Dollars and Cents:
Bringing Nebraska's Tax System Into the 21st Century

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Goals of the Workshop

- What makes a good state tax system?
- How does Nebraska's tax system (and those of other states) fall short?
- Options for reform: A national perspective
- Back to reality: the best and worst of tax reform in 2005-2006.
- Federal legislation: threats & opportunities

About ITEP

- Founded in 1980
- ITEP's research focuses primarily on state tax issues, with an emphasis on tax fairness and adequacy.
- In the past five years, we've conducted studies of state tax systems in Arkansas, Illinois, Iowa, Minnesota and New York.
- We've also conducted hundreds of smaller-scale tax analyses in over 40 states.
- What makes us useful: **ITEP Microsimulation Tax Model.**

The ITEP Tax Model-How it Works

- Based on a sample of 750,000 federal tax returns, allows a statistically valid sample for all 50 states and D.C.
- Income data from these returns is "matched" with Consumer Expenditure Survey, Census Bureau, and other data to estimate property, sales and excise tax burdens for any year from 1988 to 2012.
- This "matching" process allows us to estimate the impact of proposed changes in sales, income, and property taxes in each state—and to estimate the impact of "tax swaps" involving more than one of these tax bases simultaneously.
- The use of federal tax data allows us to estimate the effect of state tax changes on federal taxes—and vice versa.

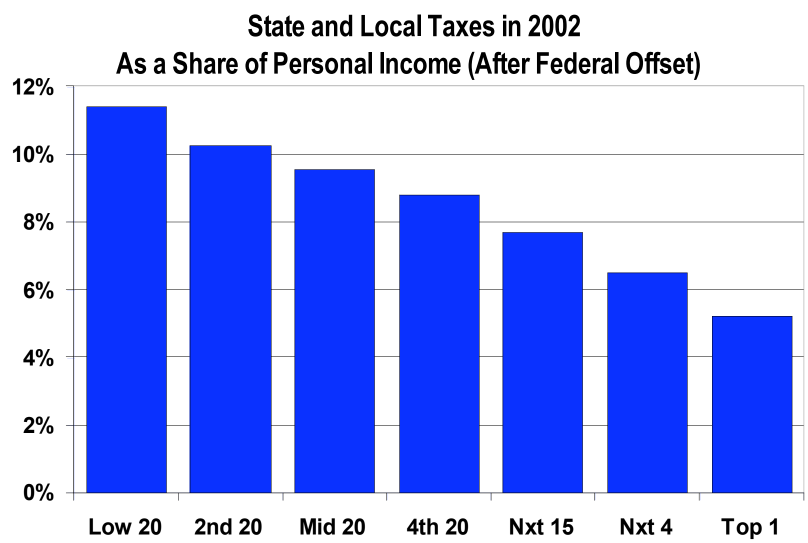
Principles for a 21st Century Tax System

- Fairness: Vertical and horizontal equity
- Base-broadening
- Adequacy– short-term; long-term
- Simplicity
- Economic Development Impact
- Neutrality
- Exportability

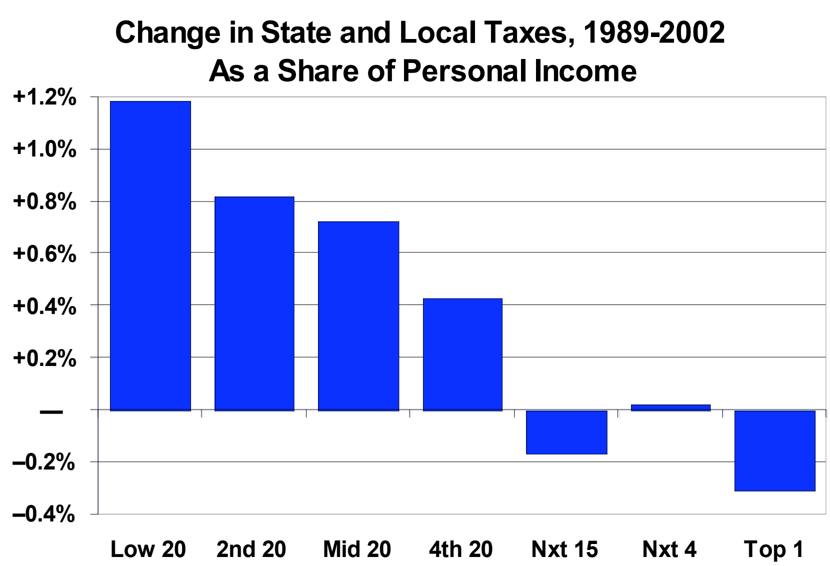
How Do State Tax Systems Stack Up Against These Principles?

