

Taking Charge of Maine's Fiscal Fortunes: Taxes are only one Piece of the Puzzle

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Are Maine's taxes too high? This question and others continue to plague policy makers and citizens throughout Maine. This article provides the first of two perspectives on how to achieve meaningful tax reform. In it, author Josephine LaPlante suggests we take the long view, evaluating carefully our tax structure and the impacts of any tax reforms. She presents a comprehensive framework for considering such changes and argues that taking charge of Maine's fiscal house includes not only tax reform but also a reassessment of how we provide public services to meet the needs and preferences of our citizens.

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The ongoing quagmire that has characterized state budgeting since the beginning of the recession has left citizens confused and frustrated. Are Maine's taxes too high? If they are, which tax type is the culprit? The property tax has been a target of reform since the mid-1980s, yet when the Legislature finally agreed to provide relief, it was the income tax that was capped. Why is the economy still so sluggish? Is it because income taxes are too high? Then why was the limitation on collections repealed? And why do our kids smoke so much, compared to teenagers in other states? Maine already has one of the highest cigarette taxes in the country, yet it has been argued that increasing the tax further will solve the problem. High taxes have been decreed the nemesis of economic recovery, the cause of what ails us, and a panacea for societal ills.

Maine's current confusion about and preoccupation with tax policy and, in particular, the personal income tax is a predictable outgrowth of the combination of continuing sluggish revenue collections and widespread recognition that we did not pay enough attention to taxes during the heydays of the 1980s. Then, the rate of increase of funds flowing into state coffers when the budget was being prepared became the basis for revenue forecasts. No one noticed that the rapid growth in income tax collections was being leveraged by a rate structure and a marriage penalty that worked together to take an increasingly heavy bite out of gains in household income. No one asked whether the level of revenue collections or the burden imposed on taxpayers was fair, wise, or sustainable. Nor was there a realistic projection of how many tax dollars would be required to implement 1985's mandated reforms to an educational system that includes more than 750 schools.

Unfortunately, our understanding of how Maine's tax effort has changed since the late 1980s, why it looks like it does today, what adjustments can be expected in the short and longer terms, and whether and how we can control the burden imposed on citizens and businesses remains naive. Proposed tax solutions sound like slogans, and the bias of action has been toward broad strokes and punitive control strategies. While policy makers have been arguing about the merits

of a cap on income tax collections, the very base upon which we rely for those revenues has been undergoing a complex metamorphosis that does not bode well for future state budgets. We need to take the time to gain a fuller understanding of the forces that affect state and local spending needs--the costs of service production, revenue capacity, and required tax effort--to permit us to control the costs of government without jeopardizing services upon which our fiscal future depends and to implement meaningful reforms to our tax and local aid systems.

This paper reviews important changes that are reshaping Maine's budgetary environment, including trends in the personal income tax base. Then, a framework is presented that can be used to untangle the influences of the complex and interconnected set of fiscal and economic conditions that both drive public expenditure needs and enable spending.

The Evolving Budgetary Climate

When we wrote *Dollars and Sense* (1993), Bob Devlin and I observed: "Although the fiscal crisis has been treated by many as a temporary, albeit prolonged suspension of business as usual, our elected officials may expect to confront intense budgetary pressures throughout the 1990s." Little did we realize how true those words would turn out to be. Between 1989 and 1995 the federal government withdrew hundreds of millions of dollars from the Maine economy through sharp reductions in defense employment and procurement. These actions reduced state personal income by an estimated \$460 million in 1996 (LaPlante, 1997) and accelerated the restructuring of Maine's employment towards low-wage, service-sector jobs that often offer little job security and few benefits (LaPlante, 1997; Nelson, Evans, Adams, 1996).

