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Publication Date
May 4, 2006

Are Property Tax Caps In Texas An Unnecessary Fix?

Let's face it, who likes paying higher taxes? The answer to that question is perhaps why Texas cities have been generally conservative and fairly mindful of their taxpayers' sensitivity to tax rate hikes and higher property appraisals. Consequently, property tax increases have tended to be fairly modest over the past decade. And even though appraisals have increased considerably in absolute terms, on a per capita basis, these, too, have remained relatively stable.

While property taxes are essential to providing the basic services and infrastructure of local governments, as well as running the public school systems, they're stirring much debate in the Lone Star State. Property taxes are also sparking calls for caps on tax rate hikes and appraisal increases that a Standard & Poor's Ratings Services analysis finds could cause more harm than good.

We believe that implementing a cap on the growth of property appraisals without a more comprehensive tax reform that addresses all sides of the budget equation could lead to fiscal stress and budgetary pressures that might potentially harm credit quality.

In November 2005, the Texas Supreme Court ruled that the current school funding system was unconstitutional. Because the majority of Texas school districts are at the constitutional tax rate limit of $1.50 per $100 of assessed value (AV), the state Supreme Court ruled this effectively imposes a statewide property tax, which is not allowed under the Texas Constitution.

This ruling comes on the heels of several years of public debate over the need to reform the way schools are funded and limit the burden on local property taxpayers. The state Legislature is currently considering various methods of lowering property tax rates imposed by local school districts and using alternative revenue sources to address school funding needs. (Please see the related article "Potential Credit Implications of Property Tax Reform

In Texas," published March 15, 2006, on RatingsDirect, Standard & Poor's Web-based credit research and analysis system.)

As part of the state's debate on property tax reform, Gov. Rick Perry recently proposed the imposition of a cap on property tax growth. His plan also includes appraisal caps that would limit residential property appraisals to an increase of no more than 3% annually compared with the current 10%.

One of the key questions in this debate is whether or not Texas cities have indeed excessively or irrationally used their current taxing powers. To answer this question, we reviewed the growth trend data, provided by the Texas State Comptroller's Office, of property tax rates in more than 950 Texas cities. In addition, we examined the growth in per capita appraised value of 100 cities over a 10-year period. Our findings point to a remarkable stability in property tax rates and per capita property appraisals over that period. This stability is consistent with the conservative financial management policies generally found in cities throughout the state and the past decade's overall positive credit rating trends.

Tax Policies And Sound Financial Management Are Key Credit Factors

From a credit rating perspective, the existence of sound financial management policies, including efficient government spending, is an important defining element of overall credit quality. Equally important, however, is a government's ability to generate the necessary revenues to meet its operational and service demands. During the rating process, Standard & Poor's evaluates whether or not a city has maintained a stable tax rate.

"This information is used to determine if management is prudently managing its tax rates, as well as addressing operating and capital expenditures," said Standard & Poor's credit analyst Sarah Smaardyk. "If a city has had a tax rate that has significantly fluctuated over a period of time, this could have a negative effect on its credit rating."

Standard & Poor's also believes that overly restrictive appraisal caps have the potential to limit this ability, hindering an issuer's credit quality. One of the **arguments** behind the use of appraisal and tax rate caps concerns how local governments try to satisfy service demands **by favoring** excessive increases in property values and tax rates over efficient government spending. According to this argument, more stringent appraisal and tax rate caps would force local governments to use their collected tax dollars more efficiently.

Backers of more stringent appraisal caps often point to how cities use their current ability to increase property tax rates beyond what they consider to be prudent financial management. Indeed, financial management is one of the cornerstones of credit quality at the local level. Sound management policies — including budget controls, close financial oversight, revenue forecasting, debt management policies, accountability to the public, and experienced staff — are all considered positive credit rating factors.

"The existence of a strong set of financial management policies lends budgetary stability through economic cycles, which ultimately strengthens a government's ability to meet its financial obligations," said Ms. Smaardyk.

Fiscal management and, more specifically, tax management strategies are important components of a strong set of budgetary policies. A prudent exercise of a city's taxing authority includes conservative revenue forecasting and an objective rationale for spending increases, as well as the addition of government programs. In a prudently managed city, tax rate increases or decreases are based on a detailed examination of government programs and spending priorities.

"The benefits of arbitrary tax rate or property appraisal increases are generally short lived," said Standard & Poor's credit analyst Horacio Aldrete. "A city that arbitrarily increases its property tax rate is generally doing so to support equally arbitrary spending habits, which often result in budgetary distress, an eventual disruption in city services, and the loss of community support and taxpayer confidence."

Limiting Property Tax Rates Could Hurt Credit Quality

Local Texas governments depend a great deal on property taxes as a fairly reliable and stable revenue source. The Texas Constitution and state law limits municipal property tax rates. Cities of 5,000 or less in population can levy a maximum tax rate of $1.50 per $100 of AV. Cities of more than 5,000 can levy up to $2.50 per $100 of AV. Cities use their tax rate to calculate the amount of revenues they will have in the upcoming year to support operations and capital programs.

