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Property Tax Compression: Growing the State Share Without Improving School Funding

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The Texas Constitution declares the mission of our public education system *'is to ensure that all Texas children have access to a quality education that enables them to achieve their potential and fully participate now and in the future in the social, economic, and educational opportunities of our state and nation.'* Texans of all backgrounds value public education and strive to unlock its promises of opportunity and shared prosperity.

How to fund a quality education across our growing and diverse state has been debated by the legislature and in the courts for decades. The first legal challenge, *Rodriguez* v. *San Antonio ISD* in 1968, claimed the school finance system was discriminatory towards students in poor school districts. The Supreme Court of the United States ruled that education was not a fundamental right and that school funding should be judged by the state constitution, not the U.S. Constitution. Then in 1989, the Texas Supreme Court ruled in the first *Edgewood* case that the school finance system was unconstitutional and stated that an efficient system must provide "substantially equal access to similar levels of revenue per pupil at similar levels of tax effort."

This principle of tax equity, "equal revenue for equal taxation," was upheld until the passage of House Bill 3 in 2019 fundamentally undermined it.

When passed, HB 3 was an $11.6 billion school finance and tax cut law that dedicated over $6 billion toward investments in education and $5 billion toward replacing school property taxes with state funds. The property tax cut provisions of HB 3 expand each year as property values grow across the state.

While HB 3 makes an ongoing financial commitment to property tax cuts, no similar promises were made to the children of Texas to keep pace with rising education costs or fix other funding shortfalls. Base level per student funding of $6,160 has remained unchanged since it was set in 2019.

Meanwhile, tax "compression" (rate cuts) cost the state $1.1 billion for the 2022-23 biennium. The base House and Senate budgets for 2024-25 estimate HB 3 compression to cost $3.118 billion for the biennium. Both chambers are also proposing an additional $2.156 billion in compression above what is required in current law. Both chambers failed to appropriate any additional funds for public education in the base budgets but expressed an intent to do so.

The most harmful aspect of HB 3 is that it forces individual school districts to compress (lower) property tax rates based on property value growth that is greater than statewide average growth. As a result, the main property tax rate used to support schools varies across districts rather than everyone taxing at the same rate for the main portion of the property tax that supports schools.

School districts with high property value growth will see their rates decrease faster than those with slower growth. Because all districts will still be entitled to similar levels of revenue for that portion of the property tax, regardless of tax rate, the state is now requiring school districts with less robust property value growth to subsidize lower tax rates for school districts seeing greater economic growth. This is a complete departure from the tax equity principle of equal revenue for equal taxation.

The ongoing property tax cuts in HB 3 limit the resources available to address rising educational costs due to inflation, improve teacher compensation, or fill other funding holes left by HB 3 such as the need to fund full-day Pre-K or improve funding for special education, bilingual education and support for low-income students. This session the legislature should put students first by raising the basic allotment, adjusting it annually for inflation, and adopting enrollment-based funding before granting additional costly and inequitable property tax cuts.

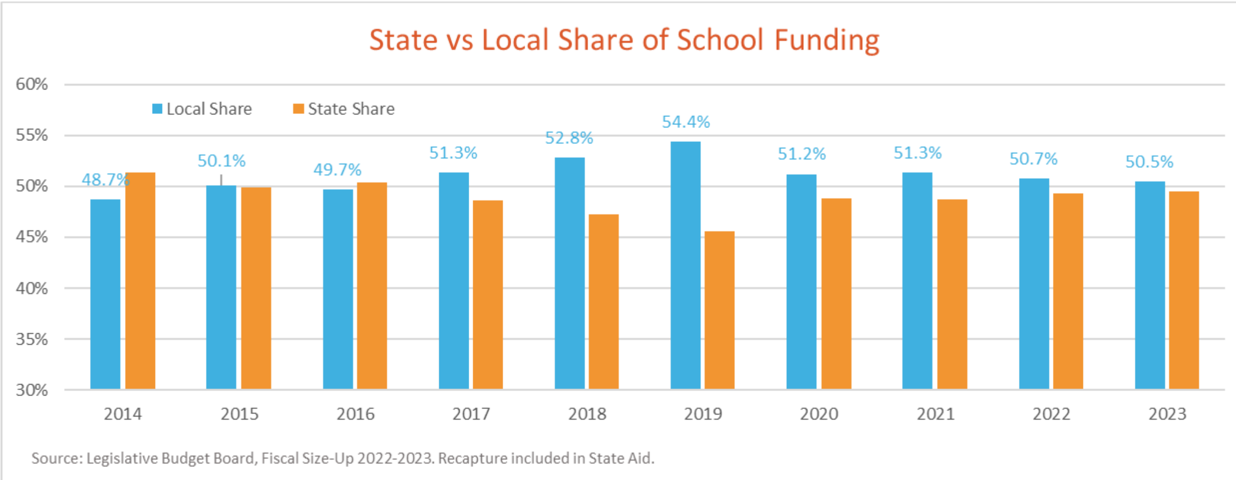
How Schools are Funded: State Revenue and Local Property Taxes

