the incentive as approximately $1.1 billion.

Recommendation: Maintain the tax incentive for high-cost natural gas production.

Given Texas' budget shortfall for the 2012-2013 biennium, legislators may encounter proposals for eliminating various tax exemptions and reductions, including the high-cost gas incentive. However, given the incentive's record of creating jobs and promoting economic growth in Texas, however, the Legislature should resist any pressure to eliminate it. Eliminating it would likely cause companies to reduce their capital investment in Texas. As the RRC has noted:

> By providing . . . reductions of the severance tax on gas production, [incentives such as the tax reduction for high-cost gas] in effect lower the cost of production. For marginal operations, in particular, these incentives might mean the difference between shutting in a well, keeping a well in production, or bringing a well back into production.[xxii]

According to one industry estimate, the elimination of the high-cost gas incentive could reduce the drilling of shale wells in the state by 30 percent.[xxiii]

The RRC further commented:

> Texas incentive programs have been so successful that other states have used them as models. Severance tax incentives continue to be needed in the future to encourage production and expansion of oil and gas operations, and sustain a vital segment of the state's economy.

In keeping with these goals, the Legislature should resist any calls to increase taxes on the Texas natural gas industry through the elimination of the high-cost gas tax incentive as just one example of the type of incentives that are proven to work and keep Texas economically competitive particularly in relation to other mega-states that are effectively choking the marketplace.

3. Workers' Compensation Reforms

During the regular session of the 79th Legislature, House Bill 7 was enacted to provide sweeping and substantive changes to the regulation and operation of the Texas Workers' Compensation System. In 2005 the system was clearly in turmoil – premiums were increasing at an alarming rate and over-regulation was stifling competition and innovation. Injured workers were struggling to get quality care and timely benefits while providers were struggling to receive payments.

According to physician groups, the number of doctors willing to treat workers' compensation patients had declined by 50 percent from just 2000 to 2004.[xxiv] At one point only 23 percent of doctors in the state of Texas were willing to accept new workers' compensation patients.[xxv] Comparatively, the Texas Workers' Compensation System was one of the worst in the nation, as injured workers made more doctor visits per claim, the average cost of each claim was substantially higher, and satisfaction rates were generally lower than similarly injured workers from other states.

At the time, the Texas Workers' Compensation Commission (TWCC) acted as an intermediary between employers, employees, health providers, and insurers. It was widely believed that the heavy-handed approach and over-regulation of government eliminated any possible economic, medical, and social incentives that would encourage better care and keep costs reasonable. The regulatory structure had little strategic direction, inefficient management, and no accountability. House Bill 7 (79R) remedied this situation by abolishing the TWCC in favor of a new Division of Workers' Compensation under the Texas Department of Insurance (TDI).

However, the most substantive and substantial of the changes in HB 7 dealt with changing the system in Texas from one of an "Approved Doctors List" (ADL), created and maintained by the state, to a Network of Providers system, allowing providers to operate in competitive networks. Prior to the passage of HB 7, an injured employee would have to select a primary care physician from the ADL. From a provider's perspective, its only incentive to improve its proficiency or to offer competitive rates was to meet whatever criteria set forth by the state in order to earn a spot on the ADL.

This system of government control and regulation significantly limited competition and innovation, while also restricting employee access to a smaller group of doctors. By allowing providers to operate in competitive networks, employers to choose among these networks, and employees to choose doctors from within their employer's network, competition drives innovation and controls prices, while the state's overall regulatory footprint is significantly and appropriately diminished.

Moving from an Approved Doctors List to a Network system also brought the Workers' Compensation system closer to that of existing health care networks. A look at the difference in costs between the two systems definitely supports the move to a Network system:

Care Delivery System	Neck Soft Tissue	Low Back Soft Tissue	Shoulder Soft Tissue	Hand/Wrist Soft Tissue	Knee Internal Derangements
Group Health	$425	$401	$817	$476	**$1,379**
Workers' Comp	***$3,698***	***$4,319***	***$4,015***	***$2,710***	***$5,552***

Source: Med-FX, LLC and the Research and Oversight Council on Workers' Compensation, 2000.

