Education Income Tax

Senate Committee on Finance

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Six Pillars of a High Quality Tax System

Six Pillars of a High-Quality Tax System

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

Sustainability and Reliability

Sustainability and Reliability: Predictability

Income taxes are less predictable than property taxes

- Property tax
  - Towns maintain their grand list (tax base), State knows the Equalized Education Grand List
  - Tax base does not fluctuate much from year to year
    - Whenever it does change, the town(s) know in advance
  - Even with property tax credit, income relies on a lookback and the credit is applied to current year property taxes
- Income tax
  - Income base changes constantly in the aggregate…
    - Withholding is about 70% of Personal Income Tax (PIT), somewhat predictable
    - Estimated payment (business payments, capital gains) are very hard to predict
  - …and at the individual level!
    - Example: Business owner makes a large capital expenditure mid-year
  - This is the primary reason why we reconcile in April each year
  - We rely on state economists to make a forecast. This is a hard job!

Sustainability and Reliability: Predictability

Income taxes are less predictable than property taxes

Personal Income Tax (in millions)			
	Forecasted	Actual	Pct Miss
January 2024 Forecast (FY25)	1,140.9	1,243.1	9.0%
January 2023 Forecast (FY24)	1,262.6	1,210.0	-4.2%
January 2022 Forecast (FY23)	1,103.5	1,267.8	14.9%

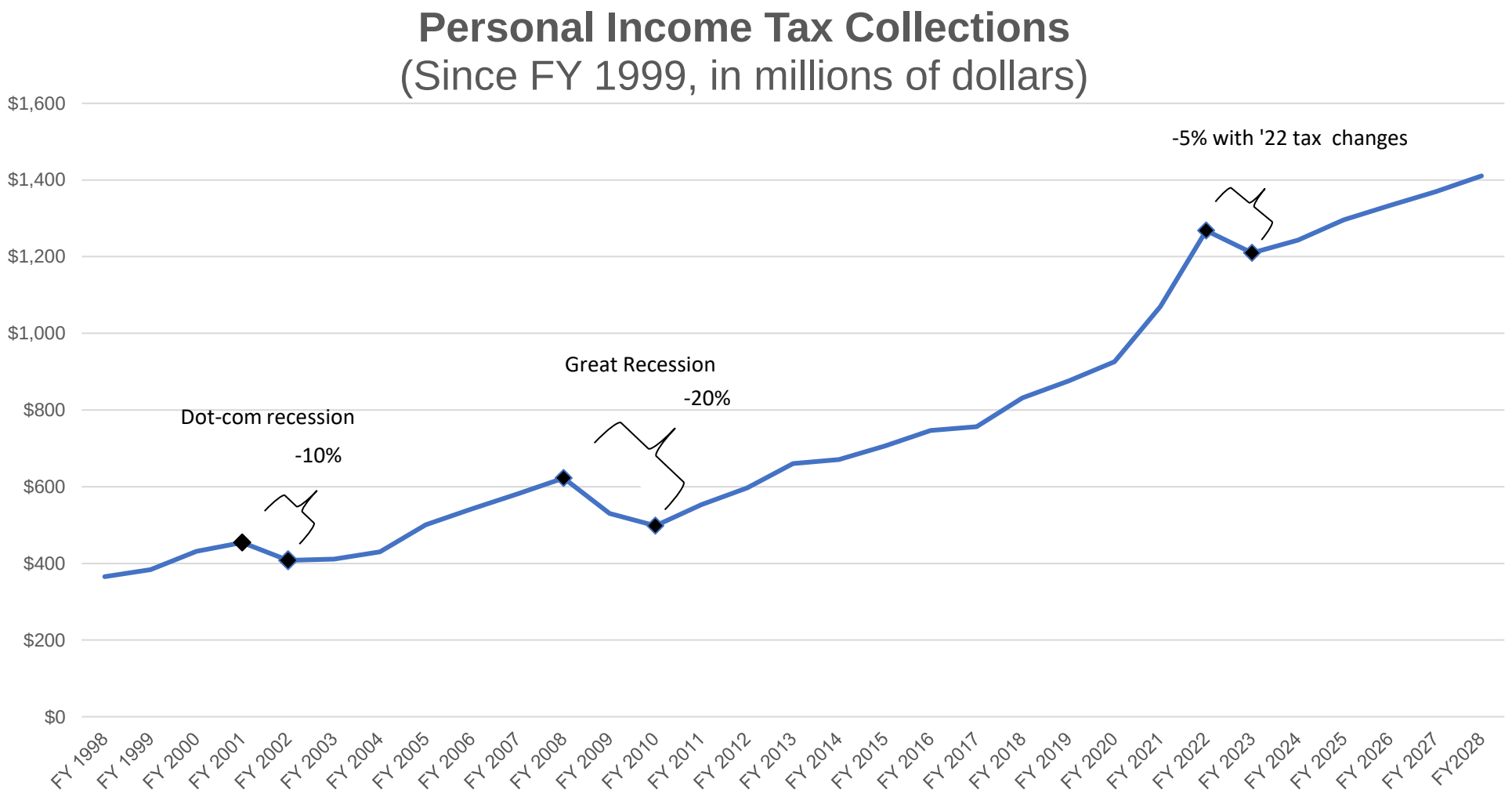
Property Taxes (in millions)			
	Forecasted	Actual	Pct Miss
Close of Session 2023 (FY24)	$ 1,299.9	$ 1,300.4	0%
Close of Session 2022 (FY23)	$ 1,191.8	$ 1,203.5	1%
Close of Session 2021 (FY22)	$ 1,214.0	$ 1,228.7	1%

