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A REVENUE-RAISING PLAN FOR MAINE

by Daphne A. Kenyon

Preface

by Max B. Sawicky

In recent years, the federal government has relegated increasing responsibility to state governments. It has accomplished this goal in some important areas, most notably the welfare reform legislation passed in 1996. States have already been required to increase expenditures on a number of fronts, with the greatest pressures resulting from growing Medicaid costs. Rising school enrollment has further strained state budgets, as has increased demand for lengthier criminal incarcerations, resulting in rapid growth in spending on corrections. Although spending demands have increased, so has state revenue. In contrast to the projected decline in federal tax revenues, combined state and local revenues increased from 9.8% to 10.8% of gross domestic product between 1979 and 1996.

Aside from maintaining current services in such areas as health care and law enforcement, there is also the question of funding for public investment-spending on infrastructure, education, and training. Although federal funds have often been available, most public investment spending is performed by state and local governments. If there is to be more public investment, states will certainly play a central role.

Important evidence attests to the value of public investment in general economic growth, but unfortunately such investment has been declining in the United States for the past 25 years. Under the latest budget agreement passed by Congress, projections indicate a continued decline in public investment for the foreseeable future. If the size of the workforce also declines relative to that of the population as a whole (as many expect), productivity growth spurred by public investment will be even more necessary to ensure growing standards of living.

The recent gains in the national economy are doing much to obscure these basic trends. Employment has risen and state budgets are in their best shape in years. In fact, budget surpluses have become common and have led to proposals for state tax cuts. New York has already cut its taxes, and proposals are expected in Wisconsin and elsewhere.

Unfortunately, two basic facts about these tax-cutting proposals commonly go unappreciated. One is that budgetary surpluses have been made possible by a peak in the business cycle that cannot last indefinitely. A second is that, in the long run, trends in health care and demographics will eventually place renewed pressures on state revenue systems. Tax increases inevitably will be considered and made all the more necessary if states choose to cut taxes now.

Beyond the current economic boom, therefore, lurks the question of how to best reform state revenue systems. Although state tax systems typically endure the closest scrutiny when they fail to produce sufficient revenue, they should not be spared analysis and evaluation during less dire times. In light of the budget deficits anticipated by experts in the field of state and local finance, the Economic Policy Institute commissioned five papers to address the question of how states can best revise their revenue systems. The authors of these papers do not necessarily advocate such increases. They do, however, try to describe the best way of increasing state revenues while simultaneously improving the design of state tax systems. As such, these papers provide insight on tax reform irrespective of revenue goals and could be used for guidance in either revenue-neutral reforms or to replace local tax systems.

The scale of the problem addressed in these papers is large compared to the usual preoccupations of state legislatures. This choice was deliberate. These papers mean to shed light on basic deficiencies in state tax systems, not merely suggest ways of modestly boosting revenue. The latter would be a simple exercise requiring little analysis. For the specific states examined, however, these papers provide guidance in preparing for imminent structural deficits.

It is hoped that this series, focusing on state revenue programs in Illinois, Maine, New Hampshire, New York, and Wisconsin, will help launch a constructive debate on state-level tax reform. Although some of these states are more hard-pressed to examine these issues than others, it is safe to say that, sooner or later, every state will have to grapple with these tough decisions.

Introduction

If the state of Maine were to consider a significant increase in public expenditures or needed more revenue to close a fiscal deficit, what changes in the state’s tax structure would best accomplish such objectives? Given that Maine’s general fund revenue for the fiscal year 1998-99 biennium is projected to be $3.78 billion, a 10% revenue increase would generate another $378 million for the state (State of Maine, Bureau of the Budget 1997). The issue considered in this report is how such an increase can best be accomplished.

In exploring options for raising revenue in Maine, this report’s analysis is based on certain basic principles. The first is that political expediency is not the most important criterion for choosing among revenue-raising strategies. While political expediency should not be ignored, public policy should first strive to achieve more important goals in designing a tax system, such as ensuring its equity, efficiency, and stability. Furthermore, any plans for raising Maine’s revenue must be considered within a broader context, one that accounts for the state’s current tax structure and fiscal situation and considers the tax policies of other states, particularly Maine’s neighbors and competitors.

