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Quest for A Competing Measure on Tax Reform

It's been a busy week for tax reform. Both the Taxation Committee and the Governor's Office have been fully engaged in an effort to develop consensus around a tax reform proposal that would compete against the citizen-initiated *School Finance and Tax Reform Act of 2003*. More ideas and alternative approaches in various combinations have been floated than can be recorded and fully explained in this *Bulletin*. The end of this article describes the proposal under consideration by the Taxation Committee as this edition of the *Bulletin* goes to press, but by the time this publication is in your hands, a very different configuration might be in the offing. The situation, as they say, is very fluid.

The place to begin is Governor Baldacci's proposal.

The Governor's Fiscal Reform Package. Since Thursday a week ago, the Taxation Committee has been engaged in work session-type discussions with members of Governor Baldacci's administration and outside consultants on the "fiscal reform" package that the Governor is proposing to compete on the November 4, 2003 ballot with the citizen-initiated proposal. At its centerpiece, the initiated proposal would require the state to provide the financial resources to pay 55% of the total statewide cost of K-12 education, widely understood be a 20-year old unfulfilled promise.

On Wednesday this week, an 8-hour public hearing on the Governor's proposal was held by the Taxation panel. The 55 page draft of the bill was available for review less than 24 hours in advance of the hearing and the testimony reflected that short review time by focusing on the several broad components of the bill rather than its details.

In summary, the proposal received mixed reviews. Many of the bill's supporters expressed reservations about some elements of the package. Some of the bill's opponents, expressed support for some of its provisions.

As reported in last week's *Bulletin*, the Governor's fiscal reform package contains 5 major elements.

1. Homestead Repeal. The Governor's plan repeals the property tax Homestead exemption and expands the Circuit Breaker property tax and rent rebate programs. Statewide, the Homestead provides $35 million of property tax relief and its repeal will increase residential property taxes by approximately 7% on average. Some of the affected homesteaders will be eligible for Circuit Breaker rebates in the following year if the household's property tax bill exceeds 3% of the household's income.

2. Personal Property Exemption. The Governor's plan exempts from property taxation all personal property that would be eligible for the Business Equipment Tax Reimbursement program (BETR) that is first placed in service after April 1, 2003 and all property currently enrolled in the BETR program when its 12-year enrollment period ends and it loses its BETR eligibility. The municipalities will gradually lose about 12% of the total municipal tax base because of this proposal, along with the tax revenue that is attributable to that tax base. 50% of that revenue loss would be reimbursed to the affected municipalities according to calculations of the exempted value executed by Maine Revenue Services (rather than the municipal assessor). The state would have the revenue to provide the 50% reimbursement because the state's obligation to reimburse eligible companies for 100% of their business tax obligations would be gradually phased-out.

In a non-specified way, the state's savings from having to pay the affected municipalities for only 50% of their revenue losses, rather than the 100% reimbursement to the businesses, would be loosely available in the state's General Fund to "incentivize" a reorganization of municipal government.

The 6% annual loss in municipal revenue, which is what municipalities would ultimately experience with this exemption (50% of the 12% loss in tax base) translates to an annual loss of $80 million. Although that annual loss would build up over time because of the phased-out nature of the exemption, it would be most acutely experienced in about 50 of Maine's industrial and service center communities.

3. Municipal Service Districts. The Governor's fiscal reform plan creates a system whereby 5 or more municipalities that encompass 2 or more school administrative units and populations greater than 20,000 can merge

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into single "Municipal Service Districts" (MSDs) that are governed by elected "District Councils". In order to merge into these municipal unions, each individual municipality would give up its town meeting and delegate its governance authority to the district council, school management authority to a single school board, and all individual school assets to a single school management district.

Some or all of Maine's "service center" communities could become eligible as an "MSD" if they try to merge with their respective neighbors but the union doesn't consummate.

It is from the money the state saves by prospectively repealing the personal property tax, that financial incentives would be provided to the MSDs. Those incentives would be: (1) 10% increases in education subsidy distributions for a 5-year period; (2) a state assumption of 50% of the participating municipalities' property tax supported general obligation debt as of June 30, 2003; and (3) state takeover of the participating municipalities' county assessments related to jails, the District Attorney's Office, and the registries of deeds and probate.

4. Local Option Taxation. The MSDs would also have access, under Governor Baldacci's plan, to levy a local option sales tax of 1%, to run for a period of no longer than 5 years, in order to finance major construction projects of regional impact, such as civic centers, regional public facilities and affordable housing.

