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Tax Policy and Economic Development in Maine: A Survey of the Issue

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Prepared for the

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Executive Summary

THIS REPORT FOCUSES ON TAX POLICY and economic development in Maine. Separate reports have been prepared as part of a broader project that includes examination of economic development trends and workforce development issues. The purpose of this report is to provide a foundation for discussion and debate of tax policy options generally and, in particular, those relating to economic development in Maine. The work in this report begins with a brief discussion of the linkages between tax policy and economic development. The discussion then turns to the criteria used to structure tax policy (known as the requirements of a good tax system), state and local revenue trends, and specific state and local taxes. Extensive references to the research literature are offered to enable the reader to probe more deeply into specific areas of policy interest. This report is simply the tip of the iceberg.

Several general conclusions emerge from this report:

1. Tax policy and economic development need to be considered in the broader context of state-provided services and state aid, and the structure of local government finances and service delivery. The fiscal system of Maine is not transparent to most taxpayers; finances are heavily centralized at the state level; state aid (particularly aid to education) limits the flexibility of state government and there is essentially no local government tax autonomy. These problems are interwoven and cannot be easily addressed in isolation.

2. Public policy should be based on well-established goals for the tax system and economic development. Tax policy goals should recognize the accepted tenets of a good tax system, including tax fairness; revenue yield, stability and elasticity; neutrality and economic development; and low costs of administration and compliance. In practice these goals can be in conflict with one another, giving rise to difficult choices for policymakers. Similarly, economic development policies—including economic development incentives—must be based on specific goals and must be amenable to evaluation to gauge effectiveness.

3. The state should sustain a relatively strong degree of overall tax system elasticity to allow for maintenance of a strong rainy day fund and to enable investments that are not possible during periods of weak revenue growth.

4. Efforts to promote tax fairness should rely on the personal income tax, not the sales, corporate income or property taxes. The personal income tax allows policy to focus on the specific circumstances of households, unlike other taxes.

5. Greater revenue balance, such as diversity in revenue sources, is needed at both the state and local levels. The state relies

too heavily on the personal income tax, while local governments have no viable alternative to the property tax.

More specific recommendations include:

1. Maine's personal income tax rate structure should be compressed, potentially moving to a single flat rate. The current structure includes a rapidly progressive rate structure that can distort economic activity. The rate structure of the personal income tax should mirror that of the corporate income tax.

2. There appears to be some room to increase selective sales taxes, meaning the unique rates levied on specific items such as alcoholic beverages and tobacco. While these items tend to grow slowly with economy-wide growth, they can still be an important complement to the overall state tax base. Concerns over the regressivity of such levies should be addressed through the income tax.

3. Maine has largely mirrored the nation with its corporate income tax, adopting a double-weighted sales factor for corporate income apportionment and enabling limited liability entities. But the evidence suggests corporate tax burdens in Maine have not fallen to the same extent as the pattern for New England and the nation. Further analysis of this issue is clearly warranted, given the importance of the corporate income tax to economic development. There is no clear understanding today of Maine's corporate tax burden relative to other states, particularly as it pertains to tax burdens for specific sectors of the economy and for firms of different sizes. Consideration should be given to elimination of the progressive corporate rate structure, moving to a flat rate commensurate with the suggested flat rate on personal income. Consideration should also be given to a business enterprise tax, akin to that in New Hampshire, as a replacement for the corporate income tax. Such a policy would expand the business tax burden to all firms, allow for low rates of taxation and provide a more stable flow of revenue.

4. Efforts should be made to move the sales tax closer to a true consumption tax. To the extent possible, business sales tax burdens should be reduced, as the sales tax borne by business exceeds the burden of the corporate income tax. Consumer services should be added to the base of the sales tax to the extent possible.

5. Grocery food should be added to the sales tax base, enhancing revenue yield and stability, increasing tax exporting opportunities, and simplifying administration and compliance. Relief can be provided at a substantially lower cost through the personal income tax, including refundable credits for low-income households.

6. The state should avoid pressures to reduce the elasticity of the sales tax, especially through tax rate reductions. External forces are at play that are working to lower the performance of the sales tax, including the continued growth in mail order sales, electronic commerce and the service sector.

7. The system of local government finance is broken. The historical benefit-property tax linkage no longer exists. The presence of the Business Equipment Tax Reimbursement (BETR) program, Tax Increment Financing (TIF) districts, circuit breakers and homestead exemptions under the property tax, coupled with no

other local tax instruments of note, compromises local government's ability to provide services and its responsibility to be accountable for the same. Consideration should be given to wiping the slate clean and simply lowering property taxes from their current levels in a revenue-neutral fashion. These issues must be addressed prior to the enabling of additional local taxing authority.

8. Specific options for expanded local taxing authority should be developed. Local options sales taxes and gross receipts taxes are particularly attractive options for consideration. Regional tax base sharing, or state aid, should be used to help equalize tax capacity across municipalities.

These are some of the more important recommendations that follow from the review of economic development and tax structure in Maine. The full report provides background and a more complete discussion of the issues.

PART ONE

Introduction

Like regional economies across the world, the Maine economy continues to undergo rapid transformation and change. These changes offer the state and its residents new opportunities as well as new challenges. The decline of traditional industries is encouraging entrepreneurs to look in new directions. The emergence of the World Wide Web enables immediate access to the global economy and new business opportunities. The work ethic of the labor force and quality of life should support new business and industry, and help to retain people and families. But change also creates threats and challenges.

In Maine's case traditional historical economic advantages—including shipbuilding, national defense and forestry and fisheries—are not being fully supplanted by new competitive alternatives. Complicating Maine's economic development situation is its location and relative isolation, which can raise the costs of doing business in the state vis-a-vis other locations. Earnings growth has stagnated. Regional differences within the state are seemingly more pronounced than ever, raising concerns about two (or more) Maines.[1] The population is aging and anecdotes suggest a brain drain of young workers. Sprawl is increasing, raising service delivery costs for state and local governments alike, aggravating a pre-existing service-center cost problem. Furthermore, in 1998, Maine found itself leading the nation in combined state and local tax burden, leading to increased pressures for tax reform generally and tax relief targeted to specific taxpayer groups. Residents of Maine find themselves asking: What went wrong? Some would like to blame taxes, others might point to location, still others would argue that global competition is the culprit. The reality is that there is no single reason for the dramatic changes taking place in the Maine economy, and hence there is no single nor simple solution.

The outlook hasn't always been as bleak as the picture painted above suggests. The 1980s brought a welcomed economic boom to the state that benefited many families, businesses and regions. This is the Maine folks would like to remember. But this same boom may have simply masked serious underlying structural defects in the economy and tax structure. The economic collapse in the early 1990s brought these weaknesses to the forefront. The 1990s were a period of introspection and debate on the subjects of economic development and tax policy. The recent recession offers yet another important challenge to the economy and state and local government finances. Today, residents of Maine

…in 1998, Maine found itself leading the nation in combined state and local tax burden,… What went wrong?

1 In September 1998, the *Bangor Daily News* ran a multi-part series on "The Two Maines: Separate but not Equal." Many learned residents have discussed different dimensions of the haves-have nots problem of the state.

are building on the experiences of the past twenty years, working earnestly to construct economic development and tax policies that can address and respond to changing economic and demographic conditions.

This report is about taxes and economic development in the state of Maine. It is one of three reports being published by the Margaret Chase Smith Center for Public Policy at the University of Maine, each of which are funded jointly by the U.S. Economic Development Administration and the University of Maine. Other work will focus more specifically on economic development trends and issues, as well as issues related to the labor force and workforce development. It is hoped that the three reports will offer a complementary view of the economic development issues and options confronting the state of Maine today. This report on taxes builds heavily on the hard work and good thinking of residents of Maine who have first-hand experience with the subject. Data and background sources of information on important policy issues are presented and discussed. The goal is to provide a common foundation for discussion and debate on the tax policy-economic development conundrum in Maine. Many of the ideas in this report are not at all original, having been drawn from the insights and experiences of others.

The report is organized as follows: The next section provides a general discussion of quality of life, tax policy and economic development in Maine to illustrate the way in which these issues are connected. The third section of the report introduces well-established tax policy criteria—known as the requirements of a good tax system—that are used to help guide the analysis of tax systems and tax reform. The fourth section provides an overview of state and local government finances in Maine, based on comparable interstate data. This helps to place Maine in both a regional and a national context. The fifth section is an analysis of major state taxes, and key local tax issues, built around the previously introduced tax policy criteria. Any tax policy proposals must be built on a thorough understanding of the way in which taxes are structured in practice, and their strengths and weaknesses. The report closes with a discussion of tax policy and economic development, including considerations for policy change.

PART TWO

Taxes and Economic Development

QUALITY OF LIFE AND A STRONG business climate are essential to any state. While it is easy to discuss the economic and fiscal woes confronting Maine, it is equally easy to discuss the many strengths of the state and its residents. The natural beauty of Maine is unrivaled, offering a high quality of life for those who want it. The people of Maine are friendly and hardworking, and there is a deep commitment to fostering further improvements in quality of life. A look at the data says a lot about the commitment of Maine residents toward their neighbors and their future. Table 1 shows national rankings for selected components of the so-called Camelot Index, which—as the name

Table 1: National Ranking for Selected Camelot Index Components

	New England States					
	ME	CT	MA	NH	RI	VT
Healthy people	12	8	2	5	6	13
Crime free	5	14	22	1	14	4
Educated population	12	15	16	17	20	7
Healthy society	12	23	26	13	44	14
Prudent government	42	47	38	30	49	45

Source: *State Policy Reports* 19(7): 2001.

Table 2: National Ranking for Selected Kids Count 2002 Indicators

	New England States					
	ME	CT	MA	NH	RI	VT
Percent low birth weight babies	6	23	18	9	20	2
Infant mortality rate	1	12	4	9	6	9
Child death rate	6	3	2	3	7	7
Teen death rate*	32	5	3	6	2	15
Teen birth rate	4	10	5	1	16	2
National composite rank	12	8	6	2	16	9

*Note: * Rate of teen death by accident, suicide or homicide; all data are for the time period 1999.*

Source: www.aecf.org/kidscount/kc2002/index.htm implies—is intended to speak to the quality of life within and across states. By most measures the state compares well with its peers in the northeast and other states across the nation. Maine ranks twelfth in the nation in terms of a healthy society, a measure which captures an array of items including homeownership, voting participation rates, the number of unwed mothers, the number of single-parent families and the percent of the population receiving welfare. All states in New England rank poorly in terms of prudent government, largely reflecting high tax burdens that prevail across the region. The nationally recognized Kids Count program also ranks Maine relatively highly by U.S. and regional standards, as shown in Table 2.

Clearly there is something terribly right about the state of Maine. Maine residents are making some good choices that have borne fruit, but some of these choices have come at a price, namely relatively high taxes at the state and local level. Like most things in life, you get what you pay for, and taxes are no exception. A question that Maine will increasingly find itself asking is whether this is a price that residents can afford to pay.

Business climate indexes, as the very name implies, focus more on factors related to business prosperity than on broad measures of quality of life. As such, it perhaps is no surprise that Maine does not rate as highly by these measures. A case in point is the annual *Development Report Card for the States,* prepared by the Corporation for Enterprise Development. Shown in Table 3 are the rankings for Maine and other New England states for 2001. Maine's best grade is in the performance category, where it receives a B, reflecting good measures of equity and quality of life. But the state received poor rankings on job quality (i.e., earnings) and short-term employment growth. In business vitality the state receives only a C, reflecting the dual weaknesses of low competitiveness and entrepreneurship. Finally is the development capacity category, where Maine earned a D. The reason for this low grade is that the state generally ranks low on human, financial, infrastructure and amenity resources, as well as innovation assets. The reader is strongly encouraged to visit the Web site that serves as the source for this information and study it carefully to identify both fact and fiction.

It is relatively easy to find similar, if not more negative rankings for Maine and the state economy. For example, the Small Business Survival Committee released its

Table 3: Report Card Ranking of New England States, 2001

	New England States					
	ME	CT	MA	NH	RI	VT
Performance	B	A	A	A	B	A
Business vitality	C	A	A	C	C	B
Development capacity	D	A	A	C	C	C

Source: *Development Report Card for the States,* 2001. Corporation for Enterprise Development, www.cfed.org.

seventh annual Small Business Survival Index in July 2002.[2] This group, which is particulary interested in the role of government policies on entrepreneurship and small businesses, placed Maine third from the bottom across all states; only Hawaii and the District of Columbia had lower rankings. Given the strong role that taxes play in this index, it is no surprise that Maine finds itself so poorly ranked.

A final perspective is offered by the Milken Institute, which has developed a New Economy Index.[3] The purpose of the index is to capture a state's preparedness for economic growth in the so-called new economy of information, knowledge and globalization. In 2001 Maine received a national rank of forty-three (a drop from thirty-five in 2000), ranking far worse than any other state in New England; Massachusetts received the top ranking. The relevance of this index reflects the criteria used in its construction, which range from measures of educational attainment to research and develop spending to business startups. The data suggest Maine is ill-prepared to integrate itself into the new economy. Again the reader is encouraged to study the index in greater detail to better understand the reasons for the state's ranking.

All of the data used in this discussion are intended to provoke thought, discussion and debate. Certainly no single index can adequately capture all dimensions of quality of life or business climate. But there are some important common themes to the data and the perceptions they reflect and help to form. Maine does support a high quality of life and residents are committed to their future. At the same time, the Maine economy is struggling; there are problems with the existing workforce and the workforce of the future; and there are imbalances in the state's tax system. To some extent, the economic development and tax problems are interwoven. The economy does influence revenue performance, just as the tax system influences economic activity. Similarly, today's workforce influences the productivity of the economy and determines the foundation for the economy of the future. Taxes influence how much one works, where people choose to live and the educational investments people make.

…why do many states and nations with high taxes prosper, and why do numerous low-tax states and nations struggle to engineer economic prosperity?

Taxes

Taxes in Maine rank among the highest in the nation and some argue that they are the major obstacles to stronger economic growth.[4] But if high taxes were the sole culprit, why do many states and nations with high taxes prosper, and why do numerous low-tax states and nations struggle to engineer economic prosperity? Taxes and economic development is a two-way street. Taxes do influence economic activity, just as economic performance influences revenue performance. Certainly taxes matter; the real question is: How much? Timothy Bartik of the W.E. UpJohn Institute for Employment Research released his summary of the

2 See www.sbsc.org.

3 See www.milkeninstitute.org/ecoindex/index.html.

4 A nice introduction to the issue is "Tax Policy and Economic Development: A Roundtable Assessment," *Maine Policy Review*, December 1996. Participants of the roundtable include Brian Mahany, Alan P. Brigham, Christopher St. John and Charles Colgan.

research of the role of taxes in influencing economic behavior in 1991, at the time representing the most comprehensive inventory of the available research.[5] Perusal of this work clearly shows that while taxes do matter, the responsiveness to variations in taxes across states and localities is in most instances quite modest. A more recent summary, based on a symposium sponsored by the Federal Reserve Bank of Boston, reached a similar conclusion.[6] Of course, the further out-of-line a tax system is relative to other jurisdictions, the greater will be the distortions. The research also shows that certain government policies, ranging from education to infrastructure, can enhance growth. Yes, taxes matter, as do quality government-provided services.

> How high can taxes be without creating excessive economic distortions? How much equity can Maine residents afford to buy through their tax system…?

Taxes are not breaking the back of the Maine economy, nor would tax reform and reductions in tax burdens likely lead to an economic renaissance in the state. But taxes are part of the problem and are part of the solution. Tax burdens are high, distorting economic activity (i.e., changing taxpayer behavior) and raising concerns over tax fairness. Fiscal flexibility at both the state and local level has been constrained and compromised. Sprawl and the infamous service center problem (i.e., communities with high public service delivery costs relative to the ability to raise revenue from own-source taxes) are sharply raising the costs of government finance.

At the same time these internal tax problems have surfaced, the state confronts the need to use scarce public funds to invest in its future to promote and support economic development, especially investments in productive infrastructure and the workforce. The plot thickens when external economic and tax influences are put on the stage. The forces of globalization and competition are creating a new environment for economic activity. Old protected industries and workers may no longer be competitive, creating ripples across regions within the state. State and local tax structure confronts its own external challenges. Capital has become more and more footloose over time as firms seek out low-cost sites for doing business, while tax planning is placing the traditional corporate franchise and excise taxes at risk. The property tax, heavily relied upon in Maine and other New England states, has long been the most disliked tax of all. Sales tax bases are being eroded through targeted exemptions granted to business, and consumer and business purchases from remote vendors. The personal income tax is subject to the threat of mobile, high-income taxpayers who increasingly resist high and progressive rates of taxation.

5 See *Who Benefits from State and Local Economic Development Policies?* by Timothy Bartik, W.E. UpJohn Institute for Employment Research, Kalamazoo, 1991.

6 See "The Effects of State and Local Public Policies on Economic Development: An Overview," by Katherine L. Bradbury, Yolanda K. Kodrzycki and Robert Tannenwald, in "The Effects of State and Local Policies on Economic Development, Proceedings of a Symposium," *New England Economic Review*, Federal Reserve Bank of Boston, March/April 1997.

A Summary: The Road Ahead

The state of Maine is at a critical juncture. High state taxes have received national notoriety, high local property taxes are discouraging growth in municipalities and straining service delivery. The economic transformation of the national economy continues to run its course and threatens to leave Maine behind. Decisions regarding tax structure and economic development policies need to be made soon to influence the state's future. Maine must decide what it wants from its tax system by setting out specific goals and objectives, some of which may be in conflict with one another. These conflicts and trade-offs must be addressed, debated and balanced. How high can taxes be without creating excessive economic distortions? How much equity can Maine residents afford to buy through their tax system, knowing that taxes distort economic activity? How rapidly should revenues grow during prolonged periods of economic expansion, and how stable should taxes be over the ups and downs of the business cycle? These and other questions should be addressed through a participatory process built on a rock-solid foundation of information and data.

Similarly, explicit goals and objectives for economic development generally, and workforce development in particular, need to be established. How aggressively should the state pursue tourism as a means of economic development? Do call centers, back-office operations and the like offer an engine of growth for the Maine economy? Should Maine be promoted as a retirement state? How should incentive programs best be structured to minimize tax losses and at the same time maximize economic development returns? What policies can be designed to promote investments in human capital and meet the workforce needs of Maine industry? Tax considerations should be of paramount concern in developing goals and practical policies to address these and other questions.

