Research Report

MAY 2004

The Lack Of Competition In Delinquent Property Tax Collections

by

Byron Schlomach, Ph.D.

Chief Economist, Texas Public Policy Foundation

with

Aaron Gibson

Texas Public Policy Foundation

Texas Public Policy Foundation

15th Anniversary

This study is available online at www.TexasPolicy.com.

ABOUT THE AUTHORS

Byron Schlomach is the Chief Economist for the Texas Public Policy Foundation.

Raised in Texas, Dr. Schlomach received both his bachelor and doctorate degrees in economics from Texas A&M University.

Dr. Schlomach came to the Foundation from the Texas Education Agency. He has also served as a staff member in the Texas Legislature, most recently as the chief of staff to State Rep. Kent Grusendorf, the chairman of the House Committee on Public Education.

Previously, Dr. Schlomach was a researcher in the Office of the Texas Comptroller. There he conducted research into education and transportation, and was the principle author of a study examining the public school start dates. He has also served as an assistant lecturer in the Texas A&M Department of Economics, and has taught at Austin Community College.

Dr. Schlomach has had a long-standing relationship with the Foundation, and was named a "Senior Fellow" in 2002.

Aaron Gibson is a Spring Research Associate for the Texas Public Policy Foundation.

He is a junior at the University of Texas at Austin, and an officer in the Young Conservatives of Texas.

ABOUT THE TEXAS PUBLIC POLICY FOUNDATION

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institution guided by the core principles of limited government, free enterprise, private property rights and individual responsibility.

The Foundation's mission is to improve Texas by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policymakers, the media and general public. The work of the Foundation is conducted by academics across Texas and the nation, and is funded by hundreds of individuals, foundations and corporations.

Texas Property Taxes in Perspective

The state of Texas depends heavily on the property tax in order to finance its local governments. County budgets are substantially funded by property taxes. The local share of school district funding comes from the property tax and funds the lion's share of school spending in the state. Cities, though they enjoy funding from the sales tax, also levy property taxes. Finally, various special districts such as hospital districts, flood districts, utility districts, and fire districts also depend on revenues from the property tax.

The property tax, unlike the state's sales tax and the federal income tax, is not collected "up front." Individuals pay the sales tax when they make their purchases. Most pay their income taxes through wage withholding or on a quarterly basis. Texas property taxpayers, however, pay the property tax in a lump sum once each year. The obvious exception to this is the monthly escrow for property taxes paid with mortgage payments but for those who own their property outright, the property tax represents a one-time lump-sum payment each year.

Delinquent Property Tax Collections: A Windfall for Attorneys

For various reasons, whether it is poor planning, financial difficulty, or simply a failure to account for all of one's assets, some property owners fail to make their property tax payments in a timely fashion. When this happens, the enforcement of the property tax law falls on the County Attorney or, in the absence of a County Attorney, the District Attorney. Counties may also contract with attorneys to collect delinquent property taxes.[1]

Property taxes become delinquent on February 1st in the year after which they are due.[2] At this time, penalties and interest begin to accrue. In February, penalties and interest total to seven percent of the tax due. Subsequent months increase the penalties and interest by two percent per month. As of July 1st, regardless of the number of months, a penalty of twelve percent is applied. Also by July 1st the interest charge has built to the point that total interest and penalties amount to eighteen percent.[3]

In 2002 (latest data available), property taxing jurisdictions levied a total of over $27 billion in property taxes.[4] School property tax delinquencies in that year totaled $1.26 billion, 7.7 percent of the $16.4 billion school tax levy.[5] Applying that same percentage to the total levy for all jurisdiction yields a total of $2.1 billion in delinquent property taxes in 2002.