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5. Income Tax Changes. Finally, the plan calls for an income tax swap whereby the automatic indexing of the four income tax brackets would be retarded in order to pay for a reduction in highest marginal rate. The plan would call for the highest income tax rate to ramp down from 8.5% to 7.75% over a 15-year period.

These 5 changes make up the Governor's proposed competing measure. Although there is nothing in this package that would increase the state's financial commitment to K-12 education, the question to the voters that the measure proposes to place on the competing ballot would be:

"Do you want the State to pay 55% of the cost of public education and lower property taxes by cutting government spending?"

Public Hearing. After the bill was introduced to the Tax Committee by its sponsor, Rep. Dave Lemoine (Old Orchard Beach), a couple of legislators from the State and Local Government Committee addressed the panel, expressing their concerns about the complexity of the legislation regarding Municipal Service Districts, and the long list of questions the proposal raised. They urged the Tax Committee to refer that section of the bill over to their Committee which has a natural jurisdiction over the matter. Rep. Chris Barstow (Gorham) and Rep. Stephen Bowen (Rockport) both explained how they had been working almost ceaselessly on regionalism issues all session and how the 30 pages of new municipal law proposed in the bill should not be rushed into a tax reform measure.

Rep. Bowen (Rockport), whose hometown was Penobscot in Hancock County, raised a series of questions concerning the MSD proposal that seems to capture a broad municipal viewpoint. Rep. Bowen's questions included:

- Why the mandatory minimums of 5 towns, 2 school systems, and 20,000 in population? Other effective consolidations that are less aggressive could provide important long-term benefits.
- Why not provide some incentives within existing governance systems to expand regional service delivery incentives? Why not work with what works?
- How are the interests of a small town protected when giving over governance to a voting block controlled from afar?
- What if the voters of a participating town feel a need to raise funds for their own protection, are the prohibited in doing so?
- If the larger regions control all land use regulation and zoning, why wouldn't a weak village in the new construct be rightfully concerned about being the landfill or junkyard siting area?

Rep. Bowen concluded that the proposal needed a good deal of work to make it an effective tool in the fight to reduce unnecessary governmental costs, and he again suggested the State and Local Government Committee be given the bill for further work sessions and mark-up.

The next hour of the public hearing consisted of a power-point presentation conducted by the former Director of the State Planning Office, Evan Richert, that was intended to provide the underpinnings of the Municipal Service District proposal. According to Richert, the MSD proposal is based on three principles: (1) it is a model of "self assembly" or "self organization"; (2) towns are losing control of their destiny because their physical jurisdictions of 40-odd square miles are too small to influence the powerful economic forces that operate over much larger regions; and (3) people who run town government are very frugal, but despite their frugality there are terrible inefficiencies because of the small physical jurisdictions within which they operate, forcing a duplication of services.

The message is that in the face of globalization, the modern paradigm that small towns must adapt to are regionalization and consolidation. If they fail to do that, Richert suggests, they will slip into an irrelevancy.

To support his claim regarding the alleged dichotomy between municipal frugality and inefficiency, Richert

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made the claim that when compared to 5 other "peer states" (Idaho, West Virginia, the Dakotas and Oregon), Maine had considerably more local government employees, and that difference was attributable to Maine's large number of local governments and schools. Richert's claim is that the relative efficiency of these peer states is based on their county rather than municipal orientation. Small counties, Richert claims, appears to be the more efficient unit of local government, and the Governor's plan is designed to reshape the state into 60 – 80 Municipal Service Districts rather than 490 municipalities.

If this is done, according to Richert, the state would save $125 - $150 million a year through the elimination of 3,000 – 4,000 local government jobs and the construction of fewer government facilities.

Richert stressed that formation of MSDs would be entirely voluntary – built from the "bottom up" – and "incentivized" through the redistribution of what amounts to the personal property tax revenue losses that certain municipalities will experience through the personal property tax exemption.

Richert's presentation at the public hearing was followed by an extended presentation by Laurie Lachance, the State Economist, who described the lack of vibrancy in Maine's economy today. Lachance traced one contributing factor to this weak economy to Maine's high tax burden, with the inefficiency of local government service delivery a contributing factor to the tax burden problem. A common refrain of Lachance and the Governor's advocacy team is that 68% of all taxes in Maine are raised at the state level but roughly 60% of all government spending is at the local level, and regardless of how much money the state "passes through" to the municipalities, the property tax problem doesn't go away.

In the state's analysis, General Purpose Aid to Education, adult education support, teacher retirement premiums, district attorney salaries, county jail prisoner support, etc., are all considered to be "pass through" money that the state provides the municipalities. K-12 education, in this analysis, is considered to be an entirely local function that the state supports through its generosity rather than as a core state responsibility.