None of these questions will be easy to answer. But Maine has the brain trust to do the work, design and implement the policies, and enjoy the benefits. The choices need to be made now.

PART THREE

A Framework for the Analysis of Tax Structure

TAX REFORM IS AN ONGOING SUBJECT of debate in Maine and the pressures for change seem to be mounting. A survey undertaken by the Maine Municipal Association in 1996 found that over three-quarters of those surveyed wanted a major overhaul of the tax system, with eyes focused heavily on the local property tax. A similar survey conducted in early 2002 found that 70% of respondents wanted comprehensive tax reform. The pressures have become so serious, especially with respect to the property tax, that tax limitation movements have sprung to life.[7]

Numerous learned Maine policymakers and analysts have written about and discussed the various tax challenges confronting state and local governments. In January 1991 the *Final Report of the Select Committee on Comprehensive Tax Reform* was released. The committee's charge was the analysis of specific tax policy questions, with no overarching framework to guide the work and no direct linkage to economic development policy. Another report, *A Preliminary Outlook on Maine Tax Policy,* was released in September 1995. This report, prepared by a group of well-regarded analysts from outside the state, provided a broad overview of Maine's tax system and discussed widely accepted tax policy goals. The report reached conclusions that would generally be accepted by citizens and policymakers alike.[8]

Requirements of a Good Tax System

What is generally needed to enable meaningful tax reform is a common foundation of information and agreed-upon goals for tax policy and economic development. There are generally accepted criteria for analysis of tax systems at any level of government, and these have been used to some extent to guide discussions in Maine. These criteria, often referred to as "the requirements of a good tax system," embody the diverse policy goals ascribed to taxes. This section presents the requirements of a good tax system as a backdrop to the discussion of specific taxes in Maine, and the

7 Josephine LaPlante's "A Property Tax Cap for Maine? Roots of Voter Discontent and Likely Impacts," *Maine Policy Review*, July 1996, places the debate in context and draws out some of the consequences of an effective tax cap. Also see the Maine Municipal Association's "Impact of a Tax Cap on Municipalities in Maine," August 1996. This report offers little discussion but presents data on the consequences of a property tax cap for Maine municipalities. In a separate paper, LaPlante discusses the cap on spendable personal income tax revenue. See "Capping Maine's Income Tax: Neglected Issues and Dimensions," *Maine Policy Review*, October 1995.

8 Also see "Challenges for Maine's Tax System," by Anthony Neves, *Choices*, VII, January 23, 2001; "Overhauling Maine's Tax System," by Paula Valente, *Maine Policy Review*, December 1996; "Taking Charge of Maine's Fiscal Fortunes: Taxes are Only One Piece of the Puzzle," by Josephine LaPlante, *Maine Policy Review*, May/June 1997; "Whose Tax Burden and Whose Tax Fairness?" by Christopher St. John, *Maine Policy Review*, May/June 1997; and "Critical Exegesis of Maine's Tax Code," by Peter Mills, *Maine Policy Review*, Fall 1997. A series of commentaries, including those by Steven Rowe, Evan Richert, Christopher Lockwood and Rick Douglas, appear in the Fall 1997 issue of *Maine Policy Review.*

strengths and weaknesses of these same taxes. There is an inherent chicken-egg problem in this discussion. That is, it is difficult to discuss the elements of a good tax system without making explicit references to specific taxes. At the same time, the reverse approach of discussing specific taxes before discussing the goals of the tax system renders the analysis unstructured and of incomplete value.

As discussed more fully below, the requirements of a good tax system are: neutrality and economic development; taxpayer equity; revenue adequacy, elasticity, and stability; and simplicity of administration and compliance. A pragmatic approach is taken here where it is recognized that the state must fulfill certain service responsibilities financed by taxes levied on state residents, and at the same time balance the sometimes competing goals of tax policy. In short, the question isn't whether to tax or not to tax, but instead how to best structure the state's tax system to realize various tax policy goals. In the following discussion, the various concepts are explained and policy tradeoffs are generally noted.

Most state and local governments deviate from pure neutrality and use part of their tax system to encourage economic development,…

Neutrality and Economic Development

It is often said that a good tax system should not distort the decisions made by people and businesses; in other words, a tax system should be *neutral.* For example, a good tax system should not influence where people live or what they buy, or how much they work or save. Similarly, a good tax system should not alter how much a firm invests or where a firm chooses to place its investment. All taxes distort some choice or decision, and taxes in Maine are no exception. The state's high overall tax burden and its high local property tax burden clearly influence the decisions of businesses and households alike. But this is part of the tradeoff embedded in overall state tax policy. Maine's high service costs, which in part reflect the choices made by taxpayers, coupled with its desire for a fair tax system, necessarily give rise to relatively high tax burdens.

The notion of neutrality is in conflict with a separate policy goal, namely the promotion of economic development. In recent years neutrality seems to have been displaced by the buzzword *competitiveness.* Most state and local governments deviate from pure neutrality and use part of their tax system to encourage economic development, as with the double-weighted sales apportionment formula used by Maine under the corporate excise tax. (See the discussion of the corporate income tax below and the example on apportionment.) In such instances the policy goal is not neutrality with respect to other taxing jurisdictions, but instead a potentially lower tax burden that will encourage job and income creation.

Maine's relatively high overall tax burden increases tax-induced distortions and nonneutralities vis-a-vis other states. In other words, taxes alter behavior. Anecdotes abound regarding the distortionary effects of Maine's personal income tax and the way it discourages residency and may encourage noncompliance. Similar stories surface regarding business taxes. The Business Equipment Tax Rebate (BETR) program administered by the state and the Tax Increment Finance (TIF) program administered by local governments have created a storm of controversy.[9] The public views these programs largely as corporate welfare while the business community views the same programs as a necessary means of tax reduction (particularly with respect to the personal property tax) to ensure competitiveness. High rates of property taxation, especially in service centers, are a source of the problem and are likely contributing to sprawl, further aggravating the service-center problem as people and businesses seek to avoid high taxes. The income tax, with its rapid progression to the top bracket rate, makes other locations look attractive relative to Maine (especially New Hampshire), even for middle-income taxpayers.

Policymakers must make explicit choices regarding the degree of tax structure neutrality, and the extent to which tax policy in general and specific programs (including incentives) will be used to promote economic development. The key to a truly neutral tax structure is broad bases and low tax rates. This requires a variety of taxing instruments and the discipline to avoid granting tax preferences to specific taxpayer groups.

On the other hand, promoting economic growth through the use of tax policy and/or incentives requires a different strategy. Economic development goals and objectives must first be identified. The goals may be very general in nature, such as calling for the creation of high-wage jobs; goals may also be very specific, as with specific job targets for specific regions of the state. The next step is consideration and evaluation of specific policies, including tax policies, that are candidates for use. There should be a clear linkage between the tax in question and the economic development goal. For example, if the goal is job creation, then there should be a clear and explicit linkage between the tax and a firm's willingness to hire workers. Similarly, if the goal is to promote capital investment, tax policy must have a clear and direct impact on a firm's propensity to make investments. The economic development benefits that are expected to accrue from policy change, including jobs, incomes, earnings and new private sector investments, all need to be evaluated. This would include the jobs, incomes and investments for those enterprises directly influenced by tax (or incentive) policy, as well as economic activity influenced through the ripple effects of the multiplier. Finally, effects on state and local revenues, including both short-term yield effects and longer-term effects on elasticity, as well as state and local service costs, need to be isolated. Lower taxes or incentives will give rise to a direct revenue cost. At the same time, increased economic activity will expand tax bases and increase tax collections. Increased economic development activity also brings about costs, especially if job opportunities attract workers and families to the state, requiring expanded public service delivery.

Adequacy, Elasticity and Stability

State government must have adequate revenue to fund its service obligations, includ-

9 State programs are now evaluated by the Maine Economic Development Incentive Commission. For a review of the state's business assistance programs (i.e., BETR, TIF), see "The Effects of Business Assistance Programs on Employment Growth in Maine Establishments," which Todd M. Gabe, Department of Resource Economics and Policy, University of Maine, prepared for the Maine Economic Development Incentive Commission, July 2000. Also see "Maine's Economic Development Subsidies in 1998-99: Tax Credits Yield Few Jobs at High Cost Per Job," by Marc Breslow, *State Tax Notes*, November 12, 2001: 533-44; and "Tax Increment Finance in Maine," by Charles Roundy, Maine Center for Economic Policy, 1997.

ing intergovernmental transfers to lower levels of government. Once the state determines the scope of its service responsibilities, the tax system should produce adequate revenues to finance these same activities without creating planning difficulties and service interruptions. Adequacy is essentially a question of how big government should be.

Elasticity is the counterpart to adequacy that captures how strongly revenues grow over long periods of time. It reflects the responsiveness of tax revenue to growth in the tax base, using a constant tax rate and common definition of the tax base.[10] Stability, on the other hand, reflects only the short-run performance of revenues over the ups and downs of the business cycle. Stability is the short-run counterpart to elasticity. A highly elastic tax system will produce strong revenue growth during periods of expansion, while revenue growth will fall off appreciably when growth declines. The opposite holds true for inelastic tax systems.

Unfortunately, current estimates of elasticity for overall state taxes and specific taxes are not available for Maine or other New England states.[11] In many instances a surrogate measure of the tax base is used, most commonly income. For example, when examining the elasticity of the sales tax, reference is usually made to growth in personal income, where personal income is used as the proxy for the base of the sales tax. It is not a perfect measure; for example, it omits the way in which out-of-state households and business spending in the state influences taxable sales and sales tax collections.

A tax, or a set of taxes, is deemed to be *elastic* if taxes are responsive to growth in income. More precisely, a tax is elastic or relatively responsive if the percentage change in tax revenue exceeds the percentage change in income. In the instance of an elastic tax, the measure of elasticity exceeds 1.0. On the other hand, a tax is *inelastic* if it is unresponsive to growth in the tax base, or if the percentage change in tax revenue is less than the percentage change in income. In this instance, the measure of elasticity is less than 1.0. The concept of elasticity can be applied similarly to other taxes, including the corporate income tax.

The importance of elasticity surfaces in the context of financing state services over the course of time. If revenue grows more rapidly than service delivery needs, there may be the fiscal flexibility to reduce taxes. On the other hand, if revenue grows too slowly, rate increases or base expansions are required. In practice the notion of elasticity is closely interwoven with taxpayer preferences for government services and hence the spending side of the budget, as with its annual counterpart adequacy. High revenue elasticity can lead to an increase in the size of government relative to the private sector. Low revenue elasticity can lead to difficulties in funding government services and a contraction in the relative size of the public sector.

10 Alternatively, the concept of *buoyancy* is used to reflect revenue responsiveness when tax rates and/or tax bases are subject to change. Buoyancy can easily be measured using actual data on revenue collections.

11 A major difficulty in developing elasticity estimates is accounting for the myriad rate and base changes embedded in historical revenue data both within and across states. One overall estimate indicates Maine has the ninth highest elasticity of any state in the country. See *The Outlook for State and Local Finances: The Dangers of Structural Deficits to the Future of American Education*, by the National Education Association, 1998.

Different taxes perform differently over time based on their specific structure and underlying economic dynamics. Maine's personal income tax has been instrumental in supporting strong revenue growth during periods of growth—due in part to the rapid degree of progressivity inherent in the rate structure—but it should not be allowed to become more elastic. The corporate income tax has not grown as rapidly for a variety of reasons, including creative tax planning practices on the part of corporations, as discussed more fully below.

In part, Maine chose to reduce the sales tax rate to reduce the overall elasticity of the tax system. But the sales tax elasticity is subject to many external threats that must be recognized when making state-level policy decisions. First, revenues are eroding due to shifts in the economy, most notably growth in the service sector. Second, the federal government has refused to address the states' problem of collecting sales tax on mail order sales, and has created a roadblock to sales taxation of electronic commerce. Finally, due to competitive pressures from beyond the state's border, more exemptions are being extended to business. Clearly Maine's entire sales tax base is not at risk, but a significant share is. For example, as noted below, estimates indicate a $57.8 million loss in sales tax revenue in 2001 due to electronic commerce alone.

Finally, there are the selective sales taxes—such as specific levies on specifically enumerated transactions—that generally show slow growth over time and have relatively small elasticities. Fees and user charges, such as fuel taxes, grow as a result of growth in the number of gallons of gasoline sold, but the higher value of gasoline is not captured in the tax base. Simple fees and excise taxes, by applying tax to the units consumed rather than the value of purchases, generally grow slowly relative to economy-wide growth. A good tax system will have a variety of taxes that together produce the desired rate of overall revenue growth.

Maine's tax system has been criticized for its relatively high elasticity, driven heavily by the performance of the personal income tax. While there may be some room to lower the overall system elasticity, policy changes should proceed slowly and recognize the external forces at play that will influence long-term revenue growth absent policy change. A relatively strong revenue elasticity is needed to fund services and investments that had been compromised during periods of poor revenue performance, and replenish rainy day fund balances. Estimates of changes in revenue elasticity should accompany all major changes in state tax policy.

Maine's tax system has been criticized for its relatively high elasticity, driven heavily by the performance of the personal income tax.

State government would like a tax system that produces a stable flow of revenue over the ups and downs of the business cycle. This avoids the need to cut services or raise taxes during periods of economic contraction, and minimizes the accumulation of large surpluses during periods of expansion. But no single tax, nor any overall tax system, is truly stable. During periods of economic decline, income and profit growth slows, in turn depressing revenue growth from the personal and corporate income tax. Similarly, consumers retrench and avoid purchasing big-ticket items (such as homes, home furnishings and automobiles), while businesses choose to postpone investments, depressing sales tax revenue.

A properly balanced tax system, one that relies on a variety of taxes that perform differently over the ups and downs of the business cycle, can minimize but not eliminate instability. Similarly, specific taxes, through the choice of the tax rate and tax base, can be designed to minimize but not totally avoid the instability problem. For example, depending on the specific services included, a sales tax that includes services in the base may be relatively more stable, as spending on services is largely sustained during economic contraction vis-a-vis the purchase of manufactured products. On the other hand, an income tax with progressive rates could support very strong revenue growth during periods of economic expansion, yet perform very poorly in the face of economic decline.

Given other policy objectives, minimizing instability is the appropriate course to take, not the entire elimination of instability. Technically, this requires an analysis of the covariance of specific taxes and tax policy options, to determine how a portfolio can be constructed to minimize instability, in much the same way financial portfolios are structured to reduce risk.[12]

Rainy day or budget stabilization funds are increasingly used across the American states to help meet spending requirements during periods of weak revenue growth. These funds are a relatively new phenomenon, rapidly growing in use following the wrenching budget experiences of the early to mid-1980s. Rainy day funds in Maine were introduced in 1985, with an initial $25 million statutory cap. Balances as a share of general fund revenue generally grew through the 1980s, then dipped as they were drawn upon to meet service needs during the recession period of 1990. The fund rebounded and by 2000 stood at $143.5 million.[13] But the recent recession caused the state to once again tap this reserve fund. To close a $90 million gap in the 2001-2002 budget, nearly $90 million was taken from the reserve fund, money that had been allocated for the subsequent fiscal year.

Due to the relatively recent introduction of rainy day funds and the generally strong economic climate that has prevailed across the nation since their inception, there is little firm agreement on the optimal size of the balance, nor how funds should be drawn upon during periods of acute need.[14] A rule of thumb of 5% has been suggested, but recent analysis suggests states should structure rainy day funds to meet their own unique needs and circumstances.[15] One thing is certain: rainy day funds are here to stay. In order to properly support and maintain fund balances it is essential that revenue growth during periods of economic expansion is relatively strong, allowing diversion of tax proceeds. In practice this requires a more elastic

12 In this context, covariance is the way in which different taxes move with respect to one another during a period of contraction or a period of expansion. While taxes are generally cyclical, growing during expansions and slowing or contracting during periods of weak growth, some taxes are highly unstable while others are relatively stable. A stable tax portfolio includes a mix of taxes where the volatility of one tax instrument is offset by the stability of another.

13 See www.state.me.us./legis/ofpr/compendium00.htm, page 50.

14 See "When it Rains it Pours: A Look at the Adequacy of State Rainy Day Funds and Budget Reserves," by Iris J. Lav and Alan Berube, *State Tax Notes*, May 17, 1999. Also see "Intergovernmental Aspects of Growth and Stabilization Policy," by William F. Fox and Matthew N. Murray, *Intergovernmental Fiscal Relations: Perspectives and Prospects*, Kluwer, 1997.

15 See "What's So Magical About Five Percent? A Nationwide Look at the Factors that Influence the Optimal Size of Rainy Day Funds," by Philip G. Joyce, *Public Budgeting and Finance*, Summer 2001: 62-87.

revenue structure than otherwise would be required to solely fund ongoing services.

Taxpayer Equity

Fairness in taxation is an essential element of a fiscal system. In the state of Maine tax fairness has taken center stage as one of the most important policy considerations in the design and reform of state and local taxes. Concerns over fairness and equity have contributed to a highly complex and less-than-transparent tax system.

Of course fairness is in the eyes of the beholder. One concept of fairness argues that taxes should reflect the benefits one receives from government services. This is an extension of the logic of the private market, where people freely purchase goods based on the price they pay and the benefits they derive from consumption. The benefits-received concept is the foundation for user charges such as gasoline taxes and park fees. User fees are a particularly good means to finance government services directly and uniquely received by individual taxpayers. They are less appropriate when government services jointly benefit a large number of citizens and the benefits for any one taxpayer are obscured. Examples include public safety, public health and policies to protect the environment.

User fees and benefit charges are often criticized as ignoring an individual's ability to pay, which is typically measured by an individual's or household's income. For example, low-income individuals do not have the same ability to pay gasoline taxes and park fees as do high-income individuals, and this may be viewed as unfair. At the same time, many view similar tax liabilities as fair to the extent ability to pay is similar. There are two well-accepted measures of tax fairness based on the notion of ability to pay.[16] The first is *horizontal equity,* or the way in which similar individuals and households are treated by the tax system. Horizontal equity calls only for the equal treatment of equals, something most people would find to be an acceptable measure of fairness. Horizontal equity is violated when two individuals or two households that are otherwise similar confront different tax burdens. In practice, *similar* is often taken to mean the same income, although adjustments for other factors such as family size may be taken into account.

