



## Local School Taxes Under Act 50 of 1998

*Timothy W. Kelsey and Kathleen K. Miller*

Department of Agricultural Economics and Rural Sociology

In late April, the General Assembly passed a local tax bill that provides opportunities and challenges for school districts in Pennsylvania. The legislation, Act 50 of 1998, should be of major interest to local officials and citizens. After years of debate, this is the first local tax reform legislation that has finally been approved. With continuing discussions about local tax reform for county and municipal governments, Act 50 likely will provide a model for these debates. It also provides taxpayers new rights and abilities that they have not had previously.

### What Do the School Tax Changes Do?

The tax reform aspects of Act 50 are intended to *shift* the source of local taxes, not *increase* the total amount of tax dollars generated locally. Increased revenues from the new structure must be used to eliminate and/or reduce other taxes. Under the act, school districts can levy a higher earned income and net profits tax rate, up to a maximum of 1.5 percent. Formerly, they were allowed a maximum of 1 percent, but this had to be shared equally with local governments if the municipalities also levied the tax. The earned income and net profits tax is a tax on wages, salaries, net profits, or other compensation people receive and is already used (with a lower tax rate) in most school districts.

In exchange for the higher earned income tax limit, school districts adopting the tax structure under Act 50 are required to use the new revenues to eliminate nuisance taxes (the occupation tax, occupational privilege tax, and per capita tax), and reduce the real property tax. These reductions in the real property tax must be made through the homestead exclusion, which is also authorized by Act 50. The homestead exclusion targets tax reductions to permanent residents by reducing their homes' assessed values for tax purposes. School districts are only allowed to keep a nominal amount of new revenue from the tax, not to exceed the percentage increase in the average weekly wages in Pennsylvania the previous year.

The most significant change under Act 50 is that school districts adopting the new tax structure will be required to get voter approval of any future noninflationary increases in real property tax rates. Previously, Pennsylvania taxpayers have not had the ability to vote directly on tax increases. Any tax rate increase greater than the percentage increase in the average weekly wages in Pennsylvania will have to be approved by local voters through these "back-end" referenda. There are six exceptions to this referendum requirement: (1) an emergency declaration by the governor; (2) to implement a court order or an administrative order from the state or federal government; (3) to pay interest

and principal on existing debt; (4) to respond to conditions that pose a threat of serious physical harm to students or staff; (5) special purpose taxes authorized by voters; and (6) to maintain per-student tax revenue for those districts with enrollment growing faster than 10 percent over a three-year period. If a ballot proposal to increase the real property tax rate fails at the polls, the real property tax rate stays at the current rate at the time of the referendum.

### **How Can the New Tax Structure Be Implemented?**

School districts are not required to change to the new tax structure, but can stay with their current structure if they prefer. School districts adopt the new local tax structure through a local referendum that clearly spells out the changes. The referendum must be written in clear language that is readily understood by a layperson, such as:

“Do you favor the imposition of an earned income and net profits tax of X% to be used to replace (NAMES OF LOCAL TAXES TO BE REPEALED), reduce real property taxes by X% by means of a homestead exemption, and provide for a one-time revenue increase of X% over the preceding fiscal year?”

The question can be placed on the local ballot either through a decision by the school board, or if the school board does not act within two years, through a series of petitions and actions by residents. If the referendum fails at the polls, no matter how it was placed on the ballot, the existing local tax structure will continue to be used in the school district.

### **How Might Reform Affect Real Property Taxes?**

Analysis using Pennsylvania school district data suggests the tax reform aspects of Act 50 would have provided an average 27 percent reduction in residential property taxes in Pennsylvania school districts in 1995. However, these savings vary

significantly across the districts (see Table 1). Forty school districts would actually have had to *raise* their real property taxes under the plan, because they will lose more by eliminating nuisance taxes than they will gain from the higher earned income tax rates.

The effect of tax reform on individual taxpayers is difficult to estimate because so much depends upon how much they already pay in nuisance taxes and in which school district they live. In general, property owners with little earned income, such as seniors and others on fixed incomes, should end up paying less in school taxes as a result of the reforms. Renters will pay more in earned income tax, but will not benefit from the real property tax reductions because they are not eligible for the homestead exclusion. The reform will have little short-term effect on businesses, vacation homes, camps, or second homes because these taxpayers do not pay the earned income tax and will not receive reductions in real property taxes. In the long run, however, they should benefit if the referendum requirement for future tax increases reduces the growth of school tax bills.

