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STATEMENT OF REVENUE-NEUTRAL TAX RATE AND PROVISION FOR MID-YEAR PROPERTY TAX RATE CHANGE

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This Finance Law Bulletin discusses the application of G.S. 159-11(e), which requires each taxing unit to disclose a revenue-neutral tax rate in its annual operating budget after a reappraisal year. The bulletin sets forth a model for calculating the revenue-neutral rate and provides sample language for disclosing the rate in a taxing unit's budget message. The bulletin also discusses an amendment to G.S. 159-15 that permits a taxing unit to change its property tax rate in the middle of the fiscal year and analyzes the consequences that may ensue from a taxing unit's decision to exercise that authority.

The Revenue-Neutral Rate as a Tool for Comparative Analysis

The 2003 General Assembly enacted S.L. 2003-264, which added subsection (e) to G.S. 159-11. This amendment requires each taxing unit to publish a revenue-neutral tax rate as part of its budget for the fiscal year following revaluation. Efforts to provide taxpayers and governmental officials with comparative analysis information on property tax rates have been ongoing. The North Carolina Association of County Commissioners has for many years published "effective" tax rates for all 100 North Carolina counties.[1] These rates illustrate the manner in which an increase in property value results in a lowering of the stated tax rate applicable to a parcel of property.

For example, a tax rate of 50 cents applied to a tax base of $10 billion results in a tax levy of $50 million.[2] If the market value of taxable property were to increase from the assessed value of $10 billion to a market value of $12 billion, the effective tax rate would be approximately 42 cents. The taxing unit would be imposing $50 million in property taxes on a tax base of $12 billion. The property tax paid divided by the actual market value of the property would equal 42 cents—the effective tax rate.

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1. *See* North Carolina Association of County Commissioners, *2004–05 Tax Rate Survey*, at http://www.ncacc.org/research/05tax.xls (last visited October 22, 2004).

2. The tax rate is expressed as the amount of tax levied for every $100 of property value.

Because local units may revalue property on different schedules or may have experienced different levels of economic growth, the publication of an effective tax rate helps local officials compare the tax rate imposed by one governmental unit to that imposed by other governmental units. The revenue-neutral rate, in contrast, provides a comparison of the tax burden borne by property owners *within* a particular taxing unit before and after revaluation. The revenue-neutral rate is the rate for the fiscal year after revaluation that, taking into account expected rates of growth in the tax base and excluding increases in market value recognized by the revaluation, would produce revenue that equals the current year's tax levy. The expected rate of growth in the revaluation year is based upon an average of increases or decreases to the assessed value since the last revaluation. This growth or decline is based upon additions to or reductions in a taxing unit's base of taxable property rather than the increases and decreases in market value that are accounted for by the effective tax rate but are not recouped by the taxing unit in nonrevaluation years.

Changes to the real property tax base in nonrevaluation years result from the construction of new homes and businesses, improvements to existing structures, divisions and conveyances of land, rezoning, and other occurrences unrelated to economic conditions affecting the taxing unit in general.[3] Changes in the personal property base occur each year because personal property is valued on an annual basis.[4]

G.S. 159-11(e) provides that the growth factor used in calculating the revenue-neutral rate is based upon the average increase in the tax base "due to improvements since the last general reappraisal." We conclude, as a result, that the term *improvements* was not intended to include only real property improvements, but to encompass all additions and reductions in the tax base recognized in nonrevaluation years. This is because the revenue-neutral rate is the rate necessary to provide the same amount of revenue received by the taxing unit in the current fiscal year. Current year revenue is based on real *and* personal property taxes. Basing the tax levy calculation in a revaluation year upon the rate of growth associated with real property improvements and ignoring the growth rate of personal property would result in an estimated tax levy noncomparable to prior year levies that included all property types.

When a taxing unit experiences overall growth since the last revaluation, the revenue-neutral rate is lower than the current fiscal year's tax rate because a lower tax rate imposed on a larger tax base produces the same amount of revenue. When a taxing unit experiences a decline in taxable property, the revenue-neutral rate is higher than the current fiscal year's rate to account for the smaller base on which to levy taxes.

Calculating a Revenue-Neutral Tax Rate

G.S. 159-11(e) instructs that the revenue-neutral rate is calculated as follows:

1. Determine a rate that would produce revenues equal to those produced for the current fiscal year.
2. Increase the rate by a growth factor equal to the average annual percentage increase in the tax base due to improvements since the last general reappraisal.
3. Adjust the rate to account for any annexation, deannexation, merger, or similar events.

