



# Local Property Tax Limitations vs. School District Employee Pension Costs in Pennsylvania

William T. Hartman and Timothy J. Shrom

*William T. Hartman is Professor in the Educational Leadership Program in the College of Education at Pennsylvania State University where he teaches courses in school finance, school district budgeting, and financial modeling. His present research focuses on understanding the impact of the current economic crisis—the “new fiscal reality”—on school districts.*

*Timothy J. Shrom has served the past 32 years as Business Manager of the Solanco School District in Quarryville, Pennsylvania. He is a past President of the Pennsylvania Association of School Business Officials and a leading expert on school funding, health care, and innovative cost-saving practices in the state.*

## **Introduction**

In Pennsylvania as in many other states, employee pension costs are a significant source of financial pressure for school districts (Zeelandelaar and Northern 2013, Pennsylvania Public Employees’ Retirement Commission 2013). In order to gain greater insight into the nature of Pennsylvania school districts’ financial burden related to pension commitments, this article presents the findings of two scenarios, one which compared the maximum amount of local property tax revenue Pennsylvania school districts could raise under a 2010 state property tax limitation statute, Act 120,<sup>1</sup> to their pension obligations; and a second scenario which incorporated a 1% annual salary increase into the analysis. The article is divided into three sections. The first provides the fiscal context for this study. This is followed by a description of the methodology used in the study and the presentation of findings. The third, and final, section presents conclusions.

## **The Fiscal Context for Pennsylvania School Districts**

In the years prior to the Great Recession of 2007-2009, state and local revenues in Pennsylvania were increasing moderately along with the economy while school district expenditures were increasing at relatively low and predictable rates. However, the national economic crisis brought about a new budget climate, one for which many Pennsylvania school district administrators and boards were largely unprepared, fiscally or attitudinally. State aid was slashed, and local revenues were limited or reduced by the downturn in the economy. Prior fiscal trends and historical operational processes offered little guidance with regard to how re-establish and maintain fiscal stability. Districts were forced to make substantial changes in their fiscal and programmatic operations. In order to balance their budgets, Pennsylvania school districts had to make significant reductions in key expenditure areas such as instruction and operations.

Even prior to the economic recession, Pennsylvania school districts were facing fiscal challenges as the result of Act 1, a state law enacted in 2006 which imposed local property tax limitations on school districts.<sup>2</sup> Then, in 2010, shortly after

the official end of the Great Recession, Act 120 dramatically increased school districts' mandatory pension contributions.

On the revenue side, there was a dramatic change in districts' ability to control local taxes with the implementation of Act 1. Prior to its enactment, school boards could raise local property tax rates with a majority vote of the board. Under Act 1, school districts were limited in raising their tax rates to an inflationary index that was the average of the percent increase in the Pennsylvania statewide average weekly wage and the federal employment cost index for elementary and secondary schools. This rate was adjusted upward for less property-wealthy school districts, allowing them to raise their tax millage. Between 2007 and 2012, the base index fell from a high of 4.4% in 2009 to a low of 1.4% in 2012, while the average adjusted index fell from a high of 5.7% in 2009 to a low of 1.8% in 2012. (See Table 1.)

Property taxes are the major revenue source under the control of the local school boards in Pennsylvania. In 2012, they made up 79% of all local revenues collected and 46% of total revenues received by districts in Pennsylvania. By contrast, state aid to school districts represented 36% of school district revenue although the state aid share per district varied from 10% to 78% depending upon the school district's property wealth (Pennsylvania Department to Education n.d.a). Consequently, constraints on property tax rates increases can affect a school district's ability to balance its budget.

The fiscal condition of Pennsylvania's public school employees' pension system is like that of many other states in that it has large unfunded pension liabilities (Pennsylvania

Public Employees' Retirement Board 2013).<sup>3</sup> Over several decades, the obligations to current and future recipients have been substantially underfunded, forcing a massive catch-up effort (Pennsylvania Office of the Budget 2012). A combination of economic conditions and political decisions led to the need for large increases in state and district payments into the pension fund (Commonwealth of Pennsylvania 2012). In 2010, Act 120 re-amortized the unfunded liabilities and established controlled, but sharply increasing district required contribution levels rising to over 30% of salaries by 2019 and continuing at that level through 2035 (Public School Employees' Retirement Board 2013).

