PHILIP B. SCOTT
Governor

State of Vermont
OFFICE OF THE GOVERNOR

May 25, 2018

The Honorable William M. MaGill
Clerk of the Vermont House of Representatives
115 State Street
Montpelier, VT 05633

Dear Mr. MaGill:

Pursuant to Chapter II, Section 11 of the Vermont Constitution, I am returning H.924, *An act relating to making appropriations in support of government*, without my signature because of my objections described herein.

Please note, the following also addresses objections to H.911, *An act relating to changes in Vermont's personal income tax and education financing system*, as the two bills are inextricably linked and their relationship factors heavily into my decision to return both bills. H.911 will be returned to you in a separate message containing the same objections.

My primary objection to the bills – and the reason that, following the Legislature's decision not to schedule a veto session, I've called the Special Session – is that together they result in an unnecessary and avoidable $33 million increase in statewide property tax rates.

We have, in this fiscal year, approximately $160 million more in revenue than last year. This additional revenue breaks down as follows:

- $82 million more from organic economic growth and federal tax reform;
- $34 million in unanticipated funds from the Attorney General's tobacco settlement; and
- $44 million in surplus revenue recently added to the budget.

Having collected far more revenue from Vermonters than expected, as well as additional revenue from other sources, we do not need to raise statewide property tax rates on Vermonters to fully fund school budgets.

I have been clear as a candidate, and throughout this term in office, that I cannot support legislation which adds or increases taxes on Vermonters. On my first day in office, I signed an Executive Order prioritizing affordability, economic growth, and protecting the most vulnerable.

After years of constantly-increasing taxes and fees, Vermonters need a break. They need the opportunity to keep more of what they earn. At the same time, our businesses need a stable and predictable environment in which they can invest, grow and create more good jobs.

Therefore, I cannot support raising the statewide property tax rates – especially in a year when we have other options for fully funding school budgets. Homeowners, those who rent homes and apartments, employers of all types and sizes – everyone who lives, works and invests in Vermont – deserves a more stable, predictable and affordable property tax system.

Many of the decisions that impact individual property tax bills – and whether they go up, down or stay flat – occur at the local level or are impacted by other economic factors. But at the State level, we can have an impact through setting the statewide rates and establishing a "yield" to determine the resulting education tax rates. As you know, H.911, as presented for my signature, raises both the non-residential rate and the average statewide homestead education tax rate, raising $33 million in additional property taxes for FY19. As the primary mechanism the State uses to influence the property tax burden on Vermonters, I cannot accept an increase to these statewide rates in a year that we have better options.

To be clear: if the Legislature wants to raise statewide property tax rates at a time when we have significant surplus revenue that could be returned to Vermonters, it will have to override a veto.

However, I believe we are much closer to an agreement than the continued political rhetoric indicates. I've detailed how close we are – and how we can very easily reach a true consensus – in more detail further below.

Working Family Taxpayer Protection Act (H.911, Sections 1-9)
When it became clear that the Federal Tax Cuts and Jobs Act had a widespread financial impact on Vermonters, I proposed my Working Family Taxpayer Protection Act in February. The goal of this plan is to give back the net $30 million State personal income tax increase the federal changes would cause to Vermonters. The hardest hit by the federal changes were middle-income families with children.

I am grateful that H.911, as passed, includes nearly every element of my proposal. The major difference is the inclusion of a $20,000 cap on the five percent charitable contribution tax credit; as you may recall, I recommended a five percent credit without a dollar limit. I believe, over time, the Legislature may want to reconsider this cap, given the impact it may have on large charitable contributions to Vermont's non-profit sector.

Nevertheless, the tax credit will provide an incentive to those 90 percent of Vermonters who are not expected to itemize deductions this coming year, and is a new tax advantage to all Vermonters, whether they itemize or not.

Altogether, this portion of H.911 achieves my goal of moderating the tax burden, with an emphasis on low to moderate income Vermonters who receive Social Security. It also promotes charitable giving by reducing the tax liability of those who choose to give. I respect and appreciate the Legislature's work in this area and I will not pursue any changes to the Working Family Protection Act sections of H.911 during the Special Session.

