



# A Study of North Dakota's Tax Structure

Presented to  
Governor John Hoeven  
and the  
57th Legislative Assembly

*Final Report*  
*Tax Study Committee*

*February 2001*

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# EXECUTIVE SUMMARY

The Tax Study Committee was created during the 1999 legislative session when Governor Ed Schafer included funding in the Office of State Tax Commissioner's budget for a citizens' study of the tax structure in North Dakota. The purpose of the study was to take a critical look at how North Dakota's tax structure serves the state. The study group began with the first meeting on March 24, 2000 and continued meeting for the next ten months.

Our goal was to analyze North Dakota's tax structure and to make recommendations to promote positive changes for a fair and simple tax system that is relevant and responsive to a 21<sup>st</sup> century economy. During our review we were committed to keeping our recommendations revenue neutral. The possibility of raising or lowering the overall tax revenue to the state was not part of our mission.

In the past, natural resources and efficient physical labor were key to wealth creation and economic growth. In the New Economy, knowledge drives growth and innovation. A competitive advantage is transferred to those regions that can generate, attract, and retain the best talent. This creates a shift from low-cost to high-quality; from attracting firms to attracting talent. Our New Economy business model is driven and valued by its most important component, people.

In the course of our review we found North Dakota's tax system has, in general, many positive components. We also found several issues that we feel need to be adjusted to account for changes in our economy, our state, and the nation.

The state's major tax source, sales and use taxes, has an eroding base. Such erosion is caused by many factors including years of additions to the list of items that are tax exempt. Many of these exemptions have sound social, practical, or financial reasons for being exempt. Each exemption granted forces ever-higher rates onto the remaining items being taxed.

We believe that changes in the economy have also eroded the sales tax base in our state. In North Dakota, the sales tax was first enacted into law in 1935. This was at a time when our economy was based mainly on goods. Since then, our economy has moved from being a "goods based" to a "service economy" and more recently to an "information economy." In spite of these changes, our tax structure has remained fairly constant and sales taxation has not moved into the "service" or "information" age. Consequently today we see income tax collections rising with higher

**During our review we were committed to keeping our recommendations revenue neutral.**



**We could significantly reduce wealth taxes if we assessed them against all assets, not just real estate.**

incomes while sales tax revenues have grown more slowly. The slower growth in sales tax revenue is due to people spending their incomes on services or data that is not subject to sales tax.

Advancement in technology has allowed more sales from remote locations outside the state and, subsequently, has made sales and use tax collection more difficult. This is not just a problem for state and local government, but also for our main street businesses which now must compete with sellers who have an automatic 5 or 6 percent tax advantage.

Another area of intense concern is our real estate tax system - a system that is older and more outdated than the sales tax. The real estate tax system goes back to the 1800s and a time when real property represented wealth. Today, wealth is not in land. Rather, wealth is in the stock market, intellectual property, software rights, etc. Yet, we continue to place an annual wealth tax on real estate and ignore all other types of assets that represent significantly more wealth than real estate. Again this forces higher taxes on the real estate assets. To put it another way, we could significantly reduce wealth taxes if we assessed them against all assets, not just real estate.

We revisited the issue of North Dakota's tax image to the rest of the country. Both our individual income tax and our corporate income tax have unique features that make our taxes appear artificially high, reducing our competitive edge in attracting people and business.

This report examines all of the above items and more. It discusses ways to address the issues and the pros and cons of the proposed solutions. We recognize that the solutions are not simple or easy, nor will they necessarily be politically popular. But, the consensus of the tax study group is that these are issues of major importance. We believe that the debate that ensues will be healthy and worthwhile.



# ACKNOWLEDGEMENTS

We extend our deep gratitude and thank you to each member of the study group. A special recognition and thank you is extended to Jay Leitch for drafting the report and Tara Holt for her assistance in editing the report. A very special and sincere thank you to Beth Boustead for recording and distributing minutes during the course of our discussions and for the major effort she has had in putting this report into its final form.

The committee members listed below devoted a substantial amount of time to the study of North Dakota's tax system. Each team member brought a special talent to the table, including an exemplary willingness to hear and be heard. The major efforts of the tax study members are recognized and appreciated.

We had long and healthy discussions and consensus was not always reached. The sometimes lively debates on the many issues facing the group helped us to develop this report and to focus on what we feel are the truly important issues.

