

Principles of a High-Quality Tax System: Considerations for an Education Income Tax

Senate Committee on Finance
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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

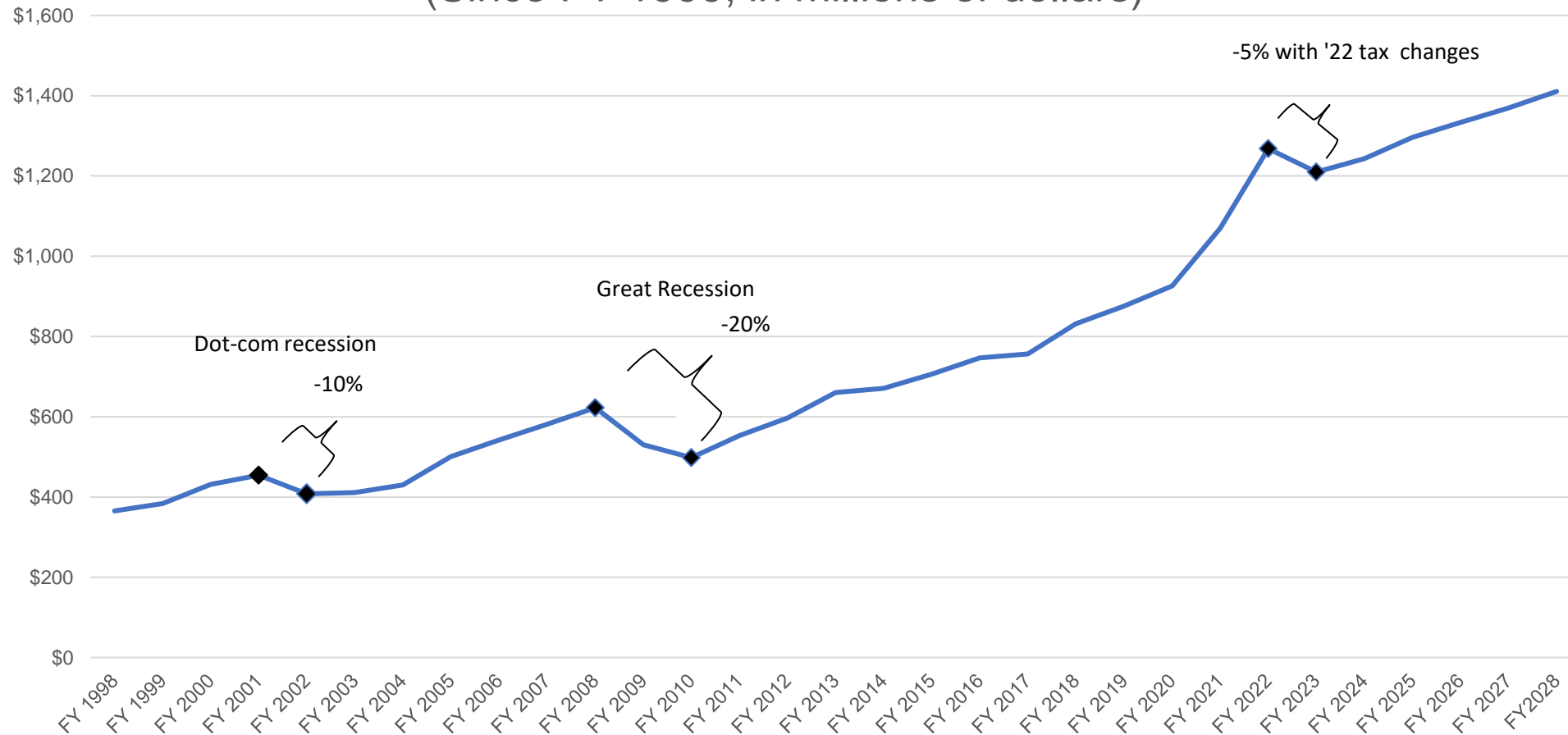
What would the Education Fund look like with an income tax and a recession?

- 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

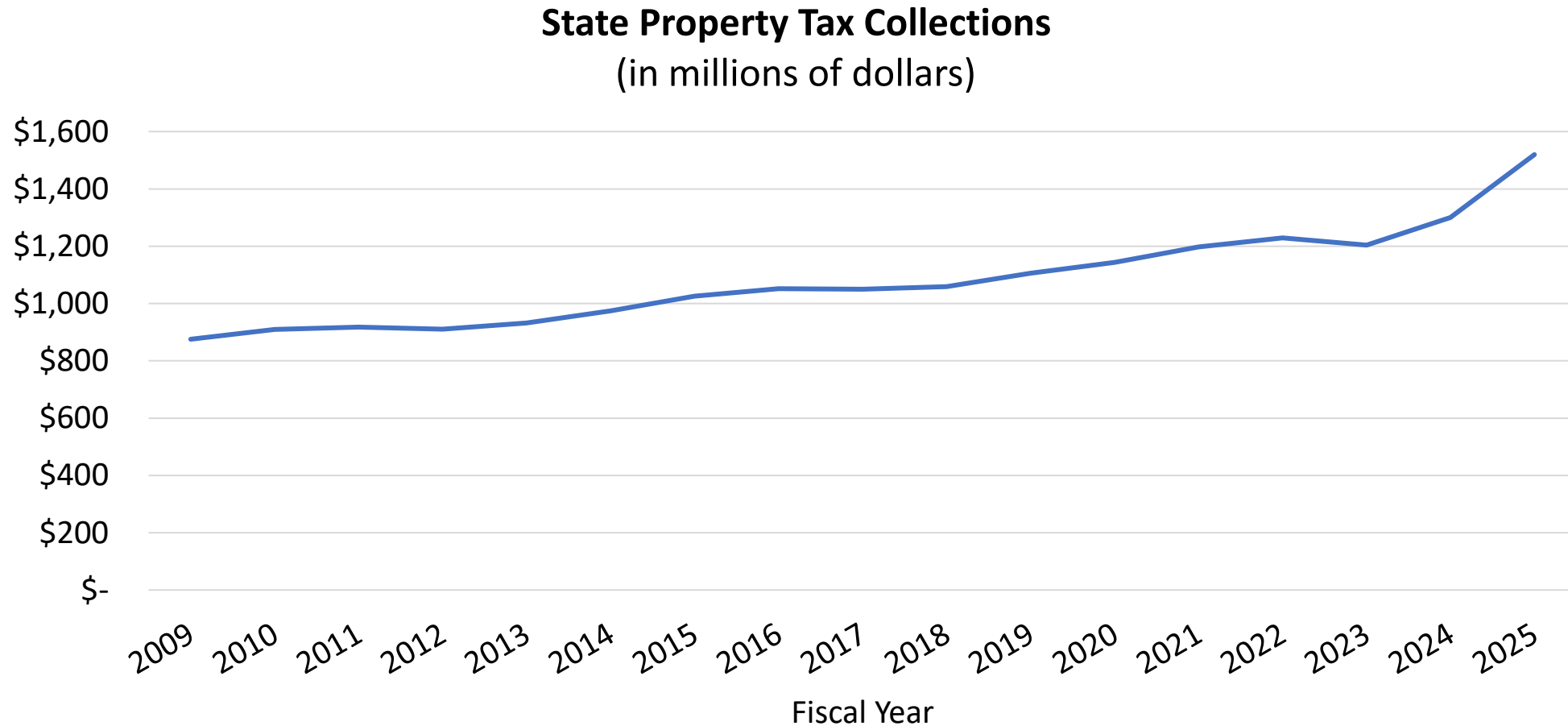
Personal Income Tax Collections (Since FY 1999, in millions of dollars)