Sustainability and Reliability: Volatility

What would the Education Fund look like with an income tax and a recession?

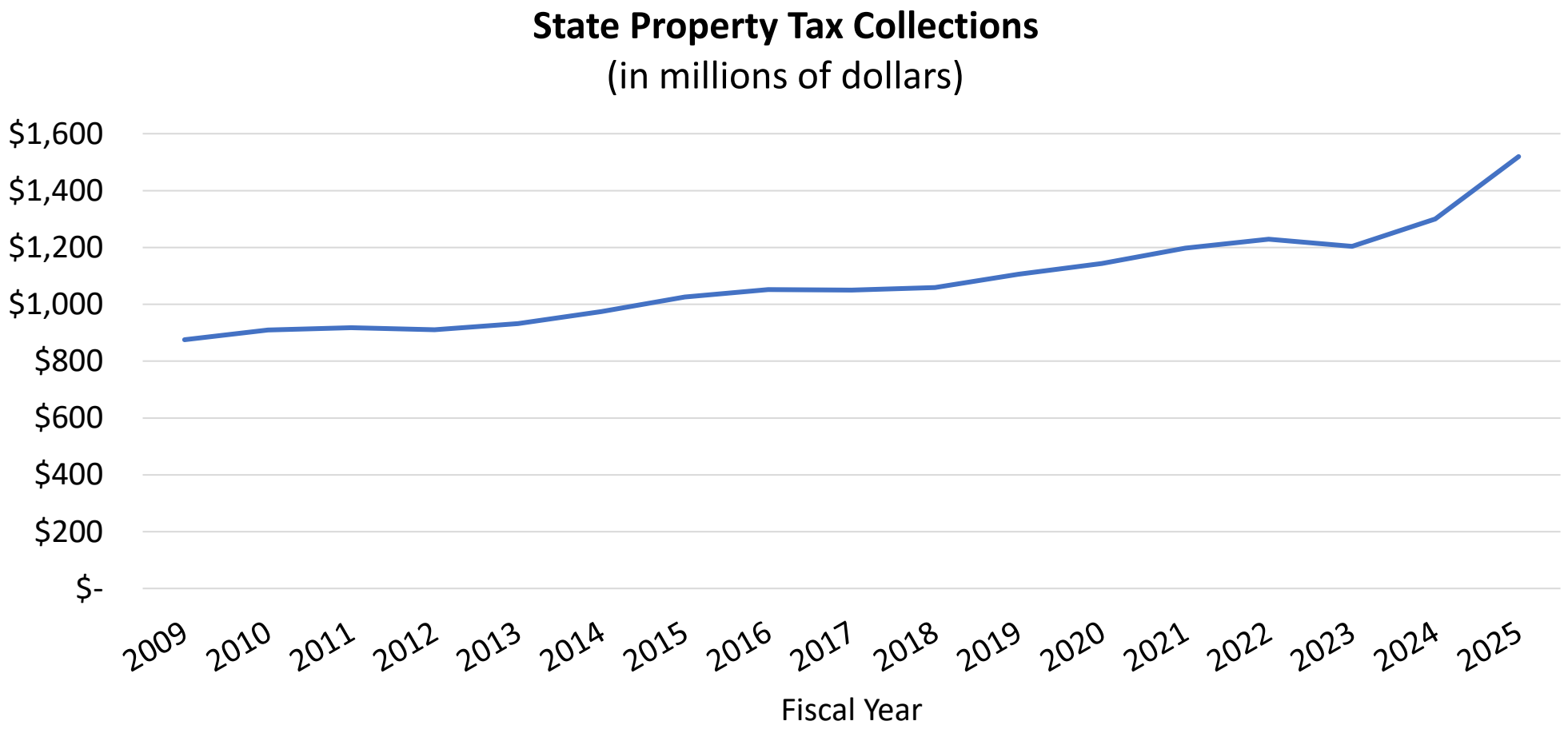
- This depends on how the income tax is structured
  - Is it tied to school budgets or not? Does it rely on income look-backs?
- If income taxes and other nonproperty tax revenues dropped like they did in 2008 recession in FY2026:
  - Estimated $160-170 million shortfall in the Ed Fund
  - $70 million of which would come from the income tax alone
  - If nonhomestead tax makes up the shortfall, would result in at least a 20-cent tax rate increase.
    - Assuming no reserves put towards shortfall
- The other side: Education Fund would benefit from upside/surpluses

