

- SUBJECT:** School property tax rate reduction
- COMMITTEE:** Ways and Means — committee substitute recommended
- VOTE:** 8 ayes — J. Keffer, Edwards, Grusendorf, Luna, Paxton, Ritter, Smithee, Woolley
1 nay — Villarreal
- WITNESSES:** For — Cynthia Borsellino; Byron Schlomach, Texas Public Policy Foundation
Against — William C. (Bill) Grusendorf, Texas Association of Rural Schools; F. Scott McCown, Center for Public Policy Priorities; Lynn Moak, Texas School Alliance/South Texas Association of Schools; Bee Moorhead, Texas Impact; Wayne Pierce, Equity Center; David Thompson, Texas Association of School Administrators, Texas Association of School Boards
On — David Anderson, Texas Education Agency; Harrison Keller, Office of Speaker Tom Craddick; Marc Levin, Empower Texans; Danica Milios, Office of the Attorney General
- BACKGROUND:** Education Code, sec. 45.003 limits a school district’s local property tax rate for maintenance and operations (M&O) to \$1.50 per \$100 of valuation. In 2005, 73 percent of school districts (743 out of 1,031) had M&O tax rates that were at or within 5 cents of the \$1.50 tax cap.
In November 2005, the Texas Supreme Court, in *Neeley v. West Orange-Cove C.I.S.D.*, 176 S.W.3d 746 (Tex. 2005), ruled that the current school tax system is unconstitutional because school districts do not have “meaningful discretion” to tax below maximum rates and still provide an accredited education. The Supreme Court upheld a district court decision that the local property tax cap of \$1.50 per \$100 of valuation has evolved into a statewide property tax, which is prohibited by the Texas Constitution.
The Supreme Court gave the Legislature until June 1, 2006, to address the constitutional violation. After this date, the court enjoined the state from giving “any force and effect to Chapters 41 and 42 of the Education Code

and from distributing any money under the current Texas school finance system.”

Under Tax Code, sec. 26.05, school boards determine local property tax rates using calculations based on each year’s tax appraisals. Besides setting their actual M&O tax rate, school districts also must calculate their effective tax rate, which generally is the rate that would raise the same amount of money using the current year's taxable property wealth base as the past year's actual tax rate generated using the past year's property wealth base. For example, if the value of the district's property wealth base increased, then the effective tax rate would be lower than the actual tax rate. The "rollback rate" is a district's effective M&O tax rate, plus six cents, plus the tax rate required to pay for any district debt. Under Tax Code, sec. 26.08, if a school district adopts a tax rate that exceeds the district’s rollback rate, voters must approve the new rate by majority vote in an election.

Education Code, chapters 41 and 42, govern the system for the collection and distribution of state funds for public education. Ch. 41 prohibits school districts from having a wealth per student — the taxable value of property divided by the weighted average daily attendance — of more than \$305,000. A school district that exceeds this “equalized wealth level” is subject to the “recapture” of local property tax revenue in excess of this amount. Districts subject to recapture have five options for meeting the equalized wealth level requirement. Most choose either to send excess tax revenue to the state through the purchase of “attendance credits” or to contract directly for payments to property-poor school districts.

Education Code, Ch. 42 establishes procedures for distributing state education funds through the Foundation School Program (FSP). Tier 1 provides a “basic allotment” per student, as well as additional funding for certain student and district characteristics, for school districts, provided that they levy an M&O tax of at least 86 cents per \$100 of valuation. Tier 2, the “guaranteed yield,” provides equalized state funding for each penny of local tax effort. The state currently guarantees school districts \$27.14 per “weighted” student for each penny of local tax effort between 86 cents and \$1.50 per \$100 of valuation.

DIGEST:

CSHB 1 would require school districts to reduce their M&O tax rates in 2006 to 88.67 percent of their 2005 M&O tax rate. School districts would receive "hold harmless" funding of the amount of state revenue necessary

to maintain state and local revenue per weighted student equal to either the amount the district would have been entitled for the 2006-07 school year under current law or 2005-2006 revenue per weighted student, including state aid received for property value decline and "recapture" arrangements under Chapter 42. The bill would appropriate \$2.39 billion to school districts for fiscal 2007 in "hold harmless" funds.

