A Review of The Tax Foundation's Report, Published October 2020

Tax Modernization: A Key to Economic Recovery and Growth in Nebraska

By David Brunori,

Senior Director, RSM US LLP

Research Professor of Public Policy, The George Washington University

---

From the start, the Tax Foundation in its October 2020 article is correct in its assessment of Nebraska's tax system; it is in need of reform.

The Quest for Sound Tax Policy

For over a century, public finance scholars have pondered the best way to raise revenue to pay for public services demanded by citizens. While there is much debate over their relative importance, there is remarkable agreement as to the general principles of sound tax policy. The Tax Foundation determined that Nebraska departed from some of these core principles citing the tax system's lack of simplicity, transparency, neutrality, and stability. Historically, commentators have included fairness and the system's ability to spur economic growth as core principles as well. The latter is discussed, appropriately, throughout the Tax Foundation's report.

Over time, most public finance experts concluded that the surest way of reaching these goals is through a tax system that has a broad base and low rates. Indeed, that mantra has been at the center of every state tax reform effort in the past fifty years. Yet, it should be recognized that no state has ever established a tax system that fully meets these principles. In a democracy, academic and theoretical ideals are often sacrificed to the realities of stakeholder policies and the demands of varied special interests. For example, public finance scholars decry the use of tax incentives. Yet most states, including Nebraska, offer significant amounts of tax breaks in return for creating jobs or investing in their jurisdiction. Similarly, all sales tax scholars urge the taxation of professional services. Only a handful of states actually do. The reality is that there is often a chasm between how scholars and the varying stakeholders view sound tax policy.

It should be noted that sound tax policy is a normative good. Some policy and political leaders will accept the status quo because their state's tax burdens are not terribly high with respect to national averages or even neighboring jurisdictions. Indeed, in many categories Nebraska is in the "middle of the pack" nationally when it comes to effective tax burdens. That does not belie the argument for reform. A tax system with a broad base and low rates has many advantages. Such a system reduces administrative and compliance costs. And, it lessens the government's involvement in choosing winners and losers in the economy. As importantly, tax reform could move a state from the "middle of the pack" to among the best in the nation in terms of tax policy. That ultimately bodes well for the state's economy.

In the quest for "good" tax policy, however that is ultimately defined, several inherent limitations should be kept in mind. First, people and firms have the ability to move. As the Tax Foundation accurately notes, tax burdens influence migration. As a result, states compete for people and firms by offering lower tax burdens and higher quality public services. Another consequence of

America's open state borders is that states cannot effectively and efficiently redistribute wealth. They do at some level of course, but every scholar who has studied this issue has concluded that only the federal government can effectively redistribute wealth. States that impose highly progressive taxes on the wealthy to support the poor inevitably end up with less of the former and more of the latter.

Policy leaders often dismiss one other important aspect of sound tax policy. Some types of taxes simply do not work as people believe they do. For example, there is a belief that corporate taxation – or business income taxation in general – is a sound way to impose higher burdens on the wealthy. In reality, however, business tax burdens often fall on labor in the form of lower wages and consumers in the form of higher prices. Still others believe that exporting tax burdens to out of state people or firms is a relatively harmless endeavor. But such taxes often result in lower economic growth in the taxing state. There are many unintended consequences of imposing state and local taxes. Some of these issues will be discussed in the analysis of the Tax Foundation's report.

It has become common to think that tax reform – the quest for sound tax policy – must be "revenue neutral." That is, whatever changes are made to the system, it should result in approximately the same level of revenue being raised. This goal is rooted in the belief that it would be difficult if not impossible to consider fundamental changes to the tax law and the effects on budgets. This approach is often incorrect. Policymakers and politicians are increasingly recognizing that tax reform can be part of a larger budgetary discussion where more or less spending is desired.

