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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' ability to independently raise revenues for operations–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%.

Both the current and proposed rollback rate calculations consider an entity's tax base growth, which can reduce the revenue impact. Most local governments also retain the ability to increase non-tax operating 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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