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FINAL REPORT OF THE SPECIAL COMMISSION TO STUDY THE USE OF STATE VALUATION IN THE ALLOCATION OF STATE FUNDING AMONG MUNICIPALITIES

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INTRODUCTION

The Special Commission to Study the Use of State Valuation in the Allocation of State Funding Among Municipalities was established by the First Regular Session of the 113th Legislature (Resolve 1987, Chapter 63). The charge of the commission was to "examine the current use of state valuation to determine local ability to pay under the School Finance Act of 1985, Maine Revised Statutes, Title 20-A, chapter 606 and the state municipal revenue sharing laws, Title 30, section 5055. The commission shall consider alternatives to state valuation for determination of local ability to pay in the allocation of state funding among municipalities under these programs."

The commission held two public hearings to gather information on local perception of problems and local suggestions as to changes to the state subsidy formulas and state valuation procedures. The first hearing was held in Portland, on October 8, 1987 and the second in Bangor, on November 5, 1987.

Paralleling the work of the commission were two other study groups established by the Governor. One was the School Funding Task Force. According to its report, the task force was to "review the school funding formula with the intent to bring reimbursement closer to the actual time of expenditures, to consider alternative methods to determine wealth in addition to property valuation, and to suggest any further change." It acted as a subcommittee to the other study, the Tax Policy Study Committee. The Tax Policy Study Committee had a broad charge to "undertake a comprehensive review of the tax system of the State."

BACKGROUND

PROPERTY TAX

One of the best things that can be said of the property tax is that it has historically functioned as a powerful source of revenues for local government. It has several advantages over the other two major sources of governmental revenues -- income and sales taxes. First, it is relatively easy to see real estate so that taxpayers can judge whether they are being treated fairly relative to other, similarly situated, members of their community. Second, most property cannot be removed from the municipality and hence can be easily attached for non-payment of taxes. Third, it taxes business and commercial enterprises as well as individuals. Fourth, it taxes nonresident (absentee and seasonal) owners as well as full-time residents.

INCOME AND SALES TAXES

The other two effective mechanisms for raising revenue are income and sales taxes. However, unlike property, income is often earned outside one's own community or by individuals who reside in another community. Similarly, purchases are often made outside one's own community or by individuals from outside. Activities which take place outside the community are difficult for municipal officials to monitor and hence a tenuous source of revenue. On the other hand, it is often feared that income and sales taxes on individuals from outside the community may discourage these individuals from seeking employment or making purchases within the community unless the taxes are assessed uniformly across all communities.

EQUALIZATION AND STATE MANDATES

One of the problems in requiring local units to fund State mandated programs with local property tax dollars is that property values are not uniform across all communities and not related to the variation in need or cost of these services. The solution, while still maintaining local control over the property tax, has been for states to devise subsidy formulas which equalize the property tax rates needed to support mandated services. The states supplement local revenues derived from these equalized rates with state tax dollars to make up all or a part of the amount needed to support required services.

WEALTH OR ABILITY TO PAY

In common usage, these equalized rates are seen as based on a community's wealth or ability to pay. However, the community's wealth or ability to pay is really the individuals', within a community, wealth or ability to pay. The value of an individual's property, however, may have little to do with ability to pay and may be more related to the individual's indebtedness than wealth. An individual's (or individual's parents') ability to purchase a piece of property may have been related to the purchase price but may no longer be related to its current, inflated, value. The property may also have been purchased with a loan based on an individual's ability to pay it back with current income rather than assets and hence reflect more what the individual owes than what the individual owns. The assets or wealth is likely to be divided between the title holder and the mortgage investor. The investor is typically a person outside the community and, with the secondary mortgage market, by someone outside the State.

Thus, when policy makers at the state level talk about equalizing state aid based on a community's ability to pay or a community's wealth, the words do not convey the same meaning or appear as reasonable to some community officials or taxpayers.