Horizontal inequities can easily result in a state tax system. For example, two households with the same income and same number of family members may purchase a different mix of sales taxable and non-taxable goods and services, and hence pay a different amount of sales tax. This might reflect a different mix of in-state purchases, or alternatively one household buying via mail order, over the Internet, or through border purchases. (This example assumes that individuals bear the burden of the sales and income taxes.) Horizontal inequities also result at the local level in Maine, such as when otherwise similar households confront different local property tax burdens depending on where they reside.

The second notion of fairness is *vertical equity,* or the way in which taxpayers with differing

16 In discussions of fairness and equity it is important to distinguish between the statutory liability of a tax and who ultimately bears the burden or *incidence* of the tax. For example, corporations may nominally pay income taxes, but some of this tax burden might be shifted forward to consumers in the form of higher prices, or shifted backward to workers in the form of lower wages. In such an instance, the firm's statutory tax liability overstates its true economic tax liability, and consumers and workers are said to share in the incidence of the tax.

abilities to pay, again typically measured by income, are treated by the tax system. A tax is said to be *progressive* if taxes as a share of income rise as income grows, *regressive* if taxes as a share of income fall when income grows, and *proportional* if taxes remain a constant share of income. Unfortunately, it is impossible to make an objective statement on whether a tax should be proportional, progressive or regressive. Progressive taxes were popular decades ago as governments sought to redistribute income away from higher income taxpayers toward the lower end of the income distribution. But there has been significant movement away from progressive taxation due to the adverse incentive effects they engender, particularly the incentives to work and save, and residential location choice. Incentive effects are especially important at the state and regional level, where high taxes and individual mobility may lead to an exodus of high-income taxpayers. Regressive taxes are viewed by many as unfair since the poor pay a higher share of income in tax than higher income taxpayers, even though higher income taxpayers may pay more in total taxes.

…there has been significant movement away from progressive taxation due to the adverse incentive effects they engender…

Income taxes can be progressive, regressive or proportional depending on how they are designed. The ultimate burden of the income tax depends on its rate and base structure, the presence of any credits, deductions, exemptions, and the incidence of the tax. Flat taxes, despite the common flat rate, can produce a progressive tax burden. For example, a flat-rate income tax of 4% with an exemption per taxpayer of $20,000 would yield a mildly progressive tax despite the flat rate. In this instance an individual earning $10,000 per year would pay no tax, whereas an individual earning $30,000 would pay $400 in tax (or 4% of income above the exemption threshold of $20,000). Maine's income tax is progressive due to the presence of exemptions and a progressive rate structure.

Sales and selective sales taxes are generally viewed as having a regressive tax burden.[17] A primary reason is that lower-income people spend essentially all they earn and often draw down savings to support current spending (so that in some instances spending may actually exceed income). Hence low-income people will confront relatively high sales tax burdens vis-a-vis current income.[18] Higher-income individuals, on the other hand, save some income, thus avoiding a sales tax burden on the saved share of income, and may spend more on non-taxable services (i.e., education tuition). These same individuals then would have a lower sales tax burden relative to income. The sales tax burden can be made less regressive by exempting those items that lower income households dispro-

17 This discussion assumes that consumers ultimately bear the burden or incidence of the sales tax, as is typically assumed. In reality this may not be the case for at least two reasons. First, retailers operating in border areas where adjacent jurisdictions have lower sales tax rates may be compelled to lower their prices to sustain trade. In this instance the retailer may enjoy lower markups and hence lower profits than their cross-border counterpart. Accordingly, retailers share in the economic burden or incidence of the sales tax. Second, many purchases made by businesses are subject to sales tax, and some of this burden may be borne by businesses through lower profits or by workers through lower wages.

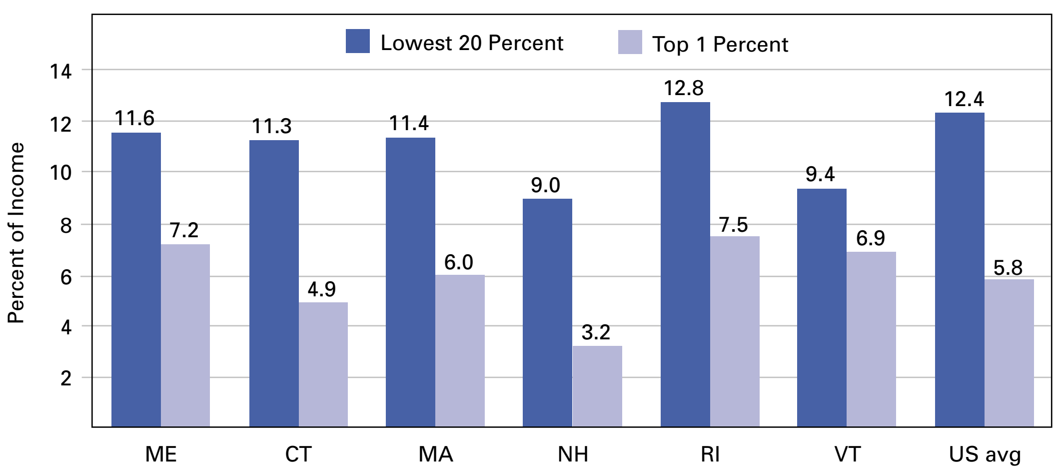
18 Some research has explored ***lifetime*** income versus ***current*** (or calendar year) income, and the way this influences the progressivity or regressivity of taxes. Generally, sales and special excise taxes become less regressive when lifetime income is used as a measure of ability to pay. See, for example, ***Who Bears the Lifetime Burden***, by Don Fullerton and Diane Lim Rogers, The Brookings Institution, Washington, 1993.

portionately consume, such as food and clothing. The primary drawbacks of this approach include the higher costs of administering and complying with the tax system, and the poor targeting (to include all taxpayers versus just the needy), which raises the revenue costs of low-income taxpayer relief. A good example is Maine's sales tax policy toward food, which is a complicated system to administer and with which to comply. These costs are just one price Maine pays to use the sales tax as a means of achieving equity objectives.

Recent evidence shows that owners of corporations likely pay most of corporate income taxes, although these findings are controversial.[19] Corporate franchise and excise taxes are likely borne more by higher income than lower income individuals, since the former have historically been holders of equity stock. But this is changing more and more as middle-to-low income households have increased their access to the stock market. It is generally agreed that corporation and business taxes are inappropriate means of achieving equity objectives in the economy of today.

Figure 1 illustrates the combined state and local tax burden for states in the region, focusing on the lowest 20% of taxpayers (i.e., non-elderly married couples) and the top one percent of taxpayers. This offers one perspective on vertical equity in Maine and across the New England states. Maine finds itself roughly in the middle-to-high range of the region in terms of tax burdens on low-income taxpayers, but is well below the U.S. average. The state's tax burden on the top 1%

Figure 1: State and Local Tax Burden, Lowest 20 Percent Income Group and Top 1 Percent Income Group, 1995



Note: These data are for non-elderly married couples and account for federal deductibility, which means the effective tax rate is somewhat reduced.

Source: "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," published by Citizens for Tax Justice and the Institute on Taxation and Economic Policy, June 1996.

19 See "Who Bears the Burden of the Corporate Tax in the Open Economy?" by Jane Gravelle and Ken Smetters, National Bureau of Economic Research, working paper 8280, May 2001.

of taxpayers (7.2%) is almost 25% higher than the national average (5.8%). Within the region, only Rhode Island imposes a higher burden on high-income taxpayers.

Maine Revenue Services now conducts an incidence and distribution analysis of tax burdens for state and local taxes. Due to difficulties and uncertainties regarding the distributional burden of business taxes, they are not assigned to specific income classes. Table 4 shows their analysis for 1998. The personal income tax is consistently progressive across all income classes, adding the greatest degree of progressivity to the overall tax system. The sales tax is mildly regressive and then burdens flatten out in the higher income classes. Aside from the lowest income group, where the data are most questionable, the state tax system produces a roughly proportional burden, with modest progressivity at the top. The local property tax is regressive, even when relief programs are taken into account that disproportionately benefit lower-income groups. Overall, state and local taxes yield a regressive system for low-income taxpayers, a proportional burden for those in the middle-income range, and a progressive burden for those at the top.

The best means of addressing equity and fairness is to focus directly on the ability to pay of specific taxpayers. The best policy instrument is a direct tax like the income tax, as opposed to an indirect tax like the sales tax. Using a direct tax, policy can focus on the specific circumstances of the taxpayer, including income and family size. By using an indirect tax, policy is complicated because the targeted group may be difficult to identify or distinguish from other taxpayers. This is the case with the sales tax and the well-intentioned policies of removing food and clothing from the tax base, or in Maine's case, of removing grocery store food. The policy can in fact help low-income

Table 4: Maine Effective Tax Rates by Income Range and Tax Type, 1998

Expanded Income Range	Family	Personal Income Tax	Consumer Sales Tax	Consumer Excise Tax	Total State Taxes	Local Property Tax on Individuals	Property Tax Relief Programs	Total State and Local Taxes
0 - $9,999	93,701	0.2	7.5	3.2	10.9	11.1	-1.9	20.0
10,000 - 19,999	77,044	0.8	4.0	2.0	6.9	6.6	-0.8	12.6
20,000 - 29,999	67,895	1.6	2.6	1.1	5.3	5.2	-0.5	9.9
30,000 - 49,999	112,120	2.5	2.2	0.8	5.5	3.6	-0.3	8.8
50,000 - 74,999	82,864	3.6	1.9	0.6	6.1	2.9	-0.2	8.9
75,000 - 99,999	34,857	4.1	1.6	0.6	6.3	2.5	-0.1	8.7
100,000 - 199,999	26,988	4.7	1.4	0.5	6.7	2.2	-0.1	8.8
> 200,000	7,081	6.4	1.9	0.5	9.6	1.1	-0.0	10.7
Total	**502,550**	**3.7**	**2.1**	**0.8**	**6.7**	**3.2**	**-0.3**	**9.6**

Note: Data problems plague the lowest income group, so caution is warranted in making inferences for this group. Business taxes, including corporate income and property taxes on businesses, are unassigned to specific income groups and are omitted here from the total burdens as well. Property tax relief includes the Residents Property Tax Program, Homestead Exemption and BETR.

Source: "Maine Tax Incidence Study," published by Maine Revenue Services, December 2000.

households, but not without cost. In fact, all households benefit, not only low-income households, so foregone revenue is higher than would otherwise be the case. The local property tax also has been complicated by the presence of the homestead exemption and the state-operated residents relief program. Yet these programs can, with proper reporting information from taxpayers, target relief to desired groups.

When the state pursues equity objectives, reliance should be placed on the income tax to the extent possible. Generally, the distributional effects of significant policy changes need to be evaluated, as do the other consequences of changes to state and local tax policy. All of the consequences need to be identified and evaluated to enable informed policy choice.

Simplicity of Administration and Compliance

Important tax policy objectives include simplicity and transparency. In practice, taxes are costly to the state to administer and are costly to households and businesses to comply with. Tax complexity is the primary source of high costs and arises from special provisions in the tax system, including multiple tax rates/brackets, exemptions, deductions, preferential treatment of specific taxpayer groups and so on. A tax with a single rate and uniform base, on the other hand, is relatively easy to administer and comply with, and it is transparent to taxpayers. The special provisions that yield complexity often arise from the pursuit of other tax policy goals, such as tax equity (e.g., the removal of grocery food from the sales tax base) and competitiveness (e.g., the BETR program).

The Maine tax system, with its portfolio of tax instruments and special provisions, is probably somewhat more difficult to administer and comply with than the tax systems of most other states. These same complications can make it difficult for taxpayers to see the true effects of the tax system they confront. (The absence of a broad-based state income tax in neighboring New Hampshire likely increases the perceived compliance burden of Maine's tax system further.) Tax simplification has not been a major driving force for reform in Maine. Still, it is an important policy consideration. High tax compliance burdens, coupled with relatively high effective tax rates, add to the distortionary effects of Maine's tax system.

Policy Tradeoffs

A good tax system would be easy to construct if the aforementioned criteria were not in frequent conflict with one another. A good example is what is referred to as the equity-efficiency tradeoff, discussed above in the context of tax progressivity and economic development. In order to provide low-income household tax relief through an income tax, revenue losses must be made up by imposing higher taxes on high-income households. The high-income households may respond by working and saving less, since the rewards to these efforts may be reduced, or by leaving the state for a lower tax place of residency. Another example is the exemption of grocery store food from the base of the sales tax. This further destabilizes the tax system over the ups and downs of the business cycle, since food is a stable consumption item for most households, leads to sharply higher costs of administration and compliance, and raises the revenue cost of low-income taxpayer relief by benefiting all consumers (including non-residents).

Summary

Maine residents must make choices regarding the desired goals for their tax system, with the knowledge of the tradeoffs to which these goals give rise. If economic development and competitiveness are the most important policy objectives, than they will need to be pursued at least to some extent at the expense of other policy objectives. In practice this may require lower taxes on footloose capital and upper-income taxpayers, with either service delivery cuts or higher taxes on other residents of the state. If vertical equity remains a primary goal, the costs and consequences of related policy choices should be well documented. It would appear that the pursuit of equity could be simplified, improving transparency and lowering both administrative and compliance costs. The fact is that the tax system and policies towards economic development need to reflect the preferences and tastes of residents. This is largely why the tax systems of the fifty states differ so markedly.

PART FOUR

Some Facts and Figures on Government Finances

The above discussion about policy goals and the requirements of a good tax system provides a useful framework for reviewing government finances in Maine. This section begins with some brief comments about the expenditure side of the government budget. Next is a discussion of own-source taxes in Maine and other states, and a comparison of tax burdens across Maine and other states in New England.

Public Expenditures

This report deals with taxes, largely ignoring the expenditure side of state and local budgets. But when practical public policies are developed, they must recognize both the tax and the expenditure sides of the budget. The typical assumption used to justify an analysis only of taxes is that the expenditure side of the budget has been set and the goal is to simply identify the best means of financing these services. If only the problem were this simple. In reality taxes and expenditures are clearly interwoven.

Maine's taxes are high because the state seeks to provide quality public services and must overcome the diseconomies of scale associated with a modestly sized and spatially dispersed population. In part, state taxes are high because the state has assumed a primary role in financing local education services through intergovernmental aid. Local taxes, namely local property taxes, are relatively high in part because of the service center problem. The service center problem arises because municipalities are the primary source of public service provision at the local level and there is a fundamental mismatch between service needs and municipal tax capacity (i.e., the ability to raise taxes and fees from existing tax bases). For example, services such as public health may be provided to non-residents of a municipality, but the municipality itself must fund the same service. Often the municipality is the home to non-taxable entities such as hospitals and charities that reduce effective local property tax capacity.

…solving the bigger puzzle of tax policy and economic development will also require a reconsideration of the structure and role of state and local spending.

While this report focuses on taxes, state intergovernmental aid and the expenditure side of state and local government budgets cannot be ignored in practice. Taxes are a piece of the puzzle, and an important piece. But solving the bigger puzzle of tax policy and economic development will also require reconsideration of the structure and role of state and local spending. This will not be an easy puzzle to solve.

Own-Source Funds

Table 5 provides a breakdown of budgeted general fund revenue for fiscal years 2002 and 2003, and the 2002-2003 biennium. The most striking feature of the data is the important—if not dominant—role of the sales and use tax and the personal income tax in financing general fund expenditures of the state. The sales tax accounts for about one-third of all general fund revenue, while the individual income tax accounts for nearly one-half of all revenue. Together the sales and individual income taxes represent well over 80% of all general fund budgeted revenue. The corporate income tax will contribute nearly $120 million in revenue fiscal year 2003, or 4.5% of general fund revenue. Cigarette and tobacco tax revenue represents over 3.5% of general fund revenue and other revenue sources account for over 5% of revenue.

Relative reliance on broad tax categories is shown in Table 6 for Maine and other states in the region, as well as the U.S., to better place Maine's finances in perspective. What is striking is the dramatic increase in reliance on the personal income tax between 1970 and 2000. While the income tax accounted for only 9.1% of own-source taxes in 1970, by 2000 the share had jumped to 40.5%, moving Maine to seventeenth place in the nation. Maine and the New England states generally rely more on the personal income tax than is the case for the average state. The simple average of personal income tax shares shows New England to be slightly less reliant on the personal income tax than the U.S. But the weighted average (not shown) places New England's personal income tax share at 45.1%, substantially ahead of the national weighted average of 34.9%. General sales and gross receipts taxes have declined in relative importance, but still accounted for 31.8% of

Table 5: General Fund Budgeted Revenue

	FY02		FY03		Biennium	
Source	**Dollars**	**Percent**	**Dollars**	**Percent**	**Dollars**	**Percent**
Sales and use tax	859,893,181	34.27%	910,218,938	34.47%	1,770,112,119	34.37%
Individual income tax	1,211,512,177	48.28%	1,299,107,049	49.20%	2,510,619,226	48.75%
Corporate income tax	117,754,012	4.69%	119,212,477	4.51%	236,966,489	4.60%
Cigarette & tobacco tax	91,410,131	3.64%	99,449,755	3.77%	190,859,886	3.71%
Public utilities tax	30,100,000	1.20%	29,300,000	1.11%	59,400,000	1.15%
Insurance company tax	43,381,856	1.73%	40,924,003	1.55%	84,305,859	1.64%
Inheritance & estate tax	32,561,478	1.30%	34,145,209	1.29%	66,706,687	1.30%
Property tax - unorg. terr.	9,278,895	0.37%	9,845,047	0.37%	19,123,942	0.37%
Income from investments	22,000,000	0.88%	16,850,000	0.64%	38,850,000	0.75%
Trans. to muni. rev. share	-111,647,128	-4.45%	-120,082,728	-4.55%	-231,729,856	-4.50%
Transfer from liquor	22,290,548	0.89%	24,611,840	0.93%	46,902,388	0.91%
Transfer from lottery	36,762,402	1.47%	36,809,911	1.39%	73,572,313	1.43%
All other	143,984,120	5.74%	140,070,292	5.30%	284,054,412	5.52%
Total revenue	**2,509,281,672**	**100.00%**	**2,640,461,793**	**100.00%**	**5,149,743,465**	**100.00%**

Source: Maine Bureau of Budget, www.state.me.us/budget/web-charth-gfrev.pdf.

tax revenue in 2000, slightly below the U.S. average but ahead of most states in New England. While the nation and the region saw the corporate income tax decline in relative importance between 1970 and 2000, the tax increased as a share of Maine revenue over the same time period. Maine's use of selective sales taxes has lagged the region, while the use of other taxes has lagged both the nation and the region over time, suggesting there is some flexibility to expand taxes in this direction if necessary.

