Senate Finance Committee
March 25, 2015

Testimony of Paul Cillo, President
Public Assets Institute
PO Box 942
Montpelier, VT 05601
802-223-6677
paul@publicassets.org

Good afternoon, Mr. Chairman, members of the committee.

My name is Paul Cillo. I'm the president of Public Assets Institute. We're a Montpelier-based nonprofit, nonpartisan, public policy think tank that was established in 2003. We analyze Vermont fiscal policy—tax, budget, and economic policy— from the perspective of ordinary Vermonters.

We regularly publish reports, fact sheets, and blog posts on our website www.publicassets.org. If you're not on our email list and would like to see our work, please let me know.

Thank you for inviting me to share some ideas about modernizing Vermont's tax code to reflect the 21st century economy.

There are two things we need to do to bring Vermont into the 21st Century:

- We have to acknowledge that what we've been doing isn't working.
- We need to change course and start investing in people and Vermont's future.

What we've been doing isn't working

We started the 21st Century with massive federal tax cuts that were supposed to stimulate the economy, create jobs and bring prosperity to all. Here in Vermont, even before the recession, we saw a push for smaller government that we also were told would equal jobs and improve Vermonters' lives.

What we got—as we show in our latest State of Working Vermont report—is greater income inequality, little job growth, growing poverty, growing homelessness, and a decline in income for working Vermonters who have actually increased their productivity.

Now some of you may say, well that was the recession, it wrecked the economy. But even before the recession, job growth was the slowest of any decade since Vermont started keeping records in the late 1930s, as we reported in our 2010 State of Working Vermont report. And since the bottom of the recession in 2009, which is the period covered in this latest report, the Vermont economy has been doing relatively well.

In fact, as you can see on page 4, we've had the second fastest growing economy in New England since 2009. In 2013, Vermont's economic growth was the best in the entire northeast (11 states and the District of Columbia). That's the good news.

The bad news is that all of the other indicators I mentioned before—household income as well as poverty, hunger, and homelessness—are moving in the wrong direction, which you can see on pages 26-29.

How could both of these be true: relatively good economic growth and increasing hardship for tens of thousands of Vermonters?

An answer is on pages 6, 7, and 8. Despite increased productivity, workers are not seeing the fruits of their labor in higher wages. Real wages have been going down. The gains are going to those at the top, who are receiving more and more of the state's total income—page 8.

There are now two Vermonts: One where some people are increasingly doing very well; and another where more and more people are living in poverty.

High income inequality like Vermont's is a social and economic ill. It dampens economic growth, increases poverty, and reduces the state's tax revenue. We think it's the biggest economic issue Vermont faces in 2015.

Clearly, what we're doing isn't working. We need to change direction.

We need to change direction because the times have change. It used to be if you wanted to make real money in Vermont, you started a manufacturing business, you hired people to mill lumber, make sausage or cheese, print books, or machine stone or metal into useful products. You produced work and provided an income for people in your community that in turn generated state and local tax revenue and stimulated the economy.

In short, you were a job creator. You could get rich doing this, and many Vermonters did.

Now, manufacturing has largely moved to Asia looking for cheap, malleable labor. And thanks to technology and the huge expansion of the financial sector, if you want to make a lot of money in Vermont, you don't need to hire anyone or invest money in physical plant. You can invest internationally and make money without creating a single job here. Even if you operate an existing manufacturing business, you can reduce the number of existing employees by off-shoring jobs, replacing them with technology, or both.

Manufacturing jobs used to pay decent salaries that allowed Vermonters with a high school education to live a middle class life. Income was more evenly distributed in society. Now income is distributed much less evenly, and those with the most income aren't necessarily producing jobs. Some are, but many are not.

We need to acknowledge this changing economic landscape, recognize that we are not creating new jobs in Vermont, and re-examine tax policies that reward wealthy taxpayers on the assumption that they are creating jobs.

Our tax policies aren't working. Neither are our budget policies.

Even before the recession, the run-up to each legislative session came with warnings about a budget gap: the need for services was greater than expected revenues, and the message was we had to “manage to the money.” For the most part, that is what we did—cut spending to match the available money, and we continue to do this. In some years, there were new revenues, but for at least seven or eight years Vermont has relied more heavily on cuts to balance the budget.

But the cuts clearly aren’t working, because every year starts out with a new budget gap forecast. This year, for the first time, the governor and others have started talking about a structural budget problem. But structural problems can’t be fixed with cuts any more than they can be fixed by simply adding more revenue.

We see structural problems on both the expense side and the revenue side.

First the expense side: health care costs in Vermont have been increasing at a rate faster than economic growth for more than two decades. This has had serious consequences for the budget, which have not been acknowledged.

Between fiscal 2010 and the budget proposed by the governor for 2016, in inflation adjusted dollars, total spending is up $283 million. The health care portion of the budget went up $367 million over that period. That means spending for rest of the state government actually went down $84 million. So while there is a perception of excessive state spending, in fact, state spending in real dollars on everything but health care has been going down.

