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IDEAS FOR SHARED PROSPERITY

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## Tax Reform: A Modest Step in the Right Direction

Ed Cervone

**M**aine's legislature will address tax reform and tax relief this session.

Policymakers have an opportunity to make simple changes that will help working families build wealth and assets, support Maine small businesses, ensure adequate revenues for key investments, and deliver greater property and income tax relief in a fair and equitable manner.

In considering their options, the legislature is faced with several considerations. First, Maine taxpayers expressed a strong desire for property tax relief during the last election but also made it clear that they were not willing to do so at the expense of public programs and investments. Based on this, a tax reform/relief strategy based purely on broad spending and tax cuts is not a feasible approach.

Second, there has been considerable public and private interest in making targeted investments in higher education, research and development,

conservation, workforce development and healthy downtowns, as well as in the traditional mainstays of state spending on K-12 education and health care. Supporters contend that these investments are critical for growing the economy and warn that

*LD 850 moves us  
in a direction  
called for by every  
expert who has  
examined Maine's  
tax system in the  
last two decades...*

foregoing them will cost the state in lost economic opportunity in the future. Such investments require new revenues and the means to raise it. This issue brief outlines a progressive tax reform proposal -- LD 850 -- that addresses these considerations.

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## Principles to Guide Tax Reform

The legislature's taxation committee has begun a very ambitious and orderly process for considering at least eight major comprehensive tax proposals. It has adopted a set of principles on a bipartisan basis:

1. Tax reform should reduce the overall tax burden on Maine residents.
2. Tax reform should be revenue neutral.
3. The benefits of tax reform should be shared by all Maine residents in all regions.
4. Tax reform should simplify the tax structure.
5. Tax reform should be pursued using a clear, transparent and participatory process.
6. Tax reform should provide an overall tax structure that is equal to or more progressive than the current system (the overall level of taxes on households should be based on their ability to pay).
7. Tax reform should strengthen the economic future of the state.
8. Tax reform should be bold and timely.

In addition to these principles are ones advanced by the Prosperity Maine Coalition that is supporting LD 850. The coalition's priority principle is fairness, meaning that the tax system should be based on residents' ability to pay. Those with more wealth should pay a higher proportion of their income in taxes than those with less wealth.

Second, the system must ensure an adequate amount of revenue to pay for the level of public services that Maine taxpayers depend upon and demand. The third priority is simplicity. The tax system must be easy to understand and navigate. Numerous exemptions and loopholes, for example, are a violation of the simplicity principle.

The fourth priority principle is exportability. This means getting out-of-state people who enjoy visiting our state to carry some of the burden of paying for the public services and resources they use. The high number of out-of-state second homeowners and tourists that visit Maine throughout the year should be prime targets for exporting some of our tax burden.

LD 850 is the most workable package in the mix of proposals for meeting both sets of principles. The

## LD 850 An Act to Reduce Taxes

Sponsor Rep. Thom Watson

Cosponsors:

Senate President Beth Edmonds

House Speaker Glenn Cummings

Senate Chair, Taxation, Joe Perry

House Chair, Taxation, John Piotti

Rep. Leila Percy

Rep. Nancy Smith

Rep. Seth Berry

Rep. Patricia Blanchette

Rep. Paulette Beaudoin

package is based on the legislature's taxation committee work in 2005 when a majority reported out a similar tax reform package.

LD 850 is a revenue neutral (revenues match costs) package that relies on expansion and better implementation of existing policies rather than a major redesign of Maine's tax system. It specifically strives for greater fairness in the system by lowering the property and income tax liabilities of low- and middle-income taxpayers, including some small business owners.

It delivers this relief while still ensuring adequate revenues. It simplifies the sales tax system by removing certain tax exemptions and expanding sales taxes on select consumer services. Where possible,

the package exports tax burden. The elements of the tax package are described in detail below.

**Property Tax Relief**

Attitudes towards property taxes are contentious in Maine and across the country. Property taxes are generally not scaled to a household’s ability to pay and they come due in large lump sums resulting in “sticker shock.” At the same time, they pay for K-12 education, fire protection, and other municipal services that residents highly value.

Most Maine taxpayers would say their property taxes are too high. But property tax relief should be targeted towards households whose burden is truly beyond their ability to pay.

