

**The Basics of the Ways and Means
Committee Equal Education
Opportunity Act**

Prepared for the Vermont Business Roundtable

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Q1. What is the general thrust of the Ways and Means Plan to change property taxes?

A1. The plan lowers residential property taxes. It does this by increasing many existing taxes and also by implementing a wide range of new taxes in order to pay for the property tax reduction. One major new tax is a local income tax.

Q2. The computer printouts that have been circulating show that nearly every town and every homeowner will see a reduction in their taxes. How can everyone be a winner?

A2. Good Question. Everyone can't be a winner. The Committee plan essentially shuffles \$700 million of taxes around, raising taxes for some and lowering it for others. We make a ballpark estimate that the plan only brings in about \$40 million of new tax revenues from non residents of Vermont. That means a \$40 million net reduction in taxes paid by Vermonters.

Q3. What are these new sources of revenue paid for by non residents?

A3. Another ballpark estimate: about \$25 million comes from taxing vacation property in ski towns. Another \$15 million will be paid by non residents who will pay a portion of the new taxes and increases in the meals and rooms tax.

Q4. What about the remaining \$660 million?

A4. There is no estimate needed here. That represents a reshuffling of taxes among Vermont homeowners, renters, and businesses.

Q5. Then how can the town by town printouts that are circulating show that just about every town comes out ahead and also show that within each town, nearly every homeowner comes out saving money?

A5. The printouts ignore many of the tax increases Vermonters will face if the bill becomes law. The printouts only focus on the reduction in property taxes on a house and two acres and the (new) local income tax Vermonters will pay. These printouts ignore:

- The property taxes that the 32,000 Vermont homeowners who own houses with more than 2 acres of land will pay. We estimate the taxes on the land in excess of 2 acres to be about \$25 million.
- The property taxes that those Vermonters who own deer camps and vacation homes will pay. We have no estimate of the dollar value of this.
- The additional sales and other consumption based taxes that are part of the plan. We estimate this to be between \$50 and \$60 million, which will ultimately be paid by Vermonters.

If these additional taxes were included in these printouts, taxpayers in many towns would find that their net tax savings are not so large.

Q6. What is the most significant change that the Committee plan would make?

A6. That would be the imposition of a local income tax. The local income tax rate would vary by town and would be set at town meeting just as the local property tax is now. The current local school property tax and the proposed local income tax are both the result of decisions to spend a certain amount of money on education.

Q7. What are some of the problems a local income tax would cause?

A7. One is that when the state and local income taxes are considered together, Vermont would have the highest combined marginal income tax rate in the nation. (The marginal income tax rate is the additional taxes paid on an extra \$100 of income.) High marginal tax rates can discourage economic activity, making Vermont a less attractive place to start or expand a business. Over time, that would lead to fewer jobs, less income growth, and a worsening revenue situation for the state and local governments.

Q8. Are there other issues that should be considered concerning a local income tax?

A8. One other that is worth considering is that income taxes are volatile and are sensitive to underlying economic conditions. If the local income becomes a significant revenue source for schools, there will be much more volatility in raising the necessary school revenues. It is not clear what would happen when the next recession hits Vermont and the local income tax does not raise the expected revenues. There will not be enough revenues in the system to pay out all of the promised funds to local districts unless other taxes and tax rates are raised. The school financing system will then face revenue problems similar to those that the state of Vermont general fund faced in the early 1990s.

Another issue is that differential local income taxes will cause people to move for tax reasons. One characteristic of a good tax system is that it should have a minimal amount of economic distortions in an economy. Significant tax rate differentials will lead to geographic mobility. This is true not just when considering tax differentials among Vermont's 251 towns, but also when considering the income tax rate differentials between Vermont and other states in the nation.

Q9. How will all these new funds be distributed to the towns?

A9. The actual formula is quite complex – even more complicated than the current foundation formula for distributing state aid to education. But it essentially works this way: Every town is guaranteed to be able to raise a certain amount of money (about \$300) per student for every one percent local income tax rate. That makes it just as easy for an income and property poor town to raise the same amount of money per student as a town that has a high income.