Source: Legislative Economist's January 2025 Forecast



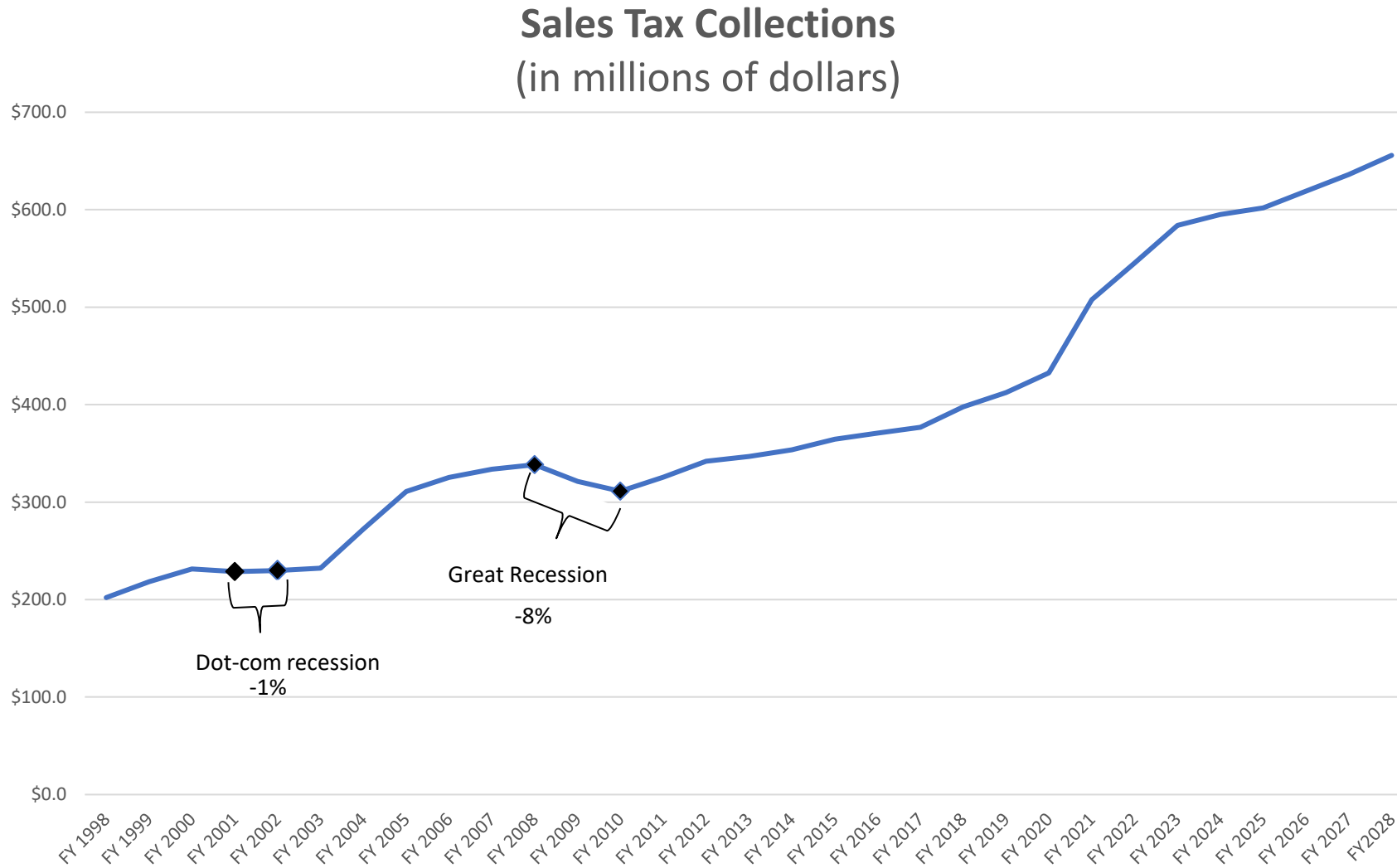
Property Tax Volatility: Slow upward climb



Source: Education Fund Outlooks



Sales Tax Volatility: Middle of the road...



