FUNDING VERMONT'S SCHOOLS FOR THE FUTURE: A DISCUSSION PAPER

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The purpose of this paper is to frame the discussion for a one-day symposium scheduled for January 14, 2014 in Burlington, Vermont. The goal of the symposium is to consider potential policy responses to the current tension underlying Vermont's unique PreK- 12 education finance system and report back to the Administration and Legislature.

There is substantial evidence that the education system is working well. Vermont has excellent educational outcomes and robust financial support, evidenced by what may be the highest per pupil spending among the 50 states. Furthermore, Vermont features high standards of equity in school finance and the strong historical norm of local engagement and control in spending decisions.

While Vermont's unique system for funding public PreK-12 schools is arguably one of the best public school funding systems in the United States today, recent voter approved spending increases for schools, combined with declines in property values have led to increased homestead and non-residential property tax rates and growing questions about the system's sustainability. A hoped for outcome of the conference is the identification of alternative mechanisms that could maintain and encourage desired education outcomes and local control with a stronger link between local spending decisions and a sustainable rate of statewide education revenue growth.

This paper is an initial attempt to outline areas for change the state might consider if policy makers feel changes to the current system are needed. This "framing" paper describes several pressure points and potential solutions, which it is hoped will further current discussions. The paper is the first step of a three-step process to provide the Legislature and Administration with more information as they consider these important school funding issues during the 2014 session of the Legislature.

The second step is the symposium itself. At the symposium, a group of experts will meet to discuss possible options, and work with a number of state policy makers and education stakeholders to further refine the ideas that emerge from this paper and the thinking of the school finance and taxation specialists. The ideas raised at the symposium will need to be evaluated for effectiveness and impact (if any) on:

- The high standard of quality in the current system
- The local control over spending currently enjoyed by local districts, and
- The high level of school finance equity currently in the system.

Following the conference, the author of this paper, with assistance from conference participants, will prepare a final briefing paper for the Legislature and the Administration. It is expected that this briefing paper will be available no later than January 30, 2014 – in time to inform Legislative debate on school funding issues.

This paper begins by establishing the context for these discussions. This discussion is relatively brief given the conference participants' anticipated general familiarity with Vermont school funding. This is followed by a discussion of the areas where modifications to the current system might be possible to meet the current challenges facing the state. Finally a brief conclusion is offered.

ESTABLISHING THE CONTEXT

Following the Vermont Supreme Court's 1996 ruling in *Brigham v. Vermont,*[1] policy makers implemented a series of school funding reforms designed to continue the state's strong commitment to local control over school funding, while at the same time meeting the Court's requirement to improve equity. The two primary vehicles that created this system, Acts 60 and 68, established a funding system that shifted responsibility for funding to the state level, conditioned property tax payments on household income, split the property tax base between residents and non-residential properties, and continued the state's system of strong local control over local school funding decisions

Overall, Acts 60 and 68 were designed to meet several goals:

1. Reduce the wide disparity in per-pupil education spending that was closely related to property wealth.
2. Reduce the disparity in academic achievement among Vermont's school children.
3. Reduce the disparity in education tax burdens for equal amounts of spending per pupil among Vermont taxpayers.
4. Allow school district voters to choose to spend as much as they wish on their children's education.
5. Ensure that higher spending per pupil in a district results in higher homestead taxes in that district.

In a report issued in January 2012, Lawrence O. Picus and Associates concluded that:[2]

> … the current funding system meets the goals established by the Court and Acts 60 and 68. The system established through that legislation provides that each town determines the budget for its schools on an annual basis and, through a combination of residential and non-residential property taxes and other state sources of revenue, funds those schools so that each town has

[1] *Amanda Brigham v. State of Vermont* (96-502); 166 Vt. 246; 692 A.2d 384

[2] Picus, L.O., Odden, A., Glenn, W., Griffith, M., and Wolkoff, M. (2012). *An Evaluation of Vermont's Education Finance System*. Prepared for the State of Vermont, North Hollywood, CA. Lawrence O. Picus and Associates, LLC. P. viii available at http://picusodden.com/wp-content/uploads/2013/09/VT_Finance_Study_1-18-2012.pdf

access to the same level of funding for a given tax rate. Moreover, the design and operation of the system has resulted in relatively little disparity in per pupil education spending related to property wealth and household income, created substantial equality in the level of per pupil spending across the state's school districts, and has reduced the variation in student achievement in reading and mathematics across schools, as measured by NECAP tests. One result of these reforms is that today, Vermont's school children enjoy one of the highest levels of per pupil funding in the United States, as well as one of the lowest ratios of pupils to teachers among the 50 states.

A description of Vermont's school funding system is provided in Appendix A of this paper. The appendix is the description of the system included in the Picus and Associates report, with updated funding numbers. The important features of the system that most directly impact the focus of this paper and the January conference are identified below following a discussion of enrollment trends – not an issue for this conference, but one that also impacts educational spending in Vermont.

Outcomes

Using the funding system summarized above and described more fully in Appendix A, Vermont has consistently had one of the highest per pupil spending levels of any state in the country. Moreover, as documented in the Picus report of 2012, Vermont also exerts the greatest effort in funding its schools as measured by education spending as a percentage of personal income.

Among the challenges the state faces moving forward are:

- Continuing Vermont's strong level of support for funding its schools and the State's tradition of local control over school funding decisions in a sustainable manner
- Maintaining the unique income sensitized approach to homestead property taxes for schools
- Meeting the school finance equity requirements of the *Brigham* Court decision which establishes the state as the basis of wealth for support of education, not local districts
- Ensuring property taxes are not an undue burden on homeowners as well as non-residential owners – who are taxed at a different rate
- Establishing an equitable way to determine property tax rates while reducing the likelihood of large annual rate increases

The next section of this paper considers possible options for addressing these challenges and offers some expected outcomes of each along with likely pros and cons of each.

School Enrollments

Vermont's student population has been declining for well over a decade. In 1999-2000 there were an estimated 104,559 students in Vermont. By 2013-14 this figure had fallen to just over 88,000 students. Moreover, as noted by the Picus report, Vermont had the smallest average district enrollment of the 50 states. Today there are an average of 345 students in each Vermont district.

The combination of declining enrollment and small districts has created substantial upward pressure on per pupil expenditures across the state. It appears that school enrollments will continue to decline for at least the next several years. The dis-economies of scale resulting from small districts combined with the challenges of cutting services when only a few students leave a district result in higher per pupil spending throughout the state. Many have expressed concern with the continued growth in overall education spending despite declines in the number of children served. There may be a question of whether the current financing system has the appropriate signals to force examination of right sizing resources in a time of declining enrollment.

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Sources of Education Revenue

There are three primary sources of revenue for schools. They are a residential property tax, a non-resident property tax (which is levied uniformly across the state subject to adjustment by the Common Level of Appraisal [CLA])[3] and funds from the state.

Residential Property Tax Rate

Under Act 68 there are a number of factors that determine a household's education tax liability. These include the base homestead tax rate computed annually by the state using a base funding level and the total homestead property valuation or grand list. The base funding level is determined using an inflation factor estimated by the state and approved by the Legislature. For FY 2015, the statutory base amount has not yet been set, but memos from the Tax Commissioner estimate it to be set at $9,382 per pupil based on a revised consensus estimate of inflation. [4] The resulting education tax rate (adjusted by the CLA) must be levied in each town. It is important to note that the base amount is computed from past base amounts and does not necessarily have a relationship to education spending needs, rather it is simply a number computed to fund this component of the system and annual adjustments are based on estimates of inflation.

