

6. Taxes Used to Fund Education

Introduction

Before attempting to evaluate or suggest improvements to the Education Tax, the commission sought comments, criticisms, and suggestions from legislators, municipal officials, school teachers and administrators, representatives of government and education organizations, and citizens. And they delivered. First, we just listened. Then we methodically organized, analyzed and discussed the comments we received before looking for ways to address them. If there was a common theme, it was that the system's strength is equity, and its weakness is complexity.

Although we looked at ways to address the different issues individually, we do not recommend a new box of Band-Aids. Instead, we looked for more fundamental structural changes that would address as many of the issues as possible while maintaining equity. We evaluated five possible approaches; two were rejected, three were considered improvements to the current system, and we recommend one of those three.

Our recommendation is to replace the current education tax on the primary residence (and up to two acres) with a locally-voted tax on income. This would abolish the homestead property tax and the property tax credit. For many households, the tax bill would be the same as the net bill under current law; the change would make the bill direct (as opposed to requiring a credit in the following year) and there would no longer be a double system of property tax and income tax on each housesite.

We do not see any principle-based reason that the education tax should be different for renters than for homeowners, and we recommend that renters be taxed on their income and credited for education taxes assumed to be paid through their rent. To design and implement this component, we recommend initiating reporting, data collection and analysis.

The sections that follow document key issues that we considered in coming to our recommendations. Rather than presenting only the points that support our recommendations, we attempted to indicate different interpretations and different solutions.

The five approaches to structural change that we examined are outlined in the Appendix to the chapter.

Background

Education is both a state and a local responsibility, and its funding comes from both broad-based state taxes and a locally voted tax. 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 in the U.S. has been partially funded with state taxes, and partially with local 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 focused on aiding those with the least ability to pay (homeowners with low incomes, or districts with low tax bases per pupil) and not on adjusting the overall system so that all homeowners or all districts had reasonably equal ability to support education.

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 the Brigham decision of 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 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

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

³ Brigham v. State. 96-502. (1997). P. 6

⁴ Brigham v. State. 96-502. (1997). P.22

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 uniform 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 district's 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.
- To better reflect the ability of taxpayers to pay the tax, the education property tax on a housesite (house plus up to 2-acre site) is adjusted to reflect the household income.

Perhaps the most important feature of the 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 adequate funding. 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 state General Fund and federal contributions to the Education Fund 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 in each district -- one for property and one for income, determined by spending per pupil in the district, divided by the state-set yields. Effectively, homeowners pay the lesser of the housesite value 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

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.

⁵ Reference summary of issues and also list of people who testified and links to testimony?

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

The Appendix includes a summary of the other models considered.

Issues

Complexity

The most common criticism was the bewildering complexity of the locally voted homestead education tax. According to the Vermont League of Cities and Towns, “The education property tax system is endlessly complicated, confusing and disconnected from the education budgets that voters adopt at the local level.”

Although several people testified that the current system is a vast improvement over the earlier property tax and that complexity is a small price to pay for the gains in equity, the commissioners agreed that the complexity is overwhelming the effectiveness of the current education tax.

The complexity is primarily due to: use of a credit that comes a year late and causes the tax bill to be disconnected from the budget vote; and utilization of both property value and income to determine the contribution of each household, creating what is essentially a double system.

The tax 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 which is error prone. The state Department of Taxes calculates the credit for each household and sends the information to each town. Local officials subtract the credit from the tax due on the property tax bills, often twice as a result of late filings and corrections. 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 commission recommends abolishing the Property Tax Credit and implementing a direct tax in its place.

The process is 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. 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. And, local officials are often stuck with trying to explain the tax bills to taxpayers.

The commission recommends replacing the hybrid property/income homestead tax base with a single tax base; and, to maintain equity, that single tax base should be income.

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 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, people measure equity differently. The income tax adherents may feel that equity results from the net (property tax minus the credit) education tax because it rises as incomes rise. So, in their view, households in the same district with equal incomes should pay the same tax, even though one owns a \$400,000 house and the other owns a \$200,000 house. Property tax adherents may feel that equity results when people with higher value housesites pay a higher property tax. In their view the tax bill of the \$400,000 house should be twice that of the \$200,000 house, and the credit is considered a subsidy for those less able to pay.

This position leads to perceived inequities of the current system, focused on the credit rather than on the net tax people pay. The household with the \$400,000 house will receive a larger credit than the household with the \$200,000 house, although the two net bills would be the same because the household incomes are the same. Looking at the credit rather than the net tax leads to the perception that the system is unfair.

