

Discussion Paper



School finance in Vermont: Balancing equal education and fair tax burdens

by Darcy Rollins Saas

School finance in Vermont: Balancing equal education and fair tax burdens

NEPPC Discussion Paper 07-1
by Darcy Rollins Saas

Introduction

Vermont lawmakers had grappled with the thorny issue of how to finance public education long before the Vermont Supreme Court's landmark 1997 ruling that the state's funding system was unconstitutional. In that case, *Brigham vs. State*, the court found that the system in effect at that time violated the state's constitutional guarantee to equal protection under the law and directed the Legislature to establish a system that would afford “substantially equal opportunity” to all Vermont school children. Less than six months after this ruling, lawmakers enacted the Equal Educational Opportunity Act (known as Act 60), under which tax rates and educational opportunities were substantially equalized across school districts by redefining property wealth—for educational purposes—as a state resource.

Act 60 and its successor, Act 68, both narrowed disparities in educational funding across school districts. But the issue of who pays for education remains contentious, with calls for further reform driven by the perception that education property tax burdens are unreasonably high and remain inequitable. Vermonters are concerned about rapidly rising education property tax burdens, which some people blame on Acts 60 and 68, though rising real estate values have recently played a larger role. Some believe that their inability to use local property wealth to fund local education expenditures is unfair.

During this biennium session, the Legislature is expected to consider a range of reform proposals, including repeal of the current system. To help inform this debate, this paper provides a broad overview of major efforts to reform education finance in Vermont since 1969.

Early attempts at education finance reform (1969–1997)

For decades before the *Brigham vs. State* ruling, Vermont towns funded public education primarily with local property tax revenues. This system supported variable funding levels and, by extension, different educational opportunities in towns of different property wealth. Property owners in districts with low property wealth generally faced higher property tax rates to fund relatively limited school budgets, while property owners in towns with high property wealth funded larger school budgets on relatively low property tax rates. No matter

Darcy Rollins Saas is a policy analyst at the New England Public Policy Center. The views expressed in this discussion paper are those of the author and do not necessarily represent positions of the Federal Reserve Bank of Boston or the Federal Reserve System.

how much voters were willing to tax themselves, poorer districts' lower property wealth constrained their education spending. Taxpayers, parents, and school administrators in such property-poor towns thus became increasingly concerned that depending upon local resources to fund education resulted in unequal educational opportunities.

Before *Brigham vs. State*, the Legislature had attempted to address growing concern about these inequities mainly by increasing the share of state funding for education and targeting available state revenues on the neediest districts. However, maintaining the higher levels of state funding needed for significant local property tax relief proved difficult. Mathis (2001) notes that between 1964 and 1997, the state's share of basic educational expenditures varied between 20 percent and 37 percent and that reform initiatives in Vermont typically followed a decline in state funding.

What state resources were available were distributed according to various formulas designed to fund more equitable educational opportunities across districts of varying property wealth. In 1969, Vermont created the Miller formula, which sought to equalize funding across districts by accounting for property wealth when distributing state aid. In 1982, the Legislature passed Act 170, distributing newly available state aid to communities through the Morse-Giuliani formula, which based aid on both district property wealth and income. In 1988, Vermont established a state education foundation aid program to enable each school district to fund a state-defined, minimum quality education, also known as the foundation cost. Towns received state aid equal to the difference between the foundation cost and how much revenue they could raise from local resources at a state-established property tax rate. After two years of state funding increases, however, the fiscal crisis of the 1990s forced cuts in the state's contribution to the foundation aid program. To compensate, local contributions increased to maintain foundation levels. As a result, local property owners maintained primary responsibility for funding education spending in Vermont.

Because local property taxes remained the mainstay of education spending, unequal education funding and property tax rates persisted. Downes (2003) notes that between FY1990 and FY1995, districts with high property wealth increased expenditures at an annual rate of 3.8 percent, while districts with low property wealth increased expenditures by only 1.9 percent. Many property-rich communities funded high levels of education spending on relatively low tax rates, while their neighbors in property-poor towns faced high tax rates to fund more modest educational spending levels. In 2001, the Vermont Department of Education reported that in 1997, tax rates in Vermont ranged from a low of \$0.12 per \$100 of property value to fund per-pupil local education spending level of \$12,300 to a high of \$2.28 per \$100 of value to fund \$7,850 in spending. This persistent inequity prompted plaintiffs from property-poor towns to challenge the constitutionality of the system in court, leading to *Brigham vs. State*.