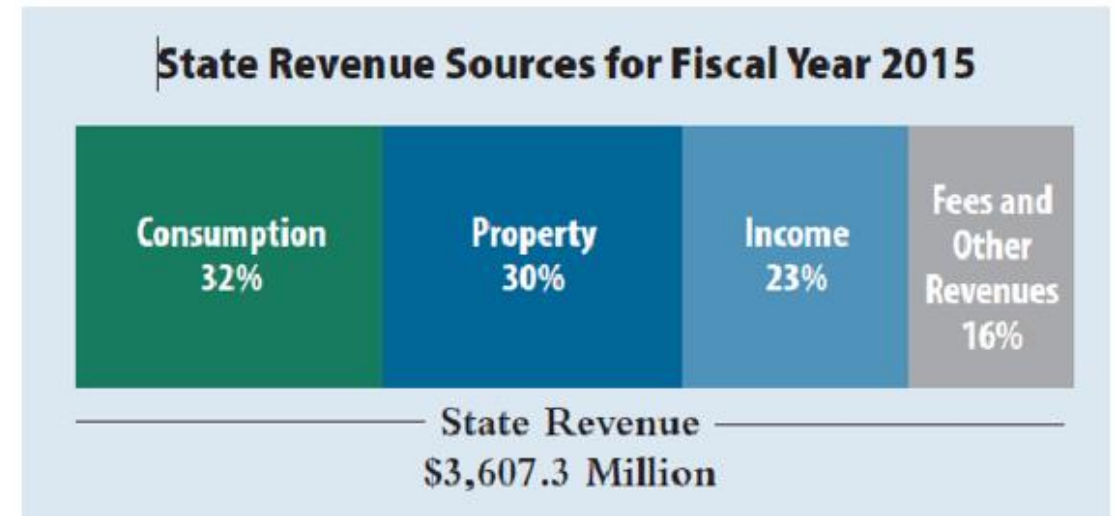
Source: Legislative Economist's July 2022 Forecast



Sustainability and Reliability: Balance

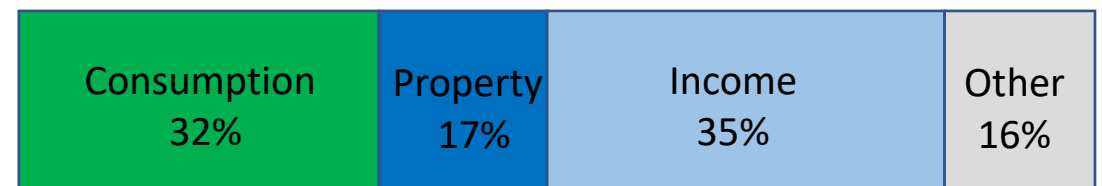
Balance is important in a revenue system, mainly for volatility and reliability

- 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



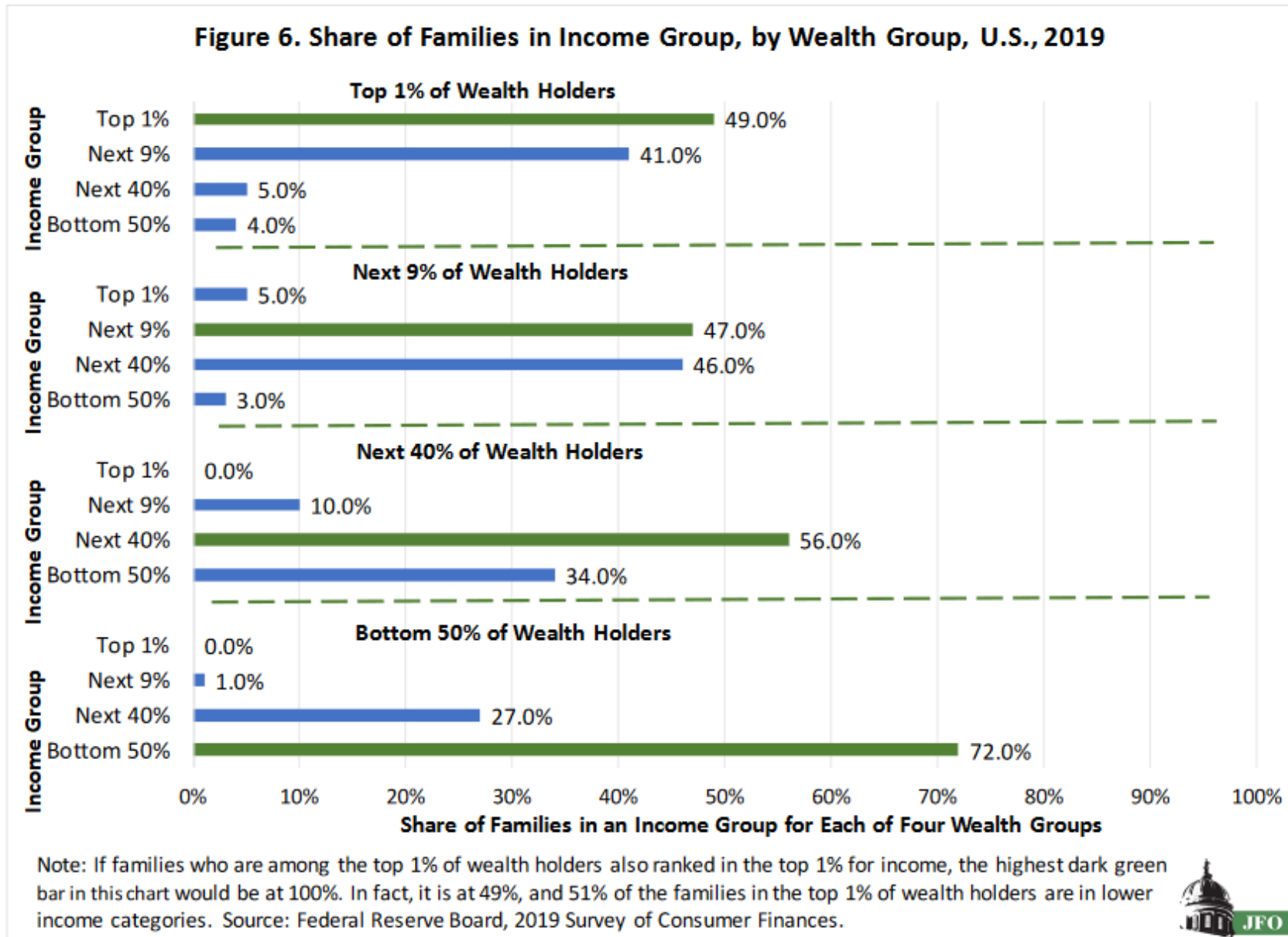
Fairness

How do we evaluate fairness?