It is important to note that the owners of the \$400,000 house still do pay twice as much as the owners of the \$200,000 house in municipal property taxes. Municipal taxes support services and

⁶ Final Report: Blue Ribbon Tax Structure Commission. 2011. P. 41

investments—including roads, recreation programs, libraries, and town government—that are more variable from town to town, less controlled by state, and more related to the value of property.

Two main reasons are offered to support the property tax adherent’s view of 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

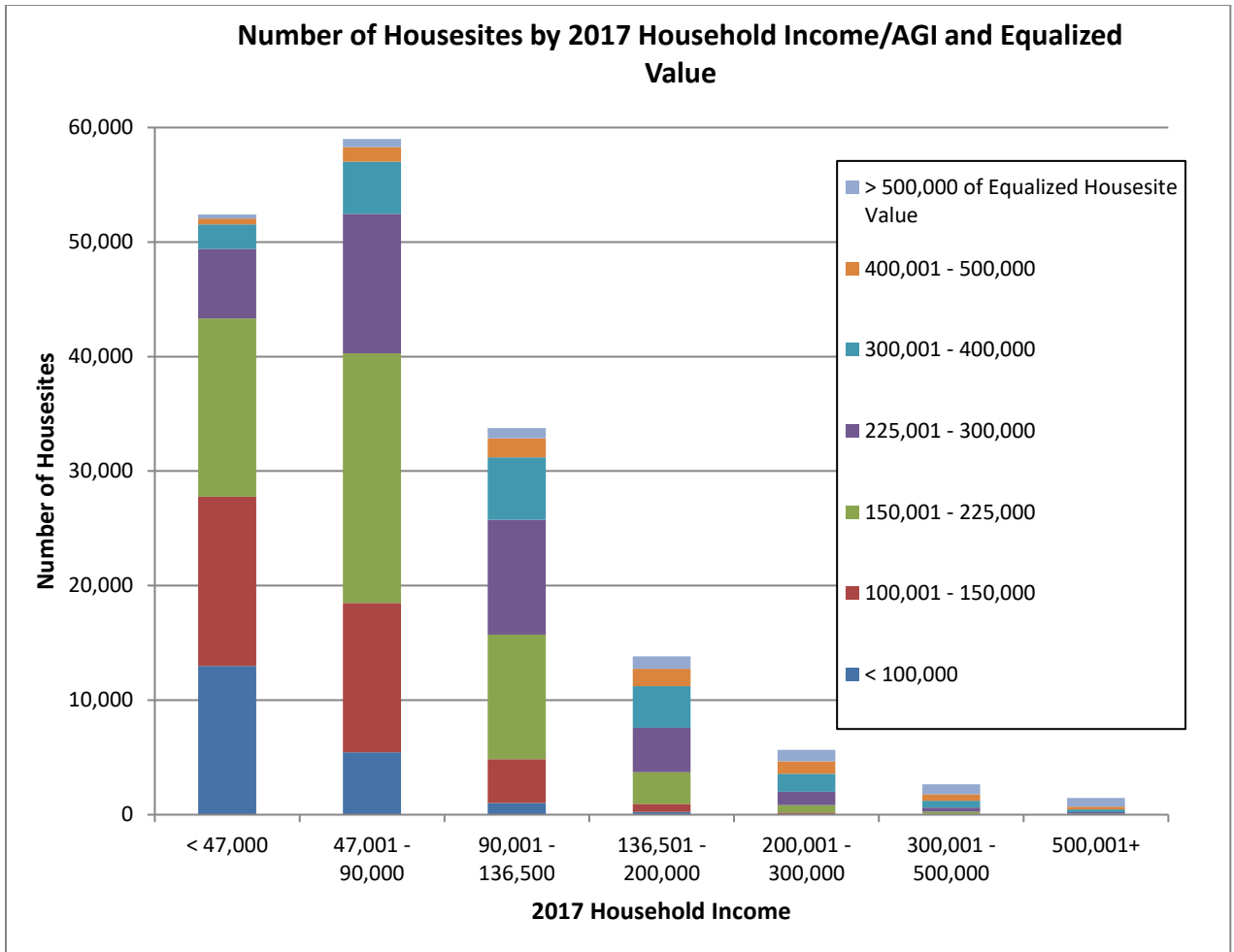
2017 Household Income	# Owner-Occupied House Sites	Median House Site Value
< 47,000	52,410	144,896
47,001 - 90,000	58,991	183,708
90,001 - 136,500	33,766	232,785
136,501 - 200,000	13,818	285,949
200,001 - 300,000	5,665	351,761
300,001 - 500,000	2,645	418,733
500,001 - 1,000,000	1,048	485,479
> 1,000,000	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

