

# Discussion Paper



## The Struggle for Tax Reform in Maine, 2003-2009

by Richard Woodbury, Visiting Scholar

## Acknowledgements

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# The Struggle for Tax Reform in Maine, 2003–2009

Tax reform has been among the most prominent topics of public policy discussion in Maine in recent history. Numerous research and policy advocacy groups have highlighted tax reform as a core recommendation for improving Maine’s economic future. Politicians have identified tax reform as a key campaign priority and a leading policy objective in each new legislative session. A continuing series of referendum campaigns have been presented and marketed as tax reform, adding to the visibility, passion, and substantive public debate on tax policy. And among citizens generally, tax reform is viewed widely as a building block of long-term economic growth, and a more stable and sustainable approach to financing state and local government. The current tax system has been described as antiquated, imbalanced, burdensome, unfair, uncompetitive, archaic, and volatile.

Over the 2003–2009 period covered by this study, many reform proposals have been advanced; and some reforms have been enacted, including a significant restructuring of the income tax system in 2009. Whether the reforms accomplished in the 2003–2009 period are modest or profound, first steps or completed steps, successes or failures, are subjects of continuing debate.

This paper lays out the issues motivating tax reform efforts in Maine, provides a historical review of the tax reform struggle as it has unfolded, and offers a descriptive summary of the major initiatives advanced or enacted. Considerable attention is paid to the 2009 tax reform package, but in a context of understanding tax reform issues more broadly.

The period covered by the study begins with the release in March 2003 of the final report of the Speaker’s Advisory Committee on Tax Reform. The Advisory Committee had some prominence, as it consisted of a former Governor, a former Chief Justice, the outgoing (term-limited) Speaker of the House, academics, and state leaders in business, business economics, tax policy and accounting. The preface to the committee’s report reiterates the depth of concern and extended duration of Maine’s inaction on tax reform, even at the start of the study period:

For the past 20 years, the general public and the private sector have voiced concerns about the impact of state and local tax structures on Maine citizens and businesses. While the Maine economy has been undergoing substantial change from a natural resource based and manufacturing economy to a service based economy over the last 25 years, Maine’s tax structure has not changed significantly since Governor Curtis reformed it 33 years ago.

—Speaker’s Advisory Committee on Tax Reform, March 2003

Framing the other end of the study period is the recent enactment of LD 1495, a package of tax reforms that purport to lower Maine’s income taxes, reduce revenue volatility, increase economic competitiveness, and lighten the burden on resident taxpayers while maintaining revenues. The package is perceived widely as the most significant tax reform in Maine of the past 40 years.

The paper is organized as follows. Section A describes the factors motivating tax reform in Maine, identifying the key issues and concerns that tax reform is designed to address. Section B provides a broad chronological overview of the major tax reform proposals advanced in recent years, highlighting the depth of interest and passionate debate on the issue over an extended period of years. The ensuing four sections focus on the distinct approaches, substantive considerations, and policy changes advanced in each major category of reform. These include property tax reform (section C), income and sales tax reform (sections D and E), and limits on the growth of taxes and spending (section F). The discussion of income and sales tax reform is in two sections, with the second analyzing in greater detail the legislation enacted this year as LD 1495. Finally, section G considers the major influences shaping the landscape of tax reform at the close of the 2009 legislative session.

## **A. Motivations for tax reform in Maine**

In both its successes and failures, the struggle for tax reform in Maine reflects the challenges of reconciling competing interests on complicated policy systems. Taxes are not a simple area of public policy. And while support for some type of tax reform is nearly universal in Maine, what people actually mean by tax reform has varied considerably among those advocating for change. Thus the paper begins by laying out the apparent problems that tax reform is intended to fix.

There are several motivations for tax reform. To some, the key issue is high property taxes, rising property valuations, the deviation between tax bills and out-of-pocket capacity to pay those bills, and the potential for people to be “taxed out of their homes.”

To others, the problem is tax burden more generally—impassioned in Maine by the annual rankings of the Tax Foundation. Every year from 1997 to 2006, Maine was highlighted at the top of the list, as the state with the nation’s highest burden of state and local taxes. The Tax Foundation has since changed its methodology for calculating tax burden, and has lowered Maine’s historical ranking retroactively, but the intense public sentiment toward reform was fueled to a significant extent by the annual press releases using the old methodology.

To still others, the key issue is the top marginal income tax rate of 8.5 percent. Higher than in most states, and paid by both middle and high-income households in Maine, the 8.5 percent rate is believed by many to be an important disincentive to business attraction and economic growth. The lowering of that rate is considered a core aspect of the tax reforms enacted this year.

And for others still, the key issue is a sales tax base that is narrow, volatile, and reflective of an older product-oriented economy: most services are exempt from the tax.

“Tax reform” is the term used universally and indiscriminately as the policy change required to address these substantially varying issues and concerns. Each of these motivations for tax reform is considered in turn.

## Property taxes

One of the motivations for tax reform is a high and unevenly distributed property tax burden. Property taxes in Maine are the primary source of funding for municipal and county government, and at least half of total funding for local school districts (excluding buildings and teacher retirement).

Figures 1 and 2 compare Maine’s property taxes to those of other states, using two measures. Figure 1 estimates property tax revenues as a percentage of personal income, based on fiscal year 2006 tax data from the U.S. Census Bureau, and income data from the Bureau of Economic Analysis. By this measure, which does not differentiate between taxes paid by residents and non-residents, or by type of property, Maine has the third-highest revenues-to-income ratio. Property tax revenues are estimated to be 5.3 percent of personal income in Maine.

**Figure 1**  
**Property Taxes as Percent of Personal Income in FY2006, by State**

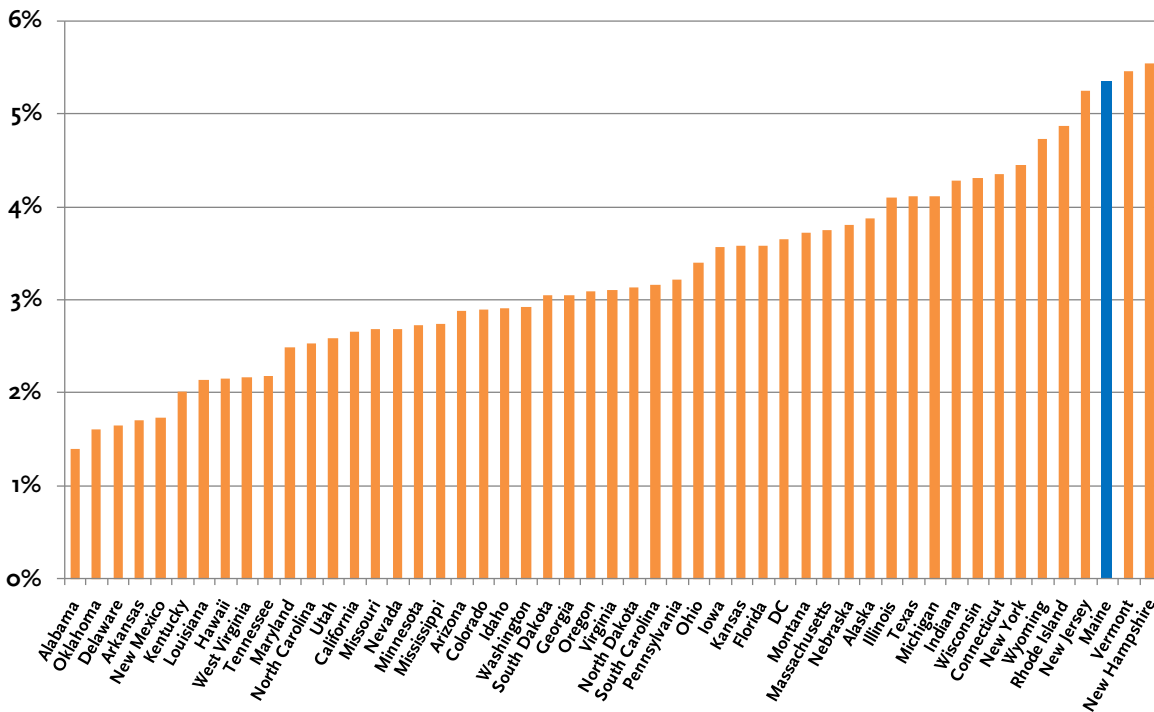
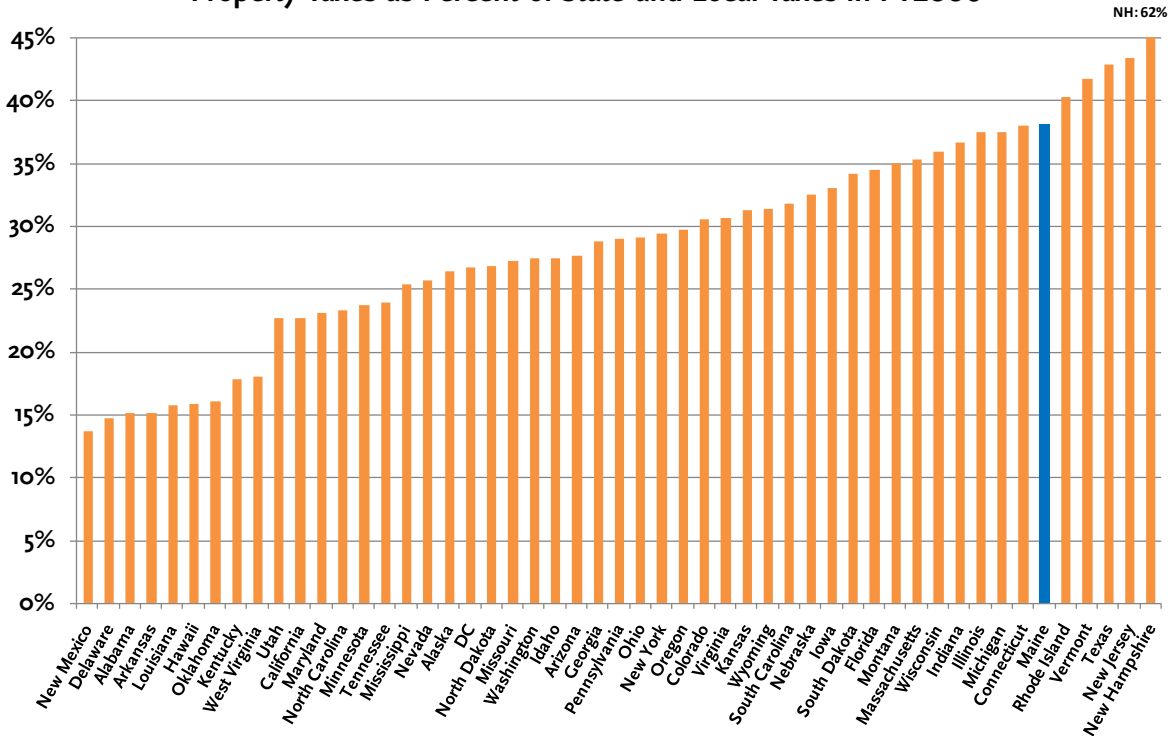


Figure 2 estimates property tax revenues as a percentage of all state and local tax revenues, again based on Census data for fiscal year 2006. By this measure, Maine ranks as the sixth-highest state in the proportion of revenues that comes from property taxes. About 38 percent of the tax revenues included in the Census data is attributable to the property tax in Maine.

**Figure 2**  
**Property Taxes as Percent of State and Local Taxes in FY2006**



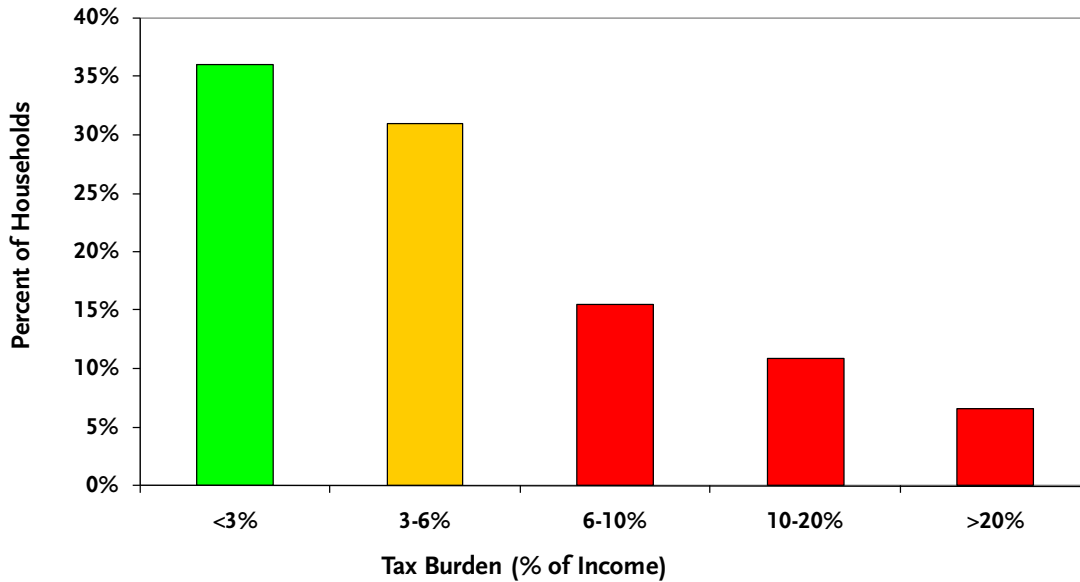
Source: U.S. Census Bureau

Concerns about property taxes are compounded by the uneven distribution across households in the out-of-pocket burden imposed. Property taxes differ from most other forms of taxation because they are imposed on an asset value rather than on a payment stream, such as income or spending. As a result, property taxes may represent a small, moderate, large, or very large fraction of income, depending on the circumstances of the individual homeowner. The wide variability in tax burdens across households, the very high burden imposed on some households, and the payment of the tax in large annual or semi-annual billings make property tax burdens particularly visible.

In previous work, Michael Allen and I estimated the distribution of property tax burdens across Maine households, based on a tax model used by Maine Revenue Services (Allen and Woodbury 2006). We estimated the median out-of-pocket burden to be about 4 percent of income, but the variation in burden across resident households is considerable. Figures 3, 4, and 5, reproduced from that study, illustrate this variability and the significant proportion of resident homeowners who face very high out-of-pocket tax burdens. Roughly one-third of households are estimated to pay less than 3 percent of their income in property taxes,

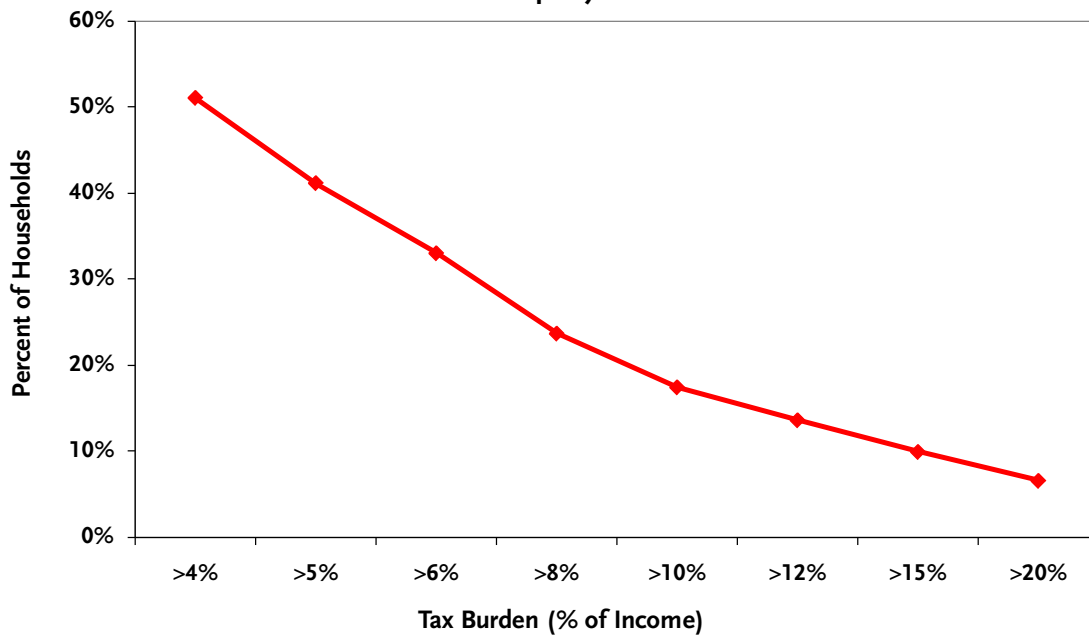
roughly a third pays between 3 and 6 percent of income, and roughly a third pays more than 6 percent. Some 17 percent of households pay more than 10 percent of their income, and 7 percent of households pay more than 20 percent of their income.

**Figure 3**  
**Gross Property Tax Burden as Percent of Income**  
**across Maine Households**



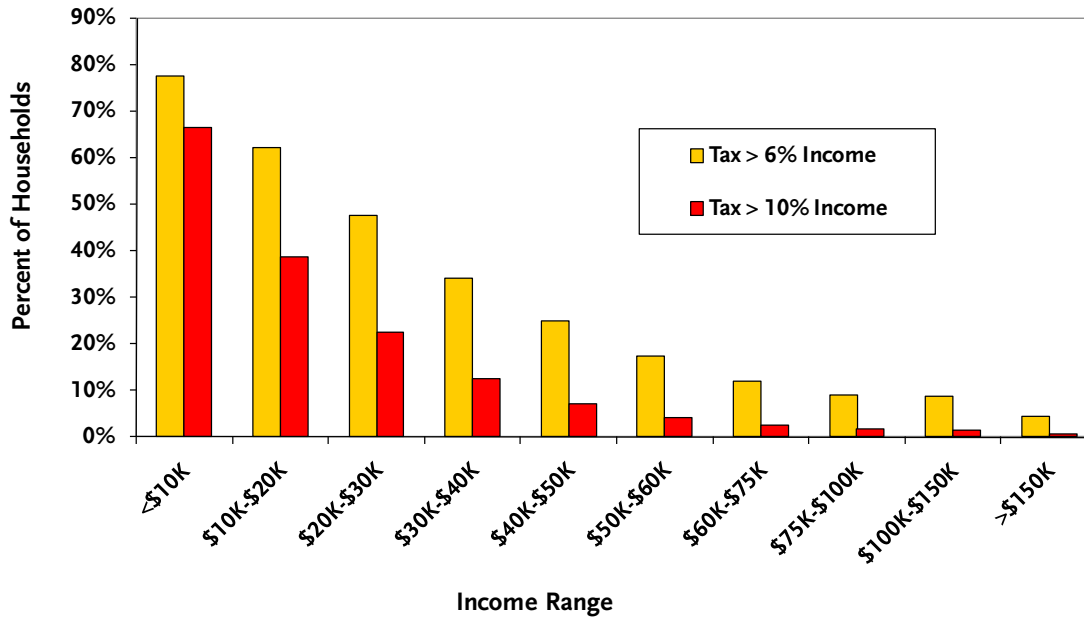
Source: Allen and Woodbury 2006.

**Figure 4**  
**Distribution of Gross Property Tax Burden in Maine**



Source: Allen and Woodbury 2006.

**Figure 5**  
**Percent of Households with High Tax Burden, by Income**



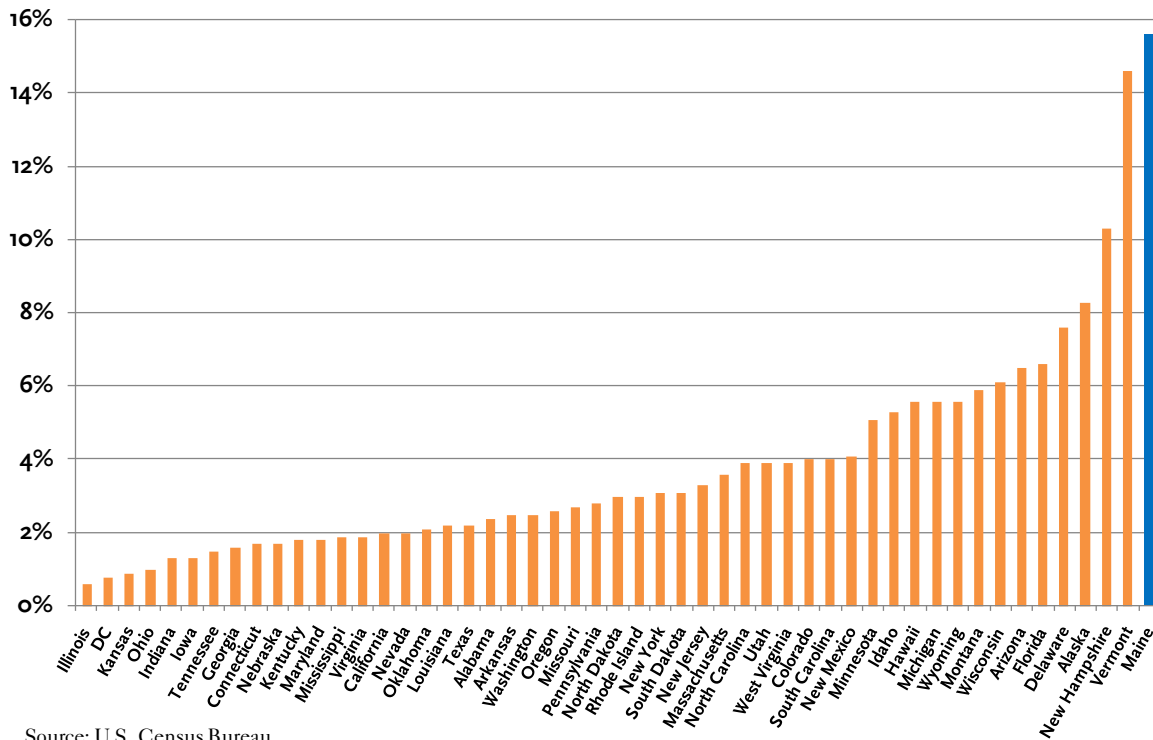
Source: Allen and Woodbury 2006.

The variation across households in property tax burdens is even more dramatic when comparing homeowners with different levels of income. Many more lower-income households than higher-income households have a high burden of property taxes, as Figure 5 illustrates. More than half (about 54 percent) of households with income below \$40,000 are estimated to pay more than 6 percent of their income in property taxes. This compares with 9 percent of households with incomes above \$60,000 who pay more than 6 percent of their income in property taxes. About one in three of the lower-income households (those with incomes below \$40,000) pay more than 10 percent of their income in property taxes. These data explain to a significant extent the feeling of some homeowners that they are being “taxed out of their homes.”

While broad public concern about property taxes in Maine is understandable, there are additional considerations that make policy prescription more complicated. For example, Maine has among the highest percentage of property owned by non-residents of any state in the country, including many highly valued residential vacation properties. Thus taxing property more heavily in Maine likely translates into a greater exportability of tax burden to non-resident property owners, and a correspondingly lower tax burden on Maine residents. Similarly, tax reforms that lower property taxes across the board would likely reduce revenues from non-residents, which policymakers might need to offset by increasing taxes on other kinds on residents. Figure 6 illustrates the important role of vacation homes in the property tax base in Maine.



**Figure 6**  
**Share of Housing Units That Are Vacation Homes, by State**



Source: U.S. Census Bureau

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.

Property taxes are also the most locally controlled tax, and the most directly translated into local services. No property taxes are redistributed for statewide uses in Maine; they stay in the communities where they are collected, and where residents have a direct voice (and often a direct vote) on how their tax payments are used. So high property taxes may reflect to some degree the government spending priorities that people have voted to support locally.

These are some of the issues that have confounded property tax reform initiatives and shaped the reform measures that have advanced. The recent history of property tax reform is discussed in greater depth in section C below.