- State tax systems provide **inadequate revenues for K-12 education**
- State taxes are **regressive**—requiring low-income taxpayers to pay the highest effective tax rate.
- Each of the state's tax bases is **relatively narrow**, exempting certain transactions that arguably ought to be taxed—and endangering the state's fiscal future.
- Targeted corporate **tax breaks** distort economic decision-making and get in the way of markets.
- State taxes are **outdated**. Inability to tax services, Internet transactions.
- Taxpayers think tax systems are **too complicated**.

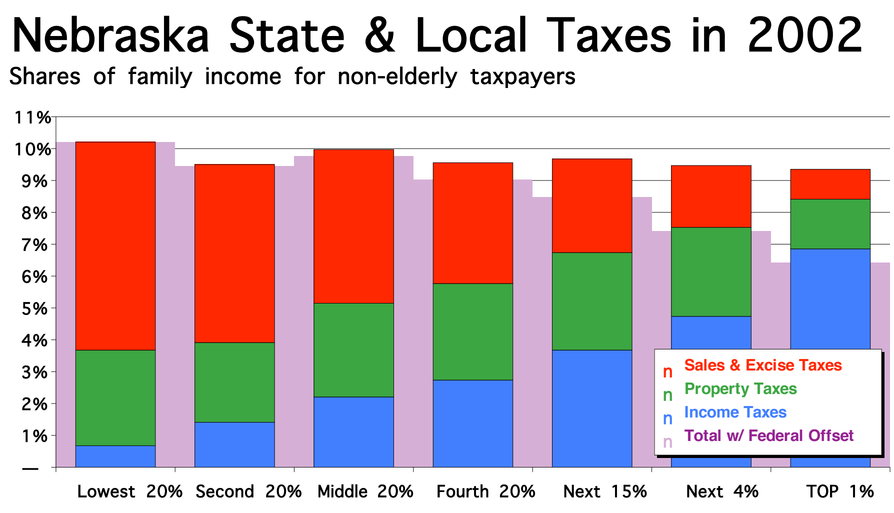
State and local taxes are regressive nationwide…



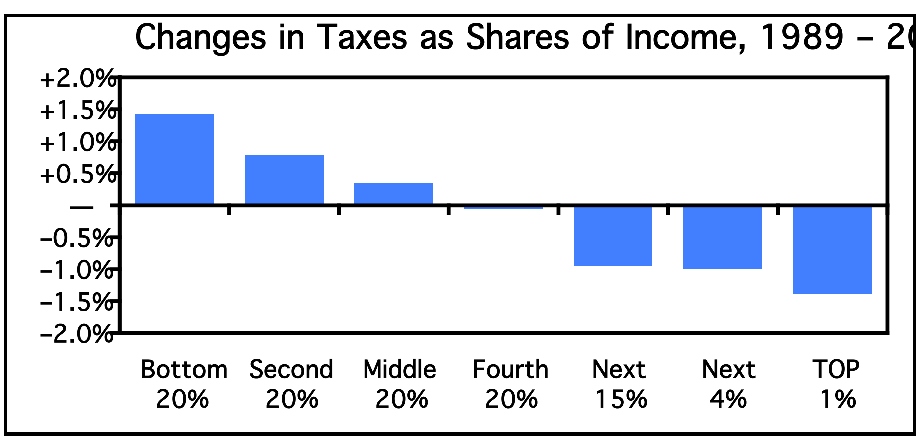
…and this problem worsened during the 1990s.



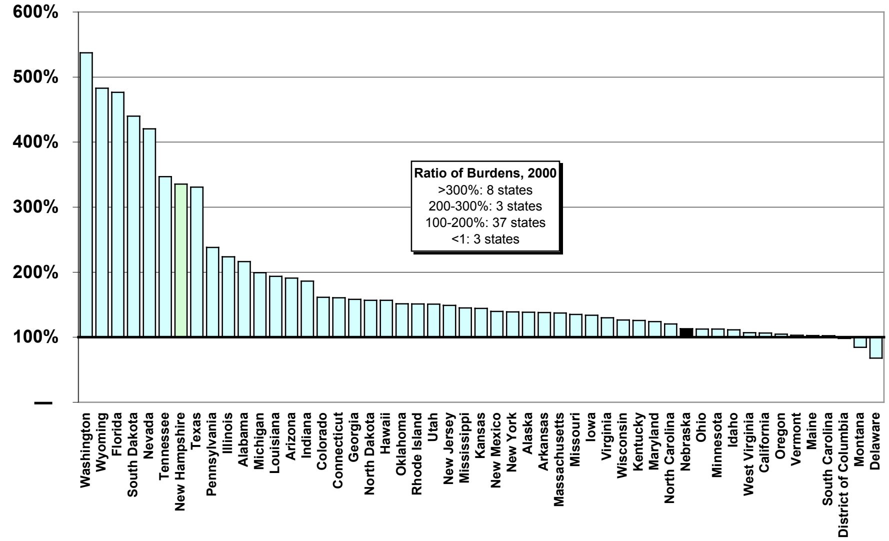
Nebraska's Tax System is Slightly Regressive Too



