The City of Houston's Finances

Is Now The Time To Raise Property Taxes?

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Overview

On July 24, 2015, the Greater Houston Partnership's Municipal Finance Task Force released its first white paper - *The City of Houston's Finances: Let's Be Clear About Where We Are*.[1] The paper included a multi-year review of the City's publicly available financial statements, with a focus on revenues and expenses associated with the City's main operating fund, the General Fund. This paper more closely examines the sources of the City of Houston's revenue, including a review and analysis of trends associated with each. This paper also examines two topics that are related to the City of Houston's revenue picture: the property tax revenue cap and the use of tax increment reinvestment zones (TIRZ).

This paper will show that Houston's economic success has created strong revenue streams in each of the City's four revenue categories – property tax, sales tax, franchise fees, and other revenue. Property and sales tax revenues, in particular, have risen consistently.

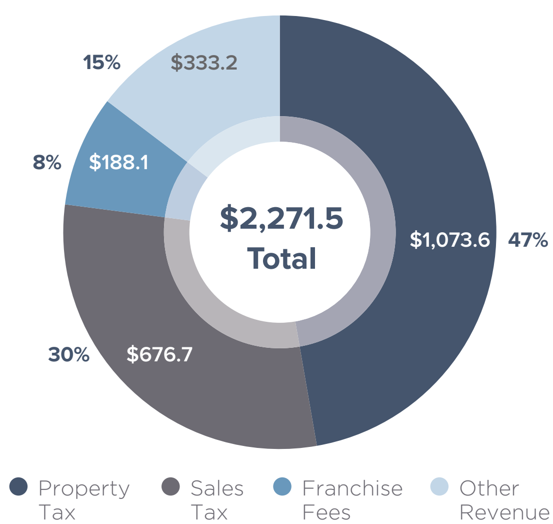
This paper concludes that a shortage of revenue has not been the cause of the financial challenges the City currently faces. Rather, City finances are being stressed by expenses, including pensions and other post-retirement benefits.

Property Tax Trends

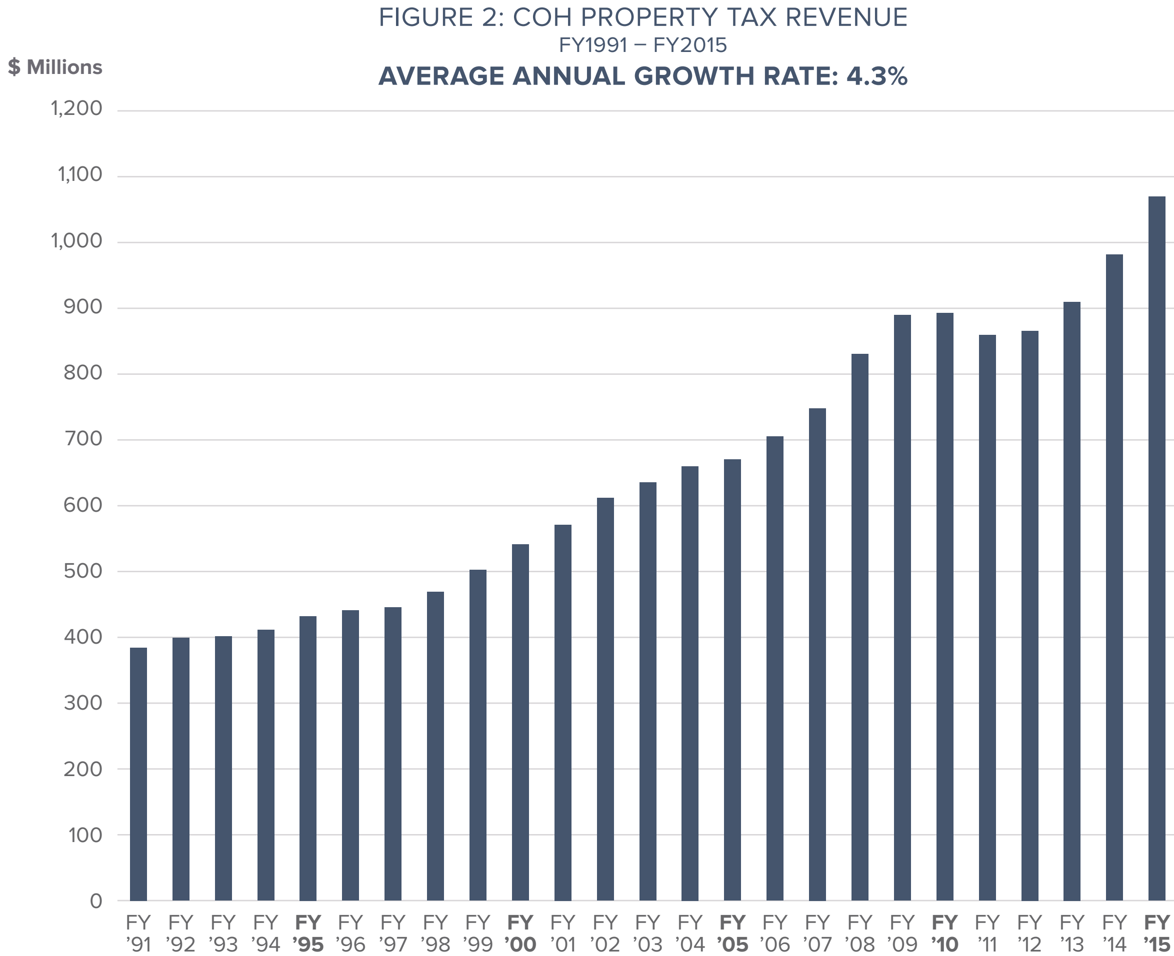
Houston is the largest city in the State of Texas and has outpaced other Texas cities in terms of job creation and economic development. Since 2005, the greater Houston region has created more than 640,000 new jobs.[2] This development has fueled population and income growth in the City, which has helped raise the amount of City tax revenues which go into the General Fund.