Funding for Texas schools comes from state revenue and local property tax collections. Each school district's demographics and other characteristics are run through a complex set of formulas to determine how much funding it is entitled to have for operations. Revenue collected from property taxes is used first to meet the funding entitlement. If a district is unable to generate all its funding locally, the state provides aid. If a district is able to generate local revenue beyond its entitlement, the excess revenue is collected by the state for redistribution to other districts and charter schools – this is known as recapture.

Prior to HB 3, when local economies were strong and property tax collections increased, the state was able to reduce its contribution to schools while ensuring that schools still received the entitled amount of state/local total revenue. State budget writers were able to take advantage of rising property tax collections because it allowed them to allocate fewer state funds for public education. As a result, the state's share of school funding would decline each year.

In a radical change, under HB 3, the state does not fully reduce its contribution to schools when property tax revenues increase. HB 3 reduces the Tier I Maintenance & Operation portion of the school property tax through both a *Statewide Tax Rate Compression* and an *Individual School District Tax Rate Compression*. Tier I is the largest portion of the M&O school property tax — it generates the money needed to run schools, pay teacher salaries, cover the cost of utilities, and provide a base level of education. Tier II allows school districts the discretion to raise additional funds to support their educational programs.

Now all school districts must decrease their local tax rates if a certain statewide average property value growth is reached. School districts that experience individual value growth above the statewide average are forced to reduce their tax rates even further. As a result, fewer local property tax dollars are collected overall. To ensure schools receive the same level of funding, the state needs to dedicate more state dollars to public education.



This change shifts where school funding comes from but *does not* increase the amount of funding for schools. Without a new source of revenue to replace lost property tax collections, education funding will become even more reliant on volatile sales tax collections. This session the Legislature has a record level beginning balance due largely to inflationary impacts on sales tax collections. If sales tax collections decline, education spending is at risk of future cuts. The state needs a robust revenue system that is able to keep pace with our growing population and increasing need for state services like affordable health care and quality higher and public education.

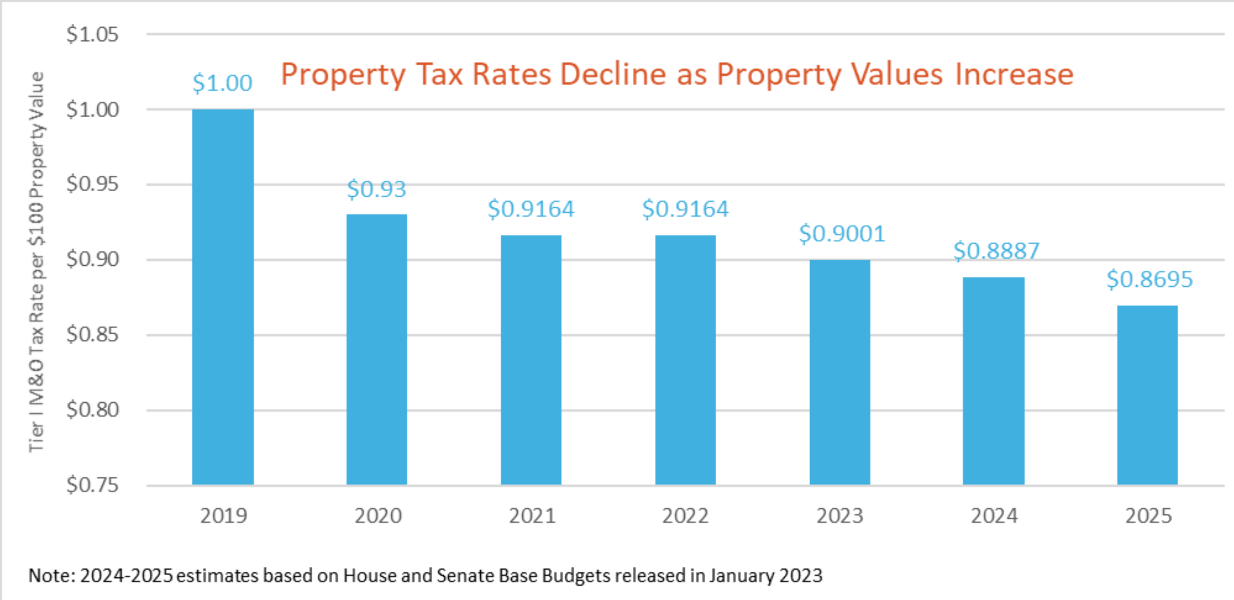
Statewide Tax Rate Compression

Prior to HB 3, school districts taxed property owners at a rate of $1.00 per $100 of property value to generate the revenue needed to operate its schools. This is referred to as the Tier I Maintenance & Operation (M&O) tax rate. At the tax rate of $1.00 per $100 of property value, for example, the owner of a house with a taxable value of $200,000 pays $2,000 for this portion of the M&O tax to support public education.

