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Whose Tax Burden? Whose Tax Fairness? And Whose Tax Reform?

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Current efforts to reform Maine's tax system represent no new business, according to Christopher "Kit" St. John. In this second article on the issue of tax reform, St. John suggests we re-examine reform principles in Maine and, more particularly, reassess conventional wisdom that professes a relationship between tax reform and economic competitiveness. He examines recent reform proposals and offers a path forward--one based on relieving tax burden while maintaining tax fairness, especially for low income citizens of Maine.

by Christopher "Kit" St. John

Is 1998 the Year for Tax Reform in Maine

There were many signs that 1997 might just be the year for significant change in Maine's tax structure, but at least for now the Legislature has carried that task over to the next session. Among the unusual signs were: a citizens' petition for a property tax cap that failed to achieve sufficient signatures but which may have more lives than the proverbial cat; the Maine Municipal Association (MMA) proposing a major tax reform initiative; the stated intention of the House and Senate Taxation Committee co-chairs that their committee report out a single comprehensive tax reform bill; and Governor Angus S. King devoting the featured place in his State of the State message to his proposals and principles for tax reform. Finally, an MMA-sponsored survey in July 1996 found that 77 percent of respondents agreed that "we need a major overhaul of the entire tax situation" (Gove, 1997).

While the accumulation of such signs is unusual, talk of tax reform is apparently easy, since various committees and commissions have addressed the subject often during the past twenty years. Charles Colgan, who has watched and helped several such efforts, observed at a Maine Business Alliance Foundation conference in September 1995 that perhaps Maine has exactly the tax system citizens want, since similar complaints have been made for twenty years without much resulting change. This article reviews common principles for an ideal state tax system, the ways in which Maine's tax system compares to such ideals and other state systems, and how recent reform proposals measure against such ideals.

What Exactly is Tax Reform

Several principles appear frequently in recent literature on state tax systems and are worth keeping in mind as individual proposals for tax law changes are considered.

A recent report published by the Corporation for Enterprise Development, *Improving Your Business Climate: A Guide to Smarter Public Investments in Economic Development*, laid out a set of principles drawn from joint work by the National Conference of State Legislatures, the National Governors Association, and the National Association of State Tax Administrators. A well-structured state tax system will meet the state's needs for investment, will be predictable, will treat different businesses and different industries neutrally and equitably, will balance different revenue sources, and will be fair or "shield the subsistence income of the poor from taxes, extract a reasonable contribution from those most able to pay, and treat businesses and households with the same income equitably." It also will provide some fiscal equalization to balance the resources available for public services in different regions, will be efficient in administration and easy to understand, and will not push the state extremely out of line with other states. (See e.g., *Financing State Government*, National Conference of State Legislatures et al, 1995, or *Principles of a High Quality State Revenue System*, NCSL, November, 1992.)

In his State of the State address last January, Governor King summarized some of these principles. He said any tax cuts should be "targeted to do the most good, benefit the most people, make the most sense . . . Tax cuts . . . should truly lower the overall tax burden in Maine, not just shift it to the towns. . . . Tax cuts should not shift the burden to the working poor. . . . They should alleviate our over-reliance on the property tax; and they should ease the volatility of our tax system which now swings wildly with slight variations in the economy" (*Kennebec Journal*, January 29, 1997).

While there appears to be considerable national consensus among knowledgeable observers about these objectives, they are not easy to reconcile. Progress on one principle sometimes can conflict with another principle. Some ways of making the tax system more stable, for example, also might make it more regressive. In the end, tax reform will result in the balance of those principles that appear most desirable to the policy makers making the particular choices at a given time. Different states end up with different tax systems, in part due to differing judgments about which principles should be given greater weight.

How Does Maine Compare

There are several ways of comparing state tax systems. The current administration has chosen the ratio of total state and local revenues to total personal income.