HB 7 also aimed to improve and encourage better return-to-work outcomes, without mandatory return-to-work, which would not be practicable for Texas. With such a wide array of jobs and industries that participate in workers' compensation in the state, requiring all employers to bring back injured workers is simply not possible. Instead, HB 7 encourages employers by ensuring that patients get the most appropriate medical care and by providing educational materials both to workers and employers about the benefits of return to work.

Finally, the network system attempts to tackle another problem that plagues the Workers' Compensation system in Texas – overutilization. It was suggested that by using primary care doctors, the networks of providers system would ensure appropriate utilization, and injured employees would be treated more efficiently and appropriately. No longer would they be seen for weeks or months on end by a practitioner whose motivation is continued payment by the workers' compensation carrier.

Legislative Recommendations:

Recommendation 1 - Stay the Course

Many of the changes in HB 7 were sweeping and fundamental. The effects of these changes are just now beginning to be felt, and the emergence of competing networks of providers will continue to control prices and encourage the highest levels of competency, service, and innovation. As time passes, the Division of Workers' Compensation will continue to refine and adapt to its regulatory and supervisory role over the workers' compensation care system, and overall quality of care and services provided to Texas workers will steadily improve.

Recommendation 2 – A Statutory Employer Law

Texas would benefit from a true statutory employer law, which would incorporate and clarify recent Texas appellate court decisions regarding workers' compensation and third party lawsuits at worksites. Such a statute would provide that if a worker has workers' compensation insurance coverage, the benefits from that policy would be the sole remedy for the worker. This will encourage workers compensation coverage for workers and will add efficiencies in construction projects that will lower the costs of construction, benefit the Texas economy and encourage job growth, while providing immediate medical care and income to injured workers without the delay and risks of litigation.

Recommendation 3 - Defend Small Business

Non-subscription is an essential right of Texas businesses which must be protected. Allowing employers to pursue coverage through vendors outside of the TDI keeps prices low through competition. In many cases, the availability of this cost-saving choice has been the factor that keeps businesses operating in Texas.

Recommendation 4 – Oppose any efforts to disallow or restrict arbitration.

Disputes should be handled at the lowest level possible, allowing for timely resolution. In fiscal year 2009, 44 percent of appealed disputes were resolved during a pre-hearing conference, indicating that given the opportunity, parties are often able to resolve differences before escalating the dispute to more formal and expensive options. Oppose additional restrictions on arbitration.

Recommendation 5 - Resist Over-Regulation

Oppose legislation that imposes new laws or regulations on Texas employers that are non-subscribers to the state workers' compensation system.

4. Financing the State's Transportation Infrastructure

Background

A modern and efficient transportation infrastructure is a cornerstone of Texas' future economic development. Achieving this goal with revenues that do not negatively impact the economic growth that they are being generated to support is a critical balance that the Legislature must seek to attain. Historically, road construction and maintenance have been directly funded primarily by a combination of the motor fuels tax and transportation bonds. As the state's population growth has accelerated in recent decades, however, the strain on parts of Texas' transportation infrastructure has become acute—especially in and around large urban areas.

This has placed a renewed focus on transportation financing and has led to legislative initiatives, such as House Bill 855 (81R), that have attempted to create additional funding options for transportation projects. While HB 855—which would have allowed voters to approve local option taxes to fund local transportation projects—did not pass, legislators need to continue to assess the extent to which new financing options are required, or whether the state's needs can be met through existing financing mechanisms and revenue streams such as the motor fuels tax and state highway fund.

Transportation Funding

Despite legislative efforts to create new sources of transportation financing, it is not at all clear that there is currently a lack of transportation funding in Texas.

