

## **ELEMENTARY AND SECONDARY EDUCATION ENHANCED FUNDING AND REDUCED RELIANCE ON PROPERTY TAXES - BACKGROUND MEMORANDUM**

Section 1 of Senate Bill No. 2404 (attached as an appendix) directs the Legislative Council to study enhanced funding for elementary and secondary education and methods, including sales tax, income tax, and tax exemptions, by which the state's reliance on property taxes to fund elementary and secondary education could be reduced. It appears that Senate Bill No. 2404 was enacted to continue the deliberations initiated by introduction and consideration of 2005 House Bill No. 1512, which would have caused a substantial restructuring of education funding, but which failed to pass.

To initiate the study directed by the Legislative Council, it may be of value for the committee to review the background for education funding and property taxes.

### **EDUCATION FUNDING Constitutional Basis**

Article VIII, Section 1, of the Constitution of North Dakota provides:

A high degree of intelligence, patriotism, integrity and morality on the part of every voter in a government by the people being necessary in order to insure the continuance of that government and the prosperity and happiness of the people, the legislative assembly shall make provision for the establishment and maintenance of a system of public schools which shall be open to all children of the state of North Dakota and free from sectarian control. This legislative requirement shall be irrevocable without the consent of the United States and the people of North Dakota.

Article VIII, Section 2, of the Constitution of North Dakota follows with the directive that:

The legislative assembly shall provide for a uniform system of free public schools throughout the state, beginning with the primary and extending through all grades up to and including schools of higher education, except that the legislative assembly may authorize tuition, fees and service charges to assist in the financing of public schools of higher education.

At least since the 1930s, the state has attempted to meet its constitutional directives by providing some

level of financial assistance to local school districts. In the 1957-58 interim, the Education Committee concluded that state assistance was set at arbitrary levels. The committee also noted that existing law did not require school districts to support their own education systems with any minimum property tax effort. The committee recommended creation of a state foundation aid program.

### **Foundation Aid Program**

The 1959 legislation establishing the foundation aid program required a uniform 21-mill county levy and provided a supplemental state appropriation to ensure that school districts would receive 60 percent of the cost of education from nonlocal sources. This program recognized that property valuations, demographics, and educational needs varied from school district to school district. The Legislative Assembly forged a system of weighted aid payments that favored school districts with lower enrollments and higher costs. This initial program also allocated higher weighting factors to districts that provided high school services.

### **Statewide Study of Education - The Alm Report**

In 1965, House Bill No. 815 directed the Legislative Research Committee (the predecessor to the Legislative Council) to study "the requirements, standards, procedures, and laws governing school districts in North Dakota as they relate to a comprehensive State educational program, comprehensive local educational programs, assessed valuation, problems of low-populated areas, rising educational costs and financial ability of districts to meet requirements, and potential educational needs." Consideration was to be given to "terrain, roads, trading centers, population centers, and any and all other factors relating to needs of education in the coming years." The study was assigned to the Legislative Research Committee's Subcommittee on Education. The University of North Dakota participated in the study and assigned Dr. Kent Alm to the study team for the project. A federal grant provided matching funds for the study, which became identified as the *Statewide Study of Education* and which has since been informally referred to as the Alm report.

Among the team's recommendations were:

- The energies of the state's colleges and universities be consolidated and focused on a new

program of personnel development, research, and service, thereby making the classroom teacher a vital part of a continuing research and improvement effort;

- Each of North Dakota's schoolchildren be placed in a reasonably organized and administratively effective school district containing at least 12 grades of instruction and enrolling at least 200 students in high school;
- The Department of Public Instruction administer seven regional service centers which would energize and facilitate local district study, planning, evaluation, reorganization, and program improvement;
- The state foundation aid plan equalize inequities among local school districts;
- The state government assume responsibility for the extraordinary cost of education services, such as school construction, debt service, transportation, and special services for rural isolated students; and
- State funds be used to reward those local districts that take the initiative to improve the quality and efficiency of their operation.

The results of the *Statewide Study of Education* were not available for action by the 1967 Legislative Assembly, and the final reports were distributed in September 1968. The 1967-68 interim Subcommittee on Education recommended three bills relating to school district reorganization and school construction as a result of this study. A bill on school construction passed while two bills on school district reorganization--one of which would have created a regional committee system for school district reorganization and the other of which would have required reorganization of all school districts into high school districts--were defeated.

