THE POLICY PAGE
An Update on State and Federal Action

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WHERE DID ALL THE MONEY GO?
The case of the optional homestead exemption

The optional homestead exemption permits school districts to exempt up to 20 percent of the value of residential homesteads from property taxes. Under current school-finance rules, the state replaces one-half of the revenue that school districts lose to the exemption. This provision could cost the state an estimated $224 million in 2005. Fewer than one-quarter of school districts offer this exemption. More than half of the benefit of the exemption goes to homeowners with a family income of over $90,000 per year.

WHAT IS THE OPTIONAL HOMESTEAD EXEMPTION?

The optional homestead exemption (Tax Code, sec. 11.13(n)) permits a school district to exempt up to 20 percent of the value of a residential homestead from school property taxes.

The exemption was enacted in 1981 as part of the wave of reform that created the current property-tax system in the late 1970s. Because the new system required all homes to be taxed at their full market value, rather than at some fraction of the total value, homeowners were facing rapid increases in their values. The optional exemption, along with other statewide mandatory exemptions, were intended to ease the "sticker shock" faced by homeowners.

WHY DOES A LOCAL PROPERTY TAX EXEMPTION COST THE STATE MONEY?

State expenditures are linked to local property tax values through the school-finance system, which guarantees each school district that it will generate a certain amount of revenue per student for each penny of tax effort. If local property values are too low to produce this amount of revenue, the state will make up the difference. If property values are reduced by exemptions, the cost to the state of making up the difference can increase.

Under current law, the state replaces one-half of the revenue that school districts lose to the optional homestead exemption, as long as the education commissioner certifies that the state has appropriated more than enough to fully fund other school-finance formulas. This provision was inserted in the school-finance system in 1999 and has resulted in higher costs to the state in fiscal years 1999, 2001, and 2003. (The commissioner can be sure there will be enough money only in the second year of each biennium.) In each case, higher-than-expected property values increased school-district tax revenue, reducing the need for state aid through other formulas.

WHAT DISTRICTS OFFER THE EXEMPTION?

The optional homestead exemption is currently offered by less than one-quarter of the 1,000-plus school districts in Texas. These districts are clumped in certain areas of the state, probably because the exemptions were adopted in response to competitive pressures within these regions. For instance, none of the school districts in Bexar County offer the exemption, but nine of the 21 districts in Harris County have the exemption.

School districts with high property wealth per student are more likely to offer the exemption than other districts. Of the one-fifth of districts with the greatest wealth, 43 percent grant the exemption, compared to only 14 percent of the one-fifth of districts with the lowest wealth. Among high-wealth districts, Brazosport (which exempts only 10 percent), Coppell, Deer Park, Highland Park, and Richardson (15 percent) have the exemption, but Alamo Heights, Austin, Carrollton-Farmers Branch, Eanes, and Plano do not.

Houston ISD, which offers the full optional exemption, accounts for one-quarter of the total cost to the state of the exemption. Other large districts benefiting from the exemption include Dallas (10 percent) Cypress-Fairbanks, Ysleta, Pasadena (10 percent), Spring Branch, United, Clear Creek (5 percent), and Irving.

A district with little reliance on residential property in its tax base is more likely to offer the exemption than a district that consists primarily of homes, since the exemption has less effect on its total taxable value. Two-thirds of the districts granting the exemption come from the minority of districts with less than 30 percent of their property wealth in residential homesteads; only 28 of the nearly 200 districts that consist primarily of homes give the exemption.

WHICH HOMEOWNERS BENEFIT FROM THE EXEMPTION?

The optional homestead exemption is one of the most regressive exemptions in the Tax Code. According to the comptroller's *Tax Exemptions and Tax Incidence* study, more than half of the benefits received by Texas homeowners goes to the one-fifth of Texas households with an annual income of more than $90,150. Only 19 percent of the benefit of the exemption goes to the one-half of families with an income of less than $44,100 per year.

Since the optional exemption applies to a percentage of the value of a homestead, it reduces the taxable value of a higher-priced home more than the value of a lower-priced home. In contrast, the mandatory statewide exemption of the first $15,000 of a homestead's value is progressive, since it has a greater impact on a low-value home than on a higher-value home.

Of course, families that rent their homes receive no benefit at all from a homestead exemption, which goes only to homeowners. Homestead exemptions also burden business property owners, since a school district must levy a higher tax rate to make up for the value lost to homestead exemptions.

WHY WAS THERE A SURPLUS TO FUND THE OPTIONAL EXEMPTION, BUT NOT IN THE REST OF THE BUDGET?

Under Education Code, sec. 42.2522, the education commissioner examines only whether there is more money appropriated to the Foundation School Program than is necessary to meet the payments scheduled by school-finance formulas. If higher property values increase school-district tax revenue, reducing the need for state aid, there will be excess money available, which permits the funding of the optional homestead exemption and certain other public-education items.

A separate provision in the 2002-03 Appropriations Act links other potential expenditures to the projected existence of a biennium-ending cash surplus. If the comptroller had certified that there was revenue available, items such as a pay increase for state employees and the Texas Grants II program for community and junior colleges would have been funded.

These two surpluses were calculated separately, so there was money available to support a homestead exemption granted by a small fraction of school districts that benefited primarily high-income homeowners, but no money for state employees or low-income community college students.
