Principles of a High-Quality Tax System

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Vermont Legislative
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Six key principles or “pillars”

- Based on “**NCSL Tax Policy Handbook for State Legislators**,” 3rd Edition, 2010
- http://www.ncsl.org/documents/fiscal/TaxPolicyHandbook3rdEdition.pdf
- **Blue Ribbon Tax Commission Final Report**, 2011
- https://ljfo.vermont.gov/assets/Subjects/Final-Report/f9d97528dc/2011-Blue-Ribbon-Tax-Structure-Commission-FINAL-REPORT.pdf
- **The Vermont Tax Study, 2005-2015**
- https://ljfo.vermont.gov/assets/docs/reports/6ca6f1666c/2017-10-Year-Tax-Study-Full-Report-Compressed.pdf
- **Final Report of the Tax Structure Commission**, February 2021
- https://ljfo.vermont.gov/assets/Subjects/Commission-Resources/0fba9fbb68/TSC-Final-Report-2-8-2021.pdf

Vermont Tax Structure Commission

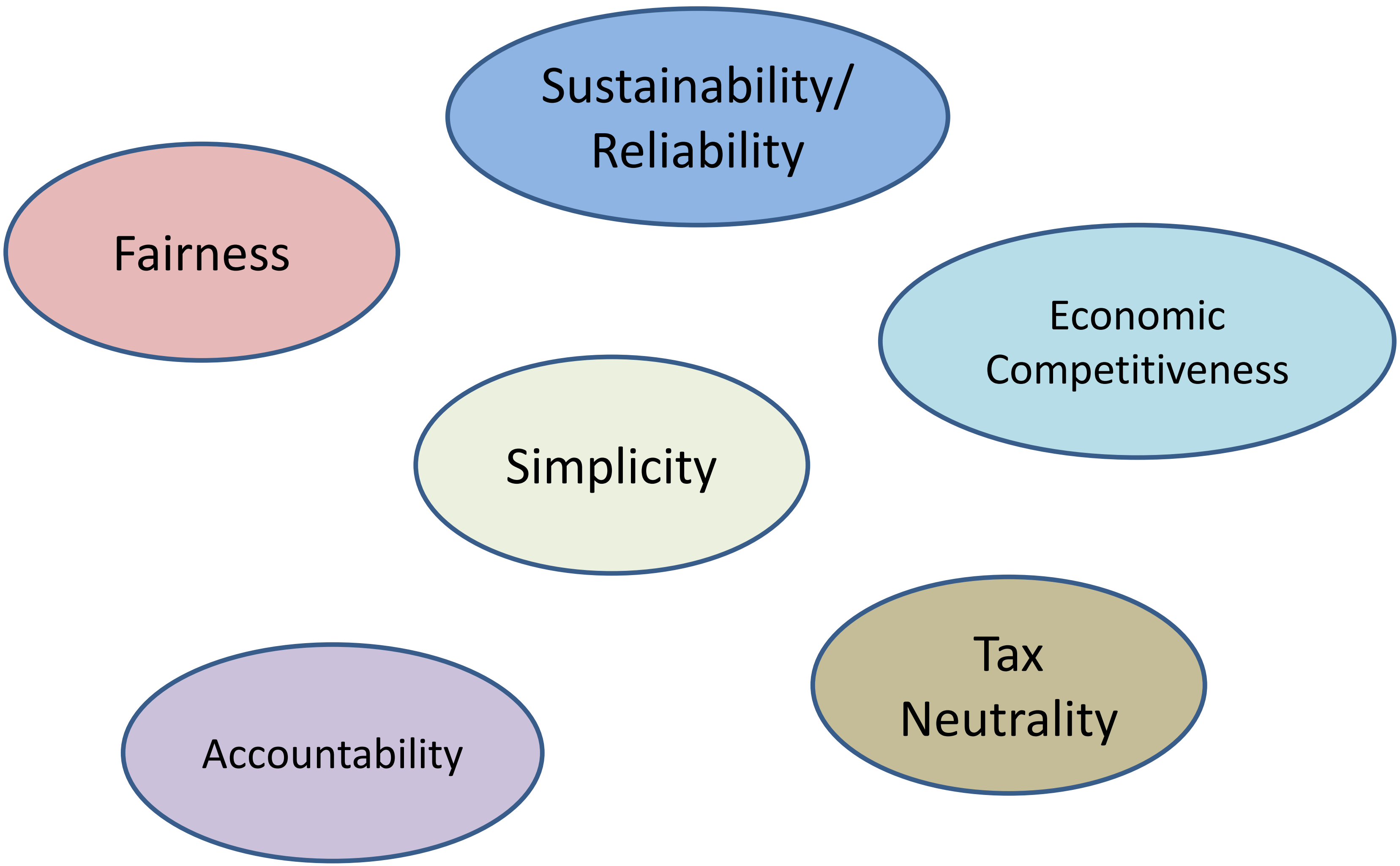
Act 11 Sec. H.17

(c) The Commission shall prepare a structural analysis of the State's revenue system and offer recommendations for improvements and modernization and provide a long-term vision for the tax structure.