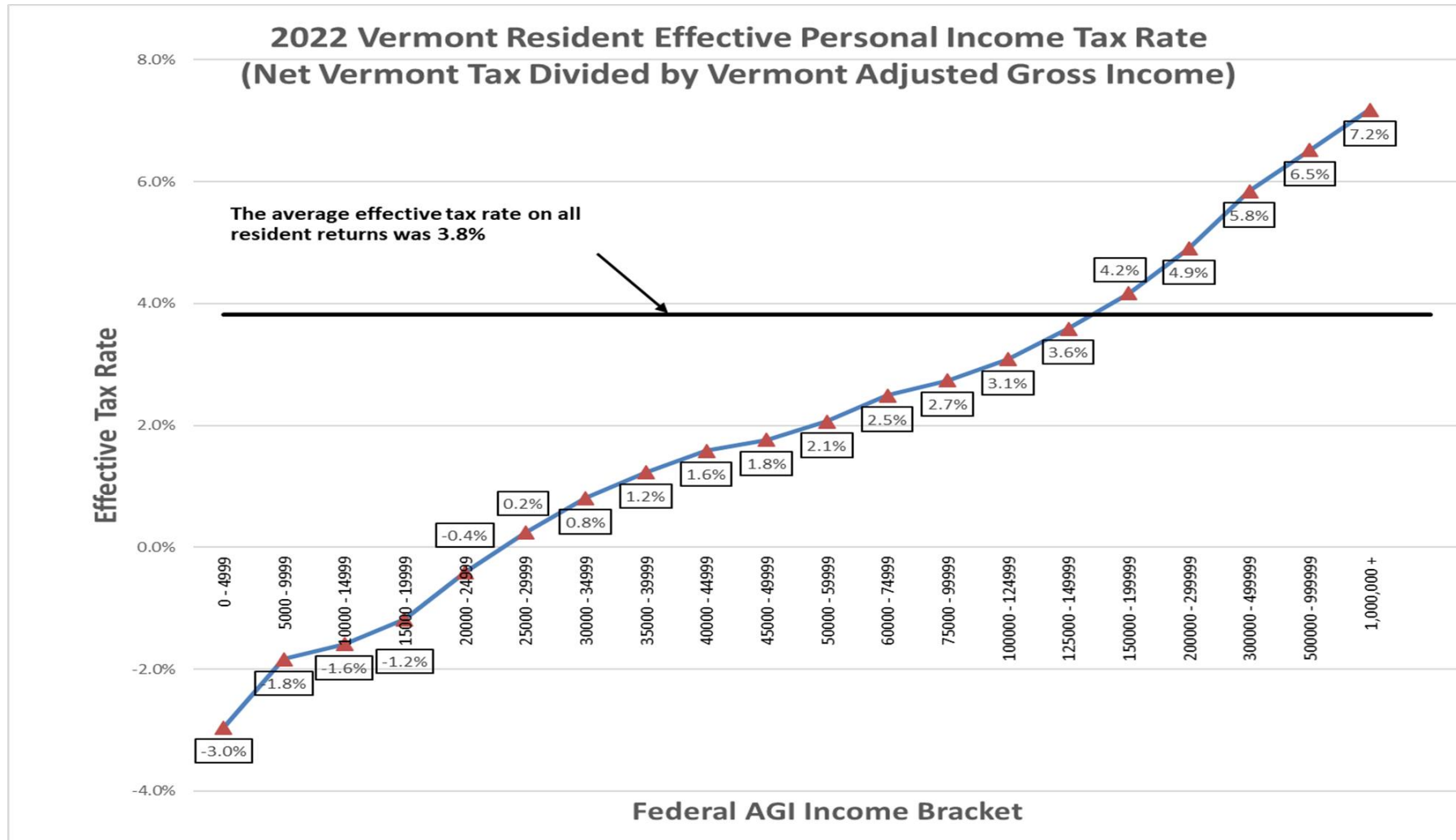
- Vertical Equity: greater ability to pay = more tax
 - Personal income tax: quite progressive and getting more and more progressive
 - Act 138 of 2022 represented a major shift in the progressivity of the income tax code
 - Property tax: after accounting for property tax credits, modestly flat up to 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



