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We begin by summarizing what has happened in our state's funding of education since we wrote the 2012 version of this municipal policy paper:

- The legislature raised the base residential education property tax rate by nine cents or 10.0 percent.
- The legislature raised the non-residential education property tax rate by 13½ cents or 9.8 percent.
- The legislature increased its non-property tax funding for education by \$31 million or 6.8 percent.
- Property taxpayers paid an additional \$83.6 million in net education property taxes, a 9 percent increase.
- The spending adjusted average residential education property tax rate rose from \$1.32 to \$1.50, a 13.6 percent increase.
- The spending adjusted tax rate on homestead income rose from 2.68 percent to 2.76 percent, a 3 percent increase.
- The number of equalized pupils being educated declined by 1,207 or 1.33 percent.
- Total expenses paid from the Education Fund climbed \$119.1 million, an 8.5 percent increase.

These increases proved unacceptable to a large portion of the voting public last March when voters in 35 school districts – many of them the state's largest – defeated their school budgets and the property tax burdens they would have imposed.

Vermont municipal government's chief interest in the education system is the demand it puts on the property tax – the only real source of revenue to fund all municipal services. Excessive school property taxes make voters unwilling to consider spending on equally important municipal priorities. Municipal officials are cast in the role of administrators of the property tax assessment and collection system, and also as the target of taxpayer ire, complaints, and confusion.

The Current Education Funding System. Our current education funding system is a compilation of laws passed over a number of years. Each legislative session generates amendments that change the existing system to some degree. As Chart 1 on page 2 shows, Vermont changes its education finance system with some regularity. We are now on our fifth system in 31 years. (The "Morse-Giuliani" formula replaced the "Miller" formula in 1983.) Chart 1 also shows that generally the only time that the rise in education property taxes levels out or actually drops is upon a dramatic change in the formula used. The only exception is the result of the impacts of the recent Great Recession where, for one year, total Education Fund expenditures actually declined, followed by a year of basically level-funding before resuming its climb at a rate faster than the increase in the consumer price index.

Since Act 60 was passed, all local education spending (a legal term that includes almost all school budget expenses) is provided from the state Education Fund and technically comes all from state taxes, even though the largest source, the state property tax, is locally billed and collected. In the school year that started July 2014, this fund is projected to take in more than \$1.5 billion of net education property taxes (property taxes billed less income sensitivity payments for eligible taxpayers), "Act 60 taxes" (35 percent of the state sales and one-third of the purchase and use tax revenues), lottery proceeds, and an amount transferred from the state's General Fund.

