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Vermont Tax Structure Commission - Introduction and Summary of Recommendations

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DEB BRIGHTON, STEPHEN TRENHOLM, BRAM KLEPPNER

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Introduction

> *In some respects, the history of taxation in Vermont is the history of a state trying to deal with alternatives to the property tax, or trying to find a better way to tax income.*
>
> \- Paul Gillies, "The Evolution of the Vermont State Tax System"

This report is written by three Vermonters of different backgrounds and varying tax system experiences.[1] We first convened in December 2018, tasked by the Legislature and Scott Administration with developing long-term recommendations to help make the State's overall revenue system more fair, more sustainable, and simpler. From the beginning, we committed to operate by consensus. We believed, and continue to believe, our commission should only put forth recommendations that all three of us can support.

We worked for almost a year and a half before COVID shut down much of Vermont in March 2020. Given the uncertainty in the early days of the pandemic around the nature of the disease and its potential effects on our society and our economy, we suspended our work for two months. Once it became clear that some economic activity would continue, and that there were measures people could take that would allow them to keep functioning during the pandemic, we resumed our work.

As we deliver this report at the start of 2021, infections and deaths are climbing across the country, but the distribution of effective vaccines has allowed us and everyone else to look forward to a post-pandemic world.

The pandemic impacted both the logistics of our work as well as the data and issues we were tasked with analyzing.

In terms of logistics, we had hoped to travel the state to hear Vermonters' concerns and to talk through priorities and solutions in-person. We did hold meetings in the State House and various public libraries throughout our first year. We also scheduled a spring 2020 series of community panel discussions with experts to explore key revenue issues. Alas, that series had to be cancelled and our last several months confined to public Zoom meetings. All told, we still managed to hold more than three dozen public meetings, both in-person and online, and take written and oral testimony from more than 60 experts and members of the public.[2]

The process concluded with our publishing a draft report in January 2021 with a two-week period for public comment. The questions, suggestions, and critiques that we received from business and professional organizations, municipal organizations, legislators, local officials, tax professionals, public policy experts, and the general public were constructive and helpful in filling in gaps in the report and strengthening weak spots, and we are grateful to all who commented.[3]

[1] Commissioner biographies can be found in Appendix 1-1 of full report.
[2] Links to foundational presentations and testimony can be found in Appendix 1-2 of full report.
[3] Links to public feedback and the Commission's responses can be found in Appendix 1-3 of full report.

In terms of data, it is clear to us that the pandemic has accelerated some long-standing trends: more shopping online and less brick-and-mortar retail, more remote work, more use of video for professional and social gatherings, more telemedicine, more remote education. It is not clear that other than accelerating these trends, the pandemic will change the contours of our economy. Our data comes from the pre-COVID economy; our recommendations (summarized in the next section below) will be implemented in the post-COVID economy. We therefore have accounted for the COVID-induced acceleration of the above-mentioned trends in our recommendations, but they are not recommendations for a COVID economy – they are recommendations for a healthy post-COVID Vermont economy.

Our approach was to work within each major tax area, and among the major tax areas, to make the overall tax burden on Vermonters more fair relative to horizontal equity, with people of similar ability to pay bearing similar tax burdens, and vertical equity, with an effort to ensure that those with less ability to pay bear a lesser burden, and those with a greater ability to pay contribute a greater amount.

We recognize the *Principles of a High-Quality State Revenue System*, developed by the National Conference of State Legislatures, apply to the entire tax structure—not to each tax. No individual tax can achieve them all. We discuss these principles and Vermont's tax structure in Chapter 3 of the full report.

We recognize the conundrum posed by income and wealth, with the latter being a more accurate barometer of ability to pay but also far more difficult to assess. In Chapter 4 we discuss the interplay between income and assets and what it means for fairness. Then in Chapter 5, we present two compelling reasons to restructure Vermont's system of taxes and transfers, particularly with respect to support for low-income Vermonters.

Our predecessor, the Blue Ribbon Tax Structure Commission of 2009-2011, concentrated on income tax reform and made significant recommendations, several of which have been enacted in recent years.[4] With that in mind, we chose to concentrate the bulk of our time on education and consumption taxes and the overall tax structure.