Using data drawn by the State Planning Office from the U.S. Census for 1994 (state) and 1993 (local), Maine's total taxes per capita rank twenty-second among states. Because total personal income is low (ranked thirty-fourth among states), Maine ranks tenth in taxes expressed as a percentage of total personal income. In other words, although we are relatively poorer, we historically have chosen to tax ourselves (and our nonresident shoppers and property owners) higher to buy government services like education, health care, and corrections more comparable to those in richer states. These have been reasonable choices, like those of Vermont (thirty-first in income, seventh in taxes/income), or Wyoming (twenty-sixth in income, ninth in taxes/income), but not like those of Tennessee (thirty-sixth in income, forty-eighth in taxes/income) or New Hampshire (tenth in income, forty-sixth in taxes/income).

Another way of comparing state tax systems was devised by the Advisory Commission on Intergovernmental Relations (ACIR). The Representative Tax System (RTS) showed the average tax rate among states for twenty-seven different tax bases. Each state's tax capacity was measured by how much would be raised if that state used the RTS, while the state's tax effort was measured by comparing its actual revenue to its potential under the RTS. These results were indexed against the U.S. average as 100. Using this basis of comparison, Maine appears to have had a tax capacity about 15 percent below the U.S. average and a tax effort 5 percent over the U.S. average in 1975. For every year since then, Maine's tax effort has continued to exceed its tax capacity, but the gap has narrowed. In 1991 the tax effort was only 2 percent over the national average while tax capacity was only 5 percent below the national average. From this measure it could be concluded that Maine's tax burden was declining in comparison with other states, at least until the ACIR compilations were discontinued due to federal budget cuts. (See Kenyon et al, 1995.)

What is the Relationship Between Taxes and Business Development

Many governors and other observers have claimed that states with higher taxes have slower economic growth, and that conversely reductions in taxes will lead to increases in economic activity. However, a further look at the comparisons of tax burdens and personal income among the states raises serious questions about this connection. For example, of the ten states with the lowest per capita state and local taxes, seven also are among the ten states with the lowest per capita income. In addition, six states are among the ten with the lowest taxes as a percentage of personal income. On the other hand, among the top ten states in total state and local taxes per capita (such as New York, Connecticut, and Alaska), seven are among the top ten in per capita income, with seven also among the top ten of total taxes as a percentage of total personal income.

The power of anecdotes appears to be so great in this area as to lead many to misstate or misinterpret the data. Because all states are vulnerable to the geographic mobility of capital and intense international competition, we also are vulnerable to misleading explanations of what will help us "win" in the perceived competition for business.

Robert Tannenwald, senior economist at the Federal Reserve Bank of Boston, looks at tax competitiveness "through the eyes of a rational, profit-maximizing business executive weighing alternative sites for a new facility" (1996). He points out that some of the most commonly used measures to compare state taxes in fact don't represent the actual tax impacts on particular firms, and that the actual tax differences between states are small. He therefore constructs a model of representative firms and compares after-tax returns for investments by the firms in a sample of states. By this measure (using 1991 data), Maine ranks (in estimated average after-tax rates of return for selected manufacturing industries) in the middle of the New England states, 0.2 percent in rate of return below New Hampshire, 0.1 percent below Massachusetts, the same as Rhode Island, 0.1 above Vermont, and 0.6 above Connecticut.

Tannenwald then used the representative firm model to estimate the impact of tax differences on business capital spending and "found a small effect that was statistically insignificant." He concluded: "While tax characteristics may affect a state's competitiveness, policy makers should

view with caution claims that changes in tax policy will dramatically improve their state's economy. Enhancing public services valued by firms may be a more effective economic development strategy."

Robert Lynch recently published an exhaustive survey of the growing literature evaluating tax effects on business decisions, "Do State and Local Tax Incentives Work" (1996) and concluded that "there is no evidence that state and local tax cuts, when paid for by reducing public services, stimulate economic activity or create jobs. There is little evidence that the level of state and local taxation figures prominently in business location decisions. State and local business tax incentives and financial inducements are not the only, or even the primary, influence on business investment decisions. Factors such as the cost and quality of labor, the quality of public services (schools, roads and highways, sewer systems, recreational facilities, higher education, health services, etc.), the proximity to markets, and the access to raw materials and supplies are more important than tax incentives in business location decisions."

