7-13-2010

Maine's General Sales Tax: An Exploration of Policy Issues and Options

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Capstone Paper
Muskie School of Public Service
July 13, 2010

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Introduction

The role of sales taxation in states' economies has been a topic of much discussion and controversy since its inception in some states more than 70 years ago. The sales tax has been a critical component of revenue generation for some 98% of states over the last 50 years, but policy-makers and economists have become concerned in recent years about the dwindling revenues being generated by sales taxation in most states.

In June of 2009, the Maine legislature passed and Governor Baldacci signed into law LD 1495, An Act to Implement Tax Relief and Tax Reform. LD 1495 is Maine's most sweeping and expansive tax reform package to be signed into law in recent years. The new law would do away with Maine's current progressive income tax structure in favor of a "mostly" flat personal income tax. The law also expands Maine's general sales tax base to include some personal, professional, and entertainment/amusement services; increases sales tax rates on meals, lodging and short-term auto rental and adds a tax on candy.

In June of 2010 Mainers will vote in statewide referendum to accept or repeal LD 1495, and the implications of acceptance or rejection of this law will have profound social and economic impacts on the state.

This project is being undertaken to provide frameworks for thinking about general sales tax policy redesign, to compile and analyze data relevant to reshaping the tax system, to consider Maine’s current general sales tax and proposed changes within a public finance framework, and to identify opportunities for reform and potential pitfalls.

I will begin with some background information on sales taxes, looking at both general sales taxes applied to goods and services and also selective sales taxes, which are applied to specific commodities like gasoline and alcohol. Next I will address frameworks for considering revenue enhancement options and general sales tax policy changes, followed by a discussion of Maine’s revenue system and general sales taxation in Maine, including an assessment of Maine’s tax reform bill.

Finally, I will provide an overview of the relevant literature and present my data and analysis, followed by conclusions and recommendations.

I. Historical View and Context

Origin of Sales Taxation in the U.S.

Prior to the stock market crash of 1929-1930, states had relied primarily on property taxes as their major source of revenue. The ensuing Great Depression had a catastrophic impact on federal and state revenue generation. Double-digit unemployment figures, combined with an almost 50% drop in the U.S. GDP and plummeting prices, dropping 72% between 1929 and 1933, necessitated comprehensive government intervention, the likes of which had not been seen in the U.S.

The creation and implementation of social and economic safety net programs during the 1930s meant that new government expenditures on public services would require new revenue streams. This need was felt at the national level, as well as among the states who were feeling the sting of steadily declining property tax assessments, depleting their coffers and threatening their fiscal solvency. Property tax assessments fell from $167.6 billion in 1929 to $136.2 billion in 1936, an almost 20% drop. In inflation-adjusted dollars, this represents a $490 billion drop in property tax assessments over a 6 year period. Clearly, states were in trouble; hemorrhaging funds while simultaneously trying to meet the steadily growing demand for services provided by newly implemented public welfare programs. As a result of sharply declining federal and state revenues, coupled with unprecedented growth in government spending, states began to examine new strategies for revenue generation, the most notable of which was what became known as the general sales tax.

The first state to adopt a general sales tax on consumable goods was Mississippi, in 1930. In the ensuing years most states followed suit, and by 1940 twenty-one states had levied a general sales tax. By 1969, all but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) had instituted a general sales tax on goods.[1] Perhaps as important as the newly created state sales taxes' role in stemming the tide of fiscal insolvency was the fact that the general sales tax represented a shift to the taxpayer of a burden that had previously been imposed on businesses, essentially for the privilege of doing business in the United States.

[1] See: Snell, Ronald. *State Finance in the Great Depression*, National Conference of State Legislatures, March 2009

The predecessor of the general sales tax was the Business Occupation Tax, which was a tax levied on businesses at various stages of the production of goods. The shifting of the burden of taxation from businesses onto consumers at the final point of sale represented both an economic and a philosophical sea-change in state fiscal policy and has remained a source of commendation and criticism over the last half century.[2]

Role of Sales Taxes in State Revenue Generation

The relative ease of administration and collection of general sales taxes made this new revenue source an attractive option for state lawmakers. During the time of the Great Depression, the few states that collected income taxes imposed those taxes almost exclusively on high-income households, and thus revenues were somewhat sparse. Property tax collections, which actually preceded general sales taxation in some states, were subject to rising and falling property valuations and were somewhat volatile as a result. Therefore, in the decades following its implementation in most states, the sales tax provided a source of revenue that was less responsive to economic upswings and downturns than property and personal income taxes. The goods-based economy that dominated the United States for at least the first half of the 20th Century provided lawmakers with a stable source of revenue and allowed states to spread the burden of taxation across a wider swath of the population.[3]

While there is some variation among the states, by and large, sales tax revenues accrue mainly to states' General Funds, the predominant fund for states' general

[2] See: Russell, Faith. *Sales and Use Tax*, Wisconsin Legislative Fiscal Bureau, January 2009
[3] See: Snell, Ronald. *State Finance in the Great Depression*, National Conference of State Legislatures, March 2009

operations. Nationwide, in State Fiscal Year 2008, state general fund expenditures were distributed primarily among the following categories of services: elementary and secondary education, higher education, public assistance, Medicaid, other cash assistance, corrections, transportation, and "all other" services. On average, the greatest percentage of general fund expenditures across the states goes toward funding elementary and secondary education, all other services, and Medicaid.[4] Some states, such as Maine, also relegate a portion of their sales tax revenues to other funds, such as state-local revenue sharing and funds serving more narrow and circumscribed purposes, such as Maine's Tourism Marketing Promotion Fund.[5]

Under the umbrella of consumption taxes are two types of taxes: narrow-based excise taxes, and broad-based sales taxes.[6] Excise taxes, also known as selective sales taxes, are typically imposed on specific products, such as cigarettes, alcohol, and motor fuel. I will discuss selective sales taxes later on in this paper, but for now I will focus my attention on the broad-based general sales tax. In all but five U.S. states, the general sales tax is applied to most goods, ranging from food to clothing to equipment purchased by households and businesses, with the exception of those goods which many states exempt from sales taxes for equity reasons; more on that later. While most states do impose a tax of the sale of goods, there is no one-size-fits-all approach to exactly which goods are taxed or exempted from taxation or what the rate of taxation should be. Today, when states talk about the need to increase sales tax revenues,

[4] See: *Distribution of General Fund Spending,* Kaiser State Health Facts, Kaiser Family Foundation, 2008, www.statehealthfacts.org

[5] See: Maine Compendium of State Fiscal Information, Maine State Legislature Office of Fiscal and Program Review, 2008

[6] See: See: Russell, Faith. *Sales and Use Tax*, Wisconsin Legislative Fiscal Bureau, January 2009

generally the policy discussions revolve around increasing general sales tax rates or extending the general sales tax to include the taxation of services, such as personal and professional services, entertainment and amusements, and repair and maintenance of personal property.[7]

Exemptions to the General Sales Tax

As previously noted, most states impose a sales tax on *some* goods and services. However, states have also seen fit to exempt specific categories of goods from taxation. In most cases, these exemptions were put into place to mitigate the inherently regressive impact of taxing consumption. I will address the issue of regressivity in taxation later on in this paper. Currently, most states impose no sales tax on food and prescription medications, as they are seen as basic necessities of life, rather than discretionary purchases. Additionally, most states have historically exempted almost all services from sales taxation, applying sales taxes to less than one-third of potentially taxable services. Five of the 45 states with sales taxes impose them on fewer than 20 of 168 taxable services. [8] I will discuss Maine's sales tax exemptions in greater detail shortly.

Nationwide Shift from Goods-Based to Services-Based Economy in the US

In early years of sales taxation, the production and sale of goods dominated the economy. Manufacturing was the chief industry in the U.S. and Americans purchased

[7] See: Mazerov, Michael. *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, July 2009
[8] See: *State Sales Tax Rates and Food & Drug Exemptions*, Federation of Tax Administrators, February 2010

tangible, consumable goods. At this time, many goods were exempted from taxation due to being considered basic necessities, and much of what was taxes were considered “luxury items.” (Snack tax paper) From the great depression up through the middle part of the century, services accounted for only about two-fifths of personal consumption. However, as manufacturing began to slow and more personal, professional, and entertainment services became widely available, fewer and fewer consumer purchases were being subject to taxation. In 1982, consumption of services for the first time surpassed that of goods nationwide, and by 2007 services represented 60% of personal consumption. Economists and policy experts believe this trend is likely to continue, as our service-based economy continues to grow and our goods-based economy continues to wane.

According to a 2009 study by the Center of Budget and Policy Priorities, “It reasonably can be hypothesized that household purchases of many services do not vary as much with economic conditions as do purchases of durable goods. People need to get their hair cut and their work clothes dry-cleaned regardless of economic conditions, and they will tend to do so as long as they themselves are not out of work. Purchases of some services may actually tend to rise in recessions; for example, consumers may decide to repair cars rather than replace them.” [9]

Complicating the impact on states of the loss of sales tax revenue is the issue of equity in taxation. As consumption shifted from goods to services, higher-income people, who

[9] See: Mazerov, Michael. *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, July 2009

could afford more of the services being offered, were able to shield more of their income from taxation, while lower-income people who devoted a larger share of their income to the purchase of goods than services began to bear a greater burden of the taxation of consumption. I will discuss equity in taxation in greater detail in the next section of this paper.

II. Frameworks for Considering Revenue Enhancement Options and General Sales Tax Policy Changes

Goals of Taxation and the General Sales Tax

In order to assess the quality and effectiveness of state tax policy, one needs to have a keen understanding of the principles that guide tax policy-making. This section aims to provide the context needed to explore the pros and cons of different types of taxation from an economic, social and philosophical perspective.

In crafting tax policy, there are established goals that policy-makers use to guide decision-making. These goals together make up the framework in which tax policy-making takes place, and while it is nearly impossible to satisfy all the goals of taxation, there are certain goals that policy-makers recognize, almost universally, as being central to creating a sound and solvent tax system. Chiefly, policy-makers strive to craft tax policy that is fair and generates sufficient revenues to fund and support public services and programs.

Tax fairness refers broadly to who pays, how much they pay, and whether the burden of taxation is reasonable. Specifically, tax fairness speaks to the equity of taxation and the economic burden it imposes on any individual or group. Tax equity is concerned with the distribution of a tax across different economic strata and is measured in terms of what is horizontally and vertically fair. A horizontally equitable tax system is one in which those in similar circumstances pay similar taxes and a vertically equitable tax system is one which imposes taxes based on different abilities to pay.

While tax equity concerns the distribution of a particular tax or collection of taxes, tax burden considers the economic impact of the incidence of that tax on people at varying income levels. In public policy arenas, tax burden is often spoken of in terms of progressive, proportional, and regressive taxation. A progressive tax is one which is imposed based on ability to pay; those with more pay more, those with less pay less. The classic example of progressive taxation is the federal income tax (and some state income taxes) which uses a graduated system whereby those in the upper income brackets pay a larger percentage of their income in taxes than do lower-income earners. Proportional taxation imposes a tax at a fixed rate that is not subject to changes based on ability to pay. An example of a proportional tax would be a flat income tax structure, in which the tax is levied on everyone at the same rate. A regressive tax is one that is inversely related to ability to pay; that is, those with less pay more, those with more pay less. [10]

Traditionally, sales taxes have been considered the most regressive form of taxation, as lower-income earners spend a greater share of their wealth on taxable purchases than

[10] See: LaPlante, Josephine. *Financing Government: Frameworks for Revenue Policy Making,* Muskie School of Public Service, University of Southern Maine, 2009

higher-income earners. Higher earners who spend less and save more are able to shield more of their income from taxation.[11] Therefore, as personal income increases, the share of that income that is subject to consumption taxes is reduced. It is not only the share of income devoted to taxable purchases that makes the sales tax regressive, it also has to do with the nature of what is taxed.

As noted earlier, tax equity and tax burden are essentially two sides of the same coin, but oftentimes efforts to mitigate the burden of taxation are superseded by efforts to achieve tax equity. However, as we have learned equity and burden are two dimensions of fairness and both need to be considered in the crafting of sound tax policy. This brings us to a concept known as the “equity-burden tradeoff.” Essentially, equity and burden, as applied to taxation are often at odds with one another and as a result one or both of these principles can end up being subsumed by the other. Revising the tax structure to increase equity through broadening the distribution of a tax across different levels of ability to pay can actually end up increasing the burden on everyone, including the poor. I will discuss how this phenomenon has played out in Maine’s tax structure later on in this paper.

[11] See: LaPlante, Josephine. *Financing Government: Frameworks for Revenue Policy Making,* Muskie School of Public Service, University of Southern Maine, 2009

Figure 1

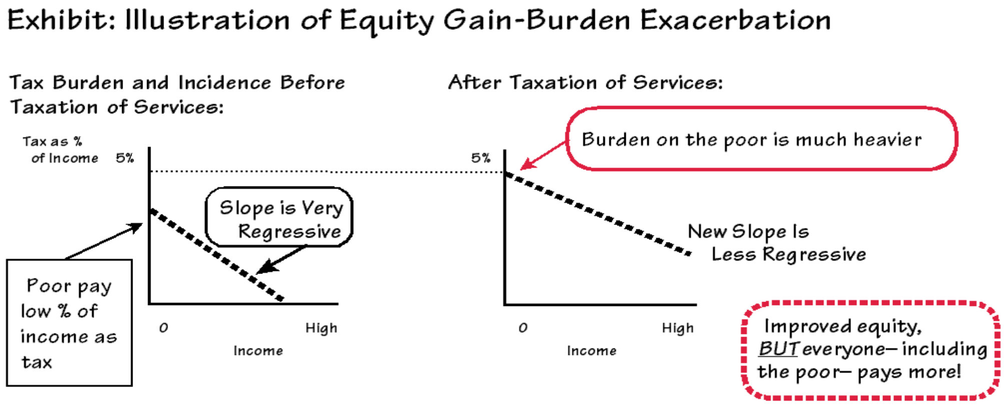

Chart used with permission by Josephine M. LaPlante, *Financing Government: Frameworks for Revenue Policy Making*, 2009

The goal of efficiency, as applied to taxation, considers the ease with which a tax can be administered, the costs associated with collecting the tax, and the relative likelihood of compliance with a tax. Essentially efficiency is about states getting the biggest bang for their buck; expending as little cost and effort as possible in administering the tax while ensuring that the application of the tax minimizes the risk of non-compliance (i.e., tax evasion). Typically, the more complex the tax, the more likely it is that certain individuals and businesses will try to avoid paying the tax and will do so successfully.

