Throwing the Baby Out with the Bathwater:

Pennsylvania Budget and Policy Center Testimony on HB 1776
Pennsylvania House of Representatives Finance Committee Hearing
June 4, 2012
(updated June 6, 2012)

Good morning Representative Benninghoff and Representative Mundy and members of the Finance Committee. Thank you for the opportunity to comment on House Bill 1776.[i] I am Michael Wood, Research Director of the Pennsylvania Budget and Policy Center. Founded in 2005, the Pennsylvania Budget and Policy Center (PBPC) is a nonpartisan, statewide policy research project that provides independent, analysis on state tax, budget, and related policy matters, with attention to the impact of current or proposed policies on working families.

Overview

HB 1776 attempts to "solve" the property tax problem in Pennsylvania by eliminating school property taxes, typically the largest portion of a taxpayer's property tax bill. While property taxes are a problem for people in specific situations, eliminating school property taxes in Pennsylvania - and imposing very strict spending limits on schools as this bill does, would have dire unintended consequences for our state, our residents, and our children.

HB 1776 is an extreme solution to a targeted problem. There are proven policy prescriptions that provide relief for individuals who have difficulty paying the tax that we would urge you to consider as an alternative to this bill.

Pennsylvania has over 5 million owner-occupied residences, according to the U.S. Census.[ii] Proponents argue that 10,000 Pennsylvanians lose their homes each year, which equates to fewer than 0.2% of the total homes in the state. Many of those foreclosures are related to mortgage payments rather than property taxes. Dismantling the school funding system as HB 1776 suggests for a problem that doesn't affect 99.8% of the homeowners would be "throwing the baby out with the bathwater."

Other states that have tried similar measures and the results are not promising for success in Pennsylvania.

As you consider this bill, and other proposals to reform property taxes, we would ask that you consider the following.

1. **Property taxes benefit our communities and our wallets.**

Our local communities invest our property tax payments in education for our children. As funding has increased, so have the offerings schools can provide. These have tangible benefits we see through increased test scores, increased graduation and college entrance rates, and improved job readiness/competitiveness. Good schools in our communities make our houses worth more and expand opportunities for us all. Over the years, property taxes have helped make this possible.

These investments show dividends. Pennsylvania was the only state of the 25 measured in a Center on Education Policy study with rising test scores in all three grades (4, 8, and 11) measured and all three achievement levels in both reading and math. [iii] Pennsylvania students are also increasingly entering college immediately after high school, growing from 53.8% of students in 1992 to 63.9% in 2008.[iv]

Studies have shown that increasing skills in local areas is a key driver of growth – and good schools are significant part of this. A 2003 paper published by the Harvard Institute on Economic Research concluded "city growth can be promoted with strategies that increase the level of local human capital. At the regional or metropolitan level, attracting high human capital workers may require provision of basic services, amenities and quality public schools that will lure the most skilled."[v]

2. **Generally speaking, property taxes are not high in Pennsylvania, although they are high in some areas. Eliminating school property taxes to fix a localized issue is bad tax policy.**

According to the most recent data compiled by the U.S. Census, local property taxes (from all levels of government - including schools, and from all payers –businesses and individuals) in Pennsylvania are slightly lower than the national average. At 3% of personal income, Pennsylvania local property taxes ranked 26th in 2008-09 – and slightly below the U.S. average of 3.3% of personal income. The same is true in terms of our neighbors. New Jersey, New York, and Ohio have higher local property taxes (as a share of personal income), while West Virginia, Maryland, and Delaware have lower levels of local property taxes than Pennsylvania.

Pennsylvania Local Property Taxes in the Middle of the Pack (2008-09)

	Local Property Taxes as a Share of Personal Income	Rank (1=highest)
New Jersey	5.2%	1
New York	4.4%	6
Ohio	3.1%	23
Pennsylvania	**3.0%**	**26**
West Virginia	2.3%	40
Maryland	2.3%	41
Delaware	1.8%	45
U.S. Average	3.3%	

Source. PBPC calculations using U.S. Census data.