### The 1970s

In the early 1970s, federal and state courts were beginning to address issues of spending levels for elementary and secondary education and whether those levels should be dependent upon the wealth of the school district in which a student resides. The Legislative Assembly responded by amending the foundation aid program. The state more than doubled the per student payment and replaced the flat weighting factor with one that recognized four classes of high schools. Elementary weighting factors were altered as well. Adjustments continued to be made during the mid-1970s. A new category encompassing seventh and eighth grade students was created, and fiscal protection for schools experiencing declining enrollments was instituted. This latter provision ensured that no school district could receive less in state aid payments for a current year than that district would have received based on its enrollment during the

previous school year. For the 1975-77 biennium, the state aid appropriation was \$153.4 million. In 1979 the Legislative Assembly appropriated \$208.4 million for the state aid program and added an additional appropriation of \$1 million to pay for free public kindergartens.

### The 1980s

The next major development affecting education finance occurred with the approval of initiated measure No. 6 at the general election in November 1980. This measure imposed a 6.5 percent oil extraction tax and provided that 45 percent of the funds derived from the tax had to be used to make possible state funding of elementary and secondary education at the 70 percent level. To meet this goal, the 1981 Legislative Assembly allocated 60 percent of the oil extraction tax revenues to the school aid program. Initiated measure No. 6 also provided for a tax credit that made the 21-mill levy inapplicable to all but the owners of extremely high-value properties. The Legislative Assembly eliminated the 21-mill county levy and increased state aid to compensate for the revenues that would have been derived from the levy.

During the early 1980s, discussions continued to center around purported funding inequities. Districts spending similar amounts per student and having similarly assessed valuations were not levying similar amounts in property taxes to raise the local portion of education dollars. Discussions focused on whether the system encouraged some districts to levy much smaller amounts than their spending levels and assessed valuations justified.

In response, the Legislative Council's 1981-82 interim Education Finance Committee examined a method of funding education known as the "70/30" concept. This proposal was a significant departure from the existing state aid formula in that it took into account the cost of providing an education in each school district. The formula required determination of the adjusted cost of education and then required the computation of a 30 percent equalization factor to arrive at each district's entitlement. It was contemplated that a local mill levy would be employed to raise the district's local share of the cost of education.

Proponents touted this approach as one that included a comprehensive equalization mechanism and which recognized local variances in the cost of education. Opponents argued it rewarded high-spending districts and penalized those that had been operating on restricted budgets. The interim committee did not recommend the concept.

During the 1980s, Legislative Council interim committees explored weighting factors, the effects of increasing the equalization factor, and the excess mill levy grant concept. During the 1987-88 interim, the Education Finance Committee established specific goals and guidelines to guide its deliberations on

matters of education finance. The interim committees recognized the need to alter the state's education funding system, but they reached little agreement beyond recommending increases in the level of per student aid.

### **District Court Litigation and 1993 Legislation**

In 1989 the complaint in *Bismarck Public School District No. 1 v. State of North Dakota* charged that disparities in revenue among the school districts had caused corresponding disparities in educational uniformity and opportunity which were directly and unconstitutionally based upon property wealth.

On February 4, 1993, after hearing 35 witnesses and examining over 250 exhibits, the district court issued 593 findings of fact and 32 conclusions of law. The court listed these "constitutionally objectionable" features of the school financing system:

- Disparities in current revenue per student are the result of variations in school district taxable wealth.
  - The 22-mill equalization factor in the state aid formula fails to equalize for variations in district wealth because the equalization factor is below the state average school district tax rate for current revenue and leaves much of the school millage outside the state aid formula.
  - The low level of state educational support fails to ensure substantial equality of resources for students in similarly situated school districts.
  - The use of cost weightings that are inaccurate unjustifiably benefits districts with large amounts of taxable wealth.
  - The flat grant allocation of tuition apportionment ignores the vast differences in taxable wealth among school districts and operates as a minimum guarantee for wealthy districts.
  - The transportation aid program exacerbates existing resource disparities by reimbursing some, often wealthy, districts for more than the actual cost of transportation and requires other, often poorer, districts to fund a substantial share of transportation costs from other revenue sources.
  - The special education funding program exacerbates existing resource disparities by giving higher-spending districts an advantage in obtaining state reimbursement of special education costs and requiring school districts to fund a large share of the excess costs of special education programs from their disparate tax bases.
  - The state aid for vocational education exacerbates existing resource disparities.
- The state system for funding school facilities relies on the unequal taxable wealth of school districts.
  - The payment of state aid to wealthy districts enables them to maintain large ending fund balances.
  - The failure of the state to ensure that resource differences among school districts are based on factors relevant to the education of North Dakota students rather than on the unequal taxable wealth of North Dakota school districts.

The district court declared the North Dakota school financing system to be in violation of Article VIII, Sections 1 and 2, and Article I, Sections 21 and 22, of the Constitution of North Dakota. The Superintendent of Public Instruction was directed to prepare and present to the Governor and the Legislative Assembly, during the 1993 legislative session, plans and proposals for the elimination of the wealth-based disparities among North Dakota school districts.

