# Memorandum

CITY OF DALLAS

DATE June 14, 2019

TO Honorable Mayor and Council Members

SUBJECT **Rating Agencies Comment on Property Tax Reform Legislation - INFORMATION**

On June 12, 2019, the Texas Property Tax Reform and Transparency Act of 2019 (SB 2) was signed into law, taking effect on January 1, 2020. The legislation limits the rollback rate to 3.5 percent from 8 percent, reducing property tax revenue increases certain local governments can levy without voter approval for Maintenance and Operations. Rating agencies, including Moody's Investor Services (Moody's), S&P Global Ratings (S&P), and Fitch Ratings (Fitch) have provided commentary on the effect of SB 2 on credit ratings.

Fitch stated that the legislation, "could negatively impact Fitch's assessment of certain local governments' independent revenue raising ability," although, "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." Moody's also noted that the property tax reform was, "a credit negative for bulk of local governments," however, "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." Following the bill being signed into law, S&P explained that, "this constraint, coupled with expanding infrastructure demands, could reduce financial flexibility and stress Texas municipalities' creditworthiness."

The legislation does not place the same restriction on the Debt Rate and as Moody's states, "given that the debt service levy is legally separate from the amount restricted under the 3.5 percent Senate Bill 2 limit, local governments will maintain direct control over the rate necessary to service debt." Additionally, the City is currently rated A1 (Stable) by Moody's, AA- (Stable) by S&P, and AA (Stable) by Fitch, backed by prudent financial management and policies, a strong local economy, and robust financial reserves.

DATE June 14, 2019

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Please let me know if you need additional information.

M. Elizabeth Reich

M. Elizabeth Reich
Chief Financial Officer

[Attachments]

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Mark Swann, City Auditor
Bilierae Johnson, City Secretary
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07 Feb 2019 | Comment

# Fitch Ratings: TX Tax Proposals Could Limit Local Government Revenue Flexibility

Fitch Ratings-Austin-07 February 2019: Bills recently filed in both chambers of the Texas legislature (HB 2 and SB 2) propose to significantly lower the rollback property tax rate for local Texas taxing entities with a certain amount of annual tax revenue and require ratification elections if rollback rates are exceeded. According to Fitch Ratings, this legislation if enacted could negatively impact Fitch's assessment of certain local governments' independent revenue raising ability--a component of one of Fitch's four key rating drivers in its U.S. public finance tax supported rating criteria.

The rollback rate in Texas currently 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. HB 2 and SB 2, which are backed by the governor, lieutenant governor and speaker of the house, would both reduce the rollback rate from 8% to 2.5% for local taxing units with combined annual property and sales tax revenue of at least $15 million. Taxing units below the $15 million threshold would retain the current 8% rollback rate. School districts, which have separate operating tax rate constraints, are excluded from the proposed changes. The bills would also require a ratification election--replacing the current petition process--if any local taxing unit exceeds its rollback rate (either 2.5% or 8%). Local rollback petitions and elections historically have been relatively rare.

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, noting that a restriction on tax revenue increases would require both a successful petition effort and subsequent election. Fitch considers the limit on operating revenues to be the more restrictive of the constitutional and statutory tax limits (e.g. $2.50 for cities, $0.80 for counties, $1.00 for community college districts), or the voted or charter caps on local government tax rates and/or revenue growth. Nearly all of the Texas local governments rated by Fitch are well below their tax rate or revenue limits. As a result, the assessments for independent revenue-raising ability for Texas cities, counties, community college and special districts are with few exceptions at the 'aaa' level.

The magnitude of the reduction to independent revenue-raising ability for targeted Texas local governments will depend on the requirements of any legislation ultimately signed into law. Previous efforts to reduce the rollback rate have failed, due in no small part to concerted opposition from local governments around the state; lobbying efforts to defeat the current proposal are already underway. Legislators also may negotiate a reduction in the rate to a level between the current 8% and 2.5%; other bills have been introduced that would reduce the rollback rate to 4%.

Most local governments retain the ability to increase non-tax revenues (e.g. fines, service charges and fees), which could offset the impact of a lower rollback rate as it relates to revenue-raising ability. In addition, Fitch considers the amount that can be raised relative to expected revenue volatility in a typical downturn; as a result, application of a uniform rollback rate limitation would not have the same effect on all governments. 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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MOODY'S
INVESTORS SERVICE

SECTOR COMMENT
30 May 2019

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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.

