A Golden Opportunity

What The Tax Modernization Committee Can Do To Extend Nebraska's Good Life For Future Generations

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Clear thinking for a stronger Nebraska

Introduction

With its study of the state's tax code, the Tax Modernization Committee has a tremendous opportunity: it can help the state change the tax code in a way that will benefit Nebraska and its residents for years to come. Pursuing the right tax reforms today will allow Nebraska to maintain a stable revenue stream so the state can invest in education, health care, roads and public safety – the bedrocks of the "Good Life" for future generations.

In the following pages OpenSky Policy Institute takes a look at the options the committee is considering and offers in-depth analysis and recommendations for each. We have split our analysis into three sections – one that examines reforms we recommend the committee pursue, a section with policy changes we oppose, and a section for policies that require further evaluation.

The committee has said that its final proposal should be revenue neutral and we strongly agree with that sentiment. The end proposal should not harm our state's vital investments in areas such as schools and health care. OpenSky Policy Institute recommends that the state do the following:

- **Expand the state's sales tax to include more services.** This will help bring the state's tax code up to date with today's service-based economy, broaden the sales tax base and generate more revenue that can be used to increase state aid to local governments and lower property taxes.
- **Increase state aid for K-12 education and local governments.** This will lessen property taxes and help bolster our investment in a key building block of our state's strong economy.
- **Provide targeted property tax assistance through the use of "property tax circuit breakers."** Circuit breakers – which provide income tax credits to those who pay high property taxes in relation to their incomes – help make sure Nebraskans who need help with property taxes get it.
- **Not cut the state's income taxes.** Cutting the state's top personal income tax rate to 5 percent, for example, would cost the state $259 million in revenue needed to support vital services and offer little to no tax reduction for most Nebraskans.
- **Not give preferential treatment to certain people.** Several of the options before the committee – such as taxing capital gains at a lower rate – would give preferential treatment to certain people without any benefit for the state as a

whole. These measures would likely increase taxes for the majority of Nebraskans who don't fall into the narrow categories.

We thank the Tax Modernization Committee for its work on this important topic and for seeking public input into the discussion.

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Section 1 -- Recommend for adoption

Issue: Tax on Consumer Services

Recommendation: Expand the sales tax to services purchased primarily by households.

Analysis

Nebraska's sales tax is out-of-date and does not raise adequate revenue. Created nearly half a century ago, the state sales tax applies to a wide range of goods, such as clothes and electronics, while exempting many consumer services like dry cleaning and massages. Failure to collect revenue from more consumer services contributes to the sales tax's inability to keep pace with the state's economy.

How we compare

The 77 services taxed in Nebraska are less than half of the 168 services that are taxed in at least one other state. South Dakota and Iowa both tax more services than Nebraska. About 30 of the exempt services in Nebraska are taxed in at least two of our neighboring states.

Revenue increase

Some estimates indicate that Nebraska could raise an additional $450 million in annual revenue if it were to expand its sales tax to all feasible services. A Department of Revenue estimate in 2009 revealed that even a modest expansion of the sales tax to about 30 additional services could raise roughly $60 million annually.

Inconsistencies and inefficiencies

Treating goods differently from services has led to inconsistencies in Nebraska's tax code. For example, Nebraska taxes rental cars but not limousines with drivers. This gives some services preferential treatment over others, and treats goods differently from many services.

City and roads fund revenue surges

If the sales tax base is broadened, cities and the state roads fund would see significant increases in revenues from local sales taxes that cities can collect and an earmark that sends a quarter cent of the 5.5-cent sales tax into the fund.

Conclusion

We strongly recommend the state expand the sales tax to include services purchased primarily by households. Care should be taken to ensure that business purchases of services remain exempt to prevent tax pyramiding. Expanding the sales tax to more services will allow the state to collect more revenue to support vital services and help remedy inconsistencies in the tax code that give some services preferential treatment over goods and other services.

However, the state should consider letting counties share in the increased local sales tax revenue to help reduce property tax reliance, and consider restructuring the roads fund earmark so that it doesn't reduce funding for other important state investments when changes are made to the state's sales tax.