⁷ Vermont Joint Fiscal Office

⁸ Vermont Joint Fiscal Office

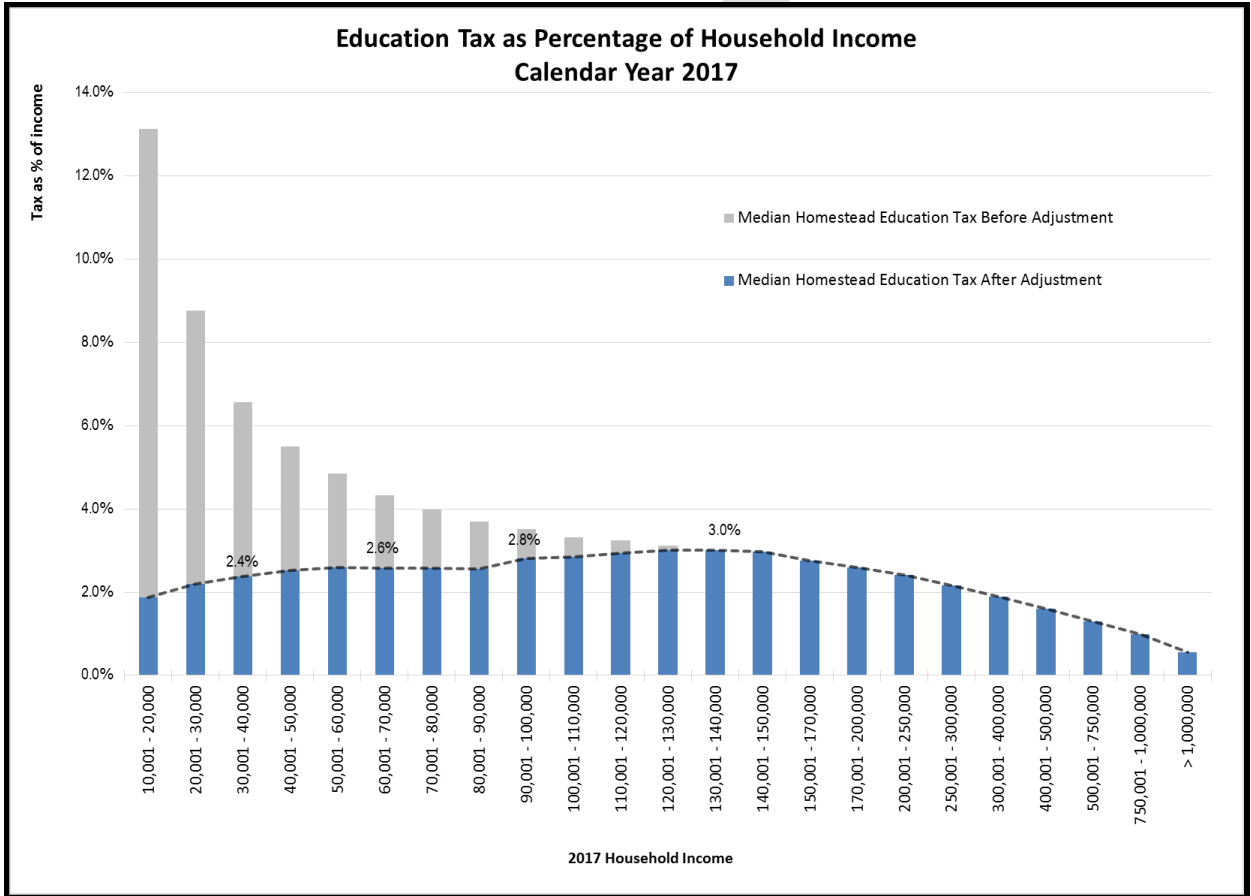


As discussed in (Chapter XX), Vermont does not have data on assets of its residents so the commission relied on national data to look at whether the value of a residence was a good proxy for wealth. At the national level, the Federal Reserve Board’s Survey of Consumer Finances collects information on 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.

