

MONTANA Policy Review

A Publication of the Local Government Center

Volume 3, Number 1 Spring 1993

TAX REFORM

It Isn't Just a Sales Tax
Dennis Burr

Montana Tax Alternatives
Paul Siebrasse and Myles J. Watts

Cities and Towns in the 1993 Legislature
Alec Hansen

Statement of Intent, Senate Bill 235

Referendum 111 Ballot Language

REGULAR FEATURES

Reflections on Local Governance

Local Government News
Renovating Title 7
Kenneth Weaver

Local Government Calendar

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Policy Review

RELECTIONS ON LOCAL GOVERNANCE

"Don't look back 'cause something bad might be gaining on you!"

As Montana's local officials begin their annual budget process this month many, if not most, must be looking over their shoulder wondering whether the outcomes of the 1993 legislative session will help or hurt them.

If the voters go for tax reform and the 4% sales tax on the June 8 referendum, thereby repealing the I-105 property tax freeze, will that long overdue but small gain be offset by a huge loss (perhaps as much as \$400 million) of taxable valuation? Will the state make good on reimbursement or will the reimbursement pledge turn out like so many other local government reimbursement pledges, a "20th century version of an Indian treaty", as suggested by the Director of the League of Cities and Towns. Certainly those counties whose state assumed welfare responsibilities have now been returned to them in order to help balance the state budget must have some reservations about the state's guarantee of reimbursement of loss in taxable value.

And what does the wonderful world of local government budgeting and finance look like if the voters reject R-111 on June 8? To begin with, we suppose that I-105 will remain in place even though it won't make any sense to continue to punish local government for the inability of state government to manage its finances. But then it never did make any sense to hold local governments hostage to tax statewide tax reform. In constant

dollars adjusted for inflation, the purchasing power of Montana's municipal revenues has shrunk by more than 20% since local officials were saddled with I-105. As remarkable as it seems and almost certainly due to an infusion of gambling revenue into the general fund, most municipal and county governments continue to cope with fiscal stress. As one analyst noted, "Any community objections to gambling have been made moot by the financial crises" imposed on local governments in 1986 by I-105.

What needs to be remembered as the voters make up their mind on June 8 is that with or without tax reform and with or without the I-105 horse collar, 1,441 locally elected officials are just now putting their own budgets together. As always, these budgets will be balanced, most will have a modest cash reserve and the great majority of them will, somehow, manage to fund existing service levels for yet another year without any increase in local revenue. For many it has been a fragile balancing act for the past eight years. That is precisely why the little bit of revenue relief in the form of a small increase in gas tax revenues for roads and streets and a dab of bed tax money for a few communities is going to look so good on the Clerk's budget work sheets.

Still, most mayors, council members and commissioners are looking over their shoulders right now wondering what the voters will do on June 8 and whether the outcome will make their budget balancing act more or less difficult. We wish them well.


Kenneth L. Weaver, Director
Local Government Center

The Local Government Policy Center is funded, in part, by the Northwest Area Foundation.

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Policy Review

VOLUME 3, NUMBER 1

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TAX REFORM

It Isn't Just a Sales Tax
Dennis Burr.....1

Montana Tax Alternatives
Paul Siebrasse and Myles J. Watts.....7

Cities and Towns in the 1993 Legislature
Alec Hansen.....13

Statement of Intent, Senate Bill 235.....17

Referendum 111 Ballot Language.....18

REGULAR FEATURES

Reflections on Local Governance.....i

Local Government News:
Renovating Title 7.....19

Local Government Calendar.....22

Publications.....23

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IT ISN'T JUST A SALES TAX

DENNIS BURR

President - Montana Taxpayers Association

Our tax system doesn't work and hasn't worked for more than 10 years. Montana has faced a budget deficit of at least \$100 million in each of the last three legislative sessions. Governor Racicot and the Legislature have presented a tax reform plan that is reasoned, progressive, and will allow our economy to grow. The plan offers property and income tax relief. Tourism will produce more than \$20 million in tax revenue. The author of this paper explains why the tax reform plan is not just about raising revenue but about adopting a more balanced tax system for our state.

Senate Bill 235, Governor Racicot's tax reform proposal was approved by the Legislature on the last day of the session and by the thinnest of margins. The House of Representatives passed the measure by a 50-49 vote and the Senate could do no better. Nevertheless, Montana voters will get their chance to cast a ballot on tax reform on June 8, 1993.

Referendum 111, as it is designated, is a complete tax reform package, not just a sales tax. The 218 page act contains sections dealing with the sales tax, the property tax and the state income tax. The Governor and the Legislature have worked hard to present the public with a chance to adopt a more balanced tax system by reducing both income and property taxes to offset the tax increase of the 4% sales tax. Tax reform is not about raising revenue, it is about improving the economic climate of the state and enacting a total tax structure that will grow with the state and the state's need to provide government services. Eighty percent of the sales tax revenue generated by the sales tax will be used to reduce income and property taxes. Eighteen percent, or \$47 million in the first year will be available for government programs to help insure that the budget deficits of the past do not continue. What follows is a discussion of the major features of Referendum 111, the Tax Reform Proposal.

THE SALES TAX

The sales tax contained in the referendum is a conventional, broad based tax. Merchants are required to add 4% to the price of goods and services and to report the amount of the tax to the customer and to pay the tax monthly to the state. Vendors are allowed to keep 4% of the amount they collect, with a maximum of \$100 per month, to cover the cost of collecting the tax and remitting it to the State Department of Revenue. The Montana Sales Tax is broad-based in that there are fewer exemptions to the tax than are found in most other states. For example, most professional services will be taxed in Montana; the services of lawyers, realtors and accountants as well as auto repairmen and photographers. Many states have provided exemptions for

services in the past. Some states are now removing the exemptions to reflect the national movement toward a larger service sector in the economy and to broaden their sales tax bases.

Here are the major exemptions to the Montana Sales Tax:

- | | |
|-----------------------|-----------------------------|
| 1. Groceries | 7. Motor Fuels |
| 2. Medical Services | 8. Transportation |
| 3. Prescription Drugs | 9. Agricultural Supplies |
| 4. Utility Bills | 10. Livestock and Crops |
| 5. Real Estate | 11. Advertising |
| 6. Day-Care | 12. Goods Bought for Resale |

In addition, government agencies, Indian tribes, and non-profit organizations are exempt from paying the tax on their purchases and from collecting the tax on their sales.