Sample Rate Calculation

Table 1 illustrates a rate calculation for a taxing unit with a general reappraisal effective January 1, 2000, an annexation of property in 2001–02 with an assessed value of $100 million, and a general reappraisal effective January 1, 2004.[5] The first step is to determine a rate that would produce revenues equal to those produced in the current fiscal year. As described in Note D in Table 1, a tax rate of 54.2 cents would produce a tax levy in 2004–05 equal to the tax levy in the current fiscal year (2003–04) of $9,750,000. The second step is to increase the tax rate of 54.2 cents by the average growth factor of 8 percent as calculated from the annual growth rates since the last general reappraisal (9.1+7.7+7.1 / 3).

The third statutorily prescribed step is to adjust the rate to account for any annexation, deannexation, merger, or similar events. This step actually occurs before calculation of the growth rate, as described in

3. *See* G.S. 105-287 (setting forth reasons for which an assessor may increase or decrease the appraised value of real property in a nonrevaluation year).

4. G.S. 105-285(b).

5. The authors thank Professor David M. Lawrence for determining the method for calculating a revenue-neutral rate pursuant to G.S. 159-11(e). *See* A. Fleming Bell II and David M. Lawrence, "Local Government and Local Finance," in *North Carolina Legislation 2003*, William A. Campbell, ed. (Chapel Hill, N.C.: Institute of Government, the University of North Carolina at Chapel Hill, 2003), 124–25.

Table 1. Sample Rate Calculations

Fiscal Year	Assessed Value	Growth Rate	Tax Rate	Tax Levy	Notes
2000–01	$1,100,000,000		0.650	$7,150,000	
2001–02	$1,200,000,000	9.1%	0.650	$7,800,000	A
2001–02	$1,300,000,000		0.650	$8,450,000	
2002–03	$1,400,000,000	7.7%	0.650	$9,100,000	B
2002–03	$1,400,000,000		0.650	$9,100,000	
2003–04	$1,500,000,000	7.1%	0.650	$9,750,000	C
2004–05	$1,800,000,000		0.542	$9,750,000	D

Notes

A. The assessed value for 2001–02 excludes the assessed value of property acquired in an annexation of $100,000,000 for calculating the tax base growth rate between 2000–01 and 2001–02 of 9.1 percent.

B. The assessed value for 2001–02 includes the annexation for calculating the tax base growth rate between 2001–02 and 2002–03 of 7.7 percent.

C. No adjustments have been made for calculating the tax base growth rate between 2002–03 and 2003–04.

D. The assessed value of $1,800,000,000 represents the tax base after the reappraisal of real property. A tax rate of 0.542 would produce a tax levy equal to the tax levy in 2003–04. The tax rate of 0.542 is then adjusted by a growth factor of 8 percent (9.1+7.7+7.1 / 3), which is the average annual growth rate of assessed value since the last general reappraisal, to determine **the revenue-neutral tax rate of 0.585**.

Notes A and B in Table 1. The annexation of $100 million is excluded when calculating the growth factor of assessed value from 2000–01 to 2001–02. However, it is included when calculating the growth factor of assessed value from 2001–02 to 2002–03. The revenue-neutral tax in this illustration is 58.5 cents, which is a decrease from the current tax rate of 65 cents.[6]

Another way of looking at this is to calculate what the tax base would have been if no revaluation had occurred. If growth had continued at the average pace of 8 percent, the tax base in 2004–05 would have been $1.62 billion. At the current tax rate of 65 cents, the tax base of $1.62 billion would have resulted in a tax levy of $10,530,000. To derive this same amount of revenue from the post-revaluation tax base of $1.8 billion, a tax rate of 58.5 cents would be imposed.[7]

Compliance with the Requirement to State the Revenue-Neutral Rate in the Budget

G.S. 159-11(e) requires that the budget officer, in the year in which a general reappraisal of real property has been conducted, include a statement of the revenue-neutral tax rate in the budget for comparison purposes. In other words, a statement of the revenue-neutral tax rate must be included in the budget document for the fiscal year following the January 1 on which the reappraisal became effective. As presented in the previous section, G.S. 159-11(e) contains the formula

6. As of this writing, the N.C. Department of the State Treasurer calculates the revenue-neutral rate in a different manner by excluding the annexed value from the calculation in the first year and in all subsequent years. See N.C. Department of the State Treasurer, *Neutral Property Tax Increase*, *at* http://www.nctreasurer.com/dsthome/stateandlocalgov/auditingandreporting/ (last visited November 3, 2004). The authors believe the better method to adjust for annexation is to exclude the annexation from the year in which it occurs and to recognize it, along with its improvements, in subsequent years.