### **What Are the Arguments For and Against Reform?**

School taxes typically account for Pennsylvania taxpayers' largest local tax bills and have consistently been growing over time. School real property tax collections in Pennsylvania rose 102 percent from 1985 to 1995, more than double the increase in worker wages and inflation during that same time period (50 percent and 49 percent, respectively) (source: Pa. Senate Policy Development and Research Office). Because of the large size of school tax collections, local tax reform must address school taxes if it is to be meaningful.

The majority of school district local tax revenue in Pennsylvania comes from the real property tax (about 79 percent in 1996), a tax that many people consider unfair. There is no doubt that the real property tax can be a burden for people on fixed incomes, since the amount owed does not correspond to taxpayers' abilities to pay the tax.

Several of the nuisance taxes, such as the occupation tax, have been subject to similar criticisms. Act 50 provides a method of shifting the school tax burden away from these taxes onto the earned income tax, a tax that many consider to be more fair. Combined with the homestead exclusion, this should benefit taxpayers on fixed incomes and make the local tax burden fairer.

The back-end referendum in Act 50 provides local taxpayers with their first opportunity to have direct say over school tax increases. Taxpayers in many other states have enjoyed this privilege, which gives them veto control over large tax increases. Act 50 provides future control over tax increases and gives taxpayers more say in what happens with school taxes.

On the other hand, some concerns have been raised about the tax reform aspects of Act 50. In many ways Act 50 is more of a tax limitation program than a method of providing schools with a fair way to collect needed revenue. Pennsylvania has the second largest percentage of elderly of any state in the United States, and has other large segments of the population without a current direct connection to local schools. This may make passing school tax referenda more difficult than in other states (many of which have already found that referenda make needed tax increases difficult to achieve), thereby reducing school districts' flexibility in responding to future needs. Act 50 provides no additional ability for school districts to control their costs, and thus, reduce the need for such increases. It simply makes raising taxes more difficult. Without a greater ability to control costs, the revenue restrictions may create severe challenges for school districts.

The changes from Act 50 are solely at the district level, and do not address issues of the state's share of local school revenues (only 16 states provided a smaller share of local school revenues in 1994) or equity across school districts. Rich districts will remain rich, and poor districts will remain poor. Recent school tax reforms in other states, such as Kansas, Michigan, South Carolina, and Wisconsin, have recognized the influence of state funding on

local taxes by substantially increasing the state share of school revenues. Act 50, in contrast, simply locks in the status quo inequities among districts without regard for what taxpayers already are paying or the need for educational revenues.

Act 50 will reduce real property tax rates, but the real property tax will remain the main tax used to balance local school budgets because other alternative taxes become unavailable under Act 50. Only allowing the earned income tax as an option prevents school districts from deciding for themselves the appropriate mix of local taxes and does not help the 40 school districts who won't be able to implement Act 50 without raising their real property taxes. Furthermore, the earned income tax itself is considered unfair by some because it only considers earned income. As a result, working families can end up paying more in local taxes than higher-income neighbors who rely upon investments for the majority of their income.

Perspectives on Act 50 vary, depending upon an individual's concerns and values. The act creates opportunities for school districts to shift the tax burden and target tax relief to homeowners. It also provides local taxpayers more voice in tax increases, giving them more control over their taxes. Act 50 also may reduce the flexibility of school districts to respond to educational needs in their communities and does nothing to address larger issues of fairness across school district boundaries. This mix of potential good and bad changes should make local debates whether to implement Act 50 interesting.





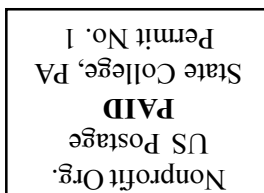
Address editorial comments or newsletter requests to:

Kathleen K. Miller, *Editor*  
**Rural Development** *views*

The Pennsylvania State University  
309 Armsby Building  
University Park PA 16802-5600  
Fax: (814) 865-3746  
E-mail: [kkmiller@psu.edu](mailto:kkmiller@psu.edu)

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**Rural Development** *views*  
Department of Agricultural Economics  
and Rural Sociology  
The Pennsylvania State University  
105C Armsby Building  
University Park, PA 16802-5600