The sales tax is expected to generate \$268 million gross revenue in its first complete year of operation, FY1995. Vendors will keep \$9 million to defray their costs of collections and the Department of Revenue will use close to \$6 million for administration. The net revenue from the sales tax will be \$253 million.

PROPERTY TAX RELIEF

Property tax reductions are provided in three ways. First, there is a residential homestead exemption of \$20,000. This means that a homeowner will pay tax only on the value of the residence above \$20,000. The individual tax savings will depend on the property tax rates where the property is located. If this exemption were in effect last year, it would have meant a tax reduction of \$338 in Great Falls, \$287 in Billings, \$397 in Missoula, and \$355 in Butte. The homestead exemption will reduce residential property taxes by \$33.5 million in FY1995.

Second, personal property taxes on business and agricultural machinery and equipment will be cut in half. Under current law, this property is assessed at 9% of market value. This rate will be reduced to 4.5% in the tax reform package (residential property is lower still at 3.86%). The property tax savings to Montana from this change is \$32.5 million in the first year. In addition, \$5 million in property tax reductions are given to railroads and airlines.

The third method of property tax relief is the reduction of property tax mill levies for public schools. Sales tax revenue will be used to eliminate property tax mill levies for teachers retirement and public school transportation. These levies vary among counties and replacing them with sales tax revenue will improve the equalization of school funding in Montana. This change would reduce the property tax on a \$100,000 residence by \$139 in Great Falls, \$139 in Billings, \$140 in Missoula, and \$148 in Butte. The same property tax saving from mill levy reductions would accrue to business, agriculture and other taxable property in the state. The total property tax savings from public school mill levy reductions is \$48 million.

Reductions in Mill Levies	\$48.0 million
Homestead Exemption	33.5 million
Machinery and Equipment Reductions	32.5 million
Railroad/Airline Reduction	5.0 million
	<u>\$119.0 million</u>

Here is how the property tax section of the tax reform act will affect two pieces of property in Great Falls, MT.

	\$100,000 Residence	\$100,000 Business Equipment
Current Tax	\$1,689	\$3,938
Homestead Tax Relief	-338	0
9% Rate Reduced to 4.5%	0	- 1,969
Mill Levy Reduction	<u>-139</u>	<u>- 162</u>
NEW TAX	\$1,212	\$1,807

Personal property taxes on business machinery and equipment are reduced more than the tax on residential property under the tax reform act. Montana's high tax on productive property is a deterrent to business expansion and economic development. These changes will allow Montana to compete for business and jobs with surrounding states. After the tax reductions to both residential and commercial properties, business equipment will still pay 50% more tax per dollar of value than will residential property. The total property tax reductions of \$162

million (including the reduction of public utilities) represents a 29% decrease in property taxes in Montana. Sales tax revenue will be used to replace this loss in property tax revenue to counties, cities, school districts, and the university system.

SPECIAL UTILITY SECTION

There is a special provision for public utilities in the property tax section of the tax reform act. Under current law, electric and gas utilities are taxed on the basis of 12%

of market value. Other personal property, which is assessed at 9% of value will be reduced to 4.5% of value in this act. Properties owned by electric and gas companies will also have their property tax reduced to the 4.5% rate at a total cost or savings to these companies of \$43 million. At the same time, however, the electrical energy production tax is increased under the act by \$50 million. Thus, public utilities will pay less property tax but will make up for it and pay an additional \$7 million in electrical energy generation taxes.

INCOME TAX RELIEF

INCOME TAX COMPARISON FY1995			
	OLD LAW	HB671 (Current Law)	R-111 (Reform Proposal)
Tax Rate	2% - 11%	6.7%	6%
Pension Exclusion	3,600	3,600	3,600
Standard Deductions			
Single	2,720	5,000	6,000
Head of Household	5,440	7,500	8,000
Married Filing Separate	2,720	5,000	5,000
Married Filing Joint	5,440	10,000	10,000
Personal Exemption	1,450	2,710	3,500
Total Revenue	\$339,696,000	\$375,441,000	\$311,106,000

For FY1995, the income tax adopted by the Legislature (HB671) will increase total income tax collections by \$35 million over the income tax system it replaced. If the tax reform proposal is adopted in June, income taxes will

decrease by \$64 million or 17% compared to current law. The effect of the income tax provisions on individuals will vary depending on their circumstances. Here are three examples of how the various tax proposals would work.

TAXPAYER	OLD LAW	HB671 (Current law)	R-111 (Reform Proposal)	DIFF.
Single 15,000 Income	\$394	\$488	\$324	-164
Married, 40,000 Income	\$1,580	\$1,647	\$1,368	-279
Divorced, 2 children, 25,000 Income	\$836	\$628	\$372	-256

In addition to the \$64 million income tax reduction contained in the tax reform proposal, income tax credits are provided for low income individuals to compensate for the regressive nature of the retail sales tax. Families with incomes below \$13,000 would receive an income tax credit of \$90 for each family member. The low income sales tax credit will reduce income taxes by an additional \$19 million in FY1995. Renters will also receive an income tax credit of \$150 per household to correspond with the property tax reduction given to homeowners through the \$20,000 homestead tax exemption. The renters credit will reduce income taxes by \$11 million in FY1995.

FY1995 PERSONAL INCOME TAXES	
Current Law Total Tax.....	\$375,000,000
Reduction in Tax - R-111.....	- 64,000,000
Low Income Credit.....	- 19,000,000
Renters Credit.....	- 11,000,000
Total Income Tax with R-111.....	\$281,000,000

Income taxes will be reduced by \$94 million or 25% from current law if the voters adopt Referendum 111 on June 8th.

SUMMARY

Referendum 111 contains many changes to Montana's tax system. It imposes a retail sales tax at the rate of 4%, less than the national average, and it uses most of the sales tax revenue to reduce income and property taxes. Local governments will receive sales tax revenue sufficient to compensate them for property tax reductions.