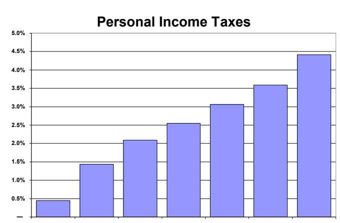
…and shows a similar trend during the 1990s.

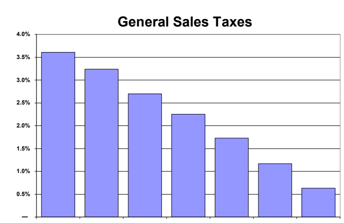


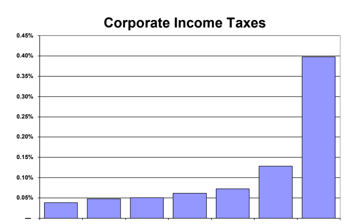
Nebraska's Tax System is Less Regressive Than That of most Other States



Building blocks of tax equity: progressive, proportional, regressive taxes.



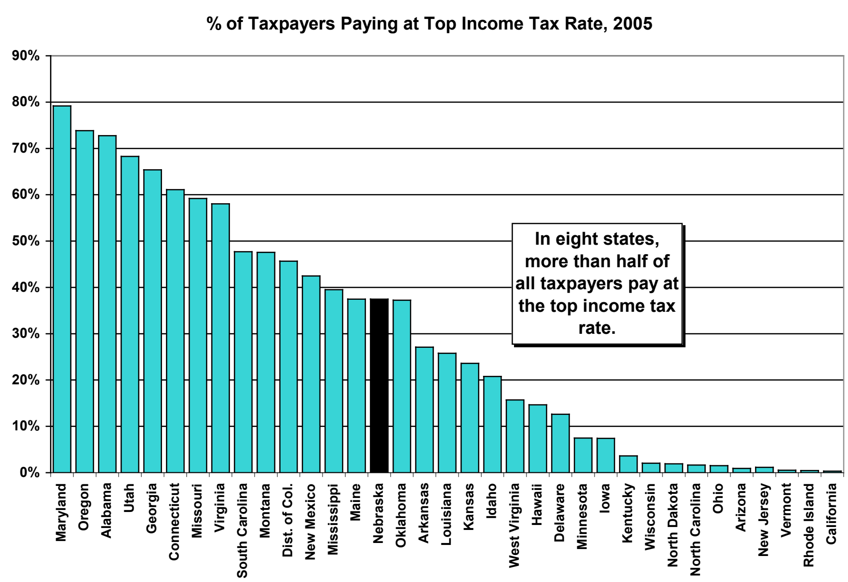


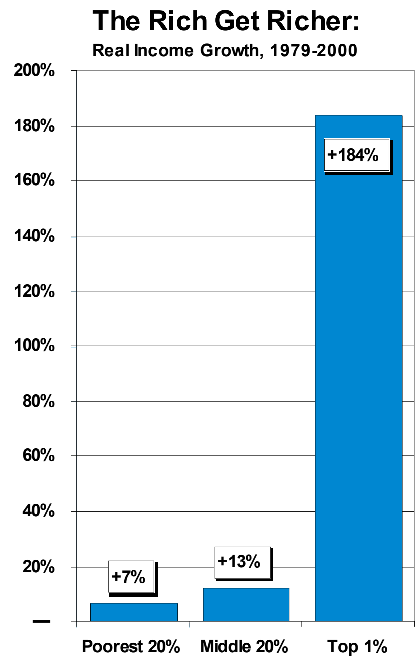


Characteristics of the Most Regressive Tax Systems

	Personal Income Tax		Heavy Use of Sales & Excise Taxes*
	Little or None	Other Details	
Washington	✔		✔
Florida	✔		✔
Tennessee	✔		✔
South Dakota	✔		✔
Texas	✔		✔
Illinois		Flat Rate	
Michigan		Flat Rate	
Pennsylvania		Flat Rate	
Nevada	✔		✔
Alabama		Fed. Ded.*	✔

Many state income taxes are "graduated" in name only.