HB 3 required all school districts to reduce Tier I M&O tax rates to $0.93 per $100 of property value from $1.00 per $100 of property value for tax year 2020. The owner of a $200,000 house would be taxed $1,860 at this tax rate, but the state must still provide the school district its full formula funding.

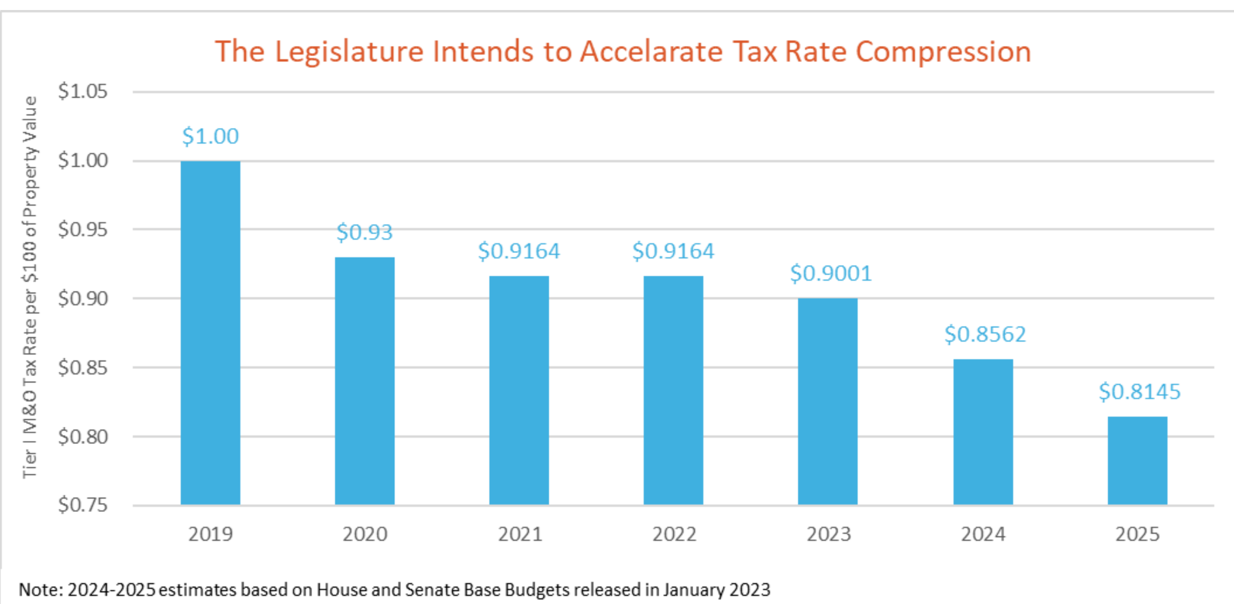
Going forward, tax compression is based on the extent to which statewide property value growth estimates exceed 2.5% each year. The Comptroller's office estimates property value growth, those estimates are then reported to the Legislature and recorded in the General Appropriations Act (the state budget). The higher the estimated property value growth, the greater the tax rate compression.

Because the compression is based on statewide property value growth, some districts see a greater decline in tax rates than they experience in growth of property tax collections. As a result, the state experiences an added cost to keep those districts whole.



For tax year 2021-22, the estimated property value growth was 1.84%, and no further statewide compression happened that year because growth was below 2.5%. For the current tax year 2022-23, the estimated value growth was 4.36% and brought the Tier I M&O tax rate down to $0.9001 per $100 of value. This modest level of compression cost the state $1.1 billion over the biennium. For the 2024-25 biennium the House and Senate base budgets estimate the rate of value growth to be 3.82% for 2024 and 4.56% for 2025. This will bring the Tier I M&O tax rate down to $0.8695 per $100 of property value for a cost of $3.118 billion for the biennium.

The base budgets for the House and Senate both seek to accelerate tax compression by setting the property value growth rate at 7.75% for both years of the biennium. This would bring the M&O Tier I tax rate down to $0.8562 per $100 of property value for 2024 and $0.8145 for 2025 and would cost an additional $2.156 billion, for a total spending of $5.274 billion on property tax rate reductions.

