Tax Foundation Testimony Before the Ways and Means Committee of the Vermont Legislature

To the committee, thank you for this opportunity for the Tax Foundation to testify. My name is William Ahern, communications director, and I'm joined by senior economist Gerald Prante.

To sum up the testimony we're about to give, we want you to make your neighboring states sweat, even New Hampshire, especially New Hampshire. We won't have succeeded if the headline that announces your tax reform is "Most Complex State Property Tax Now Most Complex Income Surtax," or "Vermont Surpasses California with Nation's Highest Wage Tax Rate," or even "Highly Progressive State Tax System Now More Progressive." Hopefully we can help you write a different headline.

I speak partly on behalf of economist Curtis Dubay, who now works for PricewaterhouseCoopers. Last spring, Governor Douglas cited Dubay's study of state-local tax burdens, which says that Vermonters are paying the highest taxes in the nation this year, 14.1% of total state income. Skeptics thought that exaggerated, and the Joint Fiscal Office (JFO) issued a rebuttal. We replied in kind, and that brouhaha is part of the reason we're here today.

The Census Bureau ranked Vermont sixth highest in their most recent year, FY 2004, and we also ranked you sixth that year. Using nationally available projections of income and taxation, Dubay then estimated that since 2004, Vermonters have risen from paying the sixth most to the most. Time will tell if that estimate is correct, but whether Vermont ranks highest or third highest or sixth highest, you should dismiss out of hand any assertion that Vermont is in the middle of the pack tax-wise, as economic development official Robert Miller was quoted saying in 2000.

Despite the similar rankings, Census and the Tax Foundation are measuring somewhat different things. Census is focused on the tax collector -- its purpose is to tally every collection, no matter if it was paid by Vermont residents or out-of-staters. We're focused on the taxpayer, and our purpose is to measure how much Vermonters are sending out in tax payments, no matter where they're sending it.

So the difference is non-resident payments. How large are they? Nowadays, hardly any tax increase in any state can be debated long before someone says it won't hurt much because non-residents will bear some of the burden. It's an especially common talking point for tax hikes on lodging and meals, rental cars, sales taxes, business taxes and, in Vermont's case, property taxes. And since that is happening in every state, a pernicious type of tax competition is at work.

Our vision of a more neutral tax system is described well on page 13 of the JFO's Volume 1. We endorse every word of that passage, and we bemoan Vermont's recent pattern of ignoring that principle of taxation. We also regret that the JFO couldn't fulfill statutory charge (c)(2) which called for the study to suggest ways to lower tax rates and broaden tax bases.

We urge Vermont's legislators not to go further down the road of non-neutrality, by which we mean targeted tax credits, deductions, exemptions and special rates. That leads inexorably to high statutory rates that raise less revenue than expected, creating pressure for even higher rates. The JFO says that in just the last few years you've enacted 19 new credits in the personal income tax, and a cynic might conclude that each one of them has been paid for by the state's poorest residents, namely cigarette smokers.

Yet a recurring theme of the JFO studies is Vermont's progressive forgiveness to the poor. Our study of state-local burdens includes all totals with no reference to income levels, but scanning the rates of taxes known to hit the poor hardest, we see little evidence of a forgiving approach.

- The JFO ranks you third highest in excise collections per capita.
- Your sales tax rate is 6%, 25th highest.
- Your cigarette tax is \$1.79, 10th highest, and a 20-cent hike is already set in law.
- Your gas tax is 19 cents, 29th highest.
- Your beer tax is 27 cents, 15th highest.
- Your 9% meals tax applies to fast food.
- Your lottery sales are 23rd highest per capita.

It's popularly claimed that your sales tax exemptions for groceries and clothing are great concessions to the poor, but they're actually badly targeted and should be scrapped or greatly reduced to bring the rate down. In fact, you're collecting so little in general sales tax revenue that you should consider scrapping the tax entirely, both for progressivity and to compete with New Hampshire retailers along the river. As for the cigarette tax, how would any normal person react if the state enacted a tax on his particular vice equivalent to 5 percent of gross income? The smokers' answer has been to buy elsewhere.