So, if we are seeking to eliminate property taxes because they are high – compared to other states – that can't be supported in the data.

However, in 2008-09, Pennsylvania state taxes and income taxes together, as a share of personal income, ranked 30th of the 50 states. This means that there is some capacity to equalize our tax effort by replacing a portion of property tax revenue with increased state income tax dollars.

The central issue for HB 1776 seems to be the burden of property taxes on residential properties. As a share of personal income, residential school property taxes do vary by district, but not by as much as generally assumed.

In 2009-10, 26 districts (only 5.2% of the total) had property tax levels that exceed 150% of the state-wide average of 3.0% of personal income.[vi] A list of these districts can be found at the end our written comments. These are clustered in Northeastern and Southeastern Pennsylvania. A number of cases in the Northeast are affected by a large presence of vacation homes. For these areas, the tax on vacation homes is exported to other areas – much like sales tax in Florida or severance taxes from Texas. Generally speaking, this is thought to be beneficial to local taxpayers.

In other areas, like inner-ring suburbs in the Southeast, declining wealth and increasing poverty have led to high taxing effort. These districts are limited in their ability to impose earned income taxes because many residents are employed in Philadelphia and pay its wage tax.

Pennsylvania relies more heavily on local sources to fund schools, ranking 8th in the nation. Conversely, the state share of funding ranks 42nd. While we rely too much on local sources to fund schools, increasing state funding will help to reduce this reliance and lessen the burden on local property tax payers..

3. **HB 1776 would do irreparable harm to Pennsylvania's ability to adequately fund public education. It replaces local control over school financing with a one-size-fits-all approach that would fail our children and our communities. It trades certainty for variability.**

The bill imposing strict limits on school district spending. HB 1776 uses the 2012-11 year as a baseline, and limits annual increases to consumer price index (CPI) or sales tax growth, whichever is lower.[vii] In recessions, when consumption decreases, sales tax growth can be negative –which would translate into cuts to schools.

Had this formula been in place during the last recession, schools would have endured three straight years of "property tax replacement" cuts, as sales tax receipts dropped 1%, 4%, and 1%, respectively from 2007-08 through 2009-10. Over the three years, this would equate with a loss of over $1.3 billion in school funding. This would have resulted in massive layoffs and fewer dollars being driven back into local communities.

The bill does not include a funding formula, so distribution of state resources is unknown. Both the state and school districts will have to contribute significant new dollars in the coming years to correct unfunded pension liabilities. Health care costs in every sector are increasing at a rate much faster than inflation. Fuel prices spike. Mandates increase. More kids are found to have special needs that have to be addressed. All of these things cost more money – more than the lesser of CPI or sales tax growth could be expected to meet. This means the funds have to come from somewhere else – classrooms.

Property tax funding is stable, protecting schools from reduced funding during economic downturns and as providing a countercyclical stimulus to local economies. Children need the same access to education in good times and bad.

With the expansion of the sales tax base, growth - and responses to the general economy – will be different than what we have experienced historically. We don't know what this would be. Linking school funding to this unknown factor is risky.

There is a real question whether the funding structure as currently developed,—.94% increase in the state PIT rate, coupled with elimination of some sales tax exemptions —is sufficient to replace the property tax. [viii]

4. **HB 1776 shifts taxes from corporations to individuals.**

HB 1776 has been promoted as necessary to protect senior citizens, yet the bill imposes highly regressive taxes on staples like food, non-prescription drugs, and many other supplies that are a large share of the purchases of seniors and lower income families. Seniors who rent would see little benefit from the elimination of school property taxes, as it is unlikely that their rent would be reduced when property taxes were eliminated.

Most previous bills proposed eliminating taxes for homesteads and farmsteads only. HB 1776 differs in that it also eliminates property taxes for corporations. Small businesses and individuals would pay higher income taxes while corporate income taxes would remain the same. The bill expands sales taxes to many services but only for individuals and small businesses. Business-to-business transactions would be exempted from sales tax[ix] and most manufacturing inputs are already exempt.