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 at the present time. However, the commission agrees that wealth is an important component of a household’s ability to pay, and we would like further research on how wealth could be measured or included in the tax structure. (Chapter XX)

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 dashed 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 homestead tax has improved vertical equity of the education tax and of the tax structure as a whole, but it is not a progressive tax.

Figure 5.⁹



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

⁹ Joint Fiscal Office

equal homestead tax rates. Nor did it receive testimony questioning the state education tax on non-residential property. The commission believes both provisions have increased between-district horizontal equity substantially, understandably, and simply.

Although the Brigham decision used equal spending per pupil as a yardstick, the legislature acknowledged that 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 student had narrowed by 35% since the passage of Act 60.¹⁰

Yet there are reasons to examine between-district equity more carefully. The commission heard concern that high-income districts were spending more than low-income 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.

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

There were significant 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.

Union districts, on the other hand, generally had 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 was 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.

As mentioned earlier, the extra cost of educating students in poverty is addressed by weighting those students. If the weighting scheme were successful, we would see inequality in spending per pupil, and equality in spending per equalized (weighted) pupil; higher poverty districts would spend more per pupil than lower poverty districts, but the spending per equalized pupil would be same. The data indicate that, to a certain extent, this is successful. Controlling for enrollment, spending per (unweighted) pupil tends to be slightly higher in higher-poverty districts, which is not what would be expected. But spending per equalized pupil still tends to be lower in higher-poverty districts, indicating that the weighting did not convince voters to support the full supplement per poverty student.

The 2020 weighting study calculates a substantially higher weight for poverty than the current weight.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 spending 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 difficulty that lower-income households may have in paying taxes.

The cost of educating students with different needs, and the distribution and allocation of funds to appropriate programs, are beyond the scope of this commission. But we do look at the ability of the tax to achieve the goals. We are not convinced that applying such a substantial poverty weight will result in the locally voted education tax raising the optimal amount for educating economically disadvantaged students. Perhaps categorical grants for specific interventions such

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

as tutoring and after-school programs may also play a role, leaving less compensating to be expected of the locally voted tax.

The commission believes that the equity of the locally voted education tax is crucially important. Unlike many other taxes, it both collects and distributes. After the allocation of categorical grants, we rely on the locally voted tax to raise the amount needed to provide the education of the students in each district. If this tax is inequitable, it is likely that education will be distributed inequitably. For this reason, we believe the relationship between income, poverty, and education spending is vitally important to track. At 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 tax.

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 appreciation as estimated by the Common Level of Appraisal), changes in education spending, changes in uses such as health insurance, 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 federal funding after during the Great Recession or the COVID pandemic.

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:

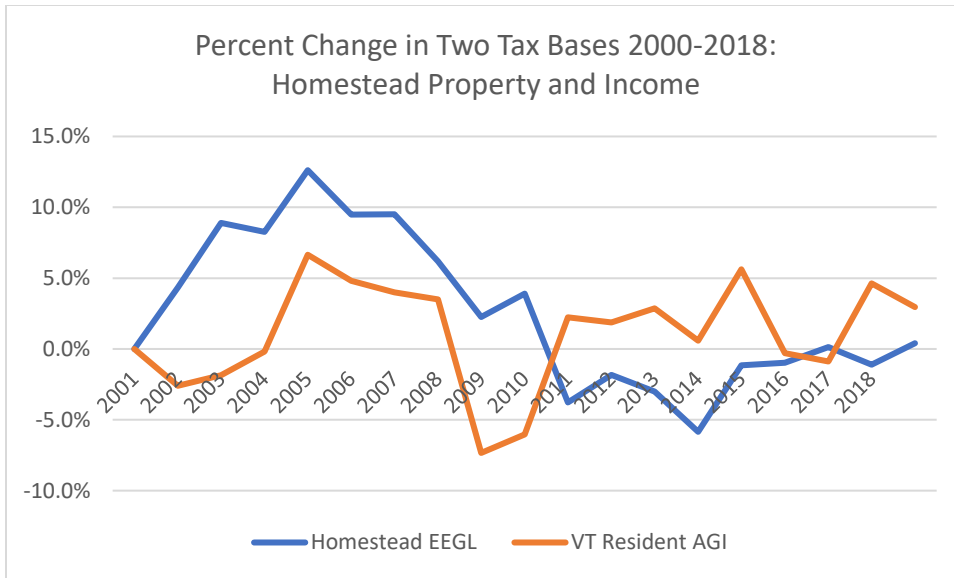
- Create a stabilization reserve, to be used to stabilize tax rates
- Eliminate the Property Tax Credit which essentially passes on a tax increase from the prior year to the current year (or pay for it out of the General Fund)
- Reduce disparity in increases in spending between districts
- Index state 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; move spending on mental health services and employee health insurance to the General Fund.

