
CITY COUNCIL REPORT

POLICY AGENDA

TO: David Cavazos
City Manager

AGENDA DATE: April 9, 2013

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ITEM: 5A

SUBJECT: PROPERTY TAX UPDATE

This report provides an update on City of Phoenix property tax for information and discussion; no Council action is required.

Property values have dropped over the last four years and the City of Phoenix maintained a total property tax rate of \$1.82 per \$100 of assessed valuation. As a result, since 2009-10 on a cumulative basis, Phoenix taxpayers have had their property taxes reduced by \$401 million. In 2013-14, Phoenix property taxes will be \$16 million less than 2012-13. The typical single family home Phoenix property tax bill has dropped from \$407 per year to \$214 per year during this period.

THE ISSUE

Property Tax Background

In Arizona, municipalities may assess two separate property tax levies, the primary property tax levy to fund operation and maintenance expenses and the secondary property tax levy to pay the debt service related to voter-approved capital projects. The two levies combined reflect the property taxes paid by businesses and residents in the City of Phoenix. For Phoenix, the combined property tax rate, per City Council policy, has been set at a \$1.82 per \$100 of assessed valuation since 1995 by maximizing the primary property tax levy and using the balance of the \$1.82 tax rate to fund the secondary property tax levy. Bond programs since the 2001 bond program have been funded from the combined \$1.82 tax rate.

The **Primary Property Tax** is levied to pay the current costs of operations and maintenance such as utilities, fuel and staff. This tax is levied on property values that are limited in growth under state law and will be further limited by Proposition 117. Further, the amount a municipality may levy each year is limited by state law to 2 percent over the prior year's maximum allowable levy plus the tax amount associated

with newly constructed or improved properties not taxed in the previous year. The maximum allowable primary levy may be adjusted upward in the amount of involuntary tort judgments paid by the municipality and approved by the Property Tax Oversight Commission.

The **Secondary Property Tax** is restricted by state law to be used to pay the costs of servicing debt on voter-approved bonds. This tax is levied on full cash property values known as secondary assessed valuation. Prior to Proposition 117 taking effect in 2015, there is no limit on growth in the property values other than the levy must be adequate to meet debt service requirements. Voter-approval is required to use property tax supported bonds.

Impacts Due to Real Estate Market Declines

From the peak in 2009-10 compared to the 2013-14 data recently received from the County Assessor's Office, secondary assessed property values in Phoenix declined 47 percent, from \$18.9 billion to \$10.0 billion. As a result, Phoenix taxpayers will pay \$141 million less than they were at the peak due to maintaining the \$1.82 combined tax rate. Cumulatively, that is a \$401 million, reduction in property taxes paid to the City of Phoenix since 2009-10. The typical single-family home Phoenix property tax bill has dropped from \$407 per year to \$214 per year during this period. The impact of these large declines has put significant pressure on the capital program as the City has maintained the allowed primary property tax revenues for the General Fund operating revenues which are a critical element of the City's AAA bond rating.

City Council Approved Property Tax Policy

On May 25, 2010 as a result of the continued decline in assessed valuations, the City Council voted 9-0 to adopt a new property tax policy to provide confidence to investors and to maintain the City's excellent credit ratings. Besides agreeing to maintain the combined primary and secondary property tax rate through the use of the secondary property tax reserves, the policy contains three options that would be considered in the event the reserve was inadequate due to continued declines in assessed valuations. Those include the following:

- (1) Allow the secondary property tax rate to float up;
- (2) Allow the primary property tax rate to float down; or
- (3) Use other general fund resources to cover General Obligation (GO) bond debt service

Other actions taken were to delay portions of the 2006 bond program and to restructure and refinance GO bonds to reduce the near term debt service to maintain the \$1.82 tax rate. A six-to nine-month reserve of secondary property tax revenues was also targeted.

In the December 2011 action on the bond-funded projects, the Council also affirmed the following property tax policy items:

1. Maintain the \$1.82 combined property tax rate.

2. Refinance and restructure GO Bond debt as necessary to take advantage of the City's AAA rating and savings from lower interest rates.
3. Strategically use the secondary property tax reserve fund until it reaches an average minimum balance of six to nine months of debt service, which avoids any bond rating impacts.
4. Continue annual primary levy growth to help offset funding the operation of GO Bond-built facilities.
5. Move forward with approximately \$132 million in GO Bond projects, while deferring the remaining projects until future economic and financial conditions allow, to be reviewed annually.
6. Initiate a process to identify and evaluate unfunded critical Citywide capital needs to present to the Citizens' Executive Bond Committee and City Council to assess whether those needs could be funded by savings realized from completed bond projects and/or replace some originally-planned bond projects.
7. Annually assess the financial conditions measured against the forecast and other assumptions to determine whether changes to property tax policy or to the Bond Program can or need to be made.

The following provides an update to the above seven policy actions directed by the City Council:

1. As mentioned, the City continues to maintain the \$1.82 rate.
2. Refinancing and restructuring of GO bond debt occurred in 2012, and further actions will take place as it is financially beneficial to do so.
3. Strategic use of the secondary property tax reserve is underway as planned.
4. The 2013-14 City Manager's Trial Budget includes the proposed action to maximize the primary levy as allowed by law.
5. The bond projects authorized to move forward have proceeded and the updated projects are included in the Preliminary CIP.
6. The evaluation of unfunded critical capital needs is in its final stages.
7. This year's analysis of financial conditions and assessed valuations related to property taxes are further outlined in this report.

