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ABSTRACT

This report describes and evaluates the North Dakota state/local fiscal system, especially as it relates to financing public education. It identifies and evaluates various fiscal policy options for raising additional tax revenue for support of schools and other public services in ways consistent with the basic characteristics of the North Dakota economy and with generally accepted principles of good tax policy. The first section of the report identifies and discusses the roots of the present fiscal crisis, including the development of an oil-based economy, the results of past steps to cut spending, the antitax petition campaigns, and emergency spending cuts in recent history. The second section compares North Dakota's tax base with the United States average. The following two sections describe the condition of North Dakota's state general fund and its system for financing public schools with a combination of state and local funds. A set of guidelines are then presented for evaluating proposed tax changes, and the remainder of the report analyzes the major state taxes and their revenue potential. The report concludes with a list of recommendations for strengthening the fiscal system of North Dakota in general and in the specific areas of school finance, property tax, retail sales tax, personal income tax, corporate income tax, excise taxes, and severance taxes. Fourteen statistical tables are included. (TE)

Toward Strengthening North Dakota's Fiscal System

by

Frederick D. Stocker

Consultant, Economics and Government Finance

A Joint Project of the National Education Association and the North Dakota Education Association

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Toward Strengthening North Dakota's Fiscal System

By Frederick D. Stocker

INTRODUCTION

The citizens of North Dakota, certainly no strangers to adversity, today face economic problems of unusual severity and public policy choices of rare difficulty. Circumstances beyond the ability of the state to control have depressed prices of farm and energy products. Federal farm programs are being cut back. Personal income is down, unemployment is becoming more severe, and bankruptcies are on the rise. The outlook promises no significant economic improvement in the near future. North Dakota, it seems, is again experiencing the hard times that have been recurrent throughout the state's history.

Just as hard times affect family finances, so also they bring problems for governmental units, local as well as state. Values and priorities need to be reexamined. Low priority expenditures must be cut. As citizens try to make up their minds where cuts can be made least painfully, cruel choices must be made between items in the public budget and those in the family budget.

At the state level, the preeminent problem facing the 50th biennial session of the North Dakota Legislature is that of the state budget. In reality, there is not one problem but two. The first is to find a way to keep the state solvent through the current biennium, which ends June 30, 1987. Following a series of budgetary cuts adopted over the preceding two years the legislature, meeting last December in special session, reluctantly resorted to increases in several state taxes. The resulting revenue package, considerably below what Governor George A. Sinner had requested, is barely enough to pay the state's bills through June 30.

Subsequently a petition for referral suspended this stopgap legislation, leaving the state's finances in an even more precarious situation, as will be discussed more fully in the next section. At this writing hope for solvency rests with still deeper emergency spending cuts and inter-fund transfers.

Perhaps an even more difficult challenge to the legislature will be that of adopting a budget for the next biennium - the two-year period from July 1, 1987, through June 30, 1989. The budget legislation must contain a plan for the state's programs and services for this 24-month period. It must appropriate funds for carrying out these programs and it must provide for the necessary revenue.

Adoption of a state budget is always controversial and difficult. It requires weighing the various conflicting and competing claims on limited state resources, balancing the pressures for funding more public services against those for holding down taxes. The Governor's budget for 1987-89 assumes increases in both the personal income tax and the sales tax and contemplates expenditures of $1,114 million in 1987-89, slightly less than the legislature appropriated for 1985-87.

Voter rejection of the tax increases would force cutbacks of major dimension. Cuts would be necessary in every program or service provided by state government but would be greatest in education simply because this is where most state money goes. The people of North Dakota and their elected leaders face a harsh choice — whether to cut public services still further, and where and how to cut, recognizing that their actions will lead directly to higher local property taxes; or whether to raise state taxes, and which one to raise, and by how much.

In such difficult circumstances, one always hears the suggestion that these unpleasant alternatives can be avoided through greater efficiency — through elimination of "waste, fraud, and abuse." This suggestion is fanciful. To be sure, efficiency in public expenditure must always be pursued energetically, especially in times of tight budgets. And there can be no doubt that some inefficiency is always present in governmental activities, as it is in every other human endeavor. It must be understood, however, that further reductions in budgets already hit by several years of belt tightening will strike bone, not fat. They will take their toll in the quality of public services available to North Dakota citizens.

Purposes of this Report

This report describes and evaluates the North Dakota state/local system, especially—but not exclusively—as it relates to financing public education. It identifies and evaluates various fiscal policy options for raising additional tax revenue, should that be deemed necessary.

Beyond noting the constraints that have affected the state budget in recent years, this report does not attempt to make the case that higher state taxes are either necessary or desirable. That judgment must be made by the people of North Dakota and their elected leaders. Nor does it consider possible ways of effecting economies in state government or in the operation of North Dakota's schools or differing ways of distributing funds to schools.

Instead, starting from the presumption that increased taxes are at least likely, if not inevitable, this report focuses on various methods for raising such tax revenues Its recommendations suggest how North Dakota might obtain increased revenues for support of schools and other public services in ways consistent with the basic characteristics of the North Dakota economy and with generally accepted principles of good tax policy.

Although this report does not attempt to analyze in detail the system through which North Dakota combines state and local property taxes for support of schools, the significant fact is that schools are the number one public service responsibility of state/local government in North Dakota. Fiscal difficulties and revenue shortfalls, at either the state or the local level, cannot but affect the schools. But other public services are equally dependent on tax support. The proposals for tax changes offered here thus have relevance for state/local public services across the board.

Roots of the Present Crisis

In a very real sense the basis for the present fiscal crisis was laid years ago. The problem today is that the state's good fortune has finally turned.

The discovery of oil in the Williston basin in the early 1950's was certainly a stroke of good luck for North Dakota and for the people of the state. The same may be said of the development of the state's enormous deposits of lignite, which has led to the construction of more than a dozen mine-mouth power plants and the generation of large amounts of electric power, most of it sold out of state.

The emergence of North Dakota as a major energy-producing state reversed the state's long decline in population and jobs. It brought much needed diversification of the state's economy from its chancy dependence on wheat, production and prices of which are notoriously unstable. It contributed in a major way to the rise in North Dakota's average per capita income from one of the lowest in the nation to a level about equal to the U.S. average.

The state reaped fiscal benefit from these developments, indirectly from their stimulus to personal incomes and spending and directly from the severance taxes that were levied on the extraction of coal, oil and gas. Since 1957, when the state enacted its first severance tax, revenue from such taxes has grown until in 1982 and 1983 it amounted to more than one-third of all state tax collections. Income taxes were reduced during this period, as were property taxes. In essence, the state used its severance tax revenues largely to relieve income and property taxpayers.

Since then it has become evident that the bonanza of severance tax revenue is a mixed blessing. With the decline in oil prices in recent years and the related decline in drilling and other energy-related economic activity, revenues have dropped precipitously. Figure 1, taken from the Governor's Executive Budget Summary, gives a dramatic picture of the deterioration that has occurred in North Dakota's energy and wheat industries.

The decline in revenue from energy production, in combination with losses in other tax collections traceable to declines in wheat prices, reduced general fund revenue for the 1985-87 biennium $200 million, or 18 percent, below that of 1983-85.

Nor is the outlook promising. Forecasts by Chase Econometrics, as summarized in the Budget Message, include the following gloomy predictions:

- Oil prices will remain in the $13.00 to $13.40 range for most of 1987, rising to $16 to $17 per barrel in 1988 but not exceeding $18 until early 1989. (Recent increases in world oil prices suggest that this forecast may be too pessimistic.)

- Oil production will continue to decline over the next two years to a level some 50 percent below that of 1984.

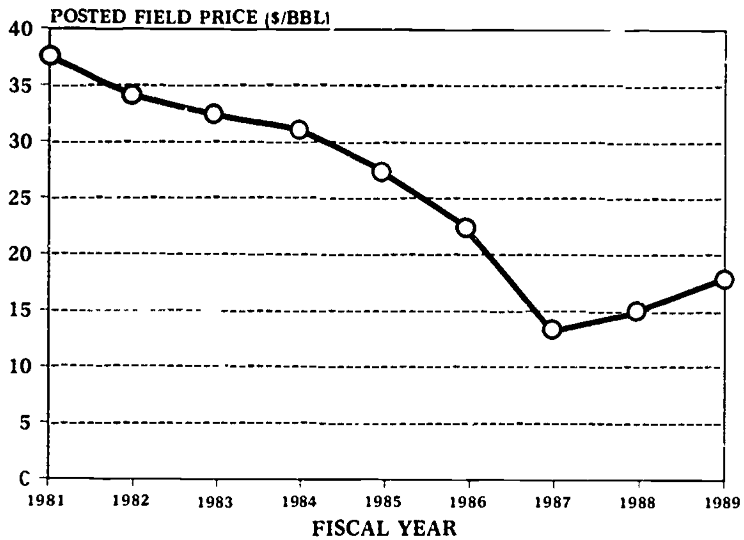
- Wheat prices will stay near their present depressed level through 1990.

Past Steps To Cut Spending

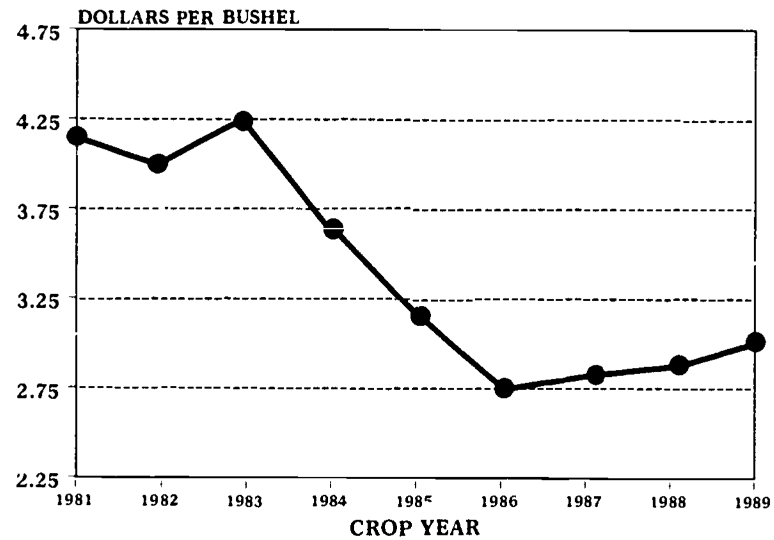
As North Dakota's economy has weakened and tax revenues dried up, attention has only recently focused on tax increases. For a long time budget balancing efforts were directed only at the spending side. Throughout the past two years hopes have remained that the downtrends would be reversed and that the state might somehow avoid both deep and painful spending cuts and the politically distasteful alternative of raising taxes.

On taking office in January, 1985, Governor Sinner, anticipating a significant imbalance in the executive budget prepared by former Governor Olson, recommended paring some $74 million from budget requests for the 1985-87 biennium. The legislature refused to go along with all these proposed cuts and put nearly $20 million back into the budget.

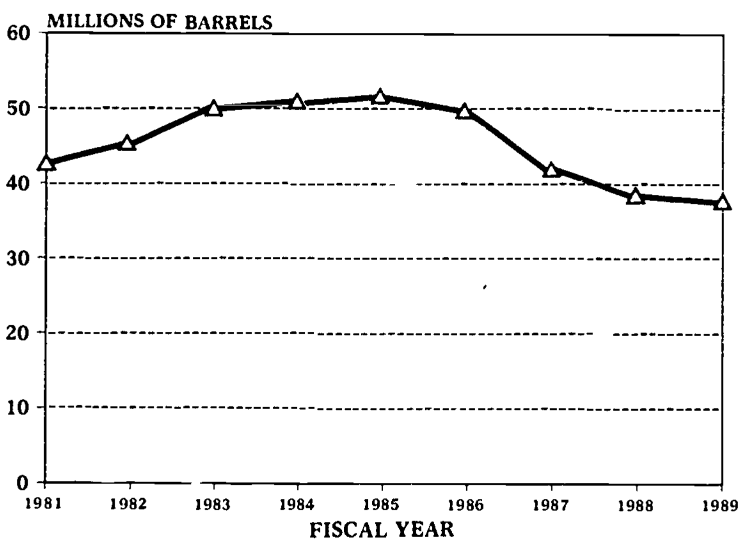
NORTH DAKOTA OIL PRICE



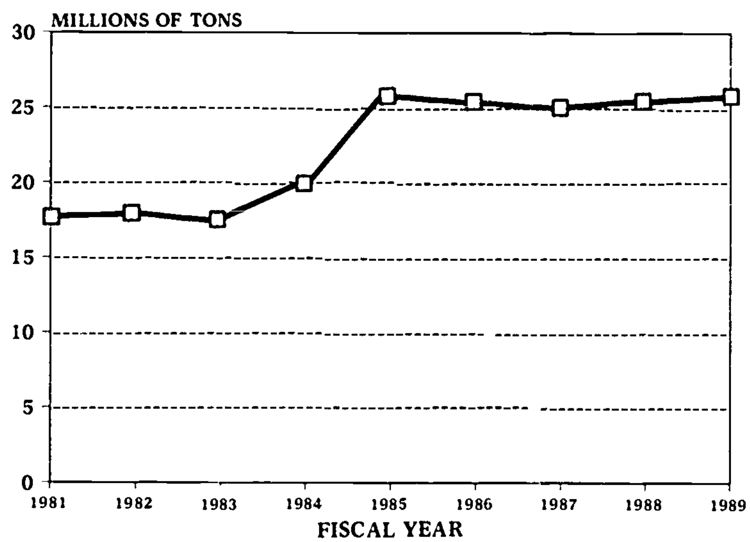
SPRING WHEAT PRICES
14% PROTEIN, MINNEAPOLIS



NORTH DAKOTA OIL PRODUCTION



NORTH DAKOTA COAL PRODUCTION
TAXABLE TONS SEVERED



Source: Governor's Executive Budget, 1987-89 Biennium, p. 20.