The commission also heard concerns that replacing the homestead property tax with 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 (Homestead EGL) in constant 2018 dollars was 4.7%, with a standard deviation of 3.8%. The average annual change in the Adjusted Gross Income (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 significantly more volatile from year to year using an income base.

Figure ¹²

¹² Source: Vermont Department of Taxes



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
- Basing the tax on the prior year’s income, as is effectively done with the current education property tax credit, so the revenue estimate would be more accurate
- Using a stabilization reserve

For an individual taxpayer, the income-based bill could be more volatile than a property tax bill—especially 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. If the tax is based on the prior year’s income, taxpayers with sudden changes in income would see the concomitant change in their tax bill until the following year. This is also true of the current homestead education tax, as the property tax credit is based on the prior year’s income.

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, and that the tax structure is not the best agent for accomplishing the most efficient delivery of quality education. 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 to 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 a base amount estimated to provide an adequate education. Compared to current law, this would result in lower rates for spending up to that base amount. For spending above this base amount, the yield would be significantly lower than current law (and therefore the rate would increase more sharply) because the yield would be supported only 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 within the tax structure 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. And, for the local tax to effectively control costs, those costs should be controllable. We recommend moving health care for school employees and mental health services to the General Fund.

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 costs of education that the voters have some control over. 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, strengthening the connection between the budget vote and the resulting tax bill. When the Legislature established the Education Fund in Act 60, it explicitly listed eligible uses, and stated that "upon withdrawal of funds from the Education Fund for any purpose other than those authorized by this section, 32 V.S.A chapter 135 (education property tax) is repealed.

The commission recommends moving expenditures for mental health services and for employee health insurance from the Education Fund to the General Fund, along with proportionate revenue sources. This would remove some of the most uncontrollably volatile costs from the locally voted tax, so that the budgets would be more directly related to education expenses, more predictable, and more easily controlled by the voters. It would also give the Legislature greater ability to manage some of the costs that they now feel are out of their hands.

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.

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 is considered spending on 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 as enabling Legislative decisions to be based on sound research.

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.

Property Tax 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 and the competence of local listers is crucial to ensure that the state tax is being administered correctly, consistently and fairly.

Times have changed since Vermont towns began electing citizens to serve as Fence Viewers, Listers and Weighers of Coal. Although the duties of Weighers of Coal and Fence Viewers have evaporated, the duties of listers have increased substantially, and so has the expertise required to do the job.

Listers were so named because their main job was to make lists. Every household had an individual list of taxable possessions. The listers compiled these individual lists into the town's Grand List, and the tax for each type of property was set by the state so they didn't need to appraise. To do the job with the support of the electorate, they needed to be honest, and good penmanship was a plus. The work was seasonal, between sugaring and planting.

At this point, the job continues throughout the year and listers need to know, among other things: appraisal practices; Act 250, Open Meeting and Public Records laws; chapters 112-135 of Title 32; how and when to capitalize income to value property; how to understand and value easement restrictions; how to use CAMA, NEMRC and other software for valuing, compiling, reporting and updating.

And once they master the job, there will be changes. They need to learn how to value the new types of property--such as cell towers, wind turbines, solar installations and subsidized housing--that may have special tax treatment. They need to understand and implement the latest changes in laws such as the education property tax or current use. And, they must adjust to frequent changes in the software and in reporting requirements.

Yet most of the listers have none of this experience when they are first elected to serve.

There is no authority to ensure that all the locally elected listers function responsibly, consistently, and competently in conformance with state laws. The Division of Property Valuation and Review has tackled this challenge admirably by offering courses, certification programs, webinars, training materials, forms to use for special property, handbooks, and frequent one-on-one assistance to listers. Significant progress has been made in the standardization of practices. However, the Division has little control, and training has been limited by funding.

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 reduced to \$2 million as the result of an appeal, the town would be out \$6,000 per year, which is not enough to warrant an expensive

defense. The state, on the other hand, would be out \$32,560 per year. 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. We also recommend analyzing other ways in which local administration could be strengthened and supported by the state. The current per-parcel payment should be reviewed and a payment schedule that is based on both the size of the town and the certification of the local officials should be considered. We believe that the state can make investments in the administration of the property tax that will be offset by increased tax revenue.

