Tax reform, Part 1: Where policy meets politics

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Editor's note: This is the first in a five-part series about the Vermont Blue Ribbon Tax Structure Commission Report. In addition to this analysis of the politics of taxation, in the coming week, VTDigger.org will examine the panel's recommended changes to the sales tax (Part 2) and the income tax code (Part 3); suggestions to sunset tax expenditures (Part 4) and reform ideas that didn't make the final cut (Part 5).

 [1]

Gov. Peter Shumlin

Taxation is the third rail of politics in Vermont, regardless of which party is in power, and that fact hasn't changed since Democrats seized control of the executive branch in November and held their majorities in the Vermont House and Senate. Though few Democratic lawmakers in the Statehouse are enthusiastic about Gov. Peter Shumlin's proposed budget (even the governor himself, in his address, said: "My administration takes no pleasure in delivering this budget"), raising income taxes is not a part of the equation at the moment.

Shumlin took a no-new-taxes pledge in the General Election, and he has made it plain in repeated interviews that he has no intention of reneging on that promise — though he has proposed new taxes on insurers, home health agencies, dentists and hospitals in his budget.

"I am not one of those Democrats who feel that Vermont's biggest challenge is that taxes are not high enough," Shumlin said shortly after he was elected. "I think they're too high. I do think they discourage economic growth. I don't want to raise taxes."

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The governor and the legislative leadership have worked hard over the last few months to quell the business community's fears that the Democratic power juggernaut in Montpelier will lead to higher taxes.

House Speaker Shap Smith and Senate President Pro Tem John Campbell, both Democrats, have also expressed reluctance to look at income or sales tax hikes as options for resolving the state's projected $176 million shortfall.

That means the Legislature and the governor's administration will likely move ahead with plans to make cuts in benefits for Vermonters who are enrolled in the Catamount Health program; taxes on health programs; and reductions in funding for the state-funded mental health and disability service nonprofits.

In light of this political climate and the state's budget crisis, it's perhaps not surprising that state leaders have relegated the Vermont Blue Ribbon Tax Structure Commission's report [5] to the back burner. The commission's 18 months of research, efforts to gather a full range of testimony and public debates on policy options didn't warrant a footnote in the governor's budget address.

In mid-January, the three-member panel outlined reforms to the state's tax system. Though their suggestions are "revenue neutral," meaning if taken as a whole, they don't raise or lower taxes, the recommendations include significant changes to the tax code. The commission suggested that the Legislature consider two main policy changes:

1. Collecting income taxes on adjusted gross income instead of taxable income;
2. Extending the sales tax to services and clothing and shoes. In addition, the commission recommends that the state continue its efforts to force Internet retailers, such as Amazon.com, to collect Vermont sales taxes. It also recommends that the Legislature re-evaluate tax expenditures. If adopted, the

> proposals would broaden the tax base and enable the state to lower income and sales tax rates.

Though these concepts are new to Vermont, they aren't exactly novel. They are standard fare in the world of tax policy, according to analysts interviewed for this series. Economists from across the political spectrum agree with the thrust of the commission's reforms, which boil down to this simple idea: If you broaden the tax base (make more income, services and goods subject to taxation), you can lower the rates.

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House Speaker Shap Smith

Policy experts have been recommending that states around the country make these kinds of changes to the tax code for some time. The problem is not the quality of such proposals, tax analysts say, the issue is politics.
Kail Padgitt [14], an economist at the conservative Tax Foundation [15], gives the report high marks because it is revenue neutral and it proposes to broaden the tax base and lower rates.

"On the whole, it's a good plan," Padgitt said. "It's always a question of how far is the Legislature willing to go. Every service tax comes with a strong special interest group."

When the Legislature carves out exemptions to protect certain constituencies, other taxpayers pick up the tab. Those exemptions can add up — in Vermont's case, the tax "expenditures," or breaks for individuals, groups and companies total $1 billion.

"Economists have a united front on good tax policy," Padgitt said. "Over time the politics of it, the special interest groups whittle away the code, they carve out exemptions for different things."

And in that regard, Vermont is no different from other states. The Democratic leadership appears to be leery of making major changes to the tax code until the political winds start blowing in one direction.

