NOW IS THE TIME FOR TAX REFORM.
CAN LD 1088 DELIVER?

by Kurt Wise

Taxes are central to our individual and collective well-being. Taxes provide the revenue that supports the physical infrastructure, the education, health care, and environmental protections that we have collectively decided are essential to keep our communities and families thriving. While the new government collects taxes has significant implications for the reliability and fairness of the system.

Maine’s tax system is unnecessarily volatile. This volatility contributes to recurring budget shortfalls and is exacerbated during economic downturns. While the Legislature has spent much of this session wrestling with large projected shortfalls caused primarily by the global economic crisis, discussion of tax reform as embodied by L.D. 1088 will figure prominently in the weeks ahead. This presents an important opportunity to assess our current tax structure with a view toward improving its efficacy and its fairness for all Maine people.

The Case for Reforming Maine’s Tax Structure

When you don’t have a reliable source of income, it is difficult to plan for the future. Unnecessary fluctuations in Maine’s revenues routinely subjects lawmakers to this budgeting conundrum and undermines prudent investment in and delivery of beneficial programs and services. A key reason for these fluctuations is our over reliance on sales taxes that are applied to too narrow a list of items and that are driven by asset appreciation.

Professor Charles Colgan, Chair of Maine’s Consensus Economics Forecasting Commission recently stated, “The bottom line is Maine’s General Fund has been living off of asset price inflation over the last two decades…sales tax growth has been largely sustained by housing price growth. Essentially by using our houses as ATM machines, we were borrowing off of that rise in our asset value and using it to sustain consumption…(The State) raked in (sales taxes) when the housing ATM was open, and now that it’s closed, we’re taking a big hit.”

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Guiding Principles for Tax Reform

A new tax system must:

1. Maintain adequate revenues to support essential government services and continue to grow at the rate of the overall economy. If revenues cannot keep pace with growth in the economy as a whole, the inevitable result is that government services will be perpetually under-funded and the need for continually higher levels of budget cuts will become a mathematical certainty.

2. Provide some benefit to all Maine residents. These may include a mix of direct household tax reductions, simplification of the tax code, and the strengthening of Maine’s present and future economic prospects.

3. Target reductions to those who pay the greatest percentage of household income in taxes. Currently, the lowest income households pay the highest percentage of their incomes toward state and local taxes and should benefit directly from any reform proposal.

4. Export the costs of government to nonresidents as much as possible. Thousands of short and long-term visitors come to Maine each year and use infrastructure and services that our tax dollars support. It is reasonable to expect that these visitors help defray a portion of these costs. Currently, nonresidents provide about 9% of all tax revenues and should therefore share in the cost of maintaining those features, LD 1088 seeks to maintain adequate state revenues and to ensure that revenue growth keeps pace with the Maine economy over the long term. This satisfies the first principle. As noted above, Maine Revenue Services estimates that LD 1088 also shifts some $75 million in taxes to visitors. Therefore, the fourth principle – exporting the costs of government to nonresidents – is unclear and debatable.

5. Balance maintain between taxes paid by households and businesses. Individuals and businesses receive numerous direct and indirect benefits from public services and would therefore share in the cost of maintaining those services. These principles were developed in 1994 by the Taxpayers for a Fair Budget Coalition. This group was instrumental in the formation of the Maine Center for Economic Policy. We believe any proposal to reform Maine’s tax system should adhere to these principles.

In addition to reducing the volatility of revenues, reforming Maine’s tax structure can and should address important issues of fairness. Currently, Maine

In addition to these three core features, LD 1083 seeks to maintain revenue neutrality, meaning that the state will collect neither more nor less revenues than it is projected to collect under the current system. By collecting more of our taxes from out-of-state visitors, LD 1083 will also reduce the taxes paid by Maine residents by some $75 million annually.

Applying the Guiding Principles to LD 1083

LD 1083 goes a long way toward satisfying three of MECEP’s five guiding principles for tax reform. By broadening the sales tax in combination with overall revenue neutrality, LD 1083 seeks to maintain adequate state revenues and to ensure that revenue growth keeps pace with the Maine economy over the long term. This satisfies the first principle. As noted above, Maine Revenue Services estimates that LD 1083 also shifts some $75 million in taxes to visitors. Therefore, the fourth principle – exporting the costs of government to nonresidents – is unclear and debatable.

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Building and Auto sales tax revenues are volatile compared to
Total Maine sales tax revenues and State GDP

<table>
<thead>
<tr>
<th>Year</th>
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<th>Auto</th>
<th>Total</th>
<th>STATE GDP</th>
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</thead>
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<td>$100M</td>
<td>$200M</td>
<td>$300M</td>
<td>$1B</td>
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<td>2012</td>
<td>$60M</td>
<td>$160M</td>
<td>$220M</td>
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MECEP estimates the cost of these improvements to be between $10 and $20 million depending on how they are structured and the uptake rates. LD 1083 already offers over $30 million in tax relief to the top ten percent of Maine households by income. Thus it would be possible to pay for these improvements and deliver a significant benefit to all Maine households through a modest reduction in the proposed benefits going to Maine’s highest income households. Such an approach would strike a better balance between a tax structure that is more reliable, rewards work and entrepreneurship, and achieves greater fairness for all taxpayers.

