

NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

FINANCE AND TAXATION COMMITTEE

Wednesday, August 10, 2005
Roughrider Room, State Capitol
Bismarck, North Dakota

Senator Herb Urlacher, Chairman, called the meeting to order at 10:00 a.m.

Members present: Senators Herb Urlacher, John M. Andrist, Dwight Cook, Michael A. Every, Harvey Tallackson, Ben Tollefson, Rich Wardner; Representatives Wesley R. Belter, Kari Conrad, David Drovdal, Pam Gulleeson, C. B. Haas, Lyle Hanson, Craig Headland, Gil Herbel, Ronald A. Iverson, Phillip Mueller, Kenton Onstad, Mark S. Owens, Arlo E. Schmidt, Dave Weiler, Clark Williams, Dwight Wrangham

Member absent: Representative Larry Bellew

Others present: See Appendix A

Chairman Urlacher welcomed committee members. He said the committee has important work to do on assigned studies. He said he expects the committee will require several meetings that will involve gathering and studying a great deal of information. He said with regard to the education funding study, he expects the committee to look at the entire package of education funding and property taxes and to measure the effects of the current tax structure and any proposed changes for taxpayers in various circumstances. He encouraged committee members to make suggestions and requests for information that they believe will further the work of the committee.

Chairman Urlacher called on Mr. John D. Olsrud, Director, Legislative Council, who reviewed the *Supplementary Rules of Operation and Procedure of the North Dakota Legislative Council*. In response to a question from Senator Urlacher, Mr. Olsrud said the decision of whether to seek expanded study authority from the chairman of the Legislative Council is often based on the judgment of the committee chairman of whether the proposed topic fits within an existing study directive. Mr. Olsrud said that if doubt exists about whether the proposed topic fits within an existing study, it is probably advisable to seek approval of the Legislative Council chairman for expanded study authority.

EDUCATION FUNDING AND PROPERTY TAX STUDY Background Memorandum

Chairman Urlacher called on committee counsel for presentation of a memorandum entitled *Elementary and Secondary Education Enhanced Funding and Reduced Reliance on Property Taxes - Background Memorandum*. Committee counsel reviewed the constitutional basis for funding of a uniform system of free public schools. Committee counsel reviewed the establishment of the foundation aid program and a 1965 state-wide study and recommendations relating to education and education funding.

Committee counsel reviewed the legislative education funding actions of the 1970s and 1980s. He reviewed the 1993 district court decision citing "constitutionally objectionable" features of the school financing system and the 1993 legislative response to the court decision. He said a 1994 North Dakota Supreme Court decision concluded that North Dakota's education funding system complied with constitutional requirements. He said three of the five justices concluded that the system was in violation of constitutional requirements but the Constitution of North Dakota requires four of the five justices to agree to declare a statute unconstitutional.

Committee counsel reviewed education finance legislation for each legislative session from 1995 through 2005. He said the total appropriation by the 2005 Legislative Assembly exceeds the 1995 appropriation by \$179,267,047, which is an increase of 34.6 percent in 10 years. He said for comparison purposes, during the 10 years from 1994 to 2004 total school district property taxes levied increased from \$217,634,159 to \$348,516,115, an increase of 60.1 percent.

Committee counsel reviewed property tax determination and payment. He said for taxable year 2004, property taxes levied by school districts were 55.5 percent of all property taxes levied in the state. He reviewed the statutory provisions for assessment and determination of property tax liability.

Committee counsel said some businesses, such as telephone companies, rural electric cooperatives, and coal conversion facilities, make payments in lieu of taxes instead of paying property taxes. He said committee deliberations affecting property taxes should

also include effects on businesses making payments in lieu of taxes.

Committee counsel reviewed 2005 property tax legislation. He said perhaps the most significant property tax impact from 2005 legislation resulted from passage of Senate Bill No. 2188, which reduces the minimum capitalization rate for the agricultural property valuation formula from 9.5 to 8.9 percent for taxable year 2005 and 8.3 percent for taxable years after 2005.

