BILL # HCR 2048

TITLE: property tax; valuation; new construction

SPONSOR: Weiers, James

STATUS: House Engrossed

REQUESTED BY: Senate

PREPARED BY: Hans Olofsson

FISCAL ANALYSIS

Description

Conditional upon voter approval in the next general election, HCR 2048 would reduce the annual percentage that the limited property value (LPV) of locally assessed real property and mobile homes is allowed to increase to the greater of 3% of the previous year's LPV or 10% of the difference between the current year's full cash value (FCV) and the previous year's LPV. Locally assessed real property is almost exclusively comprised of commercial, agricultural, and owner-occupied and rental residential real property. HCR 2048 would require the valuation of new construction and resale residential property to be the FCV of the property.

Estimated Impact

The bill would have an estimated General Fund cost of $21.3 million beginning in FY 2009. The bill will reduce statewide primary net assessed valuation (NAV), which will increase the state's K-12 education formula cost. That impact, however, could be offset by reducing the cost of automatic school tax rate reductions that are designed to offset higher assessed valuation. There will be less of a tax rate reduction since the bill will lower the growth in assessed valuation. The net General Fund impact after accounting for the school tax rate reductions would be an estimated saving of $7.4 million beginning in FY 2009.

The Department of Revenue (DOR) has indicated that the department would not implement the bill until FY 2010 due to computer programming issues.

Analysis

According to Legislative Council, if HCR 2048 is approved by the voters in the 2006 general election, the provisions under the bill would apply beginning with the 2007 valuation year. Under the state's valuation schedule, real property valued in 2007 will not be subject to tax until 2008. The state General Fund impact would begin in FY 2009. Due to computer programming issues, however, DOR claims that HCR 2048 cannot be implemented until FY 2010.

Growth Cap

HCR 2048 reduces the annual percentage that the LPV of locally assessed real property and mobile homes is allowed to increase to the greater of 3% of the previous year's LPV or 10% of the difference between the current year's FCV and the previous year's LPV. Under current law, the constitutional formula allows the LPV of locally assessed real property to increase by 10% above the previous year's LPV or by 25% of the difference between the current year's FCV and the previous year's LPV.

Using the levy limit worksheets provided by the state's 15 counties, JLBC Staff determined that statewide locally assessed real property appreciated by 5.2% in tax year 2004 and by 5.6% in tax year 2005. However, the data contained in the county levy limit worksheets was not detailed enough to determine the corresponding statewide change in the valuation of mobile homes. Historically, mobile homes tend to appreciate at a lower rate than other residential property. In addition, mobile homes represent a relatively small percentage of the statewide tax base. For this reason, JLBC Staff assumed a somewhat lower statewide annual appreciation rate of 5% for the period from tax year 2006 to tax year 2008.

Analysis (Cont'd

Because individual property data was not available for this analysis, JLBC Staff computed the difference between a 5% and a 3% appreciation rate for the statewide aggregate amount of locally assessed real property with respect to primary NAV. Under this method, the growth cap under HCR 2048 was estimated to result in a primary NAV loss of $960 million in tax year 2008 relative to current law.

<u>Valuation of New Construction</u>
HCR 2048 requires the valuation of new construction to be the FCV of the property. By contrast, under current law, new property added to the tax roll is assigned a LPV that is established at a level or percentage that is commensurate to the relationship of LPV to FCV of other properties of the same or similar use or classification. (DOR's *Assessment Procedures Manual* refers to this calculation as the "Rule B" calculation.) While assessors typically establish the LPV to FCV ratio (or rule B factor) by market area, JLBC Staff calculated the ratio based on aggregate property data for the state as a whole since no other information was available for this analysis. Under this method, the statewide aggregate LPV to FCV ratio is 0.93 for all locally assessed real property in tax year 2004. This ratio was continued through tax year 2008 as well, the first year in which HCR 2048 would become effective.

To estimate the amount of new property in tax year 2008, JLBC Staff used information contained in the 15 county levy limit worksheets. This data shows that about half of the overall growth of locally assessed real property in tax years 2004 and 2005 was attributable to new construction. In dollar terms, new construction of locally assessed real property added $1.69 billion to the primary tax roll in 2004 and $1.98 billion in 2005. For the purpose of this analysis, new construction of locally assessed real property is projected to add about $2.59 billion to the primary tax roll in 2008, as computed under existing statutes.

While the primary NAV of new construction (of locally assessed real property) is computed based on limited property value under current law, it would be computed based on full cash value under HCR 2048. This means that the $2.59 billion estimate above must be adjusted to reflect what the full cash value of new construction would be in tax year 2008 under this bill. To obtain such an estimate, JLBC Staff divided $2.59 billion by the previously estimated LPV to FCV ratio of 0.93, which resulted in a FCV estimate of $2.78 billion for tax year 2008.

The difference between the NAV of new construction based on FCV ($2.78 billion) and based on LPV ($2.59 billion) is $189 million. In other words, this particular provision of HCR 2048 is estimated to increase primary NAV by $189 million relative to current law.

