

Path to Prosperity

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LD 1088: The Illusion of Tax Reform

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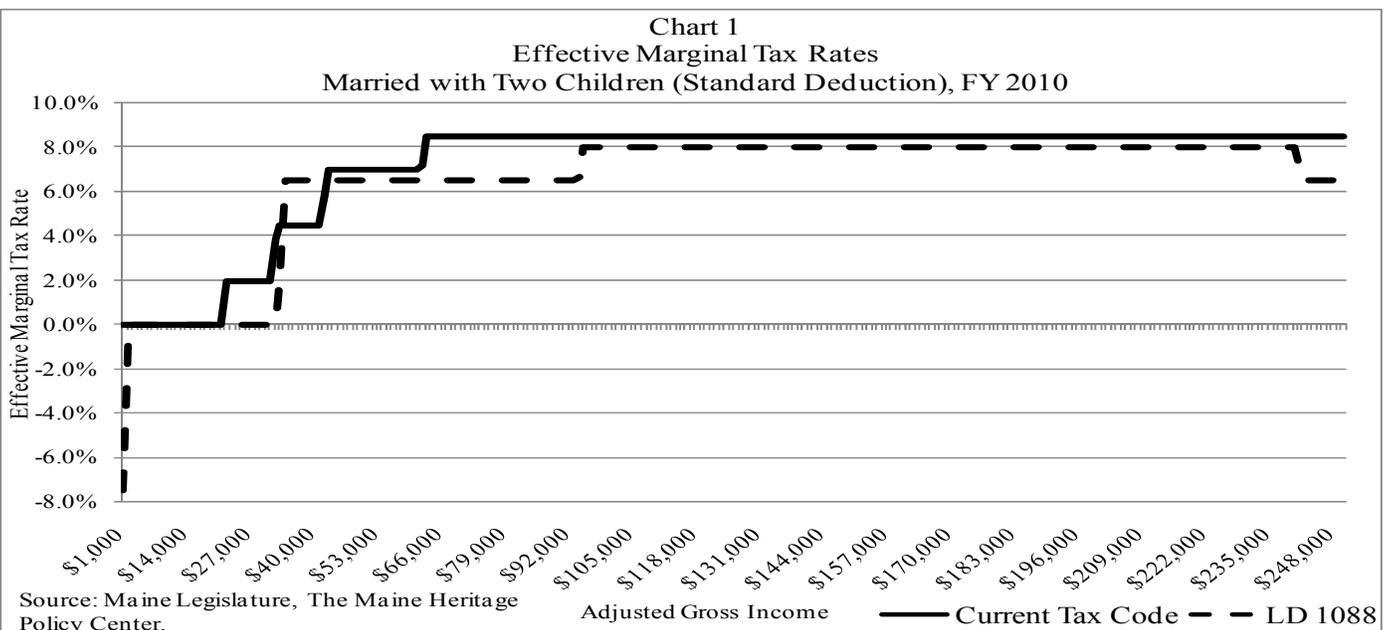
LD 1088 (An Act to Modernize the Tax Laws and Provide over \$75,000,000 to Residents of the State in Tax Relief) purports to eliminate the existing four tax brackets in Maine's personal income tax by collapsing them into a single bracket with a flat 6.5 percent tax rate. Unfortunately, LD 1088 also sweeps away the standard/itemized deductions and exemptions in favor of new household tax credit. However, since the credit is both refundable for lower-income Mainers and eliminated for higher-income Mainers, the *effective marginal tax rate* (EMTR) is very different from the statutory 6.5 percent statutory tax rate.

Chart 1 and Table 1 plot the changes in the EMTR for incomes, as measured by adjusted gross income (AGI), between \$0 and \$250,000 for a married couple with two children under current law and LD 1088 for FY 2010 (when LD 1088 would take effect if enacted). The EMTR is measured by taking the change in tax liability divided by the change in income. For example, a change in tax liability of \$80 over \$1,000 in income yields an EMTR of 8 percent. EMTR is important because work effort and entrepreneurship are determined on the margin. Put simply, people work less if the EMTR becomes punitively high.