The other New England states also have felt the federal budget ax, which has contributed to a regional concentration of effects that directly and indirectly is eroding Maine's fiscal position. Between 1989 and 1994 New Hampshire lost more federal defense jobs than any other state, which placed it right ahead of the second-biggest loser, Maine. Defense subcontractors in Maine have seen their work reduced because firms in Connecticut and Massachusetts lost federal procurement contracts (Governor's Task Force on Defense and the Maine Economy, 1992). Fewer dollars to spend within the region translates into less spending in Maine. And the worst is not over.

Phased-in cuts enacted in the budget compromise of 1997 will reduce federal aid to state and local governments each year until the annual target of \$300 million is reached in the year 2002. The renewed vulnerability of Brunswick Naval Air Station to closure is but one more example of the cost to Maine of federal budget balance. These state and regional trends mean slowed growth of Maine's income and sales tax bases, more volatile tax collections, and more citizens in need of both temporary and longer-term financial assistance. Should the state enter another recession, whether and to what extent Congress will move in to assist with spiraling welfare costs will depend upon its willingness to resume its former countercyclical spending role and the fate of the balanced budget amendment proposal.

Other tax bases upon which Maine's state and local governments depend also are undergoing long-term contraction. The property tax has been declining in productivity and continues to do so as fewer and fewer businesses depend upon the expensive machinery that once made personal property such an important source of revenue. Local governments will continue to find that the

expansion of the property tax base new development spurs supports neither the physical nor the service infrastructure required for local commerce to thrive. In addition, homeowners will continue to find themselves increasingly responsible for paying for local services as smaller portions of what constitutes business activity remain measurable through property valuation and taxable locally. The rapid rise of the Internet as a site for commerce is likely to exacerbate the loss of the local tax base and reduce the potential for states to collect sales taxes (although the Internet also offers opportunities for commerce because Maine is no longer isolated by geography).

The Truth About Income Tax Collections

Pointing to data that shows that tax-cutting states enjoy higher family incomes (averaging \$1,600 more than tax raisers), more rapidly growing economies, and more jobs (Harmon, 1997), editorial writers and other proponents of income tax cuts have promised that renewed economic vigor will be our reward.

The truth of the matter is that without any explicit action by policy makers, the average rate at which we withdraw taxes from personal income has declined dramatically since 1989. Then, the claim of the income tax against statewide personal income was 3.2 percent and ranked seventh in the United States. The U.S. Advisory Commission of Intergovernmental Relations placed Maine's use of this tax type at 60 percent above the typical state's reliance. When the recession struck, the bite of the income tax dropped suddenly and precipitously to only 2.6 percent, the largest percentage decline in the nation and a revenue loss that exceeded \$200 million. (See LaPlante and Devlin, 1993, for a full discussion of the causes and consequences of this change.) In the space of one year, Maine's average or effective rate of income taxation dropped from seventh to fourteenth in the nation, and we have continued to become more typical since that time. State Planning Office Director Evan Richert reported recently that Maine's income tax bite today ranks twenty-first in the nation, an incredible improvement upon our rank of seventh just eight years ago. The self-induced reduction in the average rate at which we tax personal income should produce an unplanned tax cut of more than \$300 million over the new biennium.

When the enormous diminution in collections Maine already has experienced has not jump-started the economy, it is difficult to accept arguments that reducing taxes further will place us at a competitive advantage among the states and stimulate growth. It is far more plausible that a further reduction in income taxes would do more harm than good, because we would be forced into damaging, shortsighted choices like closing the math and science magnet school or further gutting the state university system. Instead of being viewed as a mecca for business location, Maine would be touted nationally as the state that does not care about the quality of its work force. Should we be foolhardy enough to try to reinvent ourselves as New Hampshire, the quality of life for Maine's people would suffer dearly.

Still at a Crossroads

Maine's budget remains at a crossroads, still waiting for policy makers to take charge of the state's finances. By converting its aid system to block grants, Congress has taken a major step toward controlling the volatility of its finances. Unfortunately, it has done so at the expense of what remained of the predictability of state expenditures. We no longer have the luxury of seeing federal reimbursements increase swiftly in response to higher state spending for public welfare programs. Instead, federal aid will remain fixed or, under a constitutional amendment to balance the budget, decline in the face of an economic downturn.

