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North Dakota's Measure 2: How Would Rate Cuts Affect the Peace Garden State's Competitiveness?

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Executive Summary

This November 4, North Dakota residents will vote on Measure 2, an initiative that lowers individual income tax rates by 50 percent across-the-board, and corporate income tax rates by 15 percent.

North Dakota has a strong history of restraining taxes with the initiative process. Three months after the state sales tax was first enacted in 1935, an attempt to repeal it by initiative narrowly failed 52% to 48%.[1] A repeal measure did briefly succeed in 1965, and on several occasions sales tax increases have been rolled back at the ballot box. In 1978, another initiative cut the top individual income tax rate from 10% to 7.5%, and since 2004 the top corporate income tax rate has dropped from 10.5% to 6.5% today.[2]

Voters must bear in mind interstate and international competition for capital as they consider Measure 2. According to the Tax Foundation's *State Business Tax Climate Index*, North Dakota's tax system is about middle-of-the-pack both nationally and regionally. But when nearby states offer more inviting tax climates, capital, entrepreneurs and workers are likely to flow that way. Some anecdotal evidence suggests that this is happening to North Dakota. Measure 2 could improve North Dakota's ability to keep and attract jobs and investment.

The Tax Foundation takes no position on what the optimal amount of government spending is, but North Dakota has had several years of strong growth in tax revenues and that suggests that

Measure 2 can be afforded. Strengthening this observation is the example of neighboring South Dakota, which has only one of the three major taxes. North Dakota should be especially careful about ratcheting up government spending permanently, which could store up trouble for the future. The state should also be warned against using the surplus for economic development subsidies or one-time rebates, both of which usually cover up a broken tax system.

How Measure 2 Affects the State Budget Surplus

North Dakota's budget is in surplus for the foreseeable future, which is extraordinary considering that many states are sliding into the red. Today, North Dakota's individual income tax rates range from 2.10 percent to a top rate of 5.54 percent. While the initiative would not eliminate any of the five tax brackets, which many economists would recommend, it does lower the rate in every bracket. Each personal income tax rate would be cut in half, so the rates would range from 1.05 percent to 2.77 percent. That would be the lowest top income tax rate among all states that tax wages. The corporate income tax rates would also drop by a uniform amount but more modestly. The current corporate rates range from 2.60 percent to 6.50 percent. If Measure 2 passes, they will range from 2.21 percent to 5.52 percent.

The impetus for the initiative comes from years of North Dakota budget surpluses. According to the state Office of Management and Budget, the state government this year will see a $1.2 billion budget surplus, thanks in part to high income and sales tax collections resulting from increased natural resources activity. Montana, Wyoming, West Virginia and Oklahoma are among other resource-rich states enjoying budgetary surpluses this year.[3]

North Dakota expects tax revenues to continue growing thanks to high performance in the energy production sector. As of July, oil fields in North Dakota are producing nearly twice as many barrels per day (172,000) as they were four years ago (86,000), and the number of operating oil rigs stands at 89, up from 43 a year ago.[4] (Another initiative on the November ballot in North Dakota, Measure 1, creates a trust fund for management of oil tax revenues, which legislators would be able to access only with a three-fourths vote.) Income tax revenues have nearly doubled in the last few years thanks in part to this growth (see Table 1), and in the current budget, actual collections exceed projections by 16 percent ($218 million), and are 22 percent above the previous budget.[5]

Table 1 North Dakota Income Tax Revenue ($Millions)			
Year	**Individual Income Tax**	**Corporate Income Tax**	**Total**
2001-03	$ 396.2	$ 88.4	$ 484.6
2003-05	$ 452.5	$ 128.0	$ 580.5
2005-07	$ 587.7	$ 232.3	$ 820.0
2007-09 (projection)	$ 704.0	$ 265.3	$ 969.3
2009-11 (projection)	$ 758.9	$ 265.6	$ 1,024.5
Source: North Dakota Office of Management and Budget (Aug. 4, 2008 projection).			

If Measure 2 passes, individual and corporate income tax revenues in the 2009-11 budget are projected to be $605.2 million, a nominal increase of 25 percent from the 2001-03 budget. While Measure 2 would represent an approximately $200 million annual tax cut, the state government's revenue growth has been so strong that government spending could still increase at a modest rate.

North Dakota Faces Interstate Competitors

States do not enact tax changes in a vacuum. Every tax law will in some way change a state's competitive position both regionally and globally, particularly in today's world where states must compete not only with Indiana, but also India. Entrepreneurial states can take advantage of the tax increases of their neighbors to lure businesses out of high-tax states and countries. States with the most competitive tax systems are best suited to generate economic growth.

Promoting long-term business investment requires fiscal policies that recognize the importance of a competitive tax system. Each year the Tax Foundation publishes its *State Business Tax Climate Index*. This comprehensive study of the 50 state tax systems is designed as a guide to lawmakers who wish to make their state's business tax climate more competitive in the regional, national and international marketplace. The *Index* compares the states on 112 variables in five general areas of taxation: business taxes, individual income taxes, sales taxes, unemployment insurance taxes, and taxes on assets, including property taxes.