Two archetypal stories have been used repeatedly over the last week by Richert and Lachance to support the Municipal Service District proposal. The first involves the construction of a public safety building in South Portland that was followed several years later by the construction of a public safety building in Cape Elizabeth just five miles distant – something Richert says would never be done if South Portland and the Cape were the same governmental entity.

The other often-used observation is that Millinocket and East Millinocket were poised to conjoin, at least into a single school district, during the crisis of the paper mill bankruptcy. The allegation is that as the crisis passed, so did the willingness to consolidate.

Lachance concluded her testimony with the observation that the citizen initiated *School Finance and Tax Reform Act of 2003* represents an enormous "gift" to the State in its role of applying the necessary pressure to make the structural changes important to Maine's future, such as those embodied in the Governor's fiscal reform package.

Business Support. Five representatives of the business and industrial community testified in support of the Governor's plan. The testimony from National Semiconducter, Tambrands, Unum, and Maine Pulp and Paper focused on the importance of repealing the tax on personal property, and the additional importance of repealing that tax in the manner specified in the Governor's bill to ensure a parallel phase-out, rather than the abrupt end, of the BETR program. The business testimony also supported the goal of reducing the number of local governments.

Chris Hall of the Maine State Chamber of Commerce testified in the support of most of the elements of the bill, but he did not recommend the package to be sent out as a competing measure. Hall suggested that the Taxation Committee refer the entire Municipal Service District component of the proposal, which takes up approximately 30 pages of the bill, over to the State and Local Government Committee to continue to work with the idea and bring in the collaborative efforts of both the business and municipal communities.

Similarly, Hall recommended pulling the personal property tax exemption out of the competing measure and continue to work on that proposal until the affected municipalities are more comfortable with it, and then proceed with a simple statutory enactment. Hall observed that the income tax proposal was purely regressive and set up a dangerous policy dynamic if it were part of competing measure, and noted that the Chamber has historically opposed a local option sales tax. Hall said that the business community expressed considerable support for an element of tax reform that was not in the Governor's proposal, which was the full implementation of the Essential Programs and Services school funding model with the 10 mill cap (or 10 mill "expectation") school funding formula. Hall even indicated that there was support within the business community for properly funding that model, which would shift $136 million of annual property tax effort to the state, provided it was accomplished within an overall package that reduced Maine's tax burden.

Other interest groups. An eclectic group of other interests testified in support of the bill, but in most cases it was not entirely clear why. Groups that support social service programs and advocate for the needs of people with low incomes (Maine Center for Economic Policy, Dirigo Alliance, Maine Womens' Lobby, Roman Catholic Dioceses of Portland, etc.) spoke in support of the measure because of the conversion of the Homestead Exemption

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to the Circuit Breaker program, but their testimony was often in opposition to several elements of the bill. They did not support its regressive change to the income tax or the shift in property tax burden from industrial owners to homeowners as would occur with the personal property exemption as crafted. The Maine Innkeepers Association stood up in favor of the bill but opposed the local option tax. The Maine County Commissioners Association stood up in favor of the bill but wondered what the effect of municipal services districting would be on county government as it presently exists, which would be appear to be eventual abolishment.

The mayor of Portland, Jim Cloutier, spoke in favor of the bill because of the local option sales tax component, but expressed deep concerns about the bill's impact on the City in other areas. For example, Portland would lose access to a dynamic and growing aspect of its tax base (personal property) just at a time when the real estate market is causing a tremendous shift in property tax burden from the commercial sector onto the residential sector.

Opposition testimony. MMA, the Maine Service Center Coalition, the Maine School Superintendents' Association and the Maine School Boards' Association spoke in opposition to the bill. The Maine Education Association spoke "neither for nor against" the proposal. John Melrose said that the necessary components of a tax reform package from the perspective of service center communities were balance to the tax mix, reduction in tax burden, and mechanisms to address the problem of property tax rate disparity, where service center tax rates tend to be so much higher than the property tax rates of their suburban and rural neighbors. Melrose said that the Service Center Coalition supported the citizen initiated measure to compel the state to honor its long unfulfilled obligation to pay for 55% of K-12 education. Melrose also provided the Committee with a laundry list of recommended changes or additions to the bill to make it more effective from the more urban municipal perspective.

MMA testified in opposition to the bill because it failed to address almost all of the five principles of tax reform which the municipalities believe should be a part of any comprehensive tax reform package: (1) property tax relief through increased state funding for education; (2) stability in state revenue; (3) modernization of the tax code; (4) balance among the three major taxes; and (5) collaborative tax burden and services-delivery management. The testimony of the school folks focused on the disruption in school governance that would result from the creation of Municipal Services Dis-

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Taxation Committee members, Sen. Ethan Strimling of Cumberland County (left) and Sen. Richard Nass of York County have been key figures, from different perspectives, in the Tax Reform debate.