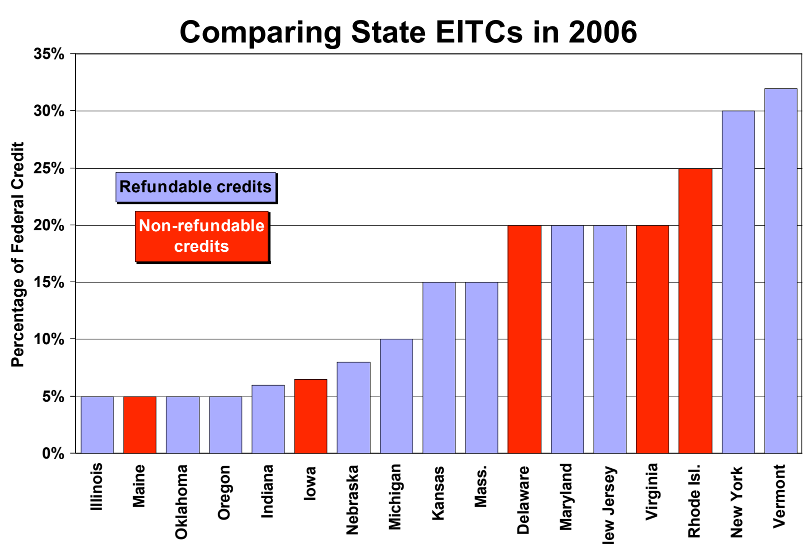
Elderly income tax breaks are usually poorly targeted—and carry a high long-term price tag.

- Many elderly tax breaks benefit pensioners while providing no benefit to wage-earners.
- Most pension tax breaks have no income limits, (Minnesota, Oregon impose limits) and some have especially high caps.
- Social Security benefits are completely exempt in most states.
- Rapidly aging population (12.4% over 65 in 2000, almost 20% by 2030) means cost of these breaks will grow rapidly.
- **Poorly-targeted income tax breaks for seniors are a ticking time bomb.**

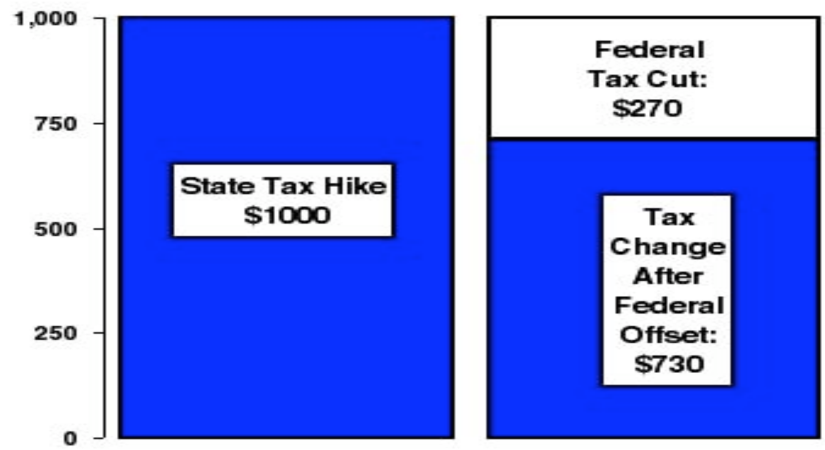
Options for Revenue-Reducing Income Tax Reform:

- Cut top income tax rates (OK, RI, UT)
- Cut all income tax rates (AZ, OH)
- Broaden income tax brackets
- Increase exemptions and deductions for poor (Alabama) or for all.
- Offer exemptions for specific types of income (pension, capital gains)
- Targeted tax credits: **EITC**, etc.

20 states now have EITC's: but only some are refundable, and some are redundant.