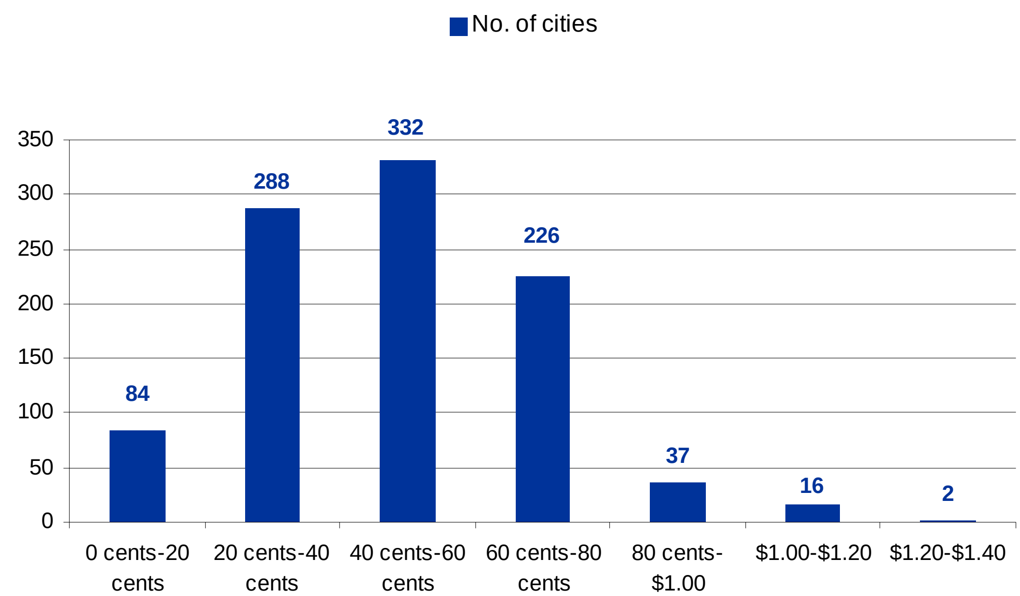
"Limiting a city's property tax rate could have an effect on operations, which could potentially affect credit quality," notes Mr. Aldrete.

Based on the tax rate data provided by the state comptroller's office, we examined the average tax rate for 985 cities over a six-year period (see chart 1). The chart illustrates that the majority of Texas cities have relatively low tax rates. For 332 cities, the tax rate ranged between 40 cents and 60 cents per $100 of AV.

"This data also demonstrates that Texas cities are well below the tax cap of $2.50 per $100 of AV," said Mr. Aldrete. "Texas cities are managing operations within their means and maintaining conservative tax rates and only supporting necessary functions."

Chart 1

Distribution Rate For Texas Cities

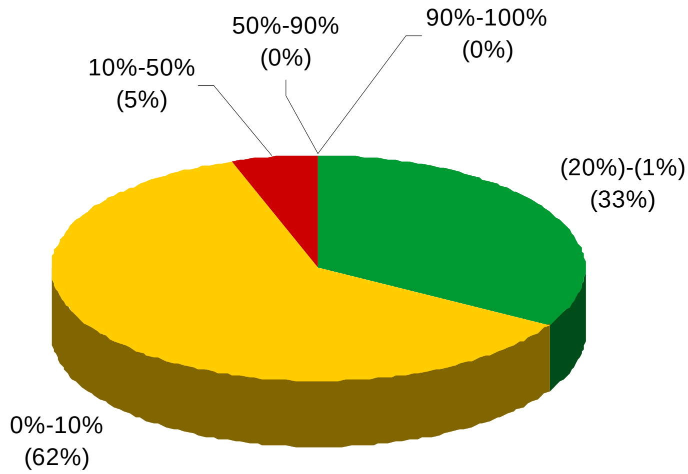


The top tax rate is at $1.50 per $100 of AV, which is attributed to a high operating and maintenance tax rate, as well as an interest and sinking rate — this rate covers the interest and principal on bonds and other debt secured by property tax revenues — that is used to pay for debt service. The lowest tax rate is two cents per $100 of AV. Part of the reason this city's tax rate is so low is that it does not administer an interest and sinking rate.

More than 400 cities generally raise their tax rates between 1% and 5% annually (see chart 2), and more than 600 raise their rates between 1% and 10% annually. Of the 985 cities surveyed, 329 decreased their tax rate.