We believe our diverse experiences are a strength and we wanted each of our voices to come through. We each drafted different sections of this report, and as a result, you may notice significant shifts in writing style from chapter to chapter.

We recognize that Vermont's school spending is among the highest in the nation and the education property tax is often cited as our state's most burdensome. Chapter 6 lays out a proposal to restructure the homestead education tax and make other reforms to the way we pay for education.

Chapter 7 enumerates steps for Vermont to dramatically expand its sales tax base while slashing the tax rate. The plan is bold, but the concept is not unique. Ten years ago, the Blue Ribbon Tax Structure Commission also called for a significant expansion of the tax base. That's two separate commissions, with six different people from a variety of

[4] A recap of the Blue Ribbon Tax Structure Commission's recommendations and subsequent legislative activity can be found here: https://ljfo.vermont.gov/assets/Uploads/c311154137/BRTSC-Recommendations_Update.pdf

backgrounds, all agreeing that it doesn't make sense for Vermont to have one of the narrowest sales tax bases in the nation.

We discuss health care taxes in Chapter 8, opportunities for income tax and estate tax modernization in Chapter 9, and obsolete and inefficient taxes in Chapter 10.

In Chapter 11 we propose a timeline for our recommendations and call attention to steps that must be taken before some of the recommendations can be implemented.

In Chapter 12, we discuss Vermont's changing landscape and how three key areas of change – demographics, technology, and climate – underscore the importance of having an agile tax structure. We provide neither comprehensive analyses nor forecasts but rather offer thoughts on how to approach the tax implications of such significant changes.

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

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

Our commission was to review how the State raises revenue, and did not include a charge to consider State spending. We did, of course, hear a great deal from Vermonters about how the State spends money. We acknowledge the concerns of Vermonters around spending, and in particular around education spending, and we recognize and are grateful for the work the Legislature has done and is doing in those areas.

We hope our recommendations improve Vermont's overall tax system in terms of making it more fair, simple, and sustainable.

Summary of Recommendations

The Commission appreciates the attention the Legislature and the Administration continue to give to guiding Vermont through the pandemic, and we agree that it should be the State's top priority this session. For this reason, we have listed our recommendations not in order of significance, but rather in an order we think can and should be implemented. We believe the first two recommendations can be initiated during these uncertain times, and they strengthen our ability to analyze, manage, and improve our tax structure.

The Commission makes the following recommendations:

1. **Undertake tax incidence analysis in order to eliminate tax burden/benefit cliffs.**
2. **Establish an ongoing Education Tax Advisory Committee.**
3. **Restructure the homestead education tax.**
4. **Broaden the sales tax base.**
5. **Modernize income tax features.**
6. **Improve administration of property tax.**
7. **Create a comprehensive telecommunications tax.**
8. **Utilize tax policy to address climate change.**
9. **Collaborate with other states so each state can build a fairer, more sustainable tax system.**

Recommendation 1: Undertake Tax Incidence Analysis in Order to Eliminate Tax Burden/Benefit Cliffs

Key components:

A. Undertake an ongoing study of income, taxes, and the transfers or benefits that help families meet their basic needs.
B. Find ways to eliminate the tax and benefit cliffs.

Although we think of taxes as payments to government, the redistribution of those payments, through benefits and credits, is crucial in determining the equity of the whole structure. A comprehensive and ongoing study of income, taxes, and the transfers or benefits that help families meet their basic needs would help future legislatures look at changes over time, recommend adjustments, and measure progress (1A).

As demonstrated in *Vermont Basic Needs Budgets and Livable Wage*,[5] different family types have different needs. Looking at the combined effect of taxes and public benefits for different family types at different income levels would reveal where the family may go backwards—earning more in wages but losing a greater amount in benefits (aka the benefits cliff). This is devastating if it is unexpected; if it is anticipated, it is a disincentive

[5] The Vermont Legislative Joint Fiscal Office publishes a biannual market-based analysis that accounts for estimated monthly living expenses in Vermont. Reports from the last two decades, including the most recent which posted in January 2021, can be found here: https://ljfo.vermont.gov

to work. We need to make it a reality for people to work more hours, take on more responsibility in their job, earn more money, and see some improvement in their ability to make ends meet.

