

An Analysis of the Vermont Tax Study

A Report to the Vermont Business Roundtable

by

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Introduction

The 1996 legislature passed Act 178, the appropriations bill, which included Section 314. That section called for the Legislature's Joint Fiscal Office (JFO) to undertake a study of Vermont taxes. The study was designed to provide "a base compilation of information to be used during legislative deliberations."¹ The result of that study was recently published by the JFO. This report analyzes the JFO study.

We start by noting what the broad conclusions of the study are and how those conclusions have been reported by the media. The study itself listed 10 key findings, but the major finding was that Vermont's state tax collections are about average when compared to the other 49 states. That finding has been interpreted by many to mean that Vermont's taxes, and especially our income taxes, are low. That, in turn, has led many to conclude that there is room to raise taxes in the state without significant undue side effects. Finally, that perception of the JFO study's conclusion has influenced the policy debate over property tax reform in Vermont.

Questions and Answers About the Vermont Tax Study

Q1. What is the Vermont Tax Study?

A. The 1996 legislature voted to appropriate \$30,000 for the Legislature's Joint Fiscal Office to undertake a study of Vermont's taxes. Legislation that was initially proposed called for a study of state and local taxes to be undertaken by an independent organization and an expenditure not to exceed \$100,000. The final bill called for a study of state taxes (not including local taxes) with a much smaller appropriation and the study was to be done by the JFO.

Q2. What were the study's goals?

A. The study looked at how Vermont's taxes compared to other states. It looked at the total state tax burden as well as the tax burden on a variety of individuals and families and on different types of businesses. It is important to remember that most of the data and analysis in the tax study focuses on state taxes only and not local taxes.

Q3. How can tax burdens among states be compared?

A. There are three ways this can be done. One is to look at the total taxes collected by governments and dividing that by the population of the state. This gives a measure of per capita tax burden. The second way is to divide total taxes by the total income

¹Vermont Tax Study, Volume I, November 1996, page 1.

earned by residents of a state. This gives a burden measure based on income, rather than population. The problems with both of these is that they do not account for who pays the taxes. Some taxes are paid by individuals, some by businesses (although the ultimate incidence of the tax is not totally borne by business), and some by non-residents of the state.

The third measure is to try to estimate actual tax burdens on different types of taxpayers. This is extremely difficult, because each state has a unique tax structure.

- Q4. Were most of the comparisons done by comparing Vermont to all 50 states?
- A. No, the study looked at aggregate comparisons of Vermont's taxes to national averages on a per capita and per income basis, but when the specific taxes paid by families and businesses were analyzed, they were compared to 11 comparison states (12 including Vermont).
- Q5. What were these 11 states?
- A. They are Connecticut, Maine, Massachusetts, New Hampshire, New York, Florida, North Carolina, Minnesota, Wisconsin, Oregon, and Washington.
- Q6. How were they chosen?
- A. The states used were a subset of the 15 other states and the province of Quebec that the Vermont Business Roundtable used in a 1993 study of Vermont's competitive position.² The JFO study used fewer states (it excluded California, Idaho, South Carolina, and Tennessee) because of time and resource constraints. Note that the comparison states included all of the New England states except for Rhode Island. The group also included neighboring New York.
- Q7. How representative are these 12 states?

²The Vermont Business Roundtable used a complex process to select this group of current and potential competitor states for its study. Forty-four indicators were chosen to gauge Vermont's relative performance in categories including financial capital, infrastructure, energy costs, human capital, labor costs, taxing and spending burdens, social policy, and quality of life.

- A. They are not representative states when it comes to taxes. In general, they have higher than average tax burdens. The JFO study uses 1995 data to show that Vermont's state taxes (ignoring local taxes) rank us exactly in the middle of the 12 states when taxes are measured against the income available to pay those taxes. It also shows that Vermont has a slightly lower-than-average tax burden (with the important caveat that this ignores local tax collections).

State	Level	Rank	% of U.S. Avg
Minnesota	\$89.02	6	27.6%
Wisconsin	\$84.02	10	20.4%
Washington	\$83.84	11	20.2%
North Carolina	\$81.02	15	16.1%
Maine	\$76.47	21	9.6%
Connecticut	\$75.93	22	8.8%
Massachusetts	\$72.90	25	4.5%
New York	\$71.95	27	3.1%
U.S.	\$69.76		0.0%
Vermont	\$68.30	30	-2.1%
Oregon	\$68.01	32	-2.5%
Florida	\$61.11	41	-12.4%
New Hampshire	\$33.46	50	-52.0%

But Table 1 shows that of these 12 states, eight had higher than average taxes and four had lower than average taxes. Moreover, six of the states had state tax burdens that were significantly above the national average and only two had tax burdens that were significantly below the national average (we define significantly different as a tax burden that is more than five percent above or below the national average). Therefore, the eleven comparison states are not representative of the 50 states' tax burdens. They have higher than average state tax burdens.