Brigham vs. State (1997)

Frustrated with what it saw as the Legislature's inability to craft a viable solution, the Vermont chapter of the American Civil Liberties Union challenged the constitutionality of the state's education finance system, suing on behalf of three groups of plaintiffs alleging both distinct and overlapping claims. Students from property-poor school districts claimed that the educational funding system denied their constitutional rights by creating unequal educational opportunities between property-poor and property-rich districts. Property owners from property-poor districts also claimed the system compelled them to contribute more than a just proportion of their income to fund education. The property-poor districts themselves claimed that because they were deprived of the ability to raise sufficient funds, they were compelled to levy disproportionately heavy tax rates on their residents. All three plaintiff groups argued that the education finance system denied them the equal protection right afforded by the Vermont Constitution's common benefits clause, which is analogous to the U.S. Constitution's equal protection clause.

Vermont was not the only state to face court challenges to its education finance system. Beginning in the 1960s, residents of property-poor communities around the country similarly argued that their rights were being violated by education finance systems, typically citing either equal protection clauses in their states' constitutions or more specific constitutional language about education. Under the latter, plaintiffs argued that property wealth in property-poor towns was insufficient to fund constitutionally guaranteed minimal or adequate levels of educational opportunity. The plaintiffs in Vermont focused on their constitutional right to equal educational opportunity because they believed they had a better chance of winning their case under the Vermont Constitution's explicit guarantee of equal protection. Further, establishing a constitutional right to an adequate or even minimal level of education could result in a Pyrrhic victory: students living in property-poor towns might receive a better education than they had previously enjoyed, but the tax base available to schools in property-rich towns would mean that peers living in these places could continue to enjoy an even better one.

In its February 5, 1997, *Brigham* ruling, the Supreme Court concurred with the plaintiffs. Vermont's method of funding public education, the court said, "...deprives children of an equal educational opportunity in violation of the Vermont Constitution." And while it conceded that unequal resources did not necessarily yield unequal effects or outcomes, the court declared that "...there is no reasonable doubt that substantial funding differences significantly affect opportunities to learn."

The Supreme Court directed the state to establish a system where "children who live in property-poor districts and children who live in property-rich districts should be afforded a substantially equal opportunity to have access to similar educational revenues." The ruling called for the establishment of an education finance system that was equitable and that no longer tied local education spending to local property wealth (i.e., a system that would be wealth-neutral). Responsibility for the design of this new system was left to elected officials.

Act 60 (1997)

The Legislature responded with the Equal Educational Opportunity Act, more commonly known as Act 60, which transferred primary responsibility for funding education to the state. Under the new system, education was principally funded through two state-established taxes on the same resource: a state-share property tax and a local-share property tax. These and other important components of Act 60 are described below.

- **State-share property tax funds equal per-pupil block grants**

Under Act 60, equal per-pupil block grants received by towns were the foundation for greater equality of education funding. The state intended these grants to cover the majority of education expenses. In FY1997, the state block grant was established at \$5,200 per pupil. The block grants were financed primarily by a new state-share education property tax, which in FY1997 was set at a uniform rate of \$1.10 per \$100 of equalized value for both homestead and non-homestead property. (A homestead is defined as a principal dwelling occupied by a resident plus up to two acres of land surrounding that dwelling.)

The new education property tax, as well as some earmarked state revenues, was the main source of revenue for the education fund that financed the block grants. Education fund revenues collected in excess of appropriations were captured in an education fund budget stabilization reserve to mitigate the potential impact of a deficit in the education fund. If revenues in the reserve account were to exceed 5 percent of the prior year's education fund, Act 60 allowed the state to use revenues collected above this threshold to fund increased support for education.

- **Education spending above the block grant financed by local-share property taxes**
Many Vermont towns wanted to provide educational opportunities above those afforded by the state grant. Under Act 60, education spending above the block grant was financed by revenues collected on a local-share property tax. A town's local-share tax rate depended on how much per-pupil spending above the block grant it approved; the rates were set by the state only after all towns had had an opportunity to approve additional spending. The rates were set such that towns approving the same level of per-pupil spending above the block grant had the same local-share property tax rate, regardless of property wealth.

Because the local-share tax rate was a function of spending and not local property wealth, property-rich communities raised more local-share revenues than the additional spending they approved. The excess local-share revenues they generated was captured in the education fund and redistributed to towns in which local-share tax revenues raised from comparable tax rates were lower than the additional spending they approved. For example, Town A had \$1,500 of property value per pupil and Town B had \$500 of property value per pupil. Both approved \$1,000 in per-pupil spending above the state block grant. The design of the local-share tax meant that they had the same local-share tax rate. The local-share tax rate applied to Town A's property generated

\$1,500 per pupil, which was \$500 above the approved additional \$1,000 in per-pupil spending. But under the same tax rate, Town B's more limited property wealth yielded only \$500 per pupil, not enough to afford the additional \$1,000 of approved per-pupil spending. Under this scenario, \$500 of local-share revenues collected in Town A would have been contributed to the state education fund and redistributed to subsidize Town B's education spending. Such redistribution among towns guaranteed that each town would receive the same yield in funding above the block-grant level for each additional penny on its local-share property tax rate.¹

Because it is largely financed by revenues raised on local-share property tax rates, Act 60's mechanism for redistributing revenues is commonly referred to as the municipal sharing pool. In theory, the local-share tax rates could be set to ensure that the total local-share property tax revenues collected exactly equaled above-block grant spending approved in all towns. This would have eliminated the need for the state to subsidize education spending approved above the block grant. In practice, the state subsidized the sharing pool annually, enabling a larger amount of locally approved spending for a given local-share tax rate.

