

# Who Pays and Who Benefits: 21st Century Tax Reform for Maine

## Introduction

Most people do not enjoy paying taxes, which are the primary source of revenue for governments at all levels, but most people also probably agree that ultimately, some kind of taxation is necessary. However, public support for taxes is greatly influenced by perceptions of whether tax systems are fair or equitable, and these perceptions are unfortunately not always based on factual information or clear understanding. The ongoing debate over Maine's latest attempt at tax reform is no exception.

Since 2003 there have been several attempts to pass tax reform in Maine.<sup>1</sup> On June 11, 2009, the 124th Maine Legislature passed the latest tax reform bill: LD 1495, "An Act To Implement Tax Relief and Tax Reform."<sup>2</sup> The next day, the bill was signed and passed into law by Governor John Baldacci. This law was described by the Maine State Planning Office as "historic legislation to lower taxes for Maine people,"<sup>3</sup> and as a significant compromise package that "will put money in the pockets of most Mainers,"<sup>4</sup> as well as creating more consistent and stable revenues for the state.<sup>5</sup> However, the new law was soon put on hold by a referendum campaign, led by legislators who had opposed the law.<sup>6</sup> The referendum vote will be held on June 8, 2010.

Why would people oppose a tax reform package that would result in lower income taxes for **96 percent** of Maine families, with tax cuts across all income levels, and in lower combined sales and income taxes for **87 percent** of families?<sup>7</sup> Some have expressed their opposition to the plan's expansion of the sales tax base, but it is not clear whether people understand that this would be effectively counterbalanced by the cuts in income taxes for most taxpayers. Although there may be several reasons underlying opposition to the plan,<sup>8</sup> it seems clear that one major reason is a lack of information about the features and implications of the new law.

This paper discusses three major issues, with the goal of clarifying the characteristics of LD 1495, the tax reform package that will be either upheld or repealed in June: 1) the features of "good" state tax systems; 2) the characteristics and limitations of Maine's current tax system, and 3) the features, changes and implications of the new law. Finally, a range of taxation policy recommendations will be discussed.

## Background: The Role and Nature of Taxation

Many scholars studying taxation have remarked that Americans generally have little understanding of the role, purpose and necessity of taxation as a necessary source of revenue for the public good. Over the past few decades, the perception that taxes are fundamentally an intrusion and violation of the rights of individual citizens seems to be more and more widely shared.<sup>9</sup> Unfortunately, this misunderstanding of the role and

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<sup>1</sup> See Richard Woodbury, "The Struggle for Tax Reform in Maine, 2003-2009"; Federal Reserve Bank of Boston; Discussion Paper 09-2, October 2009. [www.bos.frb.org/economic/neppc/dp/2009/neppcdp0902.pdf](http://www.bos.frb.org/economic/neppc/dp/2009/neppcdp0902.pdf)

<sup>2</sup> The vote was largely, although not entirely, along party lines. The roll calls can be seen at: <http://www.mainelegislature.org/LawMakerWeb/rollcalls.asp?ID=280033956>

<sup>3</sup> Maine State Planning Office, "Economics and Demographics Newsletter"; Vol. II, Issue 3; July 2009.

<sup>4</sup> Kurt Wise, "Tax Reform Package Deserves the Support of Maine Businesses"; *The Exception Magazine*; 7/06/2009.

<sup>5</sup> *Ibid.*

<sup>6</sup> The referendum application for the "People's Veto" was filed by Charles Webster, state chair of the Republican Party; Maine House Minority Leader Josh Tardy, and Maine Senate Minority Leader Kevin Raye.

<http://blogs.pressherald.maine.com/updates/gop-applies-to-challenge-tax-overhaul>

<sup>7</sup> Michael J. Allen, Maine Revenue Services; "Tax Distribution Tables" (February 2010 Update) <http://maine.gov/revenue/taxreform.htm>

<sup>8</sup> For example, some people simply oppose government taxation on principle, or believe that government should be reduced in size; others may perceive that they will be particularly affected by certain provisions of the law, such as some business interests subject to a new sales tax; and still others may simply want to overturn it for political reasons.