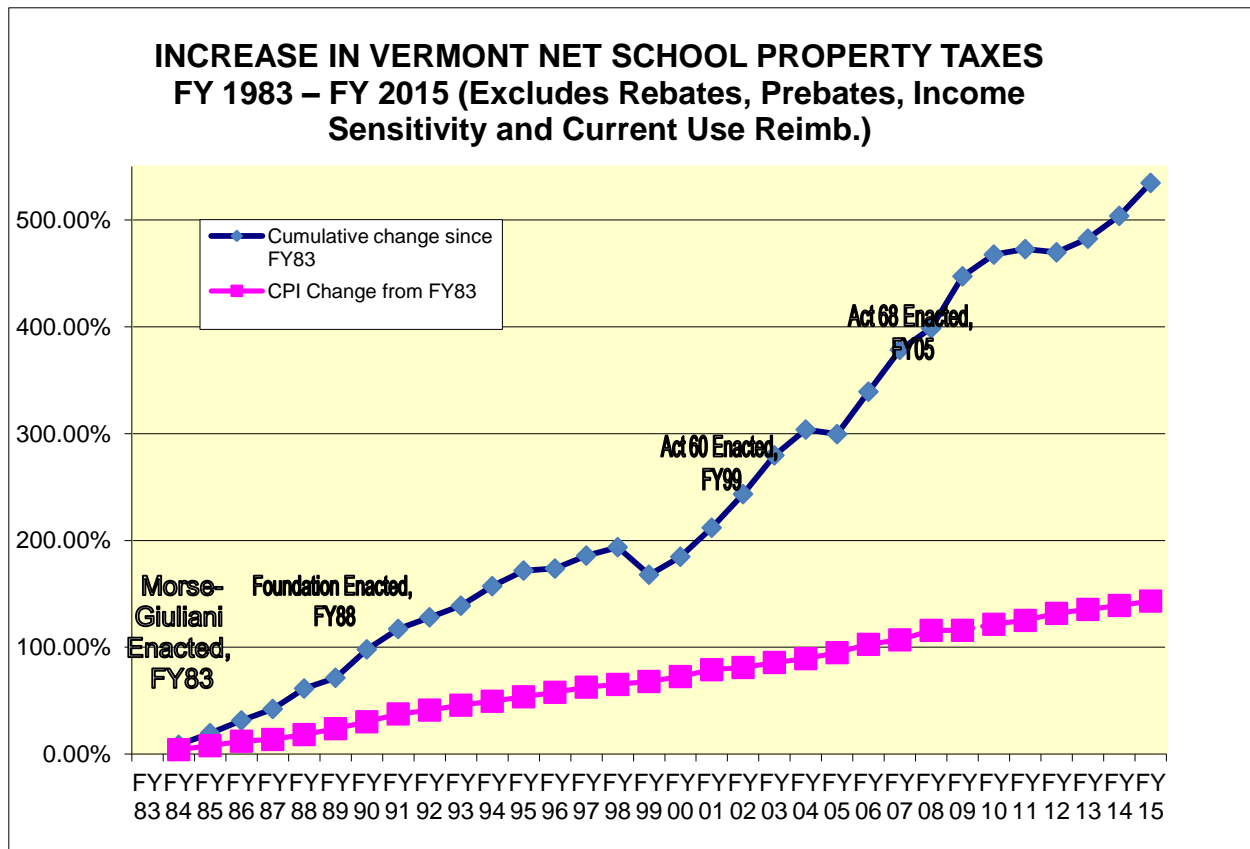


Chart 1

Sources: Division of Property Valuation and Review Annual Reports; Department of Education Reports; Joint Fiscal Office Education Fund Outlooks; Bureau of Labor Statistics Website

All taxable property in the state, except those parcels for which homestead declarations have been filed with the state Tax Department, are subject to a statewide education property tax rate of \$1.515 at full fair market value for FY15. Homestead property is taxed at a rate based on local school spending per pupil. If such spending equals or is below \$9,285 per pupil, the homestead property tax rate in that school district is \$.98. For district spending above that “base education payment amount per pupil,” the tax rate is \$.98, increased by the same percentage that the district’s spending exceeds the base education payment. For example, a school district that spends \$14,206 per pupil (the FY15 total “education spending” by school districts in the state divided by the total equalized pupil count) is spending 153 percent of the \$9,285 base education payment amount. For that district, the homestead tax rate would be 153 percent of \$.98, or \$1.50.

Homeowners with household incomes of \$90,000 or less may pay their education taxes through the above property tax rate calculation, or replace the property tax on the home and up to two acres (the homestead tax rate still applies to all contiguous land) with a tax based on income. The income tax base rate for FY15 is 1.8 percent of household income multiplied by the local spending adjustment described above. Given the same district spending example, a household with an income of \$90,000 or less living in a house on less than two acres would have its education tax capped at 2.76 percent of income. There is a \$500,000 cap on the housesite valuation that limits how much homeowners can benefit from income sensitivity. Homeowners whose houses are worth more than that (value listed on the town grand list divided by the common level of appraisal, or CLA) have to pay the homestead property tax rate for the value of the home over \$500,000, in addition to the percentage of income. Some homeowners with incomes greater than \$90,000 are eligible for a limited form of this income cap, and homeowners and renters earning less than \$47,000 are entitled to additional tax capping.