A final argument against the claimed effects of tax burden on economic growth comes from Robert Ady of the lead business location firm, Deloitte and Touche/Fantus Consulting, in comments at a symposium, The Effect of State and Local Public Policies on Economic Development, sponsored by the Federal Reserve Bank of Boston in November 1996. He concluded: "In the facility location process, taxes are not relatively important when compared to other cost factors such as labor, transportation, utility, and occupancy costs. The only case where taxes alone could sway a location decision is if a company is relocating within a relatively autonomous geographic area, such as within a city or metropolitan area, when labor, transportation, and utility costs are consistent; then tax variations, and frequently occupancy costs, can be the final determinant."

In addition to these surveys of academic and practitioner literature, Maine citizens can measure the likelihood of taxes affecting business and individual decisions about location and investment with their own experiences and observations. For generations there has been a flow of Maine natives leaving the state to find better economic opportunity. In the 1970s, '80s, and '90s there has been an equal, and in some years greater flow of people "from away" moving to Maine to take up permanent residence.

Among both those born here and out-of-state in almost any occupation, Maine residents can see other places where they could earn more, or have lower expenses. Yet we residents are still here, apparently having decided that some noneconomic benefits outweigh the theoretical "economically correct" choice of moving. While most of us don't control large amounts of investment, those of us who live in the coastal counties and areas of Oxford, Somerset, and Penobscot counties have watched neighbors move in who apparently do. The data shows that York, Cumberland, Sagadahoc, Lincoln, Knox, Waldo, and Hancock counties all have shown rapid increases in population and income in recent years. While lobster landings are indeed up, it is not enough to explain these numbers.

Of course, we know much of the income and population growth results from substantial migration of people from away, apparently undeterred by those high tax rates (top income tax rates of 10 percent before 1988) that some would tell us will prevent people from investing in

Maine. People like Harvey Picker of Wayfarer Marine, or Dodge Morgan of the Casco Bay Weekly and Maine Times, or Betty Noyce of Nissen Bakeries, Maine Bank and Trust, and so many more enterprises, apparently hadn't heard or didn't believe that Maine is not a competitive place in which to do business.

If Tax Competition is not a Good Reason for Reform, What is?

Returning to the issue of principles of a good tax system, Maine's current tax structure measures better than many states, but is not perfect. The challenge will be to ensure that change leads in a direction that improves it by these measures. The Corporation for Enterprise Development issues an annual Development Report Card for the States. Because of the difficulties discussed above with overall tax burden comparisons and the questionable relationship of overall burden to economic growth, the report does not include tax burden in its areas measured but does assess tax systems' stability and balance, fairness, and the degree to which fiscal equalization takes place between municipalities or regions of the state.

Combining all these measures, Maine ranks well--eleventh among the states. Maine's total score and good ranking benefits most from how well Maine's tax system compares to other states on measures of fairness--ranking fifth among all states. In other comparisons, Maine does not do so well. On the tax equalization measures used by the report Maine ranks thirtieth; and on the measures of stability and balance Maine ranks thirty-sixth.

Stability and balance have been noted as problems in Maine's tax system by the governor and have been discussed widely by many observers. (See e.g., LaPlante and Devlin, 1993; LaPlante, 1995; Young, 1997; Kenyon et al, 1995.) The problems of instability were illustrated dramatically in 1990 when the state's revenue collections fell sharply with the recession, declining nearly 4 percent faster than personal income. Causes of the instability generally have been attributed to a quite progressive income tax and a sales tax in which sales of a few durable goods--automobiles, building materials, and appliances--account for a disproportionate share of total revenues. When recession hits, middle income households may lose hours of work and earnings, which drop them into a lower income tax bracket. They are likely to postpone such large discretionary purchases as cars and home improvements.