- The Commission's analysis shall include a review of Vermont's income taxes, consumption-based taxes, the education financing system, tax expenditures, and property and asset-based taxes. The Commission shall have as its goal a tax system that provides **sustainability, appropriateness, and equity**. *For guidance, the Commission may use the Principles of a High-Quality State Revenue System as prepared by the National Conference of State Legislatures. . . .*

The Final Report was released on February 8, 2021.

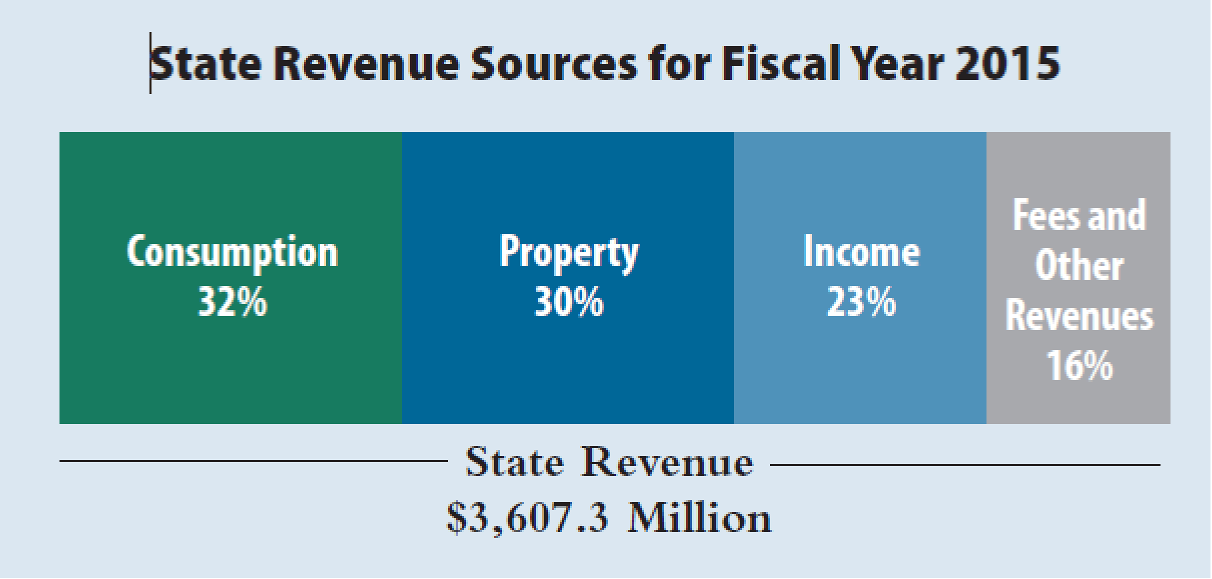
What are the six key pillars?



Sustainability and Reliability

- Revenues are
  - Relatively constant over time
    - Corporate and personal income taxes tend to be the most volatile
    - Sales taxes tend to be more stable
  - Not subject to unpredictable fluctuations
- This goal often leads to a balanced mix of taxes
- The number and type of tax changes are kept at a minimum to allow individuals and businesses to plan for the future
- Revenue sources provide the revenue growth necessary to finance the desired rate of spending growth

Vermont’s Balance among Tax Types

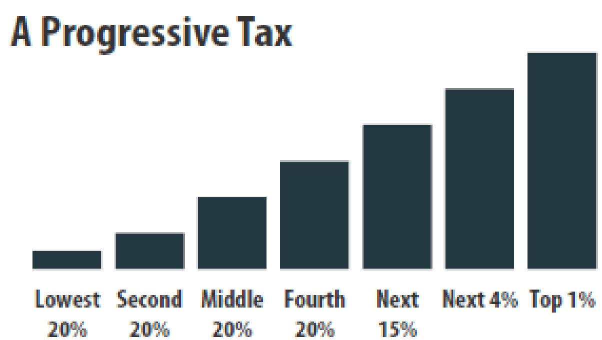


Note: FY 2020 State revenues were about $4,050 million.

