Property Taxes and Budgetary Independence in North Dakota

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Introduction

In general, a state policy that limits the extent of taxation can attract individuals and businesses to that state. Restrictions on fiscal expansion also limit the extent of the size of deficits and the overall net indebtedness of the state. If parties are sensitive to the increased marginal costs due to wealth extraction and intervention, they may produce less. Or they may leave the state if that is a feasible option. A heavy tax burden will lead to less productivity in the long run. Low levels of spending, on the other hand, limit the extent of indebtedness, making policymakers within a state more capable of shaping policy that promotes a healthy business environment and the welfare of citizens.

Following this logic, it is easy to begin thinking in aggregates and ignore the details that drive these changes. While there is nothing wrong, per se, about this logic, the devil is in the details. Tax reductions can take various forms as there exist many kinds of taxes. Some taxes are more disruptive to productivity, and others are less so. Although a graduated income tax schedule might seem fair to those who face the barbs of poverty daily, such a tax system also discourages productivity. Likewise, corporate income taxes might seem like a convenient source of revenue from institutions that hold a large proportion of the nation's wealth. However, high state-level income taxes discourage entrepreneurs from setting up businesses in the state that adopts this policy.

The Composition of Local Revenues and Expenditures

Some states observe relatively limited property taxes. However, identifying a state with low property taxes is somewhat complicated. Property taxes tend to be collected by local governments rather than by state governments. As a result, we can only estimate an effective property tax rate that compares the aggregate value of taxes collected within a state to the aggregate value of properties across the state. During 2022, the effective rate of taxation for property taxes paid on owner-occupied homes in North Dakota was 0.97%. Compare this to New Jersey, the state with the highest rate (2.08%), and Hawaii, with the lowest rate (0.26%) Tax Foundation. Further, within-state variation of property tax rates at the county level can be high, as indicated by the county-level data provided by the Tax Foundation.

It would be a mistake to think about property taxes at the state level unless the state government succeeded in dictating the extent of taxes collected by local governments in the form of property taxes. The current ballot measure under consideration in North Dakota entails such an intervention. If passed, the ballot measure would:

> prohibit political subdivisions from levying any tax on real or personal property except for the payment of bonded indebtedness incurred before the end of the thirty-day period following the date this amendment was approved by the voters, until such debt is paid, and would require the state to provide replacement payments to political subdivisions of no less than the amount of tax levied on real property during the 2024 calendar year.

In reviewing the initiative, analysts from the Tax Foundation summarize its effects as:

> 1. Moving North Dakota further away from the benefit principle of taxation, which holds that those who receive or benefit from public services should pay for them;
> 2. Shifting responsibility for local revenue from local to state government;
> 3. Creating a structural fiscal deficit, nearly $1.3 billion per year, which would need to be replaced with other more harmful taxes at the state and possibly local level.

It is helpful to detail both local revenues and local expenditures in evaluating the nature of the problems identified (Figures 1 and 2). The authors from the Tax Foundation identify that "those who receive public services should pay for them". Local governments focus expenditures on a limited range activities. The two largest areas of expenditure in North Dakota are education and highways (i.e., transportation). With expenditures supporting air transportation included, we explain more than half of annual expenditures for every year since 2005.

Just as the scope of expenditure is limited, so too is the scope of revenue extraction. For this reason, property taxes comprise about a quarter of revenues received by local governments. In fact, property taxes composed over 47% of all locally generated revenue (i.e., excluding state-to-local and federal-to-local transfers). This limited scope of local revenues and local expenditures acts as a de facto earmark for local revenues. A significant portion of revenues will reliably be spent on education and transportation.

There is also a moral case for property taxes. As economic activity improves, assets that play a fundamental role in that activity naturally increase in value. Part of this moral case includes one's ability to avoid excessive taxation by simply incurring the costs of leaving the political domain engaged in extraction. Those who do not value land for its productive use are more likely to sell land as annual property taxes increase as this cost is uncompensated by revenues. Further, land is immovable and, therefore, straightforward to monitor and tax compared to other forms of capital. Landowners also benefit from increased valuations that may or may not be owing to their productive activity. So long as property taxes are collected locally, owners have significant influence over these revenues, ensuring that property taxes are not pure losses or pure transfers. In the case of local collection, land taxes are a source of local sovereignty.

