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Taxpayers' Guide to the Rendell Property Tax Relief Act of 2006

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INTRODUCTION

For more than three decades, Pennsylvania policymakers have repeatedly attempted to devise a mechanism to reduce school district property taxes on homeowners. Such a mechanism has been elusive. A number of past attempts at school district tax reform—including Act 50 of 1998 and Act 72 of 2004—failed for two main reasons: 1) school districts were not required to participate in either law, and 2) these laws relied upon tax-shifting, whereby in order to get a property tax reduction, school district residents would pay equivalent higher taxes elsewhere.

In June 2006, the Pennsylvania General Assembly approved, and Gov. Ed Rendell signed, Special Session Act 1—the latest attempt to provide property tax reductions to Pennsylvania homeowners. Act 1 contains limited immediate property tax reductions for senior citizens and other qualifying residential property owners through a nearly $200 million expansion of the state's Property Tax and Rent Rebate Program (funded initially by borrowed Lottery Fund revenue). In addition, some revenues from slot machine gambling will be dedicated to property tax reductions, and school district voters will have the opportunity to expand the amount of relief available—if they are willing to undertake another tax shift.

In the May 2007 primary election, school district voters will be given the option of raising their local earned income tax (or instituting a local earned income tax if one has not already been imposed) or converting to a local personal income tax in exchange for a reduction in their residential property taxes. At the same time, district voters will be given a very limited measure of control over some future tax increases via a "back-end" referendum.

At first glance, Act 1 seems to be an improvement over the current system of school district taxation in Pennsylvania, under which voters have no direct control over school board taxing decisions. Yet a closer examination of the new law finds that regardless of the type of "tax shift" voters may approve, not all district taxpayers will see their tax burden decrease. Additionally, the type of shift chosen could have serious implications for a school district's future economic situation (and by extension, its future ability to fund its schools). At the same time, the "back-end" referendum intended to limit school boards' ability to increase taxes is riddled with exemptions that will undermine taxpayers' ability to control future school tax increases.

This analysis provides an overview of the major provisions and potential implications of Act 1 for Pennsylvania taxpayers. It highlights the expanded Property Tax and Rent Rebate Program available primarily for senior citizens. It outlines the "back-end" referendum process and explains under what circumstances district taxpayers will (or will not) be allowed to approve proposed tax increases. Finally, it examines the process by which school district voters may choose to partially shift from property to income taxes, and the likely impact on various taxpayers within a district. It also reviews some of the recommendations reported by the panels charged with studying how each district might shift its taxes under Act 1.

Expanded Property Tax and Rent Rebate Program

Some senior citizens 65 and older, widows and widowers age 50 or older, and permanently disabled individuals age 18 and older have been provided with an additional means of tax relief under Act 1 through an expansion of the state's existing Property Tax and Rent Rebate Program. The maximum property tax rebate has been expanded by 30% (from $500 to $650), and the income limit for eligibility has been raised from $15,000 to $35,000. Renters earning less than $15,000 are also eligible for rebates, and in school districts outside Philadelphia, Pittsburgh and Scranton, recipients earning under $30,000 who pay more than 15% of their income in property taxes will have their property tax rebate increased by an additional 50%.[1]

The expansion of this program is designed to provide the greatest benefit to low-income senior citizens and other qualifying residential property owners. Borrowing from the Lottery Fund will finance the first two years of rebates. It is anticipated that gambling revenue will be used in the years that follow (and to refund the sum borrowed from the Lottery Fund). However, a "loophole" in Act 1 will give 75,000 homeowners and renters little or no increase from their current property tax rebates, while 600,000 others, with higher and lower incomes, will get much larger increases.[2]

"Back-End Referendum": Real or Faux Taxpayer Control?

Following the May 2007 referendum on whether to shift taxes beginning with the 2007-2008 school year (the particulars of which will be discussed later in this analysis), school districts' ability to raise tax rates in the future will be limited under Act 1. The mechanism for doing so is to put those tax increases larger than a state-determined index before the voters for approval via a so-called "back-end" referendum. The index for each school district will be published every September.[3] The base index, which is the average of the percentage increase in the statewide average weekly wage and the "Employment Cost Index," may be adjusted for a given district if that district's market value/personal income aid ratio exceeds 0.400 for the school year prior to the school year for which the index is calculated.[4] The average adjusted index for the 2007-08 school year is approximately 4.4%, with a range from 3.4% to 5.5%.[5] By way of comparison, the inflation rate for the 2005-06 school year was 4.0%; 400 of Pennsylvania's 501 school districts have 2007-08 indexes equal to or in excess of this figure.[6]

The School District Budget Process under Act 1

Each Pennsylvania school board is required to adopt a preliminary budget proposal for the next fiscal year at least 90 days prior to the election immediately preceding the fiscal year in which the budget will take effect. The preliminary budget must include estimated revenues, expenditures, and proposed tax rates. Preliminary budgets must be made available for public inspection at least 20 days before adoption, and the board must make its intention to adopt the preliminary budget known at least 10 days prior to adoption. The board may hold a public hearing prior to adoption of the preliminary budget. School boards can also adopt a resolution stating that they will not raise any district tax rate by more than the index in the following fiscal year.[7]