As noted, the City has four primary sources of revenue: property taxes, sales taxes, franchise fees (fees paid by utility companies for the use of public rights-of-way), and other miscellaneous sources.[3] Property tax revenue is – and has been for many years – the largest revenue component of the City of Houston's General Fund. Figure 1 illustrates that, based on FY2015, property tax revenues account for approximately 47 percent of total General Fund revenues.

FIGURE 1: CITY OF HOUSTON (COH) GENERAL FUND REVENUES
FY2015 ESTIMATE ($ MILLIONS)



Source: Proposed Budget FY2016



A review of the City's historical property tax revenues (shown in Figure 2) demonstrates a steady upward trend, with periods of increases and brief plateaus that correspond to the region's economic performance. For example, from FY1991 – FY1997, property tax revenues increased by $61 million total, or 2.5 percent per year. From FY1997 – FY2009, property tax revenues increased by $443 million, or 5.9 percent per year. After the "Great Recession," property tax revenues flattened. Then, as Houston led the nation in recovery between FY2011 and FY2015, property tax revenues increased approximately $210 million, or 5.6 percent per year.

The City estimates it collected approximately $1.073 billion in property taxes in FY2015 (ending June 30, 2015),[4] which represents a 97% increase since 2000.

Property Tax Values and Rates

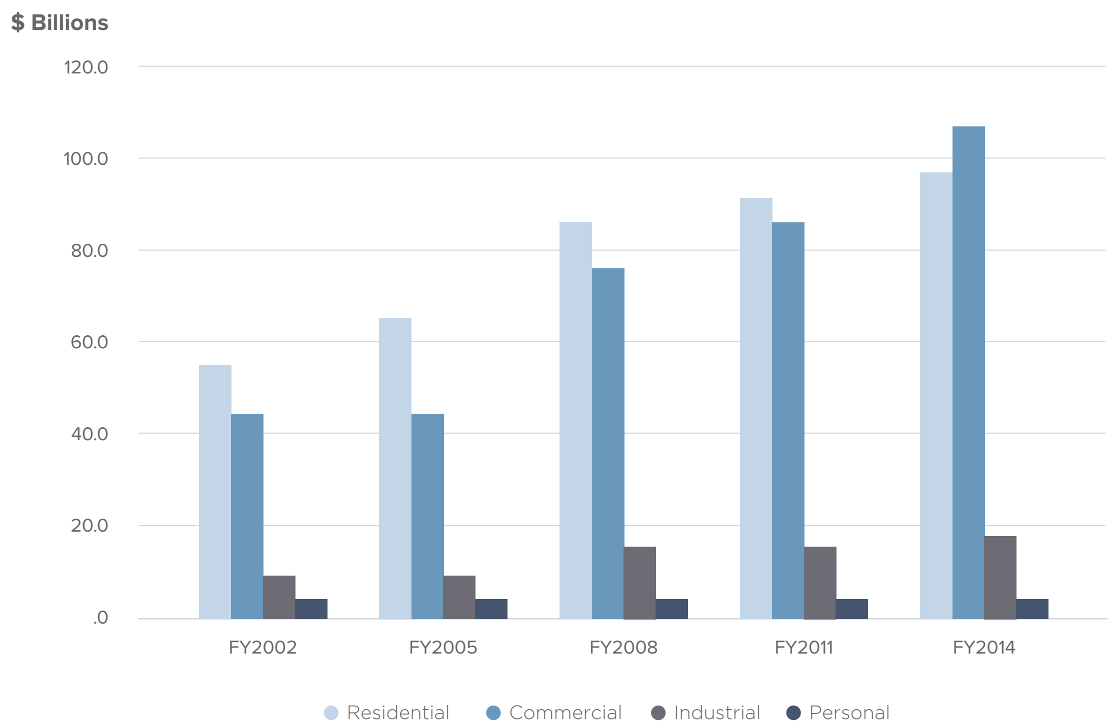
Property taxes (also referred to as "ad valorem" taxes) are both a function of property values and the property tax rate. The tax rate is typically expressed as an amount per $100 of the property's assessed valuation. Property values are established annually for all taxing jurisdictions in Harris County by the Harris County Appraisal District (HCAD). By law, residential property valuations with homestead exemptions cannot increase by more than 10 percent in a year.