### Income and estate taxes

A second motivation for tax reform is Maine’s high income tax, and particularly its highest marginal tax rate. Maine’s income tax system (before the enactment of LD 1495 this year) has had a progressive structure, with incremental marginal tax rates of 2, 4.5, 7, and 8.5 percent.

Those concerned with Maine’s income tax structure point to both the 8.5 percent rate and the moderate income level at which the 8.5 percent rate is imposed. Table 1 shows the minimum income threshold at which taxpayers are subject to the various marginal tax rates in 2009, based on a typical individual, married couple, and four-person family qualifying for a standard deduction and normal exemptions, and with earnings from non-exempt sources.

	Individual	Married Couple	4-Person Family
No Tax	<8,550	<\$15,200	<\$20,900
2% Rate	\$8,550	\$15,200	\$20,900
4.5% Rate	\$13,600	\$25,350	\$31,050
7% Rate	\$18,600	\$35,350	\$41,050
8.5% Rate	\$28,700	\$55,550	\$61,250
Source: Maine Revenue Services			

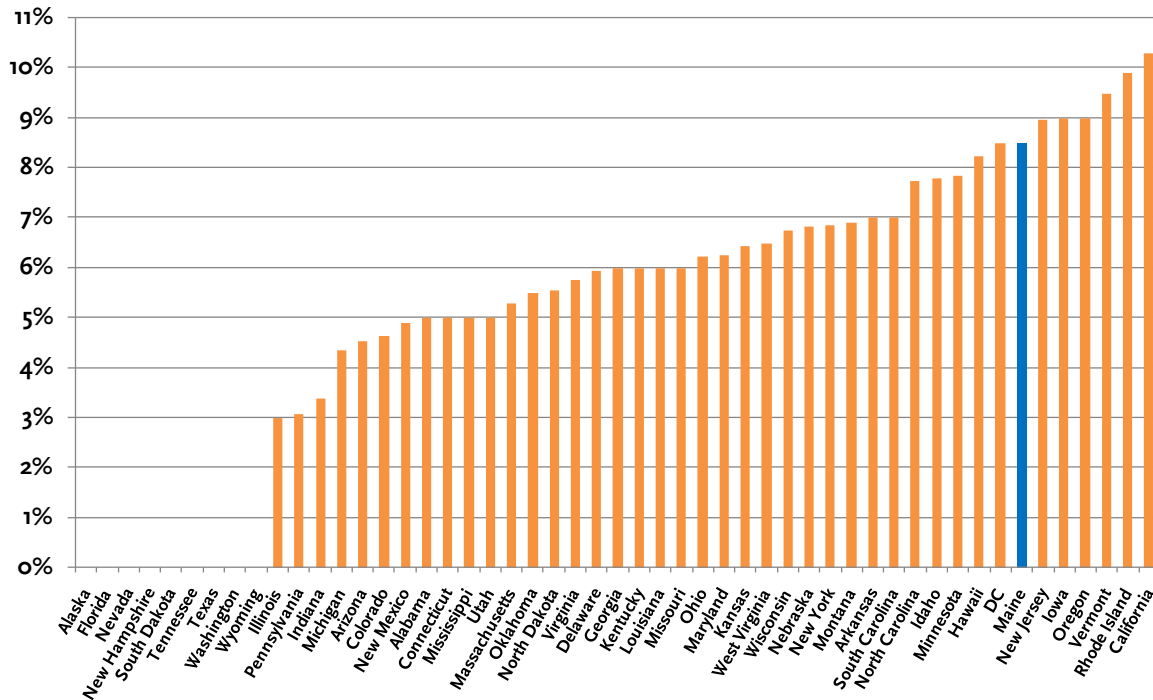
As the table shows, the highest 8.5 percent marginal tax rate is generally paid by individuals with total income above \$28,700, couples with income above \$55,550, and four-person families with incomes above \$61,250. The top income tax rate, therefore, affects middle-income as well as higher-income Maine residents. Aside from cost-of-living adjustments, the basic rates and structural features of Maine’s individual income tax system remained unchanged until the enactment of LD 1495 this year.

Figure 7 compares Maine’s 8.5 percent tax rate with the highest rates used in other states, using tax information compiled by the Federation of Tax Administrators for 2008.<sup>1</sup> The figure shows that the 8.5 percent top marginal tax rate in Maine is the seventh highest among the 50 states. The median state has a top marginal income tax rate of 6 percent.

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<sup>1</sup> The data for several states were updated from FTA tables, using online information from state tax departments.

**Figure 7**  
**Highest Income Tax Rates by State**



Source: Federation of Tax Administrators; Selected State Departments of Taxation.

While the high rate is a primary motivator for tax reform, that concern is compounded by the moderate income at which it is imposed. For example, among the states with the highest marginal income tax rates (above 8 percent), California imposes its highest rate only on individual taxable incomes above \$1,000,000. New Jersey imposes its highest rate on individual taxable incomes above \$500,000, Rhode Island and Vermont on individual taxable incomes above \$357,700, Iowa on individual taxable incomes above \$62,055; and Hawaii on individual taxable incomes above \$48,000. Maine imposes its highest rate on individual taxable incomes over \$20,150. (This equates to total income of \$28,700, if one adds back the standard deduction and personal exemption that are otherwise excluded from taxable income.)<sup>2</sup> Among the highest rate states, only Oregon imposes its highest rate at a taxable income level lower than Maine.

Those concerned with the competitive disadvantage of Maine’s income tax on the state economy often point as well to Maine’s estate tax. As the federal government has increased the amount exempted from the estate tax from \$1.0 million in 2002–2003 to \$1.5 million in 2004–2005, to \$2 million in 2006–2008, and to \$3.5 million in 2009, Maine’s exemption has remained below the federal level at \$700,000 in 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1,000,000 in 2006 and beyond.

<sup>2</sup> The amounts listed for Maine are for 2009. The amounts listed for the other states are from 2008 data from the Federation of Tax Administrators.

As a result of the lower exemption, Maine imposes a tax at death on several times more households than are subject to the federal estate tax. This, too, is viewed as a disincentive to Maine residence among those with higher incomes and wealth, particularly in later life. There is a widespread public perception that many wealthier retirees who were formerly Maine residents are now establishing a primary residence elsewhere, living “six months plus a day” in states without income or estate taxes (such as Florida) while living in Maine for “six months minus a day.” The pervasiveness of the anecdotal evidence of this mobility likely compounds its actual impact, as more households are made aware of the tax differences across states.

As with property taxes, the comparative data on Maine’s income and estate tax structure explain to a significant extent the widespread concern with the current system. However, as with property taxes, confounding policy priorities complicate policy prescription. For example, a core philosophical view held by many is that a highly progressive income tax system distributes the burden more fairly, particularly when coupled with more regressive property and sales tax systems. The incrementally rising rate structure of Maine’s current income tax, coupled with a higher top rate, is the traditional approach to achieving this progressivity. More innovative approaches to achieving progressivity were advanced as part of the LD 1495 reforms this year. These issues are discussed in sections D and E below.

### Sales and excise taxes

Maine imposes a 5 percent general sales tax, a 7 percent tax on prepared meals and lodging, a 10 percent tax on rental cars, and a 0.44 percent tax on real estate transfers. (The meals and lodging tax rate and the tax rate on rental cars will rise as part of the LD 1495 reform package this year.) There are no local-option additions or other supplements to these statewide rates.

Maine also imposes an excise tax on cigarettes at \$2.00 per pack, beer and hard cider at \$0.35 per gallon, wine at \$0.60 per gallon, and sparkling wine and low-alcohol spirits at \$1.24 per gallon. (Those rates include both the base tax rate and a supplementary premium tax.) A number of tax reform proposals have included adjustments to these various sales and excise taxes.

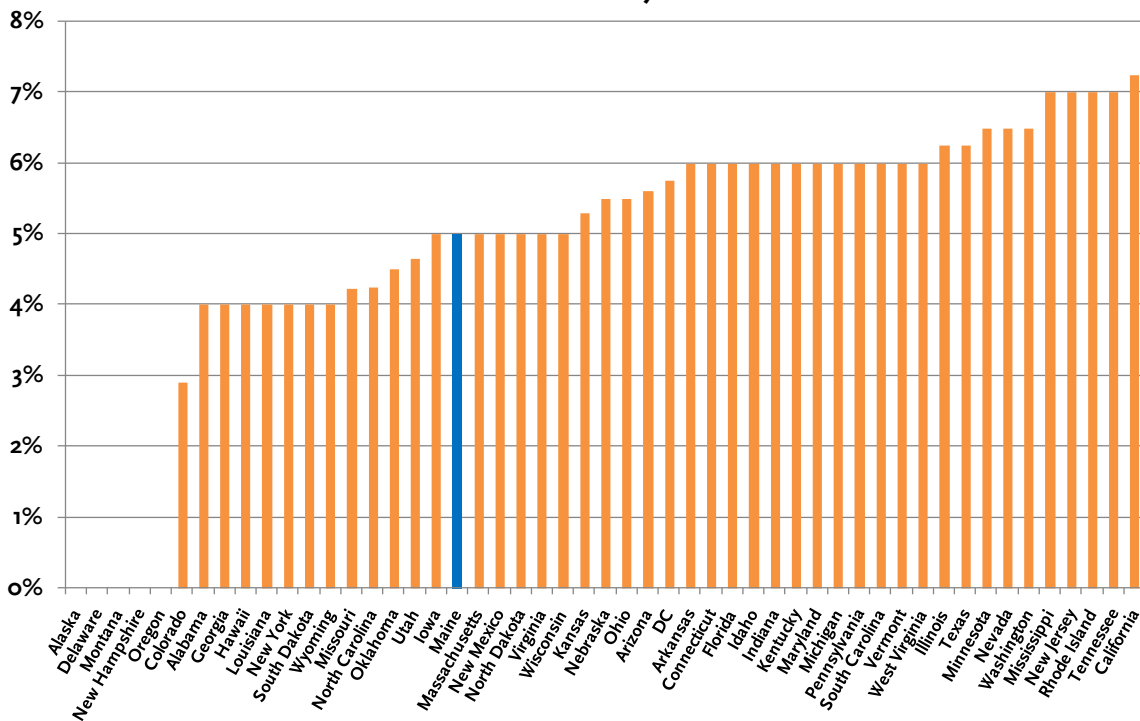
Two issues have motivated interest in reforming sales and excise taxes. First, sales and excise taxes have been suggested as the area where the state could increase revenues to offset lower income and property taxes. While income and property taxes are generally considered high in Maine, sales taxes are considered at or below the average of states. Thus sales and excise tax reform is usually advanced as part of an umbrella of reforms that aim to rebalance Maine’s tax system more comprehensively.

The second issue involves the appropriate breadth of the sales tax base, and particularly its exclusion of most services. As the composition of consumer purchases has evolved over time to include more services, advocates of reform contend that the sales tax base should expand as well. Advocates of sales and excise tax reform also emphasize the volatility of revenues that results from a narrower tax base. For example, roughly a third of sales tax revenues are

attributable to sales of automobiles and construction materials, both of which are highly cyclical industries.

So how does Maine’s sales tax rate and base compare with those of other states? Figure 8 compares the sales tax rate across states, based on summary data from the Federation of Tax Administrators. The median state has a statewide sales tax rate of 5.5 percent; Maine’s is slightly below the median at 5 percent. It is worth noting that roughly half of states allow local sales taxes on top of the statewide rates. If we include these additional local rates, Maine’s flat 5 percent rate statewide might be considered that much lower by comparison.

**Figure 8**  
**Sales Tax Rates by State**

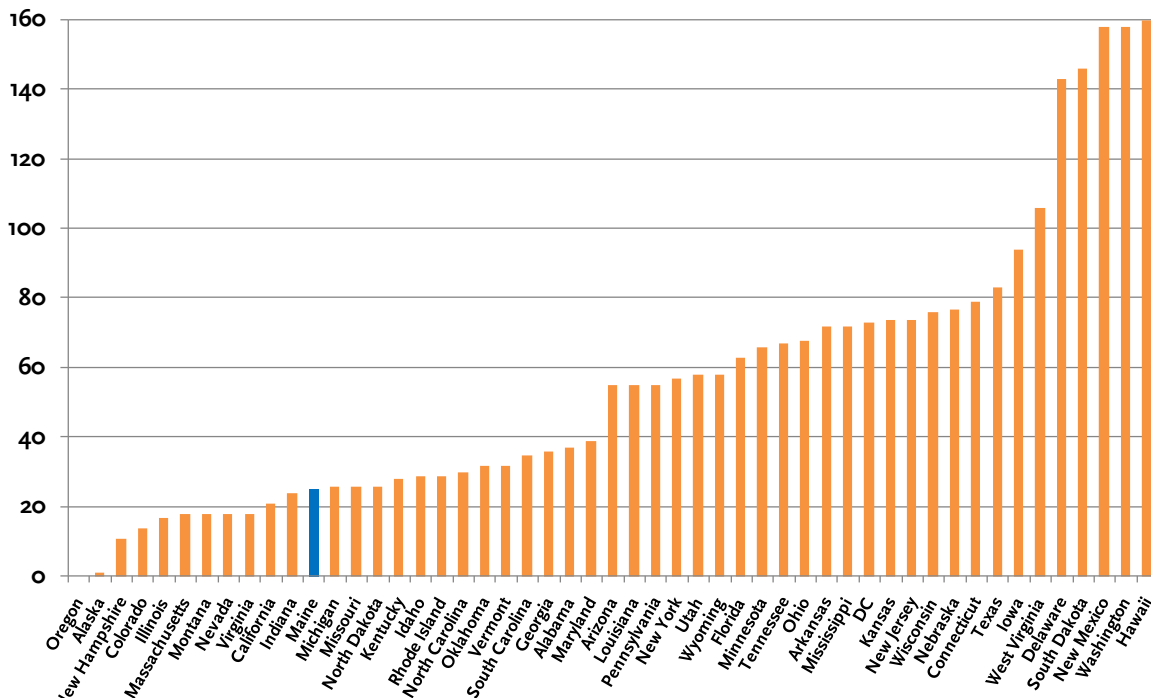


Source: Federation of Tax Administrators

Comparing the sales tax base across states is more complicated, as the definitions of product and service categories that may be subject to tax can differ considerably. The Federation of Tax Administrators, however, conducts a periodic survey of states on 168 potentially taxable services (FTA 2008). The services included in the survey are not intended to be comprehensive or complete. Nevertheless, they give some sense of the scope of services that may be taxed, and of the broad variation among states in the number of such services that the tax base may include.

Figure 9 illustrates the variation across states in the number of service categories taxed in different states, according to the FTA survey. Based on this measure, Maine appears to have a sales tax base that is narrower than that of most states, taxing 25 of the categories in the survey, compared with 55 at the median (among states with a sales tax), and up to 160 at the extreme.

**Figure 9**  
**Number of Services Taxed, by State**



Source: Federation of Tax Administrators, 2007 Survey

What product and services not currently taxed in Maine could be taxed? Some of the major categories of goods excluded from taxation in Maine are grocery staples, inputs to production, energy purchases (such as electricity, oil, and natural gas), and sales to nonprofit organizations. Also excluded have been most categories of services, such as recreation and amusement services (including movie tickets, golf, skiing, and attendance at amusement parks), personal services (such as haircuts and beauty salons), personal property services (such as dry cleaning and property repairs), separately stated labor charges (such as auto repair), real property services (such as lawn care, plumbing services, and snow plowing), and business and professional services (such as accounting services, financial services, and legal services).

Table 2 lists some of the services that the FTA survey reports as taxed in at least 10 states but that are not taxed in Maine. Further research could more fully define and fill out the various categories of sales beyond the illustrative category titles currently used in the survey.

**Table 2**  
**Illustrative Services in 2007 FTA Survey**  
**Services Taxed in at Least 10 States but Not Taxed in Maine**

<b>Admissions &amp; Amusements</b>		<b>Fabrication, Installation &amp; Repair Services (cont.)</b>	
Admission to professional sports events	37	Labor charges - repairs other tangible property	24
Amusement park admission & rides	36	Installation charges by persons selling property	23
Circuses and fairs -- admission and games	34	Labor charges on repairs to motor vehicles	21
Admission to cultural events	31	Labor charges - repairs to intrastate vessels	20
Pari-mutuel racing events.	29	Installation charges - other than seller of goods	18
Billiard parlors	27	Labor charges on repair of aircraft	16
Bowling alleys	27	Labor - repairs to commercial fishing vessels	15
Membership fees in private clubs.	23	Labor - repairs or remodeling of real property	15
Admission to school and college sports events	22	Custom meat slaughtering, cutting and wrapping	14
Pinball and other mechanical amusements	19	Labor charges - repairs to interstate vessels	11
Coin operated video games	17	Labor charges on repairs to railroad rolling stock	11
<b>Agricultural Services</b>		<b>Leases and Rentals<sup>1</sup></b>	
Landscaping services (including lawn care)	21	Personal property, short term (generally)	45
Pet grooming	18	Personal property, long term (generally)	45
<b>Automotive Services</b>		Bulldozers, draglines and const. mach.	45
Auto service, except repairs, incl. painting & lube	25	Rental of hand tools to licensed contractors.	45
Automotive rustproofing & undercoating.	25	Aircraft rental to individual pilots, short term	40
Automotive washing and waxing.	21	Aircraft rental to individual pilots, long term	39
Parking lots & garages	21	Limousine service (with driver)	16
Automotive road service and towing services	19	<b>Personal Services</b>	
<b>Business Services</b>		Tuxedo rental	38
Commercial linen supply	33	Diaper service	23
Tire recapping and repairing	28	Health clubs, tanning parlors, reducing salons	22
Exterminating (includes termite services)	21	Laundry and dry cleaning services, non-coin op	22
Telephone answering service	20	Gift and package wrapping service	21
Maintenance and janitorial services	19	Garment services (altering & repairing)	20
Window cleaning	19	Shoe repair	20
Security services	18	Carpet and upholstery cleaning	19
Armored car services	16	Swimming pool cleaning & maintenance	17
Private investigation (detective) services	16	Income from funeral services	13
Credit information, credit bureaus	13	Water softening and conditioning	13
Employment agencies	11	Fishing and hunting guide services	11
Packing and crating	11	Massage services	11
Interior design and decorating	10	<b>Storage</b>	
Temporary help agencies	10	Automotive storage	19
<b>Computer:</b>		Marina Service (docking, storage, cleaning, repair)	17
Software - modifications to canned program	29	Fur storage	16
Software - custom programs - material	24	Mini -storage	14
Software - custom programs - professional serv.	14	Household goods storage	13
Information services	13	Cold storage	13
Internet Service Providers-DSL or other broadband	12	Food storage	10
Mainframe computer access and processing serv.	11	Packing and crating	10
<b>Construction</b>		<b>Transportation Services</b>	
Carpentry, painting, plumbing and similar trades.	13	Income from intrastate transportation of persons	11
Gross Income of Construction Contractors	12	<b>Utility Service</b>	
Construction service (grading, excavating, etc.)	12	Interstate telephone & telegraph, ind.	27
Water well drilling	10	Interstate telephone & telegraph, res.	27
<b>Fabrication, Installation and Repair Services</b>		Other fuel (including heating oil), res.	23
Service contracts sold at the time of sale of TPP.	32	Natural gas, residential	22
Repair labor, generally	24	Sewer and refuse, industrial	15
Labor on radio/TV repairs; other electronic equip.	24	Water, residential	12
		Sewer and refuse, residential	11

<sup>1</sup>Maine generally taxes the leasor on the original purchase, but not the consumer leasing the property.

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. Other policy considerations are avoiding pyramiding (taxing both the inputs to production and the final product), the mobility of business activity across state lines by buyers or providers attempting to avoid the tax (such as those providing professional services), and the potential regressivity of taxing necessities (such as groceries and household utilities).

The LD 1495 reforms expand the sales tax base to certain services not now taxed. Issues relating to sales and excise tax reform, including the base expansions in LD1495, are laid out more fully in sections D and E.

### Overall tax burden

The fourth motivation for tax reform is a desire to reduce Maine's overall tax burden, which many consider an important drag on economic growth and prosperity. Even beyond the economic impact of the tax burden, the measurement of that burden has itself been a topic of considerable controversy.

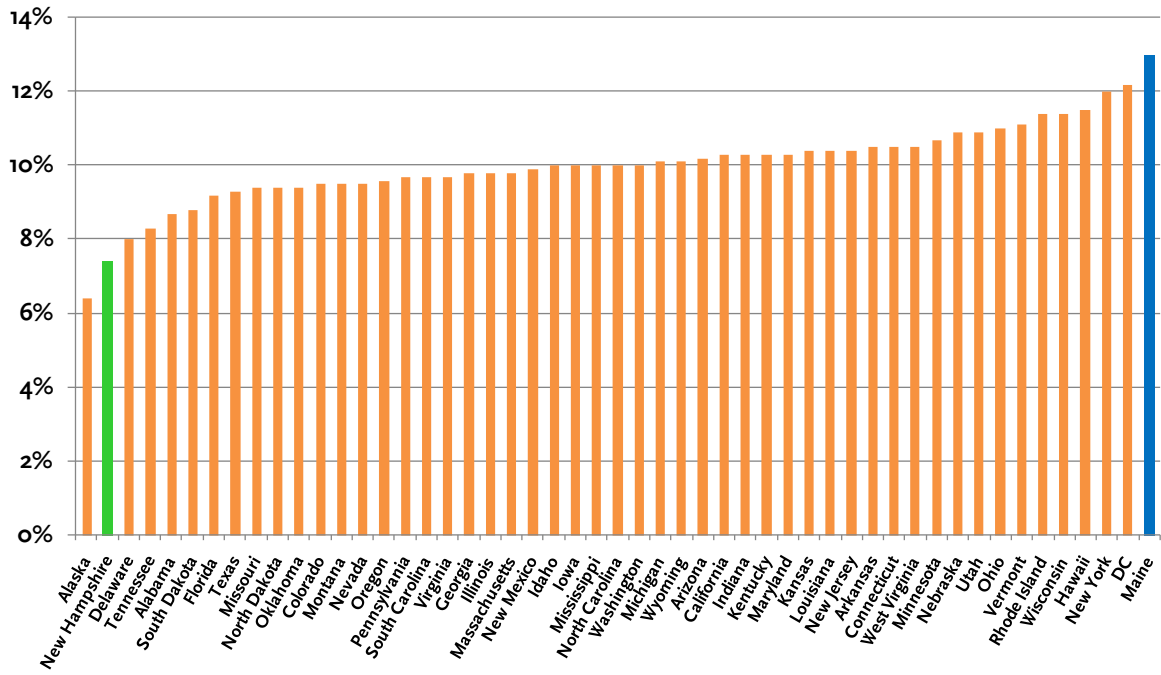
There are varying approaches to measuring tax burden, which I do not try to reconcile in this study. For example, among the significant questions is whether and to what extent to adjust the measurement of tax burden to account for taxes paid in Maine by non-residents. As noted, Maine has many non-resident property owners and visitors who contribute property taxes and sales taxes to state and local governments. Should the measurement of burden include or exclude these tax payments?

The tax burden measurements and rankings that have received the most attention in Maine have been those published annually by the Tax Foundation. As noted, the foundation ranked Maine as having the highest tax burden in the country between 1997 and 2006. In 2007 Maine's ranking dropped to second. Then, in 2008, the foundation revised its measurement methodology, subtracting a larger portion of the tax payments made in Maine by non-residents. The foundation applied the revised methodology retroactively, and Maine's reported tax burden rankings were reduced in all prior years as well as in 2008. Under the new method, Maine's burden and ranking—while still higher than average—became much less of an outlier. It was the earlier rankings, however, which influenced the public debate at the time.

