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The Coming Tax Battle of 2002

John McClaughry

The 2001 legislature adjourned without making any significant tax law changes, but in doing so they opened the door to a major tax battle in 2002.

This year legislators addressed two major tax issues. One was the financing of Act 60. The Senate proposed at one point to provide new finances by increasing the income tax. The House at one point favored increasing sales tax. Both favored increasing the state property tax. Both adjourned without doing anything.

The other tax issue was the coupling between the Vermont and the federal income tax. Congress enacted most of the Bush tax plan, plus some accretions required to attract Senate Democratic support. Some of the provisions of the plan - the instant rebate and lowering of the lowest bracket from 15% to 10% - will have immediate effects on Vermont's tax revenues. The legislature responded with a temporary fix: continuing the use of the 2000 tax tables for computing 2001 taxes. Speaker Walt Freed says the Ways and Means committee will explore the relationship between the two systems before next January, and that the possibility of having to make annual legislative adjustments could lead to support for "decoupling" the two systems.

"Decoupling" means changing Vermont's income tax rate from a fixed percentage of the Federal tax liability (currently 24%), to either a rate based on the federal adjusted gross income, or a wholly separate tax base with its own rates, exemptions, deductions, and rules.

The political history of decoupling dates back to the 1980s. Liberals like former Senate President Peter Welch favored it because they were convinced that the post-1986 Federal tax code was not sufficiently progressive. The Reagan tax rate cuts of the 1980s (from a top rate of 70% down to 28%) dramatically shifted the tax burden to higher income taxpayers. Nonetheless, liberals believe that any income tax that does not levy high marginal rates on "the rich and the big corporations" is morally unacceptable. They are thus opposed to any tax system whose low marginal rate encourages the rich to become richer, even if that system produces lots of new wealth for governments to tax, and even if it shifts the tax burden from the poor and middle class onto the rich. Their chief concern is the "income gap", which to them is a measure of a decent civilization.

For 20 years conservatives have resisted every proposal to decouple. They were content with the rate cuts of the 1980s. They feared that a decoupled Vermont income tax, in the hands of a Welch, a Bernie Sanders, or an Anthony Pollina, would be so punitive to "the rich" that they would pick up and move their enterprises, making Vermont into an economic wasteland.

If annual changes in the Federal tax code force repeated adjustments in the Vermont piggy back rate to maintain revenue neutrality, the pressure for decoupling will probably increase. Before the legislature buys the idea of decoupling, there needs to be a serious debate about the philosophy upon which Vermont will base a decoupled tax system.

For most liberals, the issue is clear. Vermont's tax system ought to have steeply progressive rates to soak the rich, and expanded exemptions and credits to aid the poor. The liberal attitude toward higher income taxpayers who might choose to move elsewhere has generally been that such people are uncaring and socially irresponsible, and the state is better off without them and their businesses. Just what Vermont's economy would look like if enough of them left is not something that liberals are much concerned about. They would hope and expect that socially responsible businesses would come into Vermont, lured by the attractions of paying high taxes to support liberal income redistribution. (Good luck.)

On the other side of the political fence, business people, conservatives, and libertarians , faced with decoupling, would prefer an income tax with low rates and thus attractive to high income wealth generators. Given Vermont's political climate, such a reuslt would not appear likely.

An intelligent debate on a new Vermont tax system needs to go beyond this narrow tug of war over tax rates and redistribution. One alternative worth exploring is a consumption-based tax. In a nutshell, a consumption-based tax would count all income received from whatever sources; deduct all outflows associated with earning that income; deduct all savings and investments, gifts, and mandatory payments; exempt a modest level of family consumption; and tax what's left at one flat rate.

Such a system rates high on the standard tax criteria of neutrality, visibility, fairness, and simplicity. By exempting savings and investment until they are cashed out and consumed, the system strongly encourages economic growth, important to business leaders, working people, and tax collectors alike. By taxing consumption above the basic exemption, the tax hits those who buy expensive cars, boats, homes, and jewelry. This will appeal to liberals who decry conspicuous consumption.

The consumed income tax is not without some problems - no tax system is. For instance, there has to be a way for the tax department to retain a grip on tax-deferred investments when the tax-averse investors decide to relocate to an income tax state; but this is solvable.

Any debate over decoupling the Vermont tax system which is limited to the conventional income tax base, and merely haggles over brackets, rates and exemptions, is not enough. A debate over decoupling will create the opportunity for looking at more attractive options. Vermont's legislators need to do that conscientiously, before taking the big leap.

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John McClaughry is President of the Ethan Allen Institute (www.ethanallen.org).