Subsequently it became apparent that the budget was still out of balance. The Governor ordered additional across-the-board cuts of $45 million. As the situation continued to deteriorate it became evident that even these were insufficient to maintain solvency.

In December, 1986, Governor Sinner called the newly elected legislature into special session to consider emergency surgery to the state budget to correct what by then was clearly emerging as a major deficit. Along with additional budget cuts of $11.6 million, the Governor recommended several tax increases as follows:

(1) an increase in the personal income tax from 10.5 percent of the taxpayer's federal tax liability to 14 percent for calendar year 1986, retroactive to January 1, 1986, and to 19 percent thereafter, with corresponding increases in the rates payable under the "long form." This increase was estimated to raise $23 million.

(2) adoption of withholding for all income taxpayers effective January 1, 1988.

(3) an increase in the state sales tax rate from 4 to 5 percent on most items, designed to produce $13.9 million in the current biennium.

These increases together were estimated to produce an additional $40 million over the remaining six months of the 1985-87 biennium and, together with the proposed additional spending cuts, would have left the state with a cash balance at the end of the biennium of $20 million — down from $150.4 million at the start of the biennium but considered an acceptably safe cushion (Table 1). For the 1987-89 biennium the revenue gain from all the proposed changes would have been about $280 million.

The legislature declined to accept all the Governor's proposals. In the end, after four days of debate, it:

(1) Approved spending cuts and inter-fund transfers totalling $10.4 million to be realized during the remaining six months of the fiscal year.

(2) Raised the sales tax to five percent, effective January 1, except for farm equipment and parts, three percent.

(3) Raised the personal income tax from 10.5 to 14 (not 19) percent of federal liability, and made the increase effective January 1, 1987, not a year earlier as the Governor had requested.

(4) Approved income tax withholding, effective January 1, 1987, one year earlier than the Governor had requested. This speed-up would have produced a one-time revenue gain of $8 million in the current biennium.

These actions were predicted to preserve the state's solvency but would allow a year-end cash balance of only $5.7 million — well below the amount the state Office of Management and Budget believes is necessary to maintain solvency through periods of low cash flow. In addition, as noted above, these changes would have produced some $280 million more revenue to the state general fund in the upcoming biennium (1987-89).

The Referral Petitions

No sooner had the legislature completed its difficult and thankless task and returned home for Christmas than a campaign was begun to undo their work. What follows is well-known to every North Dakotan but is reviewed here for the benefit of other readers who may wonder how North Dakota got into such a fix.

One of the legacies of North Dakota's strong populist tradition is ready access to the ballot by the people through the initiative and referendum process. Since 1918 there has not been an election year in which referred and/or initiated measures have not been on the ballot. Petition signatures by just **two percent** of the population can stop tax legislation in its tracks. In recent decades it has become a regular matter to refer any tax legislation to the voters.

In less than two weeks, the organizers of an anti-tax drive had collected the necessary signatures — a mere 13,050 — to suspend collection of the income tax increase and to forestall withholding. At first, the referral drive targeted only the income tax, but a second petition drive has since begun to refer the sales tax increase as well. At present writing the outcome of this second referral drive remains undecided.

But considerable damage has already been done. Without withholding of the income tax at the higher rate, the state loses money it was counting on to balance the current budget. Moreover, uncertainty as to the outcome of the sales tax referral has created problems of its own. The Governor has indicated his intention to call special elections on both issues on the same day, to save expense and trouble, but until the sales tax drive is completed or abandoned no firm plans can be made.

Still another problem is that under a new provision of the state constitution all legislation, including budget legislation, takes effect on July 1, or 90 days after passage, whichever comes **later**. While there is some debate about

TABLE 1.

GENERAL FUND FINANCIAL STATEMENT COMPARISONS FOR 1985-87 AND 1987-89 BIENNIA **06-Jan-87**

	SCENARIO IN EXECUTIVE BUDGET		POST-SPECIAL SESSION SCENARIO		SCENARIO WITHOUT REVENUE FROM INCOME TAX INCREASE	
1985-87 BIENNIUM						
July 1, 1985, "Unobligated" General Fund Balance		$150,410,122		$150,410,122		$150,410,122
Projected Revenue 1985-87 Biennium						
Legislative Revenue Forecast	$1,025,825,307		$1,025,825,307		$1,025,825,307	
Less: Adjustments to Revenue	(75,010,307		(89,860,307)		(99,660,307)	
Revised Revenue Projections		$950,815,000		$935,965,000		$926,165,000
Total Available Resources		$1,101,225,122		$1,086,375,122		$1,076,575,122
Projected Expenditures 1985-87 Biennium						
Legislative Appropriations 1985-87 Biennium	($1,133,350,036)		($1,133,350,036)		($1,133,350,036)	
Less: Adjustments to Appropriation Authority	52,092,883		52,667,910		52,667,910	
Revised Expenditure Authority		($1,081,257,153)		($1,080,682,126)		($1,080,682,126)
Projected June 30, 1987, "Unobligated" Gen Fund Balance		$19,967,969		$5,692,996		($4,107,004)
1987-89 BIENNIUM						
Projected Revenue 1987-89 Biennium		$1,123,621,000		$1,114,446,000		$1,000,946,000
Recommended Appropriations 1987-89 Biennium		(1,113,951,016)		(1,113,951,016)		(1,113,951,016)
Projected June 30, 1989, "Unobligated" Gen. Fund Balance		$29,637,953		$6,187,980		($117,112,020)

Source. OMB "Update to the General Fund Financial Statement for the Effects of the Special Legislative Session and the Income Tax Referral. January 7, 1987 the application of this new provision in a situation such as the present one, it would seem that unless a budget is enacted before April 1, state spending authority will lapse on July 1. Even in an ordinary legislative session, action on appropriation bills tends to come in the last days. This year, with especially difficult tax and spending choices to be made and the fate of the sales tax increase up in the air, still further delay is almost certain. It seems possible that on July 1 state government in North Dakota may temporarily go out of business.

Further uncertainty results from another provision of the state constitution that says measures "approved" by voters may not be repealed or amended by the legislature for seven years from their effective date, except by a two-thirds vote of the legislature. This would appear to mean that if the voters reject either or both of the proposed tax increases in a referendum, the legislature is prohibited for seven years from coming back with increases in these same taxes except with a two-thirds vote — a margin that is very difficult to gain in tax matters. The state attorney general, however, is said to be of the opinion that the seven-year restriction applies only to initiated laws, not to referrals.

Emergency Spending Cuts

Following the filing of the petitions for referral of the income tax increase the Governor, anticipating a severe cash flow crisis during the coming weeks, on December 31 ordered the Director of the Office of Management and Budget to take the following actions:

1. Postpone payments of one-half of the foundation aid payments scheduled to go to primary and secondary schools in North Dakota on January 5th until further notice.

2. Delay one-half the revenue-sharing payments to cities and counties until further notice.

3. Pay one-half of the scheduled payments to fire districts and prepare a bill draft for the legislature to consider transferring the other half of those scheduled payments to the state's general fund.

4. Delay payment of all bills over $1,000 submitted to the state of North Dakota for payment by general fund agencies until such time as a revised cash flow statement for the rest of the biennium is prepared, no later than January 21, 1987.

5. Review and submit a report to him, by January 21, 1987, on the effects, impacts and advisability of putting all state agencies on a four-day work week, except for those providing direct care in state institutions.

Such actions, of course, do not solve anything. They merely shift the brunt of the state's fiscal problem on to local governments, and on to the state's suppliers and employees. This is not to say that these actions were inappropriate. There apparently was no alternative.

The immediate concern of the administration and the legislature must, of course, be with cash flow problems and with problems associated with the possible cessation of state activities in July. But the fundamental longer run problem remains of adopting a budget for the 1987-89 biennium. In the absence of new revenues this will be most difficult. Since education — elementary and secondary education and higher education — accounts for nearly 60 percent of the state budget, cuts would necessarily fall heavily on this function. North Dakotans would be sorely torn between their historic strong commitment to education and their preference to avoid higher taxes.

Besides education, the rest of the state budget also consists largely of pass-through money for locally provided services. (State administrative agencies, contrary to what many people seem to think, account for such a small part of the budget that eliminating them entirely would not balance the budget.) The poor and the elderly, the principal beneficiaries of the state's human services programs, would bear the brunt of cuts in this area. Aid to counties and cities would also have to be cut. Needless to say, such budget cuts would be severely felt and strongly resisted.

As the public comes to understand more fully the consequences of rejecting tax increases, attention will shift to the question of where and how additional revenue might best be raised. These questions are addressed in the remainder of this report.

The outside observer cannot help but comment, however, on the problems North Dakota has created for itself with its outmoded constitutional provisions for referring legislative enactments. Perhaps such referrals are defensible on fundamental social issues such as abortion, the death penalty, and equal rights for women, and on fundamental matters pertaining to organization and functioning of state and local government. They are less defensible when they block the orderly management of the state's finances. It can be argued that tax and finance measures, besides being emotionally charged, are so complex that a responsible understanding requires thoughtful and extended study, such as is possible only in a legislative setting. The state constitution, in fact, excepts "appropriation" measures from the referral process, but not "tax" measures.

As the present crisis demonstrates, referrals create such turmoil as to make sensible management of state finance impossible. They damage the state's fiscal reputation and credit and cost the state money. There is much sense in such proposals as these, mentioned in an editorial in the **Fargo Forum** of January 13, 1987:

-increase the number of signatures from the present "miniscule" 2 percent;

-prohibit referrals or initiatives on issues affecting the state budget, which would include both taxation and appropriation measures;

-eliminate the suspension clause when applied to tax measures.

The state might also require that petition signatures be geographically distributed across the state.

In its search for ways to strengthen and stabilize the state's fiscal system in a lasting way, the people of North Dakota and their elected leaders should give just as much priority and attention to reforms in this area as to the reform of the state's tax structure.

How North Dakota's Taxes Compare

In considering matters of tax policy and tax reform, one of the first questions to arise is: How high are our taxes?

The answer to this question must be subjective. Only the taxpayer can judge how onerous he feels his taxes to be, and this judgment largely reflects personal perceptions and preferences regarding the public services provided by tax dollars To one who cares little about schools and other public services, even a small tax bill seems exorbitant. Conversely, one who places a high value on public services, however much he pays, may well feel that he or she is getting more than his or her money's worth.

It is possible nevertheless to give some objective indication of how heavy taxes are, at least in terms of comparisons with other states and in relation to tax burdens in past years.

Subject to the qualification that the data for such comparisons are never entirely up to the minute, several general observations can be made:

(1) North Dakota's taxes are not as heavy as they used to be.

(2) North Dakota's taxes are not as heavy as those of most other states

(3) North Dakota's taxes are not as heavy as they appear to be.

The following discussion elaborates on each of these points.

Taxes are not as heavy as they used to be
North Dakota's present tax levels can be put into perspective by reviewing the changes in the state's fiscal position over the past 25 years.

Twenty-five years ago, North Dakota's state and local governments received $358 per capita in total general revenue (revenue from all sources, for all governmental purposes), an amount that was 14 percent above the corresponding U.S. average figure of $313 (Table 2). Over the ensuing years this figure increased steadily, reflecting primarily inflation. In 1984-85 (the latest year for which comparable data are available) it reached $2,846. At the end of this period, North Dakota was still 14 percent above the U.S. average, the same as 25 years earlier, although ups and downs are evident in this ratio over the period.

Federal aid to state and local governments, shown in the second line of the same table, increased ten-fold, from $59 per capita in 1962 to $598 in 1984-85, and was consistently above the U.S. average. These figures, it may be noted, refer to aid to governments, such as highway aid, of which North Dakota receives large amounts, revenue sharing funds, and the like, and not aid to individuals such as farm subsidies or Social Security benefits.

In **taxes** per capita North Dakota remained below the U.S. average throughout the entire period. In 1962 North Dakota's per capita taxes, at $213 were only 95 percent of the corresponding national average figure of $224. During the late 1960's and early 1970's North Dakota's per capita taxes increased in absolute terms, but not so much as the increase in the nation at large. In 1976-77 North Dakota's figure was only 84 percent of the national average. By 1981-82, the gap had narrowed to 96 percent, but the latest figures show that in 1984-85 North Dakotans still were paying slightly less in taxes, on average, than were citizens of other states.

TABLE 2.