Issue: Local Governments and the Property Tax

Recommendation: Increase state aid to local governments to lower property tax reliance.

Analysis

Nebraska in the past several years has cut state aid to local governments, such as cities, counties and school districts. Local governments in Nebraska received 27.5 percent of their funding from the state in 2011, which ranked 43rd in the country. The national average for state support to local governments is 33 percent. Nebraska ranked 49th nationally in terms of state aid to schools. Nationally, state aid makes up on average 44.4 percent of K-12 funding; in Nebraska state aid accounts for only 30.3 percent.[1]

Nebraska has historically funded local governments at low levels relative to other states, a fact that was noted in the 1962 McClellan Study, the 1987 Syracuse Study and the 2007 Burling Commission Report. Low levels of state aid mean school districts and other local governments in Nebraska rely more heavily on property taxes to support the services they provide.

High property tax reliance leads to education equity issues

States like Nebraska that are heavily reliant on property taxes to fund K-12 have greater challenges ensuring that all students receive a good education across the state. For example, even with lower property tax *rates*, districts with the highest property values

[1] US Census Bureau, State and Local Government Finances data

are able to raise nearly 3.4 times as many dollars per student compared to areas with the lowest property values in the state.[2]

Local sales taxes

Local sales taxes are another way cities generate additional resources to reduce reliance on property taxes. Currently, most cities can add up to two cents on top of the state 5.5-cent sales tax, while Omaha can only add 1.5 cents. Local sales taxes are in effect in 208 Nebraska cities. Counties can use local sales taxes too, but they can only collect on sales that take place outside cities with local sales taxes. About 95 percent of all sales in Nebraska take place in cities with local sales taxes, which means counties can collect taxes on less than 5 percent of the state's sales. Dakota County is the only county that uses a local sales tax.

Other possible options

To provide local governments with other revenue options, the state also could pursue a countywide local sales tax as is used in other states. This tax allows cities and counties to share sales tax revenues. The state also could allow local governments to tax income and payroll wages, which is allowed in seventeen states including Iowa, Colorado, Kansas, and Missouri.[3]

Cost

For each $100 million increase in state funding that local governments receive, property tax rates could be reduced by an average of about 5.9 cents per $100 of assessed value if distributed evenly across the state.

Conclusion

We suggest the state increase state aid to K-12 education to ensure a more equitable distribution of resources while also reducing property taxes. We also suggest that the state reinstate state aid for other local governments and examine countywide local sales taxes and local income and payroll taxes as potential revenue raising options.

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[2] Nebraska's highest property value districts are able to raise $13,794 per pupil through an average $0.811 levy, while Nebraska's lowest property value districts are only able to raise $4,035 per pupil with an average $0.965 levy.
[3] Tax Foundation: *Local Income Taxes: City- and County-Level Income and Wage Taxes Continue to Wane,* http://taxfoundation.org/article/local-income-taxes-city-and-county-level-income-and-wage-taxes-continue-wane

Issue: Commercial and Residential Property Taxes

Recommendation: Enact targeted property tax assistance through a circuit breaker.

Analysis

Circuit breakers are a type of tax credit that provide assistance based on the percentage of income people pay in property taxes. The state would establish a maximum percentage of income that a household should pay in property tax and then rebate all or part of the property tax payment made above this limit. About 18 states use circuit breakers to help offset high property taxes.[4]

Nebraska offers a property tax credit that is essentially a reimbursement of a percentage of property taxes paid, and is funded at a level chosen by the Legislature each year. But, the program doesn't take income into account when determining who gets the credit, and much of the benefit of the property tax credit goes to landowners who live out-of-state, like Ted Turner. The credit also provides no assistance to renters, even though an estimated 20 percent of rent goes toward paying their landlords' property taxes. [5]

A more inclusive option

Circuit breakers provide assistance to all households that pay high property taxes relative to their incomes. Circuit breakers provide better property tax assistance than assessment limits or homestead exemptions because they can be structured to benefit all who need property tax assistance, including renters and the non-elderly.[6]