Rick Clayburgh, Co-Chair  
Tax Commissioner  
Office of State Tax Commissioner

Rod Backman, Co-Chair  
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# FOREWORD

## Issues

Taxes—the price we pay for civilization—evoke all sorts of emotions, images, and perceptions in the minds of taxpayers. No one enjoys paying taxes, yet most agree they are necessary. Policy makers want to minimize the negative aspects taxation creates while not adversely affecting revenues. In this regard, the mission of the Tax Study Committee was

*To **evaluate** North Dakota’s current tax structure, identify **strengths** and **weaknesses**, and develop a vision for a **fair and simple** tax system relevant to our economy in the 21<sup>st</sup> century.*

## Role of Taxes

Generally, taxes serve three functions:

- Generating revenue is the overwhelming reason state and local governments collect taxes.
- Implementing fiscal policy (i.e., using taxes and spending to influence the economy) is best accomplished by the Federal government. Fiscal policy efforts by state and local governments can only be modest and may prove counterproductive by causing individuals or firms to “vote with their feet,” moving into or out of the state.
- Redistributing income in the interest of societal equity (i.e., the “fair” distribution of wealth within a society) is best accomplished by the Federal government. Redistributing income within state and federal jurisdictions for the purpose of improved societal equity will be countered by movement into or out of the jurisdiction.

## Evaluating Taxes

We evaluate to create a means of comparison—a standard, a benchmark, or a desired outcome. The major difficulty with evaluating tax issues, or many issues related to taxes, is that there are no universal yardsticks, benchmarks, or desired outcomes. Some say the only “fair” tax is one that somebody else pays!

*Don’t tax you, don’t tax me, tax that fellow behind the tree.*  
Russell Long (from Rand Lindsly’s Quotations)

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There are also local vs. statewide vs. national vs. societal and present vs. future perspectives. Which is appropriate? They all are—what may be “right” at the local level, may be just as “wrong” at the state level, or vice versa. Should we benchmark our overall tax burden, its distribution, and the individual tax bites against some point in the past, against our neighboring states, or against some universal measure of fairness and balance? Unfortunately there are no single, universal measures of fairness or balance.

In the end, most tax policy decisions are based on the politics of balancing multiple objectives in a dynamic environment. There are several, more-or-less objective, characteristics that can be used to evaluate tax policy. However, the importance, or weighting, of each characteristic in achieving a desired “balance” in a tax system remains a subjective, political choice. Most changes in tax policies will have unintended side effects, such as perverse incentives, excess burden/deadweight loss, or inadvertent shifting, that need to be considered.

The following 13 characteristics for evaluating taxes are meant to be exhaustive, but not necessarily mutually exclusive. Others may present four, six, or ten characteristics; but the intent is to expose all readers to the methods of evaluation presented in public finance literature (see, for example, Brunori 1998, Holcombe 1988, Hy and Waugh 1995, Hyman 1996). Some of the characteristics are more important to taxpayers (e.g., low compliance costs, equitable), while others are more important to lawmakers (e.g., revenue adequacy and reliability, low administrative costs). Unfortunately, there is not a simple, objective procedure for answering most of the important questions about taxes. Often, if not always, adjustments to “fix” one perceived flaw, create other problems.

### **Equitable**

Equity, or fairness, is perhaps the most cited and least agreed upon concern relating to taxes. Public finance literature describes two tax equity principles:

- Ability To Pay, and
- Benefits Received

Equity *is not* a function of residence, occupation, age, business organization, or any other characteristic other than ability to pay and benefits received. These other characteristics (i.e., occupation, age,) influence ability to pay and benefits received. Nor is “balance” related to equity other than to argue that there could be a balance between reliance upon ability to pay and benefits received in the aggregate; or that there should be a balance among all the characteristics, which include equity.



The Ability To Pay principle simply states that those who have more ability should pay more (vertical equity—treat unequals unequally), and those with equal ability should pay equal taxes (aka horizontal equity—treat equals equally), *ceteris paribus*. The federal income tax is a good example of a tax based on ability to pay. However, there are many definitional, measurement, and philosophical issues involved with implementing the ability to pay principle, including:

- How is ability measured? Is the base measured by income, wealth, consumption, or by something else?
- How progressive should tax rates be relative to ability to pay?

*Progressive taxes* tax those with greater ability to pay a greater percentage of their incomes and reduce the gap between rich and poor. *Regressive taxes* tax those with a greater ability to pay a smaller percentage of their incomes and increase the gap between rich and poor. *Proportional taxes* tax the same percentage across all ability to pay categories and do not change the gap between rich and poor.

The Benefits Received principle holds that those who receive benefits should pay the costs. In principle, there is no distinction as to whether or not there needs to be a direct correspondence between a specific tax revenue (e.g., gambling tax) and a specific public program (e.g., compulsive gambling programs). However, in practice it is easier to assess the implementation of benefits received on a tax-by-tax basis. A classic example of a tax based on benefits received is highway fuel taxes: the more someone drives, the more tax they pay, and the heavier the vehicle (causing road wear and tear), the more tax is paid.

### **Efficient**

Estimating its *excess burden* assesses the efficiency of a tax instrument. Excess burden is the tax's social cost, above and beyond the actual tax revenue along with the costs of administering and complying with the tax. It is also referred to as “deadweight loss.” Excess burden is a real loss of social welfare that is not subsequently gained back elsewhere in the economy. It results from losses of consumers' and producers' surpluses brought about by government-induced distortions in the market. In other words, the range of choices available to consumers and the net gains of producers are both reduced. Estimating excess burden is difficult without good economic and market data. There are, however, some anecdotal and benchmark data available. For example, the overall excess burden of all federal, state, and local taxes in the U.S. is estimated to be in the range of \$0.13 to \$0.24 per dollar of tax collected.

