

LOCAL TAXES AND TAX REFORM

Reforming the way Pennsylvania finances public schools and local governments has been a major concern of state officials, school board members and administrators, local officials, and citizens for decades. School districts account for the largest share of local taxes in Pennsylvania, which means the fairness and efficiency of the taxes districts use has major implications for the local tax burden borne by citizens.

Much of the local tax reform debate has focused on the real property tax (which is sometimes called the real estate tax). The real property tax provides the largest proportion of local tax revenue to Pennsylvania school districts and many local governments. Critics of the real property tax claim it is unfair because it places an undue burden on some taxpayers. Because the amount of property tax a person owes is based on the value of the property they own and not on their income, the tax can be difficult for people living on a fixed income. It may not reflect their ability to pay the tax.

In 1998, the Pennsylvania legislature passed Act 50 of 1998, which provided school districts with a new local tax option. Districts who chose could increase their earned income tax rates in exchange for eliminating several nuisance taxes (the occupation tax, per capita tax, and the occupational privilege tax) and reducing real property taxes. The acceptance of these changes has been tepid, however, due to a variety of reasons. As of December, 2001, only five of Pennsylvania's 501 school districts had chosen to enact Act 50's local tax structure provisions.

Another local tax reform effort, Act 24 of 2001, focused solely on allowing school districts to raise the earned income tax just enough to eliminate the occupation tax. Like Act 50, this act gives school districts the option of staying with the current local tax system or of adopting the act's changes. Act 24 has no impact on real property tax rates, so it does little to shift the local tax burden away from the property tax.

A frequently suggested alternative to the real property tax is greater reliance on a local income tax. Municipalities and school districts in Pennsylvania currently are authorized to levy an earned income tax, but there is a maximum tax rate (sometimes called a "cap") that limits the ability of the earned income tax to replace the real property tax. Recent local tax reform efforts, including Act 50 of 1998 and Act 24 of 2001, have created the option for school districts to levy a higher earned income tax in exchange for lowering other taxes.

In addition to the questions about local taxes, there are some issues about Pennsylvania's state income tax, which is a flat rate income tax.

The Citizens' Viewpoint Surveys

The availability of data from three statewide surveys of Pennsylvania citizens, conducted in 1980, 1990, and 2001, can provide information about how Pennsylvania citizens view local tax reform options. In 1980, the Department of Agricultural Economics and Rural Sociology at Penn State surveyed more than 9000 residents about their opinions on current social issues. In 1990, a similar study was conducted by the same Department with responses from over 3600 citizens of the Commonwealth. A third Citizens' Viewpoint, carried out in 2001, surveyed 4183 Pennsylvanians seeking information on their opinions about many of the same issues as those assessed in the earlier studies. Included on the surveys were questions addressing issues of local tax reform, and a question about whether Pennsylvania should change the state income tax from a flat rate to a proportional (sometimes called "graduated") income tax.

Attitudes towards Local Tax Reform

Should Local Tax Reform be a Higher Priority?

More than half (58 percent) of the respondents in 2001 thought reforming Pennsylvania's local tax structure should be a higher priority in the future. Only 6 percent of the respondents thought it should be a lower priority, while 29 percent said it should have the same priority as in the past. About 7 percent of the respondents didn't know.

In general, older respondents were much more likely to believe the local tax reform should be higher priority than did younger respondents. More than half of respondents 45 and older believed reform should be a higher priority, compared to only 26 percent of respondents younger than 25 years old who thought it should be a higher priority (see Table 1).

Men were somewhat more likely to believe tax reform should be a higher priority than did women (62 percent compared to 53 percent).

Shift school taxes from property tax and towards an income tax

If the school tax burden is shifted from the real property tax to an income tax, the critical policy concern is what kind of local income tax is the fairest; both Acts 50 and 24 involve the earned income tax, but there have been proposals to allow local jurisdictions to levy a personal income tax instead (an earlier version of Act 50, for example, would have allowed jurisdictions to choose which income tax to levy). An earned income tax, which is the currently authorized local income tax, taxes wages, salaries, and other payment for work. The personal income tax, which is the type of income tax levied by the Commonwealth, includes these earnings, as well as

investment and dividend income. Both income taxes exclude Social Security and Pension income.