PER CAPITA REVENUES
NORTH DAKOTA AND UNITED STATES AVERAGE
Selected years 1962 to 1984-85

	1962	1966-67	1971-72	1976-77	1981-82	1984-85
NORTH DAKOTA						
Total general revenue	355	551	784	1421	2384	2846
Federal aid	59	109	177	374	460	598
Revenue-own sources	299	442	606	1047	1923	2248
Taxes	213	279	425	685	1132	1357
Non-tax revenue	86	163	181	362	791	891
UNITED STATES AVERAGE						
Total general revenue	313	461	805	1318	2020	2504
Federal aid	42	78	151	289	385	445
Revenue-own sources	271	383	654	1029	1635	2059
Taxes	224	308	526	813	1176	1465
Non-tax revenue	47	75	128	216	459	594
NORTH DAKOTA AS % OF UNITED STATES						
Total general revenue	114	119	97	108	118	114
Federal aid	140	140	117	129	119	134
Revenue-own sources	110	115	93	102	118	109
Taxes	95	91	81	84	96	93
Non-tax revenue	183	217	141	168	172	150

Source U S Department of Commerce, Bureau of the Census, **Governmental Finances** (various years)

Interestingly, while per capita taxes in North Dakota have run consistently below the national average, revenues from "all other" sources (other than federal aid) have averaged far above, as is shown in the last line in Table 2. These revenues consist largely, in the case of North Dakota, of commercial revenues of government enterprises, such as the Bank of North Dakota and the North Dakota State Mill and Elevator.

These revenues are unusually significant in North Dakota. For example, in 1981-82 North Dakota, despite its small fiscal size, accounted for more than 40 percent of the national total of governmental revenue from "miscellaneous commercial activity." Because the census statistics report such revenue on a **gross** basis (i.e. the corresponding expenditures are not subtracted from the revenues), North Dakota's figures for Total General Revenue and for General Revenue from Own Sources are somewhat inflated. Were the data reported on a net basis, it is likely that North Dakota would lie below the U.S. average in overall revenues per capita as it does in taxes per capita.

Taxes are not as high as in other states

In 1984-85, taxes per capita in North Dakota were lower than in most neighboring states, lower than most other states in the U.S., and significantly below the national average.

North Dakota was low in each of the three major categories of taxes — property taxes, income taxes (personal and corporate), and sales and gross receipts taxes. North Dakota's property taxes were 77 percent of the U.S. per capita average, income taxes were 63 percent of the average, and sales and gross receipts taxes were 78 percent of the average (Table 3). North Dakota's ranking among the states (from the highest) was in the thirties in each of these tax categories.

TABLE 3.

TAXES PER CAPITA
NORTH DAKOTA, SURROUNDING STATES AND U.S. AVERAGE, 1984-85
(Ranking among 50 states and District of Columbia in parentheses)

	All Taxes	Property Taxes	Individual & Corporate Income Taxes	Retail Sales Tax	All Other Taxes
North Dakota	$1357 (25)	$337 (34)	$234 (39)	$274 (35)	512
South Dakota	1043 (45)	455 (23)	24 (47)	323 (24)	241
Montana	1383 (22)	631 (8)	295 (29)	— (x)	457
Minnesota	1767 (6)	497 (20)	624 (5)	324 (23)	322
Iowa	1331 (27)	520 (17)	339 (20)	263 (37)	209
Nebraska	1252 (35)	541 (14)	229 (40)	247 (41)	235
U.S. Average	1465	435	374	353	303
N.D. as % of U.S. Average	93	77	63	78	169

Source U.S Department of Commerce, Bureau of the Census, **Governmental Finances in 1984-85**

North Dakota also compares favorably with neighboring states in per capita tax burdens. Except for South Dakota, which makes no use of income taxes (except for a small amount of revenue derived from taxes on banks and other financial institutions), North Dakota ranked lowest in almost all the major tax categories.

In all taxes combined, North Dakota was not quite so low — 93 percent of the U.S. average and 25th in the ranking. The explanation lies in the unusually high per capita collections from "all other" taxes. At $512 per capita, North Dakota's collections (it is a little misleading to use the term "burden" in this connection, as discussed in the next section) were 69 percent above the national average of $303. This again is a reflection of North Dakota's revenue bonanza from oil and gas and coal taxes. Half of North Dakota's collections from "all other" taxes came from the severance tax — a fraction that is far above that of most states.

North Dakota compares favorably with neighboring states and with the national average in taxes per $1,000 on personal income received by the state's residents. In part this is because of the rise in North Dakota personal income which, in 1957, was almost one-fourth below the national average but in recent years has been very close to the average (Table 4).

In 1984-85, North Dakotans paid an average of $109.64 in state and local taxes for every $1,000 received in personal income (Table 5). This was five percent below the national average and well below the figures for Minnesota and Montana, but above that for South Dakota. North Dakota shows the same pattern — far below the national average — in each of the broad-based taxes (property, personal and corporate income, and sales and gross receipts taxes). In the "all other" category, again, North Dakota is almost three times the national average.

In summary, North Dakota is (or at least was in 1984-85) a low tax state in all areas except severance taxes. The state's ability to extract significant amounts of revenue from extractive industries has obviously enabled North Dakota to hold down the other major kinds of taxes — taxes that for the most part impact more directly and obviously on the state's individual citizens.

TABLE 4.

PER CAPITA PERSONAL INCOME NORTH DAKOTA AND UNITED STATES AVERAGE Selected years 1957 - 1984

YEAR	NORTH DAKOTA	UNITED STATES	NORTH DAKOTA AS % OF UNITED STATES
1957	$1,563	$2,044	76
1962	2,294	2,369	97
1967	2,641	3,161	84
1972	4,351	4,515	96
1977	6,135	6,984	88
1982	10,896	11,097	98
1984	12,352	12,789	97

Source. United States Department of Commerce

TABLE 5.

TAXES PER $1,000 OF PERSONAL INCOME, 1984-85

	All Taxes	Property Taxes	Personal & Corporate Income Taxes	Sales & Gross Receipts Taxes	All Other Taxes
North Dakota	$109.64	$27.25	$18.94	$34 90	$28.55
South Dakota	94.49	41 24	2.17*	43.26	6.27
Montana	131.42	60.00	28.05	16.07	27.30
Minnesota	134.36	37.79	47.47	40.16	8.94
United States	115.82	34.35	29.55	41.84	10.11

Source U.S Department of Commerce, Bureau of the Census. **Governmental Finances in 1984-85.**

Taxes are not as high as they appear

Because North Dakota receives so much of its revenue from taxes that do not fall directly on the state's residents but are "exported" to other states, North Dakota's taxpayers are even less heavily burdened than would appear from the statistics on per capita taxes and on taxes per $1000 of resident personal income. Not only severance taxes, but property taxes as well, are exportable in substantial degree. Out-of-state owners of North Dakota farmland pay a certain fraction of the total property tax bill — a percentage impossible to determine with any accuracy but surely substantial.

Because of tax-export opportunities, comparisons of tax burdens between states often are made in terms of "tax capacity" and "tax effort," as estimated by the Advisory Commission on Intergovernmental Relations — a permanent national bipartisan body created by the Congress in 1959 to monitor the operation of the American federal systems and to recommend improvements.

The ACIR defines tax capacity as the revenue a state could hypothetically receive if it levied a "standard," or "representative" set of state and local taxes at national average rates. Tax effort is measured as the relationship of actual tax collections to the hypothetical potential revenue from this Representative Tax System (RTS). States can then be compared with one another in index-number fashion, with the national average tax capacity and tax effort being set equal to 100, and individual states' capacity and effort measured relative to this norm.

States like North Dakota, which export a large part of their tax burden, tend to rank lower in tax effort measured in this way then they do in taxes per $1,000 of personal income. Since much of their tax collections come out of income received by nonresidents, the tax-to-personal-income measure tends to understate tax burdens on, and tax effort exerted by, the state's own residents.

ACIR's comparisons of state fiscal capacity and tax effort for 1984 (the latest year available) put North Dakota's fiscal capacity per capita at 106 percent of the national average (Figure 2). This means that if North Dakota utilized a standard (representative) set of taxes (the RTS) at national average rates, it would realize 6 percent more revenue per capita than the national average. This figure, it can be seen, declined sharply after 1981, reflecting mainly the reduced revenue potential from energy industries. It seems likely that the capacity index for North Dakota may be still lower today than it was in 1984.

Tax effort for North Dakota is shown in the lower line of the same chart and from Table 6. In 1984, it was estimated at 93 percent of the U.S. average. Tax effort has risen in North Dakota since 1981, but, as is evident from the chart, North Dakota's tax effort, as measured by the RTS method, has long been below the national average. In other words, given the revenue sources available to North Dakota, the state (together with its local subdivisions) taxes these bases somewhat less intensively than do other states on average.

The same method is used to estimate and compare the tax effort the various states put forth in each of the major kinds of taxes — that is, the extent to which they exploit the tax capacity represented by each of the available tax bases. Such comparisons indicate where a particular state may be "overutilizing" or underutilizing" its tax bases, in relation to what other states are doing.

Thus, in Table 7 it is shown that North Dakota actually collected $883 million in 1984 from all taxes, while national average rates would have produced $947, indicating an "underutilization" of available revenue sources in the amount of the $64 million. Among just the largest items, significantly underutilized sources include the general sales tax ($36 million), the personal income tax ($68 million), and the property tax ($32 million). Severance taxes were "overutilized" to the tune of $89 million.

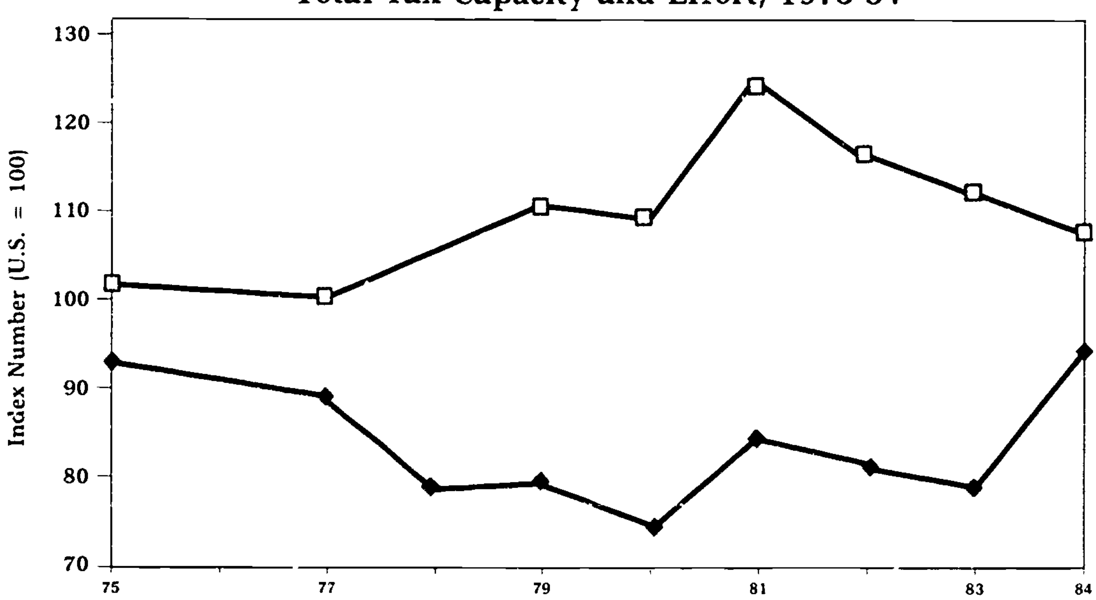
The significance of these data for North Dakota tax policy is readily apparent. Yet caution is in order before jumping to conclusions

FIGURE 2

North Dakota

1984 RTS Capacity = 106   1984 RTS Tax Effort = 93

Total Tax Capacity and Effort, 1975-84



Source Advisory Commission on Intergovernmental Relations, **Measuring State Fiscal Capacity. Alternative Methods and Their Uses** (Report M-150), September 1986

TABLE 6.

INDEXES OF FISCAL CAPACITY AND TAX EFFORT
NORTH DAKOTA
Selected Years 1975 - 1984*
U.S. Average = 100

	Fiscal Capacity	Tax Effort
1975	101.3	92.5
1977	98.5	87.8
1979	108.6	77.7
1980	108.3	78.8
1981	123.5	74.0
1982	115.1	82.6
1983	110.8	81.2
1984	105 8	93.3

*See text for explanation of the terms "fiscal capacity" and "tax effort."

Source Advisory Commission on Intergovernmental Relations, **Measuring State Fiscal Capacity: Alternative Methods and Their Uses,** Information Report M-150, Sept 1986

TABLE 7.

TAX CAPACITY AND TAX EFFORT FOR NORTH DAKOTA, 1984*

	Tax Effort Index (U.S. Avg. = 100)	Tax Capacity (millions)	Actual Tax Revenue (millions)	Under (over) Utilization (millions)
All taxes	93.3	$947	$883	$64
General sales tax	85.1	240	204	36
Sel. sales tax	92.9	104	97	7
Tobacco	113.7	11	13	(2)
Public utilities	51.9	23	12	11
Alcoholic beverages	72.8	9	6	3
Personal income	52.1	142	74	68
Corporate income	105.6	41	44	(3)
Property taxes, total	87.7	256	224	32
Severance taxes	179.9	111	200	(89)

*See text for explanation

Source Advisory Commission on Intergovernmental Relations, **Measuring State Fiscal Capacity: Alternative Methods and Their Uses,** Information Report M-150, Sept 1986

(1) For one thing, the data cited here are for 1984. While the North Dakota tax system has changed little since then (except for the emergency legislation adopted last December and at present partly suspended), personal income and expenditure and property values no doubt have changed. And, of course, changes have occurred in other states that would affect North Dakota's position relative to U.S. averages. The situation today, while certainly not exactly the same, probably is not greatly different from that shown for 1984.

