Truth Squad: Do Dubie's tax plans help the rich?

By Anne Galloway on October 21, 2010

Brian Dubie. Photo by Terry J. Allen

Lt. Gov. Brian Dubie, Vermont's Republican candidate for governor, has said reducing taxes is his No. 1 priority. To do that, Dubie has proposed capping state spending at 2 percent – after he reduces next year's budget by $112 million. Once the caps are in place, he asserts that he can give Vermonters a $240 million tax break over a three-year period.

In television and Google ads, Dubie has repeatedly mentioned the Vermont business climate's abysmal ranking – 41st in the nation — from the Washington, D.C-based Tax Foundation, a non-profit research organization. He blames the state's tax system for the poor rating. He has made much of protecting small businesses from what he characterizes as a rapacious state government that threatens to make them uncompetitive through excessive taxation and strangulating red tape (environmental regulations).

But in debates, presentations and the single press conference held this election cycle, Dubie has not explained how his tax plan would work. His 26-page economic development plan, which he holds up at nearly every public engagement, is woefully short on detail.

Dubie has not provided information about how he would reduce the state budget by 9 percent ($112 million) to resolve the budget gap — on top of three years of significant reductions and the implementation of the Challenges for Change government restructuring plan, which is supposed to make permanent reductions in state spending of $72 million in fiscal year 2011. (Peter Shumlin's plan, which is the same length, is just as vague in its descriptions of his single-payer health care plan, corrections and budget proposals.)
See related stories: **Truth Squad 1; Dubie, Shumlin score points, keep budget details under wraps,** **Video of Dubie's "Pure Vermont" launch**, **"Analysis: Dubie wants to cut taxes, dole out tax breaks,"**

In this special report, we examine what Dubie has said about how he would cut taxes, weighing his comments against information from experts.

Dubie's comments about his most important public policy initiative – tax cuts — have also been brief and simplistic. When pressed by reporters, Dubie said in August that he would like to reduce Vermont's income taxes to 6 percent. He didn't explain how that percentage would be applied to the state's five tax tiers except to say that all tax brackets would see a reduction.

Since then Dubie has referred to New Hampshire's taxation system as the ideal. (The Granite State has no sales or income tax.) He has also held up Massachusetts' flat-tax system as an "example" of a preferable model he would like to see in Vermont. In other remarks, Dubie has said he would like to cut $84 million in education spending – nearly four times the amount schools have been asked to reduce their budgets under the Challenges for fiscal year 2011.

In this special report, we examine what Dubie has said about how he would cut taxes, weighing his comments against information from state officials, the Tax Foundation, the Center for Budget Policy and Priorities, the Institute on Taxation and Economic Policy, the Vermont Tax Department, Public Assets Institute, **the Vermont Tax Commission** and the Vermont Joint Fiscal Office.

We wanted to know: Is Vermont's tax burden as onerous as Dubie says compared with other states? Is it possible to eliminate the income tax? What would happen if Vermont went to a flat tax like the one in Massachusetts? How would such radical tax changes affect Vermont tax fairness? Would an $84 million reduction in education spending result in an 8.4-cent increase in the statewide property tax rate?

We found the following:

* Vermont's tax burden isn't as bad as it looks;
* Only one state (Alaska) has eliminated the income tax in recent history (because it was able to replace the income with a slice of oil revenues);
* If Vermont adopted a 5.3 percent flat tax, Vermonters in the lowest tax bracket would have to pay $121 million more in taxes while middle- and high-income taxpayers would see a $106 million tax break;
* In New Hampshire, our income- and sales tax-free neighbor, the poor pay four times more in taxes as a percentage of their income than the richest Granite State residents, according to the Institute on Taxation and Economic Policy.

Additionally, the 2 percent cap in state spending would dramatically lower the budget for years to come.

Download this graph, which puts the lieutenant governor's plan in the context of the Joint Fiscal Office budget gap analysis.

Dubie cap, JFO budget gap analysis

Vermont tax burden redux

There are two reasons why taxes are so hard to talk about in polite society and on the campaign stump: 1. The subject puts most people to sleep; 2. Those who are riveted by the topic tend to present the information selectively.

It turns out that there are lots of different ways to look at Vermonters' tax burden. That's why we consulted with experts from different organizations to get a handle on how Vermont's taxes compare with other states.

Vermont's tax system is, like its rural character, idiosyncratic. That is to say, we are, as several organizations have told us – the Tax Foundation, Forbes Magazine – out of step with the mainstream. (Forbes ranked the state 47th for the second year running in its business cost index, which is based on cost of labor, energy and taxes, according to Vermont Business Magazine.)