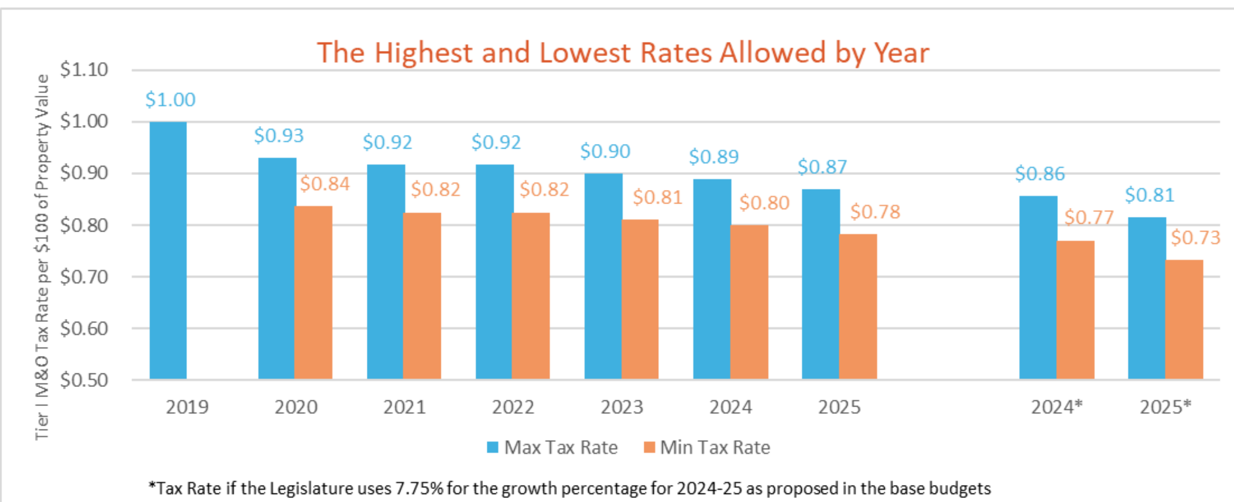


The Tier I M&O tax rate will continue to decline with property value growth each until it is completely eliminated. The Legislature has not identified an alternative revenue source to replace this ongoing loss of property tax revenue. Sustained loss of property tax revenue will strain the budget and eventually lead to future cuts in education spending.

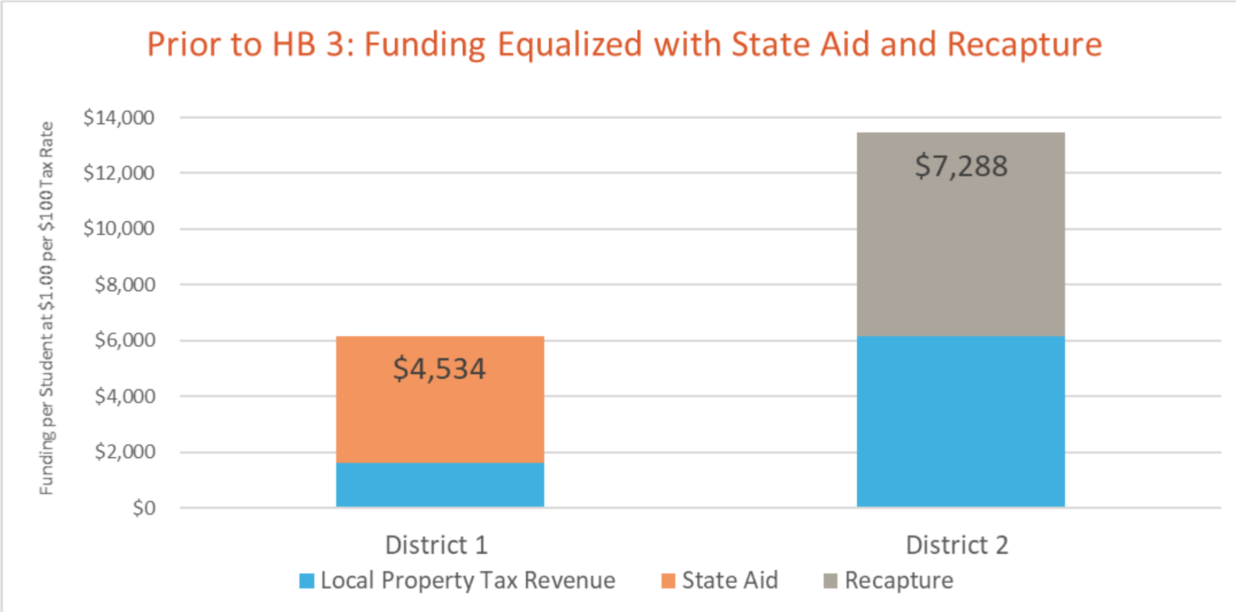
The budget is a declaration of values, and the base budget introduced by both chambers of the Legislature clearly prioritizes tax cuts over investments in the school children of Texas. In addition to the $5.274 billion for tax compression, both versions of the budget include an additional $9.726 billion to cut property tax collections for schools even further. While both base budgets included a statement of intent to increase school funding, no dollar amount was appropriated, yet $15 billion in total was directed toward reducing property tax collections for schools.

