RESTRAINTS REQUIRED
FOR REFORMED TEXAS PROPERTY TAXATION

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INTRODUCTION

The 79th Legislature has reformed the franchise tax, replacing it with a comprehensive gross margin tax with a broader base, providing greater revenue at a lower rate. At a 1 percent rate the gross margin tax will enable reduction of the cap on the public school ad valorem M&O tax from $1.50 per to $1.00 per $100 appraised valuation. The intent is not only serious property tax relief for homeowners and commerce, but finally, an arrival at constitutional state funding of public education.

However, tax weary citizens wonder. How they can be assured that these funds will buy down their property taxes as intended, rather than unintended funding of growth of public school spending as occurred with the increased state funding under Governor Bush? What will prevent "appraisal creep" from claiming these funds for future excess school district spending even if appropriately used initially as intended? And if the prior tax code is to be made constitutional, why are the Robin Hood transfers for equalization not being terminated as evident de facto unconstitutional creation of a state property tax? Aside from concerns about school district budgets, will restraint in local school spending be replaced by growth in other local government spending financed by property taxes? These questions are considered in the following recommendations.

I. <u>Determination of Realistic and Consistent Appraisals</u>

A. Residential Homesteads

Market values on recent sales are not a sufficient basis for appraisal of residential properties. Replacement values based upon size (ft^2), extras (porches, pools, etc.), impairments, and materials of construction (veneer, roofing, etc), with depreciation for age should provide valid alternatives. Value can be shown from price of listed but *unsold* properties. *Appraised value should be the lowest of these alternative measures. The 10 percent annual cap should be retained to prevent excess valuation "bubbles". When protest proves a valid reason for lower appraisal, the need for re-protesting should not arise as long as the reason remains valid. (Tax Code A23.0101, .011-.013)*

B. Commercial Properties

In general, appraisals of commercial properties should be based upon the valuation techniques of MAI appraisals, which include recent sales; replacement value, depreciated for age, wear and tear; and capitalization of cash flow, as provided by the Code. To these should be allowed pricing of unsold property for sale, and value limited by special purpose. *Here as well, the lower of these values should be applicable. Commercial property should likewise be provided a cap of 10 percent increase in any given year. (Tax Code A,B: 23.0101, .011-.013)*

C. Personal Property

Valuation of personal property (a misnomer, since it only applies to commerce) is typically taxed appropriately according to GAAP (generally accepted accounting principles). This generally allows inventories be valued at direct cost, and equipment at depreciated values, other than for motor vehicles. Most states do not tax personal property; Texas should consider eliminating application of property tax to personal property for improved competitiveness of affected commerce without compensatory tax abatements.

II. <u>Restraint of Local Government Taxation and Spending</u>

The principal means of taxpayer restraint upon taxation of property is requirement of an election to approve a tax increase, referred to as "rollback".

A. Rollback for School Districts

For school districts, rollback is automatic. A school district cannot charge a rate above the rollback rate without an election.

For the 2006 tax year, districts' M&O tax rates are compressed to 88.67 percent of their current M&O tax rates, but districts can raise the tax above that level up to four cents without triggering a rollback election.

After the current tax year, a complicated formula governs. The formula is based on the state compression percentage – which is determined by the amount of money dedicated by the legislature from HB 3 for property tax relief. Hence, if the changes in the business tax yield enough revenue to take school maintenance property taxes down from $1.50 to $1.00 per $100 of valuation, the compression percentage would be 66.67 percent (two-thirds). The rollback rate is the lesser of two sums:

1. The product of the compression percentage plus the debt (I&S) rate plus 4 cents plus any amount approved previously at rollback elections. In other words, an election is required to increase the *nominal* M&O rate by more than 4 cents above the level set by lawmakers via the compression percentage.

2. The *effective* tax rate (which reflects the one year increase in appraisal which school districts get when values are rising) plus the debt rate plus the state compression percentage times 6 cents. This part of the formula effectively caps per-student revenue increases at 4 percent, without voter approval. (Tax Code, Section, 26.08(n))

Remember, for schools, the finance formulas are all per-student. Therefore, districts automatically get more money when enrollment grows. Inflation (beyond the four percent allowed under the formulas), however, is not factored into the rollback formula. Also, the effective tax rate is based upon state and local funding combined. The effective tax rate is the rate at which districts would provide the same amount of state and local funding that they received in the prior year. (Tax code, Section 26.08(i)).

