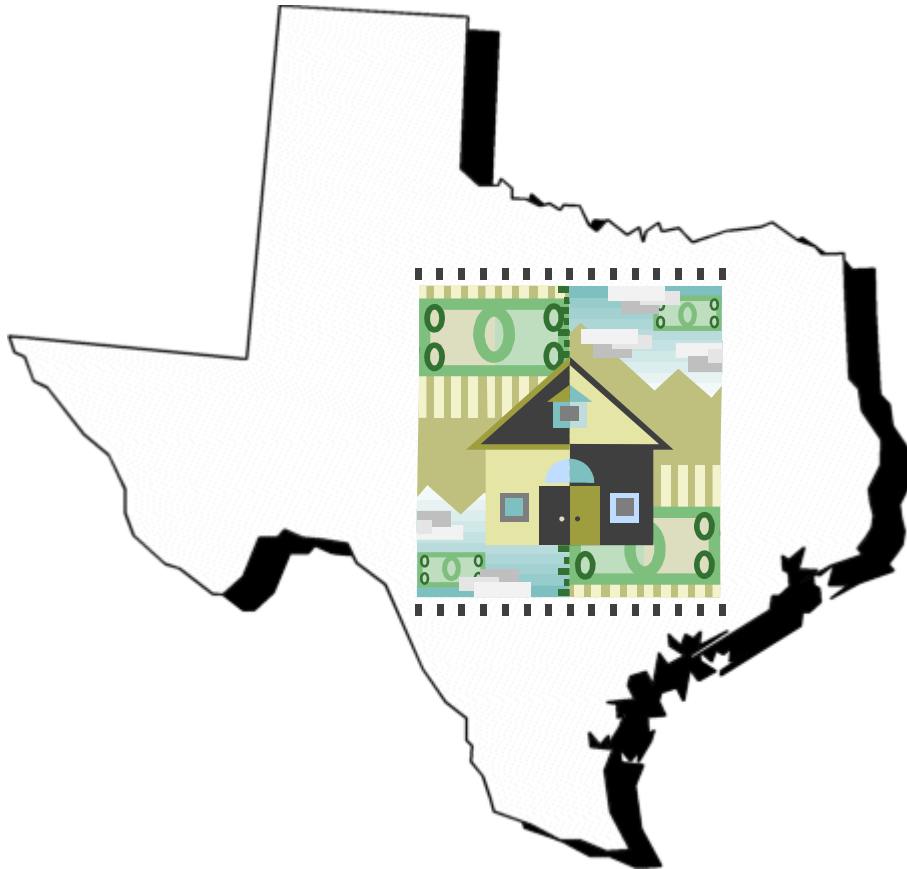


The Impact of Potential Restraints on  
Local Government Activity  
(Appraisal Caps, Expenditure Limits, and  
Revenue Limits) on the Economy of Texas



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# The Impact of Potential Restraints on Local Government Activity (Appraisal Caps, Expenditure Limits, and Revenue Limits) on the Economy of Texas

## *Executive Summary*

The process of finding alternative mechanisms to fund public education and provide reductions in school property taxes is a dominant topic in the 2005 Session of the Texas Legislature. Texas is currently facing a near crisis situation in the area of financing the state's education infrastructure. Not only is the current tax system failing to provide adequate resources, it is also falling under increasing public and legal scrutiny as to its fairness and legality. At the same time, there is growing awareness that the property tax burden on individuals and businesses within the state is becoming excessive, and there have been numerous calls for reductions in property taxes.

In particular, the property tax and the current Texas franchise tax combine to place a particularly disproportionate burden on capital intensive firms, thus constraining our capacity for economic development. While some proposed alternatives (such as certain forms of a broad-based, low-rate business tax to replace a percentage of the school property tax) could improve the fairness and responsiveness of the Texas tax structure, other options have the potential to make a difficult situation even worse.



One set of proposals that has surfaced in Texas and elsewhere is an effort to severely limit the capacity of all local governmental units to raise additional revenues or expend additional dollars. All of these proposals stand to restrict the ability of local governments to provide necessary services or adjust to changing conditions.

The fundamental issue is how to allocate the tax burden among various groups such that it is equitable, efficient, and minimally detrimental to the economy. If taxes result in a disincentive for businesses to invest, expand, and create jobs, all Texans lose. If individuals alter their behavior patterns due to tax considerations, there can also be negative consequences for the economy. If improper constraints result in a secular decline in public services and resources, then the state will surrender the competitive edge that it presently enjoys in attracting and retaining business enterprises.

The Perryman Group (TPG) was recently asked to analyze limitations on local government activity and their effects on the economy in Texas. This report summarizes findings from this endeavor.

### ***Local Tax Characteristics and Background***

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. Thus, any highly restrictive cap on property tax appraisals or revenues, no matter how it is structured, can severely hamper the activity of local governments to meet legitimate (and often legally mandated) needs.

Property taxes have certainly risen over the past decade. Focusing only on this upward pattern, however, ignores the issues of the cost of providing local services given increasing costs of most services and growing populations. Any initiative aimed at changing the property tax parameters must incorporate provisions to assure that the capacity of local governments to fulfill their proper role in society and the economy is not impaired.

