Maine Policy Review

Volume 22 | Issue 2

2013

Issues in Tax Reform in Maine

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Recommended Citation
Woodbury, Richard. "Issues in Tax Reform in Maine." *Maine Policy Review* 22.2 (2013) : 11 -25, https://digitalcommons.library.umaine.edu/mpr/vol22/iss2/4.

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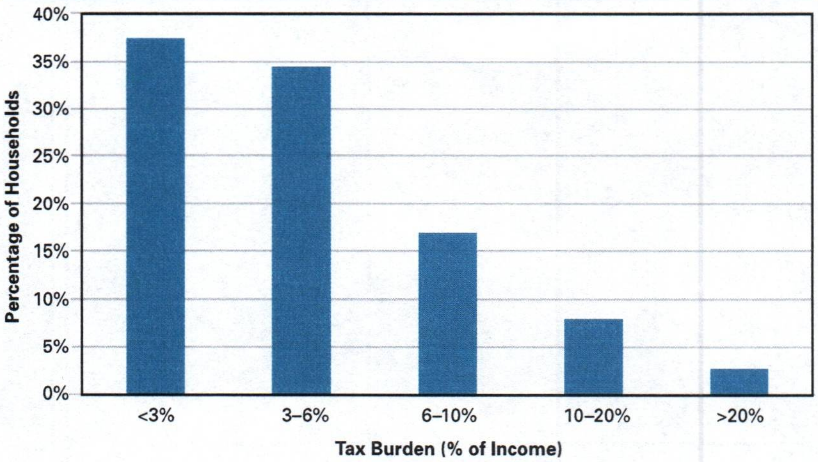
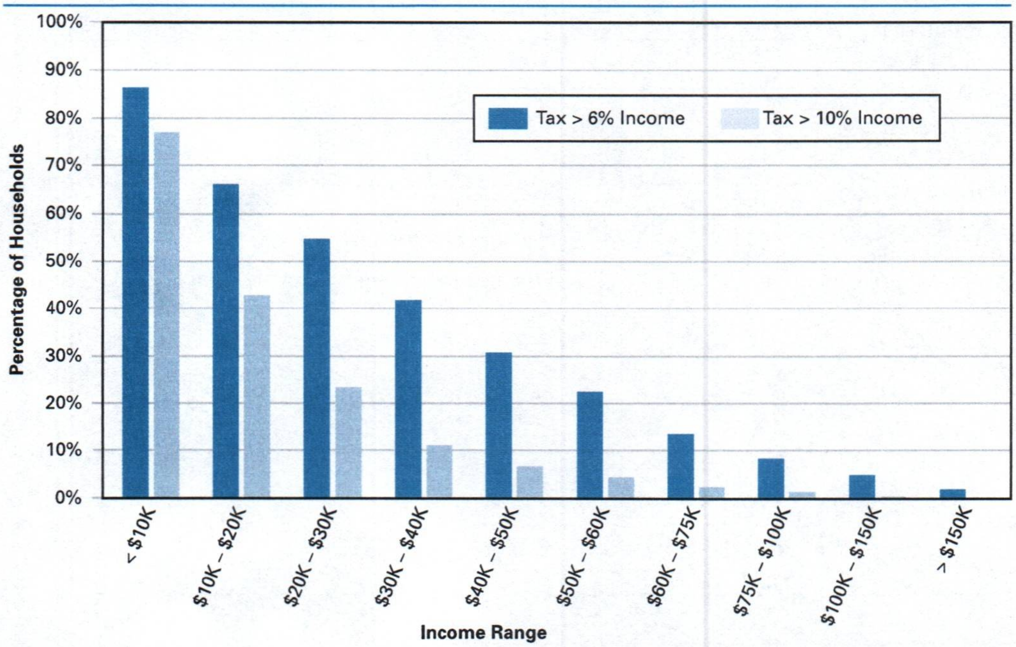
FIGURE 1: **Gross Property Tax Burden as Percentage of Income across Maine Households, 2013**



Source: Maine Revenue Services estimates, October 2013

FIGURE 2: **Percentage of Households with High Property Tax Burden, by Income, 2013**



Source: Maine Revenue Services estimates, October 2013

PROPERTY TAX REFORM

Property taxes differ from most other forms of taxation because they are imposed on an asset value rather than on a payment stream, such as income or spending. As a result, property taxes may represent a small, moderate, large, or very large fraction of income, depending on the circumstances of the individual homeowner. The wide variability in tax burdens across households, the very high burden imposed on some households, and the payment of the tax in large annual or semiannual billings make property tax burdens particularly visible. Figures 1 and 2 illustrate the degree to which property tax burdens vary across the population, as estimated by Maine Revenue Services for 2013.