- **Property values equalized annually**

Act 60 required annual equalization of the assessed value of property; previously, equalization had occurred every other year. Equalization means reassessing property at fair market value. Though responsibility for property appraisal and the development and maintenance of local property tax rolls (known as "grand lists") lies with localities, Act 60 required the state to equalize local grand list values annually for education purposes. A statewide grand list of fair market values was established for this purpose. The ratio of the aggregate value of the local property tax grand list to the aggregate value of the statewide grand list for each town is called its "common level of appraisal." A common level of appraisal less than one indicates that a town's aggregate local property value is listed below the state-determined fair market value for these properties. Through the common level of appraisal, the state ensures that education property taxes are applied to fair market value regardless of local assessment practices.²

- **Homestead education property tax adjustments for school property tax relief for low- and moderate-income residents**

While the court did not specifically rule on the inequity of tax burdens alleged by the plaintiffs in *Brigham*, the Legislature incorporated income sensitivity provisions for residents into Act 60. Homestead property owners with annual household incomes of less than \$75,000 could pay their state education property tax liability based on one of two formulas: the lesser of 2.0 percent of household income *or* the amount of state

¹ Vermont's education finance system is often referred to as a "guaranteed yield system" (GTY) in economics literature.

² In practice, the state adjusts local property tax rates to accommodate for a town's common level of appraisal. Towns with common levels of appraisal that are less than one experience an increase in their total tax rate. For more information at the mechanics of the common level of appraisal, please refer to *A Citizen's Guide to the CLA: Vermont's Common Level of Appraisal Adjustment for School Taxes*, Public Assets Institute, 2006.

education property tax assessed on the homestead after reducing its equalized value by \$15,000. The property tax adjustment received by claimants who benefit from paying on the basis of income is called a “prebate”; such claimants receive a check for the difference between the education property tax liability due on their property and the tax due as a percentage of their household income. The check is so-named because it is received prior to the first education property tax payment due date.

Homestead property owners with household incomes of greater than \$75,000 had no options for property tax relief until 1999, when technical adjustments to Act 60 provided some relief to households earning higher incomes.³ After these adjustments, all homestead property owners could limit the education property tax liability due on the first \$160,000 of property value to 2.0 percent of household income. Households remained liable for the full education property tax liability of property value above this threshold.

Under Act 60, homestead property owners with household incomes under \$47,000 could take advantage of an additional homeowner rebate. The rebate is a credit for property taxes for both municipal and education purposes paid in excess of a defined percentage of household income, ranging from 3.5 to 5 percent and based on a sliding income scale.

New perceptions of inequity

Some evaluations of Act 60, which was fully implemented by the 2001-2002 school year, found that the act successfully responded to *Brigham's* requirements for more substantially equal educational opportunities and wealth neutrality. A 2001 assessment by the Vermont Department of Education found that Act 60 had eliminated the wide variation in tax rates and that education spending was equalized across school districts. Other evaluations found similar evidence (Downes, 2002, Jimerson 2001, Mathis 2001).

Some praised Act 60 as the fairest way to fund education, but others—including Vermont resident author John Irving—dubbed it Marxism. While effective in weakening the link between property wealth and local education spending, Act 60's redistribution of local-share tax revenues was a source of contention in property-rich communities. Many felt that local resources should be used for local purposes, an argument that disregarded the fact that Act 60 met *Brigham's* requirements by redefining property, for education purposes, as a state resource. This sentiment that property tax wealth is a local resource that should be controlled locally has reemerged in recent reform proposals.

Property-rich communities were concerned about Act 60 partially because it led to lower per-pupil spending than many of them had previously undertaken. Under the prior regime, towns with substantial property wealth supported large education budgets on relatively low tax rates. Under Act 60, for “Gold Towns”—a quasi-official term for any town that collected more revenues than it spent—the state block grant provided for less per-pupil

³ Act 49: An Act Relating to Equal Education Opportunity Omnibus Act (1999).

spending than the town had previously enjoyed. But voters in property-rich towns had little incentive to approve spending above the block grant because the redistribution of local-share revenues cost them more in local taxes than the additional spending they approved.