Montana will be less reliant on the property tax, which grows slowly and more reliant on the consumption based sales tax that will grow at a faster rate than the property tax as the economy improves. The tax reform proposal also contains sufficient revenue to assure a balanced state budget in the next biennium without future tax increases.

Here is a summary of the main provisions of Referendum 111.

TAX REFORM PROPOSAL - FY 1995

4% Sales Tax Package	\$268 million
Less: Vendor Rebates	- 9 million
Cost of Administration	- 6 million
Net Revenue	\$253 million
Income Tax Package	- 64 million
Reduction in Income Tax	- 19 million
Low Income Sales Tax Credit	- 11 million
Sub Total	159 million
Property Tax Package	
Reduction in School Taxes	- 48 million
Homestead Tax Exemption	- 33.5 million
Machinery Tax Reduction	- 32.5 million
Railroad/Airline Reduction	- 5 million
Sub Total	40 million
Electric/Gas Utilities	
Property Tax Reduction	- 43 million
Electrical Energy Tax Increase	+50 million
Total New Revenue	\$47 million

Only \$47 million of the \$268 million raised by the sales tax will be available for government spending in 1995. That is 17% of the total revenue and equivalent to a 14% income tax surcharge.

Again, it is difficult to determine the consequences of this act on individual families but here are a few examples.

**Married Couples, \$40,000 Income
\$100,000 Home, Great Falls, MT**

Current Income Tax	\$1,647
Current Property Tax	1,689
Current Total Tax	\$3,336
Income Tax Reduction	- 279
Property Tax Reduction	- 477
New Total Tax	\$2,580

This couple's state income and property taxes are reduced \$756 as a result of the tax reform package. They will have to make taxable purchases of \$18,900 before the sales tax they pay will equal the property and income tax reductions they receive from tax reform.

**Single Individual, \$15,000 Income
Rent an Apartment, Great Falls, MT**

Current Income Tax	\$488
Current Property Tax	0
Current Total Tax	\$488
Income Tax Reduction	- 164
Renters Credit	- 150
New Total Tax	\$174

This individual must spend \$4,350 on taxable items before the sales tax is equivalent to the income tax reduction and renters credit.

**Divorced Individual, \$25,000 Income
\$40,000 Home, 2 Children, Missoula, MT**

Current Income Tax	\$628
Current Property Tax	794
Current Total Tax	\$1,422
Income Tax Reduction	- 256
Property Tax Reduction	- 453
New Total Tax	\$ 713

This individual must spend \$17,725 on taxable items before the sales tax payments will equal the income and property reductions afforded by the tax reform package.

Tax reform, including the 4% sales tax has a minimal effect on the three families in this example. In fact it is likely that two of the three would pay less total taxes than they pay now if R-111 is approved in June.

This is the result because R-111 is a restructuring tax system, not an addition of a new sales tax to the existing tax structure. The net new revenue, produced by this bill (\$47 million in FY1995) is no more than would be raised by the next legislature through tax rate increases on existing tax sources.

Referendum 111 offers Montana a chance to enact a tax system which will meet the needs of the state in the 21st Century. A tax system that will grow with the economy and preclude the need for tax rate increases during every legislative session. It will provide stability for individuals and businesses. Just as important, it will make Montana competitive with other states in our region for economic growth and jobs. The reforms contained in R-111 will result in lower than average taxes on sales,

income and property and it will spread the burden of paying for government services over a greater number of our citizens. The act will also allow Montana to take advantage of tourism as a way to raise money for government.

REASONS TO VOTE FOR TAX REFORM

Governor Racicot's tax reform plan will be voted on in a special election on June 8th. Public opinion polls show Montana split on the issue: 45% approve of a 4% sales tax and 45% are opposed to a sales tax.

Here are a few reasons to consider voting in favor of the tax reform proposal on June 8th:

- * Sales tax revenue will allow for property tax reductions for both businesses and homeowners. Business property taxes in Montana are the highest in the northwest. The Governor's proposal will cut them in half. Homeowners will be exempt from tax on \$20,000 of the value of their home.

- * Sales tax revenue will also provide funds for income tax relief. The income tax contained in the tax reform proposal will raise \$64 million per year less than the income tax approved by the Legislature. That is a 17% reduction in income tax.

- * And third, tourism. Montana's fastest growing industry will contribute to the cost of government services. By the most conservative estimates, tourism will produce more than \$20 million per year in tax revenue.

Consider, also, what will happen if voters do not enact the tax reform proposal:

- * Montana has faced a budget deficit of at least \$100 million in each of the last three legislative sessions. The budget gap was closed this year by an income tax increase. Without tax reform, the 1995 Legislature will be facing the same red ink and will balance the budget with another income tax increase.

- * Second, without tax reform our tax base will continue to erode. Partly because of high property taxes, Montana is losing jobs in the primary industries of mining, wood products, and manufacturing. Replacement jobs in service industries pay less

than half the wages paid in manufacturing.

The result is that income tax collections do not keep pace with the demand for state services and property tax collections do not keep up with the needs of counties, cities, and schools.

* There is one thing we know for sure: our tax system doesn't work and it hasn't worked for more than a decade.

Governor Racicot's tax reform plan is reasoned, it is progressive, and it will allow our economy to grow. We know what has happened to our economy and to government services during the past ten years. If tax reform is rejected by the voters, the next decade will be more of the same.



MONTANA TAX ALTERNATIVES:

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The authors provide a succinct description of the proposed sales tax reform package and the income tax revision law as a basis for understanding the tax and business consequences of the June 8 vote for or against Referendum 111. Of particular interest is their brief theoretical discussion of the comparative progressivity of both sales and income taxes and their assessment of the present tax structure as it relates to the Montana business climate.

The current and future fiscal crisis facing the state of Montana is being addressed by two legislative actions of the 53rd legislature. These two bills are the proposed comprehensive sales tax reform package (SB235) and the income tax revision law (HB671).

Sales Tax Reform Package

In order for the proposed comprehensive sales tax reform package to become law, it must be approved by voters at a general election to be held June 8, 1993. The imposition of the sales tax, if approved, would begin on April 1, 1994. The cornerstone of the proposed sales tax reform package is the adoption of a 4 percent sales and a use tax (2.5 percent sales tax applied to mobile homes.) The 4 percent sales tax is paid by the purchaser, collected by the seller, and paid to the Department of Revenue. As part of the sales tax, many basic consumer goods are exempt or non-taxable. The following is a partial list of these exemptions and non-taxable goods and services.

