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Fitch Ratings: Texas SB2 May Impact Local Government Ratings

Fitch Ratings-Austin-10 June 2019: Both houses of the Texas legislature recently approved and sent to the governor Senate Bill 2, which once signed into law will reduce local government control of property tax rate increases for operations. Fitch Ratings expects this change to negatively impact its assessment of some local governments' independent revenue raising ability, and that ability is a component of one of Fitch's four key rating drivers in its U.S. public finance tax-supported rating criteria.

Although Fitch does not expect the law to trigger a significant number of rating actions immediately, given other core credit strengths, it fundamentally weakens one of the key powers that a government has to control its financial position and leaves it more vulnerable to weakening if other credit strengths deteriorate.

The maximum property tax rate increase in Texas not subject to petition, currently called the rollback rate, is a calculated rate that produces an increase in operating tax levy of 8% from the prior year's levy. If local taxing jurisdictions exceed the rollback rate they are subject to a petition, and, if the petition garners enough signatures, an election to reduce the rate back to the rollback rate. SB 2 will reduce the rollback rate (now the 'voter approval tax rate') to 3.5% from 8% for local taxing units. SB2 will also require a ratification election (replacing the current petition process) if any local taxing unit exceeds its voter approval rate.

This requirement excludes junior college districts, hospital districts and taxing entities with very small property tax rates ($0.025 per $100 of taxable value or less); these entities will continue to have an 8% limit. Separate K-12 funding legislation includes a tax rate limitation for school districts, which will not change Fitch's assessment that school districts have minimal revenue-raising ability. The tax rate limitation in SB2 excludes new additions to tax rolls, allows for banking of unused margin for up to three years, and allows for disaster-related expenses and certain county criminal justice and hospital expenses. It includes a $500,000 annual allowance for cities with a population of less than 30,000, which is intended to allow smaller jurisdictions to raise taxes for large one-time outlays without triggering an election.

In analyzing a local government's revenue framework, Fitch considers the entity's ability to independently increase operating revenues without voter or other jurisdiction approval. For Texas cities, counties, community college and special districts, Fitch views the current rollback tax structure as only a potential threat to revenue-raising ability. A restriction on tax revenue increases would require both a successful petition effort and subsequent election. Constitutional, statutory and charter tax limits could also restrict revenue-raising ability, although nearly all of the local governments rated by Fitch are well below them. As a result, Fitch's assessment for independent revenue-raising ability of Texas cities, counties, community college and special districts is predominantly at the 'aaa' level.

Once SB2 is signed into law, Fitch will incorporate the lower tax rate limitation in its analytical reviews of rated Texas local governments affected by the new law. Application of a uniform tax rate limitation will not have the same effect on all governments. Most local governments retain the ability to increase non-tax revenues (e.g. fines, service charges and fees). In addition, Fitch considers the amount of tax revenue that can be raised relative to expected revenue volatility in a typical downturn. The anticipated revenue volatility varies among taxing entities given their revenue history. Finally, the assessment of independent revenue-raising ability is only one component of Fitch's analytical framework. The strength or weakness of other considerations (revenue growth prospects, expenditure flexibility, long-term liability burden, and operating performance) will determine how much a shift in the revenue-raising ability assessment will affect an entity's overall rating.

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