STATE VALUATION VERSUS LOCAL VALUATION

The State in assessing property values among communities needs a standard basis for comparison. Communities and state government only need to assure that the relative differences among properties in the community or across communities are based on the same scale.

Taxpayers do not like to pay more taxes than necessary or more than their similarly situated neighbor. They feel better if they perceive that they are not paying taxes on the full value of their property. Local communities have historically accepted this perception and assessed property at less than full value. If the assessments and reductions are uniform and the town budget does not change, the individual's taxes are the same as they would have been under full valuation. Under full valuation the mill rate would have been lower.

The State also only needs to assure that property across communities are assessed on the same relative scale. However, in an attempt to make communities perceive that the state valuation is fair and that no community is being undervalued, the State assesses property at full value. This immediately creates a disparity between tax rates based on state and local valuations. Thus, the State established mill rates upon which state subsidies for schools are based are often considerably lower than locally assessed mill rates for basic school programs. Local assessments of valuation are not always revised each year. The state valuation, however, is adjusted on a yearly basis. Hence, the difference between the local assessment and state valuation varies from year to year.

While mill rates based on state valuation can be used to compare local efforts across community lines, local rates do not provide an accurate basis for comparison. Two communities which spend identical amounts, calculated as mills of state valuation, may have very different local tax rates because of different local assessing policies or because one community has recently undergone a revaluation and the other has not. Unfortunately local voters and observers have easier access to local rates.

COMPUTING STATE VALUATION FROM LOCAL VALUATIONS

Since the state valuators base their calculations on the work of local assessors, there must be a method of adjusting under-valued and not consistently valued property to a consistent 100% state valuation. April 1 is the cut off date for property being incorporated in local municipal tax roles. New construction during the preceding 12 months is added to the tax roles at this time for the purpose of assessing local taxes. The State is also concerned with adjusting the state valuation of a community's property by the inflation in the value of property already on the tax roles. To make the adjustment, the State conducts studies, referred to as ratio studies, comparing the sales price of property sold in a 12 month period, starting 9 months before April 1 to 3 months after April 1, with the current local assessed value of these properties. In October, these sales data are sent to the town officials and the town officials have an opportunity to eliminate any sales that are not "arms length transactions," or for some other reason do not reflect "good open market sales." From January to June, of what is now the next year, the State does field visits to review the comments by town officials and in July sends the State's preliminary state valuation to the towns. Again, there is a period for comments, hearings, and discussions with the towns before the State's proposed state valuation is sent to the towns by September 1. Once the towns have received the proposed valuations, they have 45 days to request an appeal. The review of the appeals is completed by January 15, and the final state valuations are certified by February 1. This state valuation is used for calculating state subsidy for the coming fiscal year. The actual payment of subsidies based on the property value of a town occurs over two-years after the new property was added to the roles or the value of existing property has inflated.

This process creates two potential problems. First, no method of calculating adjustments can be perfect. As a consequence, there are continuous suggestions for revisions and fine tuning. The second problem is that the method requires time for the State to assess changes in local valuations and obtain local validation of these changes. This process creates a lag between the time when new construction is added to the local tax roles or the inflation in property values occurs and when the new valuation is incorporated into the community's state valuation.

On the positive side, the time lag creates a windfall revenue for the community. The community collects tax revenue on any new construction for two years before the State includes it in the state valuation. There is also a two-year lag before the inflated value of existing property is included in a municipality's state valuation. In this latter case, the benefit is derived by the individual taxpayer.

On the other hand, if the windfall the town receives from new construction is used for lowering taxes in the two-year period before the new construction becomes part of the state valuation, the community will either have to reduce their expenditures or increase their local taxes when the lag period is over. This progression is often difficult for local taxpayers to accept as fair and reasonable. Taxpayers accept that new construction and other property enhancements add to the total value of property in their community. They also accept that new construction and growth should increase the tax base and increase local revenues. Thus, they find it reasonable that their taxes will be reduced, or not increase as fast as expected, when new valuations are added to the tax roles. They do not perceive it as reasonable that this should lead, two years later, to a budget crisis or increased tax rates and increased taxes.

