Building on Success:
A Guide to Fair, Simple, Pro-Growth Tax Reform for Nebraska
Joseph Henchman & Scott Drenkard
BACKGROUND

- Provide a starting place to begin the tax reform conversation
- Review state’s current tax system and competitive position
- Why the Tax Foundation?
  - National organization familiar with tax developments in many states
  - View that tax systems should adhere to sound economic principles
  - Spirit of providing useful information and observations for Nebraska policymakers, journalists, and citizens as they evaluate their state’s tax system
- Outlines tax reform options and various smaller tax changes
- Menu of choices for making sure that Nebraska builds on its recent growth and is where investment, entrepreneurs, and talented individuals go in the years ahead
A PRINCIPLED APPROACH

PRINCIPLES OF GOOD TAX POLICY

• Simplicity
• Transparency
• Neutrality
• Stability
NEBRASKA’S ECONOMY

Nebraska’s economic performance would make most states envious, but it faces the challenge of anti-Midwest cultural bias, a middle-of-the-road tax system, and outward interstate migration.

• PERSONAL INCOME
• DOMESTIC PRODUCT
• UNEMPLOYMENT
• KEY INDUSTRIES
• KEY MANUFACTURING SECTORS
• KEY SERVICES SECTORS
• INTERSTATE MIGRATION
PERSONAL INCOME
NATIONAL COMPARISON

• Since the 1940s, Nebraska’s average personal income has been at about the U.S. average
• Rose above national average in 2012
• Agricultural boom has helped boost

Figure 1. Nebraska Average Personal Income as a Percent of U.S. Average, 1929-Present (U.S. Average = 100)

Source: Bureau of Economic Analysis
PERSONAL INCOME
REGIONAL COMPARISON

- Strong impacts of coal, oil and gas, and agriculture
- Wyoming was once poorer than Nebraska but is now significantly richer
- South Dakota has gone from Nebraska’s poorest neighbor to one of the richest
- Iowa has fallen from being a rich state to poorer than Nebraska
- Nebraska has remained steadily middle-of-the-pack through it all
UNEMPLOYMENT
NATIONAL COMPARISON

• Nebraska’s unemployment rate remains lower than the U.S. average
• Even at the trough of the recession, the Nebraska unemployment rate was enviable
• Tends to be higher in Omaha and lower in rural areas
KEY INDUSTRIES

• Substantial manufacturing sector and uniquely high agricultural and transportation sectors
• Agriculture is 8.2 percent of Nebraska’s economy, compared to 1.2 percent nationally
• Finance and insurance also large sectors
• IT, education, research, real estate, entertainment, and accommodation all lower than rest of the nation
• Manufacturing is dropping in rest of nation but staying steady in Nebraska

Figure 8. Nebraska Economy Key Industries, 1997-2011

Source: Bureau of Economic Analysis
GROWTH OF SERVICE INDUSTRIES & KEY SECTORS

- Services have grown across-the-board, with finance and insurance representing the most dramatic rise.

- The growth of services as a share of economic activity presents a particular challenge for the sales tax, which taxes goods but not services.
INTERSTATE MIGRATION

- Interstate migration is another metric of economic health
- Nebraska has consistently attracted fewer people and income into the state than has left.
- Since 1994, the state has lost a net of 39,000 people and nearly $3 billion in income.

**Nebraska GAINED net people from 14 states, including:**
- California (+19,746)
- North Dakota (+1,747)
- Illinois (+1,425)
- New York (+972)

**Nebraska LOST net people to 36 states, including:**
- Texas (-10,448)
- Arizona (-9,845)
- Missouri (-8,120)
- Florida (-7,082)
- Colorado (-4,319)
- Iowa (-3,930)
- Kansas (-3,826)
- Minnesota (-3,723)
- Georgia (-3,251)
- South Dakota (-2,931)
- North Carolina (-2,215)
NEBRASKA’S EXISTING TAX SYSTEM

• Historical reliance on property taxes for state and local government

• 1967-68: Repeal of state property tax and adoption of income and sales taxes

• 1987-88: Syracuse Study recommends expanding sales tax to services and exempting business inputs

• 2007: Burling study recommends expanding sales tax to services, adjusting income tax brackets for inflation, reviewing “breathtakingly progressive” state income tax, review effectiveness of corporate tax incentives, reject gross receipts tax, increase state aid, improve tax administration

• Nebraskans face:
  – Top income tax and corporate tax rates that are high for the region and for the revenue they collect, causing “sticker shock” for recruiting and retaining talent. Outward net migration is both anecdotal and supported by the data.
  
  – High corporate tax rates that cause increasing demands for generous tax incentives—a vicious circle.
  
  – Concern about property taxes but an equal concern for retaining local control over local spending. Property tax on business equipment is particular concern.

