

Education Finance Reform Memo to the Tax Structure Commission
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I would like to offer the Commission proposals that might reform our education finance system so that it was in better accord with what I believe to be some of our professed goals. These goals would be to be sure that the Education Fund is used only for education costs (per Act 60), to avoid excessive increases in property taxes, to be sure that the programs for assisting Vermonters with the property tax components of their housing costs are effective, equitable, and efficient, to be sure that Vermonters pay for education based on income as well as based on property, and to be sure that the system is sufficiently transparent and accountable so that voters can cast informed votes on education spending.

Progress towards achieving those goals can be made by some combination of the following three elements:

COMPOSITION OF EDUCATION FUND COSTS.

***** The costs of the Property Tax Adjustment and the Current Use program should be shifted from the EF to the GF. This will eliminate the vicious cycle in which increases in property taxes increase the cost of the PTA, which then further increases property tax rates, and so on, which means that all Vermonters pay higher property taxes than they otherwise would. This move of the PTA and CU could lower property tax rates or avoid future rate increases, depending on how it is implemented.**

DESIGN OF THE PROPERTY TAX ADJUSTMENT PROGRAM:

***** Whether or not the PTA cost is shifted out of the EF, eligibility for these credits must be limited to low and middle income households and the program should be simplified to ensure that those who are eligible actually receive a credit and that processing is easier. A wealth test must be added to the income criteria for households over a certain level. Such changes would lessen the violations of vertical and horizontal equity inherent in the current program design. Alternative approaches like exemptions or income tax credits should be considered if they might be simpler and more effective in assisting Vermonters.**

COMPOSITION OF EDUCATION FUND REVENUE SOURCES:

***** A percentage of state personal income tax revenues should be dedicated to the EF (shifted into) while the Meals and Rooms and Purchase and Use revenues are shifted to the General Fund. This ensures that Vermonters are paying for education with both their property taxes and their income taxes. If it was desirable to go further in this direction, the income tax rate reductions for the two highest income tax brackets of 2018 could be reversed, and the added revenue allocated to the EF. This would reduce property tax payments by the same amount, and it would make the financing of education more progressive, since the income tax is our most progressive tax.**

INTENDED RESULTS:

***** We will be closer to having the Ed Fund pay only for education related costs and the vicious cycle of property tax increases stemming from the funding of PTA and CU within the EF will be halted.**

***** The PTA will be simpler, more effective, and more equitable, and likely lower cost.**

***** Since fewer Vermonters are receiving the PTA as eligibility has been restricted and property taxes are lower, many voters are therefore re-connected to the direct consequences of their votes in terms of passing school budgets and seeing higher property taxes, rather than being insulated from the effects of voting to approve of increases to some extent through the PTA.**

***** Vermonters would pay for education partly with the income tax and partly with the property tax.**

COMPOSITION OF EDUCATION FUND COSTS:

*** The costs of the Property Tax Adjustment and the Current Use program should be shifted from the EF to the GF. This will eliminate the vicious cycle in which increases in property taxes increase the cost of the PTA, which then further increases property tax rates, which means that all Vermonters pay higher property taxes than they otherwise would. This move of the PTA and CU could either stabilize or lower property tax rates depending on how it is implemented.

The Property Tax Adjustment program and the Current Use program are not education programs, nor are their designs voted on by school district voters, therefore their costs should not be covered in the Education Fund. I consider it a violation of the provisions of Act 60, which say that the Education Fund can only be used for education spending. Before the Education Fund existed the costs of both programs were covered in the General Fund budget.

In addition, the presence of these costs in the Education Fund, whether as an internal transfer in the cost of PTA or as lost revenue with the CU, can create a vicious cycle of property tax increases that actually lessen the degree of support that the program participants get. Any initial increase in property tax rates sets off a series of additional increases in property taxes over time. Paying for the costs of property tax supports within the Education Fund means that the expense of those supports drives up property taxes, which in turn drives up the costs of the supports and the need for supports, and so forth.

The property tax rates are the variable that has to move to make the EF balance, so any particular increase in cost or decrease in revenue will increase property tax rates. Any decrease in costs or increase in revenue will decrease property tax rates.

Because the PTA and the CU are determined based on the previous year's income and property taxes, changes in property tax rates in one year affect the costs of the programs in the next, which in turn can affect property tax rates in the following year, and so on. An increase in property tax rates this year means that this year's property tax liabilities will be higher, but the adjustment credits and therefore the cost of the program do not increase from that since the credits are based on last year's income and property tax rates. But next year, this year's increase in property tax rates will mean larger adjustment credits, increasing the overall cost of the programs. But that increase in program costs causes higher property tax rates in that next year, which perpetuates the process. It is a kind of vicious cycle. It is as if once property tax rates are rising, participants in these programs never catch up.

I believe that if the costs of these support programs were covered in the General Fund instead of the Education Fund, the sequence of increases would not occur. In that situation if some increase in cost meant that property taxes increase in one year, that would increase the cost of the PTA and CU in the following year, but that increase in program costs would be in the GF not the EF, so there would be no resulting further increase in property tax rates from the initial change.

So I would recommend that the costs of the PTA and the CU programs be borne within the GF rather than the EF. But there would have to be a way to cover those costs as the GF is so tight, so one way to do this would be to remove the program costs AND the revenue to cover them from the EF. Then going forward the GF would be subject to any variations in program costs from changes in EF revenue and costs, but there would be no secondary effects from those variations.

