NEBRASKA TAX MODERNIZATION

PREPARED BY

Michael Lucci
Senior Policy Advisor

Nebraska Tax Modernization

Introduction

Tax reform is sweeping across the states. More than 20 states enacted income tax reductions during the pandemic recovery, positioning themselves for an increasingly competitive interstate tax environment by pushing down top rates. Iowa, Arizona, Georgia, Mississippi, and Idaho transitioned from a progressive tax structure to a flat-rate income tax structure, coupling lower rates with a more competitive tax structure.

The cycle of generational tax reforms seemed like an unrealistic pipe dream when the pandemic recession sunk the U.S. economy. Yet surging state tax revenue and unprecedented federal aid made tax reform a top opportunity. States that controlled spending were able to turn revenue surpluses into rate cuts.

Two structural changes are driving states to improve their tax codes. First, the federal tax code now caps the deduction for state and local taxes against federal taxable income. Second, remote work has accelerated as a result of the coronavirus pandemic. Both of these changes enhance the importance of state tax competitiveness, particularly for a state's income tax.

The national trend is the friend of Nebraska lawmakers. The Cornhusker State's income tax and property tax are most in need of reform, and progress has already been made on the income tax front. Nebraska's top rate for both corporate and individual income is scheduled to fall to 5.84%, lowering and flattening Nebraska's income tax structure. Additional tax reforms are realistic as revenues continue to overflow state coffers.

Nebraska's property tax is the most uncompetitive component of the state's tax code. The property tax base is overbroad, including categories of property that should not be subject to taxation. And rates are uncompetitively high. While marginal improvements are attainable to chip away at Nebraska's property tax problems, property tax reform will go much farther if it is part of a comprehensive reform of K-12 school funding.

The sales tax is the best-structured component of Nebraska's tax code, and can serve as an instrument to facilitate other tax reforms. Indeed, the primary improvement to make to the sales tax is to adjust its base by extending it to include more final retail consumption. Nebraska would generate more revenue as a result, and those dollars should be deployed into reforming the income tax and property tax.

Nebraska faces a generational opportunity for tax reform. Strong revenues can be leveraged to facilitate reform that will result in a broader, more equitable tax base with lower competitive rates.

Nebraska Property Tax Modernization

Nebraska's property tax is older than the state itself, and old taxes benefit from being updated as the state economy evolves. Property taxation was first instituted in 1857, under a territorial legislature, and then became a statewide tax when Nebraska achieved statehood in 1867. Nebraska leaders have iteratively updated the property tax system throughout the state's history, and it's time for another property tax update in the Cornhusker State.

Nebraska raised revenues through a broad, state-wide property tax for its first hundred years until 1967. The early version of the property tax was levied upon real property (land and its improvements), tangible property (physical property such as equipment) and intangible property (stocks, bonds, bank accounts).

Nebraska overhauled its tax code in 1966, resulting in significant changes to property taxation. Voters abolished the statewide property tax and intangible property was exempted from taxation. Nebraska's Revenue Act of 1967 implemented a statewide individual income tax, corporate income tax, and sales and use tax in part to replace the state property tax.

Policymakers should be emboldened by the big tax changes Nebraska has achieved in its past. It's time to modernize the state's property tax for the 21st century. As with any tax, the key factors to fix are the tax base and the tax rate. Property tax modernization should result in a refined property tax base, a lower property tax rate, and stronger caps on property taxation.

Modernizing Nebraska's Property Tax Base

Nebraska's property tax base consists of real property and tangible personal property, along with targeted taxes that are levied upon other forms of property or net worth.

Real property is the appropriate base for a modern property tax. Land and its improvements are relatively easy to value and can't be moved. Most economists maintain that a well-designed property tax is among the least economically damaging taxes available because it does not distort decision-making on the margin. However, even though the property tax is economically efficient, Nebraska must address the reality that its average property tax rate is too high. The overall burden is cumbersome and uncompetitive with other states.

Taxing real property also makes sense because it coordinates local revenues with where core local services are needed. This coordination approximates the benefit principle of taxation. By comparison, a local sales tax is not nearly as efficient at generating revenue based upon where people live because consumption tends to aggregate near retail centers, which are not always in the same taxing jurisdiction as the taxpayers who patronize them.

Tangible personal property (TPP) taxes should be removed from the tax base. They are relatively complex and taxpayer-active (meaning taxpayers must put in effort to comply), and they create an impediment to business investment in Nebraska. In general, it is wise to avoid levying taxes upon property that can be moved out of the taxing jurisdiction. Industries that require a lot of physical capital, such as farms and factories, are especially burdened by TPP. Nebraska's TPP taxes distort economic decision-making and incentivize businesses to locate their machinery and equipment elsewhere.

