



VERITAS

INSIGHTS INTO PUBLIC POLICY IN TEXAS...

Texas Public Policy Foundation

State Fiscal Health: Diagnosis & Prognosis For Texas

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A report released this fall evaluating the state's fiscal health diagnosed serious problems for Texas: the state's property tax is too high, the tort system is still perceived as presenting extra risk compared to most other states, and the costly workers' compensation system exerts an adverse economic impact.

The Texas Public Policy Foundation commissioned Stephen Moore, Donna Arduin, and Arthur B. Laffer to conduct the review. Their conclusion: Texas ranks 19th in economic outlook among the 50 states. (The full report is available online at www.TexasPolicy.com.)

Most of what determines a state's economic health, the economists acknowledge, is outside policymakers' direct control. However, fully a quarter of a state's economic health is determined by state fiscal policy—spending and taxes. As much as 14 percent is determined by other state policies. Seventeen percent is determined by neighboring states' fiscal policies. Forty-four percent is determined by national and world economic trends.

Economically, the states are in competition with each other, a fact state policymakers must bear in mind. State tax policies play a major role in a state's competitiveness and directly affect the profitability of developing a state's resources—which include its



Stephen Moore, economist and *Wall Street Journal* editorial writer, provides a diagnosis and prognosis on the health of the Texas economy as part of the Policy Primer Series, "An Examination of Texas' Economic State."

people. Excessive taxes and increasing taxes work to inhibit economic growth and well-being.

Uncertainty regarding tax policy—especially if it is likely the changes will negatively impact business—reduces a state's economic competitiveness, thereby hurting investment and growth. This implies that recent legislative sessions in Texas, with the talk of payroll taxes, gross receipts taxes, business activity taxes, and

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"...dubbed 'the official think tank of Texas' by friends and foes..."

Dallas Morning News



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The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policy makers, the media and general public.

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Veritas ♦ Fall 2005

Veritas is a quarterly publication of the Texas Public Policy Foundation. Veritas focuses on the critical issues facing public policy in Texas. Subscribe to this publication by contacting the Texas Public Policy Foundation at (512) 472-2700 or at our website www.TexasPolicy.com.

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Mission Statement

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute guided by the core principles of limited government, free markets, private property rights, individual liberty and personal responsibility.

The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policymakers, the media and general public. The work of the Foundation is conducted by academics across Texas and the nation and is funded by hundreds of individuals, foundations and corporations. The Foundation does not accept government funds or take contributions to influence the outcomes of its research.



From the President

As the Texas Public Policy Foundation continues to promote free-market ideas and innovative public policy reforms across Texas, another facet of our efforts continues to strengthen in both volume and impact. Our 2005 Policy Primer Series has become the platform in which policymakers, opinion leaders, and concerned citizens alike can come together to learn, debate, and advance the ideas and principles to shape a better Texas.

In September we set off on a whirlwind tour across Texas as we hosted a series of primers with renowned author and economist Stephen Moore. Based on the findings of a Foundation-commissioned report, “An Examination of Texas’ Economic State,” Moore presented a diagnosis and prognosis for Texas’ economic wellbeing to audiences in Houston, San Antonio, Midland, and Austin.

With barely enough time to unpack our bags, we were on to the next policy primer—an in-depth look at incentive-pay programs for public education teachers. “Professional Pay For Professional Educators” was held at the Foundation’s Austin office in October. This primer drew standing-room-only crowds for a luncheon and panel discussion to identify the reasons why Texas policymakers and the education community should stand behind a professional compensation system that rewards teachers for bringing academic excellence to the classroom.

As a jump-start to the debate, the policy primer ignited talk of a professional compensation system for Texas educators. Only a week after the Foundation’s primer event, the governor issued an executive order directing the Texas Education Agency to establish an incentive-based pay program for Texas teachers.

Next came eminent domain—protecting property rights in Texas after the *Kelo* decision. Selling-out in just a day, this topic grabbed the attention of legislative offices and property-owning Texans. And, rounding out our 2005 Policy Primer season will be a December primer covering juvenile justice programs in Texas.