SOURCES OF PROPERTY VALUATION INCREASES

Increases in a community's state property valuation has four sources. The least controversial is new construction or changes in current use which changes the status of the property from a less to a more valuable use. Inflated values due to more indirect interactions of market forces and supply and demand are less easily accepted. If all properties across the state inflated at the same rate, there would be no change in the relative differences among property owners or communities and hence no changes in a community's position in relation to the State's subsidy formulas. If an owner uses property at its highest and best use, there is also less of a chance for feeling that the formulas treat taxpayers or communities unfairly. Individuals who have traditionally used their land for another use, for example farming or fishing, find it difficult when their property is taxed as residential or scenic water frontage. Finally, if market forces did not change the perception of the value of a property's current use so that current users can no longer afford the taxes or rents, there would be less dissatisfaction. The purchase of properties by wealthier "out-of-state" buyers or the "gentrification" of lower income areas in cities are two examples of the effect of market forces on the value placed on current use.

SERVICES

State valuation and state subsidy formula for education are designed to help local units pay for specific services. Community officials analyze the subsidies in terms of these special services but they are also concerned about general increases in community services when they relate increases in property valuations with a need for additional revenues. If increased valuations are based on residential building, the added local tax revenues often do not keep pace with the expanded need for police and fire protection, other municipal services and school services. While the demand for services increases, the expanding tax base may actually lead to a reduction in state subsidy. A similar problem arises with the state-municipal revenue sharing formula if a municipality's relative increase in state valuation is higher than the relative increase in its population.

LOCAL COMPARISONS OF STATE VALUATION AND STATE SUBSIDIES

The state valuation and state subsidy formulas are designed particularly to help communities with less property wealth relative to demand for services as compared to other communities with more property wealth. The standard for judging the effectiveness of the state valuation and subsidy formulas is whether mill rates on the state valuation of property is equalized across community lines. Mill rates are related to a variety of other factors such as size of municipal budgets, actual taxes paid, and percent of state aid. If the attempt is to equalize or set the mill rate, then these other factors are, by definition, determined by the mill rate. Local officials and voters, on the other hand, often center their attention on these other factors. Even if mill rates are equal or declining, the formula is criticized for not controlling the increase in the local budget, letting the state share decline, or not equalizing the per pupil local tax costs.

SOURCES OF CRITICISM OF STATE VALUATION OR SUBSIDY FORMULAS

Under certain circumstances, state valuation mechanisms and subsidy formulas are perceived as unfair. These conditions are:

1. The mechanics of the formula used to compute state valuations from local assessments need adjusting.
2. The time lag between property being assessed locally and being part of the state valuation is not anticipated and planned for by municipal officials.
3. The properties in different and particularly neighboring communities are subject to different rates of inflation.
4. A current owner does not use the property at its highest and best use.
5. Outside demand increases the perceived value or utility of property even if the changed perception does not reflect a higher and better use.
6. A community compares unfavorably with its neighbors relative to:
   A. Percent increase in the school budget or town budget.
   B. Size or percent increase or decrease in a school district's percentage state share.
   C. The amount paid per pupil out of local tax dollars.
   D. The percent local school expenditures represent of the total municipal budget.

PUBLIC HEARING IN PORTLAND
October 8, 1987

Portland and the surrounding area has experienced a period of dramatic growth and an even more dramatic increase in property valuations. Testimony at the hearing came from a Portland legislator, a member of the Portland City Council, a member of the Portland School Committee, an assessor from Scarborough and a spokesperson from the Maine Municipal Association.