An estimated 38 percent of resident homeowners pay less than 3 percent of their income in property taxes, and 35 percent pay between 3 percent and 6 percent of their income. Some 28 percent of households pay more than 6 percent of their income; 11 percent of households pay more than 10 percent of their income; and 3 percent of households pay more than 20 percent of their income. The proportion of households with high property tax burdens is particularly high at lower income levels, as illustrated by Figure 2.

Though property taxes are collected and spent locally, rather than by the state, there are several things that the state can do to relieve property taxes. One is to provide targeted property tax refunds to taxpayers who face a particularly high property tax burden. These are often referred to as property tax circuit breaker programs. A second is to create a property tax exemption, such as the current $10,000 exemption on primary residences in Maine. In Maine, such exemptions generally require the state to reimburse municipalities for at least half of their lost revenues from the exemption. A third approach is to transfer more of the revenues from statewide sources (primarily income and sales taxes) to local governments and local school districts, lessening the amount that needs to be made up through local property taxes. Each of these approaches has costs to the state. Their distributional effects differ.

Property Tax Circuit Breakers

Property tax refund programs, or circuit breakers, are the most narrowly targeted approach to property tax relief, because the funds allocated to them are concentrated entirely on resident taxpayers with the highest individual burden of property taxes. This includes renters, who qualify by apportioning a certain percentage of their rent as the "property tax equivalent" cost of their housing. Some form of circuit breaker program has been in effect in Maine for decades, though program modifications have been frequent. The most significant circuit breaker expansion was enacted as part of the LD 1 reforms in 2005. The amount of the refunds has been cut back since 2005, and the program was replaced by a much smaller program in 2013. Maximum property tax refunds reached a peak of $2,000 following LD 1, and are just $300 (or $400 for those over age 70) now.

In earlier work with Michael Allen (Allen and Woodbury 2006), we demonstrated the potential for circuit breaker programs to offset the very high property tax burdens imposed on some households in Maine. Specifically, we analyzed the impact of the LD 1 reforms enacted by the legislature in 2005, including an increase in the maximum refund to $2,000, expanded eligibility to middle-income households, and a phasing out of the benefit at higher income levels. Our study looked at the proportion of households with a high net burden of property taxes—first, without circuit breaker benefits; second, based on the circuit breaker program in effect before LD 1; and third, based on the reformed program after LD 1.

The results of our study, reproduced in Figures 3 and 4 and based on data from the early to mid-2000s, examined the program's potential tax relief if all eligible households applied for benefits. We showed dramatic potential reductions in the proportion of households with high property tax burdens when using a generous circuit breaker refund program. The reductions in tax burden were particularly significant among lower-income taxpayers, as shown in Figure 4. As a frame of reference, the cost to state government of the LD 1 circuit breaker program was about $45 million annually following its enactment in 2005.

Despite a significant scaling back in the circuit breaker formula for 2014, including much smaller maximum refunds, the estimated annual cost of the program is still projected by Maine Revenue Services at about $35 million annually. There are at least two reasons for this. One is that the application process for property tax refunds will be integrated with the filing of state income tax returns. Formerly, only about half of households eligible for circuit breaker refunds applied to receive them. With an integrated and simplified application process, higher participation is projected in the reformed program. Second, the income measurement used to determine program eligibility now conforms to Maine's definition of adjusted gross income, which excludes Social Security and other previously counted income sources. Under the reformed program, more Social Security beneficiaries in particular are likely to qualify for property tax refunds.