Another consideration to be taken into account when crafting tax policy is whether tax collections generate a sufficient source of revenue for states to fund necessary public programs and services and whether that revenue can be counted on to be relatively stable over economic cycles. This concept is known as adequacy, and one cannot discuss the importance of adequacy without revisiting the issue of equity in taxation. I examined the relationship between equity and burden and noted that these two dimensions of fairness can often be at odds with one another in the creation and application of tax policy. This brings us to a concept known as the equity-adequacy tradeoff. The equity-adequacy tradeoff suggests that the tax sources that are most stable over time tend to be the least equitable.[12] To illustrate this concept, we must take a closer look at the major sources of states' tax revenue in terms of their relative ability to maintain a steady stream of revenue over time and how the incidence of a tax is spread across different levels of ability to pay.

In most states the lion's share of tax revenue comes from three major categories of taxation, often referred to as the "Big Three": the personal income tax, general sales tax, and property tax. In terms of equity and adequacy, each of these taxes has advantages and disadvantages. Typically, the personal income tax is considered the most fair. This is due primarily to the fact that many states (and the federal government) employ a progressive income tax system, whereby the percentage of tax collected increases as income increases. Since a progressive tax is imposed on the taxpayer based on ability to pay, vertical equity is achieved and the burden on low- and middle-income earners is minimized. However, the downside of a progressive personal income tax is that it tends to be the most vulnerable to economic upswings and downturns. During times of economic prosperity and hardship, rising and falling incomes can cause people to move from one income tax bracket to another rendering tax collections unstable and making it difficult for states to predict the sufficiency of income tax collections over time. As a result of the relative instability of the progressive income tax,

[12] See: LaPlante, Josephine. *Financing Government: Frameworks for Revenue Policy Making,* Muskie School of Public Service, University of Southern Maine, 2009

some states have moved from a bracketed income tax system to a flat tax system, or have done away with the personal income tax altogether in favor of less volatile sources of tax revenue.

Conversely, general sales taxes are considered the least volatile of states' revenue sources; however, the stability of these tax collections is contingent upon the breadth of the tax base and the rate(s) at which goods and services are taxed. As noted earlier, general sales taxes are also the most regressive of states' major tax types, as they violate the principle of vertical equity by imposing a greater tax burden on those least able to pay. Selective sales, or "excise" taxes, are not traditionally considered as part of the "Big Three" but nevertheless, an understanding of their role in state revenue generation is an important part of assessing tax equity and burden. More on selective sales taxes later.

Property taxes are generally recognized as being more stable than personal income taxes but more volatile than general sales taxes. Similarly, property taxes are considered less progressive than personal income taxes but more progressive than general sales taxes. Property taxes are more stable than income taxes because the rates of taxation do not change as homeowners' income rises and falls; rather, they change based on policy decisions made by lawmakers. Property taxes are more equitable than general sales taxes because, in theory, those in like circumstances (i.e., homes with the same market value) pay roughly the same amount in taxes. However, property taxes can still impose a greater tax burden on low- and middle-income households and individuals. Most notably, landlords often shift some of the burden of property taxation by passing along those costs to tenants. This shifting of a portion of a tax from landlord to tenant by building the tax into the cost of the rent increases the burden on low- and middle-income taxpayers, who are more likely to reside in a rental property than higher-income earners who can afford to purchase their own homes. Additionally, when property valuations decrease, as they have in dramatic fashion over the last two years, low- and middle-income homeowners are increasingly finding themselves “under water;” that is, living in homes that are worth less than is owed. These two scenarios threaten the equity and stability of property tax collections.

Finally, the general sales tax is considered the most stable but least equitable of the three major tax types. Sales taxes are stable relative to the other tax types because, quite simply, people will always need to buy “stuff.” Even in times of economic hardship, people purchase clothing and food, furniture and household appliances, hair cuts and movie tickets, so states can count on a revenue stream that is somewhat predictable.   It is precisely for this reason, that general sales taxes are simultaneously the most stable and the least equitable. While people will always need to buy stuff, those at the lower end of the income spectrum have less money to devote to the same “stuff” that high-income earners purchase, and the wealthy also tend to spend more money on high-end services that are exempt from taxation in many states.

Another familiar goal of taxation is tax balance which concerns the three tax types discussed above. Tax balance considers the makeup of states’ tax structures across different categories of taxation and the relative reliance on each type of tax as part of a state's revenue system as a whole. The concept of tax balance suggests that reliance on any one type of tax should be avoided to the extent possible and that states should strive to achieve relative parity among the "Big Three" tax types: personal income tax, general sales tax, and property tax.

It should be noted that while tax balance is a goal, it should not be sought to the exclusion of other goals, and even a tax system in balance can still be overly burdensome on some. The tax goals defined and discussed in this section will be examined in terms of their application in Maine and the U.S. in the next section of this paper.[13]

III. Maine's Revenue System

Historically, Maine's overall tax structure has been mildly regressive, due in large part to the heavy reliance on high property and selective sales taxes. Currently, Maine's income tax structure is highly progressive, with tax rates ranging from 2% - 8 ½%. However, despite its progressive nature, the current income tax structure, has received a great deal of criticism in recent years, due to the relatively low level at which the highest income tax rate is imposed and the volatility of income tax collections over time.[14]

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[13] See: LaPlante, Josephine. *Financing Government: Frameworks for Revenue Policy Making,* Muskie School of Public Service, University of Southern Maine, 2009

[14] See: Woodbury, Richard. *The Struggle for Tax Reform in Maine,* Discussion Paper 09-2, New England Public Policy Center, October 2009

Maine's general sales tax rate of 5%, which is supplemented by higher taxes on selective sales (meals, lodging, short-term automobile rental), is not especially high relative to other states, but it does place a heavy burden on lower-income taxpayers which is problematic given Maine's status as a relatively poor state. In contrast with the general sales tax, Maine's property taxes have grown by leaps and bounds and are now considered some of the highest in the nation. In 1999, Maine's property tax averaged 5.4% of personal income, earning it a rank of second among all U.S. states. This is more than two percentage points above the national average for that same year. In 2006, Maine's property tax ranked third in the nation as a percentage of personal income, at 5.2%, compared with the national average of 3.3%. Though not inherently regressive, property taxes in Maine have come to take on a more regressive quality in recent years, due to (pre-recession) rising home prices propelled to some degree by the influx of homebuyers "from away." Coastal properties, once primarily occupied by fishermen and other local residents, are increasingly being purchased by out-of-states, as primary or secondary residences. Demand for this desirable real estate has driven up property values to wholly unsustainable levels, and we have witnessed the fallout from those inflated prices over the last two years.

Among the other two major revenue sources, Maine's personal income tax, though progressive, has still ranked relatively high compared with other states and the national average. In 1999, Maine was ranked 10th in the nation in income tax burden, at 3.5% of personal income, surpassed only by Massachusetts whose income tax amounted 3.9% of personal income. In 2006, Maine's income tax rank was 11th, or 3.24%, this time surpassed by both Massachusetts and Connecticut in percentage of personal income. Maine's general sales tax, however, paints a slightly different picture. In contrast with the other two of Maine's "big 3 taxes," the general sales tax has historically positioned Maine just about in the middle of the country, in terms of its ranking as percentage of personal income. In 1999, Maine's general sales tax accounted for 2.8% of personal income, ranking Maine 22nd among all U.S. states. In 2006, general sales taxes represented 2.47% of personal income, for a ranking of 26th. (Appendix A) Legislators have long used Maine's relatively low general sales tax burden as the rationale behind increases to the sales tax rates and the expansion of the sales tax to include, at various times, meals, lodging, short-term auto rental, "snacks," and beverages sold in retail establishments.

In fact, Maine's relatively low sales tax burden has been cited by legislators and economists alike, as a partial justification for Maine's most recent efforts to implement comprehensive tax reform through the enactment of the controversial LD 1495, which I will discuss in greater detail later on in this paper. Still, Maine's general sales tax rate and rank does not tell us the whole story of taxes imposed on the purchase of goods and services in Maine and who really bears the burden of taxation on consumption.

So given what we know about the concepts of tax balance and tax burden, what can Maine's tax balance tell us about its overall fairness, and how does Maine's tax burden compare to that of its neighbors? According to a 2009 study by the Institute on Taxation and Economic Policy, "nearly every state and local tax system takes a much greater share of income from middle- and low-income families than from the wealthy. That is, when all state and local income, sales, excise and property taxes are added up, most state tax systems are *regressive*" ("Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, November 2009). In 2007, sales and excise taxes accounted for 7% of income among the bottom 20% of income-earners across the country. This is contrasted with the top 1% of income-earners who pay less than 1% of their income in sales and excise taxes. The lowest 20% also pays the largest share of income in property taxes, at almost 4%. Income tax, being progressive, is the only one of the 3 major taxes that is borne more heavily by high-income earners; however, federal income tax deductions mitigate the effect of increasing income taxes to some degree. Still, as far as overall tax burden is concerned, low-income earners, almost without exception, expend a greater percentage of their income in taxes than do any other income group in this country. [15]

IV. General Sales Taxation in Maine: Assessment & Methods

Assessment Context

According to a discussion paper by the New England Public Policy Center, there are two major factors that have guided the Maine legislature's most recent efforts toward comprehensive tax reform. First, as noted in the last section, Maine's general sales tax

[15] "The average state's consumption tax structure is equivalent to an income tax with a 7.1% rate for the poor, a 4.7% rate for the middle class, and a 0.9% rate for the wealthiest taxpayers." See: Davis, Carl et al. *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, Institute on Taxation and Economic Policy, Third Addition, November, 2009

has historically lagged slightly behind U.S. averages in terms of the rate at which taxation is imposed.[16] For this reason, Maine has looked to general and selective (excise) taxes as an area in which the state could potentially raise more revenue and simultaneously alleviate some of the burden of Maine's relatively high personal income and property taxes.

The second impetus for considering changes to Maine's sales tax structure concerns the narrowness of Maine's sales tax base in terms of what is subject to taxation and what is exempted. Specifically, previous sections of this paper have highlighted the fact that Maine taxes very few services and as such misses out on potential sources of tax revenue that could, according to some, make sales tax collections simpler and more predictable, and make their distribution more equitable. To date, the Federation of Tax Administrators has identified 168 services that could be subject to sales taxation; among those are a variety of services that are taxed by at least 10 states but exempted from taxation in Maine. These include: Industrial and residential use of interstate telephone service and cellular phone service, 900 number services, computer software, cable TV, rental of videos for home viewing; short-term auto rental, meals & lodging, custom fabrication and labor, repair material (generally), custom processing (on customer's property), taxidermy, and welding; industrial use of electricity, water, natural gas and other fuel; and business services including: ad agency fees, photocopying and photo finishing, printing, sign construction and installation. [17]

[16] According to the Federation of Tax Administrators, Maine's general sales tax rate of 5% is slightly lower than the median rate of 5.5%
[17] Federation of Tax Administrators, *Sales Taxation of Services: 2010*

Table 1, below, highlights some of the states that have expanded their sales tax bases to include a variety of services, ranging from Hawaii which taxes 156 services, to Maine which taxes only 24.

Table 1

Taxable Services	AR	AZ	CT	DE	DC	HI	ME	NM	SD	TN	TX	UT	WA	WV	WI
Agricultural Services	2	1	1	5	1	5	0	3	4	1	2	1	5	3	2
Industrial and mining services	0	2	1	4	0	4	0	4	4	0	2	2	4	1	1
Construction	0	4	4	4	0	4	0	4	4	0	3	0	4	1	0
Utilities	16	12	10	9	12	16	9	16	14	11	12	7	16	10	11
Transportation	1	5	0	4	2	7	0	7	5	1	0	2	7	4	2
Storage	3	6	2	6	1	6	0	5	6	1	2	0	6	6	1
F.I.R.E.	0	0	0	5	1	7	0	6	7	0	2	0	8	3	0
Personal services	7	2	9	20	8	20	1	20	19	10	10	8	20	17	11
Business services	12	5	20	33	11	34	6	32	28	7	14	6	33	26	7
Computer services	1	1	6	6	8	8	0	8	8	3	8	0	8	4	3
Computer services (1996 Services)	1	1	6	6	6	6	0	6	6	3	6	0	6	4	1
Automotive services	5	2	3	5	3	5	0	5	5	5	1	3	5	5	5
Admissions and amusements	12	11	10	10	7	14	2	14	13	12	12	10	12	13	14
Admissions and amusements (1996 Services)	11	11	9	10	6	13	2	13	12	11	11	9	11	13	13
Professional services	0	0	0	9	0	9	0	9	5	0	1	0	9	1	0
Professional services (1996 Services)	0	0	0	8	0	8	0	8	4	0	1	0	8	1	0
Leases	2	3	3	3	2	3	2	4	4	2	1	2	4	3	3
Fabrication, repair and installation	11	2	11	19	13	18	4	18	18	13	11	15	16	13	14
Miscellaneous	0	2	0	1	1	0	0	1	2	1	0	1	0	0	0
Non-exempt entries	72	58	80	143	70	160	24	156	146	67	81	57	157	110	74

Source: Federation of Tax Administrators, *Sales Taxation of Services: 2010*

As noted earlier, it has been suggested that revenue collected from the taxation of services is actually better able to maintain stability and predictability during economic downturns than the taxation of goods. This point is made especially salient when we consider the decline in revenue generated by auto sales and the sale of construction materials which, together, account for about one-third of Maine's tax revenue.[18] In 2009, Maine's automobile industry saw a decrease in taxable sales of 13.83% from 2004-2009 and building supply retail sales dropped 17.53% over the same period. Sales of building supplies in Maine *increased* by 4.6% from February 2009 to February 2010, suggesting a promising upswing in construction projects, but auto sales dropped by 9.5% over the same period, a comparatively drastic decrease.[19]

Due to the cyclical nature of these two industries and Maine's heavy reliance on them for sales tax revenue, it is no surprise that Maine's economy was hit hard by the recent recession which caused, among other economic ills, steep declines in revenue from the auto and construction industries. Therefore, it is no surprise that the breadth of Maine's general sales tax has been central to discussions of sales tax reform. Maine's LD 1495, which I will discuss in greater detail later on in this paper, proposes to extend the general sales tax to a number of personal, professional, maintenance, and amusement services.