- * Sales to or by United States, state of Montana, or an Indian Tribe.
- * Sale or lease of real property (home, ranch, or land).
- * Utilities (water, sewer, electricity, home heating fuels, telephone, garbage disposal, etc., but does not include cable television services).
- * Food products for home consumption.
- * Supplemental food programs for women, infants, and children
- * Nursing home services.
- * Day-care services.
- * Private school tuition.
- * Medical services and prescribed drugs.
- * Rehabilitation services.
- * Insurance premiums.
- * Wages.

- * Investments dividends, commissions, and interest.
- * Gambling and amusement services.
- * Advertising services.
- * Transportation services.
- * Agricultural products.
- * Minerals and mineral interests.
- * Fuels (fuels on which tax has been paid, e.g., gasoline, propane).
- * Feeds, fertilizers, and agricultural services.
- * Construction services - construction, fabrication, remodeling of commercial or residential structures.
- * Sales to or by a nonprofit or membership organization.
- * Sales of vehicles with GVW of 46,000 pounds or more and used primarily for interstate commerce.
- * Occasional sale or lease of property or services (includes fund-raisers for nonprofit organizations, service clubs, youth clubs, and fraternal organizations).
- * The sale of property for resale (retail merchandise).
- * Sales of personal property for leasing.
- * Sales to out-of-state buyers who do not take delivery of the product or service in the state, who do not make initial use of the product in the state, or who do not have a regular place of work in the state or spend more than brief periods of time in the state.

Each selling agent or business must obtain from the Department of Revenue a Seller's permit. The Seller's permit validates the business as an agent of the state to collect the sales tax. The collected taxes are a liability to the business and must be regularly paid to the state either monthly or quarterly on or before the 15th of the month. Each selling agent is allowed a Vendor's allowance of up to \$100 for each filing period. The revenue generated by a sales tax would be deposited in the sales tax and use tax account.

The comprehensive sales tax reform package is considered comprehensive because of the proposed changes to the property and individual income taxes. The stated intent of the proposal is to reduce property and income taxes. Revenue generated by property taxes to pay for school debt services, school transportation services, and teachers retirement is eliminated and replaced by sales tax revenue. For select property classes, the taxable rate is lowered, for personal property the taxable rate is lowered from 9 percent to 4.5 percent and for property owned by electric power companies, rural electric cooperatives and natural gas distribution companies, the taxable rate is lowered from 12 percent to 4.5 percent (the proposal also adjusts the property tax for agricultural property, but this part of the proposal has been over-

ridden by Senate Bill 168). Property tax replacement revenue lost as a result of these lower rates is replaced by sales tax revenues. The replacement revenue is calculated using various formulas.

In addition, the individual income tax structure is modified. In the old income tax law, there are ten different tax rates for various income levels. The proposed income tax reformation reduces the number of tax rates to one, 6 percent, applied to taxable income. Taxable income is calculated using the Federal adjusted gross income with the same additions and reductions as in the past to determine the Montana adjusted gross income. Taxable income is the Montana adjusted gross income less the total allowable exemptions and standard deductions. Itemized deductions are replaced by standard deductions (lost itemized deductions include mortgage interest, Federal income taxes, and charitable contributions). The exemption is \$3,500 for each valid exemption. The standard deduction is \$6,000 for a single taxpayer; \$10,000 for married filing jointly, \$8,000 for single filing head of household; and \$5,000 for married filing separately.

The sales tax reform package creates tax *credits* for renters and homeowners. It also provides tax credits to

low income persons to help offset the imposition of the sales and use tax. The total deduction in each case is limited to the total income tax liability. To qualify for up to \$150 of Renter's tax credits, an individual must have been a resident of Montana for at least nine months and must have been a renter for at least six of those months. The tax credit for Homeowners is calculated by the lesser of the market value of the home or \$20,000. The remainder is then multiplied by the property tax rate and the applicable mill levy. To qualify for the Homeowner's tax credit, the claimant must have been a resident of Montana for at least six months and must have occupied a home as owner for at least six months. The low income sales and use tax credit is \$90 for each valid exemption and is limited to those claimants who have a gross income of \$13,000 or less and have been in the state for at least six months.

The proposal limits the total distributions from the sales tax and use tax account to \$57 million for fiscal year ending June 30, 1994, and \$250 million for fiscal year ending June 30, 1995. Any monies in excess of these amounts are to be used by the 54th legislature to further reduce the property and income taxes.

This has not been an exhaustive discussion of all the changes proposed in the sales tax reform package. Rather, the discussion has focused on those issues of greatest impact to most Montanans.

Income Tax Revision Law

The income tax revision law (HB671) is independent of the proposed sales tax reform. This law revises both the individual and corporate income tax laws of the state of Montana, and, will be effective beyond tax year 1993 if the sales tax reform package is not approved. Regardless of voter approval of the proposed sales tax act on June 8, this law will be effective for tax year 1993.

This law substantially simplifies the tax system for both individuals and corporations. For individuals, there will be only one tax rate, 6.7 percent, applied to taxable income. The exemption amount is increased to \$2,710 for each valid exemption. Standard deductions replace itemized deductions (lost itemized deductions include

mortgage interest payments, Federal income taxes, and charitable contributions). The standard deduction is 40 percent of the Montana adjusted gross income but not more than \$5,000 for a single taxpayer; \$10,000 for married filing jointly; \$7,500 for single filing head of household; and \$5,000 for married filing separately. The standard deduction is reduced by 6.25 percent for every \$5,000 of adjusted gross income over \$100,000. Both the exemption and maximum standard deduction limits will be adjusted for inflation for tax years after 1993 using the consumer price index.

Similarly, for corporations the tax rate schedule is substantially simplified. There are only two tax rates for Montana businesses; 7.08 percent of net income up to \$500,000 and 7.75 percent of net income in excess of \$500,000 for tax year 1993, and 6.75 percent and 7.25 percent for same net income amounts for tax year 1994 and beyond. The minimum tax for a Montana corporation is \$100.

