Commissioner Brighton's Draft Education Chapter – v2

I. Background

Education is both a state and a local responsibility, and its funding comes from both state and local taxes. Finding the right state and local balance in both governance and revenue is a constant challenge, not only to ensure educational quality, but also to ensure equity between school districts.

Traditionally, K-12 education has been partially funded with broad-based state taxes, and predominantly with locally-voted property taxes. In Vermont, as in many other states, the property tax was adjusted in two ways to reduce inequities. First, in recognition that the value of a home did not necessarily indicate the ability to pay, a circuit-breaker program capped the tax bill on a house based on the income of the owner. Second, in recognition that the disproportionately small tax bases of some districts made it difficult to raise enough to provide an adequate education, various formulas were developed to distribute state funds to help support these districts. Both remedies treated the low end (homeowners with low incomes, or districts with low tax bases per pupil) and not the homeowners or districts with the greatest ability.

In the 1990s, what was known as the Foundation Formula was the mechanism for determining the state aid distribution. Basically, the state estimated the amount needed to provide an adequate education and compared this with the amount that could be raised with a property tax at a uniform foundation rate, district by district. If a district could not raise the adequate amount at the foundation rate, state aid made up the difference. Districts could levy an additional property tax to raise additional revenue, and most did.

As noted by the Governor's Blue Ribbon Commission on Educational and Municipal Financing Reform in 1993, the success of the Foundation plan, like all the plans before it, followed a predictable trajectory. When the program was passed, there was an infusion of state funds, making property tax rates drop. Because the level of the property tax was reduced, the level of inequity was reduced. But the profile of inequity was not changed, and over time, as the state share decreased, the inequity became urgent again.[1]

In 1997, the Vermont Supreme Court decided "that the current system for funding public education in Vermont, with its substantial dependence on local property taxes and resultant wide disparities in revenues available to local school districts, deprives children of an equal educational opportunity in violation of the Vermont Constitution."[2] The opinion notes that "We must confront the constitutionality of the system in light of the limited nature of the Foundation Plan's purpose. The object of the Plan is not equality of educational opportunity generally, or even equality of local capacity to facilitate

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[1] Governor's Blue Ribbon Commission on Educational and Municipal Financing Reform: Final Report and Recommendations. 1993. P.11

[2] Brigham v. State. 96-502. (1997). P. 1

opportunity. It is only to equalize capacity to produce a minimally adequate education, assuming the voters can sustain the state-selected rate."[3] They concluded: "We find no authority for the proposition that discrimination in the distribution of a constitutionally mandated right such as education may be excused merely because a "minimal" level of opportunity is provided to all."[4]

In response to the Brigham decision, the legislature made fundamental changes to the education funding system, some immediately with the passage of Act 60, and others over time. The main changes are:

- To reduce between-district disparity in ability to raise revenue, all non-homestead property is taxed at a unform state rate, and the revenue is shared by all districts.
- To reduce between-district disparity in the ability to raise revenue, the homestead education tax rates are a function of the district's voter-approved spending per pupil—and not a function of the Grand List. For a given spending per pupil, the rate is the same in any district. This applies to all districts; it applies to all spending levels. The Education Fund distributes the amount needed to guarantee the yield.
- To better reflect the ability of taxpayers to pay the tax, the education property tax on a housesite is adjusted to reflect the household income.

Perhaps the most important feature of the new system is its ability to maintain equity through changes in the economy and in state and federal revenue, avoiding the predictable path of past funding formulas. There are two main reasons for this. First, unlike earlier systems, all districts now benefit from state support of education, and all legislators have an interest in supporting the state's share. Earlier systems provided state aid for districts with low tax bases but wealthier districts did not benefit from the scheme. Second, the equity provisions are integral to the tax rate and apply to all levels of spending, so the equity does not erode over time if the state and federal shares decline.

The income component is not direct. The housesite tax has been referred to as an income-sensitized property tax. There are actually two rates set annually-- one for property and one for income, determined by spending per pupil in the district, divided by the state-set yield. Effectively, homeowners pay the lesser of the housesite multiplied by the property rate or the household income multiplied by the income rate. In practice, however, they pay the school property tax in one year and then receive a credit in the following year if the property tax paid on their housesite exceeds the tax that would have been due if they had paid on income.

The commission recognizes the important and significant advances made in reducing the disparity between school districts, and in reducing the regressivity of the education tax. However, after a generation of experience with the new system, the commission sought comments, criticisms, and suggestions from legislators, municipal officials, school teachers and administrators, representatives of government and education organizations, and citizens. [5]

[3] Brigham v. State. 96-502. (1997). P. 6
[4] Brigham v. State. 96-502. (1997). P.22
[5] Reference summary of issues and also list of people who testified and links to testimony?

What follows is a discussion of the main issues raised, especially as they relate to principles of taxation accepted by the commission. The main focus was the locally voted homestead tax; there was general support for the state tax on non-homestead property.

Following the discussion of the issues is a summary of various models considered, along with comments as to how they relate to issues raised during the study and to the principles adopted by the commission.

The final section includes a summary of the commission's recommendations.

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II. Issues

Complexity

The most common criticism was the bewildering complexity of the locally voted homestead education tax. The complexity is primarily due to utilization of both property value and income to determine the contribution of each household. This is essentially a double system, further complicated by the process involved in forcing the match between the two systems, administered by different levels of government, with different calendars, with different confidentiality requirements.

The commissioners agreed that the complexity is overwhelming the effectiveness of the current education tax. For taxpayers, the link between their budget vote and their tax bills is not clear and the filing process is detailed and error-prone; for local and state officials, the administration of the double system is confusing and time consuming; for legislators and policy makers, the complexity has resulted in spending penalties, income caps, house-value caps, and special rates—all of which further compound the complexity.

The method used to meld the two systems results in a tax that is not direct; homeowners to pay a property tax and, in the following year, receive a credit for the difference between the property tax and what they would have paid based on their income. Even though the net result may be the household income multiplied by the district's income tax rate, the two-year process is cumbersome and confusing. The amount of the homestead tax bill is not directly related to the budget voted that year and therefore somewhat unpredictable, as it includes a credit based on the prior year. In addition, homeowners must apply for the credit and complete a detailed compilation of the income of all household members. The state Tax Department calculates the credit for each household and sends the information to each towns. Local officials subtract the credit from the tax due on the property tax bills, often twice as a result of late filings and corrections. Local officials also answer questions from citizens who don't understand the school tax. And, because there is no longer a clear link between the budget voted and the voter's tax bill, the cost control and accountability of the budget process is weakened.