Nebraska should phase out its taxation of TPP in order to modernize its property tax. It can begin this process by restoring the $10,000 *de minimum* TPP exemption that was repealed in 2020. Restoring the exemption would move in the right direction and remove a swath of smaller firms from the TPP tax rolls.

Nebraska also allows for a county inheritance tax and a statewide capital stock tax (corporate occupation tax). States across the country have been phasing out their death taxes and capital stock taxes in a move towards modernization. Nebraska's inheritance tax was originally adopted in 1901. The revenue generated by the inheritance tax goes to counties, and is unevenly distributed across the state. Nebraska's capital stock tax was adopted in 1913, and was originally a way to tax businesses based upon their net worth before business income was subject to taxation.

Both of these taxes are anachronistic and incentivize families and firms to allocate capital to other states. Nebraska should repeal both taxes in order to modernize its code.

In addition to these specific changes, Nebraska policymakers should consider other adjustments to the property tax base to promote efficiency, equity, and stability in the property tax system. For starters, Nebraska should reconsider any broad property tax exemptions enjoyed by non-profits, in particular for non-profits that directly compete with for-profit businesses. For example, a non-profit hospital system that competes directly with for-profit healthcare providers derives a significant competitive advantage in purchasing and developing property when it is exempt from property taxation. Furthermore, non-profits derive the benefit of local government services while the bill for those services is footed by homeowners and for-profit businesses. Given that the property tax should abide by the benefit principle of taxation, and given that non-profits derive benefits from local government services, non-profits should be subject to some form of property taxation or alternative payment beyond a certain threshold of exempt property.

Lawmakers can also reconsider the treatment of different types of property as a tool to rebalance the property tax system. Nebraska law mandates that agricultural and horticultural land be assessed at 75% of its fair market value, providing a lower assessment relative to fair market value compared to commercial and residential property. It makes more sense for assessments to be equalized across property types so that different types of property are treated equitably. On the other hand, lawmakers can consider the impact of valuing agricultural land based upon its income potential in order to bring more stability and predictability to agricultural land valuations. These changes are worthy of study to balance competing interests and encourage stability in the taxing system.

Reforming Nebraska's Property Tax Rate

Nebraska's property tax is the 7th-highest of any state. So not only is Nebraska's property tax base over-broad, its tax rate is quite high. The two primary ways to achieve tax rate reform are to increase state aid to education in order to lessen local tax levies and to tighten the cap on Nebraska's property tax levy. Funding for the former task could include existing property tax credits along with new revenues from economic growth and broadening other tax bases, such as Nebraska's sales tax.

Nebraska policymakers created a credit against school district property taxes that is refundable on a taxpayer's income tax return. The credit was recently expanded to apply to both K-12 school property taxes and community college property taxes. The goal is to offset the high cost of school district property taxes.

However, it would be more efficient to use the same state revenues to directly reduce school property taxes by increasing school aid. And Nebraska might be forced to consider this alternative because Nebraska taxpayers are claiming the credit at a low rate. In fact, Nebraska taxpayers left 40 cents per dollar of tax credit unclaimed in each of the first two years of the program.

Nebraska's new property tax credit for community colleges will eventually be worth 70-80% of all community college taxes collected. Once the credit is fully implemented, the community college property tax will effectively act as an unnecessary middle-man. Nebraska policymakers should finish the job of this targeted property tax relief by eliminating community college property taxes altogether and funding the schools directly so that property owners don't need to worry about claiming a credit.

As for tax levy caps, lawmakers should be commended for enacting the state's new Truth in Taxation law. Nebraskans across the state recently engaged in the state's first Truth in Taxation hearings, enjoying a new layer of transparency on local property tax decisions. Yet Nebraska can go further to tighten its property tax cap.

One step to consider would be to follow Kansas' lead and apply the Truth in Taxation process to the first dollar of increase in the property tax levy rather than allowing local governments to capture 2 percent plus real growth before going through the transparency process. Another option is to add a harder cap to the property tax levy that requires a voter referendum for approval if the levy increases beyond a certain amount. For example, Illinois limits the growth in the property tax levy for smaller local governments to the lesser of 5% or inflation. Applying Truth in Taxation to the first dollar of property tax would improve Nebraska's cap by adding more transparency, and adding a requirement for voter approval on levy increases above a certain threshold would harden the cap.

Nebraska generates more than one-third of all state and local tax revenue from property taxation. It is the Cornhusker State's single largest tax source. Modernizing the property tax will impact more total tax dollars than any other tax reform. In addition, property tax reform ties into reforming Nebraska's sales and income taxes.