### ***Problems with Appraisal Caps and Revenue or Expenditure Limitations***

Although appraisal caps and revenue or spending limitations 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.

By restricting the capacity of local governments to provide services, appraisal caps, revenue limits, and expenditure limits 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.

- ✓ *Limitations on appraisals and revenue limitations restrict the flexibility of local governments to respond to changing needs, emergency situations, and State and federal mandates.* Texas cities and counties vary markedly in their characteristics, their needs, and their capacity to generate tax revenue under various structures. 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.
  
- ✓ *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.



- ✓ *Appraisal caps and revenue and expenditure limitations 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.
  
- ✓ *Appraisal caps and revenue or spending limitations create a ratcheting down of revenue generating capacity in times of weak economic growth and declines in property values.* Poor economic performance can cause local government revenue to fall; 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.
  
- ✓ *Empirical studies indicate that property values are depressed by appraisal caps and revenue/expenditure limitations.* One component of property values is related to the provision of local services. In school districts perceived to be excellent, for example, there is a positive effect on property values. In cities and counties which provide excellent services, from water supplies to law enforcement to roads, property values are higher than in areas without these



attributes. Appraisal caps and other restrictions on the ability to provide needed services depress property values.

In addition to these problems, which are common to all types of restrictions, **appraisal caps also raise specific concerns** in other areas. Currently, the annual amount by which appraised values for residences can rise is limited to 10%. This limitation is already leading to billions of dollars in value loss and reductions in available revenues.

- ✓ *Limitations on appraisals distort market outcomes and create systematic inequities among taxpayers.* Valuation change limitations of the magnitude currently under consideration have the effect of arbitrarily redistributing the tax burden. 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.
- ✓ *Appraisal caps tend to be regressive.* Appraisal caps lead to greater reductions in fiscal resources (1) the more rapidly property values are rising and (2) the higher priced the properties are. The result is that those in disadvantaged neighborhoods and income groups subsidize 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. Homeowners who remain in their homes could enjoy tax bills far lower than market levels; caps could keep appraised



values far below market values. There would, thus, be an incentive to remain in their current homes to maintain the favorable tax status. The real estate market would therefore be harmed. Analogously, appraisal caps discourage migration to the state by prospective homeowners.

- ✓ *Appraisal caps systematically provide incentives to use economic development resources inefficiently and limit long-term growth.* Past incentives for major corporate locations have been based on the assumption of rising property values. As changes in the tax structure affect these parameters, the implications for local governments can be substantial. In fact, local governments will have an incentive to use economic development revenues to attract retail establishments which contribute sales taxes to local coffers rather than manufacturers with highly constrained assessed property values. The result would be a shift toward lower value-added and less export-oriented enterprises, thus reducing long-term economic expansion.
  
- ✓ *Appraisal caps penalize business startups.* In an appreciating market, valuation change limitations benefit existing property owners at the expense of new buyers. For example, a business owner who had owned a location for many years might be paying taxes far below a competitor who recently purchased. This reduces the capacity of new owners to compete effectively, with corresponding detrimental effects on consumers.
  
- ✓ *Appraisal caps arbitrarily create disparities among categories of property.* If appraisal caps apply only to



residential homesteads (as in the current 10% cap), a portion of the property tax burden shifts to other types of real property which are not subject to the cap. On the other hand, appraisal caps applied to all real property would shift relative costs to homeowners in the case of economic recovery or growth, when commercial property values could be expected to rise at rates significantly higher than a 3% limit.

In addition to the problems outlined above, **revenue or expenditure limitations create further difficulties.**

- ✓ *The Consumer Price Index, which is often used as part of a formula for determining expenditure limits, is based on purchases by typical individuals and, thus, is not a reliable indicator of the cost of government services.* The Consumer Price Index (CPI) is a measure of price changes which relies on a “market basket” of goods such as food, clothing, and other goods and services purchased by typical consumers. The purchasing patterns of local governments vary greatly from the market basket incorporated in the CPI, which is determined based on typical spending by an individual or household. In a similar manner, population changes are often not clearly correlated with expenditure or revenue requirements.
  
- ✓ *Revenue or expenditure limitations typically result in substantial increases in State funding of local services.* Because of its heavy reliance on local governments and property taxes, Texas is more vulnerable than other states to dislocations from appraisal caps or spending/revenue



limitations. In other states implementing such constraints, state aid is far greater than it is in Texas. Revenue limitations have caused major dislocations in areas across the nation.

**In summary, appraisal caps and other limits have created substantial problems in providing adequate revenues in states where they have been implemented, resulting in major disparities among taxpayers, increases in other taxes, and significant increases in State transfers to local governments.** They have also distorted economic behavior and limited growth potential.

## **Impact Assessment Results**

TPG developed alternative scenarios regarding the ultimate level of appraisal caps and expenditure or revenue limitations that might be implemented. These scenarios are based on specific legislative proposals and other parameters which are frequently discussed within the policy process. Reduced quality of local services results in foregone productivity in all aspects of the business complex. In addition, these losses compound over time.