This report first examines crucial background information on Maine, including a brief description of its current fiscal structure and a comparison of its tax structure to those of neighboring and other relevant states. Current tax issues are also summarized before addressing this report’s central concern — a set of policy proposals that outline revenue-raising opportunities for Maine.

Fiscal Background

Having recovered the jobs lost during the 1990-91 recession, Maine’s current fiscal picture is bright (New England Economic Project 1995, 1997, 1998). Due to robust growth in personal and corporate tax revenues, Maine ended FY 1997 with a budget surplus of $59.6 million, or about 3% of general fund spending (Gagliardi 1997a). Indeed, during its last session, the Maine legislature passed a $76 million tax relief bill consisting of an increase in the personal exemption of the income tax and adoption of a homestead tax credit (Mackey 1998). Only in recent months has the Asian economic crisis raised the possibility of an economic downturn for the U.S., and thus a less fiscally bright future for Maine.

To create a context for better understanding Maine’s fiscal situation, this study compares Maine to a select set of a dozen other states as well as to the U.S. averages. Among these states are Maine’s New England neighbors, of which New Hampshire is the most important because it is the only one with which Maine shares a border. Because of the importance of the paper industry in Maine’s economy, the tax structures of two other leading paper-producing states, Alabama and Wisconsin, also are considered.’ Florida has also been included for comparison because of the importance of the retiree population for both states. Other states compared include Arizona, North Carolina, Mississippi, and North Dakota. Arizona and North Carolina both have per capita personal income closest to Maine’s,2 while Mississippi and North Dakota both have comparable percentages of their population living in metropolitan areas.[3]

As shown in **Table 1,** Maine can be considered a relatively high-tax state. This table presents Maine’s own-source general revenue and its tax burden relative to the U.S. average and the comparison states. Regardless of whether own-source general revenues or total taxes are considered, or whether state

TABLE 1
General Revenues & Taxes as a Percentage of Personal Income, FY1993

State	State and Local Own-Source General Revenues	Total Taxes	State Own-Source General Revenues	Total Taxes
MAINE	16.4%	12.3%	10.4%	7.7%
Neighboring States				
New Hampshire	13.8%	10.1%	6.7%	3.9%
Massachusetts	14.3	10.5	9.4	6.8
Vermont	16.5	12.2	10.5	7.1
Rhode Island	14.5	11.0	9.4	6.6
Connecticut	14.3	11.5	9.1	7.0
Competitor States				
Alabama	14.5%	**8.9%**	9.2%	6.4%
Florida	14.7	**9.7**	7.0	5.7
Wisconsin	17.0	12.5	10.1	7.8
Comparison States				
Arizona	15.5%	11.5%	8.8%	7.2%
Mississippi	15.9	10.3	9.5	7.6
North Carolina	14.2	10.3	8.8	7.3
North Dakota	18.4	11.6	12.6	8.1
U.S. Average	15.4%	10.9%	8.5%	6.5%

Source: U.S. Bureau of the Census.

and local data or state-only data are compared, Maine's revenue burden exceeds the U.S. average and ranks at least fourth among the 13 states considered here.[4] Maine's status as a relatively high tax state has led Governor Angus King to propose lowering the state's tax burden from 12.3% of total personal income to 11% by the year 2001 (King 1997).

Tables 2 and 3 reveal other facets of Maine's tax structure. Table 2 shows that the top rate of Maine's corporate income tax at 8.93% is higher than the U.S. average of 6.7% and the top rates in all but Massachusetts, Rhode Island, Connecticut, Arizona, and North Dakota. The top rate of Maine's individual income tax (8.5%) is higher than the U.S. average and higher than the top rate in all but Vermont, Rhode Island, and North Dakota. As for general sales taxes, only Rhode Island, Connecticut, Florida and Mississippi impose higher rates than Maine, and its rate of 5.5% is significantly higher than the U.S. average of 4.7%. Data in Table 3 allow a comparison of cigarette tax rates in Maine to those in other states. In 1997, the Maine legislature increased the cigarette tax rate from 37 to 74 cents per pack, giving it the second highest tax rate in both New England and among the selected comparison states.

