In the news...

Capping Maine's income tax: Neglected issues and dimensions

Josephine M. LaPlante

The Maine Legislature recently enacted a $676 million cap on spendable income tax revenues that may take effect as soon as fiscal year (FY) 1997. Should FY 1997 revenues surpass the ceiling, any excess will be used beginning in 1998 to lower marginal tax rates for the low and middle income. Annual cuts in rates will follow until an overall reduction of 20% has been achieved. This commentary suggests that unanticipated impacts arising from correctable design flaws in the new policy will have damaging consequences for Maine's state-local fiscal system:

- Inflation will erode the purchasing power of the ceiling continually, producing a permanent gap between resource needs and spendable income tax revenues.

- The share of public programs financed by the progressive income tax will be reduced annually, shifting the burden of taxation in Maine to tax types that are far less fair.

- Increasing sales or property tax collections sufficiently to compensate for shrinking income tax revenues will require sizable, annual rate increases, further unbalancing the revenue system and exacerbating the erosion of tax equity.

How high are income taxes in Maine?

Maine's income tax revenues soared during the 1980s, as the result of not only personal income growth, but also a tax structure that caused an increasing percentage of income to be claimed as taxes and incomes grew. By 1988, 3.3% of total personal income was being collected as income tax revenue, compared to only 2.4% early in the decade, and Maine's U.S. Advisory Commission on Intergovernmental Relations tax effort index increased from 116% of the U.S. average in 1981 to 160%. Prolonged economic stagnation has reduced Maine's current income tax bite to only 2.6%, which compares favorably to the national average of 2.2%. Maine's rank among the states dropped from 8th place in 1988 to 16th in the nation in 1993.

Tax burden by income level

Table 1 shows income tax bills for four different years, for three hypothetical families at different income levels. Each household is assumed to be comprised of a married couple with one child, who file a joint income tax return and claim the standard deduction. Tax liabilities have been determined using the actual forms and tax tables for each year shown.

An examination of Table 1 reveals that the low income couple have seen a significant reduction in their income tax burden since 1988. When deflated dollars are considered, their tax liability decreased by 62%. The household earning $43,000 per year has seen a tax reduction each year; in inflation adjusted dollars, the tax liability declined 38% between 1988 and 1994. The household earning $163,000 per year has experienced a slight increase in tax liability since 1988, but a large reduction since 1991, when the top rate was increased to 9.89% for taxable incomes exceeding $75,000. In real dollars, this high income household's tax liability has been reduced by 20% since 1988.

Despite the reduction in the high income household's tax liability and its claim on income, a comparison of the tax positions of the three households reveals that the household with an annual income of $163,000 earns almost four times the income of the household with income of $43,000, but pays nearly eight times the amount of tax. The difference in expected tax effort is large enough, and enough higher than most states, to offer the wealthy an incentive to live elsewhere.

Inflation and the tax cap

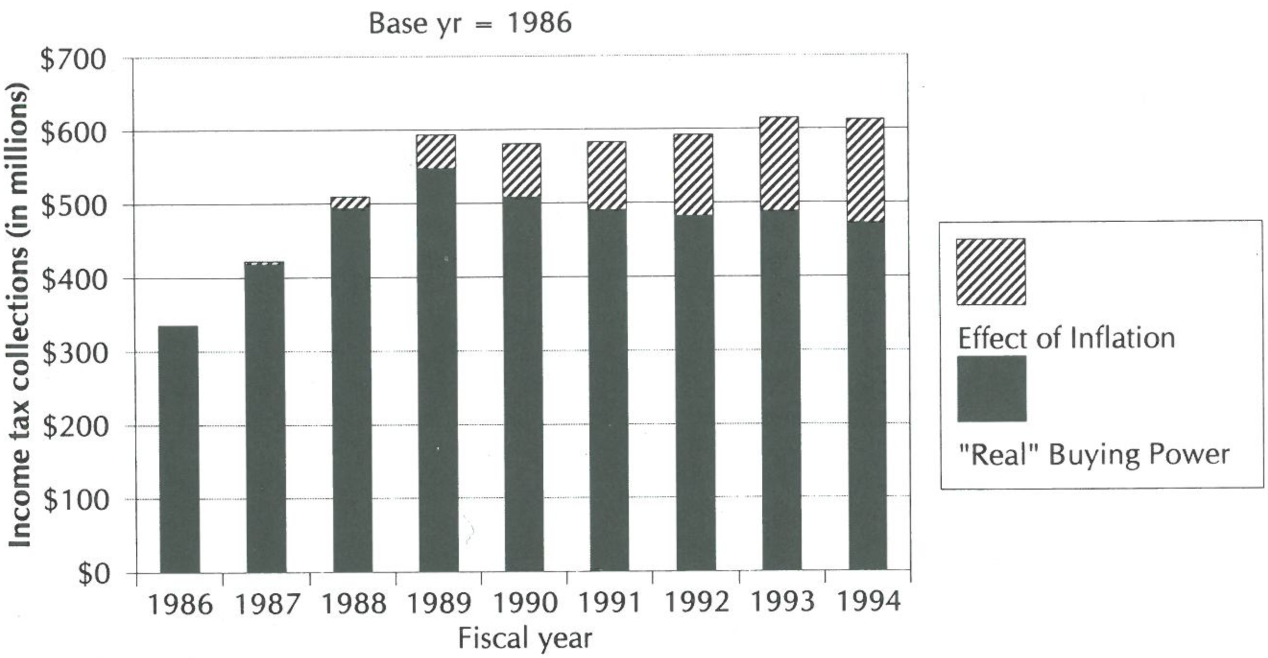
When dollars are deflated to reflect the erosion of buying power since 1986, we find that FY 1994 collections were appreciably below the 1989 level, as shown in Figure 1. To match the FY 1989 income tax yield in terms of purchasing power, FY 1994 income tax revenues would need to total $693.1 million (based upon a 1994 base year deflator). This amount already exceeds the spendable income tax ceiling established for FY 1998–four years hence!