The commissioners believe simplification is best achieved by removing one of the two systems for taxing residents: property or income.

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Equity

The commission's accepted principles incorporate two standard concepts of tax equity: horizontal equity and vertical equity. Horizontal equity calls for equal taxation of people in equal situations. Vertical equity calls for greater tax burdens for people with greater ability to pay. While these are clear in concept, they are more difficult to evaluate in practice.

Most of the equity discussion involved the vertical equity of the locally-voted tax on the housesite and the income-based credit. In addition to complexity, the current double system leads to different characterizations of the tax and different impressions of its equity. The Blue Ribbon Tax Structure Commission of 2011 noted two different perspectives: income tax adherents who believe most residents pay an education tax based on their income; and property tax adherents who believe the current system is a property tax on the housesite, with a subsidy based on income.[6]

Depending on the starting position, the equity discussion can focus on the fairness of the tax paid, or on the fairness of the subsidy. The income tax adherents may feel that vertical equity results from the net (property tax minus the credit) tax because it rises as incomes rise. Property tax adherents may feel that vertical equity results from people with higher value housesites paying a higher property tax. The commission is also sensitive to perceived inequities of the current system, focused on the credit rather than on the net tax people pay. For example, consider two households in the same district with equal incomes but different house values. The one with the higher value house will receive a larger credit, although the two net bills would be the same because they are based on income. Looking at the credit rather than the net tax leads to the perception that the system is unfair.

Two main reasons are offered to support the vertical equity of an education property tax on residences. The first is that higher income people tend to have higher value houses. The second is that the residence is a type of wealth that most people have, and it is a good proxy for total wealth, which is also an indication of ability to pay.

According to the American Community Survey, 72% of Vermont primary residences were owner-occupied in 2018, and 28% were renter-occupied. Looking at owner-occupied households only, the median value of the house site increases as the household income increases (Table 1).

Table 1.[7]

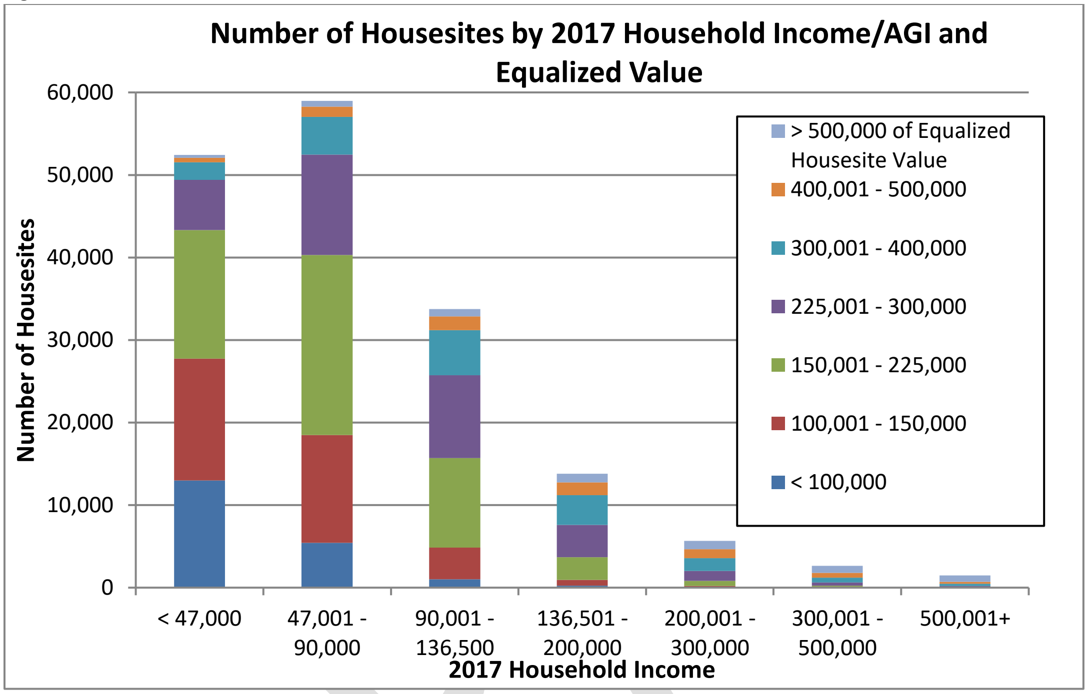
2017 Household Income	# Owner-Occupied House Sites	Median House Site Value
< 47,000	52,410	144,896
47,001 - 90,000	58,991	183,708
90,001 - 136,500	33,766	232,785
136,501 - 200,000	13,818	285,949
200,001 - 300,000	5,665	351,761
300,001 - 500,000	2,645	418,733

[6] Final Report: Blue Ribbon Tax Structure Commission. 2011. P. 41
[7] Vermont Joint Fiscal Office

500,001 - 1,000,000	1,048	485,479
> 1,000,000	434	582,394

However, the distribution is not tidy. In any income category there is quite a range of house values in a given year (Figure 1).

Figure 1[8].