[18] See: Woodbury, Richard. *The Struggle for Tax Reform in Maine,* Discussion Paper 09-2, New England Public Policy Center, October 2009

[19] See: *Maine Retail Sales Report,* Maine State Planning Office Annual Review, 2009

While extending the general sales tax to more services is likely to generate increased tax revenue for Maine, there is a downside that must be taken into account. Earlier we discussed the equity-burden tradeoff in taxation and the idea that a tax system can be made more equitable while simultaneously increasing the overall tax burden. This is precisely the context in which we need to examine efforts to alter the nature of sales taxation in Maine by expanding the general sales tax base. As illustrated in the equity-burden tradeoff diagram, an expanded sales tax base comes closer to satisfying the principle of horizontal equity, in that those people in “like circumstances,” namely those consuming goods and those consuming services would theoretically be paying about the same amount in taxes. Maine’s current sales tax structure is not horizontally equitable, as those people who purchase services, most of which are tax-exempt, are spared the burden of sales taxation, while those who purchase more goods (usually lower-income earners) bear the full burden of the tax. As we have learned, expanding the sales tax base to improve equity and generate increased tax revenues will lessen the regressivity of the tax somewhat. However, a more equitable sales tax system is achieved at the expense of lower- and middle-income earners who will continue to pay sales tax on items they have always purchased, and will and will pay additional sales taxes on services they have purchased in the past that were not previously subject to taxation. It is foolish to assume that only high-income earners purchase personal, professional, maintenance, and amusement/ entertainment services and would therefore shoulder the bulk of the burden of a sales tax base expansion.

Another concern over the expansion of Maine's general sales tax base has to do with the role of Maine's general sales tax in the state's overall tax structure. While Maine's current general sales tax is slightly below national averages as a percentage of personal income, policy experts at the Center for Budget and Policy Priorities caution that an expansion of a state's sales tax base should not increase the proportion of a state's tax revenue devoted to sales tax collection, if doing so will decrease the proportion of tax revenue generated by more progressive sources such as personal income tax.[20] In order to delve deeper into the topic of sales taxation in Maine, I have prepared an analysis of relevant data that I hope will illuminate some of the issues discussed thus far in this paper.

Research Questions and Method

At the outset of this project, I identified several research questions which I hoped to address in this paper. In this section I examine those research questions using relevant data collected from various state and federal agencies and offer an analysis of that data to provide a more thorough picture of sales taxation in Maine.

Research Question One: Of the major sources of state tax revenue; personal income, property, general and selective sales tax, and current charges, what is the relative importance of Maine's general sales tax within Maine's overall tax structure, and how does Maine compare with the U.S. in terms of tax balance and burden over time?

[20] See: Mazerov, Michael. *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, July 2009

Method: In order to address the first of my research questions, I gathered data from the U.S. Census Bureau on the major sources of state tax revenue by type and did a comparative analysis of Maine's tax balance and burden as a percentage of personal income as with that of the U.S. My analysis highlights four years; 1993, 1999, 2002, and 2007 because an analysis using data from several years allows us to get a sense of how different tax types perform over time and how tax balance and burden changes as different revenue sources rise and fall. Specifically, these four years were chosen because they represent two years in which Maine and the U.S. enjoyed relative economic prosperity and two years of economic distress. The two graphs on the following page show, respectively, the makeup of Maine's revenue structure over time as percentage of personal income, and that of the U.S.

Figure 2

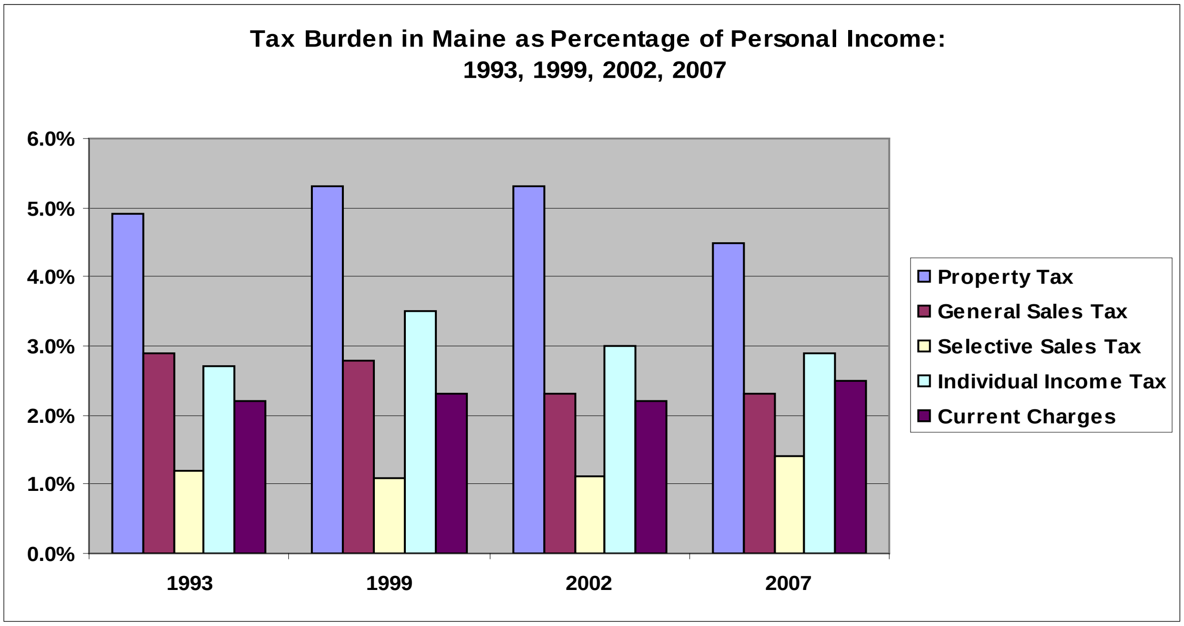
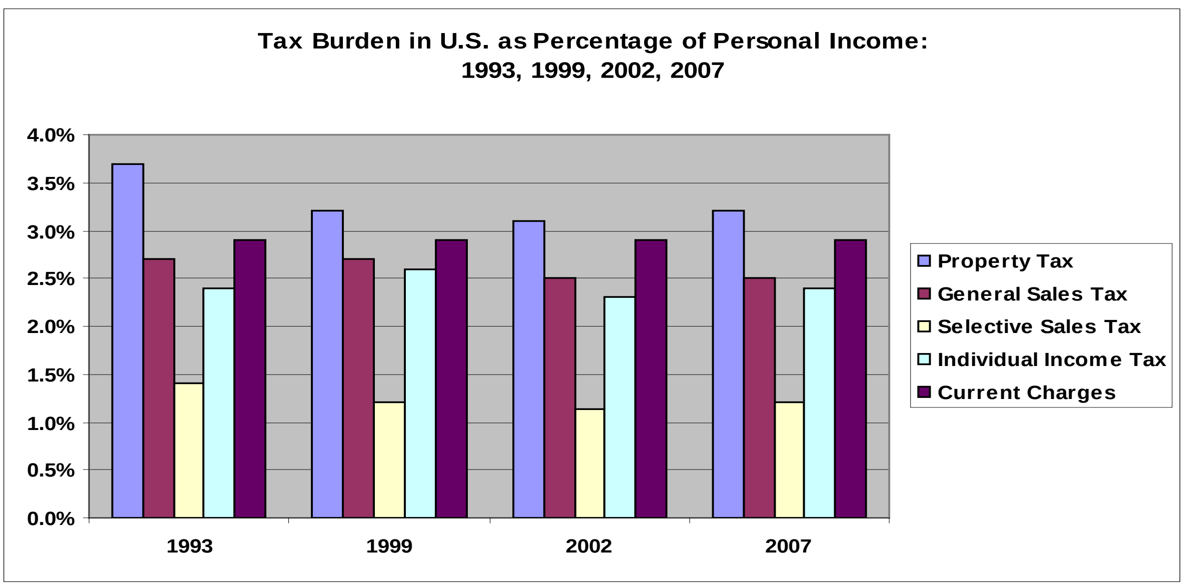


Figure 3



Source of tax burden data: *Annual Survey of Government Finances,* U.S. Census Bureau, 2007

Maine

In comparing tax structures over two "good economy" years and two "bad economy years," some interesting trends emerge. In Maine, property taxes imposed the greatest overall burden on Mainers in terms of percentage of personal income across all four years. Property taxes accounted for the largest share of personal income paid in taxes in 1999 (good economy) as well as 2002 (bad economy) but were slightly lower in 1993 (bad economy) and significantly lower in 2007 (good economy). Given what we know about the relative stability of property tax revenues, it is not surprising that property tax collections remain high over economic upswings and downturns. Still, the fact that property taxes collected in Maine as percentage of personal income are disproportionately high across all four years implies that Maine's reliance on property tax revenue far exceeds that of the other major revenue sources. The significant reduction in property tax as percentage of personal income in 2007 was likely the result of targeted property tax relief programs, like the circuit breaker and homestead exemption.

Maine's general sales tax as percentage of personal income was at its highest in 1993. This is not surprising given what we know about the relative stability of general sales tax collections over economic cycles. Typically, income tax collections dwindle during times of economic hardship, while sales tax collections, much like property tax collections, are more likely to hold steady or even increase. Additionally, Maine's snack tax which I will cover in the next section was enacted in 1991, increasing the sales tax burden on Mainers. Interestingly, sales tax collections as percentage of personal income were almost as high in 1999 (good economy) as they had been in 1993, which speaks to Maine's reliance on sales tax revenue across different economic climates. In 2002 and 2007, the general sales tax decreased significantly as a percentage of personal income.

Maine selective sales taxes held steady at about 1% of personal income until 2007, when they increased substantially due to a $1 increase in the tax on cigarettes. It should be noted that Maine's selective sales taxes (excise taxes), especially taxes on cigarettes and motor fuel, are extremely high compared to national averages, which increases the regressivity of the overall tax structure and imposes a greater burden on lower-income taxpayers.

Maine's individual income tax was highest as a percentage of personal income in 1999 (excellent economy), and decreased in 2002 (bad economy) and again in 2007 (good economy). If income tax collections fluctuate with economic cycles, we would have expected to see them down in 1993, up in 1999, down in 2002 and up again in 2007, so it is curious that the two years in which income tax collections accounted for the smallest percentage of personal income were years of economic hardship and prosperity, respectively. While personal income taxes did increase somewhat between 2002 and 2006, the subsequent decrease in 2007 could point to 2007 as a year in which the country began to see signs of an impending recession but had not yet begun to feel the full effects. 2007 can therefore be thought of as kind of a transition year between a robust economy and the slide into recession.

Maine’s current charges as percentage of personal income held steady in 1993, 1999, and 2002 then increased in 2007. One could surmise that the loss in property and personal income tax revenue in 2007 was made up to some degree by increases in selective sales taxes and current charges as a percentage of personal income. Additionally, despite the fact that the percentage of personal income devoted to current charges hovers between 2% and 3% of personal income in both Maine and the U.S., in terms of total tax burden, Maine’s reliance on current charges is dwarfed by its reliance on property taxes when compared with other U.S. states (Appendix B).

U.S.

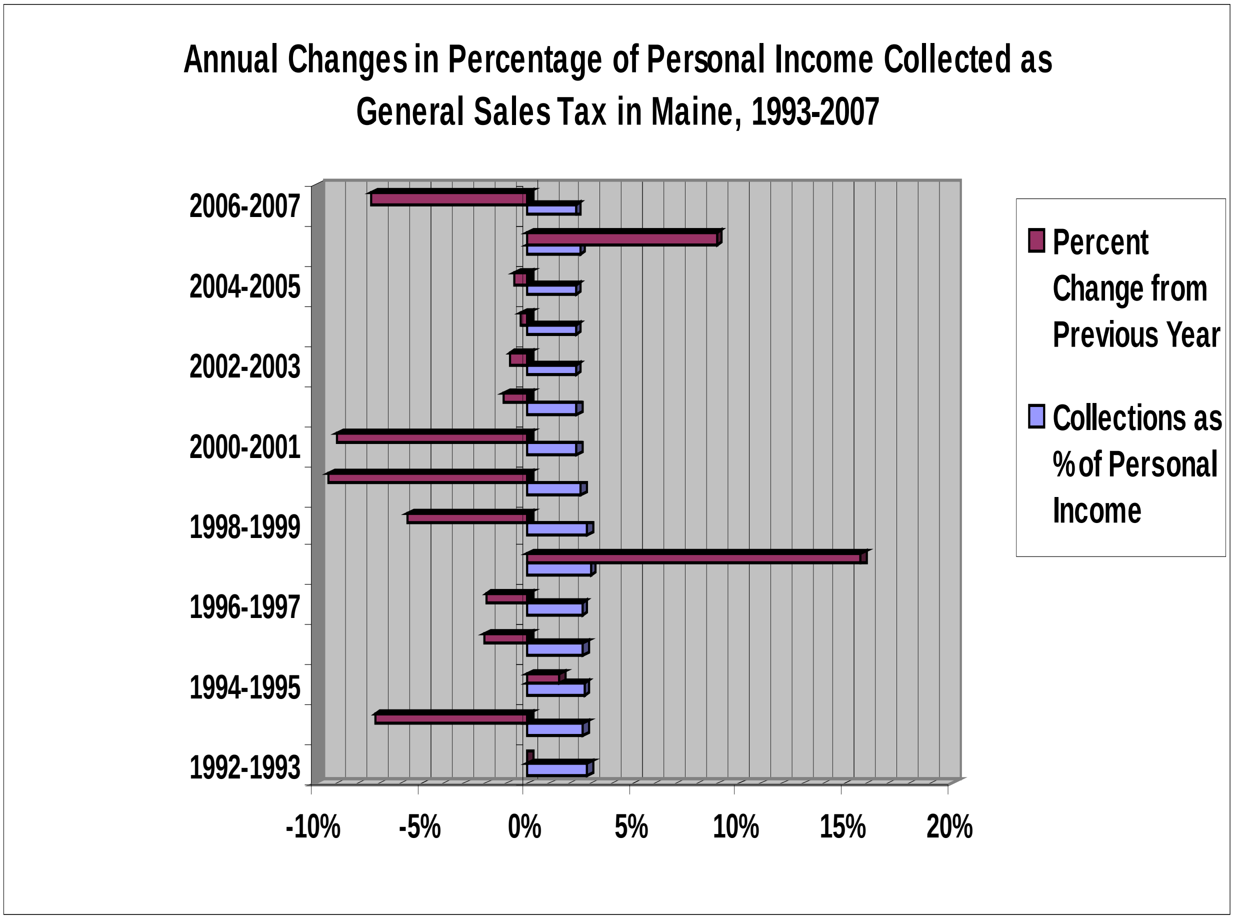
In looking at the graph depicting tax burden as percentage of personal income in the U.S., it is readily apparent that tax collections as percentage of personal income are much more balanced in the U.S. as a whole than in Maine, particularly due to a significantly lower reliance on property taxes. Income and general sales taxes are much more closely aligned with one another in Maine and the U.S. and current charges take up a slightly larger percentage of personal income in the U.S. on average than in Maine.