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

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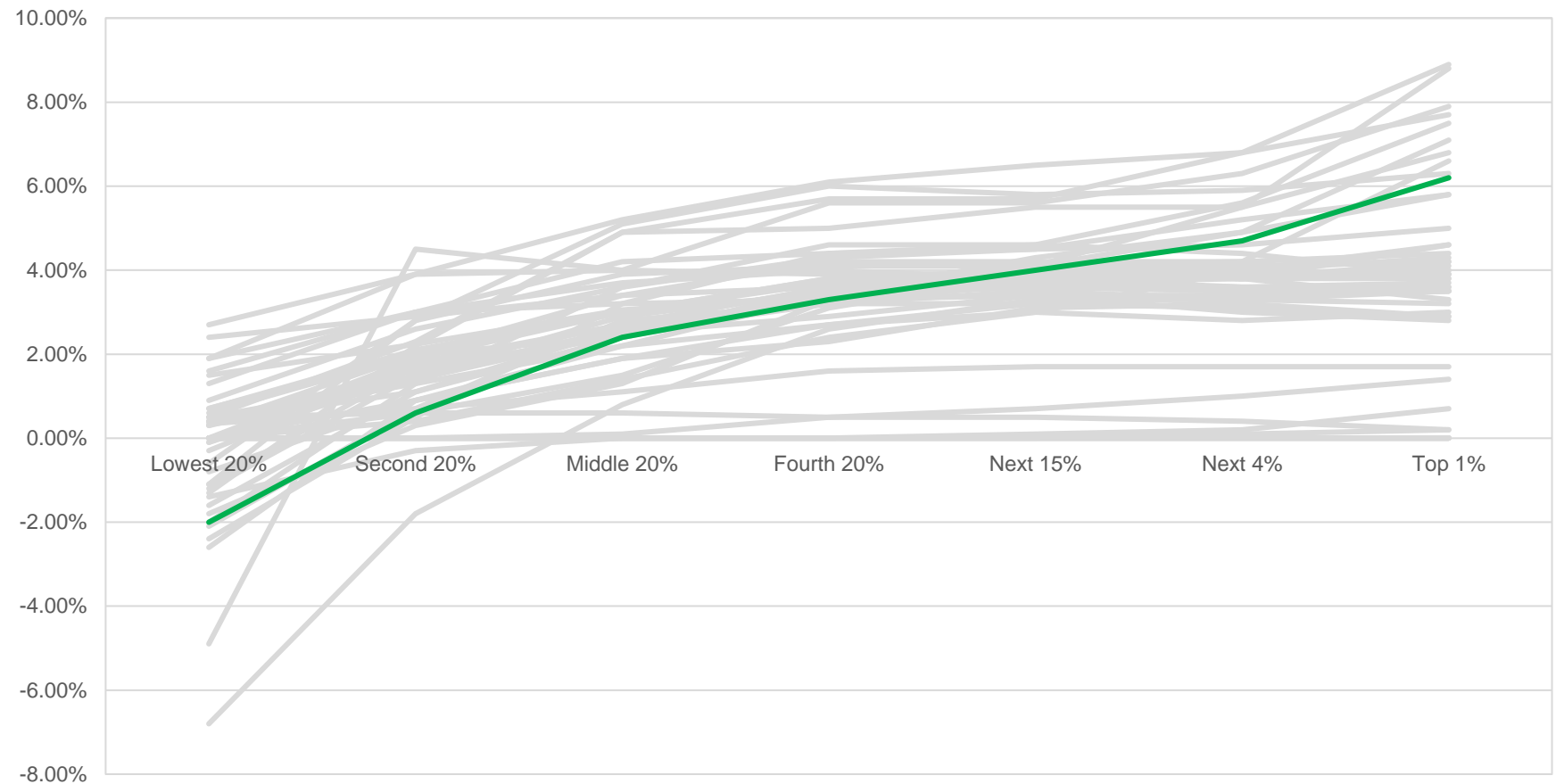
Economic Competitiveness



Economic Competitiveness: Tax Shopping

- **Vermont does not have the highest income taxes in the country**
- Lower effective tax rates for 85% of taxpayers than most states
- Upper third of states after that

ITEP Analysis, Current Effective Income Tax Rates Across Income Groups
(Other states in gray, Vermont in green, excludes taxpayers over 65)



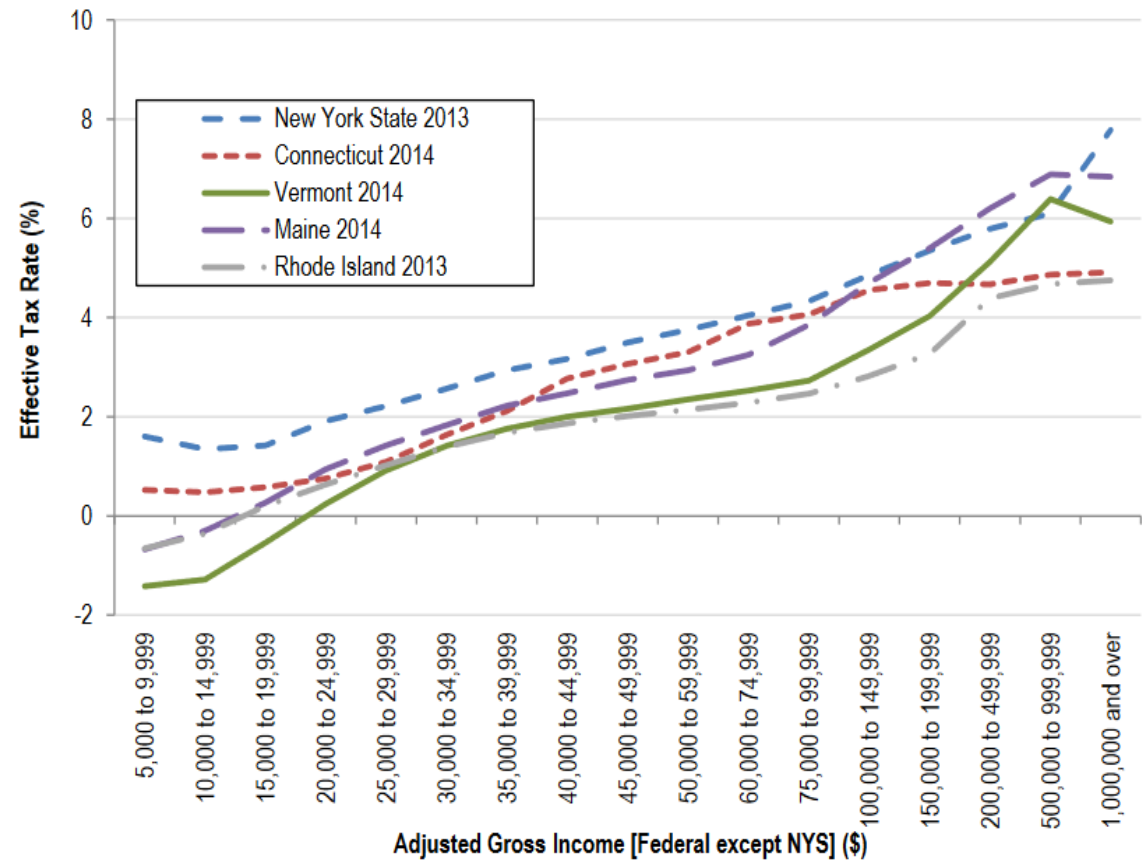
Source: ITEP Who Pays, 7th Edition.