- Q8. These numbers only analyze state taxes. What happens when we include local taxes?
- A. That is one of the major methodological and analytic problems with the JFO study. The underlying data used in the JFO report come from the U.S. Census Bureau. The Census Bureau annually collects data on taxes and spending from the states, but it takes time for the Census to collect and tabulate the data. The latest year for which we have Census data on all state and local taxes is for fiscal year 1993. The problem with 1993 data is that it is old and Vermont has lowered two major taxes since then. Our personal income tax rate dropped significantly and the meals and rooms tax went down by one percentage point. Therefore, any analysis which uses 1993 data and tries to make policy inferences about current taxes (or changes in taxes) will be based on tax collections that were higher than they currently are in Vermont.

Table 2 shows that if we use FY93 data on state and local taxes, it again appears that the twelve states are not representative of the nation. Four states have lower than average tax burdens and eight states have higher burdens than the national average. Using the same measure of significant differences as we did in the discussion of Table 1, two states have tax burdens significantly below the national average and five have a combined state and local tax burden significantly above the national average. Table 2 also shows that when local taxes are included, Vermont's tax burden becomes significantly higher than the national average.

Table 2
FY93 State and Local Taxes
per \$1000 of Income

State	Level	% of U.S. Avg
New York	\$147.4	30.5%
Wisconsin	\$131.1	16.0%
Minnesota	\$127.5	12.9%
Vermont	\$126.8	12.2%
Maine	\$126.6	12.1%
Oregon	\$118.2	4.6%
Connecticut	\$117.6	4.1%
Washington	\$115.6	2.4%
U.S.	\$113.0	0.0%
North Carolina	\$109.9	-2.7%
Massachusetts	\$108.8	-3.7%
New Hampshire	\$104.5	-7.5%
Florida	\$103.8	-8.1%

Q9. Why did the JFO study rely on 1995 data?

A. Clearly, using the most current data is the best way to analyze taxes. The Census Bureau's fiscal year 1995 data is only for state taxes. The benefit of using 1995 data is that it is more current than the 1993 data. But there is also a problem with using only state tax data because Vermont relies disproportionately more on local taxes than do most states. So any analysis which looks at 1995 data and only looks at state tax collections (and ignores local taxes) would find that Vermont has a relatively low tax burden. This is, in part, one of the problems of the JFO tax study.

In an attempt to get around this problem, the JFO study used the Census state tax data for the 11 comparison states and called each state for local tax data. This does provide a more timely set of data than one can obtain from the Census Bureau, but it is only for 11 other states, not 49. It also does not have the quality control that federally released data has. This is a problem in the JFO study. For example, the JFO's estimates of local taxes in New Hampshire are far too low. New Hampshire's local property taxes, according to the JFO data, amounted to \$1,294,151,000 in FY95. But the U.S. Census Bureau reported that New Hampshire's local property taxes in FY93 amounted to \$1,585,351,000. It's hard to believe that New Hampshire's property taxes declined by nearly \$300 million—about 23%—over that two year period. It is not clear how accurate the local tax data from other states is for FY95.

Q10. What did the JFO study find when it analyzed individual cases of taxpayers?

- A. The study quite commendably attempted to look at the 1995 tax burdens of 20 representative taxpayers, comparing them to identical taxpayers in the eleven comparison states. These taxpayers varied by income level, age, and family composition. The major problem with the methodology used in the study is that it ignored local taxes, especially property taxes. As the JFO study notes, this means that the tax burden study ignores approximately 40% of all the taxes paid to state and local governments. This again illustrates one major shortcoming of the entire JFO study: local taxes are generally ignored, and Vermont has higher than average local taxes. This makes Vermonters' aggregate tax burdens, as calculated in the tax study, appear to be lower than they actually are.

This causes problems for other parts of the comparative analysis in the JFO study. One of the most striking examples of this is in the study's analysis of the median income taxpayer. Median family income in Vermont is about \$40,000. The closest representative taxpayer to this is the study's Case #8; a married couple with two wage earners earning between \$30,000 and \$50,000. That makes this family the closest to the average Vermont family among all the individual cases studied.