• From our meetings with business leaders and policymakers in the state, and from our research on the economic efficiency of various tax structures, we have isolated several components of Nebraska’s code that, with reform, would result in an equitable and simplified tax system for everyone that would promote long-term economic growth and boost job creation.

Building on Success: A Guide to Fair, Simple, Pro-Growth Tax Reform for Nebraska
SOURCES OF REVENUE
HEAVY RELIANCE ON INCOME TAX, FEDERAL AID

• Most focus on “general fund” spending; here we look at ALL spending ($7.0 billion state and $12.4 billion local in 2012)
• For Fiscal Year 2012-13, Nebraska’s state government will spend just over $7.5 billion, rising to $8.1 billion and $8.2 billion in next two years.
  – Key items include health & human services (42%), state aid to education (29%), roads (10%), and public safety (6%)
• State spending is just 36 percent of total government spending in Nebraska. Local spending is the other 64 percent ($12.4 billion).
  – Key local items include utilities (35%), education (32%), public safety (8%), environment and housing (6%), hospitals (5%), roads (4%)
• Federal aid totals $3.75 billion, 17 percent of total spending ($19.5 billion)
SOURCES OF REVENUE
HEAVY RELIANCE ON INCOME TAX, FEDERAL AID

• Every $1 in taxes collected by the Nebraska state government is made up of
  – 41¢ in state individual income tax,
  – 33¢ in sales taxes,
  – 16¢ in excise taxes (including 8¢ in gasoline tax and 2¢ in car tax)
  – 4¢ in corporate tax, and
  – 6¢ in other taxes.

• Property tax revenue ($2.87 billion) is 79 percent of local tax revenue. The entire income tax raises just $1.7 billion.

• If you were to raise income taxes to pay for a modest (20 percent) property tax cut, it would require raising everyone’s income taxes by 33%
  – Top rate of 6.84% on income over $27,000 would need to go up to 9.12%, the fourth highest rate in the country
STATE-LOCAL TAX BURDEN
MIDDLE OF THE PACK

• Tax collections measures amounts collected by state and local governments.

• Tax burdens moves the focus from the tax collector to the taxpayer.

• Nebraskans have about-average state-local tax burden.

• In fiscal year 2010, residents of the state paid $3,853 per capita in all state-local taxes,
  — a rate of 9.7 percent of income,
  — 21st highest in the country and higher than all nearby states.

Figure 15: State & Local Tax Burdens as Percentage of State Income, FY 2010

State and Local Tax Burdens as a Percentage of State Income
Fiscal Year 2010

Source: Tax Foundation calculations using data from multiple sources, primarily Census Bureau, Tax Foundation, Council on State Taxation, and National League of Cities.

Notes: As a unique state-local entity, D.C. is not included in rankings, but the figure is consistent with states where it would rank. The local portions of tax collections figures for fiscal year 2010 rely on projections of local government tax revenue.
STATE-LOCAL TAX BURDEN

REGIONAL COMPARISON

- Nebraska’s 9.7 percent (21\textsuperscript{st} highest) compares to
  - Kansas’s 9.7 percent (22\textsuperscript{nd})
  - Iowa’s 9.6 percent (24\textsuperscript{th})
  - Colorado’s 9.1 percent (32\textsuperscript{nd})
  - Missouri’s 9.0 percent (34\textsuperscript{th})
  - Wyoming’s 7.8 percent (46\textsuperscript{th})
  - South Dakota’s 7.6 percent (49\textsuperscript{th})

- Over time, Nebraskans’ state-local tax burden has fluctuated
  - Above the national average in the early 1980s and first decade of 2000s
  - Below the national average since 2008
STATE BUSINESS TAX CLIMATE
MIDDLE OF THE PACK

• Total taxes paid is a relevant measure, another is how the elements of a state tax system enhance (or harm) the competitiveness of a state’s business environment.

• The states with the best tax systems are Wyoming, South Dakota, Nevada, Alaska, Florida, Washington, New Hampshire, Montana, Texas, and Utah.

• The states with the worst tax systems are New York, New Jersey, California, Vermont, Rhode Island, Minnesota, North Carolina, Wisconsin, Iowa, and Maryland.