Finally, the Tax Foundation spends much time discussing tax reform within the context of the COVID-19 pandemic. The health and economic effects of the pandemic are well known. In many states, the economic shutdown has wreaked havoc on public finances. Nebraska has weathered the pandemic better than most states both from a health and public finance perspective. There are many non-tax reasons for Nebraska's relative success in dealing with the crisis. And it should be emphasized that the need for reform is not necessarily tied to the COVID-19 crisis. That being said, the Tax Foundation noted that, in general, a well-structured tax system can aid a state's economic recovery. That is certainly true. But the benefits of a principled tax system go well beyond the current or potential fiscal problems caused by the COVID-19 pandemic. Indeed, a tax system that is built on a broad base and low rates could help prevent future budget pitfalls. As importantly, a sound tax system can enhance continued economic growth well after the health crisis ebbs. Still, like many states, Nebraska may need more revenue because of economic downturn. The state needs to resist raising specific types of taxes that curb an economic recovery. In many respects, the Tax Foundation's report and recommendations are consistent with the need for additional revenue while creating a tax environment that does not unduly hinder economic growth.

The Report

The Tax Foundation has been analyzing state tax systems for years. The Foundation takes a principled, pro-growth approach to tax reform. It has done so with respect to Nebraska. But the

Tax Foundation also takes a somewhat conservative approach to change. It rarely encourages radical changes to a tax system – the elimination or adoption of particular types of taxes. Rather it emphasizes incremental changes to improve the system. That is the approach it has taken in Nebraska. That approach may reflect the political reality of what is possible and practiced in most states.

In that regard, the report offers some general recommendations for improving Nebraska's tax system. The Tax Foundation suggests lowering the corporate and personal income tax rates, reducing property tax burdens, and "modernizing" the sales tax base. Some of the recommended policy changes, particularly with respect to business and individual income taxes, are absolutely necessary. Modernizing the sales tax base is a euphemism for broadening the base to include more services. Broadening the sales tax base is the most critical issue facing Nebraska public finance. As will be discussed below, the need to lower property tax burdens, rather than reform the system, is less clear.

Personal Income Taxes

As the Tax Foundation points out, Nebraska's personal income tax burden is high relative to most states. For middle- and upper-income taxpayers, Nebraska has the highest tax rates among its neighbors. Structurally, there is nothing "unprincipled" about the Nebraska income tax. It uses a relatively broad base. Indeed, Nebraska opts to impose its income tax on most retirement income although recently the state partially exempted military pensions.

Ideally, taxation of a broad base would result in low statutory and effective rates, Yet, Nebraska imposes rates uncommon in the most of the central part of United States. This has serious consequences. As the Tax Foundation noted, relatively heavy income tax burdens lead to out migration. States with low or no personal income taxes have experienced the greatest in migration (as well as economic growth) over the past thirty years. Of course, the heavy income tax burden affects Nebraska's ability to attract higher income residents. It also detrimentally affects the state's ability to retain young professionals and recent college graduates.

But the inability to attract new or retain existing citizens is only part of the problem. Heavy personal income tax burdens make a state less attractive to businesses organized as limited liability companies, partnerships, S Corporations, and other pass-through entities. The vast majority of new businesses nationwide are organized and operated as pass-through entities rather than as traditional C Corporations. Because their income is taxed at the partner or shareholder level, these entities are often reluctant to expand or relocate to states with high personal tax burdens.

The Tax Foundations recommendation that Nebraska should prioritize reducing its top marginal personal income tax rates is sound advice.

Corporate Income Taxes

The Tax Foundation accurately describes the main problem with Nebraska's corporate income tax. The state has the highest corporate tax rate – 7.81 percent – in the region. Among the 44 states with a corporate income tax, Nebraska is one of just 14 that uses a graduated-rate structure. And, two neighboring states, South Dakota and Wyoming, don't tax corporate income.