In 2006, the Texas Transportation Commission projected that $188 billion would be needed for transportation infrastructure projects through 2030, and that this would result in an $86 billion funding shortfall.[xxvi] In the same year, a Governor's Business Council (GBC) report suggested that the state would need to provide funding to meet a $44 billion transportation shortfall through 2030.[xxvii] However, the GBC report noted that:

> For all practical purposes these estimates are virtually the same. TxDOT's estimate of $86 billion in need over the same period of time statewide differs significantly from the GBC-2 report because it includes the local share of Texas Metropolitan Mobility Plan (TMMP) funding ($22 billion) and the original Texas Urban Mobility Plan (TUMP) estimate of $9 billion.[xxviii]

Alongside these projections, the "2030 Committee" established by TxDOT in 2008 estimated $315 billion in funding needs for transportation projects through 2030. The $315 billion projection is broader in scope than the other estimates, incorporating pavement maintenance that keeps 90 percent of roadways in "good" condition or better ($89 billion); bridge maintenance ($36 billion); urban mobility ($171 billion); and, rural mobility and safety ($19 billion). It is worth pointing out that the largest portion of these costs – urban mobility – is not an exclusive state responsibility; historically, cities and counties have funded around one-third of urban mobility costs.[xxix]

It is evident from these divergent projections that projecting transportation funding needs into the future is an imprecise science. A recent Grant Thornton review of TxDOT noted specifically that "some members of the transportation community hold differing views on the actual amount of funding required to sustain the State's transportation system for this period."[xxx] The review cited a 2009 House Research Organization report which concluded that "while the projected funding gap could help assess highway funding needs generally, it should not be used to make policy or funding decisions because it contained costs that should not have been included, a mathematical error, and additional undocumented costs."[xxxi]

In light of these conclusions, lawmakers should be reticent about providing additional revenue to TxDOT until the need for that revenue has been conclusively proven. This is particularly important in the current budget environment. With a multi-billion revenue shortfall projected for the 2012-13 biennium, creating new revenue streams for transportation projects based on 25-year future projections is not prudent, especially in the current fiscal and economic climate.

For instance, even if the $188 billion funding need is accurate, this would mean that the state requires $7.8 billion for transportation projects per year for the period 2006 -2030. However, in the six-year period 2006-2011, the Legislature has appropriated $46 billion to TxDOT, which is an average of $7.6 billion per year. If that rate of appropriations continues through 2030, the agency will have received a total of $182.4 billion since 2006. This would be just $5.6 billion less than the $188 billion that the Commission said was needed.