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**The economic incidence of a tax identifies whose pocket the tax ultimately comes from.**

Trade-offs between efficiency and equity are common (but usually not explicit) in tax policy. For example, a less efficient economy may be accepted for a more equitable distribution of income; or, more efficiency may be worth some loss in equity. Economists can measure the effects of tax policy changes and the subsequent effect on efficiency and equity (and all of the other characteristics), but the trade-offs are made by policy makers (although not always knowingly).

### **Minimal shifting**

It is crucial that tax system evaluation takes into consideration the ultimate incidence of each tax levy—who actually pays the tax. Who or what legal entity is responsible for the tax according to law/regulation designates the statutory incidence of a tax. For example, the consumer is usually legally responsible to pay sales taxes, but in most cases consumers do not pay the full amount of the sales tax. Some of the tax is shifted to other players in the economy. The *economic incidence* of a tax identifies, after all shifts of burden have occurred, whose pocket(s) the tax ultimately comes from. For example, a large share of the burden of sales taxes on goods with price-elastic demands, such as soft drinks, is borne by merchants and input suppliers. On the other hand, the consumer pays nearly the full amount of sales taxes on goods with price-inelastic demands (such as tobacco). Tax incidence is especially important when addressing fairness issues.

Tax on rental property is an example of tax burden shifting. The statutory incidence of real estate tax is on the property owner. However, depending on conditions in the local/regional real estate market, all or none of the real estate tax may be shifted to renters. The important point is that the market determines the ultimate economic incidence of real estate tax (of all taxes, for that matter), it cannot be determined *a priori* or mandated by regulation.

The textbook example of tax shifting is corporate income taxes, which may be shifted by more than 100 percent. In other words, the income tax burden levied against corporations is ultimately borne by other economic units, such as its shareholders, employees, holders of non-corporate debt, or customers. Again, identifying specifically who bears the burden is not a simple matter, but it greatly influences the equity of a tax.

Tax shifting is a function of

- demand elasticities (i.e., how responsive demand is to changes in price),
- supply elasticities (i.e., how responsive supply is to changes in price),
- geographic location, and
- the type of tax.



### **Neutral**

Unless meant to do otherwise, taxes should not affect individual or business decisions—they should not distort decision-making. Assuming the market is working efficiently, a tax that affects decisions introduces distortions for goods and services into the markets. Market distortions cause inefficiencies resulting in reduced social satisfaction than without the inefficiencies. Cases where taxes are not meant to be neutral include the family of sin, or sumptuary, taxes; where one of the tax policy objectives is to reduce consumption of something society has deemed undesirable. Tax neutrality may be easy to assess (as in the case of cigarette tax) or difficult to assess (e.g., property taxes).

### **Adequate**

If the principal purpose of a tax is to generate revenue, then it is obvious that, in the aggregate, the tax system should generate adequate revenue that will provide the levels of public goods and services typically supplied by a government unit. Simply put, the tax rates and bases need to be designed to achieve the desired revenue effect.

### **Reliable**

State and local governments need aggregate tax (and nontax) revenues that can be relied on through dynamic economic, social, and environmental conditions. Thus, the government unit's tax (and nontax) portfolio could include tax instruments that generate more when the economy is doing well (e.g., progressive income taxes) as well as those instruments that will continue to generate revenue when the economy is not doing so well (e.g., real estate taxes). *Revenue elasticity* measures a tax's reliability with respect to economic indicators such as annual personal income. In other words, what is the percent change in tax revenue when the state's personal income increases (or decreases) by a certain percentage?

### **Understandable**

When taxpayers understand a particular tax, they are more likely to support it and less likely to find ways to evade it. *Tax evasion* is defined as illegally avoiding tax payments that are legally due. *Tax avoidance*, however, is finding ways to legally minimize tax obligations.

### **Low compliance costs**

Taxpayers are burdened with the actual tax obligations, the deadweight loss, and the costs of complying with tax codes (i.e., record keeping and reporting requirements). Keeping compliance costs low is clearly a worthwhile goal.

**Revenue elasticity measures a tax's reliability with respect to annual personal income.**



**Taxpayers appreciate a tax code that is predictable: one that allows them to plan for the future personally or in business.**

### **Low administrative costs**

Cost to administer tax programs should be kept to a minimum. Administrators may have considerable discretion regarding the amount of money spent on enforcement or compliance. The rule of thumb would be to spend until the expected gains just offset the expected costs. Spending anything less would leave money on the table, and spending anything more would be clearly inefficient. If the primary purpose of the tax is something other than to generate revenue, then administrative costs become a lesser issue.