Effective property tax modernization will circumscribe the property tax base to real property, and then apply a low, competitive tax rate to that base. While this presents a tall task for Nebraska policymakers, they have the tools and revenues available to make property tax modernization a success.

Property tax modernization is key component of Nebraska's broader tax reform. While many property tax reforms can be done on their own, property tax modernization would work best as a part of modernizing the sales tax and the income tax. Each component of tax reform will make Nebraska more competitive for business and more friendly for families.

Nebraska Sales Tax Modernization

Nebraska was one of the last states to adopt a sales tax, allowing the Cornhusker State to benefit from the decades of sales tax experience in other states. Nebraska policymakers can once again fuse their knowledge from decades of sales tax experience with the principles of sound taxation to update Nebraska's sales tax for the 21st century.

Nebraska created its sales tax in the Nebraska Revenue Act of 1967. The transformational law reformed the tax code, decreasing Nebraska's dependence on property taxation by creating a statewide sales tax and income tax. The 1967 sales tax adoption made Nebraska the second-to-last state to enact a sales tax. Only Vermont (1969) created a sales tax after Nebraska, while Oregon, Montana, New Hampshire, Delaware and Alaska never adopted a statewide sales tax.

Mississippi created the first state sales tax in 1930, followed by 23 more states that created a sales tax in the 1930s. Another five states created a sales tax in the 1940s, five more added a sales tax in the 1950s, and then 11 states (including Nebraska) created a sales tax in the 1960s.

Nebraska now has the opportunity to modernize its sales tax in order to make it more economically efficient and suited for the 21st century economy. Furthermore, sales tax reform will play a key role in Nebraska's broader tax modernization.

Principles of Sales Taxation

For the practical purposes of this paper, consumption taxation refers to the American retail sales tax as is currently law in Nebraska.

Consumption taxation is more pro-growth and economically neutral than income taxation. The retail sales tax is the American form of consumption taxation. In Europe, consumption taxation takes the form of a value-added tax (VAT), which is economically equivalent to the retail sales tax when they are structured correctly.

By taxing consumption rather than income, policymakers give workers the option to save and invest their discretionary earnings without being immediately subject to income taxation. Thus, consumption taxation is more neutral to economic decision-making than income taxation and incentivizes savings and investment on the margin. By contrast, income taxes are deducted before a worker or investor is able to make an economic decision to invest or consume, which means income taxation is less economically-neutral and disincentivizes savings and investment on the margin.

All state sales taxes underperform on revenue generation because of their structures. Specifically, state sales taxes tend to be levied upon most retail goods consumption but not upon most retail services. This structure is less economically neutral than a tax that is levied upon both goods and services evenly. The goods-weighted sales tax structure is largely an accident of history. When sales taxes were first created, the American economy was largely goods-based, and taxing services would have been administratively challenging. Yet as the American economy has modernized, it has evolved towards relatively more retail service consumption and relatively less retail goods consumption.

Because retail service consumption is often left untaxed, the sales tax base has eroded over time. As a result, just like other states, Nebraska's sales tax collects less revenue than it otherwise would if it was applied more evenly to the retail consumption base.

Furthermore, whatever you tax more of, you get less of. So a goods-weighted sales tax favors service consumption at the expense of goods consumption. Thus, the retail sales tax creates an economic bias that favors service consumption and disfavors consumption of the goods that fall within the sales tax base. A well-structured sales tax would have as few carveouts as possible, and different types of retail consumption should be treated as neutrally as possible.

In contrast, business input purchases should be exempted from sales taxation altogether. A well-structured sales tax should only apply to retail consumption and not wholesale and supply chain business purchases. Taxing business inputs at multiple stages of production causes tax pyramiding – which results in final consumption purchases that are subject to multiple, non-transparent layers of taxation due to taxation occurring throughout the supply chain. Such taxation raises the cost of retail consumption and artificially encourages business consolidation in order to reduce tax pyramiding.

Modernizing Nebraska's Sales Tax

Nebraska's sales tax is the most competitive component of its four major taxes, ranked 14th in Tax Foundation's 2022 State Business Tax Index. Nebraska's statewide sales tax is 5.5 percent. With local sales taxes added in, Nebraska's average state plus local sales tax is 6.94%. That makes Nebraska's sales tax the 29th highest in the country, meaning that it is lower than the median state.