Income Tax Volatility: Steady growth but bumps along the way



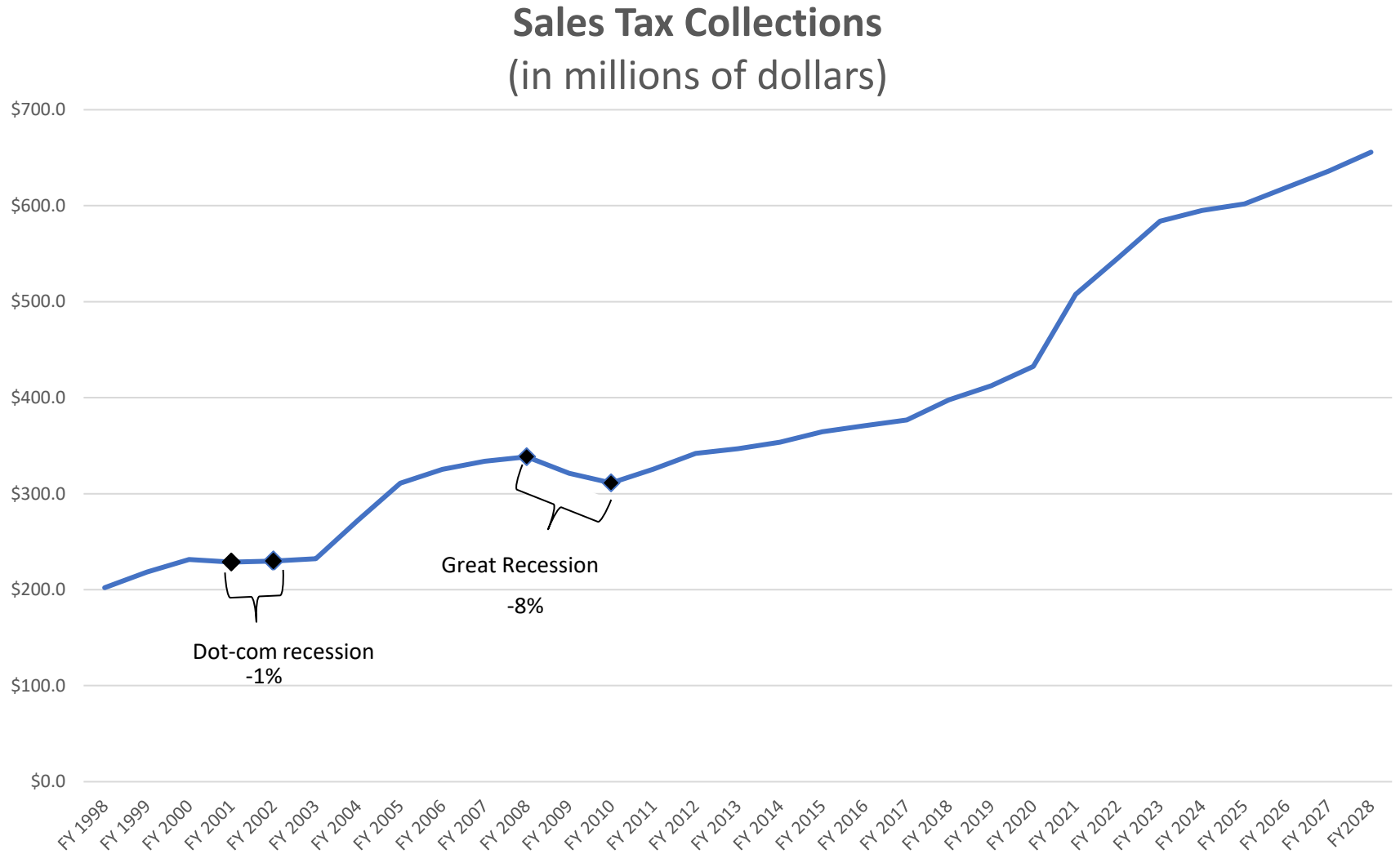
Source: Legislative Economist's January 2025 Forecast

