

DATE: March 6, 2003

Submitted by: TAXATION AND REVENUE DEPARTMENT
JAN GOODWIN, SECRETARY

BILL NUMBER: House Bill 948

SPONSOR: Representative Moore

BILL SHORT TITLE: Property Tax Yield Control Provision

DESCRIPTION: This bill repeals Section 7-37-7.1 NMSA 1978 of the Property Tax Code, commonly referred to as the "yield control" limitation, for tax years beginning in 2004. Section 1 of the proposal stipulates that for tax year 2003, the Department of Finance and Administration (DFA) must calculate and set tax rates **as if** Section 7-37-7.1 were in effect. Section 39 of the proposal, however, repeals Section 7-37-7.1 of present law for the 2003 and subsequent tax years. Remaining sections of the proposal simply strike references to Section 7-37-7.1 wherever they appear in New Mexico statutes. The measure thus effectively repeals use of yield control after Tax Year 2003. An explanation of the yield control mechanism appears in this report's "Other Issues" section.

EFFECTIVE DATE: Section 39 decrees that Sections 1 through 37 of the proposal apply to the 2003 and subsequent tax years. Section 38 repeals Section 1 (requiring DFA to calculate rates as if yield control were in effect in 2003), effective January 1, 2004. Since no effective date is applied to Sections 38 and 39, they would be effective 90 days following close of the legislative session.

FISCAL IMPACT: The proposed measure would affect neither property tax revenues imposed for state debt service purposes, nor any revenue sources not subject to the yield control statute. The impact on various revenue sources subject to yield control – primarily county and municipal operating revenues – would depend on fiscal variables affecting each of the several hundred entities whose rates are now subject to yield control, as well as how the measure is implemented.

A major effect of eliminating yield control would be to subject non-residential taxpayers to potentially large tax increases as rates remain unchanged while reassessment occurs. Residential taxpayers would be relatively unaffected due to the three percent limit on residential value increases specified in Section 7-36-21.2 NMSA 1978.

Second, the current property tax system would lose its automatic adjustment mechanism whereby rates change in the opposite direction of changes in net taxable value. If, for example, the legislature provides a substantial increase in the veterans' exemption, the present system adjusts rates in a way that prevents revenue recipients from losing revenue.¹ Without yield control, this would not occur and revenue recipients would discover their income reduced. This is also true in cases where base decreases occur in response to loss of a local business; for example, a copper mine. The negative "valuation maintenance" component in the yield control formula increases rates in response to the loss of base, leaving revenues largely unchanged. Without this mechanism, revenue recipients would be forced to increase tax rates to cover the loss in the tax base.

ADMINISTRATIVE IMPACT: The proposal would impose no significant administrative impacts on the Taxation and Revenue Department. It would probably make rate determination by the Department of Finance and Administration and other entities easier than it currently is.

TECHNICAL ISSUES:

1) The bill's assumption in Section 1 that DFA sets all rates -- including rates applicable to counties, school districts and other government units subject to the yield control statute -- is incorrect. DFA does not, for example, determine school district or community college rates that are subject to yield control. If the intent is that all rates subject to yield control should be calculated in Tax Year 2003 as if the yield control statute were in place, the

¹ For purposes of yield control, value changes are classified as either valuation maintenance or new construction. An increase in the veterans exemption will be considered valuation maintenance for purposes of yield control.

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proposed measure should be changed to state “all entities will calculate rates currently subject to yield control for purposes of Tax Year 2003 as if yield control were in effect.”

2) The proposal provides no guidance on the question of rates imposed when yield control is repealed. One set of rates has been *imposed*, but these rates have been reduced over time by the yield control mechanism. The imposed rates are substantially higher than actual rates in many counties, as shown in Table 1. If the imposed rates were substituted for the actual rates upon removal of the yield control statute, the result would be rather substantial property tax increases in many jurisdictions – particularly against residential properties. An alternative approach would be to require use of actual operating rates resulting from yield control over the last 30 years. The most appropriate method of solving this problem would be to state that rates subject to yield control in effect in Tax Year 2004 are to be the same rates set in 2003, but that various property tax recipients would be allowed to impose remaining rates in the same manner as currently.