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But not out of step in the way you might think: Our tax rate isn't as high as it seems. On paper, Vermont's income tax rates for wealthy residents (7 percent to 8.9 percent for four income brackets ranging from $82,400 to $373,000) appear to be higher than that of Rhode Island (5.99 percent for $125,000 and higher), Massachusetts (5.3 percent flat rate) and Connecticut (6.5 percent on $500,000 or more).

Here's the difference: In Vermont, residents are taxed on their "taxable income." We pay taxes on our earnings AFTER we've claimed federal standard and itemized deductions, including big-ticket itemized deductions for the wealthy, such as donations to favorite charities, health care expenses, mortgage and real estate tax deductions on multiple homes, etc.

Only 10 other states use taxable income as a base for generating revenues.

Thirty-three states, including all of the New England states, tax residents' adjustable gross income – the amount calculated before taxpayers claim standard and itemized deductions. (The AGI, as it's called includes deductions for self-employment tax, alimony, student loan interest, IRA contributions, among others, but NOT standardized and itemized deductions.)

What does that mean? Plenty.

Here's the big picture. According to the **tax commission study**, allowing the federal deductions to pass through narrows Vermont's tax base by about $5 billion dollars. Vermonters adjusted gross income (before deductions) is about $15 billion, but their taxable income (after deductions and other adjustments) is $10.2 billion. That helps to explain why a 2007 study by the Joint Fiscal Office found that Vermont's top tax rates were higher than some other New England states, but the taxes Vermonters paid were lower than they would have been in those other states.

Here's how it sugars off taxwise. Vermonters, particularly wealthy Vermonters, drastically reduce their income tax burden every year through deductions – to the tune of about $340 million in 2007 – by claiming those additional deductions, according to the Tax Foundation. A disproportionately large percentage of those deductions are claimed by people who earn more than $1 million a year.

See Department of Taxes, Statistics–Income–Taxable Income

The No. 1 takeway? The amount of taxes Vermonters actually have paid on average, also known as the "effective" rate, has been just over 3 percent. That average has held steady for about 22 years, according to information gathered by the Vermont Tax Commission from Tax Department data. This year the effective rate was about 3.9 percent, according to Public Assets Institute, a nonprofit research group in Montpelier.

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The average, of course, includes people who make under $30,000 a year and people who draw down $1 million or more.

So, you might well ask, are rich Vermonters paying more than their fair share? Compared with other New England states, not so much. In 2008, Vermonters who made $500,000 to $1 million paid an effective tax rate of 5.83 percent (everyone else paid less, in most cases significantly less). By comparison, in Connecticut, residents who earned more than $500,000 had a tax liability of 6.5 percent; in Rhode Island, the rate for earnings above $125,001 is 5.99 percent; Massachusetts has a flat tax of 5.3 percent for all tax brackets; and Maine charges an income tax rate of 8.5 percent for earnings above $19,451.

Of course, if you compare Vermont to, say, Alaska, New Hampshire, Tennessee, Florida, South Dakota, Washington, Nevada, Texas or Wyoming, none of this is relevant. All nine of these states operate without income taxes. Most also have "extractive" revenue from mining or income from tourist destinations – like Disneyland in the case of Florida, or Las Vegas in Nevada.

Read the Institute for Taxation and Economic Policy report: "Who Pays?"

From $1 billion to zero

Could Vermont become New Hampshire?

Brian Dubie wistfully refers to New Hampshire's zero tolerance policy on income (and sales) taxes as the ideal in nearly every speech he gives on the stump.

"I'm looking at Washington State that has a zero income tax," Dubie said at his September press conference. 'I'm looking at Tennessee that has a zero income tax, New Hampshire has a zero income tax. For us to be competitive as a state, we always need to benchmark ourselves. It will make us stronger, so we really need to be aware of what our small businesses are up against. We need to be consistent with the Legislature-appointed tax commission (that) they're looking at ways to try and have sustainable funding for all these programs we value as Vermonters."

But the answer to the New Hampshire question is, in a word: No. Getting rid of the income tax in Vermont would be nigh on impossible at this point, according to tax experts who say that Vermont is too dependent on the income tax to forgo that source of revenue anytime soon.

Only one state in recent history has successfully eliminated the income tax retroactively – Alaska — and that's because the state was able to replace the revenues with proceeds from its oil operations, according to Bill Ahern, director of policy and communications for the Tax Foundation.

The 20 dollar bill

"States aren't flexible with spending," Ahern said. "Very few have the ability to cut (budgets) substantially — legally or politically. Most tax reforms have to be incremental."