Cost

In 2012, Nebraska's Property Tax Credit -- which can be funded at any level the Legislature chooses -- cost the state $115 million, which amounted to a reimbursement of about $71.50 for a $100,000 property.[7] The credit for 2013 will be $65.97 for a $100,000 property.[8]

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[4] Center on Budget and Policy Priorities, The Property Tax Circuit Breaker, An Introduction and Survey of Certain Options, http://www.cbpp.org/files/3-21-07sfp.pdf
[5] Institute on Taxation and Economic Policy, http://www.itepnet.org/pdf/povertycredits0910.pdf
[6] The Lincoln Land Institute, *Property Tax Relief: The Case for Circuit Breakers.* https://www.lincolninst.edu/pubs/dl/1772_991_3%20Circuit%20Breakers.pdf
[7] Nebraska Department of Revenue, http://www.revenue.ne.gov/news_rel/sept_12/real_prop_credit_2012.html
[8] Omaha World-Herald, *How much will Nebraska property owners see in tax breaks.* http://www.omaha.com/article/20130913/NEWS/130919361

The cost of circuit breakers can vary based on how they are designed. The Institute on Taxation and Economic Policy analyzed a series of hypothetical circuit breaker options for Nebraska that ranged in cost from $121 million to $326 million per year.[9]

Conclusion

Nebraska should establish a circuit breaker that will help those who are paying a high percent of their income in property taxes and apply to both residential and agricultural property. Furthermore, the state should not expand its current property tax credit program.

Issue: Exemptions

Recommendation: Regularly review all sales tax exemptions

Analysis

Nebraska promotes and supports many services and priorities through the tax code in the form of tax credits, deductions and exemptions, also known as tax expenditures. The majority of sales tax exemptions are for business inputs, which are the purchases a business makes in order to produce the goods or services it sells, because they are instead taxed when sold to consumers. By exempting business inputs, it prevents multiple layers of sales taxes being passed on to the consumer, which is sometimes referred to as “pyramiding.” Motor fuels are exempt from the sales tax because they are instead subject to the gasoline tax and other taxes. Nebraska has also exempted local governments and select nonprofits from the sales tax, as well as sales of groceries, newspapers and school lunches.

Tax breaks escape regular review

Nebraska’s legislative process mandates that state spending be reviewed every two years to make sure the money is being well-spent but there are no such review requirements for sales tax exemptions. Certain exemptions may be debated when they are initially proposed, but without periodic reviews or expiration dates, they entirely escape scrutiny thereafter. Consequently, some sales tax exemptions may outlive their usefulness, become wasteful, and turn into significant drains on the state budget. This is even true of some of the business inputs that the state exempts because when industries transform and evolve, some the exemptions on inputs become obsolete but remain in the tax code because they are not reviewed.

[9] Institute on Taxation and Economic Policy

Cost

The state's 2012 Tax Expenditure Report estimates that sales tax exemptions reduced state revenue by about $4.1 billion. By comparison, state general fund spending in FY 2011-2012 was $3.4 billion.

Recent changes

Nebraska recently enacted two bills -- LB 612 and LB 629 -- which help the state better review sales tax exemptions and other tax expenditures. LB 612 calls for the Department of Revenue to appear at a joint public hearing before the Revenue and Appropriations Committees and present on various tax expenditure and subsidy reports. LB 629 requires Nebraska governors to include with their budget proposals, Department of Revenue reports on the state's subsidy programs and other tax expenditures.

Conclusion

LB 612 and LB 629 are a good start but we suggest Nebraska develop a system to regularly review sales tax exemptions and all other tax expenditures. Nebraska could follow the lead of other states that schedule systematic reviews every five years or have exemptions and other expenditures expire after a certain period of time so that they can be reviewed before they are continued. It would be important to have a clear objective for each tax expenditure to help with the review process, which would promote a more efficient tax code, allow lawmakers to eliminate outdated or ineffective tax loopholes and preserve scarce public resources needed to support vital investments in schools, health care and public safety.

Issue: Agricultural Machinery and Equipment Repair and Replacement Parts

Recommendation: Exempt agricultural machinery and equipment repair and replacement parts if the state can afford it.

