Principles of a High-Quality Tax System

House Committee on Ways and Means

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Six Principles of a High-Quality Tax System

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

Adapted from the "NCSL Tax Policy Handbook for State Legislators" 3rd Edition 2010

1. Sustainability and Reliability

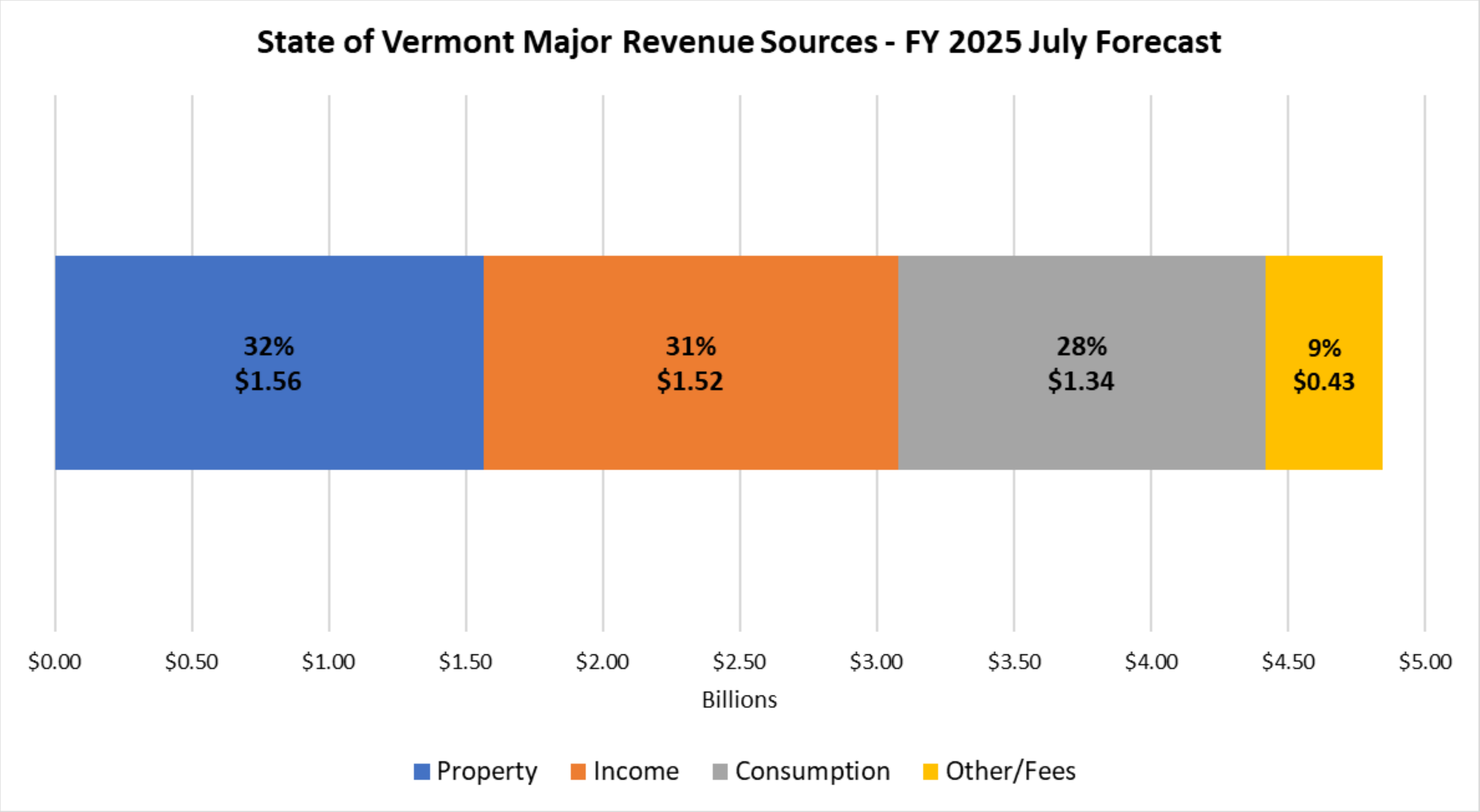
<u>Principle:</u> Maintain a reliable, sustainable, and diverse revenue stream