A balance among revenue sources is considered valuable to divide the revenue burden more equitably among different economic activities and to promote stability, as temporary shortfalls in one area may be covered by collections in another area. The pieces of the system that appear somewhat out of balance in Maine is its higher-than-average reliance on the property tax and slightly lower reliance on business taxes than many states. Considering state and local revenues together, the property tax was estimated by the State Planning Office in 1996 to be 34 percent of all state-local revenues and 44 percent of the "big three" of sales, income and property taxes. The share of property taxes in the total rose dramatically in the early 1990s as state revenues declined, and property taxes were raised to compensate for the failure of state aid to municipalities and school districts to increase.

From individual citizens' point of view, the most important effect of the state's tax system is what part of their household income they have to part with, and whether their burden seems fair

in comparison with those of other households. The Institute on Taxation and Economic Policy in Washington has constructed a microsimulation model combining large samples of household data from Internal Revenue Service files and the U.S. Census. The model was used in its July 1996 report, *Who Pays? A Distributional Analysis of Fifty State Tax Systems*. The report shows that for most income groups, the total of all state taxes amounts to about 10 percent of income, but that the share of income spent on all taxes by the bottom 20 percent of households is 11.5 percent of income. In other words, for the average married couple in this group with an income of \$15,800, the state is collecting \$1,838 in total taxes, even though the amount this household owes in income tax is very little. Thus, even though Maine compares favorably in tax fairness to other states, which have much more regressive tax systems, Maine's system is not progressive on the whole and imposes a particularly difficult burden on lower income taxpayers.

How do Current Proposals for Reform Measure Against the Objectives?

While the majority of the Legislature recently voted to repeal the income tax cap enacted in 1995, many legislators still favor some form of income tax relief. Thus, it remains important to analyze how such proposals affect the objectives of a better overall system. Any proposal that like the income tax cap reduces income tax rates equally at every bracket will reduce the progressivity of the total tax system, will likely shift the tax mix further out of balance as property taxes bear costs shifted from lost state revenues, and will provide little or no relief to the lowest income taxpayers who currently bear the greatest burden. While in the current context it may seem partisan to frown on income tax cuts, it must be remembered that Maine's highly progressive income tax was created and maintained by Republican-led Legislatures for many years before the current debate, for the explicit purpose of relieving and equalizing regressive property tax burdens.

Another problem with income tax relief is that since the state income tax is deductible on federal taxes, a part of state income tax relief ends up resulting in higher federal income tax obligations for those who itemize. As a result, as much as a third of the dollars given up by the state simply gets rerouted to Washington.

The Bureau of Taxation compiled projections of tax reductions that would have flowed to Maine income taxpayers under the enacted--and repealed--cap. In the first year, the bottom 10 percent of income taxpayers would have received a reduction of forty-five cents; the middle would have received reductions ranging from \$14 to \$24; while the top 10 percent of taxpayers would have received benefits averaging \$279.

The current administration proposed an alternative approach to income tax relief, which has some benefits in not being as steeply regressive, but suffers from the other problems of any income tax relief. Increasing the personal exemption from \$2,100 to the federal level of \$2,550 would provide tax relief of \$36 for a household of four with a \$20,000 gross income (using the standard deduction), \$81 for a household with \$30,000 in income, and \$153 for households of \$60,000 and more. The current administration also proposed to raise the income tax filing threshold to the federal level, which would remove some 150,000 households from income tax liabilities, averaging \$16. While the latter has strong supporting administrative efficiency arguments, it does not provide significant increases in other objectives, such as fairness.

The Maine Municipal Association offered a more ambitious proposal, which meets more of the objectives of tax reform. Citing the disproportionate reliance on the property tax as the major problem, MMA proposed that residential property taxes be reduced by providing a homestead exemption of \$20,000 off the valuation of all owner-occupied primary residences. The state would provide reimbursement to the municipalities for the estimated \$115 million in lost revenue by expanding the sales tax base to cover most services not presently taxed. MMA also would establish a "service charge" for currently tax-exempt property owners such as the state, private educational institutions, hospitals, and nursing homes that would be based on municipal costs without education and welfare.