For the 2007-08 fiscal year, school districts must adopt preliminary budgets (along with a schedule of proposed tax increases) by February 14, 2007. These items must be submitted to the Pennsylvania Department of Education (PDE) by February 19, 2007. After PDE reviews any proposed tax rate increases in each district's preliminary budget, it will notify districts in writing by March 1, 2007 of whether or not any of the following actions must be taken by the board:

- If a district's proposed tax increases exceed the district's index, the proposed tax rate must be reduced to the index; or
- A referendum exception must be sought from PDE or the Court of Common Pleas; or
- Voters at the May 15, 2007 primary election must approve the tax rate increases.[8]

If a district adopts a resolution stating that it will not raise any tax by more than the index, the district must then send a copy of the resolution to PDE, along with a schedule of proposed tax increases, by Jan. 30, 2007. PDE will review these documents and respond in writing by Feb. 9, 2007 as to whether or not the proposed increases are less than or equal to the district's index. If the proposed increases do exceed the index, the district must then adopt a preliminary budget in the manner prescribed by Act 1—but it will be permitted to seek exceptions to the referendum.[9]

Act 1 Referendum Exceptions: A Façade of Taxpayer Control

Act 1 permits Pennsylvania school district taxpayers to control spending directly through ballot referendum on certain tax increases. The key word is "certain," for the law provides for ten referendum exceptions—categories of district expenditure from which the district may apply to PDE or the Court of Common Pleas for relief from the referendum requirement if the revenue increase needed to fund them exceeds the district's index. Of the ten exceptions, three must be approved by the Court of Common Pleas, while the remaining seven are under the jurisdiction of PDE. The Court of Common Pleas has the responsibility of adjudicating referendum exception requests in the following areas:

- Expenditures necessary to respond to an emergency or disaster declared by the governor.
- Expenditures necessary to implement a court or administrative order from a federal or state agency.
- Expenditures necessary to respond to conditions that pose an immediate threat of serious harm or injury.[10]

For the 2007-08 fiscal year, requests for referendum exceptions must be submitted to PDE or the Court of Common Pleas in the school district's judicial district by March 1, 2007. Districts requesting a referendum exception must publish their intention at least one week prior to submission in a general circulation newspaper and on the school district's website. If the relevant body approves the exception, the district in question may raise a tax rate by more than its index if expenditures in any of the following areas will necessitate it.

School Construction and Debt

In determining which school construction expenditures may be eligible for an exception, the decision depends in part on the "effective date" of a previous action or agreement. For school districts that opted into Act 72 of 2004, the effective date is September 4, 2004; while for all other districts, the effective date is June 27, 2006.[11]

For debt incurred before the effective date with budgeted payments in 2006-07 or 2007-08, a district must provide PDE with a settlement sheet with the date of issuance, a schedule of debt payments, information documenting interest rates for 2006-07 and 2007-08 for variable rate issues/notes/loans, and the executed board resolution incurring the indebtedness (if the debt was incurred, but not yet issued, before the effective date). For notes/issues/loans not yet issued, but with payments budgeted for 2007-08, the documentation to be provided to PDE includes the proposed debt schedule for each issue, information documenting variable interest rates and payments for 2006-07 and 2007-08 for variable rate issues/loans/notes, and either a) the executed board resolution for debt incurred prior to the effective date, or b) a statement of intent to incur indebtedness signed by the superintendent.[12]

Costs associated with the refinancing of qualifying indebtedness will also be eligible for an exception. The amount of refinancing bonds that can be issued is limited to a principal amount equal to the current outstanding principal to be refinanced plus the issuance costs of the refinancing (underwriter's fees, bond insurance, legal fees, and the like). PDE must receive a copy of the executed board resolution incurring the indebtedness for the original issue (if a refinancing was issued).[13] Liquidity, remarketing and other fees on a variable rate bond issue that are not principal or interest that would require tax increases above the district's index must be approved by voters if paying for them would require a tax increase above the district's index.[14] A referendum exception may be requested if the total budgeted payments for principal and interest on certain debt rise due to an increase in the local share of those payments (total payments net of state reimbursement) or due to a decrease in non-recurring revenues.[15]

School district construction projects are among the largest—and often, among the most contentious—expenditures that school boards authorize. Taxpayers are justifiably concerned about the impact that new construction will have on their tax burden, but the experience of Michigan—a state in which voters must approve school capital bond proposals—demonstrates that if district administrators and board members make a compelling case for the necessity of a new capital project, voters will give their approval (as they did more than 60 percent of the time as recently as the 2002-03 school year).[16] In many cases, unfortunately, Pennsylvania voters will not be given the opportunity to affirm such decisions.

Special Education

Districts in which expenditures for special education programs and services for students with disabilities increased by more than the school district's index between 2004-05 and 2005-06 are eligible for an exception equal to the portion of the increase that exceeded the index. Expenditures considered here are defined as "the portion of the expenditures spent on services described in the Individualized Education Plan (IEP) for students with disabilities" in the areas of guidance, psychological needs, speech pathology and audiology, social work, instruction and curriculum development (related to the district's Director of Special Education), legal, medical, nursing and student transportation.[17]

To illustrate how an exception for special education services would be calculated, consider a school district in which the 2007-08 index is 3.4%, 2004-05 special education expenditures were $1.5 million, and 2005-06 special education expenditures were $1.8 million. If special education expenditures had increased at the same rate as the district index, that increase would have been $51,000. The allowable exception is calculated by subtracting $51,000 from the actual difference between the 2004-05 and 2005-06 special education expenditures ($300,000), producing an allowable referendum exception of $249,000.