[5] Commercial property valuations can and recently have increased by more than 10 percent per year. Notably, the new property tax appraisals that led to record City property tax revenue collections in FY2014 and FY2015 drew a record number of formal protests from both the business community and homeowners. Some businesses faced tax increases of more than 25 percent. The Harris County Appraisal District received over 200,000 commercial and residential protests during its 2014 cycle alone.[6]

The current property tax rate in the City is 63.9 cents per $100 of the property's assessed value.[7] Thus, for what is often referred to as a "typical" Houston home with an assessed home valuation of $150,000, the property tax for that home equals 1,500 times $.639, or $958.50.

Figure 3 shows the total values of the four major property categories in the City of Houston: 1) residential, including single family and multifamily, 2) commercial, or land and improvements devoted to business activities, 3) industrial, or land and improvements devoted to the development, manufacturing, fabrication, processing or storage of a product, and 4) personal, meaning all tangible personal property used by commercial businesses to produce income, including fixtures, equipment and inventory.[8] Between FY2005 and FY2014, total commercial and industrial values grew at more than twice the rate of total residential values. Over that same period, commercial and industrial values together rose from 43% to 55% of the total.

Properties held by non-profit organizations are generally exempt from property taxation. Valuations of owner-occupied residences are limited by so-called "homestead exemptions," as well as exemptions for senior citizens and disabled citizens.[9]

FIGURE 3: ASSESSED VALUE OF TAXABLE PROPERTY BY TYPE (COH)



($ Billions) Property Type	FY2002	%	FY2005	%	FY2008	%	FY2011	%	FY2014	%	FY2005–FY2014 Compound Annual Growth Rate
Residential	53.8	50%	67.3	55%	84.3	49%	90.0	48%	96.7	44%	**4%**
Commercial	43.6	41%	44.1	36%	75.2	43%	84.3	45%	103.3	47%	**10%**
Industrial	7.1	7%	7.9	7%	11.7	7%	11.5	6%	17.6	8%	**9%**
Personal	2.8	3%	2.5	2%	2.5	1%	2.3	1%	2.3	1%	**-1%**
Total	**107.3**	**100%**	**121.8**	**100%**	**173.8**	**100%**	**188.0**	**100%**	**219.9**	**100%**	**7%**

