

Maine Policy Review

Volume 6 | Issue 2

1997

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Recommended Citation

Lockwood, Christopher G. . "A Municipal Retrospective on Comprehensive Tax Reform." *Maine Policy Review* 6.2 (1997) : 68 -70, <https://digitalcommons.library.umaine.edu/mpr/vol6/iss2/13>.

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Commentary

More on Tax Reform

A municipal retrospective on comprehensive tax reform

Maine Policy Review (1997). Volume 6, Number 2

by Christopher G. Lockwood

What do a bungee cord, an unbalanced wheel, and a roller coaster have to do with tax reform? These might not be the most scholarly metaphors, but they serve a useful purpose in illustrating the difficulty of addressing important policy issues, such as tax reform, in Maine's current political climate and, in all likelihood, in most other states across the country.

Long-standing structural problems

Let's look back to the summer of 1996. For the second straight year, proponents of a drastic property tax rollback referendum drive continued to gather signatures. If enacted, this proposal would have created a budget shortfall of more than \$440 million needed to fund basic municipal services (fire, police, roads, snowplowing, etc.) and local education. Maine's economy and quality of life would face drastic upheaval as municipal and school budgets were stripped to austerity levels. The Legislature would be faced with a pressing demand to address this budget shortfall through state-level taxes.

At the same time, preliminary information suggested state government's budget shortfall for the next biennium would range from \$325-\$430 million, in part due to the income tax cap that would take effect in July 1997. With the experience of the early 1990s' state budget crisis as a guide, it was clear this state-level budget shortfall would likely result in another shift of costs onto the local property tax.

Nearly a dozen studies during the past fifteen years have identified Maine's over-reliance on the property tax, together with the volatility of Maine's tax structure (e.g., narrow sales tax base subject to significant fluctuations during economic swings), as important issues that should be addressed. In her 1993 "Dollars and Sense—Maine State Budgeting at a Crossroads," University of Southern Maine Professor Josephine LaPlante made the following observation:

"The dominance of two highly volatile revenue types within our overall tax structure makes state programs far too susceptible to the 'bungee cord' effect— spiraling increases in funding followed by sharp and potentially severe cutbacks."

Likewise, the imbalance among Maine's three major taxes (sales tax-28 percent, income tax-28 percent, and property tax-44 percent) could be likened to an unbalanced wheel with the weights unevenly distributed. This imbalance causes uneven wear and could lead to a number of serious problems if not corrected.

A call for comprehensive tax reform

Faced with this situation, the executive committee of the Maine Municipal Association (MMA) invited a small group of distinguished individuals (municipal officials, legislators, business representatives) for advice. A centerpiece of the committee's work was a major survey of 600 Maine citizens on an array of tax policy questions. The survey had three major findings:

- Seventy-seven percent of those surveyed supported a comprehensive change in Maine's tax structure.
- The property tax was identified as the major source of concern (by a 2.5-to-1 ratio compared to either the income tax or sales tax).
- Seventy-four percent wanted an opportunity to vote on any restructuring.

The committee made two major recommendations. First, MMA should embark on an effort to establish comprehensive tax reform, with a focus on reducing Maine's reliance on the property tax, as a top priority for action in the first session of the 118th Legislature. Second, MMA should formulate a proposal for consideration by the Legislature, with a referendum provision that would allow citizens to have final approval and which hopefully would avoid inaction or referral to another study commission.

The overall strategy

MMA launched an informational campaign prior to the November 1996 election to bring attention to the need for comprehensive tax reform. This effort included regional meetings with legislative candidates and municipal officials in nearly every state Senate district, meetings with members of legislative leadership and the governor, meetings with editorial boards, and correspondence with a number of organizations.

At that point, MMA was promoting the broad concept of comprehensive tax reform with the hope of establishing this as a priority issue for action in 1997. The Maine Municipal Association identified the following guiding principles:

- aggregate revenue neutrality.
- reduce volatility of tax structure during economic cycles.
- achieve roughly equal balance among sales, income, and property taxes.
- honor fundamental principles of tax policy (e.g., equity, stability, balance, and accountability).

It was our hope that this approach would allow significant latitude to craft a proposal that would address fundamental tax structure problems and establish a sound financial foundation to provide necessary governmental services as Maine entered the next century. For example, a well-considered tax policy would allow the state to mesh its economic development strategy with targeted incentives to ensure appropriate educational opportunities and to maintain important social services.

The "roller coaster" ride

As we embarked upon the monumental undertaking of promoting comprehensive tax reform, we knew this would be a difficult, if not impossible, assignment. We also knew the Maine Municipal Association could not accomplish this on its own. We were hopeful, however, that we might develop a political climate in which individuals and organizations involved in the

public policy process would come together to address Maine's tax structure issues on a constructive basis, before a crisis occurred that would narrow the options available to the Legislature and the governor.