Property-rich towns sought to escape the high cost of additional local spending in several ways. Some significantly cut school budgets so that they spent closer to the per-pupil amount afforded by the block grant. A few threatened not to send property tax revenues they collected for education to the state for redistribution, though in the end, all towns complied with state requirements. Other property-rich towns financed spending above the block grant privately, through local education foundations: nonprofit organizations with the express purpose of raising resources outside the tax base for education. Downes (2006) noted that foundations in towns with as few as 1,000 residents raised more than \$1 million in annual revenue. The Vermont Department of Education reported that in FY03, more than \$12.2 million in private donations contributed to school budgets that year.

Large, out-of-state “Gold Town” property owners were especially upset with Act 60’s perceived inequities. Several Vermont ski towns and surrounding resort areas host large, highly valued properties owned by non-residents or non-locally headquartered businesses. Under Act 60’s equalized state property tax, these large property owners paid the bulk of their communities’ state education property tax. Further, since they were not residents, they had no opportunity to vote on the local education spending that established their local-share tax rate.

In 1998, a year after *Brigham*, plaintiffs from Gold Towns argued in *Anderson and Stevens vs. State* that Act 60’s disincentives forced them to spend less on education than property-poor towns, eventually rendering unequal educational opportunity for their students. They contended that funding would eventually become unequally low because, in addition to limiting spending in property-rich towns, Act 60 gave towns with limited property wealth an incentive to spend more. The Vermont Supreme Court dismissed a trial court’s summary judgment that found for the plaintiffs on the grounds that the case involved speculation about future events, rather than an actual controversy the court could consider.

The next Act: 68 (2003)

Though several adjustments were made to Act 60 before its full implementation in 2001, the inequities perceived by taxpayers in property-rich towns were not substantially addressed until the passage of Act 68 in 2003. While Act 68 maintained many of Act 60’s provisions—including property tax adjustments for eligible resident households and the common level of appraisal—it made two significant changes. First, it split the homestead and non-homestead education property tax rates. Second, it made a town’s education property tax rate proportional to the spending approved by its residents, not on spending above the block grant approved by all towns. These and other important components of Act 68 are discussed below.

- **Differing tax rates for homestead and non-homestead property**

Under Act 60, homestead and non-homestead property within a town was taxed at the same rate. Act 68 split how a town's homestead and non-homestead tax rates were set, insulating the non-homestead property tax rate from local education spending choices. Under this system, still in effect today, the education property tax base rate for non-homestead property is set annually by the state. The rate for FY2005, which was the first year that Act 68 went into effect, was set at \$1.54 per \$100 of equalized value.

Insulating the non-homestead property tax from local spending decisions earned Act 68 more support than its predecessor. It relieved non-local property owners of paying for additional local education spending upon which they could not vote. Further, residents' complaints about the inequity of redistributing local-share revenues to fund locally approved spending largely evaporated once non-homestead property no longer financed that spending. Non-homestead property wealth was distributed especially unequally among Vermont towns, and the redistribution of local-share tax revenues raised on these properties under Act 60 had been considered especially onerous.

- **Homestead property tax rate set proportional to local spending**

Act 68 also modified how homestead property tax rates are set. Instead of being subject to both a state-share and local-share education tax rate, homestead property is now taxed at only one education rate. Unlike the situation under Act 60, a town's final homestead education property tax rate is proportional only to the level of spending its residents approve—it is no longer a function of other towns' spending decisions. In FY2005, the state set the base homestead property tax rate at \$1.05 per \$100 of equalized value. If a town approved spending 5 percent more than the annual state per-pupil block grant, its state homestead education tax rate increased by 5 percent above the base homestead property tax rate (Vermont Department of Education, 2004).

Excess revenues collected on local tax rates are still redistributed between communities through the state education fund. After accounting for prebates and rebates due to eligible residents, towns unable to raise enough revenues on their property base to support approved per-pupil spending are subsidized by the state education fund. Towns that collect more revenues than needed to fund approved per-pupil spending continue to contribute to the fund.

Several changes under Act 68 greatly reduced the degree of redistribution from property-rich to property-poor towns. First, the state per-pupil block grant was increased to \$6,800 as of FY2005, providing all towns with a larger foundation from which to start.⁴ Second, as noted above, insulating non-homestead property from local spending choices reduced the degree of such redistribution. Put another way, the tax price—or the cost of funding an additional dollar of per-pupil spending locally above the state block grant—declined. Schmidt and Scott (2004) noted that under Act 60, taxpayers in 37 towns paid

⁴ The larger block grant is not entirely funded by education property taxes; increases in the state sales and telecommunications and other taxes comprise approximately one-third of the education fund.

more than \$2 for each additional dollar of education spending they approved; taxpayers in several towns paid much more. Under Act 68, taxpayers in only a few towns paid more than \$1 for each additional dollar of spending they approved. The reduced cost of Act 68 is evidenced by the fact that property-rich towns opted to participate fully in the system: according to data collected by the Vermont Department of Education, private fundraising for schools through local education foundations declined significantly after Act 68's full implementation in 2005.