[3] The uniform non-residential tax rate – as well as the residential tax rate – is adjusted at the town level by the Common Level of Appraisal or CLA, which attempts to equalize variation in assessment levels across the state. This is described in more detail on the last page of Appendix A.

[4] November 26, 2013 tax rate letter from the Tax Commissioner and the December 13, 2013 update letter to Legislative leadership from the Tax Commissioner. See Appendix for a copies of these letters.

The actual education tax payment for a residential homesite is limited to a percentage of household income for households with income below $90,000 a year[5]. Households with incomes below $47,000 also qualify for additional super circuit breaker property tax relief from the state. Households with incomes above $90,000 pay the education residential property tax rate established for their town. For FY 2015 it is estimated that the base residential property tax rate will be $1.01, the base homestead income rate will be 1.84%. If a town votes to spend above the base amount, the respective homestead tax rate and homestead income rate are increased in tandem. This rate only applies to taxes assessed on the first two acres of a homestead property – for larger properties the local tax rate is assessed on land area beyond two acres.

There is also a disincentive to spend above a certain level, called the High Spending Threshold. The High Spending Threshold is determined statutorily, and prior to FY 2015 was defined as 125% of the state average education spending for the prior fiscal year. Beginning in 2015 this threshold was lowered to 123%. For districts choosing to spend above this level the marginal homestead tax rate and percentage of household income increases at twice the rate it does below the threshold, creating a disincentive to spend above that level.

The Tax Commissioner estimates that for FY 2015 the average education residential property tax rate will be $1.54. This includes the base tax rate of $1.01 and the average additional property taxes towns must levy if they elect to spend above the base amount. The estimated average limit on property taxes is 2.81% of income.

Non-Residential Property Tax Rate

The non-residential property tax rate is levied on all non-residential property at a uniform (CLA adjusted) rate. This figure is determined annually by the state and in recent years has been adjusted by the same amount as the base tax rate on residential property. For FY 2015 it is estimated to be $1.51. At this rate, non-residential property taxes will raise approximately 38% of total education spending.

State Funding

The third component of education spending is the state contribution to education. This includes the state's General Fund transfer to the Education Fund, along with resources from the Purchase and use Tax, and the sales and use tax, and the lottery. There are several other relatively small state sources that go to funding schools as well.

POSSIBLE FUNDING SYSTEM ADJUSTMENTS

[5] Note that the actual income level for receiving property tax assistance begins to level off above an income of $90,000. For FY 2014 this occurs at an income level of $104,444, but the actual cut off point is dependent on the base rates that are set each year.

Today there are a number of features of Vermont's school funding system that impact local education spending decisions and offer potential approaches for modifications or changes that might create a stronger link between local spending decisions and a sustainable rate of statewide education revenue growth.

These include:

- Income Sensitivity pricing
- The High Spending Threshold
- Computation of the base amount and base tax rate for school funding
- Move to a pure income tax based school funding system
- Complexity and limited connection between spending and tax burdens
- No action at this time

Each is discussed below.

Income Sensitivity Pricing

Vermont has created an education funding system that links tax rates across the state to the individual decisions of local school districts. Yet, individual decisions in local school districts may have a different tax price. Specifically, due to the income sensitivity constructs of the system, some property owners can vote for an additional dollar of education spending at a cost of something less than a dollar in the taxes they pay. At the same time, taxpayers who pay based on property face a higher tax price for each additional educational dollar, although in districts with relatively low per pupil property wealth, the tax price may still be lower than the level of spending chosen. The Picus report found that voters facing relatively low tax prices were generally more likely to support larger increases in education spending than were those facing higher tax prices, although prior spending levels and a number of other factors need to be considered in understanding how local voters determine education spending each year.[6]

It is possible to identify five groups of taxpayers who vote on school budgets and the likely impact their situation will have on their propensity to vote for or against school budgets.[7]

1. **Residential property owners with household incomes up to $47,000 a year**: Many households in this situation receive assistance from the state's circuit breaker property tax relief system. By voting an increase in local property taxes for education, there is no effective cost to an individual voting to increase education spending as long as their total tax bill remains above 5.0% of their household income. The circuit breaker payment caps total property taxes to 5.0% of household income. Even if a household

[6] For more details see Chapter 5 of the 2012 report by Lawrence O. Picus and Associates. The analysis in that section was conducted primarily by Michael Wolkoff, one of the experts invited to the January 14 conference.

[7] This classification was proposed by former State Representative Oliver Olsen during a conversation on December 4, 2013.

is not eligible for the circuit breaker payment, their property taxes may still be limited to a percentage of income based on voter approved spending level as described in number 2 below. .

2. **Residential property owners with household income between $47,001 and 90,000 a year**: Households in this category are subject to income-based sensitivity and their tax payment is the lower of their property tax bill or 1.8% of household income. The 1.8% limitation is based on the use of the base funding amount, and if a district elects to spend above the base amount the percentage of income used to determine the tax payments on a homesite increases along with the residential property tax rates.[8] In this instance the tax price will vary based on an individual's income, but is likely less than the price (or property tax increase) they would face if the income sensitivity factor were not part of the formula. It should be noted that between household incomes of $90,000 and above, it tapers off based on the base tax rate and income percentage.

3. **Residential property owners with household incomes above $90,000 a year**: Households with incomes above $90,000 do not benefit from the income sensitivity factors in the school funding formula, but their tax price may still be impacted by the overall property wealth of their town. As previously discussed, the tax rate for spending levels above the base amount is the same for all towns electing the same per pupil spending level (that is the rate is determined based on the proportional increase in per pupil spending above the base amount). As a result, low property wealth towns face a lower tax price than they would if they had to fund their desired level of spending entirely from their own property tax base. Similarly, high property wealth towns will pay a higher tax rate than they would if the increase were funded solely on the basis of the town's property wealth. It should be noted that there are no districts that raise more than their total spending through the homestead tax rate meaning that non-residential property taxes and state funding sources help fully fund the education spending in each district. Since the tax rate is uniform for any level of spending, those property taxes equalize property tax revenues for all districts.

4. **Renters**: Renters are not directly impacted by changes in property tax rates because they do not pay property taxes directly. Moreover, if one assumes that property owners are able to shift some or all of the burden of property taxes to renters over time, the tax rate that those owners face is the state-wide non-residential property tax rate, which is adjusted in tandem with the increase in the residential base property tax rate.[9] Generally, the Picus report found that in larger ADM school districts there was a slightly positive impact on school spending as the percentage of renters increased.

5. **Residential property owners facing one of several special circumstances**: There are several other situations that impact a few residential property owners in Vermont.

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[8] If local spending decisions exceed the High Spending Threshold, then the tax rates and income percentage increases double above the threshold.

[9] There are other factors that can impact the non-residential property tax rate, but the impact on the rate are modest at most.

These include: limiting the income sensitivity component to the first $500,000 of property value (taxes on property values beyond $500,000 are not eligible for the income limitation); and a total income sensitivity payment limit of $8,000 to any household..