Committee counsel said 2005 House Bill No. 1512 would have made substantial changes in education funding and in the state's tax structure. He said the bill passed in the House of Representatives but failed to pass in the Senate. He said the bill as approved by the House of Representatives and considered by the Senate would have made the following changes:

1. Creation of an individual and corporate income surtax of 33 percent to generate approximately \$184 million per biennium and a sales, use, and motor vehicle tax increase of two percentage points to generate revenue of approximately \$386 million for the biennium.
2. Pooling of state funding sources into a formula to include per student payment, tuition apportionment, supplemental payments, consolidation bonuses, transportation payments, special education payments, teacher compensation payments, and all other state-funded expenditures for education.
3. Replacement of political subdivision general fund property tax levies. The bill would allow school boards authority to levy a maximum of 80 mills for general fund purposes with a two-thirds majority vote of the board but would eliminate all other general fund property tax authority of school districts.
4. Establish a per student-based payment, with additional funds based on cost factors to recognize the size of school and categories of student with defined additional educational needs.
5. Elimination of the existing foundation aid formula, including weighting factors and the equalization factor.
6. Examine sales taxes, income taxes, tax exemptions, and any other potential sources for additional revenue for education funding.
7. Develop an assessment of how shifting from property taxes to other tax sources would impact individuals and businesses in various income and property ownership categories.
8. Assess whether property tax savings from education funding changes would be consumed by property tax increases of other taxing districts or future increases by school districts.
9. Assess how proposed changes would impact school district funding equity and adequacy.
10. Assess how changes in education funding would impact the state in times of economic growth and recession.
11. Determine whether proposed changes will provide a competitive advantage to any businesses because they are subjected to a different form of taxation as compared to their competitors.
12. Assess the effect of any proposed tax changes on business and economic development.
13. Assess trends in education funding lawsuits in other states and developments in North Dakota.

Committee counsel suggested that this study:

1. Review current and historical data on components of elementary and secondary funding. The Department of Public Instruction can provide information on these issues. It will be necessary to develop estimates of future costs.
2. Review current and historical data on property taxes levied by school districts. The Tax Department can provide information on this issue. It will be necessary to develop estimates of future school district property taxes if current trends continue.

Senator Cook asked whether any property owner in the state has initiated a lawsuit to challenge unequal tax levies on identical property located on both sides of a boundary between taxing districts. Committee counsel said he is not aware of a lawsuit of that type and it is common within the state that taxes imposed by bordering taxing districts are unequal. He said the constitution requires that taxes shall be uniform upon the same class of property. He said he does not believe this means taxes cannot be different in different taxing districts but if taxes are imposed at different rates within the same taxing district, there could be a problem. Senator Cook said the committee should bear in mind in conducting this study that large differences in tax rates between bordering taxing districts should be reduced. Senator Cook said he would like to see this study result in reduced taxes on property.

Committee counsel said that copies of a Kansas Supreme Court case summary from a June 2005 decision were distributed to committee members. He said the summary indicates that the Kansas Supreme Court unanimously ordered school funding to be increased no later than July 1 from approximately \$142 million appropriated by the 2005 legislature to \$285 million above the past school year's funding level. He said the court relied on a 2001 study by Augenblick & Myers, the consultants retained by the legislature. He said these consultants have also reviewed North Dakota's funding system.

Committee counsel said copies of a news article dated July 18, 2005, were distributed to committee members. He said this news story states that the Kansas legislature complied with the Kansas Supreme Court order by approving an increase in state school funding of \$148.4 million.

Committee counsel said copies of a newspaper article were distributed to committee members relating to testimony and discussions at a recent meeting of the State Board of Equalization. He said it was suggested to the board that the state must find a way to limit property tax increases and assessment increases. He said members of the State Board of Equalization suggested that these issues be referred to the interim Finance and Taxation Committee for study. He said Ms. Marcy Dickerson, Tax Department, will present further information on this topic to the committee.

Department of Public Instruction

Chairman Urlacher called on Mr. Jerry Coleman, Assistant Director for School Finance, Department of Public Instruction, for testimony relating to education funding issues. Mr. Coleman distributed copies of *School Finance Facts* prepared by the Department of Public Instruction, January 2005, and *Funding K-12 Schools in North Dakota* prepared by the Department of Public Instruction for the interim Finance and Taxation Committee.