Special education has been one of the fastest-growing categories of Pennsylvania school district expenditures. Allowing voters to approve **all school district spending decisions** would force district officials to take one or more of the following three actions:

- Make the case for any tax increases needed to finance increased spending in this area;
- Prioritize existing spending away from other segments of the district budget, or
- Find ways to reduce the costs of providing special education services.

One reform option that shows promise, both in terms of reducing the cost of special education and providing needed services to affected children, is Florida's "McKay Scholarship" program, which allows the families of children with special needs to spend the money allocated for their education at the school that best suits them, regardless of whether that school is public or private. A similar program tailored to Pennsylvania could possibly improve both the cost and quality of special education.

School Improvement Plan

Districts that incurred costs (not covered by federal funds) to implement a school improvement plan under the federal No Child Left Behind (NCLB) law in 2005-06 can receive an exception for the expenditures not offset by a state allocation dedicated to school improvement. These state allocations include, but are not necessarily limited to, the School Improvement Grant plus the portion of the Pennsylvania Accountability Grant and Education Assistance Program funds used for school improvement.[18]

Maintenance of Local Revenue and Actual Instruction Expense per Average Daily Membership

Under this category of potential referendum exceptions under Act 1, there are two subsections—one dealing with "fast-growing" school districts and one for all other districts.

"Fast-growing" districts are defined as those with an average daily membership (ADM) that increased by more than 7.5% between 2002-03 and 2005-06. If local tax revenue per ADM for 2005-06 does not exceed local tax revenue per ADM for 2004-05 increased by the 2007-08 index, school districts that qualify would be eligible for an exception equal to "the difference multiplied by the 2005-06 ADM."[19]

To illustrate how an exception would be calculated in this instance, consider a "fast-growing" school district in which the 2007-08 index is 3.4%. Assume that this district had a 2004-05 ADM of 2,875 and local tax revenues of $14 million ($4,870 per ADM) in 2004-05, and local tax revenues of $15 million in 2005-06 with an ADM of 3,000 ($5,000 per ADM). Increasing the 2004-05 local tax revenues per ADM figure by 3.4% yields $5,036, which exceeds the actual 2005-06 district tax revenues per ADM by $36. Therefore, the allowable referendum exception in this case will be $36 times 3,000 (the 2005-06 district ADM), or $108,000.

School districts not classified as "fast-growing" are eligible for an exception if the district's actual instructional expense (AIE) per ADM for 2005-06 does not exceed the 2004-05 AIE per ADM increased by its 2007-08 index. The exception would be equal to the difference between the two multiplied by the 2005-06 ADM.

To illustrate, assume a school district with a 2007-08 index of 3.4% had a 2004-05 AIE of $5,636 per ADM ($15.5 million divided by 2,750) and a 2005-06 AIE of $5,714 per ADM ($16 million divided by 2,800). The 2004-05 AIE/ADM increased by 3.4% equals $5,828, or $114 more than the 2005-06 AIE/ADM figure of $5,714. The allowable referendum exception is therefore $114 times 2,800, or $319,200.

Maintenance of Selected Revenue Sources

Districts in which the sum of property taxes, earned income and net profits taxes (or personal income taxes), the basic education funding allocation, and the special education funding allocation (including contingency funding for 2005-06) does not exceed the sum of those amounts for 2004-05 increased by the 2007-08 index will be eligible for an exception equal to the difference.[20]

To illustrate how an exception would be calculated in this case, consider a district with a 2007-08 index of 3.4%, and in which the sum of the "selected revenue sources" described above was $14.7 million for 2004-05 and $15 million for 2005-06. Increasing the 2004-05 amount by the index yields a figure of $15.1998 million, or $199,800 more than the actual 2005-06 figure. Therefore, the allowable referendum exception in this case is $199,800.

Healthcare-Related Benefits

The exception that Act 1 permits for school district healthcare-related benefits will likely be one of those most frequently utilized. To be eligible for this exception, the collective bargaining agreement between a given district and the union representing its employees for the 2007-08 school year must have been in effect as of January 1, 2006. Districts in which collective bargaining agreements had been renewed, extended or entered into after January 1, 2006 are not eligible.[21]

If a qualifying district anticipates that the percentage increase in the cost of healthcare benefits between 2006-07 and 2007-08 will be greater than the district's 2007-08 index, that district will be eligible for an exception equal to the portion of the increase that exceeds its index.[22] For example, suppose that a district in which the 2007-08 index is 3.4% has 2006-07 estimated healthcare-related benefit expenses of $1.25 million and estimated 2007-08 estimated healthcare-related benefit expenses of $1.5 million—an increase of $250,000. Increasing the 2006-07 amounts by the index yields a figure of $1.2925 million, or $207,500 less than the district's estimated 2007-08 healthcare-related benefits. This difference is the allowable referendum exception under Act 1.