The goal of this system has been to allow low spending/low wealth districts to increase the level of education spending by taking advantage of the overall wealth of the state rather than just their individual district. Wolkoff's analysis in the Picus report suggests that to some extent low wealth, low spending towns in Vermont have increased spending at a faster rate than higher wealth and higher spending districts.

There are a number of general approaches to creating incentives for districts to slow spending increases over time. These include caps on increases in total district spending, tax rate caps, enhanced voting requirements to approve spending increases above a certain percentage or level (which have been tried recently in Vermont), and inflation based spending caps. All of these incentive options have a tendency to reduce or eliminate local choice, which continues to be highly valued in Vermont.

Less intrusive options might focus on the 2 acre homesite limit for income sensitivity, or changing the definition of household income used to computer eligibility for income limited property tax payments.

High Spending Threshold

Another alternative would be to lower the High Spending Threshold which would have the effect of making increases in spending beyond the threshold more expensive and probably less attractive to voters. It is hard to predict exactly how this would impact spending increases. In theory, towns with higher percentages of residents who are isolated from property tax increases (groups 1 and 4 above and potentially members of group 2) would not be impacted by such an incentive as strongly as towns with more members of group 3 (who are more likely to bear the entire property tax). Overall one would anticipate a slowdown in spending increases.

Base Education Amount and Base Tax Rate

Changes in the base education amount and the base tax rate (either in tandem or separately) might also impact school spending decisions at the town level. At present, the base education level is simply a historical artifact with little relationship to spending levels or spending need. One option would be to conduct an adequacy or "costing out" study to ascertain what an "adequate" level of spending might be. The purpose of the study would be to estimate what funding level is needed to have some reasonable expectation that all schools have adequate resources to enable all students meet the new Common Core Curriculum Standards (or some other state determined standard). This amount could be adjusted for inflation annually and periodically recalibrated. A base tax rate could be associated with this funding level for both residential and non-residential property. Spending above that level as well as income sensitivity and the other features

of the Vermont funding formula could be re-computed to meet the equity standard of *Brigham* and to establish incentives for limiting spending increases by towns over time. To accommodate the varying needs of individual students, the adequacy number computed could be applied to the number of equalized pupils, and the weights used to determine that number of pupils could be imputed from the findings of the adequacy study.

While it is impossible to compute the exact impact of this change, raising the base amount to a number that more accurately reflects what schools need to be successful is likely to be by itself a powerful incentive to focus spending at or near that target level.

Move to an Income Tax Based Funding System

Although school funding in Vermont includes a combination of revenues from property taxes, income taxes and other sources of state revenues, many argue that the income sensitivity component of the funding program makes school funding an income tax based system, not a property tax based system. A number of individuals have suggested shifting to a more "pure" income based funding mechanism, and options to do so have been introduced in the Legislature and studied by Vermont's Blue Ribbon Tax Structure Commission.

System Complexity

The discussion above suggests that the current funding system is complex and may be hard to understand. For example, interviews with state policy makers and stakeholders suggested that there is considerable lack of understanding among the general public about how the funding system works or what the implications of votes on school budgets are likely to be on individual tax liabilities. Finding ways to make the system more transparent might help improve that understanding – what is unclear is what impact that would have on local spending decisions. Among the factors that might be made less complex are the following:

Understanding Tax Rates: Calculation of the annual residential base property tax rate and base amount for school spending is conceptually straightforward, but leads to confusion among voters. The generic process can be explained by a simple equation as follows:

RATE x BASE = YIELD

As simplified here, the yield in this example for Vermont is the base education amount times the number of equalized students in Vermont. Once this is determined on the basis of an inflation adjustment, the grand list is estimated and the base rate is established to meet the expected yield. In recent years, the value of the grand list has been declining while the base education amount, although flat for three years, has grown in the last two (and is expected to increase for FY 15 as well). This combination has led to increased residential property tax rates that are a function of reduced property values – and

depending on the change in value of individual properties may not result in higher property taxes. Finding ways to make it clear how all of these factors interact could reduce pressure to modify the system to reduce property tax rates.

Establish Strict Standards for Budget Presentations at Town Meetings: There are individuals who argue that the presentations made at local town meetings are often confusing and hard to understand. A clear set of presentation standards for these sessions might improve understanding of school budget votes – what is not clear is the impact that will have on spending levels, they may well go up if voters have a better understanding of each schools' budget.

Take no Action at This Time

Any consideration of policy alternatives should include the option of not making any changes to the current system for the time being. In interviews with several policy makers and stakeholders in early December 2013, some suggested that the system does not need to be changed or fixed at the present time, and that as the economy improves and property values begin to increase, tax rates will potentially go down, and the problems identified at the beginning of this paper may no longer be as critical as they appear today.

Whether or not changes are needed, Vermont policy makers should make that decision, and not making any changes to the current funding is clearly a viable option. Even if the Although the base residential tax rate and the non-resident tax rate go up as much as seven cents to $1.01 and $1.51 respectively for FY 15, the residential rate will still be well below the statutory rate of $1.10. Moreover if the percent of income for income sensitized residents increases from 1.8% to 1.84%, it too will be below the 2% statutory rate at the base education amount.

Today, Vermont has possibly the highest per pupil spending of any state in the United States. Vermonters also devote more of their personal income to education than any other state and as a result have among the lowest pupil to teacher ratio across the states. Test outcomes, compared to the rest of the United States and to other states in New England are high, and while many in the state want to see improvement, the Picus report identified five improving schools, all of which are implementing educational strategies that are likely to improve student outcomes in the future – other schools should have enough resources to enact strategies for success as well. Maintaining the status quo at the present time is certainly a viable alternative.

CONCLUSION

This paper has outlined a series of issues that Vermont policy makers may want to consider as they review the operation of the state's school funding system. The intent of this document is not to recommend changes, but rather to set the context for further discussions and to pose some initial options for policy makers to consider when faced with the challenge of increasing spending and tax rates. The suggestions contained above

should be thought of as a starting point for discussion. It is hoped that at the January 14 conference in Burlington, a number of other ideas will emerge for further consideration. Following that conference, a policy brief will be developed summarizing possible options for the Legislature to consider during its 2014 session.

APPENDIX A
VERMONT'S SCHOOL FUNDING SYSTEM[10]

In fiscal year 2014 (FY 2014) Vermont will raise an estimated $1.452 billion to educate approximately 88,000 students in 307 schools operated by 277 districts through 46 supervisory unions, 12 supervisory districts, and 2 interstate districts. This spending amounts to approximately $16,788 per pupil. Vermont's system for allocating revenue to school districts is unique among the 50 states in that local towns and districts annually determine the spending level for their schools, and the state – through a complex system of property and income taxes and other state sources of revenue – funds the schools in a manner designed to treat taxpayers choosing the same level of spending for the students in their schools equally regardless of their location across the state.

It is important to point out at this juncture that many Vermont policy makers, stakeholders and citizens view the State's funding system under Acts 60 and 68 as an income tax based system that raises money through income sensitive adjustments to property taxes. However, documents and legislation describing the system describe it more in terms of a property tax based system with adjustments for income. Moreover, all other states – with the exception of Hawaii, which is a state, funded system – view their education finance systems through a property tax lens. Consequently, the substantial school finance literature upon which we rely in this evaluation, combined with the property tax based description of Vermont's system have led us to describe the system from the perspective of the property tax and income based adjustments to that tax. While this may run counter common views of Vermont's system, this approach is, in our view, the only way to comprehensively evaluate the performance of the system within the context of the goals of Acts 60 and 68.