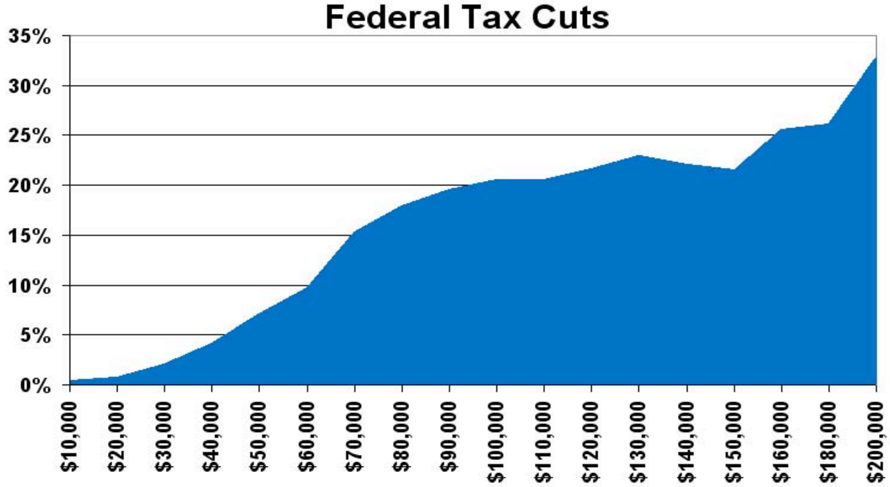


Federally deductible taxes are never as burdensome as they seem.

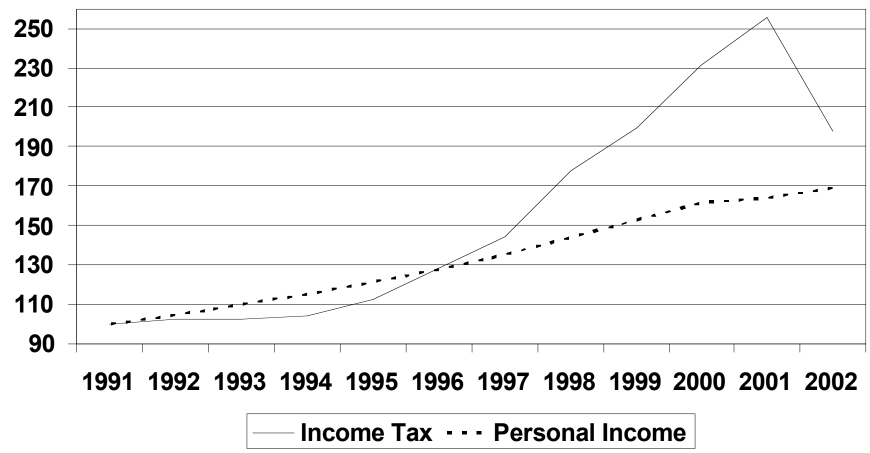


Important question for tax reformers: what fraction of a state income tax hike should be paid by state residents?

% of State Income Tax Hikes Offset By Federal Tax Cuts



Personal income taxes grow faster than the economy.



What about Income Tax Volatility?

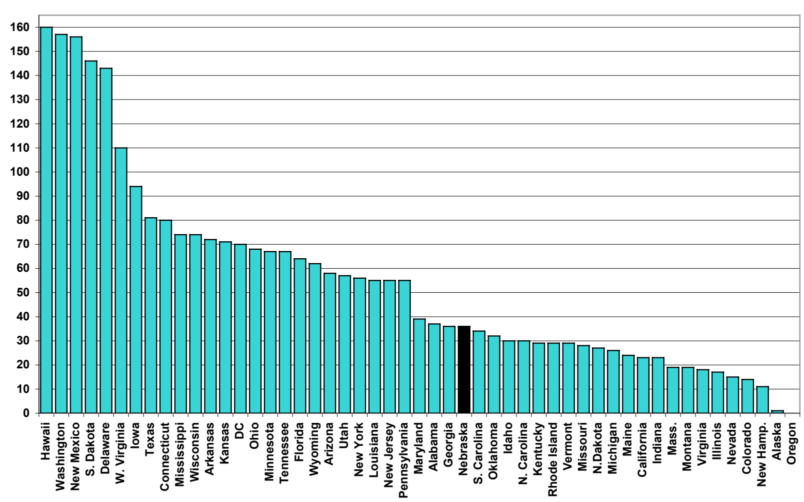
- Opponents of income tax hikes argue that states with heavy income tax reliance are susceptible to fiscal shortfalls when capital gains decline. But…
- The good times can be really good. (Google stock options responsible for 1/8 of $4 billion income tax growth in California this year.)
- Revenues can be put in Rainy Day Funds in growth periods to get through bad times.
- Temporary rather than permanent tax cuts in good times leave base intact in bad times