Recommended Change to Homestead Tax

Process

The commission considered five possible approaches to changing the locally voted homestead tax. The intention was to preserve or further the equity gains of the current system while reducing complexity.

After modifying and evaluating different approaches, we recommend levying an education tax, at a locally voted rate, on the income of all residents. This would eliminate the Property Tax Credit and the option of paying an education property tax on the housesite. Because renters are assumed to pay an education tax through their rent, they would receive a credit designed to offset that cost.

Two of the alternative approaches considered are actually small steps toward the recommendation. Model 1 would allow a homeowner to pay the lesser of the tax on the housesite or on income, as in current law, but without using a credit. This would make the tax bill directly reflect the budget vote, and remove the confusion caused by the credit that is related to the prior year's bill. Model 2 would similarly abolish the property tax credit but, in addition, it would eliminate the option of paying a housesite property tax. This would remove the double property/income calculations and move to one tax base: income. While the commission supports these changes, we don't feel either model goes far enough. Our recommendation adds changes to the way renters are paying for education.

Two approaches were rejected. Model 3 looks at property as the tax base, and uses a generous homestead exemption to address regressivity. After further analysis, this approach was rejected because, in order to maintain equity, it would require substantial adjustment based on income and would not be an improvement over the current double income/property system.

Model 4 eliminates the locally voted tax entirely and imposes a uniform state school tax. This approach was also rejected. Although it has many tax advantages, the commission concluded that local control and local democracy are more important than tax simplicity.

These are not fully detailed models; 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.

The recommended approach is discussed below; the others are outlined in the Appendix to the chapter.

Commission’s Recommended Change to Homestead Tax

We recommend levying an education tax, at a locally voted rate, on the income of all residents. We recommend eliminating the Property Tax Credit and the option of paying an education property tax on the housesite. Because renters are assumed to pay an education tax through their rent, they would receive a credit designed to offset that cost.

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.

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 a residence declaration with their Adjusted Gross Income (AGI) with their VT income tax form by April 2020.
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, and it could be deducted from the withholding or estimated payments. 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 school district budget vote would determine the local income rate, based on the spending per equalized pupil. At the time of the vote, taxpayers will have a good idea of what their tax bill will be by applying the estimated rate to the AGI that they are filing around the same time. If their income goes up or down during the year, the tax bill will not change. This is essentially what happens now, as the current property tax credit is based on the prior year's income.

For simplicity, AGI should replace household income. 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.

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.

The commission envisions listing each rental unit separately in the Grand List, and dividing the assessed value of the entire building between units--which could be done proportionally by rent. However, the renter credit could also be less specifically tied to the unit, along the lines of the recent changes in the renter rebate program.

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

There would be one statewide equalized rate for all non-housesite property. The town would send education property tax bills for all non-housesite property only.

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.

Taxing renters in the same way as homeowners is recommended by the commission, although more analysis is needed to better understand the advantages, disadvantages, rate implications, and administration of the change for renters before it can be implemented. The commission recommends initiating reporting and data collection on renters and rental units as soon as possible to enable further analysis.

Pros:

- Provides meaningful property tax relief for more Vermont homeowners and renters
- Strengthens link between local vote and local tax bill, for all district residents
- Consolidates the spending and revenue resulting from one school year to 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

Appendix. Other Structural Models Evaluated

1. Changing to a Direct Homestead Tax

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.

Recommendation: The commission feels this would reduce the complexity of the current system, but we recommend additional changes.

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

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.

¹³The 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).

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 \$225,000 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.

Pros:

- Strengthens link between local vote and local tax bill
- Consolidates the spending and revenue resulting from one school year to 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

2. School income tax (renters excluded)

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.

Recommendation: This approach is not recommended by the commission as an end goal. However, in concert with data collection, analysis and study of a residential education income tax that would incorporate renters, it could be an intermediate step.

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 housesite 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 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:

- Provides meaningful property tax relief for more homeowners
- Strengthens link between local vote and local tax bill
- Consolidates the spending and revenue resulting from one school year to 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

3. School property tax with housesite exemption

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.

Recommendation: The commission does not recommend this approach. We found that the adjustment needed to make the system equitable was substantial and this approach would only add another level of complexity to the current system.

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:

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.

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

4. Uniform state school income tax

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.

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

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.

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.

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 uniform statewide tax, it could be made more progressive by using brackets or a sliding scale to determine each taxpayer's liability.
- 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
- 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/>