District pension contributions are calculated in terms of an employer contribution rate, which represents a percentage of district employee salaries. Each year, school districts make a mandated payment into the PSERS fund based on this required rate. The most recent employer contribution rates for PSERS and the annual and cumulative percentage increases they represent are shown in Table 2. Beginning in 2012, the rates started a steep annual climb to reach 29.15% by 2018. Annual percentage increases began at 53% in 2012, but will decline to 3% by 2018. However, cumulatively, districts will see a 417% increase in their mandated pension contributions between 2011 and 2018.

For most districts, the state share of this expenditure is approximately 50%, so while the percentage increases to districts will be the same as shown in Table 2, the dollar amount is shared with the state. The district's pension contribution has to be covered local property tax revenues, other local revenues, and other state subsidies. District

**Table 1 | Base Index and Adjusted Indices: 2007-2015**

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Base Index (%)	3.9	3.4	4.4	4.1	2.9	1.4	1.7	1.7	2.1
Adjusted Index (%)									
Minimum (%)	3.9	3.4	4.4	4.1	2.9	1.4	1.7	1.7	2.1
Average (%)	5.0	4.4	5.7	5.3	3.8	1.8	2.2	2.2	2.7
Maximum (%)	6.3	5.5	7.1	6.7	4.7	2.3	2.8	2.8	3.4

**Table 2 | PSERS Employer Contribution Rates for Mandatory District Pension Payments as a Percentage of District Employee Salaries: 2011-2018**

Year	2011	2012	2013	2014	2015	2016	2017	2018
PSERS Employee Contribution Rate (%)	5.64	8.65	12.36	16.93	21.31	25.80	28.30	29.15
Annual Increase (%)		53	43	37	26	21	10	3
Cumulative Increase (%)		53	119	200	278	357	402	417

**Table 3 | Total School District Payments for Pension Contributions: 2011-2018**

Year	District Contribution (\$)
2011	295,782,380
2012	439,922,497
2013	631,749,050
2014	873,985,965
2015	1,111,097,892
2016	1,358,657,385
2017	1,505,213,335
2018	1,565,927,152

pension contributions range from \$295.8 million in 2011 to \$1.57 billion in 2018. (See Table 3.) Practically speaking, pension costs act as a prior obligation in the school district budgeting process; that is, before other components of the budget can be considered, districts must budget for pension costs.

**Methodology**

The purpose of this study was to compare the property tax revenue that districts could raise using their maximum allowable Act 1 property tax rates to their state-mandated pension costs. Then, the analysis was extended to include the impact of an annual 1% increase in district salaries. The school district was the unit of analysis, and the time period for the study was 2011-2018. The data source for 2011 and 2012 district revenues and expenditures was the Pennsylvania Department of Education. These data were also used as a basis to develop projections for 2013 through 2018.

Three district data sets were compiled for each year of this study: (1) Maximum local property taxes that districts could raise under the state property tax limitation; (2) Mandated district pension obligations; and (3) District salary expenditures with an annual 1% salary increase. The analysis first focused on comparing allowable annual increases in property tax revenues against annual pension costs faced by the districts, and then it focused on the impact of pension costs plus and an annual one percent increase in salaries.

The maximum increase in local property taxes that a school board is allowed to levy is established by the annual inflationary index of Act 1. As shown in Table 1, the base index was 1.7% in 2013 and 2014, and it is set to rise to 2.1% for 2015. For relatively property-poor school districts, an adjusted index, which increases their allowable index, is calculated by the Pennsylvania Department of Education. Consequently, the average adjusted index across all districts is higher: 2.2% in 2013 and 2014, and 2.7% in 2015. The Pennsylvania Independent Fiscal Office (IFO) has projected base indices between 2.3% and 2.4% out to 2017 (Commonwealth of Pennsylvania 2012). Future estimated adjusted indices were

calculated for each district using the IFO future estimates of the base Act 1 indices for each future year and applying the Pennsylvania Department of Education formula for adjustments for poorer districts.

The data source for 2010-2012 current and interim property taxes collected by school districts was the Pennsylvania Department of Education. For 2013-2018, the authors estimated the annual maximum property tax revenue by increasing the prior year's amount by the district's adjusted index times the prior year's amount. The difference between the new total property tax amount and the prior year's amount was the maximum increase in property tax allowable for the district. These calculations set an upper bound on the increase in property taxes available to districts. However, not all school boards choose to increase taxes to the maximum level. In practice, only half of the districts raised their property taxes to the maximum in 2012 in spite of the state revenue shortfall.

