State of Vermont
Department of Taxes
133 State Street
Montpelier, VT 05633-1401

Agency of Administration

November 26, 2013

Rep. Shap Smith, Speaker of the House
Sen. John Campbell, President Pro Tempore
Vermont State House
115 State Street
Montpelier, VT 05633-0004

Dear Speaker Smith and President Pro Tempore Campbell:

This letter is required by statute in order to publish the projected statewide education tax rates based on current law and forecasts. It marks the start of a critical dialogue between the school boards that must present budgets to local voters at Town Meeting and state policymakers who must set the tax rates based on those locally-voted spending decisions and other factors. The letter strives both to fulfill a statutory duty and provide perspective that will inform the work of the administration, the legislature, and local leaders as we pursue educational excellence that is affordable for our taxpayers.

Statutory Charge

The Commissioner of Taxes, after consultation with the Agency of Education (AOE), the Secretary of Administration and the Joint Fiscal Office (JFO), is required by 32 V.S.A. §5402b to recommend adjustments to the statewide education tax rates by December 1 if certain conditions are met. The Department of Taxes, Department of Finance and Management, AOE and JFO have prepared consensus forecasts on various components of the Education Fund Operating Statement for Fiscal Year (FY) 2015 in order to inform this required analysis.

This letter is submitted in fulfillment of that statutory obligation, and proceeds in six parts. First, the letter examines pressures on the current financing mechanism. Second, the letter discusses the Section 5402b(a)(2) mandate on the Commissioner to recommend an increase in tax rates. Third, the letter analyzes the Section 5402b(a)(3) and (4) mandates on the Commissioner to recommend possible adjustments between the homestead and nonresidential rates. Fourth, the letter addresses the Property Tax Relief Fund. Fifth, the letter sets forth spending scenarios that would avoid the rate increases. Sixth, the letter considers potential modifications to our education finance system that would more closely align spending decisions and tax consequences. The letter concludes with a discussion of a potential next step in our mutual goal of maintaining educational excellence and affordability.

Pressures on the Existing Finance Mechanism

Vermonters can be proud of our education funding system. Act 60/68 has enhanced equity and quality in education to a degree not seen in other jurisdictions, while maintaining local control. However, the Administration shares growing concern that the increases in local spending cannot be sustained, particularly in times of limited resources.

The Legislature has spent a great deal of time on the local spending issue, each biennium considering various studies and measures. Act 68 initially contained a penalty rate for districts that spend 125% or more over the prior year's statewide average cost per pupil; this threshold was reduced in the last session. From FY 2010 until repeal in FY 2014, the law also required that a district pass two votes if its spending was proposed to increase over an inflation factor after exceeding the statewide average in the previous year. Last session, the Legislature considered a number of other measures, from limiting rebates for renters, to mandating student-staff ratios. Further, every year there are debates over who might pay more, whether through an increased general fund transfer (at the expense of other programs) or through a reallocation of burdens between the various education fund taxpayers.

A review of the components of the tax rate calculation for the next fiscal year demonstrates that similar pressures remain on the tax rate despite these efforts.

Education Components

There are three main education components impacting the base tax rate:

- *Equalized Pupil Count*: The number of equalized pupils is projected to decline once again, falling by approximately 539, from 89,938 to 89,399. The drop would be even more dramatic without the addition of critical Pre-K sections.
- *Base Education Amount (16 V.S.A. §4011(b))*: The base education amount is set to decline this year due to the inflation calculation. When Act 68 passed, a base education amount was established, representing the amount per pupil that would be supported by the base homestead rates. Amounts spent over the base would trigger local spending adjustments (although the spending adjustment must be understood as solely a pricing mechanism since all revenue is raised and pooled statewide; in no case does a town raise what it spends). Section 4011(b) requires that the base education amount be reset annually incorporating inflation for all the intervening years since 2005 using the State and Local Government Price Index. The base education amount per pupil had been frozen at $8,544 for three years through FY 2012, and then in FY 2013 and FY 2014 the base amount increased a

total of $607 (to $9,151) to catch up with inflation.[1] This year, FY 2015, the price index recalibration from 2005 forward results in a *decrease* of $42, to $9,109, due to the very low inflation rate. A lower base amount also lowers pressure on the base rates. However, the lower base amount for a lesser number of students is countervailed by early information from the AOE that projects that districts may vote for significant new spending.