Looking ahead, we are excited about the 2006 line-up of policy events that will examine key issues and steer the debate in the 80th Session of the Texas Legislature. The next 18 months look to be a promising time for moving forward the principles and reforms that will continue to place Texas on the winning team in economic prosperity.

In this effort, I would be remiss not to thank the underwriters of the Policy Primer Series, the Dodge Jones Foundation of Abilene, and all of our dedicated friends and donors that give so generously to the fight for the sound conservative principles that will ensure a brighter, stronger Texas.

For Texas,

Brooke L. Rollins
President, Texas Public Policy Foundation



Foundation president Brooke Rollins speaks with Foundation board member Ramiro Galindo at the Houston policy primer, “An Examination of Texas’ Economic State.”

“Looking ahead, we are excited about the 2006 line-up of policy events that will examine key issues and steer the debate in the 80th Session of the Texas Legislature.”



Diagnosis & Prognosis... Continued from page 1

“reformed” franchise taxes have hurt Texas’ economy. On the other hand, Texas has implemented few significant tax changes over the last 15 years—stability that helps the state’s outlook.

“Texas enjoys a significant advantage from being one of the nine states without a personal income tax. The presence of a state personal income tax has been shown to hurt a state’s economy.”

Texas enjoys a significant advantage from being one of the nine states without a personal income tax, the economists report. The presence of a state personal income tax has been shown to hurt a state’s economy. Compared to the nine states with the highest marginal personal income taxes, the nine states without a personal income tax showed over a decade: 16.2 percentage points greater output growth, 17 points more personal income growth, 10.1 points more job growth, 2.2 points more personal income per capita growth, and slightly lower unemployment.

The nine states with the highest personal income tax rates have experienced many more budget difficulties in recent years than the nine without personal income taxes. States with low or no personal income tax tend to have more stable

budgets and fewer revenue shortages. This is probably because disciplined taxation leads to disciplined spending, making any shortages that might occur much more manageable. Even though Texas has grown its budget over the last ten years in excess of inflation and population growth, it has still done so more slowly than most other states.

Texas also enjoys the advantage of being a relatively low-tax state overall. At \$97.89 in state and local taxes per \$1,000 of personal income, Texas has the 12th lowest tax burden among the states—a burden only 65 cents higher than the state with the 10th lowest burden.

By far, the two most important taxes in Texas are the property tax (\$32.3 billion in local revenue) and the sales tax (\$16 billion in state and local revenue). These relatively stable revenue sources, absent the volatile personal income tax, helps Texas avoid the instability inherent in other states’ tax systems.

The authors do recommend cutting school property taxes by 25 cents and freezing other property taxes. They also suggest abolishing the state’s corporate franchise tax and cutting the sales tax rate by one-quarter to one-half percentage point. Finally, the authors recommend making up for revenue through broader consumption taxes.

The resulting economic activity, they calculate, would bring the state a net increase in yearly reve-

nues of some \$4.2 billion within two years—even if proposed sales tax reductions are enacted.

“The direction chosen by the Texas Legislature in addressing this critical issue (school finance) will impact Texans more broadly than just in the education system. It will significantly determine the future of Texas’ economy.”

Due to school finance litigation, Texas might well be on the cusp of major tax reform. The direction chosen by the Texas Legislature in addressing this critical issue will impact Texans more broadly than just in the education system. It will significantly determine the future of Texas’ economy. ★

Download the full report, “An Examination of Texas’ Economic State,” from the Foundation’s website at: www.TexasPolicy.com.



A Conversation With John Fund...

Editorial Writer for the Wall Street Journal

The Foundation's vice president, Michael Quinn Sullivan, recently visited with John Fund, editorial writer for the Wall Street Journal and author of the recently published "Stealing Elections: How Voter Fraud Threatens Our Democracy." Fund also writes for the subscription-based *OpinionJournal*. Recently, Fund said of the Texas Public Policy Foundation, "More than a think tank for Texas, (it) is setting the standard by which other research organizations in the nation will be judged."

Michael Quinn Sullivan: How is Texas viewed nationally?

John Fund: Texas is very important. The size of the state, its economy, all have very serious national implications. It is hard to underestimate how important policy decisions made in Texas, and in my home state of California, really are for the rest of the country. We look very carefully at Texas, precisely because it has the political and economic clout to truly affect the direction of the nation.