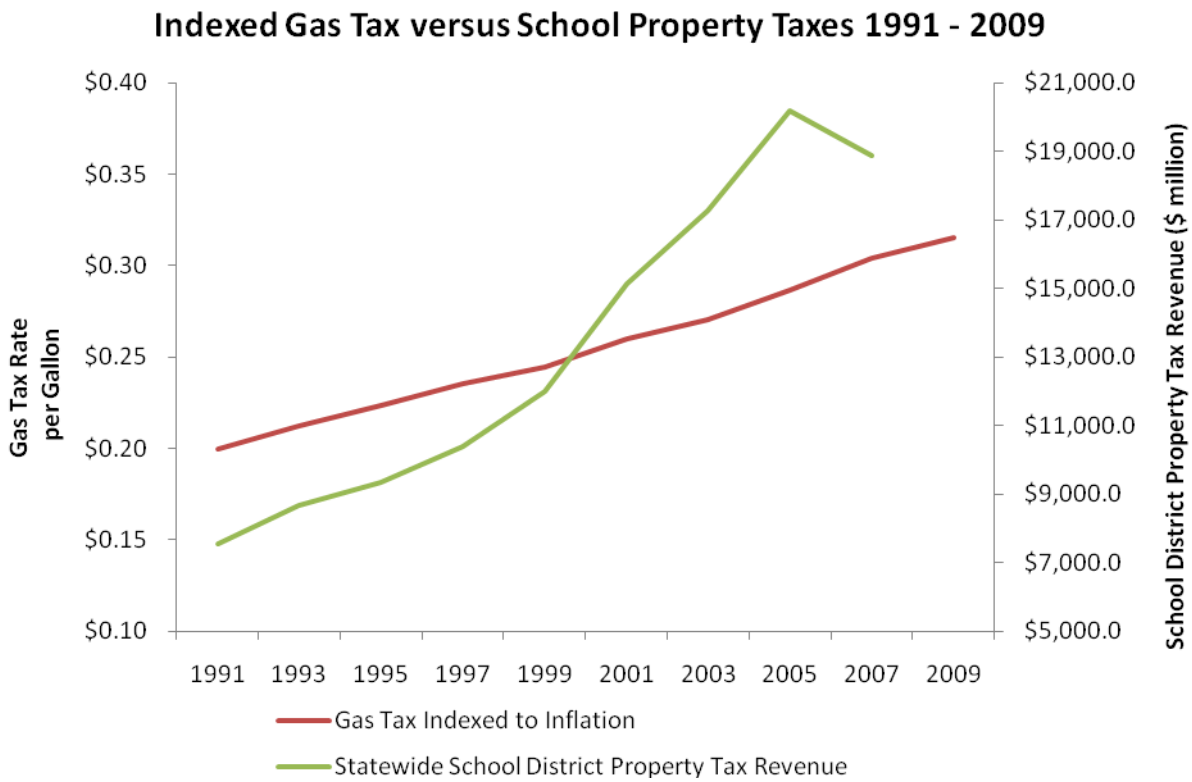
None of this is to say that there would not be benefits from devoting more funding to transportation projects, but merely to note that very substantial funding appears to exist for currently planned projects, *despite* the divergent views on how much is needed to fund transportation projects. Raising new revenue for transportation must be taken in the context of all taxes: homeowners and other property owners continue to face a perpetually-increasing property tax burden and business owners continue to grapple with the burden and complexity of the Margins Tax. Legislators should consider these facts in the context of exploring new funding mechanisms, and particularly ones that would impose additional burdens on taxpayers, as well as in drafting the state budget.

Transportation Financing Options

Much of the debate concerning transportation financing has focused on the possibility of indexing the state motor fuels tax (commonly referred to as the "gas tax") to inflation. The last time the gas tax was raised was in 1991, when the 72nd Legislature increased the rate from 15 cents per gallon to the current rate of 20 cents per gallon. Advocates of indexing the gas tax to the rate of inflation contend that such a change is necessary because the effective rate of the gas tax declines over time as a result of inflation.

However, it is fiscally irresponsible to index a tax to the rate of inflation, a measure over which state policy makers have no control. Tax rates and the revenue they yield should be based on the fiscal needs of the state and not set to increase annually based arbitrarily on the rate of inflation. Property taxes in Texas are already fixed to some measure of inflation through the annual appraisal mechanism in which taxable property values are reassessed based on estimated changes in property value. The tremendous growth in property tax revenues and the burden this places on taxpayers is a stark warning to legislators against indexing the gas tax to inflation.

The following chart illustrates the growth in the rate of the gas tax had it been indexed to inflation in 1991 when the 20 cent rate was established. The chart also shows statewide school district property tax revenues over the same period. While property tax revenues have increased at a faster rate than an indexed gas tax would have, this is largely due to the annual rate of inflation averaging two to four percent in the period shown, while residential taxable property values can increase by up to ten percent annually, and the annual increase in business property values is not restricted at all. However, the fundamental point remains: Texas does not need another tax on auto-pilot, increasing year on year without the accountability of legislative action.



Sources: Indexed Gas Tax Rate: U.S. Bureau of Labor Statistics Inflation Calculator.
Property Tax Revenues: Legislative Budget Board.

Before considering new and potentially harmful funding options, such as indexing the gas tax to inflation, the following existing funding mechanisms and revenue sources should be reviewed to determine whether they can provide the necessary resources to meet the state's needs:

1. **The State Highway Fund**

The Texas Constitution (Article VIII, Section 7-a) makes clear that subject to legislative appropriation:

> All taxes…on motor fuels and lubricants used to propel motor vehicles over public roadways, shall be used for the sole purpose of acquiring rights-of-way, constructing, maintaining, and policing such public roadways.