The general concern was that "state funds should be distributed equitably and fairly among cities and towns and to ensure that local property taxpayers actually do receive some relief." Three themes ran through the presentations. One was that increased property valuations did not necessarily indicate increased ability to pay. The second theme was that the growth in the communities created a demand for increased services and that this increased demand may exceed the expanded property tax revenue base once the state subsidy formulas have been adjusted. The final theme was that while new development undoubtedly increases a community's ability to pay, increases in valuation due to inflation are difficult, if not impossible, to tap without increasing the taxes paid by the individual property owners.

As indicated in the background discussion above, a community's tax base or valuation is an indication of the community's ability to collect revenues with a given tax rate. It does not necessarily indicate the individual taxpayer's ability to pay or their net wealth. Particularly in cities like Portland, which had a larger than average percent of individuals and families below the poverty line or on low or fixed incomes, there is an increasing discrepancy between rising property values and ability to pay. In addition, if the property values in a community have inflated faster than those in other parts of the state, the increased valuation may result in a loss of state aid.

As one member of the commission remarked during the hearing, both new development and inflation represent increased valuation, and the state subsidy formulas are designed to be sensitive to differences in the direction or rate of change in valuations among communities. The fact that the formulas may be working as designed does not mean that they are perceived as equitable. As one presentor stated "people are baffled why a community such as Portland or Freeport with its tremendous economic growth is still experiencing excessive property tax burdens."

The increase in valuations may also lead to a decrease in state aid, or a failure of the state aid to expand as fast as the demand for increased services. This phenomena was described in a hypothetical example of a community experiencing residential and commercial growth. In the example, it appeared that the increases in residential valuation were particularly likely to lead to problems in this regard. In the background discussion above, it was also mentioned that the time lag between the new valuation being first recorded in local assessments and two years later in the community's state valuation may add to the perception of a problem if the transition is not carefully planned at the local level. Whatever the reason, the perceived result is often that "drastic increases in state valuation translate into drastic reductions in state aid, particularly state aid to education" and that "drastic reductions in school subsidy are difficult to react to locally, especially if the reductions occur suddenly."

One presenter indicated the hope that "the current funding formulas should be considered as existing mechanisms and if we make sure they are working properly, other mechanisms such as circuit-breakers, which are really a safety net mechanism, will not have to be utilized." However, adjustments to the basic formula which would ease the burden on communities with increasing valuations would be difficult to do with out counter-acting the basic principle of the formulas and state valuation system -- that they be sensitive to relative changes in the valuations among communities. Since the concept of ability to pay is more properly applied to individuals who pay taxes than communities, circuit breakers or some other mechanism which address the problem at the individual level are perhaps more likely to succeed than policies which would focus on the community level.

The background discussion mentioned the problem of individuals experiencing an increase in property valuation because outside forces place a higher use value on the property than the current occupants did when they originally purchased or rented the property. As one of the presenters expressed it "I receive no economic benefit from my higher property tax value. The only time I would receive any economic benefit from the higher property values is if I sell my property. Most people in southern Maine and the remainder of the state are not using their homes as an investment opportunity. They have been committed to this state for generations and the current use of state valuation in the funding formulas is punishing them for that commitment and their lack of desire or ability to capitalize on these inflationary times." To take advantage of the inflation in the value of their property, an owner would have to sell and move to less expensive property in their community or in another part of the state.

This issue was expanded on by another presenter who discussed it in terms of the problem of "frozen assets." He mentioned California's method for dealing with the problem was to increase the taxable valuation on a home only when the property is sold. He proposed that a state capital gains tax should reach the asset when it is sold. "If it is a frozen asset, why not reach it when it is sold?"

Several of the people who testified before the commission favored the addition of a "save harmless" provision to the school funding formula. This type of provision would prevent a school's subsidy from dropping below a fixed percent of their previous year's subsidy, 75% was mentioned in the testimony. As described in the testimony, the funding of this provision would come from additional state dollars so as not to reduce the subsidies going to any other unit. This solution was not presented as solving the basic cause of the problem. As the representative of the Maine Municipal Association stated, "we can't rid ourselves of the need for a State derived valuation for each municipality. It is necessary in order to have an 'apples and apples' measure of each municipality to distribute state aid. Given that, it makes a great deal of sense to treat the symptoms of the the disease, which is exactly what we believe this recommendation does."