**Table 1: County Operating Rates –
2002 Tax Year**

County	Rate Imposed	Actual Operating Rate	
		Residential	Non-residential
Bernalillo	10.770	5.918	10.520
Catron	10.850	10.850	10.850
Chaves	10.350	6.769	10.350
Cibola	11.850	8.727	10.662
Colfax	10.350	10.350	10.350
Curry	9.850	9.850	9.850
DeBaca	11.850	11.850	11.850
Dona Ana	11.850	7.800	11.850
Eddy	7.500	6.285	7.500
Grant	11.850	6.734	6.864
Guadalupe	11.850	7.578	11.850
Harding	8.850	5.823	8.850
Hidalgo	11.850	10.559	11.850
Lea	8.600	6.679	8.600
Lincoln	11.600	4.599	8.850
Los Alamos	8.850	4.682	6.814
Luna	11.850	7.610	11.850
McKinley	11.850	5.210	11.850
Mora	11.850	6.706	11.078
Otero	11.850	7.245	11.850
Quay	11.850	8.285	10.350
Rio Arriba	11.850	4.506	9.215
Roosevelt	8.850	4.941	8.850
San Juan	8.000	6.285	8.000
San Miguel	11.850	5.262	10.331
Sandoval	10.350	5.189	8.269
Santa Fe	11.850	4.788	9.076
Sierra	11.850	8.091	11.850
Socorro	11.850	10.289	11.850
Taos	11.850	5.206	10.460
Torrance	11.850	11.282	11.850
Union	9.150	6.703	9.150
Valencia	11.850	6.032	11.850

OTHER IMPACTS AND ISSUES:

Background

The yield control statute was enacted in 1979 in an environment in which properties had not been reassessed for many years in many counties. It was understood that reassessment would generate very large increases in tax obligations in many counties. Assessors were often reluctant to reappraise properties because they feared voters would blame them for the resulting tax increases. The yield control mechanism was therefore developed to limit revenue increases in response to reassessment by *reducing* rates. It also works in reverse; loss in aggregate value due to reassessment *increases* rates as a result of the formula.

Yield Control -- An Illustration

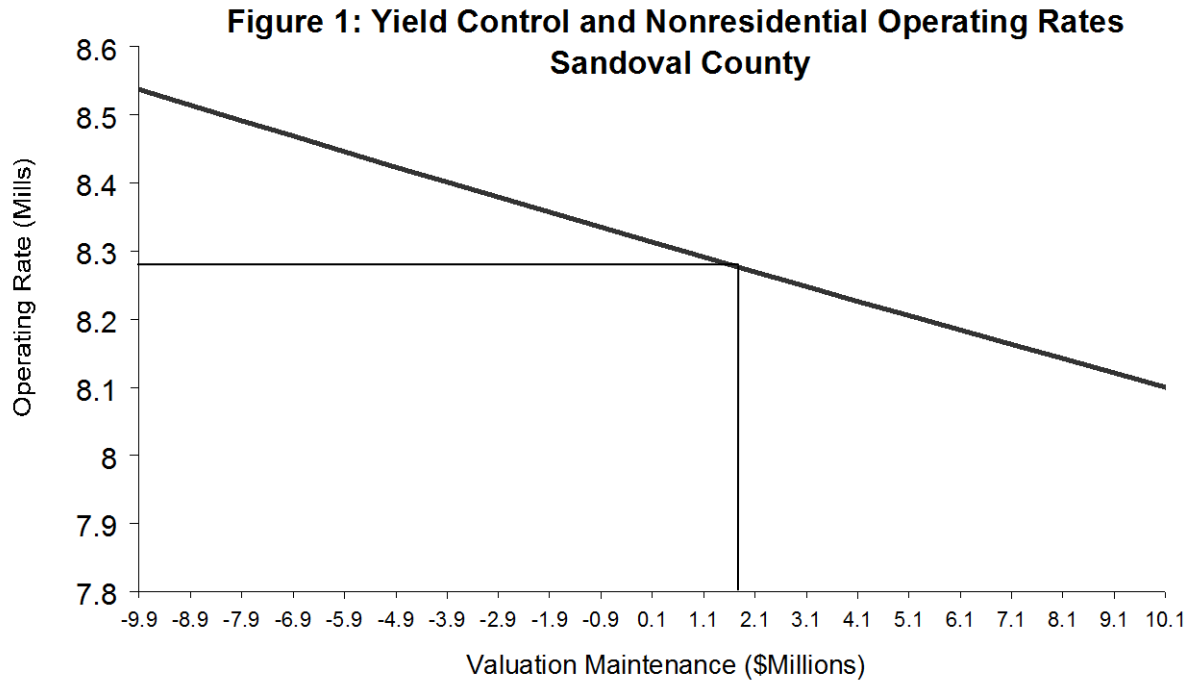
The yield control formula moves rates in the opposite direction of value changes. Value increases due to new construction do not affect rates, although the mechanism does allow new construction and increases in the cost of goods and services provided by governments to increase revenue yields. The formula applies separately to residential and non-residential operating rates.² Hence in a particular jurisdiction, residential and non-residential rates are typically different, as shown in Table 1.

² As the text in HB-948 indicates, it also applies to a number of other rates. However, revenues from county and municipal operating rates probably represent the largest sources of revenue subject to the yield control limitation.