• Nebraska does well in unemployment insurance tax but middle-of-the-pack or worse in other categories

• Among least business-friendly tax climates in the Plains states

Nebraska
Overall Rank: 31
Corporate Tax Rank: 34
Personal Income Tax Rank: 30
Sales Tax Rank: 26
Unemployment Tax Rank: 8
Property Tax Rank: 38

Figure 17: State Business Tax Climate Index, FY 2013

Source: Tax Foundation
CORPORATE INCOME TAX
HIGH RATE, NARROW BASE

- Nebraska’s tax is 5.58% on first $100,000 of profits and 7.81% above that amount.
- Top rate is high relative to neighboring states. (Iowa is an outlier but permits deductibility.)
- Tax gives away as much as a third of its potential revenue in tax carveouts and incentives.
- Despite high rate, collects just $84 per capita (35th highest) and makes up 0.72% of state and local revenue.
INDIVIDUAL INCOME TAX
HIGH FOR THE REGION

• First enacted in 1968.
• Top rate is one of the highest in the region; rates kick in at low levels of income
• Important factor in employee relocation decisions
• Excessive taxes on income less desirable than taxes on consumption because they discourage wealth creation
• Taxing a lower rate on a broader base would reduce “sticker shock” of Nebraska’s current out-of-line tax rates while reducing complexity and maintaining progressivity
• Nebraska’s 2011 state-level income tax collections were $937 per person, which ranks 16th highest in the nation.

Table 19: Nebraska Individual Income Tax Rates, Tax Year 2012

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;$50</td>
<td>2.46%</td>
</tr>
<tr>
<td>&gt;$2,400</td>
<td>3.51%</td>
</tr>
<tr>
<td>&gt;$17,500</td>
<td>5.01%</td>
</tr>
<tr>
<td>&gt;$27,000</td>
<td>6.84%</td>
</tr>
</tbody>
</table>

Source: Nebraska Department of Revenue. Income brackets for married couples are twice the number shown.

Figure 24: Top State Income Tax Rates, Tax Year 2012
SALES TAX RATE

• Nebraska was the second-to-last state to adopt a sales tax, in 1967 after the state property tax was repealed.
• Initially a 2.5 percent tax, it has gone up over time.
  – Up to 3 percent in 1976
  – Up to 3.5 percent in 1977
  – Up to 4 percent in 1983
  – Up to 5 percent in 1990
  – Up to 5.5 percent in 1992
• Local sales taxes up to 2 percent; average local sales tax is 1.29 percent
• Combined average rate of 6.79 percent is the 26th highest in the country

Figure 21: Combined State and Average Local Sales Tax Rates, as of July 1, 2013
SALES TAX BASE

• If a public finance expert designed the sales tax, it would apply to all final sales of goods and services, and no intermediate (business-to-business) transactions.
  – Not because businesses deserve special treatment, but because doing otherwise would result in “pyramiding” (distortive taxes on taxes)
  – Recommended by Syracuse study

• Sales taxes tax most goods, usually few services, and tax business-to-business transactions
  – Rise of service economy has led to erosion of sales tax base and need for sales tax rate increases
  – Nebraska taxes only 32% of personal income (average is 34%, down from 61% in 1970)
  – Business-to-business transactions are 51% of Nebraska sales tax collections (average is 41%)

• Narrow sales taxes are more volatile and grow more slowly
Table 24: Taxability of Select Final Retail Services in Select States as of July 1, 2012

<table>
<thead>
<tr>
<th>State</th>
<th>Cleaning Services</th>
<th>Landscaping Services</th>
<th>Barber Services</th>
<th>Repair Services</th>
<th>Legal Services</th>
<th>Medical Services</th>
<th>Veterinary Services</th>
<th>Information Services</th>
<th>Financial Services</th>
<th>Accounting Services</th>
<th>Lobbying Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td>Iowa</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td>Kansas</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td>Missouri</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td><strong>Nebraska</strong></td>
<td><strong>T</strong></td>
<td><strong>T</strong></td>
<td><strong>E</strong></td>
<td><strong>T</strong></td>
<td><strong>E</strong></td>
<td><strong>E</strong></td>
<td><strong>E</strong></td>
<td><strong>E</strong></td>
<td><strong>E</strong></td>
<td><strong>E</strong></td>
<td><strong>E</strong></td>
</tr>
<tr>
<td>South Dakota</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>T</td>
</tr>
<tr>
<td>Texas</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td>Wyoming</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td><strong>States that tax</strong></td>
<td>18</td>
<td>19</td>
<td>4</td>
<td>21</td>
<td>3</td>
<td>2</td>
<td>4</td>
<td>9</td>
<td>2</td>
<td>3</td>
<td>6</td>
</tr>
</tbody>
</table>

T=Taxable; E=Exempt; P=Partly Taxable Depending on Type. Total is out of 50 states + DC. Source: Tax Foundation; Commerce Clearing House
# Sales Tax Base

Table 23: Exemption of Select Business-to-Business Transactions in Select States as of July 1, 2012

