Principles of a High-Quality Tax System

Tax Policy 101

Emily Byrne, Associate Fiscal Officer

January 6, 2023

Six Key Principles to a High-Quality Tax System

Six Principles of a High-Quality Tax System

Based on the “NCSL Tax Policy Handbook for State Legislators” 3rd Edition 2010

- http://www.ncsl.org/documents/fiscal/TaxPolicyHandbook3rdEdition.pdf

Six Principles

1. Sustainability/Reliability
2. Fairness
3. Simplicity
4. Economic Competitiveness
5. Tax Neutrality
6. Accountability

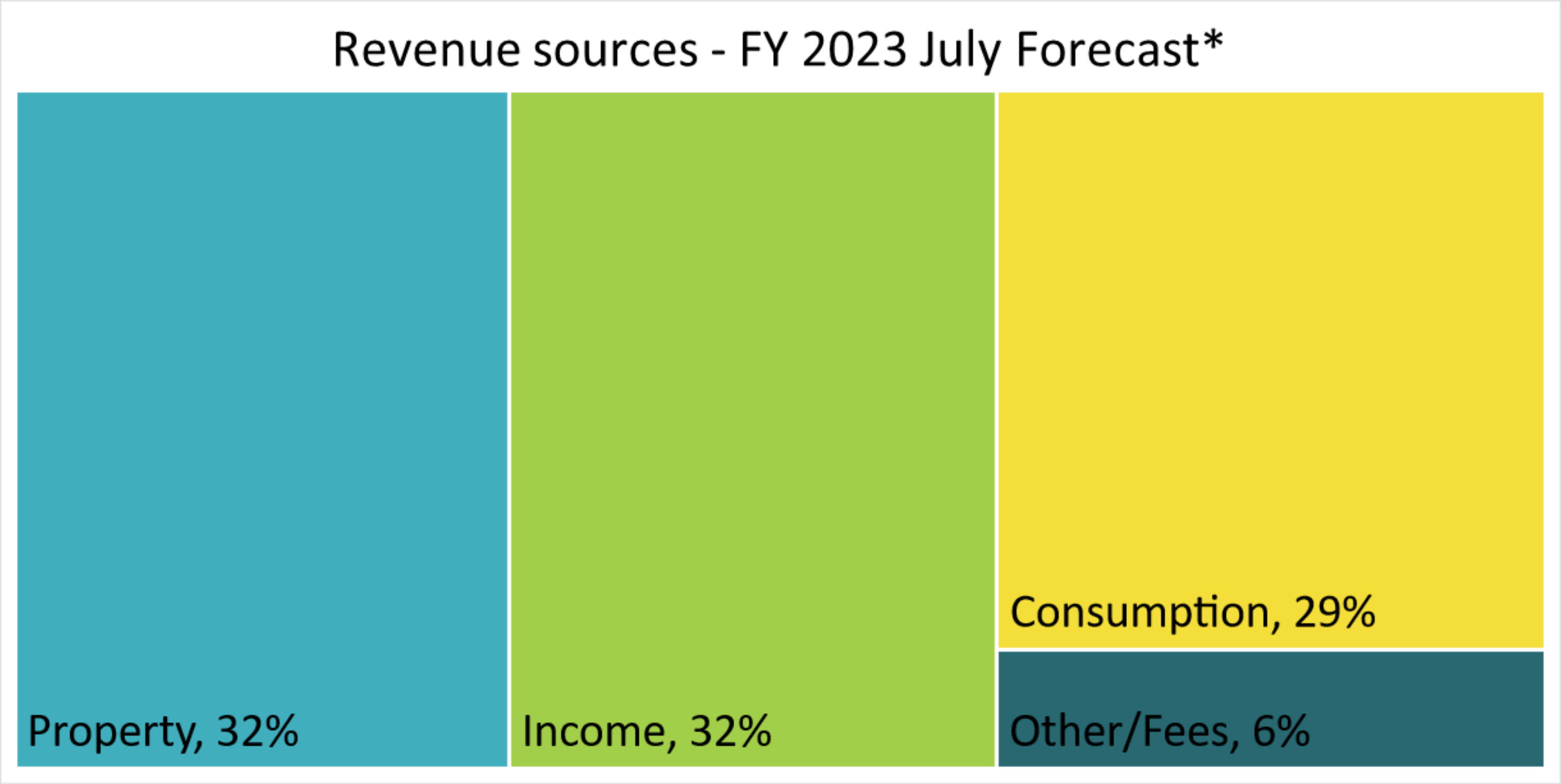
Source: https://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx#principles