### **Stable**

Taxpayers appreciate a tax code that is predictable—one that allows them to plan for the future, personally or in business. While occasional tax code changes may be necessary to satisfy some of the above nine characteristics, the negative impact of frequent or dramatic changes need to be considered.

**NOTE:** The following three characteristics for evaluating taxes will not normally be found in public finance textbooks, but they are common in economic development literature and campaign rhetoric.

### **Exportable**

Clearly, getting nonresidents to finance local government services is preferred over paying for them internally, at least from the local taxpayers' perspective. There is a benefits received argument for exporting some of the local costs. After the first ten characteristics are considered, the only remaining issue regarding exportability is whether more (or less) than a "fair" share *should be* shifted to nonresidents.

### **Competitive**

No taxing jurisdiction wants to price itself out of the market so that dissatisfied individuals and businesses vote with their feet and leave for a better "tax climate." Thus, being competitive means keeping an eye on the neighbors' tax structures and reacting accordingly.

### **Balanced**

"Balance" is something that taxpayers and politicians frequently call for in tax system assessment. A "balanced" tax system is one that appropriately weights each of the first ten characteristics, given the objectives and biases of the evaluator. If the first ten characteristics are given appropriate



attention, balance, from a public finance theory perspective, is achieved by default.

It should be clear that the objective evaluation of a tax system can only result in identification of some bounds within which fairness and equity measures should fall. It is, ultimately, politics that is necessary to make the trade-offs regarding the details within those bounds to develop specific tax regulations.

### **Fair and Simple Taxation**

Achieving universal fairness in taxation may not be simple (in fact, it may be impossible!) and if a system is simple it may not be fair. **Generally, fairness in taxation is based on either the *ability to pay* or the *benefits received* principle**, as discussed previously.

### **Revenue Neutral**

The Committee agreed we were to look for opportunities to improve the overall system while remaining revenue neutral. This was neither an opportunity to increase nor to decrease North Dakota's overall tax collections.

**The Committee agreed we were to look for opportunities to improve the overall system while remaining revenue neutral.**



# The State & Local Tax System in North Dakota <sup>1</sup>

The sources of revenue to finance state and local government are pretty consistent across the 50 states, with sales and income taxes used at the state-level and property tax collected by local government (Hy and Waugh 1995). The extent to which individual revenue sources are relied upon varies somewhat among states. For example, of the 43 states that use individual income taxes, per capita income tax collections in FY99 ranged from a low of \$28 in Tennessee to a high of \$1,301 in Massachusetts. States that levy a sales and/or gross receipts tax had collections per capita in FY99 as low as \$201 in Oregon and as high as \$1,617 in Nevada. Finally, per capita state and local property taxes in FY96 ranged from \$233 in Alabama to \$1,606 in New Jersey.

In addition to the three main sources, corporate income taxes, severance and extraction taxes, estate taxes, and gaming taxes are all used by states to generate revenue. Non-tax sources, such as lotteries, user fees, and government enterprises, are becoming increasingly more important.

## State-Level Tax Instruments

*All politics is local.* Tip O'Neill

All politics is local—and all taxes are paid by people. A large majority of state-level revenue is returned to local governments or spent locally. That same state-level revenue was collected “locally” through both income and sales taxes. In a state with a simple economic structure, there is often little distinction between state- and local-level taxes—they all come from the same people, just out of different pockets. To the extent this is the case, the economics of public finance (i.e., the characteristics) become more important.

### State Government Revenue Sources

(approximately a 10-year average)

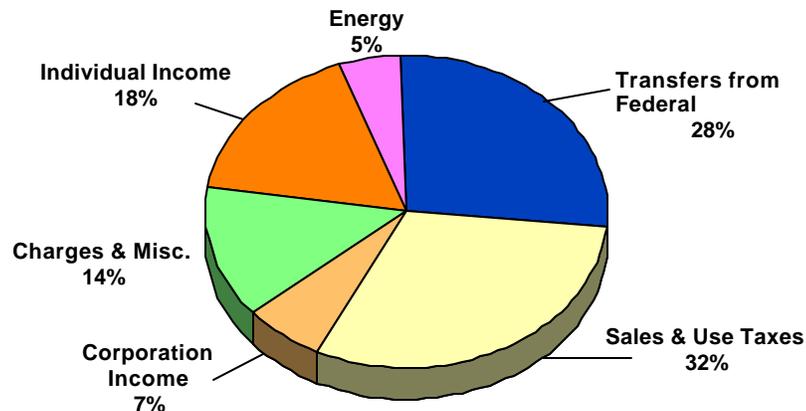


Figure 1

<sup>1</sup>Material for this section was taken largely from *State and Local Taxes: An Overview and Comparative Guide 2000* (aka, The Red Book), published every other year by the Office of State Tax Commissioner. Two other sources of North Dakota state and local tax data are: *Property Valuation and Property Taxes Levied In North Dakota* published annually, and the *Biennial Report* published every other year by the Office of State Tax Commissioner.