Figure 10 shows the Tax Foundation's burden measurement and rankings using the old methodology in 2005. Figure 11 shows the foundation's burden measurement and rankings using the new methodology in 2008. In Figure 10, Maine appears as a substantial outlier—with a markedly higher tax burden than other states—under the old methodology. Maine's measured burden of 13 percent was well above the 10 percent median of all states. This fueled a significant and passionate anti-tax movement in the state. Under the new methodology, Maine's tax burden is higher than average, at 10.0 percent, but is less markedly different from the national average of 9.7 percent.

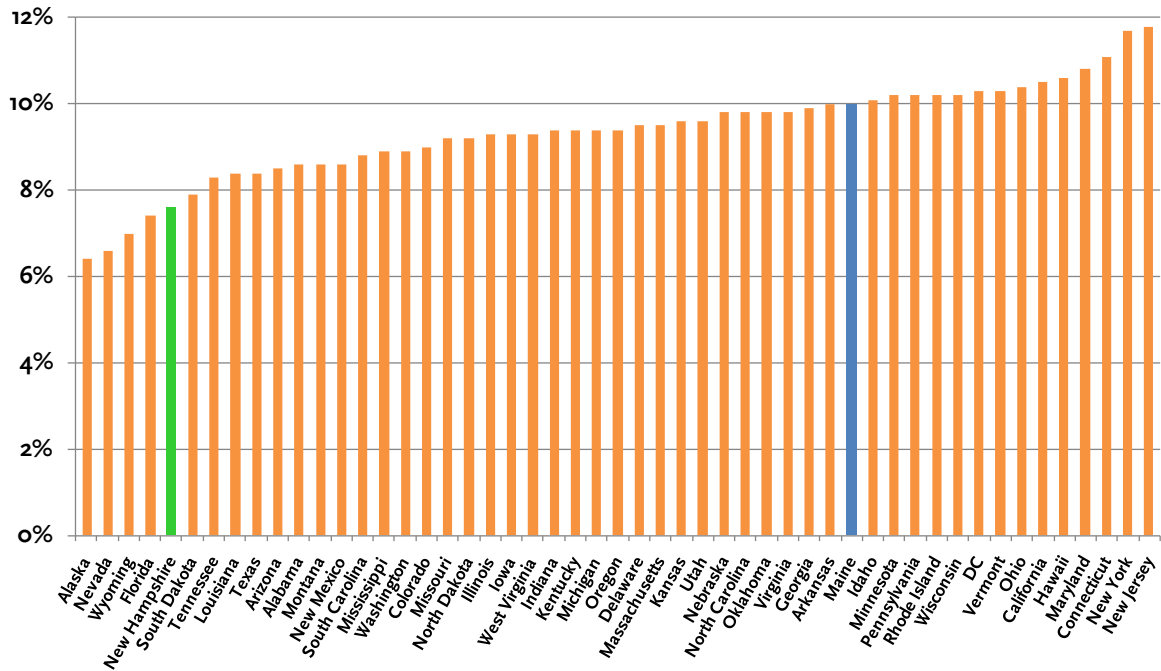


**Figure 10**  
**States' Tax Burden Rankings in 2005,**  
**under the Tax Foundation's Old Methodology**



Source: Tax Foundation

**Figure 11**  
**States' Tax Burden Rankings in 2008,**  
**under the Tax Foundation's New Methodology**

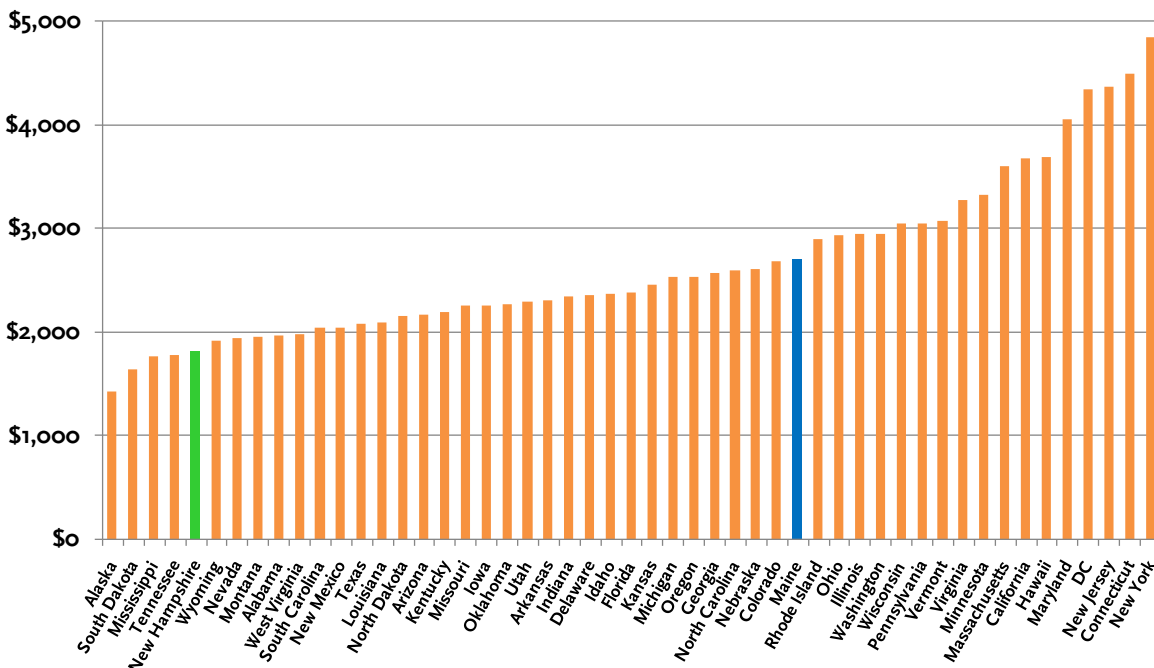


Source: Tax Foundation

In each of these figures, New Hampshire is highlighted with Maine, because New Hampshire is Maine's *only* bordering state, and because New Hampshire's tax policy is so different from Maine's. New Hampshire has no general income tax, no general sales tax, and a comparatively low tax burden by all measures. This creates at least the possibility for cross-state mobility of economic resources and activities spurred by the differences in tax policies. The contrast with New Hampshire and its potential economic impact has been another factor motivating tax reform discussions in Maine.

One other measure of tax burden is the number of tax dollars paid per capita to a resident's own state—as distinct from the percentage of income burden those taxes represent. For consistency, Tax Foundation data are presented on this measure of taxes as well, in Figure 12. According to the foundation's analysis for 2008, the per capita dollars paid by residents to state and local governments in Maine was \$2,701—just below the national average of \$2,924, though above the level of the median state. The lower incomes of Maine residents explain why the burden of those taxes is higher than average in Maine.

**Figure 12**  
**Per Capita Dollars Paid to Home State in 2008,**  
**under the Tax Foundation's New Methodology**

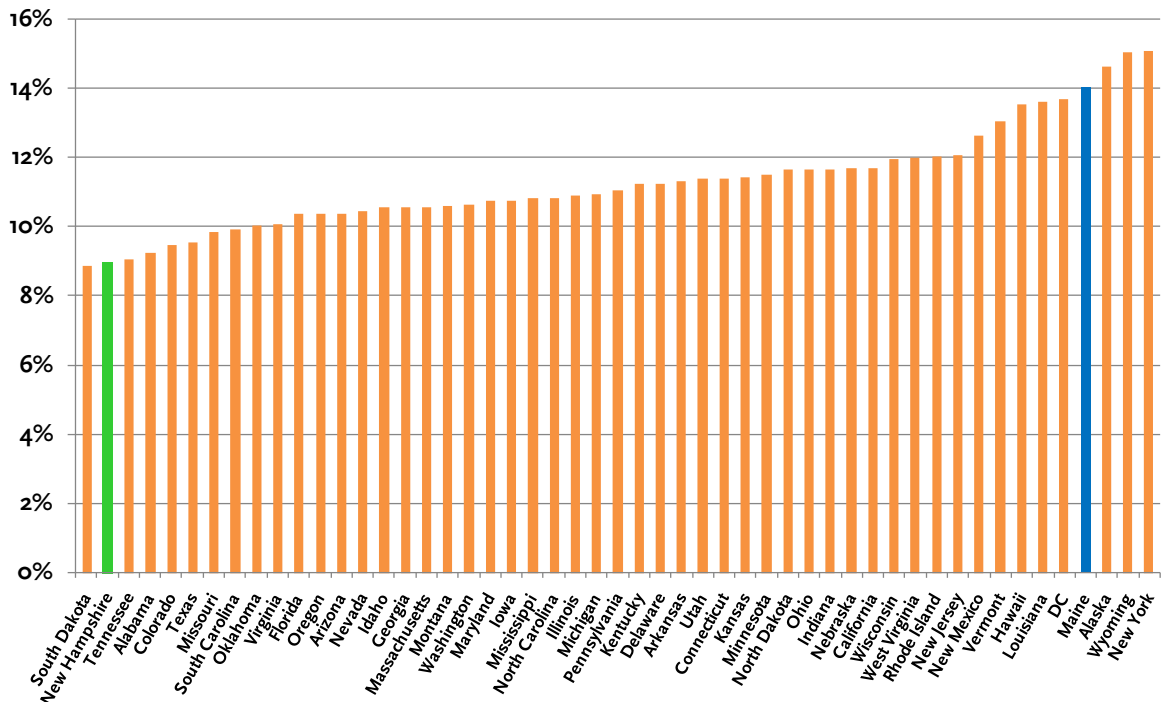


Source: Tax Foundation

While the differences in the Tax Foundation's new and old methodology highlight the substantial impact of exporting taxes to non-residents in reducing tax burden on residents, the revised approach is unlikely to eliminate entirely people's concern with tax burden in Maine. Attention may be redirected, for example, to tax burden measures calculated from

Census data. These data continue to reflect the total taxes paid by both residents and non-residents, and they continue to show Maine’s tax burden ranking as high. Figure 13 shows the burden of taxes by state using fiscal year 2006 tax data from the U.S. Census Bureau, weighted by data on personal income from the Bureau of Economic Analysis of the U.S. Department of Commerce.

**Figure 13**  
**Tax Revenues as Percent of Personal Income in FY2006, by State**



Source: U.S. Bureau of the Census; Bureau of Economic Analysis

Those who define tax reform primarily as tax burden reduction have tended to support reforms that statutorily limit taxes and government expenditures. These reforms emphasize the inherent duality of taxes and spending, and see reduced spending or limited growth in spending as the necessary precursor to lowering the tax burden. These issues, as well as the potential for tax reform to export more tax burden to non-residents, are considered later in the paper.

## B. The chronology of tax reform in Maine

The characteristics of Maine’s tax system laid out in section A provide some context relative to other states, and are the primary catalysts behind widespread and passionate interest in tax reform in Maine. They have motivated three categories of tax reform proposals in the state in recent years.

One category is designed to provide residential property tax relief, or to contain property tax burdens. A second category is revenue-neutral tax rebalancing, which typically couples reductions in the income tax (and/or the property tax) with a broader tax base and rate increases in sales and excise taxes. The third category of reform is designed to lower Maine’s overall tax burden, by either limiting growth of taxes and expenditures or exporting more taxes to non-residents. Some reform proposals include two or all three of these objectives.

Sections C through F of the paper are organized by type of reform, and analyze in greater detail the issues considered, the approaches to reform, and the specific provisions of major proposals advanced. Before turning to the more analytical discussion, however, it is helpful to review the chronological history of tax reform, as each new effort responds at least in part to the environment and events that preceded it. How has the struggle for tax reform unfolded over the last several years? A chronological overview is also useful in conveying the persistent attention the issue has drawn, and the passionate engagement of advocates and citizens demanding reform over an extended period of time.

Table 3 lists chronologically the major tax proposals considered over the study period, and the major categories of reform associated with each. Most have been defeated, either by public referendum, or an inability to garner a majority of legislative votes. The measures that have passed include the school funding referendum in 2004, LD 1 in 2005, and LD 1495 in 2009, although the school funding referendum has not been implemented as its promoters likely envisioned.

Year	Proposal	Policy Objective		
		Lower Property Tax	Income/Sales Tax Reform	Reduce Tax Burden
2003	Speaker’s Advisory Committee on Tax Reform	X	X	
2003-04	School Funding Referendum	X		
2004	Property Tax Cap Referendum	X		X
2004	State Chamber of Commerce “Maine Plan”	X		X
2005	LD 1: Property Tax Reform	X		X
2005/2007	LD 2: Valuation Growth Limits	X		X
2006	Taxpayer Bill of Rights	X		X
2007–08	LD 1925: Tax Reform Package	X	X	X
2009	LD 1088 / LD 1495: Income & Sales Tax Reform		X	X
2009	Taxpayer Bill of Rights II	X		X
All	Legislative Tax Committee Initiatives	X	X	X

## Speaker's Advisory Committee on Tax Reform and the 121<sup>st</sup> Legislature, 2003

The chronology begins in March 2003, when the Speaker's Advisory Committee on Tax Reform submitted its final recommendations. The proposed reform package included property tax relief, expansion of the sales tax base, increases in sales or excise taxes on selected purchases, and reduced income taxes. It was at its heart a tax-rebalancing plan, raising consumption-based taxes in order to reduce income and property taxes, while addressing to some extent the volatility of revenues from a narrow sales tax base.

The recommendations for property tax reform included a \$75 million expansion of the state's property tax and rent refund program. Known as the "circuit breaker," this program provides targeted means-based tax refunds to resident homeowners with the highest property tax burden. The recommendations also included a \$17 million increase in revenue-sharing payments targeted to municipalities with the highest property tax mil rates.<sup>3</sup>

The recommendations for income tax reform included raising the personal exemption to the federal level, increasing the state Earned Income Tax Credit (EITC) and making it refundable, and reducing the top income tax rate from 8.5 to 8 percent.

The recommendations for sales and excise tax reform included increasing the excise tax on beer and wine, raising the sales tax on prepared meals from 7 to 8 percent, and raising the sales tax on lodging from 7 to 10 percent. The recommendations also included expanding the sales tax base to include amusement and recreational services, personal services, funeral services, camp rentals, publications sold on short intervals, vending machine sales, consumer purchases of transportation services, consumer interstate calls, certain membership fees, and sales to various nonprofit organizations. The latter included private schools, colleges, medical research institutions, day-care centers and nursery schools, churches, and credit unions.

With the report in hand, and the prospect of multiple tax referenda on the horizon, many groups in the 121<sup>st</sup> legislature—including the Tax Committee, a joint and bipartisan "coastal-rural caucus," legislative leadership, and an advisory committee on school funding—worked to craft a compromise tax reform package that could gain a majority of votes. While these efforts proved unsuccessful in the end, a flurry of package configurations was advanced over the course of the legislative session. All were in the family of tax rebalancing: that is, they proposed to raise sales and excise tax revenues on the one hand and extend relief to property tax payers on the other. Among the property tax relief measures included in one package or another were increases in the state's share of K–12 funding, more targeting of municipal revenue sharing, local-option sales taxes, larger property tax refunds to high-burden households, and larger homestead exemptions.<sup>4</sup>

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<sup>3</sup> Mil rate is the term generally used to describe the property tax rate. A mil rate of 15, for example, refers to a property tax rate that is \$15 for each \$1000 of property value.

<sup>4</sup> The homestead exemption is a policy that excludes from property taxes some of the value of a primary residence. With a \$10,000 homestead exemption, for example, a Maine resident with a primary home worth \$100,000 would pay property taxes on just \$90,000 of that value.

Among the sales and excise tax increases considered were increases in the general sales tax rate, increases in the meals and lodging tax rates, increases in the tax rate on rental cars, expansions of the sales tax base to include various service categories, and increases in excise taxes on beer, wine, cigarettes, and other tobacco products.

The session was characterized by a certain desperation to accomplish “something” on tax reform, particularly property tax reform. The many legislative groups, coalitions, and individuals engaged in crafting tax reform in the 121<sup>st</sup> legislature made for a highly visible and energetic but ultimately unsuccessful quest, fueling more passionate interest in the referendum-initiated approaches already simmering.

### School funding referendum, 2003–2004

In November 2003, a citizen-initiated referendum campaign, led by the Maine Municipal Association, asked voters to substantially increase state funding for local school districts, thereby reducing—at least in theory—the amounts that districts would need to raise via local property taxes. The referendum mandated that the state pay 55 percent of all education costs, and 100 percent of special education costs. The 55 percent state support represented an aggregate state allocation, not a commitment to 55 percent funding in each district individually.

The incremental funding required for this referendum amounted to roughly \$250 million annually, based on education spending at the time, or about 10 percent of the state budget as a whole. The referendum did not specify where the incremental funding would be found, or what other spending might be cut, nor did it mandate that the incremental funding translate into property tax relief. If passed, local municipalities and/or school districts would retain full authority to allocate the additional funds. The referendum read:

*Do You Want the State to Pay 55% of the Cost of Public Education, which Includes All Special Education Costs, for the Purpose of Shifting Costs from the Property Tax to State Resources?*

State law allows the legislature to present to voters a “competing measure” to the original referendum, and the legislature used that authority in 2003. Thus voters were asked to choose between (1) the original referendum language; (2) the competing measure; or (3) neither one. The competing measure provided for a more gradual five-year phase-in to 55 percent state funding for education. It also defined a baseline level of education that the 55 percent funding would support, restored a \$7,000 homestead exemption that had previously existed in Maine law, and phased in an increase in the property tax circuit breaker refund.

The practical implication of the competing measure was to contain the magnitude of the state’s new funding obligation; allow time for revenues to “catch up” to the new obligation; and expand the more resident-targeted homestead exemption and circuit breaker tax relief programs.

Voters defeated the competing measure in the November 2003 election, and later passed the original language in June 2004. With the 2004 legislative session already adjourned in June, it became the responsibility of the newly elected 122<sup>nd</sup> legislature to implement the referendum in 2005. Among the major concerns were (1) how to find the funds for such a dramatic increase in state-supported aid for schools; and (2) how to ensure that municipalities would channel increased funding into property tax relief rather than more school spending. Put differently, there was concern that increased school funding from the state might do more to raise Maine's overall tax burden than to lower the property taxes that were its intended target.

### Property tax cap referendum and the chamber's Maine Plan, 2004

Even before the legislature could begin to implement the school funding referendum, debate began on another citizen-initiated measure, modeled after California's Proposition 13. That referendum—known as the Palesky tax cap after tax activist Carol Palesky—proposed to limit property taxes to no more than 1 percent of assessed value; set back that value to the 1996–1997 level; and limit growth in assessments to the lower of inflation or 2 percent per year. The referendum was presented to voters in November 2004. It read:

*Do You Want to Limit Property Taxes to 1% of the Assessed Value of the Property?*

For obvious reasons, the Maine Municipal Association, the Maine Education Association, and public employee unions aggressively opposed the referendum, as it would have cut the property tax revenues of many municipalities by as much as half. Mainstream debate on the tax cap referendum held that it was “too extreme” but that “something” needed to be done to bring down Maine's tax burden. The Maine State Chamber of Commerce characterized the referendum, for example, as “an extreme measure that would create chaos and confusion.” The chamber made clear, however, that the status quo was also unacceptable:

Our opposition to the Palesky proposal, however, should not be confused with an acceptance of the status quo. Like the proponents of the Palesky measure, we too are greatly disappointed and frustrated by the inability of Maine's Legislature to address the issue of tax reform. The Maine State Chamber of Commerce is not generally inclined to support the development of tax and fiscal policy through the referendum process – we believe that the Legislature is the appropriate forum in which to address these issues. However, when paralysis has set in and it is clear that our elected officials are unable to act, we must concede that it may become the only option available if we are to move the issue forward.<sup>5</sup>

In announcing its opposition to the tax cap referendum, the chamber put forward an alternative proposal it called the Maine Plan. The intent was to provide a blueprint for

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<sup>5</sup> Maine State Chamber of Commerce 2004.

reform that the legislature could use in its 2005 session—or, if the legislature did not act, that could work as a referendum.

The Maine Plan was in part a response to the two property tax referenda that preceded it, and in part an attempt to address Maine’s tax burden more generally. The key element was a set of limits on spending growth for municipalities, counties, school districts, and state government. The aim was to restrict growth in government spending to a rate lower than the growth rate of the overall economy, so that the tax burden would decline gradually over time. The plan also increased significantly the state’s property tax circuit breaker program, eliminating income eligibility limits and raising the maximum refund. The circuit breaker expansion was to be funded in part by eliminating the homestead exemption.

### LD 1 and the 122nd Legislature, 2005

These developments—the need to implement the citizen-approved school funding referendum, the passionate anti-tax sentiments associated with the tax cap referendum, the apparent failure of past legislatures to address tax reform (however defined), the engagement of the Maine State Chamber of Commerce in advocating for the Maine Plan, and the repeated no. 1 tax burden ranking by the Tax Foundation—all set the stage for the incoming 122<sup>nd</sup> legislature in 2005.

Using many of the elements of the Chamber’s Maine Plan, Governor John Baldacci presented a property tax reform plan for legislative consideration in late November 2004, and the newly elected legislative leadership appointed a special committee with the sole task of reviewing this proposal. The governor’s proposal, LD 1, was in practice three things: a property tax relief plan, a plan for implementing the voter-approved school funding referendum, and Maine’s first entry into spending growth limits.

In January 2005 the legislature enacted a revised version of LD 1. One component was the phase-in over four years of the commitment to 55 percent state funding for education, and the definition of “essential programs and services,” from which the 55 percent commitment would be calculated. LD1 clarified that the state was not responsible for 55 percent of any school budget—only 55 percent of a baseline budget considered “essential.” The intent of the phase-in was to avoid the need for increased taxes at the state level (or abrupt reductions in other spending), while at the same time relaxing over several years the demands on property tax assessments to support education.

LD 1 also increased both the homestead exemption and circuit breaker programs, thus providing more targeted property tax relief to resident homeowners, and, more dramatically, to homeowners with a high individual burden of property taxes.

LD 1 also established Maine’s first statutory limits on government spending growth, setting a goal of reducing Maine’s tax burden to the middle third of states by 2015. The spending limits imposed by LD 1 are relaxed automatically when the state tax assessor determines that the state has achieved this tax burden target. (The law does not specify how the



assessor should make this determination.) The spending limits apply different formulas to municipalities and counties, school districts, and state government; but as a package, the intent is a gradual reduction in the tax burden from all levels of government. The applicable governing body can exceed the LD 1 limits by simple majority vote, making them operationally more guidelines than strict limits.

As a companion to LD 1, Governor Baldacci also introduced LD 2, authorizing a municipality, at its option, to limit the rate of growth in the valuation of homestead land for property tax purposes. LD 2 was introduced as a separate bill because it involved amending the state constitution. Because rising property valuations represent one source of high property tax burdens for individual homeowners (particularly long-term owners), the intent of LD 2 was to address that particular source of tax burden. LD2 failed to pass, though the legislature considers similar proposals in nearly every session.

During the remainder of the 122<sup>nd</sup> legislature, the Tax Committee continued work on a revenue-neutral package of income, sales, and additional property tax reforms, broadly resembling reforms recommended by the Speaker's Advisory Committee and considered in the previous legislature. But comprehensive structural reform again proved too controversial to progress.

### Taxpayer bill of rights, 2006

In 2006, for the tenth year in a row, the Tax Foundation again ranked Maine as the state with the highest burden of state and local taxes, raising questions among some about whether LD 1's spending limits were strong enough. The renewed no. 1 ranking provided the catalyst and the marketing foundation for another citizen referendum, a taxpayer bill of rights (TABOR), modeled after the Colorado TABOR initiative.