Fortifying ourselves for the inevitable next recession needs to be on policy makers' minds now, before we are caught unprepared again. In 1988, Steve Gold argued that "economic, regulatory, and technological change will force states to rationalize their tax systems, moving in the direction of a level playing field, broader tax bases, and lower tax rates" (p. 7). Blindly cutting taxes or pushing more and more financial responsibility onto already overburdened hub communities and schools is not likely to produce that level playing field for Maine. The reason is simple: States with the most resources have the fewest needs.

Unfortunately, Maine has below-average income, which means our citizens have above-average needs. To compound the disparity in needs and resources, it is more expensive to produce many services in Maine because we are troubled by the high Northeastern cost structure and substantial diseconomies associated with a small scale of service provision and population sparsity. So not only does producing one unit of service require a higher-than-average tax effort, more units of service are needed. It is critical to recognize that the personal income tax remains super-sensitive to incremental gains in personal income. Should the economy take off, spiraling increases in the average rate of this tax again will propel Maine to the forefront of any tax ranking of the states. While reducing our income tax collections further will not produce the response advocates of cuts predict, permitting the income tax to spiral in response to economic growth would be reckless. For now, at least, Maine's improved comparative position provides a reprieve during which policy makers can take sorely needed steps to improve our fiscal footing. Priorities for action include:

- Restructuring the personal income tax to reduce its volatility, which could include broadening the brackets over the middle income range and/ or providing a standard deduction to each worker in a household;
- Instituting a state-level capital planning process and requiring the preparation and enactment of a capital budget, which preferably would encompass not only state but also local infrastructure needs that serve the state's priority purposes;
- Adjusting the mix of taxes away from the property tax and toward fairer tax types as revenue growth permits increases in local aid (Priority should be given to addressing the glaring disparities in tax rates between the urban centers and the rest of the state through a carefully targeted revenue-sharing program that "nets out" the costs imposed on communities when they host economic activity.);
- Broadening the sales tax base and lowering the rate, to promote fairness and more diverse and stable revenues;
- Evaluating implications of the evolution of the Maine and national economies on the array of opportunities and constraints facing the state and shaping effective responses; and,

- Improving our capacity to monitor, evaluate, and, to the extent possible, control factors that influence state and local expenditure needs, the cost of producing services, and the tax effort required to finance those services.

The remainder of this paper reviews key influences on public budgets in an effort to facilitate dialogue about how best to take charge of Maine's fiscal fortunes.

Influences on Public Budgets

The breadth of demands for public spending and the tax effort required to support services both flow from a complex set of interconnected forces: the economy; personal income levels and distribution; population demographics; needs of citizens; costs associated with providing public services; size and productivity of tax bases; and both spending and tax policy choices. Exhibit One provides a graphic overview of these forces and their interconnections. Understanding these linkages helps us separate factors that are within the control of policy makers from variables that independently influence both what governments need to spend to achieve an average level of service output and how much it can afford to spend.

The particular array of public services offered in a state, the extensiveness of each service, the balance among services within the greater service mix, and the total amount expended all are affected by the fiscal fortunes of a state. The intersection of (1) revenue capacity, (2) the needs of the populace plus demands for service that originate from the household and business sectors, and (3) the cost of producing a unit of each type of service determine how much a state-local fiscal system will be asked to spend and its opportunities for meeting those demands.

A state's revenue capacity, which establishes the maximum amount that may be expended, is determined by the number and types of revenue bases and the value of each revenue base. The value of the various tax bases depends upon the composition of the economic base, which includes the mix between residences, farms, commercial, industrial, tax-exempt, other uses, economic conditions, the income position of households and businesses, and both economic and demographic trends. In a state like Maine, where both income and the educational level of the populace are lower than in many states, revenue capacity is affected adversely.