Property Tax Volatility: Slow upward climb



Source: Education Fund Outlooks

Sales Tax Volatility: Middle of the road…



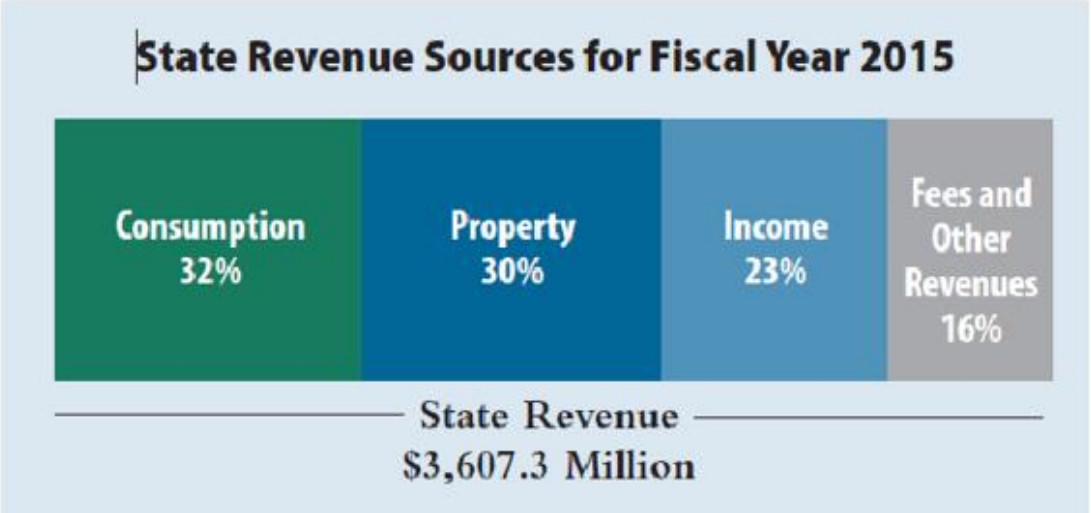
Source: Legislative Economist's July 2025 Forecast