- Reliable – not one time, predictable, doesn’t vary much from year to year
- Sustainable – revenue growth is enough to cover expenses over time
- Diverse – balanced mix of taxes to mitigate volatility and increase reliability

<u>Considerations:</u>

- How does the tax base change over the long term?
- How do changes impact people, businesses, and ability to plan?
- What is the volatility of the tax base? Income tends to be more volatile than consumption and property.
- Are the revenue sources mixed and balanced?

Vermont Balance Among Tax Types



Source	Amount (Billions)
Property	$1.56
Income	$1.52
Consumption	$1.34
Other/Fees	$0.43
Total	**$4.85**

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

2. Fairness

<u>Principle:</u> Ensuring equity in taxes paid across similar ability to pay and circumstances. Similarly situated taxpayers should be taxed similarly.

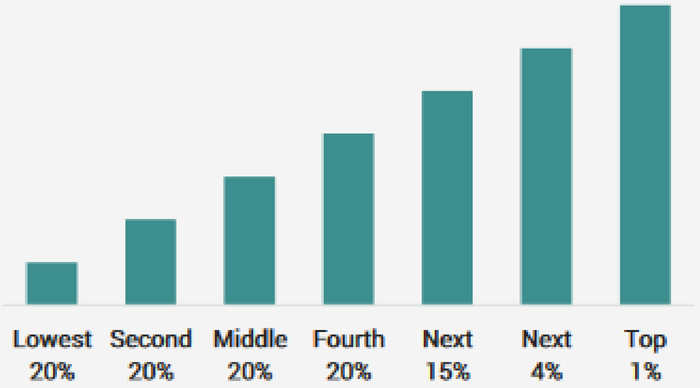
- **Horizontal Equity** – taxpayers with similar ability to pay have similar tax burdens
    - *Age-based exemptions generally violate horizontal equity since age has no bearing on ability to pay.*
- **Vertical equity or progressivity** – how the distribution of tax burdens varies among taxpayers with different economic circumstances (greater ability to pay = pay more of the tax burden).
    - *Consumption taxes generally violate vertical equity.*
    - *Regressive taxes generally fall more heavily on low-income taxpayers.*

- The word “fairness” tends to be subjective – but it can be helpful for policymakers to know the public’s perception of whether a tax is “fair”

<u>Considerations:</u>

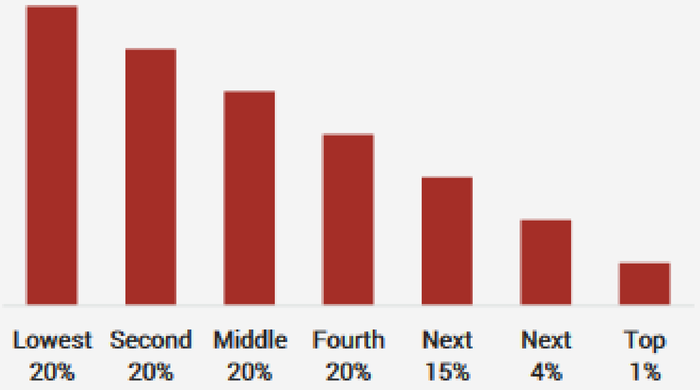
- What is more important – Horizontal or Vertical Equity?
- Does this principle apply to the entire tax system, or just to specific tax types?
- If vertical equity is the goal, what is the desired amount of progressivity?

Progressive, Regressive, or Proportional?