The basic aim of this referendum was to limit growth in government spending to population growth plus inflation, and to require both a two-thirds vote of the governing body and a majority vote of the public to override these limits. The referendum also required a two-thirds vote of the governing body and a majority vote of the public to raise any tax or fee. The referendum, presented to voters in the November 2006 election, read as follows:

*Do you want to limit increases in state and local government spending to the rate of inflation plus population growth and to require voter approval for all tax and fee increases?*

Those advocating for TABOR emphasized the magnitude of Maine's tax burden, the economic costs of that burden, and its source in an uncompetitive level of government spending. Those opposing the measure emphasized the valuable services associated with government spending, and the question of whether requiring a two-thirds vote to exceed the limits was consistent with democratic principles. They also noted the potential inconsistencies with Maine's constitution of the requirement for a two-thirds vote of the legislature to exceed the mandated limits. While the TABOR referendum was defeated, the tone of the debate was familiar: "too extreme" but "something" needs to be done.

## LD 1925 and the 123rd Legislature, 2007

The broad perception that tax reform—however defined—was still badly needed in Maine, and that the legislature had failed to address that need adequately, continued into the 123<sup>rd</sup> legislature in 2007–2008. In that session, the tax committee engaged in a particularly methodical and bipartisan process of crafting the next generation of revenue-neutral income, sales, and property tax reforms. The result was a comprehensive reform proposal introduced as LD 1925. Among its features was the most fundamental redesign of the income tax system yet proposed.

This reform would have created a flat 6 percent income tax, coupled with a “resident credit” to maintain the system’s progressivity. (This approach is described in greater detail in sections D and E.) The property tax reform consisted of additional expansions to the homestead exemption and circuit breaker programs.

As with predecessor plans, the income and property tax relief measures would have been paid for with increased sales and excise taxes. Specifically, the plan would have increased meals and lodging taxes from 7 to 8 percent, increased taxes on rental cars from 10 to 15 percent, increased excise taxes on beer and wine, and increased real estate transfer taxes. The plan would have also expanded the sales tax base to include personal care services (such as hair care, tanning, and health clubs), personal property services (such as dry cleaning), real property services (such as electrical, plumbing, and lawn care services), installation, repair, and maintenance services, transportation and delivery services, and amusement and recreational services (such as skiing, golf, and movie tickets). Because these base expansions and rate increases would have been imposed on both residents and non-residents, while the income and property tax reductions were resident-targeted, Maine Revenue Services estimated that the bill would reduce the tax burden on Maine residents by \$140 million while maintaining revenues.

Unlike previous tax reform efforts, the tax committee relied on sophisticated economic modeling to calibrate the bill provisions, and to estimate its impact on taxpayers in different economic circumstances. The goal was to share the gains across the full income distribution of state taxpayers, and to minimize the number of “losers” under the reformed system. Under the carefully calibrated final proposal, about 90 percent of Maine residents would have seen a reduction in overall burden after accounting for the combined impact of property, sales and income tax reforms. (Similar analytical work was conducted this year on LD 1495, and is described in greater detail in section E below.)

Despite the proposal’s careful analytical underpinnings, the \$140 million reduction in tax burden on residents as a whole, the fact that 90 percent of residents would experience a lower tax burden personally, and the initial bipartisanship in developing the plan, reform again proved too controversial for passage. Business opposition solidified after a June 2007 press conference, hosted by the Maine State Chamber of Commerce, where members of the business community carried signs listing the breadth of new services that would be subject to sales tax under the reformed system.

A major reason given for opposing the plan was that it represented more of a “tax shift” than a tax reduction, and that it did not include limits on government spending. The bill’s political viability was also hurt by the legislature’s passage of several new taxes to support its state-sponsored health insurance program, raising questions about the “revenue neutrality” of the collective tax changes. Indeed, public opposition to those taxes was so substantial as to inspire a citizen-initiated referendum known as a “people’s veto,” which prevented the new taxes from ever being imposed.

### Enactment of LD 1495

The House chair of the tax committee in the 123<sup>rd</sup> legislature, who had guided the process leading to LD 1925 in that session, was elected House majority leader in the 124<sup>th</sup> legislature. From that position, Representative John Piotti continued to fine-tune a tax reform proposal, market the rationale for reform, and build the political foundations for enacting the reform. This time reform did pass. Governor Baldacci signed tax reform into law on June 12, during the last week of the 2009 legislative session. In an official press release, he proclaimed that “this tax relief and reform gives Maine a tax structure for the 21st Century.”

LD 1495 (originally introduced as LD 1088) replaces the progressive income tax rate structure with a flat 6.5 percent rate on incomes up to \$250,000. An additional 0.35 percent surtax is imposed on incomes above \$250,000, leading to a top statutory rate of 6.85 percent. The new system replaces traditional exemptions and deductions with a newly designed “household credit” that restores the system’s progressivity. The credit phases out at higher income levels, and is partially refundable at lower income levels, to offset increases in sales taxes in other parts of the act. LD 1495 is projected to lower income taxes for about 95 percent of Maine resident households.

The loss in income tax revenue is offset by an increase in the meals and lodging tax from 7 to 8.5 percent, an increase in the tax on rental cars from 10 to 12.5 percent, an 8.5 percent tax on candy, and an expansion of the sales tax base to four new categories of services. These are (1) “amusement, entertainment and recreation services,” including movies, concerts, festivals, amusement parks, sporting events, miniature golf, go-carting, exhibition shows, sightseeing excursions, whitewater rafting, and the hiring of entertainers; (2) “installation, repair or maintenance services” for jewelry, cameras, guns, musical instruments, electronic and mechanical equipment, lawn and garden equipment, computer hardware and office equipment, appliances, clothes, shoes, and furniture, as well as auto repair services; (3) “personal property services,” including dry cleaning, laundry and diaper services, embroidery and monogramming, car washing, pet grooming, picture framing, house cleaning, furniture and rug cleaning, interior decorating, warehousing and storage, moving, towing and boat mooring; and (4) “transportation and courier services,” for the in-state transport of persons or property by limousine or courier.

The revenue-neutral package lowers income tax revenues by about \$90 million annually (8–9 percent), raises sales tax revenues by about \$90 million annually, and, through greater exportability to non-residents, lowers the tax burden on residents by an estimated \$48

million. If all eligible households were to take advantage of the refundable income tax credit, an estimated 87 percent of Maine residents would see a drop in their combined income and sales tax burden. (More detail on the provisions and impact of LD 1495 is provided in section E below.)

The process leading to the passage of LD 1495 might be characterized as a gradual whittling down of its scope, the moderation or elimination of certain tax increases from earlier versions, and a narrowing-down of service definitions. And while the 2007 process had relied on exhaustive work within the legislature's tax committee, the 2009 process engaged the public at large, the press, interest groups, lobbyists, and the multiple constituencies of likely political opposition.

Each reduction in scope responded to concerns raised by one or more of these interests. The governor did the final carve-down after the bill had passed the legislature once, eliminating an increase in the real-estate transfer tax and expansions of the sales tax to ski tickets, golf, and other recreational services. Each adjustment on the sales tax or revenue side of the bill required a scale-back in the income tax reductions as well, to preserve revenue neutrality.

The process also evolved from bipartisan to partisan: the final bill passed with only one Republican vote. The business community was divided. The local chambers of commerce in Portland, Bangor, and Lewiston-Auburn, the three largest urban centers in the state, all supported the bill. However, a coalition of business groups calling themselves the "Not This, Not Now" coalition urged a gubernatorial veto, at least before the governor's last modifications.

The "Not This, Not Now" coalition included the Maine State Chamber of Commerce, the Maine Merchants Association, and the National Federation of Independent Businesses. It also included many local chambers of commerce (Bar Harbor, Ellsworth, Ogunquit, Penobscot Bay, Southern Mid Coast) and many industry-specific groups such as the Associated Builders and Contractors of Maine, Associated General Contractors, Maine Association of Realtors, Maine Auto Dealers Association, Maine Innkeepers Association, Maine Grocers Association, Maine Motor Transport Association, Maine Restaurant Association, Maine Tourism Association, and Ski Maine Association.

The state's major newspapers all published editorials supporting the tax reform legislation.

### The aftermath

Whether LD 1495 marks an end to tax reform as the top policy priority in Maine or just the next phase in a continuing saga remains to be seen. In the immediate future, three tax-related initiatives are brewing.

First, the leadership of the state Republican Party has submitted signatures to the Secretary of State for a potential people's veto of the new tax reform law, automatically putting on hold the implementation of the law. If the signatures are determined to be valid, the measure

will be decided by public referendum sometime in 2010. Also raised recently are constitutional questions relating to the differential treatment of residents and non-residents in the reform.

Second, voters will decide by referendum whether to approve a revised taxpayer bill of rights in November 2009. The new version retains most aspects of the original TABOR proposal, but eliminates the two-thirds requirement for overriding the spending limits or raising taxes. A majority public vote is still required under the proposal. Third, in another November 2009 referendum, voters will decide on a citizen-initiated proposal to reduce the automobile excise tax for newer cars. Intensive debate on these measures is just beginning.

I now turn to some of the substantive issues and approaches surrounding the debate on property tax reform (section C), income and sales tax reform (sections D and E), and tax and spending growth limits (section F).

## **C. Property tax reform**

The proposals just described, and many others, suggest multiple approaches to property tax relief. These include more state funding for schools (and changes to the formula for school funding), increased municipal revenue sharing (and changes in the revenue-sharing formula), local-option sales taxes, limits on growth in property valuations, larger homestead exemptions and circuit breaker refund programs, limits on growth in public spending, and restrictive tax caps. Four issues have been fundamental to this debate.

### Balance of state versus local funding

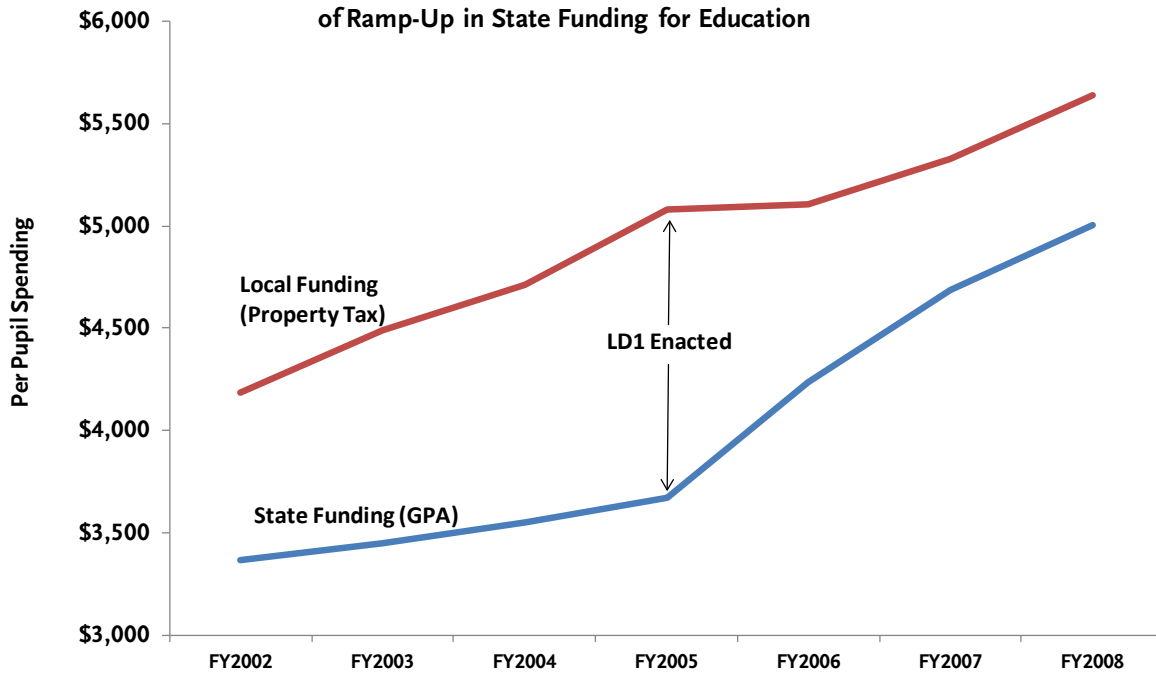
One issue involves the appropriate balance between state and local funding sources for municipal and educational services. Greater allocations of state resources (primarily income and sales taxes) potentially reduce reliance on local revenue sources (primarily property taxes). This was the idea behind the school funding referendum, and its implementation through LD 1. While not commonly advertised as tax *reform*, its explicit intent was property tax relief.

After passage of LD 1, state-supported general-purpose aid to education (excluding teacher retirement and school construction) grew from \$738 million in fiscal year 2005 to \$954 million in fiscal year 2008, while publicly-supported pupil enrollment fell from 201,000 to 191,000 students. Whether this translated into lower property taxes depends on how school districts treated the supplementary funding. Figure 14 shows trends in per pupil spending from state and local sources, both before and after the enactment of the school funding ramp in LD1.<sup>6</sup>

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<sup>6</sup> The GPA amounts for FY2003 and FY2004 are adjusted to include the temporary federal block grant funding that was used in those years as a part of the state allocation to local school districts.

**Figure 14**  
**Impact on Local Property Taxes**  
**of Ramp-Up in State Funding for Education**



Source: Author's Calculations based on data from Maine Dept. of Education, Compendium of State Fiscal Information, and Bureau of Labor Statistics.

The kink upward in state funding following the enactment of LD1 in 2005 appears to correspond with a kink downward in the growth of local property taxes spent per pupil. The extent to which this impact persists in later years is less apparent from these summary data. At least some of the increase in state funding may have relieved budgetary pressures on local school districts and facilitated more rapid continued growth in total per pupil spending.

### Broad versus targeted relief

A second issue involves differentiating between universal and targeted approaches to property tax relief. Larger transfers of state resources to municipalities and school districts, such as through general-purpose aid to education, are the least targeted approach to property tax relief. They reduce property tax mil rates for all categories of property—including business and residential property, property owned by residents and by non-residents, individuals with high property tax burdens and those with low property tax burdens. State government may target general transfers to communities with higher property tax mil rates. However, within municipal districts, the relief is distributed proportionately across all categories of taxpayers.

Homestead exemptions, by contrast, explicitly target relief to resident homeowners. Circuit breaker programs can target relief even more narrowly, by providing reductions or refunds to resident homeowners based on their individual property tax burden.

Whatever resources a state chooses to allocate for property tax relief, it faces an inherent trade-off between the breadth and depth of that relief. Thus a major controversy regarding property tax reform is how broadly or narrowly to target incremental resources. Is the aim to provide smaller amounts of relief to all taxpayers and to owners of all categories of property, or is it to provide deeper relief to certain specific categories of taxpayers, such as owners of primary homes, or individuals with the greatest individual burden of property taxes? While Maine has used both broad and narrow approaches, the passage of the school funding referendum demanded that a large majority of state funding for property tax relief be distributed broadly.

Optimizing the level of property taxes relative to other taxes on the one hand, and differentiating between targeted and untargeted forms of relief on the other, have particular implications in a state with substantial on-resident ownership. Because Maine has no statewide property tax, and little redistribution of property taxes outside municipal borders, property tax mil rates vary significantly across communities. Much of the property owned by non-residents is in locations with lower mil rates. Thus one perspective by which to evaluate property taxes and property tax reform is the extent to which one wants to allocate tax burden between residents and non-residents. Increased exporting of tax burden can be achieved by giving greater weight to property taxes in the tax mix; by targeting property tax relief to residents only, such as through homestead exemptions and circuit breaker refund programs; and by moderating variations in tax rates across communities.

The school funding and municipal revenue-sharing formulas in Maine moderate to some extent the variations in tax rates across communities. For example, there is a fixed across-the-board “mil rate expectation” in each community for supporting local schools, with the state making up the balance of “essential” school costs. The expected local contribution is currently 6.55 mils. While this equalizes (at least in principle) the mil rate for education imposed on municipalities, some can support the full local expectation for schools with a mil rate of less than 6.55 mils. Those lower rates tend to occur in communities with substantial property owned by non-residents, because of a comparatively high property valuation per student. The state’s revenue-sharing formula moderates mil rate variations across communities less dramatically, by allocating state funds in proportion to the local mil rate, with modest supplementary funding for communities with the highest mil rates.

The state’s homestead exemption and circuit breaker refund programs explicitly target tax relief to resident homeowners. Even within these programs, however, there are significant differences in targeting. Homestead exemptions provide relief to all resident homeowners in proportion to the local mil rate, while circuit breaker programs target relief to those with the greatest individual property tax burden. While both programs are politically popular, the allocation of funds between them is controversial. The legislature has enacted reforms to these programs frequently.

Maine’s current homestead exemption was implemented under LD 1, and exempts from tax the first \$13,000 in valuation of residents’ primary homes. The homestead exemption has a larger dollar value for homeowners in high-mil-rate communities than for those in low-mil-

rate communities. In a community with a property tax rate of 20 mils (or 2 percent of valuation), for example, the homestead exemption translates into a \$260 reduction in property taxes, relative to what a homeowner would pay for non-homestead property of the same value. The state reimburses municipalities for half the revenues lost from the homestead exemption.

The legislature has revised Maine's property tax and rent refund program, or circuit breaker, several times over the study period, though its basic formula has remained unchanged. The formula is structured as a two-tiered system, with one circuit breaker threshold at 4 percent of income, and another at 8 percent of income. Refunds are triggered when a homeowner's property tax (or rent equivalent) rises above the first threshold. The refund in this first tier is half the amount by which property taxes exceed 4 percent of income, up to 8 percent of income. At 8 percent of income, the second tier takes effect. The program reimburses 100 percent of property taxes paid in excess of 8 percent of income. This basic structural formula has remained unchanged over the study period.<sup>7</sup>

If there were no limits on reimbursement, this formula would effectively cap the net burden of property taxes at 6 percent of income. Taxpayers would be responsible only for the first 4 percent of their income in property taxes, plus half of the next 4 percent, for a total of no more than 6 percent. Thus circuit breaker refunds have the potential to serve as an income-based cap on property taxes. In practice, most states, including Maine, have a maximum refund limit and an income eligibility limit. It is these limits that were reformed, first in LD 1 and again more recently.

LD 1 significantly expanded the circuit breaker benefits. First, it increased the maximum refund from \$1,000 to \$2,000. Second, it raised income eligibility requirements, and phased out the maximum benefit at higher income levels.

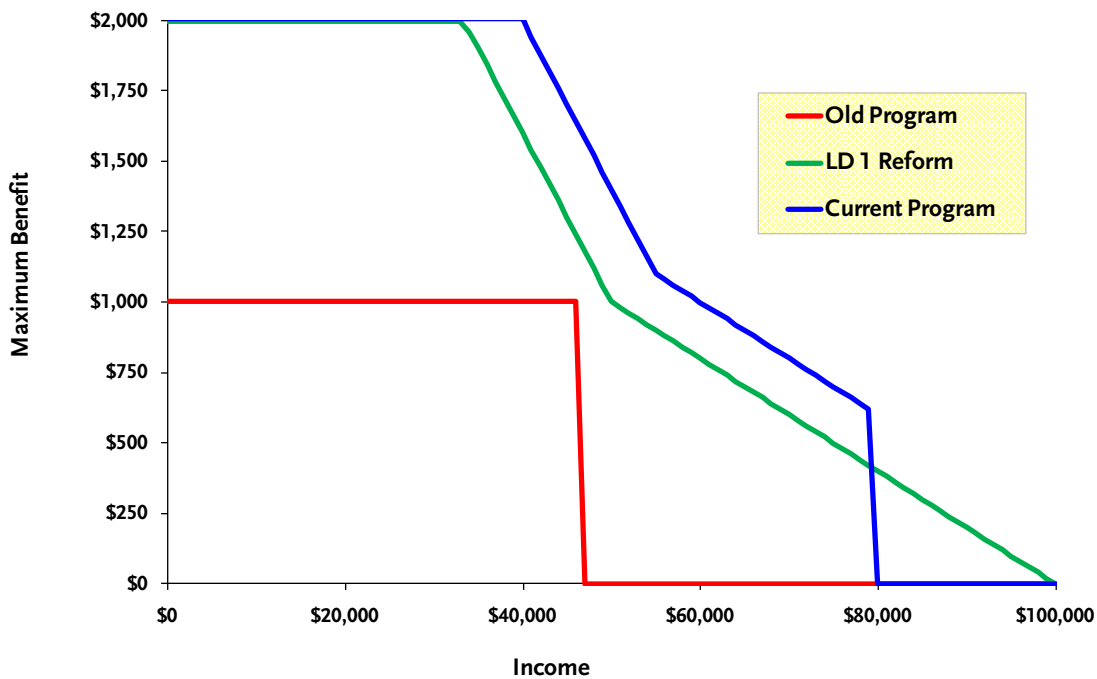
Before LD 1, households qualifying for circuit breaker benefits could have an income of no more than \$30,300 (for single-person households) or \$46,900 (for multiple-person households). LD 1 replaced these limits with a cap on the property taxes used to determine eligibility. The limit on property taxes that qualify for circuit breaker relief was set at \$3,000 for single-person households and \$4,000 for multiple-person households, adjusted for inflation. The implication of this provision is to phase out the maximum benefits of the program at higher income levels, as Figure 15 shows for multiple-person households. The red line shows the maximum benefit under the old program, with an income "cliff." The green line shows the reformed program, with its gradual phase-out of the maximum benefit.

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<sup>7</sup> Renters are also eligible for circuit breaker refunds in Maine. When calculating such benefits, renters may consider 20 percent of the amount they pay for rent in a year as their property tax component. If, for example, renters pay \$1,000 in total monthly rent, their property tax equivalent would be \$200 per month, or \$2,400 for the year. The renters would then apply the same circuit breaker formula as property owners to the \$2,400.



**Figure 15**  
**Maximum Circuit Breaker Refunds**  
**for Multiple-Person Household, by Income**



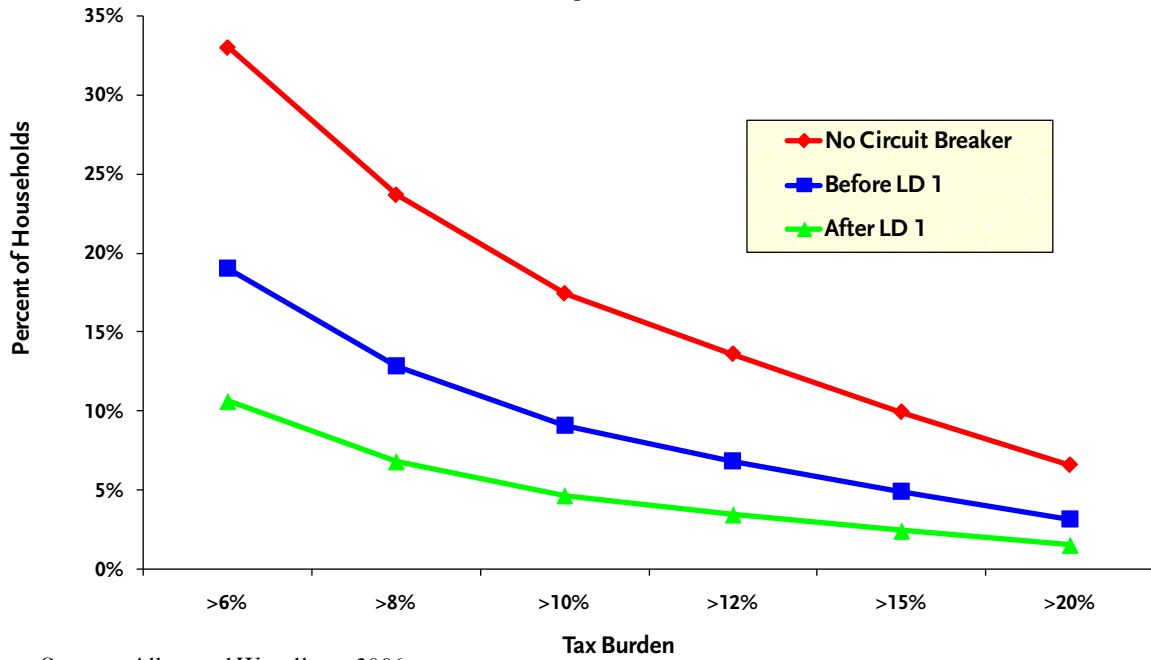
Source: Author's calculations.