Mr. Coleman reviewed the contents of the *School Finance Facts* publication. Mr. Coleman said the information on page A-2 shows the components of Fund Group 1, which includes revenues and expenditures of regular instructional programs, federal programs, operation and maintenance, transportation, tuition, special education, vocational education, and other programs. He said local revenue sources account for 42.58 percent of Fund Group 1 revenues, mostly from property taxes. He said state funding sources account for 41.45 percent of Fund Group 1 revenues and federal sources account for 13.86 percent of those revenues. He said the publication contains a ranking of high school districts by total mill levies for the 2004-05 school year. He said the publication provides a mill levy summary for each school district in the state showing taxable valuation of the district, taxable valuation per student, and levies for various purposes in mills. He said the state average school district mill levy is 223.71 mills.

Mr. Coleman said the publication contains a report of Fund Group 1 revenue and expenditures and average cost per student for 2003-04. He said this report shows for each school district in the state local revenue, state revenue, federal revenue, total expenditures, ending fund balance, and average cost per student broken down by grade levels.

Mr. Coleman said the report shows a summary of Fund Group 1 expenditures by function broken down by school district enrollment. He said the publication contains a report showing for each school district the average daily membership and expenditures broken down by expenditures for teachers, support staff, administration, and other expenditure categories.

Mr. Coleman said the publication contains reports showing current expenditures by type of school district, calculation of average cost per student, and ranking of average cost per student for districts.

Senator Andrisc said the publication shows that for most school districts local and state funding are approximately equal but for some districts there is a substantial difference between local and state revenue. He asked why the differences exist. Mr. Coleman said several factors may be involved but school districts rely on their ability to raise revenue through property taxes and that ability varies considerably among school districts.

Representative Herbel said Table A-1 shows the statewide average cost per student as \$6,675 but Table G-1 shows the average statewide cost per student at \$6,383. He asked why there is a difference in these amounts. Mr. Coleman said the statewide average includes computation of some costs that cannot be assigned to a school district and the computation in Table G-1 is based on averages of costs that are assigned to school districts.

Senator Cook said suggestions have been made that the state's share of education funding should be at 60 percent or more of the cost of education. He said it will be important for the committee to understand what expenditures are included in the total cost of education. He said it would be useful for the Department of Public Instruction to walk the committee through the foundation aid formula and how it applies to school districts and to illustrate how the school district ending fund balance affects funding for the next budget cycle.

Mr. Coleman reviewed the materials he distributed on *Funding K-12 Schools in North Dakota*. He said the first table in these materials shows historical data on the basis of local, state, federal, and other sources for each school year going back to 1981-82. He said this table shows the percentage of school district revenue from each source for those years. He said the state percentage of funding for school districts has declined from 58.5 percent in 1981-82 to 41.5 percent in 2003-04. He said local source contributions to the cost of school district revenues have increased from 23.3 percent in 1981-82 to 42.6 percent in 2003-04, mostly because of a very substantial increase in property taxes.

Mr. Coleman said the material beginning on page 4 of the handout shows equity indicators based on tables prepared by Mr. John Augenblick for the equity lawsuit and updated by the Department of Public

Instruction. He said the materials show sources of current revenue for districts, proportions of revenue by source for districts, per student revenue of districts by source, changes in per student revenue by source, and statistics on per student revenue and property wealth, operating levies, and other information. He said Table 8 of these materials shows the wide variation in per student property value among districts. He said Table 9 shows the wide variation in the number of mills levied among districts.

Representative Belter said it appears from available data that schools are experiencing declining enrollments and costs per student have increased which might lead to the conclusion that schools are less efficient than they were 20 or 30 years ago. He asked whether there is any way to assess whether that is happening. Mr. Coleman said it is difficult to respond to that question. He said many factors are involved in the cost of education.

Senator Andrist said it appears from the statistics that a decline in student enrollment has been accompanied by a modest increase in the number of teachers and administrators. Mr. Tom Decker, Department of Public Instruction, said federal education requirements have increased the needs for instructors and as enrollment declines, cost per student increases dramatically. He said enrollment declines may be more rapid in smaller districts, so cost per student in these districts goes up faster.

Representative Herbel asked whether it can be determined which of the expenditures categories for school districts are increasing at a more rapid rate. Mr. Coleman said he is not certain but it might be possible to develop an analysis of that issue.