(2) It must be emphasized that these data are descriptive in character and are not intended to carry normative implications. Merely because most states tax in a certain way doesn't mean that this is necessarily the best way or that every state should move into conformity. The fact that North Dakota is higher or lower than the national average in its utilization of a particular tax source does not mean that North Dakota is doing something "wrong," and that the other states are "right." Every state's tax structure is (or ought to be) designed to reflect the particular values, priorities, and goals of the citizens of the state. Also, it should be attuned to the economy of the state and the tax bases available.

This point has special relevance to North Dakota's much heavier than average taxation of the coal, oil and gas industries. Most states do not have much to tax in this area, and their severance taxes tend to be low in rate or nonexistent. States that have significant energy resources understandably try to take maximum advantage of this revenue opportunity. Also, the resource will not be driven out of state by such taxation. Consequently, a high tax effort in the severance tax area is both understandable and appropriate in a state such as North Dakota.

It is apparent, however, that in North Dakota reliance on severance tax revenues has led the state to excessive reduction in effort placed on the other more conventional tax sources. In the state's present fiscal difficulties, and with the oil industry depressed, the time seemingly has come when North Dakota will have to utilize other taxes at levels more nearly in line with the national average.

The Condition of the State General Fund

At this writing, it is difficult to speak definitely about the size of the prospective deficit in the state general fund or the amount by which expenditures might need to be reduced in order to balance expenditures with revenues, because of the uncertain status of the recently enacted increases in sales and income taxes. The most that one can do is to project the fiscal consequences of various alternative scenarios.

The Office of Management and Budget has estimated that without the revenue from the income tax increase the state would end the 1985-87 biennium with a negative cash balance (Table 1). Obviously this outcome is unacceptable; spending reductions must be made to keep the state solvent.

Even more significant from the longer run standpoint is the fact that for the 1985-87 biennium revenues are expected to come in at only $926.1 million, not counting revenue from the income tax increase but including that from the increase in the sales tax rate. This would leave an imbalance of more than $150 million below the $1,080.7 appropriated by the legislature. In other words, the unobligated cash balance of $150.4 million with which the state started the biennium would have been entirely eaten up.

The outlook worsens for the 1987 89 biennium. Revenues (without the income tax increase) are estimated at just over $1,000 million. But the Governor's proposed budget calls for spending of $1,114 0 million. There would be a deficit for the biennium of $113.0 million ($1,113.9 minus $1,000.9), and a negative fund balance on June 30, 1989, of $117.1 million. Even with the revenues provided by the income tax increase, revenues would only slightly exceed recommended spending and the projected cash balance would be a dangerously low $6.2 million.

Two other things must be remembered. One is that these estimates assume sales tax collections at the increased rate, although at this writing it appears that this reserve also might be cut off by referral. Without this added sales tax revenue, the deficit for the current biennium would be several million dollars greater, and that for the 1987-89 biennium $85 million greater.

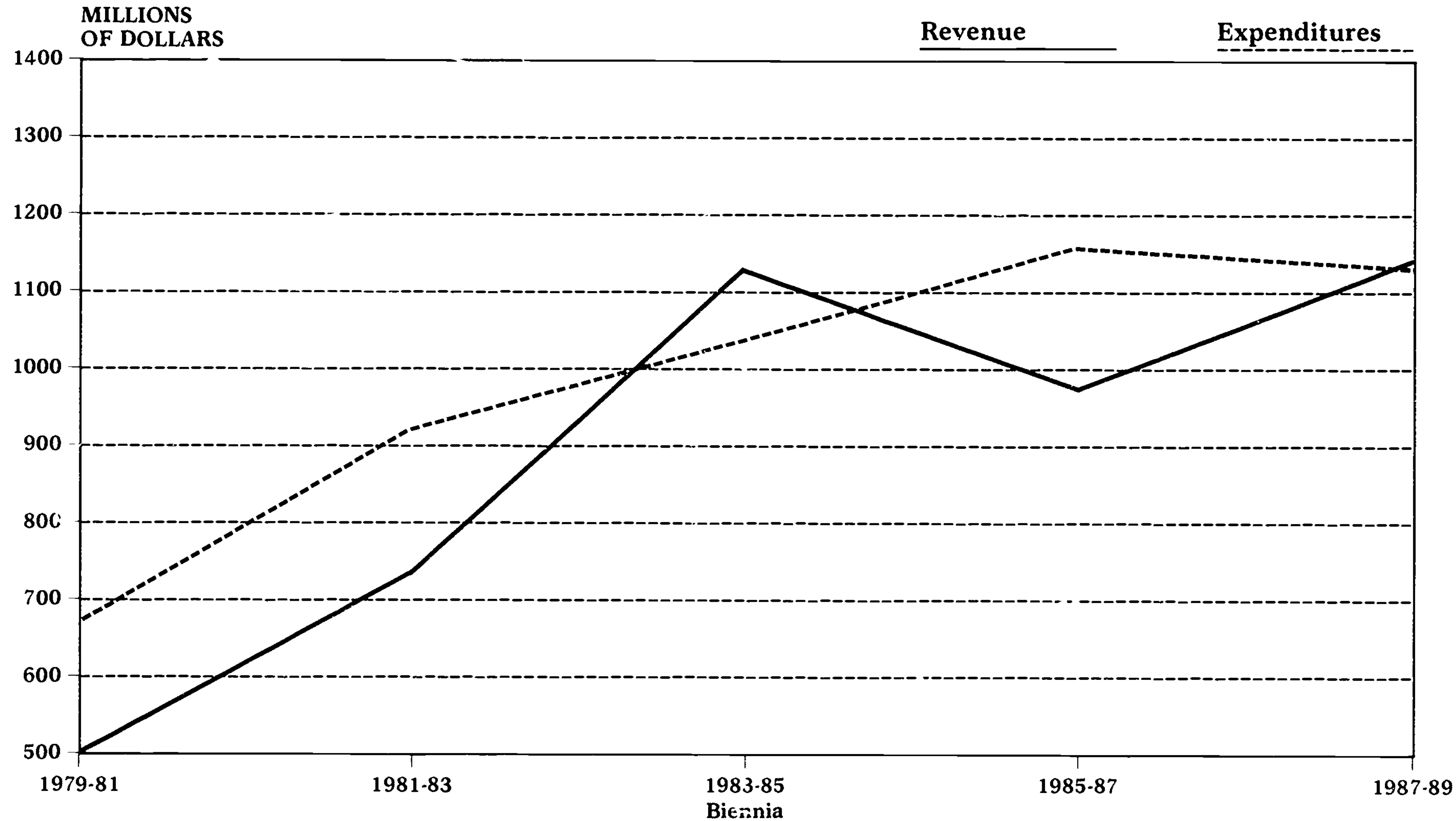
Second, the level of expenditure recommended by the Governor for 1987-89 is nearly $20 million below the appropriations approved for the current biennium and only about the same as the amount spent in 1983-85 (Figure 3). State spending, far from increasing out of control, has been held in tight check for the past several years. The 1985-87 budget as adopted by the legislature called for spending some $53 million less than former Governor Olson had requested in his Executive Budget. Subsequently, Governor Sinner made further across-the-board cuts of $45 million, followed by still another $11.6 million in cuts and transfers proposed to the special session that met last December.

FIGURE 3

TRENDS IN GENERAL FUND REVENUE AND EXPENDITURES

1981-83 through 1987-89 Biennia

State of North Dakota



Source Governor's Executive Budget, 1987-89 Biennium, p 15

Sources of General Fund Revenue

The sales tax is the largest contributor to state general fund revenue. In 1983-85, it generated 34.9 percent of general fund revenue, and this percentage was projected to rise to 39.1 percent in 1985-87 with the rate increase enacted by the special session (Figure 4). In the current biennium, the personal income tax was expected to be the second largest revenue producer (17.7 percent), followed by oil tax revenues (14.1 percent).

As is clear from Figure 4, the cause of the present budget crisis lies in the great reduction in oil tax revenues since 1983-85. Estimates for 1987-89, it should be noted, assume new revenues from both the personal income tax and the sales tax and reduced revenue from the oil tax due to proposed rate reductions.

General Fund Expenditures

Elementary and secondary education is the largest single item in the state general fund budget, accounting for $418.1 million or 37.5 percent of the $1,114.0 million total budget as proposed by the Governor. Higher education represents another $220.8 million (19.8 percent). Health and welfare comes in for $247.5 million in the Governor's request, a large part of which represents matching funds for federal welfare grants.

While appropriations from the general fund are by far the largest part of the revenue going to schools, additional funds are received from sources other than the general fund, principally federal grants and tuition apportionment funds.

How Schools are Financed in North Dakota

Like other states, North Dakota finances public schools with a combination of state and local funds, supplemented by a relatively small share provided by the federal government.

The largest part of the state money consists of Foundation Aid payments. Under the Foundation program, the state guarantees each district throughout the state a given basic amount per pupil (for 1986-87, $1,370). Toward this foundation level of support is charged off an amount equal to 20 mills (2 percent) on the local property tax base. The state makes up the rest.

North Dakota employs a "pupil weighting" system for calculating foundation support, under which the amount of money the district receives differs for pupils of different kinds. The system is intended to reflect differences in the cost of educating pupils at different grade levels and in schools of different size.

In addition to foundation aid, the state pays local school districts an average of close to $200 per pupil in tuition apportionment from proceeds from the school lands funds. The amount in this fund is distributed each year to school districts in proportion to number of children ages 6 to 17 as reported on the school census.

Local school districts also receive revenue from the state tax of 5% on oil and gas production. A portion of the revenue (about one-third in 1986) is retained in the county of origin and of this amount 35 percent is distributed to school districts. Unlike foundation aid payments, this part of state aid is not subject to any equalization such as might be provided, for example, by subtracting the equivalent of a 20-mill property levy from the amount going to each district.

Revenue from foundation aid and from tuition apportionment is estimated to produce $1,565 per pupil in the current school year (1986-87), or slightly more than half the total per pupil cost. The remainder comes almost entirely from the local property tax except for counties that receive oil tax revenue (Table 8).

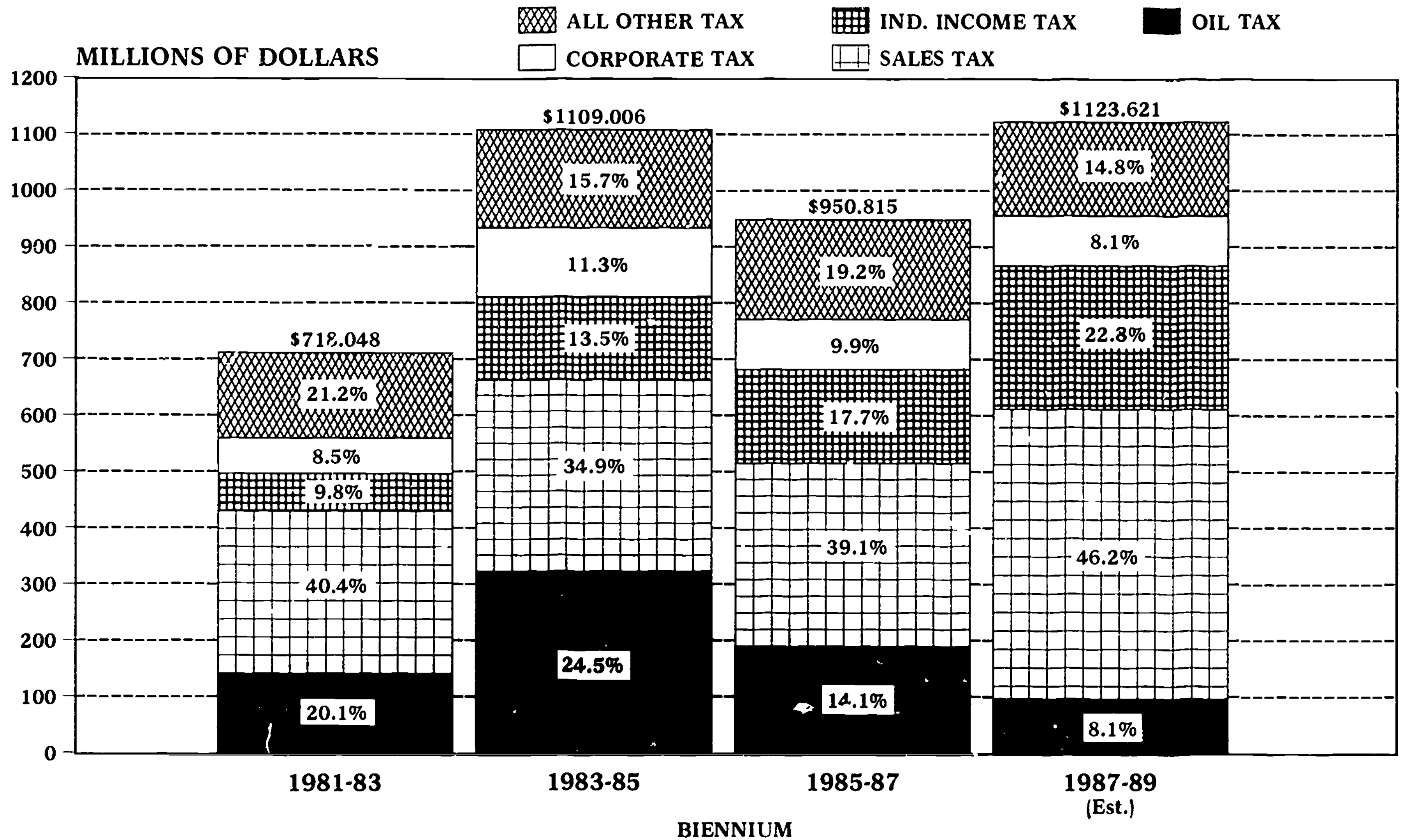
Clearly evident in Table 8 is the decline in the proportion of school costs tnat is paid from state sources. In the mid-1970's, this share was above 60 percent (the target figure established in 1959 when the foundation program was established) but it gradually declined thereafter. In 1980, initiated legislation called for the state share to be increased to 70 percent, but the state legislature in 1981 scaled down this target to 60 percent. State funds were sufficient to achieve this target through 1983-84 but since then the state share has dropped precipitously. With cutbacks in state aid due to the suspension of sales and income tax collections, it is possible that the state share may fall below 50 percent in the current school year. Without new revenues it is all but certain to fall below 50 percent in 1987-88.