School Costs. A significant portion of the education funding debate focuses on the costs of education. Public K-12 education is by far the largest single state expenditure item. It now accounts for about half of all state

appropriations when the state takes credit for the \$1.017 billion in education property taxes that were formerly local revenues and still are the responsibility of local governments to collect. Though several mechanisms have been enacted and many proposed in legislation with the purported purpose of reining in escalating school costs, there has not been any effective state effort to control and manage education costs. On the contrary, with continued imposition of new state mandates on school budgets and siphoning of Education Fund dollars to state programs, state actions have only added to the property tax burden.

There is no question that Vermont education expenses per pupil are among the highest in the country. Chart 2 shows that costs per pupil (based on the total uses of the Education Fund and the total equalized pupil count) have doubled since 2000, rising at a rate of three times that of the consumer price index.

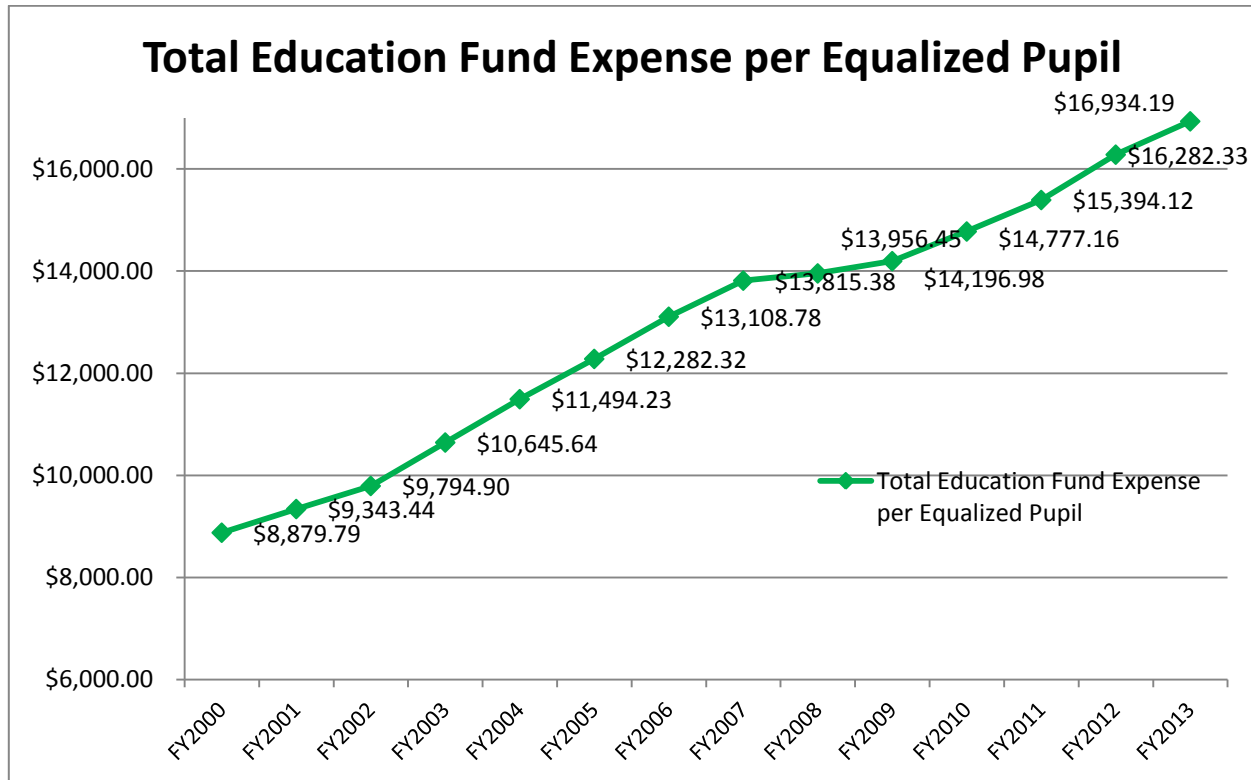


Chart 2
Source: Joint Fiscal Office Education Fund Outlooks

A recent [Wall Street Journal article](#) shows that Vermont is the fifth highest spending state per pupil for our elementary and secondary education, trailing only Connecticut, New Jersey, Alaska and New York. According to the article, “[f]or the third consecutive year, total spending on public elementary and secondary education fell nationwide, according to a recent release from the U.S. Census Bureau. Spending per student totaled \$10,608 [for FY12], roughly the same as the year before.” Contradicting national trends, Vermont’s total Education Fund expenses increased three percent for that year, and in one measure of spending per pupil, Vermont rose by 4.1 percent. (The *Journal* article lists Vermont expenses per pupil at \$16,039).

Concern over rising school costs and property taxes spawned two different summit meetings of state and local officials early in the 2014 legislative session. One focused more on the funding side of the ledger and generated a paper by a consultant that summarized the day’s events ([2014 Picus Briefing Paper](#)). Released less than a month before 35 school budgets went down to defeat