Mr. Coleman said that it appears that declining elementary and secondary education enrollments will continue. He said projections are that enrollment and graduations will substantially decline over the next 15 years. In 2004, he said, elementary and secondary school enrollments had dropped by 16 percent in 10 years.

Representative Schmidt said school districts in his legislative district have formed a cooperative for purchasing and other purposes. He asked whether any incentive is provided for school districts to cooperate for such things. Mr. Decker said joint powers agreements among school districts are a useful tool. He said there are now eight joint powers agreements in the state among school districts. He said the oldest of these agreements is only three years old but there are clear benefits from many areas of sharing to enhance resources and reduce expenditures. He said there is a special appropriation available for assistance to joint powers agreements school districts.

Testimony

Chairman Urlacher invited testimony from interested individuals in attendance. Mr. Steven Ginsbach, North Dakota Township Officers Association, Hankinson, said property tax burdens are becoming a huge problem statewide. He said combining school districts and administration could result in more efficiency. He said he hopes that possibility will be considered.

Tax Department

Chairman Urlacher called on Ms. Marcy Dickerson, State Supervisor of Assessments, Tax Department, for testimony relating to school district property tax current and historical statistics. A copy of Ms. Dickerson's prepared testimony is attached as Appendix B.

Ms. Dickerson said the percentage of statewide property taxes that is levied by schools has increased from 50.9 percent in 1985 to 55.52 percent in 2004. She said total taxable valuation has increased by 56 percent since 1985 and the average school district mill rate has increased by 62 percent. She said total school district taxes levied annually have increased by 153 percent since 1985. Ms. Dickerson said approximately 86 percent of property taxes levied by school districts are for the general fund.

Ms. Dickerson said she investigated why school district property tax statistics of the Tax Department differ from those of the Department of Public Instruction. She said it appears several factors are involved. She said the Tax Department publication reports taxes levied and the Department of Public Instruction publication reports revenue received. She said revenue received differs from taxes levied for several reasons. She said some taxes will not be paid during the tax year, taxpayers will take advantage of the 5 percent discount for early payment, tax levy adjustments will be made because of abatements and omitted property, and collections may include delinquent taxes from prior years with penalty and interest. She said it appears reporting errors were made, including reports of districts crossing county lines and failing to report total taxable valuation of the school district. She said instances were found where school district mill rates reported to the Department of Public Instruction are different from rates reported on the abstract of tax list. She said one statutory provision allows three school districts to levy a lower mill rate on certain agricultural property than on the rest of the school district. She said this situation is the result of school district consolidation.

Senator Cook asked about the three school districts with different tax rates for different properties and whether they adjust taxable valuation of property to avoid a loss from the mill deduct for foundation aid. Ms. Dickerson said that is the practice that has been followed. Senator Cook asked whether it is legal to make that kind of adjustment. Ms. Dickerson said she is not certain and it is not specifically addressed in law.

Ms. Dickerson presented the second portion of her testimony relating to discussion at the State Board of Equalization meeting on May 5, 2005, about how to address the problem of rapidly increasing residential property valuations and taxes. She said members of the State Board of Equalization expressed their hope that the Finance and Taxation Committee can address these issues.

Ms. Dickerson reviewed the information in Exhibits A and B, which she distributed to the committee. Exhibit A is a list of school district levies for 2005 and Exhibit B provides information on school district levies for 2004.

Ms. Dickerson reviewed Exhibit C, which she provided to the committee. She said this document was prepared to provide information on increasing valuation and property taxes and possible solutions that have been proposed. She said the exhibit identifies options that might be implemented by the State Board of Equalization and the options that would require legislative action, which might restrict assessment and property tax increases.

Tax Department representatives distributed copies of the *2004 Property Tax Statistical Report* and the *2004 State and Local Taxes* publications by the Tax Department.

Representative Herbel asked how interest and penalty on delinquent taxes are allocated. Ms. Dickerson said that under Tax Department rules, penalty and interest are allocated among taxing districts in the same proportion as the taxes on which they are based. Representative Herbel said in a recent assessment challenge by a large industrial facility in Pembina County, the county was forced to borrow money to cover the protested property tax amounts and the county does not get reimbursed for the cost of borrowing when the taxes in dispute are ultimately settled. He said he believes this is an oversight in the law that is unfair to counties.