## **Sales and Use Tax**

State government in North Dakota relies most heavily on sales and use taxes, which account for about 44 percent of the general fund biennial budget over the past seven biennia (Figure 1). North Dakota's state sales and use tax rate is 5 percent, with a long list of exceptions and exemptions that narrow the base. The state sales and use tax rate is higher than 16 other states, lower than 17, and the same as 12 other states. However, collections per capita rank 12<sup>th</sup> highest among the states.

Arguments for sales and use taxes:

- a relatively low rate generates significant revenue, and
- they capture payments from some taxpayers that don't pay any other state taxes.

Arguments against sales and use taxes:

- they are generally considered to be regressive taxes,
- revenues can fluctuate widely in response to the economy,
- enforcement can be an issue, and
- unless they are broad-based they can introduce distortions into the market.

Excise taxes are a special type of sales tax that are applied to specific items such as tobacco or gasoline. They can serve as mechanisms to ration or limit consumption, especially of products that society generally feels are undesirable (e.g., tobacco and alcohol). Motor fuels excise tax is one of the best examples of a tax equity benefits received principle. Excise taxes generate about 3 to 4 percent of general fund revenues (about \$53 million in 99-01) in North Dakota and contribute considerably to dedicated funds (e.g., transportation).

## **Individual and Corporation Income Taxes**

About 25 percent of the state's general fund revenues come from individual income taxes, with another 6 to 8 percent coming from corporation income taxes. The state's income tax rates are quite low, generating \$287 per capita in FY 1999, which was 41<sup>st</sup> out of the 43 states that have individual income taxes. North Dakota's individual income taxes are largely federalized, which means taxpayers start with their federal taxes due (after all adjustments have been made) and apply the state rate to that. Thus, for most taxpayers, the current state rate of 14 percent of their federal tax obligation, is actually only 2 to 4 percent of total taxable income.

All revenue from individual and corporation income taxes goes to the state's general fund.

**State government in North Dakota relies most heavily on sales and use taxes.**



**Energy tax revenues from the state's general fund are shared according to a formula by producing counties and school districts and cities within those counties.**

Arguments in favor of income taxes:

- they are progressive and based on ability to pay, and
- they are responsive to economic growth.

Arguments against income taxes:

- they are responsive to downturns in the economy,
- defining "income" is not simple,
- corporation income taxes can discourage development, and
- the incidence of corporation income taxes is entirely shifted to others.

### **Severance and Extraction Taxes (Coal and Oil)**

Energy taxes have steadily declined over the past seven biennia, from a high of about 14 percent of the state's general fund revenue in 1987-89 to a low of about 5 percent in 1999-01. Energy tax revenues from the state's general fund are shared according to a formula by producing counties and school districts and cities within those counties. They are dedicated to funds for development or to mitigate negative extraction impacts.

An argument in favor of severance-type taxes is they can be used in lieu of property taxes. An argument against severance-type taxes relates to the fact that the revenues are highly subject to dynamic international markets.

### **Estate Taxes**

North Dakota's estate tax is federalized, with the definition of the estate identical to the federal definition and subject to federal exemptions and deductions. While the tax is collected by the state, all revenues are distributed to the counties and cities in which the property is located. Annual estate tax collections run between \$3 and \$7 million.

The principal argument in favor of a state-level estate tax is that if the state didn't collect it, the same amount would be collected by federal tax. Because the tax would go to the federal government if we didn't collect it, there are no arguments against it. In the absence of a federal estate tax, the arguments for and against a state-level tax would need to be revisited.

### **Gaming Taxes**

Taxes on the gross proceeds from games of chance conducted by licensed organizations were established in the state in 1977. They generate approximately 1 to 2 percent of the state's general fund revenues.



Many states use gambling, such as lotteries, as a source of revenue. In these cases the state operates the games and keeps part of the proceeds. Administrative costs take about one-third of lottery proceeds, about one-third goes for prizes, and another third becomes government revenue.

### **State-Level Property Taxes**

Real property tax is almost exclusively a local government tax. Of the \$537 million collected in property taxes and special assessments in the state in 1999, \$1.2 million went to the state and about \$900,000 went to the Garrison Diversion Conservancy District (a 26-county agency).

### **Government Enterprises**

North Dakota has two state-owned government enterprises, the Bank of North Dakota and the State Mill and Elevator.

### **State-Level User Fees**

User fees account for an important part of some state agency budgets. For example, the Game and Fish Department is nearly 100 percent funded by user fees, either from license revenues or from excise taxes (collected by the federal government) on sporting equipment. User fees make up parts of other agency budgets, such as the University System (i.e., tuition).

The primary argument for user fees, at all levels of government, is that they conform with the benefits received principle of tax equity.