Chart 2

Annual % Increase Of Tax Rates For Texas Cities



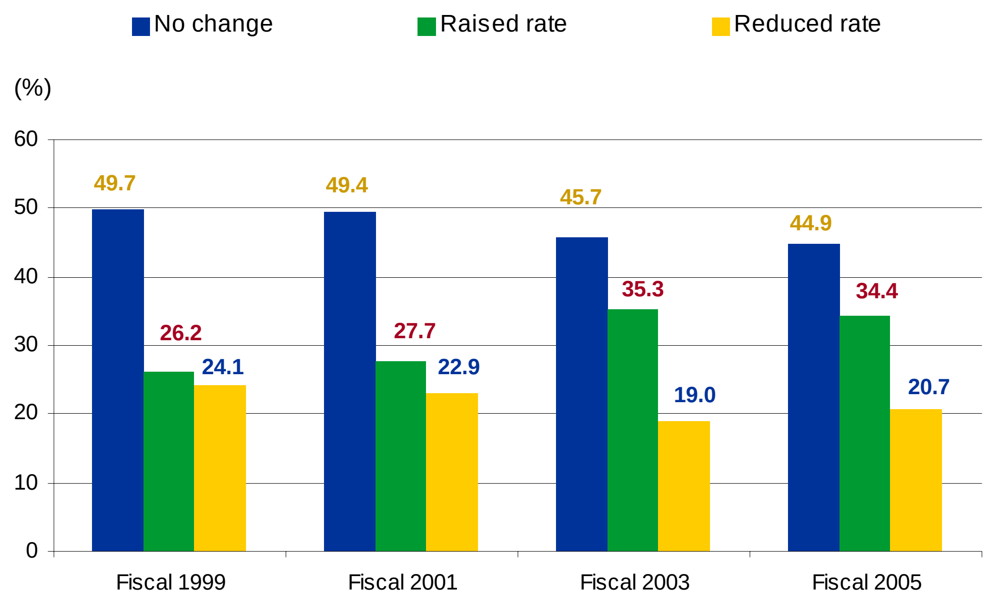
Note: Total of 985 cities surveyed.

The average annual tax rate increase is 1.9%, or 0.004 cents per $100 of AV. The median annual tax rate increase is just 0.8%, or 0.0025 cents per $100 of AV. The lowest average annual increase is a negative 17.26%, or a negative 10 cents per $100 of AV. That city's tax rate is declining because it paid off its debt and zeroed out its interest and sinking tax rate in fiscal 2003. The highest average annual increase is 91.54%, or seven cents, which is attributed to that city issuing debt and using its interest and sinking rate to pay for that debt.

According to a 2005 tracking fiscal conditions survey conducted by the Texas Municipal League, nearly 45% of cities did not change their property tax rate in 2005 compared with 46% in fiscal 2003 (see chart 3). In 2005, the number of cities that reduced property taxes increased by 2% compared with fiscal 2003 levels. We believe a stable tax rate exhibits consistency in budgeting and sound financial policies and management. We also believe a stable tax rate means the local economy is stable.

Chart 3

Property Tax Rate Changes



Studying The Effective Tax Rate

The effective tax rate allows the public to evaluate the relationship between taxes for the preceding year and the current year based on a tax rate that would produce the same amount of taxes if applied to the same properties taxed in both years (see table 1). According to the survey, 61% of the cities exceeded the effective tax rate. Just 9% set a rate that was less than the effective tax rate. Meanwhile, 30% of the 467 cities surveyed by the Texas Municipal League adopted a rate that was equal to the effective tax rate.

"In some cities an increase in the property tax rate either produced no change in collections or actually produced less revenues," said Ms. Smaardyk.

Table 1

Existing Tax Rate Changes Compared To The Effective Tax Rate

Existing tax rate changes	*Higher than the effective tax rate*	*Lower than the effective tax rate*	*No change*
169 cities reported increases	103	15	51
93 cities reported decreases	47	14	32
205 cities reported no change	104	28	73
Total	254	57	156

Of the 93 cities that reduced their nominal property tax rate, 51% set a rate that exceeded the effective tax rate, 34% set a rate equal to the effective tax rate, and 15% set a rate less than the effective tax rate. Of the 205 cities that did not change their nominal tax rate, 51% exceeded the effective tax rate, 36% were equal to the effective tax rate, and 14% were less than the effective tax rate. Of the cities that responded to the survey, the average increase was 5.19% over the effective tax rate.

"In terms of a credit outlook, this means cities are maintaining their tax rates within their AV growth and demonstrating sound financial policies and management," said Ms. Smaardyk. "Cities are able to fund their operations through AV growth, not through tax rate increases, so they are managing within their means."

Finding The Right Fix

Local governments have a limited ability to cut operating expenditures since they must provide basic services and infrastructure. If local governments want to meet their infrastructure and basic operational needs, their ability to reap the benefits of economic growth through taxation is perhaps the most important tool in their arsenal.

"Over the long term, limiting this ability could result in budgetary pressures and the accumulation of unmet infrastructure needs," said Ms. Smaardyk. "Unless alternative revenue sources are put in place to counter the effect of property appraisal caps, the potential for a significant budgetary mismatch remains."

Again, it is our belief that the implementation of a cap on the growth of property appraisals without a more comprehensive tax reform that addresses all sides of the budget equation could lead to fiscal stress and budgetary pressures that might potentially harm credit quality.

"As with other fiscal challenges, the effect on credit quality will be evaluated on a case-by-case basis," added Ms. Smaardyk. "The big question is whether or not local governments will be able to rise to the occasion and successfully address the budgetary challenges facing them."

By Frank E. Benassi

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