Commissioner Kleppner's Analysis of Education Income Tax Proposal and Considerations

Proposal to fund education through an income tax instead of the property tax, and some concerns about making that change

Problems identified in testimony with the current system of using part of the property tax to fund part of the education budget
Measured against the Commission's goals of a simpler, fairer, and more sustainable tax system

1. Simplicity: It is not simple.
2. Fairness: For the most part, it is proportional -- neither progressive nor regressive. Whether that's fair or not is debatable.
3. Sustainability: Given the chronic requests from Vermonters for lower property taxes, it is unclear that the present system is sustainable.

Other problems identified in testimony

1. Vermonters generally feel that the property tax is an unfairly large burden.
2. The calculation of property tax is so complex as to be incomprehensible to almost everyone.
3. Closely related to that, how a change in the school budget will affect an individual's property tax bill is a mystery to almost everyone.
4. There is perceived unfairness in that 40% to 50% of Vermont households pay this tax based purely on income, 34% pay purely on property value, and 16% to 26% pay on the basis of a hybrid property and income calculation, meaning that something like two thirds of Vermont households pay at least partially based on income, and only one third pay fully on property value.

The most complete proposal for ending the use of housesite property tax to fund education came from the Public Assets Institute, so we will use that for analysis.

PAI proposed:

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

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Comments in red added by Public Assets Institute 8/31/20

The most thorough set of concerns about replacing the property tax portion of education funding with income tax is articulated in an analysis by Jake Feldman of the Vermont Department of Taxes, so we used his 10 concerns to test PAI's proposal.

	Considerations raised by Mr. Feldman[1]	PAI Proposal and Testimony related to each point	Other possible concerns and Mitigations
Policy Considerations			
1	Vermont already has a very progressive income tax that raises almost twice as much revenue as the homestead education property tax. The top 10% of filers pay more than 60% of tax which is the primary revenue source to the state's general fund	1. Top 10% of filers have a disproportionate share of the state's income: 40% 2. The income tax is the most progressive tax we have, but it accounts for less than a third of all state revenue. Regressive property and sales taxes more than offset the progressivity of the income tax, leaving the state with a system that is regressive overall. 3. We're not proposing a progressive school tax. But reducing the regressive property tax moves the overall system in a more progressive direction. 4. Vermont is not creating a new system with this plan. We are modifying a system that already is income-based in part. We are shifting to using the income tax system rather than the property tax system to administer it. 5. There is broad agreemen that income is a better measure of ability to pay. Since 1969 we have tried to make the property tax system work more like an income tax. 6. Simplicity is paramount – voters have to be able to reasonably estimate tax implications on Town Meeting Day.	1. Capping the level of income subject to the Ed portion of the state income tax could mitigate a disproportionate shift to higher-income Vermonters. Capping the level of income subject to the school tax will make the system more regressive and undermine its fundamental fairness. . 2. Making the ed income tax less progressive than general income tax would address the same concern. 3. We have received testimony from legislators expressing interest in evaluating an addition to Vermont's personal income tax to fund education, and skepticism about creating a separate income tax system for that purpose.

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2	There aren't any states that have an income tax but no property tax. There are nine states that have a property tax (state, county, or muni) but no income tax. Generally, income taxes "are generally associated with lower economic growth than taxes on consumption (sales) and property."	The PAI proposal does not contemplate elimination of the property tax, just the housesite education portion. It would retain the municipal property tax on all properties, the education property tax on all properties that are not primary residences,	

[1]Feldman, Jake. "Why not pay for education with an income tax?" https://ljfo.vermont.gov/assets/Meetings/Tax-Structure-Commission/2020-01-13/9872e3ca90/Why-not-pay-for-education-with-an-income-tax_2.pdf

		and the education property tax on the portion of any homestead land beyond 2 acres. Simplicity is a key goal. Using property but trying to make it fair based on income leads to the complications we have now. The proposal would shift about $150 million in revenue from a property base to an income base. Income taxes would go from 28% to 32% of total state revenues.	
3	Vermont resident taxpayers are exposed to all major tax types so examining the progressivity of one fund may not be informative. The progressivity of any state fund can be changed through legislation, such as in Act 11 of 2018 when the general fund transfer to the education fund was replaced with 100% of sales tax (from 36%) and 25% of meals and rooms. Overall, ITEP ranks Vermont's tax system as the second most progressive state after California.	1. According to ITEP, Vermont's system is one of the least regressive in the country, but is still not progressive. 2. Going from a regressive school tax to a proportional one moves Vermont's system in a more progressive direction overall, which is the goal of a good tax system.	This seems to be more an observation than a problem, and the Commission agrees with both the observation that it's important to look at the tax system as a whole, and that Vermont currently has one of the most progressive state & local tax systems in the United States.
4	Vermont's homestead education property tax is not regressive. It's an example of a proportional tax: one where all levels of income pay roughly the same percentage of their income (see bar chart in ten-year tax study). There are anomalies at the very lowest end of income and very highest, but virtually no one sustains those levels year over year in Vermont, i.e. they tend to be one-time events.	1. The JFO chart shows the homestead school tax is regressive overall. This proposal would make it flat or proportional. 2. Going back to TSC principles: One of the equity principles is that the tax *Imposes a higher burden on people with greater ability to pay, and minimizes taxes on individuals with low income.* 3. The goal is an overall progressive tax system, so state policy should achieve that. 4. It is irrelevant if high income is a one-time event. If that's the case, the taxpayer would only pay the higher amount for one year and would see their bill fall with a decrease in income.	Important to note various views of fair. There are not many people who would argue that having every household pay the same dollar amount is fair, but whether having higher-income people pay a higher percent is fair is a matter of judgement.