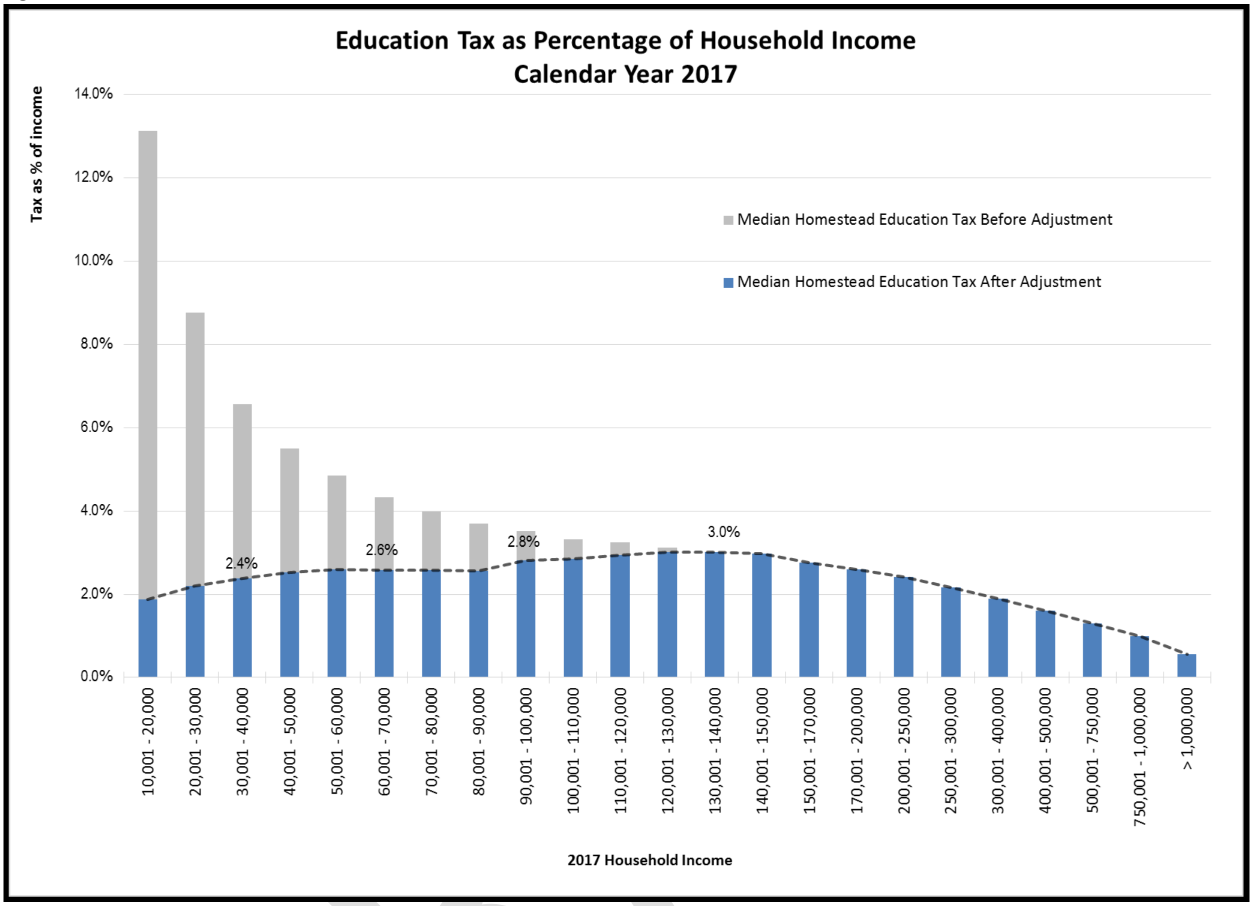


As discussed in (asset section of report), Vermont does not have data on assets of its residents so the commission relied on national data to look at whether the value of a residence was a good proxy for wealth. At the national level, the Federal Reserve Board's Survey of Consumer Finances collects information on the assets and liabilities of families, and estimates the family net worth—the difference between the family's gross assets and its liabilities. For families with low net worth, the primary residence often exceeds 100% of their net worth because they own few other assets and the residence is mortgaged. The Survey estimates that value of the primary residence represents 88% of the net worth of families between the 50th to 75th percentiles of net worth but only 25% of the net worth of the families in the top decile.

Using income as the indicator of the ability to pay, Figure 5 illustrates the vertical equity of the current homestead education tax, before and after the credit. The bars in the chart below show the property tax on the housesite, before the credit. The line shows the net education tax paid (after the credit). While the bars indicate that the housesite property tax is extremely regressive, the net tax (after the credit) is somewhat progressive up to incomes of about $140,000, and regressive at higher incomes. There are also jumps resulting from various housesite and income caps. It is clear that the current system has improved vertical equity, but it is not a progressive tax.

[8] Vermont Joint Fiscal Office

Figure 5.[9]



<u>Given the divergence between the value of a house and both income and wealth, and given the impracticality of determining, measuring or taxing net worth, the commission believes that income is the best way to measure taxpayer equity and the most progressive way to tax residents for education</u>.

One additional question about taxpayer equity was raised. Currently, the education tax on housesites does not vary depending on the number of people in the household. In contrast, the Personal Income Tax uses deductions and exemptions to adjust for the size of the family supported by the income. The commission recognizes the tradeoff between simplicity and equity and does not have a strong preference in this case.

The between-district horizontal equity received little comment. The commission did not receive testimony questioning the guaranteed yield system that provides equal per-pupil revenue for equal homestead tax rates. Nor did it received testimony questioning the state education property on non-residential property. <u>The commission believes both provisions have increased between-district horizontal equity substantially, understandably, and simply</u>.

[9] Joint Fiscal Office

Yet there are reasons to examine between-district equity more carefully. The cost of educating students to state standards can vary by district based on the differing needs of the students, the size of the school, grade levels, and transportation. For that reason, two districts might not be able to reach the same educational standards with the same spending per pupil. Currently, the variation in the needs of districts is addressed in two ways.

- Categorical state aid is sent to districts based on their need for certain programs, including transportation and special education.
- Per Pupil Weighting adjusts the student count used to calculate the spending per pupil that determines the tax rate. Heavier weights increase the student count and decrease the rate needed to fund a given budget. Currently weights are applied to account for grade level, English Language Learners, and economically disadvantaged students.

Comparing the spending per weighted student across districts shows that the extreme disparity that triggered the Brigham case has been reduced. An analysis by Public Assets Institute found that spending for 2/3 of the (weighted) pupils in the state fell within $1,400 of the $15,400 state average. They calculated that the standard deviation in spending per weighted student had narrowed by 35% since the passage of Act 60.[10]

The commission heard concern that wealthier districts were spending more than poorer districts. To examine the relationship between the household income of homeowners and spending per pupil, we looked separately at three categories of districts in 2018: PreK-12; elementary; and high school. We also looked separately at union districts and town districts.

Of course, spending per pupil depends on multiple interacting factors. The most consistent trends we found were:

In general, spending per pupil was lower in districts with more students.
In general, in districts with more students, the incomes of homeowners were higher.

Putting those two prominent trends together, it would seem that spending per pupil would be lower in districts with higher incomes. But that was not generally true. Holding enrollment constant, there was also an offsetting tendency for higher-income districts to spend more per pupil. Because this relationship was not statistically significant except in town elementary districts, and because the relationship between enrollment and spending was stronger in all types of districts, on average districts with higher incomes did not spend more per pupil.

There were important differences between traditional town districts and union districts. Town districts generally had fewer students, lower spending per pupil, and greater between-district variation in spending per pupil, than union districts. Controlling for enrollment, there was a positive relationship between spending per pupil and income in town elementary districts, although it only accounted for about 5% of the variation in spending per pupil. There was only a slight decrease in spending as enrollment increased in these districts.