However, I think that a better way to undertake the removal would be to first take steps to reduce the PTA support program so that the EF benefits from a series of reductions in costs over several years first, enjoying a virtuous cycle. THEN, when the costs are already lower, take the costs and the revenue out of the EF. (I am not proposing changes in the CU program at this time.)

For instance, I would alter the eligibility criteria for Property Tax Adjustments for this year so that those with income over \$90,000 are no longer eligible. This would reduce the cost of the PTA this year. (Yes, I know that this would create a 'cliff', but let's just ignore that for now, or shift the cliff downwards.) I would also lower the cap on the maximum payments, which would also reduce the cost. Finally, for all currently eligible households I would put in place a wealth criteria in order to insure that support payments are not going to people with incomes below \$90,000 but substantial financial, real estate, vehicles, jewelry, artwork, and other assets. (See discussion of problems with the PTA below.)

I believe that altogether such changes in eligibility criteria would reduce the costs of the PTA, perhaps by as much as \$10 m to \$20 m. If we take the high estimate, this alone would mean a decrease in costs in the EF of \$20 m, which could allow a reduction in the average Homestead Property Tax Rate of 5 cents. This would mean that all those paying education property taxes for their homesteads would see a reduction in tax liability this year. This reduction in property tax liability could partly or entirely offset the reduction in support payments from the changes in eligibility that were implemented, depending on a taxpayer's circumstances.

The reduction in property tax liability from the reduction in PTA program costs this year will reduce the costs of the credits provided next year. This will mean another decrease in the property tax rates for next year.

Given the complexity of the EF/GF interactions, it might be best to alter the PTA in a way that lowers costs by about \$20 for this year, which will reduce this year's property tax rates below what they otherwise would be. Remove the PTA and CU costs from the EF and put them in the GF, reflecting the reduction in the PTA costs. The current costs of those programs is about \$220 m. So if the costs are reduced to \$200 m, \$200 m in revenue, perhaps a chunk of the sales tax revenue, would go into the GF to cover those costs.

DESIGN OF THE PROPERTY TAX ADJUSTMENT PROGRAM:

*** Eligibility for these credits must be limited to low and middle income households and the program should be simplified to ensure that those who are eligible actually receive a credit and that processing is easier. A wealth test must be added to the income criteria for households over a certain level. Alternative approaches like exemptions or income tax credits should be considered.

Both the Property Tax Assistance program should be reformed. The current program gives more money to those with more valuable houses, which violates vertical and horizontal equity. I think that in our need to provide support for people to pay their property taxes and be able to keep their houses, we have started to subsidize the possession of particular houses rather than subsidize access to housing in general. I think that the generosity of these supports has contributed to a kind of freezing of Vermont's housing market because people can stay in their houses as they age and their families shrink. In many ways this is a good thing, but it may not contribute to the efficient use of our housing stock. The program provides no incentive for people to share housing since the higher one's household income the lower the property tax credit.

Another problem with the existing system is that it is so complex that people who are eligible may not get the support and dealing with the PTA program takes an inordinate amount of Department of Tax time. The system of support also weakens the link between voting to increase education spending and increases in a person's own property tax liability.

If we retain the existing PTA structure, I would take the steps outlined above to lower the income eligibility, lower the cap on maximum payments, and institute a wealth test.

If we are to consider alternatives, one approach would be to provide a certain refundable housing income tax credit to all renters at a certain income and a certain refundable housing income tax credit to all homeowners at the same income level (both for Vermont residents only). Then a person could apply for a larger credit if they chose, but they would have to fill out a form that includes both income and wealth, and there would be thresholds with both at which they could not reserve an added credit. The homeowners' credits could be sent directly to towns the way they are now.

A second approach would be to exempt the first \$100,000 of property from taxation for low income homeowners. The amount of the exemption could shrink as income increased.

The key for me here is that getting the credit/exemption has to be easier than the current process, it has to take wealth into account in some way, and it has to be less generous than what we do now in terms of providing assistance at such high income levels so that we both lower costs and increase equity. There would have to be steps and transition periods if such changes were made.

COMPOSITION OF EDUCATION FUND REVENUE SOURCES:

*** A percentage of state personal income tax revenues should be dedicated to the EF (shifted into) while the Meals and Rooms and Purchase and Use revenues are shifted to the General Fund. This ensures that Vermonters are paying for education with both their property taxes and their income taxes. If it was desirable to go further in this direction, the income tax rate reductions for the two highest income tax brackets of 2018 could be reversed, and the added revenue allocated to the EF. This would reduce property tax payments by the same amount.

A concrete example would be to switch about 10 percent of personal income tax revenue out of the GF and into the EF. This would be about \$90 m (\$89.3), balanced as a fairly even swap by taking the \$50m of the Rooms & Meals (25% of the total) and the approximately \$40 m in Purchase and Use (33% of total) (\$39.4m) out of the EF and allocating them to the GF. This means that the non-property tax revenues in the EF are income taxes and the sales tax. It makes the funding of education more progressive since the income tax is our most progressive tax.

INTENDED RESULTS OF IMPLEMENTING SOME VERSION OF THE PROPOSALS ABOVE:

*** We will be closer to having the Ed Fund pay only for education related costs and the vicious cycle of property tax increases stemming from the funding of PTA and CU within the EF will be halted.

*** The PTA will be simpler, more effective, and more equitable, and likely lower cost.

*** Since fewer Vermonters are receiving the PTA as eligibility has been restricted and property taxes are lower, many voters are therefore re-connected to the direct consequences of their votes in terms of passing school budgets and seeing higher property taxes, rather than being insulated from the effects of voting to approve of increases to some extent through the PTA.

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