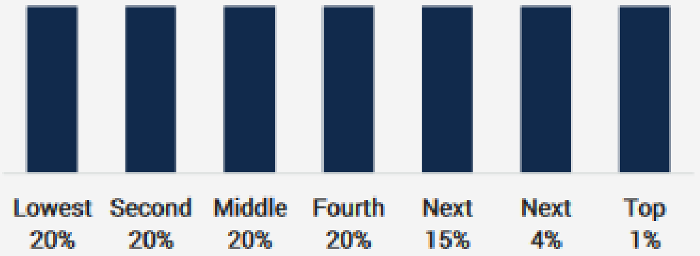
Progressive Tax

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.



Regressive Tax

A regressive tax requires poor and middle-income families to pay a larger share of their incomes in tax than upper-income families.



Proportional Tax

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

ITEP: *Who Pays, 7th Edition*

ITEP: *Who Pays, 7th Edition*

- Per the Institute for Taxation and Economic Policy (ITEP), Vermont's state and local tax system does not worsen income inequality.
    - Vermont Ranked #49 out of 51 (51 is least regressive)
    - Looks at the whole state tax system – not just one component

Note – Published in January 2024

FIGURE 5

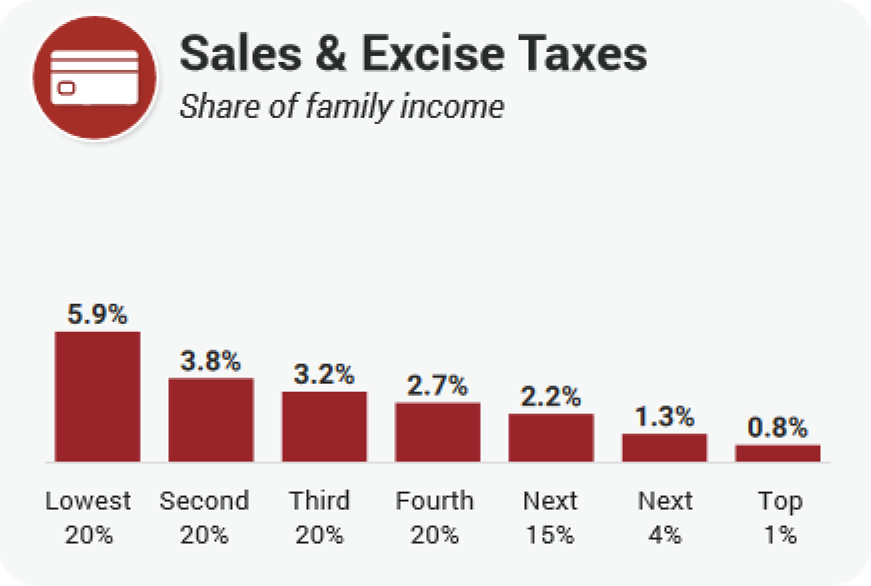
The 10 Least Regressive State and Local Tax Systems

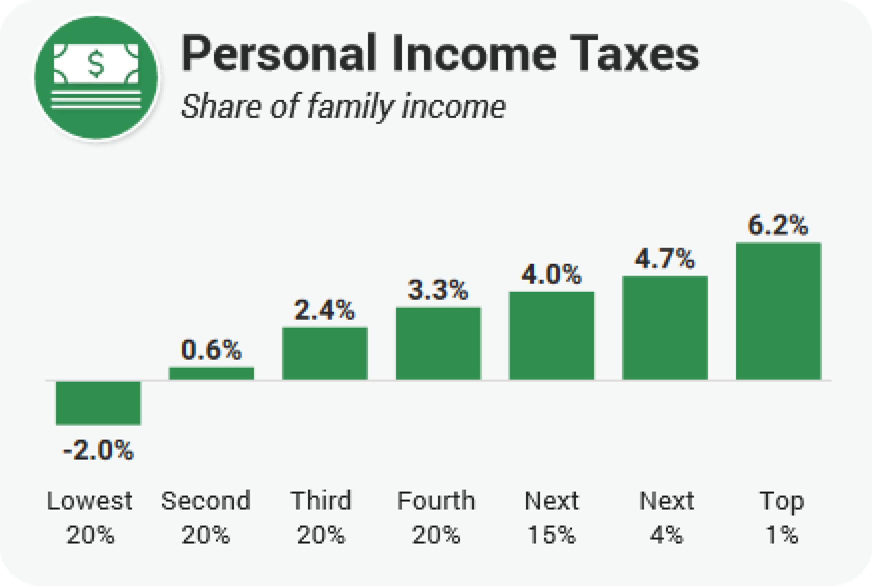
Taxes as a share of family income and tax features driving these outcomes