Five-Year Plan to Stabilize Education Tax Rates and Reinvest Savings

Earlier in May, in an effort to reach consensus, I presented a comprehensive five-year plan, built on the many ideas and concepts that have been presented throughout this Biennium. None of the core elements of the proposal were new. The plan would:

- Fully fund the school budgets local voters have approved for next year;
- Close the FY19 Education Fund gap and prevent recurring deficits;
- Stabilize (keep level) or lower statewide property tax rates for five years;
- Generate almost $300 million in total net savings over five years that can be reinvested in systemic changes to create a cradle-to-career continuum of learning. This includes more and better early education, K-12 education, technical education, higher education opportunities;
- Allow education spending to grow sustainably each year based on the average projected increase (the consensus forecast) in grand list value of 3.25 percent; and
- Set Vermont on a stable and predictable five-year trajectory allowing local school districts to take full advantage of the governance changes made under Act 46.

The plan achieves gross savings of over $450 million – as projected by the Administration's analysts and cross-agency policy team – if all the components of the plan are passed as outlined. **It is important to know that three have already been achieved and a fourth was being considered in the Senate Education Committee before adjournment**:

- **Special Education Census Model**: Changes to the method for delivering special education services in Vermont, **as passed in H.897**, *An act relating to enhancing the effectiveness, availability, and equity of services provided to students who require additional support*;

- **Staff-to-Student Ratios**: Savings through natural attrition (vacancies and retirements), which can be achieved while still filling, on average, four of five of those vacancies over the next five years. I want to be very clear, this is not a mandated ratio target. Rather it builds off the incredible efforts of local school boards in developing their FY19 budgets at an aggregate growth rate well below the targets I communicated in November 2017, in anticipation of substantial increases in the statewide property tax rates, if we did nothing.

  I agree with legislators and members of the education community who report that Act 46 will result in progress to staffing ratios more aligned with our enrollment realities and best practices in education management, and I trust that school boards will continue that important work, supported by the help and recommendations of a student-to-staff ratios task force, **as passed in Section 17 of H.911**. I believe we can achieve this goal while improving outcomes for our students and we will likely still retain our position as having the lowest student to staff ratio in the nation;

- **Tax Rate Computation**: Lower the excess spending threshold gradually from 121 percent to 110 percent over the next five years and reduce allowable aggregate exclusions to 50 percent;

- **Property Tax Adjustments**: Decrease the maximum house site value from $500,000 to $400,000 in FY19 and the $250,000 to $200,000 reduction in FY20 (**H.911, Section 14**); and reform the property tax adjustment calculation for new homesteads after July 1, 2018; and

- **Statewide School Employee Health Care Benefit**: Establish a statewide school employee health care contract, as discussed in FY18, endorsed by the Vermont Educational Health Benefits Commission, and discussed during the 2018 legislative session. If stakeholders cannot agree on the statewide negotiation dynamic at this time, the benefit should be put in session law for two years while a viable plan, supported by all stakeholders, is achieved in the next Biennium.

As you can see, we are very close. With a little more constructive dialogue during the Special Session, I am confident we can deliver to Vermonters a full package, informed by the additional perspective below, that meets my goals of affordability and movement towards a cradle-to-career continuum of education.

An additional benefit of this plan is its 5+ year horizon. The rating agencies caution that Vermont's declining demographics are one of Vermont's primary weaknesses, along with it pension liabilities. One agency noted that although state spending growth on education is "somewhat offset" by our current education funding reliance on property taxes as its source of revenue, it also noted that those taxes "collected by localities on behalf of the state" do not "fully mitigate spending increases... exposing the state to a level of ongoing expenditure growth as reflected in the steadily growing annual state general fund appropriation to the education fund." (Fitch Ratings report, August 11, 2017). The rating agencies applaud Vermont for our ability as a state to manage budget pressures, and they value multi-year management plans. My plan does exactly that.

Below is what remains to be done, from my point of view.

Property Tax Yield, Adjustments and Structure (H.911, Sections 10-16)
My primary objection to the property tax provisions of H.911 are the resulting increases in the average homestead property and non-residential property tax rates. The bill results in an average homestead tax rate of $1.526, a 2.6-cent increase from the 2018 rate. The non-residential rate is set at $1.59, an increase of 5.5 cents from 2018.