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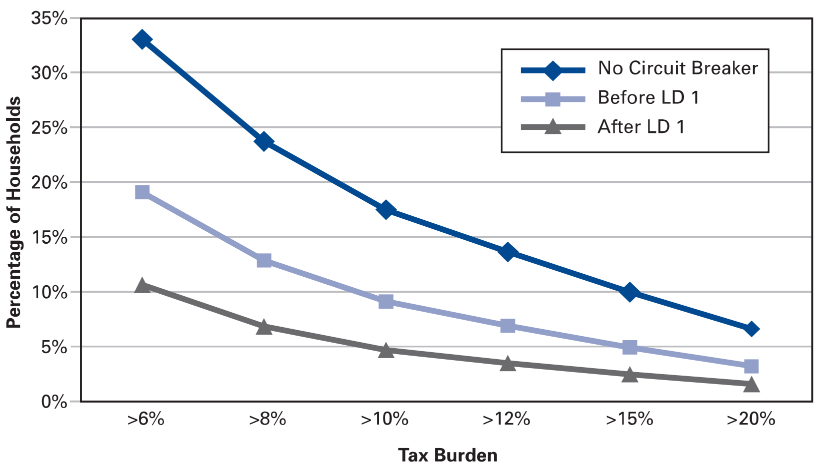
Homestead Exemptions

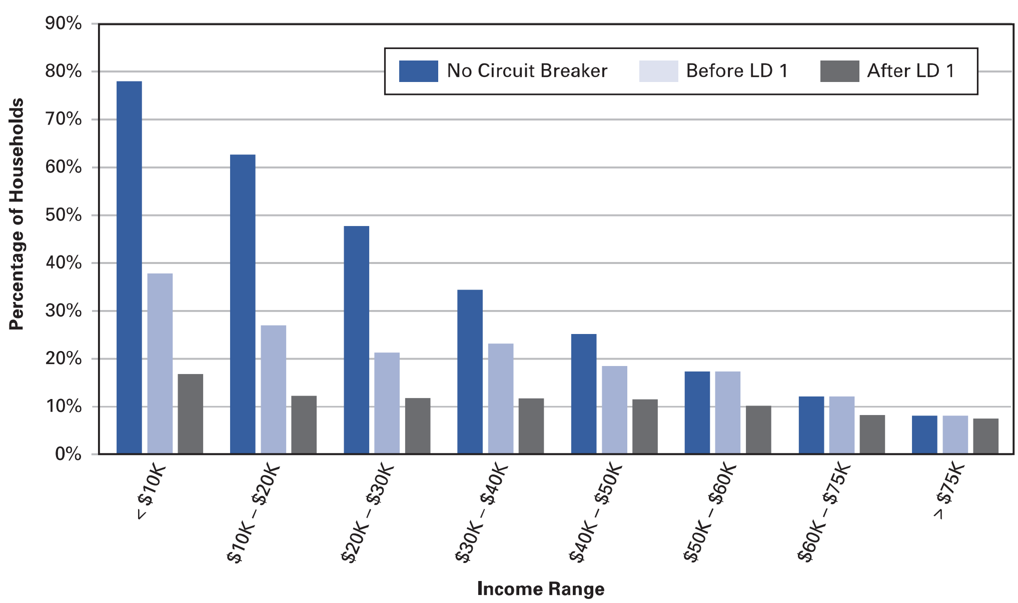
Homestead exemptions, though not means tested, are another form of property tax relief that targets Maine residents only. It is available to resident homeowners on their primary residence, but is not available to renters and does not apply to vacation property. As noted, the current homestead exemption in Maine exempts the first $10,000 in the value of one's principal residence from being taxed. The level of Maine's homestead exemption has also been

FIGURE 3: **Effect of Circuit Breaker on Percentage of Maine Households with Higher Property Tax Burden**



Source: Allen and Woodbury 2006

FIGURE 4: **Percentage of Maine Households with Property Tax Burden above 6 Percent of Income**



Source: Allen and Woodbury 2006

adjusted in past reforms, reaching a level of $13,000 following the LD 1 reforms.