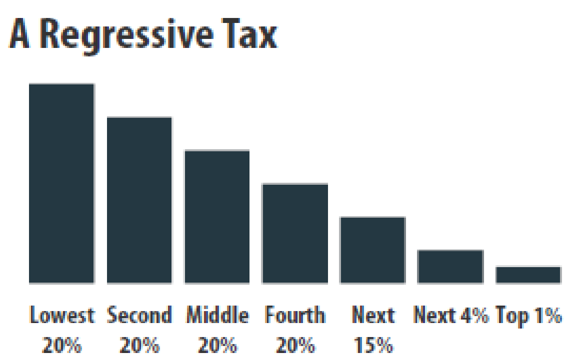
Fairness

- Do taxpayers in similar economic circumstances pay similar shares of income as taxes?
  - Horizontal equity
    - 2 single filers with income of $60,000; but one has a mortgage…
- Do taxpayers with higher income pay larger shares of income as taxes?
  - Vertical equity, or progressivity
    - Effective VT income tax rate on income of $50,000 is about 2.2%; on income of $150,000 it's about 4.0%
    - Does the system minimize both regressivity and the share of taxes paid by low-income households?
  - Regressive taxes fall more heavily on low-income taxpayers

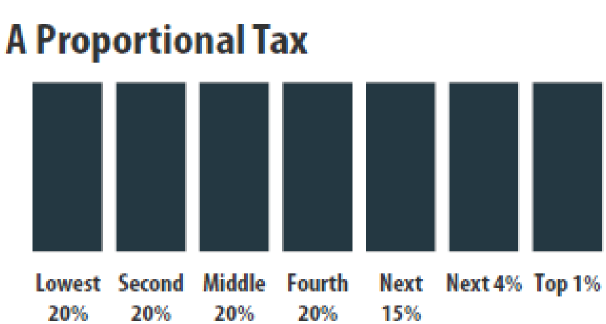
What does tax fairness/progressivity mean?



A **progressive tax** is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.



A **regressive tax** requires the poor and middle-income to pay a larger share of their incomes in taxes than the rich.