MQS: There has been a rise in recent years of think tanks. How important are they in forming public policy?

Fund: They are incredibly important. They are where the good ideas really begin, or conversely where bad ideas are exposed. We see it at the national level and increasingly at the state level. Truly original, innovative thinking is coming out of free-market-oriented think tanks. It is important that there be independent voices proposing alternative solutions, and the think tanks are doing just that.

MQS: You use the phrase "free market," which is one of our Foundation's values. What role does free market economics play in making sound public policy?

Fund: It's really the basis of who we are as Americans. Private property rights, individual liberty, free markets, those



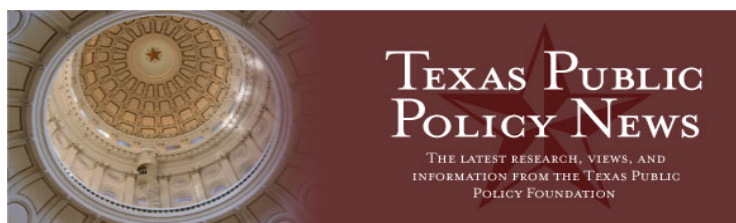
John Fund has been a featured speaker at several Foundation events, highlighting for legislators the national importance of their work in Texas.

principles are part of the foundation of our country. When we stray from those ideas, we stray from who we are.

MQS: Can the Foundation positively affect the direction of the state?

Fund: Well, we saw that the Texas Public Policy Foundation definitely had an impact during the tax debate this past spring. It shifted the debate. But that impact is obviously being leveraged in a number of other areas as well, and the potential for reform being driven by the Foundation is incredibly important to Texas. We see so many examples of bad public policy being implemented around the country, that it is all the more important that in a state like Texas, there be a clear, consistent advocate for sound policy. ★

TEXAS PUBLIC POLICY NEWS



The Foundation's e-newsletter, *TPPN*, is published every other Wednesday, keeping readers up-to-date on the latest research, news, views, activities and events of the Foundation.

To subscribe to *Texas Public Policy News*, please visit us at: www.TexasPolicy.com.



Heflin Joins Foundation Staff

Former House Appropriations Chairman Guiding TPPF Budget Study

By Michael Quinn Sullivan



Former Texas House Appropriations Chairman Talmadge Heflin joins the Foundation's Center for Fiscal Policy Studies as a visiting research fellow.

When lawmakers concluded work on the 2006-2007 budget for Texas, they approved a 18.7 percent increase in spending over the previous biennium; an increase that far outstrips inflation and population growth. As the "Spend-O-Meter" (located on the front page of TexasPolicy.com) demonstrates, the \$140 billion budget equates to spending \$2,200 every second for two years.

But where do the funds go, and why has the budget continued to rise even in an era of fiscal conservatism?

"The fact is, there is a great incentive to spend whatever comes in; there is always 'something else' to spend tax dollars on," says former State Rep. Talmadge Heflin of Houston, who served as chairman of the House Appropriations Committee.

Heflin's firm understanding of tax policy, coupled with an ability to examine budgets for cost-savings, were recognized by Democratic and Republican House speakers alike. For many legislative sessions, Heflin was the only member to serve on both the Ways and Means and Appropriations committees.

During his term as chairman of the Committee on Appropriations (2003-2004), it was Heflin who navigated a \$10 billion state budget shortfall through targeted spending cuts that allowed Texans to avoid a tax increase.

But the nature of the legislative process makes budget frugality difficult. "It's the desire of every legislator to spend every dime they can get their hands on," explained Heflin.

A well-known budget expert, Heflin this fall joined the Texas Public Policy Foundation's Center for Fiscal Policy Studies as a visiting research fellow. He and Dr. Byron Schломach, the Foundation's chief economist, are undertaking a review of the state budget in an effort to recommend cost savings in the next legislative session.

Heflin said this project is critical for taxpayers interested "in knowing how their money is spent." The 11-term legislator and former school board member believes knowledge is the first step in bringing lasting tax relief.

"As the budget continues to grow, the public needs to understand what they are getting," he said. When taxpayers are better informed, they will begin demanding fiscal restraint, such as that found in a stronger tax and expenditure limitation. "The legislature will have to start adopting a lower rate of growth."