There is a crucial link between our other recommendation to broaden taxes –particularly the sales tax—and this recommendation to analyze the current distribution of taxes and benefits, and to remedy the unintended problems. A significant portion of the new revenue resulting from the broadened sales tax would be deployed to strengthen and rationalize the distribution system to support lower-income Vermonters, and to make sure that no one is harmed by the tax changes (1B).

Recommendation 2: Establish an Ongoing Education Tax Advisory Committee

The importance of education, the size of the Education Fund, the complexity of education finance, and the fact that the yield(s) and rate(s) must be set annually lead us to the conclusion that a structured commitment to the management of the finance system is warranted.

We recommend an ongoing Education Tax Advisory Committee to monitor the system, to conduct analyses, 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. With time, study, and analysis the process would build the capacity of the members and strengthen the ability of the Legislature to manage the education finance system.

Recommendation 3: Restructure the Homestead Education Tax

Key components:

A. ***Eliminate the property tax credit.***
B. ***Eliminate the homestead education property tax, and implement an income-based education tax for all residents (owners and renters) with rate tied to locally voted budgets.***
C. ***Levy the non-homestead education property tax on all property except the residence and 2-acre site.***
D. ***Create renter credit to offset the non-homestead property tax effectively paid through their rent.***

The commissioners agree that the complexity is overwhelming the effectiveness of the current homestead education tax.

We recommend eliminating the property tax credit (3A) and levying a direct tax instead. The current system, with a homestead property tax in one year and an income-based credit coming in the following year, obscures the connection between the budget vote and the tax bill. It also leads people to see the credit as a subsidy rather than a means to calculate each household's fair share. It creates administrative issues for local officials who need to apply the credit to the tax bills, and then answer questions from homeowners. There are also confidentiality concerns, as the credit amount is an indication of household income. In addition, it means that a tax increase in one fiscal year is only partially covered in that year; some of the cost must be made up in the following fiscal year.

The current system allows homeowners to choose the lesser of the education property tax on their housesite or a tax on their income. This double system creates more than double the trouble, as it forces the match between the two systems, administered by different levels of government, with different calendars, with different confidentiality requirements. We recommend moving to a single system and, to maintain equity, the single system we recommend is a direct residential tax on income (3B).

Before endorsing income, we examined:

- Whether house value is a good proxy for wealth, and we found that it is not; house value is a high proportion of net worth for low-income households and a low proportion of net worth for high-income households.
- Whether house value is a good indication of income, and we found that it is not; a house value of average value is owned by households of all incomes.
- Whether a housesite exemption could offset the regressivity of the property tax without necessitating an income-based adjustment, and we found it could not.

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 tax burden on a given taxpayer and is the most progressive way to tax residents for education at this time.

While the historical and administrative reasons for the distinction between renters and homeowners are clear, the Commission could not find a principle-based justification for treating the two groups of residents differently. The Commission believes the locally voted education tax should be based on the income of all residents. Renters would receive a credit to offset the education property tax paid through their rent (3D). We recommend initiating a process of data collection and analysis to enable the implementation of this change.

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.

Recommendation 4: Broaden the Sales Tax Base

Key components:

A. ***Expand the sales tax base to all consumer-level purchases of goods and services except health care and casual consumer-to-consumer transactions.***
B. ***Use the gain from broadening the base to protect low-income Vermonters and reduce the sales tax rate to 3.6%.***
C. ***In health care, extend the provider tax to those provider categories that are not currently included and move to a single provider tax rate.***
D. ***Use the gains from broadening the provider tax base to lower the rate to a level below the current average rate.***
E. ***Continue to eliminate the sales tax on business inputs.***

All other things being equal, a broader tax base is more fair, more sustainable/stable, and simpler than a narrow tax base. If you combine a broader tax base with a lower rate, the new system becomes even more sustainable.

Vermont has one of the narrowest sales tax bases in the nation. There are a variety of historical reasons for the exclusion of various industries and economic categories from the sales tax. We examine each of those reasons, and find that there are only three categories whose exclusions from the sales tax still make sense: health care, whose complexity requires separate treatment; casual sales for which the administrative burden of sales tax collection outweighs the potential revenue; and business inputs (4A, 4B).

