

Is Pennsylvania Ready in 2018 to End (Most) Property Tax For Funding Public Schools?

By Bradley S. Dornish, Esq.

For over four years, I have been following efforts to change the way Pennsylvania funds public education. SB 76 of 2013 has become SB 76 Of 2017. While SB 76 was referred to the finance Committee in June, it has languished there for the rest of the year to date, with the last comment on the bill on the Senate floor in September by Senator Folmer expressing frustration, but vowing never to give up trying to pass property tax reform.

However, what appears cannot be accomplished directly may well be accomplished indirectly. First, the General Assembly passed HB 147 in the 2015-16 session, and HB 1285 in the 2017-18 session. Then, PA voters in the November general election approved the Property Tax Ballot Measure to amend the Pennsylvania Constitution to permit a change in the Homestead Property Tax Assessment Exclusion Clause, raising the exclusion allowed from fifty percent of the median assessed value of a home in a local taxing jurisdiction to **100% of the assessed value**.

This effectively abolished the longstanding protection for owners of investment real estate who do not live and vote in a taxing jurisdiction in which their properties are located that their properties had to be uniformly assessed with properties of owner occupant voters in the jurisdiction. If this amendment led to a 100% Homestead Exclusion in a taxing district, it would no longer matter to voters how their residences were assessed relative to other property in the taxing district, or the millage rate applied, as they would receive a 100% homestead exclusion and pay no property tax.

The General Assembly still has to craft enabling legislation to allow localities to adjust their property taxes under the newly approved constitutional amendment. The passage of the ballot measure did not automatically lead to reduced or eliminated property taxes. Local governing bodies will be looking to adjust their property taxes, and the vast majority of municipalities and school districts will not be able to rely solely on commercial properties to support their budgets, and will be looking to replace revenue lost in the Homestead Exclusion with revenue from other sources such as income tax and sales tax. At least for the funding of school districts, SB 76 offers a statewide mechanism to accomplish that shift in revenue source.

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. Pennsylvania currently imposes a personal income tax at the rate of 3.07 percent on the income of residents, Pa income of non-resident individuals, and income of estates, trusts, partnerships, S corporations, business trusts and limited liability companies not taxed by the federal government as corporations. 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. According to a PA Department of Revenue News Release in July of 2016, for the last reported fiscal year, which ended June 30th, 2016, Pennsylvania collected into its General Fund from all sources a total of \$30.9 Billion Dollars. Of that amount, \$12.5 Billion Dollars, or just over 40% was from personal income tax. Another \$5.1 Billion Dollars, or 16% 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. 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 Governor's Comprehensive Annual Financial Report for the Fiscal Year ended June 30, 2016 indicates that the state spent \$14.8 billion dollars on Public Education including elementary, secondary and college expenditures, equal to just under half of all tax revenue collected by the Commonwealth. Despite that amount, state funding of local public schools in Pennsylvania is just over a third of the total cost of that education, with the majority of funding coming from local school districts themselves.

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 data cited in the recent decision of the PA Supreme Court in *William Penn School District v. PA Department of Education*, 46 MAP 2015, decided September 28, 2017, 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.

The *William Penn* decision by the PA Supreme Court in September reversed a prior Commonwealth Court decision and remanded the case for further proceedings on plaintiff districts' claims that the current method of public school funding in PA violates the mandates of the Education Clause in the PA Constitution, and the rights of pupils and parents in disadvantaged school districts to equal protection and to attain a constitutionally adequate education. The claims are that the high percentage of the cost of PA public education borne by local property taxes creates inherently underfunded schools in those districts.

The passage of the Property Tax Ballot Measure, and the remand of the William Penn case by the Supreme Court last fall both make SB 76 more likely to be reconsidered in the legislature, in 2018 if not this year. But is SB 76 a good alternative to address the complex issue of school funding?

If SB 76 is passed in early 2018, 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, 2018, while other districts would end property taxes as of the end of their respective fiscal years on June 30, 2019.

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, 2018.

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 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 SB 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 9.8 billion dollars, that percentage would increase revenue by 1.6 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. How would that revenue shortfall be made up?

SB 76 also includes a dramatic expansion of the coverage of sales tax, the expanding the goods and services to which the tax applies. Exact details are subject to more lobbying efforts, like the seemingly successful effort by the organized bar to avoid tax on most legal services. 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 SB 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, SB 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.

Finally, current federal tax laws allow taxpayers to elect to deduct either state property tax or state sales tax from federal income for tax purposes. To the extent PA shifts funding of schools to sales tax, but keeps funding of municipal and county government by property tax, Pennsylvanians who itemize on their Federal tax returns will lose part of their federal deductions either way, resulting in a higher federal tax burden.

Thus, while the ballot measure and *William Penn* suit make serious consideration of SB 76 more likely in 2018, I believe it still requires a lot of work to make the bill a fair and reasonable way to reform PA school funding. (And we haven't even touched on looming school employees' pension growth).

The author, Bradley S. Dornish is a licensed attorney, title insurance agent and real estate instructor in Pennsylvania. He can be reached at bdornish@dornish.net.

November 2017