The reduced cost of local spending provides incentive for towns—especially property-rich towns—to spend more. While this has the potential of yielding greater funding inequities across districts, a potential violation of *Brigham*, Schmidt and Scott (2004) estimated that the inequity would increase only marginally relative to existing inequities. The authors estimated that approved increases in per-pupil spending in property-rich towns would, on average, increase only \$65 more than the spending increases approved by voters in property-poor towns.

However, some feel that disparity in education spending between property-rich and property-poor districts has grown in recent years. And data suggest that education funding is currently unequal across the state: the state Department of Education reported that per-pupil spending ranged from \$7,628 per pupil in Woodford to \$13,325 per pupil in Dummerston in FY2006.⁵ This spending difference is similar to the disparity which prompted the *Brigham* plaintiffs to file suit in 1997. However, taxpayers in property-poor towns may be less upset than in the past about the disparity because the tax rates they face seem more equitable. Before *Brigham*, property-poor towns had to levy disproportionately high tax rates to fund relatively low spending levels. Under Act 68, each town's tax rate is more proportionate to its spending level. In FY2006, Woodford paid for \$7,628 per pupil on a homestead property tax rate of \$1.11 per \$100 of equalized value, while Dummerston paid for its \$13,325 per-pupil spending on \$2.06 per \$100 of equalized value.

Act 68 also includes a provision to curtail local education spending in property-rich towns. Towns that spend more than a set percentage above the previous year's state per-pupil average are subject to an additional tax rate. Initially, Act 68 allowed towns to spend up to 135 percent above the prior year's state per-pupil average without facing this tax penalty. Beginning in FY2007, towns spending more than 125 percent above the average face the penalty. The penalty is assessed by double-counting any spending above the threshold when determining a town's homestead property tax rate. For example, a community that spent \$500 above the threshold would have a homestead tax rate set as if the town had actually spent \$1,000 per pupil above the threshold.

⁵ The Vermont Department of Education reports per-pupil spending by size and type of district. This analysis compares per-pupil spending between towns that operate an elementary school and belong to a union or joint high school. A plurality of Vermont's town districts (108 out of 206 schools listed in 11 categories) operate this type of school district.

- **Additional property tax adjustments**

Act 68 preserved the prebate and the rebate programs for eligible households and provided additional property tax adjustments for all property owners in the event of a surplus in the education fund budget stabilization reserve. When the projected balance of the reserve is more than the 5 percent of education fund appropriations, the state may reduce the base homestead and non-homestead education property tax rates. In recent years, appreciating property values have yielded robust education property tax collections, allowing the state to reduce the base tax rates. Between FY2005 and FY2006, the base homestead rate declined from \$1.05 to \$1.02 per \$100 of equalized value and the non-homestead base rate declined from \$1.54 to \$1.51 per \$100 of equalized value. Further, Act 68 required the state to make proportional adjustments to the base percentage of income that claimants paying their homestead education property tax on the basis of income remain liable for. In FY2006, the base percent of income was reduced to 1.85 percent.

Current reform drivers

While Act 68 responded to the perceived inequities of Act 60's finance mechanisms, its changes have not completely eased taxpayer discontent. Rising property values and the growing cost of education have made the cost of providing substantially equal education opportunities burdensome for some. Taxpayers whose property tax bills have inflated rapidly have not experienced significant relief from the modest reductions in the base property tax rates. Some are concerned that specific groups are paying a disproportionate share of the state's education costs. Others still chafe at not being able to directly use local property wealth for local school budgets. The following section investigates major factors behind discontent with the current education finance system.

Increased education spending

Tax burdens for education are growing, in part because the costs of educating Vermont students are growing. Reporting to the General Assembly, the 2004 Joint Legislative Education Cost Containment Committee noted that despite declining student enrollment, education spending in Vermont grew faster than inflation between 1996 and 2002. In September 2006, the Vermont Joint Fiscal Office projected that education spending would grow by 5.6 percent in nominal terms for FY2007 and FY2008, despite further projected declines in enrollment.

While a legislative cost containment study identified factors beyond the education finance system for such increasing education costs, the design of Acts 60 and 68 may also contribute. Act 60 responded to *Brigham vs. State's* requirement for more substantially equal educational opportunities by supporting more spending in property-poor towns. The Vermont Department of Education analyzed changes in per-pupil expenditures in towns, grouping towns into quintiles defined by property wealth. Between FY1998 and FY2001, towns with the most property wealth increased expenditures by only 2.3 percent on average, while

communities with less property wealth increased per-pupil budget expenditures up to 24.0 percent on average. As noted previously, limited expenditure increases in the top group reflected the high cost that taxpayers in property wealthy communities faced for spending above the block grant. Act 68 reduced that penalty, increasing the incentive for property-rich communities to spend more. Schmidt and Scott (2004) estimated that Act 68 encouraged local voters to spend an additional \$24.4 million on education.