Tax Burdens

Nominal (or current dollar) state and local taxes per capita for 1970 and 1999 are reported in Table 7 for Maine, other New England states and the nation as a whole. Taxes per capita are a convenient means of comparing tax burdens across jurisdictions. However, there are two important limitations of such measures. First, taxes per capita do not reflect the ability to pay taxes, which as noted above is an important basis for making

Table 6: Distribution of State Taxes, 1970 and 2000

	General Sales and Gross Receipts				Selective Sales				Corporate Taxes			
	Percent		National Rank		Percent		National Rank		Percent		National Rank	
	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000
ME	40.1	31.8	8	23	31.6	12.9	19	36	6.1	7.1	33	26
CT	34.9	33.6	23	20	34.8	16.1	12	19	16.9	5.1	5	44
MA	12.1	22.1	45	42	25.6	9.3	35	48	17.2	8.7	4	18
NH	0.0	0.0	50	50	66.2	32.8	12	1	3.2	21.5	44	3
RI	34.3	30.5	24	28	34.6	18.8	13	11	11.9	5.5	10	41
VT	12.6	14.6	44	45	36.1	17.4	10	16	4.9	4.4	40	46
NE	22.3	22.1			38.2	17.9			10.0	8.7		
US	29.6	32.3			27.3	14.4			10.5	8.5		

	Individual Income				Other Licenses				Other Taxes			
	Percent		National Rank		Percent		National Rank		Percent		National Rank	
	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000
ME	9.1	40.5	35	17	9.0	3.6	19	27	4.2	4.1	28	24
CT	0.7	39.1	42	20	7.0	2.7	31	38	5.7	3.5	18	27
MA	37.2	56.0	5	2	4.5	2.2	45	47	3.4	1.8	38	38
NH	3.7	3.9	39	42	17.1	5.3	2	10	9.8	36.5	10	3
RI	8.2	40.7	37	15	7.2	2.7	29	40	3.9	1.8	31	36
VT	32.3	29.4	9	35	10.7	3.3	10	32	3.3	30.9	39	4
NE	15.2	34.9			9.3	3.3			5.1	13.1		
US	19.1	36.0			7.0	3.5			6.6	5.1		

Source: 2000 data from U.S. Bureau of the Census Web site: www.census.gov; 1970 data from U.S. Bureau of the Census: "State Tax Collections," 1971.

equity evaluations. Second, it assumes taxes are borne by in-state residents, when in fact some share of taxes may be exported to non-residents. The data show that Maine's combined state and local tax burden was $379 in 1970, or 88.6% of the New England average, and was 10% lower than the national average. By 1999 state and local taxes had increased to $3,218, or 97.9% of the regional average, and were 10% above the national average. The New England average in 1999 was 112.4% of the national average.

Local tax burdens in Maine were $171 in 1970, rising to $1,215 in 1999. While Maine's local tax burden was 83% of the regional average in 1970, the burden was 96% of New England's in 1999. New England's burden per capita was almost 12% above the national average. Maine enjoyed a state tax burden per capita that was lower than the nation and New England in 1970. But by 1999 Maine's burden was approaching the regional average and was 111.7% of the national average.

A detailed breakdown of inflation-adjusted (or constant dollar) state taxes per capita for 1970 and 2000 is provided in Table 8 for the New England states. In 2000 Maine's total burden of $2,087 placed the state fourteenth in the nation. New England is known for relatively high taxes, and three regional states received a top ten ranking in 2000, Connecticut (first place), Massachusetts (fifth place) and Vermont (seventh place). It is interesting that Maine has such a high overall ranking, while in no instance is its ranking for a specific tax higher than fifteenth. The rank for Maine's corporate income tax has increased substantially over time (from thirty-third to twentieth), and its collections per capita have moved closer to—but still lag—the national average. The burden of the personal income tax has grown from thirty-seventh in the nation in 1970 to fifteenth in 2000. Personal income tax collections per capita were 42% of the national average in 1970, rising to 122.1% in 2000, a rather remarkable jump. Other taxes per capita have seen their ranking increase vis-a-vis the nation.

An alternative perspective on state revenue collections is state taxes as a percent of per-

Table 7: State and Local Taxes Per Capita, New England States and U.S.

	State and Local		Local		State	
State	1970	1999	1970	1999	1970	1999
ME	$379	$3218	$171	$1215	$208	$2003
CT	484	4403	240	1557	244	2846
MA	496	3528	252	1194	244	2334
NH	331	2546	203	1669	128	877
RI	408	3079	167	1254	241	1825
VT	469	2952	166	655	303	2297
New England	428	3288	200	1257	228	2030
US	426	2925	191	1132	235	1793

Source: Tax data from U.S. Bureau of the Census Web site: www.census.gov. Population data from Bureau of Economic Analysis Web site: www.bea.doc.gov.

Table 8: State Taxes Per Capita by Tax Type, 1970 and 2000, New England States and U.S.

	General Sales and Gross Receipts				Selective Sales			
State	1970	Rank	2000	Rank	1970	Rank	2000	Rank
ME	$325	15	$665	15	$256	24	$270	26
CT	$331	13	$1,004	3	$330	3	$480	4
MA	$115	45	$562	30	$243	34	$235	37
NH	$0	49	$0	48	$330	4	$449	5
RI	$320	17	$593	24	$323	5	$364	13
VT	$149	43	$354	44	$426	2	$420	7
New England	$206		$529		$318		$370	
US	$271		$621		$250		$277	

	Corporate Taxes				Individual Income			
State	1970	Rank	2000	Rank	1970	Rank	2000	Rank
ME	$49	33	$148	20	$74	37	$845	15
CT	$160	4	$151	18	$6	42	$1,167	5
MA	$163	3	$221	7	$353	9	$1,424	1
NH	$16	46	$296	3	$18	39	$53	42
RI	$111	11	$106	36	$76	36	$791	16
VT	$58	29	$106	37	$381	8	$709	22
New England	$93		$171		$151		$832	
US	$96		$164		$176		$692	

	Other Licenses				Other Taxes				Total			
State	1970	Rank	2000	Rank	1970	Rank	2000	Rank	1970	Rank	2000	Rank
ME	$73	18	$75	20	$34	30	$85	22	$810	32	$2,087	14
CT	$67	29	$81	14	$54	17	$103	18	$948	18	$2,986	1
MA	$43	43	$56	37	$32	32	$46	32	$949	17	$2,544	5
NH	$85	10	$72	22	$49	20	$502	4	$498	50	$1,372	47
RI	$67	27	$52	43	$36	26	$36	38	$933	19	$1,942	18
VT	$126	2	$79	16	$39	25	$747	3	$1,178	5	$2,415	7
New England	$77		$69		$41		$253		$886		$2,224	
US	$64		$68		$61		$99		$918		$1,921	

Note: 1970 (2000=100)

Source: Tax revenue data from U.S. Bureau of the Census Web site: www.census.gov. Population data from Bureau of Economic Analysis Web site: www.bea.doc.gov.

sonal income. Shown in Table 9 are major state tax categories for 1970 and 2000. Personal income is a widely used measure of ability to pay, and also serves to reflect the size of state government relative to the size of the private sector.[20] Total state taxes in Maine were 5.5% of personal income in 1970 rising substantially to 8.45% in 2000. In other words, the size of state government—measured by state-financed taxes as a share of personal income—has increased an average of one percentage point per decade over the past thirty years. In contrast, the U.S. and New England saw burdens as a share of income rise by less than a percentage point over the same thirty-year time period. One

Table 9: State Taxes as a Share of Personal Income, 1970 and 2000, New England States and U.S.

	General Sales and Gross Receipts		Selective Sales		Corporate Taxes	
State	1970	2000	1970	2000	1970	2000
ME	2.55	2.68	2.01	1.09	0.39	0.60
CT	1.72	2.54	1.71	1.21	0.83	0.38
MA	0.68	1.56	1.44	0.65	0.97	0.61
NH	0	0	2.23	1.42	0.11	0.93
RI	2.09	2.09	2.11	1.28	0.73	0.37
VT	1.1	1.35	3.14	1.61	0.43	0.40
New England	1.36	1.70	2.11	1.21	0.58	0.55
US	1.76	2.17	1.62	0.97	0.62	0.57

	Individual Income		Other Licenses		Other Taxes		Total Taxes	
State	1970	2000	1970	2000	1970	2000	1970	2000
ME	0.58	3.40	0.57	0.30	0.27	0.34	5.48	8.41
CT	0.03	2.95	0.35	0.21	0.28	0.26	6.65	7.55
MA	2.09	3.96	0.26	0.15	0.19	0.13	6.74	7.07
NH	0.12	0.17	0.58	0.23	0.33	1.58	6.24	4.32
RI	0.50	2.79	0.44	0.18	0.24	0.13	7.13	6.84
VT	2.81	2.71	0.93	0.30	0.29	2.86	7.68	9.24
New England	1.02	2.66	0.52	0.23	0.27	0.88	6.65	7.24
US	1.14	2.42	0.41	0.24	0.39	0.35	5.95	6.72

Source: Tax revenue data from U.S. Bureau of the Census Web site: www.census.gov. Personal income data from Bureau of Economic Analysis Web site: www.bea.doc.gov.

20 Christopher St. John provides a nice discussion of recent Census Bureau tax burden figures, arguing that several unique data circumstances, as well as high service delivery costs, conspired to produce Maine's number one ranking in 1998. See "The 'Tax Burden' Rap Reemerges," published by the Maine Center for Economic Policy in *Choices*, VII, August 22, 2001.

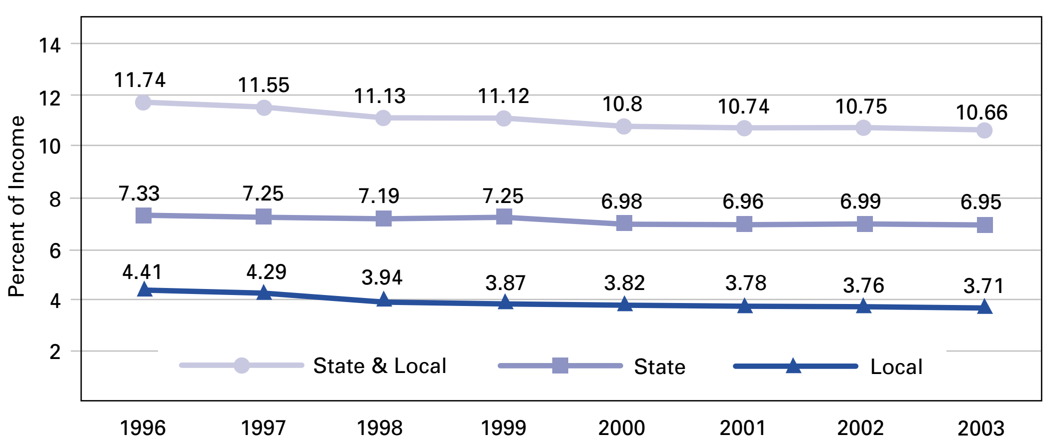
of the reasons for Maine's relatively high burden as a share of personal income is relatively low in-state per capita personal income. But equally if not more important is the desire for state spending and aid to local governments to support education and other activities. Maine's general sales and gross receipts tax burden in 1970 and 2000 is well above the regional and national norm. Growth in personal income tax burdens stands out clearly in these data. Income taxes in Maine accounted for only 0.6% of personal income in 1970, jumping to 3.4% in 2000. While the state's income tax burden was 50.8% of the national average in 1970, the burden had spiked to 40.5% ahead of the national average in 2000.

Finally, Figure 2 provides a summary of state, local and combined state and local effective tax rates (defined as taxes as a percent of income), drawing from Maine Revenue Service's tax incidence study. The first tax incidence study was completed in 2000, so data for that and subsequent years reflect projections. Note that the data are not directly comparable to those in Table 9 due to the methodology employed in the incidence analysis. The general pattern is one of slow decline in effective burdens for recent history, and projections of a similar trend through 2003.

Summary

The facts and figures only highlight the broadest of trends that have taken place in Maine government finances in the past thirty years. Some of the changes in revenue performance over time can be attributed to shifts in economic fortunes. Still, much of the change reflects policy decisions made at the state and local levels in Maine. The most striking features of the data include Maine's rapid growth in revenue (especially income tax revenue) over the past thirty years, the rapid growth in the size of state government, and the relatively high tax burdens compared to peers in the region and states across

Figure 2: Maine State and Local Effective Tax Rates, 1996 to 2003



Note: Years 2000 to 2003 represent projections.

Source: "Maine Tax Incidence Study," published by Maine Revenue Services, December 2000.

the nation. The growth in the size of state-tax-financed government—up three percentage points in three decades—highlights the importance of government spending and the expenditure side of the state budget. The corporate tax has grown in Maine, while the opposite trend is taking place more broadly in New England and the U.S. At the same time, Maine has not utilized selective taxes to the same extent as other states.

State government in Maine has increasingly placed reliance on the personal income tax, while local governments rely almost exclusively on the local property tax for own-source revenue. Both the state and local tax systems are now out of balance, in the sense that reliance now falls heavily on a single tax instrument. Hence, any shifts in fortunes for the state income tax or the local property tax can spell disaster for the financing of services. Moreover, reliance on a narrow set of tax instruments typically translates into higher tax rates on existing tax bases, increasing the likelihood for distortions in economic behavior.

PART FIVE

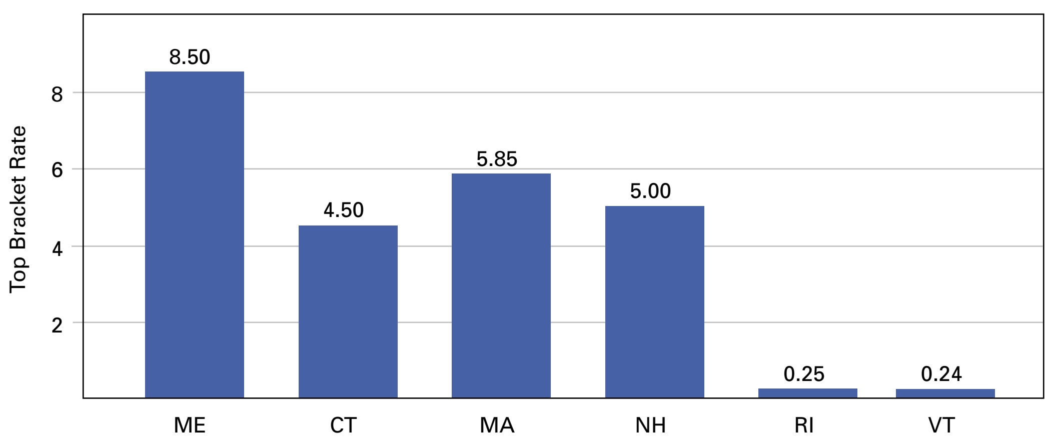
Overview and Analysis of Major State Taxes

THIS SECTION FOCUSES ON SPECIFIC state taxes in the state of Maine.[21] Key structural features are identified for each major state tax, using interstate and national comparisons. The requirements for a good tax structure, discussed above, provide the structure for the discussion of specific policies that might be considered for each tax instrument.

Personal Income Tax

The Maine personal income tax, like all personal income taxes in the New England states, uses federal taxable income as the basis for taxation. A distinguishing feature of Maine's personal income tax is its high top-bracket rate and the rapid pace of progres-

Figure 3: Top Bracket Rates for Personal Income Tax



Note: Rates are for married taxpayers, filing jointly. The taxable-income threshold for the top rate is $33,000 in Maine and $20,000 in Connecticut; Massachusetts has a different structure for non-wage income; New Hampshire's rate applies to interest and dividends only; the percent shown in Rhode Island and Vermont applies to federal income tax liability.

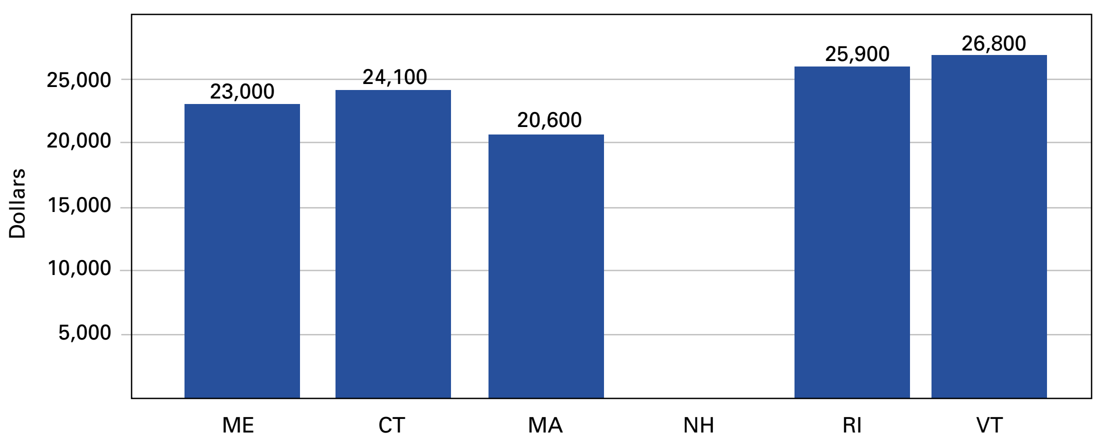
Source: *State Tax Guide*, CCH, Inc., 2001.

21 A detailed overview of state taxes is "State of Maine: Compendium of State Fiscal Information," www.state.me.us./legis/ofpr/compendium00.htm.

sion to the top rate. Massachusetts makes use of a flat rate. Connecticut has a progressive two-rate structure, while Rhode Island and Vermont achieve some progressivity by applying a flat rate to federal tax liabilities. Shown in Figure 3 are the top bracket rates for married tax payers for the New England states, including New Hampshire, which has only a narrow-based personal income tax the same top rates apply (the same top rates apply to individual filers as well). Maine's rate of 8.5% is the top rate in the region. Only the District of Columbia and six states—California, Hawaii, Iowa, Montana, North Dakota and Oregon—have higher top-bracket rates. Moreover, the 8.5% rate kicks in at taxable income of $33,000. The high tax rate can be viewed as an important source of distortion in Maine's tax system, potentially discouraging residency, entrepreneurship and the creation of higher wage and salary jobs.