I appreciate the work done by the Legislature to reduce the amount needed to close the Education Fund deficit through a combination of one-time money and changes to property tax adjustments that reduced the statewide tax rate increase to $33 million. But again, I will not sign a bill that raises statewide property tax rates mentioned above.

H.911, as passed, achieves $13 million dollars in avoided tax increases in two ways:

- First, it reduces the house site value eligible for a downward property tax adjustment from $500,000 to $400,000, consistent with my proposal, saving approximately $2 million in each of the next five years for a projected five-year savings of almost $10 million. We have no differences on that provision in H.911; and
- Second, the bill as adopted by the conferees achieves $11 million in savings through changes to income sensitivity in FY19 by lowering the eligible house site value from $250,000 to $200,000 for households who earn over $90,000.

I am very concerned about the widespread and immediate impact the $250,000 to $200,000 change will have on some Vermonters. This change may impact as many as 21,000 households immediately, the vast majority of whom have already filed for an adjustment with the Department of Taxes. This seems unreasonable.

If the Legislature pursues this change, I propose it be deferred until next fiscal year. With at least $160 million in additional revenue, we can work together to find the $11 million to offset the Legislature's proposal in FY19 – allowing us time to communicate the change and allowing taxpayers to plan for this change.

My proposal also includes a "go forward" change to the income sensitivity program that will not affect any current Vermont homeowners, and will better focus the program on those living in homes valued near the Vermont average. This is a similar approach used in many pension reforms, which limits the impacts to new employees after a date certain. Vermonters establishing a new homestead after July 1, 2018 would receive property tax adjustments where the maximum house site value used in the computation will be $250,000 minus household income. This system will moderate some of the adjustments going to higher income recipients and those living in homes valued well in excess of the statewide average. There will also be an enhanced benefit for many new homeowners by allowing a deduction of the claimants' exemptions in computing household income, many families will enjoy a greater benefit than the current system.

Finally, the Legislature did not include my proposal to reduce the excess spending threshold and allowed aggregated exclusions gradually over five years beginning in FY20. This step is a cost containment provision that, when implemented gradually over time, will result in concrete savings over the course of the five-year plan. Understanding the Legislature's hesitancy to discuss staff-to-student ratios, this is an additional tool that will potentially help avoid the need to set ratios in statute and give districts the guardrails they need to navigate the additional work necessary to achieve the goals of Act 46.

In summary, while there is a fair amount of detail here, the changes needed to the property tax provisions are limited and straightforward:

- The property tax adjustment change of eligible house site value from $250,000 to $200,000 in Section 14 should be deferred to an effective date of July 1, 2020;
- Reform the property tax adjustment calculation for new homesteads after July 1, 2018; and
- The excess spending threshold could be reduced over time.

I realize there are alternative proposals supported by legislators, which could achieve the same result. I am willing to consider all alternative paths forward if they achieve level property tax rates and contribute to long term cost containment.

Transition to Statewide Health Care Bargaining

Creation of the staff-to-student ratio task force in H.911, coupled with the passage of H.897 – which restructures the delivery of special education services – are key non-tax policy components of a multi-year plan. The final component is to move to a statewide health care benefit for school employees – one that, if achieved last year, would have saved districts up to $26 million in health care costs while bringing certainty and parity to teacher and staff plans.

This change was recommended by the Vermont Educational Health Benefit Commission, created by the Legislature in Act 85 of 2017, which worked diligently over the fall. I believe we all now agree this change is necessary, especially considering the wide disparities and increased costs that resulted from the last round of bargaining at the local level.

I applaud the Vermont-NEA for stepping forward and recognizing the need for this change and the work late in the session by the Senate Education Committee devoted to design and implementation of a statewide negotiated benefit. As I have advocated since the start of the session that this important step should be taken by placing the benefit into law for two years providing time for a viable plan supported by all the stakeholders to be achieved.