### *Appraisal Caps*

In order to assess the potential impact of implementing more restrictive appraisal caps, two scenarios were developed. In the first case, it is assumed that the appraised value of property remaining with the same owner can rise by no more than 3% and



that the long-term increase in baseline values occur at a constant rate. In the second, the appraised value change is again capped at 3% with baseline increases reflecting a typical cyclical growth pattern which includes reductions in Years 2 and 7, but overall expansion over ten years at the same rate as the constant growth framework.

<b>Net Estimated Losses in Texas Business Activity Due to Appraisal Caps</b>				
	<b>Scenario 1: 3% Appraisal Cap and Constant Growth in Baseline Values</b>		<b>Scenario 2: 3% Appraisal Cap and Typical Cyclical Growth in Baseline Values</b>	
	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>
Total Expenditures	<b>-\$4.343 billion</b>	<b>-\$20.979 billion</b>	<b>-\$5.134 billion</b>	<b>-\$22.594 billion</b>
Gross Product	<b>-\$2.071 billion</b>	<b>-\$10.003 billion</b>	<b>-\$2.448 billion</b>	<b>-\$10.774 billion</b>
Personal Income	<b>-\$1.349 billion</b>	<b>-\$6.515 billion</b>	<b>-\$1.594 billion</b>	<b>-\$7.017 billion</b>
Employment	<b>-32,175 Permanent Jobs</b>	<b>155,426 Person-Years</b>	<b>-38,037 Permanent Jobs</b>	<b>-167,396 Person-Years</b>

The higher levels of decrease in business activity in the second case also illustrate the ratcheting effect of cyclical patterns. It should be further noted that (1) all of these adverse consequences accumulate and increase over time and that (2) further declines are

likely as the state's competitiveness in attracting new industry will be eroded by the lack of adequate support services.

*Expenditure Caps*

<b>Net Estimated Losses in Texas Business Activity Due to Expenditure Caps</b>		
	<b>Cap Equal to the Annual Growth Rate in Population and the CPI</b>	
	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>
Total Expenditures	<b>-\$20.727 billion</b>	<b>-\$102.139 billion</b>
Gross Product	<b>-\$9.883 billion</b>	<b>-\$48.704 billion</b>
Personal Income	<b>-\$6.437 billion</b>	<b>-\$31.719 billion</b>
Employment	<b>-153,559 Permanent Jobs</b>	<b>-756,723 Person-Years</b>

Note that these values are much larger than those in other scenarios as expenditure limits apply to the entire budget of a local government and not merely the portion derived from property taxes.

*Revenue Limitations*

Curtailing the ability of local governments to generate needed funds and otherwise respond to evolving conditions could be expected to

bring economic harms. Without sufficient revenues, the quality of local government services would decline, leading to lost productivity throughout the economy. Although not implicitly quantified, they could also ultimately result in a decline in competitiveness for new locations, expansions, and relocations of highly desirable enterprises with significant need for governmental services.

<b>Net Estimated Losses in Texas Business Activity Due to Local Property Tax Revenue Limitations</b>				
	<b>Scenario 1: 3% Cap on Growth in Local Property Tax Revenue and Constant Growth in Baseline Revenues</b>		<b>Scenario 1: 3% Cap on Growth in Local Property Tax Revenue and Typical Cyclical Growth in Baseline Revenues</b>	
	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>
Total Expenditures	-\$10.783 billion	-\$54.592 billion	-\$11.613 billion	-\$58.796 billion
Gross Product	-\$5.142 billion	-\$26.032 billion	-\$5.538 billion	-\$28.036 billion
Personal Income	-\$3.349 billion	-\$16.953 billion	-\$3.607 billion	-\$18.259 billion
Employment	-79,889 Permanent Jobs	-404,460 Person-Years	-86,041 Permanent Jobs	-435,607 Person-Years

The following scenarios are included because they reflect one of the proposals that has been widely discussed during the current school finance debate.



**Net Estimated Losses in Texas Business Activity Due to  
Local Property Tax and School District Tax Revenue  
Limitations**

	<b>Scenario 3: 6% Cap on School District Property Tax Revenues and 3% Cap on Other Local Property Tax Revenues and Constant Growth in Baseline Values</b>	<b>Scenario 3: 6% Cap on School District Property Tax Revenues and 3% Cap on Other Local Property Tax Revenues and Typical Cyclical Growth in Baseline Values</b>		
	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>	<b>Year 10 After Implementation (annual impact)</b>	<b>Cumulative Over First 10 Years</b>
Total Expenditures	-\$7.211 billion	-\$35.950 billion	-\$7.766 billion	-\$38.719 billion
Gross Product	-\$3.438 billion	-\$17.143 billion	-\$3.703 billion	-\$18.463 billion
Personal Income	-\$2.239 billion	-\$11.164 billion	-\$2.412 billion	-\$12.024 billion
Employment	-53,422 Permanent Jobs	-266,348 Person-Years	-57,536 Permanent Jobs	-286,859 Person-Years

Clearly, revenue limitations stand to significantly dampen economic performance; these effects would compound and grow markedly in the future.

**Conclusion**

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 need 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 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 flexibility 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.