Despite the high rate and the quick pace of tax progression, low-income taxpayers appear to receive favorable treatment under the personal income tax. Figure 4 shows the lowest level of income at which a two-parent family of four would confront a state income tax burden. Maine compares reasonably well with other states in the region. A better gauge of tax fairness is offered by Figure 5, where the income tax burden as a share of income for broad income classes is displayed. Compared to the U.S., low-income taxpayers in Maine fare quite well, confronting less than one-half the burden of their national counterparts. At the same time, high-income taxpayers face a substantially higher burden than is the case for the nation as a whole. For the top one percent of taxpayers the average personal income tax burden in Maine is 6.5% versus 4.6% for the nation, a 41% premium.

Figure 4: State Income Tax Thresholds, Two-Parent Families of Four, 2000



Note: These thresholds show the lowest income at which a family has state tax liability. The threshold includes earned income tax credits, other general credits, exemptions and standard deductions. Credits for other taxes or credits not available to all low-income taxpayers are not accounted for.

Source: "State Income Tax Burdens on Low-Income Families in 2000," by Bob Zahradnik, Nicholas Johnson and Michael Mazerov, Center on Budget and Policy Priorities, March 2001.

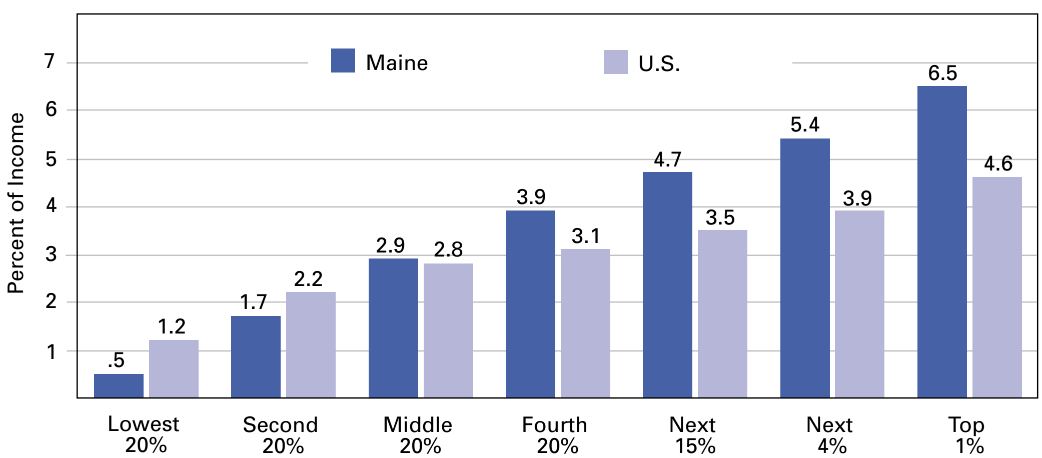
Maine has made the decision to use highly progressive income tax rates to buy a degree of tax fairness and it appears to have been successful. Still, this choice has a price in the form substantially higher taxes on upper-income individuals and, accordingly, strong disincentives to earn income in Maine. The state should continue to use the income tax as the primary means of achieving equity objectives at both the state and local level, but ensure that disincentive effects and other adverse policy consequences are identified. All efforts to achieve equity objectives should take into account the effects on other dimensions of tax policy, including revenue yield, stability, and so on.

The progressive income tax rate structure has also created a highly elastic and distortionary income tax. Consideration should be given to flattening the degree of progressivity to reduce both distortions and revenue elasticity. Rates should be roughly commensurate with corporate income tax rates to avoid distorting the choice between corporate and limited liability business structures (see below). The elasticity of the income tax should be determined in concert with the elasticities for other state taxes and overall state tax structure. As noted elsewhere, some degree of elasticity should be retained to support rainy day funds and investments during times of strong revenue growth. These and other policy considerations need to build on a firm foundation of objective data and analysis.

Taxes on Corporations

Businesses in Maine pay a wide variety of taxes, depending on the sector of the economy in which they operate and the legal form of the business entity. Businesses generally pay gasoline, property, and other taxes, including sales tax on many business inputs. Corporate entities pay some form of corporate income tax. Financial institutions are subject to the Maine franchise tax at the rate of 8 cents per $1,000 of assets in Maine, plus

Figure 5: Maine and U.S. Personal Income Tax Burden by Income Group, 1995



Note: Data are for non-elderly married couples; top three income ranges account for 20% of couples.

Source: "Who Pays? A Distribution Analysis of the Tax Systems in All 50 States," published by Citizens for Tax Justice and The Institute on Taxation and Economic Policy, June 1996.

Corporate Income Apportionment Formulas

An example is perhaps the best means of seeing the way corporate income apportionment formulas work in practice. Consider a firm with a multi-state presence that includes Maine. Assume the firm has total property (P) of $100 million, total payroll (W) of $30 million and total sales (S) of $40 million across all states. Also assume that the firm has $7 million of its total property (Pm) in Maine, $3 million of its total payroll (Wm) in Maine and $1.2 million of its total sales (Sm) in Maine. The traditional three-factor formula can generally be written as:

$$1/3\ (Pm/P + Wm/W + Sm/S)$$

Using the specific figures in this example yields:

$$1/3\ (7/100 + 3/30 + 1.2/40) = .067$$

So, using the three-factor formula, 0.067% of this firm's net income across all states would be allocated to Maine for tax purposes, while the remaining net income would be taxed by other states, depending on allocation formulas in use in other states.

When the apportionment formula is adjusted to accommodate double-weighting of the sales factor, the general apportionment formula becomes:

$$1/4\ (Pm/P + Wm/W + Sm/S + Sm/S)$$

Using the specific figures in the example yields:

$$1/4\ (7/100 + 3/30 + 1.2/40 + 1.2/40) = .058$$

In this instance, 0.058%—versus 0.067%—of total net business income would be taxable in Maine. The result is a lower tax burden for the firm under double-weighting of sales. The explanation for the lower apportionment factor for this hypothetical firm rests in the fact that the sales component is small relative to the average of the other components, benefiting export-oriented firms. Firms with a large in-state sales factor, on the other hand, will see their tax liabilities increase under double-weighting of the sales component.

a 1% income tax collected under the umbrella of the corporation income tax. Insurance companies pay a 2% tax on premiums paid on policies written in the state; different tax rates apply to long-term care policies and group policies. Corporations in other sectors confront the general corporate income tax. There is no broad-based state franchise tax applied to corporate property or stock value as is the case in many other states in the nation. Since such state franchise taxes are effectively variants of a property tax, this is good for Maine in light of currently high local property tax rates.

The base of the corporation tax is net business income apportioned to the state. Maine, like most states in the nation, now makes use of a *double-weighted sales factor* for the apportionment of interstate corporate income. Historically a uniform rule of apportionment was employed by the states. The traditional *three-factor formula* provided equal weights to a firm's in-state share of total property, sales and payroll across all states. That is, a firm added up the Maine shares of its property, sales and payroll across all states within which it operated, and simply divided by three. The traditional three-factor formula was simple and transparent, offered a level and nondistortionary playing field, and ensured that all domestic income of the corporation was in spirit subject to tax. Uniformity, however, has been compromised by the pursuit of economic development goals. The double-weighted sales factor for corporate income apportionment includes four components. The first two are the traditional measures of property and payroll. But in-state sales relative to nationwide sales now appear in the formula twice, hence the term *double-weighted sales factor.* An illustration of the double-weighted apportionment formula is provided in the adjacent box.

The purpose of applying a double weight to sales is to encourage the in-state location of businesses that produce for national markets. These same businesses typically will have small amounts of in-state sales relative to sales in the national market, thus apportioning relatively small amounts of interstate income to the domiciliary state. Several states have considered and/or adopted *single-factor* sales apportionment formulas. The jury is still out on the effectiveness of these changes in corporate apportionment on economic development. Most analysts see revenue losses and relatively little economic development gain from shifts away from the traditional formula.[22] The double- and single-weighted sales factors are good examples of the degree of interstate competition for business, and the quick policy response that follows the lead of a single state. The ultimate impact is a lowering playing field for business once all states adopt the program, and likely less revenue for the states.

Maine has followed the lead of other states across the nation by enabling the creation of limited liability corporations (LLCs), which offer limited liability like a traditional corporation, but tax income as a pass-through to the individual income tax. All states now allow the presence of LLCs. This change in corporate tax structure was initially perceived to have inconsequential revenue effects, since income would still be subject to taxation, albeit at the individual level. However, anecdotal evidence suggests a clear revenue loss. For example, the rate structure and top bracket rate of the Maine personal income tax suggests that there is a tax advantage from choosing the LLC form over the traditional corporate form, even though the advantage may be small (a 0.43% difference). Emerging research also suggests that revenue losses may be larger than first anticipated.[23] This research builds on recognition of the sophisticated tax planning practices of modern corporations and the fact that out-of-state corporations (perhaps without nexus, meaning, the legal presence to trigger tax liability) may become owners of in-state LLCs. By changing organizational forms, it is argued that corporations can remove from tax the lion's share of income that would otherwise be subject to tax. As with double-weighted sales factors, more research will need to be undertaken to isolate the magnitude of any revenue losses generally, and for Maine in particular.

Maine and Vermont each apply a progressive rate structure to corporate income apportioned to the state. All other New England states apply a flat rate to corporate income.

Maine and Vermont each apply a progressive rate structure to corporate income apportioned to the state. All other New England states apply a flat rate to corporate income. In Maine, the lowest rate of 3.5% applies to taxable income up to $25,000; the top rate of 8.93% applies to corporate income above $250,000. Vermont's top rate of 9.75% also

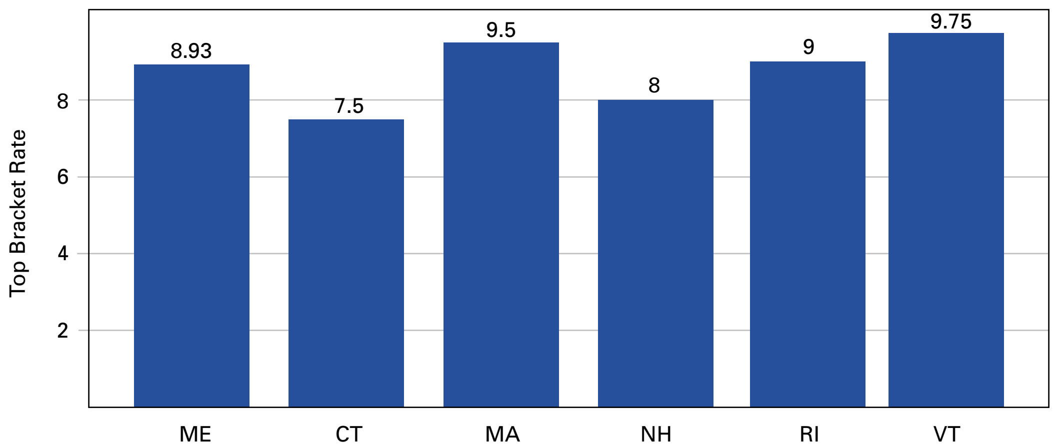
22 See "Strategic Apportionment of the State Corporate Income Tax: An Applied General Equilibrium Analysis," by Kelly Edmiston, ***National Tax Journal*** (forthcoming). Also see "The Single Sales Factor Formula for State Corporate Income Taxes: A Boon to Economic Development or Costly Giveaway?" by Michael Mazerov, Center on Budget and Policy Priorities, April 17, 2001. A more general discussion of the details of corporate apportionment formulas is provided by James K. Smith in "Guide to State Corporate Income Tax Apportionment-Part I," ***State Tax Notes***, November 27, 2000 and "Guide to State Corporate Income Tax Apportionment-Part II," ***State Tax Notes***, December 18, 2000.

23 See "Does the Advent of LLCs Explain Declining State Corporate Tax Revenues?" by William F. Fox and LeAnn Luna, Center for Business and Economic Research, University of Tennessee, Knoxville, February 2002.

applies to taxable income in excess of $250,000. Figure 6 shows the top bracket rates for the corporate income tax in the New England states. Maine's top rate is not out of line relative to other states within the region.

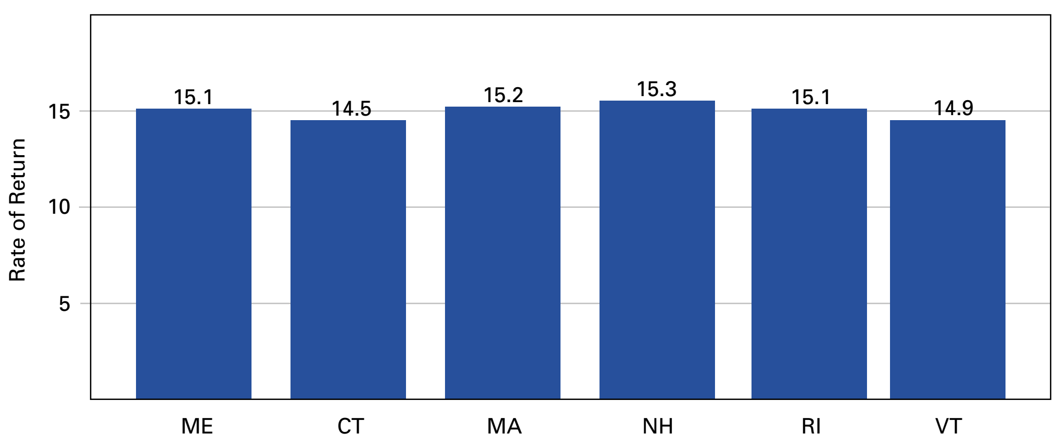
Tax rates alone do not offer a clear picture of the effective tax rate (i.e., taxes as a percent of gross or net income) businesses confront across states. But estimating effective tax rates is problematic at best. Figure 7 offers

Figure 6: Top Bracket Rates Corporate Income Tax



Source: *State Tax Guide*, CCH, Inc., 2001.

Figure 7: After-Tax Rates of Return



Note: Based on data for 1991; assumes a 25% pre-tax rate of return.

Source: "State Business Climate: How Should It Be Measured and How Important Is It?" by Robert Tannenwald, *New England Economic Review* 33 (1996).

estimates of after-tax rates of return for hypothetical investments with gross returns of 25%. The analysis attempts to account for corporate taxes, as well as other major business taxes. Maine's corporate tax burden reduces the 25% gross return down to 15.1%. By this measure, Maine again does not appear to be out of line with other states in the region.

A final perspective on the burden of corporate taxes is offered in Table 10, which shows tax effort (i.e,. actual corporate tax collections divided by potential collections) for the New England states. According to this measure, in 1996 Maine's effort was the lowest in the region, placing it forty-fourth in the nation. The reduction in effort, which took place across all states in the region between 1986 and 1996, was smallest in Maine. The largest reductions in effort took place in those states with the highest prevailing effort (Connecticut, Massachusetts, and New Hampshire).

The data presented here are sketchy, in some instances quite dated, and in some respects inconsistent. The general picture that does emerge is that Maine's corporate tax burden may be reasonable by regional standards, but within a region characterized by high taxes by national standards. And while other states in New England seem to have worked to lower business tax burdens (at least between 1986 and 1996), Maine has not kept up. This likely contributes to criticisms that Maine is a high-tax state and offers a poor business climate.[24] The problem is likely complicated by high local property tax rates which businesses confront, adding to the overall business tax burden.

Maine residents should ask themselves what role corporate taxes are expected to play in state tax structure, and how business taxes generally are to be used to promote economic development. Corporate tax revenues currently account for a relatively small share of the state revenue pie (about 4.7% of general

Table 10: Estimated Effective Corporate Tax Effort

	1996 Effort	1996 National Rank	1986-96 Effort Change
ME	48.8	44	-4.3
CT	105.8	15	-49.2
MA	118.5	10	-55.3
NH	105.0	16	-13.2
RI	75.0	30	-2.9
VT	55.8	43	-11.7

Source: *State Policy Reports* 18(22): 2000.

24 On business climate, see the *Small Business Survival Index* discussed above.

fund revenue in fiscal year 2002), but are nonetheless an important component of total collections. Corporate taxes accounted for 10.2% of all state's tax revenue in 1979, falling to 6.3% in 2000.[25] Nationwide, corporate taxes are not expected to be a growing source of revenue for the states as global and domestic competition have put downward pressure on effective tax rates. In addition, as an esteemed observer of state corporate tax policy has noted, "new attacks are… threatening to drain the lifeblood out of the tax."[26] Most prominent of the new attacks are pressures for lower rates and targeted incentives, and sophisticated tax planning practices that are difficult for states to anticipate and respond to. As Mazerov notes, between 1995 and 2000 state corporate tax revenue grew at about half the pace of federal corporate tax revenues, suggesting that a significant portion of the base is "falling through the cracks."[27]

Several policy issues surface from this overview of corporate taxes. First is the question of progressive tax rates for the corporate tax. Presumably the progressive structure is based on some desired notion of tax fairness. But if the intent is to redistribute income, the corporate in-state income tax is a poor vehicle, as it is not at all clear who ultimately pays the tax. Given the high degree of mobility of capital across the states, especially those states in a given region of the country, some of the burden may actually be shifted to in-state workers in the form of lower earnings or to land owners in the form of lower rents and land prices.

If the corporate structure is to remain, analysis should be undertaken to determine the consequences of revenue-neutral rate flattening. A revenue-neutral change with a flat rate would support a lower tax rate and would make Maine's corporate income tax appear more attractive by regional and national standards. A lower rate can reduce tax distortions and send a positive signal regarding state business climate. As noted above, the rate structure of the corporate tax must generally coincide with that of the personal income tax to avoid distorting the choice over the corporate and LLC business structures.

Second, the state should consider implementation of a business enterprise tax (BET), akin to that in New Hampshire, as a replacement for the current corporate tax and other business taxes. The primary reason is that—as noted above—the traditional state corporate income tax is at risk through creative tax planning and capital mobility. (A less desirable approach would be to maintain the existing corporate income tax, but at a lower rate, and allow crediting of BET against the corporate tax, per New Hampshire.) Such a policy change should be roughly revenue neutral, leading to no significant increase in business taxes. The corporate tax rate, which applies to profits, could be flattened and reduced rather than eliminated in entirely, while a modest BET rate could be imposed and collected from all businesses regardless of firm profitability.