We do agree that you've succeeded in imposing a very progressive personal income tax with a rate on high wages of 9.5%, second highest nationwide. You're hard on the upper-middle too: the 7.2% rate on couples' taxable income between \$50K and \$120K is only exceeded in six states. You could bring both of those down by broadening the base, which Gerald will speak on.

Your corporate tax rates have no progressive logic whatsoever, so while you've made a first stab at improving them, we recommend that you enact a one-bracket 7% corporate tax rate and start getting the word out that you have the lowest rate in the Northeast.

New Yorkers and Mainers may ultimately edge out Vermonters as the state residents who pay the most for government, but whether they do or not, Vermont's legislators would be well-advised to plot a course for somewhat lower tax rates. 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 by urging you to take this tax reform opportunity to do something big, much bigger than just replacing property with AGI as the base for a school tax. To make New Hampshire sweat instead of smile, you must turn away from the siren call of so-called economic development experts. They will urge you to keep business income and property tax rates high so that the exemption packages they use to bribe prospective employers will be more valuable.

Every one of those deals is 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.

Now, I'll turn it over to Tax Foundation senior economist Gerald Prante.

Options for Funding Education in Vermont: Income Tax vs. Property Tax

I would like to thank you for letting Bill and me speak on this property tax issue.

I would first just like to say that Vermont's entire tax structure is in need of changes. Regardless of the political debate about what the level of taxation should be or how progressive the tax structure should be, you could do much better by reforming the system even while maintaining whatever spending and progressivity levels you desired.

Vermont's state government plays a uniquely large role in education funding, allowing little control at the local level. This may not be ideal because it reduces tax competition among localities and local control generally. In other states proponents would claim these problems are outweighed by the gains in equality of educational resources. However, because Vermont has less regional economic diversity than many states, this argument seems weak. Nevertheless, that bridge has been crossed, and our analysis will avoid suggestions that you reverse course even though we suspect that you should.

Therefore, assuming this baseline, the question that has come up is: Should we fund state spending on education via the traditional funding source, property taxation, or should we fund it via an income tax, or both?

I'll start by talking about reforming the property tax and then discuss the income surtax revenue-neutral reform option that would be put in place of the property tax.

REFORMING EXISTING PROPERTY TAX

First, eliminating the education tax *only* on residential property is not sound tax policy. Businesses should not be forced to pay a property tax while homeowners do not, and trying to adjust it for landlords (a type of commercial property) is not only difficult but bad tax policy. Such distortions in tax rates between different types of property will further misallocate capital between housing and non-housing sectors. Housing is already one of the most favored industries in terms of taxing capital. The Congressional Budget Office actually cites a negative effective tax rate on owner-occupied housing capital. Other academic economists find similar significant preferences for housing in the American tax system and such preferences have been criticized extensively by those on both the right and left. There is no need for further preferences for housing via the tax system.

If you choose to stick with the property tax as a revenue source, I would suggest simplifying it from its existing complexity and making it more efficient. Circuit breakers may sound good politically and some may be due to a desire to help the poor, but there are better ways. Why not impose a flat tax on all property with no circuit breakers that raised the necessary amount of revenue to fund education? (The rate would be adjusted each year depending upon the projected base and required spending amount.) Then if you were concerned about how such a move could harm the poor in Vermont, you could change the progressivity in the state's existing income tax, reduce the state sales tax, or expand your EITC program to the extent that it offsets the loss in progressivity from the simplification of the property tax?

And under this type of flat property tax, if one is concerned about economic efficiency, there is also the option to tax only the land value and not the value of structures, or the classic Henry George land tax. The main benefit of this Georgist proposal is that it is much less distortionary because land is essentially fixed in supply. The main downside is the possible difficulty in trying to assess the value of a property that is due to the land versus structures, plus the transitional effects and possibly unfairly impacting economic decisions that were made under the assumption of a full property based tax. On the other hand, it would lead to less of a need to monitor changes in structures each year like when someone adds on a shed to the back of a house.

