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Another Proposal to End School Property Taxes in Pennsylvania

Every so often the idea comes up—shifting the school tax burden from property to something else such as the sales tax or the personal or earned income tax. And as quickly as the idea comes up, it goes away quietly without any real action. This year the House Majority Policy Committee resurrected the notion once again through House Bill 1776 that, according to a recent newspaper account, will be introduced sometime in the near future[1].

The Committee's Property Tax Reform Development Team has identified school property taxes as a significant problem for homeowners across the state and has floated a proposal that would shift that burden onto the state's personal income tax and sales tax. The latest plan calls for a 0.92 percentage point rise in the income tax and a one percentage point increase in the sales and use tax. An extra twist to the sales tax change is the elimination of previously exempt items such as food at home, clothing, prescription drugs and orthopedics, and on advertising and PR services. The Team estimates that residential properties will raise more than $9.1 billion in school district property tax revenues. Since the Team proposes to replace only the residential tax, the $9.1 billion figure is the amount we will use to gauge the amount of other taxes that would have to be raised in order to replace school property taxes for homeowners.

To start the analysis, we'll look at the State's personal income tax (PIT) and the increase in revenue a one percentage point rise in the tax rate would generate. In the 2010-2011 fiscal year the state collected $10.44 billion in PIT with a rate of 3.07 percent. Dividing the total amount collected by the rate gives the total amount of taxable personal income in the state—$339.93 billion. The proposed increase 0.92 percentage point increase (a 30 percent increase in the tax rate) would produce an additional $3.13 billion in revenues assuming the tax hike has no impact on taxable income earned. That incremental revenue gain would account for only a third of the $9.1 billion needed to eliminate school property taxes on residential properties.

The proposal to shift to the state's sales and use tax (SUT) takes two forms: raising the rate; and removing the current exemptions.

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[1] *Proposal Calls for Equity in Taxes*. Pittsburgh Tribune-Review. November 10, 2011. http://www.pittsburghlive.com/x/pittsburghtrib/news/state/s_766534.html#

In the 2010-2011 fiscal year consumers in Pennsylvania paid a six percent sales tax that garnered nearly $8.6 billion in revenue, which means there were $143.17 billion in taxable sales. Each percentage point of taxation will bring in, assuming no impact on spending, around $1.4 billion.

But what happens if the exemption on food at home and clothing are eliminated? As noted above the amount of taxable sales in the state topped $143.17 billion. Dividing that number by the state's population of 12.7 million puts the per capita taxable sales at $11,273. According to the U.S. Bureau of Labor Statistics' Consumer Expenditure Survey, the average consuming unit (household) contains 2.5 people. Multiplying the Pennsylvania per capita amount by 2.5 puts a household spending on taxable sales items at approximately $28,200. The Survey also reports that the average household spends $3,600 on food at home and $1,700 on apparel and services, neither of which are currently subject to the sales tax in Pennsylvania. If these items are removed from exemption, it would push the average household taxable expenditures to just over $33,500. That would make taxable sales $170.18 billion. And at a tax rate of 7 percent, the tax would produce $11.91 billion in revenue or $3.3 billion more than the current sales tax structure is bringing in.

By removing the prescription drugs and orthopedic devices sales tax exemption revenue could be increased by $350 million for a total increase from consumers of $3.65 billion. Adding the revenues possible from taxing medical services and advertising could boost sales tax revenue by as much as another $1.5 billion. All told the proposal to broaden the tax base and raise the tax rate to 7 percent could generate about $5.2 billion in revenues above the amount produced by the current structure. And this assumes no impact on spending levels.

In total, the sales tax change and the increase in income tax has the potential of generating about $8.3 billion in additional revenue using current income and spending. The replacement of the current $9.1 billion in school property tax is not complete but it is close. With growth in the economy, revenue would presumably grow apace with sales and income.

Of course the above represents only the mathematics of raising revenues to shift from local property tax revenues for school districts. But what are the practical and political ramifications of such a proposal?

As noted in the Team's presentation any shift in the source of a school district's revenue does nothing to control spending. Districts could easily revert to raising property taxes unless that option is taken off the table or severely restricted by legislation, as it appears to be in the proposed Bill. Moreover, because the districts would still be eligible to tax nonresidential properties they could choose to increases taxes on those properties. Not a desirable thing to do from the standpoint of maintaining a business friendly environment.

Second, how would the revenue, which would be collected by the State, be allocated back to the districts? Current allocations of the State's Basic Education Subsidy and property tax relief money derived from gaming favor poorer, low income districts. Wealthier districts would stand to lose much more if they lost the ability to tax residential property. Or will the state give every district the same total per pupil allotment or simply replace the amount of property tax lost in the tax shifting plan?

Finally, if the state does collect adequate revenues from a shift to the PIT and SUT, how does this affect the autonomy of the school districts? With the state providing the overwhelming majority of revenues for most districts, the Commonwealth will have an obligation to ensure the money is spent effectively with all the new bureaucracy that entails. Then too, with the onus of collecting the majority of revenues no longer the responsibility of school districts, the balance of power between school districts and the teacher unions will change. Teachers could no longer hold districts hostage as readily and force them to raise taxes to meet higher compensation and more generous work rules or pit one district against another in contract negotiations. This tax reform proposal—if enacted and implemented—could completely change the dynamics of labor negotiations in school districts.

A real drawback of the plan is leaving the schools with the power to tax non-residential properties. Some districts with very large fractions of their tax base made up of commercial properties will obviously have an enormous advantage over districts with little or no nonresidential property. But even more important, businesses and commercial property owners are unlikely to accept the continuation of school property taxes on them without a major political pushback. Non-corporate business owners paying a 30 percent higher income tax as well as higher sales and use taxes and still having to pay school property taxes would not be very happy. The signal being sent as it relates to the state's business climate would not be beneficial.

On top of the objections we have raised here, the Team notes that there are regional issues as well that will complicate any plan to shift away from property taxes. In some areas of the state property taxes are not as much concern as they are in others. And of course there are problems raised by the patchwork system of property assessments across the state. Moreover it is crucial to keep the problem of spending growth front and center in any discussion. The fact that the idea of tax shifting continually comes up indicates there is a huge problem engendered by both the level of taxation and the structure and sources of tax revenues. It is vitally important to make progress in addressing this issue. The plan being discussed by the House Committee is a good start, but some tweaking will be needed.

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