The funding system in use today emerged in response to the 1997 Vermont Supreme Court ruling in *Brigham v. State* and was implemented through Act 60 in 1997 and Act 68 in 2004. This section provides a brief historical description of Vermont's school funding system and offers a description of its current operation. As in other states, the actual operation of the school finance system is highly technical. This description is designed to provide the reader with an understanding of how it works, but does not include many of the technical details that can lead to confusion in understanding the overall operation of the system.

[10] This appendix was taken directly from the Lawrence O. Picus and Associates report of January 18, 2011. The only changes in this document have been to update the finance and enrollment figures.

HISTORICAL CONTEXT

Prior to the *Brigham* decision, Vermont relied on a foundation program to fund its public schools. A foundation program is the most common approach to school finance today and relies on a base – or foundation – level of revenue for each school district. To ensure that all school districts have equal access to this level of resources, a fixed tax rate is established, and state aid is provided to districts that are not able to raise the full foundation amount from the fixed tax rate.

In Vermont, the foundation level was legislatively determined on an annual basis by the Legislature and expressed in terms of funding per weighted ADM (Average Daily Membership).[11] Weighted ADM was determined by assigning weights of 1.25 to secondary students and to students from families receiving food stamps. In addition a variable weight was assigned for pupil transportation (Mathis, 1995). Downes (2004) points out that fluctuations in the state's fiscal status led to Legislative adjustments to the foundation tax rate to reduce the state's liability and the share of education expenditures fluctuated between 20% and 37% of education expenditures. In the period immediately prior to the *Brigham* ruling and passage of Act 60, the state share had been declining.

In addition, prior to Act 60, property wealthy districts were able to increase spending above the foundation level with a lower incremental tax rate than property poor districts, and thus benefited from both lower property taxes and higher per pupil revenues. Despite efforts – to that time unsuccessful – by the legislature to modify the system, the combination of reduced state share plus property tax rate inequities led to the filing of the *Brigham* suit. The ruling by the state's highest court required that local tax efforts for equal levels of school spending be substantially equal, and that the wealth of the state, not of local school districts, be the determinant of how much was spent to educate Vermont's school children. As described below, the Legislature responded with a system designed to both equalize property tax burdens and individual taxpayer liability on the basis of their household income.

ACT 60

Passed just four and a half months after the *Brigham* ruling, Act 60 dramatically changed the way Vermont's schools were financed. Act 60 established a two tier funding system and added an income adjustment to limit the amount individual taxpayers would pay for schools. The first component of the new system was a basic level[12] of spending for all districts, financed in part by a statewide property tax. Districts choosing to spend more than the basic level participated in a power-equalized system that included a

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[11] It is important to note that Vermont has a number of different pupil counts. Throughout this document we have identified the measure or count we are using, and Appendix 5 provides definitions of the many pupil counts used in the State's education system.

[12] Students of school finance will want to call this a foundation amount. Vermont does not use that term and points out that since the passage of Act 60 and as part of Act 68, the basic amount is determined annually as part of the appropriation process for education. Generally in school finance, the foundation level is determined on the basis of some minimum amount needed for all schools; this is not part of the discussion in determining the annual basic amount in Vermont.

recapture provision. A unique aspect of this second tier of the funding system was that it was funded by an additional property tax rate assessed in proportion to the level of spending a town chose. The property wealth of all districts that wanted to spend above the base spending level was pooled, and a tax rate based on the district's desired spending level set to produce the additional funds desired, with each district receiving from the "sharing pool" of revenue the amount it wanted to spend above the base spending level.

What made the second tier unique was that it did not rely on any revenue sources other than property taxes beyond the base level. Towns that chose to spend above the base level informed the state what their spending level would be. The total additional revenues for all towns that went above the base level would come from the "sharing pool" that was funded by additional property taxes on those towns that chose to raise additional funds. Town tax rates above the base rate were determined on the basis of how much their per-pupil funding proportionally exceeded the base level (that is if per pupil spending above the base level was twice as high as another district, the tax rate beyond the base rate was twice as high as well) and how much money was needed to be raised to fund fully the sharing pool from these revenues. Property tax revenues were then placed in the "sharing pool" by the state and redistributed to school districts.

Setting proportionate tax rates for the same spending levels meant that property rich districts would raise more money at the same tax rate than property poor districts. The effect of the sharing pool process was to fully recapture any property tax revenues generated by property wealthy districts as all districts making the same spending level choice paid the same tax rate. Therefore, property wealthy district funded a disproportionate percentage of the sharing pool even when taxed at the same rate as poorer districts. This feature of the sharing pool led a number of wealthy districts to limit their participation in the sharing pool to minimize the amount of property tax funding that was recaptured. While some districts were able to fund all expenditures above the basic amount through private donations, many relied on a combination of private funding and the sharing pool. At its height, wealthy districts raised about $13.9 million total privately out of a system with total spending in the range of $1 billion. As described below, Act 68 eliminated the sharing pool and the incentive to raise such large amounts of private funds.

In addition, an income adjustment was enacted to impact individual tax liability for schools. In districts that only spent the basic amount, school taxes for taxpayers with household incomes below $75,000 were limited to the lesser of the homestead property tax (the tax liability on their homestead which is their house and up to two surrounding acres) or two percent of their income. For spending above the base amount, the percent of income was increased proportionally along with the property tax rate. This income adjustment was the result of many legislators wanting to move the state to an income based tax system for schools, and represented a compromise between those who wanted to rely solely on income taxes and those who felt residential property taxes should be part of the funding scheme as well. Although Downes (2004) suggests the income adjustment was primarily developed to limit the tax liability of low-income families living in high wealth or "gold town" school districts, interviews with officials who participated in the

development of the system suggest this was not the primary goal. Rather the primary goal was an income tax based school funding system.

Act 60 succeeded in eliminating the relationship between property wealth and school district spending. However it was widely unpopular in the gold towns, many of which elected to limit participation in the sharing pool and instead raised funds through private donations as described above. The state also took on additional funding responsibility for schools – and began the process whereby all property tax collections for schools are considered state, not local, revenue sources. In response to the many concerns about Act 60 and the complexities of the "sharing pool," the state enacted Act 68 in 2004.

ACT 68[13]

Act 68 as it modified Act 60, remains the basis for Vermont's school funding system today. Act 68 eliminated the two tier funding system placing all education funds for schools in one large pot, not two. It also ended the "sharing pool" and split the property tax base between residential and non-residential property. The non-residential property tax rate is determined by the state and is uniform across all towns but adjusted for the common level of appraisal or CLA as described below. Changes since that time have increased the income level at which the income adjustment to homestead property taxes can be used and made other small alterations to the operation of the system. According to the Vermont Department of Education (2011), today, regardless of the level of per pupil spending approved by the voters of each town, taxpayers with homesteads of the same market value or the same household income, in districts with the same per pupil spending, should have the equal tax bills for education. As shown in Section four of this document, that is largely the case today. School funding under this system is outlined below.

Education Spending

Under Act 68, total funding for education has two components, categorical grants and education spending. Categorical grants are separate revenue sources provided by the state to school districts for specific purposes.