Some measure of newly delinquent taxes are paid prior to July 1st. In fact, it appears that the bulk of delinquent taxes are paid prior to any truly serious legal action being taken. Of the 50,611 new tax suits filed in Texas in 2002, 26,165 were filed by a single law firm and that firm claims that these suits represented only about $191 million in delinquent taxes.[6] If the number of cases filed by this firm as a percentage of all cases filed statewide is also reflected in the value of the delinquencies, only about $369 million in property tax delinquencies resulted in new serious legal action in 2002. Tax cases pending in any given year number about 120,000[7] and many new cases may be a result of delinquencies from earlier years, but taking the 2002 rate as representative, only about 17% of delinquencies result in serious legal action.

Introducing Competition in Delinquent Property Tax Collection

This begs an important question. Why is it that property taxing jurisdictions can only contract with attorneys to aid in enforcing delinquent property taxes? As can be seen in Figure 1 (next page), the majority of tasks that must be performed in order to collect delinquent property taxes can be performed by non-attorneys. In fact, as has already been established, some 83 percent of all delinquent property taxes are paid before any serious action must be taken. The law firm that is apparently engaged in the lion's share of the property tax collection practice states in its publication that, "A delinquent tax suit is the last step in a thorough, resource-intensive process to collect payment of delinquent property taxes."[8]

Automatically, when a tax on a piece of property becomes delinquent, a tax lien is placed on that property. At any time after the tax on a piece of property becomes delinquent, the taxing jurisdiction can file suit to foreclose on that property for payment of the tax.[9] Clearly, though, filing suit as soon as a property becomes delinquent is an uncommon practice.

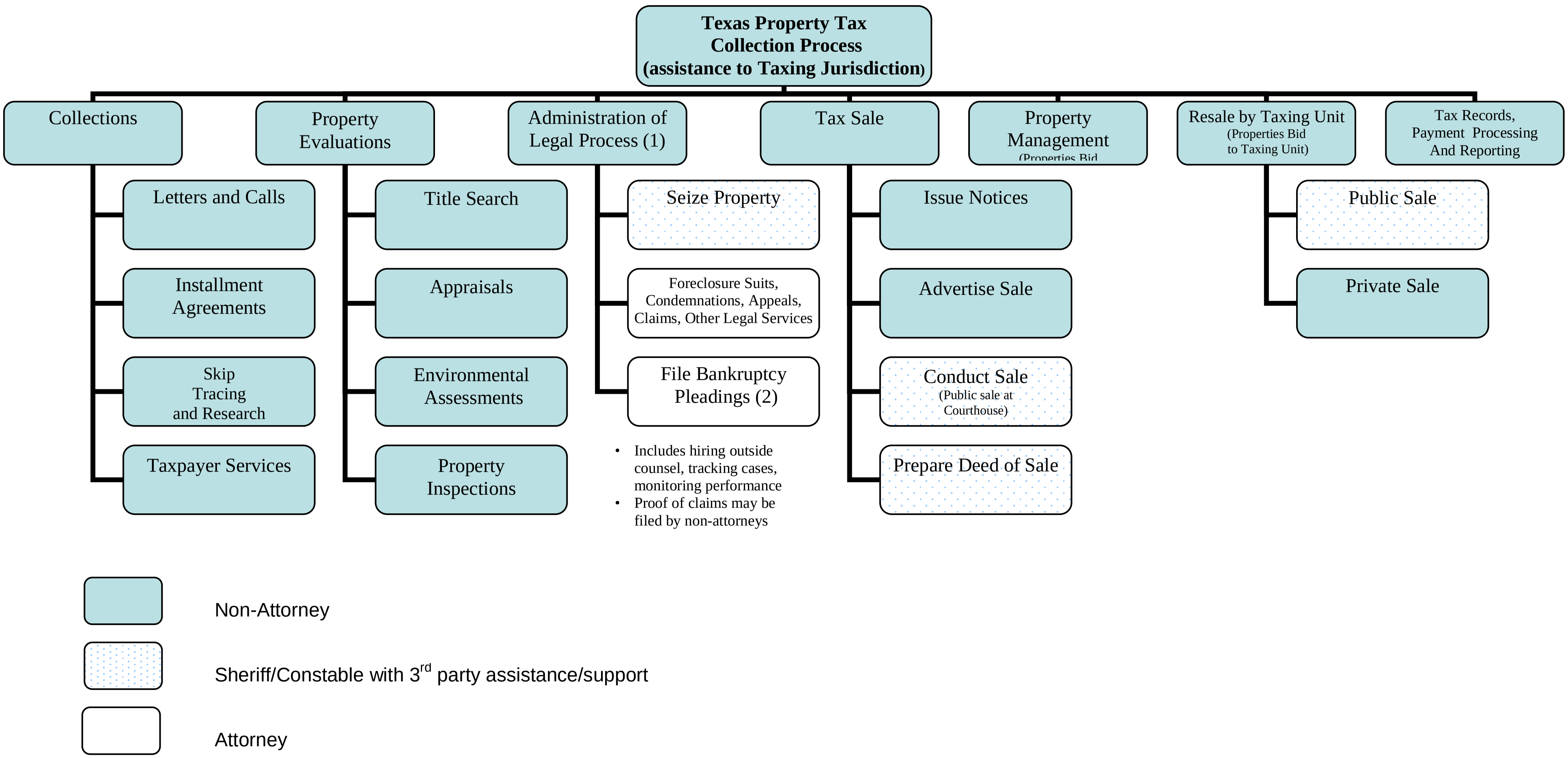
As noted earlier, Texas law specifies that property taxing authorities may contract with attorneys, but *only* attorneys – i.e., law firms – to aid in enforcing property tax delinquencies. Texas law also limits attorneys' fees for performing this service to 20 percent of the amount delinquent and the attorneys' fees are paid by the delinquent taxpayer along with penalties and interest.