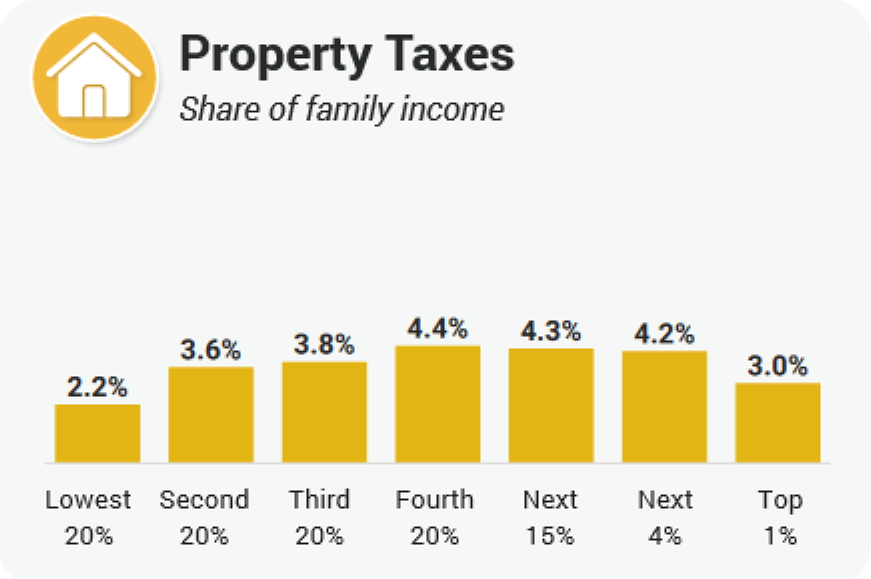
Rank	State	ITEP Inequality Index	Lowest 20%	Middle 60%	Top 1%	Higher Income Tax Brackets or Rates on Upper Incomes	Absence of Broad Preferences for Capital Gains or Business Income	High Reliance on Income Taxes	Presence of Refundable Credits	Low Reliance on Sales & Excise Taxes	Levies Estate or Inheritance Tax
51	D.C.	+3.1%	4.8%	11.8%	11.4%	✓	✓	✓	✓	✓	Estate
50	Minnesota	+2.6%	6.2%	10.1%	10.5%	✓	✓	✓	✓		Estate
49	Vermont	+2.3%	6.3%	9.8%	10.1%	✓			✓	✓	Estate
48	New York	+1.6%	11.1%	13.3%	13.5%	✓	✓	✓	✓	✓	Estate
47	California	+0.8%	11.7%	10.7%	12.0%	✓	✓	✓	✓		
46	New Jersey	+0.7%	8.8%	11.2%	10.5%	✓	✓		✓	✓	Inheritance
45	Maine	+0.2%	8.6%	10.4%	9.5%		✓		✓		Estate
44	Massachusetts	-0.1%	8.2%	9.7%	8.9%	✓	✓	✓	✓	✓	Estate
43	New Mexico	-0.5%	7.1%	11.0%	8.1%	✓			✓		
42	Oregon	-0.7%	12.0%	10.4%	10.4%	✓		✓	✓	✓	Estate

[*ITEP: Who Pays, 7th Edition*]

[ITEP: *Who Pays, 7th Edition*]







Note: All figures and charts show 2024 tax law in Vermont, presented at 2023 income levels. Senior taxpayers are excluded for reasons detailed in the methodology. Our analysis includes nearly all (99.7 percent) state and local tax revenue collected in Vermont.