Individual School District Tax Rate Compression

In addition to the statewide tax rate compression, a school district is required to reduce its tax rate if the district's individual property value growth exceeds the statewide average or exceeds 2.5% if the statewide average was below that threshold. For the 2022-23 tax year, a district would need to experience property value growth above 4.36% to trigger additional tax compression. There cannot be a gap greater than 10% between the highest and lowest taxing districts. Currently the lowest allowed Tier I M&O tax rate for 2022-23 is $0.8046 per $100 of property value.



Prior to the passage of HB 3, the Texas school finance system was based on the *Edgewood* tax equity principle, upheld repeatedly by the courts, that all school districts must have access to similar levels of revenue for similar tax effort. Every child in Texas is guaranteed the same level of education, so it is important that all communities put the same effort (measured by tax rates) into supporting public education. The state's role was to equalize funding between property-poor and property-wealthy districts through a combination of state aid and recapture.



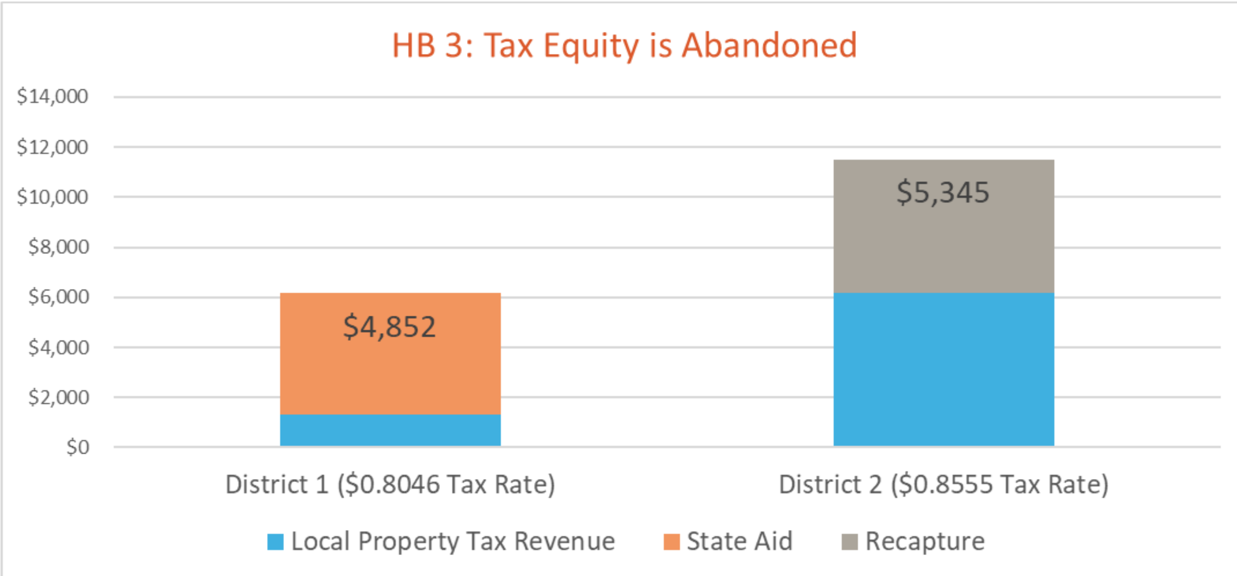
It is not unusual to see large disparities in per-student property wealth between neighboring districts, based on historic discrimination in establishing school district boundaries. The chart above is based on two San Antonio school districts, Edgewood ISD (District 1) and Alamo Heights ISD (District 2), showing what it would take to equalize both to $6,160, the current basic allotment amount with both districts taxing at $1.00 per $100 of value.

For the 2022-23 school year, Alamo Heights ISD has over $1.3 million in property value per student to tax from, while Edgewood ISD has $162,603 in property value per student.[1] These wealth disparities are often the result of the formal and informal racial and economic segregation that has shaped communities over time, especially in urban and suburban areas. An analysis by Vox shows how public officials drew school districts and attendance boundaries to perpetuate residential segregation.[2] Edgewood ISD historically educated migrant children and was excluded from consolidation with other districts in 1949 when the state system of public education was being formalized.

In a radical change, HB 3 abandons the principle of “equal revenue for equal taxation” and allows districts to still receive relatively similar levels of funding at differing levels of tax effort.