From a tax fairness standpoint, there are significant differences between an earned income (wage) tax and a personal income tax. Because the earned income tax ignores dividend and interest income, it can create a greater burden on lower income residents who make most of their income through wages or salaries than it does on wealthier residents who make most of their income through investments. It similarly creates a greater burden on working age residents than it does on retirees, who generally have little earned income.

The respondents to the Citizens Viewpoint survey were more likely to support a wage tax than they were to support shifting to a personal income tax.

About 48 percent of the respondents agreed that school taxes should be shifted to a tax on wages and salaries (e.g. the earned income tax), while only 26 percent disagreed. About 26 percent of the respondents were undecided.

About 30 percent of the respondents agreed that school taxes should be shifted to a tax on wages, salaries, and investment income (e.g. a personal income tax), while 43 percent disagreed. Another 27 percent were undecided.

The relatively large percentage of respondents who were undecided suggests that many people do not understand the substantive and equity differences between the two taxes.

Higher income respondents in general were less likely to approve shifting to either income tax than were lower income respondents. About 37 percent of the respondents with \$120,000 or more in annual household income did not want to shift more towards a wage tax, while 64 percent were against a shift towards a personal income tax, compared to 33 percent and 35 percent of the respondents with less than \$10,000 of household income.

There were some significant differences by age (see Table 2). Older respondents were more likely to support shifting away from the real property tax than were younger respondents. This likely reflects, in part, that younger people generally are less likely to own property than are seniors. It also likely reflects that the majority of seniors' income is exempt from the wage tax, and that many seniors may feel that paying for schools should not be disproportionately their responsibility. Younger respondents were much more likely to be undecided than were older respondents.

Men were more likely to believe that school taxes should shift to an income tax than were women, though women were more likely to be undecided (see Table 3). Fifty-three percent of men thought the tax burden should shift to the earned income tax, compared to 41 percent of women.

Should the state income tax be made progressive?

Pennsylvania's state income tax currently is a flat rate income tax, with every taxpayer paying the same tax rate. The Federal income tax, in contrast, is a graduated income tax (sometimes referred to as a "progressive" income tax), with higher income taxpayers paying a higher tax rate than do lower income taxpayers. Some people argue that a progressive income tax is fairer than a flat rate income tax, while others believe a flat rate is best.

Pennsylvania's constitution currently contains a provision called the "Uniformity Clause," which states that tax rates must be the same ("uniform") across taxpayers. For the real property tax, for example, this provision means that local governments cannot choose to tax one type of property (such as residential properties) with a different tax rate than other types of properties. The same principle applies to the state income tax. There are some constitutional amendments which have created some exceptions to the Uniformity Clause, including the amendment permitting the Clean and Green program (which taxes farmland on its use value rather than its higher market value), and the amendment allowing homestead exemptions (which let owner-occupied residences pay lower taxes). A similar amendment would be necessary to allow the state income tax to be made progressive.

In 2001, respondents were about equally divided in their support or opposition to making the state income tax a progressive tax.

About 45 percent of the respondents thought the state income tax should be changed to a progressive tax, while 46 percent thought it should not. About nine percent had no opinion about such a change.

Not surprisingly, higher income respondents were less likely to support such a change in the income tax than did lower income respondents (see Table 4). Around half of respondents with less than \$60,000 in income thought the state income tax should be changed, compared to only 23 percent of the respondents with \$120,000 or more annual household income. The respondents with the lowest household income also were more likely to be undecided.

Older respondents were somewhat more likely to believe the state income tax should be made progressive than were younger respondents.

There were some gender differences (see Table 4). More women wanted the state income tax to be made progressive than to be remain flat rate (47 percent compared to 41 percent), while more men wanted the tax to remain flat rate (49 percent) than to change (44 percent).

Summary:

The majority of Pennsylvania residents thought reforming Pennsylvania's local tax structure should be a higher priority in the future. This is particularly important because several major local tax reform efforts have been adopted in the past few years, but so far have had relatively little acceptance by local school districts. Act 50 of 1998 has been enacted in only a handful of school districts, while Act 24 of 2001 focuses solely on eliminating the occupation tax. The respondents seem to indicate that they do not feel these actions have been enough, and believe that more effective action should be taken to reform local taxes.