Non-residential property accounts for 28% of the assessed value of property in Pennsylvania, according to 2009 data from the State Tax Equalization Board (STEB). Tax dollars that were previously generated from these properties would be shifted to individuals through higher personal income and sales taxes.

No longer would corporations be partners with others in the community to help pay for an educated workforce and customer base. The financial benefits corporations receive would go to out of state share holders.

For typical Pennsylvania families, property taxes are less regressive than the existing sales tax. The Institute on Taxation and Economic Policy estimates that families in the lowest income fifth spend over five times as much of their income on sales taxes as the top 1% of Pennsylvania families. For property taxes, the difference is 2.7 times.[x] Adding many new goods and services to the sales tax base could make this disparity much worse.

Pennsylvania: State & Local Taxes in 2007

Shares of family income for non-elderly taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Income Range	Less than $19,000	$19,000 -$35,000	$35,000 -$56,000	$56,000 - $89,000	$89,000 - $175,000	$175,000 - $428,000	$428,000 or more
Average Income in Group	$10,500	$26,500	$45,200	$70,900	$119,300	$257,100	$1,369,600
General Sales - Individuals	2.1%	2.0%	1.8%	1.5%	1.2%	0.8%	0.4%
Property Taxes	3.8%	2.6%	2.9%	2.8%	3.0%	2.6%	1.4%

Source. Institute on Taxation and Economic Policy, *Who Pays?,* 2009.

Most egregious of these proposed changes is the taxation of many groceries. Items that qualify for the federal Women's, Infants, and Children program[xi] would be exempt from sales tax, but families would soon find out how limited that list actually is. A small sampling of Items that would be taxable include: fresh, frozen or sliced meat, butter or margarine, green peas, organic or reduced fat peanut butter, pasta sauce, salsa, white potatoes, fruit cocktail, baked goods, individually wrapped cheese, ice cream, most non-whole grain or sweetened cereals, and white bread or rice.[xii]

Most states do not tax groceries (food consumed at home). Only two states, Mississippi and Alabama, tax groceries at the full sales tax rate. Seven states tax groceries at reduced rates, and five states offer credits to offset the sales tax costs.[xiii]

5. **Many questions remain unanswered.**

How are funds distributed? Are property taxes replaced locally, dollar-for-dollar, or are they replaced based on a per student basis and enrollment?[xiv] What happens to growing or shrinking schools district?[xv]

Many schools already are funded through earned income taxes; wouldn't they receive less benefit than schools completely dependent on local property taxes?[xvi]

How does the bill address differences in local school spending preferences?[xvii]

What role would local officials have in school spending decisions?[xviii]

What happens if the new state revenue sources do not generate sufficient revenue to replace school property taxes?[xix]

6. **Similar "reforms" tried in other states have shown poor results**

California - One of the first property tax revolts occurred in California with the passage of Proposition 13 in 1978. This law rolled back property tax assessments to 1975-1976 levels, limited taxes to 1% of assessed values, and limited annual assessment increases.

Education funding was shifted largely to the volatile state income tax. Following the recession of 2001, California General Fund revenue declined by 17%, due in large part to falling income tax receipts.[xx] This continues today with California facing a budget shortfall of $16 billion, forcing cuts to schools and other critical services – at a time when the rest of the nation is slowly recovering.[xxi]

There are fewer differences in per child spending district to district in California largely because of limits on spending in wealthy districts.

Michigan – In 1993, Michigan temporarily banned schools from using property taxes and gave voters a choice – increasing sales taxes or income taxes. The voters chose to increase reliance on the state sales tax. The plan included a new state-wide property tax for schools, lower local property tax rates, restrictions on spending, offset by increased state revenue from sales tax.[xxii] As the Michigan economy collapsed in the early 2000s, state revenues plummeted, resulting in squeezing of school funding.

One of the factors cited for the problems with state school funding in Michigan was the whittling away at the sales tax base almost immediately after the passage of the new funding scheme. Small cuts add up quickly, reducing revenue for schools.