Still, Nebraska's sales tax can be improved. For example, LB 1264, proposed during Nebraska's 2022 legislative session, would have expanded the sales tax to include more retail consumption. The sales tax should be expanded to non-business retail consumption such as motor vehicle maintenance, painting and maintenance services for real property, investment consulting, personal care, and medical, dental, accounting, real estate and legal services. It would have also expanded more broadly to include more retail goods consumption, such as some medical equipment, medicines and motor vehicle fuel. These broad consumption categories rightfully belong in the sales tax base and would generate revenue that could be used to reduce tax rates.

Still more components of retail consumption would still remain outside Nebraska's sales tax base. Policymakers should thoroughly consider bringing as much consumption as possible under the sales tax in order to make the tax code as economically neutral as possible, and to generate revenue to modernize the rest of Nebraska's tax code.

Tax Foundation evaluated LB 1264's sales tax expansion and found the bill would have improved the competitive structure of Nebraska's sales tax from 14th to 11th in the country. Indeed, a broad sales tax is more economically neutral and is thus a better sales tax structure, which is reflected in Tax Foundation's rankings.

However, it cannot be ignored that simply expanding the sales tax base without any offsets would cause a net tax increase, even if it resulted in a better tax structure. Nebraska's total tax burden is one of the highest in the region. Therefore, policymakers should use any new revenue from sales tax expansion to buy down tax rates, resulting in a more competitive tax code without a net tax increase. Such a reform would comply with the straightforward principle of sound taxation – to levy taxes upon broad bases with low rates.

Policymakers should use new sales tax revenue to buy down income tax rates and to modernize the most anachronistic components of the property tax. As recounted above, the sales tax is more pro-growth and neutral to economic decision-making than the income tax. So rather than using sales tax revenues to lower the sales tax rate, policymakers should deploy such revenues to lower the income tax rate and to reform the property tax. Indeed, Nebraska's corporate income tax (24th), individual income tax (25th) and property tax (40th) are all far less competitive than Nebraska's sales tax.

Restructuring Nebraska's tax code will ensure that tax structures that made sense in a previous era are revised to make sense in the modern era. Sales tax reform is crucial to the broader mission of tax reform, as many of the critical reforms that can be made to the income tax and property tax depend upon Nebraska opting for a modern, broad retail sales tax base.

Nebraska Income Tax Modernization

Nebraska's income tax was created in the Nebraska Revenue Act of 1967 and has been applied to both individuals and corporations since its creation. The income tax was increased soon after it was created, and it evolved into a less competitive structure over its first few decades. Nebraska policymakers took steps to improve the competitiveness of Nebraska's income tax regime in 2022, which was an essential response to state tax competition that is accelerating on Nebraska's borders and across the country. Further income tax reforms will benefit the Cornhusker State for decades to come.

The income tax has a greater impact on economic decision-making and tax migration than either the sales tax or property tax. Therefore, keeping a competitive income tax is a key to a state's overall competitiveness. High tax rates and a progressive tax structure incentivize outmigration from states, while low flat income tax structures incentivize investment and inbound migration. Indeed, Tax Foundation finds a strong connection between recent taxpayer migration and the competitiveness of a state's income tax. Economic researchers have found a causal connection between marginal income tax rates and the migration of firms and families for decades.

Unfortunately, Nebraska ranked 45th out of 50 states for the net loss of income due to taxpayer migration between the 2019 and 2020 tax years. Nebraska lost nearly a full percent of state income due to one year of outmigration. Higher income taxpayers are particularly sensitive to the top marginal income tax rate, and when they depart, they bring a lot of income with them.

A History of Uncompetitive Income Taxation

Nebraska's individual income tax began in 1968 as 10 percent of Nebraskans' federal income tax. It gradually rose to 20 percent of federal liability by 1983. Next, the individual income tax was made more progressive in 1993 with a 4-bracket tax structure and a top rate of 6.99%. The top rate was reduced in 1997 and then increased in 2003 and stood at 6.84% heading into 2022.

Nebraska's corporate income tax began as a 2 percent flat tax in 1968. It was iteratively increased and evolved into a duel tax structure with rates of 5.58% and 7.81% by 1992. Those rates were maintained until tax changes in recent years.

Nebraska's income tax was the state's most-improved tax in 2022. LB 873, signed into law in April, reduced from the top individual income tax rate by 15 percent (from 6.84% to 5.84%) and the top corporate income tax by 24 percent (from 7.5% to 5.84%). These changes are an important pivot to towards a more competitive statewide tax regime.

Wyoming and South Dakota do not impose and income tax, while Colorado imposes a low flat income tax of 4.55%. Meanwhile, tax competition is heating up on Nebraska's eastern border. Missouri and Iowa have reformed their income taxes over the last two years, with Iowa headed to a flat 3.9% rate and Missouri moving to a nearly-flat structure with a top rate of 4.5%. Missouri's flat corporate income tax is 4% while Iowa's will be 5.5%.