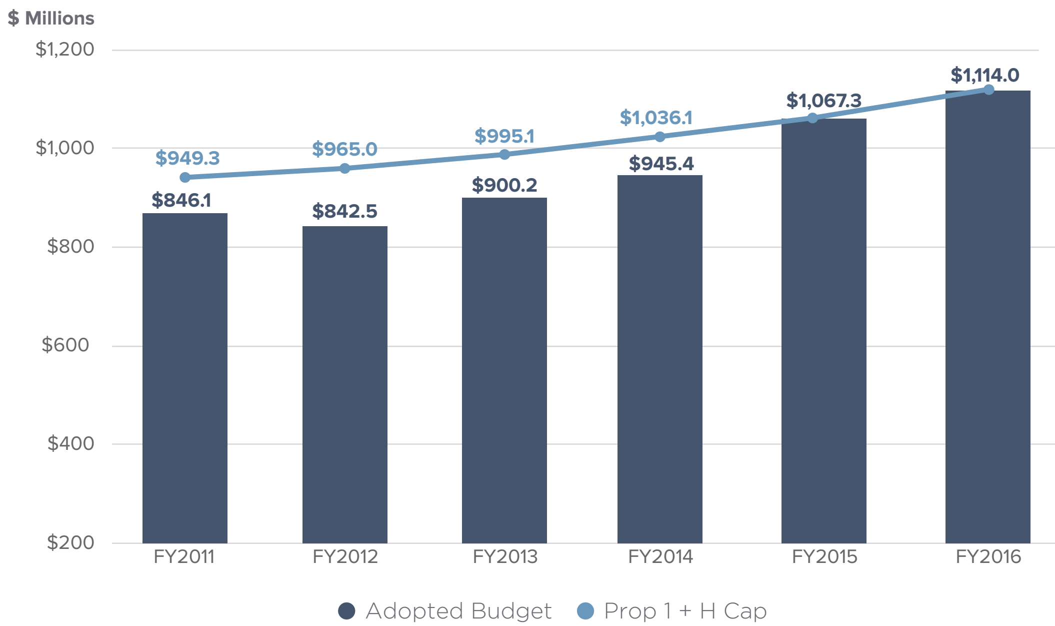
Property Tax "Revenue Cap"

With the intention of limiting the growth of City expenses to roughly the City's growth rate, a voter referendum in 2004 put in place a "floating cap" on the City's property tax revenue. The property tax revenue cap ties property tax revenue growth to the lesser of 1) population growth plus consumer price index inflation (cumulative over time) or 2) a 4.5 percent year over year growth rate.[10] In 2006, Houston voters added $90 million to the cap exclusively to fund public safety.

By its construction, this floating cap allows the City's ad valorem revenues to increase; it is not a hard, fixed cap. In FY2015, the revenue cap came back into play for the first time in many years.

FIGURE 4: COH AD VALOREM REVENUE (ADOPTED BUDGET) VS. REVENUE CAP

FY2011 – FY2016



Other Factors Impacting City Property Tax Revenues

The City tax revenue picture becomes more complex when you take into account other policy decisions that impact the amount of property tax revenue available to the City through the General Fund. The amount of tax revenue collected by the City has been reduced due to property tax exemption and discretionary decreases in the tax rate. In order to stay within the revenue cap in FY2016, the City chose to double the senior and disabled property tax exemption from $80,000 to $160,000 rather than lower the ad valorem tax rate. It is also important to note that there are many other entities whose property taxing power overlaps with the City's, including independent school districts, community colleges, municipal utility districts, and road and water authorities.

Tax Increment Reinvestment Zones

Another important City property tax policy is its use of tax increment reinvestment zones (TIRZ). TIRZ are a program governed by Chapter 311 of the Texas Local Government Code. They are used as a targeted economic development tool that contributes to the construction of public infrastructure improvements, schools, affordable housing, parks, and other cultural projects. TIRZ can be created either by petition or initiated by the City. The City of Houston currently has 25 active TIRZ, with three more currently proposed.

When a TIRZ is created, the total property values within its geographic area, and consequently that area's property tax revenues going to the General Fund, are held constant. Any growth in property values and equivalent property tax revenue (the "increment") above that base amount goes to that TIRZ's redevelopment authority. These authorities are largely self-governing, with boards of directors, budgets, and project plans that are ultimately approved by City Council. The incremental property tax revenues collected through the TIRZ are not subject to the City's property tax revenue cap. In some cases, there is an additional revenue increment associated with school district property taxes.

TIRZ revenue is either sent back to the City or used to fund public projects, which ultimately become City assets. These projects augment the City's capital improvement plan, which is the City's five-year plan for capital projects and equipment purchases.

