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A Cautionary Update on General Obligation Bond Property Taxes

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[Editor's note: From time to time, we publish guest articles that we think inform readers on topics of interest. Necessarily, the views and opinions of the authors are their own, but we think the article below is interesting and informative.]

Economic conditions will impact property taxes in a rare way this upcoming 2010-11 year. Many school districts have issued general obligation bonds, which are repaid from property taxes, to help fund facilities projects. Many school districts made campaign promises along the way as to what tax rates the community should expect. Many school districts rely on continued support from their community at the ballot box for supplemental revenues, both for operations (such as parcel taxes) and for facilities projects (such as general obligation bonds). For these school districts, this article will explain an important factor influencing your community's property tax bills this upcoming year, and how to prepare for what's ahead.

A Refresher on Property Taxes

A brief refresher on property taxes will be helpful in understanding how they are being impacted in these economic times. As a result of Proposition 13, passed in 1978, general property taxes are limited to 1% of a property's assessed value. Additional property taxes can be added if approved by voters at an election, and these can be a percentage of assessed value as well (such as general obligation bonds) or can be based on another formula such as per parcel, per unit, per square footage, etc. (examples include parcel taxes and Mello-Roos taxes).

Assessed values can only be adjusted due to the following:

1. Property is sold, and assessed value is adjusted to the sale price
2. Property is improved, and assessed value is increased to include the value of the improvement
3. Market value declines below assessed value, and assessed value can be decreased to the market value
4. A year passes, and assessed value is adjusted by the change in the California Consumer Price Index (CCPI), not to exceed 2%

Most general obligation bonds have a fixed interest rate, and therefore a fixed debt service repayment schedule. Counties collect property taxes to repay general obligations as a rate (or percentage) of assessed value. When assessed values decline, counties need to charge a higher rate in order to repay the same debt service. When debt service repayment schedules increase over time based on assumed growth in assessed

value, as is common with 55% voter approval general obligation bonds, the increase in the rate that counties need to charge is exacerbated.

What We Saw This Year (2009-10)

2009-10 was itself an unusual year for property taxes. After a decade or so of robust growth, this year saw dramatic declines in the market values of property around the State. Therefore, many property owners had their assessed values decreased to market value (also called a Proposition 8 reduction after the authorizing legislation). As a result, in many school districts the total assessed value within the district boundaries declined.

To give a sense of how severe the decline in market values was this year, for the first time since 1933, when the State Board of Equalization began keeping records, total assessed value in the State declined. From 2008-09 to 2009-10, assessed values statewide fell 2.4%. In dollar terms, this was a fall of \$107.2 billion in property value.

The unprecedented decline in assessed values Statewide occurred *despite* the fact that the CCPI increased at 3.477%. Therefore, those homes that did not change ownership, did not have improvements, and market value did not fall below assessed value, grew at the maximum rate of 2%. This growth in a portion of homes helped to prevent a more serious decline.

The consequence of a decline in assessed value means that general obligation bond property tax rates increase from the prior year. Each school district will need to compare their current property tax rate against the tax rate communicated in the ballot materials, and specifically the tax rate statement, to determine whether the current tax rate is still below what was estimated to voters in the election.

What to Expect in the Upcoming Year (2010-11)

The State Board of Equalization announces the adjustment to be used for assessed values each year in mid December, based on the October year-over-year change in the CCPI as determined by the State Department of Industrial Relations. The State Board of Equalization published the October change as -0.237% in a letter to County Assessors dated December 14, 2009. Therefore, the assessed value adjustment factor will be 0.99763.

Since the passage of Proposition 13 in 1978, this will be the first time the change in CCPI has been negative. There were five occasions previously that the CCPI grew less than the maximum 2% rate (1983-84, 1995-96, 1996-97, 1999-00, and 2004-05), but even on these occasions the growth was at least 1%. Because a negative CCPI rate has never occurred, there was some questions as to how the State Board of Equalization would interpret the application of a negative rate to adjusting assessed values. The State Board of Equalization previously announced in a letter dated September 2, 2009, that it would adjust assessed values negative should the CCPI rate be negative, and it reiterated this position in its letter dated December 14, 2009.