Health and human services, the bulk of which is Medicaid, consumes the largest portion of the budget. Following HHS is public and higher education. Combined, the three areas represent almost two-thirds of the state budget. Setting aside mandated programs and dedicated funding items, Heflin said only about 20 percent of the budget is left fully at the discretion of the legislature.

But Heflin said it is important to recognize that ultimately all dollars appropriated by the legislature are spent by the legislature, and taxpayers must be prepared to hold politicians accountable for state spending.

"There still must be discipline to live within your means as a state," he added, suggesting that times of fiscal crises are the only time politicians are willing to listen. "There was willingness in 2003 to cut back. But, I'll be honest, in the back of people's mind was the thought that enough revenues would be coming in that we could put the money back."

But that money was being put back, Heflin says, into programs that might not have been needed in the first place.

"That's why this project is so important. People need to be informed enough to say, 'We don't think you should be doing this or that at the taxpayers' expense.'"★



A Consensus On Choice?

Now We Can Talk Seriously About Price

By Tim Dunn

Compromise is common, but consensus is rare in the world of politics. With public education, however, consensus is less than rare, it simply does not exist. But things may be changing in Texas.

Dave McNeeley, the well-read and very liberal columnist, recently proposed the Texas Legislature solve the school finance conundrum by distributing vouchers for students to use at public or private schools. Yes, this was said by Dave McNeeley and yes, he did propose vouchers to “bridge the razor-edged divide between those who think Texas’ public schools need more money and those who think the education answer is vouchers.”

What Mr. McNeeley calls the “sticking point” is his suggestion that the legislature write a check of roughly \$24,000 a year to each child as a voucher. This is the amount of tuition now charged by Andover, the exclusive East Coast prep school once attended by President George Bush, and an amount, according to the columnist, that’s “apparently necessary to achieve a good education.” Perhaps he spoke tongue-in-cheek.

Notwithstanding, we think this proposal should be seriously considered by the state legislature. Here is solid, common ground on which to begin answering difficult questions related to funding education and improving student success. The state should provide sufficient money for schools to do their job well and the money should be channeled through the parents.

As long-time advocates of eliminating the government monopoly in public education, we welcome Mr. McNeeley’s proposal. Trading sufficient funding for gov-

ernment-operated schools with universal school choice offers great promise for breaking the political gridlock on school finance and meeting public demand for educational excellence.

So, to paraphrase the punch-line of a tawdry joke—now that we’ve agreed to deal, it’s time to haggle about the price.

In keeping with the spirit of the proposal—using Texas as a guide—Mr. McNeeley should use Texas-based equivalents to Andover. Texans attending private “Ivy League” prep schools in the Southwestern Prep Conference pay, on the average, \$13,500 a year. However, we would argue this number is far higher than the average tuition for private schools in Texas that send graduates to the nation’s “Ivy League” colleges. Texans can get excellent quality from private schools without the high-end price tags—average private school tuition in Houston costs about \$7,000. Clearly, students can get—and schools can provide—a high quality, education in Texas for substantially less than \$13,500.

Averaging out actual private school costs in Texas, we suggest the price for vouchers and per pupil funding for schools should be in the range of \$8,000 annually. Depending on whose numbers you use, this amount is close to what we are spending per pupil now on public education. If we try this market-based system, and there is insufficient increase in excellence, then we can talk about more money. Let’s talk about funding real change since we know that putting more money into the same monopoly-controlled system has not improved public schools.



Tim Dunn is a Midland businessman and the vice chairman of the Foundation’s Board of Directors.

“Let’s talk about funding real change since we know that putting more money into the same monopoly-controlled system has not improved public schools.”

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Consensus On Choice... Continued from page 7

While we can afford to haggle over price, we cannot afford to ignore this opportunity to create a system of school finance that adequately funds education, establishes incentives to improve public schools, and places the ultimate accountability for the success of schools where it belongs, with parents.

“We challenge policymakers to make children the primary beneficiaries of education reform and to create a system of public education that serves all children equally well.”

We challenge policymakers to make children the primary beneficiaries of education reform and to create a system of public education that serves all children equally well.