In the analysis of this family's tax burden, and in other cases as well, state property tax rebate programs are counted as an offset to the income tax. However, the property tax itself is not included.³ The study finds that this taxpayer would owe the state \$391 in state income tax (a reasonable finding), but the family also gets a \$735 property tax rebate. A quick reading of the JFO study would lead the reader to conclude that the median income Vermont taxpaying family has a state income tax liability of \$-344. This is not accurate but it does fall out of the methodology used in the study, which in essence counts the property tax rebate as a reduction in taxes but does not include the property taxes paid by this or any other family.

Q11. What were some of the other main findings of the study?

- A. The major findings were:

1. Vermont's state tax collections rank us 30th in the nation. Among the 12 comparison states, we ranked seventh highest.
2. Vermont's state income tax ranked us 31st highest in the nation.
3. Vermont's sales taxes ranked us 32nd in the nation.
4. Vermont's corporate income tax ranked us 28th in the nation.
5. Vermont has low fuel taxes compared to most other states.

³This is done because in other states, the property tax rebate program cannot be separated out from the income tax as it can in Vermont.

6. Vermont's local share of total state and local tax revenues is higher than most other states.
7. Although the study did not analyze it in much detail, it noted that Vermont's property taxes ranked us seventh highest in the nation.

Q12. How were these relative rankings made?

- A. The study elected to look mostly at tax collections per capita. That is one method of comparing taxes across states. The other commonly used method is to compare tax collections to the income available to pay those taxes. Since Vermont has a relatively low income level, when taxes are measured against income, we look like a more highly taxed state than when taxes are measured on a per capita basis.

Vermont's Personal Income Tax

Q13. What conclusions did the JFO study make about Vermont's personal income tax?

- A. There are four distinct findings made about the personal income tax. We will examine each in turn.

Q14. **The first finding:** Taken as a whole, Vermont's 1995 personal income tax burden ranked 31th out of the 50 states, based on income tax paid per capita. Is this accurate?

- A. Generally yes, but a better finding would be that "taken as a whole, Vermont's 1995 personal income tax burden ranked 28th out of the 50 states, based on income tax paid per \$1,000 of personal income."

Further, it is probably more accurate to say "overall the 1995 Vermont income tax burden was about average" for two reasons.

First, the JFO study used 1995 data, the most recent data available. However, because of taxpayer behavior, the effect of the tax rate reductions effective January 1, 1994 were still being felt in 1995.⁴ We estimate the effect caused total income tax payments in 1995 to be abnormally low by about \$10 to \$15 million dollars. Therefore, Vermont's income tax collections in FY95 of \$250.3 million were about 5% below normal. Thus, the 1995 Vermont ranking is biased downward.

⁴ The personal income tax rate fell from 28% to 25% and the 31% and 34% tiers were eliminated for high income tax payers.

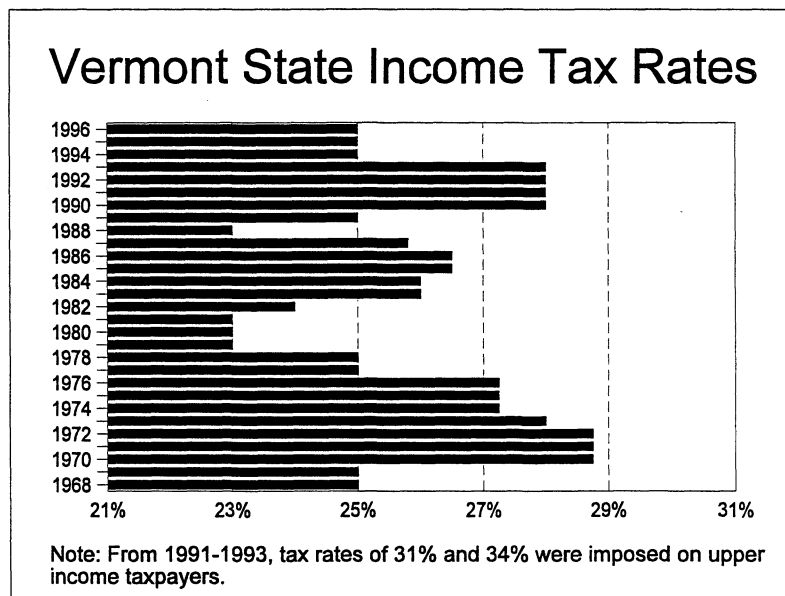
In 1995 only state personal income tax data are available, not local personal income tax. This does not affect Vermont but it does affect other states. Therefore, this biases the Vermont ranking upward.