Four large counties were contacted regarding their practices in collecting delinquent property taxes. These were Bexar, Galveston, Harris, and Tarrant counties. Each said that from February 1 to July 1, only penalties and interest accrued on property. After July 1, however, attorneys' fees kick in. The most common fee appears to be the legal maximum of 20 percent of the delinquent tax amount. The next most common fee is 18 percent of the delinquent tax amount. The lowest fee appears to be 15 percent of the delinquent tax amount.[10]

In Texas, property is sacrosanct. For this reason the law provides for multiple opportunities for a property owner to pay property tax and escape foreclosure and sale of property. The tax is not due until long after a notice is sent to the property owner. The property owner is given an extended period to pay before property is seized and sold.

Attorneys' fees, though, can be an impediment to a property owner redeeming property by paying a delinquent tax. Attorneys' fees alone will account for as much as a 20

Figure 1.



Texas Property Tax Collection Process (assistance to Taxing Jurisdiction)
Collections
Letters and Calls
Installment Agreements
Skip Tracing and Research
Taxpayer Services
Property Evaluations
Title Search
Appraisals
Environmental Assessments
Property Inspections
Administration of Legal Process (1)
Seize Property
Foreclosure Suits, Condemnations, Appeals, Claims, Other Legal Services
File Bankruptcy Pleadings (2)
• Includes hiring outside counsel, tracking cases, monitoring performance
• Proof of claims may be filed by non-attorneys
Tax Sale
Issue Notices
Advertise Sale
Conduct Sale (Public sale at Courthouse)
Prepare Deed of Sale
Property Management
Resale by Taxing Unit (Properties Bid to Taxing Unit)
Public Sale
Private Sale
Tax Records, Payment Processing And Reporting
Non-Attorney
Sheriff/Constable with 3rd party assistance/support
Attorney

percent markup over the tax owed. This is in addition to the penalties and fees and the 20 percent markup also applies to the penalties and fees themselves. Perversely, the longer tax for a piece of property is delinquent, the greater the fee the collector receives. For especially large properties with big delinquent tax bills, it could pay a collector to let the bill sit delinquent as long as possible.