PUBLIC HEARING IN BANGOR
November 5, 1987

The testimony presented at the Bangor hearing highlighted three issues. First, local officials and citizens do not always judge the fairness of the state subsidy formulas or state valuation calculations on the basis of equalized mill rates. Second, there are other measures of "ability to pay" than property valuations, in particular income. Third, the State's adjustment of state valuation using recent property sales does not sufficiently take into account the special value placed on coastal property.

The purpose of state valuation and particularly the school funding formula is to equalize the local property tax effort among local governments for the provision of basic services. The tax rates are computed on a uniform assessment of property values. As mentioned in the background discussion above, however, individuals at the local level often compare their towns not with the mill rate they are assessed on the state valuation but with other factors such as the relative difference in the percent of state aid received, the percentage change in school or town budgets from one year to the next, or local expenditures per pupil. These and other similar factors are not equalized across communities when mill rates are equalized. School units which do not receive state aid because of a high state valuation of their property feel particularly burdened when they compare their situation based on these other factors.

There are several ways as indicated in the background discussion to defend the position that property values are not necessarily a good indication of ability to pay. A school superintendent presented data indicating the difference in the ranking of counties according to property values per pupil, income per pupil, and per capita income. The differences would probably be even greater if income data was available on individual towns.

The problem of the high valuations put on coastal properties has two dimensions. One is that outside forces place a very high value on waterfront property both on the ocean and on lakes. The supply is limited, and the outside demand often creates increases in property values that traditional users cannot afford. The following written testimony of an assessor, who was not able to attend the hearings, is indicative of the problem of unfairness this situation raises.

> My major concern is that my community contains over 26,000 acres and nearly 100 miles of shore frontage. The use of the valuation, which in our case is of course relatively high, actually seems to hold Lubec responsible for an abundance of natural resources. This endowment of

natural beauty does not however measure our ability to pay. . . . Eastport which has a larger industrial base is more able to support its needed services yet its valuation is smaller enabling it to pay lower county taxes and receive more aid than Lubec."

The other part of the issue with waterfront property is that the State's adjustment of state valuation based on sales of water front property may exaggerate community wide changes. The out-of-state demand for water front property is higher than for property away from the water. If the adjustment in state valuation is based on a few sales of water frontage, the increase in valuation they reflect may not be applicable to other property in the community. An assessor from Southwest Harbor was particularly concerned about this problem. "The Bureau of Taxation's method of determining state valuation for Sourthwest Harbor creates problems for the town because the property that is selling is shore front, summer property which is being sold for much higher prices than other properties in town. The bureau ought to have two sales ratios: one for shorefront properties and one for year around properties." This solution would not address the problem of low and moderate income individuals who own shorefront property.

DISCUSSION

In general, the commission members, and many of those presenting testimony, felt that the state valuation of property accomplished the task it has been assigned. It provides a uniform method for assessing property valuation. The school funding formula, in particular, can use this valuation to assess each communty's ability to raise revenues and to provide State support in a manner which will equalize tax burdens, or mill rates needed to fund basic school programs.

The commission members were not convinced that other measures to compare communities such as their percent of state aid, local expenditures per pupil, or percentage increases in school budgets would provide fairer criteria for distributing state aid than equalizing mill rates. Towns with higher percentage state aid and lower local expenditures per pupil often exceed the state average mill rate to fund their schools. Non-receiving units, which have larger property value tax bases per pupil, can often fund their school programs with a much lower mill rate than the average school unit. The state policy has been that equalized mill rates are the fairest method of comparing the local burden of operating school programs. If one of the other factors was used as the basis for determining an equitable distribution of state aid, then the mill rates (property tax burden on residents) in different towns would not be equalized.