Healthcare expenditures are among the fastest-growing components of the budgets of many public and private sector organizations. School district and other public employees should not be immune from the effects of rising healthcare costs, especially since many of the citizens whose taxes pay for public employee health benefits have been unable to shift the cost of their benefits elsewhere. Allowing an exception for this school district budget category precludes substantive reform of how employee health benefits are provided, such as the use of health savings accounts (HSAs), which are growing in popularity among many private-sector companies due to the flexibility, consumer choice, and cost savings they provide.

Retirement Contributions

As with the healthcare benefit-related exception, the exception available to Pennsylvania school districts under Act 1 for retirement contributions is also likely to be among the most heavily requested—and among the most costly to district taxpayers. If the anticipated increase in a school district's payments to the Pennsylvania School Employees Retirement System (PSERS) between 2006-07 and 2007-08 is greater than the school district's index, the district will be eligible for an exception equal to the portion of the payment increase that exceeds the index (subject to a requirement that the revenue amount used to calculate the district's share of payments be at least 50% of the expenditure amount in the calculation).[23]

For example, assume that a given district has a 2007-08 index of 3.4%, has 2006-07 estimated district payments to PSERS of $225,000, and has estimated 2007-08 PSERS payments of $250,000—a difference of $25,000. A 3.4% increase over the 2006-07 estimated PSERS payment would be $7,650, so the allowable referendum exception would be calculated by subtracting that figure from the difference between the 2006-07 and 2007-08 estimates, which equals $17,350.

In February 2006, the Commonwealth Foundation released a study detailing the coming financial crisis facing Pennsylvania's State Employees Retirement System (SERS) and PSERS. The study found that Pennsylvania taxpayer support for SERS and PSERS would, assuming current trends continue, increase from $583 million in FY 2004-05 to $4.176 billion by FY 2012-2013.[24] Rather than potentially forcing a dramatically increased burden on taxpayers (at both the state and the school district levels), Pennsylvania must, in the words of the study, "adopt a long-term benefit strategy to control costs rather than assuming 'the perpetual life' of the taxpayers' ability to pay if it hopes to properly govern, benchmark and manage the long-term pension and healthcare liabilities."[25]

Approval or Denial of Referendum Exceptions

PDE will approve referendum exception requests submitted in one of the areas previously outlined if a review of the data demonstrates that the district qualifies for one or more exceptions. If the request is approved, PDE will determine the dollar amount of the expenditure for which the exception is sought and the tax rate increase required to fund the exception. If the request is denied, the school district must either reduce the tax rate increase to no more than its index or submit a referendum question for voter approval in the primary election (for school districts with a July 1-June 30 fiscal year).[26]

Pennsylvania's limited experience with voter referendum for school district tax increases suggests that there will be very few denials of referendum exceptions that would ultimately result in a "back-end" referendum being necessary. Act 1's predecessor, Act 72 of 2004, contained a number of referendum exceptions that were very similar to those in the new law. Yet among the 111 Pennsylvania school districts that chose to opt into Act 72, in the May 2006 primary election, only one was required to submit a tax increase higher than its index to voters for approval.[27]

Summary

Allowing districts to increase taxes by a measure of inflation, exempting certain categories (which tend to be the fastest growing segments of school spending), and exempting tax increases to "maintain" certain revenue sources defeats the primary purpose of having a "back-end" referendum—which is to allow voters the opportunity to have the final say on how district revenues should be "maintained." The experiences of other states demonstrate that if voters are provided evidence that a certain level of revenue is needed by the district, they are willing to approve the tax changes necessary to achieve that revenue level.[28] Pennsylvania school boards need not fear voter rejection of truly needed tax and spending increases—but Act 1's design severely limits that possibility via its numerous referendum exceptions.

FRONT-END REFERENDUM AND THE ROLE OF LOCAL TAX STUDY COMMISSIONS

At the heart of the property tax "relief" in Act 1 is a tax shift. Act 1 relies on two principal sources to provide revenues for "dollar-for-dollar" reductions in Pennsylvania school district residential property taxes (no relief is available for commercial and industrial properties) or for relief for taxpayers subject to Philadelphia's wage tax. One of the two sources—an anticipated $1 billion (according to estimates provided by the Rendell Administration) in tax revenue from slot machine gambling—is not expected to be available for several years, and no gambling revenues will be available for property tax reduction until $400 million is in the property tax reserve fund.[29] The other source, which is to be available for the 2007-08 school year, will be determined by school district voters (excluding those in Philadelphia, Pittsburgh and Scranton), who are to be given the option of shifting part of their school property tax burden, via a "homestead exclusion," to either an increased earned income tax or a personal income tax in a "front-end" referendum on the spring 2007 primary ballot.[30]

Each Pennsylvania school district was required to appoint a local tax study commission by no later than September 13, 2006. The commissions, which were to be made up of either five, seven, or nine members representing a "broad cross-section" of each school district's population, were required to study their district's tax system and make a non-binding recommendation on how to change it in order to provide property tax relief to residential property owners. The commissions were charged with making their recommendations within 90 days of their appointment (no later than December 13, 2006).[31] Some of those recommendations (and their potential implications for school district taxpayers) will be discussed as this analysis proceeds.