<sup>9</sup> This idea is often encouraged by the mass media's "thoughtless coverage" of taxes, says David Cay Johnston: "The perception that taxes are pure waste is reinforced by the superficial way that many news organizations cover the issue, especially the implicit assumption that taxes are bad." David Cay Johnston, "Introduction", in Stephanie Greenwood, ed.; *10 Excellent Reasons Not to Hate Taxes*; New York: The New Press, 2007; p. 1-2.

necessity of tax revenues is exacerbated or magnified by the advocacy of anti-tax movements and groups who often misrepresent or distort, deliberately or out of ignorance, the issues of governance and taxation.

Much criticism of Maine's tax system was also fueled for years by the flawed and inaccurate analyses of the conservative Tax Foundation, which charged that Maine had either the highest or second highest "tax burden" in the U.S. Despite the fact that the Tax Foundation has recently admitted that their statistical analyses were wrong, this misleading idea continues to be circulated by tax opponents and economists alike.<sup>10</sup>

In Maine and other states, having adequate and reliable state revenues from taxes is critical to economic growth, public safety, quality public education, usable roads, and a functioning state. This major point would seem to be obvious, yet apparently it is not universally understood or accepted. Governments are the mechanism through which citizens obtain social goods and services such as education, environmental protection, constructing and maintaining roads and bridges, protecting public health, and generally maintaining civil order. If these services and protections are to be provided, there must be revenue to pay for them, obtained through taxes and fees.

State tax structures are generally based on three types of taxation, which vary in how progressive or regressive they are, depending in part on how they are structured. "Progressive" forms of taxation are based on the ability to pay: people with higher incomes and wealth pay a higher proportion of their resources in taxes than lower-income households. "Regressive" forms of taxation result in lower-income people paying a higher proportion of their income than those in higher income brackets.

- Income taxes tend to be relatively progressive in most states, depending on how they are structured, and graduated income taxes are generally more progressive than simple flat rate taxes. Some states have no income taxes, such as New Hampshire and Florida, but these states must then depend on higher property taxes and other more regressive taxes and fees for their revenue.
- Property taxes tend to be relatively regressive, depending on how they are structured, but this regressivity can be lessened by homestead exemptions and "circuit breakers." Property taxes can be reformed to give more breaks and exemptions to in-state residents.
- Sales and excise taxes ("consumption" taxes) are the most regressive of state and local taxes, since lower income individuals and households must spend a larger share of their incomes on goods and services. Nonetheless, they are a critical element of state revenues. Their regressivity can be decreased somewhat by targeting goods and services which are largely purchased by people in higher income brackets, and by non-residents.

## **I. The Features of "Good" State Tax Systems**

Tax policy experts admit that one cannot simply describe a "perfect" or ideal tax structure, since "it depends on what your values are."<sup>11</sup> However, there are several features that a "good" state taxation system should have, according to tax economists such as David Brunori (a specialist in state taxation policy), the Institute on Taxation and Economic Policy (ITEP), the Maine Center for Economic Policy (MECEP), and others:<sup>12</sup>

1) Adequacy: First, state tax systems must be able to raise adequate revenue, for both current spending, and future revenue needs of the state.<sup>13</sup> Having adequate state revenue also requires stability (i.e., predictable

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<sup>10</sup> Maine actually ranked **15th** in Fiscal Year 2008, not first or second. For a summary, see Matt Wickenheiser, "Worst Tax Rankings? Not True"; Kennebec Journal, 8/8/2008. [http://www.mecep.org/news\\_detail.asp?news=416](http://www.mecep.org/news_detail.asp?news=416)

<sup>11</sup> Robert Tannenwald, talk at MECEP Forum, "Tax Reform: How Maine Compares with Other States," 4/27/2010; Portland, ME.

<sup>12</sup> David Brunori, State Tax Policy: A Political Perspective; Washington, D.C.: The Urban Institute Press, 2005; p. 11-24; Institute on Taxation and Economic Policy, "Tax Principles: Building Blocks of A Sound Tax System" ([www.itepnet.org/pdf/pb9princ.pdf](http://www.itepnet.org/pdf/pb9princ.pdf)); and Maine Center for Economic Policy, ([www.mecep.org](http://www.mecep.org)). Brunori also includes in this list the goal of "neutrality", or the idea that tax structures should minimize their impacts on market decisions. (p. 15-16).