Overall, LD 1088 is more progressive than current law since it would create negative tax rates for lower income Mainers due to it being refundable if the household credit exceeds their tax liability. However, since the refund is capped at \$75, the EMTR is -7.5 percent on the first dollar earned but 0 percent thereafter (since it is constant). Surprisingly, for Mainers in this profile earning between \$34,000 and \$42,000, they will actually face an EMTR that would be higher under LD 1088 than under current law. More disturbingly, since the credit phases-out for married filers with AGI over \$93,900, the EMTR jumps to 8 percent—only 0.5 percentage points less than current law. And it stays at 8 percent until income exceeds \$240,000!

As a result, the economic benefits of the lower statutory rate is almost completely eroded by the effects of the household credit. This is particularly devastating because, according to IRS data, married couples make-up 87 percent of all taxpayers earning more than \$100,000. These folks are also Maine's entrepreneurial class and LD 1088 does little to help them.

Note: For simplicity, this analysis only examines tax components which are modified by LD 1088 and excludes other important elements that would affect the EMTR such as the existing earned income tax credit and other tax credits.



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Table 1
Effective Marginal Tax Rates for a Married Filer with Two Children (Standard Deduction)
FY 2010

| Adjusted Gross Income | Effective Marginal Tax Rates | | | Tax Liability | | | Adjusted Gross Income | Effective Marginal Tax Rates | | | Tax Liability | | |
|-----------------------|------------------------------|---------|------------|---------------|---------|------------|-----------------------|------------------------------|---------|------------|---------------|----------|------------|
| | Current Law | LD 1088 | Difference | Current Law | LD 1088 | Difference | | Current Law | LD 1088 | Difference | Current Law | LD 1088 | Difference |
| \$1,000 | 0.0% | -7.5% | -7.5% | \$0 | -\$75 | -\$75 | \$126,000 | 8.5% | 8.0% | -0.5% | \$7,545 | \$6,472 | -\$1,073 |
| \$5,000 | 0.0% | 0.0% | 0.0% | \$0 | -\$75 | -\$75 | \$130,000 | 8.5% | 8.0% | -0.5% | \$7,885 | \$6,792 | -\$1,093 |
| \$10,000 | 0.0% | 0.0% | 0.0% | \$0 | -\$75 | -\$75 | \$135,000 | 8.5% | 8.0% | -0.5% | \$8,310 | \$7,192 | -\$1,118 |
| \$15,000 | 0.0% | 0.0% | 0.0% | \$0 | -\$75 | -\$75 | \$140,000 | 8.5% | 8.0% | -0.5% | \$8,735 | \$7,592 | -\$1,143 |
| \$20,000 | 0.0% | 0.0% | 0.0% | \$0 | -\$75 | -\$75 | \$145,000 | 8.5% | 8.0% | -0.5% | \$9,160 | \$7,992 | -\$1,168 |
| \$25,000 | 2.0% | 0.0% | -2.0% | \$80 | -\$75 | -\$155 | \$150,000 | 8.5% | 8.0% | -0.5% | \$9,585 | \$8,392 | -\$1,193 |
| \$30,000 | 2.0% | 0.0% | -2.0% | \$180 | -\$75 | -\$255 | \$155,000 | 8.5% | 8.0% | -0.5% | \$10,010 | \$8,792 | -\$1,218 |