Sustainability and Reliability: Balance

Balance is important in a revenue system, mainly for volatility and reliability

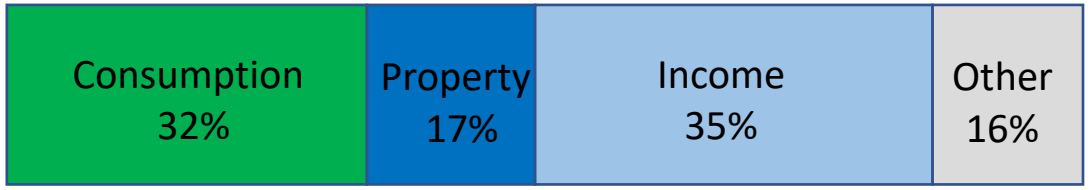
- Total property tax in FY2023: $1.192 billion (net of property tax credit)
  - $727.1 million nonhomestead
  - $465 million homestead

- What if an EIT existed in 2015?
  - Income taxes were 23% of state revenues in FY2015.
  - With an EIT, they would have been 35%



Source: Vermont Ten Year Tax Study, 2017

Hypothetical FY2015 with Education Income Tax



Assuming Education Income Tax replaces only HS property tax

Sustainability and Reliability: Meeting Budget Needs

Do revenues and expenses grow at similar rates?

- Yields and uniform NHS rate assure us that revenue will be sufficient to cover expenses in the Ed Fund
- Nominal revenue growth rates per year:
  - PIT: 4.9% per year (FY2005-FY2024)
    - 3.92% from FY2005 to FY2020
- Total Spending on Education growth rates per year from FY2005 to FY 2025:
  - Total Ed Fund Uses: 4.05%
  - Education Payment: 3.78%
  - *Note: Spending on Education does not grow at the same rate every year.*

