

August 2001

# STATE AND LOCAL TAX STRUCTURE FOR FUNDING ELEMENTARY AND SECONDARY EDUCATION - BACKGROUND MEMORANDUM

Section 1 of 2001 Senate Bill No. 2428 (attached as Appendix A) directs the Legislative Council to study the state and local tax structure for funding elementary and secondary education to determine the feasibility and desirability of enhanced state funding to school districts for the delivery of core curriculum instruction, the equity of the existing degree of reliance on property tax revenues for elementary and secondary education funding, and whether improved efficiency is attainable in the delivery of elementary and secondary education services.

## BACKGROUND

During the 1999-2000 school year, the state had 230 school districts, 8,623 full-time administrative and instructional personnel, 108,094 students, and an average cost per student of \$5,136. Of the cost incurred in educating kindergarten through grade 12 students, 43.46 percent was assumed by the state, 42.79 percent was assumed by local sources, 11.8 percent was assumed by federal sources, and 1.23 percent was assumed by county sources. Other sources accounted for 0.81 percent. Ten years earlier, during the 1989-90 school year, the state had 276 districts, 8,723 full-time administrative and instructional personnel, 116,951 students, and an average cost per student of \$3,427.14. Of the costs incurred in educating kindergarten through grade 12 students, 47.33 percent was assumed by the state, 39.34 percent was assumed by local sources, 8.21 percent was assumed by federal sources, and 1.78 percent was assumed by county sources. Other sources accounted for 3.34 percent.

As do most other states, North Dakota finances its state and local government services through state sales taxes and income taxes and through local property taxes and sales taxes. State government relies most heavily on the state sales taxes, which constitute approximately 44 percent of general fund revenue. A listing of the various sources of revenue for all 50 states is attached as Appendix B.

### Sales Tax

The state's sales tax rate is 5 percent. This places North Dakota higher than 16 other states, lower than 17 other states, and at the same level as 12 other states. The collections per capita place North Dakota 12th highest among the states. Appendix C contains the

per capita sales and gross receipts rankings for the 50 states.

In a document entitled *A Study of North Dakota's Tax Structure* (February 2001), it is stated that a sales tax provides a significant revenue at a relatively low rate and that it captures payments from some taxpayers who do not otherwise pay state taxes. It is also stated that a sales tax is generally considered to be regressive, that the revenues it generates can fluctuate widely in response to the economy, and that until it is broad based it can introduce distortions into the marketplace. Appendix D illustrates taxes per capita and as a percentage of income for all 50 states for the year 2000.

### Individual and Corporate Income Taxes

Individual income taxes account for 25 percent of the state's revenue while corporate income taxes account for an additional 6 to 8 percent. During fiscal year 1999, the state's income tax rates generated \$287 per capita, thereby placing North Dakota 41st of the 43 states that have individual income taxes (see Appendix E). *A Study of North Dakota's Tax Structure* states that income taxes are progressive in that they are based on the ability to pay and they are responsive to economic growth. On the other hand, income taxes are also responsive to downturns in the economy. Defining what constitutes income is not without its own challenges, and the document notes that corporate income taxes tend to discourage development and are shifted to those who purchase the goods generated by the corporations.

### Other State Taxes

Coal severance and oil extraction taxes accounted for approximately 14 percent of the state's general fund revenue in 1987-89 and during 1999-2001 accounted for approximately 5 percent of such revenue. Estate taxes, which are collected by the state but returned to the counties and cities in which the property is located, generate between \$3 million and \$7 million annually. Taxes on the gross proceeds from games of chance have been levied since 1977 and generate approximately 1 to 2 percent of the state's general fund revenue.

### **Local Government Tax Instruments**

Of all local government revenues, 38 percent come from the state, 31 percent come from property taxes, 23 percent come from miscellaneous sources, 5 percent come from federal sources, and 3 percent come from local sales and use taxes. Of the \$537 million collected in property taxes during 1999, 55 percent went to school districts, 24 percent went to counties, 13 percent went to cities, 4 percent went to park districts, 2 percent went to townships, and the remaining 2 percent was distributed to special districts.

During 1999, 85 North Dakota cities imposed and collected local sales and use taxes. The total amount generated was in excess of \$53 million. Local governments also collect a portion of their revenues through user fees, such as those applied to building permits, public utilities, and various facilities.

### **PROPERTY TAXES AS A FUNDING SOURCE FOR KINDERGARTEN THROUGH GRADE 12 EDUCATION**

During the 1999 legislative session, funds were appropriated to the Tax Commissioner to support a citizen's study of the tax structure in North Dakota. The study group was charged with analyzing North Dakota's tax structure, taking a critical look at how the tax structure serves the state, and making recommendations to promote a fair and simple tax system that is responsive to a 21st century economy. The study group found that, overall, the state and local tax system in North Dakota is "rather easily understood and generates fairly stable revenues. The burden is spread across a variety of traditional instruments with relatively high taxpayer compliance." With respect to property taxes specifically, the group concluded that:

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

The group found by reducing taxes on agricultural and commercial properties, through imposition of a local sales tax or through imposition of increased state sales and income taxes, school districts would be less reliant on localized real estate taxes, and the total property tax burden could be reduced. The group also concluded that as the financial burden would shift from the local level to the state level, so too would the degree of decisionmaking otherwise exercised by local

entities. In reaching its conclusions, the group noted governmental involvement in the financing of education was a matter for philosophical debate.

