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Tough choices loom for Texas cities under new tax caps

By Ronald Lipman

Mayor Steve Adler says one last 8-percent increase in property tax revenue may be the best move for city leaders this summer, as they prepare for future penny-pinching required by a new state law restricting such tax collections.

“Obviously no decision has been made on that yet, but if we’re being responsible and prudent, it’s certainly something we have to consider,” Adler said. “If only to create extra reserves so that the cuts — so the next three years aren’t felt all in the same year. So that we can transition.”

San Antonio Mayor Mayor Ron Nirenberg has directed his staff to run the same numbers.

Under current law, Texas cities and counties can collect up to 8 percent more in property tax revenue a year before the public can petition for a rollback election. The new law caps the increases at 3.5 percent without voter approval, excluding revenue from new construction.

The law won't take effect until Jan. 1, after most cities' 2020 fiscal years begin, but many are already preparing for leaner years.

The new law is intended to shield Texas homeowners - who pay the third-highest rate in the nation for a single-family dwelling — from surges in property taxes that many homeowners in fast-growing parts of the state are seeing.

While it won’t immediately lower tax bills, lawmakers said the goal of SB 2 was to make sure savings from the school finance reform law also passed this session, which provides $5 billion in school property tax relief, aren’t quickly eaten up by city and county tax increases.

City officials who long warned that such a tax cap would hamper their ability to pay for police and fire protection will soon have some difficult decisions to make, especially in high-growth cities such as Austin and San Antonio.

If Houston's experience with a similar cap is any indication, the brunt will be felt in cuts to civilian jobs in police and fire departments, as well as in other areas such as parks and libraries. The resulting tax savings are modest in the initial years — $87 a year for the owner of an average-value home in Houston.

Nirenberg calls it "quasi-tax relief," but the sponsors of the legislation say it's about time for stronger limits on government spending.

"They're going to have to start looking at spending this money like it was their own and not somebody else's money," said the bill's sponsor Sen. Paul Bettencourt, R-Houston. "And they're going to have to look at priorities."

If the cap had been in place in 2017, more than half of Texas cities would have been unaffected by it, according to data from the state comptroller.

Cities like Austin, San Antonio and Dallas, which have raised property tax revenue more than 3.5 percent in each of the last five years, will likely have a harder time.

Others, such as Houston, whose voters approved a more stringent revenue limitation on their City Hall 15 years ago, won't see much of an impact.

Contending with a cap

San Antonio budget officials have called the newly-signed legislation a "paradigm shift" and are preparing council members for changes that might be necessary when it takes effect next year.

Had SB 2 been in effect for the last decade, the city estimates it would have collected $81 million less in property tax revenue. The savings for the owner of an average-value home in that time would have been $129, or about a dollar a month.

The city's property tax revenue increases over the last five years allowed it to recover from the years after the Great Recession, when it decided not to raise the property tax rate and took in less revenue as a result, budget officials say.

City Council met Friday for a marathon goal-setting session for next year's budget. While the new cap doesn't apply to the spending plan, it was on the council's mind as they considered their priorities.

"We're entering into uncharted territory," Nirenberg said.

Most members voiced support for offering further tax relief of their own, either by introducing a citywide homestead exemption or expanding existing carve-outs for homeowners that are over 65 years old or disabled.

Nirenberg said he supports that idea, but he's also cognizant of the constraints the city will experience under SB 2. To counteract that, he asked staff Friday if the city could raise the tax rate for the first time in 25 years to preserve flexibility while it still can.

“I know several other cities are perhaps thinking about that, and doing it in response to the fact that we know our growth is not a steady, straight line,” Nirenberg said.

Public safety costs have risen by an average of 3.9 percent over the last five years, climbing from $691 million to $794 million. That's 63 percent of the city’s $1.26 billion general fund.

“There’s real concern,” Nirenberg said. “Because the legislature has not been prone to allow local options for basic infrastructure and services … They’re more interested, it seems, in quasi-tax relief.”

But Ellen Troxclair, senior fellow at the Texas Public Policy Foundation and former Austin City Council Member, said those dire warnings imply a city has no control over its spending.

The reason this bill was one of legislators’ top priorities this year, Troxclair said, is because Texans are frustrated by rising taxes, and if it forces cities to rethink their spending, that’s a positive.

“The bottom line of SB 2 is it brings the rate at which cities are spending money more in line with the people’s ability to pay,” Troxclair said. “I hope that what the cities do is hear the pleas from citizens who elected them to make more responsible decisions when it comes to spending.”