Once each district's local tax study commission has made a recommendation to its school board, the board has the option of accepting the commission's findings or devising an alternative system of its own. School boards must take a public vote to accept or reject the recommendation of the local tax study commission, must provide public notice of the vote, and must conduct at least one public hearing on the commission's findings. Regardless of the board's ultimate decision on the tax system it will offer to voters, it must present a referendum question and non-legal interpretative statement to the electorate by March 13, 2007. The question can take one of three forms, but it must state the rate of the tax being proposed and the amount of the homestead exclusion that revenue from the additional tax will fund.[32] It does not address a situation in which a district currently does not impose an earned income tax.[33]

The May 15, 2007 referendum is only for the purpose of determining whether or not to shift from school district property taxes to a higher local income tax. The referendum has no impact on whether or not the district will receive gambling funds for property tax reduction. It also has no bearing on whether or not the district will be subject to Act 1's limits on the size of future tax increases—those that would trigger a "back-end" referendum.[34] And no earlier than November 2009, voters will have the opportunity to change their earned income or personal income tax again, with another tax study commission to be appointed and with the school board again required to decide on what type of alternative tax system is to be presented to voters.[35] At that time, however, a school board can choose to either present a referendum question or do nothing.

Tax-Shifting Under Act 1: Key Issues

Local tax study commissions confronted a number of key questions in the course of their work, with the primary focus being on whether they should recommend a shift to an increased earned income tax or an equivalent personal income tax, and what the rate of the proposed tax should be. The chosen rate was to be rounded to the nearest 0.1%, and it may not be rounded up in violation of constitutional limits.

In the course of developing their non-binding recommendations, local tax study commissions were required by Act 1 to consider the following factors:

- The historic and present rates and revenues from taxes currently levied, assessed and collected;
- The percentage of total revenues provided by each of those taxes;
- Demographic information (age, income, employment and property use) about their district's tax base; and
- Projected revenues from each tax that might presumably be levied in the future.[36]

Each of these factors will impact whether or not voters ultimately decide to accept the alternative tax system offered by their district's school board. For instance, with regard to how the composition of a school district's population might affect this decision, districts with a large population of senior citizens might be inclined to choose a tax rate that provides for the largest possible property tax cut.[37] However, such a choice would mean shifting the tax burden toward the district's income earners, with the possible result that high-income individuals and families who receive a property tax reduction smaller than any concurrent increase in their income tax burden will have an incentive to move to a district where their tax treatment is more favorable.

At the same time, for districts in which earned income tax revenues have been rising faster than property tax revenues, the potential exists for increased collection of those taxes for a few years under a shift to a higher earned income tax or a personal income tax. It is likely that districts will try to tap into the faster-growing sources of taxable revenue in order to maximize the amount of revenue they can collect. However, once taxpayers adjust to the higher rates (especially those taxpayers whose property tax reductions are smaller than their corresponding local income tax increases), earned or personal income tax revenues in those districts could fall to levels equal to or below those observed prior to the tax shift. A higher earned income or personal income tax could discourage people with higher incomes from living in a given school district, for as home values increase, the likelihood increases that the property tax reduction permitted under Act 1 would be smaller than the local income tax increase faced by such a resident.

THE HOMESTEAD EXCLUSION

The Act 1 tax shift—in terms of both the rate and type of income tax—ultimately offered by school boards to voters will be closely linked with how much property tax relief those voters will have the opportunity to approve. As noted previously, the residential property tax relief provided by any tax shift under Act 1 will take the form of a "homestead exclusion." Due to the Pennsylvania Constitution's "uniformity clause," which requires that the tax rate on all types of property be the same, offering property tax relief to residential property owners (and farmstead owners) without doing the same for owners of commercial and industrial properties required the enactment of a constitutional amendment allowing for a "homestead exclusion" that "reduces the assessed value of a home or farmstead for paying school property taxes."[38]

The maximum homestead exclusion allowed by the Pennsylvania Constitution is equal to 50% of the assessed value of the median home in the district, which means that the higher the median home value in a given district, the larger the potential homestead exclusion that can be offered.[39] However, in the case of Act 1, the larger the homestead exclusion offered, the higher the earned income or personal income tax rate needed to fund it. In addition, the same homestead exclusion applies to every home in the district that is used as a primary residence, meaning that for tax purposes, each property qualifying for the homestead exclusion would see its assessed value reduced by the same amount (up to the assessed value of the property). Doing so has the effect of providing residential property owners with lower assessed values with a greater relative benefit from that exclusion than residential property owners carrying higher assessed values.[40]

To calculate a residential property owner's school property tax bill with a homestead exclusion factored in, the assessed value of the property is first reduced by the amount of the homestead exclusion, and the millage rate is then applied to the resulting figure. By way of illustration, consider a school district in which the median assessed value of the homes in the district is $50,000 and the real estate tax rate is 20 mills (or 2%). The effect on three residential properties in the district valued at $25,000, $45,000, and $75,000, respectively, is shown below.

