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Recommendations for North Dakota's Tax System

By
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Introduction

At the request of the North Dakota Taxpayers Association, we offer a list of recommendations to improve North Dakota's business tax climate. The recommendations are derived from our *State Business Tax Climate Index*, which we produce annually to enable business leaders, government policymakers, and taxpayers to gauge how their states' tax systems compare according to the economic principles of simplicity, neutrality, and broad tax bases with low tax rates.

The states that score best in the *Index* are those that embrace the established tax reform approach of broadening the tax bases and lowering the tax rates. Reforms along those lines can of course affect revenue totals. While we recommended specific base-broadening changes, we have not included any specific corresponding rate reductions in the analysis, for two reasons. First, state revenue officials are better positioned than we are to estimate revenue effects. Second, North Dakotans must decide for themselves whether they want tax reform to raise the same amount of revenue or reduce revenue.

All *Index* rank changes listed in this analysis represent what the effect would have been had North Dakota had the relevant change in effect on July 1, 2011, the first day of the standard state fiscal year and the snapshot date for the 2012 *Index*. If all of the changes listed below had been in effect on July 1, 2011, North Dakota would have ranked fifth overall in the FY2012 edition of the *Index*, instead of 29th.

The following changes would broaden the state's tax bases and thus allow for lower tax rates without reducing tax revenue. These reduced tax rates (which are unspecified and therefore not reflected in the new rankings) could improve the state's score further and provide more flexibility to choose among our other recommendations without necessarily changing the state's final *Index* rank.

Corporate Income Tax

- Provide for unlimited business net operating loss (NOL) carry-backs of up to three years. About a quarter of states allow NOL carry-backs, with the maximum generally three years. Of those that allow it, most do not limit the amount that can be carried back.

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- Broaden the corporate tax base by eliminating tax preferences such as investment credits, job credits, and research and development (R&D) credits.
- Eliminate the throwback rule. About half of states have no throwback rule.
- Adjust tax brackets for inflation to avoid automatic real corporate tax increases due to inflation.
- Currently, North Dakota requires taxpayers to make an addition to income if foreign taxes were deducted from income at the federal level. North Dakota should eliminate this provision, effectively allowing the deduction for foreign taxes paid. Twenty-one states allow the federal deduction to flow through to the state tax calculation.

Without any rate changes, the above corporate base changes would have been enough to improve North Dakota's rank to fourth, up from 21st place, in the corporate tax component of the *Index* had they been in effect on July 1, 2011. Reductions in corporate tax rates, potentially made revenue-neutral by the base-broadening mentioned, would further improve North Dakota's score, as would moving to a flat rate structure.

Individual Income Tax

- Utah and Indiana ranked 10th and 11th respectively. Each has a flat, one-rate individual income tax. If North Dakota emulated this model—for example, moving to a single 3.99 percent rate with an increased standard deduction and personal exemption (to a combined level of $15,000 per spouse)--this would represent significant improvement. Had such a system been in effect on July 1, 2011, the state would have ranked 11th in the individual income tax *Index* component, up from 35th.
- Investment income is double taxed by the federal tax system, and states should avoid aggravating that distortion with further state taxes. If North Dakota eliminated income taxes on capital gains, interest, and dividend income, they would be the first state with an individual income tax to do so. This change, in addition to the rate change above, would have improved North Dakota's rank to eighth for the individual income tax component (again, up from 35th).

North Dakota should also consider broadening the income tax base by eliminating special credits and deductions. While North Dakota currently adopts federal itemized deductions by starting their calculation with federal taxable income, calculating state tax solely on the calculation of federal adjusted gross income (AGI) would greatly simplify the system, eliminate economic distortions, and allow the state to lower the statutory tax rate even further. Such a change would not directly impact the state's *Index* score (the *Index* focuses on business taxes), but the broader base would allow for further rate reductions that would improve the state's score.

Sales Tax

Retail sales taxes are meant to tax consumption. Business-to-business transactions are not consumption; purchases by end-users are consumption. We recommend eliminating the sales tax on all business-to-business transactions and taxing all final retail sales to end-users, including services.

The above sales tax recommendations, if they had been in effect on July 1, 2011, would have improved the state's rank to sixth best on the sales tax *Index* component, up from 15th, which would be the best of the states with a statewide sales tax. Expanding the sales tax base to consumer services would allow for a lower rate, which would improve the state's score further.

Unemployment Insurance (UI) Tax:

- Reduce the time period for new businesses to qualify for an experience rating from three years to one year.
- Do not charge employers for UI claims for separations that were beyond the employer's control (e.g. employee left voluntarily) or for employees who continue to work part-time.
- All state laws use a system of experience rating by which individual employers' contribution rates vary by some measure of the historical risk of unemployment. North Dakota should consider changing to an

experience rating formula for businesses that is based on statewide experience rather than the experience of each individual business. Unlike other formulas, a state experience formula (called a "benefit-wage-ratio formula" by U.S. Dept. of Labor) adjusts tax rates based on statewide conditions, rather than adjusting them based on each businesses' employment history. This is desirable because it avoids the “shut-down effect” where struggling businesses face increasing UI tax rates, making it harder for the business to survive and potentially hastening its failure.

These UI changes, if they had been in effect on July 1, 2011, would have improved North Dakota's rank on the unemployment insurance *Index* component to eighth place, up from 31st place.

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