As we are now painfully aware, the elasticity of each revenue base affects revenue capacity at a given time. An elastic or sensitive base such as personal income responds to income growth or decline, offering added revenues during periods of economic growth but causing receipts to plummet in an economic downswing --just when they are needed most. The value of an inelastic tax base such as the local property tax does not increase automatically with economic growth, which either constrains revenue increases when they are needed to finance infrastructure investment and service expansion or produces high tax effort. These revenues also are comparatively stable during an economic downswing.

Access to each revenue base is an often overlooked component of revenue capacity, but one of increasing importance. Access depends upon laws governing the use of taxes, whether any limitations are in place, community values and political realities, and the extent and importance of competing claims against the same resource base, such as debt or pension obligations. Increasingly, the willingness of citizens to pay taxes is influencing access to revenues.

As Exhibit One illustrates (see pdf format), and as my recent study (LaPlante, 1997) of the impacts in Maine of federal retrenchment underscores, the federal government influences state and local budgetary opportunities and constraints. Decisions about what services it will produce itself, what it will buy, how much it will spend, which state and local services it will help to fund and how it will fund them (e.g., through reimbursement at a pre-specified rate for approved spending or by block grants), at what level, and how priorities are established among potential recipients establish a fiscal framework within which budgetary choices are made at the state and local levels. Federal choices about how it will raise revenues affect the size of state and local resource bases. For example, increases in federal gasoline taxes reduce state revenues from that tax.

The overall demand for public services is a combination of tastes and preferences of citizens, needs for service, and expenditure pressures that emerge from the nature of the economic base and trends. "Tastes" are residential and nonresidential preferences and desires regarding public spending. Needs are distinguished from tastes by the urgency of the requirement for service provision or the necessity for compensatory service. In order to achieve an acceptable level of well-being, some additional care or service must be provided to an individual or groups of individuals. For example, citizens may desire, or have a taste for, high quality education, but bilingual or handicapped children need more assistance to have the same chance of achieving as their English-speaking peers.

The composition of the economic base affects the nature of services that are demanded and the level of each service needed. For example, a town that depends on tourism and outlets will find it more difficult to achieve traffic control during heavy weekend and summer influxes of tourists, and will end up spending more for traffic lights and police than a town of a similar size without a similar influx of people. Similarly, a town that employs many workers faces a daily influx of users of public services. Even in a large city, infrastructure such as sewers can be overburdened quickly, leading to a need for additional facilities. The mix and types of services demanded and citizen satisfaction with public services often change as the size of the nonresidential sector in a community increases.

The economy is not only an important determinant of revenue capacity, it directly affects expenditure needs. During a recession, case loads for social service "safety net" programs swell when a state's residents find their circumstances dramatically altered. Many economic and demographic factors have a "flip side" to them, which means that they not only determine how much a government will be required to spend to achieve an average quality of output, but also its revenue potential. Often, high needs are accompanied by lowered ability to pay. The reverse is also true: High ability to pay tends to parallel a reduced need for services (although people's taste for services may increase with income increases). A mismatch between needs and demands

for services and a state or local government's ability to pay for them is called a fiscal disparity. The reduction of federal aid to state and local governments is exacerbating fiscal disparities among states and among communities within states.

Service Production Conditions and Unit Costs

In Maine, the unit cost of service provision is increased by a variety of production circumstances. Service production conditions are factors that influence the required extensity and intensity, and hence the costs, of public services. Population density is one of the most important service production conditions that influences costs. Generally, population density affects unit costs in a U-shaped pattern: Costs will be highest when density is very low or very high, with lower costs occurring over the middle range of densities. In rural communities, low density raises the unit cost of many public services like highway maintenance, schools, or garbage pickup, but tends to dampen the overall need for services like police. Rural schools face high transportation costs, the need to provide a minimum facility and teachers despite low numbers of pupils, and, in the absence of adequate state aid, exorbitant tax bills to finance education. On the other hand, very high density raises the demand for spending on garbage pickup, police services (crime, traffic control), and fire and rescue. Similarly, the age of the housing stock can drastically affect the amount of money needed for fire prevention and fighting.