For the 2006 tax year, the rollback rate for school districts whose 2005 tax rate was below \$1.50 would be \$1.36 or its effective M&O tax rate, adjusted to reflect the tax reduction, plus 6 cents, whichever was lower. In future tax years, the rollback rate would depend on the rate adopted in 2006 relative to \$1.36. If the new rate was lower than \$1.36, the rollback rate would be \$1.36 or the effective M&O rate plus 6 cents, whichever was lower. If the new rate was greater than \$1.36, the rollback rate would be the highest M&O rate adopted since 2006 or the effective M&O rate plus 6 cents, whichever was lower.

The 2006 rollback rate for districts whose 2005 tax rate was \$1.50 would be \$1.36. In future tax years, the rollback rate would be the highest M&O rate adopted since 2006 or the effective M&O rate plus 6 cents, whichever was lower. For the Harris County districts allowed to levy an M&O tax rate greater than \$1.50, the 2006 rollback rate would be 88.67 percent of the 2005 tax rate plus three cents. In future tax years, the rollback rate would be the highest M&O rate adopted since 2006 or the effective M&O rate plus six cents, whichever was lower. (In all cases, as currently, the district's debt tax rate would be included in the rollback rate and voters would have to approve by majority vote any tax rate above the rollback rate.)

For school districts subject to "recapture" of local property tax revenue under Education Code, ch. 41, M&O tax revenue on tax rates greater than \$1.33 per \$100 of valuation would not be subject to recapture.

School districts that qualify for the "guaranteed yield" would receive the current allotment of \$27.14 per weighted student for every penny of tax effort above their new compressed rate (up to \$1.50).

A tax bill for school district taxes or the separate statement accompanying a tax bill would have to include information regarding the amount by which the bill reduced property taxes. The Texas Education Agency (TEA) commissioner could adopt rules to implement this requirement.

This provision would expire January 1, 2007.

CSSH 1 specifies that funds appropriated for the purposes of reducing school district property taxes would not be considered excess funds by TEA when making FSP adjustments for cost of education or rapid decline in property value; could not be used to fund facilities; and could not be provided to school districts for a purpose other than reduction of the district's M&O rate. The bill includes "hold harmless" provisions for the School for the Blind and Visually Impaired and the School for the Deaf. It also would require a district that is under a tax increment financing (TIF) agreement to pay the same amount into the TIF fund as it would have paid using its 2005 tax rate.

CSSH 1 would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect on the 91st day after the last day of the third called session (August 15, 2006, if the special session lasts the full 30 days). The bill would apply beginning with the 2006-07 school year.

**SUPPORTERS
SAY:**

CSSH 1 would give school boards and district voters "meaningful discretion" in setting tax rates, thereby meeting the mandate of the Texas Supreme Court in its November 2005 decision. The bill also would provide significant property tax relief by using a portion of the state's \$8.2 billion revenue surplus to "buy down" school property tax rates. All districts would see an M&O tax cut of 11.33 percent. For districts now taxing at the maximum M&O rate of \$1.50, the rate would drop by 17 cents.

CSSH 1 would serve as a safety net to ensure that the Legislature addresses constitutional problems in the current system by the June 1 court deadline even if it did not adopt other tax proposals. This would prevent any disruptions in the distribution of state funding after June 1 and ensure that schools reopen in the fall. While the bill would meet the basic requirements of the Supreme Court decision, it would not preclude the Legislature from approving more extensive changes, such as additional tax relief or teacher pay raises, in other legislation during this special session.

CSSH 1 would provide the "meaningful discretion" that the Supreme Court found lacking in the current system by allowing school districts more leeway to set their M&O tax rates below the \$1.50 cap. As under current law, additional rate increases beyond the rollback rate would have

to be approved by a majority of voters in the school district. This is the ultimate form of “meaningful discretion” and local control because it places the decision about setting M&O tax rates in the hands of district voters.