Table 4 examines the percentage distribution of state and local government own-source general revenue. As shown in this table, the three most significant revenue generators for state and local govern-

TABLE 2
Top Tax Rates, Selective Taxes, November 1996

State	Corporate Income Tax Rate	Individual Income Tax Rate	Sales Tax Rate
MAINE	8.93%	**8.50%**	**5.50%**
Neighboring States			
New Hampshire	7.00%	0.00%	0.00%
Massachusetts	9.50	5.95	5.00
Vermont	8.25	9.90	5.00
Rhode Island	9.00	10.90	7.00
Connecticut	10.75	**4.50**	**6.00**
Competitor States			
Alabama	5.00%	5.00%	4.00%
Florida	5.50	0.00	6.00
Wisconsin	7.90	6.93	5.00
Comparison States			
Arizona	9.00%	5.60%	5.00%
Mississippi	5.00	5.00	7.00
North Carolina	7.75	7.75	4.00
North Dakota	10.50	12.00	5.00
U.S. Average	6.70%	5.70%	4.70%

Source: Research Institute of America (1997).

TABLE 3
Cigarette Taxes, Cents Per Pack, November 1997

MAINE	74.0
Neighboring States	
New Hampshire	37.0
Massachusetts	76.0
Vermont	44.0
Rhode Island	71 .0
Connecticut	50.0
Competitor States	
Alabama	16.5
Florida	33.9
Wisconsin	44.0
Comparison States	
Arizona	58.0
Mississippi	18.0
North Carolina	5.0
North Dakota	44.0

Source: Research Institute of America fax updating *1997 All States Tax Handbook* (12/31/97).

TABLE 4
Percentage Distribution of State and Local Government Own-Source General Revenue

State	Property Taxes	General Sales Taxes	Selective Sales Taxes	Motor Fuels Taxes	Alcohol Taxes	Tobacco Taxes	Individual Income Taxes	Corporate Income Taxes	Other Taxes	User Fees & Charges	Misc. General Revenue
MAINE	28.9%	17.0%	7.2%	3.9%	0.9%	1.3%	16.3%	2.0%	3.6%	12.7%	12.2%
Neighboring States											
New Hampshire	45.1%	0.0%	19.1%	2.7%	0.3%	1.2%	1.0%	3.6%	4.7%	13.8%	12.7%
Massachusetts	25.2	9.8	5.6	2.6	0.3	0.9	24.7	4.4	3.9	14.0	12.4
Vermont	31.5	8.7	11.7	3.0	0.8	0.7	15.5	1.8	5.0	15.6	10.2
Rhode Island	30.6	13.1	11.1	3.1	0.3	1.1	15.8	2.2	3.3	11 .o	12.9
Connecticut	30.9	15.1	7.6	2.9	0.3	0.9	16.5	6.2	4.8	9.2	10.7
Competitor States											
Alabama	7.2%	18.4%	13.7%	4.4%	1.4%	0.8%	13.2%	1.8%	7.0%	28.0%	10.7%
Florida	24.1	22.5	11.6	3.6	1.3	1.1	0.0	1.8	6.1	19.3	14.7
Wisconsin	26.8	13.8	6.9	3.4	0.2	1.0	20.0	2.8	3.4	17.2	9.1
Comparison States											
Arizona	24.5%	24.2%	7.5%	3.4%	0.4%	0.5%	12.2%	2.2%	3.6%	14.3%	11.5%
Mississippi	16.5	22.8	9.4	5.1	0.6	0.8	9.4	2.7	4.2	26.6	8.3
North Carolina	15.6	17.5	10.1	4.6	0.8	0.2	21 .1	3.8	4.4	19.8	7.7
North Dakota	17.9	15.4	10.3	3.9	0.3	0.6	6.3	2.7	10.6	23.1	13.8
U.S. Average	22.3%	16.5%	8.4%	2.9%	0.5%	0.8%	14.7%	3.2%	5.4%	17.6%	11.8%

Source: U.S. Bureau of the Census.

ments are property taxes, general sales taxes, individual income taxes, and user fees and charges. Maine's reliance on these sources is not dramatically different from the U.S. average, although Maine does rely more heavily on property taxes than most states. Conversely, Maine relies less heavily on corporate income taxes and user fees and charges than the average state.

