

Public Assets Institute
Testimony before the Vermont Tax Structure Commission
Paul A. Cillo and Stephanie Yu
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Paul A. Cillo, President

My name is Paul Cillo. I'm the president of Public Assets Institute, a nonpartisan nonprofit public policy thinktank located in Montpelier. We analyze Vermont tax, budget, and economic policy from the perspective of the average Vermonter.

I served in the Vermont House from 1989-1998 and spent most of those ten years working on school funding reform that resulted in passage of Act 60 in 1997 and Act 68 in 2003.

I'm here today with Public Assets' deputy director, Stephanie Yu.

First, I want to thank you for tackling the challenging tax issues the state faces and for your thoughtful consideration of these issues. It's needed.

I will start with some history about Act 60 & 68 and a review of the principles that guided that legislation. Then Steph will talk about our current proposal to eliminate the school property tax on primary residences, which we believe is the logical next step in the refinement of this law.

Fundamentally, the goal of Act 60 was to equalize how revenue was raised and distributed so that all school districts had equal access to the same resource pool. As the chart on page 1 of our handout shows, prior to Act 60, there was no relationship between spending per pupil and school tax rates from town to town. Each dot in the chart represents a town. In the second chart on that page, you see that tax rates are now directly proportional to spending per pupil for all towns.

The third graphic on that page shows that most students now fall within a very narrow per-pupil spending range, in fact it's about 35% narrower than prior to Act 60.

There were five principles that guided the development of Act 60. With the exception of local control, which is particular to school funding, these principles are consistent with the Principles adopted by this Commission. I'll review them briefly. They are on pages 2 and 3 of the handout.

1. Local control: The law strengthened local control by making sure that all districts have equal access to needed resources; a big change from prior to Act 60. The law does not remove or reduce a local school district's powers to operate its schools.
2. Fairness for students: the law provides for equal access to educational resources so that students have what they need as determined by their local school board.
3. Fairness to taxpayers: Taxpayers in any two towns that have the same per-pupil spending have the same tax rates.

The law works pretty well based on these three principles; not so well on the remaining two.

4. Simplicity and transparency for school district voters: We have direct-democracy decision making for our schools in Vermont. It's critical that voters understand the tax consequences of their spending decisions. The current law is neither as simple nor transparent for voters as it could be.
5. Taxes based on ability to pay: Act 60 provided taxpayers with the option of paying taxes on a residence based on property value or based on household income. However, this aspect of Act 60 has been eroded over time.

Prior to Act 60, the House passed H.541 in 1994. The bill would have eliminated the school property tax on primary residences, instituted a local income tax based on the town's spending per pupil and taxed nonresidential property at one rate statewide.

Act 60 was a political compromise with all of the accompanying complexities and confusion. While Act 60 was a clear advance for equity, as passed it wasn't the best policy package for education funding that we know of or were aware of at the time. It was the best we could get enacted in 1997.

The House wanted to do what it had passed in 1994; but the governor did not support a local income tax. And the business community did not want a separate tax rate for nonresidential property. So Act 60 provided that the tax rate based on per-pupil spending apply to all property in a town, and give residents the option of paying based on property or income for their home.

Since 1997, the Legislature has changed the law repeatedly. Some of these changes simplified the law, others made it more complex and less fair.

- Act 68 in 2003 separated nonresidential property to be taxed at one rate statewide as envisioned in H.541. Simpler and fairer.
- The Act 60 prebate check that was mailed to homeowners was eliminated, shifting to a system that deducts that amount from property tax bills. That was an important simplification.
- Requiring those paying based on income to also pay property taxes on their home's value above a certain threshold, made the law more complex and less fair.
- Capping the rebate amount made the law more complex and less fair. This was the result of concerns that some rebates were too large. But rebates were large because property taxes were excessive in some towns. Capping the rebates makes some tax payers pay a much higher percentage of their income than others.

Education Fund Advisory Committee

We discussed in the Legislature 22 years ago the idea of having an oversight advisory committee with expertise on school finance to provide some consistency in education fund policy over time. It would have helped the state through the repeated changes to the law over the past 20 years and some of the yo-yo effects of those changes.

The state has relied on expert advisors in other areas:

- Capital debt was a free-for-all prior to the advent of the Capital Debt Affordability Advisory Committee in 1989
- Similarly, revenue projections were a chaotic part of legislative negotiations prior to the state instituting consensus revenue forecasting in the 1990s.

It's time that a similar advisory committee of experts be established to stabilize the Education Fund and reduce the chaotic, sometimes contradictory, policy making that usually adds to the complexity and confusion of the law.

There is a fundamental tension between property and income as the tax base for schools. Some people feel that we should be funding schools using property taxes, which is where we started in the 18th century in Vermont. But there is no real connection between property values and education. People don't pay their property taxes by cashing out their property; they pay using their income. That's why over the past 50 years Vermont has been moving away from taxing property for schools, toward school taxes based on income as described on page 5 of the handout.

Basing school taxes on income because it is a fairer way for individual Vermonters to support our schools is undermined by evaluating the fairness of the system as if property taxes are the fairest way to fund schools. That tension has created much of the complexity and confusion in the law. Resolving that tension by eliminating the current property tax option for Vermont homeowners, would resolve a lot of the complexity and confusion in the law and make it fairer.

Now I'll turn it over to Steph to talk about what eliminating the school property tax on primary residences would look like.