<sup>13</sup> Brunori, *ibid.*; p. 13-15.

growth), and elasticity (i.e., revenue which keeps up with overall growth in the economy).<sup>14</sup> Having adequate, stable, and predictable state revenue has become far more difficult in recent decades, due to changes in the national and state economies, and this problem is exacerbated even further by the current recession.<sup>15</sup>

2) Fairness or Equity: Taxation policy experts say that it is important to have tax systems which are, and are perceived to be, fair and equitable.<sup>16</sup> There are two major ways of assessing fairness or equity. Achieving horizontal equity means that persons and businesses with similar assets and incomes are treated alike.<sup>17</sup> Vertical equity or fairness means that a tax system is based on ability to pay; i.e., a progressive tax system.<sup>18</sup>

3) Ease of Administration and Compliance: A good state revenue system needs to be relatively simple; i.e., it is easy to administer by officials, and easy to understand and comply with by taxpayers.<sup>19</sup>

4) Accountability: Brunori suggests that there are three aspects to the goal of accountability in state tax systems. First, there must be efficient and fair administration of tax laws; second, state governments must enforce the tax laws, and third, tax policy must be open and transparent to all.<sup>20</sup>

Finally, many states such as Maine try to maximize the “exportability” of their tax system. This goal seeks to increase the amount of taxes paid by out-of-state businesses and residents of other states who benefit from the state’s infrastructure and services.<sup>21</sup>

Ultimately, however, much of the debate over taxation is not about these specific principles or details, but over the legitimacy or validity of government, public spending, and taxation itself. As Brunori points out, much opposition to taxes seems to overlook a fundamental reality: states cannot provide necessary and desired services without obtaining revenue through taxation.<sup>22</sup>

## **II. Characteristics and Criticisms of Maine’s Existing Tax System (prior to LD 1495)**

Maine economist Richard Woodbury discusses four major sets of motivations underlying the various attempts at tax reform in Maine in recent years.<sup>23</sup>

1) High and unevenly distributed property taxes: One major motivation for recent tax reform efforts in Maine is “a high and unevenly distributed property tax burden.” In FY 2006, for example, Maine’s level of

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<sup>14</sup> Institute on Taxation and Economic Policy (ITEP); *ibid.*

<sup>15</sup> A report by Governing says that state tax systems are “completely inefficient” and “a drag on economic growth,” failing to bring in sufficient revenue, in part because they are based on a manufacturing economy which no longer exists. Katherine Barrett and Richard Greene, “Growth and Taxes: Why Outdated State Tax Systems Undercut Economic Vitality, and What States Can Do About It.”

GOVERNING; December 31, 2007. <http://www.governing.com/article/growth-taxes>

Also see Kurt Wise, “Now is the Time for Tax Reform. Can LD 1088 Deliver?”; Choices: Vol X: No. 5, 5/19/2009; Maine Center for Economic Policy; <http://www.mecep.org/view.asp?news=497>

<sup>16</sup> Brunori, *ibid.*; p. 16-19.

<sup>17</sup> Brunori, *ibid.*; p. 17-18.

<sup>18</sup> *Ibid.*; p. 18-19. It is “difficult if not impossible,” says Brunori, to make state tax systems more progressive, or at least less regressive, especially because states rely heavily on consumption (sales, use and excise) taxes. He adds: “States face a real dilemma. They rely heavily on regressive taxes, which are unfair, but political and economic conditions make reducing that reliance nearly impossible. State policymakers have been unable to devise a tax system that is either horizontally or vertically equitable.” (p. 19).

<sup>19</sup> *Ibid.*, p. 19-21.

<sup>20</sup> Brunori, *ibid.*; p. 21-23. Information and discussion concerning different policy options and their implications should be open to the public, and should be “understood by the electorate as well as by tax administrators.” (p. 21).

<sup>21</sup> Woodbury, 2009; *ibid.*; pp. 6.

<sup>22</sup> Brunori states: “State governments need revenue to fund the services sought by their constituents. This statement may appear obvious, but a surprising disconnect between providing services and raising the revenue to pay for those services has plagued the government sector. *The political rhetoric criticizing taxes and government spending masks a simple truth: services cannot continue without proper funding.*” Brunori, *ibid.*; p. 4-5. [Emphasis added].