With no homestead exclusion, the property tax bills for the three properties are calculated as follows:

- Property 1 = $25,000*(20 mills) = $500 property tax
- Property 2 = $45,000*(20 mills) = $900 property tax
- Property 3 = $75,000*(20 mills) = $1,500 property tax

With the maximum homestead exclusion of $25,000, the property tax calculation would be:

- Property 1 = ($25,000-$25,000)*(20 mills) = $0 property tax
- Property 2 = ($45,000-$25,000)*(20 mills) = $400 property tax
- Property 3 = ($75,000-$25,000)*(20 mills) = $1,000 property tax

As the figures above demonstrate, **the property tax bills for all eligible properties will be reduced by the same amount** ($500) up to 100% of the property tax—but on a percentage basis, the owner of the first property will have his property tax liability completely eliminated, while the second property owner will see his property tax bill reduced by more than half, and the third owner will see his property tax reduced by only one-third.

Earned Income vs. Personal Income Taxes

As noted previously, Act 1 requires that school boards submit ballot questions that offer property tax relief equal to anywhere from a minimum of half of the maximum homestead exclusion to a maximum of the full homestead exclusion. The homestead exclusion offered will be funded by either an increased earned income tax (EIT) or an equivalent personal income tax (PIT). Act 1 also states the proposed new income tax to fund this property tax relief does not have to be more than a 1% earned income tax.[41]

In making the decision about whether or not to propose an earned income tax increase or a higher equivalent personal income tax to district voters under Act 1, local tax study commissions (and ultimately, school boards) were charged with considering how the two types of taxes differ. Earned income taxes apply only to compensation and net profits, which includes salaries, wages, commissions, bonuses, stock options, incentive payments, fees, tips and net profits from the operation of a business, profession or farm. Personal income taxes includes all income taxed under the EIT, and includes interest, dividends, net gains or income from the disposition of property, net gains or income from rents, royalties, patents or copyrights, income derived through estates or trusts, and gambling and lottery winnings. Neither the earned income nor the personal income tax applies to Social Security or retirement benefits, thus limiting the impact on many senior citizens.[42]

Since a PIT can be applied to a broader base of income than an EIT, it follows that a lower overall PIT rate would be needed to generate the same amount of revenue as would a higher EIT rate. However, because a local personal income tax (which is levied on the same classes of income as the state PIT) applies to a variety of investment-related income not taxed under the EIT, individuals with such income may be discouraged from living in districts that choose to impose a PIT. It is also possible that some individuals who would be negatively affected by a personal income tax (such as small business owners who pay taxes at the personal rate) will also be owners of non-residential properties not eligible for a tax reduction under Act 1. Finally, the Pennsylvania Department of Revenue has not yet developed collection procedures for local personal income taxes, which further complicates implementation of such a tax.

To illustrate how taxpayers could be affected by the choice of either a higher earned income tax or an equivalent personal income tax, consider an example contained in data developed for the local tax study commissions of West Jefferson Hills School District (Allegheny County), Northampton Area School District (Northampton County), and Pottstown Area School District (Montgomery County). The example examines the tax burden on three households—each with a total income of $56,000—under either a 0.5% earned income tax or a 0.5% personal income tax. Each household's income is broken down by source as follows:

- Household A: $50,000 in salaries and wages, $4,000 in dividends, and $2,000 in interest, yielding total earned income of $50,000 and total personal income of $56,000.
- Household B: $25,000 in Social Security, $25,000 from a pension, $4,000 from dividends, and $2,000 in interest, yielding total earned income of $0 and total personal income of $6,000.
- Household C: $30,000 in dividends and $26,000 in interest, yielding total earned income of $0 and total personal income of $56,000.[43]

Under a 0.5% earned income tax, Household A would pay $250, while Households B and C would each have no earned income tax liability. Under a 0.5% personal income tax, however, Household A would pay $280 ($30, or 12%, more than under an EIT); Household B would pay $30 (rather than $0); and Household C would pay $280 (rather than $0). All three households would be subject to higher income tax bills under a higher personal income tax rate than a higher earned income tax rate.

Business Property Tax Relief: A Glaring Omission from Act 1

The final decision as to what proposed tax system district voters will consider rests with the school board, and regardless of whether or not that system is the product of the local tax study commission's recommendation, the board will have to evaluate not only the impact the new system will have on taxpayers in their own district, but also how that system will compare with those of neighboring districts. Act 1 will not merely affect how a given school district raises its revenue. It will also influence the location decisions of businesses and individuals, and those decisions will have short and long-term consequences for the district's economic competitiveness (while directly and indirectly affecting how much tax revenue—from all sources—will be available to finance district operations).

According to the Tax Foundation's *2007 State Business Tax Climate Index*, "Property taxes are a major concern to business because they constitute a considerable cost of doing business and significantly impact location decisions."[44] And just as residential property taxes often bear little relationship to the property owner's economic circumstances, the same is true of businesses as well, as an increase in business property tax liability is not always the product of improved economic prospects.[45] While the value of a residential or business property may rise over time, it does not necessarily follow that the "income stream" available to pay the taxes on that property will increase as well.[46]

This relationship may explain, in part, why Pennsylvania's economy has performed so poorly over the past several decades. The property tax is a "wealth tax" that is particularly harmful to smaller and start-up businesses with low or non-existent profit margins—the very businesses that are the backbone of state economies. This is not to suggest that larger, more established Pennsylvania businesses are not harmed by property taxes, but in most cases, they are, relatively speaking, better positioned to withstand such tax increases than are smaller, less stable firms. In addition, the presence of such taxes means many potential entrepreneurs may be discouraged from starting businesses in the first place.[47]