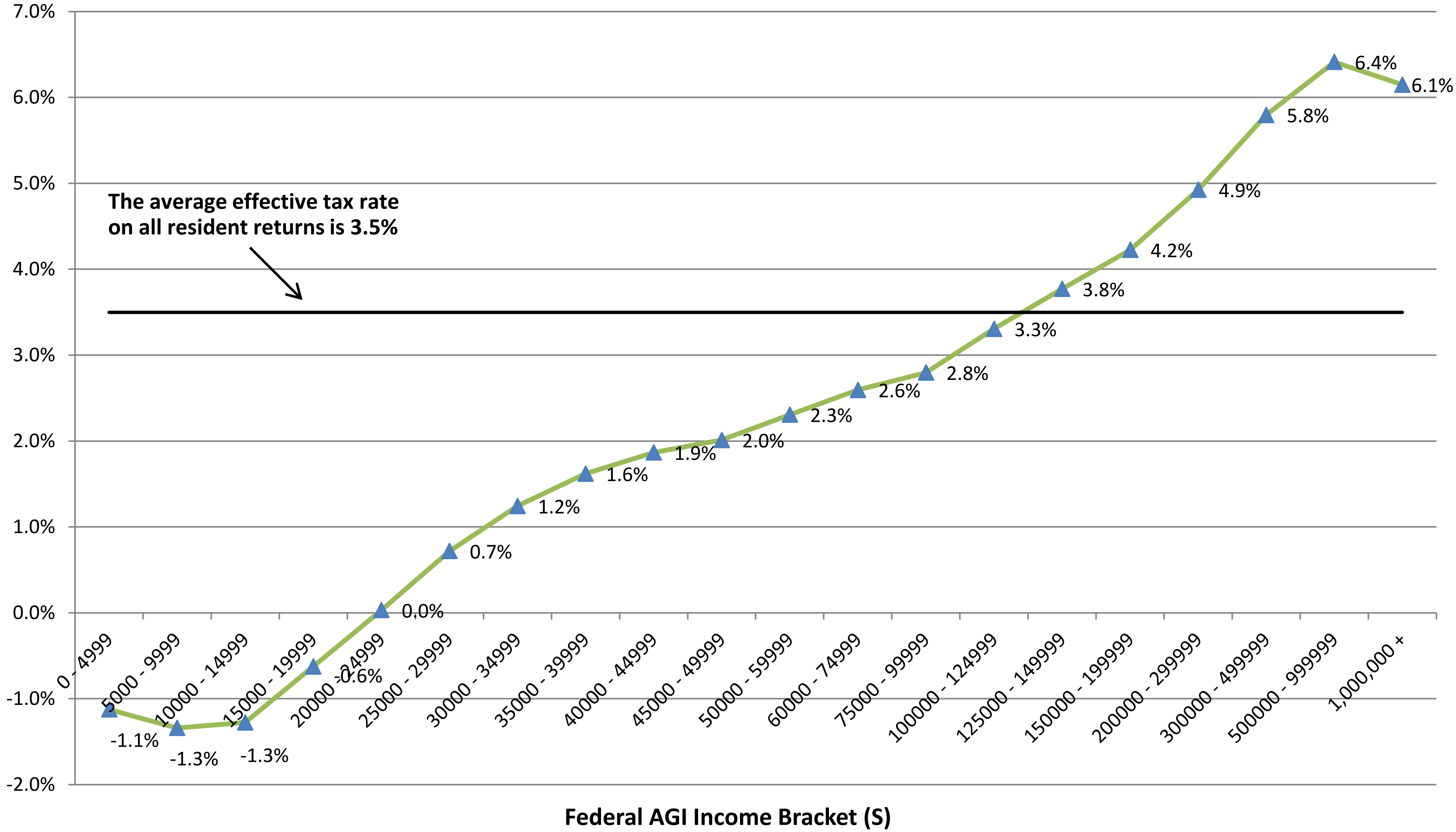
A **proportional tax** takes the same percentage of income from everyone, regardless of how much or how little they earn.