In the subsequent session, to achieve modest savings in program costs, the legislature reimposed a strict income limit of \$60,000 for single-person households and \$80,000 for multiple-person households. Figure 15 shows the maximum benefits in the current program, given inflation adjustments since LD 1 and the newly reimposed income eligibility “cliff.”

Legislators in the current session again revised Maine’s circuit breaker policy in response to much greater budgetary pressures. Over the next two years of the program, circuit breaker benefits will be reduced to 80 percent of the amount that each household would be eligible to receive otherwise. (The figure does not show this latest reduction. However, it would appear as a proportional shift downward in the blue “current program” line.)

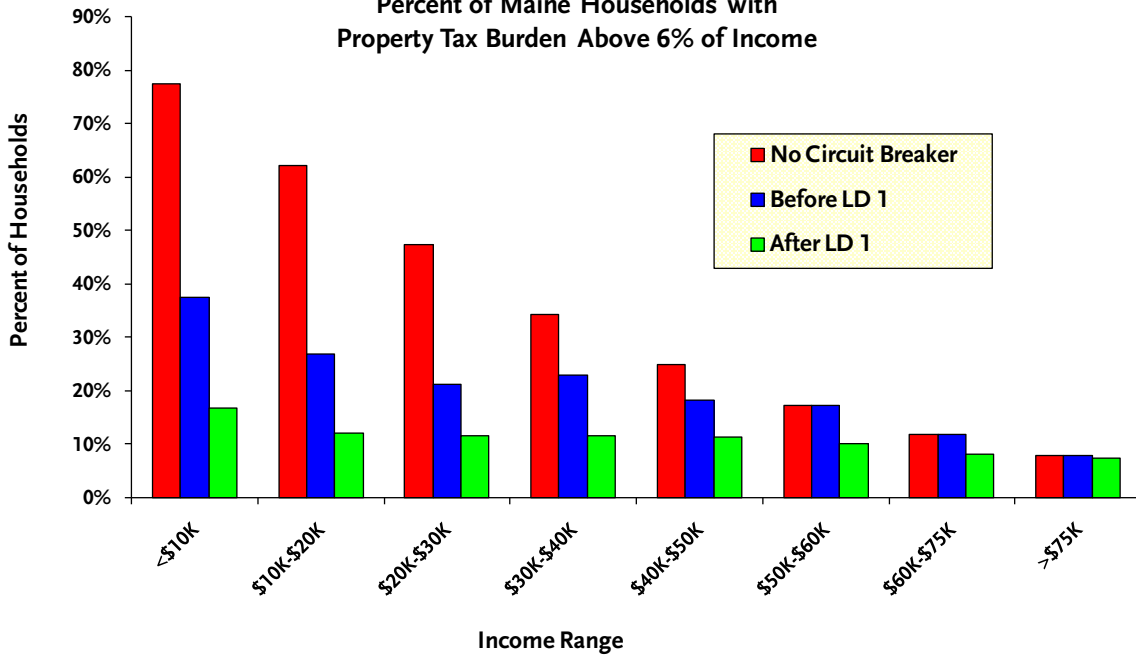
The impact of circuit breaker refunds is to reduce the *net* burden of property taxes for those whose *gross* burden is highest. My earlier work with Michael Allen shows the potential of these refunds to reduce the number of households with a high net burden of property taxes (Allen and Woodbury 2006). Our study looked at the proportion of households with a high net burden of property taxes—first without circuit breaker benefits, second based on the circuit breaker program in effect before LD 1, and third based on the reformed program after LD 1. Our study examined the program’s potential if all eligible households applied for benefits (see Figures 16 and 17).

**Figure 16**  
**Effect of Circuit Breaker on Percentage of Maine Households with High Tax Burden**



Source: Allen and Woodbury 2006.

**Figure 17**  
**Percent of Maine Households with Property Tax Burden Above 6% of Income**



Source: Allen and Woodbury 2006.

The study estimates that circuit breaker refunds can reduce the proportion of Maine households with a net tax burden of more than 6 percent of their income from 33 percent to 11 percent (Figure 16). Circuit breaker refunds can reduce the proportion of Maine households with a net property tax burden of more than 10 percent of their income from 17 percent to 5 percent. Figure 17 shows how the reduction in out-of-pocket burdens is most dramatic among households with the lowest incomes. Thus the impact of the circuit breaker is strongly related to financial means.

### Valuation for property tax purposes

The third issue is the question of what valuation base to use in determining property taxes. Maine's constitution requires that property taxes be imposed on "just value," which courts have interpreted as meaning fair market value. Revaluations are conducted periodically to account for changes in market value over time. Each revaluation has distributional consequences, however, and these reallocations of burden can be controversial. They are also one source—though certainly not the only source—of variation in out-of-pocket burden of property taxes across households.

The divergence between property tax obligations and out-of-pocket means may develop over time, and as a result of rising market values. When buyers purchase a house initially, they determine that the taxes are affordable based on their financial circumstances at the time. However, if the value of the home increases more rapidly than the household's income, the out-of-pocket burden of property taxes may increase as well. The stereotypic illustration is a retired couple, on a fixed income, living in a waterfront home they purchased decades ago for a small fraction of its market value today. Because of the rising relative market value of their property, their out-of-pocket tax burden may have grown to a substantial fraction of their income. The policy question is whether market value is still the appropriate tax base to use in these circumstances.

Some argue that municipalities should assess property taxes based on what buyers paid for a property rather than on what it is worth today. They make the case that purchase price more closely reflects homeowners' ability to pay over the long term. Thus limits on the growth of property valuation were key components of the governor's LD 2 proposal in 2005, the Palesky tax cap referendum in 2004, and other tax reform proposals. Indeed, legislators reintroduce bills with such limits every session. They have never passed, in part because they require an amendment to the state constitution, and thus a two-thirds vote of the legislature to proceed.

Both market-based property valuation and purchase-based valuation have appealing aspects, and each has passionate and engaged advocates. Controversy arises from the complex questions of fairness that arise on all sides of the issue. On the one hand, is it fair to charge property taxes on a current market value that may be many times what homeowners paid for the property originally, and many times what they could afford to pay for a home now, just because higher-income buyers moved in next door and were willing to pay more? On the other hand, is it fair to charge different property taxes on identical homes, with identical

market values, just because one household has owned property longer than another? Or further, is it fair for someone who owns a very valuable piece of property to pay less than someone in the same municipality living in a more modest home? These questions make fairness in property taxes hard to define and highly controversial.

The competing questions of fairness have tended to paralyze legislative proposals to limit property valuations in favor of more narrowly targeted circuit breaker refunds. Tax deferral programs are another approach, and have been in effect at certain times in Maine history. These programs allow homeowners to pay only the out-of-pocket costs that they can reasonably afford now, and to defer the balance (usually with interest) to whenever the property transfers ownership or the owner dies.

### Spending by local government and school districts

The fourth issue surrounding the debate on property tax reform focuses on tax burden as the product of government spending. The emphasis here is less on intergovernmental funding allocations, targeted tax relief programs, and valuation measures, and more on containing the overall cost of government. Limits on the growth of government spending such as those in LD 1, and tax caps such as the Palesky referendum, are examples of efforts to contain (or in the latter case radically cut) local government spending. These are discussed in greater detail in section F.

## **D. Reform of income and sales taxes**

The second major category of tax reform would reweight the major tax components, reducing income taxes (and/or property taxes) and making up the revenues through higher and expanded sales and excise taxes. The plans considered here are revenue-neutral. This section provides an overview of income and sales tax reform, while the next section focuses on the income and sales tax reforms just enacted in LD 1495.

### Objectives of income and sales tax reform

The rationale for tax system rebalancing is multifaceted. One goal is to make Maine's income tax more competitive with that of other states, and thus to stimulate Maine's economy. Put differently, the objective is to deemphasize taxes that discourage income generation as the fundamental driver of economic growth, by reweighting the system away from income-based taxes and toward consumption-based taxes. Reducing the potential economic disincentives associated with Maine's 8.5 percent income tax rate is often featured as a particular objective of this reform.

A second rationale is exportability. As noted, Maine attracts an abundance of non-resident visitors and vacationers, non-resident owners of second homes, and "six-month-minus-a-day" former residents. These non-residents—many of whom spend considerable time in Maine—are generally exempt from state income taxes, often reside in high-valuation regions with low property tax mil rates, and devote a large portion of their spending in Maine to purchases

that are exempt from sales taxes, including groceries, utilities, and recreational activities, such as skiing, golf, and marina services. By taxing consumption more universally and more heavily, proponents argue, the state can allocate the tax burden in rough proportion to the amount of time people spend in Maine (or the dollars they spend in Maine), rather than whether they are defined as residents or non-residents. The revenues from consumption taxes, imposed on residents and non-residents alike, can be directed to income tax relief that benefits Maine residents almost exclusively.

While the exporting of tax burden to non-residents is viewed favorably by many, and the reduced tax burden on residents likely has a positive economic impact, there are offsetting implications that need to be weighed against these benefits. Specifically, to what extent do higher taxes on non-residents discourage them from spending in Maine; and how does this negative economic impact compare with the positive impact of lower taxes on residents?

Many in the tourism industry, for example, point to the potential of tourism-related taxes (such as an increase in the lodging tax, or a new sales tax on ski lift tickets) to discourage out-of-state visitors from spending time in Maine. Many in the real estate industry make a similar case with respect to proposed increases in the real estate transfer tax. They suggest that increasing that tax may discourage purchases of second homes in Maine, or reduce the market value of existing real estate investments. There is also the potential for retaliatory taxes or trade regulations imposed by other states that feel targeted by Maine tax policy.

These arguments highlight an implicit tradeoff between the economic *benefits* of a lower tax burden on residents and the economic *costs* of lost business from non-residents. The relative weight of those two effects presumably depends on the specific proposal.

A third rationale for income and sales tax reform is greater revenue stability. Both income and sales taxes are inherently cyclical; they rise and fall more significantly than the incomes of those who pay them. The sales tax is particularly cyclical in Maine, because of its comparatively narrow base and its disproportionate reliance on automobile sales and construction materials—both highly cyclical industries. The income tax is cyclical because of its progressive rate structure, and because of the high rate at which capital gains are taxed, a source of income that is also highly cyclical. A lower top income tax rate, and a more encompassing sales tax base, would stabilize the cyclical characteristics of the tax system to some extent.

### Income tax reform: Traditional versus structural reform

Proposals for income tax reform in Maine have encompassed two distinct approaches and multiple specifics. The first approach would retain the basic structure of Maine's current income tax, which parallels the federal tax system to a significant extent. That is, the state income tax features a progressive rate structure, personal exemptions for filers and dependents, and a choice of standard or itemized deductions. The "traditional" approach to tax reform involves reducing income tax obligations within the existing framework, such as by adjusting tax rates or tax brackets.

The second approach would fundamentally change the structural foundation of the system—typically by applying a lower flat-rate tax, eliminating personal exemptions and (standard or itemized) deductions, and replacing them with a more innovative tax credit that phases out at higher income levels. LD 1495 falls in the second category: it reforms the system’s structural foundations.

The most obvious “traditional” reform is to change one or more of the tax rates in the current system, or one or more of the income thresholds at which the rates apply. It is a high priority of many, for example, to reduce the top income tax rate of 8.5 percent, and some proposals focus on that rate alone. The Speaker’s Advisory Committee, for example, proposed lowering the top rate from 8.5 to 8 percent. Others propose raising the income threshold at which the 8.5 percent tax rate applies. Still others propose to reduce all the rates, and/or raise all the tax brackets, so the gains from reduced taxes are shared more broadly across the income distribution. The legislature’s tax committee has evaluated bills proposing each of these strategies.

As one might expect, and often in conjunction with reductions in the top income tax rate, are provisions that focus on the lower end of the income distribution. For example, raising Maine’s personal exemption and standard deduction to federal levels would increase the number of households with no tax obligation. Maine’s personal exemption is \$2,850; the federal exemption is \$3,500. Maine’s standard deduction for married couples is \$9,100; the federal deduction is \$10,900. Proposals may also increase the state’s earned income tax credit (currently 15 percent of the federal amount), and/or make Maine’s EITC a refundable credit for those who would otherwise pay no tax. (The federal EITC is already a refundable credit.) Another reform included in some proposals would raise Maine’s low-income tax credit, which effectively waives income tax liability for those whose tax obligation would otherwise be small. Because Maine’s starting income tax rate is just 2 percent, the low-income tax credit can exempt tens of thousands of Maine residents from owing any income tax at all, with only modest revenue losses.

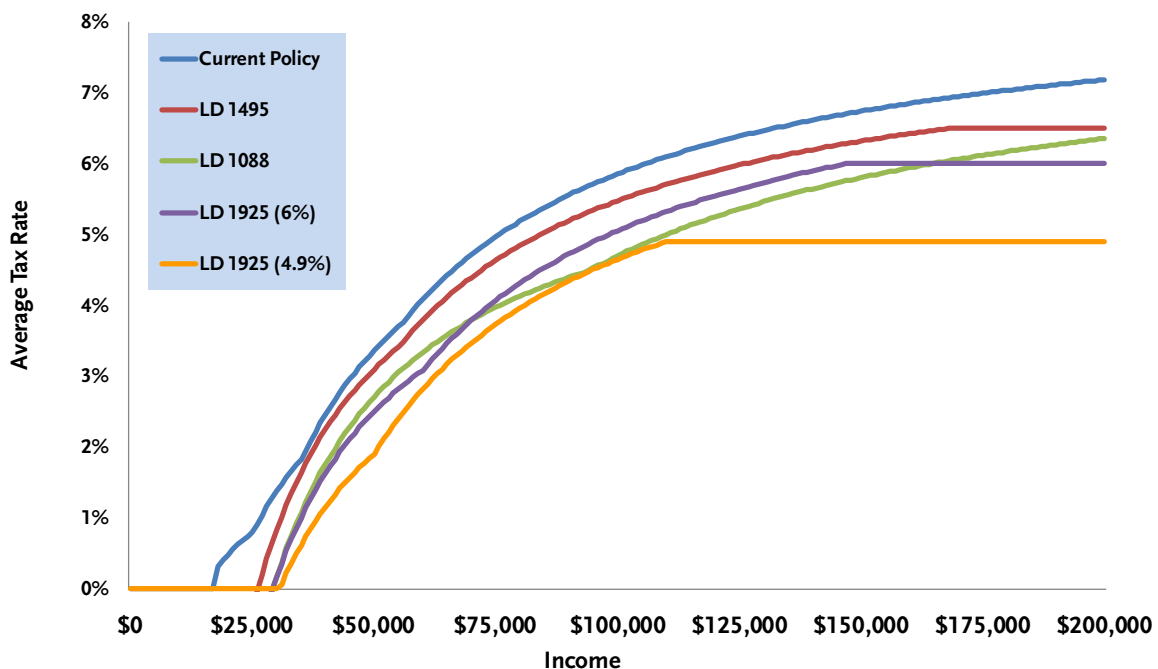
The structural approach to income tax reform involves more fundamental system change. This category of plans replaces the progressive series of tax rates with a single tax rate that is lower than today’s top rate. Personal exemptions and (standard or itemized) deductions are replaced with a progressively applied “household credit” that phases out at higher income levels. Households that qualify for the full household credit, or the partially phased out household credit, end up paying an average tax rate that is below the statutory flat rate. Thus the household credit reestablishes income-based progressivity, despite the flat rate of the tax. Higher-income households pay a pure flat-rate tax once the credit is phased out.

By choosing the flat-tax rate and calibrating the magnitude and phase-out of the household credit, one can accomplish virtually any distribution of tax burden across income groups. The level of the flat rate determines the highest average tax rate that any taxpayer will pay in the reformed system. The design and calibration of the household credit determines the distribution of reduced tax burden below the flat rate.

More aggressive reform proposals might set the flat income tax rate as low as 4 percent. While a low rate is appealing to many, such proposals require more extensive revenue replacement from other sources. Both increases in sales and excise tax rates and larger expansions of the sales tax base are usually required to achieve revenue neutrality from a very low-rate income tax. For example, the legislature peripherally considered a 4.9 percent flat-rate system in 2007 (as a floor amendment to LD 1925). That amendment would have increased the general sales tax rate from 5 to 6 percent, on top of the other sales and excise tax increases already in the LD 1925 proposal.

Each of the other structural reform proposals considered by the legislature—the core version of LD 1925 (in 2007), LD 1088 (the original tax reform bill considered in 2009, before lawmakers incorporated revisions from the governor), and LD 1495 (as finally enacted in 2009)—use a higher flat rate of 6 or 6.5 percent (rising to 6.85 percent for high-income taxpayers in LD 1495).

**Figure 18**  
**Impact of Alternative Versions of Income Tax Reform in Maine**  
**on a Couple Currently Using Standard Deduction**



Source: Author's Calculations.

Figure 18 shows how different levels of the flat rate, and different calibrations of the household credit, influence the distributional impact of reform. The figure shows the average taxes paid by income for a couple with income from non-exempt sources, and using the current standard deduction or the standard credit in the reform plans. The figure shows

five tax plan configurations: (1) current law; (2) LD 1495 as enacted in 2009; (3) LD 1088 as originally introduced earlier this year;<sup>8</sup> (4) the primary version of LD 1925 with a 6 percent flat rate, considered in 2007; and (5) the alternative 4.9 percent flat-rate version of LD 1925.

The different plans illustrate both the varying distribution of tax burden across systems and the differences in the “aggressiveness” of the reforms. As noted, the gradual whittling down of sales tax expansions in LD 1495, as enacted, means it is somewhat less aggressive in reducing income taxes overall.<sup>9</sup>

Note that each of the plans retains some degree of income-based progressivity. Higher-income households continue to pay a higher percentage of their income in taxes than lower-income households, even under a single-rate system. The figure also shows how, at very high incomes, after the credit has been fully phased out, the system works literally as a flat tax.

For example, in the 4.9 percent plan, all standard-credit couples with income above \$110,000 would pay the flat 4.9 percent income tax on all their income. In the 6 percent plan, all standard-credit couples with income above \$148,000 would pay the flat 6 percent income tax on all their income. An interesting difference in the calibration of LD 1088 (as introduced) is that it phases out the credit more gradually and at higher income levels, so a couple does not reach the pure flat-tax level until earning about \$220,000. Under LD 1495, as enacted, a couple using the standard credit would have a flat 6.5 percent tax at incomes between \$168,000 and \$250,000, and would be subject to the additional 0.35 percent surtax on income over \$250,000.

A reformed system may also include two other features related to the household credit. One would make the household credit partially refundable at lower income levels. This may be done, for example, to offset the more regressive distribution of burden from sales and property taxes in Maine, or to compensate low-income households for sales tax increases.

The other feature is to offer households a choice between a “standard” and an “alternate” credit amount, paralleling the choice between the standard and itemized deductions under current law. The formula for the alternate credit, for example, might allow the household’s credit to reflect a certain percentage of its itemized deductions (adjusted for state purposes). By allowing an alternate credit, some of the incremental tax advantages now available in the income tax code can be transferred to the structurally reformed system. This will become clearer when I describe the specific “alternate” credit enacted in LD 1495 (see section E).

What are the relative merits of the traditional progressive rate structure versus the more innovative flat tax with a progressive credit? One clear difference is the visibility of the top

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<sup>8</sup>The version of LD 1088 analyzed here is as it was first introduced, correcting for drafting errors in the bill’s original language. That version is not the one the legislature passed before the governor offered his final modifications in LD 1495.

<sup>9</sup> Figure 18 does not show the refundable aspect of the tax credits that several of the plans provide to lower-income households. Later figures in this paper will clarify those provisions.



*published* tax rate. In the current system, for example, the top tax rate of 8.5 percent is a highly visible component feature of Maine's system, and likely deters some individuals and businesses from locating in Maine. An important insight in designing the flat-rate alternative systems is that nobody actually pays a full 8.5 percent of their income in taxes, after accounting for personal exemptions, standard or itemized deductions, and the portions of income that are taxed at 2, 4.5, and 7 percent. A four-person family with income of \$200,000 and itemized deductions of \$30,000, for example, now pays about \$12,167, or 6.1 percent of its income, in Maine income taxes. The family's average tax rate of 6.1 percent is much lower than its marginal tax rate of 8.5 percent. A flat tax with a phased-out credit allows the published top tax rate in Maine to reflect the highest *average* rate, rather than the highest *marginal* rate. It lowers the top published rate associated with the income tax system.

The extent to which economic activity is driven primarily by the *published* tax rate, the *average* tax rate, or the *marginal* tax rate is a subject for another study. A case could be made that each is important. The *published* rate gets the most publicity, so if people are driven by the publicity, a lower published rate may in itself serve as an economic stimulus. Economic theory generally focuses on the *marginal* rate—the amount of additional tax people must pay on an additional dollar of income earned. Higher marginal rates are thought to be disincentives to income generation. The highest marginal rate paid in these structurally reformed systems is the rate paid by those whose household credit is being phased out. They are subject to a marginal tax rate that is the sum of the statutory flat rate and the credit phase-out rate; it is higher than the published rate.<sup>10</sup> The *average* tax rate may be most important, however, if people are making location decisions between one state and another. For these decisions, it is the total tax that matters, and this is reflected in the *average* rate.

The primary advantage of the structurally reformed approach to tax reform, as compared with reforming the traditional tax structure, is that the former allows a lower published rate, and, in all likelihood, a lower marginal rate on the highest-income taxpayers. To the extent that tax reform reduces total income taxes, all three rates may be lowered using either a traditional or structural approach. (Additional discussion of how LD 1495 changes these various tax rates is provided in section E.)

Some might make the case that structurally reformed flat-rate systems have greater simplicity as well. That seems less obvious, once one reintroduces complexity in the form of the household credit. Indeed aspects of the household credit may add complexity, such as the need to apply for the refundable credit, calculate the standard versus the alternate credit amounts, and determine the credit phase-out. Even the apparently flat statutory tax rate has a marginal rate that varies with income, because of the implicit tax associated with the credit phase-out. Greater simplicity may come into play for very high-income taxpayers, who are not eligible for the credit and who do pay a simple flat-rate tax. However, for most taxpayers, the structurally reformed approach seems at least as complicated as the traditional approach.

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<sup>10</sup> Under LD 1495, for example, households in the phase-out range have an effective marginal tax rate of 8 percent, including the direct 6.5 percent incremental tax and the indirect 1.5 percent credit reduction. More detail on how marginal tax rates vary by income under LD 1495 is provided in section E.

## Sales and excise tax reform

Sales and excise tax reform is the other side of these revenue-neutral tax-rebalancing proposals. There are four main reasons for proposals to reform sales and excise taxes, three of which I have introduced already. One is to raise revenues to offset losses from income and/or property tax reductions. The second is to stabilize revenues from the sales tax across macroeconomic cycles. The third is to increase the exportability of tax burden to non-residents, who may be more likely to pay sales and excise taxes than other forms of taxation. The fourth—a component of some proposals—is to promote public health by taxing more heavily products (such as cigarettes) that may be detrimental to health. Sales and excise tax reform proposals can be evaluated along each of these dimensions.