Instead of fixed increase in rate as restraint, it would be more logical to make increases dependent upon the rate of inflation. *It is recommended that in addition to the increase currently allowed for state and local funding of school spending proportionate to increased enrollment, funding should be increased for the Comptroller's best local measure of inflation based upon the Consumer Price Index (CPI) for the prior year, above which increase would require a rollback election. If a rollback election does not turn out 15 percent of registered voters, the rollback to limit of the tax rate increase to inflation per capita would be automatic. The burden of preventing unjustified excess spending should not be on the taxpayer; the burden of approval of justified excess spending should be on government. CPI is selected since the expenses of a school district are heavily weighted on personnel.*

B. Rollback for Cities and Counties

The rollback rate for a city or a county is 8 percent above the existing effective tax rate i.e. Local government can increase property tax revenue by 8 percent without requirement of a rollback election. The effective tax rate is basically the rate that would yield the same revenue as the city enjoyed in the prior year. It accounts for the effect of appraisal growth on revenue. Rollback is net of debt. Any taxes collected to service debt (some of which is approved by voters) are excluded from the rollback calculation. (Tax Code, section 26.04)

There are some exceptions and allowances for rollback. Local governmental units can claim additions to their rollback based on county criminal justice mandates, pollution control, and indigent health care costs. (Tax Code, sections 26.044, 26.0441, 26.045) Rollback can be reduced when cities increase sales taxes or impose a mass transit tax (Tax Code, sections 26.041 and 26.043)

Rollback for cities and counties is not automatic. An election only occurs if voters successfully petition for one. In order to petition for a rollback election, the petition must contain the signatures of at least 10 percent of the *registered* voters in the taxing jurisdiction if the tax rate generates less than $5 million in revenue and 7 percent of *registered* voters if the tax rate would generate more than $5 million. (Tax code, Section 26.07) The percentage required is of registered voters, not those who actually vote. The petition requirement is the most onerous part of the rollback process.

Rollback for cities and counties is not adjusted for population growth or inflation. It is a flat 8 percent.

There is no reason that cities and counties should not be accountable to their taxpayers on the same basis as for school districts, without the requirement of petitions for a rollback election. *It is recommended that a rollback election be automatic whenever the proposed property tax revenue would exceed inflation rate per capita compared to the preceding year. The inflation measure recommended should be the Gross State Product deflator, which would cover a broader range of cost inputs than CPI. If a rollback election does not turnout 15 percent of registered votes, the roll back to limits on the tax increase to inflation per capita would be automatic. Here as well, the burden of preventing unjustified excess spending should not be on the taxpayer; the burden of approval of justified excess spending should be on government.*

C. State Share of Public School Revenue

State equalization becomes a critical issue for school districts which must anticipate state revenue in order to determine rollback dependent upon combined state and local property tax revenues. *As a condition of local restraint by rollbacks, it is recommended that the state be committed to equalization based upon the lesser of capped or budgeted local property tax revenues. Target state participation should be 50 percent of public school funding of state and local combined equalized spending.*

III. <u>Other School and Property Taxation Matters</u>

A. Homestead Exemptions

It is generally acceded that the necessities of life be exempted from the tax base of principle taxes. The homestead exemption is not determined as such. In the U.S. approximately 70 percent of families are homeowners with the balance primarily in rental properties. One half of the latter could be considered to be at or near the poverty income level. Something like the average appraised value per family unit of the lowest valued half of rental units could be considered an appropriate level for the homestead exemption. *It is recommended that this amount be allowed as determined locally for an alternative to the statutory homestead level at local choice of the local electorate. The owners of rental units should be allowed the homestead deduction, which the competitive market would force to be reflected in lower rents for lower income famiies.*

B. "Robin Hood" Property Tax Transfers

Even as reformed and otherwise commendable, state public school financing should be found unconstitutional given continuation of "Robin Hood" inter-school district transfers of property taxes to equalize public school funding. *It is recommended that the priority use of the state* *surplus should be to end these unconstitutional transfers. This should be done without alteration of state provision of 50 percent of public school funding as a permanent commitment.*

C. Pay for Performance

Taxpayers will not get value for money under the present basis for evaluation and compensation of teachers on collegiate degree level and seniority, rather than for market values of skills and for value added in the classroom. A primary school teacher with high seniority and normal performance is paid substantially more than a low seniority advanced placement math or science teacher with far higher alternative career market value. This impairment in terms of teacher employment must be bluntly credited to failure of school management to confront teachers' unions and demand the same rights to manage incentives for value added in the classroom as are normal in the private sector. *Teachers should be paid for value added by advancement in performance of their students and for requisite skills and qualifications at their market values.*

D. Improvement of School Efficiency

Limitation of funding increases to increases of enrollment and inflation assumes that taxpayers are entitled to seek improvement in operating efficiency from applications of EDP to office and classroom management, better qualified and incentivized teachers, and resultant reductions in overhead personnel. Texas schools must incentivize more value in the classroom requiring less costly remediation, much as practiced by private sector management.

Conclusion

High standards for achievement of the skills and knowledge for all Texas students, and just rewards for performance of their teachers should be the first priority for Texas public schools. But a close second should be efficient levels and use of school funding and equitable allocation of the tax burden of public schools on Texas taxpayers.

Credit: William Lutz of The Lone Star Foundation contributed factual information for current property tax law.