To the outside observer, a peculiar feature of North Dakota's school finance system is that no minimum property tax levy is required of local school districts. At one time a 21-mill levy on equalized assessed values was required, but this was repealed in 1981 when major new severance tax revenues began to flow in. It is hard to avoid concluding that the additional severance tax revenue went not to upgrade schools and other public services but to relieve property owners.

TRENDS IN GENERAL FUND REVENUE
By Major Source — 1979-81 through 1987-89 Biennia

State of North Dakota

FIGURE 4



Source: Governor's Executive Budget, 1987-89 Biennium, p 23.

School finance also has been adversely affected by legislation under which farmland is assessed for property tax purposes not on the basis of market value but on the basis of its value in agricultural use. Data from the state Department of Taxation indicate that this system in 1985 caused farmland to be valued on the average at only 62.1 percent of its market value. The effect of this assessment policy is to diminish greatly the tax base in rural school districts. To avoid this devastating effect, the state would need to have either (a) a strongly equalizing foundation aid program, or (b) an effective system of equalizing assessed values for tax purposes. Unfortunately, North Dakota has neither.

Noteworthy too is the fact that per pupil school aid shows scarcely any increase since 1981-82. The Governor's budget for 1987-88, which is predicated on tax increases that are now in great jeopardy, calls for only a nominal rise in state support, from $1,565 to $1,590. The foundation level of support – the only component that is equalized between rich and poor districts – would increase only to $1,413. This figure is a little below what it was six years earlier, despite major increases since then in actual per pupil costs.

TABLE 8.

TRENDS IN NORTH DAKOTA PER PUPIL COSTS/PAYMENTS, 1973-74 to 1987-88

	Actual Cost Per Pupil	Foundation Payment	Tuition Apportionment	Total From State Sources	% Of Per Pupil Cost From State Sources
1973-74	$ 831				
1974-75	938				
1975-76	1,097	$ 640	$ 38	$ 678	61.8%
1976-77	1,212	690	47	737	60.8%
1977-78	1,376	775	47	822	59.7%
1978-79	1,544	850	53	903	58.4%
1979-80	1,741	903	80	983	56.4%
1980-81	1,957	970	106	1,076	54.9%
1981-82	2,392	1,425	98	1,523	63.6%
1982-83	2,477	1,353	158	1,511	61.0%
1983-84	2,577	1,400	176	1,576	61.2%
1984-85	2,736	1,350	190	1,540	56.3%
1985-86	2,838	1,425	195	1,620	57.1%
1986-87	2,940 (est)	1,370	195	1,565	52.3%
1987-88	3,040 (est)	1,413*	177*	1,590	52.3%

*The foundation payment and tuition apportionment figures for 1987-88 come from Governor Sinner's budget. It is unlikely that $1,413 will be achieved. DPI estimates it could be as low as $1,000 to $1,100.

Source: The North Dakota Education Association, based upon data provided by the Department of Public Instruction, January 1987.

How North Dakota Compares in School Finance

Although North Dakota has a long tradition of generous support for public schools, in recent years the state has fallen well below the national average. In 1985-86, North Dakota's current expenditure per pupil in average daily attendance came to $3,059, a figure that was 18 percent below the national average. The state ranked 37th from highest among the 50 states and the District of Columbia (Table 9). In comparison with neighboring states North Dakota slightly exceeded South Dakota in per pupil support for schools but was below Minnesota and Montana by a considerable margin.

The same general pattern is evident in revenue per pupil. (The reason the figures for revenue exceed those for operating expenditures is that the latter do not include money spent for capital outlay, debt service, or other nonoperation purposes.)

North Dakota, with 38 percent of all revenue coming from local government sources, was somewhat below the national average of 43 percent. Noteworthy is the contrast with neighboring South Dakota, which relies on local sources for more than 60 percent of all school revenue The converse is also evident. North Dakota (53 percent) slightly exceeds the national average (50 percent) in the share of school revenue supplied by the state, although as noted earlier, this percentage is declining sharply. South Dakota, at 28 percent, ranked next to last in the nation in the share of school costs borne by the state.

North Dakota's relatively low expenditure per pupil (18 percent below the national average) must be judged in the further perspective that the state provides education under unusually high cost conditions. Although precise data are not available, it is clear that sparse population, long school bus routes, and small classes all run up the cost of providing a given educational program.

One indication of this costly characteristic is found in the comparison of number of pupils per teacher. North Dakota, with 14.28 pupils per teacher, is 14 percent below the national average. Montana and South Dakota share this characteristic, though Minnesota is about equal to the national average in its pupil/teacher ratio.

North Dakota to some extent makes up the cost of its low pupil/teacher ratio with a low level of teacher compensation. Teachers' salaries in 1985-86 averaged $20,816. This was 18 percent below the national average. Only eight states were below North Dakota in teacher salaries. The state still compares favorably with South Dakota, where teachers' salaries are the lowest in the nation, but Minnesota, with which North Dakota is in closest competition in hiring teachers, pays on average close to one-third more than North Dakota.

Over the decade since 1975-76, North Dakota slightly more than doubled teachers' salaries in current dollar terms (increase of 102 percent). This gain just about matched the national average increase. Even after allowing for inflation there remained a small real gain, 3.3 percent compared with the national average of 2.9 percent.

However, the increase from 1984-85 to 1985-86, at 3.6 percent, was only half the national average gain and was lower than in all but five other states. The increase in 1986-87 was even smaller. The clear indication is that North Dakota, never really in an advantageous position in teacher recruitment and retention, is becoming increasingly less competitive in the market for public school teachers.

TABLE 9.

HOW NORTH DAKOTA COMPARES IN SUPPORT OF ELEMENTARY AND SECONDARY EDUCATION

	North Dakota	Surrounding States			U.S. Avg.	North Dakota	
		Minn.	Mont.	S.D.		% of U.S.	Ranking
Revenue, 1985-86 Amt. per pupil in avg. daily attend.	$3,510	[illegible]	$4,[illegible]25	$3,304	$4,121	85	35
Percent from local sources	38%	37%	42%	61%	43%	*	31
Percent from state sources	53%	59%	50%	28%	50%	*	22
Current Expend. per pupil in avg. daily attendance	$3,059	$3,982	$3,947	$2,967	$3,723	82	37
Pupils per teacher	14.28	16.39	14.36	14.42	16.63	86	41
Teachers salaries Avg. 1985-86	$20,816	$27,360	$22,482	$18,095	$25,313	82	43
Percent Increase 1975-76 to 85-86	102%	115%	104%	92%	101%	*	31
Percent Increase 1975-76 to 85-86 constant dollars	3.3%	10.1%	4.2%	-1.5%	2.9%	*	31
Percent Increase 1984-85 to 85-86	3.6%	7.5%	3.6%	4.1%	7.3%	*	46

*Not calculated

Source. NEA Rankings of the States. 1986

Guidelines for Evaluating Proposed Tax Changes

In evaluating the various potential sources of new tax revenues to which North Dakota might turn, it is appropriate to keep in mind certain criteria that are recognized to be relevant to judging the feasibility and desirability of imposing, increasing, or revising any particular tax. These may be summarized as follows:

Equity Is the proposed tax change fair in the burdens it places on various taxpayers? Does it fall equally on those whose economic circumstances are essentially equal? Does it differentiate fairly and consistently among those whose economic circumstances differ (i.e., is it progressive, regressive, or proportional to income and/or wealth)? For example, North Dakotans have always emphasized minimizing tax burdens on the poor and have favored significantly larger tax burdens on those with high incomes.

Economic Effects How does the tax effect economic incentives? Does it produce harmful distortions in economic decisions? Does it reduce profits at the margin, perhaps driving marginal firms out of business and reducing the tax base in the long run? This consideration is clearly important in evaluating present and proposed levels of taxation on oil production.

Revenue Aspects How much revenue would be produced (or lost, in the case of exemptions or rate reductions)? How does the revenue grow with inflation and with economic growth? How stable is the revenue during economic fluctations — an aspect of obvious importance to North Dakota during the present economic hard times? Also, the way in which changes in federal tax law affect North Dakota's revenues is clearly an important consideration in evaluating the present piggy-back method of levying the North Dakota personal income tax.

Exportability To what extent can the tax burden be exported, i.e., shifted to nonresident customers or perhaps nonresident owners of North Dakota land or capital? Here again, oil taxes provide the obvious example.

Administration and Compliance Can the tax provisions be administered effectively at reasonable cost? How difficult and costly is it for taxpayers, employers or retailers to comply with requirements of the law? These are issues that arise, for example, in evaluating income tax withholding, and also the possibilities of extending the retail sales tax to certain personal services.

Legal and Constitutional Aspects What changes, if any, would be required in the state constitution or statutes? In the present state of affairs in North Dakota, an important question concerns the constitutional constraints placed on the legislature by voter referenda.

Political Aspects Who would support and who would oppose the proposed tax change? The answer presumably depends largely on the answers to the preceding questions. In addition, there is the very important question of whether an action of the legislature can be, or is likely to be, forestalled by being referred.

Applying these critera to any specific tax proposal is not easy. Each criterion poses two separate questions. One is, in principle at least, a **factual question.** For example, a judgment of the equity of a given proposal requires a determination or estimate of who in fact will bear the burden of the tax. Similarly, judgment of the economic effects requires an estimate, factual in nature, of the direction and magnitude of such effects. Often the answers to such questions are by no means clear.

The second kind of question calls for a judgment of **how much importance** is to be attached to each of the criteria. The difficulty is that these considerations usually run in conflict with one another. A tax or tax proposal that ranks high in terms of equity, for example, is likely to present severe difficulties of administration. How much administrative difficulty is it worth incurring in order to achieve some increment in equity? Again, a proposal that takes maximum advantage of export opportunities may produce undesirable long run economic effects. Here one must judge how much weight to attach to these undesirable economic effects, as against the advantage of exporting a larger part of the tax load in the short run.

There is no tax that scores high on all the relevant criteria. The dilemma facing tax policy makers is that of striking an acceptable balance among undesirable features

The Major Taxes and Their Revenue Potential

The Property Tax

Taking state and local revenue sources together, the property tax is the number one revenue producer in North Dakota. It remains so in spite of reductions that have occurred over recent years. In 1984-85, according to data reported by the U.S. Bureau of the Census, property taxes generated $231 million, or 25 percent of the $929 million collected in that year from all North Dakota state and local taxes.

The property tax plays a distinctly smaller role in the North Dakota fiscal system today than it did 25 years ago. Its share of all state-local taxes has dropped to 25 percent from more than 50 percent in 1962 (Table 10). This decline largely results from the state's growing use of other taxes — personal and corporate income taxes, sales taxes, and taxes on coal and oil and natural gas.

But it also reflects a decline in effective rates of the property tax as indicated by the following:

(1) As a percentage of personal income property taxes in 1984-85 were significantly below what they were in the 1970's, though higher than in 1962.

(2) The effective rate on single family residential property averaged 1.25 percent in 1984 — above the 1981 level but below that of earlier years.

(3) Taxes per $100 of full value of farm real estate were less than half as high in 1982 as they had been twelve years earlier.

Property taxes are also low in North Dakota in comparison with other neighboring states (Table 11). North Dakota is lowest of the six states shown — and the only one of the six that is lower than the national average — in property taxes per capita and per $1,000 of personal income, and in property tax effort as measured by the Representative Tax System.

To the outside observer it seems clear that North Dakota underutilizes its property tax base — a feature of the tax system that is surprising in view of North Dakota's land and natural resource based economy and the potential that the property tax offers for exportation.

The Property Tax Base: Its Changing Composition

It is customary to speak of "the property tax" as though it were a single, simple, readily recognized form of tax. Actually the property tax in North Dakota, as in other states, is a collection of levies that apply in somewhat differing fashions to various kinds of taxable property and produce differing sorts of economic effects.