Tax Proposals

If Maine citizens were to decide that an increase in state revenues would be necessary or desirable, they can find this report's recommendations in **Table 5.**

Adjust the Sales Tax

This report's first option involves changes to the general sales tax. An initiative that broadened Maine's sales tax could have great revenue potential. Maine's current general sales tax base is rather narrow, relying mainly on consumer durables. Food for home consumption is not taxed, nor are residential utilities or personal services, for the most part. The Federation of Tax Administrators has enumerated 164 different categories of services to which the general sales tax might apply; Maine includes only 27 of them in its sales tax base (U.S. Advisory Commission on Intergovernmental Relations 1994). Because Maine's sales tax base is so narrow, it has resorted to levying a rather high general rate. (That rate dropped from 6% to 5.5% on October 1, 1998). Since the revenue yield from this tax is unstable over the

TABLE 5
Revenue Options for Maine, FY98-99 Biennium

Option	$ Million Gained	Description
Broaden sales tax, lower rate to 5%, adopt low-income credit	$666	Broaden sales tax to include food, recreation, personal services, and utilities. Use some of revenue gained to reduce tax rate and adopt refundable low-income tax credit.
Adopt value-added tax	$256	Adopt New Hampshire-style value-added tax that applies to compensation, interest, and dividends. Use 1% rate instead of NH's 0.25% rate.
Repeal exclusion of Social Security income	$65*	Federal income tax law now taxes some portion of Social Security benefits; Maine individual income tax should follow federal law.

Notes: Maine's Bureau of the Budget projects general fund revenue for FY98-99 biennium at $3,779.4 million.

* Estimate from Maine's tax expenditure budget. As detailed in Gardner (1995), the revenue gained from repealing a tax expenditure is generally less than the estimated amount of the tax expenditure.

Sources: Calculated and compiled by author from "Tax Expenditures," State of Maine Budget Document 1998-l 999; State of Maine, Maine Bureau of the Budget (1997); U.S. Advisory Commission on Intergovernmental Relations (1994); Dye and McGuire (1992); Gardner (1995); New Hampshire Department of Revenue Administration (1995); New England Economic Project (1996); Gagliardi (1997a); and various reports in the *Portland Press Herald.*

business cycle and declines substantially in a recession, this narrow sales tax base helped create a state fiscal crisis in the last recession. The sales tax could be broadened to include food, recreation services, personal services, and utilities.

The increased yield from broadening the sales tax base was crudely estimated for Table 5 using figures in Dye and McGuire (1992) indicating the percentage by which the base, on average, would increase if particular items were added. This report recommends that two measures be tied to the broadening of Maine's sales tax, both for political expediency and to improve the equity and efficiency of the resulting tax structure.

The first of these would be for Maine to use some of the revenue gained through these adjustments to lower its general sales tax rate from 5.5% to 5%. The second measure would be the introduction of a refundable, low-income tax credit, either linked to the income tax or set up as a stand-alone credit, to cushion the impact on low-income households. This combined package of broadening the sales tax base, lowering the general rate to 5%, and adopting a low-income tax credit could result in a net increase of as much as $666 million in the next biennium while simultaneously improving the overall structure of the tax system.

Adopt a Value-Added Tax

Maine could also adopt a value-added tax much like the one recently implemented by New Hampshire to raise more revenue. In 1993, New Hampshire became the second state in the nation (Michigan being first) to adopt a form of the VAT. New Hampshire's version, the Business Enterprise Tax, differs from Michigan's in three important ways. First, New Hampshire's VAT supplements its major business tax, a form of corporate income tax. Second, the Business Enterprise Tax is levied at a 0.25% rate on a tax base that consists of labor compensation, interest payments, and dividends paid out by businesses. Finally, since investment is not subtracted from the tax base, New Hampshire's VAT resembles an income tax more than a sales tax. Even at its very low rate, New Hampshire's tax has added a significant chunk to total state tax revenue. Furthermore, there has been no measurable political resistance to this new tax, which is surprising in a state with such a well-known aversion to taxes of any sort. Instead, the tax is seen as increasing the equity of the business tax structure, since it shifts the burden slightly away from corporations toward partnerships and proprietorships. More importantly, the VAT is a relatively efficient tax since it has such a broad base and makes New Hampshire better able to tap into the growing service sector (Kenyon 1996).