Economic Competitiveness: Tax Shopping

- **Vermont does not have the highest income taxes in New England**
- The answer to the question “Does Vermont have high income taxes?” is “For whom?”

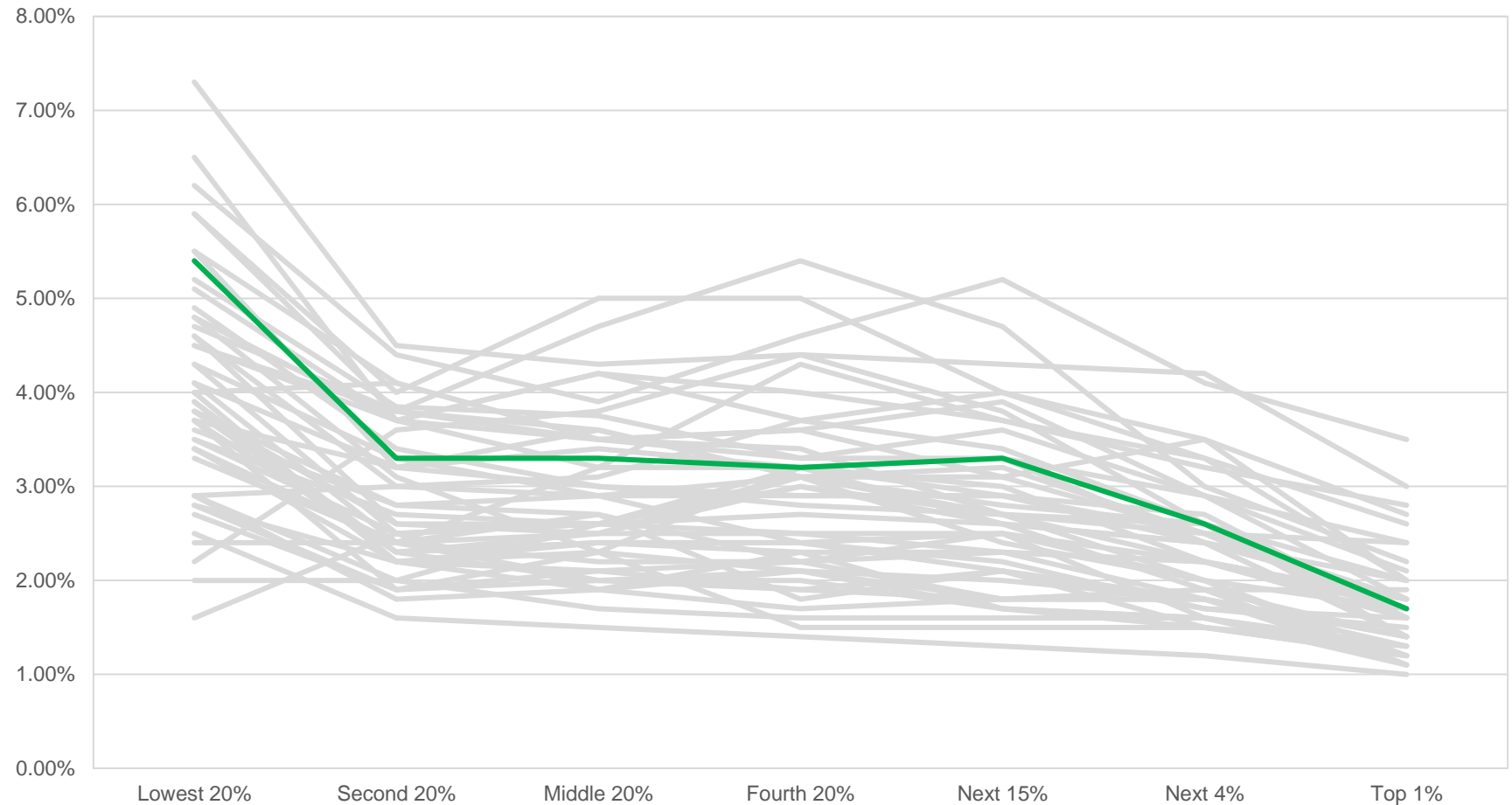
Figure 20. Effective Rate Comparison by AGI Level for the New England States and New York, Tax Liability as a Percentage of Federal AGI, 2013 and 2014



Economic Competitiveness: Tax Shopping

- **Vermont does have comparatively high property taxes**
- Generally, Northeastern states have higher property taxes

ITEP Analysis, Current Effective Property Tax Rates Across Income Groups
(State + Municipal, Other states in gray, Vermont in green, excludes taxpayers over 65)



Source: ITEP Who Pays, 7th Edition.



