Good morning Madam Chair and Members of the Committee,

My name is Timothy Vermeer, and I am a Senior Policy Analyst with the Tax Foundation. Thank you for the opportunity to testify today on the impact of the proposed individual income tax rate reduction.

North Dakota's economy is in a strong position by nearly any metric. According to the most recent state unemployment report published by the U.S. Bureau of Labor Statistics (BLS), the unemployment rate in December in North Dakota was 2.1 percent.[1] Since 2000, the average annual unemployment rate for the state has been 3.2 percent. Historically, the national natural unemployment rate, the rate at which supply and demand for labor is at an equilibrium has been near 4 percent. By both those benchmarks, North Dakota's labor market is very tight. Nearly everyone who wants a job has a job. What is left is mostly frictional unemployment—those transitioning between jobs.

According to the December Job Openings and Labor Turnover Survey, the most recent month of data reported by the Bureau of Labor Statistics, there were four open jobs in North Dakota for every unemployed person.[2] So despite the labor force participation rate and the unemployment rate having recovered and even exceeded pre-pandemic levels, the principal factor limiting North Dakota's economic growth is still the size of its labor force.[3]

People make decisions to work or reside in a particular jurisdiction for a variety of reasons. Among other things, businesses care about an educated workforce—the greater the stock of human capital, the greater a firm's productivity. Companies care about access to infrastructure and efficiently delivering their goods to market. They care about government services including police, fire, and emergency medical services. Individuals and families care about school quality, weather patterns, and

[1] https://www.bls.gov/web/laus/laumstrk.htm. Lowest state rate in the country.
[2] https://www.bls.gov/opub/ted/2022/louisiana-had-a-13-3-percent-increase-in-job-openings-in-october-2022.htm
https://www.bls.gov/eag/eag.nd.htm#eag_nd.f.1
(36,000/8,850=4.06)
[3] Labor force: all people age 16 and older who are classified as either employed and unemployed (i.e. either working or actively looking for work).

housing prices. Wage and salary levels and purchasing power also matter. The weight each person places on these factors will vary significantly. But what businesses require to remain open, and what every family needs to stay in their home, is money. Thus, tax policies come into play.

States do not institute tax policy in a vacuum. Every change to a state's tax system makes its business tax climate more or less competitive compared to other states and makes the state more or less attractive to individuals and families. Until Arizona converted its individual income tax to a flat rate of 2.5 percent on January 1, North Dakota had the lowest top marginal individual income tax rate among states that levied the tax. If HB 1158 passes, North Dakota would again have the lowest individual income tax rate at 1.5 percent.

The challenge here is that states in the region and across the country that directly compete with North Dakota forgo at least one major tax, often the individual income tax, and thus effectively have a top marginal rate of 0 percent. Alaska, South Dakota, Texas, and Wyoming—which tend to have robust energy and natural resource industries, like North Dakota—are among the states that do not levy an individual income tax. South Dakota and Wyoming also forgo a corporate income tax while Montana goes without a sales tax. That North Dakota currently has a top rate of 2.9 percent, modest as it is, may be enough to dissuade some who would otherwise pay nothing and file no return in a state that does not assess an income tax.

Although everyone puts a different emphasis on the importance various tax policies play, tax policies *do* affect how much discretionary income a business owner has to hire another employee. Tax policies *do* affect how much income an individual has to purchase a new appliance or to save for a home. At some point, taxes *do* matter, and it is that marginal impact that matters in North Dakota.

Reducing the individual income tax would improve the state's tax neutrality and lower barriers to productivity on the margin. As workers and small business owners consider the impact of taxation on their next dollar of income, they implicitly consider the extensive and intensive effects of taxation-- *whether* to work or invest and *how much* to work or invest. A lower, flatter income tax rate sets conditions for in-migration and an increase in the labor force in North Dakota. Reducing the top rate will also impact the amount of work people choose to perform. When workers can take more of their next dollar home, it will, on the margin, incentivize those already employed to work an additional term (an extra hour or week, or perhaps full time vs. part time).

Income tax reduction is good for economic growth, because tax rates influence how much people work; and all things being equal, it makes a difference in where people choose to live. But while competitive rates are an important reason for this growth, they are not the only reason. If North Dakota moves forward with the reforms of HB 1158, budget sustainability will continue to play an important role in realizing the full potential of the bill's structural alterations.

Policymakers in many states have contemplated the total repeal of the individual income tax, and while that may stimulate economic activity that does not mean it is the right or responsible decision for every state. Having said that, it may end up being the right decision for North Dakota. First, North Dakota does not rely on the individual income tax to the extent that some states do. In fiscal year 2019, the individual income tax only generated 6.2 percent of the state's total tax collection.[4] Second, the top marginal rate is already low enough that eventual repeal is within sight. The potential challenge is budget sustainability.

The wrong timing or wrong combination of revenue reductions or spending restrictions could make service delivery especially challenging. North Dakota policymakers have wisely avoided inadvertently fashioning unfunded liabilities with past reforms by making incremental changes and assessing the sustainability of future reforms each biennium. The current proposal comes at a time when many economists suggest that a recession is still possible sometime in 2023, which could pose a concern for many states' budgets. While that is not a concern to be dismissed out of hand, we find that to be less threatening in this case as the current bill does not include a total repeal and the state is in a healthy financial position with over $3.5 billion in savings and surplus expected by the end of the current budget biennium.[5]

[4] https://taxfoundation.org/publications/facts-and-figures Facts and Figures, Table 7.
[5] https://www.kxnet.com/news/state-news/north-dakotas-68th-legislative-assembly-kicks-off/

If the intent is to eliminate or repeal the individual income tax in a future biennium, the feasibility of that legislation may depend on the structure put in place this year. While the current bill exempts the first nearly $45,000 of taxable income for singles and nearly $75,000 for married filers, doing so may actually make getting to zero harder in the future. First, the narrower the tax base, the fewer people future reforms directly benefit. Additionally, if it turns out that the state becomes reliant on the revenue generated by the remaining income payers, it will be even harder to responsibly eliminate the tax. The longer the tax is levied on a narrow base, the harder it is to generate interest in repeal. Lastly, it is likely many of the skilled workers, including tradesmen and those who own trade businesses, many of those that this bill intends to attract, will earn more income than this legislation exempts. In that case a nominal income tax liability will remain for those taxpayers this biennium. In our view, a simpler, more neutral reform that would also generate the greatest possibility for future elimination of the income tax would be to create a truly flat tax that applies to the current base at the lowest rate that is sustainable for the state.

Many factors influence the location decisions of individuals and families, workers and employers. Many aspects of these decisions, including family ties and weather, transcend government control, but the individual income tax is one that policymakers *can* affect. A lower, flatter rate will improve the tax neutrality of North Dakota and is likely to yield improvements to the labor force and labor force participation.

Thank you again for the opportunity to testify today. I'm happy to answer any questions you may have.