The homestead exemption and Maine’s property tax reimbursement program (the “circuit breaker”) are two programs that deliver property tax relief. The homestead exemption lowers property taxes for all homeowners by exempting \$13,000 of property value from taxation. The circuit breaker targets additional relief to those who pay over 4% of that income in property taxes or 20% of their income in rent.

In 2006 the circuit breaker program alone delivered around \$37

million in refunds to Maine homeowners.<sup>1</sup> These refunds reflect enhancements made to both programs in 2005 through LD 1.

LD 1 also contained a tax and expenditure limit designed to cap spending in state, county, and local

**LD 850**  
**Property Tax Relief**

- *State government pays for entire homestead exemption.*
- *Increase circuit breaker maximum refund from \$2000 to \$3000.*
- *Increase circuit breaker eligibility to capture more middle-income homeowners*
- *Increase circuit breaker outreach efforts so more eligible families receive refunds.*

government in order to lower Maine’s tax burden and meet the state’s commitment for K-12 funding.

Analysis shows that these enhanced relief programs in conjunction with the LD 1 municipal

caps and increased state K-12 funding have on average lowered the property tax burden for Maine homeowners in 2006.<sup>2</sup> Other reports have focused on the value of the circuit breaker program in particular and have concluded that it is an effective tool at targeting property tax relief to homeowners.<sup>3</sup> Since these programs have been effective, LD 850 suggests improvements to them rather than proposing an entirely new property tax relief mechanism.

The current homestead exemption of \$13,000 for all resident homeowners represented a considerable expansion over the pre-LD 1 program. Currently the state pays for half of that exemption and the municipalities absorb the other half. LD 850 would use state revenue to pay for the entire exemption, relieving municipalities and thereby homeowners, provided that municipalities pass on these savings to them. Maine Revenue Services estimated that in 2007, if fully implemented, this would cost approximately \$25 million.

There are two recommendations for the circuit breaker program. The first is to improve participation among eligible homeowners and

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renters through outreach and simplification. According to the Maine Revenue Service, only about 42% of eligible homeowners will actually participate in the program this year. Some may not be aware of the program's existence; others may not believe they qualify for the benefits; others may think the application process is too difficult.

A targeted and funded media outreach by the state, based on polling and data, could increase people's awareness and understanding of the program's benefits and in turn drive participation. The nonprofit and advocacy community is already doing outreach to their constituents and should do more to augment the state's efforts. Additionally, anything to simplify the process, such as aligning it with income tax reporting by placing the program directly on the income tax form or as an attached schedule, could also improve participation.

The second recommendation is to expand the existing program to allow for larger refunds and make more middle-income homeowners eligible. This would be accomplished by raising the maximum refund from \$2000 to \$3000 and by increasing

the amount of taxes that can be considered for refunds to \$5000. Maine Revenue Services estimated that in 2007 this expansion would cost approximately \$15 million in state revenue.

## Income Tax Relief

The income tax reform proposed in LD 850 focuses on two groups: low-income taxpayers and moderate- and upper-income taxpayers, including many small businesses.

### LD 850

#### Income Tax Relief

- Increase low-income tax credit.*
- Expand state EITC to 15% of the federal EITC and make it refundable.*
- Raise the state's personal exemption to the federal level.*
- Reduce top rate of the income tax from 8.5% to 8.25%.*

As with property taxes there are already programs in place that deliver income tax relief to low-income Mainers. The low-income tax

credit eliminates income tax liability for anyone earning \$2000 or less. The state earned income tax credit (EITC) pays 5% of the federal credit, delivering income tax relief to low-income workers. The EITC enjoys bipartisan support around the country and is credited with alleviating poverty and providing money for education and savings while encouraging people to work.<sup>4</sup>

The first recommendation is to raise the maximum earnings for the low-income tax credit to \$4000 for single individuals, \$6000 for heads-of-households, and \$8000 for married couples filing jointly. This would eliminate income tax liability for more of Maine's lowest income residents, improving the progressivity -- fairness -- of the income tax system. This would have cost approximately \$7 million in 2007.

The second recommendation has two parts. The first is to expand the state EITC from 5% of the federal EITC to 15% and second, to make it "refundable." Refundable means that if someone is eligible for the state EITC and they receive a credit in excess of their income tax liability they will still receive the balance. Thus a refundable tax credit offers

relief to more low-income working families.