- *School Spending:* School spending approved at the local level continues to rise. The Governor and other leaders have emphasized that only by holding total spending flat could school boards and local voters avoid rate increases. However, we saw approximately a 3% increase in spending in FY 2013, and a 5% increase in FY 2014, even though the equalized pupil counts fell 1629 in that time period. In terms of total dollars, spending increased more than $90M. Next year, projections from the AOE suggest that spending may increase another 3.8%.

<u>*Education Tax Revenue*</u>

Our education tax revenue comes from different rates on three types of payers: a uniform statewide rate on value for nonresidential owners (land, commercial, and second home owners); a base rate on value for homestead owners that is adjusted for district spending; and finally, for qualified households, a base percentage of income that also is adjusted for district spending. The trend in the value of properties, as well as the trend in property tax adjustments for income-qualified households, exerts pressure on property tax rates.

- *Grand List:* The statewide grand list is again projected to decline slightly, down roughly 0.5%, in value from FY 2014. Lower values mean that last year's rates on property will raise less money to spend per pupil. As discussed below, it is estimated that in the current economy, the grand list will recover and increase in value in future years (from both the uptick in new construction and appreciation of individual property value). But we will likely not soon return to the rates of growth that we saw when Act 68 first passed in 2005 – growth that allowed for rate cuts even while spending grew.[2]

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[1] The base amount was frozen for FY 2010, 2011 and 2012. In the depth of the Great Recession, school leaders worked hard to keep spending down while drawing on available federal stimulus money. Vermont school spending rose only $15M over this three year period. Unfortunately, as discussed above, in the two years since, Vermont school spending has risen over $90M.

[2] From FY 2005 to FY 2007, total education spending increased over $50M each year, even while the property tax base rates were dropped $0.10 over the two years, and the income base tax rate was dropped from 1.9% to 1.8%, due to higher property values and incomes.

- *Property Tax Adjustments:* Forecasting adjustments for income-sensitized taxpayers is complicated by year-to-year changes in the components of household income, fluctuations in the number and composition of households qualifying, and variations in the size of adjustments. For FY 2015, Education Fund adjustments are projected to increase $7.9M.[3]

5402b(a)(2) Mandated Recommendation

Given these factors, the consensus forecast is that the balance in the stabilization reserve would fall below three and one half percent, under current law, if the current statewide education tax rates of $0.94 and $1.44 were applied. Therefore, 32 V.S.A. §5402b(a)(2) requires me to recommend that the base homestead property tax rates be increased. Filling the reserve to 5%, under current law, requires a $0.05 increase in the base homestead property tax rate to $0.99, and a commensurate increase in the uniform non-homestead property tax rate to $1.49.

The base homestead income rate remains at 1.8% for the coming year pursuant to §5402b(b). The base income tax rate was originally set at 2% in statute, corresponding to a base homestead property tax rate of $1.10; it was lowered in conjunction with the property tax rates until it hit the statutory floor. Maintaining the original proportionality pursuant to §5402b(b) means that the base income tax rate is set to rise only when the base homestead property rate reaches $1.00. It must be noted that raising the base income tax rate also imposes a cost on the General Fund, in order to maintain rebates that cap the total amount of property taxes paid by certain qualifying low income households. So for example, if the base income rate was raised to 2% this year, $0.015 could be taken off the increase in the property tax rates; however there would be an additional $1.2M cost to the General Fund.[4]

[3] Over $13M in additional non-property revenue is available for FY 2015. Pursuant to FY 2014 budget language directing surplus to the Education Fund, $1.3M was added to the base amount of the general fund transfer. Then using the State and Local Government Price Index (for this purpose, linked to year 2012) the transfer is set to increase $6.8M to $295.7M. There are several other sources of non-property tax revenue that contribute to the Education Fund, and like the general fund transfer, they are all up, for an additional $6.8M. The sales and use transfer is up $4.2M, the purchase and use transfer is up $2.1M, and the lottery transfer is up $.5M.

