THE POLICY PAGE
An Update on State and Federal Action

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GOVERNOR'S LATEST PROPOSAL INCLUDES DANGEROUS CAP ON LOCAL TAXES, NO NEW REVENUE SOURCE FOR EDUCATION

On March 11, as part of his Educational Excellence initiative, the Governor proposed local property tax "relief." However, the proposal does not identify funding to replace lost property tax revenue for schools, and recommends a property tax cap for local governments that could restrict their ability to fund basic services. This* Policy Page *analyzes the Governor's proposals.

FIRST PROBLEM: NOTHING YET ON HOW WE WOULD PAY FOR SCHOOLS

In January 2004, Governor Perry proposed new financial incentives and accountability measures for school districts and teachers. The price tag for the incentives was estimated at $1 billion for the next two-year budget cycle. Despite the costs of these proposals the Governor has offered no revenue sources to pay for them.
Recently, the Governor has unveiled another part of his "Educational Excellence" package that would also require new state revenue: local property tax "relief." This, too, comes without a way to pay.

The governor's four-part plan to lower local property taxes would:

- Limit property appraisal increases for homesteads to 3 percent per year, down from the current 10 percent cap;
- Cap the amount of revenue local entities can raise from property taxes to the amount raised the previous year plus an inflation and population growth factor, with local voter approval required to go beyond this revenue cap;
- Require mandatory disclosure of the sales price of real property; and
- Replace current appraisal district boards with boards of five specified elected officials in each county.

The limits on appraisals would automatically shift more of the responsibility of funding public education onto the state. Under the current school-finance system, the state guarantees that each school district will generate a certain amount of revenue per student for each penny of tax effort. Higher property values create greater local revenue, thus reducing the need for state aid. If appraisal increases were capped, and a school district were levying the maximum tax rate (as most districts already are), school property taxes could generate little new revenue, forcing the state to become responsible for supplying nearly all increases in public education funding. But neither the Governor, nor any other state leader, has released a detailed plan spelling out how the state would raise the money necessary to support our schools without the current heavy reliance on property taxes.

SECOND ISSUE: A CAP WOULD REDUCE THE ABILITY TO RESPOND TO PUBLIC NEEDS

The Governor's proposal is similar to Colorado's Taxpayer Bill of Rights (TABOR). Among other provisions, TABOR allows school revenue to grow only as fast as student enrollment plus inflation, and local government revenue to grow only by the percentage increase in real property values plus inflation. If revenue fell because of an economic downturn, the new, lower amount of revenue would become the base for the purposes of calculating allowable growth from that point on. A temporary revenue shortfall, such as just experienced in Texas, would make it nearly impossible to restore program cuts in good economic times in the future.

Colorado and other states with state-level TABOR-like measures have discovered that basic public services have been unable to keep pace with inflation and population because of the "ratcheting down" effect that occurs with revenue drops: total spending at the new, lower level often is not enough to fund anything other than K-12, Medicaid, and corrections. Funding for higher education has particularly suffered in states with TABORlike provisions. Furthermore, state leaders have lost the ability to change government spending in a way that speeds up an economic recovery, allows for adequate investment in the state's future, or addresses the state's structural fiscal problems.

Like other states, Texas already has several constitutional and statutory provisions limiting growth in public spending. At the state level, for example, the portion of the budget funded with undedicated tax revenue can grow no faster than the economy, as measured by personal income. At the local level, school district revenue is restrained by the current 10-percent annual limit on homestead appraisal increases for property tax purposes, a cap of $1.50 per $100 of property value for maintenance and operation of schools, and rollback provisions allowing voter review of large tax increases. What makes Texas stand out among the states is that, even without a TABOR-like provision, government spending is extremely low per capita, whether at the state level, or state/local combined. In state spending per capita, Texas ranked dead last in 2001; when local spending is added in, Texas rises somewhat, but only to 42nd place.

A CAP WOULD CREATE DANGEROUS IMBALANCES IN THE PROPERTY TAX SYSTEM

A cap on appraisal increases, by removing the link between the market value of a residential homestead and its taxable value, would create severe imbalances within the property tax system. The immediate effect would be a shift of the property-tax burden from homeowners onto businesses, who would not be protected by a cap. The 40 percent of Texas families who rent their home would also have to pick up an additional share of property taxes, since they pay the tax bill of their landlord, who passes it on to them in the form of higher rents.

An artificial cap also creates the “Welcome, Stranger” phenomenon. The taxable value of a homestead would be raised to its true market value when it was sold. Two neighbors living in identical houses would pay the same amount in property taxes, as long as neither moved. But if one sold his home, the newcomer (“the stranger”) would be charged taxes on the full market value of his home, while the person who did not move would pay on only a fraction of the true value. Needless to say, this would provide a real disincentive to moving up into a nicer home and might discourage people from moving to Texas.