### **Response to the Litigation**

In response to the district court's order, the Superintendent of Public Instruction presented the following recommendations to the 1993 Legislative Assembly:

- Raise the per student payment to \$3,134.
- Fund special education by dividing the 13 disabilities categories into three broad categories and assigning weighting factors to each.
- Fund vocational education by assigning weighting factors to high-cost and moderate-cost programs.
- Provide transportation reimbursements based on six categories of density.
- Provide state funding of education at the 70 percent level.
- Establish a uniform county levy of 180 mills.
- Distribute tuition apportionment in the same manner as foundation aid.
- Provide that federal and mineral revenues in lieu of property taxes and districts' excess fund balances be part of a guaranteed foundation aid amount.
- Allow districts the option of levying 25 mills above the 180-mill uniform county levy.
- Require that all land be part of a high school district and that districts having fewer than 150 students become part of a larger administrative unit.
- Provide \$25 million for a revolving school construction fund.

The Legislative Assembly addressed these issues by passage of House Bill No. 1003 (1993). The bill was the appropriations bill for the Superintendent of Public Instruction and, as it progressed through the legislative process, it became the principal 1993 education funding enactment. The bill:

- Set the state support for education at \$1,572 per student for the first year of the 1993-95 biennium and at \$1,636 for the second year.
- Raised the equalization factor from 21 to 23 mills and then to 24 mills.
- Set weighting factors at 25 percent of the difference between the prior statutory amount and the five-year average cost of education per student, as determined by the Superintendent of Public Instruction, for the first year of the biennium and at 50 percent of the difference for the second year of the biennium.
- Capped state transportation payments at 100 percent for the first year of the 1993-95 biennium and at 90 percent for the second year of the biennium and directed that any savings resulting from imposition of the 90 percent cap during the second year of the biennium be used by the Superintendent of Public Instruction to increase the per student transportation payments available under existing law.
- Reiterated the existing statutory requirement that school districts admitting nonresident students charge tuition but exempted school districts that admit nonresident students from other districts offering the same grade level services.
- Directed the Legislative Council to conduct another study of education finance and appropriated \$70,000 for purposes associated with the study, including necessary travel and consultant fees.

### **1993-94 Interim Study and Supreme Court Decision**

The Legislative Council's interim Education Finance Committee began its efforts during the 1993-94 interim before an appeal of *Bismarck Public School District No. 1* was taken to the North Dakota Supreme Court. The committee was aware that many of the issues addressed by the trial court had been the subject of interim studies and legislative deliberations for many years. However, the committee also realized that the requisite number of Supreme Court justices (four) might not necessarily agree with the lower court's determination that the state's system of funding education was unconstitutional.

The North Dakota Supreme Court issued its decision on January 24, 1994--*Bismarck Public School District No. 1 v. State of North Dakota*, 511 N.W.2d 247 (N.D. 1994). Although three of the five justices concluded that the state's education funding system was unconstitutional, Article VI, Section 4, of the Constitution of North Dakota requires four members of the court to declare a statute unconstitutional.

A majority of the Supreme Court indicated there were three principal areas in need of attention--in lieu of

revenues, equalization factors, and transportation payments. The majority decision of the Supreme Court did not, however, mandate specific legislative action. The court indicated the areas of concern and left it up to the Legislative Assembly to determine how those areas should be addressed. In a dissenting opinion, Chief Justice VandeWalle stated:

. . . [T]he present funding system is fraught with funding inequities which I believe have not yet transgressed the rational-basis standard of review but which appear to me to be on a collision course with even that deferential standard.

The Supreme Court decision was issued midway through the 1993-94 interim. By the time the Education Finance Committee had completed its work, it had considered 35 bill drafts and 3 resolution drafts. Twenty-seven pieces of legislation were recommended to the Legislative Council for introduction during the 1995 legislative session.

The committee's recommendations included increases in the minimum high school curriculum; establishment of an additional Governor's School; appropriation of funds for elementary summer school programs, professional development programs, professional development centers, and refugee student assistance; placement of all land in a high school district; alteration of the weighting categories; a variable equalization factor; reclassification of special education categories; distribution of tuition apportionment according to average daily membership; an increase in transportation payments from 28 cents to \$1 per day for all students transported by schoolbuses; and an \$80 million increase in the level of foundation aid over that appropriated during the 1993-95 biennium.

### **Education Finance - 1995 Legislative Assembly**

Although the 1995 Legislative Assembly enacted a variety of bills dealing with education and education finance, the most significant provisions were found in three bills--Senate Bill Nos. 2059, 2063, and 2519.

Senate Bill No. 2059 dealt with the funding of transportation. The bill maintained the per mile payment of 25 cents for small buses and 67 cents for large buses, and it added a payment for in-city transportation of 25 cents per mile. The per head payment for in-city students riding schoolbuses or commercial buses was increased from 17.5 to 20 cents per one-way trip. The 90 percent cap on payments, which was instituted by the 1993 Legislative Assembly, was left in place.