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An example of yield control’s effects appears in Figure 1. The chart illustrates the relationship between valuation maintenance and Sandoval County operating rates. Figures in the chart are based on simulations performed on spreadsheet files employed by DFA to calculate rates in Tax Year 2002. The county non-residential operating rate is currently 8.269 mills – as shown in Table 1. Non-residential taxable value, excluding oil and gas production and equipment properties (not subject to yield control) totals \$383 million. Valuation maintenance – increased value due to reassessment – in tax year 2002 totaled \$2.089 million. Figure 1 displays effects of varying valuation maintenance in \$1 million increments on rates. In all cases the result is a proportionate and inverse change in the county nonresidential operating rate.

Figure 2 illustrates how the rate changes translate into revenue changes. The horizontal line in Figure 2 represents revenues after valuation maintenance changes shown in Figure 1 are made. Revenues do not change because rate changes shown in Figure 1 precisely offset assessed value changes from changes in valuation maintenance. The “dashed” line in Figure 2 illustrates what would occur without yield control in response to changes in valuation maintenance. It assumes the operating rate remains at its current 8.269 mill level. Hence changes in valuation maintenance generate proportionate changes in revenues. Vertical differences between the dashed and solid lines in Figure 2 represent revenue losses or gains to the county that would occur without the yield control formula.

Rationale for Retaining or Eliminating Yield Control

Proponents of eliminating the yield control mechanism favor elimination for one of several reasons. Some of the revenue recipients simply do not like to see their rates reduced in response to revaluation. They recognize that without the yield control statute their revenues would typically increase at a greater rate than when the formula is employed. Others dislike it because they mistakenly believe the formula was designed primarily to stabilize individual tax bills – an indirect effect of the mechanism. The mechanism does tend to serve that purpose, but individual tax bills are also affected by reassessment and rate changes. If a particular property is assessed at substantially less than market value compared with other properties in a particular county and reassessment occurs, its owner will, and probably should, experience an increase in tax obligations. Hence when taxpayers receive tax increases due to reassessment because their properties are severely underassessed, they often incorrectly conclude that the mechanism does not work. Properties assessed at values much closer to market

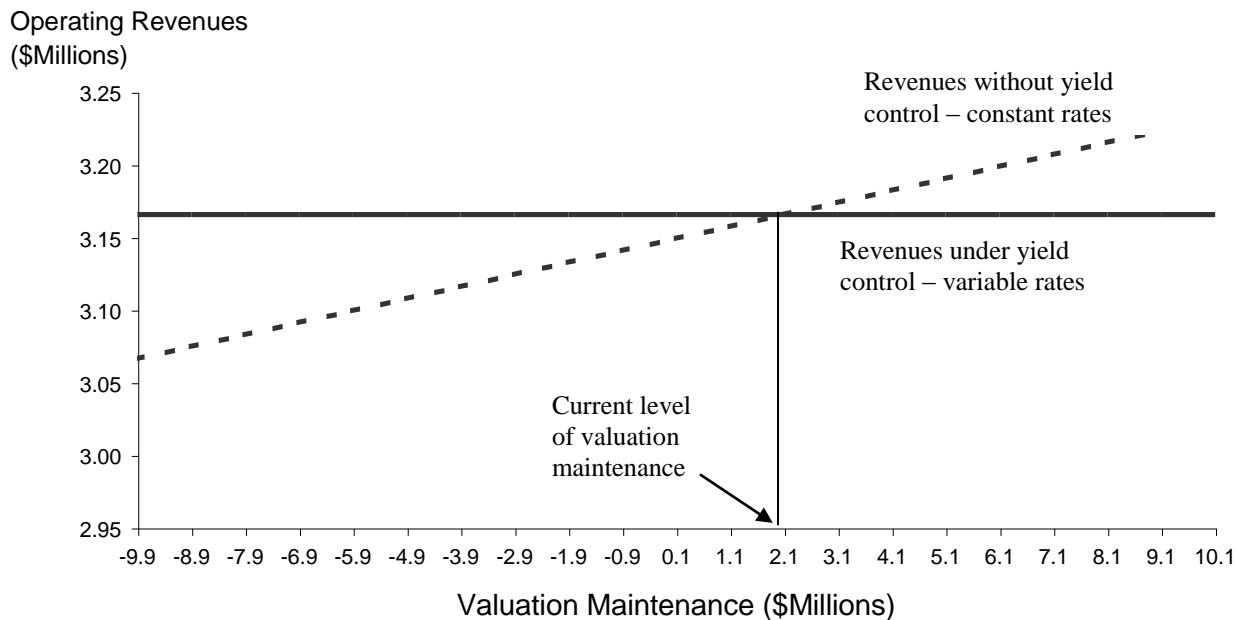
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value than average under similar conditions experience tax reductions via rate decreases caused by yield control. The net result is elimination of inequities that would happen without reassessment.