As of FY2011, this amounted to $40.5 billion since 2002. As the table below shows, the majority (81 percent) of this $40.5 billion goes directly to the Texas Department of Transportation (TxDOT); however, other amounts are diverted to seven other agencies, including the Health and Human Services Commission (HHSC) and the Texas Education Agency (TEA). Ending these diversions must be a legislative priority before creating new sources of revenue or raising existing taxes and fees is contemplated.

Agency	**Total Appropriations from State Highway Fund 2002-2011**
Office of the Attorney General	**$ 56.8 million**
Retirement & Group Insurance	*$ 6.0 million*
Social Security & Benefit Replacement Pay	*$ 3.2 million*
Health & Human Services Commission	**$ 93.9 million**
Texas Education Agency	**$ 200.0 million**
Texas Transportation Institute	**$ 49.0 million**
Higher Education Employee Group Insurance	*$ 4.0 million*
Social Security & Benefit Replacement Pay	*$ 1.1 million*
Comptroller's Judiciary Section (Public Integrity Unit)	**$ 9.5 million**
Department of Public Safety	**$ 3,945.2 million**
Retirement & Group Insurance	*$ 732.4 million*
Social Security & Benefit Replacement Pay	*$ 264.1 million*
Department of Transportation	**$32,772.5 million**
Retirement & Group Insurance	*$ 1,696.8 million*
Social Security & Benefit Replacement Pay	*$ 510.1 million*
Texas Workforce Commission	**$ 6.8 million**
State Office of Administrative Hearings	**$ 29.6 million**
Social Security & Benefit Replacement Pay	*$ 1.6 million*
Article IX, Schedule C Salary Increase	**$ 112.9 million**
GRAND TOTAL:	**$40,495.7 million**

Source: Legislative Budget Board

If the constitutional language directing State Highway funds to "acquiring rights-of-way, constructing, maintaining, and policing such public roadways" is interpreted to apply to any expenditures by TxDOT and the Department of Public Safety (which provides policing of roadways), **then $558.5 million has been diverted away from these two agencies over the past decade**. As the chart shows, most of this diversion has gone to the Texas Education Agency ($200 million) and to public employee salary increases ($112.9 million). If these expenditures by TxDOT and DPS are included as diversions from the State

Highway Fund, then **$3.761.9 billion has been diverted from the State Highway Fund over the past decade.** Retirement benefits should not constitute a permissible use of current transportation funds. If legislators are concerned about transportation funding, a close examination of the expenditures from the State Highway Fund is the first step that should be taken before new sources of revenue are considered.

This is not to argue that the Legislature should not meet the state's obligations to current and former employees of TxDOT and DPS, but merely to note that the plain language of the constitution demands that highway funds be spent on highway construction, maintenance, and policing. Legislators could apply the principle of truth-in-taxation by devoting highway funds to these narrow items, while appropriating other funds from General Revenue to pay for other obligations borne by TxDOT and DPS.

2. **Shift funding from welfare programs**

Over the past two decades, spending on welfare programs administered by HHSC has grown at a staggering rate when compared to transportation funding:

STATE SPENDING ON HHS PROGRAMS VERSUS TRANSPORTATION: 1989-2009.