Mr. McNeeley is right. Let’s link adequate education funding with educational freedom. We can haggle over the price. By increasing freedom, and letting academic results serve as the measure for success, every child in Texas will benefit. There can—or should—be no haggling over the value of that. ★

Tim Dunn is a Midland businessman and the vice chairman of the Texas Public Policy Foundation’s Board of Directors.

FOUNDATION PROFILES: Nathan Thompson

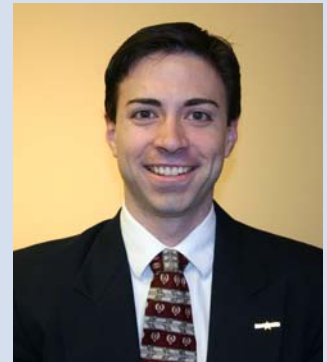
Nathan Thompson joined the Texas Public Policy Foundation as Director of Operations in September 2004.

He previously served as the Leadership Consultant for the National Fraternity of Alpha Chi Rho, traveling from the headquarters in New Jersey to 43 locations that span various college campuses throughout the Northeast and Midwest.

Nathan has a Bachelors of Science in Physics from Worcester Polytechnic Institute (WPI) in Massachusetts. In college he was elected President of the Interfraternity Council and in his senior year was chosen as the WPI Fraternity Man of the Year. He continues to be actively involved with his fraternity and WPI, serving on his class board of directors, class gift committee, and as an alumni ambassador.

Nathan was born and raised in the suburbs of New Orleans, Louisiana but now resides in Austin, Texas.

Contact Nathan Thompson at nthompson@texaspolicy.com.



Nathan Thompson



Donor Spotlight: *Jeremy Davis*

“I don’t have any great theory about the free market. I just believe in it.” These are the words of one of the Texas Public Policy Foundation’s strongest supporters, Jeremy Davis. “To kill a country, raise taxes and interest rates. There is nothing that kills enterprise faster.”

“To kill a country—raise taxes and interest rates. There is nothing that kills enterprise faster.”

Mr. Davis is a true believer in free markets. Like Ronald Reagan, he believes that government is the problem, not the solution. “Reagan re-introduced opportunity to our country after Roosevelt took it away.”

Mr. Davis first became interested in public policy after accepting a special invitation to meet parliamentarian Maurice McTigue, who served as minister of labor in New Zealand. He admires McTigue for helping New Zealand privatize many government services.

“McTigue helped introduce an education voucher system to his country, and, with the same teachers working in a different system, students excelled. Parents must become teachers’ customers.

“The socialist movement is the enemy of freedom and the negation of liberty. Under communism, everyone is equally poor.”

Mr. Davis supports the Foundation because of these principles, and has given 58 financial gifts since 2000. “I’m committed to the Texas Public Policy Foundation because without freedom, I wouldn’t be where I am today.”

A philosophy major from Williams College, Davis earned his MBA from Columbia School of Business. He worked at a small investment firm before serving in the Army in France for 11 months. Davis was later a security analyst at American National Insurance Company before learning the real estate business under Gerald Hines of Galleria fame. His father was a rancher who invested wisely in land in League City near NASA.

Because Mr. Davis loves Texas, he gives generously to the Foundation which he likens—on a federal level—to the Mercatus Center at George Mason University.



Foundation friend and donor
Jeremy Davis.

In addition to financial contributions, he has generously sponsored two TPPF policy analysts to attend a program by the Ludwig von Mises Institute to study Austrian economics and has purchased books for staff reading.

“TPPF receives everlasting credit for no income tax in Texas. The Foundation coaches state government and keeps it from overtaking the people. Freedom is what makes this country great, because individuals can start over. In Europe, once you claim bankruptcy, you can no longer even open a bank account.”

“TPPF receives everlasting credit for no income tax in Texas.”

Mr. Davis says he supports the Foundation because he supports excellence. “TPPF’s chief economist Bryon Schlomach is ahead of the curve. The Foundation attracts good people and has an excellent staff. I’m also impressed with the caliber of speakers the Foundation attracts to its policy events.”

