

Commissioner Trenholm's Draft on Overall Tax Structure

How Should We Think About the Overall Tax Structure, Progressivity, Equity, Sustainability, Volatility

When thinking about what an overall tax structure should look like, these four factors must be considered together. This is important because each of these factors can be mutually exclusive, so the right balance of all factors is important to achieve the best tax structure for Vermont.

The Vermont Tax Structure consists of the following taxes: Income, consumption, property (education funding) and other miscellaneous taxes such as transfer taxes and excise taxes.

In a progressive culture, the ability to pay is based most often on level of income. This should be looked at more closely since gross income may not be as reliable in a changing landscape as it used to be. An example of this is the current trend of telecommuting increasing the numbers of people moving to Vermont and buying homes. Although they may be in a higher income cohort from a gross standpoint, as the population shifts to younger homebuyers with mortgages, these mortgages need to be considered in the formula of ability to pay.

Now let's take a look at the four pillars of a good overall tax structure.

Progressivity in a tax structure simply stated is that the higher taxable income pays a higher rate of tax. A **progressive** tax system generally has rates that increase in steps as income brackets increase.

Equity is a method of collecting income **tax** in which the **taxes** paid increase with the amount of earned income. The driving principle behind **equity** is that those who have the ability to pay more **taxes** should contribute more than those who are not. **Equity** in a tax structure and **progressivity** generally have the same goals but take different approaches to achieve those goals. **Sustainability** with respect to a tax structure breaks down the entire structure into components to determine if the goals of the tax structure and the ability to collect the amount of revenue need can last for many years. A sustainable tax system must be designed with the future in mind, determining whether the system as a whole will work to generate the revenue needed to run the state. A sustainable tax system must have flexibility to change as the state and world economies change. An example of this would be if all forms of transportation changed to non-fossil fuel powered, then the gasoline tax which supports our highways would not be sustainable and other sources would be required to support our highway infrastructure.

Volatility with respect to tax revenue depends on three factors: (1) a state's tax portfolio (the revenue sources it relies on); (2) the volatility of economic conditions; and (3) all other potential changes to the tax base. An example of this would be in times of economic prosperity, consumers tend to consume more goods resulting in rising consumption tax revenue, versus in times of economic contraction, consumers tend to consume less goods and consumption tax revenue will decrease. The same holds true for income based taxes. The size of the population can also affect **Volatility**.

Income Tax:

Vermont taxes both individual and corporate income tax, as well as imposing tax on trusts. Business income generated by pass through entities is taxed at the individual level.

Vermont has a progressive income tax structure. Because of tiered rates that increase as income increases, a form of progressivity is achieved since those at higher income levels pay a larger percentage of their income due to the rate steps as opposed to say, a flat tax rate on all income.

Vermont's tax system achieves tax equity to some degree because of its progressivity. With respect to personal income tax, Vermont also offers other ways of achieving tax equity such as the earned income credit, renter's credit and other business related credits such as the Research and Development Credit and the Business Investment Tax Credit for Solar Investment. Sustainability of Vermont's income tax system is highly dependent on the ability to adapt to economic factors in the state and the world in general. All but five states in the United States and most foreign jurisdictions have a form of income tax indicating popularity and in turn stability again, provided the system is adaptable to changes needed.

Volatility exists in the Vermont income tax system, because it is collected based on the premise of income which can vary due to economic factors, size and composition of population and other factors which affect all states. Unfortunately the size and composition of our population tends to potentially exaggerate volatility. Despite this, income tax in Vermont has been relatively stable when compared to other Vermont taxes.

Consumption Tax:

Consumption taxes include sales and use taxes.

Consumption taxes by their nature are not progressive. They are assessed based on a flat rate on certain goods and services. The flat rate means that no matter what your level of income, you pay the same percent of consumption tax, which taken by itself can be regressive,

Because consumption taxes are somewhat regressive by their nature, without specific exemptions, they would also tend to be highly inequitable. Exemptions are put in place to create more equity based on the ability to pay, for instance, food is exempt because all people need food regardless of income level. By exempting some basic necessities, some measure of equity is achieved using the theory that those in the lower income cohort will consume fewer taxable products than those in the higher income cohorts so the percent of their income paid in consumption taxes is equalized.

