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Committee Tax Reform Plan not "Revenue Neutral"

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by J. Scott Moody

The tax reform plan proposed by the Taxation Committee that is winding its way through the Maine Legislature is "revenue neutral" in Augusta, but it would raise Mainer's taxes by almost \$40 million.

This is not due to a technical error by revenue estimators in Augusta – the revenue estimates are probably as reliable as they can be, and that the plan would not alter the amount of taxes collected. But the revenue neutrality is limited to Maine. The plan inadvertently raises the federal income taxes of Maine residents by reducing deductions.

Every state tax code interacts with the federal individual income tax code. Some states make every effort to maximize the benefits of that interaction, but the Taxation Committee in Augusta is evidently thinking about other things. As a result, the interaction of the new tax reform plan with the federal code will create a significant federal tax increase on Mainer's.

The Taxation Committee plan will lower the state individual income tax and property tax, but it will raise the corporate income tax and sales tax to make sure Augusta doesn't lose any revenue. The downside of such a change is that the individual income and property taxes are deductible on Mainer's federal income tax returns, but the corporate income tax and sales tax are not.[1]

The end result is that many Mainer's will lose a significant portion of their federal tax deductions. Table 1 shows the income distribution of Mainer's who itemize their deductions for federal tax purposes.[2]

The highest level of state individual income tax deductions is \$66,880,106 for those taxpayers earning over \$200,000. For property taxes, the highest level of deductions is \$21,374,159 for those taxpayers earning between \$50,000 and \$75,000. The differ-

Table 1
Estimated Increase if Federal Individual Income Tax due to Taxation Committee Plan
Fiscal Year 2008

	Total	Under \$20,000	\$20,000 to \$50,000	\$50,000 to \$75,000	\$75,000 to \$100,000	\$100,000 to \$200,000	Over \$200,000
Effective Tax Rate	--	2.6%	6.0%	8.0%	9.5%	13.3%	21.7%
Reduced Income Tax Deduction	\$218,807,000	\$2,313,643	\$19,189,372	\$36,231,512	\$38,357,488	\$55,834,880	\$66,880,106
Reduced Property Tax Deduction	\$98,084,000	\$6,067,912	\$20,763,618	\$21,374,159	\$17,450,226	\$20,422,948	\$12,005,136
Increase in Federal Tax Liabilities (a)	\$39,728,196	\$218,610	\$2,396,705	\$4,597,307	\$5,304,362	\$10,120,410	\$17,090,803

(a) Equals "Reduced Income Tax Deduction" Plus "Reduced Property Tax Deduction" times "Effective Tax Rate."

Source: Internal Revenue Service, Maine Revenue Service, MHPC.

ence in distribution is not surprising given that the state individual income tax is progressive while the property tax is regressive.

As shown in Table 1, The Taxation Committee's most recent estimate of the individual income tax reduction is \$218,807,000 and the property tax reduction is \$98,084,000.[3] [4] Multiply those numbers by the respective effective federal income tax rates, and Mainers could face up to \$39,728,196 in increased federal income taxes because of reduced tax deductibility. So much for "revenue neutrality." This tax increase is in addition to the higher sales tax compliance costs of up to \$14,936,000.[5]

Unfortunately for Mainers, the Taxation Committee's tax reform plan will mean higher taxes and higher tax compliance costs. The tax plan sets Maine in the wrong direction. Instead, policymakers should pursue a bold plan to reduce actual tax collections. [7] Recently, The Mainer Heritage Policy Center released such a plan.[6] The plan results in increased transparency, boosts economic activity, and reduces Mainers' high taxes.

Notes and Sources:

- [1] Technically, there is a sales tax deduction, but only the higher of income or sales taxes can be deducted. This is helpful for states like Texas with no income tax but a high sales tax. However, the deduction is not helpful for Mainers. Also, the sales tax deduction goes away after 2007 unless extended by Congress.
- [2] The federal data used for this analysis is based on calendar year 2004. This analysis assumes that the "Effective Tax Rate" as well as the income distributions hold constant. The data can be found on the Internal Revenue Website: <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=103106,00.html>
- [3] The amount of lost income and property tax deductibility is complicated by the federal alternative minimum tax. On the one hand, Mainer's subject to AMT lose their tax deductibility. As a result, this amount may be overstated. However, after tax reduction, some Mainer's will fall out of AMT. As a result, this amount may be understated. This analysis assumes the two effects offset each other.
- [4] The property tax deductibility is further complicated since there is no guarantee that state-level property tax relief will actually reduce overall property tax collections. For instance, towns could "capture" the state property tax relief by raising property taxes higher than they would have otherwise. As a result, this amount may be overstated. This analysis assumes no "capture" by towns.
- [5] See "The Sales Tax Compliance Burden" for more details: [http://www.mainepolicy.org/Portals/0/Issue%20Brief.%20No.%2013%20\(final\).pdf](http://www.mainepolicy.org/Portals/0/Issue%20Brief.%20No.%2013%20(final).pdf)
- [6] See "A Plan to Reform and Reduce Maine's Taxes" for more details: [http://www.mainepolicy.org/Portals/0/Issue%20Brief.%20No.%2016%20\(final\).pdf](http://www.mainepolicy.org/Portals/0/Issue%20Brief.%20No.%2016%20(final).pdf)

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