The calculations for the annual expenditure increases for pension commitments and salaries followed a similar process. The data source for 2010-2012 salaries was the Pennsylvania Department of Education. Future annual salary increases were estimated at 0.5% for 2013 and 1.0% for the remaining years.

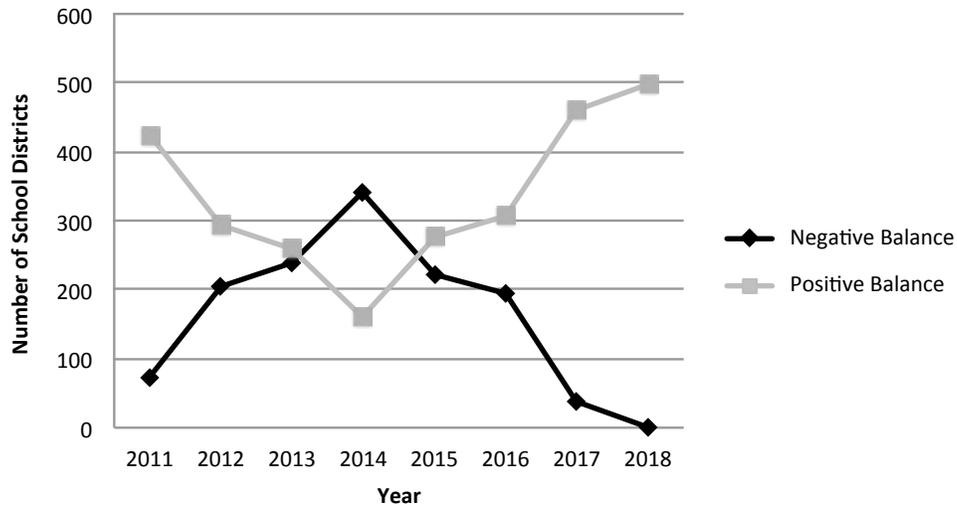
PSERS rates for the years of the study were shown in Table 2. Annual calculations were made for each district's net dollar pension cost by multiplying the total salary amount by the PSERS rate and then halving it. The annual cost increase for pensions was determined by subtracting one year's cost for pensions from the prior year.

Finally, for each year, the PSERS net dollar increase to districts was subtracted from the maximum allowable increase of property taxes to compare the two amounts. Districts with a negative balance had a larger increase in pension costs for that year than the school board's authority to raise property taxes. Districts that had larger increases in property tax revenues than pension cost increases had a positive balance; that is, some property tax revenues remained for use in other areas of the budget. The annual number of districts in each category was then determined. In addition to an annual analysis, a cumulative analysis was conducted.