[10] Presentation to Vermont Tax Structure Commission, August 29, 2019. Public Assets Institute. P. 1

Union districts, on the other hand, generally have more students, higher spending per pupil, and less between-district variation in spending per pupil, poverty ratios, and incomes. In general, the larger the enrollment in the union district, the lower the spending per pupil. In union districts there is little relationship between the spending per pupil and the average income of homeowners.

It makes sense that by combining smaller town districts, unions would tend to reduce the between-district variation in poverty and income, and blunt the impact of sudden changes that make the spending per pupil more volatile in small districts. This snapshot is from 2018, when Act 46 was in the early stages of implementation, and there were still 108 town elementary districts. It is likely that the relationship between income and spending will decrease as these small school districts are incorporated into larger unions.

Although the Brigham decision looked at equal spending per pupil as a yardstick, there are many reasons why higher or lower spending in different districts might be justified.

Recognizing that different types of students require different levels of educational services, the legislature established a weighting system. High school students, students from poverty, and English language learners receive extra weight. The idea is that, by weighting the students, a district with a higher poverty rate, for example, would receive the extra funds needed to serve those. In the current weighting formula, a student from poverty is weighted at 125% of the district's average. In effect, the assumption is that it costs 25% more to educate a child from poverty.

If the weighting scheme were successful, we would see inequality in spending <u>per pupil</u>, and equality in spending <u>per equalized (weighted) pupil</u>; higher poverty districts would spend more <u>per pupil</u> than lower poverty districts, but the spending <u>per equalized pupil</u> would be same. The data indicate that, to a certain extent, this is successful. Controlling for enrollment, spending <u>per pupil</u> tends to be slightly higher in higher-poverty districts. But spending <u>per equalized pupil</u> still tends to be lower in higher-poverty districts, indicating that the weighting did not convince voters to support the full supplement of 25% per poverty student.

The recent weighting study calculates a substantially higher weight for poverty.[11] This would mean that high-poverty districts would be able to spend more per pupil at their current tax rate, and presumably it would increase funding in those districts. And, because the poverty rate is generally higher in districts with lower incomes, increasing the poverty weighting would tend to offset the disadvantage of lower incomes.

<u>The commission acknowledges that an overall progressive tax structure can result from a mix of taxes, some of which may be regressive individually, as long as the distribution of benefits overcomes the regressivity. However, the locally voted education tax is different from other taxes in the mix. It both collects and distributes. If the tax is regressive, education will be distributed inequitably. For this reason, we believe the relationship between income, poverty, and education spending is vitally important. At</u>

[11] Study of Pupil Weights in Vermont's Education Funding Formula

<u>this time, it appears that a combination of district consolidation, heavier weighting for poverty, and moving to an income-based tax for residents will improve the equity of the education system.</u>

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Volatility

Several people commented on the volatility of the Education Tax, and the commission looked at this in two ways: volatility in terms of the total amount raised for Education, and volatility in the bills of taxpayers.

For most state taxes, such as the sales tax or the income tax, the revenue raised varies from year to year depending on changes in the tax base. Volatility in the revenue is a challenge to steady budgeting to meet state needs. Volatility is an issue even within a single fiscal year, as budgets are developed and approved without the knowledge of the amount that most state taxes will raise during the year. Usually estimates are fairly close, but a budget adjustment process is routine.

However, for the Education Property Tax the process is reversed; the budget determines the education property tax rate needed each year to raise the necessary amount. And, in contrast to other state taxes, the property tax base is known before the rate is set, so there is very little guesswork. With the exception of delinquencies, the property tax will bring in the amount budgeted. As a result, the Education Property Tax does not result in insufficient revenue due to year-to-year changes in the tax base.

However, this shifts the volatility to the taxpayer. The education property tax functions as the shock absorber that allows the Education Fund to be filled. The education property tax must be increased or decreased in response to changes in the tax base (especially due to the CLA), changes in education spending, changes in uses such as Special Ed, and changes in the other revenue sources in the Education Fund including the Sales Tax, the Rooms and Meals Tax and one-time money like ARRA.

In some years, education property tax bills have increased at a rate that exceeds the increase in school spending, frustrating voters. This is not unique to Vermont; local rates will rise to compensate for falling state aid in any state that relies on a combination of state and local funding for education. But Vermont's system has more moving parts.

Some possibilities suggested for reducing the volatility in the tax bills are:

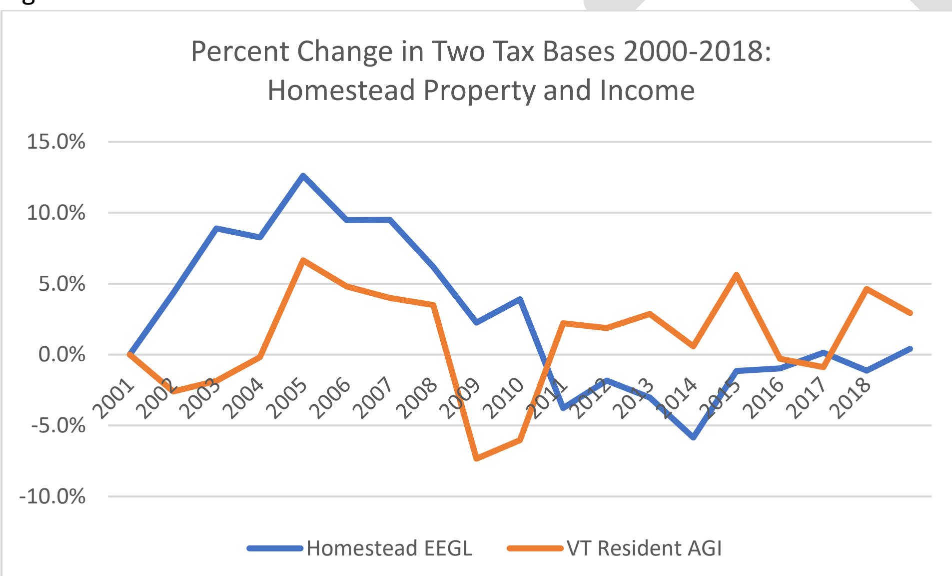
- Create a stabilization reserve, to be used to stabilize tax rates
- Eliminate the Property Tax Credit which essentially passes on a tax increase from the prior year to the current year (or pay for it out of the General Fund)
- Reduce disparity in increases in spending between districts
- Index state funding to some measure of spending growth
- Move to two-year budgeting
- Separate funding for capital construction from annual expenses
- Stabilize the yield at a certain spending level, shifting the volatility to higher spending districts
- Stabilize the adjustment of listed value to taxable value (CLA) if using a property tax
- If using an income tax, make it less progressive than the Personal Income Tax
- Use categorical grants to offset uncontrollable costs or special programs

- Limit uses other than Education Spending from receiving support out of the Education Fund

The commission also heard concerns that replacing the homestead property tax with to a direct tax on residents' incomes would increase volatility—both for in the taxpayers' bills and the revenue received by the Education Fund to support education.