Analysis

Nebraska, like most states, exempts agricultural and manufacturing machinery and equipment from sales taxes. But while Nebraska exempts repair and replacement parts for manufacturing equipment, it is one of just 14 states that taxes repair and replacement parts for agricultural machinery. Nebraska does, however, allow farmers to file for sales tax refunds for repair or replacement parts for agricultural machinery within three years of the purchases. LB 96, which is currently on general file, would replace that sales tax refund with an exemption.

Exempting inputs is good tax policy

Good sales tax policy should strive to tax items at final consumption while exempting the purchases a business makes to produce its goods or services – known as business inputs – from sales taxes. Taxing business inputs, such as the equipment parts and repairs needed to farm, inflates the final price of an item because a business had to pay taxes on the materials and resources it used to create its product.

Agricultural and manufacturing inputs

Unlike manufacturers who can move to states that don't tax inputs or raise prices to offset the cost of sales taxes, farmers cannot generally move and their prices are determined by commodities markets, not by the farmers themselves. This means farmers have to cover the cost of the sales tax on inputs out of their own pockets. To help save on the cost of taxed repair and replacement parts, Nebraska farmers may make major purchases or have equipment repaired in nearby states that don't tax these items. This puts Nebraska agricultural equipment and repair vendors at a competitive disadvantage against businesses from nearby states that don't tax repair and replacement parts.

Cost

No state fully exempts all business inputs from sales taxes, and the 1987 Syracuse Study noted that this would not be feasible for Nebraska because of the significant revenue loss it would cause.[10] Doing so would cost the state $745 million and local governments $155 million.[11] However, exempting agricultural repair and replacement parts would only cost Nebraska about $10 million annually. [12]

Conclusion

Nebraska should exempt farm business inputs to help farmers get the same benefit that manufacturers receive. This will keep farmers from having to cover the cost of the sales tax from their own pockets and will help Nebraska agricultural equipment and repair vendors compete with vendors in neighboring states. While exempting all business inputs would fall in line with good tax policy, the cost of such a measure is very high and the state has higher priorities it should address first.

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[10] The Nebraska Comprehensive Tax Study of 1988 ("The Syracuse Study"), Chapter 3, Pg. 19

[11] OpenSky analysis of data from Council on State Taxation and Nebraska Department of Revenue. COST report can be found at http://www.cost.org/WorkArea/DownloadAsset.aspx?id=84767.

[12] Fiscal note for 2013 Nebraska Legislative Bill 96. http://www.legislature.ne.gov/FloorDocs/103/PDF/FN/LB96_20130306-140900.pdf

Section 2 – Do not recommend

Issue: Income Tax Rates and Brackets

Recommendation: Do not reduce income tax rates or adjust brackets other than to index them for inflation.

Analysis

Forty-one states have a personal income tax, and in Nebraska, it's the largest source of general fund revenues, raising $1.8 billion in FY 11-12. The state's personal income taxes as a share of personal income rank 25th in the nation and Georgia State University professor Sally Wallace – an expert on personal income taxes -- told the Tax Modernization Committee in August that nothing seems out of line with Nebraska's income tax rates.

State's economy fares well

In the past decade, Nebraska's economy grew faster than all neighboring states with lower income taxes. Nebraska's unemployment rate was lower than nearly all of those neighboring states, as well. The only neighboring state with a faster-growing economy in that time was Iowa, which has a higher top income tax rate than Nebraska. Furthermore, the vast majority of academic research shows that income tax cuts do not create jobs and have no major impact on state economies.[13]

Most Nebraskans would see little or no benefit from a tax cut

The income tax is a progressive tax, which means people pay higher rates as their incomes increase. As such, it's higher earners who benefit most when income taxes are cut. If Nebraska's top personal income tax rate were cut to 5 percent from 6.84 percent, middle-class Nebraskans would see just $64 in savings per year on average. By contrast, those making more than $371,000 a year -- the top 1 percent of Nebraska earners -- would save more than $10,000 annually.

