Commissioner Trenholm's Draft on Overall Tax Structure

Updated by Commissioner Kleppner 12/2/2020

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How Should We Think About the Overall Tax Structure,
Progessivity, Equity, Sustainablity, 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 do ~~are~~ not. **Equity** in a tax structure and **progressivity** generally have the same goals but take different approaches to achieve those goals.

Sustainablilty 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 needed can last for many years. A sustainable tax system must be designed with the future in mind, determing 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 infastructure.

Volatility with respect to tas 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~~s~~ at the individual level.

Vermont has a progressive income tax structure. Be~~a~~cause 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 as 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 staes. 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 theo~~e~~ry that those in the lower income cohort will consume fewer~~e~~ taxable products than those in the higher income cohorts so the percent of their income paid in consumption taxes is equalized. However, per the full discussion of consumption taxes in Chapter XXX, we believe the goals of fairness, simplicity, and sustainability can be better served be expanding the sales tax base to include necessities, reducing the rate, and using other mechanisms to protect low-income Vermonters.

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 taxes are ~~is~~ also somewhat volatile. This volatility comes from the fact that the taxes are~~is~~ based of the consumption of goods. As economic conditions change, so do the patterns of consumption. An example of this is when the economy is t~~r~~hriving 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 affect, 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. Our recommendations address this volatility.

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 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, ie. a~~A~~ble 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 method 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 assesments 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 also 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.

The Tax System as a Whole

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We are aware of the school of taxation thought that favors taxing "bads" and not goods, which is to say, taxing things that we as a society want less of, like pollution, and less of things we as a society want more of, like work. In particular, we have studied "A Green Tax Shift for Vermont, a 2009 report from UVM's Gund Institute et al. on moving Vermont's tax system to one much more dependent on taxes designed to encourage responsible environmental stewardship.

We admire the thoroughness of Gund's analysis and the comprehensive nature of the plan for taxing bads presented in the report. We further agree with the sound economic principle articulated in the Gund report that the true cost of a product, including the environmental costs to produce it, should be borne by the producer, and that internalizing externalities allows the free market to better address environmental concerns.

Gund proposes to tax resources, to encourage a reduction in their use; pollution, to discourage it, and land, to discourage sprawl. As with many taxes on "bads", the system is designed to reduce its own tax base over time. The goal is to reduce resource use and pollution. We do not dispute the importance of those goals for Vermont; however, transforming the tax system to achieve those goals would be undermine one of our three primary goals: sustainability. The goal of taxing a "bad" is to make it go away, and therefore one starts with the goal of making the tax unsustainable. We therefore view taxing "bads" as policy tool to aid in the transition from current practice to a better practice, but not as an integral component of the tax system we are recommending.

Our statutory goals were to make the overall tax structure more fair, more sustainable, and simpler. We have worked within each major tax area, and among the major tax areas, to make the overall tax burden on Vermonters more fair relative to horizontal equity, with people of similar ability to pay bearing similar tax burdens, and vertical equity, with an effort to ensure that those with less ability to pay bear a lesser burden, and those with a greater ability to pay contribute a greater amount.

We have worked to simplify the overall tax system in two major ways. First, we have endeavored to make recommendations that will make many individual taxes simpler. Second, we have made recommendations to eliminate a number of taxes outright. Falling into both these categories is the education property tax, which currently is exceptionally complicated. We have recommended eliminating the education property tax on homestead housesites, and replacing it with an increase in the state income tax. We have also recommended eliminating the Telephone Property Tax, and a handful of other obsolete taxes.

On the subject of making our overall tax system more sustainable, we have been mindful of recommending changes that will make our tax system responsive to changes in the economy, and technology, and the environment *without requiring further legislation*. We hope that our recommendations regarding the education property tax make that more sustainable. We believe it removes one of the biggest source of potential instability in Vermont's tax system, which is the growing demands by Vermonters for lower property taxes, and for property taxes that do not grow disproportionately.

Moving that portion of education funding to the income tax also allows funding to be more stable even as the number, type, and value of people's primary residences change in response to our changing demographics and to the growing ability of people to work from home.

Similarly, our recommendations to finish the ongoing expansion of the sales tax base positions consumption taxes to be more stable. In our favorite example, including home electricity in the sales tax means that as people's cars go from using gasoline to being charged at home, the state will continue to receive revenue from the miles that Vermonters travel on our roads.

How we pay for health care is complicated and unsustainable, and we hope that there is meaningful reform to our health care system at the national and state levels. The complexity of our current system, and the likelihood of meaningful structural change to that system, make the simplicity, fairness, and sustainability of health care taxation one of the biggest challenges we faced. We concluded that health care is not amenable to a sales tax, but even so, the general principles of expanding the base and lowering the rate can be applied to the health care provider tax. Furthermore, we can harmonize rates across provider groups, and develop some relationship between the provider tax rate and the sales tax rate, and those actions do add a measure of increased sustainability, fairness, and simplicity to health care taxes and to the tax system as a whole.

We believe that Vermont's tax system is pretty fair, not very simple, and of uncertain sustainability. We hope our recommendations improve the overall system on all three counts.

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