When people refer to the property tax, especially urban dwellers, they often are thinking of the tax on their homes In North Dakota, residential real estate accounts for only 28.29 percent of taxable valuation, and part of this (.57 percent) is offset by the homestead credit allowed on owner occupied residences (Table 12).

The largest part of taxable value in North Dakota, not surprisingly, consists of agricultural land. In 1986, this represented more than 43 percent of the total. Significantly, this percentage is down from just about half in 1981, a percentage that had been holding steady for more than a decade. The decline apparently reflects the weakening in farm real estate values over recent years.

North Dakota is unusual — probably unique — among the states in that farm buildings (other than commercial) are exempt from property tax. This exemption seems unfair to nonfarm homeowners, presents serious administrative difficulties, and cuts into the tax base of rural communities.

The next largest category (20 percent) consists of commercial real estate, a component that has gradually been rising in relative importance. The remainder of the property tax base consists of railroad and public utility property.

North Dakota is one of a small number of states in which personal property (property other than real estate) is entirely exempt from property taxation, except for railroad and public utility personal property. This blanket exemption dates from 1979. Categories of property exempt from taxation in North Dakota, though they are taxed in many other states, include business machinery and equipment, business inventories, furniture and fixtures, and motor vehicles. Although the exemption of such property narrows the tax base significantly, there are problems in the taxation of personal property — problems of equity, economic effects, and administration — that support their omission from the tax base.

Evaluation of the Property Tax: Its Revenue Potential
If the voters of North Dakota or their elected representatives insist on avoiding increased sales and/or income taxes to resolve the present budgetary crisis, it is all but certain that property taxes would rise considerably. Since nearly 40 percent of the state general fund goes to support public schools, no significant budget reduction can avoid deep cuts in school aid, leaving local school districts no alternative but to increase property taxes.

How, then, does the property tax measure up as a source of additional revenue? Judged by the criteria suggested earlier, the property tax receives a mixed report card.

The **equity,** or **fairness** of the property tax is difficult to judge because of uncertainties about the incidence of the tax, especially as it pertains to non-farm business property. It is not at all clear whether taxes on business property rest on the property owner in the form of a reduced after-tax return or on consumers in the form of higher prices paid for items produced with taxed property. The latter assumption, fairly widely accepted until recently, suggests a regressive pattern of incidence.

TABLE 10.

INDICATORS OF CHANGING DEPENDENCE ON PROPERTY TAXES 1962 - 1984-85

	1962	1971-72	1976-77	1981-82	1984-85
Property tax as -					
Percent of personal income	4.9	4.8	3.9	3.0	2.7
Percent of all state and local taxes	53	40	33	27	25
Percent of home value	n.a.	2.08	1 26	1.01	1.25
Percent of farmland value	1 18 (1960)	1.21 (1970)	.74 (1975)	.48 (1980)	.48 (1982)

Sources. U S Bureau of the Census, Census of Governments, **Governmental Finances**, various years, Advisory Commission on Intergovernmental Relations, **Significant Features of Fiscal Federalism**, 1985-86 ed , U S Dept of Agriculture, **Taxes Levied on Farm Real Es'ate**, various years

TABLE 11.

PROPERTY TAX LEVELS UNITED STATES, NORTH DAKOTA, AND SELECTED OTHER STATES, 1984-85

	Property Taxes		RTS Tax Effort Index	Effective Rate on	
	Per Capita	Per $1000 of Personal Income		Farm Real Estate (1982)	Single Family Residences
North Dakota	$337	$27.25	87.7	$.48	$1.25
South Dakota	45[illegible]	41.24	111.5	.78	1.63
Minnesota	497	37.79	108.4	.49	.99
Montana	631	60.00	155.4	.43	1.14
Nebraska	541	43.55	124.8	.91	2.11
Wyoming	1,101	89.67	163.7	.33	n.a.
U.S. Average	435	34.35	100.0	.49	1.23

Sources. U.S. Bureau of the Census, **Governmental Finances in 1984-85.** Advisory Commission on Intergovernmental Relations **Significant Features of Fiscal Federalism**, 1985-86 ed. and **Measuring State Fiscal Capacity** (1986)

TABLE 12

RATIO OF TAXABLE VALUATION OF EACH CLASS OF PROPERTY TO GENERAL PROPERTY TAXABLE VALUATION 1981 to 1986

						Centrally Assessed			
Year	Agricultural Land	Commercial Real Estate	Residential Real Estate	Homestead Credit Allowance	Railroad Property	Telephone	Telegraph	Electric, Gas Heat & Water	Pipelines
1981	49.36	17.52	26.84	0.81	1.29	2.83	0.00	2.17	0.79
1982	47.79	18.63	26.80	0.74	0.55	2.69	0.00	2.06	2.21
1983	45.08	19.06	27.22	0.64	0.51	2.60	0.00	2.16	4.00
1984	46.15	18.94	27.03	0.58	0.78	2 02	0.00	2 01	3.64
1985	43.91	20.15	28.23	0.53	0.93	1.99	0.00	3.37	1.95
1986	43.74	20.34	28.29	0.57	1.08	1.97	0.00	1.79	3.35

Source 1986 Property Tax Statistical Report, North Dakota Tax Department, p 59

More recently, economists have increasingly been persuaded by theoretical and statistical analysis that the tax rests largely on property owners themselves. If so, the tax is likely to be progressive because property ownership rises more than proportionately with income.

Of course, this positive relationship to income exists only over the long run. In any one year, as every farmer or rancher knows, income may be low or negative, yet property does not immediately lose its value, and property tax bills have to be paid.

It is this failure of liabilities to adjust quickly to changes in the economic winds that gives the property tax its reputation for unfairness. On the other hand, this feature contributes to **revenue stability** and is highly regarded by those whose concern is with the financial viability of schools and other public services through bad years as well as good.

With respect to the half or more of the North Dakota property tax base that represents land, there is little question that the property tax reduces the owner's net return and therefore the capital value of the property. It is probable that the same is true for much of the improvements to real estate.

Because values adjust to reflect changes in net return, the principal effect of either a reduction (or increase) in property taxes is to increase (or reduce) property values. This is a consideration that deserves to be recognized in evaluating the equity of both North Dakota's past tax policies and possible future changes.

As it applies to residential property, whether owner-occupied or rented, the incidence of the tax is also reasonably clear; it falls on the occupant. This component therefore tends to be regressive, as consumption of housing does not represent as large a fraction of family income, on average, at high income levels as at low.

While the principle **economic effects** of the property tax, as noted above, are on real estate values, the property tax on business and residential improvements can theoretically lead to reduced investment in such assets. However, unless taxes were raised far above their present level, these deterrent effects are unlikely to be significant.

This study has not explored in depth the **administration** of the property tax in North Dakota. In most states there is much room for improvement. The same probably is true in North Dakota. Efforts to strengthen property tax administration would be well justified. Still, administrative costs, while hard to isolate, are probably low and would not be affected much one way or the other by changes in tax rates.

Compliance is simple, except for the inconvenience involved in making two sizable semiannual payments. A monthly billing system (which in effect already exists for property owners whose taxes are escrowed by the mortgage holder) would go a long way to making property tax payments more convenient for taxpayers

The **revenue** potential of the property tax is significant. According to the ACIR analysis of state/local fiscal capacity and tax effort in 1984, North Dakota's property tax capacity was underutilized by $32 million. This means that had North Dakota levied against its property tax base at national average effective rates it would have realized $32 million, or some 10 to 12 percent, more revenue than was actually obtained from this revenue source in 1984.

While it is evident that property taxes in North Dakota are not exorbitantly high, it is perhaps unrealistic to recommend that the state move toward higher property taxes during the present period of economic hardship. Economic as well as political wisdom is evident in the Governor's statement in his budget message. "Increasing the property tax would be a devastating blow to farmers and other property owners at a time when real estate values are extremely depressed." Such a course, harsh though it is, must be recognized as the likely consequence of not increasing other taxes.

Nevertheless, it must be recognized that North Dakota in years past has allowed its property tax to decline too far and has turned too heavily to other less dependable revenue sources, notably the oil tax. The lesson for the future is that property taxes should not be allowed to decline further and, as circumstances permit, the tax should be restored to a more significant position in the fiscal system.

In doing so, attention might well be devoted to reforms such as the following:

1. Assess all taxable property at 100% of its true market value, instead of about 5% as at present, with offsetting adjustments in tax rates. To base taxes on low fractional assessments accomplishes nothing and confuses the taxpayer.

2. Simplify and liberalize the present hopelessly complex system of property tax limitations.

3. Require consolidation of non-operating school districts; and require all school districts to make at least some modest minimum property tax effort — say, one-half of one percent on true market value.

4. Strengthen the system for equalizing property assessments among counties, among classes of property, and among properties in different parts of a county.

Deed Transfer Tax

North Dakota is one of a small number of states that do not tax deed transfers. The significance of this tax does not lie in its revenue — in fact, it is preferable that the rate be kept low. Rather, it is useful as a method of providing information on market prices of real estate. Such information is highly valuable in property tax assessment and equalization. In the interest of strengthening property tax administration, North Dakota should enact a low-rate tax on real estate transfers.

The Retail Sales Tax

The retail sales tax is second to the property tax in revenue productivity in North Dakota. The nearly $200 million it produced in 1985 represented 27 percent of all state tax revenues and nearly 13 of state/local tax collections combined. Like other sales-tax states (numbering 45 in all), North Dakota also levies a use tax on items purchased outside the state and brought into the state for storage, use, or consumption. The following discussion, and all statistics, apply to the combined sales and use tax as well as to the motor vehicle excise tax, which from an economic standpoint is best regarded as part of the sales tax though it is a separate statute.

The sales tax rate was increased from three percent to four percent on April 1, 1983. The special session of the legislature meeting in December, 1986, voted to increase the rate to five percent, but this increase may yet be suspended by a petition for referral. However, a three percent rate applies to new mobile homes, farm machinery and irrigation equipment; and a six percent rate applies to liquor sales.

The North Dakota tax, should it be put back at four percent, would be lower than in most other states. As of the end of 1985, only 14 states had lower rates, including the five with no sales tax. Eleven states levied the sales tax at the four percent rate and 26 states at higher rates. Additional local sales taxes are found in many states.

From an equity standpoint, the sales tax is often criticized because of its regressivity — its tendency to take a larger percentage of income from low income family budgets. The food exemption, however, substantially eliminates this regressivity, converting the sales tax into a tax roughly proportional to income. Another objection to the sales tax on equity grounds is that, because of the nontaxation of most personal services, the sales tax discriminates horizontally among families with equal incomes but different spending patterns or preferences.

The economic effects of the sales tax are generally too small to be a major tax policy consideration. Likewise administration is reasonably simple and efficient once the tax is established, as it is in North Dakota. However, administration of the sales tax becomes more difficult in some of the personal service items. Taxpayer acceptance of the sales tax ranks above that of other taxes, probably because it is paid in small amounts every day rather than hitting the taxpayer in one large bill.

A significant consideration in North Dakota sales tax policy is the fact that neighboring Minnesota levies a six percent sales tax while North Dakota's at present is five percent. This rate increase has not put North Dakota out of line, although it would diminish as any competitive advantage North Dakota merchants have had relative to their Minnesota competitors. Montana has no sales tax, but border competition poses less of a problem in the sparsely populated area long the state's western border.

A peculiar exemption which North Dakota should repeal is that of purchases by residents of Montana and Manitoba. The exemption of purchases by certain nonresidents is unusual and indefensible. Although the revenue loss may be small, the practice is inequitable and possibly unconstitutional. The few vendors who seek to perpetuate this exemption are in effect acknowledging that they cannot compete without the subsidy other state taxpayers are giving them. In addition it is almost impossible to police.

The increase in the rate of the sales tax to five percent is an obvious source of revenue. At estimated 1987 levels of personal income and consumer expenditure each one percent of sales tax generates about $45 million annually in general fund revenue.

Because the 4% tax rate was below the national median, North Dakota was found to be slightly underutilizing its sales tax capacity in the 1984 ACIR comparisons of state fiscal capacity and tax effort. The index of tax effort for the general sales tax was estimated at 97 percent (of the U.S. average), and the dollar amount of "unused fiscal capacity" at $7 million.

The North Dakota sales tax base is relatively broad in some respects, narrow in others. North Dakota is one of 44 states that exempt prescription drugs and one of 29 that exempt food. The former exemption involves little revenue but the latter reduces the sales tax base significantly. The food exemption serves to reduce the burden of the sales tax on low income families, in whose budgets food usually is a large item. The North Dakota sales tax also fails to reach as broad a range of personal services as do the sales taxes of many other states. Yet, North Dakota taxes more purchases of machinery and equipment than most other states do.

Broadening the base of the sales tax to include more personal services would be an appropriate source of additional revenue. To do so would improve the equity of the tax by reducing discrimination due to differences in consumption patterns. The regressivity of the tax might be increased or reduced, depending on the services chosen for taxation; in any case, the effect would be small. Likewise, the revenue obtainable would depend on which services were made taxable.