on Town Meeting Day, the report failed to call for major changes in our funding system: *While there was no clear consensus that nothing should be done, there was a strong general sense that if policy changes are made, they should be modifications to the existing structure and there was no need to throw the system out and start over. Additionally the current law conforms to the requirements of the Brigham decision for equity and the state’s desire for strong local control, both of which constrain policy changes moving forward.*

Cost reduction, particularly in light of a decline in enrollment of 14.9 percent since the enactment of Act 60, needs to be a key component of the legislative work on education funding in the 2015 session. That discussion may be a redux of last year’s award winner for “Most Legislative Effort with Least Amount of Outcome”: school district governance (“Who decides?”). Service delivery (“How many schools and school districts do we need to provide high quality education at the most affordable price?”) should also be on the table for consideration of its costs and benefits.

Rising School Property Taxes. As Chart 1 shows, without an offsetting shot of new state assistance, Vermont property taxpayers are experiencing another overall increase in education property taxes – an increase of about 5.1 percent or \$49.5 million, compounded by the continued decline in the number of children being educated. (See also Chart 1.) Residents (those paying through the homestead income tax rate as well as those without the benefit of income sensitivity) will see their net property taxes increase by only \$100,000 in total. This is in stark contrast to the \$21 million increase residents paid in the previous year. All non-resident property taxpayers will see their school taxes increase by \$49.4 million this year, a 9 percent increase.

State Non-property Tax Support for Education. As Chart 2 illustrates, education property tax relief has traditionally come only in conjunction with an education funding formula change and accompanying state tax increases. Immediately after the adoption of Act 60 (as with formula changes in the past), General Fund and other non-property tax revenues for education fell and remained flat, meaning that all additional spending was supported solely through increased school property taxes. Chart 3 shows this development.