While the commission recognizes that property values are a measure of a community's ability to raise money with a given mill rate and not a measure of an individual taxpayer's "ability to pay," they recognized several problems with incorporating income as a measure of wealth or ability to pay. In addition to the present technical problems of collecting good income data on towns, there are some conceptual problems with attempts to compare property valuations and income. Property valuations include industrial, commercial, and out-of-state (out-of-community) owned seasonal properties as well as year around residential property. Income figures, in the best of circumstances, do not include the income of industrial, commercial or non-resident owners. The conceptual problem with comparing industrial, commercial, and nonresidential property values with individual income is that it implies that the income of permanent residents must pay the tax on these other properties as well as on their own residences. In point of fact, non-resident individuals or entities, who are not counted in the income figures of the community, are responsible for these taxes.

Industrial, commercial and seasonal property may increase the town's total valuation but instead of adding a burden to local residential property owners, it may lower their tax burden. Industry adds tax revenues but does not add additional pupils to the school unit. A similar benefit is derived from seasonal residential property and commercial property. However in the case of seasonal property, the benefit is partially negated by the tendency for seasonal property to cause higher residential property values. The close proximity of an industry may, on the other hand, actually hold down residential property values. Commercial property creates a demand for additional police and fire services which may also negate some or all of the benefit of a larger tax base.

It must also be recognized that the addition of income to any formula for distributing state aid will alter that distribution. Some communities will get more aid than before and some less. Based on the assumption that communities will still have to rely on property taxes as their primary revenue source, taxpayers, even if they are on low or fixed incomes, in communities which have higher than average incomes and lower than average property valuations will have to pay increased property taxes. Taxpayers, even if they have high incomes, in communities with lower than average incomes and higher than average property values will experience a reduction in their property taxes.

In general, ability to pay is a problem for individual taxpayers. It is difficult, if not impossible, to find community wide averages which equitably deal with differences among individuals in their ability to pay property taxes. Circuit breakers on property taxes and rent, or tax credits applied to the individual income tax for property taxes or rent, represent more direct and effective methods for addressing the issue of ability to pay. Circuit breakers and tax credits can also be sensitive to the fluctuations in an individual's income from year to year.

RECOMMENDATION: The problem of ability to pay should be delt with through the development of circuit breakers or tax and rent relief mechanisms which deal directly with the individual's difficulty in paying property taxes.

The commission agreed with the suggestion that waterfront property should be analyzed separately from year-round property off the water in adjusting a community's state valuation. The representative from the Bureau of Taxation on the committee felt that an adjustment to their procedures could be made without additional legislation.

RECOMMENDATION: The Bureau of Taxation should examine the possibility and desirability of instituting separate sales ratios for waterfront and non-waterfront residential property to be used in calculating adjustments to a community's state valuation. The Bureau should give a report by April 1, 1988 to the Joint Standing Committee on Taxation on its analysis and decision of whether to implement two different ratios.

CONCLUSIONS

The commission concluded that state valuation accomplishes the task of providing a uniform method of assessing property values across the state. It also provides a sound basis for computing state aid in a manner which helps equalize tax rates for basic services like education.

The state valuation mechanism and subsidy formulas are often criticized by local officials for not equalizing or controlling other factors such as changes in the percent of state aid received by a school unit, the percent of increase in the school or town budget, or the amount of local dollars spent per pupil. The commission feels that to adjust the state valuation or subsidy formulas in an effort to control variation in these factors can not be done with out partially negating the current policy of equalizing mill rates for basic services like education.

The commission felt that the issue of ability to pay property taxes was best seen as a problem of individual tax-payers. Community wide figures on average individual income neither adequately reflected the ability of industrial, commercial or seasonal property owners to pay property taxes nor adequately accounts for the variation in ability to pay among permanent residents. The commission felt that ability to pay was best delt with through circuit breaker or tax credit mechanisms applied to individuals.

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