Parties who pay local taxes can more reliably lobby the local authority concerning oversight of expenditure of these funds as municipalities and county governments hold regular meetings that are open to the public. Likewise, local representatives can be directly confronted at these and are very often present at local community functions like high school football games, farmers markets, or weekly religious services. Although accessible, state authorities are naturally more difficult to lobby. One must compete with a much larger constituency if one is to succeed in acquiring the attention of these authorities. Likewise, if one is to persuade other members of this constituency to promote a particular policy outcome, the relatively great number and diversity of interests make effective persuasion significantly more costly at the state level than at the local level. The benefit principle described by Tax Foundation analysts is, for this reason, a useful baseline for structuring effective fiscal policy.
Revenues not collected in the form of property taxes will likely be collected in the form of a different tax. This offset would conceivably be in the form of greater sales or income taxes. Either of such taxes will be considered by potential residents and by companies considering doing business within a given state.

The incentives that accompany a property tax are quite neutral compared to the other forms of taxation. If one wishes to avoid paying a high level of income taxes, they can simply work less. Likewise, if one wishes to avoid paying a high level of sales tax, they can make fewer purchases. In other words, they can earn less to avoid income taxes or spend less of their incomes within a state or region with high sales taxes to avoid paying them. A party that wishes to avoid property taxes can simply limit the ownership of real estate. Since there is a fixed stock of land and practically all of it is already owned, property taxes (unlike income or sales taxes) do not negatively impact either consumption or productivity on the margin, though they would impact the mix of ownership real estate. For the purpose of calculating federal taxes owed, it is possible for residents and corporations to write off at least of some of the sales, income, and property taxes paid at the local and state level. To the extent that these taxes are deducted from federal tax obligations, these effects on production and consumption are mitigated.

Tradeoffs for Property Tax Revenue Reduction

If local governments do not collect property taxes, then there are three possible consequences.

1. Another form of taxation offsets the fall in property tax revenues.
2. The fall in property tax revenues increases the deficits of local governments.
3. Transfers from the state government offset the fall in property taxes.

Local governments face significant intergovernmental competition, which limits their ability to increase taxes. Most citizens are willing to suffer a limited amount of taxation. However, as this burden increases, they may seek to engage in business in neighboring counties or even move away from the county in question if taxation becomes too burdensome.

Counties containing or close to a city center or, say, the state capital will tend to have a greater ability to levy burdensome taxes, including high rates of property taxation. Thus, we see high property tax rates in highly populated counties near major metropolitan centers. Counties near Chicago, San Francisco, Seattle, Los Angeles, San Diego, New York City, Austin, and Dallas, to name a notable but incomplete set of urban centers, are all subject to high property tax rates. We tend to observe low property tax rates in more rural areas. Of course, we may find exceptions to this trend, but it generally holds. (We invite you to take a close look at other major metropolitan areas.)

Intergovernmental competition makes property taxes an attractive source of funds for local governments. Property taxes are costly to avoid, as they require the sale of property by the owner. Of course, someone else will acquire the property, maintaining this source of revenue even if property values fall modestly due to a decrease in demand. Given the incentives facing tax collectors and taxpayers, it should be no surprise that a significant portion of local government revenues are derived from property taxes.

Concerning actual property taxes, we reference data aggregated at the state level between 2005 and 2021; property taxes and special assessments comprise between 9% and 64% of local revenues within any single state. In general, there seems to be a negative correlation between local government deficits within a state and the extent of property taxes. This is especially true in states where the proportion of local revenues generated from property taxes is relatively large.

We are explicitly concerned with the behavior of budgetary components in North Dakota. A careful look at the data reveals that when the budget is divided between 1) Property Taxes and Assessments, 2) State Transfers, and 3) remaining sources of local revenue, a clear tradeoff emerges. Between 2005 and 2021, state-to-local transfers in North Dakota, indicated by the bolded points, compensated whenever property tax income growth did not keep up with GDP growth. In Figure 3, we see that state transfers increase as the remaining portion of the budget increases for a given value of property taxes and special assessments as a portion of GDP. Likewise, in Figure 4, we see that for a given level of property taxes per capita, there is a tendency for state transfers per capita to increase as the level of GDP per capita increases. State transfers have been used as a substitute for locally collected property taxes.