CSHB 1 would provide school districts with sufficient discretion in establishing local tax rates to meet the Supreme Court's requirement. Districts that currently are taxing well below \$1.50 would continue to be able to increase their tax rate up to six cents per \$100 of valuation beyond their effective tax rate without voter approval, as they can now under current rollback requirements. Many districts currently taxing at \$1.50 still could raise their M&O taxes by more than three cents before having to seek voter approval if their effective tax rate went down as their property values increased. Districts that reached the rollback limit and could justify the need for additional funding to pay for teacher pay raises or other essential needs should be able gain approval from their voters, who already are accustomed to being asked to approve local bond proposals that increase their school tax rates.

Without adjusting the rollback rate to reflect the reduction in school M&O tax rates, any property tax relief could quickly evaporate as school boards increased local property taxes year after year. The revised rollback rate triggering voter approval would serve as a regulator to slow down tax creep and provide more lasting property tax relief for Texas taxpayers.

CSHB 1 would ensure that all school districts had the funding necessary to provide a basic, accredited education, as required by the Texas Constitution. In its 2005 decision, the Supreme Court determined that the constitutional requirements for “adequacy” are being met at this time. The bill still would provide every school district with a “guaranteed yield” of \$27.14 for every penny of local tax effort for tax rates that they set up to \$1.50 even beyond the new reduced rates, at a cost to the state of about \$159 million in fiscal 2007, according to the Legislative Budget Board (LBB). However, increasing the guaranteed yield by any significant amount would be expensive and would commit future legislatures to even higher costs in the years ahead.

Over the past 10 years, property-wealthy districts have had more and more of their local property taxes subject to recapture, with some districts now sending as much as 70 percent of their local tax revenue to the state. As a result, some property-wealthy districts have had to cut personnel and

programs to make ends meet. CSHB 1 would provide some relief by eliminating recapture on local enrichment taxes and reducing the amount of funds recaptured from property-wealthy districts from an estimated \$1.8 billion to approximately \$1.2 billion in 2007, according to the LBB.

The Texas Supreme Court has consistently ruled that local district supplementation of education funds is allowable as long as these funds provide “additional revenue not required for an education that is constitutionally adequate.” It is unlikely that eliminating the recapture of local enrichment funds would generate extreme funding disparities. The greatest projected disparities are based on the assumption that districts would raise local taxes back to \$1.50. Voters in the property-wealthy districts would be unlikely to approve a tax increase to rates at or near \$1.50 any time in the near future, so these extreme funding disparities are unlikely to materialize.

The “hold harmless” provisions would protect school districts from unintended funding shortfalls that could result from the compression of local taxes and changes in funding formulas. Most school districts have already budgeted for next year and should not experience disruptions in funding levels as the changes in the bill are put into place. Any further adjustments would require a full-scale overhaul of the school finance formulas, which is beyond the scope and purpose of this bill.

Devoting one-fourth of the surplus to property tax relief is appropriate because it would return to taxpayers at least a portion of excess funds the state has collected. A general rule of thumb developed by past comptrollers has been that it is safe to use one-quarter of any surplus for new expenditures because this amount is likely to remain in the revenue stream, regardless of any changes in circumstances.

**OPPONENTS
SAY:**

CSHB 1 would not meet the Supreme Court’s standard for “meaningful discretion” and would create new inequities that could lead to further litigation. Rather than being a bare bones bill that addresses only the basic requirements of the Supreme Court, CSHB 1 would introduce a major new component into the existing “recapture” system that would make the school finance system less equitable.

CSHB 1 fails to address the fact that school districts have not had sufficient revenue to keep pace with inflation and enrollment growth. While the bill would ensure that districts receive current funding levels, it

effectively would prohibit them from generating necessary revenue locally by imposing voter approval limitations so restrictive that even modest levels of inflation and enrollment growth could not be financed without voter approval.

School boards are elected by voters in the district and invested with the authority to determine tax rates within reasonable limits. The rollback provisions in current law provide sufficient protection against excessive tax increases by school districts without adding a new arbitrary cap. Given the state's record of failing to provide adequate financing for the public education system, school districts, as they have before, will be forced to raise local taxes to make up for the state's funding deficiencies. As more and more districts reach the new rollback cap, any new rate increase will require voter approval, which will become increasingly difficult to obtain. New state restrictions that would allow school boards even less flexibility to set their tax rates are not likely to be considered "meaningful discretion."

