

Analysis of HB 1776 and SB 1400 of 2012

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Disclaimer: The Independent Fiscal Office does not support or oppose any existing or proposed tax or budget policies. Consistent with its mission, the office will not make any policy recommendations.

Background

- The analysis was consistent with the mission of the Independent Fiscal Office (IFO).
- The IFO cannot comment on whether policy is good /bad or better/worse than current law.
- The report provides a general framework for analysis of the proposal. The IFO defers to the committees of the General Assembly for further analysis of the fiscal and policy implications of any amendments.

Today's Presentation



- Brief overview of HB 1776 / SB 1400 of 2012.
- Analysis Objectives.
- Analysis Results:
 - Surplus or shortfall to (1) the Education Stabilization Fund and (2) school districts.
 - Detail by revenue source.
 - Background on Property Tax forecast.
 - Some general economic analysis.

The Proposal



- Eliminates local school property tax.
 - Property taxes to service debt existing as of Dec. 31, 2011 retained and phased-out.

- State funding based on FY 2012-13 district collections. Three sources:
 - Raise sales tax rate from 6% to 7%; expand tax base.
 - Raise PIT rate from 3.07% to 4.01%.
 - Transfers from Property Tax Relief Fund.

- Analysis assumes that *General Fund is held harmless* and Department of Revenue able to separate new revenues from existing revenues.

Analysis Objectives

1. Are dedicated revenues sufficient to fund proposed distributions to school districts?
2. How do distributions compare to a “current law” property tax baseline for schools?
3. Potential economic impacts.
 1. Business and non-business.
 2. Homeowners and renters.
 3. Home prices and rent payments.
 4. Business competitiveness.

What Analysis Does/Does Not Do ^{IFO}

- It **does** capture response to higher tax rates.
 - Higher sales taxes implies consumers buy less.
 - Minor increase in non-compliance and tax avoidance in response to higher rates.

- It **does** capture “secondary” effects.
 - The interaction among tax cuts. For example, property tax cut increases sales tax collections.

- It **does not** capture any macroeconomic “feedback” effects. Impact is unclear.
 - Such as change in employment levels.

Table 1

Overview Of Property Tax Replacement

	Fiscal Year (\$ millions)				
	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>	<u>2016-17</u>	<u>2017-18</u>
DEDICATED REVENUES					
Sales Tax - Rate and Base	\$5,211	\$5,472	\$5,751	\$6,028	\$6,302
Personal Income - Rate	3,361	3,543	3,716	3,886	4,049
Property Tax Relief Fund	<u>526</u>	<u>539</u>	<u>552</u>	<u>566</u>	<u>580</u>
TOTAL	9,098	9,554	10,019	10,480	10,931
 PROPERTY TAX REPLACEMENT					
Property Tax Forecast	12,678	13,184	13,704	14,103	14,497
Existing Debt Service	<u>-2,071</u>	<u>-1,939</u>	<u>-1,807</u>	<u>-1,675</u>	<u>-1,543</u>
Property Tax Replacement	10,607	11,245	11,897	12,428	12,954
 NET ANNUAL IMPACT	-1,509	-1,691	-1,878	-1,948	-2,023

Table 2



ESF and School District Impact

	Fiscal Year (\$ millions)				
	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>	<u>2016-17</u>	<u>2017-18</u>
EDUCATION STABILIZATION FUND					
Dedicated Revenues	\$9,098	\$9,554	\$10,019	\$10,480	\$10,931
Distributions to Schools	<u>10,453</u>	<u>10,744</u>	<u>11,097</u>	<u>11,437</u>	<u>11,802</u>
Difference	-1,355	-1,190	-1,078	-957	-871
SCHOOL DISTRICT IMPACT					
Distributions to Schools	10,453	10,744	11,097	11,437	11,802
Replacement Baseline	<u>10,607</u>	<u>11,245</u>	<u>11,897</u>	<u>12,428</u>	<u>12,954</u>
Difference	-154	-501	-800	-991	-1,152
NET IMPACT	-1,509	-1,691	-1,878	-1,948	-2,023

The Sales Tax Base Expansion

- Newly taxed goods:
 - Food items (except WIC and SNAP purchases).
 - Clothing and apparel > \$50.
 - Non-prescription drugs (e.g., pain relievers, vitamins)
 - Personal hygiene (toiletries, diapers)

- Newly taxed services:
 - Certain health care (for-profit nursing homes, day care)
 - Recreation (movies, bowling, amusement parks)
 - Basic cable
 - Personal (barber, beauty salons)
 - Intrastate transport of persons (taxis, bus, rail)

The Sales Tax Base Expansion

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- All telecommunications services exempted.
- Vendor discount cap at \$300 per year.
- Expansion of exemption to certain entities supplying educational services.
- See technical appendix for a complete listing.