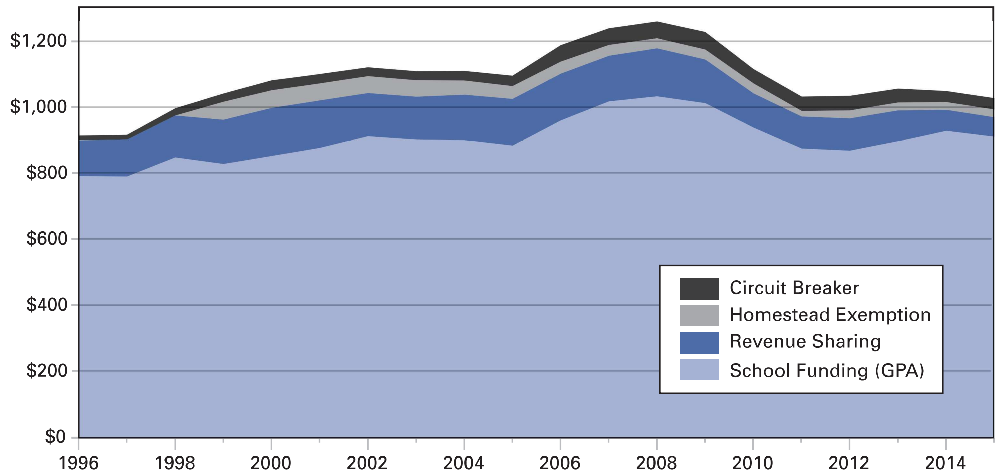
There are at least three distributional implications of the homestead exemption. First, it is worth proportionately more to owners of lower-valued homes than it is to higher-valued homes. For example, today's $10,000 homestead exemption reduces by just 1 percent the taxable value of a $1 million homestead, but it reduces by 20 percent the taxable value of a $50,000 homestead. Second, the exemption is worth more in communities that already burden taxpayers with high property tax rates. In a community with a high property tax rate, say 25 mils for example, Maine's current homestead exemption translates roughly into $250 in property tax relief. In a community with a low property tax rate, say 8 mils, the relief would be just $80. Third, because the homestead exemption is only partially reimbursed, non-homestead property owners may pay higher taxes to make up for lost revenues that are not reimbursed. Higher taxes will generally be paid on property owned by nonresidents, commercial property, and vacation property.

To summarize, the homestead exemption provides more concentrated property tax relief to resident homeowners (relative to nonresident and commercial taxpayers), to lower-valued homes (relative to higher-valued homes), and to communities with higher tax rates already.

School Funding and Municipal Revenue Sharing

Transfers from state revenues to municipalities and school districts are a broader form of property tax relief. The way the school-funding formula works, the state first determines the total amount that it will transfer to local school districts in general purpose aid to education (GPA). Based on that allocation, the state then calculates a statewide property tax "mil rate expectation" that will raise sufficient additional funds to fully support "essential programs and services" (EPS) at all of Maine's public schools. When more state resources are allocated to school funding, the statewide mil

Figure 5: **State Expenditures Related to Property Taxes ($ millions, inflation-adjusted)**



rate expectation is reduced, thereby lowering property taxes.

A similar substitution of state funds for local funds occurs when the state allocates money for municipal revenue sharing. Given a fixed local budget, more municipal revenue sharing translates into less being required from local property taxes. Of course, the dollars spent by the state on school funding and municipal revenue sharing need not all translate into property tax relief. It may also allow municipalities and school districts to spend more than they otherwise would. There is no broad consensus on the extent to which incremental funding for these programs lowers property taxes, as compared with increasing local spending.

The stated aim of state government is to distribute 5 percent of its revenues to municipalities in the form of municipal revenue sharing and to support 55 percent of the EPS cost of K-12 education. In practice, however, budgetary pressures and other legislative priorities have reduced these allocations. Figure 5 shows real spending by the state on the circuit breaker program, homestead exemption, revenue sharing, and general purpose aid to education, respectively, for fiscal years 1996 through the recently approved 2014 and 2015 budgets. (The historical amounts are inflation-adjusted to fiscal year 2013 dollars.)