Growing property values and slow income growth

While the cost of education has increased, rapidly rising property values and relatively sluggish income growth are the primary cause of currently high education property tax burdens. Between 1997 and 2005, home values in Vermont increased, in real terms, by 55.4 percent; between 2003 and 2005, housing prices appreciated by over 10 percent annually in real terms. However, according to the author's analysis of data published in the 2005 Current Population Survey, average real household income actually fell for all income quintiles in Vermont between 2003 and 2005.⁶

Property values are exploding for certain towns and types of property. This volatility is especially burdensome in places where local grand lists are not updated to reflect fair market values, often due to limited sales volume or local appraisal capacity. For example, the Vermont League of Cities and Towns reported that in 2005, rapid increases in the state's equalized grand list of fair market property values relative to values listed in local grand lists resulted in sharp increases in property tax burdens for the small towns of Morgan and West Windsor. In that year, the difference between listed local property values and state-defined fair market values widened, resulting in a 20 percent decline in their common levels of appraisal. To compensate, the listed property values were increased to ensure that the education property tax was applied to equalized values. This low common level of appraisal meant that the education property tax burdens in these towns increased significantly over a very short period of time.

Fair market values are projected to continue to increase. In September 2006, the Vermont Joint Fiscal Office forecast that the value of the state education grand list will grow by more than 13 percent annually in both FY2007 and FY2008, despite the cooling regional real estate market. Though addressing appreciating property values is largely beyond the purview of the education finance system, some have called for reforms in the method for determining common levels of appraisal, with an eye to constraining upward adjustments by the state.

Concern about shifts in the distribution of the education tax burden

Most Vermonters can take advantage of provisions that limit their education property tax relative to income, thus insulating their education property tax bill from a booming real estate market. In 2005, a House study committee noted that more than 70 percent of

⁶ U.S. Bureau of Labor Statistics, Current Population Survey, 2005. Analysis refers to the three-year moving average of Vermont real household income by quintile (2001-2003 and 2003-2005).

Vermont homestead owners were eligible for the prebates and rebates, some are concerned that not all eligible households are taking advantage of the provision.

Though technically all Vermont homestead property owners are eligible for at least part of the state's income-sensitivity provisions, not all benefit by participating. According to the Vermont Joint Fiscal Office, households with income of more than 55 percent of their homestead property value do not benefit because their income-adjusted liability is more than their property tax bill. Until 2005, if a taxpayer's household income was greater than \$88,000 (55 percent of the \$160,000 property value that all residents can "income-sensitize"), there was no mechanism for a property tax adjustment.

Homestead property owners unable to benefit from income sensitivity provisions have become concerned that they are bearing a disproportionate share of the growing cost of education. Increasing education costs and property values have resulted in large increases in their property tax bills, while those paying their education property tax liability as a percentage of their relatively slow-growing incomes have experienced smaller property tax bill increases. Non-homestead property owners, none of whom are eligible for the Vermont's income sensitivity provisions, are concerned about a perceived education tax shift between homestead and non-homestead property classes. Some analysis suggests that non-homestead property taxpayers are paying a growing percentage of the total state education tax. Analysis of preliminary education tax data reveals a slight shift in education property tax burden between homestead and non-homestead property classes from FY2005 to FY2007, when the non-homestead share of the education tax grew from 58.8 percent to 59.1 percent and the resident or homestead owners' share declined from 41.2 percent to 40.9 percent.

Post-Act 68 changes and proposals for reform

In recent years, the following actions or proposals sought to make both incremental and comprehensive reforms to Act 68 to address voter discontent with growing education costs, the property tax adjustment provisions, and taxable property values.

Act 38: 2005

In 2005, the Legislature increased eligibility for the prebate program to provide more property tax relief against rapidly accelerating property values. Under Act 38, homeowners with household incomes of \$85,000 or less in 2006 (increasing to \$90,000 in 2007) can choose to pay their education taxes through property taxes or replace the property tax with a tax based on income. Further, Act 38 raised the amount of homestead value that could be income-sensitized to \$200,000. As previously noted, households earning up to 55 percent of the value of their home generally benefit from these provisions. With this change, households earning up to \$110,000 (55 percent of \$200,000) can benefit from income-sensitivity provisions.

The eligibility expansion increased the cost of the prebate program. In September 2006, Vermont's Joint Fiscal Office reported that prebates cost the state \$81.2 million: 23.4 percent of the \$346.6 million homestead education tax revenues collected that year. For FY2007, the prebate programs was projected to cost the state \$107.0 million, or 25.4 percent of projected homestead education tax revenues.