7. To some degree, the revenue-neutral rate must be based upon estimations of the tax base in a revaluation year because appeals of assessments will not be resolved at the time the rate is published. Successful taxpayer appeals lower the revaluation year tax base.

for calculating the revenue-neutral tax rate. It does not, however, provide for the location of a statement of the revenue-neutral tax rate within the budget or provide recommended language for such a statement.

Recommended Placement

There are several places within the budget document that could be used by the budget officer to address the revenue-neutral tax rate, including the budget message, the budget summary, the revenue section, or the budget ordinance. We recommend that budget officers use the budget message for providing a statement of the revenue-neutral tax rate. One reason for using the budget message is found in G.S. 159-11(b), which requires that the budget, together with a budget message, be submitted to the governing board not later than June 1. The Local Government Budget and Fiscal Control Act does not require the submission of other sections commonly found in budget documents.

G.S. 159-11(b) also recommends that the budget message address any major changes in fiscal policy and in appropriation levels. A difference between the actual tax rate for the forthcoming fiscal year and the revenue-neutral tax rate represents a change in fiscal policy, resulting in an effective tax increase or decrease for taxpayers. Because the revenue-neutral rate may represent such a shift in fiscal policy, we do not recommend incorporating such a statement into the budget ordinance. The budget ordinance is not the preferred place for communicating changes in fiscal policy, and it does not always accompany the proposed budget submitted to elected officials for consideration by the budget officer.

Another reason for using the budget message is found in the recommended budget practices promulgated by the Government Finance Officers Association (GFOA). The GFOA recommends that the budget contain a budget message that summarizes the major factors and trends affecting the preparation and adoption of the annual operating budget.[8] Such factors and trends include revenue collections, tax rates, debt obligations, and changes in fund balance. Placing a statement of the revenue-neutral tax rate in the budget message highlights the significance of the reappraisal process, gives readers a benchmark for an increase or decrease in the property tax rate, and represents professional financial management.

Recommended Language

The variables needed to calculate the revenue-neutral tax rate are the reassessed value of real property, the tax levy from the current fiscal year, and the average growth factor of the tax base. A statement of the revenue-neutral tax rate in the budget message should contain these variables in communicating the change in fiscal policy. Additional detailed information is needed to perform the calculation of the revenue-neutral tax rate, including the annual percentage change in the tax base for each year since the last reappraisal. The average annual percentage change in the tax base is the growth factor as defined by G.S. 159-11(e). The authors believe that the additional information required for calculating the revenue-neutral tax rate represents work papers as opposed to information needed to comply with G.S. 159-11(e). The sidebar on page 5 contains recommended language for communicating the revenue-neutral tax rate within the budget message.

The sidebar includes language sufficient to satisfy the statutory requirements for publishing a revenue-neutral tax rate in a taxing unit's budget. A taxing unit may wish, however, to provide its citizens with a fuller explanation of the revenue-neutral rate. Forsyth County, for example, published such an explanation on its county Web site.

Implications of a Mid-Year Tax Rate Amendment

Another major change to the Local Government Budget and Fiscal Control Act enacted by the 2002 General Assembly gives units of local government more flexibility with amending the budget ordinance after the governing board has approved it.[9] Before the change, G.S. 159-15 prohibited units of local government from amending their budget ordinances to increase or reduce a property tax levy or in any manner alter a taxpayer's liability for property taxes. The only exception was a change ordered by a court of competent jurisdiction or by a state agency with legal authority.

G.S. 159-15 was amended by the 2002 General Assembly to provide in part: "If after July 1 the local government receives revenues that are substantially more or less than the amount anticipated, the governing body may, before January 1 following adoption of the budget, amend the budget ordinance to reduce or increase the property tax levy to account for the unanticipated increase or reduction in revenues." While this change in law gives units of local government more flexibility in responding to unanticipated changes in

8. Government Finance Officers Association, *Recommended Practices for State and Local Governments* (2001).

9. S.L. 2002-126 (S 1115).

Revenue-Neutral Tax Rate: An Example

The general reappraisal of real property for Carolina City occurs once every four years. State law requires that units of local government, including public authorities, publish a revenue-neutral tax rate in the budget immediately following the completion of the general reappraisal of real property. The purpose of the revenue-neutral tax rate is to provide citizens with comparative information.

The FY 2004–05 operating budget follows the general reappraisal of real property for Carolina City. The revenue-neutral tax rate, as defined by G.S. 159-11(e), is the rate that is estimated to produce revenue for the next fiscal year equal to the revenue for the current fiscal year if no reappraisal had occurred. The rate is then adjusted by a growth factor equal to the average annual percentage increase in the tax base due to improvements since the last general reappraisal.