Senate Bill No. 2063 dealt with the funding of special education. The bill provided that \$10 million had to be used to reimburse school districts for excess costs incurred on contracts for students with disabilities, for low-incidence or severely disabled students, and for certain boarding care. The bill also provided

that \$400,000 had to be used to reimburse school districts for gifted and talented programs approved by the Superintendent of Public Instruction, and \$500,000 had to be used to reimburse school districts with above-average incidences of moderately or severely disabled students. Any amount remaining in the special education line item was to be distributed to each school district in accordance with the number of students in average daily membership. The line item for special education was \$36,850,000. The bill also provided that, during the 1995-96 school year, no district or special education unit could receive less than 95 percent of the amount it received during the 1993-94 school year, excluding reimbursements for student contracts, boarding care, and gifted and talented programs. During the 1996-97 school year, no district or special education unit could receive less than 90 percent of that amount.

Senate Bill No. 2519 provided an increase in the per student payment for isolated elementary schools and high schools and increased by 20 percent the weighting factors applied to students attending school out of state. The bill raised the equalization factor from 24 to 28 mills for the first year of the biennium and to 32 mills for the second year of the biennium and provided that thereafter the equalization factor would be tied by a mathematical formula to increases in the level of foundation aid. The equalization factor would not be permitted to fall below 32 mills nor rise above 25 percent of the statewide average school district general fund mill levy. Weighting factors, which had been set at 50 percent of the difference between the factor stated in statute and the five-year average cost of education per categorical student, were left at 50 percent of the difference for the first year of the biennium and then raised to 65 percent of the difference for the second year. High school districts whose taxable valuation per student and whose cost of education per student were both below the statewide average could receive a supplemental payment, again based on a mathematical formula. The sum of \$2,225,000 was appropriated for supplemental payments. Per student payments were set at \$1,757 for the first year of the biennium and \$1,862 thereafter.

The 1995 Legislative Assembly appropriated \$517,598,833 for foundation aid, transportation aid, supplemental payments, tuition apportionment, and special education. That figure is \$41,561,941 more than the 1993-95 appropriation.

### **Education Finance - 1997 Legislative Assembly**

The 1997 Legislative Assembly incorporated the substantive provisions of its education finance package within Senate Bill No. 2338. That bill set the per student payments at \$1,954 for the 1997-98 school year and \$2,032 for the 1998-99 school year. The

equalization factor, which was raised to 32 mills by the 1995 Legislative Assembly and thereafter tied by a mathematical formula to future increases in the level of foundation aid, was left at 32 mills. All references to formulated increases were removed. Weighting factors, which were set at 65 percent of the difference between the statutory factor and the five-year average cost of education per categorical student, remained at 65 percent for the 1997-98 school year and increased to 75 percent for the 1998-99 school year.

Supplemental payments to high school districts whose taxable valuation per student and average cost of education were below the statewide average were maintained by House Bill No. 1393, but the mill range for eligible districts was raised from the 1995 level of 135 to 200 mills to the 1997 level of 150 to 210 mills. Payments to school districts for the provision of services to students with special needs were increased from the 1995-97 appropriation of \$36,850,000 to \$40,550,000. Of this amount, \$10 million was set aside for student contracts, \$400,000 for the provision of services to gifted students, and the remainder was to be distributed on a per student basis.

The total amount appropriated for per student payments, transportation, supplemental payments, tuition apportionment, and special education by the 1997 Legislative Assembly was \$559,279,403. That figure exceeds the 1995-97 appropriation by \$41,680,570.

### **Education Finance - 1999 Legislative Assembly**

The impact of declining demographics found its way into a number of bills addressed by the 1999 Legislative Assembly. One of these bills, House Bill No. 1033, was recommended to the Legislative Council by the 1997-98 interim Education Finance Committee. The bill required that on or before June 30, 2002, each school district offer all educational grade levels from 1 through 12 or become attached, through a process of reorganization or dissolution, to a district that offers those grade levels. The bill, which would have had the likely effect of reducing the number of school districts from 231 to approximately 182, was defeated in the House.

Another way in which declining demographics was addressed by the 1999 Legislative Assembly involved authorization for school districts to jointly employ school district superintendents. That concept was embodied in 1999 Senate Bill No. 2162. Senate Bill No. 2162 was enacted and signed.

Declining demographics found their way into discussions regarding school construction approval. Senate Bill No. 2162 provided that the Superintendent of Public Instruction may not approve the construction, purchase, repair, improvement, renovation, or modernization of any school building or facility unless the

school district proposing the project demonstrates the need for the project, the educational utility of the project, and the ability to sustain a stable or increasing student enrollment for a period of time at least equal to the anticipated usable life of the project, or demonstrates potential utilization of the project by a future reorganized school district.

