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Hot Topic in Local Government Ratings

## Moody's Will Treat Debt Issued by Pennsylvania School Districts Under Act 72 Property Tax Constraints as Limited Tax Debt

*A One-Notch Rating Distinction from Unlimited Tax Debt is Likely, But Not Automatic*

### Summary Opinion

Moody's Investors Service will rate non-electoral debt issued by Pennsylvania School Districts that are subject to the property tax limitations related to Act 72 as limited tax debt and will likely make a one notch distinction from general obligation debt that is not subject to the limitations. Beginning in the fiscal 2007 year, Pennsylvania school districts that avail themselves of the additional State funding under Act 72 will be required to hold a public referendum to increase the property tax rate beyond an annual index. Although debt approved prior to September 3, 2004 and debt refunding pre-Act 72 issues will be exempt from the tax limitations, school districts will not be able to raise the property tax millage beyond the index for new, non-electoral debt without annual voter approval. The uncertainty of gaining such approval will prevent participating school districts from pledging their unlimited taxing power to secure general obligation debt. Given the history of the index (based on the average increase in the statewide average weekly wage and the employment cost index for schools), which averaged 3.2% from 1994 to 2003, and given ongoing growth in wage, pension and health benefit costs, Moody's believes participating school districts will be left with little annual levy capacity for non-personnel costs. Although Moody's may make exceptions for school districts with substantial financial flexibility, non-electoral debt issued under the property tax limitations of Act 72 will be considered limited tax debt and will likely be rated one notch lower than debt secured by an unlimited tax pledge.

### Act 72 Limits School District Revenue-Raising Ability

On July 5, 2004, the Governor of Pennsylvania signed into law Act 72, which established a distribution mechanism for new revenues that will be generated from the legalization of slot machines in various areas around the state. The main objective of the new law was to increase state funding for education, thereby reducing local property taxes given the relative dependence of local school districts on such taxes. School districts access the new state revenue source by levying an earned income tax of 0.1%. School districts may also levy an additional earned income tax, or convert to a personal income tax, to further lower property taxes, but these are subject to voter approval.



Property tax reductions will be implemented through homestead exemptions, which entail the reduction of valuation of residential properties, thus lowering the amount by which the property tax is calculated. The size of the exemptions will depend on the amount of additional revenue generated by the 0.1% earned income tax and the amount of gambling revenue distributed by the state. Current projections have the new funding distributed in the 2007 fiscal year.

The new legislation includes new limits on school districts' ability to raise revenue. In fiscal 2007, school districts that have opted into Act 72 will be required to hold a referendum in order to increase property taxes beyond an annual index (based on the average increase in the statewide average weekly wage and the employment cost index for schools). Although there are a variety of expenditures that are exceptions to the limitations (costs related to emergencies, court ordered expenses, spikes in special education spending and health benefit costs,), they require approval of either the Court of Common Pleas or the Pennsylvania Department of Education.

## **Most Non-Electoral Debt Will Not Be Exempt from Act 72**

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New non-electoral debt issued for new projects will be subject to the Act 72 property tax limitations, with some exceptions. Debt that was approved prior to September 3, 2004, will be grandfathered and districts may continue to increase the property tax millage for principal and interest obligations on such debt. This exemption includes any post-September 3 debt that is refunding issues that have been grandfathered. School districts may also seek exemptions for new non-electoral debt, but must meet a series of conditions, including the commitment of all undesignated reserves to the projects and even then, only 60% of the debt can be exempted. Given these conditions, Moody's does not expect many school districts to seek such an exemption. Debt service of new debt that has been approved by the electorate is also exempt from the limits.

## **Distinguishing Unlimited and Limited Tax Debt**

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Once a school district opts to receive Act 72 gambling funds, it will no longer be able to pledge its unlimited taxing ability to secure new, non-electoral debt that does not receive an exemption. In order to increase taxes to pay debt service (beyond the Act 72 index), a participating school district will need to go to referendum for public approval. The indexed increases, which have averaged 3.2% over the past 10 years, will allow for limited growth in property tax levy capacity. Given that the index is driven by increases in statewide employee costs, however, Moody's believes that ongoing growth in wage, pension, and health benefit costs, which have been steadily rising, will capture most of those additional revenues. School districts that are experiencing growth in taxable real estate values will also gain some additional property tax revenue given that the limitation is on a district's millage rate, as opposed to its property tax levy. Moody's will analyze school district tax base trends to determine if continued additional property tax revenues are expected driven by growth in taxable values. Given that most school districts in Pennsylvania are not expected to experience taxable growth beyond moderate levels, Moody's believes that increased revenues driven by growth will be limited. Moody's will also incorporate a district's financial operations, particularly financial flexibility derived by available reserve levels. Given the 8% General Fund balance limitation established by Act 48, however, Moody's expects most districts to have, at best, satisfactory reserve levels.

Moody's believes that these property tax limitations are sufficiently restrictive that new debt that is subject to Act 72 constraints will merit, in most cases, a one notch distinction from debt that is free from these limitations. Although other credit factors (financial flexibility, taxable growth) will be considered in determining the limited tax rating for participating school districts, it is likely that a school district issuing debt under the tax limitation will be rated one notch below its unlimited tax rating.

## **Conclusion**

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Moody's will, in most cases, rate debt issues that are not exempt from the property tax limitations under Act 72 one notch below a school district's unlimited tax rating. The notch distinction reflects Moody's belief that the Act 72 property tax limitations restrict ad valorem taxing power to the extent that the security of a general obligation pledge is weaker than one without limit. Moody's will examine each school district's credit factors to determine if strong financial flexibility exists to counteract the weaker pledge, but we believe it is likely that the rating distinction will apply to most Pennsylvania school districts.

## Related Research

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### **Special Comments:**

[Act 72 Implementation to Prompt Accelerated Borrowing for Pennsylvania School Districts over the Near Term, July 2004 \(88191\)](#)

[Moody's Maintains Stable Outlook on Pennsylvania School Districts Despite New Legislation Capping Financial Reserves, March 2004 \(81453\)](#)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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