Given these two biases, it is best to hedge a specific numerical conclusion with some general wording. Vermont's overall personal income tax burden in 1995 was about average for the 50 states.

Q15. Is some Vermont income tax rate other than 25% appropriate to use?

- A. No and yes. The 1995 rate was 25% of the federal tax liability. However, Vermont's personal income rate has ranged from a low of 23% to a high of 28.75% for all Vermonters and 34% for some Vermonters between 1968 and 1996 (the 34% rate was in effect from 1991 to 1993), as the JFO study notes. The rate tends to rise during economic recessions when income tax revenues drop and the rate tends to fall slowly during economic expansions when income tax revenues recover. For all practical purposes the Vermont personal income tax acts as the state's "rainy day fund." That is, it has been a major tool available for raising additional funds in a budget crisis.

The 1995 rate of 25% is roughly in the middle of the historical range of Vermont's personal income tax and slightly lower than the average rate over time. The personal income tax rate has been lower than 25% for 5 of the 28 years since Vermont coupled to the federal income tax in 1968. It has been higher than 25% for 17 of the 28 years. In six years the rate has been 25%.



A competitive analysis of Vermont's income tax needs to consider the likely range of Vermont's income tax rates. If at 25% Vermont 1995 personal income tax is near the average, then during future recessions Vermont's personal income tax can be expected to climb substantially above the average. Should the personal income tax rate be increased during a period of economic expansion such as today in order to fund ongoing spending, then the "rainy day" fund will have been spent before the next

recession occurs. In this case Vermonters can expect either their personal income tax to increase even further during coming recessions or can expect severe budget cuts during coming recessions.

Q16. **The second finding:** Most Vermonters pay less income tax than similarly situated people in most other states. Is this accurate?

A. Yes. The JFO study “reinvented the wheel,” which it recognized in its report. The Tax Research Division of the Minnesota Department of Revenue recently completed a study of state by state income tax burdens for all states in 1994.¹ The JFO report states “The results of the Minnesota study mirror the FY95 analysis in [our report].”

For example, the Minnesota study showed that married Vermont families with two wage earners earning a combined family income of \$20,000 had a negative income tax liability of \$88. This is the lowest income tax burden of any state. Indeed, because of Vermont’s refundable earned income tax credit, our income tax burden on low income people is below that of states with no income tax. The JFO study shows that married Vermont families with one wage earner earning between \$15,000 to \$30,000 had a negative income tax liability of \$51.

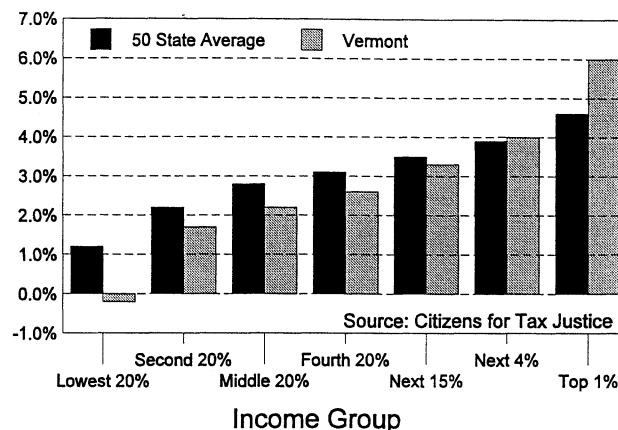
Further, the Minnesota study shows the income tax on the same Vermont family earning \$35,000 would rank Vermont 35th out of fifty states. The income tax on the same family earning \$100,000 would still rank only 33rd out of fifty states. Finally, the income tax on the same family earning \$200,000 would finally reach the middle, ranking 26th out of fifty states.

An analysis of the 1995 tax systems in all 50 states by the Citizens for Tax Justice and the Institute on Taxation & Economic Policy found the same result for Vermont. The graph below shows the CTJ/ITEP finding. Again, Vermonters’ income tax rates were below the national average for all income groups but the top 5%. And only the top 1% paid more than the national average.

¹ *Comparison of 1994 Individual Income Tax Burdens by State*, Tax Research Division, Minnesota Department of Revenue, November 1995.

The obvious conclusion not stressed by the JFO study is that the structure of Vermont's personal income tax is very different from most other states. It is much more progressive. And most Vermonters pay lower income taxes than average; but a few Vermonters pay much more than average.

Effective State Income Tax Rates



Q17. **The third finding:** As of July 1, 1996, Vermont's top marginal rate ranked fifth nationally, but

Vermont's high marginal tax rate affects very few taxpayers. Is this accurate?