Roughly, the same number of tax suits are resolved each year as are filed, or about $370 million worth in 2002. That represents a maximum legally allowable income of $74 million (not counting 20 percent of penalties and interest) for the law firms involved. If delinquencies continue to rise at the same average rate as the last five years, the value of settled delinquencies in 2005 could be as high as $447 million with law firms receiving a legal maximum of $89 million in income.

To be sure, the calculations above for incomes of law firms in the property tax collection business represent what could be made if the maximum legal amount was charged. It was noted that in some cases as little as 15 percent is charged. Also, it might well be that not all of the suits are filed by contracted collectors but include filings by county and district attorneys. Nevertheless, we know that a single firm represents more than half of the filings and there are more than 40 firms in the property tax collection business. It seems reasonable that at least 80 percent of the suits are filed by private collection firms and the average rate charged is more than 15 percent.

Suppose only 80 percent of the tax collection suits in 2002 were filed by private firms and that they all charged only 15 percent of the original delinquent tax amount. Even so, this would still represent $44.4 million in income with about $23 million of that income going to a single law firm. In 2005, the amount of money changing hands to satisfy attorney fees on property tax delinquencies, using these same very low assumptions, will exceed $53 million with about $27 million going to a single firm.

All of this money is being transferred from the hands of taxpayers who redeem their property or from taxpayers who buy foreclosed property since fees, interest, and penalties are paid before any other debts are settled on a piece of property. In other words, in cases where the property is ultimately sold at auction, the attorneys are paid before the city or the county, or the special district, or the school district.

So far, only income for law firms specializing in property tax collection from tax suits has been considered. In fact, most delinquencies are settled without recourse to the courthouse. Many of these delinquencies that do not result in suits also represent income for tax collecting law firms. To collect a double-digit commission in these cases, a law firm simply has to send a demand letter and have the taxpayer pay the tax bill – with penalties, interest, and the collection fee included.

Undoubtedly, law firms that specialize in property tax collections actually file suit on less than a third of all the delinquencies they handle. But suppose it is only a third. Then, conservatively estimated, in 2002 these law firms took in somewhere between $133 million and $178 million in delinquent property tax collection fees (15 to 20 percent of

$887 million in delinquencies in 2002). Some measure of this law firm income comes from the hands of individuals who buy the property in tax sales and this, in turn, is lost tax income for which taxpayers in general must make up.

In New York City, the process of locating property owners, writing demand letters, and carrying out general tax collection processes is somewhat more cumbersome. In 1996, it began outsourcing its debt collections in a process more open than that of Texas. Bidders were not limited only to lawyers. The result has been a marked improvement in the amount of time from delinquency to foreclosure. On average this time period is now 13 months in New York City. In Texas, the largest law firm averages 14 months in what is a far simpler process.

Texas would greatly benefit from a more competitive delinquent property tax collection system. In New York City, when the competitive tax collection system was first instituted, there was really only a single firm available to bid. Now, there are a half dozen. Collection fees range from 7.25 percent to 15 percent in a much more difficult legal environment.

Texas appears to have what economists typically call an oligopoly, but one whose particular form is that of price leadership. One firm dominates with over 50 percent of the market. Other firms nibble at the edges. Taxing jurisdictions, because most properties are redeemed, have little incentive to shop around for better deals since the delinquent taxpayers pay the fees.

Given the choice, most responsible property-taxing bodies, which are elected, will prefer to see delinquent taxpayers penalized less rather than more and they would rather see the taxing entity receive all the money that delinquent taxpayers must pay rather than private collectors. One way to achieve this would be to allow the taxing entities to collect their own taxes and receive the collection fee. Many taxing entities would choose to contract with a collection firm anyway and share the collection fee. However, the current market would seem to indicate that much of the delinquent tax money would end up in the hands of law firms rather than in the hands of taxing entities who could, in turn, reduce taxes and benefit taxpayers.

What would a competitive tax collection market look like when a taxing entity could charge a collection fee and contract with private entities other than law firms? A competitive market for property tax collections would entail repealing the requirement that only law firms could be contracted to collect delinquent taxes. In order to incentivize local taxing entities to keep collection costs low, they could be allowed to collect the full 20 percent collection fee or receive a portion of it if they contract with a collection firm.