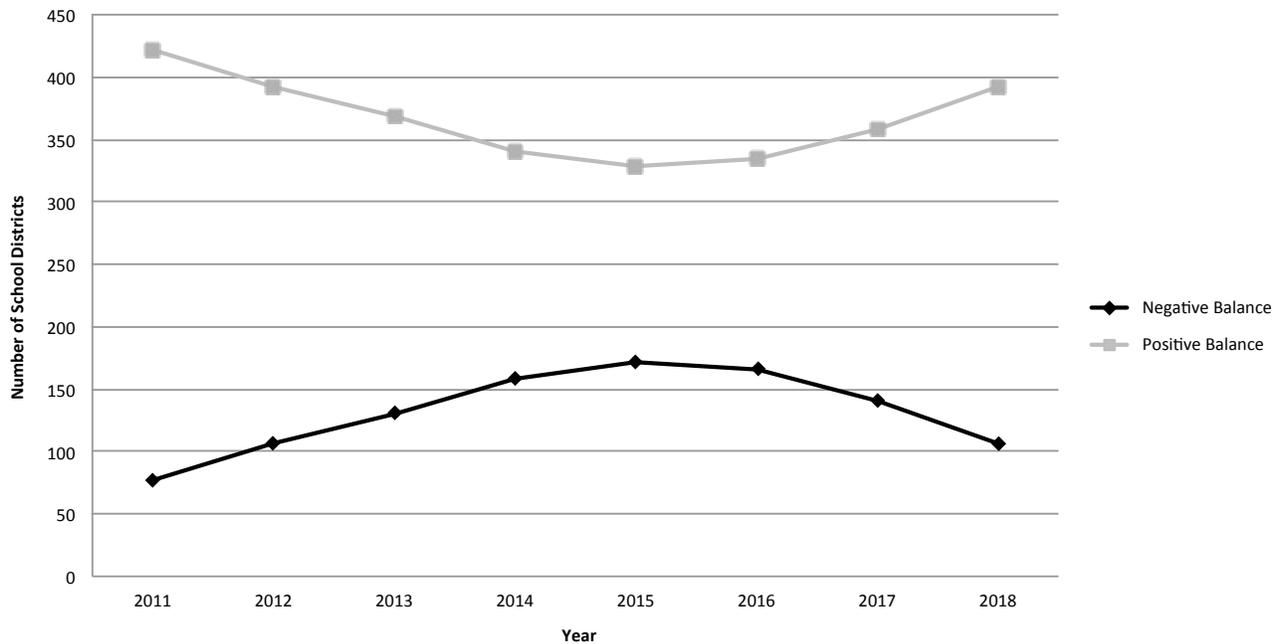
**Findings**

Figure 1 shows the number of districts with positive and negative balances after subtracting pension obligations, even after the school district levied the maximum allowable property tax rate. The numbers of negative and positive districts show a changing pattern over the eight years of the study. In 2011, approximately 85% of districts had positive balances. However, between 2012 and 2014, the percentage of school districts with negative balances grew steadily, from 41% to 68%, as the maximum property tax rate increase allowed declined from 3.8% to 2.2%. At the same time, pension contribution rates rose from 5.64% to 16.93% of salaries. The percentage of districts with negative balances peaked in 2014, and, from that point forward, the pattern was projected to reverse with the number of districts with negative balances falling to zero in 2018. Even though pension contribution rates were projected to rise during this

**Figure 1 | Annual Number of School Districts with Positive and Negative Balances after Subtracting Pension Obligations: 2011-2018**



**Figure 2 | Cumulative Number of School Districts with Positive and Negative Balances after Subtracting Pension Obligations: 2011-2018**



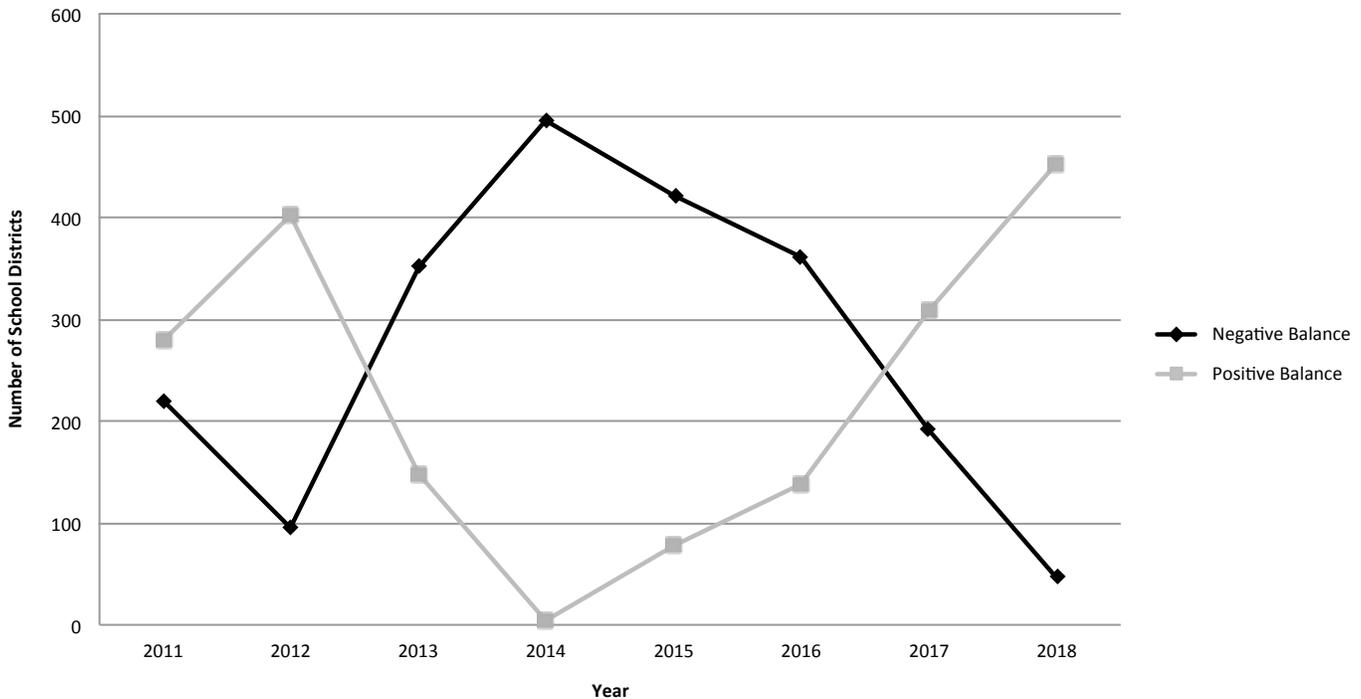
period from 21.3% to 29.2%, the number of negative-balance districts dropped steadily due to lower annual and cumulative increases in the contribution rates, low salary increases, and higher allowable property tax rates. Nevertheless, as late as 2016, more than one-third (38.7%) of school districts were projected to have negative balances after meeting pension obligations.