How would Pennsylvania be different? A look in the expenditure section of the Pennsylvania budget shows that our sales tax base has been riddled with exemptions. Just a few weeks ago, the House of Representatives approved the an exemption for the purchase and repair of private planes. How long would a sales tax base expansion last?

North Dakota – while not enacted, the North Dakota proposal that is model for HB 1776 is opposed by a number of groups – including many in the business community.[xxiii] The North Dakota plan uses severance tax revenue from their oil boom to eliminate property taxes. While businesses would seem to benefit from the plan, the uncertainty the plan creates makes the state a riskier place to do business.

7. **Better, more targeted options exist**

House Bill 1776 proposes to eliminate all property taxes. Some proponents don't like the property tax. Some are concerned with the coercive powers of the state. There are several clear problems with the property tax—it is not based on ability to pay and some areas have high school property taxes that are a drag on the local economy. Both of these problems can be addressed with smaller, more measured changes. There are two approaches: target tax relief to individuals based on ability to pay, or target relief by school district.

Options:

A. Expand the Property Tax /Rent Rebate program for seniors –Pennsylvania already has a program, the property tax/rent rebate (PTRR) program, to address this need for the poorest of elderly Pennsylvanians. Currently, the program provides a modest state subsidy ($250 to $650, based on income up to $35,000 per year) for homeowners.[xxiv] This program could be expanded to offset property taxes for seniors with limited incomes and for properties up to the median value in a school district – or the payments could be sent directly to the district to offset any tax an eligible senior would otherwise owe. The program expansion could be funded with more modest increases in the state's personal income tax rate, or a higher tax rate on unearned income.

B. Enact a "circuit breaker" to target property tax relief to needy taxpayers, regardless of age – these programs compare property tax payments to a family's income and like an electrical circuit breaker, the program benefits activate once property taxes exceed a set threshold.[xxv] This would be means tested and accountable – no matter what school district you live in. In 2008, 18 states had some form of a circuit breaker program – whether targeted to seniors or all homeowners.

C. Create a property tax deferral program – like a reverse mortgage, property tax deferral plans allow specific groups of homeowners (typically, the elderly), to tap into the unrealized equity of their homes to pay their property taxes. The taxes would be paid when the house is sold. Oregon and Washington currently offer such programs.[xxvi]

D. Increasing state funding for schools - and sticking with it – Pennsylvania's larger than average dependence on local funds for schools could be addressed by increasing state funding for all districts. This cannot be a promise of convenience for the state, as has been the case in past years.

E. Develop a new school funding formula that incorporates tax effort as a critical variable - Pennsylvania had a funding formula adopted in statute in 2009, which it has since abandoned. That formula could be modified to include a variable that better measures local tax effort, and distributes a higher share of state dollars to districts with high tax effort, as well as areas with high poverty, and other variables.

Thank you for this opportunity and I am happy to answer questions.

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[i] References to HB 1776 refer to Printer's Number 3369, and can be viewed here: http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?syear=2011&sind=0&body=H&type=B&BN=1776.