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5	Ideally, a fair and progressive tax system would not only tax income and consumption but also wealth. Valuations of assets are difficult to administration for a broad-based wealth tax but removing the tax on property would move Vermont farther away from taxing wealth since, for most people, their residence is their principal asset. Relatedly, the Lincoln Institute of Land Policy recommends looking at home value as a proxy for assets when designing a circuit Breaker	Most Vermonters pay their property tax with their income. If they lose their job, their income drops, and their ability to pay their property tax drops, putting them at risk of losing their home. Is it fair to tax them on the value of their home when their income has decreased? 1. The property tax does not just raise a question of fairness. When homeowners' incomes are inadequate to pay property taxes, it creates social & economic instability in communities. 2. We agree that Vermont should look at a wealth/assets tax, but it should not be tied to the direct vote on the school budget, because it complicates that decision-making. 3. Other states are exploring a wealth tax and Vermont can learn from them and explore possibilities. 4. Property value means different things at different income levels. Generally, for higher-income households, property value reflects a positive part of their net worth. At the lower end, households may owe more on their property than they have in equity or even than the house is worth in some cases. So any assessment of wealth should treat property differently depending on the person's net assets.	The Commission agrees that taxing wealth is theoretically sound and practically unfeasible. Homesite value is not a bad proxy for wealth but does have some problems -- owning a home is an expense, and the wealth it represents is not liquid.

6	A system entirely based on income that ignores property value would exacerbate current demographic and housing problems. Property taxes are one of the reasons that retirees opt to downsize after their children have left home and the mortgage is paid off. Many states have modest circuit breakers available to seniors, but there is no state with a maximum credit anywhere close to Vermont's maximum of $8,000.	1. People should be able to stay in their homes. Raising taxes on seniors to get them out of their homes should not be state policy & flies in the face of the humane policy we've had for the last 50 years. 2. Other states' systems are much more regressive than Vermont's. 3. A rebate cap would make the system more regressive, which is not the goal. 4. A big problem with the hybrid system—trying to find fairness with a combination of property and income—creates complicated adjustments as opposed to simply levying a fair tax.	The property tax is a blunt and perhaps inappropriate tool to try to address housing and demographic issues. If the goal is to encourage seniors to stay in Vermont, and to make it easier for first-time house-buyers, higher property taxes may in fact be counterproductive, as seniors may opt to move out of state rather than downsize instate, and property taxes raise the amount of income needed to get a mortgage to purchase a home.

Administrative considerations			
1	1. An income tax applied only to declared homesteads would be easy to avoid. Here are a few ways to do that: rent out your house for the day on April 1st, rent out your house for more than half the year, don't declare the property as homestead (there are no homestead police to check), or change domicile. If residents change domicile to avoid a ~2.5% homestead education income tax, that would erode regular personal income tax revenue, too	1. In most places the nonhomestead rate is higher than the homestead rate. Shifting your residence to another state means your VT property becomes nonhomestead. 2. The universe here is Vermont residents. Income tax is not only applied to declared homesteads. If you pay VT income tax and are a resident, you pay VT education tax. So someone could end up paying an education income tax and a nonresidential school tax on VT property if they don't declare their homestead. 3. Homesteads would still be appraised the same way – with 90%+/- of the value in the housesite (home + 2 acres) and the residual value of the land would be taxed at the nonhomestead rate. This would be a very modest difference from the current homestead rate. So the reason to declare a homestead is to be exempt from the nonhomestead tax. 4. There is no evidence that high-income people are leaving the state; in fact the opposite has been true recently. Taxes don't play a big role in most people's decision to move. 5. On both a percentage and a number basis, more people from New Hampshire (which also does not have an income tax) moved to Florida. (pre-Covid data)	1. The April 1st issue isn't hard -- define homestead as the place you live most of the time. 2. Avoiding the "six months and a day" problem is harder. Would some people who were planning on spending 5.5 months in FL go to 6.5 months? Probably. How many? 3. How to ensure that all primary residences are counted as homesteads is an important question. There is an incentive to declare a homestead so you don't pay twice, (both on income and on property) so this will not be an issue. 4. We want to allow people to stay in their homes.

2	A system where everyone gets a property tax adjustment, some adjusted up, some down, would pose substantial confidentiality and fairness problems. Households with high income in the prior year would essentially be "outed" to municipal officials. Households with lower incomes are currently "outed" but there are some obscuring factors	An income tax would avoid this issue by eliminating the property tax adjustment.	
3	A system where everyone gets a property tax adjustment would force the "lag" on every taxpayer because it would necessarily be based on prior year income. Suppose someone sells their business in 2019 and makes $1M. In 2020 their income may be minimal, but they will have an upwards adjustment to their property tax bill of roughly $25,000	There will be no property tax adjustment, but the same question applies to the income tax: if we base resident ed tax on last year's AGI, someone selling a business in 2019 will face a higher income tax in 2020. If your income jumps in one year, your taxes only go up for one year. You would have to plan ahead to pay taxes just like you do now with income taxes.	

4	Income-sensitized property taxes are extremely difficult to administer. An extension of that program to those with higher and more complicated income situations would force more administrative burden on the tax department and municipal officials.	Going to straight income tax solves this problem.	