**BILL #** HCR 2035

**TITLE:** ~~technical correction; judicial ballot~~
NOW: property; valuation; increases; limitation

**SPONSOR:** Weiers, J.

**STATUS:** As Amended by Senate APPROP

**PREPARED BY:** Hans Olofsson

# FISCAL ANALYSIS

### Description

Conditional upon voter approval in the next general election, the strike-everything amendment to HCR 2035 would limit the annual valuation increase of locally assessed real property and mobile homes to 2% of the previous year's value. (Locally assessed real property is almost exclusively comprised of commercial, agricultural, and residential real property.) The 2% valuation limitation would apply not only to primary property taxes levied to pay for the maintenance and operation of taxing jurisdictions but also to secondary property taxes levied to pay for bonded indebtedness, special districts, and budget overrides. Thus, the full cash value growth of existing real property would also be capped at 2% annually. Furthermore, the bill would eliminate the exemption of equalization orders from the property valuation limitation.

### Estimated Impact

The bill could have an estimated General Fund cost of $46.7 million beginning in FY 2009. The bill will reduce statewide net assessed valuation (NAV), which will result in an increase of the state's K-12 education formula cost. However, the fiscal impact resulting from the NAV loss could be offset by reducing the cost of automatic school tax rate reductions under the state's truth-in-taxation (TNT) provisions. Under TNT, there would be less of a tax rate reduction since the bill would lower the valuation increase of existing property. The net General Fund impact after accounting for the school tax rate reductions under TNT would be an estimated savings of $(4.2) million beginning in FY 2009.

The estimates above do not reflect the potential General Fund impact of this proposal on the "1% Cap" program under the Arizona Constitution since this cannot be determined in advance. However, as discussed below, HCR 2035 may significantly increase the future cost of this program.

### Analysis

According to Legislative Council, if HCR 2035 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 statutes, real property valued in 2007 will not be subject to tax until 2008. The state General Fund impact would begin in FY 2009.

HCR 2035 will directly affect the state General Fund by reducing the statewide property tax base (statewide NAV) and indirectly by changing local property tax rates, as discussed below.

<u>Impact on Property Tax Base (NAV) – Basic State Aid and Homeowner's Rebate Impacts</u>
The property tax base in Arizona is comprised of 3 types of property: locally assessed real property (LARP), locally assessed personal property (LAPP), and centrally valued property (CVP). LARP is valued by the state's 15 county assessors and includes land, buildings, and improvements to land. LAPP is also valued the by the county assessors and includes property used for commercial, industrial, and agricultural purposes, such as office furniture, business equipment, and tools. Most mobile homes are also taxed as personal property. CVP is valued by the Department of Revenue and includes geographically dispersed and complex properties, such as mines, utilities, airlines, and railroads. Generally, LARP tends to appreciate over time, whereas LAPP and CVP typically depreciate. For the 2006 tax year, 86.1% of statewide NAV is comprised of LARP, 4.6% of LAPP, and 9.2% of CVP.

Under current law, the annual percentage that the limited value of LARP and mobile homes is allowed to increase is the greater of: (1) 10% of the previous year's limited value or (2) 25% of the difference between the current year's full cash value and the previous year's limited value. The limited value of a property cannot exceed its full cash value. As noted above, this bill would limit the annual valuation increase (for both primary and secondary tax purposes) to 2% of the previous year's property value for LARP and mobile homes. (NAV data for mobile homes was not available for this analysis. However, since mobile homes represent only a small fraction of the statewide tax base and often depreciate over time, they were not assumed to materially affect the outcome of this analysis. For these reasons, this analysis only considers the impact on LARP.)

Based on levy limit worksheets provided by the state's 15 counties, it can be inferred that statewide NAV grew by an average annual rate of 9.7% between tax years 2004 and 2006. Of the total growth rate, 4.0% was attributable to the appreciation of existing property and 5.7% to new construction. Of the 4.0% statewide appreciation rate, 5.3% was attributable to LARP, (2.8)% to LAPP, and (3.4)% to CVP. In other words, both LAPP and CVP negatively impacted the statewide growth rate for existing property. For the purpose of this analysis, the same growth rates as above (including the 5.3% appreciation rate for LARP) were assumed to hold for tax years 2007 and 2008.

