Is Pennsylvania Ready to End (Most) Property Tax for Funding Public Schools?

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At the September PROA Board meeting, the hot topic of conversation was House Bill 76, a bill sponsored by over 60 state representatives, which if it became law would replace the bulk of Pennsylvania property taxes for support of schools with sales and income tax increases on the state level. The law would also allow school districts to supplement their share of tax money from the state with earned income and net profits or personal income taxes on residents of their respective districts. At the PROA meeting, I committed to read the proposed new law, to do a little research, and to offer my opinion on the proposed change. This article is the result of my review of the bill and research.

Before we get to the proposed new law, however, we need to understand how PA taxation now works generally, and for public K-12 education in particular. For years, Pennsylvania has funded state and local governments, and public school elementary and secondary education with a combination of three main types of taxes; Income taxes, sales and use taxes, and real property taxes. Of course, there are many other taxes and fees collected at all levels of government, but this article will focus on the big three.

Starting with income tax, Pennsylvania imposes a personal income tax at the rate of 3.07 percent on the income of resident and non-resident individuals, the non-residents only for income earned in Pennsylvania. The Commonwealth also imposes the personal income tax on income of estates, trusts, partnerships, S corporations, business trusts and limited liability companies not taxed by the federal government as corporations. The personal income tax is assessed against wages, commission and other forms of compensation, interest, dividends, and profits from a business, profession or farm. The tax is also assessed on gains from the sale or disposition of real property (other than a the taxpayer's personal residence) and personal property, net gains or income from rents, royalties, patents and copyrights, income from estates or trusts, and gambling and lottery winnings except winnings from the PA Lottery. There are no personal exemptions or standard deductions, but there are a host of deductions, credits and exclusions available to taxpayers. Nearly one in five PA households including many retirees and low income families qualify for tax forgiveness.

Pennsylvania also has a corporate net income tax of 9.9% on the federal taxable income of corporations doing business, carrying on activities, having capital or real property in Pennsylvania. Both personal and business income taxes are collected by quarterly estimates and annual returns, and employers must withhold personal income tax from employees' wages, and remit amounts withheld to the Department of Revenue According to a PA Department of Revenue News Release on July 1, 2013, for the last fiscal year, which ended June 30th, 2013, Pennsylvania collected into its General Fund from all sources a total of $28.6 Billion Dollars. Of that amount, $11.4 Billion Dollars, or just under 40% of it was from Personal Income tax. Another $5.2 Billion Dollars, or 18% more, was collected from corporate income tax, so almost 60% of Pennsylvania's annual tax revenue came from income taxes.

Pennsylvania also imposes a sales, use and hotel occupancy tax. The tax rate is 6% in the rest of the state, 7% in Allegheny County and 8% in Philadelphia. The tax is charged on retail sales, use, rental or consumption of tangible personal property, and on certain services. Major exemptions from the current tax include food not ready to eat, candy and gum, most clothing, textbooks, computer services, pharmaceutical drugs and residential heating fuels such as electricity, oil, gas, coal and firewood. For hotel occupancy, the tax is applied to all room rentals for fewer than thirty days. The use or consumption in Pennsylvania of tangible personal property or certain services purchased out of state is subject to the use tax owed by the purchaser, in the same amount as sales tax.

The July 1, 2013 press release from the PA Department of Revenue indicated that 8.9 Billion Dollars was collected by Pennsylvania for sales tax in the fiscal year ending June 30, 2013. The press release did not clearly state that the sales tax number included use tax and hotel occupancy, but since neither of those items were reported separately, it is reasonable to conclude that it did.

From the July 1, 2013 press release by Governor Corbett's office, it appears that the State paid about 9.5 billion dollars in fiscal 2012/2013 for elementary and secondary education, including 5.4 billion dollars directly to the state's 500 school districts for "Basic Education Funding". The rest of that money was spent on Special Education funding to districts, block grants, career ant technical education, science grants, school busing and social security and retirement benefits for school employees. The 9.5 billion dollars spent on K-12 education represents over a third of the entire state budget. This is consistent with the governor's report that 41 percent of state tax revenue is committed to education.

The third main source of tax revenue in Pennsylvania is property tax. Property tax is based on the respective county's assessed value of each property, and the rate of tax or millage set by the county, municipality and school district applied to that assessed value. Property tax is the primary source of tax dollars for county and municipal governments, and currently the main source of funding for school districts. According to PAgov.org, a website of the Commonwealth Foundation, a nonprofit research and educational foundation, the total revenue of public school districts in Pennsylvania for the 2010-2011 fiscal year, the last year for which data has been analyzed, was just under 25.4 Billion Dollars. Just under 13.5 Billion Dollars came from local property taxes, just under 8.7 Billion Dollars came from State funding, and the rest from federal, other local and outside sources. This meant that over 53% of the cost of public K-12 education in PA was supported by local taxes, while 34% of funding came from the state, and only 8.6% of funding came from the federal government.

With the above background, we can examine the details of House Bill 76 of 2013. The bill would bar all school districts in PA from imposing most property taxes beyond the current fiscal year. Philadelphia (and probably Pittsburgh and Scranton districts) would end most property tax as of December 31, 2013, while other districts would end property taxes as of the end of their respective fiscal years on June 30, 2014.

Notice the word "most" in both sentences. All districts would still collect property tax to pay debt service and pay down principal on existing debt of the districts as of December 31, 2012. I live in a school district which recently built a new high school, funded by an 11 million dollar bond. The district also has about 2.5 million dollars in general bond debt. That means I will still pay property taxes to the school district for quite some time, to cover debt service and repayment of principal on those bonds. I may end up continuing to pay over 20% of the school tax I pay now, if my calculations of how much of the school budget is devoted to interest on and repayment of the principal of those bonds is correct. Since the district's rating has gone down, the interest it pays on its debt may even go up, and my calculation of how much I will still pay in school property tax may be low. Of course, the county and municipality will still be getting their respective property taxes, and the county will remain responsible for reviewing and adjusting my assessment to reflect current value of my property and any improvements, and so my assessment could go up in the future. That would increase my respective school property tax burden as well as municipal and county taxes.