25 See "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States," by Michael Mazerov, Center on Budget and Policy Priorities, April 9, 2002.

26 See "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," by Richard Pomp, *State Tax Notes*, March 22, 1999: 939.

27 See "Closing Three Common Loopholes," by Mazerov, page 3 (footnote 25).

The New Hampshire BET is in spirit a production-oriented value-added tax.[28] The base of the tax is essentially the disbursement of income (or value added through production) on the part of the business entity, the largest component of which is wage and salary payments (which nationally represent about 60% of personal income). The breadth of the base allows for low rates of taxation (in New Hampshire the rate of tax is 0.25%) and Kenyon argues that tax base growth is superior to the growth in corporate profits. Thus the BET could enhance the elasticity of business taxes, providing the flexibility to reduce the elasticity of other state taxes if desired. The tax is also neutral with respect to firms in different sectors, to disbursement of different forms of income, and to business structure. All businesses would pay tax (even those without profit), and the tax would do a better job of capturing growth in the booming service sector of the economy. The tax could allow expensing (i.e., full deduction of the cost of capital) to encourage investment, a strategy that would be most appropriate if the existing corporate tax is eliminated. The base of the tax would likely prove to be more stable than the base of the existing corporate income tax. Simplicity is an important virtue, as with the New Hampshire BET structure. But like any tax instrument, it is subject to political pressures and could become exceedingly complicated if used to pursue multiple policy objectives (e.g., the Michigan single-business tax became exceedingly complex and is now being phased out).

A major drawback of the BET is that the tax base is essentially income, which is already subject to relatively high rates of personal income taxation. Still, it must be recognized that all taxes fall on either the sources of income (i.e., a personal income tax) or the uses of income (i.e., sales and selective excise taxes). The BET has many advantages that should be considered when policy change is considered.

Third, the state should undertake an analysis of the effective burden of the corporate income tax, and other state and local taxes, to identify the magnitude of tax burdens and potential distortions across sectors of the economy. Ideally this would be done in tandem with a similar analysis in competitor states to determine Maine's relative business tax burden. This could help guide policy regarding the level of business taxation, as well as identify specific sectors with relatively high burdens that might be mitigated in other ways, including the use of incentives.

…the state should consider implementation of a business enterprise tax akin to that in New Hampshire, as a replacement for the current corporate tax and other business taxes.

Fourth, policies that would erode corporate tax revenues through incentives or other initiatives should be supported by careful research. Economic development objectives should be explicit and measurable, and consequences for revenue yield (i.e., adequacy), elasticity and other elements of a good tax structure need to be considered.

Finally, the state tax administration, which is viewed favorably by the business communi-

28 For a general discussion of production and consumption value-added taxes (VATs) and the role they might play in state government finance, see "Issues in the Design and Implementation of Production and Consumption VATs in the American States," by William F. Fox, LeAnn Luna and Matthew N. Murray, ***State Tax Notes***, January 21, 2002. For a careful and insightful discussion of the New Hampshire BET, see "A New State VAT? Lessons from New Hampshire," by Daphne A. Kenyon, ***National Tax Journal*** 49 (1996): 381-99.

ty, needs to stay on the frontier of corporate tax planning strategies.[29] This will require great expertise in the tax law and tax accounting arenas. Corporate tax planning may represent the single largest threat to the corporate tax today. Mazerov, for example, identifies the issue of the distinction between apportionable business income and allocable non-business income as one of revenue importance to the state of Maine.[30] Pursuing policy issues of this type is not for the faint hearted and requires tremendous knowledge of corporate tax structure and tax law.

Sales Tax

Maine's sales tax is the second most important state revenue source, accounting for nearly $860 million in budgeted revenue for fiscal year 2002. The tax was implemented in 1952 with an initial rate of 2%. While rates have grown substantially, revenue has not grown at the same pace for many reasons, including the general shift in economic structure toward largely nontaxed services. Significant changes to the tax have recently been implemented, most notably a June 1, 2000 rate reduction to 5%. Maine retained its separate tax rates of 7% and 10% applied to specific transactions. The 7% rate applies to liquor sales and the sale of prepared food in liquor establishments, and room rentals (a 7% gross receipts tax also falls on nursing home patient care). Part of the objective of having higher tax rates is to enable the exportation of taxes to nonresidents. The sales tax in Maine and in other states is perceived to be at risk from a variety of sources, including traditional mail order sales, electronic commerce (especially business-to-business, or B2B sales) and targeted exemptions and incentives granted to business. The tax was designed and implemented in a very different economic and political environment than prevails today. The tax simply has not kept up with the rapid pace of economic transition taking place across the American states.

While [sales-tax] rates have grown substantially, revenue has not grown at the same pace for many reasons…

Statutory liability for the sales tax falls on consumers (whether they be firms or individuals), while businesses actually collect and remit the tax on behalf of buyers. Collection and remittance obligations fall only on those business enterprises that have nexus in the state, generally construed as some form of physical presence (e.g., through the location of a retail or wholesale facility, or the presence of employees). Many so-called remote vendors, including mail order firms and electronic commerce entities, do not have such a physical presence and are hence not required to collect tax on sales. Generally, businesses and individuals who purchase taxable goods without payment of tax are required to pay the complementary *use tax* in the state of consumption. In Maine this is facilitated for individuals through explicit entries and reporting requirements on personal income tax forms.

Maine's sales tax rate, as shown in Figure 8, is relatively low by regional standards, matching up with the 5% rates in

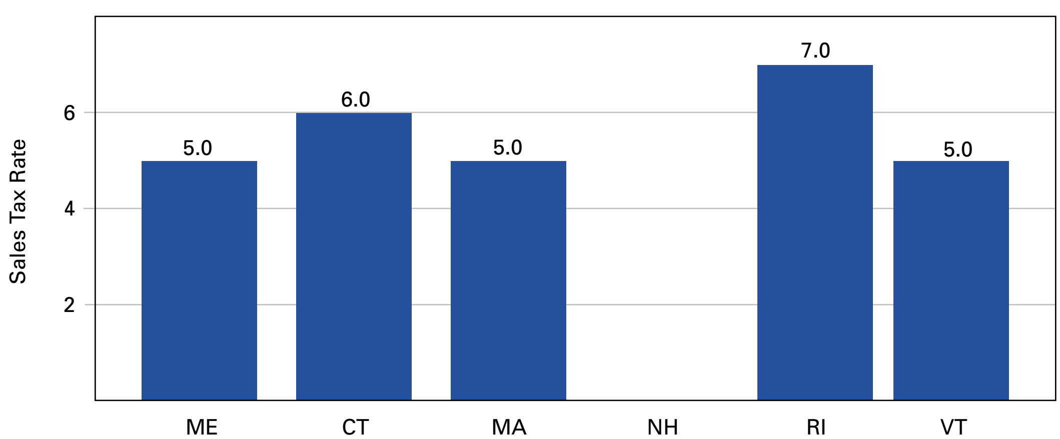
29 See "Best and Worst of State Tax Administration: COST's Scorecard," by Douglas L. Lindholm and Stephen P.B. Kranz, ***State Tax Notes***, June 18, 2001.

30 See "Closing Three Common Loopholes," by Mazerov (footnote 25).

Massachusetts and Vermont, and is consistent with the national median rate across all states.[31] New Hampshire, of course, has no sales tax, which makes Maine's rate appear high, and clearly leads to a leakage of sales across the border. It is interesting that no state in New England enables general and broad-based local option sales taxes. Vermont does allow local option taxes, but there are strict restrictions on the definition of the tax base and receipts must be used to support education. Thirty-three states do allow local option sales taxes.

The base of the sales tax is a hodgepodge of goods and services consumed by both individuals and businesses. In general, tangible goods are subject to tax unless explicitly enumerated for exemption, while services are exempt unless specifically enumerated for inclusion in the base. This practice is a reflection of the historical origins of the tax, as wholesale (or manufacturer-based) taxes were replaced by retail taxes, and as the service sector was an inconsequential element of the economy. Most economists argue that business purchases should be tax exempt to avoid *pyramiding* or *cascade* of tax through the production chain. That is, when businesses pay sales tax on purchased inputs, the sales tax at subsequent stages of the production process and at the final retail stage are effectively imposed on sales taxes earlier in the chain. This means that product prices will differ in part by the amount of tax embedded in costs, distorting business input choices and consumer product choices. Taxes on business inputs can also distort where businesses choose to locate and can encourage vertical integration to avoid payment of tax. Sales for resale are generally exempt from sales tax, as are many purchased inputs that are directly conveyed to consumers as manufactured products. However, local service providers would pay sales tax on virtually all business expendi-

Figure 8: Sales Tax Rates, New England States



Source: *State Tax Guide,* CCH, Inc., 2001.

31 Federation of Tax Administrators, January 2002, www.taxadmin.org/fta/rate/sale_vdr.html.

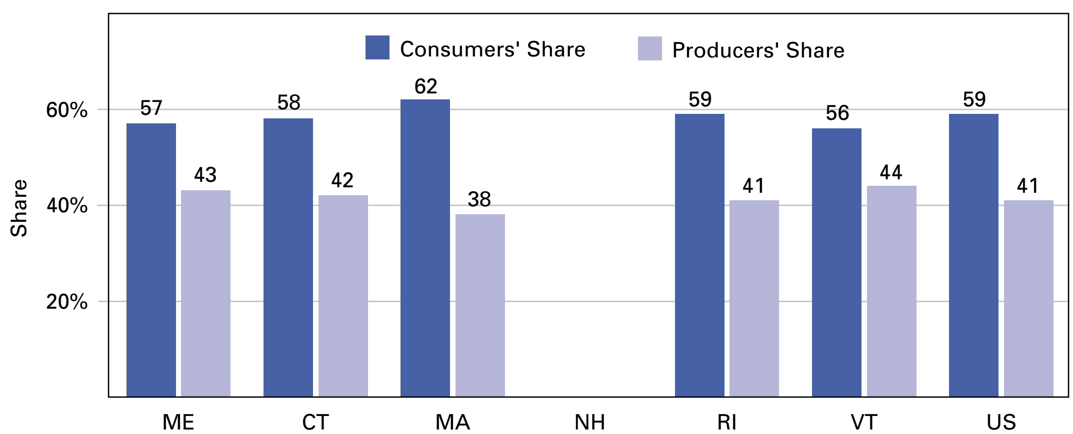
tures on tangible goods. Similarly, manufacturers would pay sales tax on construction materials, office supplies and furnishings, and so on.

It is also argued that the ideal sales tax would tax all individual and household consumption. The presence of uniform taxes on all goods and services consumed would not distort choices made by consumers, aside from border effects. Of course the real world sales tax is far from the idealized model.[32]

The relative burden of the sales tax on consumers and producers has proven to be a difficult question to answer. Administrative records are of no value in the sense that they do not reveal who the buyer was (i.e., a business or an individual). Figure 9 shows the most recent estimates of the sales tax burden on businesses and consumers in Maine and other states in the region. Maine finds itself in the middle of the New England states and slightly below the nation, with a business share of 43%. Using fiscal year 2002's budgeted sales tax revenue of $859.9 million, this means that businesses are paying almost $370 million in sales tax, which is over three times the amount of tax generated by the state's corporate income tax. Pressures will continue to mount to reduce this tax burden on business.

Table 11 draws from the work of John Mikesell, a preeminent scholar on indirect taxes and the sales tax, and shows how the sales tax treats selected business purchases. Again, commonality within the region is the

Figure 9: Consumers' and Producers' Share of Sales Tax Burden, New England States



Note: Estimates are for 1989; producers' share includes sales to government and nonprofits.

Source: "Consumers' and Producers' Share of the General Sales Tax," by Raymond J. Ring, Jr., *National Tax Journal* 52 (1999): 79-90.

32 For a discussion of changing the current sales tax to the ideal form, see "Moving the Retail Sales Tax to a Retail Tax: Optimal Tax Considerations," by Matthew N. Murray, *The Sales Tax in the 21st Century*, Praeger, 1997. A primary conclusion of this work is that given competing policy objectives, it may prove difficult if not impossible to fully restructure the state sales tax away from its current form.

norm, likely due to regional policy awareness and regional competition for business. No state in the region provides broad exemptions for purchases of electricity and natural gas; only a handful of states across the country provide such relief. Mikesell argues strongly for broader exemptions for business to reduce distortions, respond to international competitiveness[33] and facilitate administration and compliance.

Table 12 shows a comparison of the sales tax base for Maine and other states in the region, drawing on a popular list of base components. (Detailed footnotes that appear in the original source have been suppressed in this table.) In general, Maine's sales tax base is largely consistent with that of its peers in New England, and most discrepancies involve items of relatively modest value. Maine is the only state in the region not to provide any form of relief on the purchase of

Table 11: State Sales Tax Provisions for Full and General Exemption of Categories of Business Purchases

	New England States					
	ME	CT	MA	NH	RI	VT
Resale	X	X	X		X	X
Materials - ingredients	X		X		X	X
Materials - processing	X	X	X		X	X
Materials - research	*		X			X
Electric						
Gas						
Water		X	X			X
Telecom service - intrastate						
Telecom service - interstate	X					
Internet access	X	*	X		X	X
Software custom	X		X		X	X
Mfg. equip. & machinery	X	X	X		X	X
Pollution control - air	X	X			X	
Pollution control - water	X	X			X	

Notes:
**Connecticut: exempt after July 1, 2002.*
**Maine: exemption for supplies used in biotechnicology applications.*

Source: "Why Are States So Stingy with Sales Tax Production Exemptions?" by John L. Mikesell, *State Tax Notes*, July 30, 2001.

33 Under the European VAT, input taxes are generally removed for goods subject to export. In the United States, however, sales tax liabilities will be embedded in product price, making American-produced goods less competitive in the global arena.

Table 12: Tax Status of Selected Components of the Sales Tax Base

	New England States					
Component	**ME**	**CT**	**MA**	**NH**	**RI**	**VT**
Clothing	T	$75.0 E	$175.0 E	-	E	$110.0 E
Grocery food	E	E	E	-	E	E
Meals	T	T	T	-	T	E
Caterers	T	T	T	-	T	E
Nonpres. med	T	E	T	-	E	E
Med. services	E	E	E	-	E	E
Med. devices	E	E	E	-	E	E
Newspapers	E	E	E	-	E	E
Periodicals	E	T	E	-	E	T
Occasional sales				-		
MVs, vessels, air	T	T	T	-	T	T
All other	E	E	E	-	E	E
Trade-ins	excluded	E	E	-	E	excluded
Food vending sales	E	E	T	-	T	T
Other vending sales	T	T	T	-	T	T
General services	MT	M	NT	-	NT	NT
Cleaning	E	T	E	-	E	E
Transportation	E	E	E	-	E	T
Repair	E	T	E	-	E	E
Professional/personal services	E	T[1]	E	-	E	E
Vehicle leases	T	T	T	-	T	E
Tangible personal property lease	T	T	T	-	T	T
Rooms, lodgings	T	T	T	-	T	E
Canned soft	T	T	T	-	T	T
Custom soft	E	T	E	-	E	E
Modified canned	E	T	E	-	T	E
Computer hardware	T	T	T	-	T	T
Downloaded software	E	T	E	-	E	E
Mgf. and mach.	E	E	E	-	E	E
Utilities	T	E	E	-	E	E
Farm mach.	E	E	E	-	E	E
Air pollution control equipment	E	E	T	-	E	T
Water pollution control equipment	E	E	T	-	E	T
Sales for resale	MTC	MTC	no	-	MTC	MTC
Vendor comp	none	none	none	-	none	*

Notes:
Special taxes may apply in specific instances.
E = exempt
T = taxable
MTC indicates use of Uniform Multijurisdictional Exemption Certificate.
MT = many taxed
NT = not taxed
[1] Most professional services exempt.
** Can keep revenue collected under bracket system that is less than tax due.*

Source: CCH, Inc., 2001.

clothing. The schemes in place in Connecticut, Massachusetts and Vermont are difficult to administer and lend themselves to abuse, so Maine should not move in their direction. For example, it is relatively easy to split up one's purchase of clothing into two separate transactions to enjoy tax relief. The clothing exemption, predicated on offering relief to low income taxpayers, provides relief to all taxpayers regardless of ability to pay and of place of residence. Most business services are exempt from sales tax. Commerce Clearinghouse, Inc. (CCH, Inc.) identifies Maine as a state that taxes many general services relative to other states. As most states broadly exempt services, this does not mean that Maine has necessarily cast a very broad tax net when it comes to services taxation.

More information on the tax status of services is offered in Table 13. These data seem to be in conflict with the data above showing relatively modest taxation of services in Maine. One reason is the data are not directly comparable. The data in Table 12 are confined to the general sales tax; the data in Table 13 include the general sales tax as well as levies on specific services (e.g., utilities in New Hampshire are taxed under a specific utilities tax).

Not included for consideration in Table 13 are services generally untaxed across the

Table 13: Number of Services Taxed by Category and State

	New England States												
	ME		CT		MA		NH		RI		VT		
	Number of Services	%	Number of Services	%	Number of Services	%	Number of Services	%	Number of Services	%	Number of Services	%	Potential Service Categories
Utilities	9	56.3	10	62.5	9	56.3	8	50.0	10	62.5	3	18.8	16
Personal services	1	5.0	11	55.0	1	5.0	1	5.0	1	5.0	2	10.0	20
Business services	6	17.6	20	58.8	4	11.8	0	0.0	6	17.6	4	11.8	34
Computer services	3	50.0	6	100.0	0	0.0	0	0.0	3	50.0	1	16.7	6
Admis./amus.	2	14.3	13	92.9	1	7.1	0	0.0	3	21.4	10	71.4	14
Professional services	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	8
Fabrication, repair & installation	4	21.1	14	73.7	2	10.5	0	0.0	3	15.8	2	10.5	19
Other services	2	4.3	13	27.7	3	6.4	2	4.3	2	4.3	1	2.1	47
Total	**27**	**16.5**	**87**	**53.0**	**20**	**12.2**	**11**	**6.7**	**28**	**17.1**	**23**	**14.0**	**164**
Percent of potential service categories		16.5		53.0		12.2		6.7		17.1		14.0	

Note: Percent is the share of potential services actually taxed in a state.

