

Fiscal Fact

Maine Governor Sneaks Subtle Income Tax Hike into Budget; Suspends Funding to Local Governments

By

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Last week, Maine Governor Paul LePage released his 2014-2015 biennial budget. Most of the tax-related items relate to changes in property tax programs (in the form of an increased homestead exemption for elderly taxpayers and changes to the state’s “Circuit Breaker” program¹), but the governor also called for the temporary suspension of municipal revenue sharing and a stealth increase in income taxes. Not only is the new income tax policy tacked on to the very end of the tax-related provisions in the budget briefing,² it is also difficult to understand how the new measure will affect state residents if one is not well-versed in income tax indexing and inflation.

The provision has two key parts: first, it suspends inflation indexing of the state income tax brackets for two years; second, it alters the manner in which the calculation is completed in subsequent years. The implications of this are that for 2014 and 2015, bracket levels will not be adjusted for inflation but instead remain at 2013 levels. After 2015, indexing will be done using what is known as “chained CPI.” The two changes together are expected to raise an additional \$8.6 million over the biennium.³

The Two Year Indexing Suspension

Inflation adjusting income tax bracket levels is important for taxpayers. When an income tax system does not adjust tax brackets for inflation, a phenomenon known as bracket creep can occur. Higher income can bump a taxpayer into the next tax bracket, even if that higher income is merely keeping pace with inflation. Maine’s income tax statute even explains that inflation results “in increasing the taxpayer’s liability while the taxpayer’s purchasing power has remained the same, or in some instances has decreased,” requiring bracket adjustments to “compensate for the impact of inflation.”⁴

¹ The Circuit Breaker program is intended to grant state residents a partial refund (up to \$1,600) for rent paid or property taxes paid on a primary residence. According to the state’s Revenue Services website, “nearly 200,000 Maine households qualify for a partial refund of property tax assessed and/or rent they paid in 2011.” See Main Revenue Services, *Maine Residents Property Tax and Rent Refund - Program Summary*, <http://www.maine.gov/revenue/taxrelief/tnrsummary.htm>.

² Office of Governor Paul R. LePage, *2013 Supplemental Budget Briefing* (Jan. 11, 2013), http://statedocs.maine.gov/cgi/viewcontent.cgi?article=1001&context=bob_docs.

³ *Id.* at 17.

⁴ ME. REV. STAT, tit. 36, § 5401, <http://www.mainelegislature.org/legis/statutes/36/title36sec5401.html>.

A lack of inflation adjustment can also push more of a taxpayer's income into the highest bracket for which they qualify. This combined with bracket creep can lead to a higher average tax rate. This is problematic because increased incomes haven't risen in *real* terms—only *nominally*. Indexing addresses this by altering each bracket level each year by the level of annual inflation.

The governor's plan would freeze the income tax brackets at these 2013 levels for 2014 and 2015, eroding them as inflation occurs at an expected level of about two percent per year.⁵ The 2013 Maine income tax rates for a single individual can be found in Table 1 below.⁶

What does this mean for Maine taxpayers? Take an individual who earns \$40,000. Currently, that person takes a standard deduction of \$6,100 and a personal exemption of \$3,900, leaving \$30,000 as taxable income. After applying the tax table, he would owe \$1,744 in state income tax. If the taxpayer then gets a 2 percent raise to keep up with inflation, his income rises to \$40,800. Under existing state law, the tax brackets also adjust with inflation and his state income tax bill will rise only to \$1,779 (a 2 percent increase). But under the governor's proposal, the tax brackets do not adjust for inflation, so the taxpayer's state income tax would rise to \$1,808 (a 3.6 percent increase).

Table 1: Maine Individual Income Tax Brackets & Rates, Single Filers, 2013

Taxable Income	Income Tax Rate
\$0-\$5,199	0%
\$5,200-\$20,899	6.5%
>\$20,900	7.95%

Source: Maine Department of Revenue. Taxable income is adjusted gross income minus deductions and personal exemptions. Maine offers a standard deduction of \$6,100 (\$12,200 for couples) and a personal exemption of \$3,900.