Act 38 also created an education program for municipal property listers and assessors to improve local valuation practices in an effort to mitigate dramatic equalization of property values and resulting sharp increases in tax burdens. The act also established a committee to propose further changes in how the state's property tax adjustment provisions are administered and to investigate financing education through alternative sources (see below).

House Legislative Study Committee on Income-Based Education Property Tax for Vermonters: 2005

In 2005, the House Study Committee charged with evaluating and improving the state's property tax adjustment provisions submitted two proposals. The first further simplified and streamlined the existing prebate and rebate provisions, while the second called for an education income tax. In 2005, the committee proposed a significant lowering of the base property tax rate to 30 cents and funding a portion of education through a new 1.5 percent education income tax on residents. The first proposal was largely adopted by Act 185, passed by the Legislature in 2006 (see below). Vermont's Joint Fiscal Office is developing a proposal for an education income tax for consideration this biennium session.

Some of Vermont's elected officials have long proposed funding a portion of public education through a state income tax. A Democratic proposal for an income tax was considered just prior to the *Brigham* ruling, and a House bill for an education income tax advanced but was not approved in 2003.⁷ While the existing income-sensitivity provisions already allow a majority of Vermonters to pay their property tax liability on the basis of income, this approach is popular again in light of growing property tax burdens and the complexity of administering the program. However, some are concerned that the higher marginal tax rates needed to finance education could negatively affect the economy. Others are concerned that because they are relatively sensitive to economic cycles, income tax revenues are too volatile to finance expanding education costs.

Act 185: 2006

As discussed above, each of the following three tax provisions is reduced in the event of a surplus in the education fund: (1) the property tax rate on homestead property; (2) the tax rate on non-homestead property; and (3) the percentage of household income paid by claimants who choose to have their education tax levied on the basis of income rather than property value.

Education fund surpluses have enabled the legislature to reduce these rates annually. Surpluses have been growing largely as a result of increases in education property tax

⁷ Vermont House Ways and Means education finance bill (H. 462).

revenues collected from homestead property owners paying their full education property tax liability and from non-homestead property owners. As previously discussed, these claimants' property tax liabilities increased due to rising property values. Though tax bills for those paying on the basis of income have increased because they are indexed to relatively slow income growth, these households have benefited from the proportional reductions required for the base income rate.

Because of concerns that these reductions were unfairly benefiting these claimants, whose tax bills increased much more slowly than the growing costs of education, Act 185 established a floor for adjustments for households paying on the basis of income: the percent of income that defines the education property tax liability for these households cannot be reduced below 1.8 percent.

Act 185 also sought to simplify the way the income-sensitivity provision is administered and connected the prebate provision more clearly to education property tax relief. Beginning in the fall of 2007, Vermonters will receive their prebate as a discount within their property tax bill, rather than as a separate check mailed before the tax bill was due.

Governor Douglas Education Tax Proposal: August 2006

The governor's proposal sought to relieve growing tax burdens by capping local education spending. Specifically, the governor proposed capping annual increases in local education spending at 4 percent in FY2008 and at 3.5 percent after one year. The proposed limits would sunset after five years. A vote by 60 percent of residents would be needed to exceed the cap. The scope of this paper does not permit extensive analysis of the pros and cons of limiting local education spending in this manner.⁸

The governor also sought to dampen the effect of the volatility of the system that equalizes property values for some towns. He proposed capping growth in the value of the state education grand list in the 25 municipalities with the most rapid appreciation in property values. Finally, the proposal would limit another growing cost of the education finance system—the prebate and rebate provisions—by decreasing the income limit for eligibility and by increasing cap on homestead education property tax liability back to 2 percent of income.

⁸ The impact of the proposed education spending limits on property tax burdens, school budgets, or education quality in Vermont depends in part on the specific design of the limit. For further discussion about the theory and design of state and local tax and expenditure limitations, see *Reading the Fine Print: How Details Matter in Tax and Expenditure Limitations*, New England Public Policy Center, October 2006.

Revolt and Repeal: October 2006

In September 2006, five Vermont Republicans, declaring that the “...educational financing system in use today is fundamentally and irreversibly flawed and cannot be repaired,” launched a campaign to repeal the statewide education property tax. Five towns have formally endorsed the initiative and more than 40 have passed resolutions supporting repeal of the statewide property tax. The campaign offers no alternative for how to the current education finance system. Any new system would have to meet the standards set under *Brigham* ruling unless the Supreme Court reversed or adjusted its decision.

Vermont League of Cities and Towns: October 2006

The Vermont League of Cities and Towns voted in October 2006 to repeal the laws that govern the current education finance system and endorsed guidelines for a new system that included less reliance on the property tax. Specifically, the League recommended an education income tax.