The severity of weather conditions is another important cost difference that makes it more expensive for a state like Maine to provide public services. Very cold weather means more heating oil will be required to bring a room to a comfortable level than would be the case if the climate were milder. Bad weather also escalates the cost of highway maintenance and repair.

Some of the other cost differences that occur among states, or among communities within states, are easily identified. The prices of inputs such as labor will vary, sometimes dramatically, in different areas of the country and to some extent even within states. The prices of supplies, materials, and equipment will be somewhat more uniform but will be influenced by transportation costs, proximity of the supplier, and regional price differences. Labor costs tend to be lower than average in Maine, but other prices, particularly those that reflect transportation of goods, often are higher.

Tax Impacts of Small Size and Low Population Density

Maine municipalities face the same high unit cost problem endemic to public service provision everywhere, but the problem is exacerbated by low population density, the small size of the state, and particularly the small size and rural nature of many communities. The high unit cost problem emerges because there is a threshold level of service provision attached to most public services. Teachers, sewage treatment plant operators, and police officers usually are purchased in whole units, even when the number of users they serve is small. There is also a threshold, or minimum size, for capital facilities that include buildings, sewers, water treatment plants, and water supply that must be provided even though the population to be served is small. The costs of even minimal service provision in areas with low population density is divided among fewer service recipients, yielding a much higher unit cost than the same service provided in a more populous area of the same size. Small community size also means that fewer residents pay for services, so the unit tax price will be higher.

In some parts of the state, we are not talking about "in fill" or adding capacity, but initial provision of physical and service infrastructure. The start-up costs associated with the provision of new capacity are much greater than later additions to capacity. Diseconomies of small

scale arise when infrastructure is provided in low density regions of the state and when small communities individually provide services. A unit cost gap between small and larger governments results because small towns cannot tap into economies of scale--the declining marginal cost associated with additional increments of capacity expansion. The operating budget impacts of facility expansion can be greater than anticipated because of the semi-fixed nature of costs. For example, opening an additional school requires teachers, books, and equipment, with the result that unit or per pupil costs increase as the current group of students is spread among more classrooms and teachers. When students in the new school have left another school, such as when a town builds its own elementary school or when vouchers are provided so pupils can attend private schools, the unit cost of educating the remaining students in the first school increases proportionately.

Another problem related to the relatively small geographical size of local governments in Maine (and the lack of a strong regional governance mechanism) is cost spill-overs from one community to another without a spill-over of revenues. Spill-overs can occur when one local government takes an action, such as a zoning decision or permitting commercial development, and the effects of that decision are felt by neighboring communities even though they had no control or input into the decision. Both tangible and intangible costs often are imposed on one community by another in this manner, without the added tax base to help pay for the new expense. For example, Westbrook sees an incredible amount of traffic, with resultant congestion and accidents, because of its geographic location between the eastern communities of Portland, South Portland, and Scarborough and the western lakes region. The impact of "passers through" on the police, rescue, and public works budgets is extreme.

Conclusion

State and local budgetary choices affect trends in economic, political, and demographic characteristics of the state, and hence, the long-term fiscal future of citizens. However, choices are not fully separable from circumstances. Economic, political, and demographic consequences affect the budgetary opportunities and constraints facing the state and local governments. To hold the line on taxes, we will need to control and, where possible, reduce the costs of producing public services at both the state and local levels of government in Maine. Getting a handle on costs need not be synonymous with reducing service levels. In fact, capitalizing on opportunities to achieve greater efficiency in service delivery can lead to more and better services, as local governments that have pursued interlocal arrangements for service delivery and purchasing can attest.