There is absolutely no doubt that businesses looking to invest in a state take corporate tax burdens into account. Similarly, Nebraska businesses looking to expand examine corporate tax rates and burdens. Nebraska's heavy corporate tax burden makes the state less competitive. The higher-than-average corporate tax rates have led to Nebraska's heavy use of often inefficient and ineffective tax incentives as a way to counter the burden. It has also led to adoption of a single sales factor apportionment formula – that does not penalize companies for creating jobs or investing in plant and equipment. But these policies in turn make it harder to raise corporate income tax revenue. Indeed, the corporate income tax accounted for just over $264 million or a mere 3.8 percent of the state's tax revenue. Even the adoption of combined reporting has not helped boost corporate income tax revenue.

The Tax Foundation encourages Nebraska to lower the top corporate tax rate. That is sound advice. But if anything, the Tax Foundation report does not go far enough. The corporate income tax is among the least efficient and effective methods for raising state revenue. It is difficult, if not impossible, to tax mobile capital in a global economy. As noted, the tax raises comparatively little revenue. The tax also consumes an inordinate amount of resources both in terms of compliance and administration.

There is little justification for taxing corporate income. There are three oft-cited reasons for taxing corporate income. First, there is the argument that states need revenue. But the tax does not raise very much revenue in Nebraska – and never will. Second, there is the argument that the corporate tax adds a measure of progressivity to an otherwise regressive tax system. But states that conduct robust incidence studies have found the tax falls primarily on workers in the form of lower wages and consumers in the form of higher prices. Finally, there is the argument that the corporate tax is a "benefits tax", compensating the state for services used by corporate entities. But the adoption of a single sales factor apportionment formula belies that argument. Corporations can invest and use more resources without incurring greater burdens. The biggest problem with the tax is that, even with combined reporting, there are a plethora of ways to minimize corporate tax burdens. And, increasingly new businesses are formed as pass-through entities, a tactic designed specifically to avoid the tax.

Repealing the corporate income tax, while bold, would likely greatly boost investment in the state. The lost corporate tax revenue would inevitably be replaced by increased personal income and sales taxes that result from more investment in the state.

<u>Taxation of International Income</u>

To its credit, the Tax Foundation report is highly critical of Nebraska's continued taxation of Global Intangible Low-Taxed Income (GILTI). This taxation is, as the Foundation notes, a byproduct of the state's conformity to the Internal Revenue. Many, if not most, states are moving to exclude GILTI from their tax bases. Yet, Nebraska not only taxes GILTI, it does without safeguards, like credit for taxes paid.

Because they operate in a global, sophisticated economy, businesses look to state taxation of GILTI when considering location and investment decisions. The Tax Foundation correctly points out that taxation of GILTI makes Nebraska less competitive. From a more philosophical perspective, there is no policy justification for a state to tax income earned outside the nation's borders.

Sales Taxes

As the Tax Foundation report illustrates, Nebraska's sales tax regime is badly in need of reform. But make no mistake, addressing the sales tax issues in a principled manner will invoke intense opposition.

The primary problem with the personal and corporate income tax in Nebraska is that the rates are too high. From a sound tax policy perspective, Nebraska's sales tax system is badly in need of structural reform. Nebraska violates two fundamental principles.

First, the sales tax should fall on all personal consumption. That is, everything an individual purchases for personal use should be subject to tax. As the Tax Foundation notes, the state fails to tax much personal consumption. The failure to impose the tax broadly, forces the sales tax rate to be higher on the products and services that are taxed. Deciding what is and isn't taxed also creates government engineered market distortions. The government is determining which industries and products should have a tax advantage.

Broadening the base has several advantages. It will decrease market distortions. More importantly, it will raise substantially more revenue. The United States has an increasingly service-dominated economy. As that continues, states that fail to tax services and digital goods will see their sales tax base continue to shrink. In a vacuum, additional revenue would allow sales tax rates to be reduced. But that additional sales tax revenue could also be used to lower personal and corporate income tax rates.