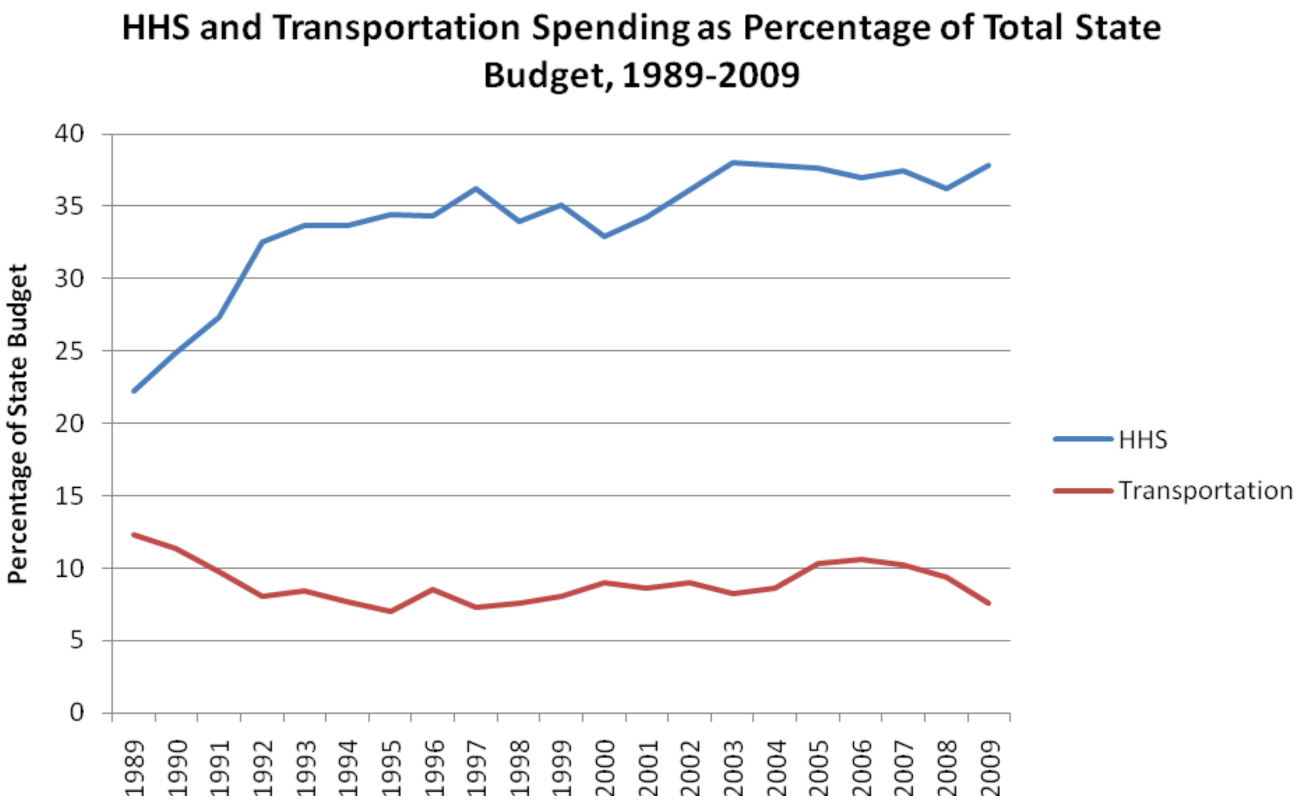
	Health and Human Services		Transportation	
	Total Funding	Percent of State Budget	Total Funding	Percent of State Budget
1989	$4.6 billion	22.2 percent	$2.5 billion	12.3 percent
1999	$16.0 billion	35.1 percent	$3.7 billion	8.1 percent
2009	$33.5 billion	37.8 percent	$6.7 billion	7.6 percent

Source: Texas Comptroller of Public Accounts, Expenditure History by Function: 1978-2009.

As the chart shows, in 1989 spending on Health and Human Services (HHS) programs stood at just $4.6 billion, which represented 22.2 percent of the entire annual state budget. In the same year, transportation funding was $2.5 billion or 12.3 percent of the entire state budget. Over the subsequent two decades both HHS and transportation spending have grown, though at markedly different rates. HHS spending has grown more than sevenfold and now accounts for a much higher percentage of the total state budget (37.8 percent). Transportation spending, however, is only a little more than two and a half times larger than it was in 1989, and it now accounts for a much smaller proportion of the state budget (just 7.6 percent).