The *2007 State Business Tax Climate Index* notes that in 2005, businesses paid $497 billion in state and local taxes—$182.8 billion (or 37%) of which were property taxes (including real, personal and utility property).[48] In addition, a March 2006 study by Ernst & Young (in conjunction with the Council on State Taxation) found that property taxes comprised the largest portion of state and local business taxes nationally in 2005, and this was true of Pennsylvania as well (property taxes represented 31% of total state and local business taxes in that year).[49] A number of academic studies also point to the importance of low property taxes in attracting business investment and the negative consequences to new business start-ups and existing business location decisions from increasing property taxes. The glaring omission of businesses from the discussion of Pennsylvania school district property taxes will have a far-reaching impact on the state's economic competitiveness.

Who Benefits and Who Loses From Act 1 Tax-Shifting?

To illustrate how differently situated taxpayers in various Pennsylvania school districts might be affected under Act 1, it is helpful to once again consider data developed for the local tax study commissions of West Jefferson Hills School District (Allegheny County), Northampton Area School District (Northampton County), and Pottstown Area School District (Montgomery County). The data include projections, for the first two years under Act 1 (using the earned income tax base, assuming first year collections of 70% of total estimated collections, and assuming an additional earned income tax rate of 1% for West Jefferson Hills and Pottstown and of 0.8% for Northampton), of the impact of the new law on homeowners (as well as homeowners working in Philadelphia for Northampton and Pottstown) and renters (as well as renters working in Philadelphia for Northampton and Pottstown). The projections for each of these classes of taxpayers in each district are discussed in turn.

Homeowners

For West Jefferson Hills, estimates of the impact of Act 1 were provided for homeowners earning $100,000, $50,000, and $25,000 annually. For Pottstown, estimates were provided for homeowners earning $100,000, $50,000 and $20,000 annually, and estimates were provided for Northampton for homeowners earning $110,000, $55,000, and $25,000 annually. Each taxpayer was assumed to receive the same amount of property tax relief from their district's homestead exclusion in each of the two years, with the amount of relief from the second year's homestead exclusion expected to be larger in all three cases.

As Table 1, opposite page, demonstrates, applying a uniform level of property tax relief with a income tax rate increase may reduce the overall school tax burden on low- and moderate-income homeowners, while increasing the tax burden on higher-income homeowners.

Homeowners Receiving Credits against the Philadelphia Wage Tax

Estimates were available for Pottstown and Northampton homeowners who work in Philadelphia for the first and second years under Act 1 (assuming that voters approve the tax shift described in the previous section). Each of the three hypothetical homeowners would receive a credit equal to the amount of additional district earned income tax they would owe, as well as a tax reduction via the homestead exclusion, resulting in a net tax savings equal to the amount provided by the homestead exclusion for each of the three homeowners.[52]

Renters

Renters at each of the income levels examined for West Jefferson Hills and those Pottstown and Northampton renters who do not work in Philadelphia would sustain net tax increases in both the first and second years of Act 1, due to the fact that they would not be eligible for property tax relief via the homestead exclusion. Renters for Pottstown and Northampton who work in Philadelphia would receive a credit against the Philadelphia wage tax equal to the increase in their earned income tax liability under Act 1, so none of them would see a change in their school district tax liabilities in either the first or second year.[53] Most renters across the state, unless they work in Philadelphia, would see a net tax increase.

Small Business Owners

At the same time, owners of non-residential properties see no property tax relief under Act 1. Also, depending on the outcomes of individual school district referendums, small business owners or self-employed individuals who pay business taxes at the earned income or personal income tax rate may have additional incentive to migrate to lower-tax school districts. Furthermore, the administrative burden to businesses will increase as the number of different rates that must be applied to the earnings of employees living in various jurisdictions adds more complexity to an already complicated process.

Summary

While there are myriad possible scenarios under Act 1 for each Pennsylvania school district and each taxpayer, in general, those Pennsylvanians most likely to benefit are senior citizens, lower-to-middle-income homeowners, and people who work in Philadelphia. Higher-income homeowners are more likely to be negatively impacted, as are renters not covered by the Property Tax and Rent Rebate Program (or not working in Philadelphia),

Table 1: Effect of Act 1 Tax Shift on Hypothetical Pennsylvania Homeowners							
		Year 1			Year 2		
West Jefferson Hills	Income	Property Tax Savings	Income Tax Increase	Net Tax Change	Property Tax Savings	Income Tax Increase	Net Tax Change
Homeowner 1	$25,000	-$356	$250	-$106	-$509	$250	-$259
Homeowner 2	$50,000	-$356	$500	$144	-$509	$500	-$9
Homeowner 3	$100,000	-$356	$1,000	$644	-$509	$1,000	$491
Pottstown							
Homeowner 1	$20,000	-$426	$200	-$226	-$609	$200	-$409
Homeowner 2	$50,000	-$426	$500	$74	-$609	$500	-$109
Homeowner 3	$100,000	-$426	$1,000	$574	-$609	$1,000	$391
Northampton							
Homeowner 1	$25,000	-$413	$200	-$213	-$585	$200	-$385
Homeowner 2	$55,000	-$413	$440	$27	-$585	$440	-$145
Homeowner 3	$110,000	-$413	$880	$467	-$585	$880	$295

Source: Public Financial Management, Inc., "Act 1 of 2006—Taxpayer Relief Act," Pottstown Area School District (October 16, 2006); West Jefferson Hills School District (October 13, 2006); Northampton Area School District (October 10, 2006).

due to the fact that they will have to pay higher local income taxes while receiving no property tax relief.