<sup>23</sup> Woodbury, 2009, *ibid.*, pp. 2-17. However, the factual or empirical support for some of these “motivations” may be debatable.

property tax revenues, as a percentage of personal income, was the third-highest in the U.S.<sup>24</sup> While roughly 1/3 of Maine households are estimated to pay less than 3 percent of their incomes on property taxes, about 17 percent of households pay more than 10 percent.<sup>25</sup>

This problem becomes more complex given that a significant portion of property taxes in Maine are paid by non-residents, since Maine has one of the highest proportions of properties owned by non-residents in the nation.<sup>26</sup> If property taxes were substantially lowered, Maine would lose out on tax income from non-resident property owners. In addition, if state tax revenues distributed to localities are reduced, local governments may be forced to raise local property taxes to make up for the deficit.<sup>27</sup>

2) High income tax rates (and concerns with estate taxes): Maine's current income tax structure is considered to be a progressive one, says Woodbury, with "incremental marginal tax rates" of 2 percent, 4.5 percent, 7 percent, and 8.5 percent. However, the top marginal tax rate of 8.5% is considered by many to be very high, particularly since it applies to taxpayers with relatively low incomes – beginning at \$28,700 (Maine adjusted gross income) for an individual, and \$55,550 for a married couple, as of 2009.<sup>28</sup>

In 2008, Maine's top marginal tax rate of 8.5 percent for income taxes was the seventh highest in the nation. While many other states have much higher marginal tax rates, in most cases, they begin to apply at much higher income levels than in Maine. As Woodbury points out, "Among the highest rate states, only Oregon imposes its highest rate at a taxable income level lower than Maine."<sup>29</sup>

3) Issues with sales and excise taxes: As Woodbury states, Maine's sales tax base is "narrow, volatile, and reflective of an older product-oriented economy."<sup>30</sup> This fact makes the state extremely vulnerable to the ups and downs of budget crises and unreliable levels of revenue from year to year, and reduces the level of potential revenues that would be available from an expanded sales tax base.

In addition, since Maine's sales taxes are "considered at or below the average of states," says Woodbury, the reform of the state's sales and excise taxes has been seen as a critical element of recent attempts to restructure and rebalance Maine's tax system.<sup>31</sup> The expansion of the state sales tax to a broader base, including four new categories of services such as recreation, installation and repair, personal services, and limousine/courier services, has become one of the most debated elements of the tax reform package.<sup>32</sup>

4) Widely voiced desires to reduce Maine's overall "tax burden": As noted above, for many years, the Tax Foundation regularly promoted the idea that Maine had the "highest tax burden" (or second highest) in the

<sup>24</sup> *Ibid.*; p. 3. This measure does not differentiate between taxes paid by Maine residents and non-residents.

<sup>25</sup> *Ibid.*; p. 4-5. Many of these are also low-income households, according to Woodbury.

<sup>26</sup> *Ibid.*, p. 6-7. Woodbury states: "According to these Census data for 2000, Maine has the single highest proportion of housing units that are vacation homes of any state in the country. An estimated **15.6 percent** of housing units in Maine are secondary residences, compared with a national average of **3.1 percent**." [Emphasis added]

<sup>27</sup> Maine's statewide "circuit breaker" program helps to reduce the regressive aspects of property taxes, by capping property tax bills for both lower-income and middle-income taxpayers; applying to both owners and renters. Maine's "circuit breaker" and homestead exemption programs for property tax relief were expanded in 2005, with the passage of LD 1. (Woodbury, *ibid.*; p. 22 and 30.)

<sup>28</sup> Woodbury, *ibid.*; p. 7-8. He also discusses concerns with Maine's estate tax. These Maine Adjusted Gross Income figures for the 8.5 percent bracket apply to a single taxpayer and a married taxpayer without dependents, both using standard deductions.

<sup>29</sup> *Ibid.*; p. 8-9. For example, New Jersey's highest rate only applies to taxable incomes over \$500,000 for individuals.

<sup>30</sup> *Ibid.*; p. 2. Woodbury also states (p. 11-12) that in a recent survey of states on 168 potentially taxable services, the Federation of Tax Administrators found that Maine taxed only 25 categories, quite low compared to the median state number of 55 categories.

<sup>31</sup> Woodbury, *ibid.*; p. 10. Maine's current sales tax of 5 percent is slightly below the national median state sales tax of 5.5 percent. However, since "roughly half of states allow local sales taxes on top of the statewide rates," unlike Maine, Maine's comparative sales tax rates, combining state and local sales taxes, are in effect even lower. (*Ibid.*, p. 10-11.)