[1] Texas Education Agency. 2022-23 Summary of Finance for Alamo Heights ISD and Edgewood ISD. Weighted Average Daily Attendance (WADA) used for student count to more accurately reflect student need in each district.

[2] Chang, Alvin. *We can draw school zones to make classrooms less segregated. This is how your district does.* Vox; 2018. https://www.vox.com/2018/1/8/16822374/school-segregation-gerrymander-map



In the chart above, both districts are still being equalized to $6,160 per student, but are taxing at different rates to get there. Tax rates are tied to property value growth, not property wealth, and in this example the faster-growing property-poor district is actually taxing at a lower rate than the lower-growing property-wealthy district. Education costs for the state increases as it pays more state-aid to the property-poor district and collects less recapture from the property-wealthy districts, but there is no change in the amount of revenue available to schools.

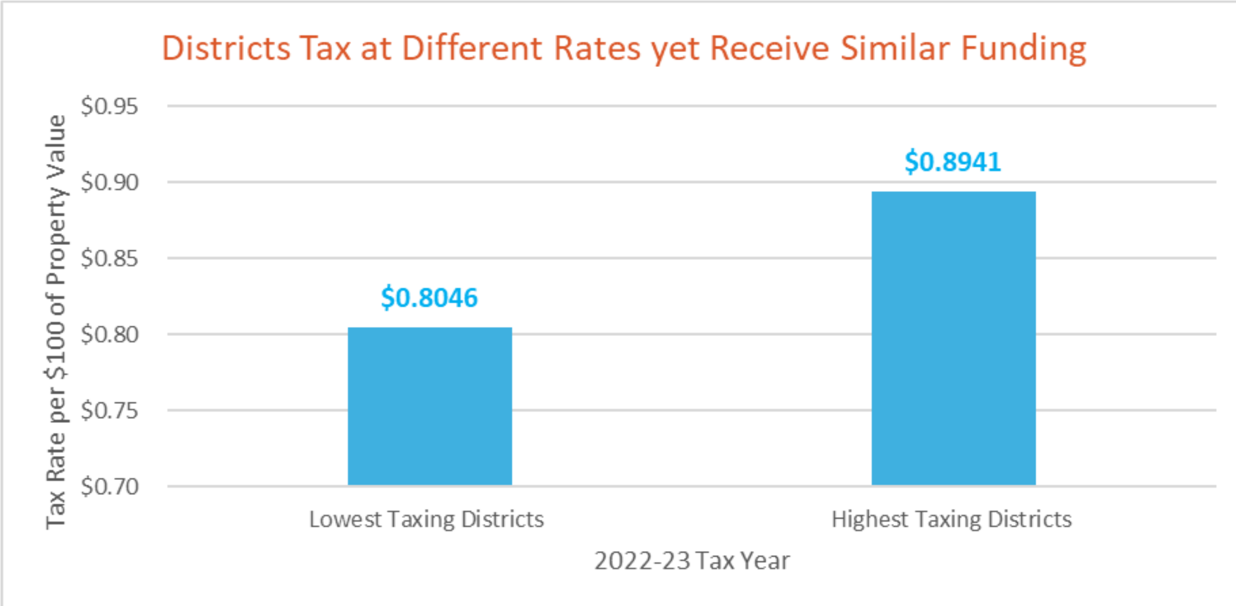
New Divisions Between School Districts

Property wealth levels have long been used to sow discord between property-poor and property-wealthy school districts. Though recapture is a tool intended to level the playing field between districts, by keeping school funding levels harshly inadequate, the Legislature has used recapture to divide districts and create distractions that keep districts from coming together to advocate for full funding for all.