Stephanie Yu, Deputy Director

As you state in your tax principles, the system should impose a higher burden on those with greater ability to pay, should be easy to understand, simple to administer and transparent to taxpayers. An income-based system would be much fairer and simpler than what we have now.

Our current system is regressive. **[handout]** Higher-income people pay a smaller share of their income in school taxes. 2/3 pay based on the best measure of their ability to pay, their income, and we should apply that to all Vermonters.

Our current system is extremely complicated, both for taxpayers and the local and state officials administering it. The tax department recently said it could take up to 24 steps for someone to estimate their school taxes. It's the opposite of simple, easy to understand and transparent. If you wanted to calculate your taxes on Town Meeting Day, you would have to know:

- Whether all of the income in your household—based on the unique definition of income used for school funding calculations—was above or below \$90,000 last year
- if below, how much of your housesite value is above \$400,000

- if above, how much of your housesite value is above \$225,000
- Whether household income was above or below \$47,000
- Your homestead listed value
- Your housesite listed value
- Your town's Common Level of Appraisal
- The equalized homestead property tax rate required for proposed budget
- The income-based tax rate required for proposed budget

It's incredibly difficult to follow. Very few people including local school officials feel like they have a good handle on how it works or could explain it clearly, and that leads to frustration for voters, which distracts from the real conversation we should be having about what our schools need. Instead, concern about rates, which don't even apply to many people, dominates the school budget conversations.

How income-based school tax would work:

- All Vermont residents pay school taxes based on income.
- Individual town income tax rates will continue to be determined by per pupil spending approved by local voters.
- All housesites (a primary residence and up to 2 acres of adjacent land) are exempt from school property taxes.
- All property other than housesites will be taxed at the uniform non-homestead rate set by the Legislature.
- All residents pay a school income tax rate on their adjusted gross income (AGI).
- Renters pay the school income rate, but receive credit for landlord's school property taxes paid through their rent.

It would be much fairer. Everyone would pay through the same system based on the best measure of their ability to pay. The system would move the remaining 1/3 of Vermonters—the higher-income ones—to paying based on income.

It would be much simpler. Anyone could estimate their school taxes on Town Meeting Day. All they would have to know is their income and the school tax rate for their district. And it would eliminate a lot of the messy steps in the current process: the CLA adjustment, the income adjustment, paying both property and income taxes on housesites, the two yields (property and income) for primary residences and two rates for each town (property and income).

There are a lot of misconceptions about how the system works now and about how the new system would work that really muddy this conversation, so we want to try to make a few things clearer.

Let's start with volatility. This is the most common response to this idea: "Hey but isn't income more volatile than property values?" Volatility means different things to different people. First the whole volatility conversation is based on comparing apples to oranges. You can't compare how we raise, set, and collect school taxes with any other state revenues because with school taxes we change the rates every year to ensure we raise the money we need, unlike the rest of the

state budget where we take what revenue we get with the current rates and then adjust expenses to fit.

But setting that aside, people's concerns about volatility tend to fall into 3 categories:

- Volatility in tax collections
- Volatility in revenue forecasting
- Volatility in tax rates

The first two are really about volatility from the state's perspective. For tax collections, people emphasize the stability of the property tax. But that perceived stability is really about the hammer the state has to seize property – meaning that people prioritize paying their property taxes and the state always gets its money.

As for the volatility in revenue estimating, the proposed system would use last year's income for this year's school taxes, so the state would know just as much about the income tax base as they do about the property tax base from year to year, so there really shouldn't be any difference in the accuracy of the forecast.

And on volatility in tax rates: This won't get worse under an income-based plan. In fact it might be better since there will be fewer places policymakers can influence the yield. Now and with an income-based plan, education tax rates get adjusted every year to meet schools' needs. That won't change. Under this system we would continue to determine the money we need for schools first, and then set the rates accordingly. And in fact, looking back, the rates actually would have been less volatile—meaning rates would have changed less from year to year—had there been an income-based system in place. **[handout]**

The last thing that we'd say about volatility is that much of the conversation centers around volatility from the state's perspective. And the focus should be on the Vermont taxpayer and how volatile it is for them. For example, if you lose your job but live in a town where your property values keep going up, you're on the hook for a growing school tax bill even when your ability to pay it has gone down. And you can lose your house if you can't pay. Don't we want to protect that person rather than create an unreasonable hardship for them based on the idea that the state needs its money regardless of the impact on the individual?

Which brings up a related idea that sometimes gets conflated with the volatility conversation: that as a state we need diverse revenue sources and shouldn't be over-reliant on any one source to fund state government. This really isn't an issue here. This proposal isn't shifting that much money onto income. Across the whole state budget, the revenue mix would not change much. It's a net of about \$150 million onto income, taking the share of state revenues based on income from 28% to 32%. **[handout]**

And as you're thinking about and talking about changes across the whole state revenue system, I want to mention one more idea that would help make the education funding piece fairer that has to do with what affects the individual town tax rates. Schools are human services providers, and they're providing more of those services than ever before. It's worth considering separating

human services from the rest of school spending and treating it as categorical aid. Like transportation and special education, all schools do not face the same challenges with human services. Some schools provide more human services for more kids, and places with more acute needs should not bear those costs on the town tax rate. This would also allow us to better track the human services that schools are providing to kids because categorical aid would require accounting for those costs.

I know we've just scratched the surface here of what these changes could look like and what they would mean for taxpayers and students. We're happy to answer any questions with whatever time we have left.

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