WHICH TAX SHIFTS MIGHT BE PLACED BEFORE VOTERS?

As noted previously, local tax study commissions have examined their districts' options under Act 1 and made recommendations on the type of tax shift to offer voters in May 2007. The following section provides a sample of some of the recommendations under consideration in districts across Pennsylvania.

- The Muncy School District's (Lycoming County) tax study commission recommended an increase of 0.6 percentage points in the district's earned income tax (from 1.25 to 1.85%)—the minimum amount allowable under Act 1. The increase would fund a homestead exclusion that would produce a $288 property tax reduction. According to published reports, commission members were not "happy with the choices available to them" and chose the minimum exclusion "as the lesser evil."[54]
- The Bald Eagle Area School District (Centre County) accepted the recommendation of its tax study commission, which was to increase the earned income tax by 1 percentage point in order to fund "an estimated $400 average decrease in property taxes." The commission also recommended that the district school board wait until 2007 to pass a resolution with specific language on the referendum, citing concerns about "how much it would cost to pay for the reduction in property taxes" and noting that "better information about the average assessed value of homes in the district and the number of people who have been approved for property tax relief" may

be available.[55]

- The Pennsbury School District (Bucks County) local tax study commission reluctantly recommended an additional 1% earned income tax to its school board, as the commission's chairman opined that "there seems to be no community support for either tax."[56]
- North Penn School District's (Montgomery County) tax study commission recommended an additional 1.1% earned income tax to fund a homestead exclusion providing an estimated $1,145 in property tax relief—the maximum amount allowable. Under such a plan, a family earning $50,000 per year and owning a home would save approximately $500 per year, while a family earning $200,000 per year would pay an additional $1,055 in taxes annually.[57]
- The York City School District's (York County) tax study commission recommended an additional 1% earned income tax, which was expected to fund a homestead exclusion sufficient to provide each homeowner with $270 in annual property tax relief. The commission's report noted that homeowners with earned incomes of less than $28,000 will see a net tax reduction under such a plan, but those homeowners earning more than that amount will realize a net tax increase.[58]
- The Carmichaels Area School District's (Greene County) tax study commission announced a recommendation of a 0.5% additional earned income tax. The commission's figures reveal that homeowners earning less than $30,000 will receive a net tax reduction, while homeowners earning more than that figure will see a net tax increase.[59]
- The Hempfield Area School District (Westmoreland County) tax study commission publicly favored converting its earned income tax to a personal income tax (levied at a rate of 0.9%) under Act 1—but only if a mechanism is in place to collect it. If not, the commission planned to recommend an additional 0.6% earned income tax. Under a 0.9% personal income tax, district homeowners with incomes of more than $70,000 would see an increase in their total school district tax burden, while those homeowners earning less would realize a net tax decrease.[60]
- The Lebanon School District's (Lebanon County) tax study commission was slated to recommend a plan that would ask voters to approve an additional 0.7% earned income tax in return for a $249 property tax reduction for homeowners. However, because approximately half of the district's households are renters, and about half of those who are homeowners are expected to pay more in earned income taxes than they would save in property taxes under the commission's recommended tax shift, the result is that three of every four Lebanon School District households would see a tax increase if voters approve it as recommended.[51]
- The Central Dauphin School District's (Dauphin County) tax study commission made, in the words of one member, "a recommendation we don't believe" by proposing an additional 0.5% earned income tax that would give district homeowners a $412 decrease in property taxes. In fact, the committee made a "specific recommendation" that voters "not approve any change to the existing tax structure" of the district.[62]
- The South Williamsport Area School District's (Lycoming County) tax study commission took the unusual step of recommending no change be made in the district's tax system, despite the fact that the school board does not have the option of enacting that recommendation. Commission members argued that three of every four homeowners in the district would be negatively impacted under a tax shift.[63]

CONCLUSION

Despite its billing by Gov. Rendell as the "largest property tax cut in Pennsylvania history,"[64] Act 1 of 2006 is likely to fall short of expectations for the same reasons that its predecessors did—it shifts the school district tax burden, rather than reducing it; and it provides for no meaningful controls on the real culprit behind ever-increasing property taxes: school district spending increases in excess of citizens' ability to pay. The choices available to districts and voters in shifting taxes yield no net benefit, but are a zero-sum game creating winners and losers. Senior citizens, low- and moderate-income homeowners, and those working in Philadelphia may see a tax break, but upper-income homeowners and renters are far more likely to see a tax increase. In addition, its glaring omission of business and commercial properties from tax relief threatens to worsen Pennsylvania's already substandard business climate.

The only sure way to attain control over school district fiscal policy is to subject all district tax and spending decisions to referendum—with no exceptions. At the same time, market-based reforms are needed in how education is provided in Pennsylvania, so that the true cost of providing public education in the Commonwealth can be ascertained.

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