Declining demographics were the impetus behind the provision in Senate Bill No. 2162 which allowed school districts to terminate their operations, become nonoperating districts for up to three years, and during the period of "nonoperation" to provide for education of their students in other school districts.

Senate Bill No. 2162 also set aside up to \$2 million for school districts whose 1999-2000 fall enrollment was less than their 1994-95 fall enrollment and provided up to \$2 million in reorganization bonuses for school districts that reorganized with one or more contiguous districts or portions of districts, provided at least one of the reorganizing districts was a high school district and further provided that the newly reorganized district consisted of at least 800 square miles.

The 1999 Legislative Assembly appropriated \$479,006,259 for foundation aid and transportation, \$3,100,000 for supplemental payments, \$53,528,217 for tuition apportionment payments, and \$46,600,000 for special education payments. The total appropriation of \$582,234,476 exceeds the 1997-99 appropriation by \$22,955,073.

### **Education Finance - 2001 Legislative Assembly**

The 2001 Legislative Assembly provided \$49,898,695 for special education, \$67,239,025 for tuition apportionment, \$2,200,000 for supplemental payments, \$473,971,648 for per student payments and transportation, and for the first time, \$35,036,000 for teacher compensation payments. The total appropriation of \$628,345,368 exceeds the 1999-2001 appropriation by \$46,110,892. House Bill No. 1344, which contained the teacher compensation payments, also required school districts to provide each teacher with a minimum salary of \$18,500 for a nine-month contract during the first year of the biennium and \$20,000 for a nine-month contract during the second year of the biennium.

House Bill No. 1344 set the per student payment levels at \$2,287 for the first year of the biennium and \$2,347 for the second year of the biennium. The bill set aside \$2 million from which prorated hold harmless payments could be made to districts that, over the biennium, received less money under the bill than they would have received had the money allocated to teacher compensation payments been included in the per student payments. The bill also provided for contingent declining enrollment payments and capped those

payments at \$250 per student for a maximum of 400 students.

### **Education Finance - 2003 Legislative Assembly**

The 2003 Legislative Assembly maintained special education funding at \$49,898,695, raised the appropriation for tuition apportionment from \$67,239,025 to \$69,495,371, raised the appropriation for per student payments from \$474,971,648 to \$489,379,990, and raised the appropriation for teacher compensation reimbursement from \$35,036,000 to \$51,854,000. In addition, the 2003 Legislative Assembly increased the appropriation for supplemental payments from \$2,200,000 to \$5,000,000. The total appropriation of \$665,628,056 exceeds the 2001-03 appropriation by \$37,282,688.

The per student payment levels for the 2003-05 biennium were increased to \$2,509 and \$2,623. Senate Bill No. 2154 (2003) also increased the high school and elementary weighting factors from 75 percent of the difference between the stated factors and the five-year average cost of education per category to 85 percent of the difference in the first year of the biennium and thereafter to the five-year average cost of education per category. It provided for an equalization factor that would rise from 32 to 34 mills during the first year of the biennium, to 36 mills during the second year of the biennium, and continue increasing by 2 mills each year thereafter.

Senate Bill No. 2154 amended the existing formula for calculating supplemental payments so that all tuition payments and county and unrestricted federal revenues would be accounted for in determining eligibility and further provided for the application of an additional equalization factor in the event that a district levied fewer than 140 mills for general fund purposes plus high school transportation and high school tuition. In addition, it provided for the block-granting of transportation payments, thereby ensuring that each school district will receive as much in transportation payments as the district received during the previous biennium.

Senate Bill No. 2154 also articulated the subjects that public and nonpublic schools must make available over the course of a student's high school career. Contingent payments were set aside for joint powers agreements that met specified criteria and for school district reorganizations. Any remaining money was to be distributed as additional per student payments.

Senate Bill No. 2154 was vetoed by the Governor. The veto message indicated the veto was because the bill did "not commit any increase in education funding to teacher compensation in order to continue the progress that we initiated in the last legislative session."

Section 38 of Senate Bill No. 2154 provided that the "board of a school district shall consider continuing the

efforts made in the 2001-03 biennium to increase teacher salaries throughout the state.” During the special session of May 2003, the content of Senate Bill No. 2154 was introduced as Senate Bill No. 2421. The only change made during the special session concerned Section 38. As Senate Bill No. 2421 was passed by the Legislative Assembly during the special session and subsequently signed by the Governor, Section 38 provides that the board of each school district shall use an amount equal to at least 70 percent of all new money received for per student payments and tuition apportionment payments for the purpose of increasing the compensation paid to teachers and for the purpose of providing compensation to teachers who begin employment with the district on or after July 1, 2003. The section also provides that the requirement does not apply to a school district if the board of the district, after a public hearing at which testimony and documentary evidence are accepted, determines by a vote of two-thirds of its members that complying with the requirement would place the district in the position of having insufficient fiscal resources to meet its other obligations.