Under the above assumptions, total statewide NAV would be $58.0 billion in tax year 2008. Under HCR 2035's 2% growth cap, NAV would be $56.4 billion. This means that the 2% growth cap under the bill would reduce statewide NAV by $(1.6) billion relative to current law.

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 a percentage (38% in FY 2009) of owner-occupied residential property taxes through the Department of Education's Homeowner's Rebate program. By reducing NAV by $(1.6) billion in tax year 2008, the bill will result in a direct increase of the state share of K-12 funding by $46.7 million in FY 2009. This estimate includes the net impact of both Basic State Aid and the Homeowner's Rebate.

<u>Impact on School District Property Tax Rates – Truth in Taxation Impacts</u>
Under the state's TNT provisions for equalization assistance to schools, the Qualifying Tax Rate (QTR) and County Equalization Tax Rate (CETR) are reduced each year to offset the valuation increase of all existing property in the state. These rate reductions occur automatically unless the Legislature overrides the TNT adjustment with a two-thirds majority vote. Since TNT reduces school district tax levies, it imposes a cost on the General Fund by increasing the state share of K-12 funding. Generally, the state's TNT cost increases as statewide property appreciation increases.

As noted above, under current law, all existing property is assumed to grow by 4.0% (of which 5.3% would be attributable to LARP) in tax year 2008. The 2% growth cap of LARP under HCR 2035 would reduce the growth rate of all existing property from 4.0% to 1.3%. Under current law, the FY 2009 QTR would be reduced by an estimated (13.5)¢. Since the ballot proposal will reduce the expected rate of growth in school district tax levies, the QTR is projected to decline by (4.4)¢ under HCR 2035. It is estimated that the 9.1¢ higher QTR under the bill would reduce the state's TNT cost by $(50.9) million. This means that TNT would change the net General Fund impact from a cost increase of $46.7 million to a cost savings of $(4.2) million in FY 2009. Most of the net cost savings would be attributable to the fact that the tax rate applied to new property would be 9.1¢ higher under this bill than under current law. The estimated net General Fund savings includes the net impact of both Basic State Aid and the Homeowner's Rebate.

<u>Impact on Non-School District Property Tax Rates – 1% Cap Impacts</u>
The individual primary property tax rates set by the state's counties, cities, towns, and community college districts (hereafter referred to as non-school districts) do not directly impact the state General Fund. However, when non-school tax rates are combined with school district tax rates, they may indirectly impact the state General Fund through the state's "1% Cap" program. Under the Arizona Constitution, a homeowner's total primary property tax bill is capped at 1% of the property's limited value. The state pays school districts any amount of primary property taxes that exceeds 1% of a residential parcel's value. Thus, HCR 2035 may increase state General Fund costs by directly affecting non-school district tax rates.

Non-school district property taxes are limited by both local TNT statutes and by the "2% levy limit" under the Arizona Constitution. Local non-school district TNT rates are computed in the same manner as state TNT rates. The constitutional "2% levy limit" disallows non-school districts from levying primary property taxes on previously existing property in excess of a 2% increase from the maximum allowable amount in the preceding year unless approved in an override election. While local TNT rates can be exceeded, the maximum allowable tax rate under the "2% levy limit" provision cannot. The direct impact of HCR 2035 on local TNT and the "2% levy limit" and thus indirectly the state General Fund is discussed below.

*Local TNT*

The impact of HCR 2035 will vary among local taxing jurisdictions. For example, if the 2% growth cap had been in effect for the 2005 tax year, 5 of the state's 15 counties would not have been affected by the cap (Graham, Greenlee, La Paz, Santa Cruz, and Yuma). For this reason, their TNT rates would have been the same as under current law. For the other 10 counties, the 2% growth cap on LARP would on average have reduced the growth rate for all existing property from 4.7% to 1.2%. Thus, HCR 2035 would have had the effect of reducing the county TNT rate by 1.2% on average compared to 4.7% under current law. This means that if non-school districts were to adopt their TNT rates, local tax rates would decrease under HCR 2035 (albeit to a smaller extent than under current law). However, this outcome is highly uncertain since data from the Property Tax Oversight Commission (PTOC) indicates that many non-school districts have a history of exceeding their TNT rates. Under existing statutes, local TNT rates can be exceeded by a simple majority vote of the governing body. For example, according to PTOC, 13 of the state's 15 counties exceeded their TNT rates in 2005.