If just a fraction of the new revenue that has been directed to HHS programs had been used on transportation projects over the past two decades, Texas' transportation infrastructure would likely be significantly better off today. Legislators must be cognizant of the fact that HHS programs have become an unsustainable drain on the state's resources and that they now materially impact the state's ability to adequately fund necessities such as roads and highways. Passage of the Patient Protection and Affordable Care Act of 2010 will exacerbate this trend since it prohibits the state from making meaningful cost-saving reductions to HHS programs such as Medicaid and CHIP.

The following graph also charts this trend:



Source: Texas Comptroller of Public Accounts, Expenditure History by Function: 1978-2009.

3. **4a and 4b Sales Taxes**

The Development Corporation Act of 1979 (found in Article 5190.6 of Vernon's Civil Statutes) allows certain cities to levy additional sales and use taxes in order to fund economic development projects including:

- Manufacturing and industrial facilities, recycling facilities, distribution centers, or small warehouse facilities.

- Research and development facilities, regional or national corporate headquarters facilities, primary job training facilities for use by institutions of higher education, job training classes, or telephone call centers.
- A general aviation business service airport that is an integral part of an industrial park.
- Certain infrastructure improvements, which promote or develop new or expanded business enterprises.
- Port-related facilities to support waterborne commerce.

The Act also allows cities that are located within regional transportation authorities to use 4a and 4b sales taxes for transportation projects, with voter approval. Since transportation infrastructure is a vital prerequisite to any meaningful economic development, political subdivisions should ensure that they are fully utilizing all revenue options, including 4a and 4b sales tax revenues to finance transportation projects at the local level. More broadly, local officials should ensure that they are fully utilizing existing revenue sources (typically a one cent local sales and use tax) for transportation funding before new revenue sources are considered. The City of Irving, for example, utilizes a one cent local transit tax to fund transportation projects. If transportation is a primary concern of local officials, they should re-organize their spending priorities by fully utilizing their ability to levy a one cent local sales tax for transportation purposes.

4. **Private Equity**

The sheer scale of the investment that Texas taxpayers have made in the state's transportation infrastructure in recent years underscores the cost that is involved in developing and maintaining a modern transportation network. Faced with such costs, it is important that the state utilize private financing in order to mitigate costs that would otherwise be borne exclusively by taxpayers.

It is also important to note that many private companies have significantly more experience with toll projects than do American companies, and that there is no inherent risk to the State of Texas if its highways are funded with private capital. As Leonard Gilroy, a senior policy analyst at the Reason Foundation, noted in his testimony before the Texas Senate Committee on Transportation and Homeland Security:

> States want to deal with firms that have extensive experience as toll road providers. The simple fact is that the United States has no such industry, as yet, because we have used only public-sector agencies to build and operate toll roads. Thus, responsible governments, wanting to ensure that the toll road is in experienced, professional hands, will weigh prior experience very heavily in their selection criteria… Attracting billions of dollars in global capital (and expertise) to modernize America's vital highway infrastructure is a huge net gain for Texas.[xxxii]

Choosing to keep development of the state's transportation infrastructure in the public sector when realistic and effective private sector alternatives exist is anathema to the fundamental conservative principles of limited government and free enterprise.

The folly of rejecting private equity is particularly stark in contrast to the fact that private companies build the cars, trucks, gas stations, street lights, traffic signals, and virtually every other item that is necessary for travel on the public highway. Private companies also extract and refine the petroleum and petrodiesel that is used to fuel the vast majority of vehicles that use public highways. There would be no meaningful system of highway transportation without the investments made by these private companies. Involving private equity in the construction of public highways is an entirely logical approach to delivering an effective and efficient transportation network.

Recommendation: Examine and prioritize funding options for the state's transportation needs.

Transportation infrastructure is critical for the future of Texas, and it must therefore be funded as a priority that is at least as pressing as other areas of the budget such as health and human services programs and public education. Ending diversions from the State Highway Fund is imperative before legislators consider other revenue alternatives, and the state should be ready to continue working with the private sector in order to utilize its financial and practical expertise to deliver a modern transportation infrastructure for Texas.

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