In addition to these two components, an estimate of total estimated revenue for FY 2014 includes the state appropriation for school employee pensions ($73.1 million) as well as Federal funding for a total of $1.452 billion or approximately $16,500 per ADM. There are several revenue sources for state funds. They include:

- Non-residential property tax
- General Fund transfer
- One-third sales and use tax
- One-third purchase and use tax

[13] This section draws heavily from the Vermont Department of Education's document, *Vermont's Education Funding System, June 2011*.

- State Lottery
- Medicaid reimbursement
- Vermont Yankee
- Homestead property tax (with adjustments)
- Estimated State Pension Contribution
- Estimated Federal Funds

Property taxes are split into two components, a non-residential component and the homestead property tax. The tax rate for non-residential property is set annually by the state as part of the process of determining how much revenue will be needed to fund schools. The residential component – which is subject to both the income adjustment and a circuit breaker relief program for households with incomes below $47,000 – is the most complex part of the formula. Act 68 establishes tax rates of $1.59 per $100 of fair market value for non-residential property taxes and a base rate of $1.10 for homestead property although both are adjusted annually by the Legislature upon recommendation by the Tax Commissioner based on projections of the amount of money in the education fund reserve and the stipulation that the non-residential property tax revenues must fund at least 34% of education spending (total minus categoricals). For FY 2015, the non-residential property tax rate is estimated to be $1.51 and the base homestead rate is $1.01.

Determining the actual tax payments for individuals in local school districts is relatively complex and based on a number of factors. The state does not limit how much a local district can spend on education although as described below there is a disincentive to spend at very high levels .

To determine homestead tax rates, the first step occurs when the Legislature establishes the base homestead tax rate (estimated to be $1.01 for FY 2015) and the base education spending amount per pupil (estimated to be $9,382 in FY 2015). A district's education budget, which can be larger than the base spending, is then divided by its equalized pupil count.[14] This yields an education spending per equalized pupil figure for each district in the state. That amount is compared to the base education spending amount per pupil to determine the percentage variance from that amount. If a district's equalized per pupil spending amount is less than or equal to the base education spending level, its tax rate is the base homestead rate. If the district's per pupil spending exceeds the basic education per pupil amount, the base education homestead tax rate is increased by the percentage by which its per pupil spending amount exceeds the base amount. In addition, there is a threshold beyond which increases are funded at rates double the proportional increase (see below). The following describes how the education homestead tax rate is first determined for each town and then for each individual resident's property in the town.

[14] The equalized pupil count is determined by the Vermont Department of Education based on a specific formula and differs from enrollment, ADM and weighted ADM.

First, a district's base homestead tax rate cannot be lower than the state determined base rate. Districts spending less than the base spending level therefore pay the same homestead tax rate as districts spending at the base spending level.

Second, when a town decides to spend above the base spending level, the education homestead tax rate is increased proportionally, i.e., by the same percentage as the increase in per pupil expenditures approved by the town.

Third, there is a built in disincentive to spend above a certain point, called the High Spending Threshold. The High Spending Threshold is determined statutorily to be 25% above the state average education spending per pupil for the prior year. For districts choosing to spend above this level (after adjustments for approved capital construction debt services, certain special education costs, and deficit repayments in some cases) the marginal homestead tax rate increases at twice the rate it increases below the threshold. The marginal percentage of income paid under the income adjustment also doubles above this threshold.

Fourth, an individual taxpayer's tax payment is subject to an income-based adjustment if their household income is below $90,000 (with a smaller adjustment between $90,000 and $90,000). The current estimates suggest that in 2015, for school districts with per pupil spending equal to the base spending level ($9,382), the homestead property tax is the lower of the property tax assessment or 1.84% of household income. As equalized spending per pupil exceeds the base spending level, the percentage of household income used to determine tax liability increases by the same percentage that spending exceeds the base amount. This too is subject to the High Spending Threshold so the additional proportion of income to be paid in school taxes doubles for amounts above the threshold. Above incomes of $90,000 this adjustment is reduced until household income reaches $90,000 at which point no adjustment is available.

Fifth, the income adjustment to property taxes only applies to the first $500,000 of homesite market value. Any value above $500,000 is subject to the homestead property tax rate of the school district.

Sixth, Vermont has a circuit breaker property tax relief program for households with incomes below $47,000. This provides further income based property tax relief for some households. The important consideration related to the circuit breaker is that once a taxpayer qualifies for circuit breaker assistance, they do not pay for additional homestead property taxes even if their school district's spending increases. This adjustment has been in place since the 1970s, but after Act 60's passage, the income adjustment reduced tax liabilities of many households and reduced the number of households that qualify for the circuit breaker, which is applied after the income adjustment is computed.[15]

[15] It should also be noted that Vermont has a $15,000 homestead exemption for property taxes. Property worth less than $15,000 is not subject to taxation, and tax rates are applied to homestead property values minus the $15,000 exemption.

Seventh, there is one more adjustment that has caused a great deal of confusion about the system. The common level of appraisal or CLA is designed to adjust property tax rates to accommodate differences in assessment practices across the state. The CLA is computed by the Vermont Tax Department based on actual sales data over the past three years and additional statistical analysis. The CLA compares the town's education grand list with what the grand list would be if all properties were listed at 100% of fair market value as determined through this analysis. The CLA is then expressed as a percentage such that a town that has under assessed its property would have a value less than 100% and a town that over assessed its property would have a value exceeding 100%. The CLA is then applied to the town's education tax rate by dividing the homestead and non-residential tax rates by the CLA. For example in a town with an education tax rate of $1.22 and a CLA of 80%, the tax rate would be divided by 0.8 and the actual tax rate shown on tax bills would be $1.53 ($1.22/0.8). Similarly, a town with a CLA of 120% would find a tax rate of $1.22 adjusted downward to $1.02 ($1.22/1.20). Again, this important adjustment, which is made in most other states as well, is to ensure that property tax rate calculations are made on the basis of comparable valuing of property.

Eighth, another confusing aspect of the system is the annual determination of the base amount as well as the non-residential property tax rate and the homestead base tax rate. Because these are determined by the Legislature and likely to be impacted by the level of other state revenue available for education, if a district's education spending were to remain constant from one year to the next, but the Legislature were to reduce the funding from other state sources, homestead and/or non-residential property tax rates could increase. Similarly, it is possible for a town to hold spending constant while others increase spending and similarly see tax rate increases.

While this system appears quite complex, the intent is to ensure that property tax payments, whether based on the value of the property or household income should be equal for individuals in school districts with the same per pupil spending level and equal property values or household incomes. In short, the property wealth of individual school districts and the income of district residents should not impact the amount of money a district spends for education. We address how well the Vermont system of school funding addresses this issue in Sections four and five below.

Appendix B
Education Tax Rate Letters

State of Vermont
Department of Taxes
133 State Street
Montpelier, VT 05633-1401

Agency of Administration

November 26, 2013

Rep. Shap Smith, Speaker of the House
Sen. John Campbell, President Pro Tempore
Vermont State House
115 State Street
Montpelier, VT 05633-0004

Dear Speaker Smith and President Pro Tempore Campbell:

This letter is required by statute in order to publish the projected statewide education tax rates based on current law and forecasts. It marks the start of a critical dialogue between the school boards that must present budgets to local voters at Town Meeting and state policymakers who must set the tax rates based on those locally-voted spending decisions and other factors. The letter strives both to fulfill a statutory duty and provide perspective that will inform the work of the administration, the legislature, and local leaders as we pursue educational excellence that is affordable for our taxpayers.