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## Local Government Tax Instruments

Local governments rely almost exclusively on property taxes as their own-source revenue (Figure 2). However, revenue from other sources (i.e., pass-throughs from the state, foundation aid payments, revenue sharing) makes up a larger proportion of local government budgets. For example, sales and use taxes are now used by 85 local governmental units in North Dakota.

### **Local Government Revenue Sources**

(approximately a 10-year average)

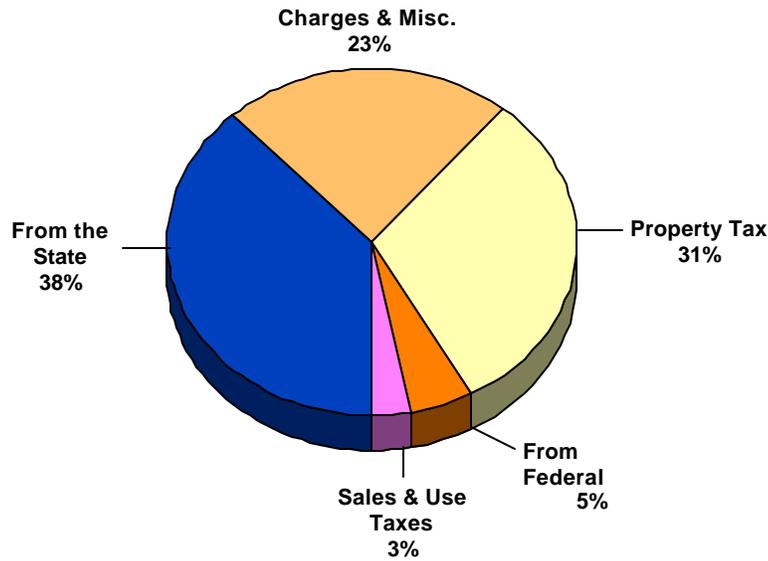


Figure 2

### **Local Property Taxes**

Property taxes are the oldest and most stable of the common taxes. All local units of government depend, to some extent, on property tax collections. Of the \$537 million collected in 1999, about 55 percent went to school districts, 24 percent to counties, 13 percent to cities, 4 percent to city park districts, 2 percent to townships, and the remaining 2 percent to some other special districts.

### **Local Sales and Use Taxes**

At least 85 North Dakota cities impose local sales and use tax. Just over \$53 million was collected in FY99, representing about 10 percent of all taxes collected by local government units in the state.

### **Local User Fees**

Local governments collect a portion of their revenues through user fees, such as building permits, public utilities, or facility use fees.

Local governments rely almost exclusively on property taxes as their own-source revenue.



# THE STUDY

## Strengths, Weaknesses, and Proposals

The following are significant items that the committee feels should be commented on in this report. There are no absolute statements as to specific changes suggested. Rather, the following discussion lists several significant items with possible solutions and reasons on both sides of the issue.

### Strengths of the Current Tax Structure

Overall, the state and local tax system in North Dakota is rather easily understood and generates fairly stable revenues. The burden is spread across a variety of traditional instruments with relatively high taxpayer compliance.

An assessment of how North Dakota's tax system compared to neighboring states (Minnesota, Montana, Wyoming, South Dakota, and Nebraska) in 1992 found that the total state and local tax burden was about average (Leitch et al. 1994). An earlier assessment of state-level tax equity found North Dakota tax burdens were fairly distributed based on the benefits received principle, at least when considered from a location perspective.

The existing structure of state and local taxes in North Dakota is working, but it could use some adjustments to take advantage of the New Economy and to be E-government compatible. Any adjustments should be subject to each characteristic in order to assess its overall effect on the taxpayer's well-being.

### Weaknesses in the Current System

Since the Committee's mission included identifying weaknesses, possible areas for improvement in the system were identified. However, we do not mean to imply that they are all necessarily weaknesses, but rather areas where some possible change could lead to a more equitable and/or simplified tax system.

Some issues are largely philosophical, such as:

What level of government should finance K-12 education? Or,  
Should services be exempt from sales taxes?

Other issues are empirical, such as:

What is the cost of exempting services?

**The existing structure of state and local taxes in North Dakota is working, but it could use some adjustments to take advantage of the New Economy and to be E-government compatible.**



**Tax regulations must be flexible enough to withstand a future in which the speed of business continues to accelerate.**

Still others are administrative, such as:

What is the feasibility of having only one individual income tax form?

The following perceived weaknesses in North Dakota's state and local tax system are identified for discussion by lawmakers. We have not attempted to either categorize or to prioritize perceived weaknesses identified by the Committee.

## **Proposals**

Committee discussions ranged from very general taxation and governmental issues, to political philosophies, and to the specific administrative provisions of selected taxes. The New Economy, property tax, income tax, and tax expenditures were identified as areas where changes might be made to better align the tax system with the changing economy.