Next, a cumulative analysis was conducted to examine the effects of property tax revenues and pension costs over time. (See Figure 2.) Although only 15.4% of districts had negative balances in 2011, the percentage more than doubled to 34.3%

in 2015, but then declined to 21.4% in 2018. Even though the cumulative effects of property tax increases are projected to reduce the number of districts with negative balances between 2015 and 2018, they are insufficient to move approximately 20% of school districts to a positive balance.

The previous analyses held district salaries constant. This scenario added the effect of an annual 1% salary increase. (See Figure 3.) The percentage of school districts with negative balances initially dropped by more than half between 2011 and 2012, from 43.9% to 19.2%. However, the percentage of districts with negative balances then skyrocketed to

**Figure 3 | Effect of Annual One Percent Salary Increase on the Number of School Districts with Positive and Negative Balances after Subtracting Pension Obligations: 2011-2018**



99.2% in 2015; that is, 495 out of 499 school districts had negative balances. The trend then reversed with only 46 school districts, or 9.2%, with negative balances in 2018. The introduction of even a modest salary increase clearly made the pattern of districts with negative and positive balances much more volatile.

Figure 4 illustrates the cumulative effect of the addition of an annual 1% salary increase. The effect, in general, was less volatile, but, ultimately, it resulted in a negative balance for more than one-third (33.9%) of school districts. Initially, the percentage of districts with negative balances dropped sharply from 43.9% in 2011 to 20.9% in 2012. However, the percentage of districts with negative balances then rose to a high of 41.9% in 2016 before falling a few percentage points to 33.9% in 2018.

**Conclusions**

As the results of this study indicated, a number of Pennsylvania school districts face a volatile financial future as a result of recently enacted state laws related to property tax limitations and pension commitments. Even if these districts annually raise their local property tax rates to the state-allowed maximum for each of the next five years, the revenues will be insufficient to fund their mandated pension contributions and still provide employees with a 1% annual salary increase. Under these conditions, in order to balance their budgets, these districts would have to: (1) use their fund balance, if they have one (a short term tactic); (2) reduce and/or eliminate programs and services; or (3) reduce personnel expenditures, e.g., through attrition or furloughs. Also, it