In all cases, the suspension will raise average tax rates. Under this proposal, some individuals who formerly had incomes under the allowable exemption amount will become taxable. Some will spill into the next higher tax bracket and some will simply push deeper into the bracket to which they are subject.

The Switch to the Chained CPI for Income Tax Adjusting

The Consumer Price Index (CPI) is calculated monthly by the Bureau of Labor Statistics to estimate “changes in the prices paid by urban consumers for a representative basket of goods and services.”⁷ This measure, technically called CPI-U, is currently the way in which Maine calculates cost-of-living adjustments for its income tax brackets. Governor LePage proposes switching in 2016 to “chained CPI,” which has a slightly different methodology. Chained CPI varies expenditure weights monthly rather than retaining weights reflecting expenditures in a specified base year and is thought to be a more accurate picture of cost-of-living changes and the way in which households substitute between goods when prices change. Using the chained CPI would cause taxes to increase faster than if the CPI-U were used because income tax bracket

⁵ Executive Office of the President and Council of Economic Advisers, *Economic Report of the President* (Feb. 2012), http://www.whitehouse.gov/sites/default/files/microsites/ERP_2012_Complete.pdf.

⁶ Maine Revenue Services, *State of Maine – Individual Income Tax 2013 Rates*, http://www.maine.gov/revenue/forms/1040/2013/1040RateSched_13.pdf.

⁷ Bureau of Labor Statistics, *Consumer Price Index*, <http://www.bls.gov/cpi/>.

levels would not rise as fast. Taxable income would rise up through the brackets more each year compared to current practice.

The resulting tax increases would continue over time. The use of a lower measure of inflation would make it more likely that an increase in wages would move a non-taxpayer onto the tax rolls or result in a big percentage increase in the amount of his wages that are subject to tax. Not only could this force more individuals to be subject to the income tax on the lower end (because their incomes would now reach the non-zero brackets), but it could also push taxpayers in the second bracket into the top-rate bracket. Although the bracket creep is only expected to increase the average resident's tax modestly (by \$39) over the next two years,⁸ this amount could increase over time.

The Suspension of Municipal Revenue Sharing

Another tax-related portion of Governor LePage's budget proposal is a temporary suspension of municipal revenue sharing. This would halt the distribution of state income and sales tax revenue to local governments for two years, saving the state almost \$200 million during 2014 and 2015. Maine's local governments currently rely on state aid for about a third of their spending.⁹ How this dramatic reduction in local aid is expected to affect services administered by local governments remains to be seen.

Conclusion

Although Governor LePage has made a commitment to income tax reductions during his term, some state legislators this year have suggested increasing rates on high-income earners.¹⁰ Despite pressures to make up revenues elsewhere, changes to the way in which the state indexes for inflation should not to be used as a quick tool to fill a budget gap. Indexing is intended to ensure that taxpayers' taxes do not grow faster than their real incomes. Further, since local governments in Maine depend on the state for a significant portion of their overall revenues, suspending revenue sharing for even two years could force localities to shift to other revenue sources, such as increased property taxes. Temporary changes such as these make it difficult for taxpayers and local governments alike to effectively make long-term plans.

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⁸ Steve Mistler, *Slight tax increase in LePage's budget plan*, PORTLAND PRESS HERALD, Jan. 15, 2013, http://www.pressherald.com/news/slight-tax-increase-in-governors-budget-plan_2013-01-15.html.

⁹ U.S. Census Bureau, *State & Local Government Finance, fiscal year 2010*, <http://www.census.gov/govs/estimate/>.

¹⁰ Robert Long, *Republican state senator proposes raising taxes for households earning at least \$250,000*, BANGOR DAILY NEWS, Jan. 16, 2013, <http://bangordailynews.com/2013/01/15/politics/republican-state-senator-proposes-raising-taxes-for-households-earning-at-least-250000/>.