An analysis of the changes in the two tax bases between 2000 and 2018 indicates the income base has actually been less volatile. The average annual change in the homestead equalized value in constant 2018 dollars was 4.7%, with a standard deviation of 3.8%. The average annual change in the AGI of Vermont residents was smaller – 3.3%--and the standard deviation was 2.2%. The number of years that the tax base declined was equal. Assuming that the tax rate would be set each year to raise the revenue needed, it does not seem that the rate would be more volatile using an income base.

Figure [12]



For an individual taxpayer, the income-based bill could be more volatile than a property tax bill—if the taxpayer's income is more volatile than the house value. However, this volatility would be tied to the ability of the taxpayer to pay the bill.

Shifting from the current homestead education to an income-based tax would increase the chances that Education Fund tax revenue actually received in a year would not match the budget estimates because the income tax base would not be completely known at budget time. However, an income-based tax would not need to assume the same volatility of Vermont's Personal Income Tax. Some possibilities suggested to reduce volatility are:

- Setting the rate annually to raise the required amount, as is done currently with the education property tax

[12] Source: Vermont Department of Taxes

- Basing the tax on the prior year's income so the revenue estimate would be more accurate
- Using a stabilization reserve

Cost control

Many people felt that education spending is too high, and several legislators expressed frustration that they were unable to keep spending from increasing. The commission feels the spending level is not in its scope. However, the commission does recognize the potential for some controls on spending to be built into the tax system, and these would be preferable to separate penalties or incentives.

At one extreme, spending could be controlled if the state took over the system of taxation and revenue distribution. This would allow the legislature to set the uniform tax rate(s) each year, and distribute the revenue to each district based on a state determination of need.

Assuming the tradition of local control, locally voted budgets and local tax rates continues, higher spending could be constrained by reducing the yield (increasing the rate) as per-pupil spending increases. The current system essentially halves the yield at spending levels that exceed 121% of the prior year's average.

Representative Beck has suggested a variation in this approach that would direct the Education Fund's revenue from the non-residential tax, non-property tax sources, and a basic homestead tax to support per-pupil spending at an amount estimated to provide an adequate education. For spending above this amount, the yield would be significantly lower (and the rate would be higher) because it would be supported totally by the homestead taxes of the districts spending above the base amount. This approach would tend to lower and stabilize the tax rates in the low-spending districts and increase both the amount and the volatility of the tax in higher-spending districts.

The commission believes that the confusion surrounding the current Property Tax Credit and the double system for determining the tax bill has removed the direct link between the budget vote and the tax bill. The first step in improving cost control and accountability should be simplifying the system so that voters have a clear idea of the effect their vote on the school budget will have on their tax bill.

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What the Education Fund Should Pay For

There seems to be general agreement that the uses of the education fund should be limited so that the non-residential property tax and the locally voted homestead tax are only covering the cost of education. This would make it more likely that a district's rate would rise and fall in sync with its spending, rather than with other spending. It was also suggested that, although it makes sense to provide services like mental health counseling in schools, the cost should not be considered education spending (which is used to set the local rate) and it should not be paid for out of the Education Fund.

The commission recommends further study of the costs now covered by the Education Fund to see what the effect would be on both the level of the local tax and the volatility.

Renters

The current system raises education taxes from homeowners through an annual tax bill based on a school budget approved by voters – homeowners and renters. Because rental property is taxed for education at the non-homestead rate, it is assumed that renters contribute this amount through their rent.

As a result, the two groups are taxed for education at different rates. And the connection between the local budget vote and the effect on their tax bills is different. While the historical and administrative reasons for this distinction are clear, the commission could not find a principle-based justification for treating the two groups of residents differently.

Administration

In addition to comments about the complexity resulting from the administration of the homestead tax, the commission heard several concerns about the local administration of the property tax in general.

The property tax was once only a local tax, but it now is predominantly a state tax. While the competence of local listers was always important, it is even more crucial to ensure that the state tax is being administered correctly, consistently and fairly. The Division of Property Valuation and Review has made significant progress in standardizing listing practices and providing training for listers. However, listers are constantly changing, and so are the challenges. The commission recommends these efforts be supported and strengthened.

One particular concern is the ability of small towns to appraise large and complicated properties and to defend the appraisals. For example, consider a $4 million property in a town with a municipal tax rate of 30 cents. If the listed property were dropped to $2 million as the result of an appeal, the town would be out $6,000, which is not enough to warrant an expensive defense. The state, on the other hand, would be out $32,560. The state not only has better ability to appraise and defend appraisals, it also has more at stake. The commission recommends developing a program at Property Valuation and Review to appraise large and/or complicated property and to defend the appraisals.

Ongoing oversight

Assuming we continue to have a locally voted education tax, finding the right balance will always be a challenge. The tax rates must be set each year, with a careful analysis of anticipated changes in incomes, property values, school district spending, and anticipated Education Fund revenue from other sources such as the sales tax and the rooms and meals tax. As demonstrated by the recent weighting study, equity in spending needs to be evaluated to ensure the weights are effective. Similarly, what is distributed through categorical grants and what considered general education to be raised via the local tax should be reviewed and analyzed periodically. Rather than create a special commission to tackle each of these when a crisis arises, the state would be better served by an ongoing review process and regular reports to aid the legislature.

There are a few examples of similar state efforts. The Debt Affordability Advisory Committee makes annual recommendations of the maximum level of the state's general obligation debt, after an annual study of history and projections. The recommendation is advisory, but generally followed because of the thorough and consistent review. Similarly, the Current Use Advisory Board, after analyzing the economic situations for farms and forestry, establishes use values that reflect the income-producing capability of the land. These efforts create stability in the programs, as well enabling Legislative decisions to be based on sound research.

<u>The commission recommends establishing an ongoing Education Tax Advisory Committee to monitor the system, to report regularly, and to make annual recommendations to the Legislature</u>. Annual recommendations would include the tax rate(s) and yield(s) and the amount of the stabilization reserve. Other recommendations, such as adjusting student weights or other changes to the system could be brought to the Legislature's attention as needed.