Each school district will also be able to assess and collect its own taxes to supplement the additional money it would receive from the state. However, the new taxes assessed by school districts will not be property taxes. Instead, school districts will assess either personal income taxes or earned income and net profits taxes. Either tax must be approved by a referendum of voters, so that at least in theory provides some protection from a rush to tax. However, my district, like many others in PA, has a large number of property owning voters who are retirees, and who would not be as substantially affected by either a personal income tax or an earned income and net profits tax as they are by property taxes. Many other voters in the district are lower income wage earners, who would not pay a substantial portion of either new tax. And the new law would allow a complete exemption from such a tax for those individuals earning less than $12,000.00 per year. Thus, I fear my objection to such a tax, and that of other higher income voters, would be outvoted by those who would pay disproportionately less of either such tax, or no tax at all.

The most significant revenue replacements to local property taxes, however, will be expanded state taxes, collected by the Department of Revenue and distributed to the school districts. The first such tax would be an “Education Tax”. That tax would increase Pennsylvania income tax by over 40%, from the current 3.07 % to 4.34%. I’ve done a rough calculation and realize that if I were not the owner of multiple investment properties, that increase in income tax alone would wipe out any savings I realized from the reduction of school property taxes on my personal residence. Pull out your own 2012 PA 40, and add 40% to the total tax you paid last year. Would that substantially reduce the benefit of saving on your school property tax? Based on last year’s Personal Income taxes collected, the 40% increase would add over 4.5 billion tax dollars to state coffers.

The increase in personal income tax, however, is only part of the state tax increase planned in House Bill 76 to offset the reduction in school property tax. The second state tax increase is an increase of state sales tax from 6% to 7%, a 16 and 2/3% increase in the sales tax. On last year’s reported sales tax revenue of 8.9 billion dollars, that percentage would increase revenue by 1.5 billion dollars.

Going back to the numbers cited above, over 13.5 billion dollars was raised by school property taxes in fiscal 2010/2011. If 6 billion dollars were to be satisfied by increases in the rates of personal income tax and sales tax, another billion dollars or so were covered by continuing school property taxes to cover debt of school districts, and yet another billion dollars were covered by the new personal income, or earned income and net profits taxes charged by school districts themselves, education funding would still be over five billion dollars a year short. Where would that revenue be collected?

House Bill 76 also includes a dramatic expansion of the coverage of sales tax, the expanding the goods and services to which the tax applies. The bill specifically mentions Coca Cola, Pepsi Cola, Dr. Pepper and numerous generic soft drinks, including lemonade, orangeade, and even carbonated water. The tax is also extended to candy and gum, and any foods not covered under the federal food stamp program. The 7% tax will be extended to disposable diapers, incontinence products (covering both young and old) colostomy deodorants, toilet paper, sanitary napkins, tampons, toothpaste and dental floss.

The sales tax will be collected on sales of non-prescription drugs, clothing over $50 per item, newspapers, caskets, burial vaults and tombstones, flags and textbooks, and investment metal bullion, among other items.

The sales tax will be extended by House Bill 76 to a large number of services not currently taxed. Medical services by doctors, dental services by dentists, and most hospital charges will remain exempt from tax. Only certain legal fees, including contingent fees, business legal fees, fees for family law legal representation and criminal law legal representation will not be taxed. Other legal fees will be taxed.

It appears that the drafters of the bill believe these extensions of the sales tax to additional types of goods and services will raise the additional five billion dollars a year needed to replace most school property tax. I don't know how they can predict the amount of sales tax which will be collected on these items, because the tax may cause people to shift from buying, using or consuming taxable goods, to finding non-taxable substitutes. Also, sales tax by its very nature depends on spending. If the economy weakens and consumer spending drops, the amount of sales tax collected will likewise drop.

Even assuming that the new taxes collected will completely replace the property tax eliminated, there remains to be considered the mechanism for distribution of tax dollars collected by the state to individual districts. Right now, my school property tax dollars go to my local tax collector, and she passes those dollars directly to the school district within which my property is located. Under House Bill 76, the money collected throughout the state from income taxes and sales tax would go to the Department of Revenue, and the formula by which it will be distributed is based on last year's operating costs for each district, exclusive of interest and principal payments each district made on its debt. Frugal, well managed districts would be penalized for their past good practices, while spendthrift districts would lock in the benefit of more money to subsidize their expenditures. Apparently, wide variations in teacher salaries and benefits would be preserved from district to district despite statewide tax dollars being the primary means used to fund education. People who chose to buy property in well run districts with low per pupil costs would save on their property tax, but see large increases in the sales and income taxes they pay being used outside the districts where they live, work and even spend money on taxable purchases.

Further, House Bill 76 does not have a clear mechanism for reapportionment of tax dollars to account for changes in enrollment, changes in districts' mandatory costs like retirement and health care for employees. It appears that districts which face additional cash requirements would have to look to local earned income tax to cover their needs, while districts with declining enrollment or other events lowering costs might continue to receive funds based on their prior history.

I do support shifting the burden of funding Pennsylvania public schools from property owners in each district to a combination of income, sales and property based revenue sources. However, I am not convinced that House Bill 76 in its present form is the answer to that problem. Right now, if I have to choose between the rock I know and the hard place I do not know, I reluctantly choose to stay on the rock.

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