### **Education Finance - 2005 Legislative Assembly**

The 2005 Legislative Assembly increased special education funding from \$49,898,695 to \$52,500,000, increased the appropriation for tuition apportionment from \$69,495,371 to \$71,600,000, increased the appropriation for per student payments from \$489,379,990 to \$516,853,759, reduced the appropriation for teacher compensation reimbursement from \$51,854,000 to \$50,912,120, and continued the appropriation of \$5 million for supplemental per student payments. The total appropriation of \$696,865,879 exceeds the 2003-05 appropriation by \$31,237,823. The total appropriation exceeds the 1995-97 appropriation by \$179,267,046, which is an increase of 34.6 percent in 10 years. 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.

House Bill No. 1154 (2005) set per student payments at \$2,765 for the first year of the biennium and \$2,879 for the second year of the biennium. The per student payment for the second year of the biennium is \$1,017 more than the comparable amount for 10 years earlier, an increase of 54.6 percent. The bill establishes a 38-mill deduct with an annual increase of 3 mills and reconfigures weighting categories. The bill requires that in order to be eligible for supplemental payments, a school district must levy at least 180 mills and have less than 35 percent of its actual expenditures plus \$20,000 in its ending fund balance. The bill maintains teacher compensation reimbursements at \$3,000 and at \$1,000 for new teachers and establishes

minimum salary levels of \$22,000 for the first year of the biennium and \$22,500 for the second year of the biennium. The bill requires inclusion of two days of professional development in the school calendar, provides criteria for approval of educational associations governed by joint powers agreements, requires that school boards consist of at least five members, provides that land from dissolved districts may be attached only to high school districts, requires distribution of unobligated cash balances upon dissolution to the school districts receiving land from the devolved district, requires school districts not offering certain grade levels to pay for both tuition and transportation, and includes extracurricular activity costs in the determination of tuition. The bill provides for distribution of \$33,500,000 in transportation grants, \$759,000 in reorganization bonus payments, and \$30,000 for transportation efficiency training.

Senate Bill No. 2033 (2005) provided that with respect for a student placed for noneducational purposes, a determination regarding residency must be made each September 15. The bill precludes a school district from enrolling a student who is placed in the district for purposes other than education by an out-of-state agency or entity unless a contract exists governing responsibility for payment of tuition and tutoring charges.

House Bill No. 1237 (2005) authorized the Superintendent of Public Instruction to forward per student payments for special education students directly to the school district in which the students received special education services.

House Bill No. 1311 (2005) provided \$119,000 in contingent payments from the 2003-05 biennium to the Velva, TGU, and Lewis and Clark School Districts because they received reduced state aid during the 2003-05 biennium as a result of reorganizations or dissolutions.

House Bill No. 1076 (2005) provided that as a condition of school approval, each classroom teacher must teach only in those course areas or fields for which the teacher is licensed. The bill provides an exemption by which teachers who are not licensed to teach a particular course or area or field may become so licensed.

House Bill No. 1374 (2005) required each school district to provide a program of instruction for students who are English language learners.

Senate Bill No. 2260 (2005) provided an approval mechanism for early childhood programs and makes clear that per student funding is not available for those programs.

## **PROPERTY TAXES Determination and Payment**

The primary reason education funding and property taxes are often linked in discussions is that school district property taxes constitute a majority of all property taxes. For taxable year 2004, property taxes levied by school districts were 55.5 percent of all property taxes levied in the state.

The property tax liability of a property owner is determined by multiplying combined mill rates for all taxing districts in which the property is located times the taxable value of the property. Although this formula is relatively simple, complexities are involved in determining the mill rate, taxable value, and tax status for the property.

All locally assessed property taxes are collected by the county and distributed among appropriate taxing districts. Property taxes are due January 1 following the year of assessment and are payable without penalty until March 1 of the year they are due. If property taxes are paid in full by February 15, the taxpayer is entitled to a 5 percent discount. Penalties begin to accrue if property taxes are not paid by March 1. Taxpayers have the option of paying property taxes in installments.

### **Determination of Mill Rate**

The mill rate for a taxing district is established through the budget process. Each taxing district prepares a proposed budget based on anticipated expenditures for the upcoming fiscal year. Hearings are held on the proposed budget and adjustments are made as needed. The deadline for amendments to budgets and for sending copies of the levy and budget to the county auditor is October 10. From October 10 to December 10, the county auditor prepares tax lists, which must be delivered to the county treasurer by December 10 and mailed to property owners by December 26.