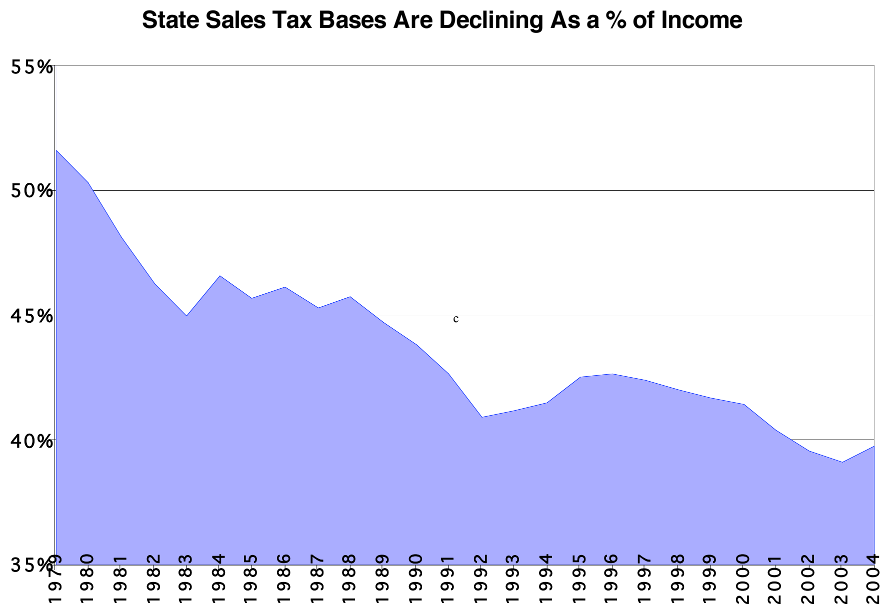
General Sales Taxes: Leg #2 of the Three-Legged Stool

- The most regressive major tax
- *Generally* not deductible on federal income tax returns
- Most states exempt many goods and services.
- Services are growing as a share of consumption, while goods are declining.
- Broadening the base will, in general, help with efforts underway to allow taxation of Internet-based sales. (SSTP)

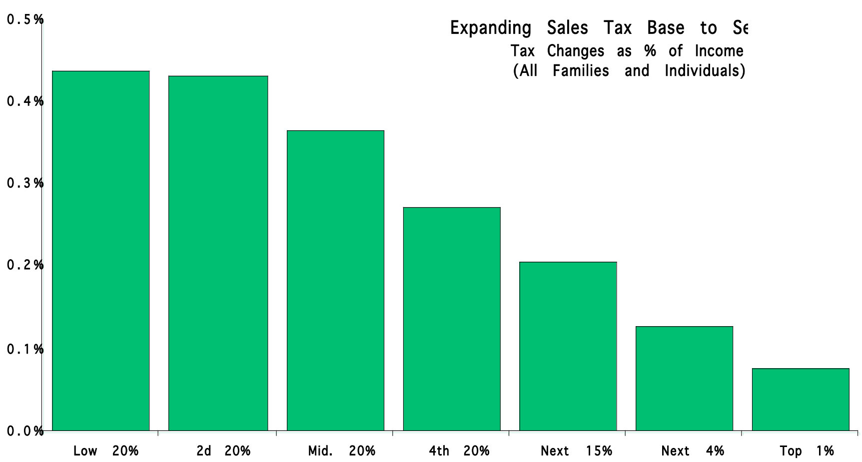
FTA survey: most states (including Nebraska) tax less than half of available services.

Sales Taxation of Services, 2004





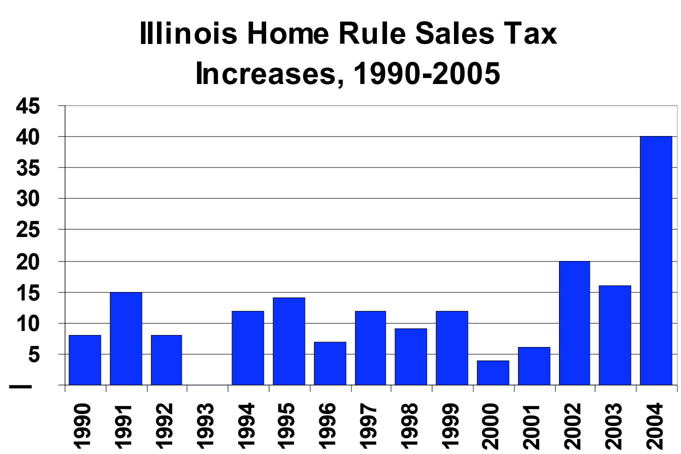
There are sound tax policy reasons for expanding state sales tax bases to include currently untaxed services– but this option would still make the tax system more regressive.