TAX REFORM (cont'd)

tricts and the loss of town meeting access to the school budget approval process.

Where are we now?

About 12 hours after adjourning the public hearing for the night, the Taxation Committee reconvened for two purposes.

First, the Committee received a more penetrating analysis by the Department of Education's Jim Rier about the actual impacts of implementing the "10 mill expectation" school funding formula according to the Essential Programs and Services (EPS) funding model. Under this system, no municipality would be required to levy more than 10 (full value) mills in property taxation to support public education. The state would provide the difference between what 10 mills of effort raises locally and the "total allocation" as defined by the EPS model. Municipalities wishing to spend beyond EPS would be free to do so, but on their own nickel. There is growing support for the EPS model because it is hot-off-the-press, carefully researched, sophisticated, and light-years ahead of the existing allocation model, which is functionally bankrupt.

In an effort to address some of the confusion and rumors that inevitably crop up when changes are proposed to the school subsidy distribution system, Rier walked the Committee through the actual impacts on several school administrative units that would be variously affected by the changes, including Augusta, Gorham, Scarborough, Biddeford, Bangor, Portland, Sanford, SAD #71 (Kennebunk, Kennebunkport), SAD #53 (Burnham, Detroit, and Pittsfield), and SAD #64 (Bradford, Corinth, Hudson, Kenduskeag and Stetson).

The analysis shows the potential for substantial property tax relief in many communities throughout Maine and a status-quo effect or modest property tax relief possibilities for nearly all others. A few communities would be either pressured or required to raise more local dollars for the school under this proposal. In this small group are the communities that are not raising 10 mills for education currently and whose local contribution to education does not cover what EPS defines as the necessary and adequate level of financial support for the school system. Anyone interested in reviewing the material Jim Rier provided to the Committee should feel free to contact MMA's Laura Veilleux at 1-800-452-8786 or lveilleux@memun.org.

After the Rier presentation, the Taxation Committee settled down to identify the plan it would like to pass onto the full Legislature as the competing measure to the citizen initiative. The Committee seemed to immediately recognize that the Governor's plan was too big and complicated to adequately serve as a competing measure, and the Committee's task was to create a simple and directly competitive plan. Rep. Lemoine proposed the following alternative for the Committee's consideration.

- Full implementation of Essential Programs and Services with the 10 mill expectation funding model;
- A 1% meals and lodging local option tax, adopted by local referendum vote, with a five-year but renewable limit, and with the revenue generated dedicated to municipal purposes;
- A directive to the Legislature's State and Local Government Committee to report out legislation in 2004 that will create the Municipal Services District program; and
- The statutory, going-forward exemption of BETR-qualifying personal property going forward, with 50% municipal reimbursement for the lost revenue, except that a special constitutional exemption for business machinery and equipment would also be advanced, so that the state would not have to reimburse the municipalities for the lost value associated with that class of property.

After the presentation of that proposal, the Committee retreated into partisan caucuses to prepare their respective responses to the plan. The Republican response, expressed by Sen. Richard Nass (York Cty.), was to put forward nothing more as a competing measure except the school funding proposal. Sen. Nass said that the other elements of the plan should be picked up next year as regular statutory legislation, and no good purpose would be

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Taxation Committee members, Rep. Josh Tardy of Newport (left) and Rep. Earle McCormick of West Gardiner have worked to build consensus around the Tax Reform package.

TAX REFORM (cont'd)

served by confusing the competing measure with those ideas.

Sen. Nass expressed solid support for the EPS school funding model, which he considers a very important step in benchmarking for the first time in the state's history and in a responsible way what the costs of K-12 education should be both on a statewide basis and for the benefit of the local school boards. Sen. Nass indicated that his caucus swallows hard at the thought of adequately funding the new school model, which at the "10 mill expectation" level would increase the state share of education by $136 million a year, but appears to believe that the model deserves funding and full implementation.

Another advantage to the 10-mill-expectation proposal, Nass observed, over the citizen-initiated plan, is that the citizen initiated proposal prohibits the Legislature from properly funding education by appropriating other property tax relief resources (e.g., the Homestead Exemption, municipal revenue sharing, etc.). If the voters adopt the 10-mill alternative to the citizens' initiative, the Legislature's hands in 2004 would not be tied with respect to funding the educational commitment.

That is where the Committee wrapped it up on Thursday evening. The Democrats on the Committee have not yet articulated their caucus response to Rep. Lemoine's proposal.