Personal services to which the sales tax might feasibly be applied include:

Consumer electric utilities
Printing and duplicating
Closed circuit telecasts of sport contests
Repairing, altering, mending, pressing, fitting, dyeing, laundering, dry cleaning, or cleaning of tangible personal property
Washing, cleaning, waxing, polishing, and lubricating of motor vehicles
Parking of motor vehicles and trailers
Exterminating services
Barber and beautician services
Advertising
Storage of personal property
Cleaning, maintenance and repair of real property
Cable TV charges
Computer services
Consulting services
Services of employment agencies
Accounting and legal services

Experience in other states indicates that it is feasible to apply the sales tax to items such as these. Administrative and compliance costs, however, are not negligible. The number of additional vendors to be registered and audited is large relative to the potential tax revenue. Concentrated political opposition is, of course, to be expected.

Taxation of Mail Order Sales

North Dakota, along with other states, suffers a growing revenue loss on mail order sales shipped into the state by out-of-state vendors. Such sales are legally taxable at present under the use tax, but enforcement is all but impossible. A bill now under consideration by the North Dakota Legislature would try to require out-of-state vendors to collect the North Dakota tax. This is an exercise in futility. North Dakota lacks legal jurisdiction over such vendors and cannot compel compliance.

Hope for remedying this problem rests with federal legislation. North Dakota, in cooperation with other states, is supporting a proposed law to require mail order vendors to collect the sales tax. Efforts should be continued along this line.

The Personal Income Tax

Third most important in the North Dakota tax structure, after the local property tax and the state sales tax, is the state personal income tax. The tax produced $294 million in 1985 or some 8 percent of all state/local tax collections. This is a smaller percentage than in most of the 41 states that have broad-based personal income taxes. All revenue from the tax goes into the state general fund.

North Dakota has had a graduated personal income tax since 1919. As of 1986 the rates were as follows.

Taxable Income	Rate
Up to $3,000	2%
$3,000 to $5,000	3%
$5,000 to $8,000	4%
$8,000 to $15,000	5%
$15,000 to $25,000	6%
$25,000 to $35,000	7%
$35,000 to $50,000	8%
Over $50,000	9%

Taxable income is calculated in much the same way as it is for federal tax purposes, with the notable exception that North Dakota allows deduction of federal tax liability in calculating taxable income for state tax purposes. This practice, which is followed in 16 of the 41 income-tax states, significantly reduces the tax base, especially for high-bracket taxpayers. It reduces the progressivity of the state tax and requires higher nominal rates to raise any given amount of revenue.

Since 1981, the state has provided an alternative "short form" under which the taxpayer can choose to pay the state a flat percentage of his or her federal tax liability. As of 1986 this percentage was 10.5 percent. The legislature recently in special session voted to increase this to 14 percent, but the increase is now suspended pending a referendum on the issue.

North Dakota is one of only four states that "piggy back" the state income tax on the amount of the taxpayer's federal liability, and the only one that allows a choice between this method and filing according to a statutory rate schedule on taxable income. More than 85 percent of North Dakota taxpayers opt to use this simplified filing method, presumably most of them because their tax bill is lower under the short form.

In comparison with other states, North Dakota is relatively light in its taxation of personal income. In 1984, the ACIR estimated North Dakota's effort in this area to be only 52 percent of the national average. In other words, North Dakota realized only 52 percent as much revenue from this source as it would have if the state income tax had been levied at national average effective rates. This strikes one as a remarkable divergence. States like North Dakota that have strong populist traditions usually favor heavy income taxation.

Other interstate comparisons by ACIR indicate that North Dakota's effective tax rates on income are lower throughout the income range than most other states (Table 13) Using 1980 data and tax rates (the latest available), a North Dakota married couple with two dependents and an adjusted gross income of $10,000 would be taxed at .5 percent. This is just half of the median rate among the 41 income tax states. Effective rates are well below the 41-state median at all levels of income. Even at $100,000, the effective rate in North Dakota, at 2.6 percent, is only slightly more than half the national median rate of 4.5 percent. The disparity relative to Minnesota and Montana, both high-income-tax states, is even more dramatic. South Dakota, on the other hand, has no personal income tax.

Similar calculations for the years 1953, 1965, 1977 and 1980 show a remarkable decline in North Dakota in effective rate of personal income tax at various income levels (Table 14). The 1980 effective rates were less than half what they had been fifteen years earlier at each income level. In 1965, North Dakota taxed more heavily than the national median at the $17,500 and $25,000 levels of income but by 1980 had dropped considerably below.

This change, as has been noted earlier, reflects North Dakota's discovery of energy resources as an eminently productive source of tax revenue and its consequent backing away from taxes that impact directly on the state's own taxpayers.

Evaluation of the Personal Income Tax

The personal income tax measures up well by the criteria reviewed earlier.

It is reasonably equitable, being tied directly to family income, which is generally regarded as the best single measure of "ability to pay." It is also the only major tax that can be personalized to the circumstances of the individual taxpayer (taking account, for example, of age, marital status, family size) and that can be applied at graduated rates It is flexible and can be designed to produce whatever pattern of tax progressivity is thought fair.

Because of its unique adaptability to tapping high incomes, the income tax is well-suited to picking up for North Dakota some of the income-tax relief provided through the recent federal tax cuts, should that be desired.

Its **revenue potential** is sizable. The tax also tends to be highly responsive to growth in the state's economy, although this characteristic is a two-edged sword that can cause trouble in times of unstable economic conditions.

The tax is relatively simple to administer, as long as the tax base is closely linked to that of the federal income tax. Taxpayer compliance is also simple, for the same reason.

There are, however, some negative aspects to consider.

For one, the income tax falls directly and obviously on individual taxpayers, especially the vocal and politically influential middle-income brackets. Unlike the sales tax, there is nothing subtle about the income tax. This is certainly one of the reasons for the strong resistance to the recently proposed increases.

Another problem is that awareness of evasion and avoidance of the federal tax (to which North Dakota's income tax is closely tied) has to some extent undermined taxpayer confidence in the equity of the income tax. It remains to be seen whether the federal reforms enacted in 1986 will improve its reputation.

Finally, supply-side theories, recently in vogue in many quarters, warn that state income taxes may undermine initiative and work effort incentives. Some stress the possibility that income taxes may drive economic activity out of state. The significance of these arguments is hard to assess. Since North Dakota's income tax is far lower than Minnesota's (the principal area of cross-line competition), the effect is not likely to be large.

All things considered, the personal income tax measures up well by the accepted criteria of state tax policy. In view of the fact that it is relatively underutilized in North Dakota, the personal income tax must be regarded as a high priority source of additional tax revenue.

TABLE 13.

EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES FOR SELECTED ADJUSTED GROSS INCOME LEVELS
Married Couple with Two Dependents
North Dakota, Surrounding States and U.S. Median
1980
(Percent)

	Adjusted Gross Income Level							
	$10,000	$15,000	$17,500	$20,000	$25,000	$50,000	$75,000	$100,00
North Dakota	.5	.6	1.0	1.1	1.5	2.2	2.5	2.6
South Dakota			no income tax					
Minnesota	-4.3	2.8	3.5	4.5	5.5	7.3	7.4	7.4
Montana	1.2	1.1	1.5	2.1	2.9	4.6	4.9	5.0
U.S. Median	1.0	1.4	1.8	2.0	2.3	3.8	4.0	4.5

Source Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1981 82 ed , p 57

TABLE 14.

EFFECTIVE RATES OF STATE PERSONAL INCOME TAXES FOR SELECTED GROSS INCOME LEVELS
Married Couple with Two Dependents
1953, 1965, 1977 and 1980
North Dakota, Surrounding States and U.S. Median
(Percent)

	Adjusted Gross Income Level											
	$10,000				$17,500				$25,000			
	1953	1965	1977	1980	1953	1965	1977	1980	1953	1965	1977	1980
North Dakota	1.1	1.2	.8	.5	*	2.7	1.7	.8	3.8	3.8	3.1	1.5
South Dakota					no income tax							
Minnesota	3.0	4.1	1 4	-4.3	*	4.8	5.6	3.5	4.6	5.6	6.7	5.5
Montana	.9	1.9	2.8	1.2	*	2.9	2.7	1.5	1.9	3.6	3.6	2.9
U.S. Median	1.3	1.7	1.4	1.0	*	2.2	1.9	1.8	2.5	3.1	2.6	2.3

*Not computed

Source: Same as Table 13, p 59

Structural Problems with the Personal Income Tax

Several observations may nevertheless be made about the structure of the income tax in North Dakota and suggestions offered as to how the tax might be made to work better for the citizens of the state.

(1) In adopting the "piggv back" option in 1981, North Dakota clearly chose the simplest possible way of levying the state income tax, from the standpoint of both administration and taxpayer compliance.

It is questionable, however, whether this method is best adapted to the North Dakota economy or the state's fiscal goals. For one thing, it makes the state's revenues very dependent on actions taken by the national Congress, as witness the devastating effect the recent federal tax changes had on the North Dakota tax base.

For another, it builds into the North Dakota tax system the same degree of progressivity as is contained in the federal income tax North Dakota might well prefer to choose for itself the optimum degree of progressivity. The recent federal tax changes significantly reduce progressivity at high-income levels, but eliminate many poor from the tax rolls.

Likewise, the piggy-back method makes the North Dakota income tax highly elastic. That is, its revenue is highly responsive to changes in economic activity and personal income. The state tax, in fact, has exactly the same elasticity as the federal tax. Elasticity is a characteristic much to be desired in the federal income tax, where economic stabilization is an important goal of tax policy.

At the state level, because of the (perfectly appropriate) requirement of a balanced budget, too much revenue elasticity can be dangerous. In a state like North Dakota, where personal income is subject to wide fluctuations caused by the vagaries of the weather and changes in national or world economic conditions, revenue stability is a characteristic more to be emphasized. A lesser degree of graduation would work in this direction.

On balance, it would seem wise to drop the piggy-back option and require all taxpayers to file according to a graduated rate structure applied to **adjusted gross income** as defined in the federal Internal Revenue Code, allowing such personal exemptions (or credits) as may be desired. (This method would be preferable to basing the tax on "taxable income" as calculated for federal tax purposes, as some have suggested). Taxable income automatically incorporates federal exemptions and deductions. Such a system would be every bit as simple from the standpoint of administration and compliance and would be far more flexible. In addition, it would allow statutory tax rates to be much lower — a matter primarily of appearances but important nonetheless.

(2) **Withholding** The outside observer finds it difficult to understand the reluctance of North Dakotans to accept income tax withholding. Virtually every other income-tax state, requires employers to withhold state income tax from employees' paychecks. Once adopted, withholding ceases to be an issue, no state has ever abandoned withholding.

The advantages are clear. Withholding is an important aid to collection. It also benefits taxpayers by making it easier and more convenient to keep current with their taxes. It evens out cash flow to government and to taxpayers and facilitates fiscal management. From the enforcement standpoint, withholding clearly reduces revenue losses from non-filers — a feature that one would think would cause every honest taxpayer to support it.

A major objection to the recent withholding legislation (at present under suspension) seems to be that there would be a speedup of collections in the amount of some $8 million — a one-time gain in taxes that otherwise would be paid in future years. This objection is hard to understand. In the present fiscal crisis of the state, it would seem that this is one of the least painful ways to maintain state solvency. Surely those who oppose more state spending should prefer this to an alternative that involves permanent tax increases.

Even more difficult to understand is the objection that withholding makes the income tax "less painful" to the taxpayer. Support of public services is not supposed to be painful. In a world in which consumer durable goods, homes, and many other items are bought on "easy monthly payments" it is absurd to deny income taxpayers the same convenience.

The only valid objection is that withholding imposes some added burden on employers, but this is surely minimal in view of the fact that employers must withhold federal taxes anyway. Nor is it necessary for the determination of the amount to be withheld to be complex — surely not as complex as are the new IRS W-4 forms. A simple flat percentage of the amount withheld for federal tax purposes would be sufficiently accurate.

Withholding is long overdue in North Dakota. The state should adopt this administrative practice promptly.

(3) Allowance of federal tax payments as a deduction in the "long form" calculation is a practice of dubious wisdom, as noted above. The deduction significantly narrows the tax base, especially at higher income levels, and necessitates higher rates to produce any given amount of revenue. North Dakota would do well to eliminate this deduction and make whatever corresponding reduction in rates is necessary to achieve the desired distribution of income tax burden by income class.

The Corporate Income Tax

North Dakota, along with 46 other states and the District of Columbia, taxes corporations on their net income. In fiscal 1986, this tax produced just under $40 million, all of which went into the state general fund.

The tax applies at graduated rates to taxable income, essentially as defined under the federal tax Since 1983, the rates have been:

Taxable Income	Rate
Up to $3,000	3%
$3,000 to $8,000	4.5%
$8,000 to $20,000	6%
$20,000 to $30,000	7.5%
$30,000 to $50,000	9%
Over $50,000	10.5%

These rates appear high; very few states have top bracket rates as high as North Dakota's. But appearances are deceiving. Because North Dakota allows corporations to deduct their federal tax payments in determining income for state tax purposes, the effective rate on pre-tax corporate income is much lower.

For interstate corporations, North Dakota follows the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act, which essentially divides income of the corporation according to a three-factor formula based on the percentage of the corporation's total **property** and **payrolls** located in North Dakota and the percentage of **sales** made in the state. North Dakota, as a member of the Multistate Tax Commission, benefits from the Commission's professional audits of multistate and multinational corporations and from exchange of information with other member states, as well as from assistance in litigation and in various administrative matters. In each of these respects, the North Dakota corporation tax conforms both in design and in administration to generally accepted principles of good tax policy.