The amount budgeted by a taxing district may not result in a tax levy exceeding levy limitations established by statute. Levy limitations for political subdivisions are summarized in the schedule of levy limitations prepared biennially by the Tax Commissioner's office. Since 1981 the Legislative Assembly has provided optional authority to levy taxes with a maximum amount determined by comparison with a base year levy amount in dollars. This method is an alternative to the use of statutorily established mill levy limitations. Most taxing districts in the state use this optional method of determining the maximum levy to which they are entitled. From 1981 through 1996, percentage increases were allowed by law over the base year levy in dollars. The compounding of these increases allowed taxing districts to increase levies well beyond the amount they would be able to levy under mill levy limitations. For taxable years after 1996, taxing districts may use the optional method to

levy up to the amount levied in dollars in the base year without a percentage increase.

To determine the mill rate for a taxing district, the county auditor determines whether the amount levied is within statutory levy limitations and, if it is, the county auditor divides the total property taxes to be collected for the taxing district by the taxing district's total taxable valuation. This generates a percentage that is the mill rate for the district.

### **Assessment of Locally Assessed Property**

All property in this state is subject to taxation unless expressly exempted by law (North Dakota Century Code (NDCC) Section 57-02-03). Real property must be assessed with reference to its value on February 1 of each year (Section 57-02-11). All property must be valued at the "true and full value" of the property (Section 57-02-27.1). True and full value is defined as the value determined by considering the earning or productive capacity, if any, the market value, if any, and all other matters that affect the actual value of the property to be assessed. For purposes of agricultural property, this includes farm rentals, soil capability, soil productivity, and soils analysis (Section 57-02-01). The assessed value of property is equal to 50 percent of the true and full value of the property (Section 57-02-01). Taxable valuation of property is determined as a percentage of assessed valuation, which is 9 percent for residential and 10 percent for agricultural, commercial, and centrally assessed property. The taxable valuation is the amount against which the mill rate for the taxing district is applied to determine the tax liability for individual parcels of property.

Residential and commercial property true and full value is established by local assessors. True and full value of railroad, public utility, and airline property is centrally determined by the State Board of Equalization.

True and full value of agricultural property is based on productivity as established through computations made by the North Dakota State University Department of Agricultural Economics based on the capitalized average annual gross return of the land. Annual gross return must be determined from crop share rent, cash rent, annual gross income, or annual gross income potential. Average annual gross return for each county is determined by taking annual gross returns for the county for the most recent 10 years, discarding the highest and lowest annual gross return years, and averaging the remaining 8 years. Statistics from the most recent 10 years for prices paid by farmers are used to adjust annual gross return. Annual gross return is then capitalized using a 10-year average of the most recent 12-year period for the gross agribank mortgage rate of interest. However, the minimum capitalization rate

under the formula is set at 9.5 percent for tax year 2004, 8.9 percent for tax year 2005, and 8.3 percent for tax year 2006 and later. Personnel from North Dakota State University determine an average agricultural value per acre for cropland and noncropland on a statewide and countywide basis. This information is provided to the Tax Commissioner by December 1 of each year and then provided by the Tax Commissioner to each county director of tax equalization. The county director of tax equalization provides each assessor within the county an estimate of the average agricultural value of agricultural lands within the assessor's assessment district. The local assessor must determine the relative value of each assessment parcel within that assessor's jurisdiction. In determining relative values, local assessment officials are to use soil type and soil classification data whenever possible.

### **Assessment of Centrally Assessed Property**

Property of railroads, public utilities, and airlines is assessed by the State Board of Equalization as required by Article X, Section 4, of the Constitution of North Dakota. Under NDCC Section 57-13-01, the State Board of Equalization consists of the Governor, State Treasurer, State Auditor, Agriculture Commissioner, and Tax Commissioner. The assessment process for centrally assessed property differs from the procedure for locally assessed property. The owner of centrally assessed property must file an annual report with the Tax Commissioner by May 1. The Tax Commissioner prepares a tentative assessment for the property by July 15. Notice of the tentative assessment is sent to the property owner at least 10 days before the State Board of Equalization meeting. On the first Tuesday in August, the State Board of Equalization meets to receive testimony on the value of centrally assessed property and to finalize assessments. The Tax Commissioner certifies the finalized assessments to the counties, to reflect the portion of centrally assessed property for each property owner which is taxable in that county.

Airlines serving North Dakota cities pay a property tax computed by averaging mill levies in all the cities served by an airline and applying the average levy against the taxable valuation of property of the airline in North Dakota. Taxes imposed on an airline are collected by the State Treasurer and distributed to the cities in which the airline operates, to be used exclusively for airport purposes.