North Dakota currently ranks favorably in our property tax index (5th), but below average in other rankings: corporate income tax (30th), individual income tax (35th), sales tax (28th), unemployment insurance tax (34th), and overall (30th).

Although Measure 2 does not repeal any of North Dakota's major taxes, it is instructive that states without a major tax (individual income tax, corporate income tax, sales tax) typically fall in one of three categories. Some states rely on severance taxes on natural resources (*e.g.*, South Dakota or Wyoming). Some rely heavily on one tax (*e.g.*, Florida with sales taxes or

Delaware with corporate income taxes). Still others have a tradition of limited government which obviates the need for heavy taxes (*e.g.*, New Hampshire).

North Dakota is similar to its neighbor to the south, and not only in its roughly equal size and population. Both North Dakota and South Dakota have high severance tax collections, but South Dakota has used that revenue to do without corporate and individual income taxes, and it has low property taxes as well. North Dakota still has all the major taxes at relatively high rates, which means it compares unfavorably nationally and regionally. A comparison of the rankings of North Dakota and the two states closest to much of its population (South Dakota and Minnesota) is shown in Table 2 and 3.

Table 2

State Business Tax Climate Index Rankings, FY 2009

State	Overall Rank	Corporate Income Tax	Individual Income Tax	Sales Tax	Unemployment Insurance Tax	Property Tax
South Dakota	2nd	1st	1st	38th	37th	12th
North Dakota	30th	30th	35th	28th	34th	5th
Minnesota	41st	44th	39th	40th	38	17th
Note: In the Index, states rank from best (1st) to worst (50th)						

Table 3

Tax Rates of Nearby States

State	Top Individual Rate	Top Corporate Rate	Sales Tax Rate
South Dakota	None	None	4.0%
Wyoming	None	None	4.0%
Montana	6.90%	6.75%	None
North Dakota	**2.77%**	**6.50%**	**5.0%**
Nebraska	6.84%	7.81%	5.5%
Wisconsin	6.75%	7.90%	5.0%
Minnesota	7.85%	9.80%	6.5%
Iowa	8.98%*	12.00%*	5.0%
* Iowa permits federal deductibility.			

Table 4 estimates how Measure 2 would have affected this regional comparison in the individual income tax and corporate income tax rankings, and overall, assuming it had been enacted as of July 1, 2008:

Table 4

Overall 2009 *State Business Tax Climate Index* with Measure 2 Changes (Assuming enacted as of July 1, 2008)

	Overall Rank	**Corporate Income Tax**	**Individual Income Tax**
North Dakota (current law)	30th	30th	35th
North Dakota (Measure 2 rates)	24th	19th	17th
Note: In the Index, states rank from best (1st) to worst (50th).			

Current net migration statistics underscore the importance of improving North Dakota's competitiveness by reforming its tax code. According to the United Van Lines 2005 Migration Study, North Dakota is first in the United States for outbound moves as a percent of all moves, with 67.8 percent of moves done by the company being outbound.[6]

North Dakota may be middle-of-the-pack in the *Index*, but the current fiscal picture presents a good opportunity to be better than mediocre. If North Dakota moves in the direction of lowering tax burdens without undermining government services, there is a strong likelihood that better economic performance will follow. To compete regionally, nationally and internationally for capital, jobs and entrepreneurs, states should adopt a tax system that acts as a welcome mat to all players on a neutral basis.

What is the Optimal Amount of Government Spending?

Many individuals are reluctant to support permanent tax rate reductions due to uncertainty about future revenues and spending, and in North Dakota, an alternative proposal offers one-time property tax rebates. Central to this proposal is fear that long-term changes to the tax code could be regretted if an economic downturn or other calamity causes a sharp drop in government revenue, thus causing a sharp drop in government services. This of course presumes that additional government spending beyond the amount projected by Measure 2 proponents is desirable and optimal. (The arguments of some Measure 2 critics, such as the Center on Budget and Policy Priorities, are premised on this unstated view that a greater level of spending is always optimal, and that any broad-based long-term revenue reduction is *ipso facto* harmful.[7])

Determining how much government spending in North Dakota is optimal is beyond the scope of this study and will undoubtedly be thoroughly discussed before and after November 4.[8] But North Dakotans should give some thought to the possibility that their state government can survive with reduced revenues, given the recent history of revenue growth and the ability of neighboring South Dakota to get by without taxing income at all.

Rate Cuts Are Preferable to Rebates

One danger with huge surpluses is that government will use it to increase spending beyond what future revenue can support. For individuals who warn against permanent tax cuts for fear that revenues may drop, this is a mirror argument: increasing permanent spending would cause a similar budget crisis as a permanent tax cut in the event of a revenue shortfall. (See California, for instance, which ratcheted up annual spending during the dot com boom and has found it politically impossible to cut it after the annual revenue increases disappeared.) Americans share the skepticism of increased tax revenues being used in a sensible way, with 50% believing that a tax increase to close the federal budget deficit would mostly be spent and not used to reduce the deficit.[9]

One proposal recently adopted in North Dakota was a one-time property tax rebate, and some have argued for more of those instead of a permanent rate cut. However, a key argument against one-time rebates is that permanent rate cuts are more likely to change marginal behavior. A lower tax rate gives workers and entrepreneurs more incentive to innovate, invest and earn. By contrast, a lump-sum rebate has an economic effect that is merely similar to a government spending program that sends checks to people.