The reappraisal produced a tax base of $1,800,000,000 for Carolina City. The tax levy for the current fiscal year is $9,750,000, and the growth factor since the last general reappraisal is 8 percent. Using the formula mandated by state law, the revenue-neutral tax rate for Carolina City is 58.5 cents. The proposed property tax rate for FY 2004–05 is 60 cents, which represents a decrease from the property tax rate of 65 cents for FY 2003–04.

revenue sources, local officials and governing board members should be extremely cautious in using this authority to change the property tax rate.

G.S. 159-13(a) requires that not earlier than ten days after the day the budget is presented to the board and not later than July 1, the governing board shall adopt a budget ordinance. The budget ordinance contains estimated revenues, appropriations, and the property tax levy, which includes the tax rate.[10] Because property taxes are legally due on September 1, this gives units of local government approximately two months to prepare and distribute tax bills to property owners.[11] An amendment to the budget ordinance to change the tax levy after July 1, but before the tax bills are mailed to property owners, may or may not hinder the preparation and distribution process of those bills.

From a practical standpoint, however, a budget amendment that occurred so soon after July 1 would have been preceded by uncertainty of budgetary needs at the time the governing board adopted the original budget ordinance. The preferred alternative would be an interim budget ordinance allowed under G.S. 159-16. An interim budget gives units of local government more time to gather information, gives tax collectors notice that the tax levy remains outstanding before the billing process is started, and prevents the governing board from debating and adopting two property tax rates within a short period of time.

One could argue that a change in the property tax rate after September 1 but before January 1 might become necessary because of unforeseen events. Nevertheless, there are major considerations that should be addressed before a decision is made to change the property tax rate after tax bills have been mailed. The first involves the process of preparing and distributing the bills themselves. A change in the tax rate would require tax collectors to prepare and distribute a second set of bills for the difference in tax liability—a major administrative burden.[12]

Another consideration in changing the property tax rate in the middle of the fiscal year is how bond rating agencies would view the decision. One of the major financial factors used by bond rating agencies to measure the financial strengths of local governments is general fund balance as a percentage of revenues.[13] This measure provides an indication of how prepared units of local government are to respond to unforeseen contingencies, including changes in actual revenues as compared to forecasted revenues. A change in the property tax rate may indicate that a local government's financial position has not been properly managed. While we cannot predict how a rate change would impact an organization's overall bond rating, we can predict that rating agencies would intensify their analysis of the following factors:

- Revenue diversity
- Revenue forecasting
- Fund balance (cash position)

10. David M. Lawrence, *Local Government Finance in North Carolina* (Chapel Hill, N.C.: Institute of Government, the University of North Carolina at Chapel Hill, 1990).

11. We recognize that local governments are not required by law to send property tax bills to property owners. *See* G.S. 105-348 (providing that all persons with interest in property are charged with notice of taxes). Nonetheless, it is the recommended and followed practice in local government to mail such bills annually in July and August.

12. Tax collectors would not have the option of refunding amounts already paid and sending new bills for the entire tax liability. *See* G.S. 105-380 (prohibiting refund of property taxes except as expressly provided); G.S. 105-381 [permitting the governing board to refund taxes only if the tax was (1) imposed through a clerical error, (2) was illegal, or (3) was levied for an illegal purpose].

13. Linda Hird Lipnick et al., *The Determinants of Credit Quality* (Moody's Investors Service, Inc., 1999).

- Long-term planning
- Management strategies
- Political stability

A mid-year change in the tax rate also would have negative political consequences. The governing board and senior administrators would come under extreme scrutiny from the media and from the citizenry. Informing property owners of what would be perceived as two property tax liabilities in the same fiscal year and explaining the reasons for the change in liability would be extremely challenging for units of local government. We propose that the best way to avoid a change in the tax rate is to make short-term and long-term financial decisions under the framework of the old law where the tax rate could not be changed after adoption.

Conclusion

The calculation and publication of a revenue-neutral tax rate is another step toward transparency in local government. It permits citizens to better evaluate the impact of a revaluation on property owners' tax liability. It also informs the important—and often controversial—decision that elected officials must make about the appropriate tax rate to impose after a countywide revaluation of real property.

The amendment to G.S. 159-15, allowing a taxing unit to adjust its tax rate after July 1 but before January 1, gives local officials more flexibility in managing their revenue sources. However, for the reasons outlined in this bulletin, we recommend that local officials be extremely cautious when exercising this authority.

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