Sustainability and Reliability

<u>Principle:</u> Maintain a reliable, sustainable, and diverse revenue stream

- Reliable – not one time, predictable, doesn't vary much from year to year
  - State Perspective:
    - Corporate and personal income tax tend to be the most volatile
    - Sales taxes tend to be more stable
  - Taxpayer
    - Tax changes are kept to a minimum to allow individuals and business to plan
- Sustainable – not one time, is enough to cover expenses over time
  - Match revenue growth with expenditure growth where possible
- Diverse – the tax base is broad enough to mitigate volatility and increase reliability
  - Goal is to have a balanced mix of taxes

Vermont balance among tax types



Source	Amount (in Millions)
Property	$1.43
Income	$1.41
Consumption	$1.31
Other/Fees	$0.28
Total	**$4.43**

**Note – only includes revenues as part of the official state revenue forecast, does not include other non-consensus-forecasted revenues sources such as certain dedicated special fund fees and taxes, etc.*

Fairness

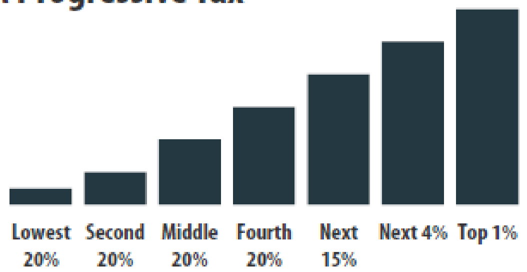
<u>Principle:</u> Ensuring equality in taxes paid across similar ability to pay and circumstances

- Horizonal Equity – taxpayers with similar economic circumstances have similar tax burdens
    - 2 married couples with combined income of $60,000; but one couple has a mortgage….
- Vertical equity or progressivity – how the distribution of tax burdens varies among taxpayers with different economic circumstances

Taxpayer	Income	Effective Tax Rate
Single - A	$50,000	3.00%
Single - B	$150,000	6.00%

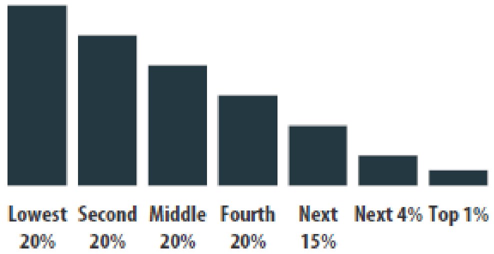
Progressive vs Regressive vs Proportional Tax

A Progressive Tax



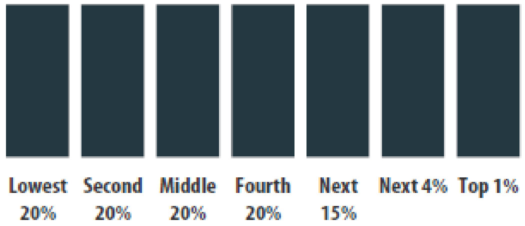
A **progressive tax** is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.