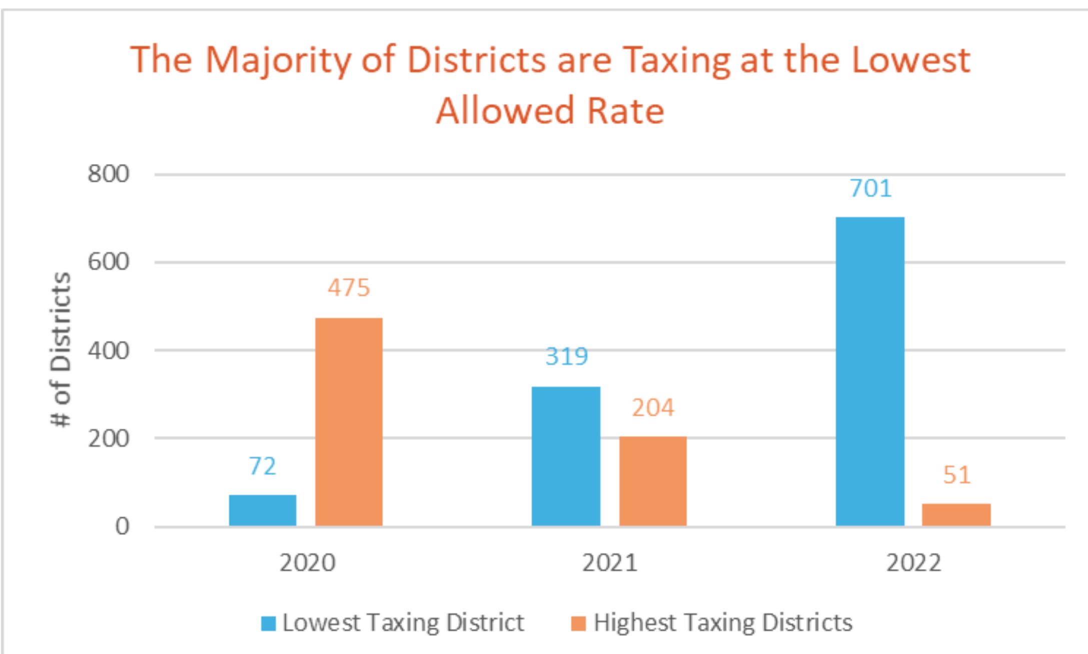
In addition to property-wealthy and property-poor districts, HB 3 has created divisions around high and low taxing districts that are most easily seen when comparing districts by community type and family incomes.

High and Low Taxing Districts

Instead of all school districts taxing at the same Tier I M&O tax rate to generate similar levels of funding, tax rates currently range from $0.8046 per $100 of property value to $0.8941. HB 3 caps the inequity gap at 10% between the highest and lowest taxing districts.



The number of lowest taxing districts has accelerated substantially since individual district compression started in the 2020-21 tax year. Currently 69% of districts are at the lowest allowed taxing rate, compared to 7% in 2020-21. Meanwhile, only 5% of districts are currently at the highest rate, compared to 47% of districts in 2020-21.[3] This large growth in districts taxing at the lowest rate is due to property value growth being much greater than anticipated by the Comptroller when setting estimates during the 2021 Legislative Session.



Property Wealth vs Property Value Growth

Because property value growth determines tax rates, divisions between districts based on

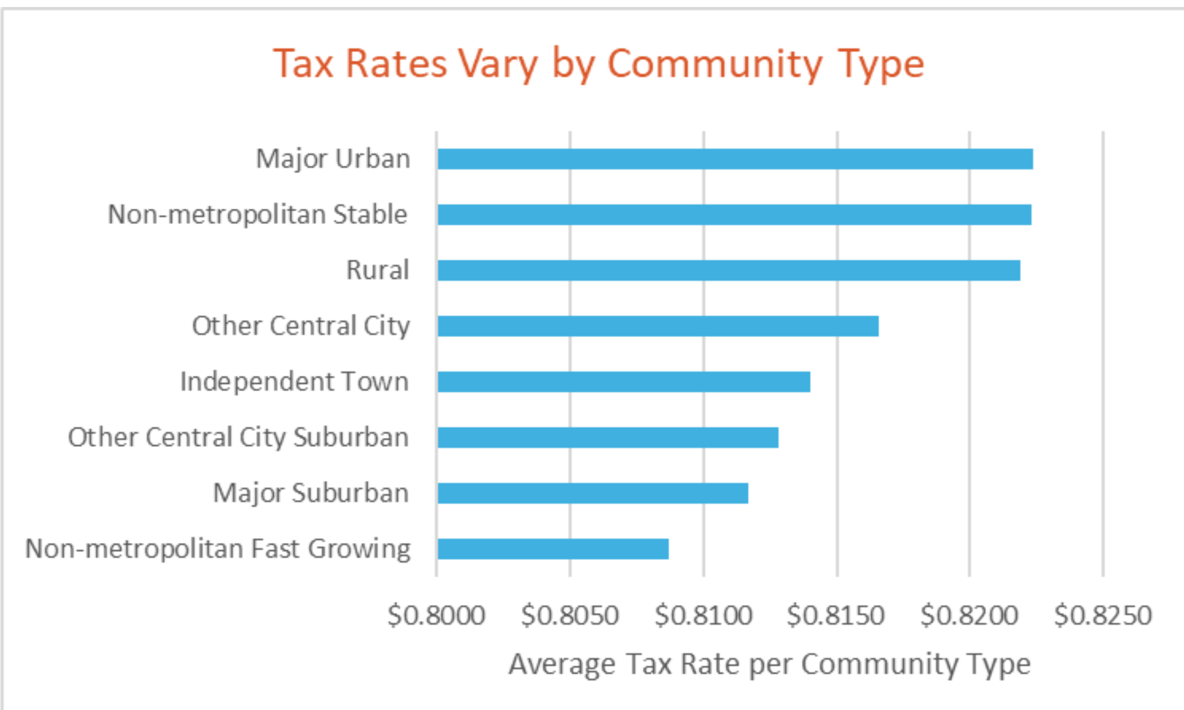
[3] Texas Education Agency. Maximum Compressed Rate 2020 and 2022.

property wealth are not as immediately apparent. The average Tier I M&O tax rate for property-wealthy school districts designated as recapture districts is $0.8158 per $100 of property value. That is just slightly less than the average rate of $0.8195 for a non-recapture district.