The simplest reform is to raise one or more sales tax rate. For example, there have been proposals to raise the general sales tax rate from 5 to 6 or even 7 percent. There have been proposals to raise the meals and/or lodging tax from 7 to 8, 9, 10 percent, or more. There have been proposals to raise the sales tax rate on rental cars from 10 to 15 percent or more. There have been proposals to raise the real estate transfer tax from 0.44 percent to 1 percent or more, and/or to apply a higher tax rate to higher-value real estate sales.

Each of these reforms would provide additional revenues, and could, at least to some degree, increase the exportability of the tax burden. For example, rental cars, lodging, and restaurant meals, while purchased by residents too, have a comparatively higher purchase rate by non-residents compared with other sales categories. But even the general sales tax, which is imposed on residents and non-residents in proportion to their purchases in Maine, can effectively export burden, if the counterbalancing relief funded by those taxes is targeted toward residents only. Higher sales tax rates would be unlikely to reduce the volatility of revenues.

The policy justification for broadening the sales tax base to purchases not now subject to the tax may be even stronger. Expansions in the sales tax base not only raise revenues and increase the potential exportability of the tax system; they may also decrease the volatility of revenues across macroeconomic cycles.

Different considerations—both economic and political—are relevant to each category of potential expansion in the sales tax base. For example, proposals generally exclude inputs to production because of the potential pyramiding of the tax, if both the inputs and the final products are taxed independently. Proposals also often exclude professional services (such as those of lawyers, accountants, architects, and financial advisors), because of the potential mobility of professionals across state borders. Necessities (including grocery staples and heating fuels) are often excluded because of their potential regressivity: they create a greater burden for lower-income households than for higher-income households. Certain categories of business purchases may be excluded (or at least limited), because of their potential to discourage business activity in the state—undermining a key goal of tax reform in the first place. The Speaker's Committee recommended including sales to some nonprofit organizations, but that idea has also proved controversial.

Proposals more often include services that are more consumer-targeted. Examples are amusement, entertainment, and recreational services such as golf, skiing, movies, amusement parks, and concert tickets; installation, repair, and maintenance services for cars, computers, lawn mowers, appliances, furniture, and clothing; personal property services such as dry cleaning, car washing, pet grooming, house and rug cleaning, picture framing, interior decorating, storage, moving, towing, and boat mooring; personal care services such as hair cutting, beauty salons, and massage; and real property services, such as lawn care, plowing, electrical work, and plumbing. Some but not all of these categories were part of the reforms enacted in LD 1495.

Proposals for excise tax reform have included raising the cigarette tax from \$2.00 per pack to \$3.00 per pack, the tax on beer and hard cider from \$0.35 to \$0.60 per gallon, the tax on wine from \$0.60 to \$0.90 per gallon, and the tax on sparkling wine and low-alcohol spirits from \$1.24 to \$2.24 per gallon. Proposals have also been made to create a new excise tax on soda. Health promotion is often used as additional justification for these components of reform.

### Distributional implications

All proposals for reforming income and sales taxes advanced over the study period have some kind of distributional implication. The income tax components generally *lower* the taxes paid by some, most, or all Maine resident households. The sales and excise tax components generally *raise* taxes paid by some, most, or all Maine households. Thus for any individual household, total tax burden could increase or decrease.

For example, if policymakers raised sales taxes across-the-board but lowered only the top income tax rate, this would impose a new burden on all households, while offsetting gains would accrue only to those paying the highest rate. Thus the reform would redistribute resources from lower-income to higher-income households, relative to the current tax system. While there may be reasons to do that, the distributional implications of tax reform have always been central to the discussion and the controversy.

Distributional effects were a fundamental consideration in calibrating LD 1495 and its predecessor proposals. One goal was to retain at least as much progressivity of tax burden across income groups as exists in current law. Another was to minimize the number of “losers” under the reformed system. Some of the detailed quantitative work used to achieve those goals is described in section E.

Another dimension on which to evaluate distribution is between resident and non-resident taxpayers. Many of the proposals for income and sales tax reform would raise taxes on sales that affect both residents and non-residents, while targeting the gains from reform to reducing taxes on residents only. Thus there is potential for across-the-board gains for Maine residents, through an increased exporting of tax burden to non-residents.

Each of the major tax reform proposals of the last several years has clearly emphasized that goal. Indeed, LD 1925 in 2007 was explicitly entitled An Act to Cut Taxes on Maine Residents by over \$140,000,000. The pared-down version of tax reform introduced as LD 1088 in 2009 was entitled An Act to Modernize the Tax Laws and Provide over \$75,000,000 to Residents of the State in Tax Relief. Maine Revenue Services estimated that the further pared-down tax reform bill enacted as LD 1495 would reduce the tax burden on Maine residents by about \$50 million. In each case, by exporting more of the burden to non-residents, the gains from reform could be distributed more broadly across a larger share of resident taxpayers.

This section has focused on income and sales tax reform proposals generally. I turn now to a specific income and sales tax reform: the recently enacted LD 1495. How will it work, if it is implemented? What does it do?

## **E. Details and analysis of LD 1495**

LD 1495 is widely viewed as the most significant tax reform legislation of the past four decades. As noted in the introduction, and as suggested in the previous section, LD 1495 purports to lower Maine's income taxes, stabilize revenue volatility, increase economic competitiveness, and reduce the burden on resident taxpayers while maintaining revenues.

### How the new income tax works

LD 1495 replaces the series of increasing tax rates with a flat-rate income tax of 6.5 percent on income up to \$250,000, rising to 6.85 percent on the portion above \$250,000. The law replaces personal exemptions and (standard or itemized) deductions with a progressively applied household credit that phases out at higher income levels. Residents can claim either the standard credit or an alternate credit, paralleling their choice between standard and itemized deductions under the current tax system. The standard credit is \$700 for individual filers, \$1,050 for heads of household, and \$1,200 for married couples. The credit rises by \$250 for each personal exemption claimed under the current tax code.

An example may be helpful. Consider a married couple with two children and adjusted gross income of \$40,000. The flat tax, before the credit is applied, would be \$2,600 (6.5 percent of \$40,000). But this family's standard household credit is \$1,200, plus \$1,000 for the four personal exemptions claimed on the federal return. That leaves the family with a net tax obligation of \$400. (Under current law, this family would owe \$606.)

This simple example becomes more complicated for taxpayers with significant itemized deductions, higher incomes, or very low incomes. These situations may require four additional calculations. The first involves the alternate household credit. Taxpayers with itemized deductions may calculate an alternative household credit based on their federal itemized deductions, adjusted for state purposes. The alternate credit is the sum of three components: (a) 5.5 percent of itemized deductions, as adjusted; (b) \$400 for single filers, \$600 for heads of households, or \$800 for joint filers; and (c) the same \$250 for each

exemption claimed in the current tax code. The *maximum* allowed for parts (a) and (b) combined is \$1,150 for individuals, \$1,750 for heads of household, and \$2,300 for joint filers.

The second calculation is the phase-out of the household credit. The credit is reduced by 1.5 percent of the amount by which income exceeds \$27,500 for individual filers, \$41,250 for heads of household, or \$55,000 for married couples.

The third additional calculation required in certain circumstances is the tax surcharge on any portion of income that exceeds \$250,000. Filers pay an additional 0.35 percent tax on this income, on top of the 6.5 percent already accounted for in the baseline flat-rate formula. Thus the highest statutory rate in the new tax system is 6.85 percent, although this rate applies only to highest-income taxpayers in Maine.

A final characteristic of LD 1495 is that the household credit is refundable up to \$50 for individual filers (or heads of households) and up to \$70 for joint filers. This means that most resident households that owe no taxes now could apply for this \$50 or \$70 refundable payment under the reformed system. The rationale is to share the gains from reform with those who now pay no income tax, and to offset any increases in sales and excise taxes that lower-income households might pay as a result of other reform provisions of the law.<sup>11</sup> Table 4 summarizes the calculation of the household credit.

Table 4 Calculation of Household Credit in LD 1495		
Minimum Credit	Alternate Credit	Maximum Credit
Single filer: \$700 Household head: \$1,050 Joint filer: \$1,200	Single: \$400 plus 5.5% of itemized ded. HH: \$600 plus 5.5% of itemized ded. Joint: \$800 plus 5.5% of itemized ded.	Single: \$1,150 HH: \$1,750 Joint: \$2,300
Add to the amounts above \$250 for each personal exemption claimed.		
Then subtract from the total 1.5 percent of the amount by which income exceeds: \$27,500 for single filers \$41,250 for heads of households \$55,000 for joint filers		

<sup>11</sup> The act also includes a new credit of \$60 for taxpayers 65 years of age or older. That credit also phases out at higher income levels, although on a different schedule and at a different rate than the household credit. The act also makes the state's EITC partially refundable up to \$150 for married couples filing jointly, and up to \$125 for other filing categories.

Unlike deductions under the current tax system, the household credit may be fully phased out at higher income levels, restoring to some degree the basic simplicity of the flat-rate tax. For single filers with no dependents, for example, the standard credit is fully phased out at incomes above about \$91,000. For a family of four that qualifies for the maximum alternate credit, the phase-out continues up to an income of \$275,000.

The maximum credit also acts as a limit on the incremental value of expenses that now qualify as itemized deductions. The implicit limit on the incremental value of itemized deductions under the reformed system is \$13,636 for single filers, \$20,909 for heads of households, and \$27,273 for joint filers. Additional mortgage interest payments, local property tax payments, charitable contributions, high medical expenses, and other currently deductible expenses would have no incremental value in reducing taxes, if these levels have already been exceeded. As shown in greater detail below, this is an important factor in assessing the distributional implications of the reform.<sup>12</sup>

As another illustration of the system's mathematics, consider a four-person family with income of \$90,000, and \$20,000 in itemized deductions. The family's tax before credits would be \$5,850 (6.5 percent of \$90,000). The family would determine its credit by multiplying its itemized deductions by 5.5 percent (\$1,100), and adding the baseline amount of \$800 and another \$1,000 for the four people claimed as exemptions. Thus the credit, before the phase-out, would be \$2,900. Because the household's income is \$35,000 more than the level at which the credit begins to phase out, the credit is reduced by \$525, or 1.5 percent of the \$35,000. That leaves the household with a remaining credit of \$2,375, and a net tax of \$3,475. (Under current law, the family's tax would be \$3,618.)

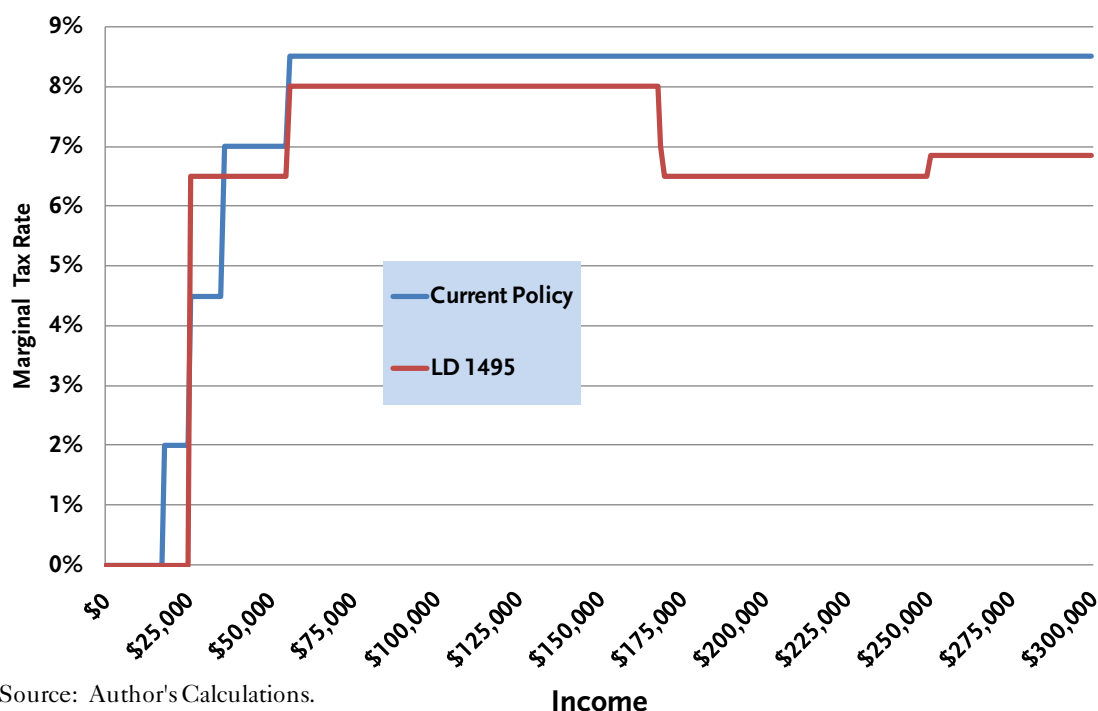
The labeling of Maine's new income tax system as a "flat tax" can be misleading, for two reasons. The first is the extensive progressivity in the average tax burden reintroduced by the household credit formula. Most households continue to have a tax obligation that is substantially less than the flat 6.5 percent rate implies.

The second reason is the hidden marginal tax rate associated with the credit phase-out. If a household's income is within the phase-out range, then its marginal tax rate includes both the 6.5 percent statutory tax rate and an implicit 1.5 percent tax in the form of a credit reduction. The marginal tax rate on incremental income earned by households in the phase-out range is 8 percent, not 6.5 percent. For most households, the new marginal tax rate is still lower than what they pay today. Figure 19 shows how the pattern of marginal tax rates by income differs between current law and the LD 1495 reforms. The illustration is based on a married couple filing jointly, and using the standard deduction under current law or the standard credit under the reformed system.

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<sup>12</sup> Interestingly, the legislation reintroduces an incremental tax credit for charitable deductions above \$250,000 in a year. That means that deductions up to the effective itemization limits are tax-advantaged, and that charitable deductions above \$250,000 are tax-advantaged, but that incremental contributions within a very large range are not tax-advantaged.

**Figure 19**  
**Marginal Tax Rate by Income,**  
**for Couples Currently using Standard Deduction**



Source: Author's Calculations.

The new system actually has five tiers of marginal tax rate. At low incomes, households are eligible for the \$50 or \$70 refundable credit, and additional dollars earned do nothing to reduce the refund. The marginal tax rate is zero. The marginal tax rate rises to the “flat” 6.5 percent statutory rate, once the household gains enough income to owe any tax. The household continues to qualify for the full household credit, but each incremental dollar earned raises their tax obligation by the 6.5 percent statutory tax rate. When income reaches a level at which the credit begins to phase out, then each dollar earned increases the tax obligation by 8 percent—the sum of the 6.5 percent tax rate and the 1.5 percent phase-out rate. Once the credit is fully phased out, the marginal tax rate falls back again to the 6.5 percent statutory rate. Finally, at incomes above \$250,000, the marginal tax rate rises again to reflect the 0.35 percent tax surcharge.

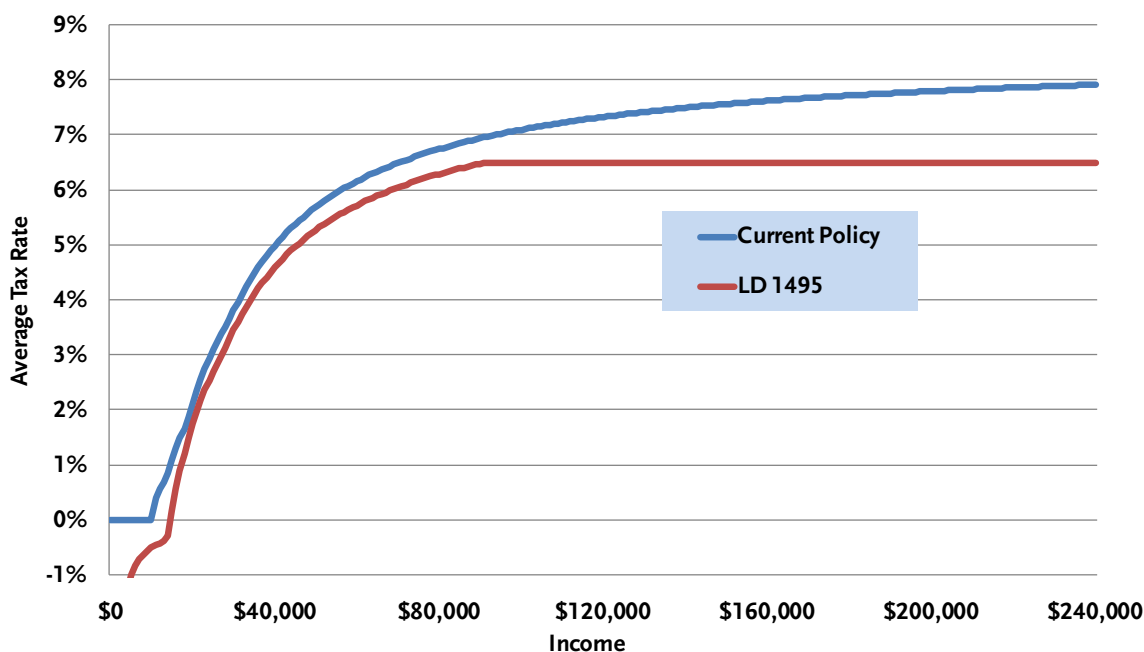
The extent to which economic activity is driven primarily by the published top rate (8.5 percent now versus 6.5 or 6.85 percent under the reformed system), the marginal rate of the highest-income taxpayers (8.5 percent now versus 6.85 percent under the reform), the highest effective marginal rate (8.5 percent now versus 8 percent), the marginal rate that applies to the specific taxpayer (which may be higher for taxpayers in rare circumstances, but is generally lower), or the average tax rate (which is lower for an estimated 95 percent of Maine households) is a subject for another study.

## Effects on income taxes owed

The credit structure can be calibrated to mirror to a significant degree the distribution of taxes under the current system, offering reductions in income tax across the full income distribution. In the particular calibration of LD 1495, most—but not all—taxpayers see a reduction in their income tax obligation.

Figures 20 through 25 illustrate the impact of LD 1495 on taxpayers in different circumstances. The first three figures show the effect on taxpayers who use the *standard* deduction now, and would apply for the *standard* credit under the reformed system. These figures show the average tax obligation by income for individuals, married couples, and four-person families, respectively.

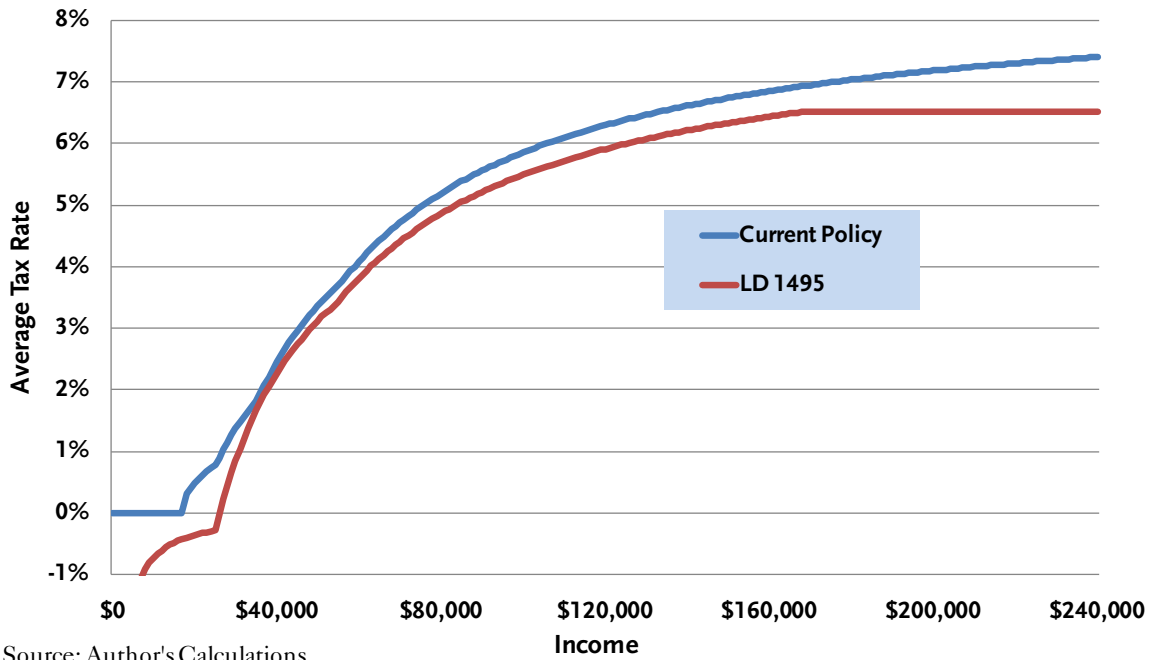
**Figure 20**  
**Impact of Tax Reform by Income,**  
**for Individual Taxpayer Currently using Standard Deduction**



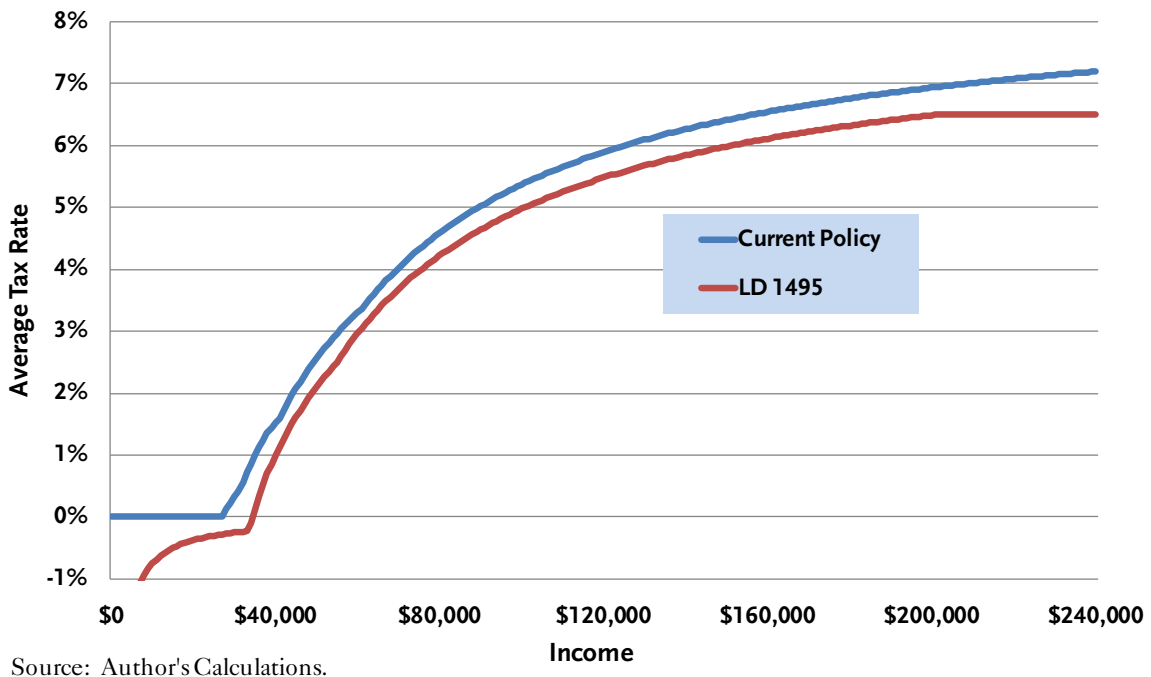
Source: Author's Calculations.