The federal EITC is refundable as are 15 of the 19 other current state EITCs. This benefit rewards a family's work efforts, serves as supplemental income to meet basic needs, and helps alleviate poverty. At 15% of the federal EITC, Maine would still be at or below the benefit afforded by the majority of the states with an EITC.

In addition to the low-income tax credit and EITC enhancement, LD 850 proposes that Maine raise the state personal exemptions to federal levels. This would provide more tax relief by exempting more income from taxation and by dropping some taxpayers down to lower tax brackets with lower tax rates.

Many of Maine's small businesses are sole proprietors, S-corporations, and partnerships or limited liability companies whose business income is taxed only through the individual income tax. These business owners along with all individual taxpayers in the current top bracket would pay lower taxes due to increasing the exemptions and deductions and to lowering the current top rate from 8.5% to 8.25%. Six other states

currently have higher top rates than Maine.

The Prosperity Maine Coalition is concerned that lowering the top rate reduces needed revenue from the highest income taxpayers. On the other hand there are other proposals that recommend even larger decreases in the top rate and would require either large cuts in public services or larger increases in other taxes to balance the lost revenue.

By contrast LD 850 proposes a modest and affordable reduction in the top rate balanced by other progressive adjustments within a revenue neutral package.

There are components of LD 850 described below that would generate revenue and might make it possible in future years to further lower the top rate. However, it is fiscally irresponsible to make greater cuts now without first accounting for the lost revenue

### Modernizing Maine's Sales Tax

Maine's sales tax system has not changed to reflect the new economy. It relies on the sale of goods when, in fact, people are spending more and more on services. Many states have broadened their sales tax to include more services but Maine's system is

far behind. As an example, the Federation of Tax Administrators list 168 services a state could tax.

### LD 850 Sales Taxes

- *Repeal sales tax exemptions on:*
  - *packaging materials,*
  - *long-term rentals (raise exemption period to 100 days)*
  - *ship stores*
  - *railroad track materials*
  - *snacks*
  - *interstate phone calls (consumers only)*
  - *some vending machine sales*
- *Add sales tax on:*
  - *personal services (e.g. dance instruction, tanning salons)*
  - *personal property services (e.g. mooring rentals for noncommercial watercraft and furniture upholstery)*
  - *real property services (e.g. chimney sweeping and pest extermination)*
  - *amusements and recreation*
  - *lawn-landscaping/tree services*
  - *taxi and limousine services*
  - *phone directory advertising*
  - *safe deposit box rentals*
- *Increase lodging tax from 7% to 8%.*
- *Increase meals tax on class-A restaurants from 7% to 8%.*
- *Increase short-term auto rental from 10% to 15% or \$5 for every \$100.*

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Connecticut taxes 80 of those and Maine taxes 24. If Maine were to tax the same services as Connecticut, Maine could collect an additional \$120 million in revenue.<sup>5</sup>

Additionally, Maine's sales tax has many exemptions, meaning that we are dependent upon a smaller share of a shrinking base. Purchases of cars and construction materials represent over one-third of total sales tax revenues. These revenues are highly volatile due to the cyclical nature of spending on such big-ticket discretionary purchases.

Lifting sales tax exemptions and including more services would update Maine's tax system and make it more fair, stable and adequate. The revenue generated from this expansion would be used to pay for the property and income tax relief described above.

While Maine could tax over 140 additional services, each taxable service brings a constituency that will argue why a tax would negatively affect their business. The business community as a whole has been particularly sensitive to the possibility of tax "pyramiding" -- charging sales taxes both on the purchases by businesses and again on the products or services sold by

such businesses to consumers. LD 850 avoids this problem by focusing additional sales taxes on services that primarily affect individual rather than business consumers. Our proposed sales tax inclusions also export a greater proportion of the tax liability to nonresidents.

***Lifting sales tax exemptions and including more services would update Maine's tax system and make it more fair, stable and adequate.***

The first recommendation is to repeal exemptions for the following goods and services: packaging materials, long-term rentals (increase the period triggering the current exemption to 100 days), ship stores, railroad track materials, snacks, consumer interstate telephone calls, and certain vending machine sales.