### **The New Economy**

A primary concern is that the state's traditional tax instruments are not well suited for the New Economy. For example, in the old economy, real estate was the primary measure of one's wealth. In the New Economy significant wealth is identified in items such as investments, vehicles, recreation items, and intellect. Because of this, the bases of some traditional taxes (property, sales, and corporate income) are not growing as fast as they otherwise might. In the New Economy, wealth accrues in nontraditional ways, transactions are conducted electronically and remotely, and products and services are increasingly difficult to define. Yet the definition of the three major tax bases (wealth, consumption, and income) has changed little with the changing economy. In the future, there may be currently unrecognized activities that could be included in these tax bases, the exclusion of which prevents the base from growing. The state should be very careful about assessing taxes on what is regarded as new wealth assets so as not to jeopardize economic development. Tax regulations must be flexible enough to withstand a future in which the speed of business continues to accelerate.

We have become a society that consumes goods and services, yet many goods and services are exempt from, or outside of, the tax base. Some items, such as electronic and mail order commerce may require federal statutes to provide tax collection capabilities and ensure uniformity among the states. However, appropriate federal statutes may not be enacted unless the states work together to create a uniform tax code from state-to-state and within states. Without reduced complexity and significant uniformity, tax collections from items sold electronically may not be able to keep up with tax



collections from storefront business sales. This would create a disadvantage and consequent decline in the number of these mainstreet businesses.

**Proposals:**

- (1) Redefine and reposition consumption/sales tax bases in ways that capture the fullest extent of future economic activities in the New Economy. A uniform federal solution, especially for sales tax, may be appropriate. However, state statutes should be reviewed and decisions made regarding the type of items to be included or excluded from the consumption tax base in both present and future economies.
- (2) Redefine and reposition wealth/property tax bases.

**Pro:** Revenues will be collected from a broader base of traditional and nontraditional sources, thereby possibly reducing tax rates (to remain revenue neutral). However, each specific tax policy change should be assessed according to the criteria, as well as the aggregate effects of all changes. Without this assessment, the ultimate incidence of the tax may lead to undesirable equity effects, or other unintended consequences.

**Cons:**

- (1) Without a uniform federal solution, North Dakota’s progressiveness may discourage in-state development.
- (2) North Dakota’s state and local taxes are heavily reliant on the benefits received principle; expanding the sales and property tax bases may make the state’s tax system even more regressive.
- (3) Identifying, defining, and bringing other economic activities into the tax base with uniformity and simplicity will require considerable political will.

**Tax Expenditures**

The variety and growth of legislated tax expenditures (deductions, exemptions, credits, exclusions) leads to inequities in tax obligations and eroding tax bases. Some examples are:

- economic development incentives,
- taxation of certain rural residences,
- exclusion of most services from sales taxes,
- a different tax rate for green tractors (agriculture) and yellow tractors (industrial), and
- excluding food and “remote sales” from sales taxes.

The political process has resulted in an erosion of traditional tax bases. See the **Red Book** (*State and Local Taxes: An Overview and Comparative Guide 2000*, Office of the State Tax Commissioner, Bismarck) for examples. Page 39 (Red Book) identifies over 50 exemptions to North

**The political process has resulted in an erosion of traditional tax bases.**



**The property tax burden to support K-12 education is disproportionately borne by agriculture in rural counties.**

Dakota's Sales and Use Tax resulting in an estimated \$388 million to over \$500 million in foregone collections per biennium. Over 30 exemptions/credits from property taxes are identified on page 66.

Compliance with, and administration of, local sales taxes are complex and burdensome. At least 85 jurisdictions in North Dakota levy a sales tax with varying rates and bases. Keeping up with changes is especially troublesome for businesses which operate in several jurisdictions with different policies or operate in one jurisdiction and deliver goods to another. The difficulties in handling remote sales are magnified when so many jurisdictions have different rates and bases. Identifying jurisdictional boundaries can be challenging. The political process has resulted in an erosion of the traditional tax base. Due to its complex nature, our current tax base encourages lower levels of compliance.

**Proposals:**

- (1) Reconsider each tax expenditure and other provisions that have eroded the tax bases.
- (2) Consider preparing a state tax expenditure report.
- (3) Consider the National Streamlined System proposal.
- (4) Work to capture taxes on remote sales.

**Pros:**

- (1) A broader tax base is more efficient, more neutral, and would greatly reduce the tax rate if revenue neutral.
- (2) The revenue raised by reducing exemptions on property and consumption taxes could be used to provide property tax relief.

**Cons:**

- (1) Many tax expenditures were implemented to enhance equity (i.e., adjust tax burden for taxpayers' ability to pay), therefore broadened bases may make taxes more regressive.
- (2) Standardization may result in some loss of local control/autonomy.

**Agricultural and Commercial Property Tax and K-12**

The property tax burden to support K-12 education is disproportionately borne by agriculture in rural counties. Statewide, agricultural property contributes 32 percent of the property taxes paid to school districts. By county, the percentage of agriculture-related property taxes paid to school districts varies from 4.4 percent to 97.3 percent. A "typical" agricultural or commercial property taxpayer in a rural county pays 55 percent of their property tax to support the local school district.