Source: "Sales Taxation of Services: 1996 Update," published by Federation of Tax Administrators, April 1997.

states, such as most education and health care services. The activities under the personal services category typically are consumed almost exclusively by individuals and households (e.g., health clubs, cleaning, personal instruction, hair dressers), and therefore represent good general candidates for sales-tax-base expansion. On the other hand, the services in the business, professional, and other categories are consumed by people and firms. For example, business services such as advertising, marketing, lobbying, and secretarial services are consumed almost exclusively by businesses, but interior design, photo finishing, photocopying and security services are potentially acquired by individuals or firms. Similarly, professional services such as accounting, attorney and engineering services are purchased by households and businesses alike, but services like dentistry are purchased almost exclusively by people. Other services capture a wide array of largely untaxed services ranging from construction to transportation to automotive services; many of these also may be used by firms or individuals. It is clear that the broad taxation of services would add considerably to business tax burdens absent rate reductions and/or exemptions for business entities. However, it is also clear that Maine does not make extensive use of specific excise taxes. In few instances does Maine tax a significant share of the potential number of services (shown in the right-hand column of the table), and in few instances does Maine lead the region. The highest share of any category taxed falls under the utilities heading, with all states (but New Hampshire) taxing more than one-half of the potential categories. Of the eight professional services considered by the FTA survey, no state in the region taxes any of them.

The above discussion indicates that Maine's sales tax structure is largely consistent with the structure that prevails in other New England states and states across the nation. Nonetheless, several important tax policy issues related to the sales tax can be identified, and each can be linked back to the requirements of a good tax system discussed above.

Table 14: Sales Tax and Electronic Commerce

	2001		2006			2011		
	Revenue Loss	Percent of Total State Taxes	Revenue Loss	Percent of Total State Taxes	Percentage Point Rate Increase to Replace Revenue	Revenue Loss	Percent of Total State Taxes	Percentage Point Rate Increase to Replace Revenue
ME	57.80	2.01	150.60	4.17	0.99	221.60	4.88	1.20
CT	248.10	2.26	658.80	4.79	1.19	974.20	5.61	1.44
MA	256.00	1.60	687.20	3.42	0.97	1,015.90	4.01	1.18
NH	-	-	-	-	-	-	-	-
RI	48.90	2.28	126.50	4.75	1.40	184.80	5.53	1.69
VT	27.50	1.75	73.20	3.70	0.98	108.60	4.34	1.19

Note: Dollar amount in millions.

Source: "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," by Donald Bruce and William F. Fox, Center for Business and Economic Research, The University of Tennessee, September 2001.

First is the yield and elasticity of the sales tax. It is likely that base expansion and/or rate increases will be needed in the years to come to meet general revenue needs and to overcome erosion of the base due to economic factors. The state recently made the decision to lower the sales tax rate, reducing both yield and elasticity. The policy decision was made after a prolonged period of decent economic and revenue growth, perhaps not the best time to make such a choice. There are important external forces at play that will likely further compromise yield and elasticity, including interstate competition for business and remote sales. Table 14 shows some of the projected consequences of electronic commerce for Maine and other regional states to illustrate the magnitude of the problem. Estimates suggest Maine lost $57.8 million in sales tax revenue in 2001, or 2.01% of total state taxes. By 2006 the revenue loss is expected to grow to $150.6 million (4.17% of state tax revenue) and by 2011 the loss will total $221.6 million (4.88% of state taxes). Maine will need to increase its sales tax rate by 1.2 percentage points in 2011 simply to maintain revenue yield.

Maine has chosen to participate in the *streamlined sales tax project,* a joint effort of the states to simplify sales tax laws, filing procedures and tax administration.[34] Governor King signed legislation adopting simplification on March 1, 2002. The practical outcome of this initiative would be uniform definitions of the tax base across states for remote vendors. This would have implications for the tax base in the state of Maine and would likely entail some loss in revenue. At the same time it may allow for broader taxation of remote vendors, increasing yield. It is essential that the state stay actively engaged in the streamlining process.

The state recently made the decision to lower the sales tax rate, reducing both yield and elasticity.

The alternative to rate increase is base expansion should additional sales tax revenue be needed. Generally, rate increases are less costly to administer and comply with than an expansion in the base. However, services represent a natural target as they are largely untaxed in Maine and other states, and base expansion to include services has long been advocated.[35] The service sector is a growing element of the economy, while traditional manufacturing is a declining share of economic activity. However, there are two major problems with a policy change that would broadly tax services. The first is political. A substantial expansion of the base will encounter concentrated political opposition, along the lines of the situation in Florida in the late 1980s. Florida expanded the base to general-

34 An overview of this effort can be found at www.geocities.com/streamlined2000. For background on the sales tax and electronic commerce, see "The Sales Tax and Electronic Commerce: So What's New?" by William F. Fox and Mathew N. Murray, *National Tax Journal* 50 (1997): 573-92; "Telecommunications Services and Electronic Commerce: Will Technology Break the Back of the Sales Tax?" by Matthew N. Murray, *State Tax Notes*, January 12, 1997; "Evaluating the Costs and Benefits of Taxing Internet Commerce," by Austan Goolsbee and Jonathan Zittrain, *National Tax Journal* 52 (1999): 413-28; and "Achieving a Level Playing Field for Electronic Commerce," by Charles McLure, *State Tax Notes*, January 14, 1998. The National Tax Association has been actively involved in policy analysis related to taxation of electronic commerce; see "The National Tax Association's Project on Electronic Commerce and Telecommunication Taxes," by Kendall L. Houghton and Gary C. Cornia, *National Tax Journal* 53 (2000): 1351-71.

35 For example, see "Economic Aspects of Taxing Services," by William F. Fox and Matthew N. Murray, *National Tax Journal* 41 (1988): 10-36.

ly include services, but the policy was quickly rescinded due to political opposition. This suggests a more politically acceptable approach would be incremental versus sweeping base expansion. Of course incremental expansion can produce little revenue at a point in time and may raise taxpayer uncertainty over future tax liabilities. The second problem relates to the very nature of services that might be brought into the base. Some will meet objections due to ethical concerns, especially in the context of education and health services. (In this context, should Maine encounter a compelling need for revenue, it may be preferable to impose a low-rate gross receipts tax on sectors like health services, rather than the 5% regular sales tax rate.) Many other services are consumed heavily by the business sector—as is shown in Table 13—so that base expansion would represent a substantial increase in business costs. Any burden on businesses could be reduced through broadened access to exemptions as the sales tax base itself was broadened or, potentially, by a lower sales tax rate.

One attractive component to add to the sales tax base would be construction services. Individuals and households would pay sales tax on the value of construction materials and the value of construction services, while businesses would be provided an exemption. Some might object to this policy, but it would move Maine to the frontier of state sales tax policy. Base expansion to include services could be done on a revenue neutral basis as well, producing an increase in the sales and hence overall tax structure elasticity. At a minimum, Maine should proceed along the lines of other states and incrementally add services to the base, moving closer to a true consumption tax. Generally, if the sales tax base is expanded to include services, efforts should be made to relieve the sales tax burden on the purchased inputs of service providers to avoid pyramiding of tax.

Another important sales tax issue is the way in which Maine uses the sales tax to address equity concerns. As argued above, the best means of dealing with equity on an ability to pay basis is through the income tax. (A sales tax will typically lead to horizontal inequities due to different consumption of taxable versus nontaxable items by different households.) The current practice of exempting grocery food and defining taxable foods and eateries, while well intentioned, has many problems. It is exceedingly difficult to administer and comply with this structure;[36] it raises the revenue costs of low-income tax relief substantially by benefiting all taxpayers, including higher-income taxpayers; it limits the state's ability to export the sales tax burden to visitors who buy grocery food; and it reduces the stability of the sales tax and overall tax structure. Despite these costs, more than twenty-five other states around the country follow a similar practice.[37]

Maine could choose to fully tax grocery food and provide tax relief to low-income households through a targeted and refundable credit under the income tax, as is done in a half dozen states. Estimates of the sales tax burden by level of income and by fami-

36 See "Sales and Use Tax Reference Guide," www.state.me.us/revenue/salesuse/reference-03.htm. The complications inherent in Maine's sales tax structure are apparent from reviewing this document, as well as various information bulletins released by the state.

37 Another example of using the sales tax to achieve equity objectives is the infamous sales tax holiday, increasingly popular across the states. An excellent discussion of the problems associated with sales tax holidays is provided in "Six Reasons to Hate Your Sales Tax Holiday," by Richard R. Hawkins and John L. Mikesell, *State Tax Notes,* March 5, 2001: 801-03.

ly size could be developed and formalized into the income tax filing structure. There are criticisms of credit and rebate programs, but these largely reflect choices made by policymakers (e.g., offering insufficient credits) rather than inherent defects of a credit program.[38]

A final sales-tax policy issue is the taxation of business inputs. The sales tax is the largest business tax in the state. The goals of neutrality and economic development call for lower taxes on business input purchases. But Maine does not have the revenue flexibility to fully relieve the sales tax burden on business. It will be increasingly important in the years to come to offer general and targeted exemptions as the Maine economy moves further into the competitive global economy. The focus should fall initially on footloose businesses that are producing goods or services for export from the state, where the extent of interstate and international competition is likely the greatest. Exemptions need to be considered and justified in the broader context of state revenue goals, including revenue yield and elasticity.

Local Tax Issues

The primary thrust of this report is state tax policy and economic development. The role of the local property tax in Maine government finances, if it can even be called a local property tax today, is too important to sidestep. Maine confronts its own unique challenges to local government finance, reflecting the current web of the local property tax, limited alternatives to the property tax, TIFS, BETR and service centers. But local governments in Maine also confront more general challenges being faced by communities around the country.[39] This section of the report briefly explores issues related to the property tax in Maine, as well as local-option sales taxes.

Property Tax. The property tax in Maine is the near-exclusive source of own-source revenue for municipalities, accounting for about 90% of collections. Local governments in Maine have very little fiscal autonomy and very little fiscal flexibility. In many communities there is no room to raise property tax rates further, and there are no other viable local taxing instruments available to city (or county) governments today. Even the local vehicle tax rate is fixed by the state. The role of the property tax is complicated by a variety of forces, including local tax-increment finance (TIF) programs, the state-operated BETR program, the presence of both circuit breakers and homestead exemptions, state intergovernmental aid (particularly education aid) and the local service-center problem. It is no surprise then that Maine has encountered increasingly fierce opposition to the property tax and that solving the problem, however defined, has been exceedingly difficult.

The linkage between property taxes paid and benefits received has been stretched to the breaking point in many states, including Maine.

38 See "Should States Tax Food? Examining the Policy Issues and Options," by Nicholas Johnson and Iris J. Lav, *State Tax Notes*, June 1, 1998: 1785-807.

39 See "Metropolitan Taxation in the 21st Century," by David Brunori, *National Tax Journal* 51 (1998): 541-51. The mobility of capital and labor will make it increasingly difficult to fund local services. Brunori argues forcefully that *land value* taxation is one potential solution, where land is taxed but improvements are not taxed, or taxed at reduced rates. The practice is rare in the United States, but it has been done.

The property tax has long been viewed as the primary taxing instrument and *benefit tax* at the local level. That is, people and businesses move to a community knowing the property tax rate they will pay and the benefits they will receive from their local government. The linkage between property taxes paid and benefits received has been stretched to the breaking point in many states, including Maine. Education finance has been increasingly assumed at the state level to ensure a reasonable degree of equity and wealth neutrality. The tax has become overly complicated as policymakers have asked more and more of the tax to achieve both equity and economic development objectives.

Maine needs to fix its property tax, but in so doing must also address state government revenue problems, the financing of incentives, and the structure of aid to local governments.

The property tax has never been high on the popularity list of taxes paid by households and businesses. A primary reason is that tax falls on *stocks* of property, which may have little bearing on the current-year flow of income. At the same time, property values do closely align with long-term or *lifetime income,* so in practice property tax relief mechanisms address taxpayer liquidity constraints. Maine's property tax also falls on the personal property of business adding substantially to their local tax burden. Table 15 shows property tax rates for the largest city in each state for 2000. Portland's burden is tenth highest in the nation, and it is small comfort that Bridgeport, Providence and Manchester have higher rates. The rate in Portland is 58% higher than the median rate.

Aggravating the problem within Maine are wide disparities in municipal mill rates, as shown in Table 16. Table 16 shows the highest and lowest rates within counties, and the simple average within counties, for 1999. The highest average of 20.08 prevails in Androscoggin County, while the lowest average of 13.10 prevails in Hancock County. All counties have at least one high-tax municipality. The highest rate of 47.0 applies to Pownal in Cumberland County. The lowest of the lows is 2.32 in Garfield Plantation. The rate disparities create in-state inequities and distort the locational choices of businesses and households alike. But there are other property tax pressures as well. In many instances, property tax burdens have grown at a faster pace than the burden of other taxes; there is a shrinking school-age population; state-aid for education is supplanting the role of local taxes; and the relative burden on households versus commercial and industrial enterprises is growing. Moreover, in Maine the property tax falls on the personal property of businesses, sharply increasing their tax liabilities and giving rise to pressures for the BETR program. Maine residents may think the trends and problems are unique to their state. The fact is that many of the same problems exist in other places across the country.[40]

Rate disparities and high property tax rates in Maine have lead to the implementation of circuit breakers and homestead exemptions to provide household relief, and the BETR and TIFs programs to provide business relief. There are many ways to provide such relief in practice and there is controversy over the justification for tax relief for both businesses and households.[41] Maine needs

40 For example, see "Pennsylvania's Local Property Tax," by Robert P. Strauss, ***State Tax Notes***, June 4, 2001.

41 A nice discussion of alternative property tax relief mechanisms for households is provided in chapter 13 of Ronald C. Fisher's ***State and Local Public Finance***, 2nd edition, Irwin, Chicago, 1996.

Table 15: Residential Property Tax Rates in the Largest City in Each State, 2000

Rank	City	State	Nominal Rate 1/ Per $100	Assessment Level 2/	Effective Rate Per $100
1	Bridgeport	CT	6.50	70.0%	4.55
2	Providence	RI	3.49	100.7%	3.52
3	Newark	NJ	24.88	13.4%	3.34
4	Manchester	NH	3.05	100.0%	3.05
5	Milwaukee	WI	2.98	101.1%	3.01
6	Philadelphia	PA	8.26	32.0%	2.64
7	Houston	TX	2.59	100.0%	2.59
8	Des Moines	IA	4.36	56.3%	2.45
9	Baltimore	MD	6.03	40.0%	2.41
10	Portland	ME	2.40	100.0%	2.40
11	Fargo	ND	49.38	4.2%	2.07
12	Burlington	VT	2.20	93.7%	2.06
13	Jacksonville	FL	2.03	100.0%	203.00
14	Indianapolis	IN	12.67	15.0%	1.90
15	Atlanta	GA	6.68	40.0%	1.87
16	Detroit	MI	5.94	30.4%	1.81
17	Omaha	NE	1.88	95.0%	1.79
18	Boise	ID	1.82	97.4%	1.77
19	New Orleans	LA	17.00	10.0%	1.70
20	Anchorage	AK	1.77	94.5%	1.67
21	Columbus	OH	5.15	31.9%	1.64
22	Jackson	MS	16.39	10.0%	1.64
23	Memphis	TN	6.91	23.1%	1.60
24	Sioux Falls	SD	1.58	100.0%	1.58
25	Billings	MT	2.12	72.5%	1.54
26	Columbia	SC	37.93	4.0%	1.52
27	Kansas City	MO	7.88	19.0%	1.50
28	Portland	OR	2.07	72.1%	1.50
29	Salt Lake City	UT	1.45	99.0%	1.43
30	Boston	MA	1.32	100.0%	1.32
31	Louisville	KY	1.30	100.0%	1.30
32	Wilmington	DE	2.30	56.3%	1.29
33	Wichita	KS	11.04	11.5%	1.27
34	Little Rock	AR	6.30	20.0%	1.26
35	Minneapolis	MN	1.45	85.9%	1.25
36	Oklahoma City	OK	10.53	11.0%	1.16
37	Albuquerque	NM	3.46	33.3%	1.15
38	Charlotte	NC	1.20	94.3%	1.13
39	Virginia Beach	VA	1.22	92.0%	1.12
40	Seattle	WA	1.27	88.3%	1.12
41	Los Angeles	CA	1.07	100.0%	1.07
42	Las Vegas	NV	3.03	35.0%	1.06
43	Phoenix	AZ	10.00	10.0%	1.00
44	Washington	DC	0.96	100.0%	0.96
45	Chicago	IL	9.31	10.0%	0.93
46	Charleston	WV	1.52	60.0%	0.91
47	New York City	NY	10.88	7.3%	0.80
48	Denver	CO	7.27	9.7%	0.71
49	Cheyenne	WY	7.45	9.5%	0.71
50	Birmingham	AL	6.95	10.0%	0.70
51	Honolulu	HI	0.37	100.0%	0.37
	Unweighted average		6.78	56.3%	$1.67
	Median				$1.52

Note: All rates and percentages in this table are rounded.
1/ Source: City Assessor.
2/ Source: City Assessor or State Board of Equalization

Source: "Tax Rates and Tax Burdens in the District of Columbia—A Nationwide Comparison," published by Government of the District of Columbia, August 2001.

to fix its property tax, but in so doing must also address state government revenue problems, the financing of incentives, and the structure of aid to local governments. These problems cannot be solved in isolation. The best approach would be to wipe the slate clean, eliminate all special provisions and start from scratch. Currently rates are perceived as too high. So business relief is then offered, and offered essentially as an entitlement to all businesses, regardless of sector, capital investment, job creation, and so on. All households receive the state-supported homestead exemption to alleviate part of the property tax burden, while local circuit breakers also are available for some households. Why not simply lower the rate and adjust the role played by intergovernmental aid? Incentive programs should be incentive programs, not entitlements. Equity can be better addressed through the income tax and targeted to Maine residents. Local government tax capacity needs legislated expansion. That is, there needs to be broader portfolio of local taxing instruments that can allow the spreading of tax burdens across tax categories and different types of economic activity. These changes are likely too ambitious to achieve through incremental, piecemeal reform.