Jon Shure of the Center for Budget Policy and Priorities in Washington, D.C., puts it this way: "It's a very expensive idea."

"That would be a pretty heavy lift," Shure said. "It's not really practical for any state to suggest it could simply … do away with one of its major tax sources and not have to deal with the consequences."

Eliminating the income tax is a particularly difficult sell in Vermont, according to Ahern, because of the state's commitment to progressivity.

New Hampshire, which provides "the same basket of government services," makes up some of its revenues in fees, Ahern said. He characterizes the Granite State as very frugal.

New Hampshire accomplishes its zero income tax feat in part by placing the tax burden disproportionately on residents in the lowest three brackets. New Hampshire's wealthiest 1 percent of taxpayers contribute just 2 percent of their overall income in property, excise taxes and income taxes (a small percentage on investments). The poorest taxpayers, in the lowest 20 percent bracket, pay 8.2 percent of their incomes in taxes, according to 2007 statistics from the Institute on Taxation and Economic Policy.

Ahern disagrees with this assessment. He says "selective and general sales taxes are unquestionably the source of most tax burdens for the poor, and since New Hampshire has no general sales tax and comparatively modest selective sales taxes, the comparison to VT is almost certainly wrong." He said because New Hampshire's revenues are largely from business owners and property owners, the province of high-income people, the Granite State "may well have the most progressive state tax system in the nation."

In Vermont, sales, property and income taxes cost residents between 7.5 percent and 8 percent in all brackets in 2007, according to ITEP.

The Tax Foundation, on the other hand, says Vermonters on average spent 10.3 percent of their income (averaging $42,626), or $4,410, on taxes.

See the Tax Foundation list of state individual income tax rates.

That calculation gives the state an overall tax burden ranking of 8th highest nationwide. The national average local and state tax burden is $4,283, according to the Foundation. The average tax burden in New Hampshire, which the Tax Foundation ranks 46th, is $3,642, or 7.6 percent of income.

A recent study from Public Assets Institute placed Vermont's income tax rate 23rd nationally, based on the effective tax rate, which it pegged at 3.9 percent.

The Tax Foundation recommends that Vermont drop income tax deductions to pay for the elimination of the sales tax.

Ahern, who testified before the tax commission last year, said Vermont is too invested in the progressivity of its tax system to give up the income tax. He suggested the state should consider giving up the sales tax instead. The state raises about $340 million from its 6 percent sales tax – about the equivalent of what it could gain in income taxes if it broadened its tax base by eliminating the deductions, based on 2007 figures, according to Ahern.

Ahern recommends dropping the deductions to pay for the elimination of the sales tax.

Read Ahern's letter to JFO.

"Vermont has to have some tax advantage over somebody," Ahern said. "So that was what the tax commission was looking for, and that's what I offered up. You're committed politically and in a populist way to income taxation. The thing you have to do is get rid of the sales tax."

In general, Ahern said in a letter last year to the Legislature's Joint Fiscal Office, "state governments are incapable of rapid change."

“Their spending commitments are long-term and often legally binding,” he wrote. “Their workforces are heavily unionized with costly limitations on termination. For these reasons and more, states must avoid revenue fluctuations that lead to large deficits and panicky revenue grabs, usually enacted as cigarette tax hikes on the poor and new, higher tax rates on business or high incomes. Budgetary institutions such as rainy-day funds have an important role to play here, but the structure of the tax system is critical.”

Read Deliberating Tax Reform in Vermont by Billy Hamilton of Tax Analysts.

A flat tax?

Brian Dubie. Photo by Terry J. Allen

Dubie has also cited the Massachusetts tax system as another “example” of a tax alternative for Vermont. Our neighbors to the south have a flat tax of 5.3 percent; all earners pay that rate, regardless of income – there are no brackets differentiating the very poor from the very rich.

Low-income Massachusetts residents, like their compatriots in New Hampshire, pay a higher proportion of their overall income in taxes than do Vermonters, according to ITEP. Sixty percent of Massachusetts taxpayers in the lowest three brackets pay between 8.8 and 10 percent of their incomes in sales and excise taxes, property and income taxes. The top 1 percent pay less than 5 percent of their incomes in the three taxes combined.

If a flat tax was implemented, Vermonters in the four upper brackets would see a $106 million tax break.

According to information obtained by Rep. Michael Obuchowski, D-Rockingham, chair of the Ways and Means Committee, from Vermont’s Joint Fiscal office, if Vermont adopted a flat tax of 5.3 percent, taxpayers in the lowest bracket, who are now paying 3.55 percent, would contribute an additional $121.8 million in income taxes; Vermonters in the four upper brackets would see a $106 million tax break.