The individual income tax structure is modified dramatically

This, too, has not been an exhaustive discussion of all the changes that will be effective in the income tax revision law. Rather, the discussion has focused on those issues of concern to most Montanans.

Regressivity/Progressivity of Sales and Income Taxes

The proposed addition of a sales tax to the Montana tax system re-ignites a common criticism of a sales tax, that a sales tax is regressive and therefore, unfair. In conjunction with this, it is commonly believed that using an income tax with progressively increasing tax rates builds progressivity and equity into the tax system. Economic theory and recent research tempers both of these traditional perspectives.

Tax equity considerations is based on the idea that those who have a greater ability to pay should pay more and those who have less ability should pay less. When the total sales tax paid by an individual is based on the individual's expenditures on all goods and services (excluding savings), the proportion of income paid in tax is greater for lower income groups. This

is the basis of the perceived regressivity of a sales tax and the inherent unfairness. It also seems reasonable to conclude that progressively increasing income tax rates should add progressivity to a tax system and thus more fairness.

However, some recent economic research shows that the actual regressivity of a sales tax and the actual progressivity of an income tax is less than commonly believed. When one considers the decision to consume in light of a sales tax, does an individual base that decision solely upon their ability to pay as measured by their yearly income? It has been suggested that this is not a very realistic perspective and, perhaps, a better way to view the decision is based on an individual's permanent income. The concept of permanent income reflects what an individual expects their income to

...research shows that the actual regressivity of a sales tax and the actual progressivity of an income tax is less than commonly believed.

be over a longer periods of time. In the early years of a person's life, the expectations of a future earning potential contribute to the person's willingness to consume more than their current income will allow. In other words, individuals borrow from their future earnings to consume now. During the middle years of life, the individual's earnings are commonly the greatest. And, as such, people would consume less than their total ability to consume. The remainder is saved. In the retirement years of life there is less reason to save for the future and, therefore, it makes sense to consume more than current income allows by tapping savings.

Using the concept of permanent income as the base for consumption decisions research has shown a sales tax without any exemptions is regressive for low income groups, progressive for middle income groups, and essentially proportional for high income groups. If a sales tax exempts certain common goods such as food, medical services, etc. (similar to the exemptions of the proposed sales tax), a sales tax is progressive for low and middle income groups and essentially proportional for high income groups.

Applying the same concept of permanent income, an income tax is, by definition, less progressive. High income years, during which an annual income tax would be high, are offset by low income years. Naturally the tax on this offset

permanent income would be less progressive as compared to the annual income tax for the high year alone. More importantly, very high tax rates create incentives for the taxpayers to avoid these rates through using tax "loopholes", either legally or illegally. This inherent disincentive to avoid the top marginal tax rates necessarily causes the income tax to be less progressive.

Therefore, using the life cycle approach to permanent income, it has been shown that a sales tax is less regressive than commonly believed and a progressive income tax is typically less progressive than the incremental rates suggest.

Even though it is difficult to estimate the incidence of sales tax for the sales tax reform package, both the reform and the revision packages will result in tax increases .

Montana's Business Climate

There are many factors that contribute to the business climate of each state. Such factors are the availability of natural resources, skill level of the labor pool, and the cost of transporting goods to their markets. One common element to every state's business climate is the tax system. From the perspective of the business, all other things being equal, businesses prefer lower taxes. In addition, businesses differ in which method of taxation they prefer given that they must pay. Many businesses prefer a sales tax over an income or property tax. However, unlike income and property taxes, sales tax payments are not deductible in calculating the federal income tax. From the perspective of the state, the revenue generated from taxes are used to maintain an environment necessary for healthy business activity. Clearly, there are trade-offs in this balance between the performance of the business and an effective business climate.

The location choice of a business is affected by the previously mentioned balance. Given that businesses are able to choose their location, the important comparison is the relative benefits and costs associated with each of the possible choices. Put succinctly, businesses choose the location that creates the largest benefits compared to costs.

Relatively speaking, Montana's past taxation system has contributed to it's lower appeal as a place to do business.

It has had one of the highest top income tax rates, 11.77 percent, among all the states. Considering the past deductibility of Federal income taxes and the surtax, the maximum effective marginal tax rate was 8.43 percent. This was the seventh highest in the nation. Montana has had the third highest property tax rate in the nation (as a percentage of income). Under the sales tax reform package, the marginal tax rate is 6 percent which is a

Montana's past taxation system has contributed to its lower appeal as a place to do business.

reduction from the old maximum effective rate of 8.43 percent. Furthermore, the sales tax reform package

will reduce the property taxes which business will find desirable. The income tax revision law sets the marginal tax rate of 6.7 percent which is also a reduction in the top specified marginal tax rate. However, because of changes in various deductions (particularly home mortgage interest and other itemized deductions), it is difficult to make comparisons to the old system. None-the-less, aggregate income taxes will be higher under the income tax revision law than under the comprehensive sales tax reform package.



CITIES AND TOWNS IN THE 1993 LEGISLATURE:

ALEC HANSEN

Executive Director - Montana League of Cities and Counties

Montana's cities and towns actually improved their financial position during the 1993 legislative session. Although the sales tax reform referendum, if adopted, will provide no direct financial benefits for municipalities it will lift the burden of the I-105 property tax freeze. If adopted the referendum would reduce residential and business property taxes by \$110 million per year and would guarantee replacement revenues for local jurisdictions. Additional revenue sources for local governments approved by the 1993 legislature included an increase in the municipal share of the state gasoline tax and a share of the increased bed tax. At press time the bed tax bill was awaiting final action by the Governor.

Last fall, as the light faded and a dangerous winter loomed, representatives of Montana cities and towns were suspicious that the legislature would ransack local government treasuries to balance the state budget. Local leaders were concerned about user fees, special assessments, and tax revisions that would transfer money from cities into the state general fund. Fortunately, these dark visions did not materialize, and the legislature was able to put together a balanced budget without weakening the already precarious financial position of municipal governments.

At the beginning of the 1993 legislature, the House of Representatives adopted a budget resolution that set targets for all revenue and spending decisions. This bipartisan agreement, House Resolution 2, specified that the legislature would shoot for \$99 million in both spending reductions and tax increases. The deal also included a commitment to avoid raising costs or reducing revenues for municipal and county governments.