Recalling our previous discussion on tax balance and burden, what conclusions can we draw about Maine’s revenue structure as compared with the rest of the U.S.? Well, a cursory glance at the two graphs tells us that Maine’s tax system is clearly not in balance and that Maine’s disproportionate reliance on property taxes in conjunction with moderately high general sales taxes and high selective sales taxes likely places an inordinate burden on low- and middle-income taxpayers. While we have learned that tax balance is not a cure-all, and not a goal that should be sought to the exclusion of other important goals, Maine's consistent imbalance between its reliance on progressive and regressive tax types has no doubt been at the root of many of Maine's fiscal problems.

Research Question 2: How responsive are sales tax collections in Maine to economic upswings and downturns and how do changes in the percentage of personal income devoted to the general sales tax from year to year affect the stability of sales tax collections over time?

Method: In order to address the second of my research questions, I examined data from the U.S. Census Bureau and the Bureau of Economic Analysis illustrating the sensitivity of sales tax collections over a period of 14 years. This question concerns the responsiveness of sales tax collections in Maine to economic upswings and downturns and the extent to which changes in the percentage of personal income devoted to the general sales tax from year to year affect the stability of sales tax collections over time. The graph below depicts the fluctuations in sales tax collections in Maine as a percentage of personal income from 1993 to 2007.

Figure 4



Source: *Personal Income and Population Data*: Bureau of Economic Analysis, U.S. Department of Commerce, 2010 and the *Annual Survey of Government Finances*, U.S. Census Bureau, 2007

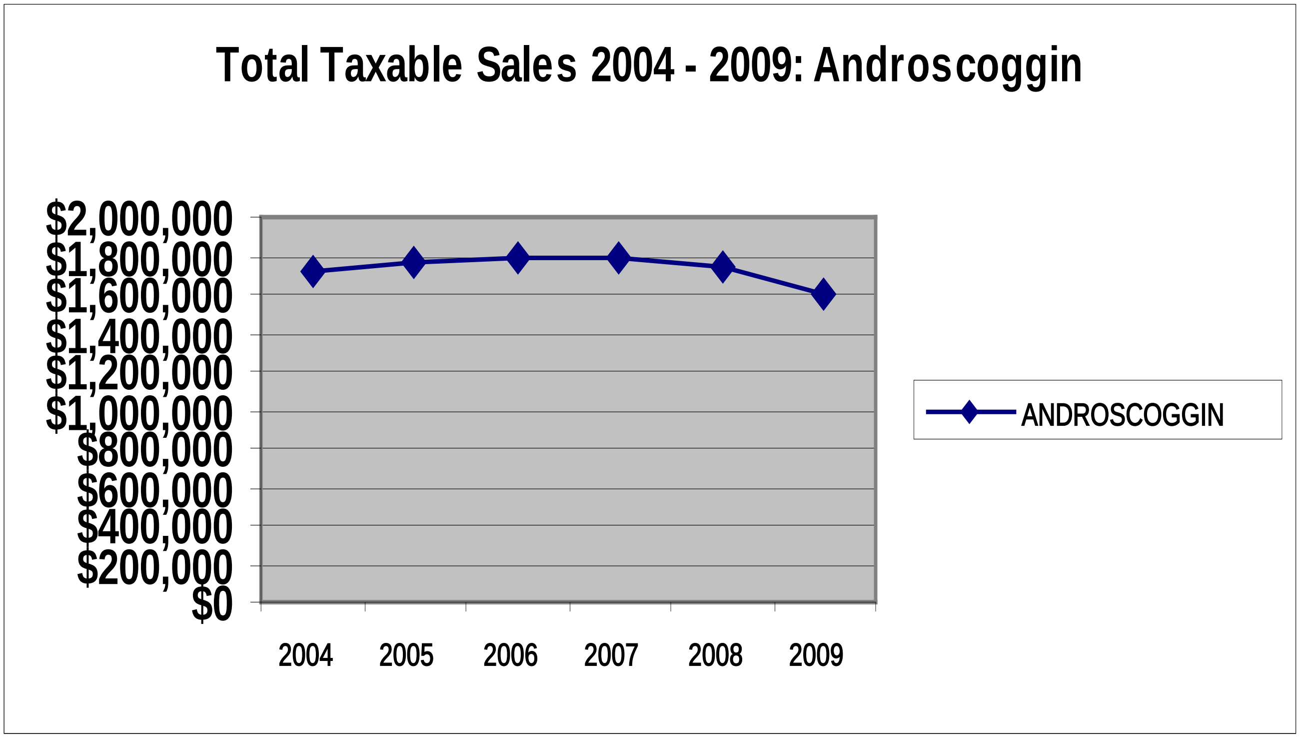
Looking at the percent change from the previous year, one can see that Maine's sales tax collections have been volatile, with the change in collections as percentage of personal income fluctuating dramatically from year to year, only increasing twice over the period. This calls into question previous assumptions about general sales tax collections being stable over time. Despite the fact that general sales tax collections as percentage of personal income hover between 2% and 3% of personal income over the entire period, the annual fluctuations illustrated above amount to a great deal of instability, as compared with the rest of the country. In fact, in terms of overall volatility of general sales tax collections, Maine ranked 14th in the U.S. based on a calculation of the absolute difference between the maximum and minimum "bite" of sales tax collections as percentage of personal income over the period in question.[21]

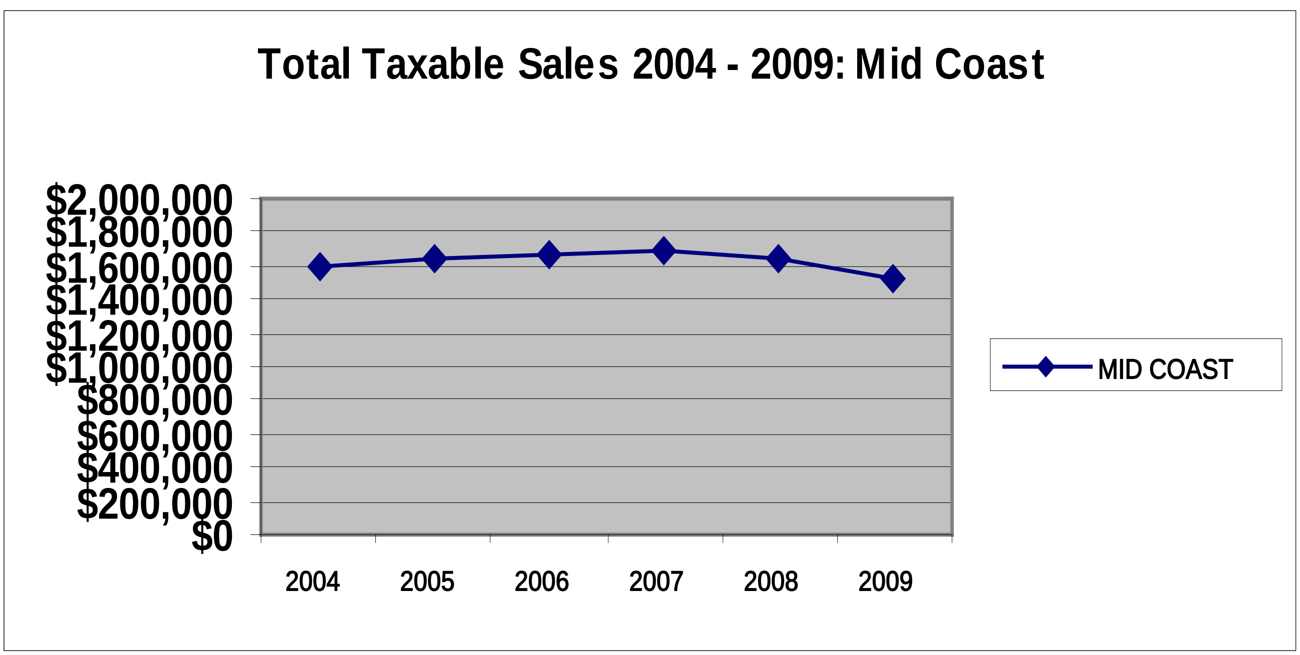
Research Question 3: How have revenues from Maine's taxable sales fared in recent years and what trends have emerged that might offer clues in predicting the solvency of Maine's general sales tax in the future?

Method: In order to address my third research question, I used data from the Maine State Planning Office to illustrate the rise and fall in taxable sales revenues across all economic statistical districts in Maine between 2004 and 2009 and to examine what trends have emerged in recent years that might help in predicting what retail sales in Maine may look like in the future.

[21] *Personal Income and Population Data*: Bureau of Economic Analysis, U.S. Department of Commerce, 2010

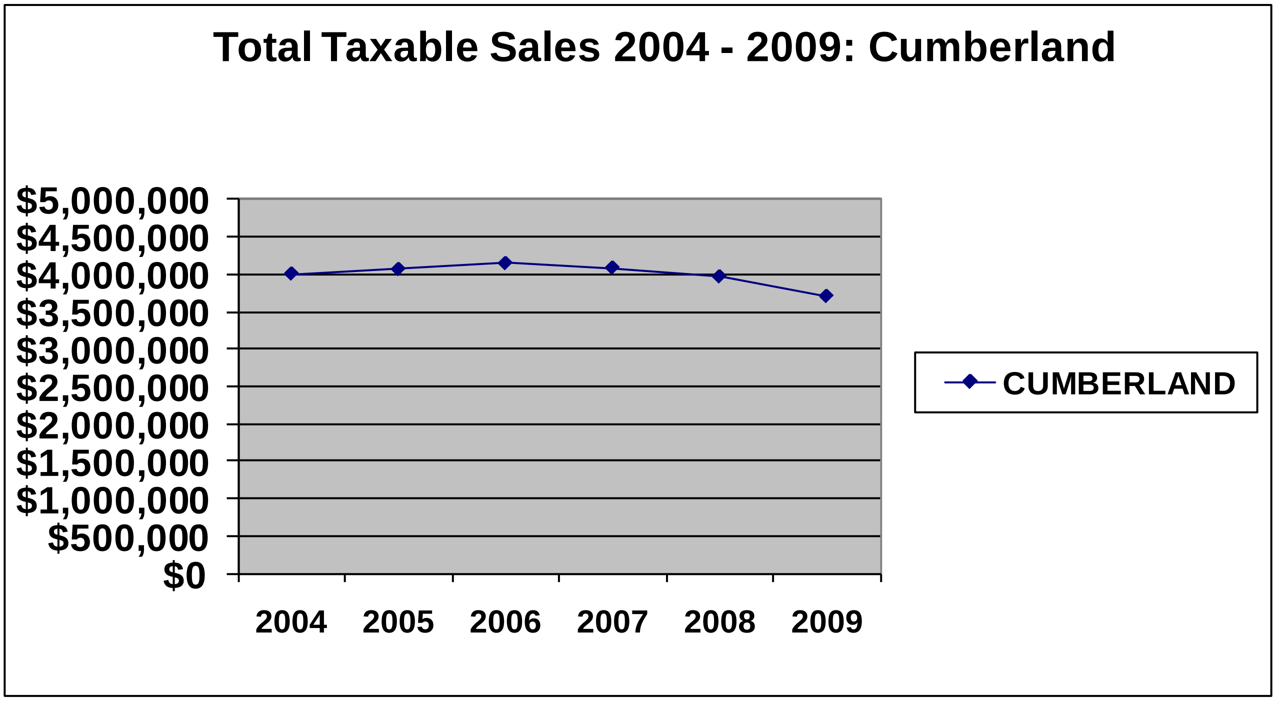
Figures 5-6

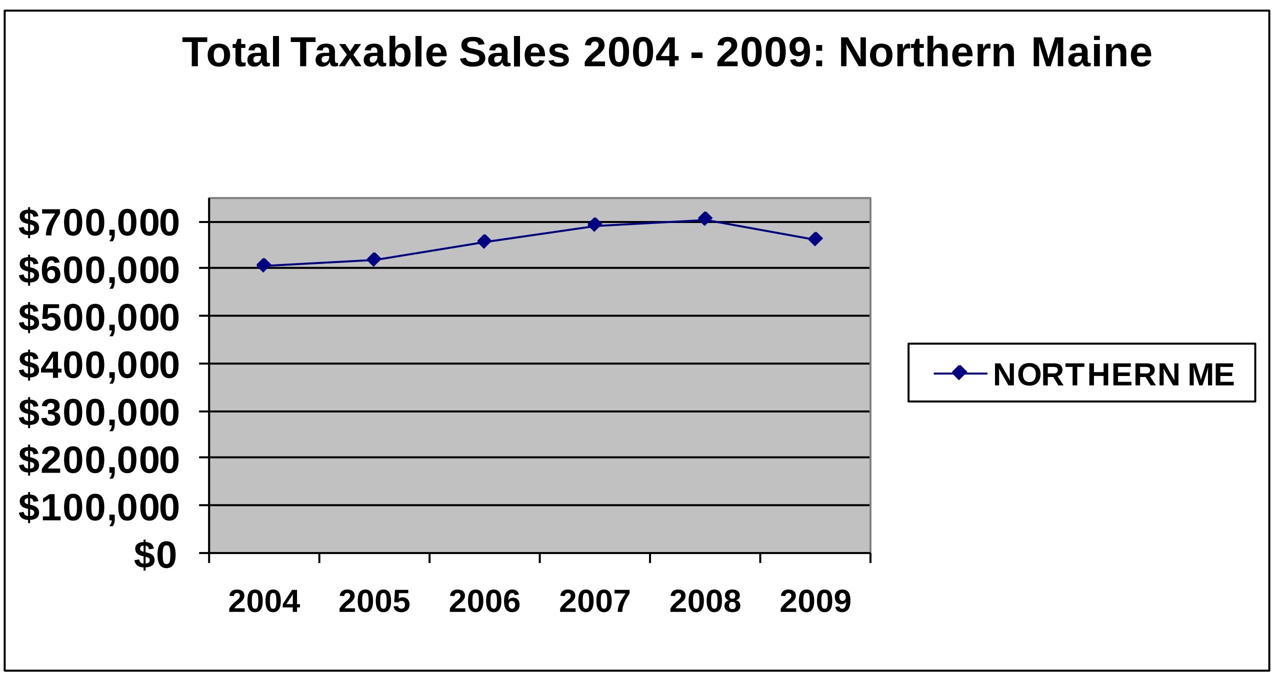




Source: *Maine Retail Sales Report,* Maine State Planning Office Annual Review, 2009