As a result, those homes that do not change ownership, do not have improvements, and market value does not fall below assessed value, will suffer a small decline in assessed value. This means that Proposition 8 reductions, due to market value falling below assessed value, will not be bolstered this year by growth in the CCPI. Hopefully though, the largest impacts to market values were felt in the 2009-10 year, and so the Proposition 8 reductions will not be as severe in 2010-11. If so, school districts will not see as dramatic a

fall in their assessed values, and property tax rates will not increase as much. However, while the upcoming year may be less of a bad situation, the change in CCPI suggests that it will also not be a return to substantial positive growth.

One silver lining to Proposition 8 reductions is that, when the real estate market rebounds, assessed value increases are not limited to the 2% maximum rate. County Assessors still keep track of what assessed values would have been absent Proposition 8 reductions. On a rebound, County Assessors can increase assessed values with the increase in market values, as long as they do not exceed what the assessed values would have been absent the Proposition 8 reductions. Therefore, when a rebound occurs, it is more likely to result in significant increases to assessed value growth.

How to Prepare for What's Ahead

Based on the CCPI, 2010-11 will not be a "return to normal" for growth in assessed values. Therefore school districts should understand how they are faring with respect to their growth in assessed values and their property tax rates, as compared to what was planned for during the general obligation bond election. This will help school district staff to be prepared to address questions from the Board and the community, and the month of December is a likely time for questions to be raised, given that most property owners have just paid the first installment of their property taxes. Those school districts that used conservative assumptions, and had elections sufficiently long ago to benefit from assessed value growth, will be in the best shape.

For several school districts, a key limitation in their financing plans is bonding capacity. Bonding capacity limits the amount of general obligation bonds that can be issued to 1.25% of assessed value for a union school district and 2.50% of assessed value for a unified school district. Because bonding capacity is dependent on assessed value, many school districts will not see expected growth in their bonding capacity, and may see their bonding capacity decline. Those school districts that are at, or near, their bonding capacity may need to issue less bonds, or delay the issuance of bonds until bonding capacity has had a chance to grow. Another potential option is to obtain a waiver of bonding capacity. School districts may request the State Board of Education to waive the particular section of the Education Code that includes the bonding capacity limitation. The State Board of Education has been willing to grant waivers in the past if need is demonstrated, and in the instance of 55% voter approval general obligation bonds, if the estimated tax rates will still be below the legal maximum tax rate projection of \$30 per \$100,000 for a union school district and \$60 per \$100,000 for a unified school district.

Some school districts are considering bridge financing as a tool to continue financing facilities projects while being unable to issue general obligation bonds. Common bridge financing methods include bond anticipation notes and certificates of participation. School districts need to be extremely cautious when considering such an approach. Those school districts planning for bridge financing typically plan to repay the financing with the eventual issuance of general obligation bonds, and commonly with State funding as well. However, in this recessionary climate, and given the State's budget and financial problems, being able to issue general obligation bonds and/or receive state funding in time for repayment of a bridge financing is a risky proposition. Even more worrisome, bond anticipation notes are often an obligation of the General Fund, and certificates of participation are always an obligation of the General Fund. Most school districts are not prepared to have their General Fund support a bridge financing if needed. Therefore, extreme caution and conservatism is needed if bridge financing is being considered.

For those school districts that are currently planning a general obligation bond election, the change in CCPI

stresses the need to be conservative with assumptions of assessed value growth, particularly over the next few years, as it remains unclear when growth will return to being more consistent with long-term historical trends. It also underscores the need to look back at assessed value changes during previous recessionary times. Those school districts relying on only five or ten years of historical assessed value growth upon which to base their assumptions will only be capturing the robust growth of a booming real estate market. School districts should look back at the last real estate recession, in the early to mid 1990s, to better gauge how assessed value growth might fare during a recession.

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