After 90 days of controversy, debate, negotiation, and compromise, the legislature balanced the budget without violating the essential integrity of this resolution. As a result of strict adherence to the budget agreement and aggressive lobbying on other money bills, cities and towns actually improved their financial position during the 1993 legislature.

The sales tax referendum proposed by Governor Marc Racicot was the big bang issue that dominated legislative discussion. The largest committee rooms in the Capitol were packed for the hearings on the sales tax bill, as hordes of lobbyists proposed exclusions, exemptions, and adjustments to protect their principals. After months of numbing debate, jagged differences, and premature death notices, the bill was resuscitated and approved, which means the final decision on a sales tax will be made by the voters at a June 8 special election.

The sales tax proposal includes no direct financial benefits for local governments. Cities offered amendments during the committee hearings

that would have dedicated a share of the sales tax revenue to a local assistance program, but these proposals were lost in the confusion and left out of the final version of the measure that will go to the voters.

If the sales tax referendum prevails, Initiative 105 will terminate. This section was included, because the 1986

....cities and towns actually improved their financial position during the 1993 legislature.

ballot measure specified that the freeze would only remain in effect until a general tax reform package

was approved. Removal of the freeze will end the dark ages when local governments were held to a higher standard of financial accountability, but it could also become a serious liability in the political discussion of the sales tax referendum.

The Governor's reform proposal will reduce residential and business property taxes by approximately \$110 million per year. The measure adopted by the legislature guarantees full reimbursement for local jurisdictions through the 1996 tax year. After that date, the formula will be indexed to sales tax collections, and there is a possibility payments could exceed the \$110 million bottom line cost of the reimbursement program. There is no guarantee, however, that sales tax collections will increase or even remain static, and in this situation, local jurisdictions will cover the difference.

In the past 12 years, the legislature has put together three separate programs to reimburse local governments for money lost through property tax reductions and exemptions. Reimbursement for the removal of business inventory taxes was terminated after one year. The block grant program to compensate for the reduction of motor vehicle taxes was repealed, and the legislature was forced to change the assessment procedure. Finally, the recent legislature froze the amounts that will be returned to local jurisdictions to cover the losses resulting from the 1989 adjustments in personal property tax rates. Reimbursement programs are the 20th century equivalent of Indian treaties, and cities are legitimately suspicious of these promises.

Cities were able to persuade the legislature to increase the

municipal share of the state gasoline tax the equivalent of one cent, or \$2.8 million annually. This boost in state assistance of approximately 35 percent was desperately needed, because inflation has stolen more than 40 percent from city street budgets since the last time the local share of the state gas tax was increased 10 years ago.

The increased allocations for cities were included in a bill that will raise the Montana fuel tax seven cents over the next two years. Testimony indicated that this money was needed to match up with available federal funds to finance a \$500 million highway maintenance and construction program. This bill had an irresistible momentum, and once the increase for cities was on board, the rest of the journey was a boat ride.

The legislature also agreed to increase the bed tax from four to five percent and to divide the additional revenue equally between local governments and the state general fund. In this bill, the legislature finally recognized that the 7 million people who visit Montana each year exert explosive pressures on local services. The measure will raise only \$960,000 for local governments next year, but this money will help pay for police and fire protection and other public services and facilities that are the foundation of a sustainable tourist economy.

This bill has not yet been signed, but a delegation of city leaders met recently with the Governor, and it was obvious that he understood the importance of this legislation to municipal governments.

Opponents of the bill claimed that an increase in the bed tax would put them in a competitive hole, but even at 5

The sales tax proposal includes no direct financial benefits for local governments

percent the rate in Montana would be well below national and regional averages. They also said that it was unfair to

use bed tax funds to support local services, because motels pay property assessments. This argument ignores the fact that many other businesses, including bars, casinos, gas stations, insurance companies, mines and utilities, pay taxes on both their property and the products they sell. The industry also testified that acceptance of the bed tax in 1987 included an agreement that the

proceeds would be pumped forever into advertising and promotion. This is a preposterous assertion, because bed tax collections are public funds that can be used for any purpose that is considered appropriate by the legislature.

This bill benefited from the luck of the Irish. It faced withering opposition from the Chamber of Commerce, the Innkeepers Association and the Tourism Coalition. It

The Legislature finally recognized that the 7 million people who visit Montana each year exert explosive pressures on local services.

failed four times, and survived on 11 other narrow votes. The Governor will make the final decision, and cities have got to believe that logic and ne-

cessity have finally caught up with politics on the issue of allocating money from the bed tax.

The last line of the ledger, the place in the book where it really counts, shows that the 1993 legislature produced results. About 60 percent of the 1,130 bills were approved, and when you add up all the winners and losers it is obvious that this winter cities and towns finally were recognized as a vital partner in Montana government.



SENATE BILL 235

Statement of Intent

Sales Tax Reform Package

In consideration of the legislative action on the sales tax, it is the intent of the legislature to provide a comprehensive sales tax reform package that brings balance to the Montana tax structure and makes Montana competitive with other states.

In recognition of the uncertainty of the fiscal impact of a 4% sales tax, it is the intent of the legislature that all funds in excess of estimates pursuant to 5-18-107 be used exclusively for reductions in property and income taxes.

The priority for use of any excess funds will be:

- (1) reduction of mill levies used for school equalization; and
- (2) reduction of income taxes.

A statement of intent is required for this bill because the department of revenue is granted authority to adopt rules for the administration and enforcement of the sales tax and use tax. The rules are intended to provide for an efficient process for the collection of the taxes, with minimum expense to both the taxpayer and the state.

The legislature contemplates that rules adopted by the department should, at a minimum, address the following:

- (1) the registration and issuance of permits to persons engaging in the business of retail sales and services;
- (2) the reporting form for the payment of the taxes, along with the requirements for the retention by the taxpayers of the necessary records;
- (3) the required security and the acceptable forms of security for those taxpayers required to give security for payment of the taxes;
- (4) the use of the nontaxable transaction certificate and clarification of any exemption from the taxes, including nontaxable sales;
- (5) the necessary forms and the required procedures for reporting the taxes;
- (6) the definition of terms and establishment of procedures as appropriate for efficient administration of the sales tax and use tax;
- (7) procedures for the timely and efficient transfer of revenue to local governments and schools as replacement revenue for the reduced property tax base and property tax revenue; and
- (8) procedures for payment of the sales tax and use tax based on bracket amounts rather than using a rounding method.