Fairness

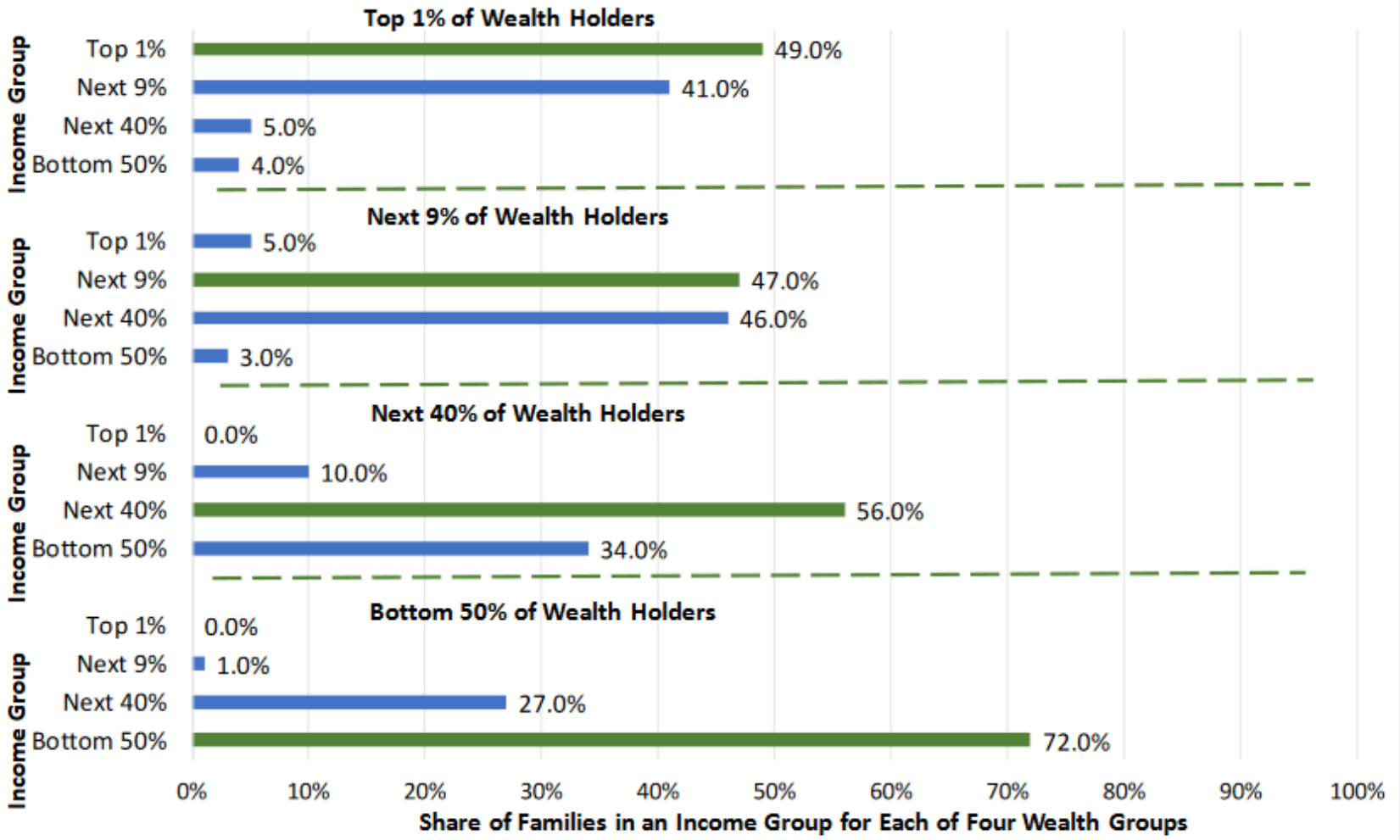
Fairness

How do we evaluate fairness?

- Vertical Equity: greater ability to pay = more tax
  - Personal income tax: quite progressive and getting more and more progressive
    - Act 138 of 2022 represented a major shift in the progressivity of the income tax code
  - Property tax: after accounting for property tax credits, modestly flat up to higher incomes, then regressive.
- But: how do we define “ability to pay?”
  - How much do assets matter? Should we treat housing different?
    - $300,000 worth of long-term bonds or artwork versus $300,000 worth of house?
  - Estate tax, property transfer tax suggest ability to pay should be based upon value of assets
  - There is a lot of churn in Vermont’s highest income filers year to year.
- Horizontal equity: two taxpayers with similar circumstances pay the same in taxes.
  - How do you define similar circumstances?
    - Two individuals who both make $50,000 but one lives in a $150,000 house and the other lives in a $400,000 house. Are these two in the same circumstance?

Fairness – wealth doesn't always equal income

Figure 6. Share of Families in Income Group, by Wealth Group, U.S., 2019



Note: If families who are among the top 1% of wealth holders also ranked in the top 1% for income, the highest dark green bar in this chart would be at 100%. In fact, it is at 49%, and 51% of the families in the top 1% of wealth holders are in lower income categories. Source: Federal Reserve Board, 2019 Survey of Consumer Finances.