**Figure 2: Yield Control Impact on Operating Revenues
-- Sandoval County**



Several other factors suggest that eliminating yield control may be a good idea. One factor is that it is probably less necessary than in the past due to the recently enacted three percent limitation on residential value increases mentioned above. Another is that without yield control, rates would be much easier to calculate, and perhaps much more readily understood, than rates that result from the yield control formula.

There are several reasons why eliminating yield control may not be a good idea. First, if DFA and other agencies ceased yield control, resuming its use would be difficult. Reemploying the mechanism may be appropriate if the three percent valuation increase limitation were eliminated. Secondly, use of yield control in setting nonresidential rates is probably appropriate for the same reason the formula was developed in the first place. Moreover, absence of the revenue limitations produced by yield control might provide strong incentives for some jurisdictions to aggressively reassess commercial properties with resulting tax increases – assuming their assessors did not fear voter retaliation. Thirdly, as discussed above, changes in the tax base under yield control produce automatic and offsetting changes in rates. Without this mechanism, jurisdictions would be required to make literally thousands of rate imposition decisions in response to changes in the tax base.

Some Limitations of Yield Control

The mechanism is far from perfect for several reasons. First, there is no obvious way for revenue recipients to reduce rates under the yield control mechanism. This issue is very complex and would probably require considerable effort to resolve.

The second issue may be described as follows: In an ideal property tax system, county assessors would maintain values at "current and correct" levels while rate adjustments maintain revenues at approximately "revenue-neutral" levels as if due to yield control. However, in many New Mexico jurisdictions, most of the rate totals contain debt-service components. Hence when reassessment occurs, governing bodies of entities imposing debt service rates – primarily school districts, although the list includes the City of Albuquerque – often fail to reduce rates. As a result, sometimes there are substantial tax increases from reassessment. Assessors are

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understandably reluctant to reassess. Inequities – for example, cases wherein owners of properties whose market value are essentially identical often pay very different property tax bills – are the inevitable result of failure to reassess. A solution to this “problem” is to apply the equivalent of a yield control mechanism to voter-approved rates and to impose increased disclosure requirements on entities seeking voter approval for bond issues.

Additional Notes

An unanticipated (perhaps) feature of yield control; it tends to keep the proportion of residential/nonresidential revenues constant by moving rates in opposite directions as changes in value due to reassessment. Suppose, for example, imposed rates on residential and non-residential property rates are both 10/\$1,000 in a jurisdiction, residential and non-residential assessed values are 10,000 each, and no inflation or additions to the base occur. Revenues will total $(10/1,000 \times 10,000)$ \$100 from residential and \$100 from nonresidential properties; each will bear 50 percent of the total tax burden.

Now assume residential values are increased by 25% to 12,500, but non-residential values remain unchanged. Yield control will decrease the residential rate to 8/1,000, but have no effect on the non-residential values. As a result, residential revenues will be $8/1,000 \times 12,500 = 100$, and nonresidential revenues will remain at \$100. In this example, the yield control mechanism controlled yields perfectly AND maintained the proportion of residential/nonresidential revenues at 50 percent after the assessed value change; each paid 50 % of the \$200 in total revenues.

In absence of rate limitations, this effect would be complete. To understand why, assume that in the above example, the assessed value of nonresidential property *falls* to 900 because it is assessed at cost less depreciation. Yield control does indeed work in reverse, and the mechanism will tend to actually *increase* the nonresidential rate and keep revenues constant. HOWEVER, it can not increase the rate by more than the amount imposed. In this case, we said the jurisdiction imposed a rate of 10 mills. Hence the nonresidential rate will remain unchanged because it can not rise above 10, and the relative burden of paying property taxes will tend to shift to residential real estate. Residential revenues will, as explained above, total \$100, BUT nonresidential revenues will total $10/1,000 \times 9/1,000 = 900$. The ratio of residential to total revenues will now be $100/190 = 52.63\%$, while the nonresidential portion will be $90/190=47.36\%$. Hence the combination of 1) non-residential rates that are not able to rise above statutory maximums, and 2) negative valuation maintenance – i.e., reduced assessed value due to the manner in which non-residential properties are assessed – have combined to gradually shift the burden away from nonresidential and toward residential property owners in New Mexico over time.

The proportions would remain the same as they were when the scheme was imposed. Rate limitations whereby yield control rates can not exceed imposed rates or the statutory maximum prevent this from being complete. Nonetheless, years of applying the formula had this effect. Residential rates were reduced under yield control to a greater extent than nonresidential rates because 1) yield control was applied to residential rates some years after it was applied to residential rates; it therefore had more time to reduce residential than non-residential rates, and 2) probably because nonresidential properties were more underassessed than residential properties; simply take a look at “valuation maintenance” figures during reassessment years.