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>P</td>
</tr>
<tr>
<td>Iowa</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>P</td>
</tr>
<tr>
<td>Kansas</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>P</td>
</tr>
<tr>
<td>Missouri</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>T</td>
</tr>
<tr>
<td>Nebraska</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>T</td>
</tr>
<tr>
<td>South Dakota</td>
<td>T</td>
<td>T</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>T</td>
<td>T</td>
</tr>
<tr>
<td>Texas</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>T</td>
</tr>
<tr>
<td>Wyoming</td>
<td>T</td>
<td>E</td>
<td>T</td>
<td>E</td>
<td>E</td>
<td>T</td>
<td>P</td>
</tr>
<tr>
<td>States that exempt</td>
<td>4</td>
<td>37</td>
<td>0</td>
<td>33</td>
<td>45</td>
<td>32</td>
<td>1</td>
</tr>
</tbody>
</table>

*T=Taxable; E=Exempt; P=Partly Taxable Depending on Type. Total is out of 50 states + DC. Source: Tax Foundation; Commerce Clearing House.*
PROPERTY TAX

• Main source of funding for local governments (79 percent of local tax revenues)
  – REAL PROPERTY TAX: Land, structures, and fixtures.
  – TANGIBLE PERSONAL PROPERTY TAX: Business equipment, furniture, possessions. 5.6% of local tax collections

• Property taxes are higher than most.
  – Property tax collections in 2011 were $1,560 in 2011, higher than U.S. average of $1,377. Average tax rate as a percent of home value was 1.82% in 2010, 6th highest in the country

• Additional state aid has been ineffective at lowering property taxes, both in NE and in other states.
  – Nebraska adopted income tax and sales tax in part to pay for property tax relief; 2007 property tax relief credit also serves that purpose ($115 million/year)
  – Meaningful property tax growth caps are more effective in other states
PROPERTY TAX

Figure 26: Median Property Taxes Paid by County, 2005-2009 Average

Source: Tax Foundation.
**Option 1** reforms the income and corporate taxes with minimal revenue impact.

- **Simplified income tax with top rate of 5.5%**
  - First $7,500 in income exempt from tax for each person in household (up to $22,500 for a family)
  - Tax rate of 4.0% on first $35,000 above that, and 5.5% on rest
  - Brackets adjusted for inflation
  - Earned income tax credit is doubled
  - Retains progressivity while dramatically simplifying code
  - Rates become competitive with neighboring states

- **Corporate income tax rate of 5.5%**, leveling playing field between businesses of all times and reducing pressure for generous tax incentives.

- **Modest sales tax reform**, exempting business-to-business transactions and extending to select services.

- Strengthened local **property tax cap** to prevent future tax burden increases.

- Approximately revenue-neutral to current system (-$4 million)

- State tax system would rank 17th on the *State Business Tax Climate Index*, up from 31st
Option 2: Option 1 plus a “trigger” for further corporate tax reductions

• Rate reduced further to 4% if revenue exceeds a stated goal
  – Would cost approx. $30 million
• Rate reduced further to 3% if revenue exceeds a stated goal
  – Would cost approx. $40 million

Option 3: Option 1 plus a “trigger” for further individual and corporate tax reductions

• Rates reduced further to 4% if revenue exceeds a stated goal
  – Would cost approx. $530 million
• Rate reduced further to 3% if revenue exceeds a stated goal
  – Would cost approx. $790 million
Sales Tax Reform: All options include “small” base broadening. Our report also presents options for “medium” and “large.”

- **Current**: Tax applies to ~21% of transactions, taxes many business-to-business transactions, raises $1.37 billion with 5.5 percent rate.
- **“Small” Base Broadening**: Tax applies to ~41% of transactions, exempting business-to-business and including personal care services, periodicals, repairs, admissions, and professional association dues. Would pay for reducing income and corporate taxes as presented in Option 1.
- **“Medium” Base Broadening**: Tax applies to ~65% of transactions, exempting business-to-business and including financial services, legal services, accounting services, health outpatient services, and groceries. If revenue gain was split 50-50 between income tax and sales tax, would pay for reducing the sales tax to 4.5% and the income tax to 4%.
- **“Large” Base Broadening**: Tax applies to ~80% of transactions, exempting business-to-business and including all final purchases of goods and services by personal consumers (such as health care and education). If revenue gain was split 50-50 between income tax and sales tax, would pay for reducing sales tax to 4% and income tax to 3%.
CONCLUDING THOUGHTS

• Menu of choices to help conversation
• Nebraska has much to celebrate
  – Low unemployment
  – High quality of life (cost of living, well-being, safety, financial stress, music, etc.)
  – Diverse array of successful businesses
• But there are anxieties under the surface
  – Future of agricultural prices
  – Outward migration of young people and retirees
  – Cultural perception of the Plains states
  – Heavy reliance on tax incentives to retain businesses
• A strong tax system can overcome weaknesses in other areas.
  – Reduce individual and corporate rates that are high compared to other states
  – Reduce dependence on offering corporate tax incentives
  – Offer meaningful local property tax reform, not just more checks from the state
  – Sales tax modernization options