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The Pine Tree State Chops Down Income Tax: Maine Enacts Major Tax Reform

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Summary
Maine passed the most sweeping changes to their tax code since the establishment of the income tax in 1969. This reform moves the state to a much flatter income tax at a highly reduced rate. The reform is revenue neutral, so the revenue loss from the reduced income tax rate will be made up for with an expanded sales tax base (i.e. more items will be subject to the sales tax). This *Tax Foundation Fiscal Fact* will examine the reform process and provide a critique of the newly overhauled tax system.

Background on the Reform Efforts
This reform effort was created through two different bills, LD 1088 and LD 1495. The first was under the design of the legislature in the form of LD 1088. This bill was revised at the urging of the governor and became LD 1495. It was signed into law on June 12, 2009.

LD 1088[1]
LD 1088 was passed by the House on June 4th and by the Senate the next day. It was a partisan bill with only one Republican in the House voting in favor and none in the Senate. This bill had two major components: a reduction in the income tax and an expansion of the sales tax.

LD 1088 was designed to replace the income tax brackets and rates with a flat 6.5% rate. This bill amounted to a significant income tax cut of 24% for those with taxable income over $19,450. Everyone with taxable income greater than $9,700 would see a reduction in the amount of income tax owed. Additional credits were created for the two lower brackets to prevent an increase in the tax burden of filers in those brackets (see table for details on the previous rate structure).

In order to recover the funds lost through the income tax reduction, the state sales tax would be expanded to include a number of new services. These services would include activities such as entertainment and rentals. In addition to broadening the sales tax to include a number of additional services, the sales tax on prepared food and lodging would rise from 7% to 8.5%.

LD 1495[2]
Governor Baldacci expressed concerns with the bill, and the legislature proposed a revised bill, LD 1495. It was passed by both the House and Senate on June 11. Baldacci signed the bill into law on the following day.

The creation of a second bracket with a 6.85% tax on income greater than $250,000 through a tax surcharge is one of the major changes. These sorts of taxes on the rich have been increasingly popular in recent years. The most recent example was in Oregon, where the legislature established an additional tax bracket of 11% for individuals earning over $250,000. Maine's 6.85% seems more palatable in contrast, but still results in a more complex tax code.

Table 1
Income Tax Rate Comparison between LD1088 and LD1495

Before Reform		**LD 1088**		**LD 1495**	
Rate	Income	Rate	Income	Rate	Income
2.0%	>$0	6.5%	>$0	6.5%	>$0
4.5%	>$4,850			6.85%	>$250,000
7.0%	>$9,700				
8.5%	>$19,450				

Additionally a number of entertainment services were removed from the taxed list including skiing, swimming, bowling and golf. An earned income tax credit was added for low-income families while a transfer tax for homes over $500,000 was eliminated.

In Praise of the Reform
The reform effort has a number of appealing qualities that are worth highlighting here.

One of the principles of sound tax policy is neutrality: decreasing the number and size of tax credits and exclusions makes the tax system more neutral. LD 1088 is a partial attempt to do just that. Expanding the sales tax to cover services allows the rates to be lowered in other areas—in this case, income. LD 1495, although retaining this general idea, creates a number of additional exceptions and exclusions.

This reform also aims to stabilize tax revenue. The revenue from income taxes is known to be correlated with the ebbs and flows of the economy. This means that the state can experience high levels of revenue fluctuation with economic booms and busts. Broadening the sales tax base and lessening the reliance on income tax will lead to greater tax revenue stability.

The reform is scheduled to take effect on January 1, 2010. This means that individuals will be able to plan for the effects of the tax. This helps to ensure the stability of contracts and transactions.

Criticism of the Reform

The reform has a number of downsides that need to be considered as well.

New Hampshire is a famously low-tax state, with no tax on general sales. By extending its sales tax to previously untaxed services, Maine would improve the fairness and efficiency of its own sales tax, but it would also lengthen the list of services that are less expensive in New Hampshire.

Maine is attempting to shift some of the tax burden off their citizens and onto out-of-state residents. The list of newly taxed services include numerous items specifically designed to disproportionately tax "out-of-staters" such as rentals, entertainment and recreation services. (Not that Mainers never purchase these products.) This tax-your-neighbor strategy is likely to draw retaliation from neighboring states and distort economic decision making. The most egregious example of taxing the tourist is the raising of rates on lodging and prepared food from 7% to 8.5%.

Additionally, the statutory 6.5% rate does not represent the full effect of all the new tax provisions. Many Maine families would lose part of the new credit and so their effective marginal tax rate would be 8%[3], still better than the status quo but not as big an improvement as it seems.

The current bill is being touted as revenue neutral by its proponents. There is a concern that the services targeted for the sales tax will recover faster than the rest of the economy. As these services recover they will produce greater tax revenue.

Moving Forward

The Maine legislature has attempted broad and far-reaching reform of their tax system. Ultimately the reform effort is a positive step forward. It would have been better if LD 1088 had been enacted into law instead of LD 1495. However, both represent an attempt to simplify and stabilize the Maine tax system. LD 1495 loses some of the simplicity of the flat tax and creates specific exemptions for certain industries. This represents partial failure to broaden the base and lower the rate.

The Maine legislature should remain focused on creating a tax code that pushes for simplicity, neutrality and stability. Whether this marks the beginning of larger tide of beneficial tax reform or the high watermark is yet to be seen.

Notes

1.http://www.mainelegislature.org/legis/bills/bills_124th/billpdfs/HP075001.pdf.

2. http://www.mainelegislature.org/legis/bills/bills_124th/billpdfs/HP105101.pdf.

3. J. Scott Moody, "LD 1088: The Illusion of Tax Reform" *Path to Prosperity* 7, April 16, 2009.

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