Senator Cook said he would like to see the committee move forward on the suggestion from the State Board of Equalization that the committee examine the growing problem of assessment and property tax increases.

Testimony

Chairman Urlacher called on Mr. Allan Braaten, Richland County Township Officers, Barney, for testimony relating to the committee study. Mr. Braaten said he would like to see the committee expand its study topics to include examination of reducing agricultural property assessments based on severe weather impact. He said he would suggest that if a farmer loses a crop to drought, hail, or flood, that land would be reduced to a pastureland assessment for one year.

Representative Herbel said he agrees that severe weather impact is a serious problem for farmers but he

would question how the suggested change would impact budgets of political subdivisions and taxes of other taxpayers. Mr. Braaten said these impacts would need to be considered as part of the suggested study.

Representative Guleson said the committee should review the agricultural assessment property formula and the authority of assessors to address the problems of severe weather impact.

Chairman Urlacher called on Mr. Larry Osborn, Supervisor of Tax and Property, Richland County, Wahpeton, for testimony relating to the committee study. A copy of Mr. Osborn's prepared testimony is attached as Appendix C.

Mr. Osborn said in the past 18 years, Richland County property taxable valuations have increased 56.5 percent and mill rates have increased as well. He said the result has been a very large increase in consolidated taxes for agricultural and residential property.

Representative Conrad said one of the concerns that arose often during discussion of 2005 House Bill No. 1512 is that if school property taxes are reduced, other political subdivisions are likely to increase property taxes. She asked whether Mr. Osborn believes that will occur. Mr. Osborn said he does not think that would have much impact because counties, cities, townships, and other political subdivisions are subject to levy limitations by law. He said he also believes that these subdivisions try to hold down property tax levies as much as possible.

Representative Herbel said it appears property tax reduction must be accomplished by revenue replacement from another source. He asked how Mr. Osborn would suggest property tax revenue be replaced. Mr. Osborn said his opinion is that income tax is the best vehicle for property tax revenue replacement. He said the income tax is based on the ability to pay and, because of home rule sales taxes, the state is limited in how far it can go on sales tax rate increases.

Senator Cook asked what the trends are in market value in agricultural land in Richland County. Mr. Osborn said agricultural market value and sales prices are rising, even during the current bad weather cycle.

Representative Schmidt asked why Minnesota property taxes would be so much lower than North Dakota taxes on residential property. Mr. Osborn said the Minnesota homestead credit makes a big difference and Minnesota income taxes are much higher than North Dakota income taxes, which allows the state to provide more state funds to hold down property taxes.

Chairman Urlacher called on Mr. Perry Miller, Richland County Commissioner, Wahpeton, for comments relating to committee study activities. Mr. Miller said he appreciates the committee undertaking the study of reducing property tax burdens. He

said property, sales, and income taxes are the three primary tax types available for funding state and local government. He said he believes that shifting property tax burden to the income tax would be the fairest method of providing property tax relief. He said that older residents who do not qualify for the homestead credit are facing rapidly rising property taxes. He said that increasing income taxes for all taxpayers would reduce this burden for older residents and would be a fairer basis for taxation.

Mr. Miller said the farm residence property tax exemption continues to be a problem in administration. He said Richland County has set up a separate committee to review farm residence exemptions. He said this committee has encountered problems and hard feelings but is attempting to administer the exemption in accordance with the law. He said one improvement he would suggest is to place a cap on the value of a farm residence that is exempt from property taxes. He said the highest value farm residences should not be completely exempt.

Representative Belter said it seems from testimony brought to legislative committees that Richland County has had the greatest problem with the farm residence exemption. He said the Legislative Assembly has repeatedly examined this issue and will continue to examine this issue but most of these issues must be addressed locally.

Representative Mueller, noting that Mr. Miller suggested an income tax increase to reduce property tax burdens, asked how Mr. Miller believes his constituents would feel about increasing income taxes. Mr. Miller said that any tax increase presents problems for taxpayers but if the shift is phased in, he believes it would be a more equitable way of funding government.