In 1992, Florida passed a 3-percent cap on appraisals, known as “Save Our Homes.” But an analysis of the effect of the cap led some to refer to the measure as “Save Our Mansions,” since expensive homes in areas with quickly rising real estates prices benefited much more than homes in slower growing parts of the state. A 1998 state study showed that 43 percent of the tax savings went to just 16 percent of homeowners; nearly a fifth of the savings went to people whose homes were worth more than $350,000. NBA star Shaquille O’Neal alone saved $65,000 in property taxes by claiming his lakefront mansion as his permanent address.

Another odd result of a cap on residential appraisals is a strong incentive for local governments to attract retail business, rather than new homeowners. Retail centers supply local governments with sales tax revenue, which would be unaffected by an appraisal cap and could exceed the cost of any additional demand for public services, such as police and fire protection and new roads.

THE REAL FACTS BEHIND LOCAL PROPERTY TAX INCREASES

In proposing property tax caps, the Governor argues that if a cap tied to inflation and population growth had been in effect starting in 1997, property taxes would be about 20 percent lower today. But a closer look at local property tax trends, combined with an examination of local sales tax trends, reveals that local elected officials have in fact done a pretty good job of keeping property tax revenues in line with population and inflation.

Only in recent years has slower growth, or even an actual decrease, in sales tax revenues put more pressure on the property tax and on other local government revenue sources (such as fees). Furthermore, the rapid increase in health care costs (averaging 10 percent annually once again, after much lower growth for most of the 1990s), combined with the state’s shifting of some health care costs to local governments, is putting more spending pressure on localities.

Look first at inflation (as measured by the U.S. CPI, which is what the Governor’s proposal would require), without regard to population increases. Since 1986 there have been four years where property tax levies by local governments (special districts, cities, and counties) have not even kept up with inflation. In other words, in these four years—1987, 1989, 1990, and 1992—local property tax revenues actually dropped in real, inflation adjusted terms.

Another thing to note about inflation is that consumer inflation is not the right yardstick to use when assessing real growth in government spending. Instead, most analysts use the Implicit Price Deflator for State and Local Governments (developed by the U.S. Bureau of Economic Analysis). This is because government does not face the same kind of inflation as consumer households: consumers typically have items such as housing (mortgage or rent), food, utilities, gasoline, car insurance, and clothing in their budget, while the average government is buying health insurance (for its employees or for those elderly, disabled, or impoverished residents qualifying for government-funded health programs), as well as covering the costs of employee salaries and pensions, computers and office supplies, and road and building construction and repairs. Any proposal that links growth in government spending to consumer inflation overlooks this critical distinction and could cripple the ability of government to pay for health services in periods of rapid health cost inflation.

Taking into account the other factor that would be allowed under the Governor's proposal for local government property tax growth—an adjustment for construction—makes it even clearer how loath local governments were to raising property taxes for most of the 1990s (see chart). City property taxes during the 1990s dipped slightly and did not exceed the 1990 level (after adjustments for inflation and residential construction) until 2000. County property taxes grew slightly until 1994, were more or less flat until 1997, then resumed modest growth throughout 2002. Special district property taxes were flat until 1998, and then began to grow faster than inflation and residential construction through 2001.

NOTE: This trend analysis is based only on residential construction; nonresidential construction, which would also create demands for new infrastructure and services provided by local governments, is not included in these adjustments.

Besides rising health care costs, another contributing factor behind the recent increase in property taxes is that sales tax revenue has fallen for many counties and cities. Between 1999 and 2000, as the economic downturn began, total local sales tax revenue fell for cities, counties, and metropolitan transit authorities and was flat for special districts. Sales tax revenues have begun to grow again, but not at the rapid rates seen prior to 2000. The extent to which local governments raised property taxes to make up for lost sales tax revenue differed from community to community, because the share of total revenue that comes from property and sales taxes (and from current charges and fees) varies widely.

For example, a Census Bureau survey of 17 large Texas cities shows that two of them get more revenue from sales taxes than from property taxes; ten get more from charges and fees than they do from property taxes. County finances also vary widely. The Governor's proposed property tax caps would thus have very different impacts on local governments, based on their local sales tax trends and their ability to raise fees or charges. The final issue to examine is what could get cut if local voters refuse to support a property tax increase, and if increasing sales tax revenue, fees, or charges is not an option. In 2000, the Census Bureau estimates that Texas local governments, excluding school districts and community colleges, had the following funding priorities: health programs and hospitals (18 percent of general spending); debt service (13 percent); police and sheriffs (11 percent); streets and highways (9 percent); sewers and solid waste management (8 percent); fire protection (5 percent); corrections (4 percent); parks (4 percent); and courts (3.5 percent).

With the decreased flexibility that would result from the governor's proposals, local governments could find themselves deciding among these critical services for budget cuts or forced to raise fees to pay for them.