SENATE BILL 235 REFERENDUM III Ballot Language

BALLOT LANGUAGE IN SENATE BILL 235

The question of whether this act will become effective shall be submitted to the qualified electors of Montana at the election called pursuant to section 184 by printing on the ballot the full title of this act and the following:

- FOR imposing a 4% sales tax and use tax as part of comprehensive tax reform**
- AGAINST imposing a 4% sales tax and use tax as part of comprehensive tax reform**

Full title of the act:

An act generally revising taxation; enacting a 4 percent sales and use tax; allowing exemptions from the sales tax and use tax; exempting certain property from taxation; revising debt limits for local governments and schools; revising individual income taxes and property taxes; allowing credits against individual income tax liability; providing for distribution of sales tax and use tax revenue; providing state support for certain school funding; providing that this act be submitted to the qualified electors of the state at a special election.



**LOCAL
GOVERNMENT
NEWS**

RENOVATING TITLE 7

KENNETH L. WEAVER
Local Government Center

At its annual fall assembly last year and about one year in advance of the 1993 legislative session, the Local Government Policy Council decided that Title 7 Montana Code Annotated, which includes most of the local government law, needed renovation. A group of experienced county and city attorneys were quick to endorse the decision as were a number of mayors and county commissioners.

The most experienced of the Policy Council members were mindful, however, that an earlier effort at comprehensive reform of Montana's local government law during the 1973 legislative session failed because HB 122 was simply too big and too complex for the law makers to gag down. Since then Title 7 has continued to "grow like topsy" requiring increasingly long hours of research by local officials looking for the right statute and, more often than not, leaving them doubtful as to whether what they had found was the most recent law. To avoid a repeat performance of the ill fated HB 122 effort, the Policy Council asked the Local Government Center to convene a small working group of county and municipal officials along with their city and county attorneys to develop a strategy of "incremental renovation" of Title 7.

That strategy (perhaps best characterized as a nibbling strategy) was set in motion early in the 1993 session when a package of eight bills dealing with Title 7 were introduced by Representatives Diana Wyatt and David Ewer, both of whom serve on the House Local Government Committee. The bills were hardly the stuff of controversial, rock'em sock'em politics. Indeed the working group had carefully screened out a number of proposed amendments to the Title 7 statutes precisely because they were thought to be too controversial. Rather, the purpose was to demonstrate to the legislators that renovation of Title 7 is needed and that a long term, carefully researched and well coordinated process could accomplish that long overdue task while avoiding partisan politics and intergovernmental friction.

Shortly after the bills were introduced the staff of the Local Government Center briefed both the House and the Senate Local Government Committees on the package of eight housekeeping bills. We also explained the long term renovation process that we intended to bring before the Legislature during the next two or three sessions and, on behalf of the Policy Council, we promised to work closely with the two committees as well as with the local government leadership to make that process as productive and painless as possible.

If the first go round of the project during the recently completed 1993 session is an indication, the renovation process is off to good strong start. Seven of the eight bills (as detailed below) sailed through both houses of the Legislature and have since been signed into law by Governor Racicot. Perhaps of greater significance is that all of the bills, having been carefully coordinated by the Policy Council and local governments units in advance of the legislative session, were readily supported by both the League of Cities and Towns and the Association of Counties. They were also unopposed by any of the several associations of local officials or by any unit of local government.

The one housekeeping bill in the renovation package that fared poorly (HB 302) died in the House Local Government Committee. Even though the bill sought only to adjust municipal bid requirements and to bring them into alignment with those enjoyed by county governments, the bill was apparently not well understood by the law makers. We think it failed because we failed to provide the committee with an adequate understanding of the bill's purpose and provisions. Out of context, the proposed changes seemed far more significant than they were because we had not briefed the committee adequately.

This failure highlights an important procedural step if the total renovation project is to succeed during the next two or three legislative sessions. As each package of Title 7 reform proposals is presented to the Local Government Committees, the importance of timely access by the committees to knowledgeable resource persons will increase. Each succeeding package of legislation designed to simplify Title 7 will almost certainly involve increasingly complex statutes. Clearly, the roles of the

League and MACo, the principal legislative spokesmen for local government, in supporting and explaining the reform legislation will become much more important than it was during the 1993 session. Additionally, state and local government officials who are knowledgeable about the proposed revisions will have to be available to testify and explain the significance of each of the proposals if we are to accomplish long term improvement of local government law.

The following is a brief review of the legislative outcomes for the Title 7, renovation package during the 1993 Session:

- **Municipal Oath of Office.** The intent is to consolidate current Sections 7-1-4137, 7-3-4318 and 7-4-4108 MCA pertaining to the municipal oath of office. HB 367 was signed by the Governor with an effective date of April 22, 1993. Ch. 486, L. 1993.

- **Petition Requirements.** The intent is to eliminate conflict in several statutes concerning the percentage of signatures required for petitions and to standardize the base reference for calculating the required percentage as the "number of electors registered to vote at the last general election". The petition requirement language from Section 7-3-125 MCA is proposed for insertion into Sections 7-2-4902, 7-3-103, 7-3-4305 and 7-3-4327. HB 481 was signed by the Governor with an effective date October 1, 1993. Ch. 319, L. 1993.

- **Disposal of Municipal Property.** The intent is to amend 7-8-4201 MCA in order to exempt the sale of municipal property acquired by tax deed from the requirement for voter approval. HB 132 was signed by the Governor with an effective date of October 1, 1993. Ch. 305, L. 1993.

- **Municipal Contracts.** The intent is to adjust the dollar limits and installment period limits of municipal contracts to be congruent with those adopted in 1991 for counties. HB 302 was tabled in the House Local Government Committee.

- **Penalties for Violation of Ordinances.** The intent is to fix the penalties for violation of local ordinances at a level that will meet EPA requirements. An act amending Sections 7-5-109 and 7-5-4207, MCA to increase the fine limit from \$500 to \$1,000 for violating

local ordinances. HB 301 was signed by the Governor with an effective date of October 1, 1993. Ch. 597, L. 1993.