Statutory Charge

The Commissioner of Taxes, after consultation with the Agency of Education (AOE), the Secretary of Administration and the Joint Fiscal Office (JFO), is required by 32 V.S.A. §5402b to recommend adjustments to the statewide education tax rates by December 1 if certain conditions are met. The Department of Taxes, Department of Finance and Management, AOE and JFO have prepared consensus forecasts on various components of the Education Fund Operating Statement for Fiscal Year (FY) 2015 in order to inform this required analysis.

This letter is submitted in fulfillment of that statutory obligation, and proceeds in six parts. First, the letter examines pressures on the current financing mechanism. Second, the letter discusses the Section 5402b(a)(2) mandate on the Commissioner to recommend an increase in tax rates. Third, the letter analyzes the Section 5402b(a)(3) and (4) mandates on the Commissioner to recommend possible adjustments between the homestead and nonresidential rates. Fourth, the letter addresses the Property Tax Relief Fund. Fifth, the letter sets forth spending scenarios that would avoid the rate increases. Sixth, the letter considers potential modifications to our education finance system that would more closely align spending decisions and tax consequences. The letter concludes with a discussion of a potential next step in our mutual goal of maintaining educational excellence and affordability.

Pressures on the Existing Finance Mechanism

Vermonters can be proud of our education funding system. Act 60/68 has enhanced equity and quality in education to a degree not seen in other jurisdictions, while maintaining local control. However, the Administration shares growing concern that the increases in local spending cannot be sustained, particularly in times of limited resources.

The Legislature has spent a great deal of time on the local spending issue, each biennium considering various studies and measures. Act 68 initially contained a penalty rate for districts that spend 125% or more over the prior year's statewide average cost per pupil; this threshold was reduced in the last session. From FY 2010 until repeal in FY 2014, the law also required that a district pass two votes if its spending was proposed to increase over an inflation factor after exceeding the statewide average in the previous year. Last session, the Legislature considered a number of other measures, from limiting rebates for renters, to mandating student-staff ratios. Further, every year there are debates over who might pay more, whether through an increased general fund transfer (at the expense of other programs) or through a reallocation of burdens between the various education fund taxpayers.

A review of the components of the tax rate calculation for the next fiscal year demonstrates that similar pressures remain on the tax rate despite these efforts.

Education Components

There are three main education components impacting the base tax rate:

- *Equalized Pupil Count*: The number of equalized pupils is projected to decline once again, falling by approximately 539, from 89,938 to 89,399. The drop would be even more dramatic without the addition of critical Pre-K sections.

- *Base Education Amount (16 V.S.A. §4011(b))*: The base education amount is set to decline this year due to the inflation calculation. When Act 68 passed, a base education amount was established, representing the amount per pupil that would be supported by the base homestead rates. Amounts spent over the base would trigger local spending adjustments (although the spending adjustment must be understood as solely a pricing mechanism since all revenue is raised and pooled statewide; in no case does a town raise what it spends). Section 4011(b) requires that the base education amount be reset annually incorporating inflation for all the intervening years since 2005 using the State and Local Government Price Index. The base education amount per pupil had been frozen at $8,544 for three years through FY 2012, and then in FY 2013 and FY 2014 the base amount increased a

total of $607 (to $9,151) to catch up with inflation.[1] This year, FY 2015, the price index recalibration from 2005 forward results in a *decrease* of $42, to $9,109, due to the very low inflation rate. A lower base amount also lowers pressure on the base rates. However, the lower base amount for a lesser number of students is countervailed by early information from the AOE that projects that districts may vote for significant new spending.

- *School Spending:* School spending approved at the local level continues to rise. The Governor and other leaders have emphasized that only by holding total spending flat could school boards and local voters avoid rate increases. However, we saw approximately a 3% increase in spending in FY 2013, and a 5% increase in FY 2014, even though the equalized pupil counts fell 1629 in that time period. In terms of total dollars, spending increased more than $90M. Next year, projections from the AOE suggest that spending may increase another 3.8%.

Education Tax Revenue

Our education tax revenue comes from different rates on three types of payers: a uniform statewide rate on value for nonresidential owners (land, commercial, and second home owners); a base rate on value for homestead owners that is adjusted for district spending; and finally, for qualified households, a base percentage of income that also is adjusted for district spending. The trend in the value of properties, as well as the trend in property tax adjustments for income-qualified households, exerts pressure on property tax rates.

- *Grand List:* The statewide grand list is again projected to decline slightly, down roughly 0.5%, in value from FY 2014. Lower values mean that last year's rates on property will raise less money to spend per pupil. As discussed below, it is estimated that in the current economy, the grand list will recover and increase in value in future years (from both the uptick in new construction and appreciation of individual property value). But we will likely not soon return to the rates of growth that we saw when Act 68 first passed in 2005 – growth that allowed for rate cuts even while spending grew.[2]

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[1] The base amount was frozen for FY 2010, 2011 and 2012. In the depth of the Great Recession, school leaders worked hard to keep spending down while drawing on available federal stimulus money. Vermont school spending rose only $15M over this three year period. Unfortunately, as discussed above, in the two years since, Vermont school spending has risen over $90M.

[2] From FY 2005 to FY 2007, total education spending increased over $50M each year, even while the property tax base rates were dropped $0.10 over the two years, and the income base tax rate was dropped from 1.9% to 1.8%, due to higher property values and incomes.

- *Property Tax Adjustments:* Forecasting adjustments for income-sensitized taxpayers is complicated by year-to-year changes in the components of household income, fluctuations in the number and composition of households qualifying, and variations in the size of adjustments. For FY 2015, Education Fund adjustments are projected to increase $7.9M.[3]

5402b(a)(2) Mandated Recommendation

Given these factors, the consensus forecast is that the balance in the stabilization reserve would fall below three and one half percent, under current law, if the current statewide education tax rates of $0.94 and $1.44 were applied. Therefore, 32 V.S.A. §5402b(a)(2) requires me to recommend that the base homestead property tax rates be increased. Filling the reserve to 5%, under current law, requires a $0.05 increase in the base homestead property tax rate to $0.99, and a commensurate increase in the uniform non-homestead property tax rate to $1.49.

The base homestead income rate remains at 1.8% for the coming year pursuant to §5402b(b). The base income tax rate was originally set at 2% in statute, corresponding to a base homestead property tax rate of $1.10; it was lowered in conjunction with the property tax rates until it hit the statutory floor. Maintaining the original proportionality pursuant to §5402b(b) means that the base income tax rate is set to rise only when the base homestead property rate reaches $1.00. It must be noted that raising the base income tax rate also imposes a cost on the General Fund, in order to maintain rebates that cap the total amount of property taxes paid by certain qualifying low income households. So for example, if the base income rate was raised to 2% this year, $0.015 could be taken off the increase in the property tax rates; however there would be an additional $1.2M cost to the General Fund.[4]

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[3] Over $13M in additional non-property revenue is available for FY 2015. Pursuant to FY 2014 budget language directing surplus to the Education Fund, $1.3M was added to the base amount of the general fund transfer. Then using the State and Local Government Price Index (for this purpose, linked to year 2012) the transfer is set to increase $6.8M to $295.7M. There are several other sources of non-property tax revenue that contribute to the Education Fund, and like the general fund transfer, they are all up, for an additional $6.8M. The sales and use transfer is up $4.2M, the purchase and use transfer is up $2.1M, and the lottery transfer is up $.5M.