[4] Act 143 of 2012, Section 40 requires that the Commissioner also calculate the dollar equivalent of revenue per equalized pupil that would result under a homestead property tax rate of $1.00. Incorporating all of the current law assumptions, the dollar equivalent is $9,201 per equalized pupil in a given district. Section 40 suggests that the dollar equivalent rate assume a 2.0% base homestead income rate. This is not possible in the current year, since the base income rate remains at 1.8%.

Both the \$0.99 and 1.8% base homestead rates will be subject to adjustment based on local spending decisions. For FY 2015, with a base rate of \$0.99, the projected average equalized homestead property rate is \$1.55.[5]

<u>Section 5402b(a)(3) and (4) Triggers: Consideration of Adjustments Between Rates</u>

The law contains triggers related to the nonresidential tax rate and its relationship to total spending and residential tax rates. Section 5402b(a)(3) directs the Commissioner to consider adjustments to the nonresidential rate when it fails to raise at least 34% of total education spending. Section 5402b(a)(4) is triggered "in any year in which the nonresidential rate is less than the statewide average homestead rate." This subsection directs the Commissioner to "determine the factors contributing to the deviation in the proportionality of the nonresidential and homestead rates and make a recommendation for adjusting statewide education tax rates accordingly." FY 2015 projections show that the nonresidential rates yield over 34% of total projected education spending; however, for the first time, these same projections show that the statewide average adjusted homestead rate would be higher than the nonresidential rate.

<u>The Nonresidential Rate Continues to Raise More than 34% of Total Spending Under Section 5402b(a)(3)</u>

In FY 2014, nonresidential payers funded over 37% of total spending. In FY 2015, with the recommended rate of \$1.49, this share is projected to increase slightly to 38%. Therefore, this statutory provision has not been triggered.

<u>Factors Causing a Higher Average Adjusted Homestead Rate Pursuant to Section 5402b(a)(4)</u>

Three factors contribute to the projected statewide average homestead rate rising above the recommended \$1.49 nonresidential rate:

- *Base Education Amount:* As explained above, the base education amount is tied to the State and Local Government Price Index using 2005 as a base year. After large increases in the past two years, the base amount decreases slightly this year due to very low inflation. Meanwhile, school spending in Vermont has grown faster than this price index since 2005, meaning that the proportion of spending reflected in local adjustments to the rates has increased.[6]

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[5] As with any average, it can be expected that the adjusted rates will vary greatly from town to town based on spending decisions. In FY 2014, the statewide average spending adjusted tax rate was \$1.41. However, in 101 districts (39%), the homestead rate was higher than the uniform statewide nonresidential rate of \$1.44.

[6] As discussed, it must be understood that the spending adjustments to the rates are only pricing mechanisms. It is always true that a district that spends more per pupil will have higher spending adjustments applied to the base

- *Year to Year Base Rate Adjustments:* In prior years, rapid growth in property values allowed for the base rates to be cut–even in the face of increased spending. In that period, the nonresidential and homestead base rates were reduced by equal pennies rather than by equal percentages. Homestead rates therefore experienced proportionally greater reductions since the rate was lower than the nonresidential rate. In more recent years, both rates have been raised in most cases by equal pennies, meaning that the homestead rates have now experienced proportionally greater increases in recent years.[7]

- *Spending:* Spending has increased at a greater rate than inflation, and also at a greater rate than the growth in the revenue sources dedicated to education. The financing system reflects local spending decisions in local spending adjustments. Again, it must be emphasized that these spending adjustments are simply pricing mechanisms for the overall system. In no case does a local district directly absorb the total cost of its own education budget; all spending decisions are spread across all our education revenue sources. However, local decisions to increase spending lead to higher spending adjustments which are in turn driving the growth of our total education spending statewide.

<u>*Section 5402b(a)(4) Mandated Recommendation*</u>

Section 5402b(a)(4) provides that "in any year in which the nonresidential rate is less than the statewide average homestead rate, the Commissioner of Taxes shall determine the factors contributing to the deviation in the proportionality of the nonresidential and homestead rates and make a recommendation for adjusting statewide education tax rates accordingly." If this statute were interpreted to require a recommendation such that the nonresidential rate be set higher than the projected average statewide homestead rate, the nonresidential rate would need to be raised by $0.08 to $1.52, and the base rate increase for homesteads would need to be limited to $0.03.