### **Payments in Lieu of Taxes**

State law provides that some enterprises make payments in lieu of taxes rather than paying property taxes. Mutual or cooperative telephone companies and investor-owned telephone companies pay a tax of 2.5

percent of adjusted gross receipts. This tax is paid to the Tax Commissioner and allocated among counties.

Rural electric cooperatives pay a gross receipts tax in lieu of property taxes for all property except land. Rural electric cooperatives with generating facilities are subject to a transmission line tax of \$225 to \$300 per mile in lieu of property taxes on transmission lines of 230 kilovolts or more.

Coal conversion facility taxes are paid in lieu of property taxes. These taxes are allocated by state law and provide revenues to affected taxing districts.

Property owned by certain state agencies and certain agencies and instrumentalities of the federal government is subject to payments in lieu of property taxes.

### **2005 Property Tax Legislation Enacted**

Senate Bill No. 2188 reduces the minimum capitalization rate used in the agricultural property valuation formula for property tax purposes from 9.5 to 8.9 percent for taxable year 2005 and 8.3 percent for taxable years after 2005.

Senate Bill No. 2018 reduces from 3 to 1.5 percent the portion of assessed value used to determine taxable valuation of wind turbine electric generation units with a generation capacity of 100 kilowatts or more. To qualify for the reduced taxable valuation, a generation unit must have a purchased power agreement executed after April 30, 2005, and before January 1, 2006, and construction must begin after April 30, 2005, and before July 1, 2006. The reduced taxable valuation applies to that property for the duration of the initial purchased power agreement for that generation unit.

Senate Bill No. 2267 changes the funding method for the state matching program for senior citizen services and programs by dedicating sales, use, and motor vehicle excise tax revenues equal to the amount of revenue that would have been generated by a levy of two-thirds of one mill on the taxable valuation of all property in the state subject to the county or city levy for senior citizen services and programs in the previous year. A matching grant is provided by continuing appropriation from the senior citizen services and programs fund to each eligible county, equal to two-thirds of the amount levied in dollars in the county for the taxable year, but the matching fund grant applies only to a levy of up to one mill. A statement of intent is included, providing that counties or cities should allocate an amount equal to one-third of one mill of property tax revenue from their funds raised or received under their general fund levies or state aid distribution fund allocations.

House Bill No. 1354 increases the maximum county property tax levy for a county veterans' service officer from 1.25 to 2 mills.

House Bill No. 1398 increases the maximum county levy for regional or county correctional centers from 5 to 10 mills and allows counties to contract for services from another public or private entity for regional or county corrections.

Senate Bill No. 2065 increases the maximum levy for comprehensive health insurance for county employees from 4 to 8 mills.

House Bill No. 1182 allows a political subdivision, excluding a school district or park district, to use funds from its insurance reserve fund levy for payment of Workforce Safety and Insurance contributions, premiums, judgments, and claims.

Senate Bill No. 2212 allows the 15-mill school board levy for asbestos abatement to also be used for repair, replacement, or modification of any heating, ventilation, or air-conditioning systems.

House Bill No. 1263 allows the 15-mill school board levy for asbestos abatement to also be used for mercury and hazardous substance abatement or removal.

Senate Bill No. 2157 increases the income limits to qualify to the homestead credit by \$500 in each income classification. The bill increases the reduction in taxable valuation in homestead property for eligible individuals by approximately 50 percent.

### **Failed 2005 House Bill No. 1512**

House Bill No. 1512 (2005) would have made substantial changes in education funding and the state's tax structure. The bill was passed by the House of Representatives but failed to pass in the Senate. During its consideration, the bill was the subject of considerable legislative and public debate and media attention. 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 tax 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. All of the revenue from the tax increases was to be deposited into the education tax adequacy and equity fund.
2. Pooling of all state funding sources into a formula, including per pupil payments, tuition apportionment, supplemental payments, consolidation bonuses, transportation payments, special education payments, teacher compensation payments, and all other state-funded expenditures.
3. Replacement of political subdivision general fund property taxes. 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 students with defined additional educational needs.
5. Elimination of the existing foundation aid formula, including weighting factors and the equalization factor.

### **SUGGESTED STUDY APPROACH**

1. Review current and historical data on components of elementary and secondary funding. The Department of Public Instruction can be requested to 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 has agreed to provide information on this issue. It will be necessary to develop estimates of future school district property taxes, if current trends continue.
3. Examine sales taxes, income taxes, tax exemptions, and any other potential sources for additional revenue for education funding.
4. 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.
5. 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.
6. Assess how proposed changes would impact school district funding equity and adequacy.
7. Assess how changes in education funding would impact the state in times of economic growth and recession.
8. Determine whether proposed changes will provide a competitive advantage to any businesses because they are subjected to a different form of taxation from their competitors.
9. Assess the effect of any proposed tax changes on business and economic development.
10. Assess trends in education funding lawsuits in other states and developments in North Dakota.