<sup>32</sup> Woodbury, *ibid.*; p. 50. Currently, roughly one-third of sales tax revenue in Maine comes from the sales of automobiles and construction materials, and both of these are "highly cyclical industries." (*Ibid.*; p. 10-11.) Woodbury adds: "The extent to which Maine could or should expand its sales tax base is a question of considerable political and substantive controversy. No industry now exempt from sales tax wants to lose that exemption." (*Ibid.*; p. 14.)

country. Although this widely-promulgated idea has since been discredited, many people in Maine still consider the state's overall tax burden as "an important drag on economic growth and prosperity."<sup>33</sup> In fact, under the revised or corrected methodology now used by the Tax Foundation, Maine's "tax burden" of 10.0 percent in 2008 was only slightly higher than the national average of 9.7 percent.<sup>34</sup>

### **III. Provisions and Changes in LD 1495: A "Good State Tax System?"**

Does LD 1495 increase taxes for Maine people, as charged by many of its opponents? To what extent would these tax reform measures bring about a "good tax system?" How would it affect "tax fairness?"

The detailed analyses of the LD 1495 tax reform by economist Richard Woodbury, Maine Revenue Services economist Michael Allen,<sup>35</sup> and the Maine Center for Economic Policy (MECEP)<sup>36</sup> all point to a critical conclusion: the implications and consequences of this measure can only be fully understood as a package of interconnected elements. Taken separately, each element could be criticized for any number of reasons. But this package was carefully "calibrated," in a deliberate process, to produce an integrated whole.

First, as each of these analyses points out, in its entirety, the LD 1495 law is "virtually revenue neutral and benefits Maine people at all income levels."<sup>37</sup> This tax reform package makes three broad transformations in the structure of the state's tax system: 1) it reduces income taxes, 2) it broadens the base of the sales tax to compensate for the loss of income tax revenue; and 3) it improves access to property tax relief, through the Maine Residents Property Tax and Rent Refund Program.<sup>38</sup> Here are the most important changes:

- A reduction in income taxes for most Maine residents: **96** percent of households would pay less in income taxes, according to detailed analyses by state tax economist Michael Allen, and **87** percent of households would pay less in combined income and sales taxes.<sup>39</sup>
- The replacement of the current incremental system of income taxes, based on exemptions, with a "credit-based tax system", built around a (published or statutory) flat rate of 6.5 percent, and an additional .35 percent for taxpayers with incomes over \$250,000 (6.85 percent for those households).<sup>40</sup>
- The "restoration of progressivity" to the income tax, through replacing the current system of exemptions (which reduce taxable income) with a system of tax credits ("household credits"), which directly reduce the amount of taxes owed. These tax credits or household credits are partially refundable for low-income households, and are phased out at higher income levels, so that higher-income households will "pay the full statutory rate on all of their income".<sup>41</sup> One measure of progressivity in the reformed tax structure is that while almost **99 percent of families** earning under \$40,000 would receive a **tax cut** in their income taxes, a significant percentage of high income families, particularly those with a high amount of itemized deductions, would be paying more taxes.<sup>42</sup>
- A broadening of the sales tax base and an increase in some tourism-related sales taxes. This would make up for the reduction of income tax revenue, and would reduce the volatility of state revenues.
- Enhanced property tax relief, with streamlined, greater access to "Circuit Breaker" tax credits.

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<sup>33</sup> *Ibid.*

<sup>34</sup> Tax Foundation, "State & Local Tax Burdens by State, 1977-Present"; [www.taxfoundation.org/taxdata/show/335.html](http://www.taxfoundation.org/taxdata/show/335.html)

<sup>35</sup> Michael J. Allen (Maine Revenue Services); "Tax Distribution Tables"; *ibid.*

<sup>36</sup> Dan Coyne, "Tax Reform Delivers Benefits to Maine Households," *MECEP Choices*, Vol. XI: No. 4; Maine Center for Economic Policy, April 19, 2010. <http://www.mecep.org/view.asp?news=775>

<sup>37</sup> *Ibid.*

<sup>38</sup> Coyne, *ibid.*; p. 1-4; Allen, *ibid.*; Woodbury, 2009, *ibid.*, p. 25-26, and Richard Woodbury, "Income Tax Reform in Maine: How It Works and Who Benefits?", March, 2010. Paper available at: <http://taxreformmaine.org/>

<sup>39</sup> Allen, *ibid.*

<sup>40</sup> Richard Woodbury, 2010, *ibid.*; p. 1-3 and p. 15.