**Proposal:** Reduce school property taxes on agricultural lands and commercial properties and make up the lost revenue by using another local or state tax instrument. Some likely alternative sources include:

- (1) Local sales tax—depending on the local economy, this will shift the burden to other economic sectors, nonresidents, or almost entirely right back to property owners or renters. Alternatively, increased local sales taxes may cause retailers and customers to “vote with their feet,” potentially increasing shopping costs or product prices to local residents.
- (2) State sales or income taxes—depending on the state’s economic structure, this will shift the burden to other economic sectors, to nonresidents, and/or partially right back to those who were given a property tax break.
- (3) An in-lieu-of-property tax, such as a business privilege tax, based on agricultural net income may be used.

**Pros:**

- (1) The taxes for educating our youth would be less reliant on revenue from old economy assets (i.e., localized real estate).
- (2) The total property tax burden could be reduced.

**Cons:**

- (1) With less local support may come less local control.
- (2) Property tax revenues are more stable than either sales or income tax revenues, so shifting away from property taxes may cause fluctuation in year-to-year revenues.
- (3) Replacing a federally deductible tax with a nondeductible tax may have a negative impact on personal income.

In theory, a reduction in property tax is only a short-term gain to landowners, since the tax on unimproved land in a competitive market is largely benign. The long-term effect of reducing property tax on farm operators’ net returns may be negligible.

**Property Tax and Social Services**

The local property tax burden to support social services mandated by state and federal governments, but delivered by local units of government, is perceived to be too high.

**Alternatively, increased local sales taxes may cause retailers and customers to “vote with their feet,” potentially increasing shopping costs or product prices to local residents.**



**Proposal:** Shift more of the mandated social services costs, currently delivered by local units of government, to state level revenue sources.

**Pros:**

- (1) This may conform better to both equity criteria (i.e., benefits received and ability to pay).
- (2) The mandate for social service activities would be funded by those imposing the directive.

**Con:** The reduced local property tax revenues would need to be replaced by another source at the state level, requiring a close examination of the ultimate tax incidence.

### **Property Tax Equalization**

Property tax equalization across/among taxing jurisdictions is difficult to keep current. There may be many, under-trained individuals across the state charged with keeping property value assessments equalized across jurisdictions. The natural administrative lag within jurisdictions is a lesser issue if it is somewhat consistent across jurisdictions. Unless property tax equalization across/among jurisdictions is current, the burden of the tax is not spread according to the intent.

**Proposal:** Consider Montana's system, where all property tax assessment is accomplished by equally trained, state-level employees.

**Pro:** Consistently administered property tax statewide would lead to enhanced equity in the system.

**Con:** Property tax rates may increase slightly in total to cover the added cost of enhanced assessment and may increase for those who previously benefited from the lack of consistency.

### **Individual and Corporate Income Taxes**

North Dakota's individual and corporate income taxes are often misunderstood, with people frequently thinking the rates are much higher than they actually are. For example, a recent CFO magazine story showed North Dakota having the highest corporate income tax rate in the country. Unfortunately, this type of national notoriety is far from limited to this one article. Having two alternative filing methods for individuals (short and long forms) contributes to confusion, complexities, and inconsistencies. Additionally, both of the existing individual income tax forms provide a misconception that we are a very high tax state. One return reflects a 14 percent tax rate and the other a 12 percent tax rate. Tying North Dakota



income taxes almost entirely to federal income tax obligation brings about both confusion with respect to the rates and state tax collections that are subject to the whims of federal policy makers. Having an individual long form creates confusion regarding the actual taxes that almost all North Dakotans pay and increases administrative costs.

**Proposal regarding Individual Income Taxes:** Eliminate both of the existing individual income tax returns (short and long forms) and replace them with one individual income tax return that starts with either federal adjusted gross income or taxable income.

**Pros:**

- (1) Tax rates would be much more reflective of actual revenues and tax rates.
- (2) Reduces the impact of changes in federal tax policy, since most of the tax from this source is significantly tied to changes by the federal government.
- (3) One form rather than two.
- (4) The lost deductions and credits on the long form would not really be lost because very few people can currently take advantage of them.

**Cons:**

- (1) Tax burdens would be shifted.
- (2) A lower nominal rate may tempt subsequent legislatures to increase the tax rates.
- (3) Many taxpayers would lose the possibility of using the special deductions that are currently on the long form.
- (4) Special interest groups may convince lawmakers to put the deductions and credits from the existing long form onto a new state form.

**Proposal regarding Corporate Income Taxes:** Eliminate the federal tax deduction and reduce rates accordingly.

**Pro:** The printed tax rates would be much more reflective of the real or effective rates.

**Cons:**

- (1) Tax burdens would be shifted.
- (2) With a lower nominal rate, subsequent legislatures may be tempted to increase the rates.

Having an individual long form creates confusion regarding the actual taxes...



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February 2001