Updated Financial Analysis

The Finance and Budget and Research departments recently updated property tax information and the assessed valuation forecast. The analysis included a review of current and near-term property tax revenues, development of a long-term assessed valuation forecast that reflects the impact of Proposition 117, and analyzing necessary actions in the capital program to maintain the \$1.82 combined property tax rate given current secondary property tax reserves. To assist in the development of a long-term assessed valuation forecast, a recognized expert in the area of real estate forecasting, Elliott D. Pollack and Company, was consulted to develop a forecast through 2020.

Assessed valuations of all property in the City of Phoenix are conducted by the Maricopa County Assessor's Office. The current year property tax collections actually

reflect market conditions from approximately two years ago. This two-year delay provides the City the ability to forecast revenues fairly accurately two years into the future and adjust capital programs and financing strategies each year.

Assessed Valuation Forecast

Elliott D. Pollack & Company provided a forecast that reflects projected market changes and the impact of Proposition 117. This information was used to determine actions necessary to maintain the \$1.82 combined property tax rate and if any of the three options of floating the primary or secondary tax rates or using other General Fund revenues would be required.

The forecast reflects the reality that secondary assessed valuations have dropped by 47 percent since the peak in 2009-10 to 2013-14. Property values have begun to recover across the state. Based on current market data, Elliott D. Pollack estimates a 10.3 percent increase in total assessed valuations reflecting a 20.4 percent increase in residential and 2.3 percent in all other property values for the 2014-15 budget. After 2014-15, property values will be restricted by Prop 117 in any future recovery of market values.

Impact on Ability to Maintain \$1.82 Combined Tax Rate and Financial Capacity

Using the Pollack forecast and reflecting the reduced recovery in the tax base as a result of Prop 117, an analysis on the financial capacity of the system was completed. Historically low interest rates and the City's AAA bond rating provide opportunities to refinance and restructure existing general obligation debt service to lessen the need to use current reserves. The overriding basis for the analysis was to not recommend any actions that may negatively impact the current AAA credit rating. As a result, the analysis was based on the following assumptions:

- All bonds will be refinanced and/or restructured when callable (ten years after issued and when no penalty is incurred);
- Restructuring will not increase principal & interest costs over term of bonds and the term (last payment date) will not be extended;
- Refinancings and restructuring assume current market (February 2013) for all future refinancing;
- The secondary property tax reserve will be maintained at six to nine months of annual debt service;
- The remaining approximately \$150 million in the 2006 bond program would be deferred until capacity for the program at the \$1.82 combined tax rate recovers; and
- The primary levy will continue to grow as allowed by law to help offset funding operations of GO Bond-built facilities and to maintain the most stable source of general fund revenues (currently approximately 13 percent of total General Fund revenues).

The results of the modeling indicated the cap imposed on the recovery of the assessed valuations related to Prop 117 from the 47 percent decline has an impact to the future property tax base. As a result, the ability to complete the approved \$150 million of the remaining 2006 bond program or future programs at the \$1.82 combined tax rate level is deferred until after 2022. Projects already underway can be completed. The

\$1.82 combined property tax rate can be maintained if interest rates remain at current levels as refinancing and restructurings are completed over the next few years through a drawdown of the secondary property tax reserves.

Impact of Increased Interest Rates

As was mentioned above, the forecast assumes interest rates will remain at the current low levels. To illustrate the sensitivity of the program to interest rates, an additional analysis was completed. If interest rates were to rise by 1.0 percent (100 basis points), impacting the ability to refinance debt service for savings, the combined tax property rate would need to increase 19 cents to \$2.01 by no later than 2019 to maintain the same reserve levels. This continues to assume deferral of the nearly \$150 million remaining in the 2006 bond program until after 2022.

Impact of Advancing Remaining Bond Program or a New Bond Program

Further analysis was completed to determine what level of an increase in property taxes would be required given the current and projected tax base. If interest rates stayed at the current levels and the remaining 2006 bond program or a new bond program were to be advanced forward as early as July 2015, the combined rate would need to increase by an estimated 5 cents to \$1.87 for a \$100 million bond program and 5 cents for any additional \$100 million. This rate would be effective at the date of the new program.

Conclusion

The City continues to maintain a secondary property tax reserve that provides capacity to maintain the current policy of maximizing the primary levy and using the reserve to maintain the combined \$1.82 tax rate. Taxes on Phoenix property owners are \$140.5 million less than at the peak levels of 2009-10. If interest rates remain close to current low levels, by mid-2014 the Finance Department will have the opportunity to complete a significant refinancing of existing general obligation bond debt. This will be a significant step in achieving the plan of finance discussed above. By mid-2014 that time the full impact of property valuation changes will be known before Prop 117 takes full effect. After the 2014 refinancing, critical information necessary to advance the current bond program schedule or to initiate a new bond program would be available to fully determine the impact on property tax rates.

RECOMMENDATION

No Council action is requested.