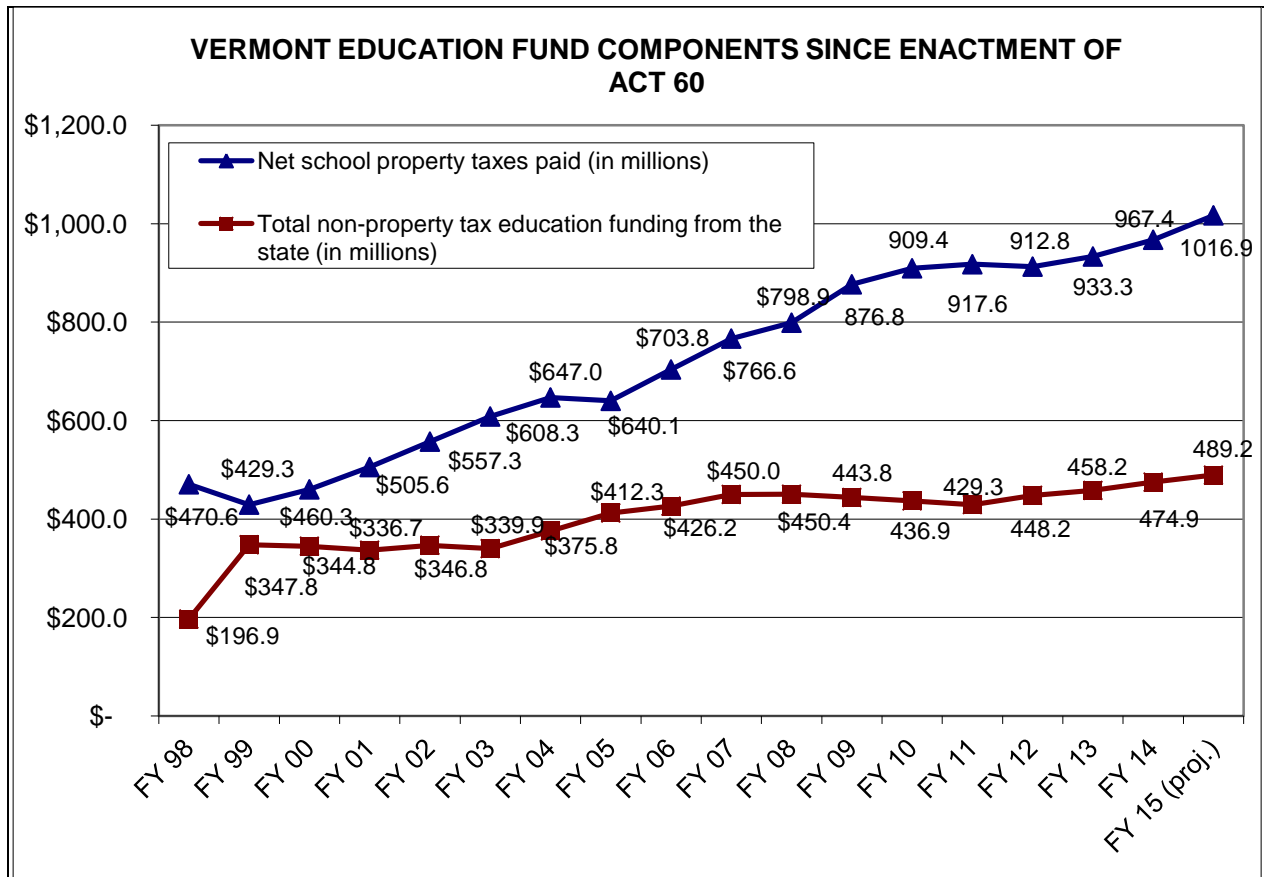


Chart 3
 Changes in Property Tax and Non-property Tax Education Revenues, FY98-FY15
 Source: Joint Fiscal Office Education Fund Outlooks

The 2003-2004 legislature supposedly put a stop to this practice by passing a law that required future legislatures to adjust state support of education upwards each year, pegged to the “most recent New England economic project cumulative price index for state and local government purchases of goods and services” (16 V.S.A. § 4025(a)(2)). Not to be outdone, the 2009-2010 legislature reinstated the practice by including in the appropriations bill “Notwithstanding 16 V.S.A. § 4025(a)(2),” and then cutting the state support. State General Fund support for education for FY15 had just now exceeded for the first time that provided in FY09 (\$298.8 million vs. \$291.8 in FY09). Another figure “notwithstanding” is the base education payment that is supposed to be adjusted annually to reflect inflation. Due to legislation in 2009 (Act 60, ironically), that figure was frozen for FY11 and FY12 at that set for 2010, and then was only adjusted to make up about one-half the change that was supposed to be made for the FY13 calculations. This year, in an apparent attempt to keep the base homestead education property tax rate below \$1.00, the legislative conference committee on the education funding bill reduced the base education amount from the statutorily-mandated amount of \$9,382 to \$9,285, and the base tax rate dropped to \$.98. Unfortunately, legislative promises are only good for as long as it takes to make them. Today’s expediencies will trump promises made yesterday, making it so much harder to deal with chronic issues ... such as education funding.