Taking New York City as representative of the collection fees charged in an institutional structure like that described, the standard collection fee charged by a private firm is likely to be 7.25 percent (and possibly less, given Texas' legal environment). Many taxing entities would do their own collections and would collect the entire 20 percent collection fee. Others would contract with collection firms and collect 12.75 percent of the collection fee.

In New York City, about 60 percent of delinquent taxes for which collection firms are contracted never go to court. This roughly coincides with the numbers cited above in which only a third of all collections end up in the courthouse. Since about $375 million in delinquencies ended up in court in 2002, and assuming that 80 percent of this amount originated with private collectors, this indicates that about 36 percent of all delinquencies go to collectors who charge a fee.

In 2005, the total dollar value of delinquencies will be approximately $2.6 billion. If 36 percent of this amount is contracted to be collected by private collectors and they split the collection fees with 7.25 percent to the collectors and 12.75 percent to the tax entities, tax entities could collect an extra $119 million in 2005. Even if only a fifth of the remaining 64 percent of delinquent taxes was collected with the full 20 percent collection fee going to tax entities, local government could collect an additional $66 million in 2005. With growth in property taxes, over the two-year period 2005-06, local entities could collect an additional $380 million in funds.

Conclusion

From a public policy perspective, it should always be kept in mind that competition works best. It works best for taxpayers by keeping costs, and therefore taxes, low. It works best for government through more timely and efficient performance of tasks. While no one likes paying taxes, and taxes need to be kept as low as possible, tax collections must be enforced in order for fairness to be preserved and to ensure honest government. Given these facts, it would be beneficial to have a competitive market in property tax collections.

ENDNOTES

[1] Texas Property Tax Code, Section 6.30(a).
[2] Texas Property Tax Code, Section 31.02.
[3] See Texas Property Tax Code, Section 33.01.
[4] Texas Comptroller, Annual Property Tax Report, 2002, http://www.window.state.tx.us/taxinfo/proptax/02annual/statewide.html.
[5] Excel Spreadsheet provided by the Texas Education Agency.
[6] Dover, Marguerite, "Litigation at the Heart of Delinquent Tax Collections," *et cetera*, Spring/Summer Edition, Linebarger Goggan Blair & Sampson, LLP, Attorneys at Law, 2003, p. 5, http://www.publicans.com.
[7] Dover, Marguerite, "Litigation at the Heart of Delinquent Tax Collections, *et cetera*, Spring/Summer Edition, Linebarger Goggan Blair & Sampson, LLP, Attorneys at Law, 2003, p. 5, http://www.publicans.com.
[8] *Id*. at 4.
[9] Texas Property Tax Code, Section 33.41(a).
[10] Interviews conducted by Aaron Gibson, TPPF intern.

We need your help!

The Texas Public Policy Foundation is a non-profit, non-partisan research institute guided by the principles of limited government, free enterprise, private property rights and individual responsibility. We seek to improve Texas government by producing academically sound research on important issues offered to policymakers, opinion leaders, the media and general public.

We do not take government funding or sell research outcomes, so we completely rely on the generous contributions of individuals, foundations and civic-minded corporations.

If you believe studies like this are important for Texas, won't you consider a financial gift to support the Foundation and our mission?

Give generously today by visiting us online at
www.TexasPolicy.com,
or calling toll-free, (800) 694-8773.

After supporting the Foundation with your financial gift, please pass this publication on to a friend and introduce them to our work!

Thank you for your generous support!

Log On to Learn More!

All of the Foundation's research and reports on education finance reform are available online at
www.TexasPolicy.com.

When there, be sure to sign up for the **Texas Public Policy News**.
This free e-publication is issued every other Wednesday and includes information about upcoming events and publications.
Don't miss a single issue!

Texas Public Policy
FOUNDATION
15TH ANNIVERSARY

www.TexasPolicy.com