[4] Act 143 of 2012, Section 40 requires that the Commissioner also calculate the dollar equivalent of revenue per equalized pupil that would result under a homestead property tax rate of $1.00. Incorporating all of the current law assumptions, the dollar equivalent is $9,201 per equalized pupil in a given district. Section 40 suggests that the dollar equivalent rate assume a 2.0% base homestead income rate. This is not possible in the current year, since the base income rate remains at 1.8%.

Both the $0.99 and 1.8% base homestead rates will be subject to adjustment based on local spending decisions. For FY 2015, with a base rate of $0.99, the projected average equalized homestead property rate is $1.55.[5]

Section 5402b(a)(3) and (4) Triggers: Consideration of Adjustments Between Rates

The law contains triggers related to the nonresidential tax rate and its relationship to total spending and residential tax rates. Section 5402b(a)(3) directs the Commissioner to consider adjustments to the nonresidential rate when it fails to raise at least 34% of total education spending. Section 5402b(a)(4) is triggered "in any year in which the nonresidential rate is less than the statewide average homestead rate." This subsection directs the Commissioner to "determine the factors contributing to the deviation in the proportionality of the nonresidential and homestead rates and make a recommendation for adjusting statewide education tax rates accordingly." FY 2015 projections show that the nonresidential rates yield over 34% of total projected education spending; however, for the first time, these same projections show that the statewide average adjusted homestead rate would be higher than the nonresidential rate.

The Nonresidential Rate Continues to Raise More than 34% of Total Spending Under Section 5402b(a)(3)

In FY 2014, nonresidential payers funded over 37% of total spending. In FY 2015, with the recommended rate of $1.49, this share is projected to increase slightly to 38%. Therefore, this statutory provision has not been triggered.

Factors Causing a Higher Average Adjusted Homestead Rate Pursuant to Section 5402b(a)(4)

Three factors contribute to the projected statewide average homestead rate rising above the recommended $1.49 nonresidential rate:

- *Base Education Amount:* As explained above, the base education amount is tied to the State and Local Government Price Index using 2005 as a base year. After large increases in the past two years, the base amount decreases slightly this year due to very low inflation. Meanwhile, school spending in Vermont has grown faster than this price index since 2005, meaning that the proportion of spending reflected in local adjustments to the rates has increased.[6]

[5] As with any average, it can be expected that the adjusted rates will vary greatly from town to town based on spending decisions. In FY 2014, the statewide average spending adjusted tax rate was $1.41. However, in 101 districts (39%), the homestead rate was higher than the uniform statewide nonresidential rate of $1.44.

[6] As discussed, it must be understood that the spending adjustments to the rates are only pricing mechanisms. It is always true that a district that spends more per pupil will have higher spending adjustments applied to the base

- *Year to Year Base Rate Adjustments:* In prior years, rapid growth in property values allowed for the base rates to be cut–even in the face of increased spending. In that period, the nonresidential and homestead base rates were reduced by equal pennies rather than by equal percentages. Homestead rates therefore experienced proportionally greater reductions since the rate was lower than the nonresidential rate. In more recent years, both rates have been raised in most cases by equal pennies, meaning that the homestead rates have now experienced proportionally greater increases in recent years.[7]

- *Spending:* Spending has increased at a greater rate than inflation, and also at a greater rate than the growth in the revenue sources dedicated to education. The financing system reflects local spending decisions in local spending adjustments. Again, it must be emphasized that these spending adjustments are simply pricing mechanisms for the overall system. In no case does a local district directly absorb the total cost of its own education budget; all spending decisions are spread across all our education revenue sources. However, local decisions to increase spending lead to higher spending adjustments which are in turn driving the growth of our total education spending statewide.

Section 5402b(a)(4) Mandated Recommendation

Section 5402b(a)(4) provides that "in any year in which the nonresidential rate is less than the statewide average homestead rate, the Commissioner of Taxes shall determine the factors contributing to the deviation in the proportionality of the nonresidential and homestead rates and make a recommendation for adjusting statewide education tax rates accordingly." If this statute were interpreted to require a recommendation such that the nonresidential rate be set higher than the projected average statewide homestead rate, the nonresidential rate would need to be raised by $0.08 to $1.52, and the base rate increase for homesteads would need to be limited to $0.03.

It is, however, my opinion that such an adjustment to rates is not warranted. In one sense, the formula, as applied, has done what it was designed to do, which is create a consequence in the homestead rates in districts that have voted to spend at higher per pupil levels.[8] In FY 2015,

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homestead rates. However, no district raises sufficient money from its homestead payers to cover its budget; all education revenue, from non-property and property sources, is pooled statewide to meet spending.

[7] Last year an additional cent was added to the nonresidential rate, departing from the general rule to raise or lower each rate by the same amount.

[8] In comparing spending by districts, it is important to remember that the formula has had various adjustments over the years when the Legislature has chosen to mitigate a circumstance for a district, including small school size, rapidly growing student population, construction, and extraordinary special education costs.

even though a base rate of $0.99 generates a statewide average spending adjusted homestead rate that is projected to be over $1.55, an individual district has to spend more than 50% over the base rate to experience that result. Moreover, the total spending funded by nonresidential payers remains above the 34% level of sufficiency set forth by statute in Section 5402b(a)(3). Therefore, by another measure in the statute, nonresidential property owners are still bearing an appropriate proportion of spending.

Rather than focusing solely on rates, it is instructive to look a few different ways at the amounts of revenue raised by the different taxpayers, to determine who is bearing the brunt of the education spending increases. The story that emerges is that although the share of total spending paid by nonresidential payers has fallen somewhat, a bigger shift has occurred with respect to the increasing contribution by homestead owners who do not qualify to pay based on income.

Consider the percentage of education taxes (versus total revenue) raised by the three types of payers. In the first year of Act 68, FY 2005, nonresidential property owners contributed 60.3% of the total education taxes. In FY 2014, that percentage had fallen somewhat to 56.4%, compared to the 43.6% paid by homestead property owners.

Furthermore, consider the rate of growth in revenue raised by the three payers. Overall, education taxes increased 10.3% from FY 2009 to FY 2014, but the growth was unevenly distributed. From FY 2009 to FY 2014, the amount of tax raised by nonresidential payers increased a total of 4.1%, while the amount raised by homestead owners who pay based upon on income increased a total of 9.1%, and the amount raised by homestead owners who pay based upon property value increased a total of 25.4%.[9]

Some may argue that the formula has worked precisely as designed. Even though statewide revenues are pooled and distributed across the state, there is a consequence in homestead rates for districts that choose to spend more and, cumulatively, that has meant that as education spending has grown, taxes have shifted somewhat to homestead owners. The formula however is designed to incorporate affordability, so that shift has not been spread equally across all homesteads.