The state non-property tax portion of the cost of education in Vermont has always been low. Vermont’s General Fund contribution runs counter to the national average for state contributions for education. In FY97, the average state funded 48.8 percent of the education bill from state non-property tax sources. Vermont provided only 29.2 percent, and was second only to New Hampshire in its reliance on local property taxes to fund education, providing 66.1 percent of the total. (Source: Public Education Finance, 1997, U.S. Census Bureau.) Act 60 converted the local property tax into a state tax, so national statistics show the portion of Vermont education now paid by the state as being among the highest in the nation. That did nothing to change the fact that it is still a property tax. Chart 4 shows that only by including the federal stimulus monies during the Great Recession did we avoid exceeding the abysmal heights of property tax reliance of 70 percent of the cost of education that we reached just as the Vermont Supreme Court in *Brigham v. State of Vermont* (166 Vt. 246) declared that reliance on the local property tax to fund schools was unconstitutional and Act 60 was enacted. We now rely on the property tax to pay two-thirds of the cost of education.

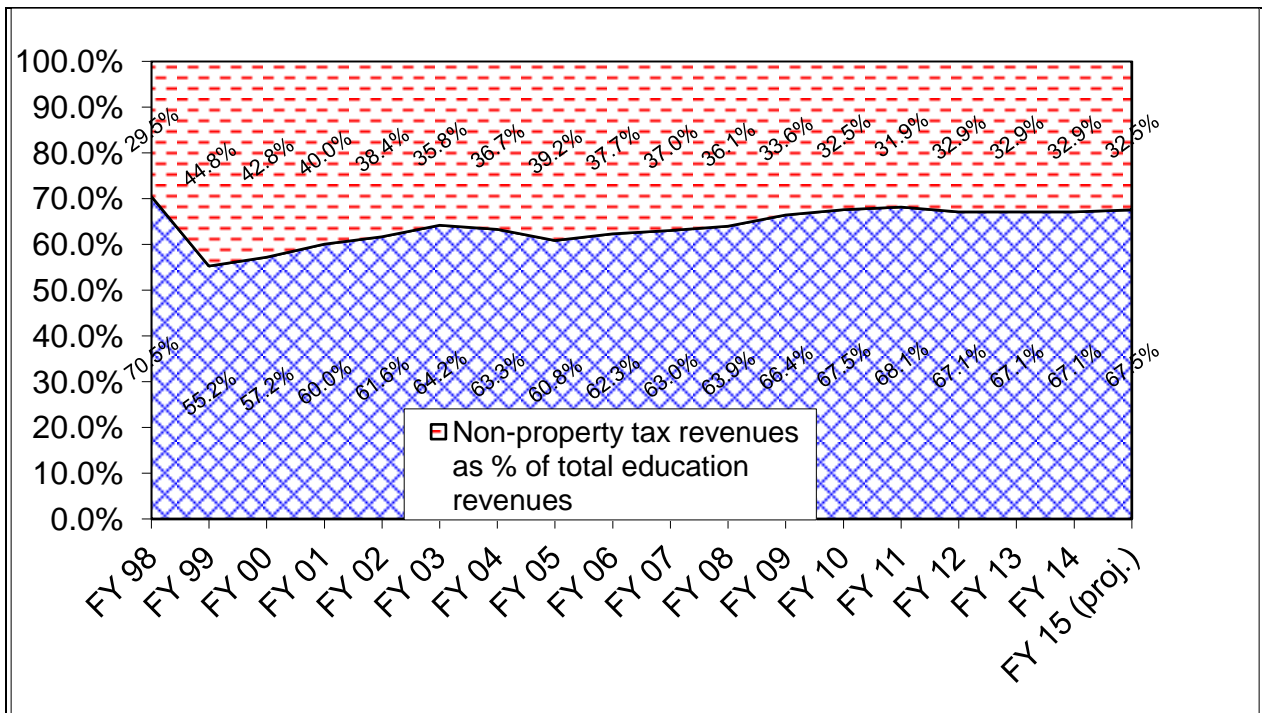


Chart 4
 Percentage of Education Revenues from Property Tax and Non-Property Tax Sources, FY98-FY15
 Source: Joint Fiscal Office Education Fund Outlooks

State Property Grand List Maintenance.