**Figure 21**  
**Impact of Tax Reform by Income,**  
**for Married Couple Currently using Standard Deduction**



**Figure 22**  
**Impact of Tax Reform by Income,**  
**for Four-Person Family Currently using Standard Deduction**

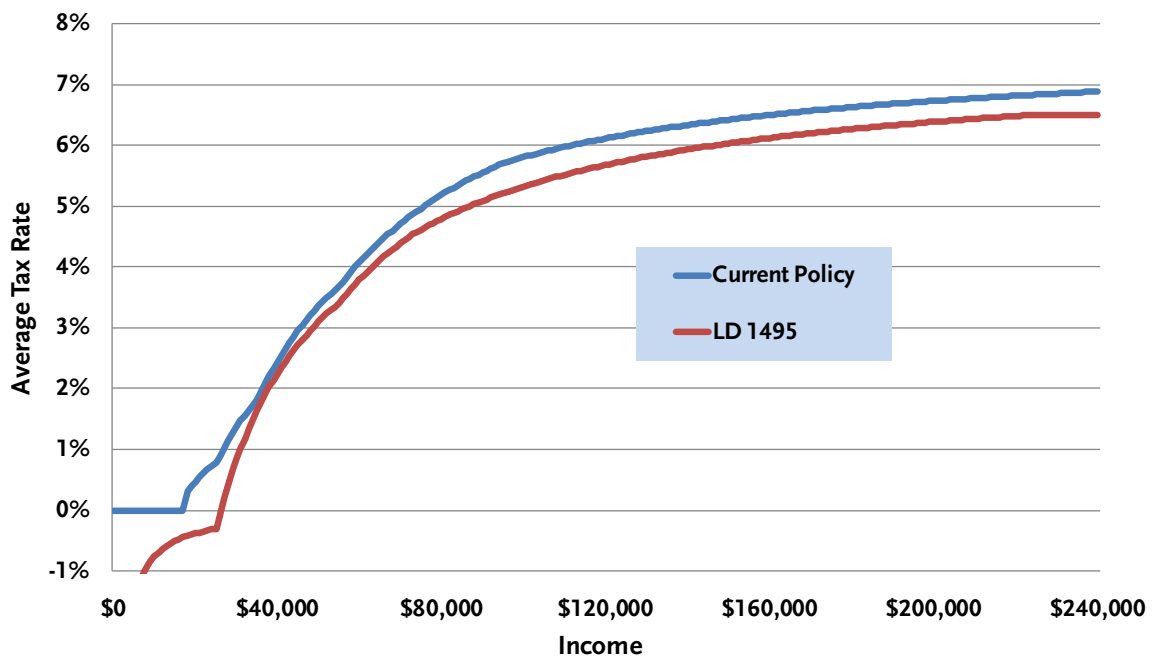


These figures clarify several aspects of the reform. First, as noted, the reformed structure retains the broad progressivity of the current tax system, with average tax rates rising throughout the income ranges in the figures. Second, the gains from reform (or the reductions in tax burden associated with reform) are distributed across all income categories. Third, the “negative” tax rates paid by those with the lowest incomes are a result of the \$50 or \$70 refundable credit. Fourth, there is a slight kink upward in the tax burden trend at the income levels where the credit begins to phase out—this is where the effective marginal tax rate rises to 8 percent. And fifth, the tax burden flattens at 6.5 percent, once the credit is fully phased out. (It would begin to rise again at \$250,000, which the figures do not show.)

Among households using the standard deduction now, these illustrations show a reduction in taxes paid across the full income distribution. Individual taxpayers, married couples, and families all appear to have a reduced burden of income taxes, regardless of their income, if they use only the standard deduction under the current system.

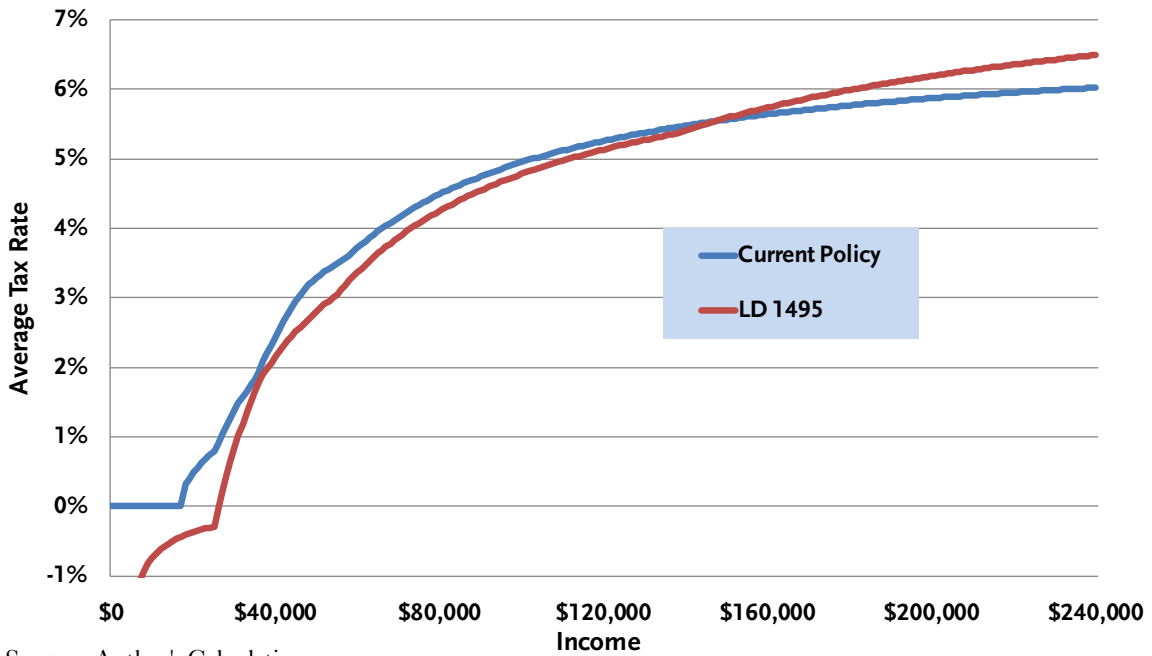
Figures 23 through 25 focus on households that are more likely to apply the *alternate* credit. The illustrations are based on married couples with expenses that would qualify for itemization amounting to 10, 20, and 30 percent of their total incomes. Except at lower incomes, these couples would generally use *itemized* deductions now and the *alternate* credit in the reformed system. While most of these households still see a reduction in income taxes, the new structure tends to increase taxes on households with the highest itemized deductions. This is a natural corollary to the maximum limit on the alternate credit.

**Figure 23**  
**Impact of Tax Reform by Income,**  
**for Married Couple with Itemized Deductions at 10 percent of Income**



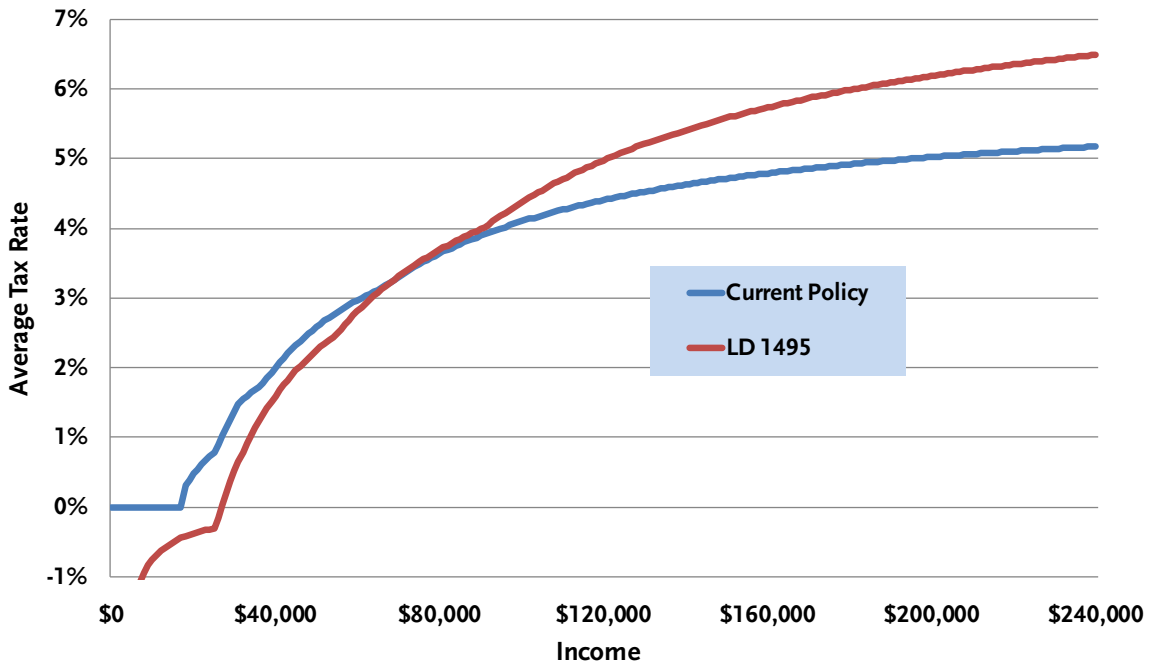
Source: Author's Calculations.

**Figure 24**  
**Impact of Tax Reform by Income,**  
**for Married Couple with Itemized Deductions at 20% of Income**



Source: Author's Calculations.

**Figure 25**  
**Impact of Tax Reform by Income,**  
**for Married Couple with Itemized Deductions at 30% of Income**



Source: Author's Calculations.

The potential for some households to see their income taxes increase under the reformed system is most clearly seen in the last illustration, for households with itemized deductions amounting to 30 percent of income. Because the alternate credit is capped, there is an implicit limit on the amount of itemized deductions that “count” under the reformed system. That limit is \$13,636 for single filers, \$20,909 for heads of households, and \$27,273 for joint filers. Incremental itemized deductions are also irrelevant to the new tax calculation, if income is at a level where the household credit is already fully phased out. The distributional implication is that very high itemizers today may pay more tax under the reformed structure.

Whether the tax increase for high itemizers was a deliberate policy objective, a calibration error in the new formula, or a cost-reducing necessity to achieve revenue neutrality is unclear from the legislative history. There are reasons to believe that the redistribution was deliberate: that the enormous tax advantages extended to high itemizers under the current tax code is something that policymakers do not want to continue under a structurally reformed system.

For example, if one looks at two identical households with \$150,000 incomes, do we want to give additional tax breaks to the household that chooses a more expensive house with a more expensive mortgage? Or do we think there should be a limit on these types of tax-advantaged expenses? These are questions that may or may not have entered the policy debate but that are reflected in the policy outcome. That a broader tax base and lower tax rate typically create less economic distortion and welfare loss is also a central tenet of the economics of taxation. So there may be “efficiency” arguments for removing the more extreme tax advantages of the current system as well. Still, high itemizers are the apparent “losers” under the system’s redistribution of tax burden.

### Sales taxes in LD 1495

As described in the chronological overview in section B, the loss in income tax revenue under LD 1495 is offset by an increase in the meals and lodging tax from 7 to 8.5 percent, an increase in the tax on rental cars from 10 to 12.5 percent, a tax on candy at 8.5 percent, and an expansion of the sales tax base to four new categories of services. These include (1) “amusement, entertainment and recreation services,” including movies, concerts, festivals, amusement parks, sporting events, miniature golf, go-carting, exhibition shows, sight-seeing excursions, whitewater rafting, and the hiring of entertainers; (2) “installation, repair or maintenance services” for jewelry, cameras, guns, musical instruments, electronic and mechanical equipment, lawn and garden equipment, computer hardware and office equipment, appliances, clothes, shoes and furniture, as well as auto repair services; (3) “personal property services,” including dry cleaning, laundry and diaper services, embroidery and monogramming, car washing, pet grooming, picture framing, house cleaning, furniture and rug cleaning, interior decorating, warehousing and storage, moving, towing, and boat mooring; and (4) “transportation and courier services” for the in-state transport of persons or property by limousine or courier.

While significant, the list of sales tax base expansions is narrowed down substantially from earlier tax reform proposals. Of the \$87 million in additional sales tax revenues projected for fiscal year 2011, \$37 million comes from the increased meals and lodging tax, \$3.7 million comes from the tax on candy, \$1.3 million comes from the tax on rental cars, and the remaining \$45 million comes from expansions of the sales tax base.

### Impact on revenues and total tax burden

LD 1495 was designed to be approximately revenue neutral while exporting more of the tax burden to non-residents. I look at both effects here.

The first is straightforward. All legislation in Maine is accompanied by a “fiscal note” estimating the budgetary impact. Table 5 summarizes the total projected budgetary effect of LD 1495, as estimated in the official fiscal note. Because of the implementation timing in the act’s various provisions, the cost-of-living adjustment schedules in the formula parameters, and seasonal variations in sales and income tax collections, the act is not precisely revenue neutral in each fiscal year. However, it is roughly revenue neutral over the combined four-year period of the budgetary projection. Approximately \$90 million in reduced income tax revenue annually is offset by about \$90 million in increased sales tax revenues annually.

	FY 2010	FY 2011	FY 2012	FY 2013
Total Revenues				
-- Income Tax	(\$34.5)	(\$88.9)	(\$92.2)	(\$84.8)
-- Sales Tax	\$42.8	\$86.7	\$90.1	\$94.4
	\$8.3	(\$2.3)	(\$2.1)	\$9.6
Net General Fund Impact				
-- Allocation to Local Gov't	(\$0.4)	\$0.1	\$0.1	(\$0.5)
-- Allocation to Tourism Fund	\$0.0	(\$2.9)	(\$4.3)	(\$4.3)
-- New Administrative Costs	(\$0.5)	(\$1.5)	(\$1.0)	(\$1.0)
	\$7.4	(\$6.5)	(\$7.3)	\$3.7

Source: Maine Legislature, "Fiscal note" for LD 1495.

Maine Revenue Services conducted a separate analysis of the estimated impact on residents versus non-residents, independent of the timing issues. The agency attempted to analyze the effect of the bill’s provisions in a 12-month year, assuming full implementation of all

reform provisions over that period. Table 6 summarizes these computations. The numbers are not precisely reconcilable with those in Table 5, because they abstract from the budgetary timing issues incorporated in Table 5.

	Residents	Non-Resident	Unknown	Total
<b>Income Tax Reform</b>				
-- Reduction in Taxes Paid	-\$96.21	\$15.32	\$0.00	-\$80.89
-- Refundable Credits (Full Eligibility)	-\$15.54	\$0.00	\$0.00	-\$15.54
-- Refundable Credits (Unclaimed)	\$5.68	\$0.00	\$0.00	\$5.68
	-\$106.07	\$15.32	\$0.00	-\$90.75
<b>Sales Tax Reform</b>				
-- Taxes included in MRS Model	\$57.85	\$27.95	\$0.00	\$85.80
-- Taxes excluded from MRS Model	\$0.00	\$0.00	\$0.63	\$0.63
	\$57.85	\$27.95	\$0.63	\$86.43
<b>Net Budgetary Impact</b>	-\$48.22	\$43.27	\$0.63	-\$4.32
Source: Maine Revenue Services.				

The estimates in Table 6 suggest a modest reduction in overall tax revenues, broadly similar in magnitude to the lost revenues projected for fiscal year 2011 and fiscal year 2012 in Table 5. However, the tax burden on Maine residents is estimated to decline by \$48 million, while the tax burden on non-residents increases by \$43 million. These effects stem from two key components. First, \$28 million of the \$86 million in new sales tax revenues is estimated to come from non-residents. Second, the income taxes of non-residents actually rise under the reform package, rather than decline. The reason for this second effect is that only residents can claim the household credit. Thus the income tax reforms are projected to lower resident income taxes by \$106 million, but *increase* non-resident income taxes by \$15 million.<sup>13</sup>

### System calibration

Maine Revenue Services conducted substantial analytical work to inform and calibrate the tax reform provisions eventually enacted as LD 1495. A sampling of that work is provided here. For each incremental iteration in the tax committee's development of the reform

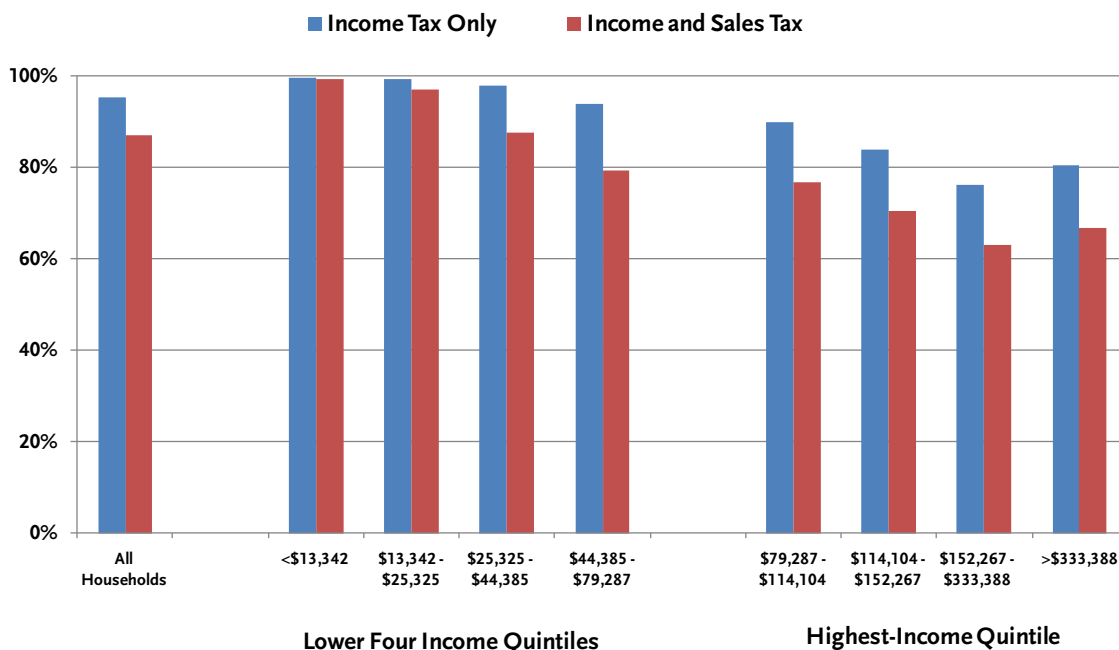
<sup>13</sup> Questions have been raised, at least informally, about the legality under federal law of limiting such a large-scale tax credit to residents only. Because resident-only eligibility is a major piece of the exportability of the burden under the reform structure, its legality may warrant more in-depth investigation as the reform provisions are implemented.

package, Maine Revenue Services analyzed the tax implications by income decile, based on estimations from the agency’s tax simulation model. Each report listed the changes in taxes paid by households in each income decile, the number of households whose taxes increased and decreased, respectively, and the average magnitude of the tax changes. For the income tax changes in particular, the model relied on data from the actual tax returns of Maine filers. The computations were made separately for the income and sales tax reforms and then integrated, to determine their combined impact.

Figure 26 shows the percentage of households in each income quintile that experience a reduction in income tax (the blue bars), and the percentage that experience a reduction in the combined burden of income and sales taxes (the red bars). Across all resident households, 95 percent are estimated to see a reduction in their income tax liability, and 87 percent of taxpayers are estimated to see a reduction in the combined burden of income and sales taxes.

The proportions are lower in the highest-income quintile. For example, among taxpayers in the 95<sup>th</sup> to 99<sup>th</sup> percentile of household income in Maine, earning between \$152,267 and \$333,388, 76 percent see an income tax reduction under the reform, and 63 percent see a reduction in their combined tax burden. That means 37 percent of households in this income group will pay more taxes after the reform.

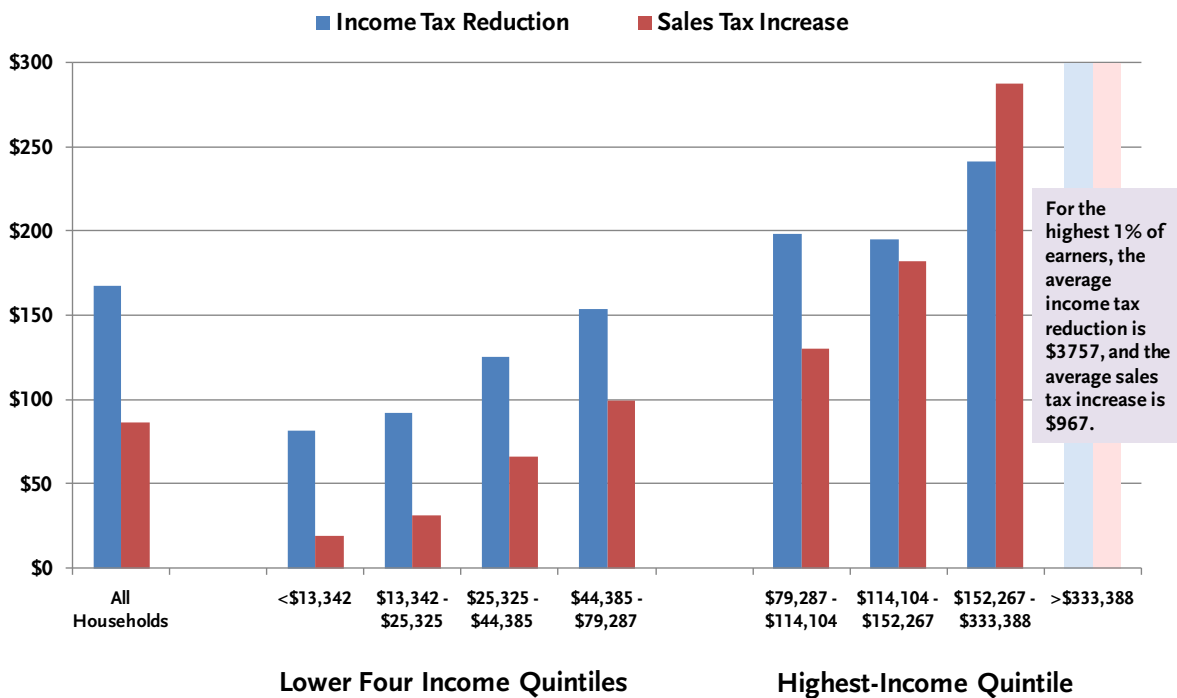
**Figure 26**  
**Percent of Resident Households in Maine with**  
**Reduction in Tax Burden under LD 1495**



Source: Maine Revenue Services.

Figure 27 shows the average income tax reduction and average sales tax increase under the LD 1495 reforms. It shows that the income tax reductions outweigh the sales tax increases in every income group, except for the 95<sup>th</sup> to 99<sup>th</sup> percentile group. For this income group, the average sales tax increase is larger than the average income tax reduction. Among the 90 percent of Maine households with income below \$114,104, the average net reduction in tax burden is about \$60. The average reduction in tax burden for the highest 1 percent of earners is \$2,789. The average increase in tax burden for households earning between \$152,267 and \$333,388 is \$47.