However, if a town spends too much per student, it gets penalized. It will pay far more in local income taxes than it gets for the additional spending. This hits high spending towns hard and

forces them to have a very high local income tax if they want to continue to spend their current level of per student spending.

Q10. Is this a method of cost control?

A10. No. At best it is an attempt at controlling costs in high spending districts. But it is a spending inducement to most districts. The funding distribution mechanism is designed to allow low spending towns to easily raise their per student spending. That will mean a higher overall level of education spending (Vermont currently ranks among the top six states in per student spending).

The cost control elements come into play because of the assumption that districts with high local income taxes will want to cut their costs in order to reduce their local income tax rates. The statewide average rate will be somewhere around 8% of the federal tax liability (the current statewide rate is 25% of the federal tax liability). But some towns will have very high income tax rates, such as Charlotte (15.5%), Cornwall (15.5%), Dorset (23.6%), Fayston (16.8%), Manchester (16.1%), Norton (14.9%), Norwich (14.5%), Shelburne (17.4%), Stowe (20.2%), Vernon (21.8%), Weybridge (15.7%), Whitingham (19.1%), Williston (15.7%), and Winhall, with the highest tax rate of 31.4%. Note that all these rates are the income tax rates that would have prevailed in 1996 if each town had the same spending level as they actually did have in 1996 but used the local income tax under the Committee plan.

The cost control theory is that people in these towns will not be willing to pay these high income taxes and those towns will reduce their spending so taxes will go down. But there is a problem and that has to do with the structure of the Vermont income tax. Vermont has a very progress income tax. Low income Vermonters pay little or no income tax, and even middle and upper middle income Vermonters pay relatively low income taxes – at least by national standards. Only high income Vermonters pay a lot of taxes. Statewide, 1.3% of Vermont taxpayers pay 25% of the total state income tax burden. That will basically be true for the local income tax as well. What that means is that even in high spending towns, there will only be a few families that will pay extremely high taxes.

Take Weybridge, for example. A family earning \$40,000 in Weybridge would pay \$480 in local income taxes at their new tax rate of 15.7%. This would allow Weybridge to continue spending \$7,966 per student. The Weybridge family would have the option to reduce its income taxes down to the local average rate of 7.5% and pay only \$228 in local income taxes. But that would reduce their per student spending to the statewide average of \$6,297. Would those residents sacrifice \$1,600 of spending per student in order to see their local income taxes drop by \$250? If they don't, then there is no cost control built into the structure of the Committee plan even for high spending towns. Only a small number of Weybridge families would be hit hard by the local income tax. The vast majority of residents would not.

Q11. What about a low spending town with low income taxes?

A11. Let's use Richford as an example. Richford's income tax rate would be a low 3.3%. A family earning \$40,000 in Richford would pay \$100 in local income taxes to support its current per student spending level of \$5,361. For only \$118 more in local income taxes, Richford residents could raise their per student spending by \$900. That's quite a bargain and would very likely be one that Richford residents would embrace.

Q12. What is the likely net impact of the plan if these behavioral changes are considered?

A12. High spending towns would probably not ratchet down their spending as much as low spending towns would likely raise their spending. That means overall spending on education would increase. We estimate that overall costs will increase somewhere between \$25 and \$35 million if the low spending towns bring their spending up close to the state average and the high spending towns do not cut their spending by much.

Q13. Where would the extra money come from to support the extra spending in towns like Richford which currently have low spending levels?

A13. It certainly would not come from Richford taxpayers. That's what makes it so attractive on paper. But there is no analysis or accounting for where these extra funds would come from in the town-by-town printouts that are being circulated. The way the system is structured, a new entity, the School Board Trust Fund, would be able to set the residential and non residential tax rates and certain state aid parameters in order to insure that the system had enough revenues to fund all local towns' education plans. But there is still some degree of uncertainty involved. The Trust Fund has to forecast the overall level of funds that will be necessary to distribute to towns, and then estimate the tax rates and other parameters needed to raise that amount of funds. Those are not easy tasks.