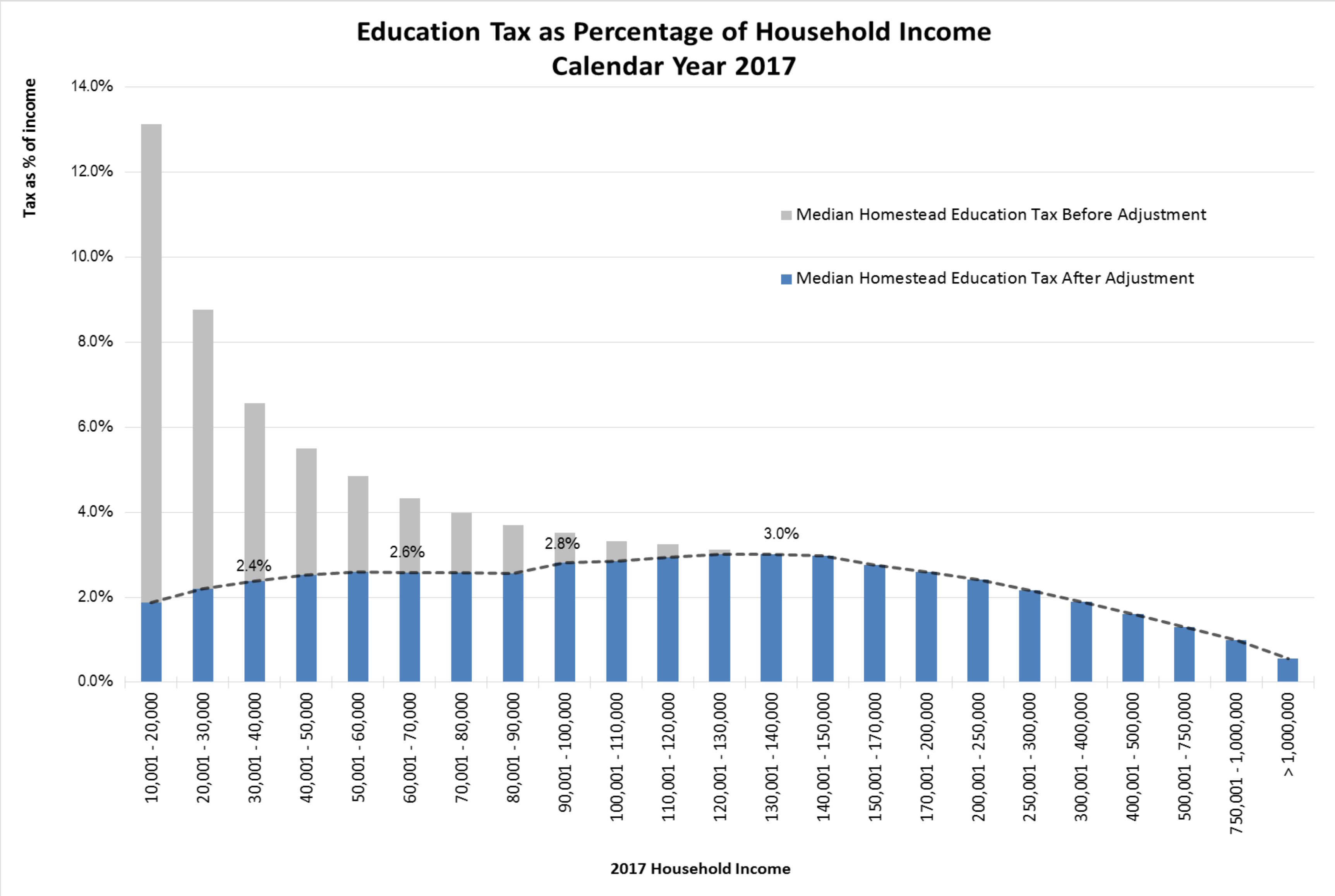
ITEP report: *Who Pays?* 6th Edition

- ITEP Tax Inequality Index Ranking
  - Vermont's state and local tax system does not worsen income inequality and ranks 49th on ITEP's Tax Inequality Index. [Tax law as of Sept 2018 at 2015 income levels.]

					Top 20%		
Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Income Range	Less than \$21,200	\$21,200 to \$39,100	\$39,100 to \$59,500	\$59,500 to \$94,000	\$94,000 to \$196,000	\$196,000 to \$460,100	over \$460,100
Average Income	\$11,500	\$29,200	\$49,200	\$74,800	\$131,100	\$279,700	\$993,600
TOTAL TAXES	8.7%	9.0%	10.1%	9.1%	10.4%	10.0%	10.4%

2018 Vermont Effective Personal Income Tax Rates, or Net Vermont Tax Divided by Federal Adjusted Gross Income (AGI), Residents Only





*In this analysis the income adjustment is applied directly to the year in which it is calculated, when in practice the adjustment is provided in the following year.

Simplicity

- A high-quality revenue system:
  - Is easy to understand and minimizes compliance costs, such as time and effort necessary to comply with the law
  - Is as simple as possible to administer, raises revenue efficiently, and is administered professionally
- A high-quality tax system requires informed taxpayers who understand how tax assessment, collection, and compliance work
  - There should be open hearings, and revenue estimates should be fully explained and replicable.

Starting point for Vermont individual income taxes is now federal AGI as of Act 73, passed in 2017; Act 11 passed in June 2018 made additional changes effective in 2018

Federal AGI

\+ Interest income and dividends from non-VT state & local obligations

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- Income from U.S. government obligations
- A portion of capital gains
- Vermont-defined personal exemptions ($4,250 each, TY 2019)
- Vermont-defined standard deduction based on filing status ($12,300 for Married Filing Jointly, TY 2019)
- All Vermonters can claim a 5% non-refundable credit for charitable contributions; maximum amount of contributions eligible is $20,000
- Income-eligible Social Security beneficiaries can claim an exemption for the taxable portion of their Social Security benefits

= Vermont taxable income

Economic Competitiveness

- A high-quality revenue system is responsive to interstate and international economic competition
  - And also to high-tech changes such as internet sales and electric or driverless cars
- It provides a level playing field devoid of unnecessarily high rates and compliance burdens
- It discourages tax liability-shopping and interstate migration

Individual Income Tax Rates by Vermont Taxable Income Bracket

Vermont Tax Rates and Tax Brackets–2020 Tax Year		
Married Filing Jointly	Single	Tax rate (%)
0 - $67,450	0 - $40,350	3.35
$67,451 - $163,000	$40,351 - $7,800	6.60
$163,001 - $248,350	$97,801 - $204,000	7.60
$248,351 and over	$204,001 and over	8.75

How Does Vermont's Top Individual Tax Rate Compare to That in Other States?