It is, however, my opinion that such an adjustment to rates is not warranted. In one sense, the formula, as applied, has done what it was designed to do, which is create a consequence in the homestead rates in districts that have voted to spend at higher per pupil levels.[8] In FY 2015,

homestead rates. However, no district raises sufficient money from its homestead payers to cover its budget; all education revenue, from non-property and property sources, is pooled statewide to meet spending.

[7] Last year an additional cent was added to the nonresidential rate, departing from the general rule to raise or lower each rate by the same amount.

[8] In comparing spending by districts, it is important to remember that the formula has had various adjustments over the years when the Legislature has chosen to mitigate a circumstance for a district, including small school size, rapidly growing student population, construction, and extraordinary special education costs.

even though a base rate of $0.99 generates a statewide average spending adjusted homestead rate that is projected to be over $1.55, an individual district has to spend more than 50% over the base rate to experience that result. Moreover, the total spending funded by nonresidential payers remains above the 34% level of sufficiency set forth by statute in Section 5402b(a)(3). Therefore, by another measure in the statute, nonresidential property owners are still bearing an appropriate proportion of spending.

Rather than focusing solely on rates, it is instructive to look a few different ways at the amounts of revenue raised by the different taxpayers, to determine who is bearing the brunt of the education spending increases. The story that emerges is that although the share of total spending paid by nonresidential payers has fallen somewhat, a bigger shift has occurred with respect to the increasing contribution by homestead owners who do not qualify to pay based on income.

Consider the percentage of education taxes (versus total revenue) raised by the three types of payers. In the first year of Act 68, FY 2005, nonresidential property owners contributed 60.3% of the total education taxes. In FY 2014, that percentage had fallen somewhat to 56.4%, compared to the 43.6% paid by homestead property owners.

Furthermore, consider the rate of growth in revenue raised by the three payers. Overall, education taxes increased 10.3% from FY 2009 to FY 2014, but the growth was unevenly distributed. From FY 2009 to FY 2014, the amount of tax raised by nonresidential payers increased a total of 4.1%, while the amount raised by homestead owners who pay based upon on income increased a total of 9.1%, and the amount raised by homestead owners who pay based upon property value increased a total of 25.4%.[9]

Some may argue that the formula has worked precisely as designed. Even though statewide revenues are pooled and distributed across the state, there is a consequence in homestead rates for districts that choose to spend more and, cumulatively, that has meant that as education spending has grown, taxes have shifted somewhat to homestead owners. The formula however is designed to incorporate affordability, so that shift has not been spread equally across all homesteads.

[9] It is important not to extrapolate these trends to individual taxpayers, since the groups are very fluid. For example, a second home one year may be someone's residence the next. Households are also constantly moving from paying on income to paying on property value – household composition changes, household income determinants change, etc. In several years, the total number of households paying on income fell. Moreover, property values have been volatile in this period. By one rough measure, nonresidential properties may have held their value better over the entire period since Act 68 was enacted – in FY 2006 they comprised 50% of the total grand list, and in FY 2013 they comprised 52%. Again, it is difficult to extrapolate: within the categories, rates of new construction likely have varied, existing second homes likely experienced a greater decline in value than commercial properties, and values differ geographically.

Tweaking the rates to recalibrate the formula around the edges simply redistributes the burden. There is now an opportunity instead to examine in a comprehensive way how the formula is functioning overall—a decade after enactment—and to consider the underlying question of whether there are appropriate incentives or disincentives to limit spending to a sustainable, affordable level.

After consideration of all the above, I recommend continuing to take our previous approach to implementing the statutory rate increases for FY 2015 by adjusting the residential and nonresidential rates equally. I furthermore recommend that the Administration and the Legislature work this year to examine possible comprehensive modifications to limit spending growth rates going forward.

Supplemental Property Tax Relief Fund

In the FY 2014 Budget, the Legislature directed that a certain amount of any general fund surplus be directed into the base general fund transfer (this amount turned out to be $1.8M), and a certain amount be directed into a "Supplemental Property Tax Relief Fund" established in 32 V.S.A§6075 (that amount turned out to be $11.8M). The uses of this fund include the "development of proposals for property tax relief," including "incentives or rewards to promote or control education spending while improving quality."