The second recommendation is to expand the sales tax to include personal services (e.g. dance instruction and tanning salons), personal property services (e.g. mooring rentals for noncommercial watercraft and upholstery of furniture), real property services (e.g. chimney sweeping and pest extermination), amusements and recreation, lawn-landscaping-tree services, taxi and limousine services, telephone directory advertising, and safe deposit box rentals.

Other services and items to be included in the sales tax broadening are lodging, meals and short term auto rentals. All three are used by Maine visitors and would make these taxes more exportable.

LD 850 recommends raising the lodging tax to 8%. While some believe that this would put Maine at a competitive disadvantage, Maine is already below regional lodging sales tax levels. It is difficult to believe that someone spending \$100 for a hotel room would cancel their vacation because the cost went up by \$1 (from \$107 to \$108).

The meals tax would also be raised to 8% but only for class-A restaurants (those establishments with liquor licenses). This avoids

taxing items like takeout pizza that have become a staple for many families.

The tax on short-term auto rentals could be raised from 10% to 15% or an additional \$5 for every \$100. Again, this targets Maine visitors, many of whom pay comparable taxes on auto rentals in other states and do not make their vacation decisions based on such minor costs.

### **Excise Taxes and Real Estate Transfer Taxes**

Maine should revisit the excise tax on beer and wine. Both were last updated many years ago. LD 850 recommends increasing the excise tax on a gallon of beer from \$0.25 to \$0.60. This translates roughly to an increase of \$0.50 per six-pack of beer. LD 850 also recommends increasing the excise tax on wine from \$0.30 to \$1 a gallon -- the same tax that exists for sparkling wines -- or about \$0.20 per 750 ml bottle. These increases keep Maine in the middle third of states for the beer and wine excise tax (when also considering additional local taxes in place in other states).

LD 850 also calls for an excise tax of \$4 per gallon of soft drink

#### **LD 850**

##### **Excise and Real Estate Transfer Taxes**

- *Increase excise tax on beer and wine.*
- *Add excise tax on soft drinks.*
- *Increase real estate transfer tax per \$1000 on higher value homes.*

syrup and \$0.42 per gallon of bottled soft drinks.

The real estate transfer tax system could be made more progressive by increasing the tax per \$1000 on homes of the greatest values. This would start at \$1 per \$1000 for transactions between \$100,000 and \$200,000 and would incrementally ramp up to \$7 per \$1000 for transactions over \$1 million. This would capture those second homes of higher value along Maine's waterfront purchased as vacation properties from people out of state. Again, this would be an opportunity to export some of Maine's tax burden.

### **Revenue Neutrality**

Revenue neutrality was a key objective of LD 850. All state costs are intended to be matched by

increased revenues. Based on calculations from Maine Revenue Services for 2007, the cost of this income and property tax relief is approximately \$140 million. The revenue generated from altering the sales tax, excise taxes, and real estate transfer taxes approximately matches this figure.

These numbers would have to be recalculated once a final version of the proposal was decided upon. If the final proposal is found to be slightly revenue heavy or light, the increase to the state EITC can be adjusted up or down to make up the difference.

Several tax reform proposals before the legislature make much more radical departures from our current system of taxation. LD 850 modestly moves in a direction that has been called for by every expert who has examined Maine's tax system in the last two decades: expand the sales tax base and use the revenues to lower both property taxes and income taxes. We doubt that the legislature can do much better than a package that looks substantially like LD 850.

We recognize that many residents will be disappointed that the package does not result in more

immediate and substantial tax reductions. But we believe such expectations simply cannot be met while continuing to meet the basic demands of Maine residents for government services.

The legislature has adopted spending limits that have demonstrably reduced the rate of growth in both state and local spending. There will be continuing efforts to realize efficiencies in the administration of schools and health services. But there is also a real

chance to rebalance our tax code in ways that will shift some of the present costs of services to nonresidents and relieve resident property and income taxpayers. Legislative leaders and the taxation committee have committed themselves to these objectives and we support their efforts.

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### Endnotes

1. Phone conversation with Maine Revenue Services January 31, 2007.
2. Maine Revenue Services. LD 1: Second-Year Impact On Tax Burden. Prepared for Maine Joint Standing Committee on Taxation. January 17, 2007.
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