A state effort to promote greater efficiency and reduced costs at the local level would include a refusal to subsidize choices that exacerbate existing inefficiencies and the provision of incentives and rewards for regionalization and similar efforts to achieve cost economies. For example, state funds should not be used to retire debt for the construction of a new, small school whose capacity duplicates existing resources and raises the unit cost of service in both schools. Similarly, the true costs associated with school voucher proposals need to be examined carefully and benefits not simply assumed to outweigh costs. This approach may be unpalatable to some because it implies strong state-level coordination and, when necessary, enforcement (and hence less local control).

As part of an overall strategy to control tax effort, the state must develop an improved capacity to project fiscal impacts of budgetary decisions affecting both state agencies and local governments. Although the Maine Municipal Association has made important strides in collecting local financial data during the last decade, projections are easily disregarded by state policy makers because they come from lobbyists for municipal government. Better data on local government and school district finances will facilitate improving state aid policies to more equitably share revenues and redress wealth disparities.

Monitoring spending and revenue choices, including tax breaks, should focus on several issues. What does state and local spending buy, and how much? Who benefits from government services, and to what extent? Do households benefit primarily, or are businesses also receiving services? Is the distribution of benefits among households equitable, which means in accordance with needs and not necessarily equal, by income class, region, and type of community? Finally, and perhaps most importantly because the issue is rarely considered, to what extent do efficiency losses (due to diseconomies of small scale and other production issues) erode the quantity, quality, and equity of distribution of public services? Reducing the number of school districts and facilitating and rewarding resource-sharing costs across districts are strategies the state can use to promote economies of scale and improvements in educational offerings where small size, low wealth, or taxpayer indifference are limiting students' opportunities to learn. Although it is difficult to prioritize resources when it means someone will receive less, continuing resource scarcity and tremendous disparities in property tax efforts make it absolutely necessary to target state aid to the neediest locations.

A key issue, of course, is whether citizens are satisfied with the mix and level of services they either receive directly or believe government should provide to others. This is not an issue to leave to speculation; regular surveys can provide important insights and identify trends. We also must ask whether businesses are satisfied with the mix and level of services they either receive directly, including those that extend beyond the obvious (e.g., garbage pickup) to encompass transportation improvements, telecommunications investments, and government expenditures that maintain or improve the quality of the work force, or that they believe government should provide to others.

Regular research on who pays taxes and how heavy a burden they impose is an important ingredient of managing a state-local fiscal system. State taxes cannot be considered in isolation, as they have been in Maine in the past. Citizens and businesses see taxes in terms of the total they must pay rather than whether the state, county, school district, or municipality imposes the tax. Fees, charges, and regulatory requirements are an important but often neglected aspect of the state-local revenue system. The amount of the fee or charge should be proportionate to the benefit received, not simply what the market will bear. Periodic reviews of the burdens imposed by fees, their fairness and necessity, and whether there is a reasonable linkage between who pays and the benefit received can prevent citizens and businesses from becoming disgruntled. In evaluating the fairness of a fee, we need to ask whether a tax subsidy is required. Policy makers must scrutinize requests to increase fees and charges, particularly when the department or agency retains the revenue.

While fees and charges need to be monitored, it is important to recognize that we miss important opportunities to enhance the equity of government finance and to control costs when we do not

impose fees for services that benefit only a particular segment of the population. At the local level in particular, the full costs associated with inefficient land uses and diseconomies of small scale are disguised by both the one-year time horizon of governmental accounting practices and their comparatively small marginal impact on total property tax requirements. Using impact fees to finance infrastructure improvements not only asks the beneficiary to pay, but also aligns the costs associated with efficient and inefficient land uses with the fees charged. For example, a choice to cluster new housing while leaving surrounding areas undeveloped will be rewarded with small impact fees while a decision to build new homes on five-acre lots will be met with a bill for the higher costs of infrastructure provision.

Most of these suggestions are not new and many are just common sense. It is time to acknowledge that the state and local governments are partners in a single fiscal system and they must work together to get a grip on Maine's finances and tax effort.

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