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Laurie G. Lachance
Maine State Planning Office

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An Outcome-Based Approach to Rational Tax Reform

Op-Ed by Laurie G. Lachance, State Economist

As election time nears and State Government officials struggle to close a $240 million budget gap, the cry for tax reform in Maine has, once again, reached fever pitch. Overhauling Maine's tax structure has been the topic of numerous studies, papers, and political debates for decades, and yet for all of our good intentions, heartfelt passion, and countless councils, the fact remains that no major changes to Maine's tax system have taken place since the income tax was introduced 30 years ago.

Why is progress in this area so elusive? It could be that we have not yet hit a crisis point, or that the system only needs a tune-up, not an overhaul. It could be that the magnitude of the changes we're envisioning is just too difficult to work through the system or the harsh reality that a tax cut for one group often means a tax increase for another group. I've grown to believe that part of the problem may, in fact, be that the term "tax reform" means very different things to different people. To some, tax reform means lowering property taxes or slashing income taxes. To others, it might mean aligning the tax structure to the new economic base. Still others may view it as stabilizing the revenue flow to avoid the annual battles over sustained funding for high-priority public goods like education, transportation or human services.

Perhaps the reason that our attempts at major reform have failed is that we've never really taken the critical first step of defining, truly defining in writing, what we are trying to accomplish and how we are going to evaluate proposed changes and measure success. Perhaps if we could articulate and agree upon the goal of tax reform, a set of principles to guide us as we evaluate proposals, and some measurable outcomes against which we could measure our progress – then we could truly enact meaningful change.

This idea, "An Outcome-Based Approach to Rational Tax Reform", was created by former State Planning Office Director Evan Richert, and I, humbly, have taken a first pass at proposing some parameters and priorities for consideration.

First, as to the goal of any proposed tax reform, it seems that, at a minimum, a long term goal should include the following elements:

"To create a fair tax structure that provides a stable stream of revenues which is both adequate for funding the sustained investment in high priority public goods and services and which minimizes the distortion of economic investment in Maine"

Embodied within this goal are a number of principles that Mainers hold dear including fairness, stability and competitiveness. When we shift our gaze from the longer term to the current reality, however, a new hurdle emerges. Major tax reform, which is extremely difficult in the best of times, is even more challenging when facing a sizable budget gap. The trick then becomes to resolve the current challenge without jeopardizing

movement towards our long term goal. Thus we may want to consider adopting a short term goal such as:

"To put in place a series of expenditure cuts and, if necessary, tax increases that resolve the current structural gap and which, at a minimum, make the volatility of the current structure no worse and which preserve, to the fullest extent possible, the investment in the highest priority public goods and services."

But agreeing to the goal, whether short term or long term, is likely the easiest part, because, as we all recognize, the devil is truly in the detail. One needn't look too far to find that, in fact, these principles can not be simultaneously maximized. As we learned all too harshly in April, the principles of fairness (which, to many, means a good dose of progressivity) and stability can act against each other, and any movement to tame volatility may also move the system towards regressivity. The trick then becomes finding a structure which optimizes, rather than maximizes, the principles. Translation … some degree of fairness (progressivity) may have to be foregone to achieve greater stability.

Central to the debate in Maine is the appropriate mix of taxes to achieve the goal. If one wanted to maximize stability, one might choose the property tax. To maximize equity, the income tax is the better mechanism. To maximize investment in capital equipment, one might choose to replace taxes on capital investment with a sales tax on certain services. Unfortunately, there is no perfect tax structure that Maine can adopt. The best structure for Maine is the one that best embodies the principles that Mainers hold dear.

To start the discussion and to provide an example of a framework that might help guide policymakers through any tax reform process, here's a set of outcome based goals for consideration that would move us towards the principles we are trying to optimize:

<u>Tax Mix</u>: A broad mix of taxes – no single type of tax will account for more than 28% of all tax revenues raised at the state and local levels.

Maine's current mix is: Property Tax (32%), Income Tax (31%), Sales Tax (20%), Other (17%). The property tax burden is excessive for some residents and some (though not all) communities and, with 2 property tax initiatives circulating, the state may be at a flash point.

<u>Burden</u>: Reduce Maine's tax burden to the national average.

Despite the fact that recent cuts in excess of $400 million in State taxes led to an improved ranking of 11th in FY01 (from 8th in FY00), the <u>combined</u> state and local tax burden (estimated to be 12.3% in FY01) remains among the highest in the nation and is believed to be inhibiting investment. Meaningful improvement in the burden category means cutting or containing <u>both</u> state and local expenditures and/or significantly raising income.

<u>Fairness</u>: No quintile (of median household income) will pay a larger percentage of income to state and local taxes than the next higher quintile.

While Maine does not quite achieve this standard, Maine's tax structure is nationally recognized for fairness, which is a deeply held value for Maine people.

<u>Stability</u>: The percent change in state and local tax revenues, separately and jointly, will not vary from the percent change in total personal income by more than 20%.

The current structure is highly volatile with state tax revenues growing/declining at a rate that is 2 to 3 times (200%-300%) faster than personal income growth. These wide swings impede sustained investment in high priority public goods and destabilize the environment for private investment.

<u>Competitiveness / Economic Neutrality</u>: Taxes that alter decisions about economic investments, particularly taxes on the creation of wealth, will be reduced to their lowest possible level, preferably 0%.

Maine's high top marginal income tax rate and personal property tax on machinery and equipment act as disincentives to business investment. Maine's economic vitality, productivity and income are directly dependent on our ability to attract private investment in Maine businesses.

<u>Exportability</u>: The percentage of Maine's tax revenues paid by non-residents should be increased to 15%.

Currently, an estimated 8% of Maine's total tax collections from individuals are "exported" (paid by Maine non-residents).

<u>Efficiency</u>: The cost of collecting taxes will not exceed 1% of the revenues generated.

Maine's administrative costs are very reasonable, near 1%.

Once the principles are agreed upon, some level of priority assigned, and measurable outcomes clearly defined, then each and every proposed tax change can be evaluated and compared to other proposals. I do not mean to suggest that this is in any way simple, but at least a framework would exist that would force us to take a hard look at how any proposed change will effect the whole system, not just the issue we are seeking to address at that point.

An economist at the Boston Fed recently told me that no other state had ever been successful in overhauling its tax structure absent a crisis, and the crisis usually came in the form of a property tax cap. In essence, he said "It can't be done." Perhaps he is correct, but if Mainers are clamoring for reform, isn't a thoughtful, comprehensive approach worth a try?