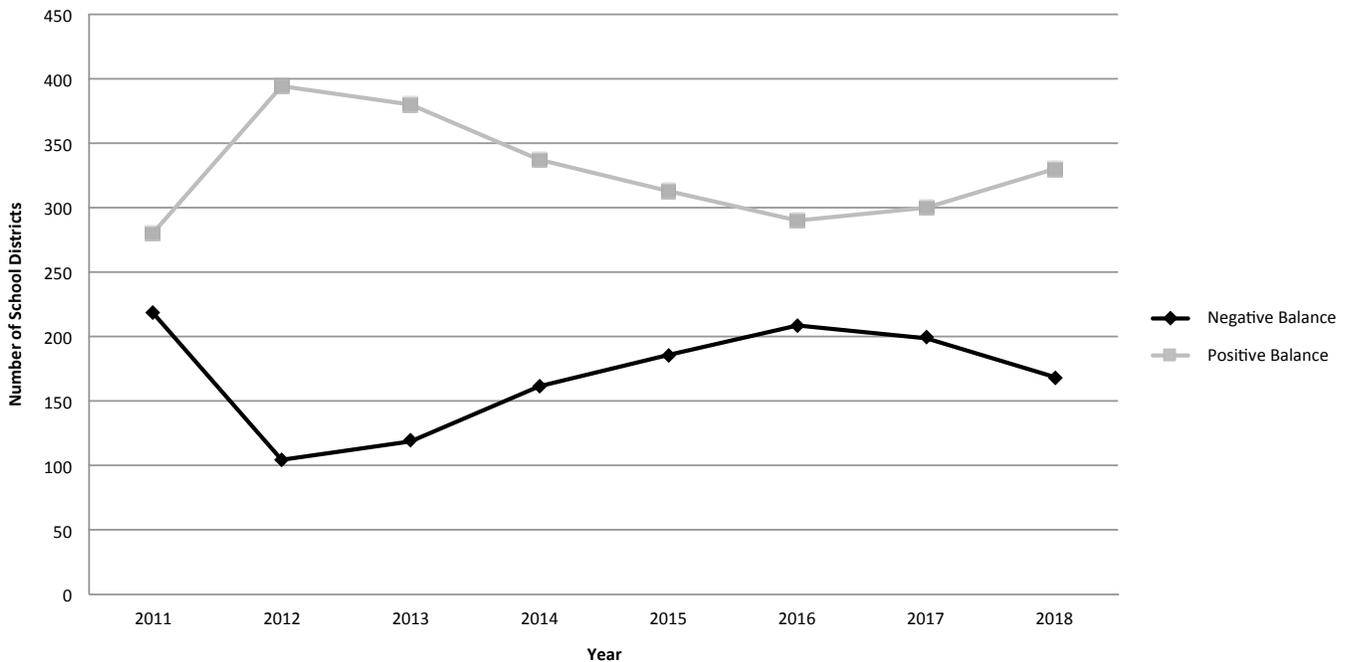
should be noted that even districts with positive balances may still have insufficient revenues to address the remainder of their budgeted expenditures.

In order for districts to balance their budgets, revenues must be increased or expenditures must be reduced. On the revenue side, both property-poor districts and property-wealthy districts are constrained. Property-wealthy school districts rely primarily on local property taxes as their major source of revenue. This source is limited to small annual increases in the base index for the next five years. On the other hand, property-poor districts receive the bulk of their revenue from state subsidies. However, given recent history, substantial increases in state funding are unlikely.<sup>4</sup>

Consequently, reduction in expenditures is the only feasible approach for districts to balance their budgets. Of the two expenditures used in this analysis—pension costs and salary increases—districts have no flexibility with regard pension payments since they are mandated by state law. The only source of relief is through legislative action. Several modifications to the current PSERS funding approach have been proposed, but none has gained sufficient support for approval by the legislature.

Salaries, on the other hand, are an expenditure over which districts have some control or influence. Actions that districts can take to reduce payroll costs include reducing the number of employees through attrition or layoffs, or engaging in collective bargaining for salary concessions or lower salary levels. There is some evidence that this happened in 2012 following significant reductions in state funding.<sup>5</sup> The fiscal effects of these actions was evident in the latest available

**Figure 4 | Cumulative Effect of Annual One Percent Salary Increase on the Number of School Districts with Positive and Negative Balances after Subtracting Pension Obligations: 2011-2018**



actual salary data in 2011-2012, where there was a 3% reduction in salary expenditures over the prior year. This was a result of both the reduction in personnel and other salary actions, such as wage freezes by a number of districts.

This study considered only two of the critical expenditure areas that school districts have to fund in order to maintain their operations. For those districts facing negative balances after making mandated pension contributions or pension contributions plus a modest salary increase for staff, there are no funds available for other areas of the budget, even those that are mandated or essential to maintain. These include, but are not limited to, mandated tuition payments to charter schools,<sup>6</sup> special education costs,<sup>7</sup> and health care benefit costs.

As each of these major expenditure areas is considered and added to the budget requirements, it becomes increasingly difficult for districts to balance their budgets. Looking at the budget equation, there are serious difficulties on each side. School district revenues are restricted or growing slowly due to a continued weak economy. Many critical expenditures are growing rapidly; significant ones are mandated by the state or federal governments and are out of district control. Other desirable, but not mandated, expenditures must be reduced. This has already led to painful, controversial budget reductions in staffing and programs in Pennsylvania. Given the projections of a likely continuing structural imbalance over the next five years, districts face the critical budget-balancing task of fulfilling all their financial obligations and maintaining the existing levels and quality of programs and services for students.

