# Testimony to Vermont Blue Ribbon Tax Structure Commission: Options for Improving Vermont's Tax Competitiveness

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**by William Ahern**

To the commissioners, thank you for this opportunity for the Tax Foundation to testify. My name is William Ahern, directory of policy and communications, and I'm joined by lottery expert Alicia Hansen.

I speak on behalf of the many economists who have, during my long tenure here, authored the annual editions of our two principal studies of state-local finances: our measurement of state-local tax burdens, and our State Business Tax Climate Index.

**State-Local Tax Burdens in the Most Recent Year We've Measured, FY 2008**
You have our *Tax Foundation Special Report*, No. 163, on state-local tax burdens in front of you, published in August 2008, with estimates of the tax burden in FY 2008 and selected prior years back to 1977. The burden for each state in each of those years is available on our website at taxfoundation.org.

By "state-local tax burden," we mean the percentage of all income earned that is taken by state-local taxes. Nationwide, our advance estimate of this fraction's numerator in FY 2008 was $4,283 per capita in taxes paid, and we pegged the denominator at $44,254 of income per capita. So the burden was 9.7% nationwide.

Vermonters' taxes were slightly higher, $4,410 per capita, while income earned was slightly lower, $42,626. Dividing taxes by income, we arrived at a state-local burden in Vermont of 10.3%. Seven states' residents had a higher burden. The 50 states appear in rank order in Table 1 on page 2 of the report.

This study's claim to fame is that we count non-resident payments in the state of the taxpayer, not the tax collector. This enables us to divide only residents' tax payments into the same residents' income. If non-resident payments were trivial, or all states garnered the same percentage of revenue from out of state, this difficult estimation of non-resident payments would be unnecessary. But nationwide, non-residents pay almost a third of state-local collections, and the variability is considerable (see Tables 6 and 7).

**Vermont's State-Local Tax Burdens Over Time**
Vermonters' tax burden has been dropping, from 10.9% in 2006 to 10.6% in 2007 to 10.3% in 2008 (See Tables 3 and 4). The ranking also fell from 4th to 6th to 8th over that 3-year period.

*Revisions from Year to Year*
By trying to estimate the state-local tax burden in the most recently completed fiscal year, we run into some predictable problems, which is to say the unpredictability of revenue flows. In 2007, our advance estimate of Vermonters' tax burden in FY 2007 tax burden was 14.1% which put you in the top spot. Some skeptics thought that exaggerated, and the Joint Fiscal Office (JFO) issued a mostly accurate rebuttal.

The principal reason for such a sizeable revision was property taxes, in two respects, one nationwide and one specific to Vermont and a few other states.

- The reporting of property taxes lags further than any other tax source, and revenues had been falling faster than we forecast. However, that revision applied to all states, equally enough so that the burden estimates came down with rankings mostly unchanged.
- As the JFO pointed out, and as the Maine policy community had been complaining for years, unlike other tax sources which we adjusted for non-residency, we had not been able to do so for property taxes. We simply did not have a nationwide dataset of non-resident property ownership and tax payment.
  In 2008 we devised a proxy for non-resident property taxes, and the result was exactly what the JFO had predicted the year before and to which we had testified before your Ways and Means Committee in late 2007: states with the most vacation homes dropped in the ranking. Maine, Vermont and Wisconsin dropped the most.

In summary, Vermonters have a high tax burden by any measure, and for its citizens to be happy about that, they need to believe that their government services are superior, which they may be. Our study makes no attempt to judge which states' citizens are getting the best bang for their tax dollars, and we refer to the highest-taxed states as the "highest," not the "worst" for that reason.

Many legislators, however, are taking Table 6 to be the report's most important finding, concluding wrongly that whichever state has arranged its tax system to maximize non-resident collections is the winner. From our perspective, that's an unfortunate conclusion since it leads to exorbitant taxes on rental cars, lodging, local sales tax rates in college towns and resorts, and businesses generally, none of which meets any tax reformer's definition of sound tax policy.

**State Business Tax Climate Index, FY 2010**
The Index could be called our guide to re-arranging tax systems. Or it could be called a declaration of war against the nation's economic development specialists and the three-legged-stool crowd.

It pays almost no attention to collections and focuses instead on statutes. How high is the rate? How many brackets? How many credits, exemptions and deductions? In each of the 5 tax areas measured—corporate income, personal income, sales, unemployment insurance and property—we want the answers to reflect the classic mantra of all tax reformers: broad base and low rate.

We punish sales tax exemptions for gasoline or groceries, no matter how popular those may be with leaders of both parties. Nor do we want to see a flurry of corporate tax credits, and among those, we consider that the more targeted they are, the worse. Our pet peeve of the moment is film tax credits, which may take the cake for worst tax investment possible from the perspective of state revenue.

