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Texas Local Governments Could Face Budget Headwinds--And Credit Quality Strain--From Property Tax Reform

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Key Takeaways

- New legislation limits Texas governments' ability to raise maintenance and operations (M&O) property tax revenues above 3.5% without voter approval.
- Cities and counties likely will explore various strategies to manage the new revenue restriction.
- We believe that this constraint, coupled with expanding infrastructure demands, could reduce financial flexibility and stress Texas municipalities' creditworthiness.

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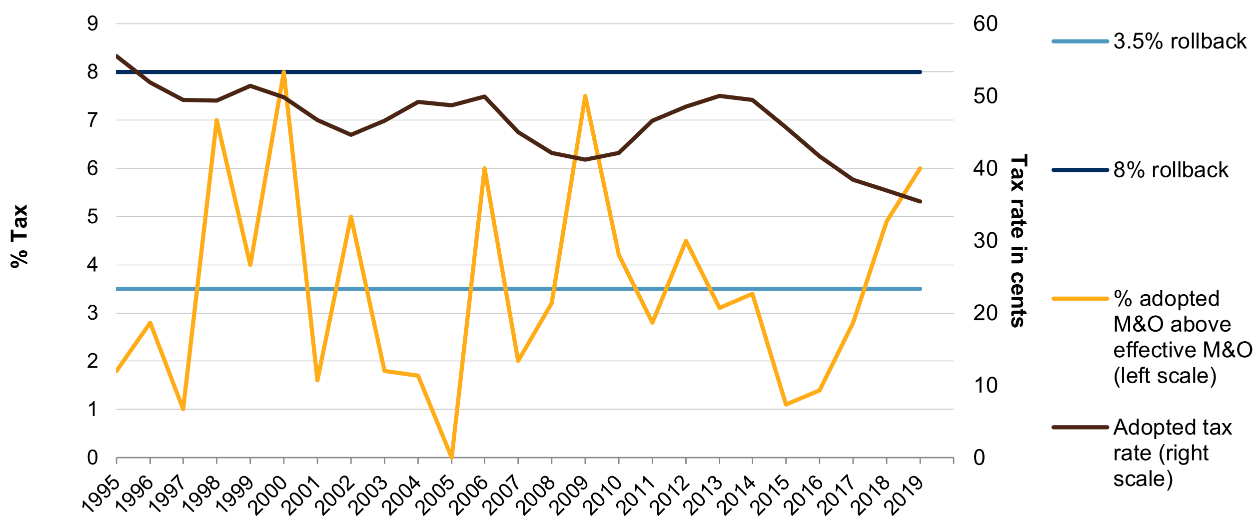
On June 12, 2019, the governor of Texas signed the Texas Property Tax Reform and Transparency Act of 2019, a law requiring certain local government units to obtain voter approval to increase maintenance and operations (M&O) property tax revenues more than 3.5% above the previous year, excluding new construction. The effective date of the legislative change is tax year 2020, and S&P Global Ratings notes that the law does not affect the levy of property taxes for debt service. The legislation does provide carve-outs for low M&O rate taxing units, such as hospital districts, junior colleges, and certain taxing entities--including cities with a population of less than 30,000--to have a de minimis rate; and an unused increment rate to be added to the 3.5%.

The potential reduced flexibility associated with the new voter-approval requirement could hurt/stress credit quality for cities, counties, and other taxing entities affected by the legislation. For many years, local governments could collect up to 8% more in annual M&O property tax revenues without the risk of a petition process by voters to trigger an election to increase the rate above the revenue-neutral tax rate. S&P Global Ratings believes that lowering the voter-approval threshold for M&O property tax revenues could restrict many local governments' ability to collect revenues to meet growing budgets and service demands. While proponents of the bill argue that the legislation provides taxpayer relief and local governments should find ways to reduce wasteful spending to manage budgets, many local governments are already allocating money to high or rising fixed costs such as debt and pension obligations. Texas cities and counties maintain higher-than-average debt burdens compared with local governments across the country, spurred by required infrastructure investment due to above-average population growth. Some options to offset the revenue-raising constraints are cutting services, deferring maintenance, and reducing payroll and benefits.

For example, over the past 25 years, Travis County (AAA/Stable) levied property taxes at a rate much lower than the previous 8% allowed while maintaining budget balance and financial flexibility. Only once in the past 25 years has the county needed to levy 8% above the effective M&O rate. However, in many years the county levied more than the 3.5% voter-approval threshold, to keep up with rising budgets and demand for services tied to rapid population growth (see chart). Travis County is not unique in this case: many cities, counties, and taxing jurisdictions would have similar outcomes.

Despite Travis County Living Within Its Means, New Legislation Could Negatively Affect Budgets



M&O--Maintenance and operations

Some Flexibility Is Available To Manage Tax Rates

The law allows for an unused increment to factor into the calculation. For example, if a local government adopts a tax rate below the 3.5% voter-approval rate, the unused difference can be carried forward for up to three years. This is similar to other states where tax caps exist, providing future revenue-raising flexibility. Despite this provision, there is an argument that in years where a local government could levy well below the 3.5% voter-approval rate, it would be incentivized to levy at least 3.5% to ensure it could capture maximum revenues and protect against future budgetary pressures. In the example of Travis County, this would have occurred in 16 of the past 25 years.

Another consequence of the revenue-limiting legislation could be higher-than-normal transfers into general operating funds from water and sewer or enterprise funds, which could be supported by rate increases. This alternative to funding expenditures would likely be more prevalent in the case of smaller local governments that manage general and enterprise funds more holistically.

Officials from major cities and counties, including Dallas and Houston, spoke out against the legislation while it was being debated during the legislative session. Officials from Fort Worth noted that recent changes to the city's funding of pension obligations, which included increased contributions, would have been extremely difficult in the environment that the new law creates.

The Legislation Has Potential To Strain Municipalities' Creditworthiness

We believe local governments in Texas benefit from a general lack of statutory property tax levy limits, which is reflected in our institutional framework score and above-average ratings on rated Texas local governments. Revenue loss from the new legislation has the potential to create structural gaps in future years, particularly in circumstances where economic growth is stagnant. While municipalities with strong economic development initiatives are better positioned to deal with the legislative change, we believe that areas of slow growth with moderately-sized property tax bases could begin to rely more heavily on alternative forms of revenue like sales taxes and service charges/fees, which can be more volatile. In addition, local governments that use pay-as-you-go financing to cash fund portions of their capital budget may begin redirecting excess revenues to cover recurring and inflationary costs and instead issue debt financing for capital projects, subsequently raising their debt service tax rate. Considering new election requirements to surpass the 3.5% limit as well as reduced revenue-raising flexibility, coupled with increasing service and infrastructure demands, we believe the legislation could adversely affect Texas local governments' credit quality.

Related Research

Texas Budget Talks Involve Wrangling Property Taxes, School Funding, And Other Long-Term Liabilities, April 11, 2019

This report does not constitute a rating action.