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III. Approaches to revising the locally voted homestead tax

The commission considered five possible approaches to changing the locally voted homestead tax. The intention is to preserve the equity gains resulting from the uniform state non-homestead tax and guaranteeing the yield of the locally voted tax. In addition, the commission would like to make the system less regressive. But the main focus is on reducing complexity.

The first approach is a small change from current law. It simply allows a homeowner to pay the lesser of the tax on the housesite or on income, as in current law, but without using a credit. (Approach #1).

However, the commission feels this does not go far enough. The commission supports eliminating the complications stemming from attempting to meld property and income taxes, and choosing one tax base for residents: either property or income.

Two approaches choosing income as the tax base were considered. One taxes homeowners directly on income (approach 2), and the other taxes all residents (including renters) on income (approach 3).

Approach #4 chooses property as the tax base.

Approach #5 eliminates the locally voted tax entirely and imposes a uniform state school tax.

These are not fully detailed proposals; in all cases there are components that could be changed. For each approach, the purpose, a general description of how it could work, its advantages and disadvantages, and the commission's recommendations are outlined.

1. <u>Changing to a Direct Homestead Tax</u>

This model represents a minor change in the current system. Homeowners would pay the lesser of a tax on their housesite or a tax on their income. The tax would be paid directly, without a credit in the following year.

Purpose: To make the relationship between what you vote and what you pay clear and direct. A homeowner could go to town meeting and know what the school tax would be, given the budget. The credit would be replaced by a direct tax.

<u>**Recommendation**: The commission feels this would reduce the complexity of the current system, but it does not go far enough</u>.

FY 21 example. (School budget voted in March, 2020 for 2020-2021 school year)

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Homeowner's education housesite tax bill calculated as the lesser of education property tax and education income tax

Property	OR	Income
Property Tax Assessment as of April 1 2020[13] equalized with CLA determined December 2019		Income for CY 2019, filed in April 2020
X		X
Spending per pupil FY21 / yield FY21 (property rate)		Spending per pupil FY21 / (Income rate[14] X yield FY21) (income rate)

1. The budget presentation to voters includes estimated property rate and income rate so people can estimate what their tax bill will be if the budget is approved.
2. Education taxes on housesites are paid to the state. The town does not send out education bills for declared housesites.
3. Homeowners file their 2019 household income and their SPAN with their VT income tax form by April 2020 as they do now.
4. Homeowners pay estimated taxes (or withholding) to the state between April 2020 and April 2021.
5. Reconciliation takes place in April 2021. If the filer has overpaid, a credit would be issued; if the filer has underpaid, a payment would be due.

The town sends education property tax bills for all non-housesite property at the non-homestead education rate. The $225 housesite cap would be eliminated so there would not be a jump in tax bills as households exceed the $90,000 income mark. Housesite property could be defined as it is currently, or it could have a maximum value, indexed to some measure of appreciation.

For simplicity, the household income would not be adjusted for household size, although a case could be made for reducing the taxable income to account additional household members. As the filing status and number of exemptions already appear on the income tax form, no new paperwork would be required.

The circuit breaker program could be changed to a sliding scale program to avoid two issues with current law: it creates a sudden jump in tax bills when incomes exceed $47,000, and it insulates eligible taxpayers from the tax consequences of the budget vote. For example, homeowners could pay 50% of the district rate at incomes of 0, rising to 100% for incomes of $50,000. There would be no separate paperwork needed; there would be no credit coming a year later.

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[13]The state applies the CLA determined in December of 2019 to the equalized rates to determine actual rates to be applied to the 2020 house site value. In towns that are reappraising in 2020, a hybrid CLA is calculated (as is done currently). This means that, for most house sites, it is the 2019 house value that is used.

[14] To simplify link between spending and tax rates, there would be one yield for both property and income. The income percent (now 2%) would be adjusted annually (instead of the income yield).

Pros:

- Strengthens link between local vote and local tax bill
- Consolidates the spending and revenue resulting from one school year in one fiscal year so Education Spending and Tax rates are in sync
- Eliminates the taxpayer confusion resulting from the adjustment
- Reduces administrative work of municipal governments
- Shifts the focus to what is a fair tax amount to pay, rather than what is a fair subsidy
- Eliminates tax jump at incomes of $90,000
- Makes only minor changes to current law

Cons:

- Does not address other issues with current law. In particular, it does not change the complexity of having both a property and income tax, and it does not reduce the regressivity in the high-income range.
- May increase need for a stabilization reserve as not all income tax filings will be processed by the time the legislature adjourns
- The state (and not the local tax collector) would deal with delinquencies

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2. <u>School income tax (renters excluded)</u>

This alternative would eliminate the option of paying an education property tax on the housesite; for each housesite, the education tax would be based on the income of household members. The tax would be paid directly; there would be no credit.

Purpose: To simplify current law by taxing all homestead owners on income and eliminating the property tax option as well as the credit.

<u>Recommendation:</u> <u>This approach is recommended by the commission, in concert with data collection, analysis and study of a residential education income tax that would incorporate renters</u>.

FY 21 example. (School budget voted in March, 2020 for 2020-2021 school year)

School Income Tax (Renters Excluded)
Income for CY 2019, filed in April 2020
X
Spending per pupil FY21 / (Income rate X yield FY21)

1. The budget presentation to voters includes estimated income rate so people can estimate what their tax bill will be if the budget is approved.
2. The town does not send out education bills for declared house sites. Instead, the owner files with the state.
3. Homeowners file the a 2019 a homestead declaration, including the names of household members, with their VT income tax form by April 2020 as they do now. The education tax could be based on a compiled household income as it is now, or separately on the AGI of each filing unit.
4. Installment payments, estimated taxes, or withholding would be paid to the state between April 2020 and April 2021.
5. Reconciliation takes place in April 2021. If the filer has overpaid, a credit would be issued; if the filer has underpaid, a payment would be due.

The town sends education property tax bills for all non-housesite property at the non-homestead education rate.

Housesite property could be defined as it is currently, or it could have a maximum value, indexed to some measure of appreciation.

The tax could be based on household income as it is now. However, it would be simpler to have the tax based on the AGI. In the case of multiple filing units in the household, the AGI for each filing unit would be taxed separately instead of being compiled into a household income. For simplicity, the tax would

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not be adjusted for household size, although a case could be made for doing so. As the filing status and number of exemptions already appear on the income tax form, no new paperwork would be required.

If the legislature feels there should be a maximum education tax, this could be set at a certain income level as is done with the social security tax.

