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Panel suggests major tax reforms

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MONTPELIER — In the "preamble" to its long-awaited report on Vermont's tax code, the Blue Ribbon Tax Structure Commission suggests the state's motto — "Freedom and Unity" — "embodies the inherent tension embedded within tax policy."

Freedom from excessive tax burdens, the three-person panel writes, must be weighed against a commitment to community through a "strong social safety net."

This "noble paradox," as the commission calls it, will guide a legislative debate this year over what could be one of the most dramatic rewrites of the tax code in state history.

The commission, created by an act of the Legislature in 2009, unveiled a list of recommendations Thursday that would, in short, allow the state to lower rates on income tax and sales tax by broadening the tax base.

The proposal, 18 months in the making, has won plaudits from policymakers eager to drive down the high tax rates blamed for hurting the state's economic competitiveness. But aspects of the plan, which would eliminate some income-tax deductions and impose new taxes on professional services, will face stiff opposition from sectors of industry that fear negative repercussions.

Though the panel's recommendations, on the whole at least, won't raise or lower Vermonters' total tax obligation, some House Republicans say they worry that lowering rates now could pave the way for tax increases in the future.

"Given the makeup of the Legislature, and what it's done historically, does it lay the groundwork to just increase those rates in future years to support increased state spending?" said Rep. Heidi Scheuermann, a Stowe Republican.

The mechanism for lowering tax rates lies in altering the baseline used to calculate them. Vermont is one of 10 states to tax residents based on their "taxable income." That means Vermont recognizes all the itemized and standard deductions granted by the federal government — things like mortgage interest, job expenses and property taxes.

If the state taxed residents instead on "adjusted gross income," and eliminated those deductions, the tax base would grow by about $5 billion overnight, from $10.3 billion to $15 billion, and allow the state to reduce its income tax rates by about one-third.

Vermont's income tax rates, among the highest in the nation, have long been targeted as an impediment to economic growth. Commission member Bill Schubart said the panel's proposal will rectify that misperception and make Vermont's rates more competitive with neighboring states.

"You've heard over the last few months that Vermont has the highest income tax rate in the galaxy," Schubart said, referencing heated debates in the recent gubernatorial campaign.

"In fact Vermont's high marginal tax rate is a function primarily of how we calculate our taxes."

The panel's proposal would reduce income tax rates for the state's highest earners from about 9 percent to below 7 percent.

The commission applies the same concept to its proposal on the sales tax. By expanding the tax to include not just goods but services as well, the commission says, Vermont could use the wider revenue base to ratchet the sales tax, now at 6 percent, down to 4.5 percent. The panel's plan would exempt taxes on business-to-business services.

Not only would the sales tax more accurately reflect an increasingly service-based economy, said Schubart, the retired CEO of Resolution Inc., it also tries to minimize the tax disparity between Vermont and New Hampshire, which has no sales tax.

"It doesn't solve the problem of New Hampshire but it does address it, and that was certainly taken under significant consideration," he said.

The Blue Ribbon panel, which includes members appointed by then-Senate President Pro Tem Peter Shumlin, House Speaker Shap Smith and then-Gov. James Douglas, did not deliver a consensus report.

Though he said he agrees in principle with the aims of the majority opinion, Bill Sayre, Douglas' appointee, has written a minority report that would allow taxpayers to retain some of their deductions — notably the home-mortgage interest deduction.

"An enormous percent of the population has come to develop expectations about the opportunity to take that deduction," said Sayre, former chairman of the board of Associated Industries of Vermont. "And it felt to me that taking it away would be too disruptive."

Sayre rejected altogether the proposal to expand the sales tax to include services.

"Why worsen the competitive disadvantage (with New Hampshire) we already have?" he said.

Policymakers too are split over the merits of the recommendations. In a written statement, Gov. Peter Shumlin said the income tax proposal "makes good sense, although we would want to be sure that any rate structure maintains progressivity and that adequate consideration is given to any unintended consequences of such a change."

He offered a cooler reception to the sales-tax proposal, citing fears about its impacts on lower-income Vermonters and businesses along the New Hampshire border.

Chris Rice, a Statehouse lobbyist who represents Vermont Association of Realtors, Vermont Mortgage Bankers Association and Vermont Apartment Owners Association, said taxing services will create new impediments to homeownership.

New taxes on services provided by the lawyers, mortgage brokers, home inspectors and Realtors involved in any property transaction, Rice said, could put homeownership out of reach for some people.

"For the first-time homebuyer, who's scraping together every nickel and dime, that's potentially significant," Rice said. Rice also said he worries about the ability of existing homeowners to withstand financially the loss of the mortgage deduction on their income taxes.

“Even if it’s only $250 to $500 a year, for someone struggling to keep their head above water, that’s a good chunk of change,” he said.

The expansion of the sales tax is particularly controversial, especially in light of a December report from University of Vermont economist Art Woolf that suggested Vermont’s sales tax costs it more than $500 million in foregone retail sales annually along the Connecticut River.

“There’s the obvious concern about what that (tax on services) does to the competitiveness of businesses already struggling on the New Hampshire border,” said Rep. Oliver Olsen, a Jamaica Republican.

Not only would the panel’s recommendations broaden the tax to include services, it would increase the range of goods subject to the sales tax, including soft drinks and heating oil.

Matt Cota, head of the Vermont Fuel Dealers Association, said the new tax on heating oil would add about $108 to the average homeowner’s fuel bill.

“Presumably the Legislature has deemed heating fuel as an essential commodity that should not be assessed a sales tax, much like food and medicine,” Cota said.

In fact, the panel’s recommendations would direct the Legislature to sunset every tax exemption (with the exception of food, education, and some health-care services) written into the so-called “Green Books” that govern tax policy in the state.

Schubart said the state’s tax policy represents an often-arbitrary list of exemptions compiled over several decades. Some of those might make sense, according to Schubart, while others may not anymore.

For instance, only recently did lawmakers remove tax exemptions on pension benefits for the survivors of the Spanish-American War. Until last year, Vermonters could claim tax exemptions for expenses related to the construction of fallout shelters.

If Vermont eliminates all exemptions and starts from scratch, Schubart said, policymakers can have a clearer discussion about whether the “social benefit” of a tax exemption merits its “social costs.”

Those costs are significant. This year alone, Vermont will lose more than $1 billion in foregone revenue due to tax exemptions.

Rep. David Sharpe, a Bristol Democrat who sits on the House Committee on Ways and Means, said exemptions represent a significant state expense and, as such, should face more scrutiny.

“We spend as much in Ways and Means (on exemptions) as they do in Appropriations on state spending, but they look at those expenses every year and we don’t” Sharpe said.

Sharpe said he can’t explain why, for instance, Blue Cross & Blue Shield gets a $500,000 property-tax break, or why Vermonters get tax breaks for insurance annuities (at a cost of $10.5 million in foregone revenue annually), but not for certificates of deposit in banks.

“If we truly want a fair and open government policy, then we have to take a look at these tax expenditures,” he said. “That’s more than $1 billion in what amounts to state spending, and we essentially never look at it and the public isn't aware of it."

The House Committee on Ways and Means and the Senate Finance Committee will vet the panel's proposals in the coming week and are expected to fashion legislation based on its findings.

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