In FY2015, TIRZ collected approximately $103 million in revenues. Of that amount, $5.3 million was sent to the General Fund and $1.6 million went to the City's Affordable Housing Fund. The remaining $96.2 million was paid to TIRZ authorities.[11]

TIRZ are designed to reinvest economic gains back into specific areas, spurring further redevelopment. Going forward, the benefits that TIRZ provide should be carefully monitored along with their contribution to the City's capital improvement objectives. The TIRZ structure must also be balanced against the impact on the City's General Fund property tax collections.

Sales Tax

While property taxes are the largest single General Fund revenue source, other types of revenue also factor significantly into the City's budget. In FY2015, sales taxes, the second largest source, accounted for approximately 30 percent of General Fund revenues. In the City of Houston, an 8.25 percent sales tax is applied. The Metropolitan Transit Authority (METRO) receives 1 percent, and the State of Texas receives 7.25 percent. The State Comptroller remits a 1 percent share back to the City, after withholding a small service charge from that amount. Like property tax revenues, sales tax revenues generally correspond to the Houston region's economic performance. Between 1998 and 2015, sales tax revenues have grown at an average of 5.1 percent annually.

Other General Fund Revenues

The third largest category of General Fund revenues is franchise fees. Various utility companies, including electric, natural gas, telephone, cable TV, and solid waste haulers, pay these fees to the City for use of public rights-of-way. Franchise fees constituted 8.3 percent of the City's General Fund revenues in FY2015.[12] Remaining General Fund revenues include license and permit fees, fines, interest on investments, and charges for services. Together, they accounted for 14.7 percent of General Fund revenue in FY2015.

Conclusion

Our first white paper presented an overview of the City's finances in the context of a national rating agency changing Houston's debt rating outlook to "negative" and the marked increase in the City's unfunded liability to its employee retirement plans in recent years. This second paper examines in more detail the City's revenue sources, focusing more specifically on the strong growth in property tax revenue. While that growth may not continue at the extraordinary rates of the past few years, we expect that property tax revenue will remain a steady and growing revenue source to fund City operations for many years to come. But, to state the obvious, property tax revenue as a source of City funding is not unlimited and property tax payments have become an increasing burden on homeowners and businesses in the City.

Despite strong revenue growth, the City has seen a rapid increase in expenses associated with employee pension costs even as it has seen an increase in unfunded pension liabilities. The City currently projects General Fund budget deficits going forward for each year through FY 2020 in excess of $100 million per year. The City's projected budget deficits can no longer responsibly be closed through asset sales or other one-time fixes, as has often been done in the past.

The people of Houston, as they always have, will come together to solve this financial problem. As this paper has shown, the problem is not principally a revenue problem. The solution must principally come from a focus on expenses, including limiting or eliminating the rapid growth in pension expense and unfunded liabilities. This is a topic we will address in future white papers as part of our effort to outline a path for the City to a stable financial future.

Sources

[1] Available at http://ghp.informz.net/GHP/data/images/Public%20Policy/Municipal%20Finance/Municipal%20Finance-FINAL.pdf
[2] United States Bureau of Labor Statistics
[3] Sources: CAFR FY2000-FY2014
[4] Sources: CAFR FY2000-FY2014
[5] HCAD, see http://www.hcad.org/Help/CappedValues.asp
[6] Tax protests flood in as deadline looms, KPRC, June 2 2014, http://www.khou.com/story/news/local/2014/07/25/12501894/
[7] Source: FY2016 Adopted Budget
[8] http://comptroller.texas.gov/taxinfo/proptax/pdf/96-1425.pdf
[9] CAFR 2014; Biennial Property Tax Report, Tax Years 2012 and 2013, Texas Comptroller of Public Accounts, December 2014
[10] Election held in 2004 (Proposition 1), it limits the growth of City's property tax revenue to the lesser of cumulative population and inflation growth over a 2005 base or 4.5% growth over the previous year's actual collections. Proposition H, passed in 2006, allows City officials to raise an additional $90 million above the applicable revenue limitation for public safety purposes.
[11] CoH City Council Agenda - 6/9/2015, Agenda Item 27
[12] Sources: CAFR FY2000-FY2014, Proposed Budget FY2016