We observe that states are much more reluctant to enact politically motivated deductions, exemptions and credits if they don't have other every other tax handy to make up the revenue. So the absence of a major tax is a plus for a state tax system. We observe that it saves a considerable amount on tax enforcement to concentrate tax collection activities, and in those remaining taxes, it enforces a discipline that preserves the integrity of the tax base.

And we see no evidence to support the standard critique heard from tax collectors on this point, the virtue of a "three-legged stool," that is, an approximately equal reliance on income, sales and property tax revenue. On the contrary, the 12 states that do without a major tax do not experience more revenue volatility or budget problems than states that levy every tax in the arsenal.

As for the economic development specialists, they are urging an aggressive giveaway campaign in response to the economic downturn, believing that the only way to grow business in state is to bribe them to move in or expand. We believe just the opposite. A state that grants huge tax concessions to prospective businesses is administering a sharp slap in the face to every resident business and usually for little or no payoff. The Kelo and Dell fiascoes in Connecticut and North Carolina are only the best known.

We are aware that multi-state businesses have gotten quite good at playing the states and counties off against each other, but to coin a phrase, just say no. If your statutory tax rates are reasonably low, which you'll be able to achieve if the state legislature doesn't carve up your tax base as gifts for powerful constituencies, resident firms and prospective new arrivals will know that the playing field is level. That confidence is worth a lot. I'm not saying a state should never promise a highway exit or sewerage provisioning for a big incoming firm. I'm just saying that when you pave the road to Vermont with corporate and property tax credits, you treat your existing taxpayers with disrespect.

Vermont ranks 41st in the Index, worse than all but 9 states. Luckily, in a sense, one of those states is New York, so there is some incentive for upstate NY businesses to look across the border and consider Vermont's tax system as an improvement, hopefully more of one after your recommendations are signed into law. Massachusetts ranked 36th best, and New Hampshire ranked 7th best.

Two years ago I suggested to the Ways and Means Committee that Vermont could dispense with its general sales tax, and I repeat that suggestion now. Your sales tax collections are fairly low, and such a radical change would make news, which is exactly what you want to do. If enacted on a revenue neutral basis, some of the recently enacted tax preferences in your income taxes would have to go.

**Progressivity**
I suggest repealing your general sales tax in part because the Oregon/Delaware/Montana model of total reliance on income and property taxes should appeal to the Vermont electorate.

In many cases, the argument that sales taxes are regressive has been grossly exaggerated. (Prof. Crain at George Mason University has published some convincing analysis on this point.) But replacing sales tax revenue with income tax revenue would almost certainly increase progressivity to some extent.

The Index does indeed treat Vermont's tax system harshly, but the absence of a sales tax would outweigh any hikes you enact along with the repeal, and your ranking would probably rise from 41st to something around 20th. Oregon ranks 14th best.

**Conclusion**
Vermonters' tax burden is comparatively high, and the state tax code is comparatively inhospitable to business activity. Those are the basic conclusions of our burden study and the Index.

To what extent do those conclusions agree with official in-state analysis? From Volume 1 of the JFO's 2 volumes on tax reform, we would like to single out the description of tax neutrality on page 13. We endorse every word of that passage and urge lawmakers to repeal some of the targeted credits, deductions, exemptions and special rates, leading as they do to a combination of high statutory rates with low collections.

The JFO's Volume 2 seems designed to prove that even a heavy tax burden is okay if it's mostly shouldered by higher-income people. However, our Index doesn't find Vermont ranking particularly well on some of the taxes known to hit the poor hardest. For example:

- Most regressive is your cigarette tax, $2.24 per pack, 7th highest;
- Your beer tax is 26.5 cents, 18th highest;
- Your modest gas tax is 20 cents, 39th highest;
- Your lottery taxes are high, which you'll hear more about from Ms. Hansen in a moment; and
- Your sales tax rate is 6%, tied for 13th highest with 10 other states;

You're already comparatively hard on high incomes with a top rate on wages of 9.4%, sixth highest nationwide, but you're hard on the middle and upper-middle too: your 7% rate on income between $34K and $82K is exceeded throughout that income range in only six states, and in two other states in part of the range. Three other states levy the same 7% rate in that middle-income range.

The residents of New York, New Jersey and a few other states will probably continue edging out Vermonters in the burden and Index rankings, but whether they do or not, Vermont's legislators would be well-advised to take bold action. Getting out of the bottom 10 is too modest a goal when it's possible to leapfrog a couple dozen states. There is only so much you can extract from non-residents, and there is only so much of a tax disparity between Vermont and other states that employers and other mobile taxpayers will tolerate in the long run.

I'll close with a repetition of my warning to ignore the siren call of economic development experts. They will urge you to keep statutory rates high so that the exemption packages they offer to prospective firms will be more tempting. That's just a stick in the eye to your loyal employers in state who need a rate cut and will be galled by the sight of a red carpet being rolled out for newcomers.