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Potential Credit Implications Of Property Tax Reform In Texas

The Texas State Legislature is considering passing law that will attempt to lower the property tax rates imposed by local school districts and utilize alternative revenue sources to address school funding needs. As part of this debate on property tax reform in Texas, Governor Rick Perry proposed the imposition of a cap on the growth of property taxes. Under Governor Perry's proposal, municipal property taxes would be capped at the previous year's level plus a growth factor made up of inflation and population growth (any increase beyond that would require voter approval). The proposal also includes appraisal caps that would limit residential property appraisals to an increase of no more than 3% per year (versus the current 10%).

In November 2005, the Texas Supreme Court ruled that the current school funding system is unconstitutional, because it effectively imposes a statewide property tax, which is not allowed under the state's constitution. This ruling comes on the heels of several years of public debate over the need to reform the way schools are funded and to limit the burden on local property taxpayers.

The potential for the implementation of property appraisal caps in Texas presents an opportunity to discuss the implications that such measures can have on credit quality at the state and local level. This article answers some of investors' frequently asked questions about the credit implications of property tax caps.

Questions And Answers

How will the proposed appraisal caps affect issuers?

Local governments in Texas depend a great deal on the collection of property tax revenues, which provide a fairly reliable and stable source of revenue. Texas is one of the fastest growing states in the nation, and many local issuers have benefited from that growth through a consistent expansion of their revenue bases, primarily the property tax base. The ability of local governments to reap the benefits of economic growth through taxation is perhaps the most important tool that they have to address infrastructure and service delivery needs. Limiting this ability can, over time, result in budgetary pressures and the accumulation of unmet infrastructure needs. Unless alternative sources of revenue are implemented to counter the impact of property appraisal caps, there is potential for a significant budgetary mismatch.

Local governments have a limited ability to cut operating expenditures, particularly in the face of growing service delivery needs such as ballooning health care and personnel costs. Implementing a cap on the growth of property appraisals without a more comprehensive tax reform that addresses all sides of the budget equation can lead to fiscal stress and budgetary pressures that could potentially affect credit quality. As with other fiscal challenges, the credit quality ramifications will be evaluated on a case-by-case basis, and will largely depend on an individual government's ability to successfully address these challenges.

Will the appraisal caps affect the credit quality of issuers?

Appraisal caps have the potential to negatively affect credit quality by impacting an issuer's ability to support their debt, but we would review it on a case-by-case scenario. When Standard & Poor's evaluates credit quality, we look at very closely at the stability of a government's revenue sources. Obviously, appraisal caps take away the revenue-raising flexibility that an organization may have in order to support its debt.

What effects will the appraisal caps have on the funding of capital programs and operating expenditures?

We believe that tax caps will have an impact on the ability of state and local governments to finance capital programs and infrastructure needs and meet their day-to-day operations. Regarding capital improvement plans, municipalities could become more reactive rather than proactive in planning infrastructure and facility needs based on funding availability. Municipalities currently develop their capital improvement plans based on projected growth in their property appraisals, which is used to determine funding available for specific capital projects. However, if municipalities are limited by appraisal caps, some of their flexibility to adequately plan and develop infrastructure improvements on a timely basis will be constrained. Local officials could be forced to address capital needs as they arise rather than as planned maintenance. If the tax caps are put in place, they will also affect operational expenditures facing municipalities, such as police, fire and sanitation services. In addition, municipalities must address rising health care costs and employee compensation.

What are other potential revenue sources?

Texas cities are allowed under state law to levy a one-cent city sales tax. They can levy an additional one-cent sales tax for certain purposes that include mass transit or economic development. Franchise fees are rental fees paid by utility and other industries that use city property to distribute their services. Permits and fees are determined based on the cost of providing the service. Court fines are used to offset the cost of law enforcement and the operation of the municipal court system. Interest earnings are based on investment income. Transfers from other funds are utilities that generate substantial gross revenues. There are also user fees, which include hotel occupancy taxes.

However, the revenue generating potential of these sources is very limited and does not always track economic growth.

Will the appraisal caps affect the incentives of companies doing business in the region?
There are two sides to this argument. One of the main strengths of having a higher property appraisal cap is that there is a direct correlation between economic growth and a government's ability to benefit from that growth through taxation. Tax abatement is one of the main incentives that municipalities can offer companies in the region. If appraisal caps are put in place, municipalities won't be able to offer special incentives to keep existing businesses or attract new businesses to the region, as they will be constrained by their revenue sources. The counter argument to this is that property appraisal caps actually make it less expensive overall for companies to do business in the state because of the lower property taxes in the area.

If the appraisal caps are signed into law, will there be an immediate consequence?
The potential impact on credit quality might not be felt immediately, but it could have a long-term impact. Looking ahead, we will closely monitor the debate in the legislature over appraisal caps and examine the potential outcome on credit quality on a case-by-case basis.

By Frank E. Benassi