Second, the sales tax should never fall on business purchases. That Tax Foundation mentions this issue but does not go into detail. Taxing business inputs is among the most cynical, non-transparent ways to raise revenue. The tax is often passed on to customers in the form of higher prices. Thus, individuals are often paying the tax without knowing it. Moreover, taxing business inputs often leads to "pyramiding" where the tax passed along as a cost is actually taxed again. Every public finance expert will say that such a tax system is unsound. Finally, the initial tax on business purchases makes acquiring equipment and supplies more expensive. Even though much of the tax burden is passed on to unsuspecting consumers, the tax on business inputs has proven to be a detriment to economic growth.

The Tax Foundation does not recommend what products and services should be taxed. Again, a principle approach would be to start with all personal consumption. At the same time, the state should take steps to further exclude business purchases from the sales.

While the problems with Nebraska's tax system are clear, the solutions are much harder to achieve than most political and policy leaders think. Expanding the sales tax base in some areas is difficult.

For example, no state has expanded its sales tax base to professional services in 50 years. People who sell professional services do not want those services taxed. Imposing taxes on groceries and other necessities is equally difficult. At the same time, making the case – and paying – for eliminating the tax on business inputs has proven very difficult over the years. Still the Tax Foundation's conclusions regarding the Nebraska sales tax system are correct.

Property Taxes

The Tax Foundation report accurately describes some of the serious problems associated with the property tax system in Nebraska. The per-capita property tax burden is much higher than the national average ($1,957 in Nebraska versus $1,617 nationally). The effective property tax rate (1.65 percent) is the eighth highest in the country. Most people would be surprised to learn of the relatively high property tax burdens imposed by Nebraska. Higher property taxes have been associated with New England and Middle Atlantic states with traditions of strong local government. High property taxes are also associated with states that do not impose broad-based income taxes like Florida, Texas, and Tennessee. The curiously high property tax burden in Nebraska leads to efforts to provide relief. For example, the state recently enacted the Property Tax Incentive Act (L.B. 1107) which provides a refundable income tax credit against the income or franchise tax. The credit is based on the amount of property taxes paid to the school district by the taxpayer in the previous year. But this measure merely shifts the costs of paying for schools further to the state. It is unclear what effect it will have on property tax rates.

The Tax Foundation does not offer specifics to reduce the property tax on real property. States wishing to limit property taxes have limited rates and assessment increases, increased homestead and circuit breakers, and created deferral programs for elderly homeowners. But property tax reform should be approached cautiously. Most public finance experts believe the property tax is the best way to pay for local government services. The property tax allows for local political autonomy. Property tax limitations lead to more state centralization of finance and less local control. The property is among the most stable and reliable sources of income. Decreasing reliance on the property makes the entire state and local tax system more volatile – and more susceptible to harsh revenue declines. And, in many situations, the property tax is capitalized in the value of real property. That is, there is a connection between property taxes, public services, and real property values.

Most importantly, however, efforts to limit property taxes have inevitably led to higher state-level income and sales tax burdens. Raising income and sales taxes to pay for local government has proven to have a detrimental effect on the economy.

As the Tax Foundation notes, Nebraska still continues to subject tangible personal property to tax. The trend nationwide has been to move away from taxing personal property. Most states, including Nebraska, no longer tax inventory. And many states have been repealing their tax on machinery and equipment. Unfortunately, Nebraska continues to tax some machinery and equipment. But subjecting personal property to tax is unsound policy. The tax discourages investment in machinery and equipment. States should want more, not less, such investment. That alone should be reason to repeal the tax. Indeed, the argument for repealing the tax is the same as adoption of single sales factor apportionment. Firms are not penalized for investing in the state.

In any event, the Tax Foundation analysis of the state's property tax burdens are correct.

Conclusion

The Tax Foundation correctly identifies the theories of sound tax policy and many of the areas that Nebraska falls short of those ideals. The recommendations regarding lowering personal and corporate income tax rates are sound. Indeed, reducing those rates are necessary for Nebraska to increase its competitiveness for both people and firms. The report's recommendation to expand the sales tax base is equally important. It is not clear what the Foundation's recommendations are with respect to the property tax. But for the reasons noted above, property tax reform should be approached cautiously.

The report's recommendations can and should be the basis for further tax reform discussions.