

THE ECONOMIST

By M. Ray Perryman

Capping Prosperity

Property tax relief has become a major goal among many Texas legislators and other public officials, business and community leaders, and citizens across the state. The reasons for support may vary, but one point of agreement is that local governments are heavily dependant on property tax receipts for their ongoing operations. More than 80% of all tax receipts to local governments stem from property taxation. For school districts, the proportion is even higher. There are some viable options being discussed, most of which involve broad-based, low-rate levies to reduce dependence on property taxes. Other ideas, however, could be extremely detrimental to our well-being.

Among the most troubling concepts floating around the halls of the big granite edifice involve various forms of restrictive caps on appraisals or property tax receipts that would apply to all local governments (cities, counties, schools, and special districts). Appraisal caps are limitations on the amounts property values can rise each year for the purposes of property tax levies. Currently, Texas has a 10% cap on residential homesteads in place, meaning that the tax appraisal value of such a home cannot rise by more than 10% regardless of market values. One proposed measure would reduce the cap to 3% and apply it to all real property. Another seeks to limit revenue growth to 3%.

Although appraisal caps may have the appearance on the surface of valid methods for reducing the property tax burden, in reality, they involve many undesirable characteristics. Evidence from areas with severe restraints in place demonstrates that they lead to fiscal problems, arbitrary inequities, and detriments to economic progress. In fact, California has created a fiscal crisis of

enormous magnitude in the wake of its infamous Proposition 13, and, in Massachusetts, those areas most impacted by caps have actually seen property values decline in moderation.

By restricting the capacity of local governments to provide services, appraisal caps, revenue limits, and expenditure limits (another variation on the theme that is also discussed at times) lead to a reduction in the quality of life and economic performance of the state. If infrastructure investments are delayed, for example, productivity suffers. If school districts are unable to raise funds to meet their needs, educational quality declines. In addition, local governments are forced to operate in a less efficient manner if they are compelled to deal with perpetual fiscal crises.

The end result is a deviation from the optimal growth pattern for local areas and, hence, the economy as a whole. Some of the major channels through which these effects are manifested include the following.

Texas cities and counties vary markedly in their characteristics, their needs, and their capacity to generate tax revenue under various structures. Another problem is that property values are particularly prone to cycles, both in the general economy and in the real estate market. When revenue or appraised values drop, the new, lower level becomes the base from which future expansion is calculated. A tax structure that resets the base at the trough of every cycle will inevitably fail to adequately provide for local needs over an extended time horizon.

Appraisal caps and revenue limitations bear no relation to the legitimate demand for costs of public services provided by local governments. Revenue limitations do not account for demographic shifts, industrial development, and other factors that legitimately impact the demand for public services. In particular, they

constrain the capacity of high-growth regions to meet public service and expanded infrastructure needs.

A limit on the flexibility of local governments to change tax rates in response to needs specific to their areas will clearly inhibit their capacity to respond to the requirements and priorities of their residents. Empirical studies indicate that property values are depressed by appraisal caps and revenue/expenditure limitations because the quality of local services declines.

Appraisal caps and revenue and expenditure limitations also adversely impact bond ratings, thus limiting the ability to meet vital infrastructure needs and raising the cost structure of local governments. Bond ratings agencies analyze outstanding debt and the capacity to raise additional funds in assigning ratings. To the extent that local governments fail to measure up as well along these parameters, bond ratings will be affected, thus restricting the ability to use such debt vehicles and increasing their costs.

Limitations on appraisals distort market outcomes and create systematic inequities among taxpayers. The timing of the purchase of a real estate asset can be the driving factor in the total tax bill rather than the underlying value of the property. They also tend to be regressive, with those in disadvantaged neighborhoods where market values are growing more slowly subsidizing those who are more fortunate.

Appraisal caps discourage real estate market activity and new home purchases. Caps on assessed values also introduce a disincentive to buy and sell property if a sale/purchase results in a significantly higher tax appraisal. They also penalize business startups; in an appreciating market, valuation change limitations benefit existing property owners at the expense of new buyers.

All of this is bad news for the economy. My firm recently studied the issue and found that a 3% appraisal cap would cause a reduction output in the state each year of between \$2.1 billion and \$2.4 billion. In terms of jobs, between 32,175 and 38,037 positions could be expected to be lost due to the shrinking quality of local services and infrastructure and the resulting effects on productivity. The effects of a 3% revenue cap are over twice that high. Moreover, the losses reflect only the declines in private sector productivity as a result of inadequate public services. The economic development consequences are even more severe.

There is no doubt that the current Texas tax structure, particularly the high degree of local government reliance on property taxes, is in need of reform. It is not keeping pace with the demand for funds and it is dampening economic performance. However, it is crucial that any changes implemented represent real improvement, rather than illusory gains at the cost of future well-being.

While property tax rate reductions and corresponding shifts to a more equitable and efficient funding mechanism for public schools and local governments will notably improve the fiscal structure of the state, such initiatives must be accomplished without introducing further, and particularly more serious, problems. There are proposals surfacing which represent notable mechanisms for improving the tax system in the state. These efforts should not be accompanied, however, by the introduction of the additional and compounding problems associated with severely reducing local government resources and flexibility.

In summary, artificial limits on the ability of local governments to provide for the legitimate and expanding requirements of their citizens are contrary to basic economic principles of optimality, can generate substantial inequities, and needlessly reduce the capacity of local governments to function effectively and efficiently. Our future prosperity can ill afford the consequences.

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