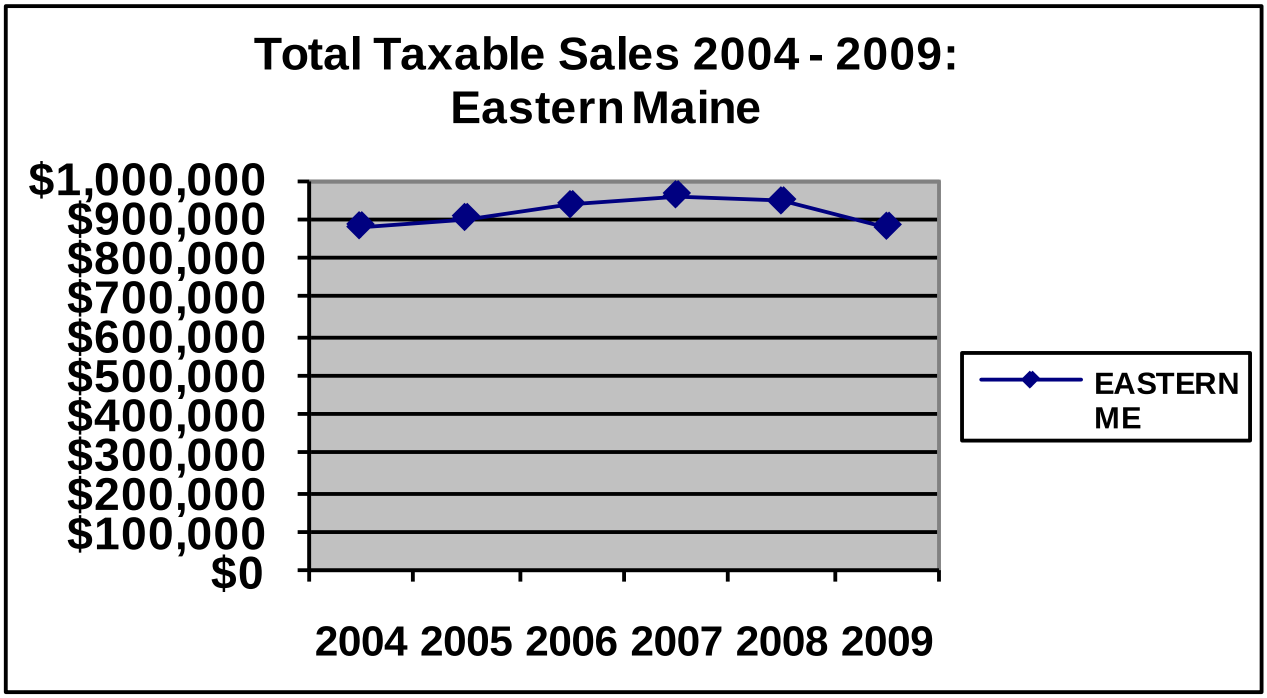
Figures 7-8

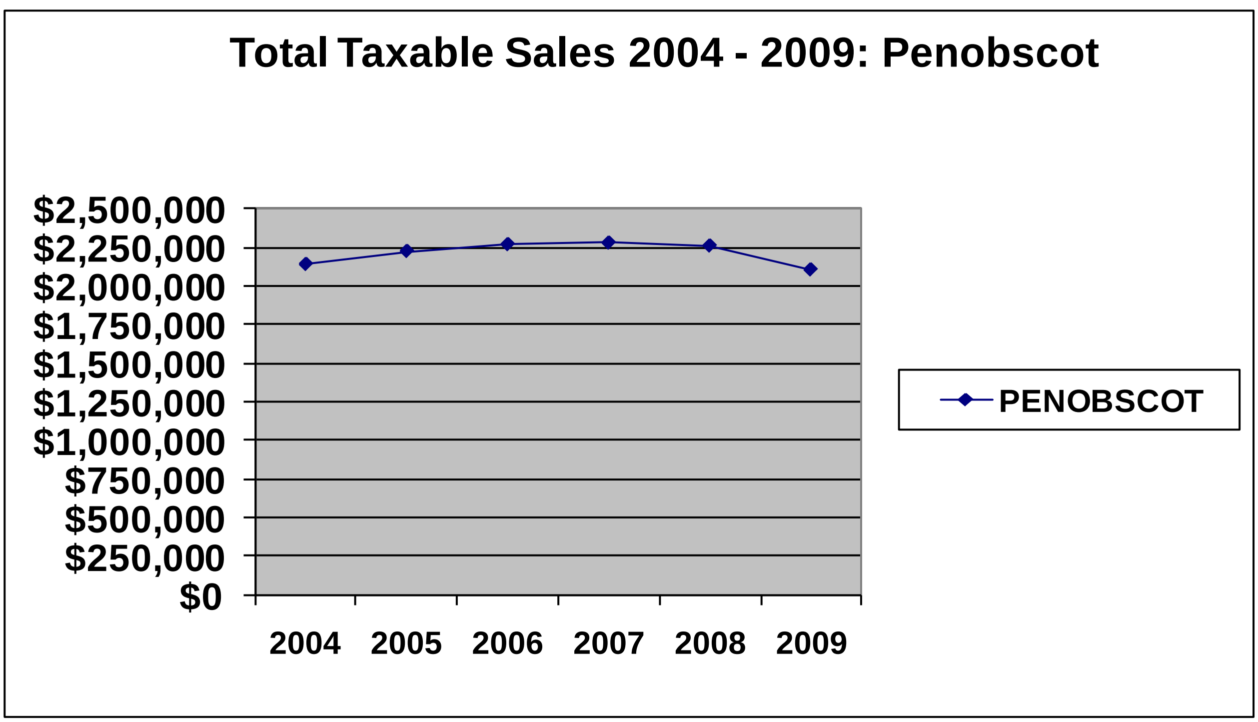




Source: *Maine Retail Sales Report,* Maine State Planning Office Annual Review, 2009

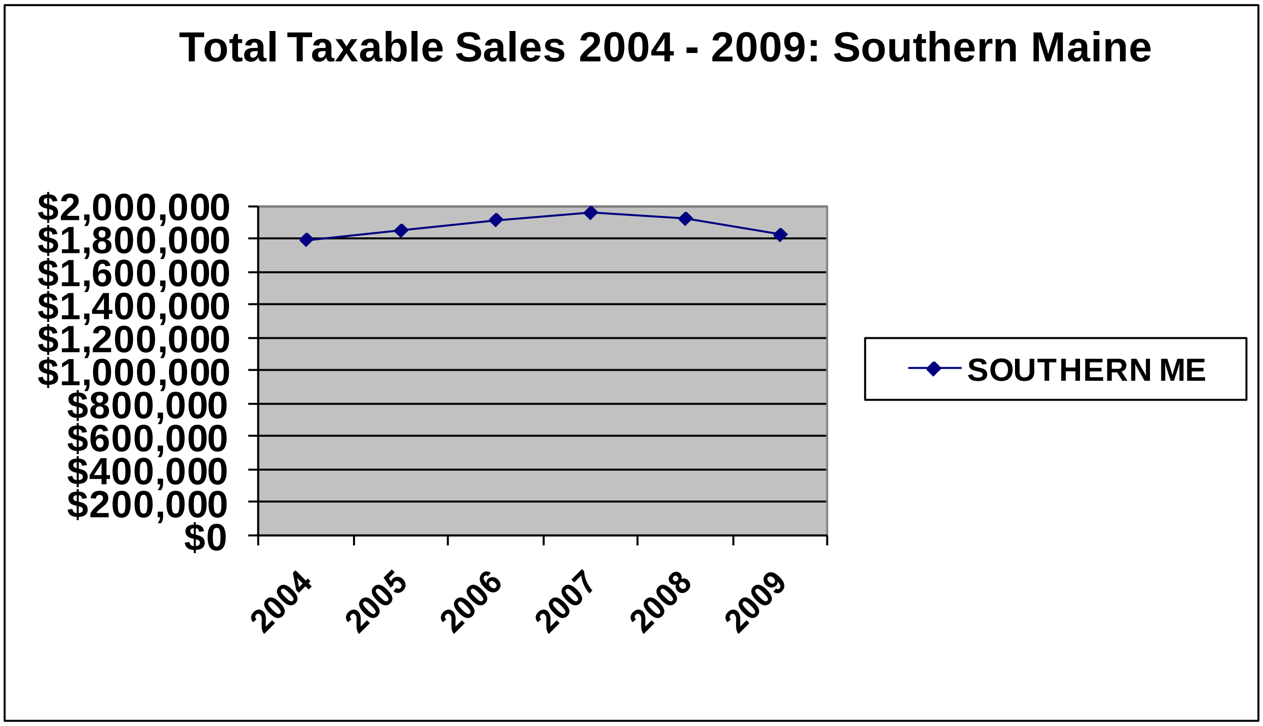
Figures 9-10

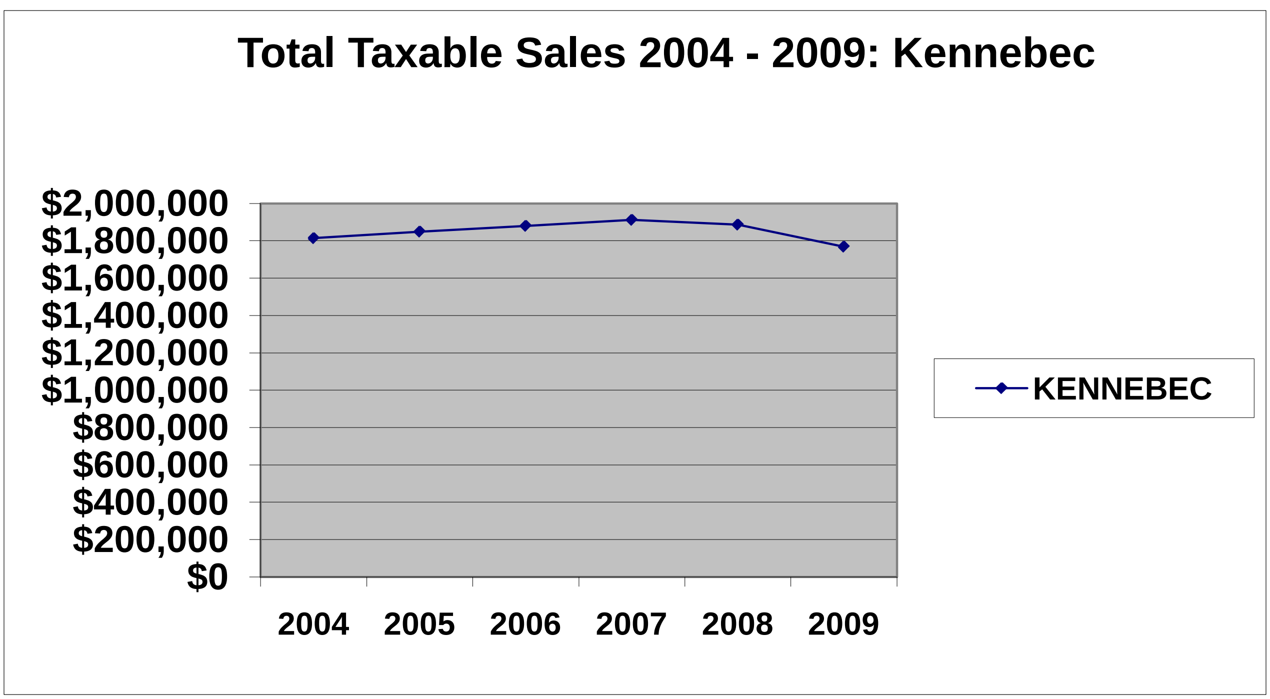




Source: *Maine Retail Sales Report,* Maine State Planning Office Annual Review, 2009

Figures 11-12





Source: *Maine Retail Sales Report,* Maine State Planning Office Annual Review, 2009

The tables above represent figures compiled in 2009 by the Maine State Planning Office for their annual Maine Retail Sales Report. Sales are broken down by economic summary district, as defined by the Planning Office. As we can see, in 2006 taxable sales began to decline in the Androscoggin and Cumberland economic areas. This decline in taxable sales preceded the recession by at least a year. In 2007, taxable sales began to decline in Eastern Maine, Kennebec, Mid Coast, Penobscot, and Southern Maine economic statistical districts. Far Northern Maine is one of the most economically disadvantaged regions of the state so it is somewhat surprising that taxable sales in the Northern Maine economic area continued to rise through 2007 and did not begin to decline until 2008. This discrepancy can likely be explained, however, by Northern Maine's proximity to Canada. Much of the Northern Maine district borders Canada, including Houlton, home to one of Maine's two border-crossings; tourism dollars from Canada could account for the relative stability of sales during that period. All four economic statistical areas experienced steep declines in retail sales between 2007 and 2009.[22]

This illustration of the overall decline in retail sales across the state between 2004 and 2009 suggests that revenue generated from taxable sales is in fact responsive to changes in economic conditions over time. The fact that Maine retail sales fared so poorly over the 5 year period in question belies the conventional wisdom that sales tax collections remain relatively stable over economic cycles but it also bolsters the argument for expanding the general sales tax base to improve stability.