In 1981, the U.S. Congress, through the Economic Recovery Tax Act (ERTA), liberalized corporation depreciation allowances, with the result that corporate income as calculated under federal tax rules was greatly reduced. In order to minimize the adverse effect on North Dakota tax revenue the state allowed only part of the more generous federal depreciation deduction to be claimed for North Dakota tax purposes. The excess amount had to be carried forward and claimed in later years. Now, beginning with 1986, depreciation deductions not allowed in earlier years can be subtracted from taxable income. The effect is that now, when the state can least afford it, North Dakota is experiencing the revenue loss it avoided in earlier years.

On the other hand, the Tax Reform Act of 1986 will benefit North Dakota fiscally. By closing various loopholes and scaling down depreciation write-offs the new law enlarges the state tax base and adds to revenue from the corporation income tax. North Dakota is likely to receive a small revenue gain.

Worldwide Unitary Combination A decade or so ago a number of states, including North Dakota, began to tax multinational corporations on a "worldwide unitary" basis. This method requires corporations doing business in the state to report their combined income from activities all over the world, including those of its subsidiaries and affiliates. The income taxable in North Dakota is determined by applying the three-factor formula mentioned above (property, payrolls, and sales) to this worldwide total. The worldwide unitary system was designed to prevent multinational corporations from sheltering income from state taxes by assigning it to subsidiaries in tax-haven countries.

Over the past decade, the unitary tax has been the subject of much controversy and litigation. The business community has maintained that the compliance costs (more complexity, extra bookkeeping expenses, etc.) are excessively burdensome. The federal government, too, has tried to discourge the states from this practice, though it has refrained from prohibiting it.

The unitary tax battle, in which North Dakota was a leader, has been lost. Whatever may be the merits of the arguments on both sides, the fact is that most states have refused to adopt the worldwide unitary principle and, of those that did, most have now backed off. States are increasingly adopting the "water's edge" principle, under which the three-factor formula is applied only to income attributable to operations within the U.S. As the number of states applying the unitary principle declines, it becomes increasingly hard for North Dakota to force multinational corporations to undertake the more complex record-keeping calculations. The state should reconsider whether, in light of developments in recent years, it should continue to attempt to tax multinational corpc ations doing business in the state on the worldwide unitary basis.

According to the ACIR analysis of state fiscal capacity and tax effort, North Dakota in 1984 exploited its corporate income tax capacity at 106 percent of the national average.

On the whole, it does not appear that the corporation income tax is a likely source of significant new amounts of tax revenue.

The Excise Taxes

Like other states, North Dakota imposes excise taxes on a number of products and activities. None of these generates much revenue for the general fund. Most significant in terms of the revenue generated are the tax on cigarettes and tobacco products and the tax on motor fuel.

The cigarette tax is levied at the rate of 18 cents per pack. (Cigarettes are subject also to the state sales tax.) Five-sixths of the revenue, amounted to about $11.5 million in fiscal 1986, goes into the state general fund, while the other one-sixth is allocated to cities on the basis of population. The tax on other tobacco products (pipe tobacco, chewing tobacco, and snuff) is levied at the rate of 11 percent of wholesale price, and all the revenue (about $350 thousand in 1986) is deposited in the state general fund.

North Dakota's cigarette tax rate is a little above the median of the 50 states. The more significant comparison, however, is with Minnesota, where cigarettes are taxed at 23 cents per pack, in addition to the sales tax of six percent North Dakota clearly could, if it wished, increase the cigarette tax rate without harming retailers' competitive position along the Minnesota border. Of course, an increase in the tax rate could cut into a competitive advantage North Dakota vendors now have because of the tax differential.

From an equity standpoint the cigarette tax is no doubt one of the most regressive in the entire tax structure. Some object to it also as an unwarranted interference by government with the consumers' freedom of choice. Today, however, most people seem to favor heavy cigarette taxation for the effect it supposedly has on restraining smoking.

While the revenue potential is not great, North Dakota might well consider a modest increase in the rate of the cigarette tax.

The state **gasoline** tax, at 13 cents per gallon, is slightly above the national average but four cents below the Minnesota tax Special fuels (fuels other than gasoline) are taxed at the same rate if sold for use on the highways. Aviation gas is taxed at eight cents per gallon and the proceeds paid into the state Aeronautics Commission Construction Fund.

The law earmarks one cent of the 13-cent highway gasoline tax for township highway aid Of the remainder, 63 percent is earmarked for state highway purposes and the remaining 37 percent is allocated to counties on the basis of motor vehicle registration.

Again, a modest increase in the tax rate would not be inappropriate.

Severance Taxes

North Dakota makes extensive and productive use of taxes on the severance, or extraction, of minerals. Four separate taxes are involved.

One is the Oil and Gas Gross Production Tax. First imposed in 1957, this tax applies at the rate of five percent to the gross value of oil and gas production and is in lieu of property taxes In 1986, this tax was estimated to yield about $54 million, of which about two-thirds went into the state general fund, the rest being distributed to counties according to a detailed formula established by law.

Second is the Oil Extraction Tax, a six-and-a-half percent tax on gross wellhead value of crude oil, but not gas. The law exempts stripper operations (those producing an average of less than ten barrels per day). This tax, which is levied in addition to the Gross Production Tax, resulted from an initiated measure passed by the voters in 1980. In 1986, it produced $58 million, 90 percent of which went into the state general fund.

The third tax in this group is the coal severance tax, which dates from 1975. An unusual feature is that the rate escalates from year to year depending on the rate of inflation. In 1986, at $1.05 per ton, the tax produced $26 million, 30 percent going into the state general fund, 20 percent being turned back to local governments in the coal-producing counties, and the remainder deposited in trust funds.

Finally, there is the coal conversion tax, also adopted in 1975. This tax applies to the output of electricity or gas generated from coal, but it is economically similar to a tax on the coal itself. The rates are one-half mill per KWH of electricity produced for sale, and 10 cents per 1,000 cubic feet of gas produced or 2.5 percent of gross receipts whichever is greater. Most of the revenue ($10.6 million in 1986) goes into the state general fund, but 20 to 25 percent is returned to the three counties in which plants are located. Part of this is in turn distributed to school districts on the basis of average daily membership. The tax is in lieu of property levies on the plants themselves.

The complexities of these taxes prohibit detailed discussion here of each one individually. The taxes, however, have been thoroughly analyzed in a recent study by Professors David E. Ramsett and Richard V. Kauffman, of the University of North Dakota, entitled **Economic Dimensions of Severance Taxation on North Dakota Industries,** (Bureau of Business Research, University of North Dakota, August, 1986.)

All such taxes have certain common characteristics that make possible some generalizations.

Severance taxes have in their favor that much of their burden tends to be exported, perhaps to out-of-state consumers, but, more likely, to stockholders in the firms that own underground resources, many of whom probably live outside North Dakota. Also, they generate revenue which the state can if it wishes use to compensate for environmental damage and any unusual governmental costs associated with the extractive industries If levied on gross output or tonnage (as they are in North Dakota) they also are reasonably simple to administer.

On the other hand, all these taxes are fickle revenue producers. Those that are levied on physical output, as is the coal production tax, are vulnerable to fluctuations in output. Those levied on gross value (the oil and gas taxes) are additionally vulnerable to fluctuations in price, as has been acutely apparent in recent years during which oil prices have plummeted.

Economic effects depend on the design of the severance tax. Taxes imposed on physical output or gross value affect the profitability of extractive operations and can have the effect of reducing activity and driving marginal producers out of production. Ramsett and Kauffman point out that the negative effect is not so much on production from wells already in operation but on drilling for future production. In a simulation analysis they develop estimates of the extent to which North Dakota's taxes can be expected to affect future oil drilling and extraction under various assumptions as to price and tax rate.

In a time of depressed prices and low or nonexistent profit margins, the severance tax can be a significant deterrent to new exploration. This is the basis for the rate reduction proposed in the Governor's budget for the 1987-89 biennium. Ramsett and Kauffman suggest that a variable rate related to oil prices would be less adverse in its economic effects than the present system. It would, however, accentuate fluctuations in the revenue.

The tax must, of course, be kept in perspective. In relation to a sixty percent decline in world oil prices, the effect of the state's 11.5 percent combined oil taxes pales into insignificance. Ramsett and Kauffman estimate that at prices below $16 a barrel few if any wells will be drilled, even with no tax. But if drilling is halted, or if wells are capped and mining operations shut down due to low prices and profit, the resource will not disappear. When prices recover drilling will resume and mines and wells can be expected to reopen, although the process of capping and reactivating wells is obviously not costless.

This is to say that the deterrent economic effects of severance taxes, adding to the effects of the world price decline, take the form of a postponement of economic activity rather than a permanent loss.

With respect to coal, Ramsett and Kauffman's analysis stresses the highly competitive market for electric power in the Northern Plains and the relatively weak competitive position of North Dakota coal as an energy generating resource. They offer the interesting suggestion of reducing or eliminating the tax altogether for production that exceeds a pre-specified tonnage — a strategy designed to minimize revenue loss while reducing production costs at the margin. For the long run, they conclude, North Dakota will be better off by erring on the side of too little taxation of coal and power as opposed to too much.

From a budgetary standpoint, the significant issue in severance taxation concerns the state's heavy dependence on such taxes and the instability of this revenue. Clearly, much of the present difficulty that the state faces results from the drying up of severance tax revenues on which North Dakota has come to depend. Especially it was a mistake to use severance tax revenues to reduce state income and property taxes.

In retrospect, it is clear that present difficulties could have been avoided if the state had placed severance tax revenues in a special trust fund or used them to establish a budget stabilization fund. It was a mistake to believe that other sources of tax revenue would not be needed. Recognizing that North Dakota's future, like its past, will be characterized by major economic and fiscal fluctuations, it would be wise even now — or as soon as the state regains solvency — to establish such a "rainy day" fund. Until recently it was thought politically impossible to establish and hold onto such funds. Over the past decade, however, budget stabilization funds have been set up in more than half the states and in many they have been well-funded and well-protected against short term raids

With respect to severance taxes, the state now faces the reality that taxes on coal, oil and gas produc[illegible] not take the place of more conventional broad-based taxes such as those on property, retail sales and personal income. It has no choice but to move toward a better balanced tax structure in which schools and other public services receive more of their support from relatively stable revenue sources — despite the fact that these taxes, unlike severance taxes, come out of the pockets of the state's own residents.

RECOMMENDATIONS

The analysis in this report leads to the following recommendations for strengthening the fiscal system of North Dakota. In most cases, supporting argument is found on the indicated pages of the report.

General

Seek to avoid periodic fiscal chaos by reforms such as: exempting tax and budget legislation from referral; eliminating the suspension clause in referenda on tax and budget legislation, requiring a larger number of signatures on referral petitions; requiring a minimum percentage of signatures in all counties, or in a majority of counties.

Establish a budget stabilizaion fund from severance tax receipts or income tax receipts in excess of a certain amount.

Seek to achieve greater stability in state/local revenues by preserving or increasing the fiscal role of the local property tax and reducing state general fund dependence on severance tax revenue.

School Finance (pages 15-18)

Require consolidation of non-operating school districts.

Require all school districts to make at least a minimum property tax effort.

Significantly increase the state share of school support.

Increase the effectiveness of the school foundation program in equalizing financial support among school districts.

Apply an equalizing charge-off to oil tax revenues comparable to that now applied to property taxes

Property Tax (pages 20-24)

Preserve and protect the property tax against further deterioration in its revenue productivity.

Assess all taxable property at 100% of true market value, with corresponding reductions in millage rates.

Simplify and liberalize the present systems of property tax limits.

Adopt a low-rate tax on deed transfers as an aid to obtaining accurate market price information on which to base assessments.

Repeal the exemption of farm residences.

Retail Sales Tax (pages 24-25)

Retain the 5% state rate.

Eliminate the exemption now given to residents of Montana and Manitoba.

Broaden the base of the tax to include more personal services.

Support federal legislation to require mail order vendors to collect sales tax on items shipped into other states

Personal Income Tax (pages 25-28)

Require withholding for all taxpayers.

Abandon the surcharge on federal tax liability (the "short form"), instead levy the tax at graduated rates on adjusted gross income as defined in the Internal Revenue Code, allowing personal exemptions but not non-business deductions.

If the present system is retained, repeal the "long form" deduction for federal income taxes paid.

By rate increases or broadening the tax base, increase the revenue obtained from personal income taxation.

Corporate Income Tax (pages 29-30)

Abandon efforts to tax multinational corporations on a worldwide unitary basis, adopting instead the "water's edge" principle.

Eliminate deductibility of federal tax paid, with offsetting reductions in the tax rate.

Excise Taxes (page 30)

Depending on revenue needs, the state might appropriately.

- increase the cigarette tax rate.
- increase the gas tax rate.

Severance Taxes (pages 30-31)

Reduce state general fund dependence on severance tax revenues.

Revise severance tax rates to make them less burdensome on marginal production.

Re-examine and reconsider the level of severance tax rates in light of the competitive position of North Dakota producers.