Economic Competitiveness: Tax Shopping

- Vermont does have comparatively high property taxes

2021 State & Local Property Tax Revenue Per Capita

State	Revenue	Rank	State	Revenue	Rank
New Jersey	3,537	1	South Dakota	1,676	26
New Hampshire	3,328	2	Michigan	1,656	27
Connecticut	3,318	3	Florida	1,642	28
New York	3,302	4	Hawaii	1,599	29
Vermont	3,010	5	North Dakota	1,565	30
Maine	2,861	6	Ohio	1,547	31
Massachusetts	2,797	7	Georgia	1,405	32
Rhode Island	2,463	8	South Carolina	1,396	33
Illinois	2,443	9	Missouri	1,337	34
Alaska	2,329	10	Arizona	1,267	35
Texas	2,242	11	Utah	1,250	36
Nebraska	2,172	12	Nevada	1,227	37
Wyoming	2,167	13	Indiana	1,214	38
Colorado	2,080	14	Mississippi	1,202	39
California	2,078	15	Idaho	1,140	40
Iowa	1,941	16	North Carolina	1,135	41
Virginia	1,918	17	Delaware	1,120	42
Washington	1,905	18	West Virginia	1,073	43
Montana	1,873	19	Louisiana	987	44
Minnesota	1,870	20	Kentucky	968	45
Oregon	1,818	21	New Mexico	935	46
Maryland	1,815	22	Tennessee	932	47
Kansas	1,790	23	Oklahoma	924	48
Wisconsin	1,778	24	Arkansas	837	49
Pennsylvania	1,680	25	Alabama	662	50

U.S. Average = \$1,901 per capita

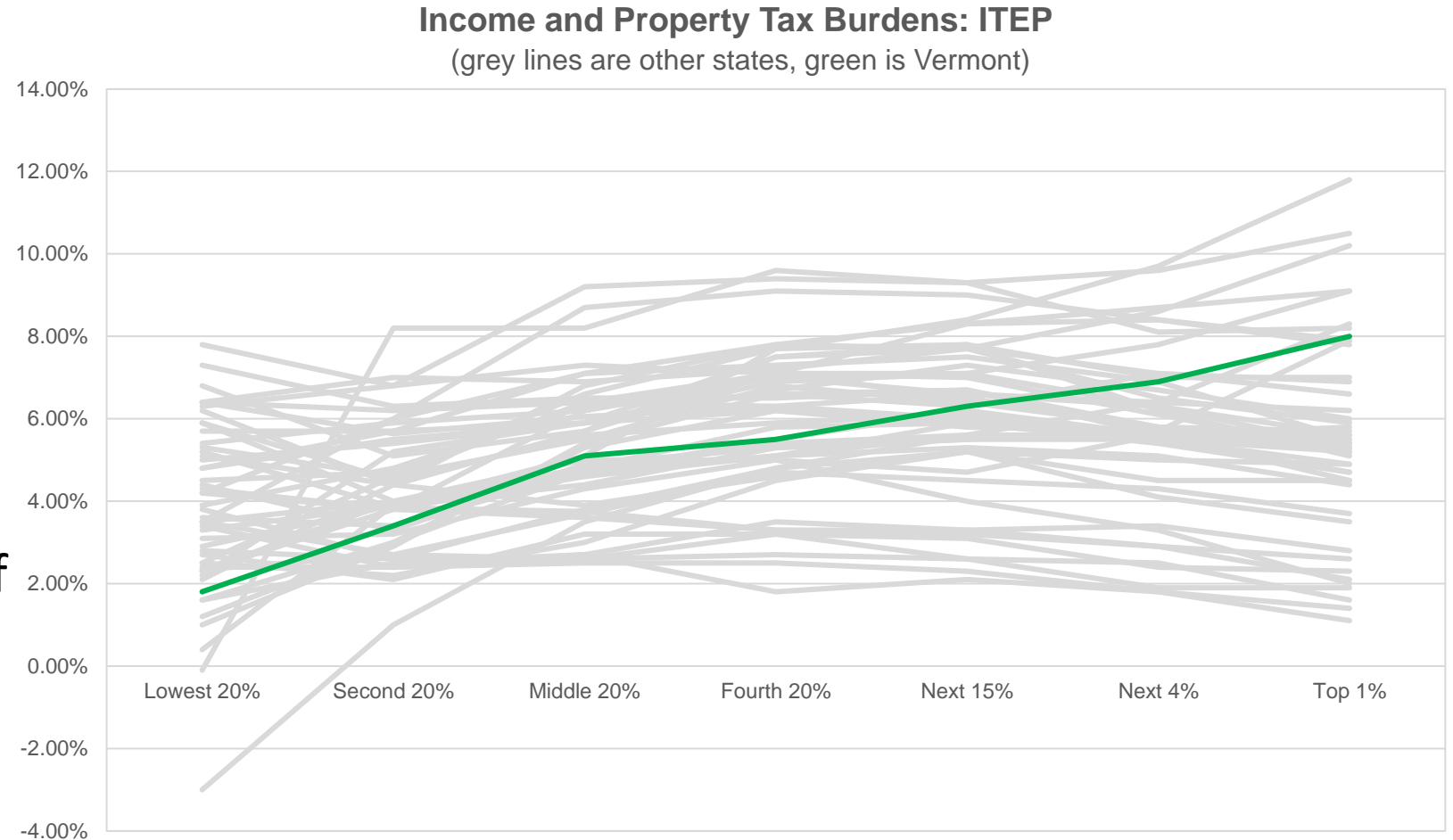
Source: U. S. Census Bureau



Economic Competitiveness: Tax Shopping

What does the tax burden look like across income and property?

- Vermont still has low effective tax rates for 85% of the population.
- Effective tax rates for the highest taxpayers relatively high compared to the rest of the country.



Source: ITEP Who Pays, 7th Edition for other states.

Notes: ITEP populations for states exclude taxpayers over the age of 65.

- Property tax includes municipal and state property taxes

Economic Competitiveness: Tax Shopping

- Easier for individuals to move/adjust income without major disruption to their lives:
 - Delay realizations of capital gains, accelerate deductions or even change legal residency (without selling houses) to lessen income tax burden.
- Tax shopping is more difficult with property taxes because:
 - Physical property that is not as liquid as income.
 - Not easy to establish a new physical location with significant life changes
 - Many individuals have ties to community that keeps them there. Ex:
 - Children in school
 - Business headquartered in Vermont
 - Owning a property and avoiding property taxes is not easy
 - Few incentives in the tax code to reclassify property to lower a tax bill without significant consequences (ie, putting property in current use, but also paying land use change tax when it is pulled out).