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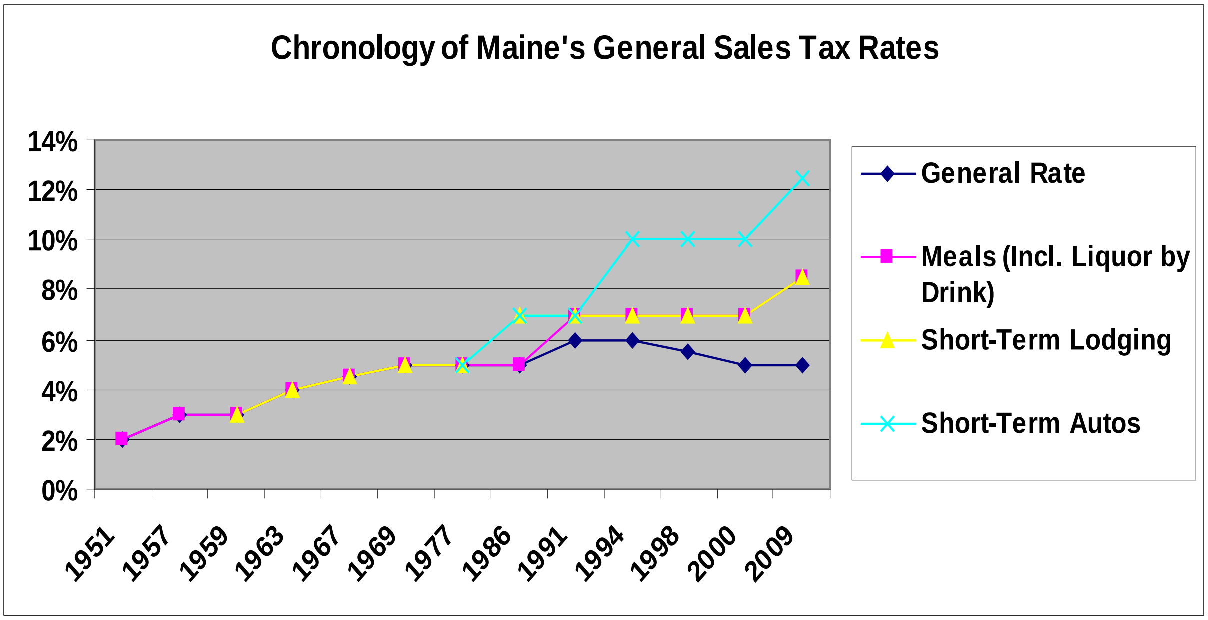
[22] See: *Maine Retail Sales Report,* Maine State Planning Office Annual Review, 2009

V. A Closer Look at General Sales Taxation in Maine

Historical View of Maine's Sales Tax



Source: *Maine Compendium of State Fiscal Information,* Maine State Legislature Office of Fiscal and Program Review, 2009

Sales taxes were first introduced in Maine in 1951. At its inception, the general sales tax rate was 2%, and was imposed on goods as well as meals served in restaurants. In 1957, the general sales tax rate was increased to 3% and in 1959 the general sales tax was expanded to also include a 3% tax on short-term lodging. In 1963, the general sales tax rate was increased to 4%, inclusive of meals and lodging and in 1967 the tax rate was again increased to 4.5%. In 1969, the general sales tax rate was increased to 5%, where it stands today. In 1977, Mainers saw yet another expansion of the general sales tax to include the application of the tax to short-term auto rental. In 1986, the Maine Legislature elected to increase the sales tax rate only on certain services; making it the first year in which Mainers were required to pay sales taxes at three different rates: the general sales tax rate remained at 5% but taxes on meals, lodging and short-term auto rental increased to 7% and taxes on liquor served by the glass increased to 10%. In 1991, the general sales tax rate was increased yet again to 6%, the highest sales tax rate applied to date since the inception of the tax.[23]

Policy Changes to Maine's General Sales Tax

In 1991, during a time of economic distress, Maine instituted a new and controversial "snack tax," which taxed, among other items, chips, cookies and soda at a rate of 6%, the general rate at the time. In 1998, the general sales tax rate (including snack tax) was reduced to 5.5%, where it remained until 2000, when it was once again reduced to 5% during a time of economic prosperity. In 2000, the legislature repealed the so-called "snack tax," under increasing pressure from the general public, industry groups, and some lawmakers who had gathered signatures to force a referendum. This repeal was by no means insignificant, as it represented a backlash against a tax that had been increasingly criticized as regressive. Until 1991, grocery items deemed as basic necessities of life had remained exempt from the general sales tax, as it is widely accepted that taxes on grocery staples are in fact regressive. As we learned earlier, regressive taxes are those that are borne more heavily by low-income taxpayers. The snack tax was particularly controversial because some argued that the tax was arbitrary and difficult to enforce[24], that the items taxed should in fact fall under the umbrella of grocery staples, and that the tax was at least in part a government effort to impose its own feelings about health and nutrition on taxpayers. Not surprisingly, some voters

[23] See: *Maine Compendium of State Fiscal Information,* Maine State Legislature Office of Fiscal and Program Review, 2008 and 2009

[24] In "Tilting at a Twinkie Tax," by Christopher Swope, Congressional Quarterly DBA Governing Magazine, May 2000, a Maine legislator and grocery store owner was quoted as saying "I wouldn't snack on Saltines. To me, they're just something I put in my tomato soup."

saw this tax not only as additional hit to their pocketbooks, but many also saw it as an assault on personal liberty by a government wishing to legislate its citizens' health.

Maine's ill-fated snack tax was not the last attempt by the legislature to single out specific consumable goods for taxation. Nor was it the first time voters and industry groups fought back against a tax seen by many as arbitrary, regressive, and unpopular. In April of 2008, the Maine legislature enacted a tax increase on the retail sale of soft drinks, flavored water, beer, wine and other alcoholic beverages, in an attempt to boost revenues for Maine's Dirigo Health program, a health insurance plan aimed at covering previously uninsured Mainers. Under the new beverage tax, Mainers would be charged an additional 11 cents on a liter of soda, 16 cents on a six-pack of beer, and 7 cents on a bottle of wine.

Opposition to the beverage tax was galvanized by a coalition of business interests who formed the group Fed Up with Taxes and began a petition drive that would ultimately prove successful in forcing a referendum on the bill. The beverage industry rode the wave of opposition, claiming that staying afloat in a faltering economy was hard enough; the imposition of an additional tax would surely prove catastrophic. Similarly, Maine voters, also "fed up with taxes" and fueled by the beverage industry and mounting public criticism over Dirigo Health, jumped on the opposition bandwagon and rode it all the way to a repeal of the tax in November of 2008, barely six months after its enactment.

Selective Sales Taxes

Not reflected in the chronology of Maine sales taxation, but important nonetheless, are selective sales, or excise taxes, and the impact of the imposition of these taxes on overall tax burden. As noted earlier, the narrow-based selective sales tax or "excise tax" is imposed on specific goods that do not fall under the umbrella of general sales taxation. Goods most commonly subject to selective sales taxation are tobacco products, alcohol, and motor fuel in Maine. Maine's selective taxes, though often excluded from discussions of taxes on consumption, impose an additional burden on consumers. Narrow-based selective taxes are widely recognized by economists as being highly regressive, as the costs tend to be borne more heavily by low-income consumers.[25] Selective sales taxes are also criticized as being "hidden taxes;" that is, taxes that are built into the price of goods, rather added to the price at the point of purchase.

Further complicating the issue of selective sales taxes is that the dual purpose of this tax, often levied simultaneously to generate revenue and to discourage unhealthy behavior, especially with respect to alcohol and tobacco, makes it at once an unstable and unsustainable source of revenue for states. Specifically, some states have imposed steep selective sales taxes on tobacco products and used a portion of that revenue to fund anti-tobacco public health initiatives, such as Maine's Tobacco Prevention and Control program within the Department of Health and Human

[25] See: Padgitt, Kail. "The Pine Tree State Chops Down Income Tax: Maine Enacts Major Tax Reform," *Fiscal Fact No.* 174, Tax Foundation, July 23, 2009

Services.[26] These public health campaigns have enjoyed significant successes in curbing the use of tobacco products across the country, particularly among young people; good for the physical health of taxpayers, not so good for the fiscal health of states.

In 1999, one year prior to the repeal of the infamous “snack tax,” Maine’s selective sales taxes were among the highest in the nation. The tax on tobacco products was ranked second highest in the U.S. as a percentage of personal income, at more than double the national average. Maine’s taxes on alcohol and motor fuel were also quite high, ranking 7th and 13th in the nation, respectively. By 2006, Maine’s selective sales tax on tobacco products had grown from .267% of personal income to .367% of personal income, bumping it up in the ranks from second to first in the nation. From 1999, Maine saw a significant decline in the selective sales tax on alcohol as a percentage of personal income from .111% to .033% of personal income, making its new rank 30th in the nation. During that same period, the selective sales tax on motor fuel as percentage of personal income remained relative stable, hovering between .5% and .6% of personal income. However, despite little change in the percentage of income devoted to selective sales taxes on motor fuel, Maine’s ranking, as compared with the rest of the country jumped from 13th to 6th.[27]

[26] See: *Maine Compendium of State Fiscal Information,* Maine State Legislature Office of Fiscal and Program Review, 2008 and 2009
[27] See: *Annual Survey of Government Finances,* U.S. Census Bureau, 2007, www.census.gov

VI. Maine's Tax Reform Bill: An Assessment

Changes to sales tax structure

Among the proposed changes to Maine's tax structure under LD 1495, the bill would expand Maine's general sales tax base to include some personal, professional, repair/maintenance, and entertainment/amusement services currently exempt from sales taxation under Maine law. Additionally, the bill would increase the sales tax rate on meals and lodging from 7% to 8.5% and the tax on short-term automobile rental from 10% to 12.5%. The bill would also extend the 8.5% tax rate to "candy," which is defined by the legislature as a "preparation of sugar, honey or other natural or artificial sweeteners in combination with chocolate, fruits, nuts or other ingredients or flavorings in the form of bars, drops or pieces and that does not contain flour or require refrigeration."[28] Notably exempt from taxation under LD 1495 (though originally included in the Maine Senate's initial bill, LD 1033) are ski lift tickets, health club memberships, and golf course greens fees.

As we've learned, an expansion of a state's sales tax base can prove lucrative and can help states weather economic storms. In order to make the general sales tax less vulnerable to economic downturns, taxing a wide swath of goods and services is advisable. Maine's new sales tax expansion would help in maintaining the solvency of Maine's sales tax revenue, but some argue that it doesn't go far enough. Maine will still exempt from taxation necessities such as groceries and medication; the most stable revenue sources over time, and as noted above, certain "entertainment and

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[28] See: An Act to Implement Tax Relief and Reform, LD 1495, 124th Maine Legislature § 1752 (2009)

amusement" and other services. In the case of groceries and medication, the exemptions *should* be preserved, as they mitigate to an extent the regressive effect of sales taxation. However, exempting certain services from categories that will be widely taxed under the new law may be problematic.

Earlier, I explored policy changes around Maine's sales tax, including the enactment and repeal of the snack tax and short-lived beverage tax. The events surrounding the repeal of those two taxes should be a caution to lawmakers against imposing seemingly arbitrary taxes on certain categories of goods and services while exempting others. This type of selective taxation (not to be confused with selective sales taxes) poses problems not only in terms of the equity and efficiency of a tax, but can also affect the stability of tax collections over time.

Equity and burden implications of expansion of sales tax base

In terms of tax equity, LD 1495 does offer some improvement over Maine's current sales tax structure. LD 1495 will come closer to satisfying the principle of horizontal equity through spreading the incidence of the sales tax across a wider swath of consumers who purchase goods and services. In other words, under LD 1495's sales tax expansion, taxpayers in "like" circumstances, i.e., those purchasing consumable goods, will be subject to the same taxation. LD 1495 improves the vertical equity of Maine's sales tax structure somewhat in that sales taxes will be distributed over different income levels, with wealthier taxpayers presumably purchasing more high-end personal, professional, and entertainment services, based on their ability to pay.

However, it is here that the equity-burden tradeoff discussed earlier comes into play. Despite the new sales tax being more equitable than the current highly regressive structure, low- and middle-income earners will likely purchase some of the new services being taxed under LD 1495, and as such they will see their overall tax burden increase.

Potential economic impacts of "exporting" more taxes to tourists

Supporters of LD 1495, including legislators and policy experts claim that changes to the general sales tax under the bill will be borne mostly by tourists and will therefore reduce the sales tax burden on Mainers.[29] This shift in tax burden from Mainers to out-of-staters would provide Maine with a robust revenue stream while not taking more money out of Mainers' pocketbooks. This claim, however, is problematic and likely exaggerated. According to a paper prepared for the Brookings Institute's Metropolitan Policy Program, "While there are good and bad reasons to export taxes to non-residents, a critical question is whether or not this is even possible given market conditions. In other words, who ultimately bears the burden of taxes that nominally fall on non-residents? In some instances, the tax may be borne by non-residents, while, in other instances, the tax may be shifted in such a way as to be borne by state residents."[30] While Maine currently generates some revenue through taxing goods purchased by out-of-staters, the percentage borne by tourists is less than one might suspect. The Maine Revenue Service estimates that 11% of sales taxes are paid by

[29] See: Coyne, Dan. "Tax Reform Delivers Benefits to Maine Households," *Choices*, Volume XI. No. 4, Maine Center for Economic Policy, April 19, 2010
[30] See: Murray, Matthew. *Exporting State and Local Taxes: An Application to the State of Maine*, Prepared for the Brookings Institution Metropolitan Policy Program, Brookings Institution, October 2006

tourists; another 27% is borne by businesses, leaving 62% of sales taxes to be paid by Mainers.[31]

The flip side of this coin is that, yes, *some* of the additional sales taxes will be borne by non-resident and as a result, there is a concern that extending sales taxes to cover more purchases made by tourists could have the effect of decreasing tourism in Maine. Under LD 1495, Maine could see a drop in tourism revenues, as non-residents may choose to vacation in states such as New Hampshire that impose few sales taxes on consumers.[32]

Shift in reliance on more progressive income tax to combination of flat income tax and a broadened sales tax base

The other proposed change to Maine's tax structure under LD 1495 is that the law would change Maine's current progressive income tax structure to an (almost) flat tax. Proponents of the bill claim that the change in Maine's income tax structure will be offset by the expansion of Maine's sales tax base and changes to the sales tax that might increase the tax burden on low-income Mainers will be offset by a new Household Credit that will reduce the incidence of the income tax on low-income taxpayers. However, as a result of a phase-out of Maine's Household Credit as income rises, LD 1495 will redistribute burden toward middle-income earners in particular because they

[31] MRS figures cited in: *Exporting State and Local Taxes: An Application to the State of Maine*, Prepared for the Brookings Institution Metropolitan Policy Program, Brookings Institution, October 2006
[32] See: *Exporting State and Local Taxes: An Application to the State of Maine*, Prepared for the Brookings Institution Metropolitan Policy Program, Brookings Institution, October 2006

are not given the income tax breaks enacted for the lower income through the Household Credit.[33]

Perhaps most importantly, LD 1495 does nothing to address the need for more property tax relief in Maine. As I discussed earlier, Maine's property tax is extremely high compared to U.S. averages, and it increases the overall burden imposed by taxation in Maine. Under LD 1495, neither property taxes nor mortgage interest will be deductable from state income taxes, both of which are deductable under current law.