Whither (or *wither*) Property Values? Proponents of heavy reliance on the property tax always argue that it is a “stable” tax source because property values have historically remained relatively stable. However, one of Vermont’s hottest real estate markets in its history developed early in this millennium and has quickly turned around and gone the other way. Because the state education grand list is based on the equalized values, which are in turn based on the trailing three years of sales, the first drop in value took place with the grand list used for the FY12 budget. The taxable value dropped by 1.6 percent that year, accelerated the following year, and has continued to drop through 2014. The fact that property values are not rising as in the past is a mixed blessing. The good news is that property taxpayers won’t see as much of a hidden tax bill increase that results from property value increases (through reappraisals or CLA adjustments). The bad news is that without property value inflation, the legislature will have to continue to increase the base property tax rates.

The huge run-up in property values had allowed the state to appear to provide “property tax relief” by lowering the base state education property tax rates the first three years following the passage of Act 68. The statute sets the rates at \$1.10 for homestead property and \$1.59 for non-homestead property, but allows the rate to be changed given the fiscal health of the Education Fund. Due in large part to the rise in property values, the rates dropped from \$1.10 to \$.86 for homesteads and from \$1.59 to \$1.35 for non-residential property in several steps over six years. (See Chart 5.) As we stated above, the tax rates have increased for four straight years each from their historic lows, and will most definitely be increased again next year, perhaps substantially unless reform is achieved.