Shumlin went on the attack when the commission's recommendations were released, and openly dismissed the sales tax on services. In statements to the press, Shumlin praised the panel's work ("The report provides an excellent foundation for an important conversation, which I welcome") — and agreed with the income tax reform proposal in theory, but he said he remains "skeptical of any increased reliance on the sales tax."

The fact of the matter is, if the top rate is 8.95 percent, the reality is, no one is paying 8.95 percent in income taxes."
~Exec. Dir. Matt Gardner,
Institute on Taxation and Economic Policy

Signals from the legislative leadership also indicate that the sales tax recommendations could be dead in the water. Senate President Pro-Tem Campbell, who hails from Windsor County, doesn't have an appetite for broadening the sales tax to include services, or certain goods like clothing and shoes.

"I'm on the (N.H.) border," Campbell said. "I hear more discussion about sales taxes than other people do. One of the things I found of interest was the expansion of the base where we could possibly actually reduce the sales tax. If we took away all the exemptions, the sales tax would be 1.8 (percent). The problem with that is, that always leaves room to raising it down the road to 3 percent or 4 percent. That's a potential problem."

House Speaker Smith fully endorsed the commission's work in December before the final report was released (see our Q & A with Smith [16]), and last week he reiterated his willingness to take a "full look" at the recommendations. He was cautious, however, about backing the sales tax extension to services unless the 6 percent tax can be cut in half to roughly 3 percent. The commission's recommendation is 4.5 percent.

Smith has charged the House Ways and Means Committee with fully vetting the report, and lawmakers have taken testimony over the last several weeks. No omnibus bill based on the recommendations has been drafted yet, though two lawmakers on the Committee have introduced bills based on pieces of the proposal.

"I'm committed to taking a look at all aspects of the Tax Commission report and having full vetting in the committees," Smith said. "We'll clearly have push back on the sales tax on services, and (changes to the income tax)."


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House Chamber stamps

When a bill might emerge from the House is an open question. Political observers say lawmakers will wait as long as they can to decide whether they will adopt any or all of the recommendations. Some lawmakers speculate the report will languish until the second half of the legislative biennium (right before the 2012 election cycle) when the commission is slated to present its findings and recommendations for the state's property tax system.

Campbell dispels that notion. He pointed out that the House has already started vetting the report, and he said he has asked the Senate Finance Committee to take testimony so that "when and if something comes over we'll be up to speed."

"We will have reached a decision by the end of the session," he said in a telephone interview.

Campbell described the change in the income tax code as "a commonsense decision to do," and he said that portion of the report has a "favorable possibility."

As for the sales tax? Not likely, Campbell says. "That is a more difficult conversation to have, and one I don't think we'll be completely (finished with) by the end of session." He expects lawmakers will either reject it outright or fail to reach consensus on an expansion of the sales tax base.

When perception becomes reality

Remember this line? "Vermont ranks as 47th best state to do business. Is that good enough? (Yes or NO.)"

That was the No. 1 refrain of Lt. Gov. Brian Dubie's campaign, sung in tandem with the second line: Vermont is one of the highest taxed states in the country. Dubie repeatedly used these two phrases on the stump, and they appeared in his television and print ads, and most notably, on the *New York Times* website.

Democrats haven't forgotten. Shumlin won by 1.8 percent over Dubie, whose Vermont-taxes-are-bad-for-business campaign, gave him the traction to finish the gubernatorial race a close second.

Over time, Padgitt said, politicians allow special interest groups to erode the code. How can you give a tax break or deduction to one group without hurting another? You can't, basically, in Padgitt's view."

The specter of the 2012 election cycle isn't far away, and Democrats appear to be most worried about their right flank in light of their gubernatorial standard-bearer's narrow win, even though Shumlin's views on taxes aren't as different from his Republican counterpart's as you might think.

Shumlin sang Dubie's song in a slightly different key. He portrayed Vermont's business climate in a positive light, but just like Dubie, he called for reforming the tax structure so that the wealthiest 1 percent of residents who pay "more than a quarter of Vermont's income taxes" don't feel compelled to flee to other states. (Read page 22 of Shumlin's "A Vision for Vermont." [6]) Campbell, like the governor, believes middle-class Vermonters are tapped out and wealthy residents are leaving the state.

Are these assumptions true? Are Vermonters overtaxed? Do poor and middle class Vermonters pay their fair share? Are wealthy individuals leaving the state?