Top Tax Rate Comparison, MFJ -- NE States, Tax Year 2019		
State	Top Rate (%)	On Taxable Income ($) Above:
Connecticut	6.99	1,000,000
Maine	7.15	105,200
Massachusetts	5.0	0
New York	8.82	2,155,350
Rhode Island	5.99	148,350
Vermont	8.75	243,750

Note: New Hampshire does not tax an individual's earned income (W-2 wages). The state does tax, at a **5%** rate, income from dividends and interest.

Effective rate comparison by AGI level, State Income Tax Liability as a percentage of AGI; 2013 and 2014

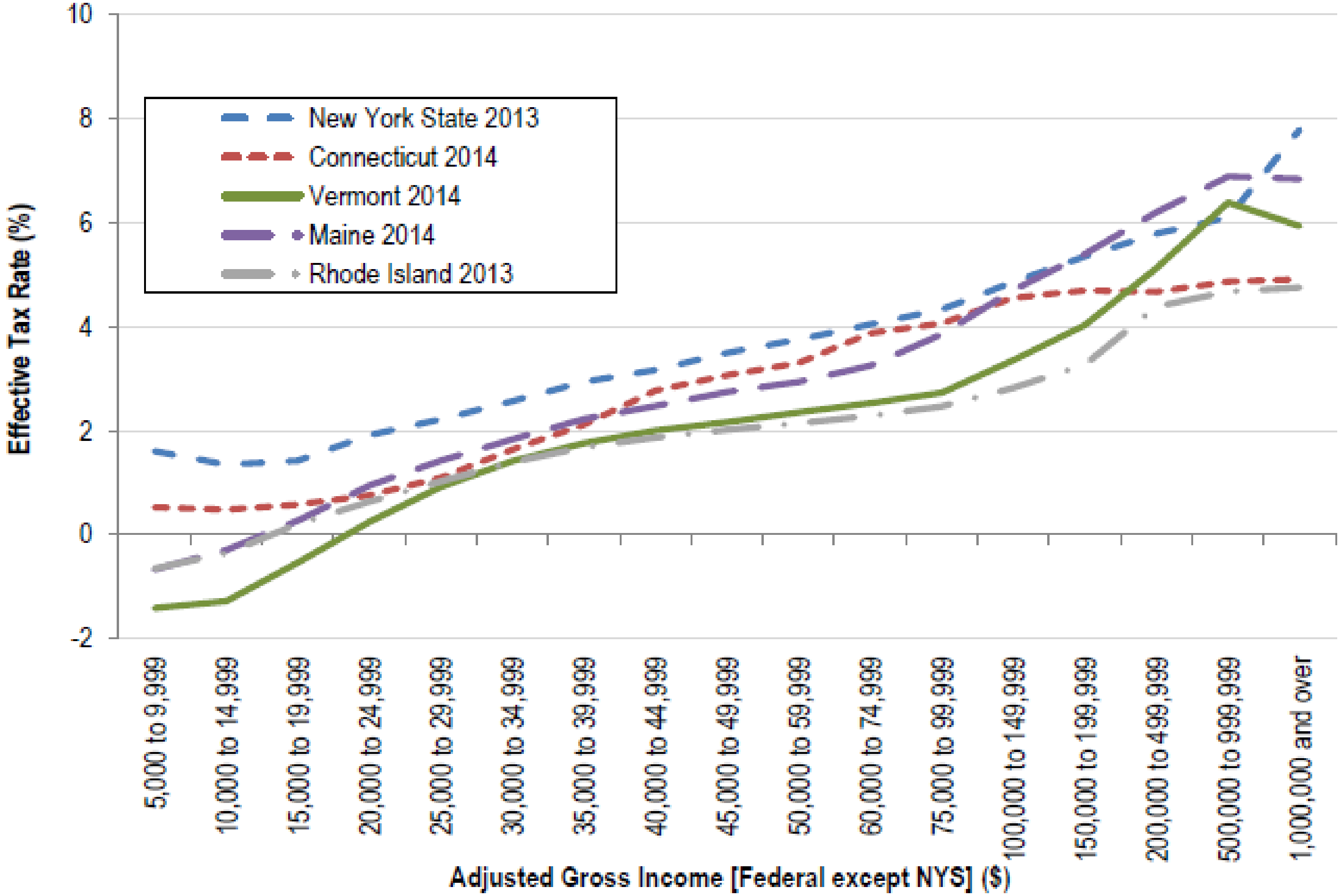
Effective tax rate at AGI of $200,000 - $500,000