When a recapture district reduces its tax rate, its recapture payment goes down because it collects less money. The state must make up for those lost recapture dollars. When a non-recapture district sees its rates decrease it too collects less revenue and the state fills the gap. In both scenarios the cost of education for the state goes up, but kids in classrooms do not benefit.

Tax Rates Vary by Community Type

The starkest divisions in Tier I M&O tax rates can be seen between different types of communities.[4] Because the tax rate is based on property value growth, it is not surprising that non-metropolitan fast growth districts on average have the lowest tax rate compared to any other community type. The Texas Education Agency classifies these districts as having seen enrollment increases of 20 percent or more over five years, and at least 300 students enrolled that represent less than 75 percent of students in the county.[5] These communities are growing by adding new businesses, housing, and other development — that growth is reflected in property value appraisals.



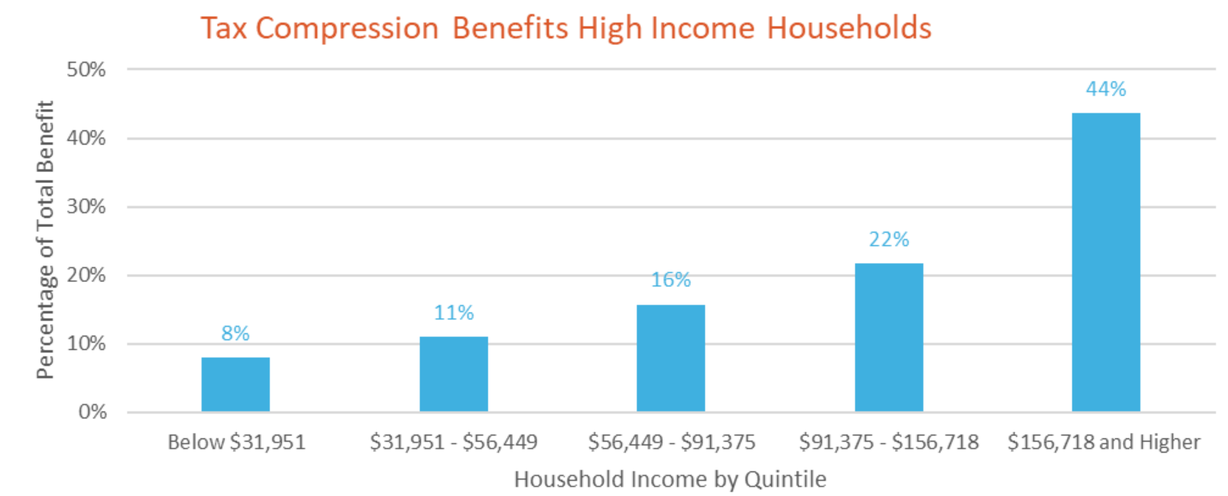
[4] Every Texan analysis of Texas Education Agency *2018-2019 Snapshot Data, Tax Year 2022 Final Maximum Compressed Tax Rate*.

[5] Texas Education Agency. District Type Glossary of Terms, 2018-2019. https://tea.texas.gov/reports-and-data/school-data/district-type-data-search/district-type-glossary-of-terms-2018-19

This [map link] allows you to explore school district tax rates by community type across the state.

Tax Compression Provides a Greater Benefit to High Earning Households

Tax compression benefits wealthy households the most. For every $1 billion spent on tax compression only 8% benefits the lowest income Texans.



Source: Texas Comptroller of Public Accounts, Biennial Property Tax Report Tax Years 2020 and 2021, Dec 2022

Households with higher incomes pay the most in property taxes, so when rates are reduced they see the most benefit. Texans will lower incomes are more likely to rent and there is no guarantee that rents will decrease as property tax rates decline.

Tax Compression Puts Kids Last

The lasting legacy of HB 3 may be the slow elimination of the Tier I M&O property tax without a plan to pay for it. Now the Legislature wants to accelerate tax compression while ignoring the needs of our schools. Base level per student funding has been stagnant for four years, leaving our students in overcrowded classrooms with underpaid educators. Prioritizing tax rate compression puts the children of Texas last.