Economic Competitiveness: Responsiveness

- **Income tax system may be more responsive to a changing world.**
- There are no local income taxes in Vermont.
- Majority of states have income taxes to develop best practices for structure, compliance, cooperation, comparisons, etc...
- But: changes to income tax require Legislative approval
 - Year to year changes to the property tax rate are “par for the course”
- Vermont’s current statewide property tax system is decentralized and operated at the town level.
 - Changes in assessment practices may take longer and may not be applied uniformly.
 - Any change to the funding mechanism involves many stakeholders.



Tax Neutrality



Tax Neutrality: Behavior Changes

Income tax likely drives more individual behavior changes than property tax

- Income tax changes regularly spur distortionary decision making
 - Income shifting, deduction taking, residency, etc...
 - Elasticity of income, literature on response to state tax policy supports this.
 - https://www.nber.org/system/files/working_papers/w26349/w26349.pdf
- Property tax is residence-based, wealth highly illiquid
- What types of incentives/disincentives does the homestead property tax create?
 - Moving to lower tax towns? Buying smaller houses? Not doing improvements to the home?



Tax Neutrality: Behavior Changes

Income tax might make people less sensitive to school spending decisions

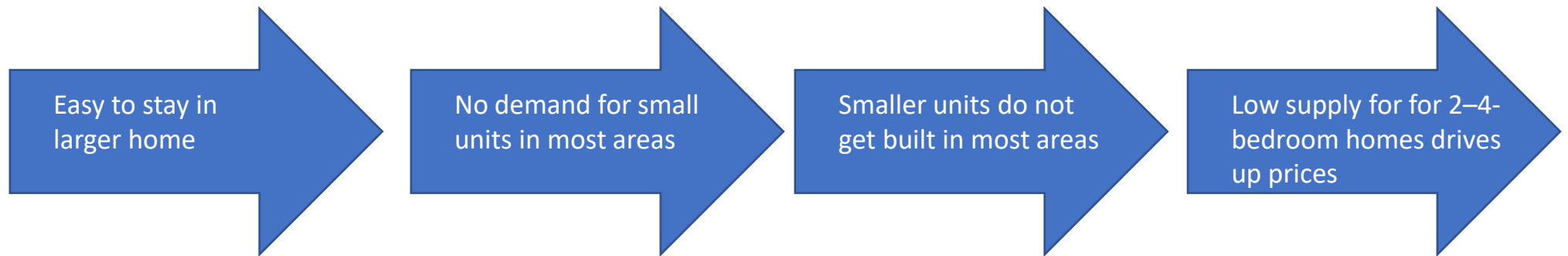
- Key fact: if Legislature sets yields (property or income) based on school spending decisions, taxpayers will not know for certain what their tax rate and bill will be when they vote
- Withholding is designed to “spread” a tax bill over many periods
 - Side-effect: taxpayers don’t feel tax pressure as acutely
- Property taxes are generally paid in only 2-4 installments
 - People who own their home write sizeable checks every year (very visible).



Tax Neutrality: Housing Mismatches

Consider the incentives created by property taxes based upon income or education income taxes

- Do these taxes allow for smaller and/or older, households to stay in larger homes?
 - Current property tax credit: Approximately \$150 million per year.



- Mismatch in housing supply and demand within the market
 - Over \$40 million in State funding has been allocated to address Missing Middle housing since the start of COVID: more modest, single-family homes and apartment buildings



Simplicity



Simplicity: Taxpayer Understanding

Any tax system tied to local-voted school budgets and statewide yields creates complexities regardless of the financing system.

- Homestead property tax rate, bill and property tax credit: difficult
 - Voters will never know their tax bill when they vote their school budget because their tax rate is dependent upon what other towns do.
 - Mismatch in timing between property tax credit and tax bills
- Education Income Tax: depends
 - Will the income tax rate be tied to school budgets?
 - If so, system becomes far less simple: voters will never know their tax rate when they vote, may involve income tax look-backs depending upon design.
 - If not, with a rate that doesn't change, taxpayers can easily calculate their tax if they know their rate and income.



Simplicity: Administration

Ease of administration for an education income tax varies drastically depending upon design

- Current system: Multi-level administration

Towns

- Assessments and appeals
- Issuing of bills
- Collecting money

State

- Set yields
- Assessment assistance
- Distributing money
- Property tax credit

- Layers of administration can lead to lack of understanding/frustration for taxpayers
- **Would an Education Income Tax be simpler?**
 - Department of Taxes has established systems to collect income taxes
 - Complications arise depending upon the system:
 - Residency requirement? How does Department ensure compliance?
 - How would “income” be defined?
 - Concern for renters? Is a new renter credit involved?
 - Rates tied to local spending decisions? How does Department implement that into their collections systems?



Accountability



Accountability: Exemptions and Credits

Carve-outs in the current system are minimal.

- Tax expenditures in the property tax system mostly apply to nonhomestead property
- Property tax credit definition of household income does not include exemptions for various groups or types of income.
- Income tax code contains more exemptions for individuals:
 - Social Security, people with medical expenses, people who give to charity, people with young children, people who contribute to 529s.
- Legislators should consider whether similar exemptions may be requested in an Education Income Tax
- Policy incongruence: exemption on personal income tax but not the education income tax?



A few closing notes...

- Whether an education income tax conforms to or runs counter to these principles depends upon the system created by Legislators
- No tax system adheres to the principles exactly
- Tradeoffs are inherent so prioritization is key:
 - Does the Legislature prioritize Simplicity over Fairness in this tax?
 - Is sacrificing economic neutrality worth increased fairness?
- Goal is not designing a system that is perfect, but one that hews close to priorities and improves on the current system
- **What are the goals and priorities of an education income tax?**
 - How closely can Legislators marry those goals with these principles?
 - If this exercise were straightforward, then there wouldn't be a need for this committee