<u>Valuation of Resale Residential Property</u>
HCR 2048 requires the valuation of resale residential property to be the FCV of such property. The primary NAV of any residential property resold in calendar year 2006 will be an amount equal to 10% of its FCV for valuation year 2007. (Under current law, the primary NAV of such property would be 10% of its LPV.) Note that under the state's valuation schedule, residential property valued in 2007 would not be subject to tax until 2008.

To determine the impact of this provision of HCR 2048, JLBC Staff must first estimate the number of residential properties that will be resold in 2006 and thus for which only the FCV will be entered onto the 2008 primary tax roll. To do so, JLBC Staff began by estimating the number of existing parcels that are expected to be listed on the 2006 tax roll based on the recent growth trend.

Based on DOR's annual publication *State and County Abstract of the Assessment Roll*, JLBC Staff projects that 1,684,708 parcels will be included on the tax roll in 2006. Of this amount, 1,621,471 parcels are expected to represent the existing housing stock. A little less than 10% of the existing housing stock is projected to change ownership, based on sales data provided by DOR and the Arizona Real Estate Center at ASU for the 3-year period from 2002 to 2004. Thus, JLBC Staff predicts that 155,385 existing homes will be sold in 2006.

Based on valuation and sales data furnished by DOR and the Arizona Real Estate Center, the average difference between an existing residential parcel's FCV and LPV is about $4,430 in 2006. The total difference between FCV and LPV for all parcels predicted to be resold in 2006 is thus an estimated $690 million (= 155,385 * $4,430). This means that this particular provision of HCR 2048 will increase primary NAV by $69 million in tax year 2008.

Net NAV Impact of HCR 2048

The net effect of the three key provisions under HCR 2048 is a reduction of primary NAV by $(702) million in tax year 2008 relative to current law. The reduced growth cap provision will result in a NAV loss of $(960) million. However, this NAV reduction will be offset by $189 million in increased valuation of new construction and by $69 million in increased valuation of resale residential property. Thus, the estimated net impact of HCR 2048 with respect to primary NAV is a reduction of $(702) million beginning in tax year 2008.

General Fund Impact of HCR 2048

Under the Basic State Aid formula, the state pays for the cost of K-12 education not generated through local property taxes. The state also pays 35% of residential property taxes through the Department of Education's Homeowner's Rebate program. By reducing NAV by $(702) million in tax year 2008, the bill will result in a direct increase of the state share of K-12 funding by $21.3 million in FY 2009. This estimate includes the net impact of both Basic State Aid and the Homeowner's Rebate.

The NAV reduction under HCR 2048 will also generate savings in the cost of the state's Truth in Taxation (TNT) program. TNT reduces the QTR and county equalization tax rate to offset growth in existing property values. This reduction occurs automatically unless the Legislature decides to forego the TNT adjustment. For FY 2009, the school tax rate is projected to be reduced by 13¢ under existing statutes. However, the lower NAV under HCR 2048 would result in the tax rate reduction being 5¢ less than under current law. The higher QTR under the bill will change the net General Fund impact from a cost increase of $21.3 million to a cost saving of $7.4 million in FY 2009.

Under the state's TNT provisions, any increase in the valuation of existing property is offset by a proportionate decrease of the QTR and county equalization tax rate. This means that growth in existing property values does not result in any saving for the General Fund since the local share of the funding formula remains unchanged for such property. Instead, all else equal, only valuation growth attributable to new construction will reduce the state share of K-12 funding. Thus, under HCR 2048, the combination of higher primary NAV for new construction and QTR for all properties will generate a net saving of $7.4 million relative to current law.

The proposal will also affect the cost of the 1% Cap. Under the Arizona Constitution, total primary taxes are not allowed to exceed 1% of a residential property's limited value. The lower valuation of residential property (other than property that is resold or newly constructed) under HCR 2048 will likely reduce the cost of the constitutional provision. However, this cost saving will be offset by the higher QTR under the bill. The net effect of HCR 2048 on the 1% Cap cannot be determined in advance.

Besides General Fund expenditures, HCR 2048 will also affect General Fund revenues. Although the state property tax was repealed in 1996, the General Fund still receives property tax revenues from unorganized districts and school districts that levy the minimum qualifying tax rate. The impact on state revenues could not be determined but is expected to be small.

As noted above, the fiscal impact of this bill depends on whether the TNT impact is included or not. In the absence of a TNT adjustment, JLBC Staff estimates that the cost to the General Fund, beginning in FY 2009, will be about $21.3 million. However, if the QTR is adjusted to account for TNT, the bill is estimated to save the General Fund $7.4 million.

Local Government Impact

Under the Arizona Constitution, a county, city, town, or community college district is not allowed to levy primary property taxes on previously existing property in excess of a 2% increase from the maximum allowable amount in the preceding tax year unless approved in an override election. However, for many taxing jurisdictions, most of the annual increase in levy limits is not attributable to existing property but new construction. This suggests that since new construction is valued higher under HCR 2048 than under current law, local governments' levy limits would also be higher under this proposal than under current law.

While many taxing jurisdictions would be allowed under the constitution to increase their primary tax rates in response to HCR 2048, JLBC Staff cannot predict in advance whether they will do so or not. To the extent that they do, property taxes will be shifted from locally assessed real property to locally assessed personal property and centrally valued property. In addition, property taxes may also be shifted from owners of existing homes to owners of newly constructed property.

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