It depends on who you ask. Dubie based his advertisement on Vermont's *Forbes Magazine* 2009 ranking. In 2010, the state moved up two notches to 45th. Vermont Business Magazine [18] pointed out that Forbes gave high rankings to states that have lighter regulation and cheaper energy.
The Tax Foundation ranks Vermont 38th in the nation for overall business climate in 2011, and Vermont comes in 8th place for the highest state and local taxes, according to the Foundation [19].

The problem with the Tax Foundation and Forbes rankings, according to a 2007 statement [7] from Burlington-based policy analyst Doug Hoffer, is they were created in a vacuum (the calculation methods are not transparent), and they are based on erroneous information. In addition, Hoffer argues that both organizations have a conservative point of view that skews the objectivity of the rankings. The *Burlington Free Press* [20] agreed with this assessment.

Part of the problem is the complexity of Vermont's income tax system. The state has five tax brackets, and the state taxes income after itemized and standardized deductions have been subtracted from adjusted gross income. Most states have fewer brackets and they tax on the AGI.


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Senate President Pro Tempore John Campbell

Vermont's top marginal rate is 8.95 percent for income over $373,650; 8.9 percent for incomes between $171,850 and $373,650; 8 percent for incomes between $82,400 and $171,850 and 7 percent for incomes between $34,000 and $82,400. Anyone who earns less than $34,000 pays a 3.55 percent income tax rate. The tiers look like a wedding cake: People who earn more than $373,650 pay the top rate on income above that amount; the lower tax rates apply to the income below that total. The first $34,000 earned, for example, is taxed at 3.55 percent, no matter how high a Vermonter's income is.

Tom Kavet, the consulting economist to the Legislature, says the published rates, which are on the high end, are a public relations problem. That's because what Vermonters actually pay — the effective rate — is a lot lower than what outside groups like Forbes and the Tax Foundation suggest.

The effective rate, or the amount of personal income tax rate actually paid by Vermont residents, has averaged 3.08 percent for the last 32 years, according to data from the Department of Taxes.

An analysis by Montpelier-based Public Assets Institute shows that rankings based on effective income tax rates place Vermont in the "middle of the pack." Vermont ranks 23rd in the PAI study [22], based on the actual percentage paid by residents.

The Tax Commission's findings

The bipartisan Vermont Blue Ribbon Tax Structure Commission began its work with a thorough vetting of tax information. The commission spent months gathering facts, data, expert opinions and anecdotal testimony before it began to consider tax reform models.

The commission encourages Vermonters to abandon the discussion of what wealthy Vermonters are doing based on their taxes. Such speculation is murky and, even if it were not so, it is questionable and dangerous to design a tax code for fewer than 200 people."
~ Vermont Blue Ribbon Tax Commission

The commission's three members — Bill Schubart (who is president of the Vermont Journalism Trust board, which is the parent organization for VTDigger.org); Kathy Hoyt, former chief of staff for Democratic Gov. Howard Dean; and Bill Sayre, chair of the Associated Industries of Vermont — attempted to examine tax reform options without looking through the lens of politics. Near the end of their deliberations, however, Sayre, a conservative, split from the more liberal majority group, Schubart and Hoyt, and issued a minority statement. The report that the commission published is a reflection of all three members' views, except in certain instances, cited in Sayre's minority opinion, which is included in a separate section.

The report attempts to debunk certain myths about taxes in its findings of fact. The commission determined that misperceptions about the state's tax code have been based on apples-to-oranges comparisons between Vermont's rates and those of other states. Because our rates are high, outside groups incorrectly assumed the amount Vermonters actually pay in taxes is also high. In fact, the commission found that because Vermont allows taxpayers to take so many deductions, the state's rates are comparable to, or lower than, those of its neighbors in New England, which all limit deductions. (New Hampshire, is the notable exception, because it has no income tax.)

Another myth? The idea that some Vermonters don't pay taxes. Not true, says the commission. Everyone pays, and the distribution is relatively even across income levels. Poor people who pay a very small tax on their income contribute through regressive sales taxes.

That said, only a small proportion of Vermont taxpayers generate most of the state's income tax revenue. Eleven percent of Vermonters who earned more than $100,000 in 2008 were responsible for generating 59.5 percent of the state's income tax revenues. The report includes a chart that shows that this group of taxpayers contributed just 30 percent of the state's income revenue in 1991. In the intervening 17-year-period, wages for the three lowest income classes below $75,000 saw a corresponding drop in earnings. The report points to this dramatic shift as an indication that middle- and low-income Vermonters have seen wages stagnate or drop since 1991.