Ultimately, this comes down to normative questions of what the proper tax base should be, which is itself dependent upon one's view of how taxes should be levied – ability to pay or the benefit principle or some other moral view? And this brings up the next issue that I will now briefly address – the income surtax option.

INCOME SURTAX

The two main arguments that proponents of switching from the current property tax funding mechanism to an income tax mechanism have used are simplicity and fairness. In terms of simplicity, it is true that the current system of property tax bills being a function of income in Vermont is overly complicated and something should be done to simplify this. Thinking deeper, however, what your concern for ability to pay has given you is almost like an income tax already. If you have many circuit breakers and differing tax rates on property based upon income, you have a quasi-income tax already.

On the issue of fairness, this is in the eye of the beholder, but some have concerns for the degree of progressivity in a tax system. Unfortunately, the degree to which the property tax is progressive or regressive is unclear in the economic literature. For example, under one theory, if you were to suddenly eliminate the property tax, such a change would mostly benefit current property owners as they are the existing landowners. Therefore, the property tax is likely progressive under this theory. However, if you switched to an income surtax in place of the property tax, it would likely make your state tax system even more progressive.

On the issue of the education surtax, regardless of whether you should switch to an income tax or not, I would commend those who are advocating for the income tax switch for suggesting that AGI be used instead of a narrower base like taxable income. A broader base allows for lower rates to raise the desired level of revenue. If this proposal becomes law, I urge you to resist any pressures from special interest groups to provide further exemptions or deductions that would shrink the tax base. If you give into these pressures, in the end, your income tax will end up looking like the Swiss cheese that we see in the federal tax code; and we'll be back in this same position a few short years from now. In fact, I would urge you to make your current income tax more like this suggested surtax in terms of the base. Unfortunately, over the past ten years, the Vermont state income tax has gotten worse as the number of credits and deductions has exploded.

If you are going to go to a surtax, another suggestion would be to just eliminate the property tax altogether in the state by some constitutional statute. We typically don't favor such a move as it reduces local control, but if you are going to reduce its revenue significantly by eliminating the education tax component, the fixed costs of administration and enforcement may not be worth the remaining revenue raised from taxing property at the local level. On the other hand, raising tax rates in an income tax system that you already have, while it does have negative economic consequences, does not increase substantially compliance or administrative costs except to the degree that higher income taxes lead to higher evasion rates. A local option income tax that piggy-backs off the Vermont income tax or a local option sales tax could be more efficient than having a small property tax. We can't give you an answer on which is better, and this may be worth an empirical study by researchers in either Vermont government or academia.

TAX EXPORTING

One final issue is the effect that various tax policies could have on tax exporting. As you know, your neighbor to the east, New Hampshire, has no state income or sales tax. Therefore, any policy change you make should keep in mind the possible border activity or migration that could result from the policy change.

CONCLUSION

In closing, I would like to emphasize three important points made:

(1) If you're going to do an income tax, do it right; and a broad base like AGI with few deductions or exemptions is the way to go.

(2) While we typically do not favor outright elimination of a property tax, given the costs to government of enforcing a property tax throughout a state, if you're going to get rid of the education portion of the property tax, it may be worth exploring elimination of the property tax altogether at all levels of government and having localities possibly piggy back off the state income or sales tax.

(3) The current statewide education property tax needs fixing. With its current exemptions and circuit-breaker clauses, it's almost like an income tax already. If keeping a property tax meant keeping this terrible property tax in place, you might as well go to an income tax. I would suggest possibly sticking with the current property tax yet eliminating all

those special provisions even if it meant higher property tax payments on the poor. It is likely better to help lower-income individuals directly through the income tax where provisions to help the poor already exists or through lowering of other taxes known to hit the poor such as the sales tax rather than through mucking up the property tax.