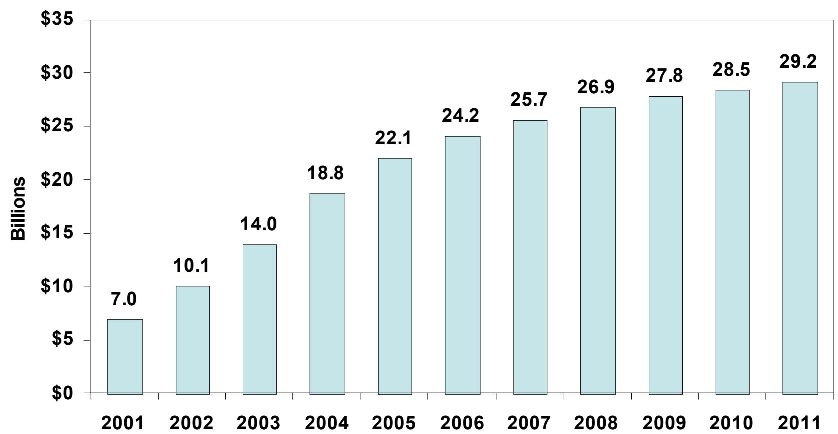
What About Exempting Groceries. Clothing, Utilities?

- Undeniably a progressive tax cut.
- Cutting the food tax is not a partisan issue.
- But it's expensive. Food can be 10 to 20% of a state's sales tax base.
- If it turns out to be unaffordable, long-term impact can be bad for low-income families (New Mexico, North Carolina)
- Cheaper alternatives are available.

Failure to broaden the sales tax base can lead to higher rates.



States’ inability to tax e-commerce will take a growing toll on revenues.



Sales tax credits can deliver targeted, low-income sales tax relief at a lower cost than exemptions.

The Kansas Food Sales Tax Refund

Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.

Income Level	Refund
$0 to $12,500	$60 per exemption
$12,501 to $25,000	$30 per exemption
$25,001 or more	no refund

What About Property Taxes?

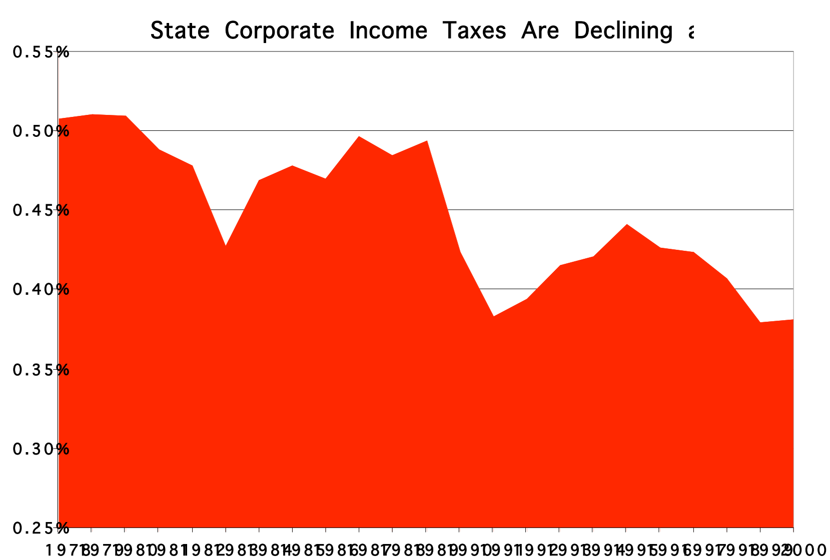
- Less regressive than sales taxes
- Historically important revenue source
- **Very unpopular**
- Especially burdensome for those who are "property rich" but "cash poor."
- At the heart of school funding concerns
- Administrative concerns: local assessment practices can vary

Options for Property Tax Reform: Rethinking Tax Relief

- Exemptions vs. "Circuit Breakers"
- Exemptions provide general tax relief—which means they're expensive and poorly targeted.
- Many states provide especially generous exemptions to growing elderly population.
- Circuit breakers can be designed to give tax relief to any population—elderly or nonelderly—at any income levels.
- Since property taxes can be written off on federal tax forms, some of the cost of exemptions will never be received by state residents.
- Avoid general, "across the board" tax cuts and perversely designed **tax caps**.

Options for Property Tax Reform: Improving Fairness

- **Improve Quality of Assessments**: Professional Training for Assessors, Centralize the Process
- **Require regular reassessment.** Experience of California and Florida shows why important.
- **Statewide property tax**: require equal effort between school districts, use state aid to make up differences in yield.
- The goal of property tax reform should be to make it sustainable and fair– not to make it disappear.



Corporate tax disclosure can help shore up the corporate tax base.