| \$35,000 | 4.5% | 6.5% | 2.0% | \$374 | \$75 | -\$299 | \$160,000 | 8.5% | 8.0% | -0.5% | \$10,435 | \$9,192 | -\$1,243 |
| \$40,000 | 4.5% | 6.5% | 2.0% | \$599 | \$400 | -\$199 | \$165,000 | 8.5% | 8.0% | -0.5% | \$10,860 | \$9,592 | -\$1,268 |
| \$45,000 | 7.0% | 6.5% | -0.5% | \$913 | \$725 | -\$188 | \$170,000 | 8.5% | 8.0% | -0.5% | \$11,285 | \$9,992 | -\$1,293 |
| \$50,000 | 7.0% | 6.5% | -0.5% | \$1,263 | \$1,050 | -\$213 | \$175,000 | 8.5% | 8.0% | -0.5% | \$11,710 | \$10,392 | -\$1,318 |
| \$55,000 | 7.0% | 6.5% | -0.5% | \$1,613 | \$1,375 | -\$238 | \$180,000 | 8.5% | 8.0% | -0.5% | \$12,135 | \$10,792 | -\$1,343 |
| \$60,000 | 7.0% | 6.5% | -0.5% | \$1,963 | \$1,700 | -\$263 | \$185,000 | 8.5% | 8.0% | -0.5% | \$12,560 | \$11,192 | -\$1,368 |
| \$65,000 | 8.5% | 6.5% | -2.0% | \$2,360 | \$2,025 | -\$335 | \$190,000 | 8.5% | 8.0% | -0.5% | \$12,985 | \$11,592 | -\$1,393 |
| \$70,000 | 8.5% | 6.5% | -2.0% | \$2,785 | \$2,350 | -\$435 | \$195,000 | 8.5% | 8.0% | -0.5% | \$13,410 | \$11,992 | -\$1,418 |
| \$75,000 | 8.5% | 6.5% | -2.0% | \$3,210 | \$2,675 | -\$535 | \$200,000 | 8.5% | 8.0% | -0.5% | \$13,835 | \$12,392 | -\$1,443 |
| \$80,000 | 8.5% | 6.5% | -2.0% | \$3,635 | \$3,000 | -\$635 | \$205,000 | 8.5% | 8.0% | -0.5% | \$14,260 | \$12,792 | -\$1,468 |
| \$85,000 | 8.5% | 6.5% | -2.0% | \$4,060 | \$3,325 | -\$735 | \$210,000 | 8.5% | 8.0% | -0.5% | \$14,685 | \$13,192 | -\$1,493 |
| \$90,000 | 8.5% | 6.5% | -2.0% | \$4,485 | \$3,650 | -\$835 | \$215,000 | 8.5% | 8.0% | -0.5% | \$15,110 | \$13,592 | -\$1,518 |
| \$95,000 | 8.5% | 8.0% | -0.5% | \$4,910 | \$3,992 | -\$918 | \$220,000 | 8.5% | 8.0% | -0.5% | \$15,535 | \$13,992 | -\$1,543 |
| \$100,000 | 8.5% | 8.0% | -0.5% | \$5,335 | \$4,392 | -\$943 | \$225,000 | 8.5% | 8.0% | -0.5% | \$15,960 | \$14,392 | -\$1,568 |
| \$105,000 | 8.5% | 8.0% | -0.5% | \$5,760 | \$4,792 | -\$968 | \$230,000 | 8.5% | 8.0% | -0.5% | \$16,385 | \$14,792 | -\$1,593 |
| \$110,000 | 8.5% | 8.0% | -0.5% | \$6,185 | \$5,192 | -\$993 | \$235,000 | 8.5% | 8.0% | -0.5% | \$16,810 | \$15,192 | -\$1,618 |
| \$115,000 | 8.5% | 8.0% | -0.5% | \$6,610 | \$5,592 | -\$1,018 | \$240,000 | 8.5% | 8.0% | -0.5% | \$17,235 | \$15,592 | -\$1,643 |
| \$120,000 | 8.5% | 8.0% | -0.5% | \$7,035 | \$5,992 | -\$1,043 | \$245,000 | 8.5% | 6.5% | -2.0% | \$17,660 | \$15,925 | -\$1,735 |
| \$125,000 | 8.5% | 8.0% | -0.5% | \$7,460 | \$6,392 | -\$1,068 | \$250,000 | 8.5% | 6.5% | -2.0% | \$18,085 | \$16,250 | -\$1,835 |

Source: Maine Legislature, The Maine Heritage Policy Center.

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Path to Prosperity is a special series of publications by The Maine Heritage Policy Center which focus on Maine's overspending and the resulting tax burden that threaten long-term, stable, sustainable prosperity. All information is from sources considered reliable, but may be subject to inaccuracies, omissions, and modifications.

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