The proposed homestead exemption both redresses some of the disproportionate reliance on property taxes in the state's mix and provides some greater progressivity to the burden of property taxes on households. All primary residences would get the same amount of valuation reduction, but both because lower income households tend to have lower-valued residences and because their property tax is a higher proportion of their income, the exemption would provide them greater benefit as a proportion of income. In an example MMA provides, at the same mill rate of 16.80, the owner of a \$60,000 house would get \$336, or 33 percent, off their tax bill; the owner of a \$100,000 house would get the same dollar reduction, which would be 20 percent off the tax bill; and the same reduction would be 11.1 percent off the tax bill on a \$180,000 house. Viewed as a percentage of income, the exemption in these cases would represent a 2.2 percent reduction in the proportion of income taxed (or almost one-fifth of all taxes) in the average bottom quintile household with income of \$15,800. For the middle income household with \$41,200 in income, it would represent a reduction of 0.8 percent of income (about 8 percent of all taxes); and for the household with \$74,200, it would represent 0.45 percent of income, or about 4 percent of all taxes.

The proposal to expand the sales tax to services addresses the instability caused by the narrowness of the current sales tax base. While all sales taxes suffer some ups and downs with the business cycle, collections from the purchase of services tend to be more stable than from the purchases of a few large-ticket goods. As a greater portion of economic activity takes place within the service sector and moves away from the traditional goods-producing sectors, a broadened sales tax base has a greater chance of increasing at a rate similar to the underlying economy. In a recent survey by the Federation of Tax Administrators, only sixteen states tax fewer services than Maine. Calculations by Charles Colgan for the Maine Municipal Association show that sales taxes on services would have slightly reduced the volatility of the sales tax during the last decade and would have been less volatile than the property tax.

A calculation by the Institute on Taxation and Economic Policy, using its microsimulation model of Maine's current tax system and the proposed addition of sales taxes on services, showed that the additional sales taxes would be moderately regressive by themselves. The average tax that would be paid by those in the top 20 percent of income earners would be nearly seven times that paid by those in the lowest 20 percent. But the proportion of income paid through the sales tax on services by those in the lowest 20 percent of income earners is 0.59 percent, while the top 20 percent of income earners would pay 0.33 percent of their income.

On the other hand, the proposed homestead exemption on property taxes was found to be moderately progressive, benefiting low income homeowners more than higher income households. Most homeowners, both low and middle-to-upper-middle income, would receive greater property tax reductions than they would receive increases in sales tax under this combination of proposals. Renters, however, would not receive the benefit of the homestead exemption. This could be remedied at least for low income renters by expanding the Maine Residents Property Tax Relief ("circuit-breaker") program.

MMA's proposal to require service "fees" on nonprofit buildings currently exempt naturally raises particular problems for organizations not currently paying taxes, just as the collection of sales taxes by service providers not currently subject to sales tax naturally gives rise to objections. But there is fundamentally sound logic behind the proposal that the service center communities where large nonprofit property ownership is concentrated currently have to shift the cost of snow plowing, police, and fire services for such buildings to other property owners. While not uniformly true, such service center communities tend to have higher property tax mill rates than more rural and suburban towns. There is an argument that the cost of municipal services for such facilities as hospitals and schools should be borne by all who use them rather than simply by the residents and businesses in the town where the facilities are located. Thus, the service charge to nonprofits gets at both the objectives of general property tax relief and, specifically, at equalizing the fiscal burdens among different municipalities in the state.

How Does Increasing the Cigarette Tax Fit the Reform Agenda?

Another part of the tax reform puzzle this year were the proposals to increase the cigarette tax by varying amounts from thirty-four cents to \$1. None of these proponents argued that such a tax in itself contributes much to tax reform: The purpose is to decrease smoking, especially among teens, so the tax cannot be viewed simultaneously as a reliable long-term source of revenue. As a proportion of income, such a consumption tax naturally falls heaviest on those households with the least income.