- The SEC requires publicly held corporations to disclose basic information about their federal income tax payments.
- Thanks to these reporting requirements, we know that many of the largest and most profitable corporations have been able to reduce or zero out their tax liability—and we have some ideas about how.
- Most states impose little or no reporting requirements on corporations' state taxes.

Information is Power

- **Disclosure** of corporate tax payments and tax breaks is the gold standard in tax transparency.
- Regular **tax incidence analysis** reminds lawmakers that fairness is lacking.
- **Tax expenditure reports.** Lawmakers (and the public) should know where the money is going.

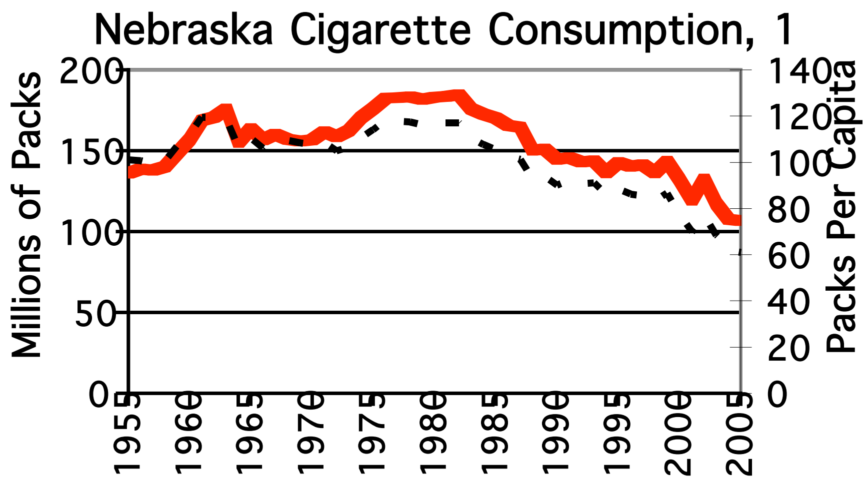
Summing Up: Strategies for a Sustainable and Fair State Tax System

- **Personal income tax:** keep it progressive; keep the base broad. Allow low-income credits like the EITC.
- **Corporate income tax:** eliminate loopholes. Better disclosure of tax information.
- **Sales taxes:** Broaden base to include services, eliminate certain exemptions for goods.
- **Property taxes:** Targeted credits or exemptions, not caps. Tax property uniformly.

What Not to Do: Counterproductive Tax Increases

- **Regressive taxes:** push low-income taxpayers further into poverty. Should be coupled with low-income credits (Kansas, Indiana, New Mexico)
- **Slow-growth taxes:** “sin taxes” will make revenues less responsive to economic growth in the long run– and may not raise any money!
- **Unethical taxes:** State-sponsored gambling amounts to a sin tax in reverse, actively encouraging low-income taxpayers to take part in a socially harmful activity.

The Nebraska cigarette tax base is shrinking.



Federal Tax Changes: Why Nebraskans Should Care

- **Corporate tax breaks:** states must choose to conform or decouple. Conformity will cost $.
- **Estate tax repeal:** Since the Bush tax cuts, states levying estate tax are now adding to the estate taxes paid by their state's residents. (formerly free)
- **Business Activity Tax:** Pending legislation (HR 1956) would make it harder for states to collect corporate taxes on multistate businesses.
- **Internet transactions**: Congress has it in its power to enable states to tax Internet-based transactions.

Tax Changes in the States, 2002-2006: Noteworthy legislation

- >20 states increased cigarette taxes
- Massachusetts repealed a capital gains break– and New Mexico created one.
- Major property tax cuts (ID, SC).
- Strengthening corporate income tax (NJ, NY,TX)
- Cutting sales tax on food (NM,UT,WY,SC, WV).
- Income tax rate cuts (new fad: optional flat rate).
- Decoupling from federal tax breaks.
- Continued expansion of EITC

Takeaway Points:

- Fairness-enhancing tax reform can help achieve other worthy tax goals, especially adequacy.
- Base-broadening is an important goal, and can be more politically palatable than rate hikes.
- Transparency is an important goal too.
- It’s important to recognize the difference between short-term and long-term solutions.
- Taxes and spending are two sides of the same coin.

State Tax Fairness Resources:

- Weekly “Tax Justice Digest.” Best and worst of state (and federal) tax politics and policy. Sign up by emailing ctj@ctj.org
- Our tax policy weblog: www.talkingtaxes.org.
- Our website: www.itepnet.org.
- Center on Budget and Policy Priorities (www.cbpp.org).