**Endnotes**

- <sup>1</sup> P.L. 1269, H.B. 2497, <http://www.legis.state.pa.us/cfdocs/legis/li/uconsCheck.cfm?yr=2010&sessInd=0&act=120>.
- <sup>2</sup> Act 1 of 2006, Special Session 1, P.L. 1873, No. 1.
- <sup>3</sup> The Pennsylvania Public School Employees’ Retirement System (PSERS) is a guaranteed benefits system in which school districts and the state have equal funding responsibility. The state funds its portion of PSERS costs through a subsidy to school districts.
- <sup>4</sup> State general aid revenues were cut by approximately \$900 million in 2012 followed by small increases of 0.9% in 2013 and 2.3% in 2014, leaving districts more than \$600 million below what they received in 2011.
- <sup>5</sup> In a survey by two state administrator organizations, districts identified reductions of approximately 20,000 positions over a two year period, 2011-2012 and 2012-2013, in order to balance their budgets (Pennsylvania Association of School Business Officials (PASBO) and Pennsylvania Association of School Administrators (PASA), “School District Cost Cutting Continues for a Second Consecutive Year,” News Release (October 2012), <http://www.bpsd.org/Downloads/2012PASBOFundingSurvey.pdf>.
- <sup>6</sup> Pennsylvania school districts are required to fund 100% of tuition payments to charter schools. The state subsidy to offset approximately 25% of these costs was terminated in 2012.
- <sup>7</sup> State subsidies to school districts for special education have not increased since 2008.

## References

- Boyd, D., and L. Dadayan. 2013. "The State Budget Crisis Task Force and Fiscal Challenges Ahead." In *The Book of the States 2013*, 341-349. Lexington, KY: Council of State Governments.
- Commonwealth of Pennsylvania. 2012. "The Economic & Budget Outlook: Fiscal Years 2012-13 to 2017-18." Harrisburg, PA: Independent Fiscal Office. <http://www.thenonprofitpartnership.org/files/pa-fiscal-outlook-2013-2017.pdf>.
- Pennsylvania Association of School Business Officials (PASBO) and Pennsylvania Association of School Administrators (PASA). 2012. "School District Cost Cutting Continues for a Second Consecutive Year." News Release, October 1. <http://www.bpsd.org/Downloads/2012PASBOFundingSurvey.pdf>.
- Pennsylvania Department of Education. n.d.a. "Summaries of Annual Financial Data." [http://www.portal.state.pa.us/portal/server.pt/community/summaries\\_of\\_annual\\_financial\\_report\\_data/7673/afr\\_excel\\_data\\_files/509047](http://www.portal.state.pa.us/portal/server.pt/community/summaries_of_annual_financial_report_data/7673/afr_excel_data_files/509047).
- Pennsylvania Department of Education. n.d.b. "Summary of State Education Appropriations." [http://www.education.state.pa.us/portal/server.pt/community/education\\_budget/8699/summary\\_of\\_state\\_appropriations\\_for\\_education/539258](http://www.education.state.pa.us/portal/server.pt/community/education_budget/8699/summary_of_state_appropriations_for_education/539258).
- Pennsylvania Office of the Budget. Fall 2012. "The Keystone Pension Report: A Discussion of Structural Reform and Relief to Pennsylvania's Retirement System for Long Term Sustainability." <https://www.picpa.org/Content/Files/Documents/Advocacy/PensionPlanBooklet.pdf>.
- Pennsylvania Public Employee Retirement Commission. 2013. "Special Report: Funding and Reforming Public Employee Retirement Systems." Harrisburg, PA.
- Pennsylvania Public School Employees' Retirement Board. 2013. "Pennsylvania Public School Employees' Retirement System Budget Report Fiscal Year 2013-14." Report presented to the House Appropriations Committee, February 15. <http://www.psers.state.pa.us/content/publications/budget/FY2013%20House%20Budget%20Document%20Final.pdf>.
- Zeelandaar, D., and A.M. Winkler. 2013. "The Big Squeeze: Retirement Costs and School-District Budgets: Summary Report." Washington, DC: Thomas B. Fordham Institute, June. <http://www.edexcellence.net/publications/the-big-squeeze.html>.