Simplify and Integrate the Circuit Breaker

The Circuit Breaker program provides up to $2,000 of relief to households with incomes below $20,000 per year whose direct income taxes exceed five percent of their income or whose rent exceeds 20% of their income. Currently, people must file an application for this refund separate from the forms submitted for income taxes. Maine Revenue Services estimates that less than half of eligible households participate in the program. Simplifying the filing process and incorporating the program directly into Maine’s income tax structure would likely improve participation in the program. It would reduce the time and cost burden for individuals, and allow the state to provide relief to low-income households in a more reliable, cost-effective way.
This problem is compounded by the fact that Maine's sales tax revenue collected from just two sources, auto sales and the sale of home building supplies, together, these two sources supply roughly $350 million in annual revenues, or about one third of all the sales tax collected in Maine. When the economy falls into recession – precisely the time state governments are called upon to do most for their residents – auto and housing related sales tend to drop off sharply and leave sizable gaps in the budget. Indeed, the latest data available from the Maine State Planning Office show that February auto sales were down 14% and building supplies sales are down over 23% from a year ago, a further worsening from the dismal January figures. 

In order to maintain our important public investments, revenues should be less volatile and should allow government spending to keep pace with inflation. An important step Maine can take is to restructure the sales tax in such a way that is less subject to economic bubbles and is better connected to real economic activity and growth (State GDP). Part of the problem is that the current sales tax structure is outdated, focusing heavily on taxing a narrow set of goods. An ever increasing percentage of total economic activity involves the purchase and sale of services rather than goods. Of the 168 categories of taxable services defined by the Federation of Tax Administrators, Maine taxes just 24. By comparison, Connecticut taxes 80 of these services. If Maine followed suit, state revenues would climb by as much as $185 million annually. Such an expansion also would ensure that Maine exports a larger share of taxes to nonresident visitors and tourists.

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5. Maintain balance between taxes paid by households and businesses. Individuals and businesses receive numerous direct and indirect benefits from public services and should therefore share in the cost of maintaining those services.

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Building Principles to LD 1088: The sales tax would be broadened from 2% to 7%, with a new 2% tax on lodging and car rentals. To offset what otherwise would be a tax increase on those who pay the greatest percentage of their income in taxes, the bill includes a new state income tax refund credit. As a result, LD 1088’s current design in fact may be somewhat regressive.
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Maine’s credit is capped at less than $250 per household, and helping to keep working families out of poverty. Maine’s EITC is also non-refundable, meaning that once the credit has reduced a family’s tax liability to zero, any remaining credit value goes uncollected by the family. Data from Maine Revenue Services shows that in 2006, some $1.85 million dollars went uncollected from reliable infrastructure and was shared more equitably by all Mainers.

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Maine’s level of total state spending as a percent of total personal income (a rough measure of Maine’s ability to afford the government services they request) has increased very little over the last 10 years, rising from 14.15% in 1997 to 14.90% in 2006. Moreover, the percentage has declined steadily since 2004 and is almost certain to decline further over the next three years.

Maine has created an opportunity to improve the way we collect taxes. In Maine’s case, it is possible to restructure our tax system to achieve greater reliability and fairness. L.D. 1088 is an important step in this direction and merits serious consideration by lawmakers on both sides of the aisle. However, some modification is necessary in order for L.D. 1088 to adhere to the guiding principles adopted by MECEP and its coalition partners. Such changes are both feasible and appropriate.

Conclusion

Tax reform provides an important opportunity to improve the way we collect taxes. In Maine’s case, it is possible to restructure our tax system to achieve greater reliability and fairness. L.D. 1088 is an important step in this direction and merits serious consideration by lawmakers on both sides of the aisle. However, some modification is necessary in order for L.D. 1088 to adhere to the guiding principles adopted by MECEP and its coalition partners. Such changes are both feasible and appropriate.

About the Author

Kurt Wise is the State Fiscal Analyst at the Maine Center for Economic Policy.

Endnotes

1. Spending growth is not the cause of Maine’s ongoing budget woes. Maine’s level of total state spending as a percent of total personal income (a rough measure of Maine’s ability to afford the government services they request) has increased very little over the last 10 years, rising from 14.15% in 1997 to 14.90% in 2006. Moreover, the percentage has declined steadily since 2004 and is almost certain to decline further over the next three years.

2. See link to his remarks at MECEP’s Economic Policy’s e-newsletter and alerts at www.mecep.org.


4. SPO website: http://www.mecep.org/

5. Maine State Planning Office (SPO), “Economic Policy Institute, for example, has found little correlation between tax rates and business activities. Similarly, evidence from Ohio and New Jersey demonstrate that sharp increases in top income tax rates did not have significant impacts on patterns of mobility into or away from those states, particularly among top earners.

6. Ibid

7. Much has been written about the relationship between locating top income tax rates and the effect on business activity and mobility. While the notion that lower top rates will have a “hidden boom” effect that will stimulate more economic growth and revenue has become a dominant idea in our political discourse, the empirical evidence directly contradicts this view. A survey by Robert Lynch of the Economic Policy Institute, for example, found little correlation between tax rates and business activities. Similarly, evidence from Ohio and New Jersey demonstrate that sharp increases in top income tax rates did not have significant impacts on patterns of mobility into or away from those states, particularly among top earners.