If the legislature feels the tax is too high for lower-income households, the district rate can be phased in smoothly rather than using the current circuit breaker. For example, homeowners could pay 50% of the district rate at incomes of 0, rising to 100% for incomes of $100,000. There would be no separate paperwork needed; there would be no credit. This could be designed to avoid two issues with the current circuit breaker: it creates a sudden jump in tax bills when incomes exceed $47,000, and it insulates eligible taxpayers from the tax consequences of the budget vote.

Pros:

- Strengthens link between local vote and local tax bill
- Consolidates the spending and revenue resulting from one school year in one fiscal year so Education Spending and Tax rates are in sync
- Eliminates the taxpayer confusion resulting from the adjustment
- Reduces administrative work of municipal governments
- Shifts the focus to what is a fair tax amount to pay, rather than what is a fair subsidy
- Eliminates tax jump at incomes of $90,000
- Reduces regressivity that now occurs at high incomes

Cons:

- More likely to influence high-income homeowners to choose another state as their residence, or find other ways to avoid the higher school tax
- May increase need for a stabilization reserve as not all income tax filings will be processed by the time the legislature adjourns
- The state (and not the local tax collector) would deal with delinquencies

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3. <u>School income tax (renters included)</u>

This alternative would eliminate the option of paying an education property tax on the housesite; all residents would pay an education tax based on income. To avoid double taxation, renters would receive a credit for the education property tax paid on their units.

Purpose: To simplify current law by taxing all residents on income, and providing the same link between voting decisions and tax bills for both renters and homeowners.

Recommendations: <u>This approach is recommended by the commission, although more analysis is needed to better understand the advantages, disadvantages, rate implications, and administration</u>.

<u>The commission recommends gathering data on rental units and renters to enable further analysis</u>.

FY 21 example. (School budget voted in March, 2020 for 2020-2021 school year)

Local Residential Education Income Tax
Income as of Dec. 31 2019, filed in April 2020
X
Spending per pupil FY21 / (Income rate X yield FY21)

1. The budget presentation to voters includes the estimated income rate so people can estimate what their tax bill will be if the budget is approved.
2. Local residential education taxes are paid to the state. The town does not send out education bills for declared house sites.
3. The local Grand List includes a code (expanded SPAN) for each rental unit within a property, and an assessed value.
4. All residents file their 2019 AGI and their homestead declaration and SPAN with their VT income tax form by April 2020 as they do now.
5. Installment payments, estimated taxes, or withholding would be paid by residents to the state between April 2020 and April 2021.
6. Reconciliation takes place in April 2021. If the filer has overpaid, a credit would be issued; if the filer has underpaid, a payment would be due.
7. The rental credit would be refundable. The Tax Department would determine the tax paid on the rental unit by using the Grand List. The Landlord Certificate would be used to verify the renter and the rental unit.

The town sends education property tax bills for all non-housesite property at the non-homestead education rate. Housesite property could be defined as it is currently, or it could have a maximum value, indexed to some measure of appreciation.

Landlords would need to file annually, as they do now. However, they would not need to calculate allocable rent. The landlord's filing would list the names of people responsible for rent. If the renters change during the year, the landlord would indicate the responsible renters by month.

For simplicity, AGI should replace household income. All residents would pay a school tax based on the rate of the school district and their AGI. For simplicity, the AGI would not be adjusted for household size, although a case could be made for reducing the taxable income to account additional household members. As the filing status and number of exemptions already appear on the income tax form, no new paperwork would be required.

If the legislature feels there should be a maximum education tax, this could be set at a certain income level as is done with the social security tax.

If the legislature feels the tax is too high for lower-income households, the district rate can be phased in smoothly rather than using the current circuit breaker. For example, homeowners could pay 50% of the district rate at incomes of 0, rising to 100% for incomes of $100,000. There would be no separate paperwork needed; there would be no credit. This could be designed to avoid two issues with the current circuit breaker: it creates a sudden jump in tax bills when incomes exceed $47,000, and it insulates eligible taxpayers from the tax consequences of the budget vote.

Pros:

- Strengthens link between local vote and local tax bill, for all district residents
- Consolidates the spending and revenue resulting from one school year in one fiscal year so Education Spending and Tax rates are in sync
- Eliminates the taxpayer confusion resulting from the adjustment
- Eliminates household income calculation; can use AGI
- Shifts the focus to what is a fair tax amount to pay, rather than what is a fair subsidy
- Eliminates tax jump at incomes of $90,000
- Reduces regressivity that now occurs at high incomes
- Less likely to affect behavior of high-income homeowners because renters are treated the same way as homeowners

Cons:

- Administrative changes at both the state and municipal levels to account for renters
- May influence high-income homeowners to choose another state as their residence

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4. <u>School property tax with housesite exemption</u>

This would eliminate the option of paying an education tax based on income. All homesteads would be subject to an education property tax only. There would be a substantial housesite exemption to reduce the regressivity.

Purpose: To shift from the double income/property system to a property-only tax in order to make the locally voted education tax simpler, clearer to taxpayers, easily administered, and similar to education taxes in other states.

<u>**Recommendation**: The commission does not recommend this approach.</u>

FY 21 example. (School budget voted in March, 2020 for 2020-2021 school year)

Local Education Homestead Property Tax
(Property Tax Assessment as of April 1 2020[15] equalized with CLA determined December 2019
Less
Homestead Exemption)
X
Spending per pupil FY21 / yield FY21 (property rate)

1. The budget presentation to voters includes estimated property tax rate so people can estimate what their tax bill will be if the budget is approved.
2. All residents file their homestead declaration and SPAN with their VT income tax form by April 2020 as they do now to be eligible for the exemption.
3. The state notifies the town of the declarations filed, as it does now.
4. The state exemption amount is adjusted by the 2019 cla and subtracted from the listed value of each homestead property by the local listers.
5. Residents pay the local Education Homestead Property Tax to the town.

Pros:

- Strengthens link between local vote and local tax bill, for homeowners
- Consolidates the spending and revenue resulting from one school year the one fiscal year so Education Spending and Tax rates are in sync
- Eliminates the taxpayer confusion resulting from the adjustment

[15] The state applies the CLA determined in December of 2019 to the equalized rates to determine actual rates to be applied to the 2020 house site value. In towns that are reappraising in 2020, a hybrid CLA is calculated (as is done currently). This means that, for most house sites, it is the 2019 house value that is used.