Troxclair added that the bill doesn’t stop cities from going to taxpayers and asking to raise their taxes above 3.5 percent if officials deem it necessary.

Austin is projecting a budget shortfall of $52.6 million by fiscal year 2023 because of the cap. It also faces an annual reduction of $4 million next year and $5.6 million from 2020-21 onwards because of other legislation passed this year that limits the fees the city can collect from cable and telecommunications providers.

Adler said built-in cost drivers, such as wages and health insurance increases, are rising at 3.8 percent a year, faster than the city can make up for it with the revenue cap in place.

“I think that cuts are going to have to impact all parts of city operations,” Adler said. “We’re not going to be able to protect any one area.”

Austin and San Antonio, which both have the highest credit rating of AAA, are also concerned that the caps will have an effect on their ability to borrow. The nation’s three major credit rating agencies have warned that the caps could have a negative impact.

Bettencourt and Troxclair, however, dismissed those concerns, saying that as long as cities are being fiscally responsible, credit rating agencies will have no reason to dock their scores.

Bettencourt added that SB 2 doesn’t affect the debt portion of the tax rate, which are set by bond elections.

A glimpse into the future

In some ways, Texas’ largest city, which has been operating with a revenue cap for years, offers a glimpse into the impacts of such a policy.

Houston’s revenue cap — placed on the city by its voters 15 years ago — lets the city’s annual property tax collections grow only by the combined rates of inflation and population growth, or 4.5 percent, whichever is lower. Since the city first ran into the cap in 2014, that growth rate has averaged less than 3 percent a year.

The city’s cap also applies to the city’s overall tax rate — which includes its operating rate and a debt service rate — not just its operating rate, as the new state law does.

Because of that difference, the state cap would have affected the city’s tax revenue in just two of the last five years, assistant finance director Melissa Dubowski said.

City attorneys are still examining how the city and state revenue limits interact, Dubowski added.

In its upcoming budget year, Houston’s cap will let the city collect up to $1.2 billion in property taxes, about $150 million more than it collected five years ago. Without the cap in place, a city analysis shows, Houston could collect $1.4 billion.

The $172 million gap between what the city will collect and what it could collect absent the cap would cover the combined annual budgets of the city’s solid waste and parks departments, with room to spare.

For Houston homeowners, meanwhile, the cap has saved the owner of an average home with a homestead exemption a cumulative $436 since the council began cutting the property tax rate, an average of $87 per year. Homeowners older than 65 have saved more, as the council also doubled the senior exemption to $160,000 four years ago.

Leaders of other Texas cities argued against SB 2 by saying revenue constraints would undercut their ability to deliver services, including police and fire protection. If Houston’s years of tight budgets are any guide, however, cuts would come in other areas first.

Houston’s police and fire budgets have grown faster than the overall general fund over the last 5 years, and there are more police and firefighters on staff than when it hit the cap in 2014.

The number of municipal workers paid from the general fund has fallen by more than a third in the last 15 years, however, as Houston has moved roughly 2,000 workers into special funds fed by fees rather than property and sales taxes. The city also has shrunk numerous departments, including parks and libraries, and employs far fewer civilians in its public safety departments.

Houston's example is muddied, however, by its pension crisis, which began in 2001 and continues to burden its budget, though reforms Mayor Sylvester Turner got through the Legislature in 2017 are expected to improve the situation in the coming decades.

In part due to rising pension costs, Houston already employed fewer police officers than in prior decades, already mowed its parks less regularly, already replaced its vehicles less frequently and had already accumulated hundreds of millions of dollars in deferred maintenance on its facilities years before it first hit the revenue cap in 2014.

Still, it's clear Houston's revenue cap has forced cuts, said Kelly Dowe, a Houston venture capitalist who served as city finance director from 2011 to 2017, if only because the cap ensured growing pension costs would continue to crowd out other spending.

"I get the idea of a revenue cap and using it to control government spending. I'm a taxpayer," Dowe said. "But the Houston cap is a very blunt instrument that doesn't leave room to deal with challenges that were there before the cap started having an effect — like the pension challenges, like deferred maintenance. The cap has limited the city's ability to maneuver through them."

Dowe said SB 2 exempting new construction and debt service from its calculations seem to be clear improvements on Houston's cap, particularly because new construction often drives up demand for public services. Still, he said, to the extent the new rules were intended to cut taxes, local governments will still face pressure to cut.

"They'll be faced with the same choices Houston was, and that will mean moving people to special funds, deferring maintenance, deferring car purchases, and those things will probably all happen before cuts to public safety," Dowe said. "My experience was that's the last thing anyone wants, and it hasn't really happened in Houston."

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