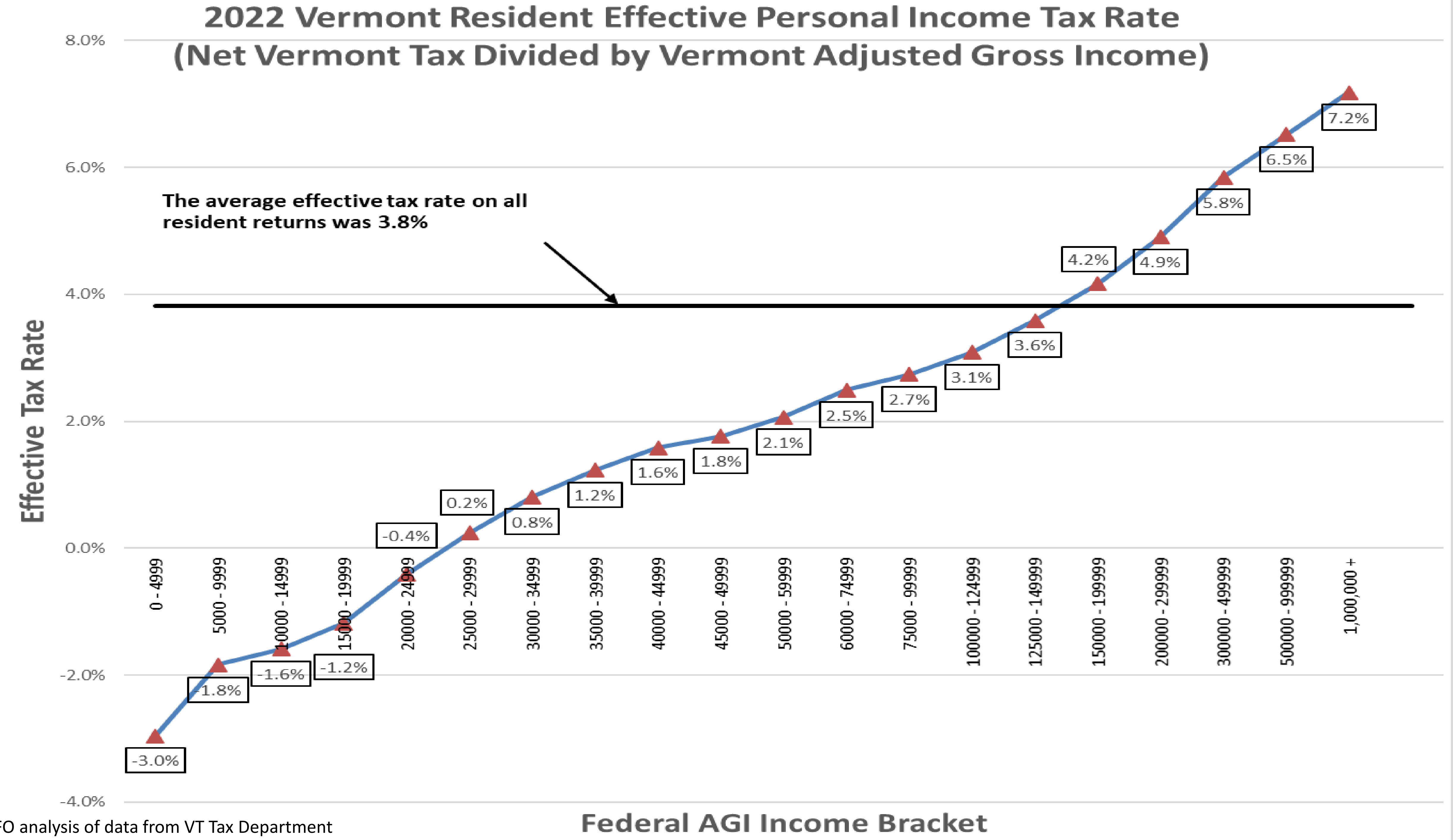
ITEP: *Who Pays, 7th Edition*

WhoPays?