Figure 5 shows an increase in inflation-adjusted state spending for these purposes from 1996 to 2008, particularly following the enactment of LD 1 in 2005, and then a pronounced drop in funding precipitated by economic conditions and other factors since 2008. (It is worth noting that school enrollment has also declined over this period, from about 214,000 public school students in 1996 to about 185,000 today.) The article by Shaw (this issue) provides further discussion about the changes in revenue sharing and school funding, and the municipal responses to these state revenue changes.

Who Benefits from Each Approach?

Throughout this discussion is an implicit trade-off between the depth and breadth of property tax relief associated with different funding measures. The circuit breaker program is the most narrowly targeted, benefiting resident homeowners with high property tax burdens and resident renters with high housing cost burdens. The homestead exemption is the next most targeted, benefiting resident homeowners only, and with larger proportionate benefits to those with less valuable homes and to those with higher property tax rates already.

Incrementally increasing municipal revenue sharing or school funding are broader forms of property tax relief, but their impact across communities is uneven. Within any community, their effect is to reduce the property tax mil rate across the board for all property tax payers, whether resident or nonresident, primary home or vacation home, residential or commercial. The relief is proportional to what taxpayers pay already. Comparing across communities, however, there are distinct differences between the effects on property taxes of revenue sharing and school-funding support.

For most communities throughout Maine, an increase in general purpose aid to education lowers the EPS mil rate expectation by the same amount—about 0.1 mil per $10 million in incremental state funding—regardless of the existing property tax rate in each community. The exceptions are those communities in Maine, referred to as "minimum receivers," that have enough property value to raise the full cost of EPS with a tax rate lower than the mil rate expectation. These communities benefit little or not at all from an increase in state funding for education. Though they are a minority of communities in the state, a disproportionate number of Maine's vacation properties are located in minimum receiver communities.

Municipal revenue sharing is allocated across communities using a different formula, where communities with higher property tax mill rates receive larger allocations. Thus, higher-mil-rate communities, including so-called service center communities, are more explicitly targeted. The municipal revenue sharing formula works in a continuous way—the higher the mil rate, the greater the relief provided. The school-funding formula has more of a kink in the formula, where communities on one side of the kink (the minimum receivers) get virtually nothing, whereas communities above the kink (those paying the EPS mil rate expectation) get essentially the same mil rate relief, regardless of overall tax rate.

Illustrative Effects of State-Funded Property Tax Relief

To further illustrate these implications, I estimate the impact on property taxes of allocating an additional $50 million in state resources to four alternative property tax relief measures. The first approach would add $50 million to general purpose aid to education, raising the allocation from $947 million to $997 million, and bringing Maine closer to its stated goal of 55 percent. The effect of this reform is to lower the statewide mil rate expectation for K-12 education from 7.86 mils to about 7.34 mils, or by about 0.52 mils in most Maine communities. The property tax savings would be about $50 on a $100,000 home, $100 on a $200,000 home, and $500 on a $1 million home. There would be no property tax savings in minimum receiver communities.