CSHB 1 would give a huge windfall of new money to property-wealthy districts that already are funded at the highest levels, while leaving the guaranteed yield for the large majority of districts at a level that has not changed since 2001. Under current law, the wealthiest 10 percent of districts have a funding advantage that provides about \$270,000 more per elementary school campus. Under CSHB 1, this funding advantage could increase to as much as \$700,000 per elementary school campus. The state's 20 wealthiest districts could generate \$1.7 million more than property-poor schools per elementary campus.

Highland Park ISD could raise \$127 more per student merely by adopting a tax rate of \$1.34, and \$2,163 more per student by adopting a tax rate of \$1.50. By contrast, property-poor school districts could only raise \$27.14 more per student at a rate of \$1.34, and only \$461 more per student by adopting a rate of \$1.50. On average, taxing at \$1.50, the wealthiest 10 percent of districts could raise \$841 more per student than the remaining 90 percent of districts.

While the Supreme Court has not prohibited local supplementation of school funding, in its November 2005 decision it warned that too great a level of local enrichment could "destroy the efficiency of the entire system" and lead to unconstitutional inequities. By eliminating recapture for local enrichment while leaving the guaranteed yield unchanged,

CSHB 1 would open the door to unconstitutional disparities in access to education funding.

CSHB 1 would mandate property tax reduction and then stipulate that all districts would receive sufficient state aid to cover the loss in local revenue through a hold harmless provision. Using a hold harmless provision rather than adjusting the funding formulas, such as by increasing the guaranteed yield amount, would make it more difficult for future legislatures to craft funding formulas to accurately reflect costs.

It would be unwise to use the current surplus as a long-term revenue source for property tax reduction. The state will have to continue paying this ongoing expense in coming years whether or not the economy continues to produce a surplus, as it has this year. Surplus funds should be used to cover pressing one-time expenses such as hurricane relief or unanticipated expenditures. If the economy changes and the surplus evaporates, the Legislature will have to come up with additional state revenue or spending cuts to cover the new spending commitment made by this bill.

OTHER
OPPONENTS
SAY:

CSHB 1 would provide only a short-term fix to the constitutional problem identified by the Supreme Court because it would create incentives for school districts to increase local taxes. By both providing a guaranteed yield and eliminating recapture for local enrichment taxes, the bill would encourage school districts to increase local property taxes in order to access these funds. Not only would property tax relief evaporate as school districts took advantage of this windfall, but the state again might find itself in constitutional straits as increasing numbers of districts taxed at or near the \$1.50 cap.

The “bare minimum” approach of CSHB 1 may not be enough to satisfy the Supreme Court. In its 2005 decision, the court encouraged the Legislature to make long-term, structural changes to the system to address a variety of problems in the state’s school finance system. The court did not adopt a standard for meaningful discretion but concluded that a variety of elements indicative of meaningful discretion for school districts do not exist in the current system. CSHB 1 falls short of fundamentally changing the circumstances that caused the court to find the system unconstitutional.

CSHB 1 would not go far enough. A much larger portion of the \$8.2 billion surplus should be earmarked for school property tax reduction to refund to taxpayers more of the money that they overpaid.

NOTES:

According to the fiscal note, CSHB 1 would result in a loss to the state of \$2.39 billion in general revenue-related funds in fiscal 2007, of which approximately \$2.15 billion would result from the replacement of local property tax revenue with state aid.

The committee substitute eliminated provisions in the bill as filed that would have required approval of a two-thirds majority of voters in a school district for tax increases of more than 5 cents for the 2006 tax year, 10 cents for 2007 and 2008 tax years, and 15 cents for the 2009 and 2010 tax years. The substitute would set a basic rollback limit of \$1.36, three cents more than the reduced M&O rate of \$1.33 for districts now taxing at an M&O rate of \$1.50. The substitute also specified an appropriation of \$2.39 billion to replace local revenue from reducing school property tax rates and would repeal Rider 97 of the general appropriations act for fiscal 2006-07, which would have appropriated \$1.79 billion to fund school finance legislation.

On April 21, the House adopted a Calendars Committee rule for consideration of HB 1 prohibiting amendments that would increase the cost of the bill or that would decrease the amount of property tax relief.