Capping spendable revenue at a specific dollar amount is equivalent to annual reductions, because inflation will continually erode the purchasing power of those dollars. Balancing the state budget first will mean forcing state spending to beneath the FY 1989 real dollar level, then forcing expenditures lower and lower each year thereafter. Thus, barring significant new revenue from other sources, there is no way a continual dismantling of public programs can be avoided, given the present design of the cap.

Table 1. Comparison of changes in tax bills for three Maine households, 1988 - 1994

Tax year	Tax owed, total income = $21,500	Tax as % of total income	Tax owed, total income = $43,000	Tax as % of total income	Tax owed, total income = $163,000	Tax as % of total income
	$410	1.9%	$1,960	4.6%	$11,500	7.1%
1988	$232	1.1%	$1,629	3.8%	$13,040	8.0%
1991	$199	0.9%	$1,516	3.5%	$11,678	7.2%
1993	$192	0.9%	$1,505	3.5%	$11,666	7.2%
1994						

Figure 1. Income tax yields showing erosion of buying power



Fiscal system issues

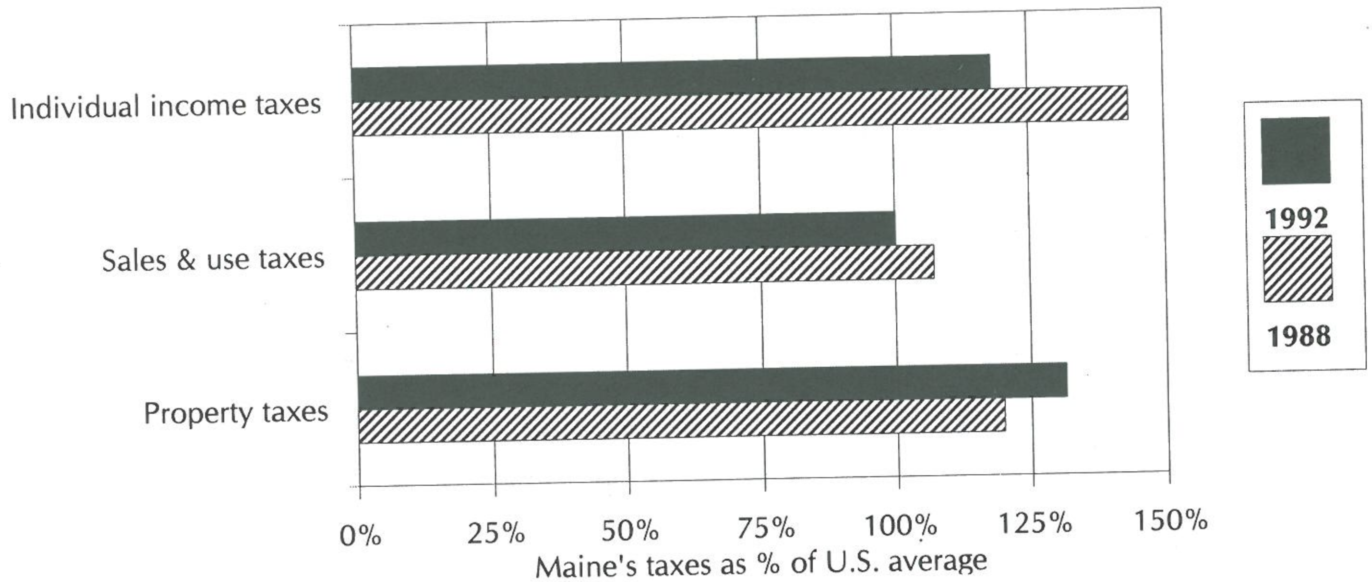
Even if other taxes are increased to compensate for dwindling personal income taxes, there will be several negative consequences for the state-local fiscal system, because the income tax is the cornerstone of a high quality revenue system. Among all revenue sources, no single revenue type can provide adequate revenue at all times because their sensitivities to economic conditions or "elasticities" differ. Elastic taxes grow with the economy, but decline with a downturn. Inelastic taxes are not as strongly affected by economic change. Increasing sales or property tax collections sufficiently to compensate for shrinking income tax revenues will require sizable, annual rate increases.