Administrative implications of changes to sales tax structure

Discussions of tax reform should also address the administrative capacity and costs associated with an expansion of the sales tax base to add new services to the tax code all at once.   Policy experts at the Center for Budget and Policy Priorities caution that while an expanded sales tax base may simplify and streamline the administration and collection of taxes in the long run; initially, Maine may experience additional administrative costs by adding so many new businesses to the tax code in one fell swoop. [34]

Potential impacts on businesses

Finally, we must look at the potential impact on businesses, particularly small businesses, of the passage of LD 1495. While business-to-business sales are exempt

[33] See: An Act to Implement Tax Relief and Reform, LD 1495, 124th Maine Legislature § 1752 (2009)
[34] See: Mazerov, Michael. *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, July 2009

from sales taxation under current Maine tax law, under LD 1495 businesses may be saddled with an additional tax burden, depending on whether they can afford to perform secretarial services, human resources, legal and accounting and other professional services in-house, or whether they need to outsource these services to outside vendors. This new tax burden will likely be borne more heavily by small businesses who are often not able to afford to perform these services in house and therefore must obtain these resources through outside services. Larger businesses who can afford to perform these services in-house will experience less hardship under the bill.

In addition to increasing the tax burden on businesses through the taxation of professional services, such as those identified above, the imposition of sales tax on professional services will likely be felt by consumers as well. This is primarily due to a concept known as *tax pyramiding*. Tax pyramiding refers to the imposition of a tax on businesses who in turn pass a portion of that tax onto consumers in the form of higher prices on goods and services. These types of taxes are referred to as “hidden taxes,” as consumers may be unaware the tax has been built into the cost of a product or service. This is particularly problematic when it comes to businesses that both utilize and perform services that will be taxed under LD 1495. For example, a small law firm may purchase accounting, payroll and human resource services from outside vendors while performing legal services for its clients in-house. This law firm would be required to pay taxes on the out-of-house professional services they use and as a result may pass some of these additional costs onto clients. However, clients will also pay taxes on the legal services they receive so, in essence, these consumers may be paying the new tax twice, without realizing it. This could harm both businesses and consumers.

There is also a concern that Maine restaurants, hotels, and car rental companies may lose business as a result of increased sales tax rate under LD 1495. There is some danger that this could increase the incidence of "border-hopping," that is, traveling out of state to make tax-free, or reduced tax purchases in places like New Hampshire. [35]

VII. Findings, Conclusions and Recommendations

Recap of Findings

In June 2009, the Maine legislature passed, and Governor Baldacci signed into law LD 1495, An Act to Implement Tax Relief and Tax Reform. The bill proposes a change in Maine's progressive personal income tax to an (almost) flat tax structure, as well as an expansion of the general sales tax base to include some services and an increase in the sales tax rate on meals, lodging and short-term auto rental. Mainers will vote on whether to accept or reject the bill in June 2010.

The general sales tax was first implemented during the early 1930s as a means of raising new revenue for states who were suffering the losses in property tax revenues as a result of the Great Depression. The imposition of a sales tax on consumers also represented a shifting of the burden of taxation from businesses to taxpayers. The goods-based economy that dominated the United States for at least the first half of the

[35] See: Mazerov, Michael. *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, July 2009

20th Century provided lawmakers with a stable source of revenue and allowed states to spread the burden of taxation across a wider swath of the population.[36]

The general sales tax has been a crucial source of tax revenue for states over the last 70+ years. While there is some variation among states in terms of the breadth of the general sales tax base as well as the rate(s) at which the tax is imposed on consumers, in most states, sales tax revenue accrues to states' General Funds, which fund the majority of states' public programs and services, such as K-12 education and health and human services. Most states tax some goods and very few services. In the early days of sales taxation, when the production and consumption of goods dominated states' economies, exemptions were put in place to mitigate the hardship of the imposition of the tax on consumers. As a result, most states currently do not tax groceries and prescription medication, seen as basic necessities of life. Taxation of goods that people need to purchase to survive has been shown to be highly regressive, due to the fact that lower-income earners spend a larger share of their income on consumable goods than do higher-income earners.

In assessing states' tax systems one must consider some of the commonly understood goals of taxation. Maine's current sales tax violates the principles of horizontal and vertical equity and imposes a greater tax burden on the low- and middle-income. In terms of efficiency, proponents of LD 1495 claim that Maine's current tax system is complex and that the new law will simplify Maine's tax system and improve the ease of

[36] See: Snell, Ronald. *State Finance in the Great Depression*, National Conference of State Legislatures, March 2009

administration and compliance. In terms of adequacy, Maine's current system is clearly falling short and state budget gaps have been an impetus for expanding Maine's sales tax base in an effort to gain more tax revenues from out-of-staters.

Maine's current tax structure is unbalanced. Maine relies disproportionately on property taxes and selective sales taxes for revenue generation. Proposed changes to Maine's tax structure do not address these concerns and may actually exasperate some of the current inequities that exist in Maine's tax system.

Despite historical claims that the general sales tax is the most stable of states' revenue sources, exemptions to Maine's sales tax and decreasing revenues as a result of the shifting on consumption from goods to services, have increased the volatility of Maine's sales tax collections over time. The fluctuations in the percent of personal income devoted to paying sales taxes in Maine, as well as a decline in taxable retail sales in Maine over the last several years have threatened the stability of the sales tax as a revenue source.

Under LD 1495, changes to the general sales tax include an expansion of the sales tax base to include some personal, professional, repair/ maintenance and entertainment/ amusement services, as well as an increase in the general sales tax rate on meals and lodging from 7% to 8.5% and on short-term auto rental from 10% to 12.5%. The bill would also add a tax of 8.5% on candy. Proponents of the bill claim that much of the additional burden of sales taxation will be borne by out-of-staters and that the rest will be offset by changes to the income tax structure, however policy experts and economists warn that Mainers may be saddled with a larger percentage of new sales taxes than tourists, thereby increasing the tax burden on Maine residents. Additionally, supporters tout the new bill as increasing the equity of Maine's overall tax system. This is true to a point, but does not represent the full picture. While LD 1495 improves horizontal equity by spreading the sales tax across a wider swath of consumers, it increases the overall burden on low- and middle-income consumers who will pay additional taxes on services they purchase that had previously been exempt from taxation. This is a classic example of the equity-burden tradeoff in taxation.

Conclusions

Maine's current tax structure is regressive and the burden falls heavily on lower-income Mainers and the middle income. Furthermore, the narrowness of the current (pre-LD 1495) tax base and the number of exemptions to Maine's sales tax contribute to volatility and instability of tax collections over economic cycles.

While LD 1495 proposes some changes to Maine's tax structure that may improve the equity of taxation in Maine, LD 1495 does not address Maine's property taxes, some of the highest in the country. Spreading the incidence of the general sales tax across different levels of income comes closer to satisfying the principle of horizontal equity, but overall it increases the burden of taxation on low- and middle-income earners who will pay more in sales taxes and receive no property tax relief.

Claims that out-of-staters will bear most of the burden of the expansion of the sales tax base under LD 1495 are exaggerated. Maine cannot rely on tourism to offset the expansion of sales tax base and rate increase as the majority of revenue from meals and entertainment comes from Mainers, not can tourism ensure the long-term solvency of sales tax collections, as tourism dollars can be a highly volatile source of revenue.

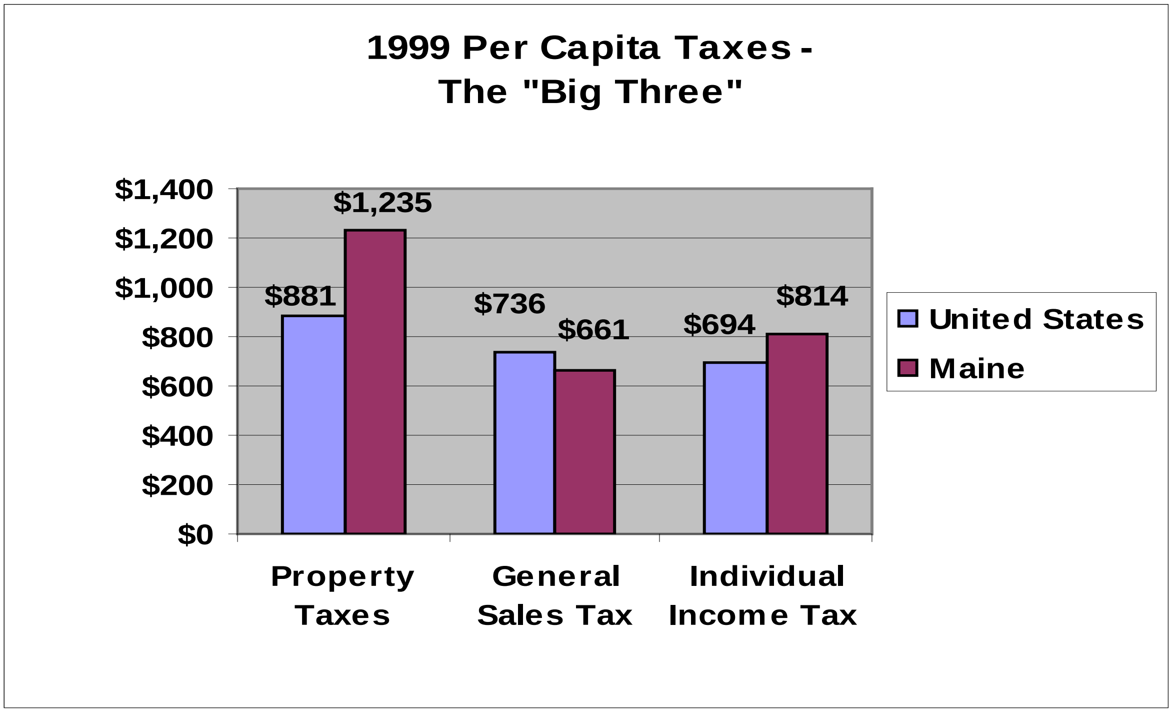
Maine's general sales tax collections as a percentage of personal income have historically lagged slightly behind U.S. averages, so there may be room to increase general sales tax reliance somewhat. However, the burden of the sales tax is comparatively heavy already, in part due to Maine's high selective sales taxes, which increase the burden on low- and middle-income taxpayers, so drastic changes to the general sales tax must be considered carefully.

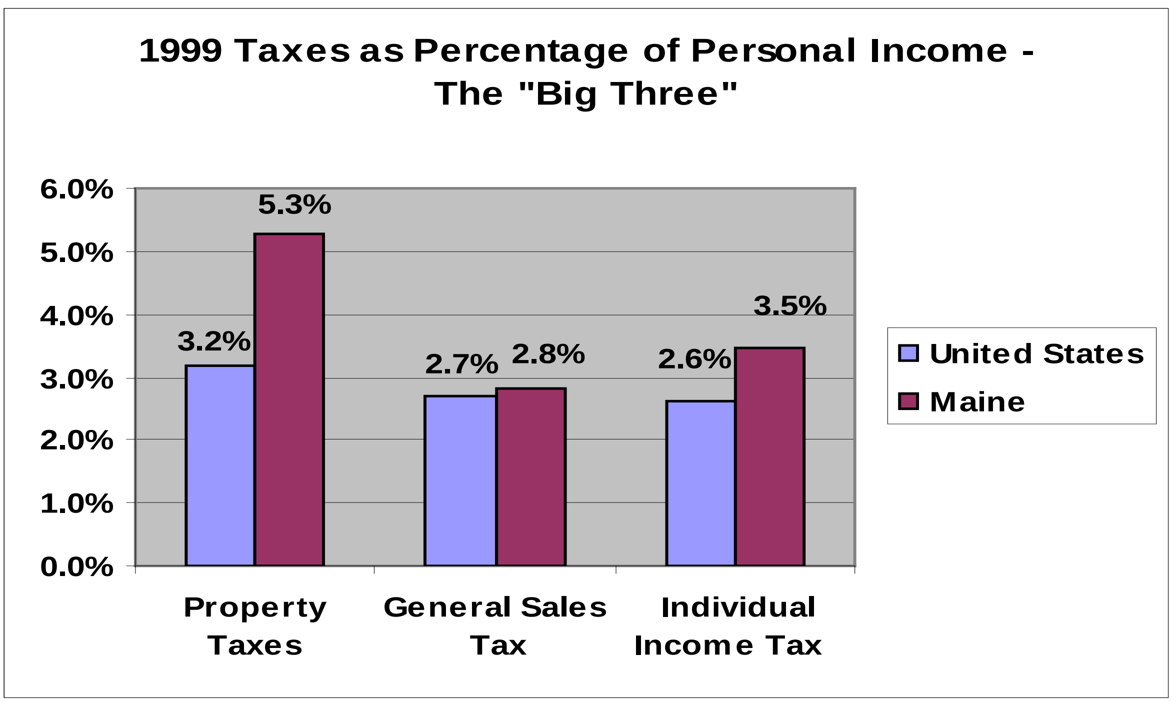
Recommendations

Expanding Maine's sales tax base to include items purchased by middle and upper income households has been promoted as an opportunity to shift the burden of the tax out of state and improve the equity of the general sales tax. However, many Maine residents will pay more sales taxes as a result of these changes. The increase in burden on the middle income could be excessive. Therefore, any increase in reliance on sales taxes should be targeted toward reducing local reliance on the property tax. This might be accomplished by increasing the share of state funds devoted to Maine's municipal revenue sharing-program.