In particular, we believe there are more efficient ways to protect low-income Vermonters from the burden of a sales tax on necessities, and more effective ways to promote community goods, than exemptions from the sales tax. We also believe that there is nothing inherent in services that makes them less amenable to a sales tax than goods, and the historic exclusion of most services from the sales tax will become more destabilizing over time as services become a larger and larger portion of the consumer economy.

As part of our proposal, the Commission recommends extending the sales tax to those grocery-type items currently exempt from the meals tax, including items like whole pies, cakes, loaves of bread, etc., to be consistent with the extension of the sales tax to groceries.

We conclude that health care is not amenable to a sales tax, but that we can improve on the fairness, simplicity, and sustainability of our current system of taxing health care without limiting Vermonters' access to health care by extending the provider tax to the remaining health care provider categories that are not currently subject to the provider tax (4C, 4D).

The new revenue resulting from the broadened sales tax would be deployed first to strengthen and rationalize the distribution system to support lower-income Vermonters, and to make sure that no one is harmed by the tax changes, and second to lower the sales tax rate to 3.6% (4C).

Recommendation 5: Modernize Income Tax Features

Key components:

A. ***Expand the personal income tax base.***
B. ***Study the effect on Vermont pass-through entities of an entity-level tax.***
C. ***Examine opportunities to improve Vermont's estate tax.***
D. ***Explore options to improve the corporate income tax.***

We recommend expanding the personal income tax base by a) continuing to promote Vermont as a remote worker destination and ensuring that rural areas have the infrastructure such as high-speed broadband internet to support remote workers, and b) continuing to review tax expenditures to ensure these expenditures are accomplishing the purpose for which they were intended (5A).

We recommend studying the effect on Vermont pass-through entities (PEs) of an entity-level tax to replace the present system of nonresident withholding and composite return filing (5B). The Commission considers this study to be a long-term recommendation and not one that should be rushed in pursuit of short-term benefits, such as a workaround for the federal Tax Cuts and Jobs Act's $10,000 state and local tax deduction cap. Consider mandatory composite filing for all PEs with nonresident members. Continue to allow the individual nonresidents to file a Vermont return and take a credit for their share of the taxes paid.

We recommend examining opportunities to improve Vermont's estate tax by: a) continuing to monitor what our neighboring states and the federal government are doing relative to exemptions, b) studying in the future the possible elimination of the present estate tax structure and replacing it with a "deemed sale" type of tax on death (5C). The Commission understands the recent overhaul of the estate tax in 2016 and increase in the exemption in 2021 to $5,000,000 was a meaningful change and has made the estate tax much easier to understand and administer. The goal of the Commission is to look to the future, ten to 20 years and as such, we make this recommendation to the Legislature for future reference.

We recommend exploring several aspects of corporate income tax, including: a) the effect of adopting Finnigan with respect to unitary tax apportionment, b) the effect of adopting a Single Sales Factor approach to apportionment for multistate corporations, c) tax expenditures related to the corporate tax to ensure they are still serving their intended purpose (5D).

Recommendation 6: Improve Administration of Property Tax

Key components:

A. ***Move expenditures for mental health services and for employee health insurance from the Education Fund to the General Fund.***
B. ***Develop a program at Property Valuation and Review to appraise large and/or complicated property and to defend the appraisals.***
C. ***Study alternatives to the common level of appraisal.***

In order to align local budgets with the costs local officials can actually control, we recommend the State move expenditures for mental health services and for employee health insurance from the Education Fund to the General Fund (6A), along with proportionate revenue sources.

We recommend the creation of a program at Property Valuation and Review to appraise large and/or complicated property and to defend the appraisals (6B). 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.

Finally, we call for a study of alternatives to the common level of appraisal (CLA) (6C). The State must ensure Vermonters in different towns pay a comparable education tax on properties of equal value and therefore must be able to determine what constitutes equal value. However, the CLA can contribute to wild swings in valuation estimates and tax liability. Several alternatives have been proposed and should be studied to evaluate fairness, simplicity, and administrative burden.