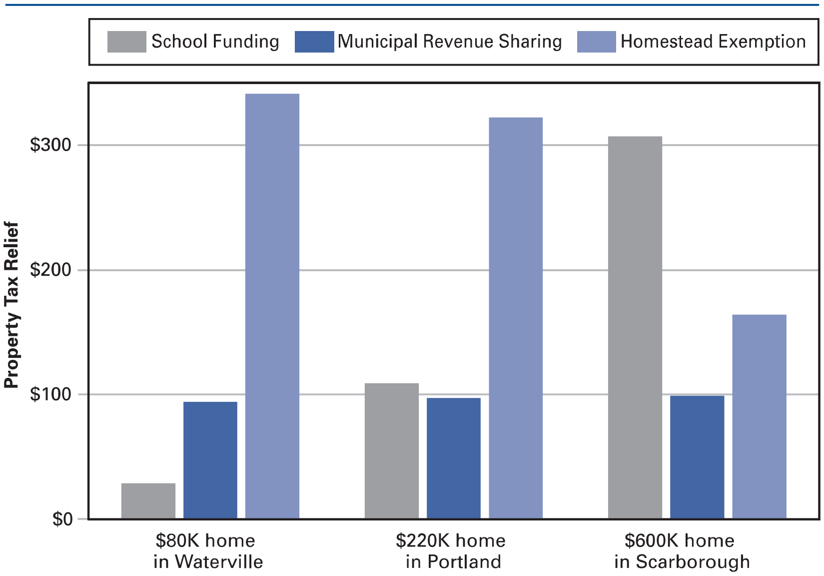
The second approach would add $50 million to municipal revenue sharing, raising the allocation from $65 million to $115 million, and approaching the stated public policy goal of 5 percent. The effect of this policy is to lower the mil rate for all taxpayers throughout the state, but more significantly in communities with higher property tax mil rates already. For example, the 50,000 resident homeowners paying the highest property tax rates would see an average reduction of about 0.96 mils, from 20.61 to 19.65, translating to about $100 in property tax savings on a $100,000 home, $200 on a $200,000 home, and $1,000 on a $1 million home. The 50,000 resident homeowners paying the lowest property tax rates in the state would see an average mil rate reduction of 0.14 mills, from 9.16 to 9.02, or about $15 in property tax savings on a $100,000 home, $30 on a $200,000 home, and $150 on a $1 million home.

The third approach uses the $50 million to increase the homestead exemption from the current level of $10,000 to $30,000. Because municipalities are reimbursed for only half of the lost tax base, this results in an average increase in mil rate of 0.31, from 13.32 to 13.63. This draws a modestly increased property tax share from nonresident and commercial taxpayers. For all but the most valuable homestead properties, the increase in the exempt amount far outweighs the increase in rate. The property tax savings in an "average" community, therefore, would be about $250 on a $100,000 home, $210 on a $200,000 home, and no savings on a $1 million home.

The fourth approach uses the $50 million to restore the circuit breaker benefit formula enacted in LD 1 in 2005. The effect of this policy varies with the individual circumstances of the property owner or renter. For those without a high burden of property taxes (or rent), there would be no property tax savings from the increased funding. For those with the greatest burden of property taxes (or rent), savings are as much as $2,000 per household.

To further analyze these impacts, I consider three illustrative homesteads and three illustrative nonresident properties, shown in Figures 6 and 7, respectively. (The circuit breaker is not included in these illustrations because its effect—though the

FIGURE 6: **Impact of $50 Million in Property Tax Relief (Residents)**



largest of all for residents with high property tax burden—cannot be generalized across properties in the same way.)

In Figure 6, the Waterville residence is illustrative of a modest home in a high-tax-rate community. The Portland residence is illustrative of a typical home in Maine's largest city. The Scarborough residence is a higher-valued home in a coastal community. Because the homestead exemption benefits high-mil-rate communities and lower-valued properties more, its biggest impact is in the Waterville and Portland illustration. The more valuable Scarborough home benefits most from the lower-mil-rate expectation created by increased school funding.

The nonresident and commercial illustrations in Figure 7 are also instructive. For example, the first illustration is for the same $600,000 Scarborough home included in Figure 6, but owned by a nonresident rather than a resident. The nonresident receives essentially the same property tax relief from additional school funding as the resident, and the same property tax relief from additional revenue sharing as the resident. The homestead exemption, however, increases taxes on the nonresident and commercial taxpayers, while decreasing them on the resident.

Figure 7 also compares two identical homes in Scarborough and Camden owned by nonresidents. The effects of an increase in revenue sharing or the homestead exemption are comparable across these properties. The effects of school funding, however, are dramatically different. Scarborough is subject to the statewide EPS mil rate expectation, which declines with additional school funding, thereby lowering property taxes. Camden, on the other hand, is a minimum receiver, able to support EPS costs at a mil rate that is already lower than the statewide rate. Therefore, additional school funding has no impact in Camden. Camden is illustrative of the most highly valued recreational areas of Maine's coast, lakefront, and mountains where a lot of Maine's vacation properties are concentrated.

FIGURE 7: **Impact of $50 Million in Property Tax Relief (Nonresidents)**