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[9] It is important not to extrapolate these trends to individual taxpayers, since the groups are very fluid. For example, a second home one year may be someone's residence the next. Households are also constantly moving from paying on income to paying on property value – household composition changes, household income determinants change, etc. In several years, the total number of households paying on income fell. Moreover, property values have been volatile in this period. By one rough measure, nonresidential properties may have held their value better over the entire period since Act 68 was enacted – in FY 2006 they comprised 50% of the total grand list, and in FY 2013 they comprised 52%. Again, it is difficult to extrapolate: within the categories, rates of new construction likely have varied, existing second homes likely experienced a greater decline in value than commercial properties, and values differ geographically.

Tweaking the rates to recalibrate the formula around the edges simply redistributes the burden. There is now an opportunity instead to examine in a comprehensive way how the formula is functioning overall—a decade after enactment—and to consider the underlying question of whether there are appropriate incentives or disincentives to limit spending to a sustainable, affordable level.

After consideration of all the above, I recommend continuing to take our previous approach to implementing the statutory rate increases for FY 2015 by adjusting the residential and nonresidential rates equally. I furthermore recommend that the Administration and the Legislature work this year to examine possible comprehensive modifications to limit spending growth rates going forward.

Supplemental Property Tax Relief Fund

In the FY 2014 Budget, the Legislature directed that a certain amount of any general fund surplus be directed into the base general fund transfer (this amount turned out to be $1.8M), and a certain amount be directed into a "Supplemental Property Tax Relief Fund" established in 32 V.S.A§6075 (that amount turned out to be $11.8M). The uses of this fund include the "development of proposals for property tax relief," including "incentives or rewards to promote or control education spending while improving quality."

If approximately $10M from this fund were directed to the Education Fund to reduce rates in FY 2015, the base rates could be set at $0.01 less. While it is likely that the Legislature will examine this approach in order to provide some relief to the overall property tax increases, I urge careful consideration prior to deciding whether to utilize the fund in the manner. Instead of across-the-board rate decreases, the surplus fund could be directed more strategically as an incentive for cutting spending. In that way, the money would be leveraged to yield further savings in the future, and assist in the goal of bringing spending to a sustainable level in the longer term. I recommend that the Administration collaborate with the Legislature to design appropriate incentives.[10]

Alternative Scenarios Based on Lower Spending Decisions

The statutorily-required recommendations outlined above are premised on a projected 3.8% growth in education spending. Rate increases will be mitigated if the budget decisions of the local voters yield a lower rate of growth. If overall spending was level funded, the rate increase would be $0.025. If spending increases were held to 2%, the rate increase would be $0.035.

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[10] For example, the adjustment to rates could be modified such that, in addition to a penalty rate for jurisdictions voting to spend over a certain threshold, there could be an incentive rate for jurisdictions that spent under a certain threshold, or that held to a certain growth rate.

The cost drivers are well known. Salary and health care costs for personnel are often cited as "fixed" costs – however the number of staff employed can be adjusted, particularly with falling enrollments. The Legislature has taken up the issue of whether staff-student ratios need to be mandated or at least recommended. Additionally, large schools are encouraged to capitalize on their economies of scale, while small schools can explore existing innovations in education delivery methods. Economies of scale may be achieved between supervisory unions through combined purchasing or other initiatives. The falling number of students, as well as the falling State and Local Government Price Index, suggest that level funding should be achievable in many districts.

Consideration of Modifications to Act 60/Act 68

It has been over 15 years since the *Brigham* decision and the legislative response, Act 60. It has been 10 years since the enactment of the only major amendment to Act 60, Act 68. In 2012, the Legislature engaged a leading national expert, Lawrence Picus and Associates, to study whether Act 60 and Act 68 had achieved their goals. The conclusion of that legislative study was that Vermont had indeed achieved equity, at the same time that quality was demonstrated through academic achievement of our K-8 students. Local control has been preserved. The question raised by the study, however, was whether Vermont could achieve these results at a lower cost. Vermonters spend a higher proportion of income per capita on education than any other state, and although the academic results are impressive, peer states have seen comparable achievement at a lower price.

PreK-8 education carries not only its own price tag, but also opportunity cost as it competes with other spending priorities – for example, higher education that is critical in today's job market. This year is a very opportune time to examine whether our funding formula is optimal, or whether it could be adjusted to better align spending with revenues, while still preserving equity, quality, and local control.

Two possible modifications are suggested for consideration in this letter. Currently, the penalty rate is tied to the previous year's average spending, which means each year's overall growth is automatically built into the threshold the next year. The threshold spending level instead could be fixed, for example at the FY 2014 statewide average spending, and then grown by the State and Local Government Price Index. Under that scenario, the penalty would be triggered by district spending growth that exceeded the inflation factor. An additional modification could be to include a lower incentive rate, as well as the higher penalty rate. The incentive could be available to districts that kept spending growth below a certain target.

Conclusion

The letter describes the ongoing tension between educational excellence and affordability. The Administration is committed to taking steps to consider the best way forward for all Vermonters and nonresident taxpayers. Accordingly, the Administration intends to partner with the legislature to co-host an education finance symposium of local and national finance experts. We will engage Lawrence Picus to convene a group of local and national finance experts in January to consider and suggest modifications to the funding formula that might more closely align local spending decisions with local and individual tax consequences, while balancing equity, quality, and local control.

Thank you for your consideration. As always, this Administration is committed to working with legislators and local leaders towards educational excellence that is affordable for our taxpayers. In the meantime, I extend my gratitude to staff at the Department of Taxes, Department of Finance and Management, AOE and JFO, for the enormous collaborative effort in assembling the data necessary for the projections that underlie the statutory recommendations herein.

Sincerely yours,

Mary Peterson
Commissioner, Department of Taxes

cc: Jeb Spaulding, Secretary, Agency of Administration
Armando Vilaseca, Secretary, Agency of Education
Jim Reardon, Commissioner, Department of Finance and Management
Rep. Janet Ancel
Sen. Tim Ashe
Rep. Johannah Leddy Donovan
Sen. Dick McCormack
Stephen Klein, Joint Fiscal Office
Luke Martland, Legislative Council

State of Vermont
Department of Taxes
133 State Street
Montpelier, VT 05633-1401

Agency of Administration

December 13, 2013

Rep. Shap Smith, Speaker of the House
Sen. John Campbell, President Pro Tempore
Vermont State House
115 State Street
Montpelier, VT 05633-0004

Dear Speaker Smith and President Pro Tempore Campbell,

As you know, the statutorily mandated recommendation from the Tax Commissioner on adjustments to the statewide education tax rates is based on various forecasts. Although those forecasts routinely continue to change throughout the year, it has come to my attention that consultants erroneously reported the current State and Local Government Price Index, which affects several calculations to the point that a revision to my November 26, 2013 letter is warranted. Staff has worked to recalculate the elements affected by this error. The most significant impact is that the base education amount per pupil for next year by statute would be $9382, which would necessitate an additional $0.02 increase in the base homestead property tax rate and the uniform non-homestead property tax rate, and the base homestead income rate would rise to 1.84%. However, please be aware that if the Legislature chooses to keep the base education amount at this year's level of $9151, such additional increases over the base rates initially reported are unnecessary.

Sincerely yours,

Mary Peterson
Commissioner, Department of Taxes

cc: Jeb Spaulding, Secretary, Agency of Administration
Armando Vilaseca, Secretary, Agency of Education
Jim Reardon, Commissioner, Department of Finance and Management
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VERMONT