All the advantages of the VAT that benefit New Hampshire could also work for Maine. Adopting a value-added tax would add stability to Maine's tax base and help it capture some of the growth in the service sector. The broad base of this tax also makes it a relatively efficient one. This report suggests that Maine consider imposing a 1% rate, as opposed to New Hampshire's 0.25% rate. Although high in comparison to its neighbor, this rate is still considerably lower than the current 2.3% rate imposed by Michigan's VAT. At a 1% rate — based on a comparison of Maine's gross state product to New Hampshire's, and relying on the ratio of VAT revenues to gross state product in New Hampshire — this report estimates a VAT could bring in $256 million for the biennium.

Because Maine already imposes an individual income tax and has a narrow general sales tax base, it might consider one modification to New Hampshire's value-added tax. By allowing a deduction for expenditures on capital goods, Maine could transform its value-added tax from an income-type tax into a consumption-type tax. If the Maine legislature could not broaden the general sales tax base directly, adoption of a consumption-type VAT might accomplish much the same thing. This variation on New Hampshire's VAT might be considered more "business-friendly" than an income-type value-added tax.

Repeal Exclusion of Social Security

The final revenue raiser suggested in this report would be to eliminate the loophole that totally excludes Social Security from taxation under Maine's individual income tax. The elimination of this tax preference could add up to $65 million in the next biennium, if 100% of Social Security income was subject to taxation. A more palatable alternative would be to follow the federal government's lead and tax 85% of Social Security income, producing a slightly smaller revenue yield. This measure would increase taxes primarily on the well-off elderly, thus preserving Maine's commitment to equity goals. Perhaps most importantly, this would help prevent a major hole in Maine's income tax structure from developing in the next century. In 2006, the baby boom generation will begin to retire, and any special tax preferences that favor the elderly will cause a significant loss of revenues.

Conclusion

No matter which tax options Maine voters choose, they will have tough choices to make regarding the conflicting goals of competitiveness and equity. Governor King is one of many policy makers who has voiced concern about Maine's relatively high taxes and their potential for driving high-income taxpayers and businesses to lower-tax states, such as neighboring New Hampshire. However, unlike New Hampshire, Maine has a long-standing commitment to tax equity, and it has maintained a somewhat progressive tax structure overall (Ettlinger et al. 1996).[5] With that noted, some of the options explored in this report (such as the adoption of a sales-type value-added tax, including a deduction for the purchase of capital equipment) might encourage business investment, but they also would clearly reduce the progressivity of the state's tax structure. The options discussed here reflect an effort to balance the inevitable pros and cons inherent in any ambitious revenue-raising exercise.

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DAPHNE A. KENYON IS A PROFESSOR OF ECONOMICS AND CHAIR OF THE ECONOMICS DEPARTMENT AT SIMMONS COLLEGE IN BOSTON, MASS.

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Endnotes

1. The leading pulp and paper producing states in terms of tons produced are Wisconsin, Maine, and Alabama, in that order (Office of Legal and Policy Analysis, Maine Legislature 1995).

2. In 1995, Maine's per capita personal income (in 1992 dollars) was $19,086, earning it a rank of 34th in the U.S. North Carolina ranked 33rd with $19,158 per capita and Arizona ranked 35th with $18,987 per capita (Statistical Abstract of the United States 1996).

3. In 1994, Maine ranked 44th among the states in terms of the percentage of population in metropolitan areas, with 35.9% of its population residing in metropolitan areas. North Dakota had a slightly greater percentage of its population in metropolitan areas and Mississippi had slightly less (Statistical Abstract of the United States 1996).

4. When tax and revenue burden are calculated on a per capita basis rather than as a percentage of personal income, Maine's tax burden looks about average (Kenyon, Plesko, and Collins 1996). Maine's status as a relatively low-income state makes its tax burden look higher relative to the U.S. average whenever the tax burden is measured as a percentage of personal income.

5. According to this study, taxes as a share of family income for nonelderly married couples (including sales & excise, property, income, and the federal deduction offset) follow this pattern in Maine with respect to the first four quintiles: 11.6%, 9.7%, 9.9%, and 10.1%. This compares favorably (if one favors tax progressivity) to New Hampshire's pattern of 9.0%, 6.7%, 5.7%, and 5.6%. Neither state shows progressivity at the very highest income range (the top 20% of income levels).

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