“When the pilgrims had common land, nobody wanted to work and they starved. When they had private property rights, they prospered. That’s why we need the Texas Public Policy Foundation.”★



Getting The Incentives Right

Health Care System Shouldn't Make Bad Behavior Easy

By Mary Katherine Stout



Mary Katherine Stout is the policy analyst in the Foundation's Center for Health Care Policy Studies.

I never got paid for grades; this was one of the great injustices of my childhood. Every grading period other students talked about getting paid for each A and B. I got nothing. For many, high school graduation was about elaborate parties and gifts; again, I got nothing.

My parents made it clear: meeting their expectations was not cause for great fanfare. I was expected to make good grades and graduate from high school, and failure to meet expectations would have almost certainly resulted in punishment. Perhaps this was a case of a bigger stick than carrot, but the fact was my parents did not create incentives for what I was expected to do.

Perhaps I learned the lesson too well.

In recent years, the new fad in health care has been to create incentives encouraging healthy living. Stop smoking, lose weight, go to the gym, eat healthier, go to the doctor for annual checkups...the list goes on. There is no doubt a healthy lifestyle is important. The almost daily reminder from the media that Americans are gaining in girth is but one example of how unhealthy the country is becoming.

This doesn't just mean bigger people, it means bigger costs.

Many employers see wellness programs as a way to increase employee health and productivity, while hoping to save on the cost of employee health benefits. Even Medicaid is getting into the action by encouraging a modicum of personal responsibility in exchange for a prize. Some state Medicaid programs, like many private employers, have encouraged this attention to personal

health through small contributions to special savings accounts or lower co-payments, while others consider such lavish rewards as color televisions and similar gifts.

Incentives work. At first glance, the rush to create incentives for healthy living makes sense. State governments and private employers buckling under the cost of health care are desperate for the silver bullet to bring expenses under control. They theorize they can create incentives for people to make better decisions, and they may well be right.

But are big government rewards programs the solution to big government problems?

There is no lack of incentives; the incentives are just in the wrong place. The health care system today is generally devoid of incentives to do the right thing, and ripe with incentives to spend more, spending unwisely, while neglecting important aspects of health care. In fact, for many the effects of an unhealthy lifestyle are masked by an insurance structure that shelters the patient from much of the cost, along with medical innovations that minimize the personal burden created by unhealthy choices.

If patients made decisions with perfect knowledge and heightened personal responsibility, the clear incentive would be on doing the right thing at the beginning. This means revealing prices and expecting patients to take greater responsibility for first-dollar coverage, creating an environment where the patient must be a well informed consumer in complete control of their health care decisions.

This is the foundation of consumer directed care, and it ought to be the foundation for

“To fund Medicaid, CHIP, and state employees' health insurance over the next two years, a family of four will pay almost \$7,400.”

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health care reform, whether in Medicaid or private health insurance. Many critics of consumer directed care suggest people are either incapable of making decisions, or will make the wrong decisions. They wrongly predict people will not want to spend money on an inhaler, for instance, if they must bear the upfront costs. Yet this scenario does not make sense. While some people may choose wrongly, we know people will make the rational decisions to purchase the inhaler, rather than pay for a more expensive trip to the emergency room during an asthma attack. In this case, it isn't necessary to give this person a television for using their inhaler regularly—the incentive will be to avoid the more costly consequences.

The solution isn't to create another program to encourage better behavior, but to instead remove the incentives that make it so easy to choose bad behavior. Unless incentives are placed correctly across the entire system at the outset, this focus on wellness and healthy lifestyles will join the ash heap of failed programs and leave the health care system continuing to struggle under the weight of an aging and unhealthy population. ★

Mary Katherine Stout is the policy analyst in the Foundation's Center for Health Care Policy. The author welcomes your thoughts on this article. Please send your comments to: mkstout@texaspolicy.com.

“The solution isn't to create another program to encourage better behavior, but to instead remove the incentives that make it so easy to choose bad behavior.”

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Mark Your Calendars... *4th Annual Policy Orientation for the Texas Legislature*



The dates have been set for the 4th Annual Policy Orientation for the Texas Legislature. Each year, the Texas Public Policy Foundation brings together lawmakers and policy experts from across the political spectrum. This two-day symposium, which has sold-out since its inception, draws legislators and interested Texans to discuss and learn about a wide range of policy issues facing the state.

January 9 & 10, 2006
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