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SECTOR COMMENT
30 May 2019

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Analyst Contacts

Gera M. McGuire +1.214.979.6850
VP-Sr Credit Officer/Manager
gera.mcguire@moodys.com

Brett Adelglass +1.214.979.6866
Associate Lead Analyst
brett.adelglass@moodys.com

Alexandra S. Parker +1.212.553.4889
MD-Public Finance
alexandra.parker@moodys.com

Local government – Texas

Property tax reform limits revenue-raising ability, a credit negative for bulk of local governments

On May 25, the Texas (Aaa stable) legislature passed property tax reform legislation (Senate Bill 2) that further limits most local governments' ability to raise revenue, a credit negative. The governor is expected to sign the bill into law, which would then take effect on January 1, 2020.

The bill reduces property tax revenue increases without voter approval to 3.5% from 8% annually on existing properties (new construction is excluded from the limit). Voter approval to override the limitation requires a simple majority. The restriction applies to the portion of municipal revenue used for government operations; it does not restrict revenue for debt service. The legislation offers some flexibility by allowing local governments to “bank” up to three years of unused margin for an increase greater than 3.5% in a year.

The measure lowers the limit for cities, counties, municipal utility districts (MUDs) and other entities that can levy a property tax, but the limit will remain at 8% for community college and hospital districts. At the same time, the bill reduces the number of signatures required to petition a rollback in the event the 8% limit is exceeded by the districts. Small local governments can increase their operational levy up to $500,000 as long as the amount does not equate to more than an 8% revenue increase derived from existing property. If the amount is above that limit, only 3% of voters are required to initiate a rollback election under Senate Bill 2, down from 7% or 10%. Under separate legislation, also expected to be signed by the governor, school districts would have to reduce tax rates if property value growth exceeds 2.5% in fiscal 2021.

With Senate Bill 2 set to take effect in fiscal 2021, local governments have time to adjust budgets, though most have already begun to prepare. The bill will mostly affect budgets that take effect in August and September of 2020.

The bill also aims to increase transparency by creating an online database that defines, simplifies and highlights proposed levy changes and provides for immediate citizen input with an online comment form and information on when public hearings will be held.

Revenue-raising ability to pay debt service not affected by legislation

Limitations on revenue-raising restrict financial flexibility, hampering credit quality. However, Senate Bill 2 does not hinder the ability to raise revenue to pay debt service.

In Texas, property taxes are set based on two legally separate rates that combine to form an overall governmental unit's levy: an "operational rate," which is subject to the revenue limit in Senate Bill 2, and a "debt service rate," which is not subject to the limit. Expenditures using funds raised under the debt service rate are defined by statute and approved and enforced by the attorney general. Revenue raised under this rate cannot be used for operational expenditures.

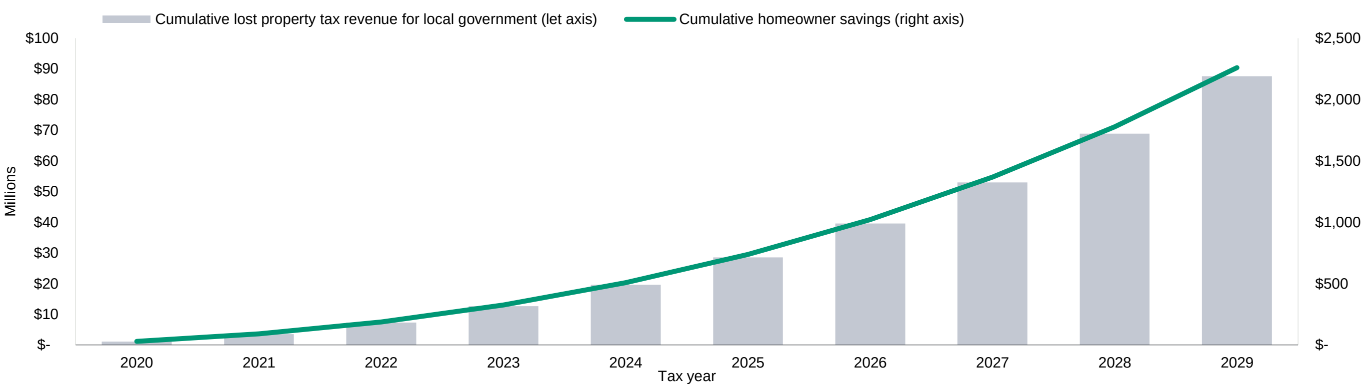
Given that the debt service levy is legally separate from the amount restricted under the 3.5% Senate Bill 2 limit, local governments will maintain direct control over the rate necessary to service debt. In Texas, most school and municipal utility debt carries a general obligation unlimited tax (GOULT) pledge; most city and county debt has a general obligation limited tax (GOLT) pledge.

Homeowner savings minimal, but budgetary impact on governments would be significant

The new legislation stands to reduce individual tax burdens minimally but hurt local governments substantially. The median home price in Texas is $150,000; the median operational tax rate is $4.30 per $1,000 of assessed value. An 8% increase in the revenue would lead to the owner of a $150,000 home paying $696.60, assuming the rate in the previous tax year was $4.30. Under the 3.5% limitation in Senate Bill 2, the homeowner would pay slightly less at no more than $667.58 — a difference of only $29.00. Under that scenario, the homeowner's cumulative savings over 10 years would be just $2,260 (see Exhibit).

For a local government with property tax operating revenues of $25 million, however, the difference between a 3.5% increase annually versus an 8% increase would translate to a cumulative 10-year loss of over three times the current year's revenues. More specifically, the 3.5% restriction would result in an $87.6 million loss in potential property tax collections over 10 years. However, the short-term impact would be much less dramatic. In the first year with municipal revenue increases subject to the 3.5% limit, the reduction in potential revenues would be only $1.1 million.

Senate Bill 2 provides homeowners with marginal property tax relief, while limiting local governments ability to raise revenue



Source: Moody's Investors Service

Economic slowdown would magnify impact of Senate Bill 2

Texas cities have relatively high debt burdens compared with their national peers — 2.0% vs. 1.1%, respectively, for Moody's-rated cities. Senate Bill 2 stands to increase debt burdens if reduced excess tax revenue forces cities to use the capital markets more frequently to address infrastructure needs versus the cash funding that traditionally has offset rising debt burdens.

If debt ratios rise while tackling capital needs, a prolonged economic slowdown and escalating debt service schedule could reduce a government's political will to increase taxes. As a result, a government may be forced to tap dwindling reserves or cut services, leading to considerable credit challenges.

Despite the limitations in Senate Bill 2, most local governments in Texas will continue to benefit from new investment resulting in taxable property not subject to the 3.5% revenue-increase limit. However, if the economy cools significantly, the restriction would become much more of a burden. For example, cities that face rising pension liabilities, debt service payments and other necessary operational costs, such as emergency response employees, would likely have fewer expenditure-cutting options.

REPORT NUMBER 1178257

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