A Regressive Tax



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



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

ITEP: *Who Pays, 6th Edition*

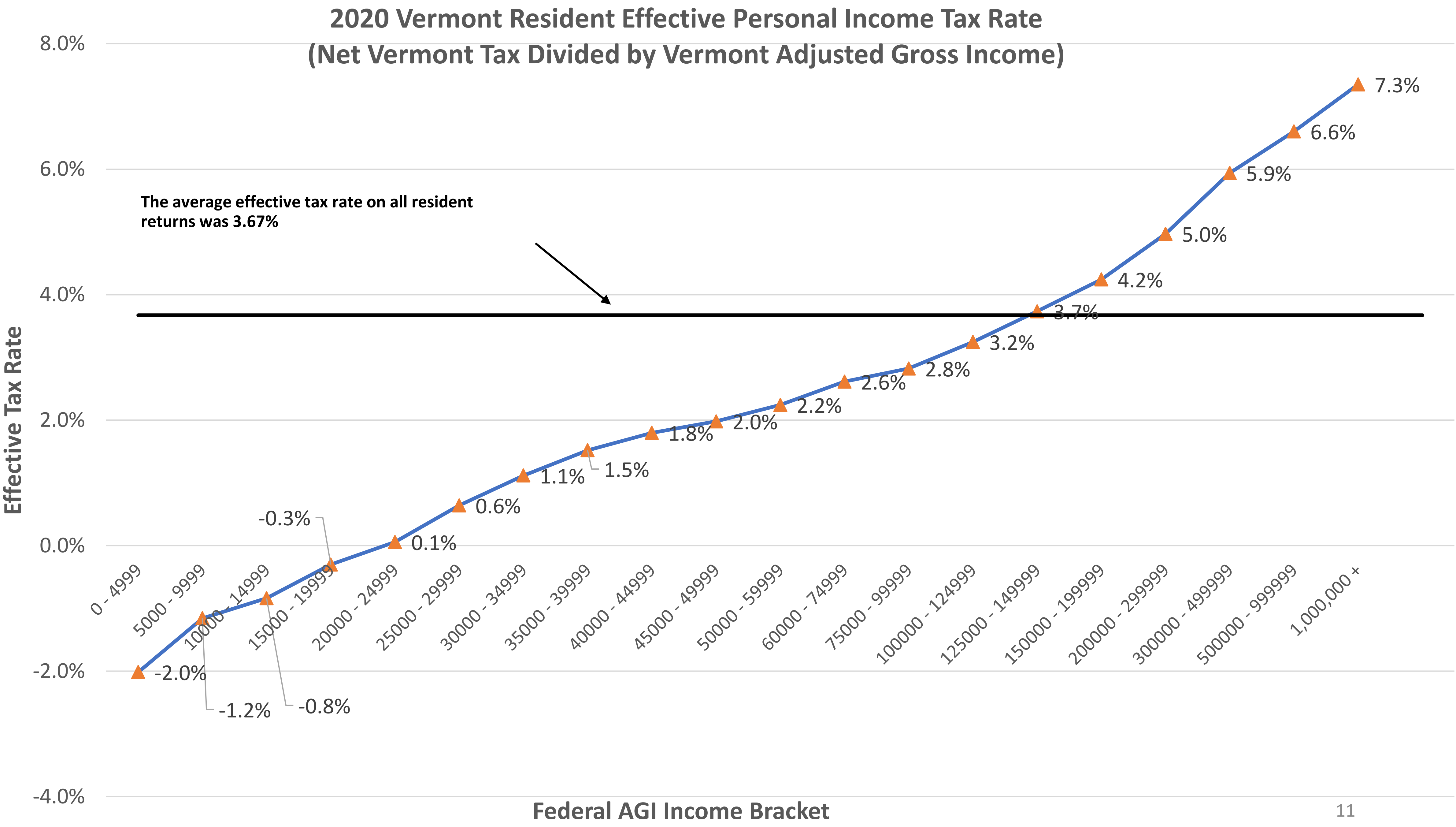
- Per the Institute for Taxation and Economic Policy (ITEP), Vermont's state and local tax system does not worsen income inequality
  - Meaning that the income gap between lower- and middle- income taxpayers, as compared to the wealthy, is somewhat narrower after state and local taxes than before.
  - In 2018, Vermont Ranked #49 out of 51 (51 is best)
  - Looks at the whole state tax system – not just one component
    - When considering new tax policy consider the whole system

Note – Published in October 2018, Vermont and other states have changed their tax codes

[*ITEP: Why Pays, 6th Edition*]

ITEP: *Who Pays, 6th Edition*

					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%



2020 Vermont Resident Effective Personal Income Tax Rate
(Net Vermont Tax Divided by Vermont Adjusted Gross Income)
The average effective tax rate on all resident returns was 3.67%
Effective Tax Rate
Federal AGI Income Bracket
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
0 - 4999
5000 - 9999
10000 - 14999
15000 - 19999
20000 - 24999
25000 - 29999
30000 - 34999
35000 - 39999
40000 - 44999
45000 - 49999
50000 - 59999
60000 - 74999
75000 - 99999
100000 - 124999
125000 - 149999
150000 - 199999
200000 - 299999
300000 - 499999
500000 - 999999
1,000,000 +
-2.0%
-1.2%
-0.8%
-0.3%
0.1%
0.6%
1.1%
1.5%
1.8%
2.0%
2.2%
2.6%
2.8%
3.2%
3.7%
4.2%
5.0%
5.9%
6.6%
7.3%