Vermont State and local tax (cont.)

Individual figures may not sum to totals due to rounding.

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%: Next 15%	Top 20%: Next 4%	Top 20%: Top 1%
Income Range	Less than $27,500	$27,500 to $55,400	$55,400 to $83,300	$83,300 to $135,900	$135,900 to $240,200	$240,200 to $588,500	Over $588,500
Average Income in Group	$13,100	$40,600	$68,200	$109,000	$167,400	$352,600	$1,096,200
Sales & Excise Taxes	**5.9%**	**3.8%**	**3.2%**	**2.7%**	**2.2%**	**1.3%**	**0.8%**
General Sales–Individuals	1.4%	1.4%	1.3%	1.1%	0.9%	0.5%	0.2%
Other Sales & Excise–Ind.	3.6%	1.6%	1.2%	0.9%	0.7%	0.3%	0.1%
Sales & Excise–Business	0.9%	0.8%	0.7%	0.7%	0.6%	0.5%	0.4%
Property Taxes	**2.2%**	**3.6%**	**3.8%**	**4.4%**	**4.3%**	**4.2%**	**3.0%**
Home, Rent, Car–Individuals	1.3%	2.9%	3.1%	3.7%	3.6%	3.2%	1.5%
Other Property Taxes	0.9%	0.8%	0.7%	0.7%	0.7%	0.9%	1.5%
Income Taxes	**-2.0%**	**0.6%**	**2.4%**	**3.3%**	**4.0%**	**4.7%**	**6.2%**
Personal Income Taxes	-2.0%	0.6%	2.4%	3.3%	4.0%	4.7%	6.2%
Corporate Income Taxes	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%
Other Taxes	**0.2%**	**0.2%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**
TOTAL TAXES	**6.3%**	**8.2%**	**9.6%**	**10.5%**	**10.6%**	**10.3%**	**10.1%**



JFO analysis of data from VT Tax Department

3. Simplicity

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

- Informed taxpayers who understand how the tax works.

<u>Considerations:</u>

- How well do taxpayers understand what they need to pay each year?
- Are taxpayers informed about how the tax is assessed, collected, and enforced?
- Is the tax equally easy for all taxpayers to comply with?
- Does the system minimize compliance costs?
- How simple and efficient is it to administer and raise revenue?
- Is there existing infrastructure in place to efficiently administer the tax change?

Simplicity vs. Fairness: A Tradeoff

- **Decisions about simplicity might be made to achieve specific policy goals at the expense of fairness.**
  - Consumption taxes are often flat (and inherently regressive) because it would be complicated to integrate ability to pay into the collection of the tax.
- **Decisions about fairness might be made to achieve specific policy goals at the expense of simplicity.**
  - Renter Rebate ensures that a renter's contribution to property taxes is aligned with their ability to pay.

<u>How can policy strike a balance between the two principles?</u>

- A diversity of revenue sources can allow for more fairness in one tax to offset less fairness/more simplicity in another tax (e.g., refundable income tax credits).
- Exemptions for necessary goods/services/expenses, or exempting a portion of value from taxation.
- Remember scale and applicability – flat taxes/fees might be regressive, but they are not always financially significant to any individual (e.g., $8 annual car inspection sticker fee = $0.02/day), nor are they paid by everyone equally (e.g., beverage, cigarette tax).
- Broader tax bases can translate to lower tax rates

Vermont's Personal Income Tax

From federal form 1040

Federal 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*
$7,400 for single filer, $14,850 for married filer

Personal exemptions*
$5,100 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 2024; indexed annually for inflation*

4. Economic Competitiveness

<u>Principle</u>: 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

<u>Considerations:</u>

- Does the tax incentivize tax shopping and avoidance?
- Does the tax unnecessarily harm Vermont taxpayers and economy?
- Does the system put the state significantly out of line with other states? And if so, does that have a meaningful impact on behavior/competitiveness?