If approximately $10M from this fund were directed to the Education Fund to reduce rates in FY 2015, the base rates could be set at $0.01 less. While it is likely that the Legislature will examine this approach in order to provide some relief to the overall property tax increases, I urge careful consideration prior to deciding whether to utilize the fund in the manner. Instead of across-the-board rate decreases, the surplus fund could be directed more strategically as an incentive for cutting spending. In that way, the money would be leveraged to yield further savings in the future, and assist in the goal of bringing spending to a sustainable level in the longer term. I recommend that the Administration collaborate with the Legislature to design appropriate incentives.[10]

Alternative Scenarios Based on Lower Spending Decisions

The statutorily-required recommendations outlined above are premised on a projected 3.8% growth in education spending. Rate increases will be mitigated if the budget decisions of the local voters yield a lower rate of growth. If overall spending was level funded, the rate increase would be $0.025. If spending increases were held to 2%, the rate increase would be $0.035.

[10] For example, the adjustment to rates could be modified such that, in addition to a penalty rate for jurisdictions voting to spend over a certain threshold, there could be an incentive rate for jurisdictions that spent under a certain threshold, or that held to a certain growth rate.

The cost drivers are well known. Salary and health care costs for personnel are often cited as "fixed" costs – however the number of staff employed can be adjusted, particularly with falling enrollments. The Legislature has taken up the issue of whether staff-student ratios need to be mandated or at least recommended. Additionally, large schools are encouraged to capitalize on their economies of scale, while small schools can explore existing innovations in education delivery methods. Economies of scale may be achieved between supervisory unions through combined purchasing or other initiatives. The falling number of students, as well as the falling State and Local Government Price Index, suggest that level funding should be achievable in many districts.

Consideration of Modifications to Act 60/Act 68

It has been over 15 years since the *Brigham* decision and the legislative response, Act 60. It has been 10 years since the enactment of the only major amendment to Act 60, Act 68. In 2012, the Legislature engaged a leading national expert, Lawrence Picus and Associates, to study whether Act 60 and Act 68 had achieved their goals. The conclusion of that legislative study was that Vermont had indeed achieved equity, at the same time that quality was demonstrated through academic achievement of our K-8 students. Local control has been preserved. The question raised by the study, however, was whether Vermont could achieve these results at a lower cost. Vermonters spend a higher proportion of income per capita on education than any other state, and although the academic results are impressive, peer states have seen comparable achievement at a lower price.

PreK-8 education carries not only its own price tag, but also opportunity cost as it competes with other spending priorities – for example, higher education that is critical in today's job market. This year is a very opportune time to examine whether our funding formula is optimal, or whether it could be adjusted to better align spending with revenues, while still preserving equity, quality, and local control.

Two possible modifications are suggested for consideration in this letter. Currently, the penalty rate is tied to the previous year's average spending, which means each year's overall growth is automatically built into the threshold the next year. The threshold spending level instead could be fixed, for example at the FY 2014 statewide average spending, and then grown by the State and Local Government Price Index. Under that scenario, the penalty would be triggered by district spending growth that exceeded the inflation factor. An additional modification could be to include a lower incentive rate, as well as the higher penalty rate. The incentive could be available to districts that kept spending growth below a certain target.

Conclusion

The letter describes the ongoing tension between educational excellence and affordability. The Administration is committed to taking steps to consider the best way forward for all Vermonters and nonresident taxpayers. Accordingly, the Administration intends to partner with the legislature to co-host an education finance symposium of local and national finance experts. We will engage Lawrence Picus to convene a group of local and national finance experts in January to consider and suggest modifications to the funding formula that might more closely align local spending decisions with local and individual tax consequences, while balancing equity, quality, and local control.

Thank you for your consideration. As always, this Administration is committed to working with legislators and local leaders towards educational excellence that is affordable for our taxpayers. In the meantime, I extend my gratitude to staff at the Department of Taxes, Department of Finance and Management, AOE and JFO, for the enormous collaborative effort in assembling the data necessary for the projections that underlie the statutory recommendations herein.

Sincerely yours,

Mary N Peterson

Mary Peterson
Commissioner, Department of Taxes

cc: Jeb Spaulding, Secretary, Agency of Administration
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