Modernizing Nebraska's Income Tax

The pathway to modernize Nebraska's income tax is straightforward. The income tax rate structure should be flattened and lowered for both the individual and corporate income taxes.

Under current law, Nebraska's individual income tax rates will be 2.46%, 3.51%, 5.01% and 5.84% once the 2022 reforms are fully phased in. An income tax overhaul would collapse this multi-rate structure into a single flat income tax rate. In order to prevent a net tax hike on income earners of any level, the standard deduction should be increased.

For example, suppose Nebraska moved to a flat income tax of 4.5%. This might appear to cause a net tax increase on earners who fall into lower income tax brackets of 2.46% and 3.51%. Those brackets cover the first $21,000 of taxable income. However, policymakers could ensure a net tax cut at all income levels by expanding the standard deduction, which was $7,350 for individuals and $14,700 for those married filing jointly in 2022. Nebraska should aim for a low single-rate income tax structure, and should expand the standard deduction to ensure everyone gets a net tax cut.

The same structural change is needed for Nebraska's corporate income tax. Flattening the corporate income tax will be easier to achieve compared to flattening the individual income tax. This is due in part to changes already made in LB 873 in 2022. Nebraska's top corporate rate is scheduled to decline to 5.81%, and so Nebraska is on the path to a two-rate structure of 5.58% and 5.81%. Policymakers will easily be able to consolidate these two rates into a single-rate structure, and then iteratively lower that single rate.

Tax triggers are a valuable policy tool to effectuate these tax policy changes. Tax triggers create a schedule for lower income tax rates that are achieved so long as certain revenue targets are met. For example, Nebraska policymakers might allow revenues to grow by the lesser of 5% or inflation each year, with any excess revenue growth being deployed to rate cuts. This is a stable and effective way to lower the tax rates for the individual income tax and corporate income tax over several years.

Finally, Nebraska should preserve the 2022 structure of its business income tax base. Nebraska law currently allows businesses to immediately write off the cost of new investments in machinery and equipment. This policy is called full expensing, which Nebraska adopts from the federal tax code, and which states like Oklahoma have made permanent state law. However, with federal full expensing phasing out, Nebraska needs to lock in full expensing at the state level to avoid a business income tax hike starting in 2023. These changes are particularly important for physical capital-intensive industries such as manufacturing and agriculture. LB 827, proposed in 2022, would achieve this tax fix.

Policymakers can achieve these income tax reforms by cutting taxes against natural revenue growth, which will result in gradual tax reforms. This strategy has worked well in the recent high revenue years. On the other hand, policymakers could leverage revenue growth from sales tax modernization to pay to for income tax and property tax reforms. Ideally, both natural revenue growth and sales tax modernization will be leveraged to achieve broad tax improvements.

State tax codes need to be updated every few decades, and Nebraska's tax code is due. In fact, the Cornhusker State's tax restructuring is already underway. The code should be updated to fit the modern economy, and restructuring the income tax is perhaps the most important part of Nebraska's broader tax reforms.

Modernization is critical for each of Nebraska's major taxes, including the property tax, sales tax and the income tax. These tax reforms go hand in hand with each other. Reforms of one tax component make it easier to achieve reforms of another, creating synergies to achieve a broad tax overhaul.

Conclusion

Nebraska faces a generational challenge and a generational opportunity to achieve comprehensive tax reform. The challenge comes in two forms. First, every state tax restructuring draws political challenges even when lawmakers know that the result will bear fruit in terms of greater homeowner security, business investment, and economic opportunity. Changes to the tax code always involve tradeoffs between interest groups. That is why tax changes should be governed by the principles of sound taxation.

On the other hand, Nebraska also faces the challenge of competition from other states. Although Nebraska has recently improved its income tax, so have other states around the country. In particular, neighboring Iowa has achieved a major tax restructuring that will result in a low, flat income tax, and Missouri is poised to do the same.

In the end, these challenges will be overcome if policymakers embrace their opportunity to profoundly improve Nebraska's tax code. Tax modernization will enhance the Good Life for Nebraska families and businesses in the near-term, and pay dividends for generations to come.

PLATTE INSTITUTE RESOURCES

The Platte Institute is a nonpartisan nonprofit that works to remove barriers to opportunity for Nebraskans through research, education, engagement, and advocacy.

You can learn more about our work at PlatteInstitute.org.

You can sign up for our weekly email covering important economic issues here.

Be sure to listen to our podcast, Nebraskanomics on YouTube, Apple Podcasts, and Spotify.

PlatteInstitute.org 402-452-3676