Table 3

Sales Tax: Rate Increase and Base Expansion

	Fiscal Year (\$ millions)				
	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>	<u>2016-17</u>	<u>2017-18</u>
Rate Increase: 6% to 7%	\$1,450	\$1,514	\$1,574	\$1,628	\$1,680
Food (Exclude WIC/SNAP)	1,110	1,165	1,221	1,276	1,330
Clothing > \$50	418	439	463	487	514
Recreation Services	570	589	611	633	655
Health Services	612	651	698	748	797
Professional Services	378	395	414	434	453
Personal Services	235	246	258	270	283
All Other	257	281	307	335	361
Secondary Effects	<u>181</u>	<u>192</u>	<u>205</u>	<u>217</u>	<u>229</u>
TOTAL SALES TAX	5,211	5,472	5,751	6,028	6,302

Table 5

Personal Income Tax Rate Increase

	Fiscal Year (\$ millions)				
	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>	<u>2016-17</u>	<u>2017-18</u>
Rate: 3.07% to 4.01%	\$3,483	\$3,670	\$3,847	\$4,023	\$4,191
Increase in Refunds	-142	-148	-153	-161	-167
Secondary Effects	<u>20</u>	<u>21</u>	<u>22</u>	<u>24</u>	<u>25</u>
TOTAL PIT	3,361	3,543	3,716	3,886	4,049

School Property Tax Forecast

Recent school property tax growth rates
based on reported data:

FY 2006-07	5.9%
FY 2007-08	4.6%
FY 2008-09*	4.7%
FY 2009-10*	3.1%
FY 2010-11*	3.7%

See Technical Appendix B for a 30-year history.

*Includes property tax reduction allocations from the proceeds of gaming.

School Property Tax Forecast ^{IFO}}

The IFO forecast uses the structure of “Act 1” to forecast property taxes. There are two major components:

1. The Adjusted Index, which places a cap on the increase in millage rates.
2. Exceptions, which allow school districts to exceed the index for certain expenditures (mainly pensions and special education).

IFO Act 1 Index Projections



	<u>Base Index</u>	<u>Adjusted Index*</u>
FY 2013-14	1.7%	1.9%
FY 2014-15	2.2%	2.5%
FY 2015-16	2.3%	2.6%
FY 2016-17	2.3%	2.6%
FY 2017-18	2.4%	2.7%

* Weighted average for all districts.

Act 1 Pension Exception

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Projected employer contribution rates
(currently 12.36%):

FY 2013-14	16.75%
FY 2014-15	21.25%
FY 2015-16	25.56%
FY 2016-17	26.26%
FY 2017-18	26.80%

School Property Tax Forecast

Combined effect of Act 1 Adjusted Index and exceptions: the current law baseline.

FY 2011-12	2.3%
FY 2012-13	2.6%
FY 2013-14	3.4%
FY 2014-15	4.0%
FY 2015-16	3.9%
FY 2016-17	2.9%

Table 6



School District Property Tax Forecast

	Fiscal Year (\$ millions)				
	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>	<u>2016-17</u>	<u>2017-18</u>
Prior Year Adjusted	12,340	12,754	13,263	13,786	14,188
Act 1 Index Growth	164	239	259	251	249
Act 1 Exceptions	<u>174</u>	<u>191</u>	<u>182</u>	<u>66</u>	<u>60</u>
Act 1 Total Increase	338	430	441	317	309
Current Law Prop. Tax	12,678	13,184	13,704	14,103	14,497
Less: Debt Service	<u>-2,071</u>	<u>-1,939</u>	<u>-1,807</u>	<u>-1,675</u>	<u>-1,543</u>
Net: Amount Subject to Replacement	10,607	11,245	11,897	12,428	12,954

Who Bears the Tax Burden?

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- It was requested that the IFO examine the business vs. non-business impacts.
- Analysis considers the “statutory tax incidence” or the party with legal obligation to remit payment.
- Three cautionary notes:
 - Need NOT reflect the true economic burden.
 - Business vs. non-business distinction is not meaningful in many cases.
 - Excludes impacts on federal income taxes.

Table 7

Change in Statutory Tax Incidence

FY 2013-14

<u>Revenue Source</u>	<u>Total</u>	Non- <u>Business</u>	<u>Business</u>
Sales Tax	\$5,211	\$4,624	\$587
Personal Income Tax	3,361	3,038	323
Property Tax	<u>-10,607</u>	<u>-7,425</u>	<u>-3,182</u>
TOTAL	-2,035	237	-2,272

Note: Assumes 30% of business tax cut accrues to business entities. Assumes businesses pay 39% of sales tax rate increase.