The stability of consumption taxes is highly dependent on adaptability to current economic conditions. Vermont has become a much more service based economy, and the sale of consumer goods in traditional brick and mortar establishments has decreased. Steps to counteract that trend have been taken to tax all goods consumed by Vermonters regardless of purchase via the

internet or in stores. Without this adaptation the sustainability of this tax would be greatly threatened.

Consumption tax is also somewhat volatile. This volatility comes from the fact that the tax is based on the consumption of goods. As economic conditions change, so do the patterns of consumption. An example of this is when the economy is thriving and people have more expendable income, they tend to consume more non-essential goods because they have the ability to do so. Because consumption taxes tend to not be progressive as mentioned above, to counteract some of this effect, essential goods tend to be excluded from consumption tax so as the economy contracts and people have less expendable income, the consumption of non-essential goods decreases along with the tax collected.

Property Tax (Ed Funding):

There are three types of property tax in Vermont, Homestead Real Property, Non-Homestead Real Property and Personal Property

Property tax, by its nature as an ad valorem tax, tends to not be progressive when income is used as the measure of ability to pay. The tax is based on the value of the property being taxed, generally at a flat rate regardless of income level. Vermont's Education Tax on residential property uses a two step approach, calculating tax on the lesser of an income based formula or a formula based on the value of the property. This helps to add a progressivity to this tax but along with it adds a lot of complexity.

Property tax also by its nature, when using income as the benchmark for ability to pay, is also somewhat inequitable. Because as stated in the paragraph above this tax is based on value of the property, someone in the lowest income cohort will pay the same tax as someone in the highest income cohort on the same property in the same jurisdiction. Vermont attempts to make the system more equitable by using the two step approach mentioned above and Common Level of Appraisal (CLA). The system in place today is very complex and hard to understand. Attempts at more equity across cohorts and jurisdictions as well as to comply with the 1997 Vermont Supreme Court Decision in the Brigham Case have made the present property tax extremely difficult to administer as well with the goal of local control within a statewide tax.

The property tax system within a state or locality must be sustainable, i.e. Able to collect the revenue expected for many years. It cannot be looked at in a vacuum based on today or even a couple years out if the tax is to be sustainable. At present, the Vermont Education Funding Tax based on residential property does not look forward. It is based on formulas and methods cobbled together in an attempt to make it fair, equitable and compliant with the Brigham decision. It also incorporates local control into a statewide system, which places a burden on the state for administration of the tax without control on the spending in a particular school district. Because property tax is based on current value, current assessments should be updated frequently to keep up. Unfortunately this takes resources which many local jurisdictions are lacking.

Property taxes, whether homestead, non-homestead, or personal property are by their nature volatile because they are based on value and value is dependent on the economy of the state at the time of assessment. The disparity of values throughout the state is one example of this.

Values in Chittenden County tend to be higher than other parts of the state due to demand. The demand tends to be higher because there are more higher wage jobs in Chittenden County. Contrast that with the potential influx of homebuyers to Vermont due to the Pandemic and Vermont's handling of it which is driving up demand which will drive up the prices which can increase the revenue. Another factor in the volatility is the changing landscape of telecommuting, allowing more people to live rurally which can increase the demand for rural residences which in turn will increase prices which in turn will increase revenue from the tax based on property values.

With respect to non-Homestead property, the system is is not progressive and not equitable in the same manner as Homestead Property Tax. Equity is compensated for through state and local incentives available to the property owner.

Non-homestead property tax is als subject to the same sustainability and volatility as Homestead property tax, but to a much lesser degree.

Non-income based excise taxes are not by their nature looked at in these four contexts since they are designed for a specific purpose.

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