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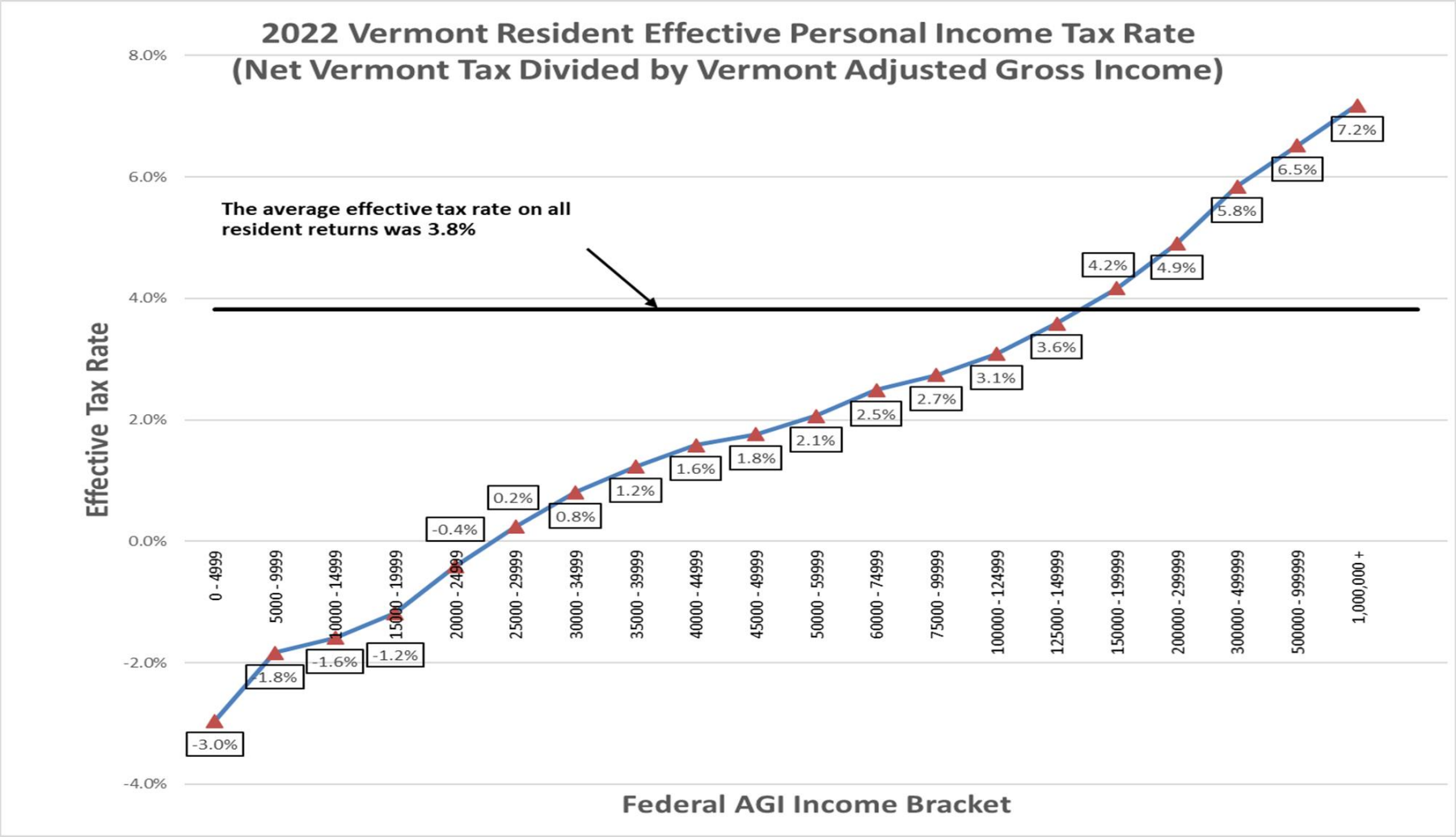
Fairness and PIT: Quite progressive



Source: Vermont Department of Taxes

Fairness and property tax: flat for almost everyone except the very top

- For most households, the tax incidence is flat:
  - 96% of households in Vermont pay roughly 3% of income in property taxes
- But: highly regressive at the top:
  - Top 4% pays only 1.43% on average

FY20 Property Tax Incidence			
Income Group	**Number of Households**	**Total Property Taxes Paid Current Law (millions)**	**Avg Effective Tax Rate**
0 to 47K	47,860	$50.94	3.67%
47K to 90K	58,240	$116.39	2.94%
90K to 140K	38,660	$142.91	3.31%
140K to 250K	17,820	$94.90	2.95%
250K to 1M	6,630	$50.69	1.93%
Over 1M	450	$5.90	0.44%

Source: Department of Taxes

Population is the 2020 homestead declarations

Income is 2019 Vermont Household Income (when available) or sum of 2019 AGI of household members if HHI not available

Note: This modeling was conducted for the Education Income Tax Study Committee in 2022.

Fairness in the overall system

Evaluations of fairness in the tax system should not look at one tax in isolation

- HS Property + PIT in FY20: $1.278 billion worth of revenues
- Combined incidence: (mostly) progressive.
  - Do legislators want a steeper, more progressive slope than the green box?

FY20 Property and Income Tax Incidence					
Income Group	Number of Households	Total Property Taxes Paid Current Law (millions)	Avg Effective Tax Rate (Property Tax)	Avg Effective Tax Rate (Income Tax)	Combined EFT
0 to 47K	47,860	$50.94	3.67%	0.73%	4.40%
47K to 90K	58,240	$116.39	2.94%	2.40%	5.34%
90K to 140K	38,660	$142.91	3.31%	3.09%	6.40%
140K to 250K	17,820	$94.90	2.95%	4.13%	7.08%
250K to 1M	6,630	$50.69	1.93%	5.63%	7.56%
Over 1M	450	$5.90	0.44%	6.05%	6.49%

Source: Department of Taxes, Chainbridge Tax Model

Population is the 2020 homestead declarations

Income is 2019 Vermont Household Income (when available) or sum of 2019 AGI of household members if HHI not available

Note: This modeling was conducted for the Education Income Tax Study Committee in 2022.