**Figure 27**  
**Estimated Average Change in Income and Sales Tax, by Income, under LD 1495**

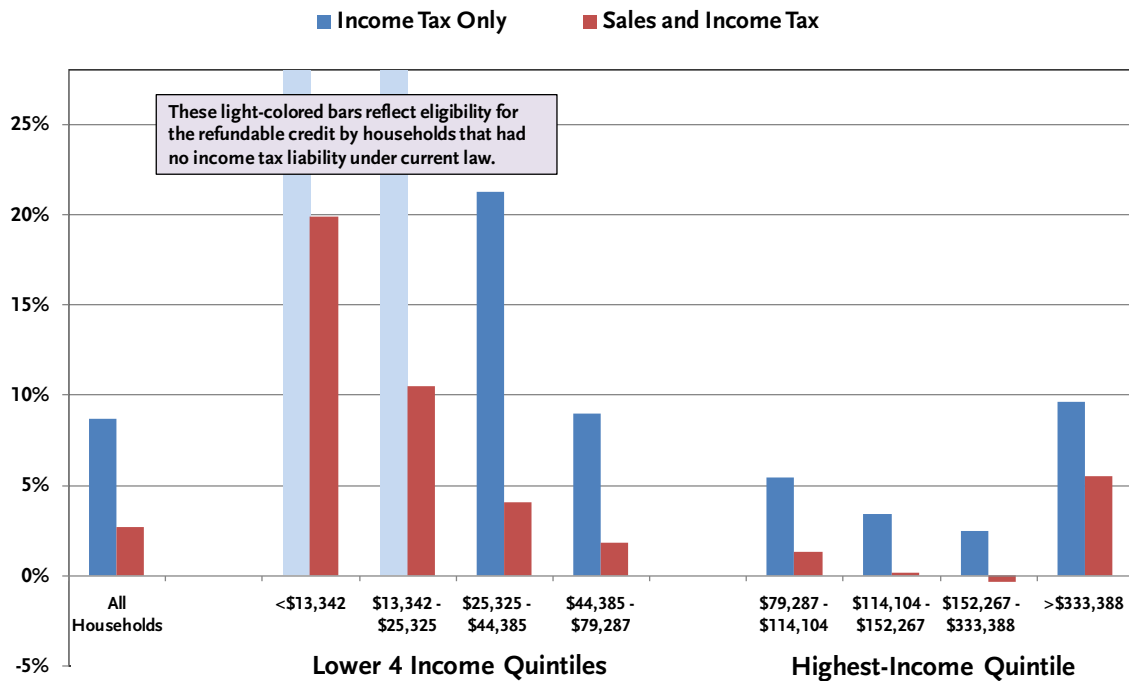


Source: Maine Revenue Services.

In Figure 28, the same Maine Revenue Services estimates are used to calculate the *percent* reduction in income taxes paid (the blue bars) and the *percent* change in combined income and sales taxes paid (the red bars). The percent reduction in combined tax burden is greatest for those with low incomes, assuming that they apply for the refundable income tax credit. The percent reductions in combined sales and income tax burden for the first, second, third, and fourth quintiles are 20 percent, 11 percent, 4 percent, and 2 percent, respectively.



**Figure 28**  
**Percent Reduction in Taxes Paid in Maine under LD 1495**

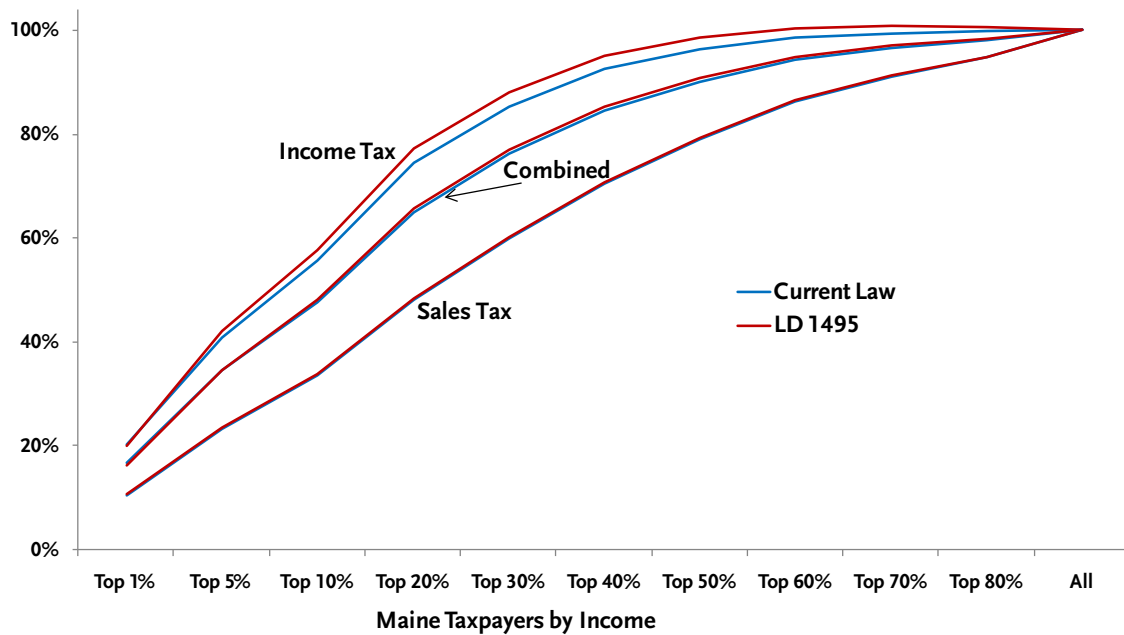


Source: Maine Revenue Services.

A final set of calculations by Maine Revenue Services presents the distribution of total tax revenues across income groupings. A stated goal of some tax reform advocates was that the restructured system allocate the burden with “at least as much progressivity” as the current tax system. This was interpreted to mean that higher-income groups should pay at least as large a percentage of total taxes as they pay now, and that lower-income groups should pay no larger a percentage of total taxes than they pay now.

Figure 29 shows the cumulative income, sales, and combined taxes paid, beginning with the highest earners and proceeding down the income distribution. A steeper arc signifies that those with higher earnings pay a larger portion of taxes. By this measure, sales taxes are nearly identical in progressivity after the reform. Income taxes are modestly more concentrated at higher income levels, suggesting greater progressivity. The combined burden of sales and income taxes is slightly more progressive under the reformed system.

**Figure 29**  
**Progressivity of Maine's Tax Burden:**  
**Cumulative Percent of Taxes Paid, by Household Income**



Source: Maine Revenue Services.

## F. Limits on the growth of taxes and spending

The third major category of tax reform proposal uses statutory limits on the growth of taxes and government spending as a mechanism for reducing tax burden. The evaluation of such proposals highlights the implicit duality of taxes and spending: that taxes pay for programs and services that at least some people value at some level. So the question becomes not simply how to reduce tax burden at any cost, but rather whether each component of government spending is worth the incremental tax burden it imposes. While it would be impossible to find anything approaching consensus on the “right size” of government, the imposition of growth limits on taxes and spending is based on a presumption that government is larger and more costly than its value.

In practice, reductions in spending can be implemented directly, through specific cuts (or cost-efficiencies) in government programs and services; procedurally, through global spending limits that force constraints on budget-making authorities; or indirectly, through reductions in tax rates or limits on tax increases, thus constraining revenues available to be spent. The current economic recession is a clear example of spending constrained by lower revenues, as the Maine legislature passed a biennial budget this year that was smaller in absolute dollars than its predecessor, even without accounting for inflation.

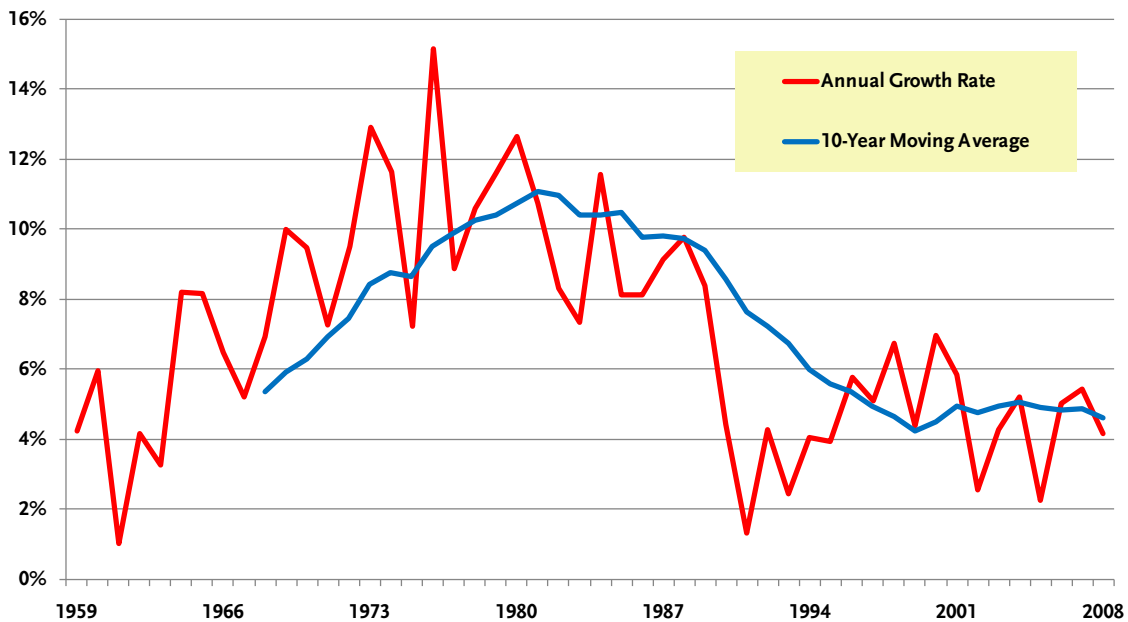
## Spending growth limits

Many of the proposals put forward to reduce the tax burden would limit the rate of growth in government spending by future budget-making authorities. The philosophy behind such limits is to constrain growth in government spending to a level that is lower than growth of the overall economy, so the size of government as a proportion of the economy declines gradually over time. Three criteria are particularly relevant in the design of such limits on spending growth: the level of the limits, their flexibility or enforceability, and their duration.

A useful way to compare the growth limits proposed in Maine is to consider total personal income as an indicator of tax capacity. If government spending can be constrained to a growth rate that is slower than the growth rate in total personal income, then tax burden should decline over time.

Because the growth rate of personal income in any one year can be volatile, spending limits may be benchmarked to moving averages from multiple prior years. Figure 30 shows the annual growth rate of total personal income over the past 50 years, and the moving 10-year average growth rate of personal income.

**Figure 30**  
**Annual Rate of Growth in Total Personal Income in Maine,**  
**1958-2008**



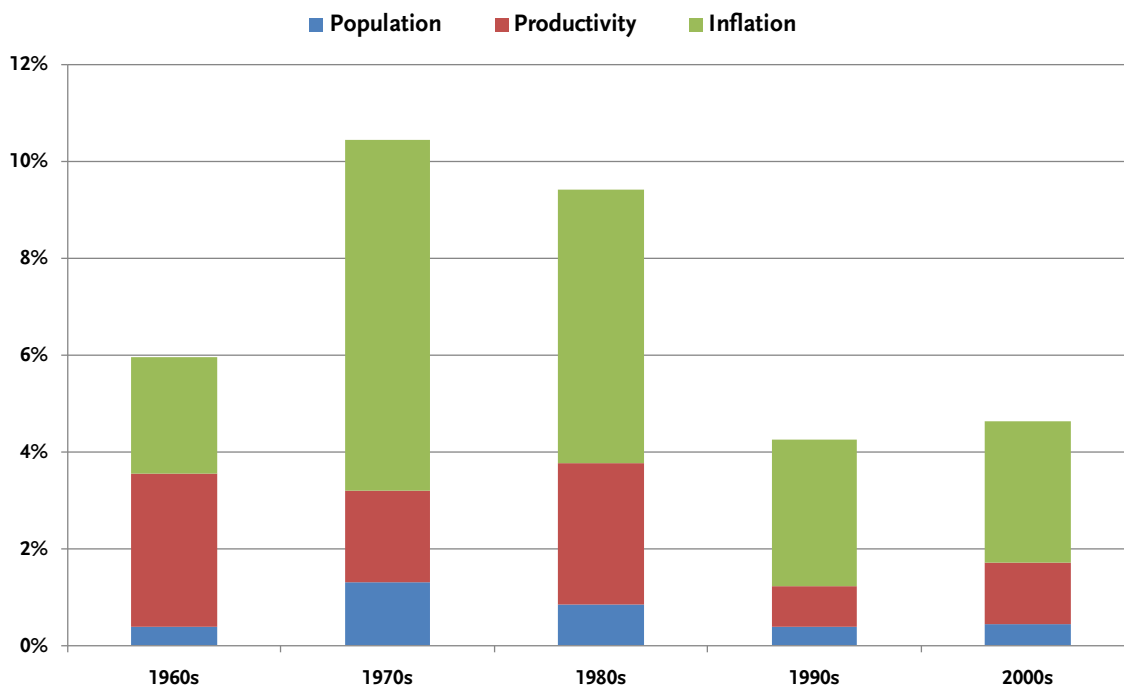
Source: Bureau of Economic Analysis.

The annual growth rate of total personal income has fluctuated significantly over the past 50 years, from a low of 1.0 percent in 1961 to a peak of 15.1 percent in 1976. Since 1990, that growth has been somewhat less volatile, ranging from 1.3 percent to 7.0 percent annually, and averaging 4.4 percent per year. This more recent history suggests that the tax burden would likely fall over time if government spending were constrained to an annual growth rate below this 4.4 percent average. Of course, differences in the growth rate of government spending and personal income compound over time, so small variations in the spending limit can have a large impact over longer time horizons.

The mainstream proposals advanced in Maine have not reflected this simpler approach. To understand these proposals, it is helpful to subdivide income growth into three components: growth in prices (inflation), growth in population (the number of people earning an income), and growth in productivity (the standard of living per individual). Total personal income in Maine grows over time at a rate that aggregates these three component pieces. Maine’s income base rises through the combined effects of inflation, population, and productivity.

What is noteworthy about the proposals advanced in Maine in recent years is that each focuses on aspects of these three component growth factors but excludes others. The result in each case is a growth limit that is lower than the growth rate of total personal income overall, but that does not fully reflect the multiple determinants of income growth. Figure 31 shows the relative contributions of inflation, population growth, and productivity growth to total personal income growth in each of the past five decades.

**Figure 31**  
**Composition of Total Personal Income Growth in Maine**



Source: Author's calculations based on data from Bureau of Economic Analysis and Bureau of Labor Statistics.

Maine's annual population growth rate has averaged 0.7 percent over 50 years, and 0.4 percent since 1990. Maine's annual productivity growth rate has averaged 2.0 percent over 50 years, and 1.0 percent since 1990. The inflation rate has averaged 4.1 percent over 50 years, and 3.0 percent since 1990. Aggregated together, total income growth has averaged 6.9 percent over 50 years, and 4.4 percent since 1990. These components have been the key building blocks used to construct spending limits for tax reform.

Both TABOR I and TABOR II—the taxpayer bill of rights—propose a growth limit that allows for inflation and population growth only, but excludes productivity growth. This allowance is below the growth rate of total personal income, because none of the growth rate of productivity can be allocated to government programs and services. Over the post-1990 period, this growth limit formula would have amounted to about 3.4 percent allowable growth, compared with the 4.4 percent growth rate in total personal income.

The state spending limits in the Maine Plan, as developed by the Maine State Chamber of Commerce and later implemented in LD 1, turn out to be a theoretically awkward composition of these economic variables, though the limits are much more restrictive than those of TABOR given recent trends. This plan calls for a spending limit that is the sum of real personal income growth and population growth. The awkwardness of the measure is that real personal income growth is not computed on a per capita basis, so it grows with both productivity changes and population changes. The result is a formula that is one part productivity growth, two parts population growth, and zero parts inflation. Over the post-1990 period, when both population and productivity growth have been small, the formula equates to about a 1.8 percent allowable growth rate—well below the 3.4 percent rate that TABOR I and II would impose, and the 4.4 percent growth rate in total personal income.

In terms of economic rationality, it is not clear that a growth limit that assigns zero weight to any of the three determinants of income growth is desirable. A more rational system might take an equal fraction of each component: three-quarters of inflation, plus three-quarters of productivity growth, plus three-quarters of population growth, for example. Of course, this equates to the simpler version of a spending limit already described, as the sum of these parts would be three-quarters of total personal income growth.

The second key variable in the design of spending limits is their enforceability. What needs to be done to override the limit, if an override is determined to be desirable? TABOR I proposed the strongest hurdle, requiring a two-thirds vote of a governing body (such as a school board, a town council, or the state legislature) and a majority public vote to override the limit. TABOR II eliminates the two-thirds voting requirement of a governing body, and requires only a majority public vote to override the limit. LD 1 has the weakest provision, requiring only a majority vote of the governing body to override the limit. Because the LD 1 override requires little more than a regular budget vote, the LD 1 provisions are more like guidelines than strict limits.

The third key variable in the design of spending limits is their duration. The TABOR referenda impose restrictive limits on spending indefinitely, restraining the growth rate of government spending below the growth rate of incomes no matter how low the tax burden becomes, or how much spending has been reduced. Some attribute problems with the TABOR system in Colorado to these infinite pressures downward. LD 1, on the other hand, identifies a target tax burden as “in the middle third of states,” and imposes more restrictive spending limits only until this target is reached. Still other proposals have suggested 5- or 10-year plans to reduce the tax burden that disappear altogether at the end of the transition period.

### LD1 spending limits in greater detail

While the philosophical underpinnings of LD1’s spending limits are described above, there are additional details, particularly in how the limits are applied differently to state government, municipal and county government, and school districts.

For the state as a whole, the restrictive growth limit is set at the 10-year average of real personal income growth, not to exceed 2.75 percent, plus the 10-year average rate of population growth. As noted, inflation is the one component of income growth excluded from the formula. Once Maine’s tax burden is reduced to the middle third of states, the formula is relaxed to account for real growth, population growth, and forecasted inflation.

For municipalities and counties, the restrictive growth limit is set at the 10-year average of real personal income growth, not to exceed 2.75 percent, plus a property growth factor, designed to allow for new property, or newly renovated property. Property growth substitutes for population growth in the municipal and county formula, as potentially more relevant to municipal costs, and because of its more accurate annual measurement at the municipal level. Again, inflation is the omitted growth factor. Once Maine’s tax burden is reduced to the middle third of states, the formula is relaxed to account for real growth, property growth, and forecasted inflation. In practice, and perhaps not anticipated in the development of LD 1, the municipal and county spending limits are more lenient, on average, than the limit on state government.

School districts are assigned a different limit altogether. For school districts, the LD1 limit is set at the amount determined as part of the “essential programs and services” (EPS) methodology to be necessary to achieve Maine’s learning results standards in each school district. Most school districts already spend above this EPS baseline amount, so the LD 1 limits translate into a reduction in spending, rather than a limit on growth. In some districts, adhering to the limit would require a dramatic reduction in spending. LD 1 overrides have become routine in the budget-making process of many school districts.

All of the LD 1 limits can be exceeded in any single year to account for various “extraordinary circumstances” that might arise, or increased for other reasons if explicitly authorized by a majority vote of the governing body. While the new limits are part of state law and considered explicitly in budget-making processes, governing bodies can continue to

set budgets at any level by majority vote, as they did before. The limits are generally considered easy to override—that is, “without teeth”—because doing so entails minimal special requirements.

Since the enactment of LD 1, and as required by the law, the State Planning Office produces an annual report on its effectiveness in achieving tax reduction targets. These reports conclude that spending is generally below the LD 1 limits for municipalities, counties, and the state. As noted, however, most school districts have routinely voted to spend more than the EPS-defined baseline amounts. In a reform enacted in 2007 and implemented in 2008, a majority public vote must approve these overrides for schools, and indeed all school budgets.

### Tax limits

An alternative to spending limits is to restrict the tax side of the equation. For example, some proposals would impose reductions in future tax rates, or phase-down schedules of tax rate reductions over multiple years. Others have coupled tax system rebalancing with additional future reductions in income tax rates.

Stricter tax limits, such as those in the Palesky tax cap referendum, have also been considered and rejected. The Palesky referendum, for example, would have limited property taxes to 1 percent of property valuation, set back the assessed value of properties to their 1996–1997 level, and limited growth in assessments over time to the lower of inflation or 2 percent per year.

The TABOR referenda apply to both taxes and spending. TABOR I required a two-thirds vote of the governing body and a majority public vote to raise a tax or fee. TABOR II eliminates the two-thirds requirement but still requires a majority public vote to raise a tax or fee.

## **F. The tax reform landscape today**

This study has reviewed the struggle for tax reform in Maine from 2003 to 2009, outlining the motivations for reform, the chronology of proposals introduced and advances made, and the key issues considered in property tax reform, income and sales tax reform, and tax and spending growth limit. Advances of some kind have been made in each area of tax reform.

In the realm of property tax reform, a key lasting impact of LD1 is the expanded circuit breaker refund. Though budget pressures have resulted in some cutbacks, the circuit breaker is still a significantly larger program for property tax relief than it was. School funding has also increased significantly compared with its earlier level—though not to the level presumably intended by the 2004 referendum.

In the realm of limiting government spending, or reducing tax burden, steps have also been made. LD 1 implemented spending guidelines that are mathematically restrictive but weakly enforced. Annual progress reports suggest that the measure is having some impact,

though perhaps not substantial. For state government, low revenues have been a far more limiting factor. LD 1495 also reduces tax burden on residents through exporting, weighting more heavily certain taxes that are shared with non-residents.

In the realm of sales and income tax reform, a notable package enacted this year includes a significant restructuring of the income tax system and a broadening of the sales tax base to certain services not now taxed. This reform had been scheduled to take effect in 2010, but is now on hold, due to the submission of signatures for a “people’s veto.”

Whether the reforms accomplished in the 2003–2009 period are modest or profound, first steps or completed steps, successes or failures, are subjects of continuing debate throughout the state. While impossible to forecast what will happen with tax reform in the year and years ahead, six issues shape the tax reform landscape in Maine today.

The first is the structurally reformed income tax system just enacted. If the signatures for a people’s veto of the measure are validated by the Secretary of State, it would deliver the matter to voters for further consideration as a referendum question, sometime in 2010. Once its provisions are more widely understood, will the public like it or reject it? The reform has received positive coverage from the *Wall Street Journal*, which referred to it as the “Maine miracle” (*Wall Street Journal* 2009). There have also been positive editorials from the major newspapers in Maine, and endorsements from some policy analysts. But with just one Republican vote in the legislature, some vocal critics of the reform, a highly-visible Republican-led campaign for a people’s veto, and newly raised constitutional questions, the ultimate fate of the reform package is by no means sealed.

The second issue shaping the tax reform landscape is the decline of the state economy, and the need for further reductions in government spending, on top of steep cuts already imposed. These fiscal challenges eclipse to a significant extent all other policy concerns. They also constrain the ability of state government to direct resources to tax relief of any kind.

The third issue is the lukewarm public reception to LD1, school consolidation, and other efforts by Augusta lawmakers to influence municipal decision-making. While there is interest in further steps toward property tax relief, past efforts by Augusta have reignited grassroots protection of local control, and a sense that actions in Augusta may do more to hurt communities than to help them. All this may mollify what has been quite passionate advocacy for continuing property tax relief and reform from Augusta in the past.

The fourth issue shaping the current landscape is the recent change in the Tax Foundation’s analytical methodology, and the dramatic drop in how they assess Maine’s tax burden ranking relative to that of other states. After a decade of annual publicity surrounding the state’s no.1 ranking, the new methodology puts the state at number 15. Not only that, the new methodology, applied retroactively, shows Maine declining each year, from 5<sup>th</sup> in 2004 and 2005 to 7<sup>th</sup> in 2006, to 14<sup>th</sup> in 2007, and to 15<sup>th</sup> in 2008. How this will affect the popular perception of Maine’s tax burden remains to be seen.



The fifth issue, related to the fourth, is the upcoming referenda on TABOR II and the automobile excise tax. Whether these referenda pass or fail in November 2009 may depend on how the changes in the foundation's tax burden rankings have altered popular perspectives. These proposals are in many ways less extreme than predecessor initiatives, and would be more likely to pass than previous versions if anti-tax passions remain high. However, the struggling economy, the imperfect legacy of past reforms, and the Tax Foundation's new methodology may have changed the tenor of the discussion.

The sixth issue is the 2010 gubernatorial campaign. Governor Baldacci will be completing his second four-year term, and is ineligible to run for reelection. Close to twenty prospective candidates have expressed an interest in running; many have announced formally. Turnover in the governor's office will bring new ideas on how to shape Maine's policy environment, including, no doubt, the next phase in tax policy development.

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