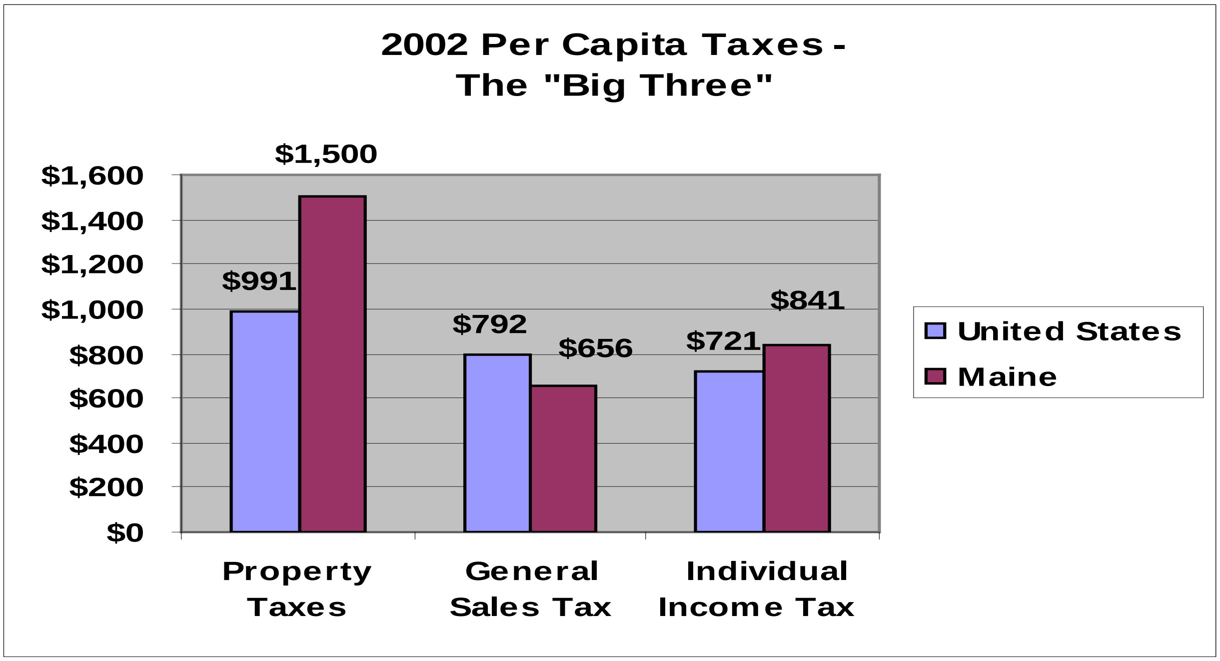
Finally, any expansion of the general sales tax base should be accompanied by a reduction in the sales tax rate, making the broadened base less burdensome and reducing the responsiveness of tax collections to economic changes. Maine's proposition to extend the sales tax to services while simultaneously increasing the rate on certain items could actually dissuade Mainers from purchasing some of the newly taxed services and could also threaten tourism in Maine.

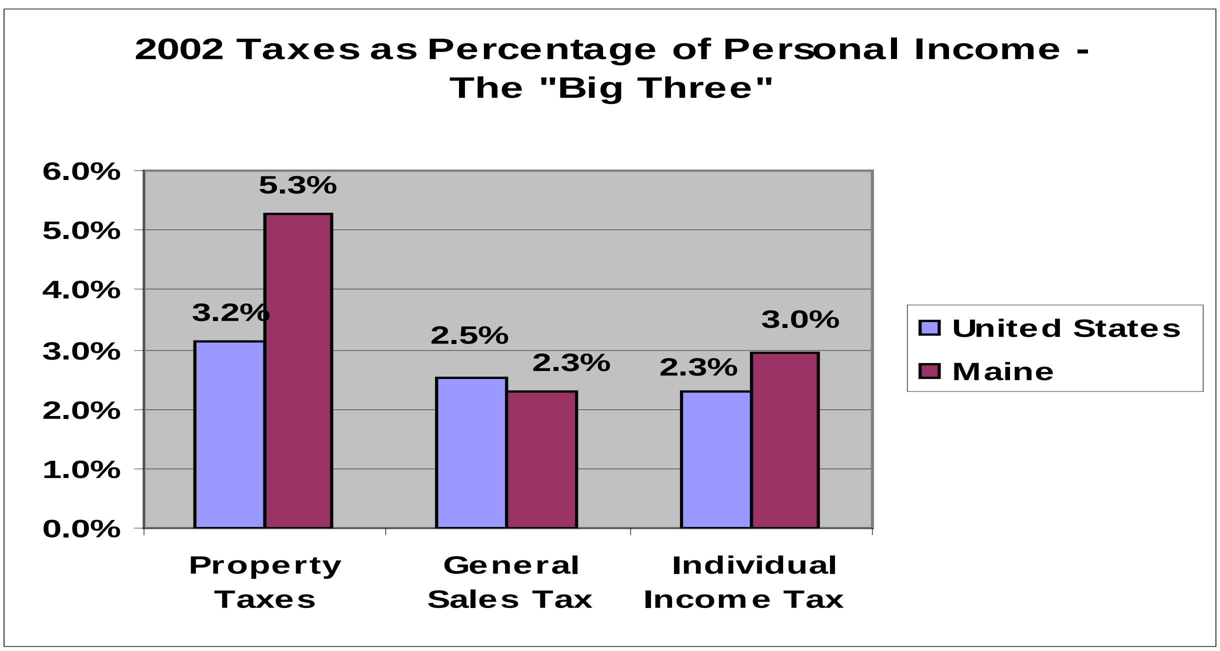
Appendix A: Tax Balance – The “Big Three”



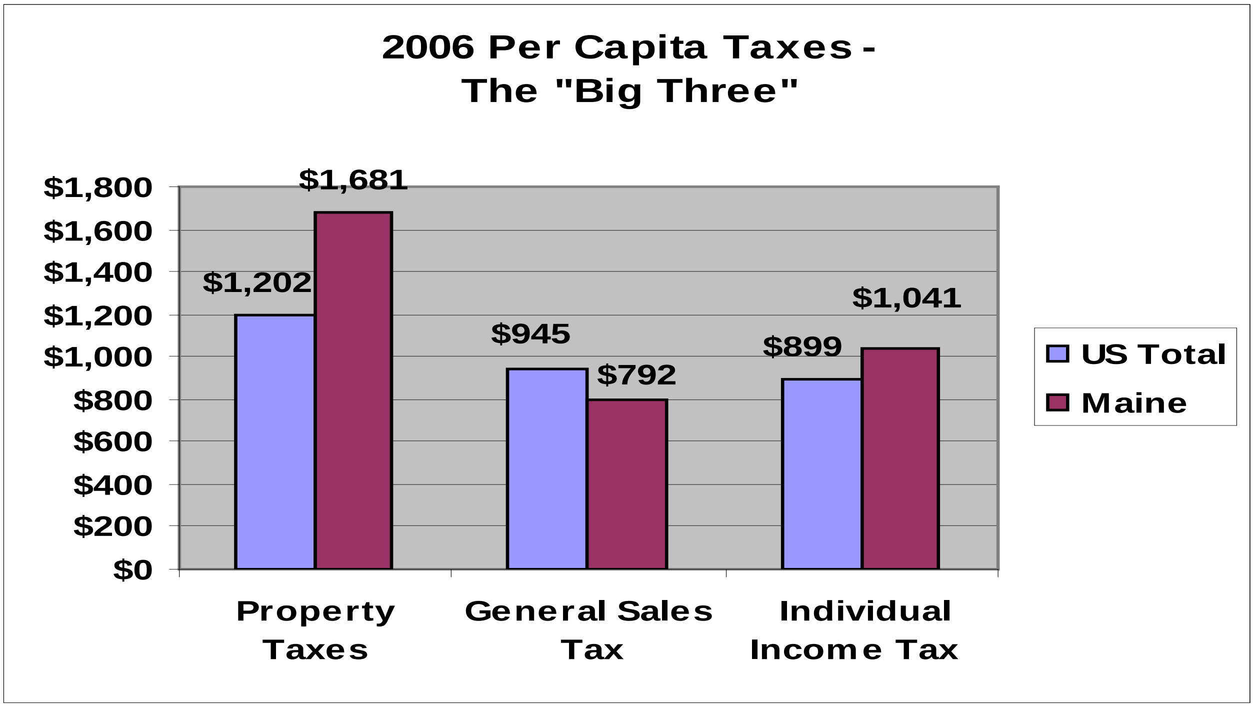


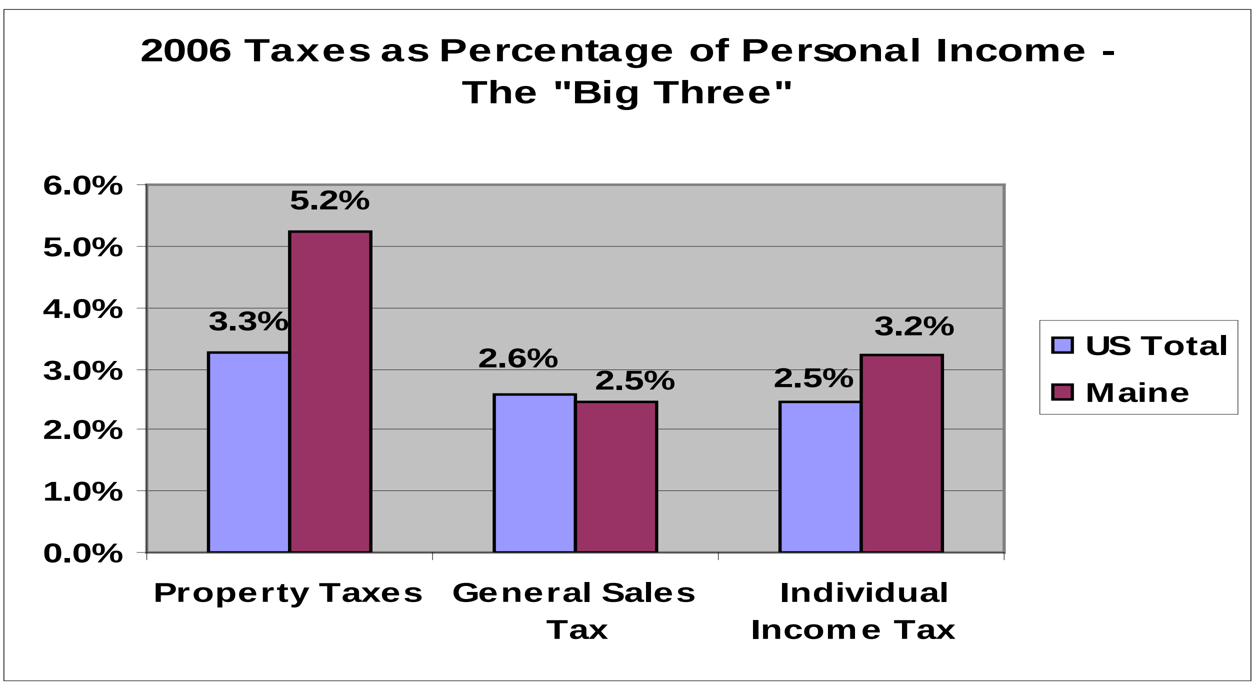
- In 1999 property taxes as percentage of personal income were very high in Maine, as compared with U.S. averages
- General sales taxes as PPI in Maine were more or less in line with national averages
- Individual income taxes were somewhat higher in Maine than in the U.S.





- In 2002 property taxes as percentage of personal income were very high in Maine, as compared with U.S. averages (same % as 1999)
- General sales taxes as PPI in Maine were slightly lower than national averages, and general sales taxes were down overall
- Individual income taxes were somewhat higher in Maine than in the U.S.; individual income taxes were down overall





- In 2006 property taxes as percentage of personal income were very high in Maine, as compared with U.S. averages (almost the same % as in 1999 and 2002)
- General sales taxes as PPI in Maine were slightly lower than national averages
- Personal income taxes were somewhat higher in Maine than in the U.S.

Source: *Annual Survey of Government Finances,* U.S. Census Bureau, 2007, www.census.gov

Appendix B: Current Charges and Property Taxes as Percentage of Personal Income

	Revenue Source as a Percent of General Own Source Revenue, 2007			
	Current Charges		Property Taxes	
STATE	Percent	Rank	Percent	Rank
US	25.2%		44.4%	
AK	26.1%	27	45.2%	22
AL	40.5%	3	18.4%	50
AR	28.2%	19	21.6%	49
AZ	24.5%	32	36.4%	39
CA	32.8%	9	34.3%	42
CO	26.6%	25	35.5%	40
CT	9.6%	50	83.6%	1
DE	25.5%	28	43.8%	27
FL	28.0%	20	44.0%	26
GA	29.4%	15	37.6%	38
HI	18.0%	43	58.2%	8
IA	31.3%	12	47.8%	18
ID	46.6%	2	38.5%	34
IL	18.5%	41	55.7%	9
IN	31.0%	13	43.3%	28
KS	24.8%	31	47.2%	19

KY	26.6%	26	32.0%	44
LA	27.1%	23	23.4%	48
MA	17.1%	44	72.8%	6
MD	16.0%	46	38.4%	35
ME	18.0%	42	74.9%	5
MI	28.8%	18	53.2%	11
MN	33.9%	8	44.1%	25
MO	25.5%	29	37.9%	36
MS	47.6%	1	37.8%	37
MT	29.0%	17	50.7%	15
NB	27.7%	21	47.0%	20
NC	36.6%	6	38.6%	33
ND	20.0%	38	52.6%	13
NH	12.5%	48	79.7%	2
NJ	15.2%	47	76.2%	4
NM	22.4%	36	30.7%	46
NV	29.8%	14	34.8%	41
NY	16.1%	45	40.3%	30
OH	20.4%	37	44.1%	24
OK	32.4%	11	29.2%	47
OR	29.2%	16	44.5%	23
PA	19.9%	39	49.1%	16
RI	12.2%	49	78.5%	3

SC	39.2%	5	41.2%	29
SD	22.4%	35	48.2%	17
TN	34.8%	7	34.0%	43
TX	22.7%	33	53.1%	12
UT	27.1%	22	38.8%	32
VA	19.2%	40	52.3%	14
VT	25.4%	30	54.9%	10
WA	32.7%	10	31.7%	45
WI	22.6%	34	63.9%	7
WV	26.7%	24	45.4%	21
WY	39.2%	4	39.4%	31

Source: *Annual Survey of Government Finances,* U.S. Census Bureau, 2007, www.census.gov
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