Tax Reform Considerations in Vermont

Presentation to the Vermont Blue Ribbon Tax Structure Commission

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Don Boyd
Senior Fellow, Rockefeller Institute of Government
(Affiliation for identification purposes only)
boydd@hughes.net
Introduction and outline

- My background
- State and local governments in the overall fiscal system
- Financing challenges for state and local governments
- Principles of taxation and tax reform
- Vermont in the national system
- General advice as you approach tax reform
- Specific advice as you think about AGI and taxable income
- Concluding remarks
State and local governments in the federal-state-local fiscal system

- For nation as a whole, S&L Gov’t is larger than the manufacturing sector; accounts for 1 out of 6 workers. Large in VT, too.
- SLG direct spending on domestic programs - education, health, public protection, transportation, income support – larger than federal gov't direct spending. (Feds play major role in financing)
- Responsible for over 90% of all prisoners, approximately 95% of the public road system; spend more than 90% of all public capital infrastructure money
- Financing systems are not up to the task.
Financing challenges for state and local governments

Short and medium term
- Volatile revenue, stable and rising spending demands
- Huge budget gaps in recessions, annual budget balance requirement → fiscal and policy roller coaster
- The “cliff” after federal stimulus $ goes away

Longer term
- Rising demographic & cost pressures on Medicaid
- Pensions and OPEB
- Continued movement toward service-based economy
- Erosion of the sales tax
Financing challenge: Taxes could take 4-5 or more years to re-attain prior peak (Data are for nation)

Taxes adjusted for population growth, inflation, and legislative changes
By fiscal year, indexed to approximate start of each fiscal crisis (Year 0)

Sources: Tax revenue (Census Bureau and Rockefeller Institute estimates), Inflation (BEA GDP price index), Legislative changes (NGA/NASBO Fiscal Survey of States Fall 2008)
Principles of taxation and tax reform – comments on selected NCSL principles

- Adequacy – stability, certainty, sufficiency
- Equity – horizontal, vertical
- Minimize economic distortion, responsive to economic competition – Repeat: “broad base, low rates,” BBLR, BBLR, …
- Easy to comply with and administer
- Must look at whole system – state-local, all major sources
Unfortunately, principles often conflict with each other!

- Steeply progressive income tax may meet some policymakers’ equity goals, but it is volatile and high marginal rates are distortionary.
- Sales tax on food and services may be stable and less-distortionary, but will violate some policymakers’ equity goals.
- Crucial to think about system as a whole. Some otherwise-problematic individual options can be attractive as part of a larger package.
Vermont has ranked about 6th to 10th-highest for most of 30 years
Vermont’s higher taxes driven by property tax and selective sales (esp. meals & rooms)

State and local government taxes as a percentage of personal income, 2006

<table>
<thead>
<tr>
<th>Vermont</th>
<th>Individual New England States</th>
<th>VT indexed to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of personal income</td>
<td>Connecticut</td>
<td>Maine</td>
</tr>
<tr>
<td>Total taxes</td>
<td>13.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Individual income tax</td>
<td>2.7%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>General sales tax</td>
<td>1.6%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>Property tax</td>
<td>5.6%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Corporate net income tax</td>
<td>0.4%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Selective sales taxes</td>
<td>2.4%</td>
<td>1.2%</td>
</tr>
<tr>
<td>All other taxes</td>
<td>0.8%</td>
<td>0.3%</td>
</tr>
</tbody>
</table>

Source: U.S. Bureau of the Census (taxes); Bureau of Economic Analysis (personal income)
Historically, Vermont’s tax structure has been volatile

State-local total tax volatility – 1986-2005
(AK excluded as extreme outlier: value=19.6)

General comments as you approach your study

- Adequacy – esp. stability - is a crucial consideration. Must consider the state system. Consider financial management tools as well as volatility.

- Equity/incidence analysis – can models analyze the complexity of important parts of VT’s system, esp. property tax? How will they deal with rooms & meals tax?

- Economic considerations – the BBLR goal more likely to be achieved by a package than a single option. But that raises equity and planning issues – can you get there from here?
Specific comments as you think about AGI versus taxable income

- Broad base, low rates is a *possible* outcome
- Will be great pressure to deviate from this
  - Retirement income, other income
  - Itemized deductions
  - “Incentives”
  - Credits
- Distributional consequences potentially severe, credits or other low-income offsets may be desirable
- Will not eliminate whipsawing from federal tax changes; will not eliminate complexity
Concluding comments

- This is certainly the right work at the right time
  - Short-term volatility
  - Medium-term adequacy issues as economy recovers
  - Longer-term issues as economy continues to shift toward services