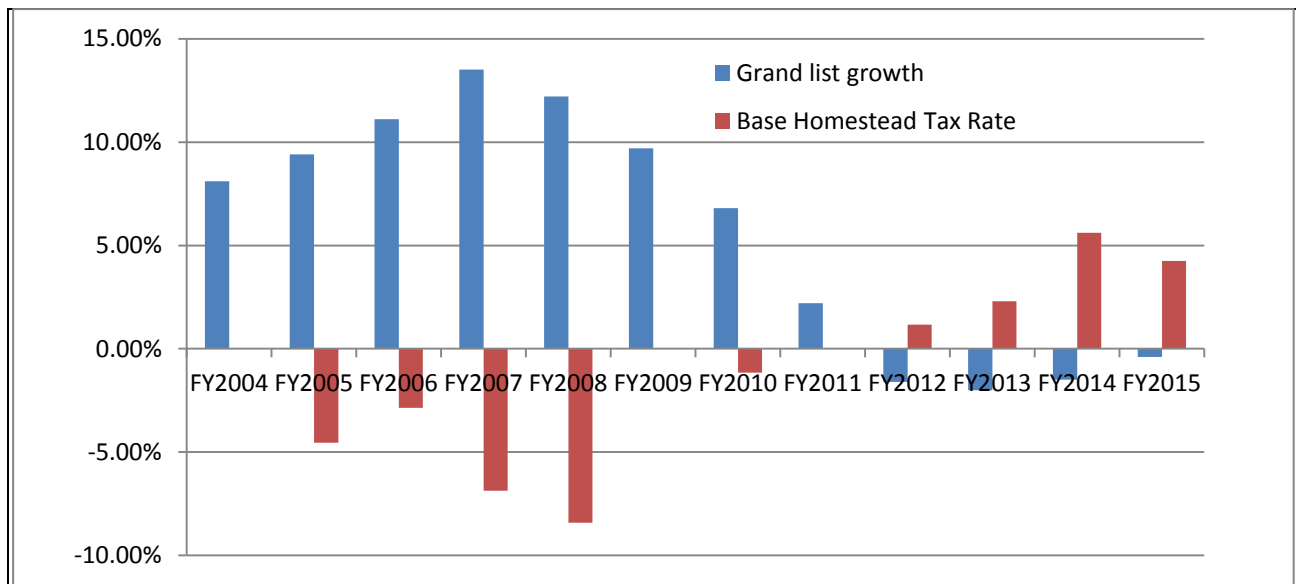


Chart 5

Source: Joint Fiscal Office Education Fund Outlooks

As we mentioned, the last biennium’s legislature raised the state’s property tax rates both years, and the outlook for FY16 is no rosier. With the state grand list treading water, at best, school budgets not reflecting the drop in the number of students being educated, and new state-mandated expenses being forced on school districts and out of the Education Fund, the 2015 legislature will likely raise state education taxes again.

Threats to the Education Fund. For the past three years, the legislature has failed to fund the total cost of education incurred during that period. The state and school districts have spent a cumulative \$33.2 million more than what has been deposited into the Education Fund over that period. The Education Fund was created under Act 60 to provide a dedicated fund to meet the mandates of the *Brigham* decision. The promise made on a

number of occasions and in a number of forums when the legislature imposed the state property tax was that it could only be used to fund local school districts. As a matter of fact, according to state law (16 V.S.A. § 4025), Education Fund monies can only be used “to make payments to school districts and supervisory unions for the support of education,” short-term borrowing for the same, education tax “income sensitivity” payments to homeowners, and assistance to towns for property reappraisals – that is until the 2010 session, when it added “and to make payments to carry out programs of adult education” and 2011 when it added “and to provide funding for the community high school of Vermont.” “Upon withdrawal of funds from the education fund for any purpose other than those authorized by this section, chapter 135 of Title 32 [education property tax] is repealed.”

Despite this constraint and apparent automatic self-destruction of the state property tax for any other use, the previous governor proposed in past sessions to “redirect” \$14 million of Education Fund revenues (one-half of the state purchase and use tax on motor vehicle purchases currently dedicated to the Education Fund). He also proposed in numerous state budgets to shift the responsibility for funding the state teachers’ retirement system – a system created by the state in 1947 that has been allowed to accumulate an \$845 million deficit – from the state General Fund to the Education Fund. There was no promise of future General Fund taxes supporting either the elimination of the deficit or of paying for future obligations. In 2010, the former governor also proposed moving the cost of school construction aid (30 percent of the cost of the projects) from the General Fund to the Education Fund.

He is not alone on the assaults on the Education Fund. Thanks to the efforts of various legislators over the years, the state now makes up for its own underpayment to persons who provide live-in assistance to developmentally disabled adults by reducing the amount of their income used to determine how much they should pay in income-sensitized homestead school property taxes. (The lower your income, the less you pay in education taxes, and the more others have to pay to make up the difference.) As mentioned above, much of the cost of the state’s prison education program and many adult education agencies are now paid for by property taxes, as is an Agency of Human Services program designed for preschoolers. Nonprofit teen pregnancy organizations receive Education Fund revenues. State and private colleges that allow high school students to take college courses with them through “dual enrollment” will now receive property taxes, as will schools and private providers of services to children not even old enough to be enrolled in kindergarten. “Lifelong learning” has become the passkey to gaining access to a new source of funding and to relieve pressure on the state’s General Fund.

VLCT Recommendation

- Municipal and school officials, the state administration, and the legislature should begin immediately, as equal partners, to accurately analyze the issues within Acts 60/68 (including ways in which they do not meet the *Brigham* decision) and then create a new education finance system that reduces and reforms the property tax burden. Until then, Education Fund monies should *only* be used for functions listed in 16 V.S.A. § 4025(b). Further, the billing and collection of the state education property tax should remain at the local level.