A. Yes. As pointed out in the JFO study, the 1996 marginal tax rate does not kick in until taxable income exceeds \$263,750, and few Vermonters have taxable incomes which surpass this level. In 1995 only about 800 taxpayers fell into this category. Therefore, the JFO dismisses the marginal tax rate as a problem.

Q18. What are the dangers of ignoring the marginal rate in a study?

A. First, the JFO study notes that these taxpayers paid about 15% of all income tax revenues. The JFO also notes that the top 3.3% of Vermont's income taxpayers pay 35% of the total income tax revenues. The income taxes from these taxpayers are very crucial to state revenues.

Second, the high marginal tax rate in Vermont means these taxpayers have a much higher personal income tax burden in Vermont than in most other states. (See the diagram above). This is a serious negative incentive to current or potential very high income individuals to live in Vermont versus most other states. While many high income individuals may consider Vermont's attributes large enough to cause them to locate here, on balance this high marginal rate will discourage some of them. Given that a significant portion of these individuals earn their incomes from entrepreneurial pursuits, Vermont's economy will suffer in the long run from their absence.

Third, this marginal tax rate affects more than only 800 Vermont taxpayers. Each year undoubtedly this top income group consists of many different Vermonters, some who may have one-time income events which raise them into this category.

Finally, the JFO study ignores the negative incentive effects of taxes. The case for very high income Vermonters is well known. A marginal federal income tax rate of 39.6% coupled with a 25% Vermont income tax rate means high income Vermonters pay 45¢ of every additional dollar as income taxes to some level of government. Those high income Vermonters who choose to remain in the state in spite of the high state income tax rate still face the high disincentive affects from the combined federal and state income tax.⁶

Q19. **The fourth finding:** Among the JFO comparison states, Vermont ranked ninth in personal income tax revenue as a percentage of total state and local revenue among the 12 comparison states. Is this accurate?

A. Yes. But as pointed out earlier the 12 comparison states are abnormally high income tax states compared to the full 50 states.

Q20. What is the popular perception of the implications of the findings of the JFO study as concerns the personal income tax?

A. Perceptions are difficult to identify and may not be based on fact. The major problem with the JFO study is not what the study actually says but what some have concluded the JFO study implies. Some have concluded that the JFO study shows Vermont's personal income tax is below average and therefore there is room to raise additional revenues by raising the rate.

Our analysis demonstrates that Vermont's personal income tax is not below average overall but should be considered near average. Further, we have shown that the structure of Vermont's personal income tax is very different from the average state, as Vermont has a very progressive income tax. In addition, the state's income tax carries serious disincentive effects.

Raising the 25% rate or reinstating the tax tiers would lead to serious increased disincentive effects on Vermont's entrepreneurial strength. Vermont's effective tax rate on the highest income earners would discourage the location (or continued location) of their businesses in Vermont. The increased marginal tax rate on all who work in Vermont would have long run disincentive effects on economic growth. Should these effects have only a small effect on economic growth, say a quarter of one percent less growth per year, the compound effect over time will lead to

⁶ Note that some Vermonters pay a higher marginal income tax rate than 45%. A two earner family in the 28% federal bracket could still be subject to the social security tax (7.65% on both employee and employer, but effectively 15.3% on the employee) and face a marginal tax rate of 48%. The disincentive effects of personal income taxes affects all tax payers.

significantly fewer jobs and much lower income in Vermont than we would have enjoyed otherwise. A small effect over time has a large impact.

Q21. Which group of Vermonters do not pay their “fair share” of personal income taxes?

- A. The answer to this depends on one’s perception of what is the “fair share.” Given the thrust of the JFO study a comparative analysis is a legitimate method. The JFO study shows that the highest income groups in Vermont pay a greater proportion of the state’s income tax than the highest income groups do in the twelve comparison states. This suggests they pay their fair share.

The lowest income Vermonters do not pay any state income tax but rather receive payments back from the state through the earned income tax credit. Most Vermonters do not wish to tax this group to raise more funds.

On a comparative basis, it is middle income and upper middle income Vermont who do not pay their “fair share” of the state’s personal income tax. Do those who perceive Vermont’s personal income tax as low wish to raise the income tax of these Vermonters?

Q22. What is the problem with looking to the income tax for more state revenues?

- A. While the Vermont personal income tax is about average overall, its structure is very different from average. The Vermont personal income tax is very progressive. These two facts mean that permanently raising the income tax rate will cause significant negative effects to long run economic growth of the state. Vermont cannot safely raise more income tax revenues without changing the structure of its income tax.