Figure 1: Local Government Finances Percent of General Revenue: ND

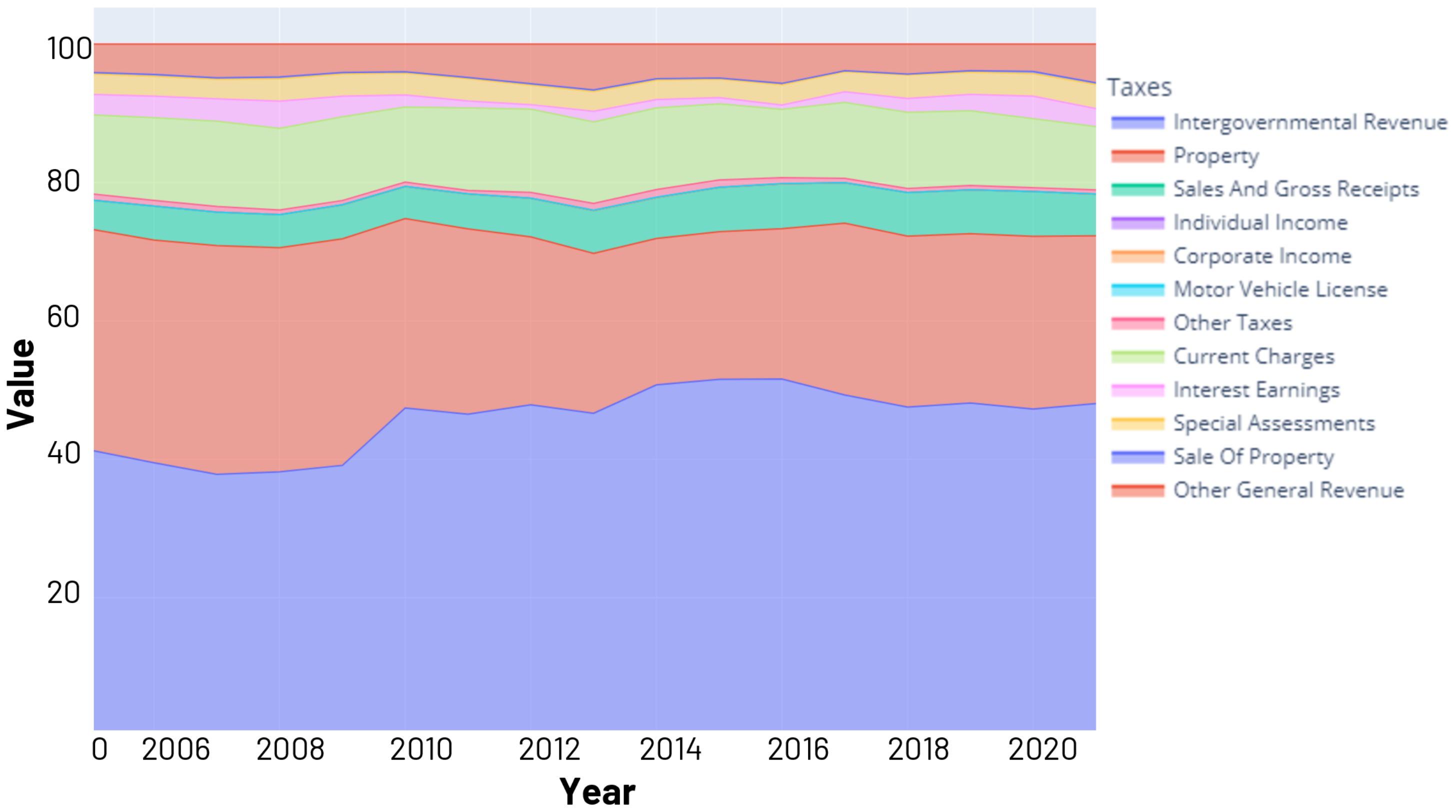

Figure 2: Local Government Finances Percent of Expenditure: ND

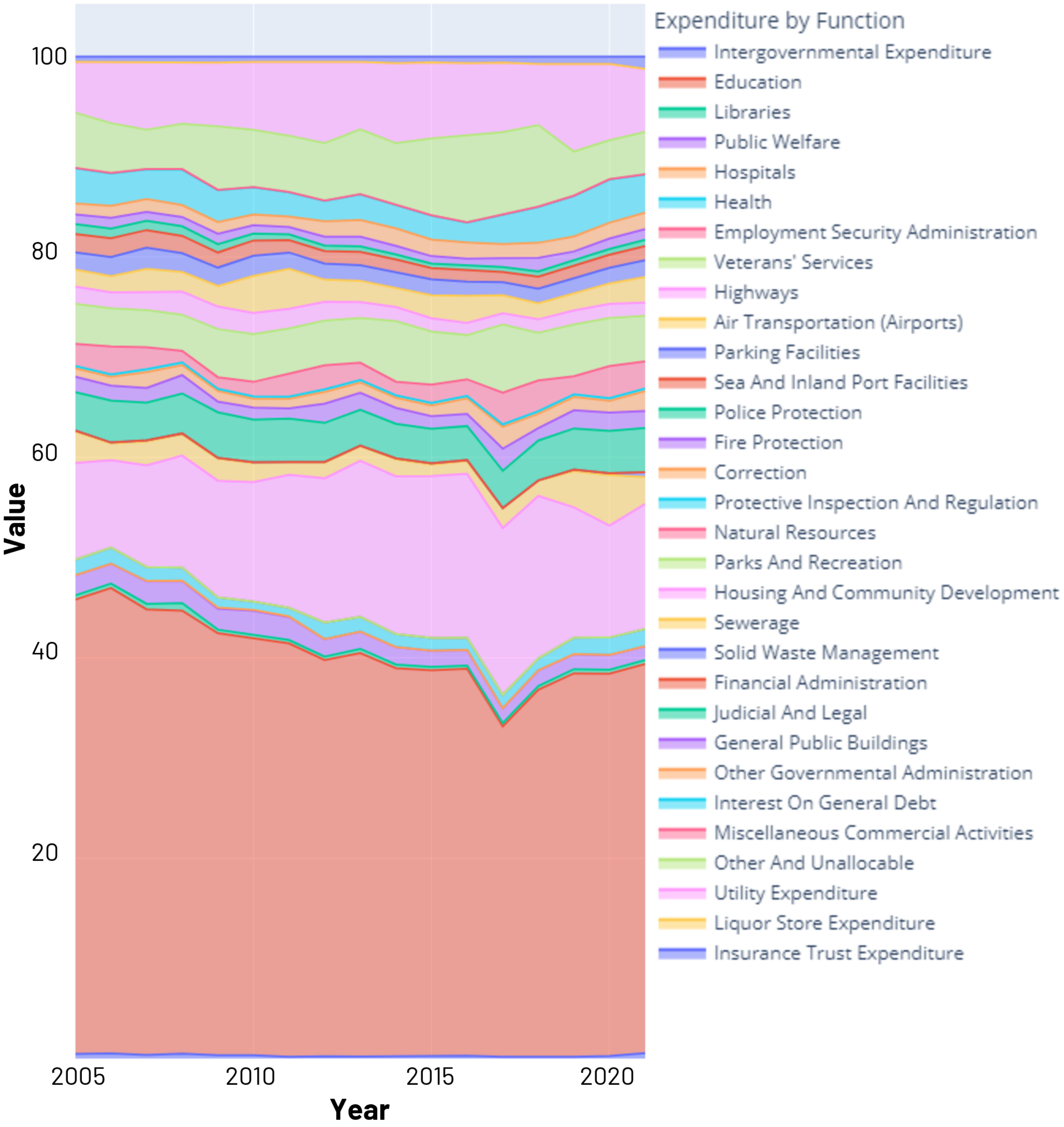

Figure 3: Percent of General Revenue

Figure 4: Per Capita Values

Starting in 2009, the state has implemented property tax relief. Even as of 2024, a North Dakota resident "[h]omeowners with an approved application may receive up to a $500 credit against their 2024 property tax obligation." This offset is reflected most clearly in Figure 1, showing the increase in the percent of local revenues coming from state transfers. The percent of local revenues coming from state transfers ranged from 37 to 41 percent between 2005 and 2009, while it ranged between 47 and 52 percent between 2010 and 2021.

The state has been partially offsetting local tax obligations. The current ballot measure would prohibit collection of property taxes. Instead, the state will transfer funds to localities equal to the full value of property taxes according to the value collected in 2024.

There is no neutral choice here. Either property taxes remain local and local sovereignty is maintained, or local revenues diminish and local governments become financially dependent upon higher levels of government. One's view of the significance and legitimacy of property taxes must be formed in light of the alternative outcomes that would manifest should property taxes be eliminated, whether in part or in whole. We recommend that voters and policymakers critically consider the implications of the proposed measure with regard to the soundness of the state budget and the vitality of local governance.

Appendix

For an interactive chart and graph experience, visit: https://jameslcaton.com/StateoftheState/PropertyTaxPolicyBrief.html

Relevant Sources

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State and Local Finances: United States Census Bureau. Example: 2021 State and local Government Finance Historical Datasets and Tables

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