*"2% Levy Limit"*

Each non-school district taxing jurisdiction uses a levy limit worksheet to calculate the maximum allowable levy and thus tax rate under the Arizona Constitution. As noted above, the primary tax levy on existing property cannot grow by more than 2% above the maximum allowable levy in the previous year. This means that whenever all existing property appreciates by less than 2% in a taxing jurisdiction, its maximum allowable tax rate will increase; when it appreciates by more than 2%, its maximum allowable tax rate will decrease.

Non-school districts with a LARP appreciation rate of less than 2% would have the same maximum allowable tax rate under HCR 2035 as under current law. By contrast, all other non-school districts would have a higher maximum allowable tax rate than under current law. The "2% levy limit" provision would apply to a smaller existing tax base under HCR 2035 than under current law, which would cause the maximum allowable tax rate to increase. For example, all existing property in Maricopa County grew by 5.1% in tax year 2005, of which 6.3% was attributable to LARP, (1.5)% to LAPP, and (1.6)% to CVP. The 2% growth cap of LARP under HCR 2035 would have had the effect of reducing the growth of all existing property from 5.1% to 1.0%. Since all existing property in Maricopa County grew by 5.1% in tax year 2005, the "2% levy limit" provision required a reduction of the maximum allowable tax rate by (3.1)%. Under HCR 2035, the growth cap of LARP would have reduced the overall appreciation rate to 1.0%, which under the "2% levy limit" would have had the effect of increasing the maximum allowable rate by 1.0%. This means that the Maricopa County maximum allowable tax rate would have been 4.1% higher under HCR 2035 than under current law. However, while Maricopa County adopted the maximum allowable tax rate in 2005, it is not certain that the county would have done the same if HCR 2035 had been in effect at that time.

In conclusion, the impact of HCR 2035 on future non-school district tax rates cannot be predicted with certainty. While local TNT has the potential to reduce non-school district tax rates even under HCR 2035, it is unlikely do so as long as taxing districts continue exceeding their TNT rates. By contrast, the "2% levy limit" will cause the maximum allowable tax rates to increase since the 2% growth cap of LARP under HCR 2035 will result in an overall property appreciation rate of less than 2%. As noted above, this results from the fact that property other than LARP tends to depreciate. Thus, if taxing jurisdictions respond to the 2% growth cap by increasing their primary tax rates, as allowed under the constitution, there is also the risk that the state's cost for the "1% Cap" could increase. Under this scenario, tax rates would increase over time, which could result in significant future cost increases of the state's "1% Cap" program. However, as noted above, neither the direction nor the magnitude of tax rate changes under HCR 2035 can be predicted with absolute certainty.

General Fund Revenues

Besides General Fund expenditures, HCR 2035 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.

Summary

The direct fiscal impact of this bill depends on whether the state TNT impact is included or not. In the absence of a TNT adjustment of the statutory school district tax rates, it is estimated that the bill would increase the state General Fund cost by $46.7 million in FY 2009. However, if the K-12 tax rates are adjusted to account for TNT, the bill is estimated to save the General Fund $(4.2) million. Besides the direct fiscal impact resulting from the change in NAV and the K-12 tax rates, the bill has also the potential to indirectly affect the cost of the state's "1% Cap" program by impacting non-school district tax rates, as explained above.

**Local Government Impact**

HCR 2035 will result in a primary property tax revenue loss for local governments and/or a tax shift from owners of locally assessed real property to owners of centrally valued property and locally assessed personal property. In addition, since the bill would also limit full cash value growth, it would have the effect of raising the secondary property tax rates in order to pay off existing bonded indebtedness. HCR 2035 would also reduce the future debt capacity of counties, cities, towns, community colleges, and school districts due to the existing debt limitations under the Arizona Constitution.

5/04/06