RI	4.4%
MA	4.5%
CT	4.7%
VT	5.1%
NY	5.8%
ME	6.2%

Source: The Vermont Tax Study, 2005-2015;

2013 data for NY, RI; 2014 data for CT, VT, ME; 2016 data for MA

Figure 20. Effective Rate Comparison by AGI Level for the New England States and New York, Tax Liability as a Percentage of Federal AGI, 2013 and 2014



Note: The Effective Income Tax Rate is calculated using Federal AGI, except in New York, which uses state AGI in its calculation. New Hampshire does not tax income, and data was unavailable for Massachusetts.

Comparison of State Sales Tax Rates

	State Sales Tax Rate	Meals
Connecticut	6.35%	7.35%
Maine	5.5%	8.0%
Massachusetts	6.25%	6.25%
New Hampshire	None	9.0%
New York	4.0%	4.0%
Rhode Island	7.0%	7.0%
Vermont	6.0%	9.0% (10% alcohol)

All the New England states exempt grocery food, but CT, ME, NY, and RI tax nonessential food such as candy and soda. Vermont began taxing soft drinks in July of 2015. Vermont exempts all clothing and footwear. Note that New York City taxes meals and goods at 8.875%.

Tax Neutrality

- Tax policy can influence economic behavior
  - Encourage or discourage consumption of goods and services (cigarettes, gasoline)
  - Influence decisions to save and invest (401(k), housing and land)
  - Affect fundamental business decisions about the use of labor and capital (health insurance)
- A quality tax system tries to minimize the effect of the tax system on the allocation of resources

Tax Neutrality, continued

- When lawmakers decide to use the tax system to make budget decisions or influence behavior, those decisions should be explicit and subject to frequent evaluation and review
- How can lawmakers reduce the effect of taxation on economic decisions?
  - Use broad bases and low rates
  - Spread taxes across a wide range of sources and economic activities

Accountability

- Taxes should be explicit, not hidden
- A high-quality tax system aims to minimize credits and exemptions in the tax code
  - Review credits and exemptions frequently to determine their cost in lost revenue and to determine whether they unfairly benefit some taxpayers at the expense of others
    - Tax-exempt nonprofits for charitable, religious, educational, scientific, literary purposes; all clothing exempt; etc.
- A high-quality tax system uses taxes that are paid directly and openly by taxpayers
  - Taxes that are designed to flow through to consumers provide less accountability
    - Healthcare provider taxes, sales taxes at the wholesale level

Is it possible to design a perfect tax system?

- Policy makers must weigh what is most important to them
- Trade-offs frequently occur
  - Consider fairness vs. simplicity
    - E.g., property taxes in Vermont
  - Consider tax neutrality vs. discouraging negative behavior
    - E.g., cigarette taxes, soda taxes; gasoline taxes

Recommendations of the Blue Ribbon Tax Commission

- Restructure the personal income tax
  - E.g., implement a lower, flatter rate and bracket structure
- Broaden the sales tax base
  - E.g., include all consumer-purchased services except certain health and education services and business-to-business service transactions
- Enhance scrutiny of tax expenditures
  - E.g., sunset all tax expenditures that remain in the tax code in a multi-year cycle and require a sunset for new tax expenditures
- Invest in tax policy resources
  - Develop a tax incidence study

Select Recommendations of the Tax Structure Commission, 2021

- Undertake tax incidence analysis
  - To eliminate tax burden/benefit cliffs
- Restructure the homestead education tax
  - Eliminate the property tax credit and the homestead education property tax
  - Implement an income-based education tax for all residents (owners and renters) with rate tied to locally voted budgets
  - Levy the non-homestead education property tax on all property except the residence and 2-acre site
  - Create renter credit to offset the non-homestead property tax effectively paid through their rent
- Broaden the sales tax base
  - E.g., include all consumer-purchased services except certain health services and business-to-business service transactions
- Improve administration of the property tax
  - E.g., sunset all tax expenditures that remain in the tax code in a multi-year cycle and require a sunset for new tax expenditures
- Invest in tax policy resources
  - Develop a tax incidence study
- Utilize tax policy to address climate change