The League also proposed guidelines to restrain education costs without sacrificing local control, such as financial incentives for school consolidation, which the League claims has been shown to reduce costs and enhance educational opportunity. The recommendations also call on the state to provide schools with the resources needed to educate children, proposing that the state clearly delineate core educational costs that would be covered by the education fund and require local voters to fund remaining local expenses. This aspect of the proposal could be problematic since it essentially reestablishes the foundation aid program which the court found unconstitutional under *Brigham*.

Finally, the League offered several recommendations about how to fairly distribute property wealth resources and tax burdens throughout the state, including adjustments to the methodology of the common level of appraisal process.

Conclusion

While many Vermonters remain committed to an education system that promotes substantially equal educational opportunities, some are frustrated with the cost and system of paying for it. Those taxpayers that are ineligible for existing property tax adjustment provisions have perceived new types of inequity, galvanizing calls for further reform. Rapidly inflating property tax burdens for some (compared to levels that taxpayers are more comfortable paying), along with the perceived unfairness of being unable to use local resources to fund local education expenditures, drive current reform initiatives. Though the property tax is no longer a local resource, some towns resent having their primary and traditional resource—property wealth—administered and controlled by the state.

Providing equal education opportunities, containing growing education property tax burdens, and resolving this perception of a lack of local control likely cannot be achieved simultaneously. An education finance system that is constitutional under the *Brigham* ruling mandates sacrifices on the part of taxpayers for a public good—educated citizens. It remains

to be seen if current proposals can make that sacrifice more palatable or ensure that those bearing the burden have the most stake in the outcomes of the system.

Acknowledgements

The author would like to thank Bo Zhao, Economist and Robert Tannenwald, Director of the New England Public Policy Center, for their guidance. For their thoughtful comments on a draft of this report and additional insights, special thanks go to Paul Cillo of the Public Assets Institute, Thomas Downes of Tufts University, Mark Perrault of the Vermont Joint Fiscal Office, and William Mathis of the Northeast Kingdom School Districts.

Appendix A Additional reading

Brome, Heather and Darcy Rollins Saas. *Reading the Fine Print: How Details Matter in Tax and Expenditure Limitations*. New England Public Policy Center, Research Report 06-3, 2006.

Cillo, Paul. *A Citizen's Guide to the CLA: Vermont's Common Level of Appraisal Adjustment for School Taxes*. Public Assets Institute. 2006

Downes, Thomas. *Lessons from Vermont. Working Paper 2003*. Department of Economics, Tufts University.

Downes, Thomas and Jason Steinman. "Alternative Revenue Generation in Vermont Public Schools." (unpublished manuscript), March 2006.

Mathis, William. "Vermont's Act 60: Comprehensive School Finance Reform: Effects in the First Year of Full Implementation." 2001 Annual Meeting of the American Education Finance Association.

Jimerson, Lorna. *A reasonably equitable share: Educational equity in Vermont*. Rural School and Community Trust Policy Program, 2001.

Olabisi, Oyebola. "New Hampshire's quest for a constitutionally adequate education." New England Public Policy Center, Discussion Paper 06-2, 2006.

Rebell, Michael. "Rapid response, radical reform: The story of school finance litigation in Vermont." *Journal of Law and Education*. 2002.

Report of the Vermont House Legislative Study Committee on Income-Based Education Property Tax for Vermonters. December 2005.

Schmidt, Stephen and Karen Scott. "Reforming reforms: Incentive effects in education finance in Vermont." *Education Finance and Policy*, Fall 2006.

Swaine, Daniel. "Can Guaranteed Tax Base Formulas Achieve Either Wealth Neutrality or Spending Equality?" *Fiscal Facts*. Federal Reserve Bank of Boston. 2001.

Appendix B

Court rulings, legislation, and reform proposals

Brigham vs. State

http://dol.state.vt.us/gopher_root1/supct/166/96-502.op

Act 60

<http://www.leg.state.vt.us/docs/1998/acts/ACT060.HTM>

Act 49

<http://www.leg.state.vt.us/docs/2000/acts/ACT049.HTM>

Act 68

<http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2004/acts/ACT068.HTM>

Act 38

<http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2006/acts/ACT038.HTM>

Act 185

<http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2006/bills/passed/H-880.HTM>

House Legislative Study Committee on Income-Based Education Property Tax for Vermonters

http://www.leg.state.vt.us/Temp/CMTE_DOCS/Committee_Report_on_House_Study_on_Income-Based.htm

Components of the governor's education tax proposal

<http://www.leg.state.vt.us/jfo/Reports/09-21-06%20Components%20of%20Governors%20Education%20Tax%20Proposal.pdf>

Vermont League of Cities and Towns education finance reform guidelines

<http://www.vlct.org/>

“Revolt and Repeal” campaign website

<http://www.revoltandrepeal.com/index.php>