How are Residents Impacted? ^{IFO}

- The analysis uses two characteristics that drive tax changes: housing tenure and age.
- Analysis considers four groups:
 - Homeowners: working age and retired.
 - Renters: working age and retired.
- Uses median characteristics from U.S. Census (income) and spending patterns from U.S. Dept. of Labor (by age and income).
- Compare taxes under current law and the proposal.

Table 8

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Median Homeowners and Renters

Current vs. Proposed Tax Law

	Change in Tax Liability	
	<u>Fully</u> <u>Phased-In</u>	<u>First</u> <u>Year</u>
Median Homeowner - Working	-7.0%	-4.6%
Median Homeowner - Retired	-37.5%	-30.8%
Median Renter - Working	10.6%	21.7%
Median Renter - Retired	7.7%	25.2%

Note: Median income data for age cohorts and housing tenure from U.S. Census Bureau. Law imposed against 2010 data.

Homeowners

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- Research suggests an average property tax capitalization rate of roughly one-third.
 - Median home price 2014 \$180,000
 - Median school property tax \$2,200
 - Discount factor 4.0%
 - Gain w/ full capitalization \$55,000
 - Property tax capitalization 33.3%
 - Potential long-term gain \$18,300

- Analysis very sensitive to assumptions.

Homeowners

- Capitalization rates will vary substantially throughout the Commonwealth.
 - Higher rates in more developed areas.
 - Current homeowners capture more of tax cut.

- Two key assumptions on housing gains:
 - 1. The level of services provided to homeowners does not change.
 - 2. Prospective homebuyers convinced property taxes will not be levied in the future. If unconvinced, then lower price appreciation.

Renters

- More uncertainty. Mixed results, but more evidence suggests property tax pushed forward to renters.
 - Should receive some rent relief.
 - Again, more developed areas get less relief.
 - As a group, generally worse off under proposal.

- Any rental relief would occur over many years. Little immediate relief.

Businesses



- Data suggest property taxes comprise:
 - roughly 0.4 to 0.9 percent of business receipts.
 - one-third of total taxes to state and local govt's.
- Potential for significant reduction in tax.
- Firms with much real property gain.
 1. Large manufacturers.
 2. Firms engaged in rental of real estate.
 3. Certain telecommunication firms.

Businesses

- But, other business might fare worse:
 1. Small pass through entities (partnership, sole proprietors, independent contractors) with little real property.
 2. Firms affected by base expansion: clothing, food, pharmaceutical retailers, certain service providers (personal, recreation).
 3. Firms in close proximity to state border.
 4. Firms that must compete against internet sales. Use tax compliance very low.

Table 9

Effective and Statutory Tax Rates

	<u>Property</u>		<u>Income</u>		<u>Sales</u>
	<u>Real</u>	<u>Personal</u>	<u>Corporate</u>	<u>Other</u>	
PA	4.12%	0.00%	9.99%	3.07%	6.00%
NJ	1.67%	0.00%	9.00%	8.97%	7.00%
NY	3.88%	0.00%	7.10%	8.82%	4.00%
OH	2.20%	0.00%	0.26%	5.93%	5.50%
MD	2.02%	5.67%	8.25%	5.50%	6.00%
VA	0.65%	1.48%	6.00%	5.75%	5.00%
NC	1.08%	1.30%	6.90%	7.75%	4.75%

Source: Property Tax Rates from MN Taxpayer's Association. Rates are for 2009.

Other rates are statutory maximums from Federation of Tax Administrators for 2012.

Federal Income Tax Impact



- Proposal interacts with federal income taxes.
 - Itemizers realized federal income tax increase of approximately \$550 million for 2014.
 - Firms lose roughly 25% of property tax cut benefits due to higher federal tax liability.

- Broad view: an exchange of tax that is deductible (property tax for business and homeowners) for one that is not (sales tax on consumers).

General Fund and Local



- Some gains to General Fund:
 - Realty Transfer Taxes (\$30-\$40 million per year) once housing prices respond. Gains to local units too from Realty Transfer and remaining property tax.
 - Sales Tax to Allegheny County and Philadelphia from base expansion (\$100-\$200 million).
 - Corporate Net Income (\$30-\$40 million).

- Not included in revenue estimates since they do not affect revenue neutrality of proposal.

Summary



- Analysis suggests shortfall in proposal.
 - Revenues roughly \$1 billion short of proposed distributions to school districts.
 - Distributions roughly \$1.0-\$1.5 billion less than school district property tax baseline.

- Current homeowners clear winners. Many will realize large windfall gains.
 - Most renters likely worse off. Outcome unclear for prospective homebuyers. Depends on individual circumstances.
 - Mixed results for business too.



Full Report Available at

www.ifo.state.pa.us