Senator Cook said he commends Richland County for its review of eligibility for the farm residence exemption. He said he believes that problems with the farm residence exemption are more widespread than Richland County and the committee should examine this issue further.

Senator Tallackson said he agrees with the concerns expressed by Mr. Miller regarding the farm residence property tax exemptions. He said in his area there is considerable frustration that some farm residences are exempt and some are not, especially with the larger and more expensive farm homes that are being built that are exempt.

Representative Herbel said income taxes should fund property tax relief and that might be part of the solution but property taxes and income taxes are not paid by everyone. He said he believes that sales taxes must be a part of the ultimate solution to reducing property taxes. Mr. Miller said he would agree with Representative Herbel and that sales taxes are partly paid by nonresidents, so that would help reduce the burden of North Dakota taxpayers.

COMMITTEE DISCUSSION

Chairman Urlacher requested committee suggestions for information to be considered at the next meeting. Representative Conrad said she would like to see information comparing the balance among the three primary tax sources in North Dakota and other states and information on education funding from state and local sources in other states.

Representative Mueller said it appears necessary to develop information relating to concerns raised regarding 2005 House Bill No. 1512 providing property tax relief to out-of-state property owners. He said information should be developed on how extensive out-of-state ownership is and that the committee should examine sales tax exemptions and revenue effects.

Representative Herbel said it will be necessary to develop information on nonresident property ownership because that was an issue during the last legislative session. He said there are difficulties collecting information about nonresident property taxes. He said the committee should also obtain information on the impact of sales tax rate increases on cross-border shopping habits. He said he also suggests a review of sales tax exemptions and revenue effects.

Senator Cook said there seems to be general agreement that property tax relief is needed and that the three-legged stool of property, sales, and income taxes needs adjustments. He said the committee should pick a dollar amount for property tax relief and then evaluate where the relief should come from and how the relief would be offered.

Representative Haas said he believes the committee needs a starting point for deliberations. He said he would suggest preparing a concept paper based on a number of core features, including state assumption of approximately 70 percent of school district general fund levy funds. He said he would suggest limiting school spending increases based on a price index and allowing excess increases only with approval by two-thirds of voters. He said once the committee sees the cost to the state of assuming the 70/30 percent split of general fund levies, the committee could examine potential revenue sources for the state share of this cost.

It was moved by Representative Haas, seconded by Representative Herbel, and carried on voice vote that a concept paper be developed for committee consideration based on core features described by Representative Haas.

In discussion of the motion, Representative Belter said he believes the Legislative Assembly should also impose a two-thirds voter approval requirement to protect against allowing property tax relief to be eaten up by increases by school districts or other political subdivisions. He said this would probably have to be in the form of a constitutional amendment.

Representative Wrangham said the committee should not forego looking at belt-tightening and efficiency as ways school districts can reduce property tax burdens.

Representative Conrad said the committee should review information on the percentage of property taxes currently and historically paid statewide for residential, commercial, agricultural, and other property.

Committee counsel asked the chairman for direction on how to determine the contents of the concept paper. Chairman Urlacher said committee counsel should consult with Representative Haas for the details of the concept paper.

PROPERTY TAX LEVIES IN MILLS STUDY

Chairman Urlacher called on committee counsel for presentation of a memorandum entitled *Alternatives to Expressing Property Tax Levies in Mills - Background Memorandum*. Committee counsel reviewed determination of property tax liability, mill levy limitations, assessment, and examples of determining tax liability by applying mill rates. He said there are numerous statutory references to levies in mills and to true and full, assessed, and taxable valuation of property. He said amendments to the Constitution of North Dakota

might also be necessary if these measures of value of tax imposition are changed. He said taxpayers' primary exposure to levies and mills and taxable valuation comes from trying to understand the property tax statement from county treasurers. He said an alternative to statutory revision would be consideration of requiring more taxpayer friendly information on property tax statements or in accompanying documents.

Committee counsel said other states have taxpayer bill of rights provisions that require understandable information be provided to taxpayers regarding assessments, tax levies, and the right to protest or appeal tax administration decisions.

Chairman Urlacher said the committee should review a bill of rights that has been enacted in another state for the next committee meeting.

The committee adjourned at 3:00 p.m.

John Walstad
Code Revisor

ATTACH:3