Are rich people leaving the state? According to information from the IRS, tax filers moving into the state earn about 18 percent more on average than taxpayers who leave the state. In 2008, the average income of a new Vermonter was about $53,000, while the wages of the average Vermonter migrating out of state were about $44,000.

As for the 3,926 high-income taxpayers in Vermont who had adjusted gross incomes of $500,000-plus in 2007, more than a third saw their incomes decline precipitously in the following year. The commission concluded that the high single-year incomes were "event driven."

"The commission encourages Vermonters to abandon the discussion of what wealthy Vermonters are doing based on their taxes," the authors wrote. "Such speculation is murky and, even if it were not so, it is questionable and dangerous to design a tax code for fewer than 200 people."

On this point, Sayre disagreed. In his minority report, he said, "Vermonters should not be satisfied if anyone is leaving Vermont due to high taxes, and there is substantial anecdotal evidence that it happens frequently."

What the experts say

Vermont's Blue Ribbon Tax Commission report generally gets high marks outside the state because it continues to provide a level of progressivity (poor people pay less, the rich contribute more); it simplifies the tax code by compressing the number of brackets down from five to three; and it removes itemized deductions from the income tax rules and eliminates exemptions for services. The latter is important because over time, Vermonters (and Americans on the whole) are spending more money on services and less on consumer goods purchased from brick-and-mortar retail stores.

The tax economists' Golden Rule (regardless of political persuasion) is broaden the base, lower the rates, and the commission's recommendations do just that, experts say. Fundamental to that effort is eliminating itemized income tax deductions for mortgages, charities, health care costs, moving expenses and the like. On the sales tax front, economists say most goods and services should be taxed. Some economists even recommend putting a levy on food and medicine, as long as people in the lowest income bracket get a tax credit at the end of the year for sales taxes.

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Jeff Thompson

Jeffrey Thompson [24], an associate professor with the Political Economy Research Institute based in Amherst, Mass., described the report as "very sober and thoughtful."

As far as taxation policy goes, what the commission has proposed isn't exactly radical, Thompson said. What they have recommended is standard operating procedure in economic circles.

"They certainly wouldn't be confused for a band of progressive reformers," Thompson said. The report, he said, is "a great example of thoughtful good government."

Kail Padgitt, the economist at the conservative Tax Foundation, agreed with that assessment.

Padgitt said if Vermont follows the commission's recommendations, "it would definitely be an improvement," and the Green Mountain State would likely rise through the ranks of the less-than-business-friendly states in the Tax Foundation's annual ranking. (That upward shift would be due in part, though, because other states will be likely facing tax hikes this year.)

“I think it would help the rankings for the state certainly,” Padgitt said. “Even if the overall tax rates stay the same, if the state lowers the top rate (down from) 9 percent, it would have an effect on business.”

What are the potential pitfalls? Pure politics. Over time, Padgitt said, politicians allow special interest groups to erode the code. How can you give a tax break or deduction to one group without hurting another? You can’t, basically, in Padgitt’s view.

“They (lawmakers) carve out exemptions for different things,” Padgitt said. Once lawmakers go down that path, it’s hard to maintain tax fairness, he said.

The shift from adjusted gross income to taxable income is a no-brainer as far as Matt Gardner [25], executive director of the Institute on Taxation and Economic Policy [12], is concerned.

“The fact of the matter is, if the top rate is 8.95 percent, the reality is, no one is paying 8.95 percent in income taxes,” Gardner said. “A good goal is to make it clearer what people are paying. Going to AGI (adjusted gross income) makes it easier to understand what the rates are.”

Gardner said the commission has identified the main problem with Vermont’s tax code: “The proliferation of deductions and exemptions that reduce the yield of the tax system.”

“Their recommendations seem like an excellent first step toward making the system more sustainable,” Gardner said. “When you face…budget deficits, that’s its own political will. When it’s spending cuts, it’s a lot easier. They’re running out of easy ways to make cuts on the spending side. It’s been acted on in states in the last year. I think the problems identified in the report are very real and will have a very real long-term impact.”

Reform, Gardner said, is “just facing facts.”