The private health insurance market left more and more Vermonters uninsured and underinsured, so the state has stepped in and expanded Medicaid to solve the problem. But the Legislature has not provided a reliable revenue stream to cover this increasing state expense.

We need health care reform and the continued work of the Green Mountain Care Board to slow the growth of health care costs. But in the meantime, we can’t simply keep cut the rest of state government while we wait for health care to be brought under control. We agree with the governor that a new source of revenue is necessary to cover these health care cost obligations. We think his payroll tax proposal makes sense.

On the revenue side, the state’s overall tax system is regressive. While Vermont does have a progressive income tax, which is projected to perform better than the other major General Fund taxes next year as it has in the past, the highest income Vermonters still contribute a smaller share of their income overall to pay for state services than do middle- and lower-income Vermonters. That becomes a greater problem for revenue growth as more and more of the income of the state goes to those at the top, which, as I pointed out earlier has been the trend in Vermont for more than 30 years.

Finally, while the projected budget gap has been blamed on lagging income tax revenue, income taxes, projected to grow 5.5 percent next year, still show the strongest growth of any of the major general fund revenue sources. Consumption taxes, especially the sales tax, on the other hand, which typically have much slower annual growth, are projected to grow between 3 and 4 percent next year. The slow growth in the sales tax doesn’t just contribute to the annual General Fund budget gaps, it also has been driving up property taxes.

One reason sales tax growth lags economic growth is that it doesn't apply to the fastest growing consumer purchases: services. We can expand the sales tax base and lower the rate to address that problem.

Change course: invest in people and Vermont's future

After acknowledging that what we're doing isn't working, we need to try something new. We need to shift our focus back to people and create a Vermont that works for everybody. Nobel prize-winning economist Joseph Stiglitz in his book "The Price of Inequality" warns: "Inequality leads to lower growth and less efficiency. Lack of opportunity means that its most valuable asset—its people—is not being fully used. Many at the bottom, or even in the middle, are not living up to their potential, because the rich, needing few public services and worried that a strong government might redistribute income, use their political influence to cut taxes and curtail government spending. This leads to underinvestment in infrastructure, education and technology, impeding the engines of growth."

In short, as economist Jeffrey Thompson of the Federal Reserve and many others have said, income inequality causes poverty.

Vermont, alone, isn't going to solve income inequality, but we can start investing in people and infrastructure with the aim of reducing poverty, improving education, and helping Vermonters build for the future.

In the spirit of changing course and trying something new, we recommend the following:

1. Adopt the administration's 0.7 percent health care payroll tax.
The governor has proposed a 0.7 percent payroll tax to raise the revenue the state needs to increase its payments to hospitals, doctors, and other health care providers. Meanwhile, the Green Mountain Care Board is making progress in slowing the growth of health care costs through regulation and redesign of the system for paying for health services. Both of these steps can begin to take the pressure off the portion of the budget that supports the rest of state government.

2. Refrain from making additional cuts to state services.
Cuts over the past decade or more have already undermined the state's ability to competently deliver the services that Vermonters need and want. The failure to raise sufficient General Fund revenue to support these services has shifted costs onto the property tax and pushed up health insurance premiums.

3. Eliminate income tax breaks and lower tax rates.
Vermont is one of six states in the country that still uses federal taxable income rather than adjusted gross income as the base for the state income tax. That means our top marginal rate is higher than necessary to raise the needed revenue. Additionally, tax breaks that primarily benefit upper-income taxpayers are undermining the progressivity and performance of the state's tax system. The state can lower marginal rates, increase revenue, and improve the progressivity of

the tax system by eliminating itemized deductions and replacing personal exemptions with a refundable tax credit.

Public Assets' analysis based on projected fiscal 2016 budget gap data from JFO shows that by taking these steps the Legislature can balance the budget without additional budget cuts while lowering income tax rates and make progress on addressing the structural problems that create budget gaps year after year.

We recommend that the Legislature make three additional reforms, not to raise additional revenue, but to make the tax system more responsive to the economy.

First, the Legislature should expand the sales tax to include services and lower the sales tax rate. We recommend that that the Legislature not use the sales tax to raise additional revenue at this time, but simply expand the base to services and lower the rate. Consequently, we have not recommended this action as part of the solution to the 2016 projected budget gap.

Second, the Legislature should eliminate the school property tax on primary residences. Since the state currently has parallel tax systems that set rates—both income and property rates—for school taxes on primary residences, eliminating the property tax option will leave a tax based on income as the remaining school tax on primary residences. Rates would continue to rise and fall with spending per pupil as they do now. This would help to make Vermont's overall tax system less regressive and simpler to understand the tax implications as voters decide on school budgets.

Finally, we recommend that the Legislature explore an assets tax that would go to the General Fund. The asset that is taxed in Vermont to the exclusion of other less essential personal assets is a primary residence. Vermont needs to review where wealth resides and fairly tax a broader scope of assets where it's practical to levy a tax, not just tax Vermonter's homes. Like with the sales tax, a broader base would mean lower rates.

I realize that I've covered a lot of territory today. I have details on our income tax proposal if you'd like to hear those, and I'd be happy to answer any questions about any of these ideas.