Recommendation 7: Create a Comprehensive Telecommunications Tax

Key components:

A. ***Repeal the Telephone Personal Property Tax.***
B. ***Study changing Federal Communications Commission regulations.***
C. ***Craft a comprehensive telecommunications tax with an adequate revenue stream to sustainably support the Vermont Universal Service Fund, E911, and public access services.***

We recommend repealing the Telephone Personal Property Tax as it is declining every year and is based on somewhat outdated technology as a base for the tax (7A). The State should replace the lost revenue with another source based on more contemporary and long-term sustainable technology, or simply increase other telecommunications taxes on the providers to make up for this lost revenue.

We recommend creating a comprehensive telecommunications tax, with careful attention to changing Federal Communications Commission regulations (7B), that also supports the Vermont Universal Service Fund, E911, and public access services (7C).

Recommendation 8: Utilize Tax Policy to Address Climate Change

Key components:

A. ***Implement tax credits and exemptions to reduce the upfront cost of some investments that will make the transition to a low-carbon economy possible.***
B. ***Take a fresh look at the role of taxes in mitigating climate change.***
C. ***Whether it is a carbon tax or a cap-and-trade agreement, care must be taken to return revenue to lower-income households.***

Even though the Commission strives to keep the tax base as broad as possible, we support the use of tax credits and exemptions to reduce the upfront cost of investments that will make the transition to a low-carbon economy possible (8A).

We recognize that Vermont, being farther north and farther from the Atlantic than many northeastern cities, will see interest from people moving to avoid the consequences of climate change. At the same time, we recognize that intact forests are important tools in addressing climate change as they store carbon, prevent erosion and flooding, and protect biodiversity. Are we able to guide new development toward villages and away from forests? The Vermont Climate Action Commission report puts it this way: "Demographic change, greenhouse gas emissions, severe weather, and financial challenges prompt a fresh look at Vermont's smart growth strategies and land use governance as means to address climate change" (Vermont Climate Action Commission, 2018). We agree. And we recommend that the fresh look include the role of taxes in the mix (8B).

Although the tools chosen to speed the transition to clean energy may not technically be taxes, we recommend carefully returning revenue or benefits to overcome any potential regressivity (8C).

Recommendation 9: Collaborate With Other States to Build a Fairer, More Sustainable Tax System

Key components:

A. ***Add an annual road use fee to the registration fees for electric cars.***
B. ***Partner with other states to coordinate and strengthen our tax structures.***
C. ***Work with other states to develop uniform asset-reporting requirements and collect information.***

Every state in the nation is evaluating decreases in gasoline consumption as a threat to transportation funds. We recommend that Vermont add an annual road use fee to the registration fees for electric cars as their contribution to the Transportation Fund in lieu of paying gas taxes (9A). This fee should persist until the technology is available to charge each vehicle for the miles, or even better, the pound-miles it travels on Vermont roads. We also recommend that the Vermont Agency of Transportation and Department of Taxes track other approaches as they progress in other states to ensure that our system continues to evolve and adopt best practices. We note this is a first step, and that it does not address the decline in gasoline taxes caused by the transition to electric cars by visitors from out of state, who will also not be paying gasoline taxes but who will be using Vermont's roads. Over time, we expect that a portion of the tax collected on electricity will need to go into the Transportation Fund.

The Commission recommends collecting information on assets in Vermont, initiating reporting requirements if necessary, and working with other states to explore the issues and to design and evaluate possible uniform approaches (9C). The effort of the Multistate Tax Commission to bring clarity and consistency to the sales tax through the coordination of member states is a recommended model.

The Commission recommends collaborating and partnering with other states to coordinate and strengthen our tax structures (9B). Some past successful efforts include streamlining the sales tax with the Multistate Tax Commission and joining the Regional Greenhouse Gas Initiative. This type of partnership has the advantage of reducing the "race to the bottom" in which states try to lure business by lowering taxes; it clarifies jurisdictional issues; it simplifies filings for businesses in several states; and it improves the states' tax structures. Rather than racing to the bottom, together we may be able to move the middle, and end up with a fairer system.

Download the Vermont Tax Structure Commission's full final report here:

https://ljfo.vermont.gov/subjects/revenue-and-tax/vermont-tax-structure-commission/