Simplicity

<u>Principle</u>: The tax system is easy for a taxpayer to understand and comply with, and it is easy to administer

- It is easy to understand so that compliance costs and the time it takes to comply with the law are minimized
- It is easy to administer and raises revenue efficiently
- Need informed taxpayers who understands how tax assessment, collection, and compliance work

Vermont’s Personal Income Tax

From federal form 1040

Adjusted gross income

plus

Additions to adjusted gross income

Bonus depreciation, interest from non-Vermont state and local bonds

minus

Subtractions from adjusted gross income

Standard deduction*

$6,350 for single filer, $12,700 for married filer

Personal exemptions*

$4,350 for taxpayer, spouse, and any dependents

Other subtractions

- Interest income from U.S. bonds
- Capital gains exclusion
- Social Security exemption
- Medical expenses

equals

Vermont taxable income

Note: Amounts for Tax year 2021; indexed annually for inflation

Economic Competitiveness

Principle: A tax system is responsive to interstate and international economic competition

- Provides a level paying field devoid of unnecessarily high rates and compliance burdens
- Discourage tax liability-shopping and interstate migration

State by State Comparison of Effective PI rates

Top Tax Rate Comparison - Married Filing Jointly NE States - Tax Year 2019*		
State	Top Rate %	On Taxable Income ($) Above:
Vermont	8.75	243,750
Connecticut	6.99	1,000,000
Maine	7.15	105,200
Massachusetts	5.00	-
New York	8.82	2,155,350
Rhode Island	5.99	148,350

** Does not account for changes to Income Tax Structures that have occurred since 2019.*

Note: New Hampshire does not tax individual's earned income (W-2 wages). The state currently taxes income from dividends and interest but is scheduled to start phasing it out starting in 2023.

State by State Comparison of State Sales, Rooms, and Meals Tax Rates

Comparison of State Sales, Rooms, & Meals Taxes NE States - Tax Year 2022			
State	**Sales Tax Rate**	**Rooms Tax**	**Meals Tax**
Vermont	6.00%	9.00%	9.00%
Connecticut	6.35%	15.00%	7.35%
Maine	5.50%	9.00%	8.00%
Massachusetts	6.25%	5.70%	6.25%
New Hampshire	None	9.00%	8.50%
New York	4.00%	4.00%	4.00%
Rhode Island	7.00%	5.00%	7.00%

Note: VT charges 10% meals tax on alcohol
This doesn't include any local taxes – New York has significant local taxes, Vermont has Local Option Taxes

JFO 1 Baldwin Street • Montpelier, VT 05633-5701 • (802) 828-2295 • https://ljfo.vermont.gov

Tax Neutrality

Principle: The tax system tries to minimize the unintended consequences

- Encourage or discourage consumption/production of good and services
  - “Sin” taxes
- Change the allocation of resources
  - Influence decision to invest in land and a house or other types of wealth
- Impact business decisions

- When Policy makers use the tax system to drive behavior changes, those choices should be explicit and evaluated frequently
  - E.g., Using the cigarette tax to discourage smoking

Accountability

<u>Principle</u>: The tax system should include taxes that are explicit, minimize credits and exemptions, and limit the amount of tax flow through

- Tax systems and individual taxes should be evaluated regularly to ensure consistency with intended policy goals
  - Tax Expenditure Report and Tax Expenditure Reviews
- Does the policy unfairly benefit some taxpayers at the expense of others?

Is it Possible to Design a Perfect Tax System?

- Policy Makers need to decide what is most important to them
- Trade-offs Frequently Occur…
  - Tax Neutrality vs Influencing Behavior
    - Cigarette tax
    - Soda Tax
    - Gasoline Tax
  - Simplicity vs Fairness
    - Sales Tax

Is it Possible to Design a Perfect Tax System?
Sales Tax

- Sales tax rate is 6%
  - Regressive because blind to Vertical Equity (ability to Pay)
  - Enter Sales Tax Exemptions:



- Enter Complexities

Conclusion

Lawmakers need to consider, balance, and prioritize these principles when developing Tax Policy

1. Sustainability/Reliability
2. Fairness
3. Simplicity
4. Economic Competitiveness
5. Tax Neutrality
6. Accountability

Questions?