Since 1990, the rate of increase in local property taxes has far outpaced the state's two major tax types. Property tax revenues are approaching half of the combined total of income, sales, and property tax collections. Although the volatility of Maine's income and sales tax collections make a somewhat larger role for the property tax appropriate, today's system of revenues is very lopsided, with far too heavy a reliance on an unpopular, inelastic tax. A further reduced reliance on the income tax will seriously erode the ability of state and local governments to fund the necessary infrastructure and services that must be in place if Maine is to prosper economically (see Figure 2).

While both state tax types have become more similar to the U.S. during this period, Maine property taxes have grown more out of line because most states have been decreasing their reliance on this tax. In 1992, Maine raised 4.5% of personal income as property tax, while the U.S. average was only 3.5%.

Both the property tax and the sales tax burden the lowest income households disproportionately. While the income tax exempts them from taxes, any reduction of the share of all revenue borne by the income tax will shift the burden of financing Maine government further onto those citizens who are least able to pay. If the state then were to attempt to reduce their burden through tax

Figure 2. Comparative tax burden taxes as % of personal income, ME & US



credits or refunds, the total amount of property and sales taxes collected would need to be increased further to permit the redistribution of burden. Eventually, we could see a system of taxes in Maine that is just as costly and burdensome as what we have today, but much less efficient or equitably distributed.

Rethinking reform

While policy-makers are to be applauded for a serious effort to bring Maine's fiscal affairs under control, an income tax cap implemented as a dollar amount will have more extensive and damaging consequences for our state-local fiscal system than those identified previously by critics of the policy, and will do nothing to reduce the high volatility of the income tax type. Given current data, it is not clear that reducing overall income tax collections is a priority at this time, nor is it clear that the low and middle income require income tax reductions.

Without sacrificing the goal of achieving enhanced control over state finances, the potentially fatal design flaw of specifying a tax ceiling in dollar terms is easily corrected by modifying the legislation to specify a tax bite target based upon the desired percentage of personal income to be raised as taxes instead of a dollar amount. Under this approach, annual revenue growth would match income increases, rather than outpacing gains during economic growth and lagging behind during downturns. This would prevent the state budget from growing more rapidly than incomes during good times and establish a revenue "floor" during economic downturns, thereby averting the plunge of revenues that accompanied the onset of the recent recession in Maine.

Achieving a stable claim on personal income does not mean we must replace a progressive tax system with a flat percentage income tax. However, income tax rates and other features of the tax will need to be revamped to mitigate the magnitude of the revenue fluctuations that accompany economic change. Strategies like broadening the base of taxation by phasing out deductions for high income households enable states to use a moderate top marginal tax rate providing more stable collections while nonetheless achieving an average rate of taxation for each income group that is progressive. As part of reforming the income tax, policy-makers will want to discuss whether Maine can afford to continue to tax the wealthy quite so heavily.

Realizing the tax bite target will require lessening the escalation in tax burden that occurs when a second wage earner in a middle income household enters the workforce. Potential strategies include using fewer tax brackets (so the frequency of movement into higher brackets is reduced), eliminating any remaining marriage penalty, and permitting a tax credit for a second wage earner. These tax breaks could be limited to households with low and middle incomes, to maintain progressivity and to target the income groups most likely to be employed in contingent labor markets.

Josephine M. LaPlante is an associate professor in the Graduate Program in Public Policy and Management at the Edmund S. Muskie Institute of Public Affairs, University of Southern Maine, where she specializes in state and local public finance and statistical methodology. Professor LaPlante holds an interdisciplinary doctorate in economics and social science from the Maxwell School at Syracuse University. She is the author of "Dollars and Sense: Maine State Budgeting at the Crossroads."

The importance of health insurance reform

Nancy Landon Kassebaum

When Congress failed to pass comprehensive health care reform last year, many lawmakers proclaimed proudly that they had saved the American people from a "government-takeover" of the private health care system. Yet, the number of Americans without health coverage continues to climb and the vast majority of Americans continue to believe that healthcare reform is a top priority.

Problems in the current system

The barriers to obtaining affordable health coverage in the current system can be overwhelming–particularly for small businesses and individuals in poor health.

Because many insurance companies and employers impose exclusions for preexisting medical conditions and deny coverage to those considered poor health risks, millions of Americans are caught in "job lock." They would like to change jobs or start their own business to advance their careers and improve their family's standard of living, but the risk of losing their insurance coverage is too great.

In fact, millions of Americans are at risk of becoming uninsured or subject to preexisting condition exclusions under the current system because they change jobs, lose jobs, or work for employers who change insurance policies. As many as 81 million Americans suffer from preexisting medical conditions that could make it difficult for them to obtain health insurance coverage.

Even those with health insurance cannot be sure of maintaining their coverage if illness strikes. Insurers can collect premiums for years and then suddenly refuse to renew coverage if individuals or employees begin to incur large health costs.

The bipartisan health insurance reform act

Earlier this year, in a show of bipartisan cooperation, the Senate Labor and Human Resources Committee unanimously approved legislation I wrote that will make