State by State Comparison of State Top Marginal Personal Income Tax Rates

VT Income Tax Rate Schedules (2024)

Married Filing Jointly, Schedule Y-1
Use if your filing status is:
Married Filing Jointly; Qualifying Widow(er); or Civil Union Filing Jointly

If VT Taxable Income is Over	But Not Over	VT Base Tax is	Plus	of the amount over
0	75,000	0.00	3.35%	0
TAXABLE INCOME UNDER $75,000 USE THE TAX TABLES				
75,000	79,950	2,513.00	3.35%	75,000
79,950	193,300	2,678.00	6.60%	79,950
193,300	294,600	10,159.00	7.60%	193,300
294,600	-	17,858.00	8.75%	294,600

Top Marginal Tax Rate Comparison - Married Filing Jointly NE States - Tax Year 2024		
State	**Top Rate %**	**On Taxable Income ($) Above:**
Vermont	8.75	294,600
Connecticut	6.99	1,000,000
Maine	7.15	123,250
Massachusetts	9.00	1,053,750
New York	10.90	25,000,000
Rhode Island	5.99	176,050

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 repeal that tax beginning in 2025.

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

Comparison of Sales, Rooms, & Meals Taxes NE States - Tax Year 2024			
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	8.50%	8.50%
New York	4.00%	4.00%	4.00%
Rhode Island	7.00%	6.00%	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 1% Local Option Taxes, Rhode Island has a 1% local meals and beverage tax, etc.

5. Tax Neutrality

<u>Principle</u>: The tax system tries to minimize unintended consequences on the allocation of resources.

- Encourage or discourage consumption/production of goods and services
- Change the allocation of resources
  - Influence decision to invest in land and a house or other types of wealth
- Impact business decisions about the use of labor and capital

<u>Considerations:</u>

- How can policy makers reduce the unintentional effect of taxation on economic decisions?
- Is the tax policy trying to change behavior? If so, is the policy explicit about the type of behavior it is trying to influence (or not)? Is the policy effective and evaluated frequently?
- Are policy makers comfortable with the indirect consequences or behavioral shifts that result from the tax change?
- Taxes with broad base and low rates, broadly applied, reduce the effect of taxation on economic decisions (generally).

6. Accountability/Transparency

<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 changes should be transparent, not hidden.
- Tax systems and individual taxes should be evaluated regularly to ensure consistency with intended policy goals
  - Tax Expenditure Report

<u>Considerations:</u>

- Do taxpayers know the true cost of transactions and when a tax is assessed?
- Are exemptions, credits, and other tax expenditures openly available to taxpayers who are eligible?
- Will the intended payor ultimately be the one paying the tax?

Is it Possible to Design a Perfect Tax System?

- Sales tax rate is 6%
  - Regressive because blind to Vertical Equity (ability to pay)
  - BUT….enter sales tax exemptions:

- Enter complexities:

Is it Possible to Design a Perfect Tax System?

- **Policy makers need to decide what is most important to them, and think through the following:**
  - What makes a good tax system, including all tax types?
  - Which principles are higher priority than others?
  - What is the goal of any tax change, and what will be sacrificed to achieve it?
- **Trade-offs Frequently Occur…**
  - Tax Neutrality vs. Influencing Behavior
  - Simplicity vs Fairness
    - Sales Tax vs Income Tax
    - Education property taxes
  - User pays vs. Everyone pays

Conclusion

When developing tax policy, legislators should consider, balance, and prioritize these 6 principles:

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

There are tradeoffs – it is difficult to create the "perfect" tax system within these 6 principles!

Questions?