In many ways, MMA's experience in promoting comprehensive tax reform has been a "roller coaster" experience. It has been replete with the great highs one might associate with the initial ascent of a roller coaster, as well as the steep plunges and wild twists and turns. The experience raises a fundamental question. Is it possible to elevate the debate and dialogue on this critical issue to enable Maine's Legislature and governor to address structural tax system problems constructively before a crisis ensues?

Using the roller coaster metaphor, we were buoyed in the fall regional meetings with legislative candidates. It appeared candidates generally agreed with the concept of comprehensive tax reform, and that they shared the view that something needed to be done to reduce Maine's reliance on the local property tax. There also appeared to be support for reducing the volatility of the state's tax structure to avoid a repeat of the early 1990s' budget upheaval. Meetings with newspaper editorial boards also were encouraging. A number of editorials called for a comprehensive approach to tax reform during the 118th Legislature.

Several major challenges lay ahead. Working with potential sponsors and an ad hoc MMA Tax Structure Committee, we set out translating a broad concept into a specific proposal. Time pressures were enormous. We faced a late- December cloture deadline for bill submission, with little latitude for "concept" drafting. This severely constrained our ability to reach out to other organizations to invite participation in formulating a specific proposal. Nonetheless, we sought to communicate openly that our focus was on the overall goal of comprehensive tax reform that would be shaped through the legislative process. We were committed to bringing forward a responsible proposal as a starting point for discussion with the expectation that other parties would join in a commitment to address Maine's tax structure problems constructively—without waiting for a crisis.

The proposal that ultimately emerged was Legislative Document 1742—An Act to Comprehensively Realign the Tax Structure of the State. The major components of the proposal were:

- Homestead exemption— Enactment of a \$20,000 homestead exemption to reduce property taxes paid by Maine residential property taxpayers. Municipalities would be reimbursed by the state for 100 percent of the revenues lost to the homestead exemption.
- Expansion of the sales tax base— To generate revenues to reimburse municipalities for the homestead exemption, the sales tax base would be expanded to include selected services in the following currently exempt categories: amusement and recreation services, professional services, business services, and personal services.
- Expansion of the property tax base—Most structural property currently 100 percent exempt from property taxation would be subject to a partial in lieu service fee (not to exceed 50 percent) to cover the costs of municipal services (e.g., fire, police, snowplowing, etc., but not including education or welfare costs). "Benevolent and charitable" organizations also would be more precisely defined for purposes of property tax exemption.

- Referendum approval—The bill would be submitted to the voter for approval at the November 1997 general election. This approach would allow for a comprehensive proposal to be shaped through the legislative process while recognizing the strong interest of Maine citizens in having a voice on major changes to Maine's tax structure.

Unfortunately, the civil discourse plummeted as the broad concept of tax reform was translated into a specific proposal. Various interest groups focused on what they perceived to be negative aspects of the proposal—particularly the expansion of the sales tax base and the application of service charges to tax-exempt property. Without a crisis creating a clear and present threat, it became easier to focus on the potential shortcomings of a tax reform proposal than on the underlying structural problems in Maine's tax system. The message to many potential sponsors was that this would be a politically volatile issue rather than an affirmation that Maine citizens are looking for political leadership in addressing difficult issues constructively before a crisis ensues.

Nonetheless, throughout the process there continued to be high points. Early in the session, the Taxation Committee identified comprehensive tax reform as a major goal. The committee devoted a significant block of time each week to become conversant with tax policy issues, previous studies, and the tax structure of other states. Sen. Jill Goldthwait and Rep. Marc Vigue manifested political leadership through their willingness to sponsor LD 1742. A number of newspapers also went beyond general support of the concept of comprehensive tax reform through their editorial endorsement of LD 1742, and the Maine chapter of the American Association of Retired Persons joined in formal support at the public hearing on the measure.

Ultimately, however, comprehensive tax reform did not take place during the 1997 session of the 118th Legislature. Although there is hope that a tax reform proposal will emerge from the series of meetings the Taxation Committee will be conducting prior to the second session, it was clear a political consensus did not yet exist to address Maine's structural tax system problems.

Where do we go from here?

The structural problems remain. The Taxation Committee is scheduled to meet several times prior to the convening of the second session of the Legislature to formulate recommendations on the use of several tax relief funds that have been established.

The Maine Municipal Association will continue to call for meaningful action to reduce Maine's heavy reliance on the local property tax and to provide property tax relief, particularly to Maine's residential property taxpayers. We continue to support the need for a comprehensive approach to tax reform, but our approach going forward will be tempered by the political reality that surrounds significant shifts in public policy, particularly on an issue such as tax policy.

Our experience during this past year suggests that strong political leadership is needed if parties involved in the public policy process are to be expected to focus on addressing major structural issues before a crisis ensues. Likewise, the optimum time to consider structural changes is during positive economic times, but this is the period when there is little or no pressure to

consider changes. Although the past year has been a roller coaster experience, we hope we have made a positive contribution towards addressing Maine's tax structure problems in a constructive fashion.



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Full cite: Lockwood, Christopher. 1997. *A municipal retrospective on comprehensive tax reform*. Vol. 6(2): 68-70.