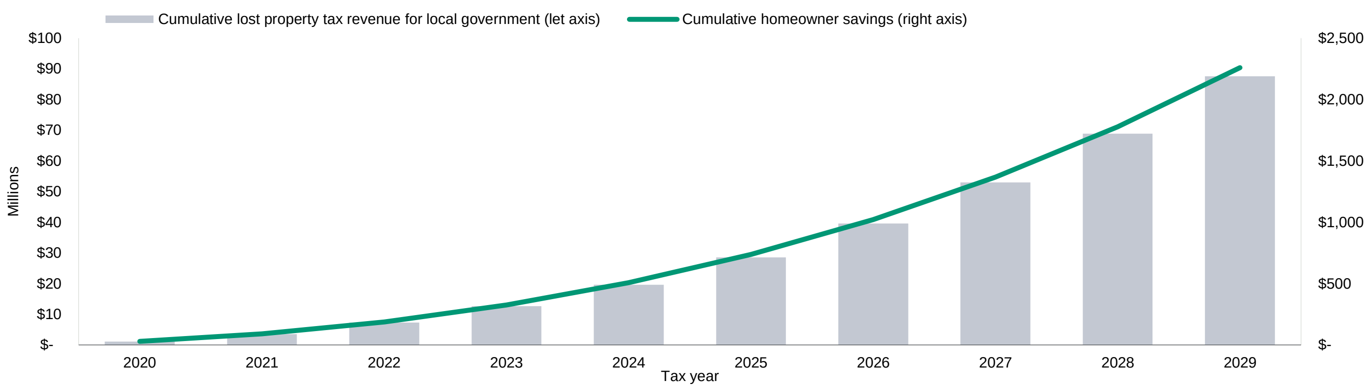
Given that the debt service levy is legally separate from the amount restricted under the 3.5% Senate Bill 2 limit, local governments will maintain direct control over the rate necessary to service debt. In Texas, most school and municipal utility debt carries a general obligation unlimited tax (GOULT)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

MOODY'S
INVESTORS SERVICE

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

**Jun 12, 2019**

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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.

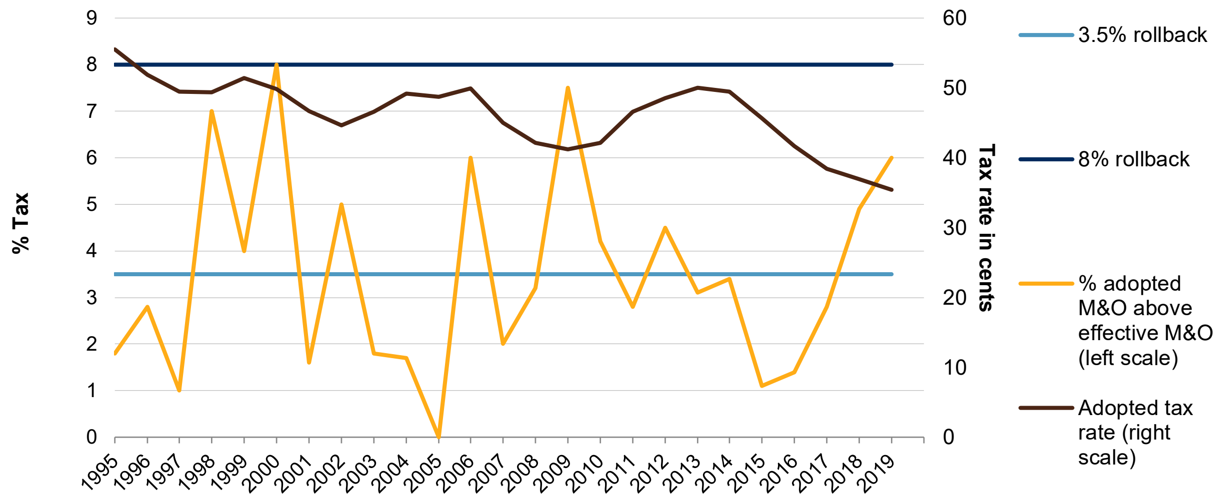
On June 12, 2019, the governor of Texas signed the Texas Property Tax Reform and Transparency Act of 2019, a law requiring certain local government units to obtain voter approval to increase maintenance and operations (M&O) property tax revenues more than 3.5% above the previous year, excluding new construction. 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.

**Download Chart Data**

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.

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