In addition to the positive impact on public health all proponents see flowing from the increased tax, all would use a portion of the proceeds for anti-smoking activities. In addition, one proposal urged expanding health coverage for low income children, their parents, and elders for prescription drugs. The administration's proposal, on the other hand, was to use the proceeds to fund the administration's income tax proposals discussed above. From a tax equity point of view, this involves using a quite regressive tax to relieve the most progressive source of revenue, hardly the direction of reform.

Tax Relief for Those Who Need it Most

In this mix of proposals, the MMA's combination offered the greatest impact on both over reliance on property tax, modest improvements in stability, and at least not serious erosions of progressivity. More substantial improvements in progressivity could be achieved by the last tax reform idea to be reviewed here: the recommendation of the Commission to Study Poverty Among Working Parents to adopt a state earned income tax credit.

The enactment of a state earned income tax credit that would provide eligible households a percentage of the federal earned income tax credit presents both the best opportunity to reduce poverty among families with children and the fairest and most effective way of targeting tax relief to those who face the biggest current tax burdens. It was the recognition of both the injustice of federal payroll taxes and the justice of "making work pay" that has led to the bipartisan support of three presidents and sessions of Congress spanning two decades for the creation in 1975 and subsequent expansion (in 1986 and 1993) of the Earned Income Tax Credit (EIC) on the federal level. Since the EIC is refundable, a family receives a check from the government if the credit exceeds the family's federal income tax bill. For example, a married couple with two children and earnings of \$18,000 would qualify for an EIC of \$2,216. The family would owe a federal income tax of \$163 and would receive a check for the difference (\$2,216 minus \$163, or \$2,053) in addition to any withholding.

A state earned income tax credit could be awarded simply as a proportion of the federal credit. Following the example above, a 30 percent state credit would add \$615 to household income, or reduce the burden of property and sales taxes by that amount--about a third of total taxes. A state earned income tax credit at 30 percent of the federal credit is estimated to cost \$19 million in the first year and \$24 million in future years. That's less than two-thirds of the \$34 million needed for the administration's proposed income tax relief measures, or the amount raised by the smallest proposed cigarette tax increase.

Easy to Make Maine's Tax System Worse; Difficult, but Not Impossible to Improve it.

These choices illustrate the fundamental truth of tax reform--there is no free lunch. Providing relief for some taxpayers comes at the expense either of foregoing state services or, more likely, increases in some other form of tax. It is critical that all reforms be considered together to determine their impact on the tax system as a whole and on typical taxpaying households at different income levels. In the comparisons of Maine's tax system to other states discussed above, Maine's current tax mix has measured well against the ideals many observers profess and has stood up against many earlier proposals for change. The challenge faced by policy makers now is not fundamentally different from those faced in earlier years, to make sure any changes contemplated make the system even better.

It is theoretically easy to construct a reform proposal that would improve Maine's tax system in line with several ideals. As discussed above, the MMA proposal offered gains in stability and balance among tax sources. The addition of a state earned income tax credit and strengthening the property tax circuit-breaker program could further enhance progressivity. (The various proposals to reduce income taxes, on the other hand, would continue to erode progressivity, with little gain on any of the other articulated objectives for the system.)

But the cost of achieving these changes within the tax system would be to require the collection of sales taxes by large numbers of businesses currently not required to make such collections. Representatives of such businesses understandably argued forcefully against such a new burden, and legislators at this session understandably abandoned the effort for now. It remains to be seen whether public complaints about property tax burdens are great enough to force more serious consideration of this choice next year.

It would be easy to criticize the Legislature for "doing nothing," but since opportunities to make the tax system worse seem greater than those to improve it, we may be grateful for its cautious approach. There are strong arguments, particularly the long-term need for revenue stability and adequacy, to revise the current system to reflect more effectively changes in the economy. To achieve that goal we must get beyond the political resistance to raise any tax, even to lower another one; educate ourselves better about how the right tax reforms actually could lower the overall burden for most citizens; and convince our representatives that such a benefit to the majority could be paid fairly by a minority with a greater ability to pay.

Christopher St. John serves as executive director of the Maine Center for Economic Policy, a small, nonprofit research organization that addresses Maine state tax and budget issues.

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