[ii] U.S. Census, 2010 Census, Table DP-1, Profile of General Population and Housing Characteristics: 2010, 2010 Demographic Profile Data, http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=DEC_10_DP_DPDP1&prodType=table.
[iii] Center on Education Policy (CEP), *News Release: New Study Finds Little Evidence That Federal Emphasis on "Proficient" Performance Has Shortchanged Advanced or Low-Achieving Students*, June 17, 2009, http://www.cep-dc.org/cfcontent_file.cfm?Attachment=PressRelease%5FSTST07%2D08%2DPart1%5F061709%2Epdf.
[iv] NCHEMS Information Center for Higher Education Policymaking and Analysis, "College Participation Rates: College-Going Rates of High School Graduates Directly from High School," Compiled by Tom Mortenson, Postsecondary Opportunity, http://www.higheredinfo.org/dbrowser/?year=2008&level=nation&mode=data&state=0&submeasure=63.
[v] Edward L. Glaser and Albert Saiz, *The Rise of the Skilled City*, Harvard Institute of Economic Research Discussion Paper Number 2025, December 2003, Harvard University, Cambridge, MA, http://time.dufe.edu.cn/spti/article/harvard/2025.pdf.
[vi] Pennsylvania School Employees Association analysis of State Tax Assessment Bureau and Pennsylvania Department of Education data.
[vii] Page 166 of HB 1776.
[viii] The accuracy of estimates as to new revenue from the expanded sales tax base would be further complicated by the business-to-business service tax exemption. Potential sales tax revenue from services could vary significantly depending how these provisions are administered.
[ix] Pages 96 and 97 of HB 1776.
[x]Carl Davis, et al., *Who Pays?; A Distributional Analysis of the Tax Systems in All 50 States*, *Pennsylvania Factsheet*, Institute on Taxation & Economic Policy, 3rd Ed., November 2009, http://www.itepnet.org/wp2009/pa_whopays_factsheet.pdf.
[xi] Page 90, HB 1776.
[xii] WIC Pennsylvania, Managed by Adagio Health, Pennsylvania WIC Food List, Effective: October 1, 2011 thru September 30, 2012, (accessed May 28, 2012) http://www.pawic.com/foodlist-en.pdf.
[xiii] Center on Budget and Policy Priorities, "Which States Tax the Sale of Food for Home Consumption in 2009?" Revised November 4, 2009, http://www.cbpp.org/cms/?fa=view&id=1230.
[xiv] Section 1303 of the bill (page 167) states that funding in 2012-13 will be distributed based on a replacement of property tax revenue from 2011-12 with the lower of the sales tax or CPI growth adjustment and that for future years "the department shall make disbursements to each school district as required by statute." This could be interpreted many ways, including using the CPI/sales tax growth adjustment method from this bill.
[xv] As the funding formula is unclear, this cannot be currently answered.
[xvi] The likely answer to this question is yes. Schools with income taxes would receive less relative local tax relief with the same level of increased state taxation as other districts. The districts with income taxes would be subsidizing other districts.
[xvii] The bill permits districts to enact either an earned or personal income tax with a public vote, but it is unclear how this would work in schools with existing income taxes. It is also unclear what purposes the revenue from income taxes could be used – particularly regarding new facilities.
[xviii] Currently, local officials determine property tax rates to help determine available revenue for the operating schools. This is replaced in the bill with state control of the property tax replacement allocation and voter control over income tax rates.
[xix] At the June 4, 2012 hearing, Representative Cox indicated that this would be remedied by a further increase in the state personal income tax rate. However, the bill as written makes no mention of this.
[xx] Daphne A. Kenyon, *The Property Tax – School Funding Dilemma*, Policy Focus Report, Lincoln Institute of Land Policy, Cambridge, MA, 2007, https://www.lincolninst.edu/pubs/dl/1308_Kenyon%20PFR%20Final.pdf.
[xxi] Steven Harmon, "California's budget deficit has ballooned to $16 billion, Gov. Jerry Brown says," *MercuryNews.com*, 5/12/2012, http://www.mercurynews.com/breaking-news/ci_20611259/californias-budget-deficit-has-ballooned-16-billion-gov.
[xxii]Daphne A. Kenyon, ibid. https://www.lincolninst.edu/pubs/dl/1308_Kenyon%20PFR%20Final.pdf
[xxiii] Keep it LOCAL North Dakota, Vote No on Measure 2, http://keepitlocalnd.com/
[xxiv] Pennsylvania Department of Revenue, "Property Tax/Rent Rebate Program," (accessed May 28, 2012) http://www.portal.state.pa.us/portal/server.pt/community/property_tax___rent_rebate_program/11410.
[xxv] Center on Budget and Policy Priorities, "Policy Basics: Property Tax Caps," December 18, 2008, http://www.cbpp.org/files/policybasics-taxcaps.pdf.
[xxvi] Washington State Department of Revenue, "Property Tax Deferral for Senior Citizens and Disabled Persons," November 2011, http://dor.wa.gov/docs/pubs/prop_tax/seniordefs.pdf.