Overall, the respondents were more supportive of increasing the earned income tax (which primarily focuses on wages and salaries) to reduce real property tax rates, than they were of using a personal income tax (which includes investment income). Respondents who are older and have higher income are much more likely to prefer the earned income tax over the personal income tax.

References:

Kelsey, Timothy W. "Understanding School Tax Change Under Act 50 of 1998." Extension circular. Department of Agricultural Economics and Rural Sociology. Cooperative Extension, The Pennsylvania State University. November, 1998. 12 pp.

Kelsey, Timothy W. "Understanding Act 24 of 2001: The Optional Occupation Tax Elimination Act." Extension circular. Department of Agricultural Economics and Rural Sociology. Cooperative Extension, The Pennsylvania State University. September, 2001.

Kelsey, Timothy W. "What are the Local Taxes in Pennsylvania?" Extension Circular 418. Department of Agricultural Economics and Rural Sociology. Cooperative Extension, The Pennsylvania State University, February, 1994. 4 pp.

Prepared by:

Timothy W. Kelsey (814) 865-9542 tkelsey@psu.edu
<http://www.aers.psu.edu/d/fac/kelsey.htm>

Fern K. (Bunny) Willits

Stanford M. Lembeck

Mario Picon

The Pennsylvania State University is committed to the policy that all persons shall have equal access to programs, facilities, admission, and employment without regard to personal characteristics not related to ability, performance, or qualifications as determined by University policy or by state or federal authorities. It is the policy of the University to maintain an academic and work environment free of discrimination, including harassment. The Pennsylvania State University prohibits discrimination and harassment against any person because of age, ancestry, color, disability or handicap, national origin, race, religious creed, sex, sexual orientation, or veteran status. Discrimination or harassment against faculty, staff, or students will not be tolerated at The Pennsylvania State University. Direct all inquiries regarding the nondiscrimination policy to the Affirmative Action Director, The Pennsylvania State University, 201 Willard Building, University Park, PA 16802-2801, Tel 814-865-4700/V, 814-863-1150/TTY.

Table 1. What Priority Should Local Tax Reform be in the Future, by Respondent Age

Age	Lower priority	Same priority	Higher priority	Don't know
Less than 25	5%	51%	26%	17%
25-34	7	38	46	9
35-44	6	28	59	7
45-54	7	30	58	5
55-64	5	30	58	7
65-74	3	26	66	5
75 or older	5	23	61	11

Table 2. Shift Primary Basis for School Taxes from Property Tax to a Local Income Tax, by Respondent Age: Earned Income Tax versus Personal Income Tax (*Personal Income Tax in Parentheses*)

Age	Strongly Agree	Agree	Undecided	Disagree	Strongly Disagree
Less than 25	1% (0%)	26% (13%)	38% (47%)	17% (22%)	18% (18%)
25-34	10 (8)	20 (12)	44 (42)	18 (26)	8 (13)
35-44	13 (9)	23 (12)	29 (28)	27 (38)	8 (12)
45-54	18 (11)	27 (16)	26 (25)	20 (33)	9 (15)
55-64	21 (11)	31 (19)	22 (21)	18 (33)	9 (16)
65-74	29 (18)	34 (24)	21 (24)	10 (25)	5 (9)
75 or older	27 (21)	34 (22)	23 (29)	13 (22)	3 (7)

Table 3. Shift Primary Basis for School Taxes from Property Tax to a Local Income Tax, by Gender: Earned Income Tax versus Personal Income Tax (*Personal Income Tax in Parentheses*)

Gender	Strongly Agree	Agree	Undecided	Disagree	Strongly Disagree
Male	24% (15%)	29% (18%)	23% (23%)	16% (30%)	8% (14%)
Female	14 (9)	27 (17)	32 (31)	21 (31)	7 (11)

Table 4. Make State Income Tax a Progressive Tax, by Income

Annual Household Income	Yes	No	Undecided
Less than \$10,000	46%	34%	20%
\$10,000 to 19,999	54	30	17
\$20,000 to 39,999	55	36	10
\$40,000 to 59,999	47	46	8
\$60,000 to 79,999	43	55	2
\$80,000 to 99,999	34	63	3
\$100,000 to 119,999	25	69	6
\$120,000 or more	23	74	3

Table 5. Make State Income Tax a Progressive Tax, by Gender

Gender	Yes	No	Undecided
Male	44%	49%	7%
Female	47	41	12