<sup>41</sup> *Ibid.*, p. 3. Woodbury explains that the new tax system, based on a system of household credits rather than exemptions, will result in a five-tiered hierarchy of marginal tax rates, based on both income and household credits available only to state residents. (p. 15).

<sup>42</sup> Maine Revenue Services, 5/17/10, and Woodbury (*ibid.*, p. 13-14), who says that 23 percent of filers with incomes over \$143,000 would face an income tax increase. Among families with incomes below \$39,500, 98.9 percent will have an income tax cut.

Taken as a package, LD 1495 is designed to produce a similar level of tax revenue (hence it is “revenue neutral”), with a restructuring of the system so that it will be less volatile. It is also designed to shift the state’s overall “tax burden” from residents to non-residents, through expanded categories of sales taxes which are targeted to non-residents and higher-income households, tax credits available to residents only, and lower income taxes for the vast majority of Maine households and taxpayers.<sup>43</sup> It clearly does NOT raise taxes for most residents, as some opponents have charged, although it will raise income taxes for some high-income families with high levels of deductions.

So, do these changes in Maine’s tax system result in a “good” tax structure? The analyses by Woodbury, Coyne and Allen support the conclusion that, seen in its entirety, the LD 1495 tax reform plan is an improvement over the present system, and is “moderately more progressive” than the current tax structure.<sup>44</sup> On the whole, this evidence suggests that, while not ideal, this integrated package of tax reforms would help to bring Maine’s tax system closer to the “good tax structure” criteria outlined above, than the present system.

It is critical to emphasize that while the flatter “published” income tax structure outlined in LD 1495 appears at first glance to be a more regressive taxation policy than the existing graduated income tax, a simple comparison of published tax rates is misleading and incomplete. The data on the effective tax rates, by Woodbury, Allen and others, show that the other complementary pieces of the reformed tax structure, such as the calibrated system of household credits, would offset the regressive effects of a flatter income tax.<sup>45</sup>

### **What are some further steps that Maine can take to reform its budgeting and tax system?**

Based on the analyses and studies cited in this paper, there are a number of possible taxation policy suggestions that Maine citizens and policymakers may want to consider.

1. To make an informed decision, voters and community groups should educate themselves and others about the nature and implications of the new tax law, LD 1495, and about the potential impacts of a repeal.
2. Given the current recession and economic crisis, state policy makers may want to consider a temporary 1% increase in general sales tax, until the recession ends, as was done in the early 1990’s in Maine.
3. Maine may want to work with other states to develop a uniform system for sales taxes on Internet purchases.
4. Maine policy analysts may want to monitor carefully the actual economic and budgetary consequences of the new tax reform legislation and/or of subsequent legislation, including how it affects the distribution of various “tax burdens” among different income groups, and between residents and non-residents.
5. The state may want to reconsider the question of allowing local option sales taxes, at least temporarily.
6. The state may want to reconsider any moves to widen corporate tax incentives, since various experts on state taxation policy and budgets agree that this is generally not a wise or effective use of state revenues.
7. Maine may want to avoid major cuts to essential services, education, health and infrastructure which will be more costly to the state in the long term, and can damage the prospects for economic development.
8. Maine can work to build greater transparency in taxation and budgetary issues, by periodic public hearings, town hall meetings, and sharing regularly updated, comprehensible information with the public.

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<sup>43</sup> Woodbury, *ibid.*, and Allen, *ibid.*

<sup>44</sup> Coyne (MECEP), *ibid.*; p. 1. Woodbury (*ibid.*, p. 1) states that “the reform is calibrated to retain broadly similar progressivity in tax burden across the income distribution, while lowering the income tax assessments on 96 percent of resident taxpayers.”

<sup>45</sup> See Woodbury, 2010 (*ibid.*, p. 1-18) for more detailed explanations and useful graphs, showing the impacts of the LD 1495 tax reform package on various households at different income levels.