It should also be noted that North Dakota's Constitution permits the Legislature, by supermajority vote, to repeal an initiative.[10] If the rate cuts turn out to be a fiscal problem, the course can be reversed.

Economic Development is a Poor Use of Tax Dollars

One proposal floated in North Dakota is to use the surplus to "promote economic development." Governor John Hoeven (R) has advocated such a use for surplus money,[11] as has the North Dakota Tourism Alliance.[12] North Dakota and other states should be wary about using tax dollars in this way.

State lawmakers, trying to be mindful of their states' business tax climates, are often tempted to lure business with lucrative tax incentives and subsidies instead of pursuing broad-based tax reform and creating an inviting climate for all businesses. This can be a dangerous proposition, as a case in Florida illustrates. In July of 2004, Florida lawmakers cried foul because a major credit card company announced it would close its Tampa call center, lay off workers, and outsource those jobs to another company. The reason for the lawmakers' ire was that the company had been lured to Florida with a generous tax incentive package.[13] Lawmakers create these deals under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for a woeful business tax climate.

While officials roll out the red carpet for new businesses, existing in-state employers are taken for granted and are stuck paying higher taxes. A far more effective approach is to systematically improve the business tax climate for the long term so as to improve the state's competitiveness. Businesses are treated the same, and politicians aren't put in the position of picking economic winners and losers.

Conclusion

Tweaking their state's tax code through the ballot box is nothing new for North Dakotans. Compared to their neighbor to the south, with zero percent rates on corporate income and personal income, Measure 2 looks modest. The state government can probably handle the reduction in revenue, and alternatives proposed by Measure 2 critics fall short of what is needed to improve North Dakota's economic performance now and for the future.

Note: The author would like to acknowledge the research and analysis contributions of Tax Foundation economists Josh Barro and Gerald Prante and analyst Mark Robyn.

Notes

1. "Sales Tax Approval Ends Fiscal Worry," *The Bismarck Tribune* (Jul. 17, 1935).

2. Initiative & Referendum Institute, "North Dakota," at http://www.iandrinstitute.org/North%20Dakota.htm.

3. Daniel Wagner, "Wyo economy avoids meltdown," Associated Press (Oct. 9, 2008), at http://www.trib.com/articles/2008/10/10/homepage_lead/d46875cad0f25218872574dd007ce94e.txt.

4. Department of Mineral Resources, "North Dakota Drilling and Production Statistics," at https://www.dmr.nd.gov/oilgas/stats/statisticsvw.asp; North Dakota Office of Management and Budget, "North Dakota Rev-E-News," (Sept. 2008), at http://www.nd.gov/fiscal/revenews/200809news.pdf.

5. *Id.*

6. "2005 Migration Study," United Van Lines. The study excludes Hawaii and Alaska.

7. *See* Nicholas Johnson and Elizabeth Hudgins, *North Dakota's Measure 2 is Imbalanced and Would Harm Efforts to Secure State's Economic Future*, Center on Budget and Policy Priorities (Sep. 18, 2008), at http://www.cbpp.org/9-18-08sfp.htm (arguing that Measure 2 would prevent improvements to bridges, roads, education, and health care).

8. One area of government spending unique to North Dakota is the Bank of North Dakota, a commercial bank managed and operated by the state. The state has received approximately $30 million per year in profits from the Bank over the last ten years. Resembling a central bank in some respects, it was until recent weeks the only government-owned commercial bank in the United States.

9. Andrew Chamberlain, *What Does America Think About Taxes? The 2007 Annual Survey on U.S. Attitudes on Taxes and Wealth*, Tax Foundation Special Report No. 154 (Apr. 2007), at http://www.taxfoundation.org/research/show/22331.html.

10. *See* N.D. Const. art III, sec. 8.

11. *See, e.g.*, Gov. John Hoeven's 2007-2009 Budget Address (Dec. 6, 2006), at http://governor.nd.gov/media/speeches/061206.html ("This general fund surplus when combined with $228.0 million in current reserve funds (the budget stabilization fund and oil tax trust fund) provides a total of $540.0 million in surplus and reserves. Our budget takes a portion of these resources - $188.0 million - and invests them in one-time capital needs, like economic development, technology systems, equipment, capital projects, extraordinary repairs, and deferred maintenance. These are the kinds of investments that will further stimulate economic activity, build infrastructure, help lower costs for the future, make our state more competitive, and improve our standard of living.").

12. *See* "North Dakota Tourism Alliance- Partnership 2007 Legislative Positions," at http://www.northdakotadestinations.org/TapPositions.pdf.

13. *See* Dave Wasson, "Florida Lawmakers Slam Capital One's Layoff After Years of Tax Breaks," Tax Analysts, July 27, 2004.

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