- Effective Date of Municipal and County Resolutions. The intent is to: (1) Eliminate the conflict between 7-5-123 and 7-5-4203 concerning the effective date of municipal resolutions by amending 7-5-4203 to parallel the language at 7-5-123; (2) Eliminate the conflict between 7-5-104, 123 and 7-3-4325 concerning the effective date of resolutions and the vote required to adopt emergency measures in the municipal commission-manager form of government by amending 7-3-4325 to parallel the language at 7-5-104 and 7-5-123; and (3) Eliminate the conflict between 7-5-123 and 7-5-2201 concerning the effective date of county resolutions by repealing 7-5-2201 and 7-5-2202. HB 368 was signed by the Governor with an effective date of October 1, 1993. Ch. 309, L. 1993.

- Notice of Sale of County and Municipal Bonds. The intent is to repeal the statutory requirements that city and county governments notify the Board of Investments of their bond issues. The Board of Investments no longer has an interest in or need for this information and the reports have therefor lost their usefulness and yet remain a nuisance to local governments. An act repealing Sections 7-7-2253 and 7-7-4253

pertaining to the requirement that county and municipal governments supply information to the Board of Investments related to the issuance of bonds. HB 54 was signed by the Governor with an effective date of October 1, 1993. Ch. 6, L. 1993.

- Election Requirements for Water and Sewer Bonds. The intent is to remove present ambiguity with respect to the requirement to conduct an election on the question of issuing bonds for municipal water and sewer systems. 7-7-4222 MCA imposes the requirement that the issuance of municipal bonds related to water and sewer projects be approved by the voters even though most water and sewer bonds are "revenue bonds", which are not backed by the general credit and taxing authority of the local government. 7-7-4403 MCA specifically exempts "revenue bonds" from the voter approval requirement whereas 7-7-4221 MCA clearly states that a municipal government must submit the question of issuing G.O. bonds to the electorate for approval. By repealing 7-7-4222 the ambiguity with respect to "water and sewer bonds" is removed while retaining the statutory requirement that G.O. bonds, even if used for water and sewer projects, be approved by the voters. An act repealing the requirement that municipal water and sewer bonds be approved by the voters and repealing 7-7-4222, MCA. HB 39 was signed by the Governor with an effective date of October 1, 1993. Ch. 73, L. 1993.

LOCAL GOVERNMENT CALENDAR

JUNE

- 8: Special Election on Tax Reform Referendum
- 10: County filing deadline for estimate of revenues and expenses for the next fiscal year with county Clerk and Recorder.
- 14-17: Clerks of District Court Annual Meeting, Virginia City
- 16-17: Montana Sheriff's & Peace Officers Annual Meeting, Great Falls
- 30: State Fiscal Year ends

JULY

- 1: State Fiscal Year begins
Deadline for municipal candidates to file for election
- 5: Independence Day Holiday observed
- 10: Municipal filing deadline for estimate of revenues and expenses for the current fiscal year with clerk
- 16-20: NACo Annual Conference, Chicago, Ill.
- 19: Preliminary budget submitted to County Commissioners by the county Clerk and Recorder
- 20: Municipal Clerk submits preliminary budget report to Council
- 25: City/Town Council completes revisions to preliminary budget.
- 26: County Commissioners complete revisions to preliminary budget.

AUGUST

- 9: Deadline for adoption of county and municipal budgets
- 16-20 County Clerk & Recorder's Annual Meeting, Butte
- 26-28 MACo Board of Directors Retreat, Forsyth

SEPTEMBER

- 6: Labor Day Holiday
- 14: Municipal Primary Election
- 15: Deadline for submittal of county and municipal budgets and tax levies to Department of Commerce
- 19-23: MACo Annual Conference, Lewistown
- 20-24: County Treasurer's Annual Meeting, Bozeman

OCTOBER

- 6-8: Montana League of Cities and Towns Convention, Great Falls
- 11: Columbus Day Holiday observed
- 28: Deadline for filing annual county and municipal financial statements with the Department of Commerce and county and city governments

NOVEMBER

- 2: Municipal Election Day
- 11: Veteran's Day Holiday
- 25: Thanksgiving Day Holiday

PUBLICATIONS

The following publications are currently available from the Local Government Center, Wilson Hall, Montana State University, Bozeman, MT 59717 (406-994-6694).

Proceedings, Rocky Mountain Trade Corridor Summit

The conference, held in Great Falls, addressed the means necessary to organize Trade Corridor efforts. The speakers evaluated recent developments regarding cross-border trade, and explored the actions that will be needed in the future to take advantage of these developments. (No charge.)

Montana Policy Review, Spring 1992

Topics addressed in this issue include a study of the Missoula region, privatization of solid waste, well-water protection, the Rocky Mountain Trade Corridor, the Americans with Disabilities Act, and redistricting. (No charge.)

Montana Municipal Profiles and Montana County Profiles, Judy Mathre, editor.

The *Profiles* are two wall charts, updated annually, which present census, budgetary, taxation, and government structure data for Montana's 128 incorporated municipalities and 56 counties. These quick reference tools provide important overview information at a glance. The latest editions include FY 1992 fiscal data and 1990 census data. (No charge.)

Proceedings, 2nd Rocky Mountain Trade Corridor Conference

The conference, held in Lethbridge, Alberta, addressed the potential for economic development and increased trans-border trade between Canada and the United States. The speakers evaluated trade trends following the Free Trade Agreement, and explored the actions that local leaders can take to develop linkages across the border. (No charge.)

Montana Policy Review, Fall 1991

Topics addressed in the second issue include the effects of migration on small communities, state solid waste policy, the Montana Local Government Policy Council, the Rocky Mountain Trade Corridor, and trends in Montana local government. (No charge.)

Reflections on Tribal Governance in Montana, Kenneth L. Weaver, editor

Perspectives on tribal government are provided by leaders of Montana's seven Native American communities. A brief chronology of "Federal Indian Policy" and the governing charters of all Montana tribes are also included, along with the text of the Indian Reorganization Act of 1934. (No charge.)