- Eliminates household income calculation, except for households applying for circuit breaker
- Shifts the focus to what is a fair tax amount to pay, rather than who should get a subsidy
- Eliminates tax jump at incomes of $90,000
- Will not affect behavior of high-income homeowners
- Simplifies local administration
- Eliminates state administration of the Property Tax Adjustment

Cons:

- More regressive than current system
- Would require income-based program to reduce regressivity. This would reintroduce complexity of the current double property/income tax

This approach was originally suggested for simplicity. It was intended to eliminate the need for using both income and property filings to determine the tax bill. The approaches the commission considered moved to income; this approach moved to property.

The original idea was to use a generous and uniform housesite exemption to reduce the property tax. The concept was that a flat exemption would counteract the regressivity of the property tax because it would represent a larger proportion of the value of lower-value houses than of higher value ones. The exemption would replace the current income-based credit and circuit breaker.

The Tax Department estimated that a homestead property tax with a flat exemption of $65,000 would bring in roughly the same amount of revenue as the current system does. But, a quick look at the results indicated a substantial and regressive shift in tax burden. Tax total education tax on households with incomes less than $100,000 would increase by about $50 million; the tax on households with higher incomes would decrease by the same amount. Although the $65,000 exemption did moderate the regressivity of the property tax, it was still a step in the wrong direction.

To further counteract this regressivity without resorting to incorporating income in the process, the commission considered phasing out the amount of the exemption based on the value of the housesite. However, it was quickly apparent that the distribution of house values by income, as illustrated earlier, was too variable to make this approach effective. The commission concluded that overcoming the regressivity would require correcting the property tax with an income screen. This would reinstate the complexity it was designed to eliminate.

5. <u>Uniform state school income tax</u>

This would replace local school homestead taxes with a uniform state income tax. The state would distribute revenue to the school districts based on a needs-based formula.

Purpose: To shift responsibility for taxing and distribution of funds to the state.

<u>**Recommendation:** The commission does not recommend this model, believing that benefits of local democracy outweigh the benefits of having a uniform education tax.</u>

FY 21 example. (School budget voted in March, 2020 for 2020-2021 school year)

State Education Residential Tax
Income as of Dec. 31 2019, filed in April 2020
X
Uniform state income tax rate(s) FY21[16]

1. There could be a budget presentation to district voters but it would not affect their tax bills.
2. Education taxes on income are paid to the state. The town does not send out education bills for declared house sites.
3. Funds would be distributed to school districts based on categorical grants, formulas, and weighted students.
4. Homeowners file their 2019 household income and their homestead declaration and SPAN with their VT income tax form by April 2020 as they do now.
5. Homeowners pay estimated taxes (or withholding) to the state between April 2020 and April 2021.
6. Reconciliation takes place in April 2021. The education income tax (on the 2019 household income) is compared with the education taxes paid through withholding, and either a credit is issued or a payment is due.

Pros:

- Allows legislature to control spending
- Allows state to control student equity through the distribution of revenue
- Horizontal equity would be perceived as fair as the rate in all districts would be the same
- Because it would be a state tax, it could be made more progressive by using brackets or a sliding scale for the rate.
- Consolidates the spending and revenue resulting from one school year in one fiscal year so Education Spending and Tax rates are in sync

[16] Because this would not vary by district, it would be possible to make the tax more progressive than the current method. For example, there could be brackets or a sliding scale. This could then eliminate the circuit breaker program.

- Eliminates the taxpayer confusion resulting from the adjustment
- Shifts the focus to what is a fair tax amount to pay, rather than who should get a subsidy
- Could eliminate tax jump at incomes of $90,000
- Could reduce the regressivity that now occurs at high incomes

Cons:

- Loss of local control
- Weakens community connection to schools and local democracy
- The Legislature would deal with pleas for more money and proposals to tweak pupil weighting, to add special categorical grants, etc. This would make it likely that it would become more complex each year.
- Not likely to have public support

The commission looked at this option because of testimony received. Several legislators felt that the current system does not give the Legislature enough control over spending. Others sensed that the state was in the process of taking more and more control away from local districts, so ceding taxing authority was not a huge step.

On the other hand, many people defended local control of schools, pointing out it can strengthen both the schools and democracy. The principle of subsidiarity--assigning the responsibility for a public function to the lowest level of government that can competently fulfill it—is not just a quaint Vermont tradition. The principle has been accepted internationally and incorporated in the charter of the EU.[17] In Vermont, local citizens are involved in their schools, serve on school boards, elect their school directors, and approve local budgets. By tying the voters' tax bills directly to the budgets approved, public accountability is more direct than in government functions supported by other state taxes.

Although the commission received complaints about local control, no one expressed support for abolishing it.

[17] Treaty on European Union, Articles 5 and 11 https://eur-lex.europa.eu/

Summary of Recommendations

The commission believes the adoption of a uniform tax on non-homestead property and of a guaranteed yield for the locally voted tax have increased between-district horizontal equity substantially, understandably, and simply.

The commissioners agree that the complexity is overwhelming the effectiveness of the current homestead education tax

The commission believes that the confusion surrounding the current Property Tax Credit and the double system for determining the tax bill has removed the direct link between the budget vote and the tax bill. The first step in improving cost control and accountability should be simplifying the system so that voters have a clear idea of the effect their vote on the school budget will have on their tax bill.

The commissioners believe simplification is best achieved by removing one of the two systems for taxing residents: property or income

Given the divergence between the value of a house and both income and wealth, and given the impracticality of determining, measuring or taxing net worth, the commission believes that income is the best way to measure taxpayer equity and the most progressive way to tax residents for education.

While the historical and administrative reasons for the distinction between renters and homeowners are clear, the commission could not find a principle-based justification for treating the two groups of residents differently.

The commission recommends replacing the homestead education tax with an income tax. In the short term, this would apply to residents of owner-occupied houses only; in the longer term, it should apply to all residents, including renters.

The commission recommends initiating a process for data collection, analysis and implementation of a locally voted school income tax on residents.

The commission recommends further study of the costs now covered by the Education Fund to see what the effect would be on both the level of the local tax and the volatility.

The commission recommends the efforts to educate and train listers be supported and strengthened.

The commission recommends developing a program at Property Valuation and Review to appraise large and/or complicated property and to defend the appraisals.

The commission recommends establishing an ongoing Education Tax Advisory Committee to monitor the system, to report regularly, and to make annual recommendations to the Legislature. Annual recommendations would include the tax rate(s) and yield(s) and the amount of the stabilization reserve. Other recommendations, such as adjusting student weights or other changes to the system could be brought to the Legislature's attention as needed.