Similarly, if the state lowered tax rates for all income brackets, roughly evenly, and brought the top rate of 8.95 percent down to 6.5 percent, the result would be a 42 percent personal income tax cut. The total drop in revenues would be $248 million – roughly what Dubie has proposed to send back to taxpayers in his plan to cap state spending after fiscal year 2013.

The biggest tax cuts in a shift from a graduated income tax to a flat tax rate go to the richest people, according to Shure, of the Center for Budget Policy and Priorities.

Ahern said a flat tax is the best "because it brings people together." That's because, he said, it constrains movement in the rate. "If liberals want to raise rates on high incomes, they can't do it (without) raising them on lower incomes," Ahern said. "It puts you in a good bind. It's an institutional restraint we would say is a big economic plus just because it runs against the worst political impulses with regard to tax code. A 5.3 percent tax is better for investors making big money decisions than 8.9 percent."

The time to do it, however, is during recovery, he said. It is hard to accomplish now. Ahern said he didn't think a flat tax would have much of a chance in Vermont. "If you have the progressive impulse in spades as you do, a flat tax is unpopular."

An $84 million haircut for education

Dubie argues that education spending has spiraled out of control at a time when student enrollments are declining. (According to the JFO, education spending in fiscal year 2011 will be $1.3 billion; it was approximately $776 million in 1999.)

In a recent research brief, the Vermont-based independent nonprofit research group Public Assets Institute said that education spending as a percentage of the state's economy has remained steady at about 5 percent since 1992, five years before the enactment of Act 60, the state's education finance law. Spending has declined since 2005, when annual increases were running at more than 6 percent, according to the report. Last year's spending rate was held to 2 percent – in response to a plea the Douglas administration sent to school boards across the state last year.

Dubie has said he would place a mandatory cap on future school spending (Burlington Free Press debate, Oct. 13.) In other remarks, he mentioned a 2 percent cap. He has also said that raising the student-teacher ratio from 10.7 to 1 to 11.8 to 1 would save $84 million.

Tom Pelham, a deputy secretary for the Agency of Administration who says he has helped Dubie with his economic development plan in his spare time, said the $84 million would be a reduction in the General Fund contribution to the Education Fund. Pelham points to the cut as the solution to the $112 million deficit in fiscal year 2012.

It's not clear, however, from Dubie's public statements, whether he would force local school boards to absorb that amount through a mandate from Montpelier or if the $84 million reduction would be a shift of 8.4 cents onto the statewide property tax. Dubie has refused under direct questioning to clarify what he means. In either scenario, it appears that no property tax cuts would be in the offing in the short term. If he is proposing to cut education spending by $84 million and, according to Pelham, all of the savings would go to the General Fund, none of the savings would be left to reduce property taxes, which now provide more than two-thirds of the money to support education.

Here is the verbatim description Dubie gave of his plan at his September press conference:

"We have the lowest student-staff ratio in the country, and the $84 million comes from if we were just to move slowly in a direction to the next state that has a student-teacher ratio that would represent $84 million in our education spending. That is used just to maybe provide a benchmark of what the savings could be. Our entire projected shortfall in 2012 is $110 million, and if Vermont moved in a direction for the next state that had the 49th student ratio or second student ratio, that would represent $84 million, so it's a means to indicate a benchmark."

"To cut $84 million from school budgets and expect (results) requires a plan," Vilaseca said. "The only one I see putting out a plan is this office. Whenever we put out (ideas), nobody likes it. We have to have a plan that requires some sacrifice."

The state in question is North Dakota, which, **according to the National Center for Education Statistics**, has a student-teacher ratio of 1 to 11.8. (The state also has 4,000 fewer students.)

Vermont's student-teacher ratio is 1 to 10.7.

An official from the Tax Department, who didn't want to be named, confirmed that this $84 million reduction could amount to a property tax shift.

Armando Vilaseca, commissioner of the Department of Education, said he hadn't been consulted by Dubie about that target figure. "To get to $84 million seems like a very difficult number."

Vilaseca has been trying to find ways to help school districts consolidate under new legislation. He has asked schools to cut their budgets by 2 percent last year (about $23 million), and he's asked them to make the same level of reduction this year under the Challenges for Change legislation. Both years it has been a difficult pitch to make to schools.

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House Speaker Shap Smith was skeptical about whether it could be done. "I'd like to see how he does that without raising prop taxes," Smith said in an interview. "I just don't know how he would do that. We're always willing to look at what he is proposing."

Editor's note: A paragraph from Bill Ahern, clarifying New Hampshire's tax policy was added 8 a.m., Oct. 22, 2010. Links to ITEP were also added.