Elasticity

Potential Behavioral Responses - California

- In 2012 California increased marginal tax rates by up to 3 percentage points for high-income households.
- A 2021 paper studied the effect of this increase in tax rates and estimated that behavioral responses eroded 45.2% of state windfall tax revenues.
- There were two effects the paper studied:
  - Extensive Margin: Out migration due to tax increase.
  - Intensive Margin: Decrease in reported taxable income due to tax increase.

Potential Behavioral Responses - California

- The combined extensive and intensive responses were estimated to have resulted in an approximately 45.2% decrease in new tax revenue.
  - The extensive margin is estimated to have accounted for 9.5% of the total behavioral response.
  - The decrease in reported taxable income was estimated to account for the majority of the 45.2% decrease.
- Note: 45.2% decrease *does not* mean a decrease in overall revenue. It is the decrease in potential revenue without any behavioral responses.
- https://www.nber.org/system/files/working_papers/w26349/w26349.pdf

Potential Behavioral Responses - Massachusetts

- Massachusetts implemented a 4% surcharge on taxable income over $1 million starting in tax year 2023.
- Initial estimates projected an additional $2 billion in annual revenue.
  - This estimate was a “static” analysis which did not account for potential changes in taxpayer behavior.
- The Tufts Center for State Policy Analysis estimated that with behavioral changes the surcharge would raise $1.3 billion.
- Preliminary results indicate the surcharge generated approximately $1.5 billion in revenue in 2023.

Potential Behavioral Responses - Massachusetts

- The Tufts Center for State Policy Analysis considered behavioral factors including:
  - Some high-income residents may relocate to other states, but indicated the number of movers was likely to be small.
    - This factor was estimated to reduce the expected revenue by 5%.
  - A drop in reported incomes due to tax avoidance strategies like curtailing stock trading, financial restructuring that shifts economic activity out of state.
    - Unlike the question about relocation, estimates of the relationship between tax rates, tax avoidance, and state collections vary widely.
    - Tufts ultimately estimated that 30% of estimated revenue would be lost to tax avoidance, although noted there is research indicating it could be less and also evidence from California that it could be higher.

Potential Behavioral Responses - Massachusetts

- Combined, Tufts estimated behavioral responses would reduce the "static" analysis estimates by 35%, from $2 billion to $1.3 billion.
- For context, MA appropriated $1 billion in anticipation of surcharge revenue in their last budget, well below the initial estimates.
- **Result: Massachusetts ended up collecting $2.2 billion from the tax in 2024.**
- Resources:
  - https://cspa.tufts.edu/sites/g/files/lrezom361/files/2022-01/cSPA_Evaluating_MA_Millionaires_Tax.pdf
  - https://www.masslive.com/politics/2023/12/no-the-millionaires-tax-has-not-been-a-disaster-in-mass-analysis.html
  - https://massbudget.org/2022/08/18/fair-share-tax-on-incomes-over-1-million-would-generate-at-least-2-billion-a-year/

Income Distribution

2022 Personal Income Tax Receipts

AGI income bracket	Number of in state returns	% of total	Amount of taxes paid ($ Millions)	% of total
Negative to 24,999	89,206	27%	-11.40	-1%
25,000 - 44,999	61,461	19%	22.68	2%
45,000 - 59,999	39,688	12%	39.93	4%
60,000-74,999	28,825	9%	47.35	5%
75,000-99,999	32,932	10%	76.65	8%
100,000-149,999	38,964	12%	153.88	15%
150,000-299,999	27,793	8%	243.43	24%
300,000 +	9,232	3%	422.93	42%
Total	328,101		995.45	

Note: In 2022 there were 53,890 out of state returns providing $106.88M in PI receipts

Questions