Attached as Appendix F are tables showing general property taxes by county in North Dakota, per capita state and local property taxes for all 50 states, and state and local property taxes per \$1,000 of personal income for all 50 states.

### **2001 Legislative Proposals to Change Taxation for Purposes of Funding Kindergarten Through Grade 12 Education**

The 2001 Legislative Assembly gave consideration to two principal measures that were designed to significantly alter the way revenue is generated and subsequently distributed to school districts. Senate Bill No. 2428, as introduced, would have raised the federal income tax liability from 14 to 17 percent. This would have generated approximately \$95 million, all of which would have been distributed to school districts in accordance with the current system of state aid distribution. Half the amount received by a district would have been deducted from the estimated expenditures used to determine the maximum levy of the district. The other half would have been excluded from the determination of the school district's levy. The language of Senate Bill No. 2428 was subsequently amended to replace the original provisions with a section to provide for the current study.

The second measure considered by the 2001 Legislative Assembly to change the way revenue is generated was House Bill No. 1432. As introduced, this bill would have imposed an individual income tax surtax of 4.5 percent and a separate 2 percent sales tax. The moneys generated from these taxes would have been distributed to school districts in a prorated manner, based on the relationship between the general fund dollars levied by a district in taxable year 2000 versus the total general fund dollars generated by all school districts in that same year. School districts would have lost their authority to levy property taxes. The bill was defeated in the House of Representatives by a vote of 31-67. See Appendix G for 1999-2001 and 2001-03 estimated general fund revenues by source plus information on actual collections for the 1995-97 and 1997-99 bienniums.

### **EDUCATION FUNDING LAWSUITS IN OTHER STATES - UPDATE Ohio**

Under a court mandate to overhaul the state's education finance system, the Ohio Legislature provided an additional \$1.4 billion to public schools for the next two years. The additional dollars will provide a 12 percent increase in guaranteed per student spending, which was set at \$4,294 this year and at \$4,814 in

2002. Opponents still contend that even with the additional \$1.4 billion, the state is not meeting the requirement that it provide a "thorough and efficient" school finance system. Furthermore, opponents state that the new legislation fails to reduce school districts' reliance on property taxes and fails to provide sufficient funds for severely underfunded special education programs.

### **Montana**

Two Montana school district trustees have filed another lawsuit contending the state's method of financing kindergarten through grade 12 education violates the state constitution. They believe the funding formula is unfair, given the significant difference in property values throughout the state. The position of the state is that there is a rational basis to its formula and that as long as there are counties, and as long as there are property taxes, taxpayers will be charged different amounts for services.

### **Arkansas**

In late May 2001, a Pulaski County judge struck down the state's formula for distributing moneys to schools. He claimed the system is neither adequate nor fair to the poorer districts. The decision, which for the third time in 20 years declares the state's education funding system to be unconstitutional, will be appealed. During the trial, experts stated that Arkansas would require an infusion of \$400 million to \$900 million to provide the necessary improvements in its education system. While the court did not indicate how that money was to be generated, legislators agreed they would have to consider new property taxes and sales tax increases. The court also awarded \$9.3 million in attorneys' fees.

### **New York**

New York is also under a court order to fix its education funding system by this fall. The court indicated the current system hobbles the New York City School District's ability to provide a sound basic education for its 1.1 million students and that it disproportionately harms minority students. The New York decision is viewed as being indicative of judicial trends that focus on adequacy of education rather than on the equalization of education funding. Standards and assessments are being used to determine whether a state is providing sufficient funding to its schools.

### **Alaska**

Nearly two years ago, an Alaska judge ruled the state discriminates against its rural, Native Alaskan schoolchildren by failing to provide adequate school

buildings. In late March the court determined the manner in which Alaska pays for its school facilities is unfair to rural communities and directed the legislature to remedy the situation or face the court's own solution. Last year, the Governor of Alaska proposed a \$510 million plan for school construction, and the legislature appropriated \$93 million.

### **New Hampshire**

In early May 2001, New Hampshire's highest court upheld the constitutionality of the statewide property tax the state used to pay for its schools. The state has had its education funding system declared unconstitutional in both 1993 and 1999. Five poor towns claimed they were unable to provide an adequate education for their children because the state's former funding system relied too heavily on local property taxes to pay for schools. To fix the problem, the state instituted a statewide property tax of \$6.60 on \$1,000 of property value. Communities that were better off argued their property was being taxed to subsidize schooling in poorer towns. Representatives of the "donor" towns won their case at the trial court level but were denied a victory by the state supreme court. The supreme court found that the system is flawed but not so flawed as to be determined unconstitutional.

In addressing the problem, the state legislature increased the room and meals tax from 8 percent to 9 percent. It was argued an electricity tax is something that everyone has to pay, including the proverbial little old lady on fixed income. A room and meals tax, on the other hand, was arguably discretionary. Lawmakers also agreed to lower the state property tax from \$6.60 to \$5.95 per \$1,000 of property value.

### **Texas**

Culminating a decade-long legal battle, the state of Texas in 1993 implemented a new education funding formula. Now it appears that another lawsuit is on the horizon. The Texas Constitution prohibits a statewide property tax. However, the postlawsuit funding formula required wealthier districts to give up part of their tax revenue to assist the state's poor districts. The required revenue shift has resulted in significant consternation, and at least 22 districts have already committed to being plaintiffs in a lawsuit to challenge the distribution. In order to avert a lawsuit, the Texas Legislature was considering the appointment of a commission to examine the current finance law and to report back in time for the legislators to consider an overhaul in the 2003 legislative session.

ATTACH:7