Local Sales Taxes. State and local governments across the country are looking for ways to stabilize government finances in the face of competitive pressures and changes in the structure of the economy. The role of the property tax has declined over time and is not likely to recover any time soon. So there is the compelling need to look to new and alternative revenue sources. Maine likely

Table 16: Municipal Mill Rates, 1999

County	Highest Municipality	Lowest Municipality	Average
Androscoggin	27.65 Lewiston	14.04 Turner	20.08
Aroostook	33.25 Grand Isle	2.32 Garfield Plt.	17.22
Cumberland	47.00 Pownal	10.30 Harpswell	19.45
Franklin	21.20 Wilton	4.85 Rangeley Plt.	14.53
Hancock	19.90 Mariaville	5.30 Cranberry Isles	13.10
Kennebec	24.65 Waterville	10.60 Rome	17.56
Knox	24.30 Rockland	8.19 Matinicus Isle	14.43
Lincoln	21.30 Alna	5.80 South Bristol	13.02
Oxford	24.50 Mexico	3.20 Lincoln Plt.	14.93
Penobscot	25.70 Woodville	4.10 Lakeville	16.42
Piscataquis	22.95 Milo	2.86 Lake View Plt.	13.74
Sagadahoc	21.00 Bath	11.14 Arrowsic	15.94
Somerset	26.15 Anson	5.50 Dennistown Plt.	14.72
Waldo	25.00 Winterport	9.60 Isleboro	17.03
Washington	26.00 Eastport	5.40 Beddington	16.30
York	24.35 Berwick	10.50 Wells	16.02

Source: www.memun.org/resources/Pub_tax/Full_Value/1999/fullpage1.html.

has the capacity to increase the use of specific taxes and user fees at both the state and local level. Resistance to such initiatives from groups concerned with tax fairness will be pronounced, but in practice local governments need a broader revenue portfolio.

At the local level, consideration of expanded taxing authority needs to be accompanied by a careful assessment of alternatives in terms of the requirements of a good tax system discussed above. There are several other factors that should be considered regarding local tax levies.[42] First and most generally is the important local role of accountability and flexibility in meeting local service delivery needs of residents. The current wave of fiscal decentralization taking place across the globe recognizes the importance of putting both financing and service delivery at the local level, where the consumers of government services can more easily evaluate quality and efficiency. As it currently stands Maine's system of local government finance is effectively centralized at the state level. There simply is no local autonomy.

Second, since it is the state that would enable local government taxing authority, including a local option sales tax, consideration must be given to how this may constrain future tax policy choices of the state. A local option sales tax of any magnitude would make it somewhat more difficult for the state to raise the state sales tax rate.

A third consideration is balance, which is sorely missing in municipal government finance in Maine. A more balanced tax system—one that relies on an array of tax instruments—enables lower rates and reduces perceived inequities and distortions. Currently there is little revenue balance since there are no viable alternatives to the property tax.

Fourth are the fiscal disparities across communities that can result depending on how local taxes are structured. The existence of sharp fiscal disparities under the property tax is one reason Maine and other states have increasingly assumed the burden of education finance. In Maine the problem is on both sides of the budget. That is, many communities have insufficient revenue capacity, while other communities suffer from onerous service delivery requirements. In most instances, the revenue potential of new taxing instruments will be highly correlated with the yield of the existing local property tax. However, this is not always the case. For example, simple pairwise correlations of taxable sales and total plus real personal property by city in Maine yields a correlation coefficient of only .59, although there is wide disparity around this figure. The fact is that a local options sales tax, gross receipts tax or any other tax will benefit some communities substantially and offer little to other communities. The Maine Service Centers Coalition has proposed a restricted variant of a local option sales tax that would enable local option rates of up to one cent, with proceeds earmarked for infrastructure and one-time projects. Perhaps restrictions are in order given the current structure of state and local finances in Maine, but the

Other benefits of tax base sharing include reduced incentives for sprawl and less fiscalization of land use.

42 See *Critical Issues in State-local Fiscal Policy: A Guide to Local Taxes*, published by the National Conference of State Legislatures, Washington, November 1997. More specific information can be found in *Local Revenue Diversification: Local Sales Tax*, published by the U.S. Advisory Commission on Intergovernmental Relations, Washington, September 1989.

proposed initiative does little to solve the range of financing problems confronted by all local governments in Maine. The bill never made it out of the legislature's Joint Tax Committee.

There are two broad perspectives on local revenue need that help put the fiscal disparity problem in context. The first reflects relatively low local government tax capacity and calls for some form of redistribution from higher capacity districts. This is the traditional Robin Hood approach of many state aid programs to local governments. The second reflects an imbalance between local capacity and local service needs, where many of the consumers of local government services reside outside the taxing jurisdiction. In this instance a different policy remedy is needed. Charles Colgan of the University of Southern Maine is among those who have argued for some form of tax base sharing should a local option sales tax be implemented. In spirit the jurisdictions comprising consumers of a municipal government's services would be identified, the base of the shared tax would be expanded to include these same jurisdictions, and some share of the revenue proceeds would accrue to the municipality confronted with the burden of service provision. Other benefits of tax base sharing include reduced incentives for sprawl and less fiscalization of land use. It would be important for any tax base sharing system to offer local governments some degree of autonomy and flexibility. Tax base sharing is a much discussed and debated subject in local public finance, but few practical models have actually been put in place. One example is around the Twin Cities area of Minnesota. This program has been in place since 1971 and allocates a share of the growth in sales tax revenue to support tax base sharing across the region.[43]

A final consideration is deductibility under the federal personal income tax. Income and property taxes remain deductible, while the sales tax is no longer deductible. This helps to tip the balance away from a local option sales tax, but given Maine's high property tax rates and high income tax burdens, there is little flexibility under the current structure to raise property rates further or allow local option income taxes.

Other Alternatives. There are a limited number of alternatives to local sales taxes. Local income taxes are in place in a number of states, but given the important role played by the income tax at the state level, it is impractical for Maine municipalities because rates would simply be too high. Payroll taxes, imposed on firms as opposed to households are another option. But local payroll taxes are extremely unpopular and would encourage firms to locate to rural areas with no tax. Local option corporate income taxes exist in a small number of communities across the country, but given the direction and complexity of the corporate income tax, this is not a viable local alternative either. Other options include gross receipts taxes, special excise taxes and user fees. Consideration should be given to all three of these latter alternatives, individually and as a group. A low-rate gross receipts tax might be applied specifically to nonprofit entities, particularly benefiting the state's service centers; an alternative would be a general low-rate gross receipts tax. New Mexico provides a practical example, having enabled effective July 1, 2002, a local hospital gross receipts tax in selected counties.

43 See "Regional Tax Base Sharing: The Twin Cities Experiences," by Thomas Luce, *Local Government Tax and Land Use Policies in the United States*, Edward Elgar, Cheltenham, 1998.

Legislation is subject to local voter approval and carries a maximum rate of 0.5% on gross receipts.[44] Special excise taxes and user fees, while perhaps insignificant on a tax-by-tax basis, can together provide a significant boost to local government tax coffers. A danger is that these taxes are put in place only in service center communities, potentially exacerbating the existing sprawl problem by encouraging outmigration.

There are many compelling reasons to expand local government taxing authority. The current structure simply offers no local government autonomy and flexibility, there is no revenue balance and it has become harder and harder to fund local services. But new local taxes should not be enabled by the state until it addresses fundamental tax reform. The last thing Maine needs is another complicated levy layered on top of the current state and local tax regime.

Summary

This lengthy section has provided a detailed overview of major state taxes in Maine relative to other New England states and the nation as a whole. Local tax issues have also been addressed, focusing almost exclusively on the existing local property tax. Several important issues surface that warrant policy consideration. As argued elsewhere, these problems are often linked together and cannot be easily addressed in isolation.

The personal income tax has relatively high rates and a quick pace of rate progression. While the state buys considerable vertical equity from this rate structure, substantial burdens appear to fall on high-income taxpayers increasing the potential for serious tax distortions. Revenue-neutral rate restructuring should be considered. The personal income tax should be the primary if not exclusive means of securing tax fairness through the overall state tax system.

The state corporate income tax is in a declining mode nationwide. At the same time, corporate tax collections in Maine do not appear to have fallen commensurate with the nation nor the region. As with the personal income tax, efforts should be made to flatten the current progressive rate structure and align it with the personal income tax. Consideration should be given to implementation of a business enterprise tax, similar to that employed in New Hampshire, as a replacement for the corporate tax. The business tax burden would be expanded to include all businesses, while the base would be so large as to allow low rates and a more stable flow of state tax revenue. More information is needed on the way in which the corporate income tax, as well as other state taxes, effect businesses. Finally, the use of incentives, whether as a stand-alone policy or under the umbrella of the corporate income tax, needs to be carefully evaluated in terms of both their costs and benefits.

> The personal income tax should be the primary if not exclusive means of securing tax fairness through the overall state tax system.

Sales tax policy should seek to generally protect the tax base and avoid rate reductions that would compromise yield and elasticity. Legitimate exemptions to businesses should continue to be extended, as revenues permit. At the same time the base should be expanded to include consumer services,

44 House Bill 290 of the New Mexico 2002 legislative session. Revenues are dedicated to support hospital capital costs.

including construction services. The sales tax should not be used to pursue equity objectives, as is currently the case with the special treatment of food.

Finally, something must be done about local government finances. Currently, local governments have little if any autonomy in setting rates and generating revenues from own sources, but expanded taxing authority is not warranted until the web of local government finance and state aid is addressed more fully, including BETR and TIFs. Several options exist for expanding local taxing authority, including local option sales taxes, gross receipts taxes, and specific taxes and fees. Tax-base sharing or state aid may be needed to help account for disparities between tax capacity and service delivery needs.

PART SIX

Conclusions and Discussion

THIS REPORT HAS COVERED A LOT of ground, and much of that which has been covered has not received the detailed attention that is truly warranted. Still, it is hoped that the issues surveyed, data presented and ideas offered will help prompt further discussion and dialogue regarding tax policy at the state and local levels in Maine.

Tax Policy and Development

A major focus of the report has been tax policy and economic development. Taxes clearly influence development, just as development and growth patterns influence revenues. But economic development is just one goal for state and local tax structure. Policies to promote economic development must be balanced against other tax policy objectives, including tax fairness; revenue yield, stability and elasticity; and low costs of administration and compliance. Compromises will most certainly be required in practice as the state's tax system is subject to reform and change in the years to come. There is plenty of work to do. The complexity and transparency of the tax system needs improvement; greater balance in state and local tax portfolios is needed; tax rates need to be flattened and if possible reduced to avoid distortions; sincere and practical incentive programs must be developed; and the service-center problem requires a remedy.

To effectively use taxes to promote economic development, it is important to begin with well-established and agreed upon goals. General goals might include increasing average earnings, the rate of job creation and private capital investment. More specific goals may be required in practice, and to the extent possible they should be practical and measurable. Specific strategies will then need to be designed and implemented to meet development goals. If taxes are to be used, there should be a clear linkage between specific tax policies and specific development strategies.

Similarly, any potential tax gains from economic development policies should be identified. In Maine there have been numerous discussions of tourism development and the promotion of the state as a place for retirement to improve economic fortunes and expand the tax base. Such policies need to be critically evaluated in terms of economic gains and fiscal effects, including both the tax and expenditure sides of the budget. Tourism appears attractive because of the abundant natural resources in Maine that can attract visitors and enable exporting of taxes to non-residents. Visitors will help to create new jobs and expand incomes for some in Maine, and will help boost tax revenues as well. But tourism, as with any development strategy, has its limitations as well. For example, many jobs

To effectively use taxes to promote economic development, it is important to begin with well-established and agreed upon goals.

in tourism offer relatively low pay and seasonal employment. In addition, while exporting taxes sounds like a good idea, it may not achieve the desired objective. That is, taxes paid by tourists actually may be borne by local landowners or local workers, if tourists are sufficiently mobile in seeking out alternative travel destinations. In general, both the strengths and weaknesses of different candidate development strategies must be identified to enable informed choice.

Attracting retirees entails a somewhat different cost-benefit calculus.[45] Retirees are viewed as especially attractive by communities with few other viable economic development opportunities in part because of potentially high levels of disposable income. As this income is spent, jobs and earnings are supported, as are state and local tax bases. Retirees do consume government services, although they do not use educational services. Still, many retirees also spend a considerable portion of their income on travel and in places other than their primary place of residency. From a tax perspective, income may be sheltered from the personal income tax and spending may be disproportionately on non-taxable services (i.e., health care), thus offering little boost to the sales tax. Finally, most retirees do not have full-time jobs. In practice most households do not pay enough taxes to finance the services they derive from state and local government, requiring tax payments from businesses. Like tourism, any specific strategy for economic development will have its strengths and weaknesses, but these need to be drawn out to support the policymaking process. This is true of call centers, back offices, traditional manufacturing, and so on.

The current progressive corporate rate structure should be flattened, ideally to a single rate. Similarly, the progressivity of the personal income tax should be reduced to avoid distortions for entrepreneurship and the creation of high-quality jobs. Sales tax burdens on business input purchases should be reduced to the extent allowed by revenue yield, while consumer services should be brought into the base. Incentives—as opposed to entitlements—need to be developed to allow Maine to be competitive with other states in New England and across the nation.

If incentives are to be used, they should be designed with care and used with caution. Generally, incentives will not be self-financing.[46] That is, tax cuts to promote growth seldom yield a large enough private sector response to produce revenue gains that offset the costs of the incentive program. The logic is simple: State and local government budgets are in balance absent incentives, so how can government sustain service delivery and keep budgets whole while giving away part of the tax base? In general, incen-

45 For work specific to Maine, see "Taxes and Retirement in Maine," by John D. Donahue and Herman B. Leonard, prepared for the Libra Foundation, Harvard University, October 20, 1999. Also see "Economic and Fiscal Implications of Nonmetropolitan Retirement Migration," by Nina Glasgow and Richard Reeder, *The Journal of Applied Gerontology* 9 (1990): 423-51; "Migrating Retirees: A Source for Economic Development," by Mark Fagan and Charles F. Longino, Jr., *Economic Development Quarterly* 7 (1993): 98-106; "Economic Impact of Retirement Migration," by Steven Deller, *Economic Development Quarterly* 9 (1995) 25-38; and "The Elderly's Income and Rural Development: Some Cautions," by Robert A. Hoppe, *Rural Development Perspectives*, February-May, 1991: 27-32.

46 There is little, if any, careful analytical work on economic development incentives. An overview of both conceptual issues and practical strategies is *Economic Development Incentives and the Tennessee Valley Economy*, by Matthew N. Murray, Center for Business and Economic Research, The University of Tennessee, Knoxville, June 1990. Also see *Directory of Incentives for Business Investment and Development in the United States: A State-by-State Guide*, National Association of State Development Agencies, Urban Institute Press, Washington, 1986. While now dated, it provides a nice descriptive overview of a wide range of incentives used by the states.

tives should be used to create something that would not be created without the incentive. (Of course, proving that incentives work in practice is impossible.) And they should be targeted to companies that are creating high-quality jobs (with above-average earnings) and making above-average capital investment (to ensure competitiveness). Incentives should not be used when firms will be competing with one another in the state; generally, incentives should be used to help firms that export goods or services from the state. Finally, it should be recognized that in certain parts of Maine there are relatively higher costs of doing business because of factors like location and isolation. In these instances an incentive premium might be needed to overcome the extra hurdle associated with running a business in a relatively isolated location. This is a common state practice.

Other Tax Policy Considerations

Tax fairness should be pursued primarily through the state income tax as it can specifically address differences in taxpayer ability to pay. Generally, residents must re-evaluate how much equity they can afford to buy through the tax system. Both capital and high-income workers have acquired considerable sensitivity to high tax rates. Since the pursuit of tax fairness requires some degree of redistribution from higher-income and/or business taxpayers, such policies are distortionary. Consideration should be given to placing the sales tax on food and providing refundable credits through the income tax. This would reduce administration and compliance costs, improve revenue yield and stability, and allow exporting of the tax to nonresidents.

Both state and local tax systems need greater balance. At the state level there is excessive reliance on the income tax, while at the local level there is near exclusive reliance on the property tax. Options at the state level include incremental taxation of consumer services, a low-rate gross receipts tax, a low-rate business enterprise tax like that in New Hampshire, and greater reliance on specific taxes and fees. At the local level there needs to be more local autonomy and flexibility in generating own-source revenue. The current property tax can hardly be called a local property tax given tax relief mechanisms for households and business, and the currently high rates. Options include local option sales taxes, gross receipts taxes, specific excise taxes and user fees. Some form of tax base sharing or state aid program will be required to address the infamous service-center problem. Greater balance reduces distortions and provides a more stable tax portfolio.

Incentives—as opposed to entitlements—need to be developed to allow Maine to be competitive with other state in New England and across the nation.

The elasticity of specific taxes and the overall tax system needs to be carefully evaluated in light of short-term and long-term financing needs. Generally, some degree of elasticity should be protected to allow for public investments and the replenishment of rainy day funds following periods of weak economic and revenue growth. Flattening of the personal income tax rate structure would reduce elasticity. Elasticity could be enhanced through a business enterprise tax or the sales taxation of certain consumer services.

Finally, there needs to be a foundation of models, data and research to support tax policy reform. Many of the ingredients are already in place. For example, the state has the capacity to evaluate tax incidence and equity, although it needs to fine-tune its approach to the incidence of business taxes, which is no easy task. Similarly, forecasting is done by the Maine State Revenue Forecasting Committee. Generally, analysis needs to encompass all dimensions of the requirements of a good tax structure. Unless all the consequences of a policy change can be identified, there is no assurance that the policy choice will be the right one for Maine and its residents. Perhaps most important is the need for a catalyst that can motivate the process of comprehensive tax reform. Hopefully the catalyst is the hard work of Maine residents who understand most of the problems and the options at their disposal. In practice, crisis often serves as a catalyst. It is hoped that this is not the case in Maine.

Appendix

Interviews and Contacts

Dana Connors, Maine State Chamber of Commerce
Christopher Hall, Maine State Chamber of Commerce
Todd Gabe, University of Maine
Kit St. John, Maine Center for Economic Policy
Josephine LaPlante, University of Southern Maine
Charles Colgan, University of Southern Maine
Geoff Herman, Maine Municipal Association
Peter Mills, Senator
Ralph Townsend, University of Maine
Laurie Lachance, State Planning Office
Michael Saxl, Representative and Speaker of the House
Joe Bruno, Representative and Republican Floor Leader
Paula Valente, Institute for a Strong Maine Economy
John Oliver, L.L. Bean
John Hart, National Semiconductor
Anne Gauthier, National Semiconductor
Steven Levesque, Department of Economic and Community Development
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