Staff-to-Student Ratio Task Force

As mentioned above, I am very pleased that the Legislature created a staff-to-student ratio task force in H.911. There seems to be some lingering misinformation being presented that I am currently championing placing mandated ratio targets in statute. Instead, I have proposed achieving an established staff-to-student ratio over time through sound management of the naturally occurring vacancies, many expected through the final stages of implementation of Act 46, with the help of a task force to develop recommended strategies for schools. It is crucial that this task force also consider that there is no "one size fits all" approach because of our different school sizes and configurations. The task force will provide critical input on how to best achieve optimal target ratios and will inform the work of school districts as they prepare their FY20 budgets and the work of the Legislature next session.

H.924 An Act Relating to Making Appropriations for the Support of Government
In general, I'm pleased to see the Legislature included most of the priorities outlined in my budget proposal in January. While I would have preferred a slightly lower level of spending growth – H.924 grows the General Fund by almost $6 million more than the budget I submitted – and I would have made different choices on a few specific appropriations as outlined in the Administration's May 8, 2018 letter to the budget conferees, I commend the House and Senate on the body of work they have done.

As was the case last year, however, the budget and yield bill are intrinsically linked. The appropriations made from the budget to the Education Fund are contingent on the tax rates set by the statewide yields. While I do not expect the level of the appropriation to change this year, we can reduce our current dependence on property taxes to fund them. This will require some combination of different decisions on General Fund surplus money and tobacco settlement money than those made in H.924.

Specifically, the $34.5 million in appropriations to Vermont State Teachers Retirement System from both tobacco settlement money and surplus General Fund money should be redirected to the Education Fund. While making an extra payment on the unfunded liability this year will yield long-term savings in avoided interest, Vermonters won't see this savings until 2038 when the final payment is made under the current plan to pay down the debt.

In addition to reversing the transfer of the surplus to retirement, an additional $9.2 million in surplus revenue is available so that the property tax adjustment made in H.911 can be deferred to give taxpayers time to plan for it in FY20. The $7.1 million contingency in FY18, appropriated in the event Medicaid revenues fall short, could be redeployed considering the $10 million of additional drug rebates and the $7 million underspending in claims with less than six weeks to go in the fiscal year. Finally, there is an additional $2.1 million set aside as part of a $3 million contingency should sales tax revenue to the Education Fund fall short in FY18.

To achieve your goals for the Teachers' Retirement Fund, in addition to amending H.924 to reflect the above transfers, the bill could be further amended to provide the surplus be returned to the General Fund as savings accrue and then transferred to the Retirement Fund. This would meet the Legislature's goal of paying down the unfunded liability in the Teachers' Retirement

Fund faster than currently laid out in the Treasurer's amortization schedule and save interest costs in the long run.

Proposal to Amend H.911 and H.924 As-Passed

To summarize, I currently see a consensus path forward with the following actions:

Amend H.911 as follows:

- Defer the effective date of the $250,000 to $200,000 house site value change to FY20;
- Include a reduction of the excess spending threshold over five years; and
- Reform the property tax adjustments for new homesteads after July 1, 2018.

Amend H.924 as follows:

- Reverse the transfer of $34.5 million in surplus funds to the Teachers' Retirement Fund;
- Transfer $43.7 million in surplus funds to the Education Fund in FY19;
- Provide for reimbursement of the surplus funds to the General Fund from the savings achieved through the policy and tax changes reflected in the tax stabilization plan I proposed;
- Transfer those savings to the Teachers' Retirement Fund at the time of reimbursement; and
- Define a health care benefit in session law in the budget, allowing time for the Legislature to complete its work to design and implement a structure for a statewide bargained benefit.

My commitment to reaching an agreement that stabilizes tax rates and improves the operational efficiency of our education system, so we can direct more spending directly toward the education of our kids, is unwavering. Growing operational inefficiency is eroding quality and expanding inequality between our schools – even while taxes and spending have increased to record highs and student enrollment has declined by an average of 3 students per day for 20-years and counting.

As noted, based on the objections outlined above, I cannot support this legislation and must return it without my signature pursuant to Chapter II, Section 11 of the Vermont Constitution.

Thank you for considering my thoughts on how to achieve a consensus plan that will strengthen our education system without raising property taxes in a year of unprecedented surplus revenue.

Sincerely,

Philip B. Scott
Governor