Flat tax would be a tax increase for most

Adopting a single-rate tax, also known as a flat tax, would mean a tax increase for most Nebraskans. In order to raise the same amount of revenue currently generated by the state's four tax rates – which rise along with the taxpayer's income -- the state would

[13] OpenSky Policy Institute, *Personal income tax cuts don't spur economic growth,* http://www.openskypolicy.org/personal-income-taxes-dont-affect-economic-growth

need to adopt a 5.2 percent flat income tax rate, and 95 percent of Nebraskans would pay higher taxes[14] under such a proposal.

Indexing for inflation is good policy

Making sure that the state's individual income tax rates and brackets automatically take account of inflation, a process known as indexing, would remedy "bracket creep," which occurs when a family's income increases over time due to inflation, pushing it into a higher tax bracket. With indexing, families no longer would pay higher tax rates when their real purchasing power has not increased.

Itemized deductions worth a look

Nebraska also may want to consider reforming its itemized deductions. An Institute on Taxation and Economic Policy analysis proposed five options that could raise between $12 and $70 million.[15]

Cost

The cost of cutting the income tax would vary depending on the size of the cut. Reducing the top rate to 5 percent would cost the state approximately $259 million per year in lost revenue at the outset.[16] A large portion of the revenue the state would lose would end up flowing either to the federal government, since Nebraskans would have less in state taxes to write off their federal returns, or to out-of-state residents who work in Nebraska or earn money from Nebraska sources and who would pay less in Nebraska taxes. Indexing the individual income tax brackets would cost the state $11 million per year. [17]

Conclusion

Income tax cuts have little-to-no economic benefit and, in fact, likely would hurt the state in the long run by draining resources from schools, health care and other building blocks of a strong economy. Indexing the tax rates and brackets, however, would help ensure Nebraskans don't pay higher income taxes than warranted by their true incomes.

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[14] Institute on Taxation and Economic Policy analysis

[15] ITEP, *Nebraska Can Help Balance Its Budget By Reforming Itemized Deductions.* http://www.itep.org/pdf/itemize0810/ne_factsheet.pdf

[16] ITEP, http://www.openskypolicy.org/analysis-shows-large-chunk-of-income-tax-cut-would-leave-nebraska

[17] ITEP analysis

Issue: Corporate Income Tax Brackets and Rates

Recommendation: Don't change Nebraska's corporate income tax rates.

Analysis

Nebraska's corporate income tax generated $235 million in FY 2012. For companies that do business in Nebraska, the corporate income tax represents a small fraction – likely less than two-tenths of one percent -- of total expenses.[18] Corporations in Nebraska are taxed based on the percentage of their total sales that take place within the state's borders. Businesses can build, expand and hire in Nebraska and not incur any additional income tax liability.

Nebraska's rates

Forty-four other states and the District of Columbia collect corporate income taxes, and the average top state corporate income tax rate is 7.36 percent, slightly less than Nebraska's 7.81 percent. But less than 8 percent of Nebraska corporations made enough profit in 2010 – the most recent year for which figures are available -- to pay that top rate, which applies to profits greater than $100,000; profits below that are taxed at 5.58 percent. That means that the vast majority of Nebraska corporations pay less than Missouri's 6.25 percent flat rate and less than any of the rates paid in Iowa, which range from 6 percent to 12 percent. Seventeen states and the District of Columbia have higher top rates than Nebraska.

Corporate income tax cut would do little for economy

State corporate income tax cuts have a very small effect on state economic growth and job creation.[19] The vast majority of state corporate income taxes are paid by a small number of large corporations, most of which are publicly-traded multi-state corporations

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[18] Nationally, total state and local business taxes account for 2%-3% of business costs (Internal Revenue Service data). In Nebraska, corporate income taxes are 5.8% of total state and local business taxes (Council on State Taxation, *Total state and local business taxes: State-by-state estimates for fiscal year 2012* (July 2013), http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81797). 5.8% of 2%-3% is .1% to .2%

[19] See for example: James Alm and Janet Rogers, *Do State Fiscal Policies Affect State Economic Growth?* (Public Finance Review: July 2011); Donald Bruce, John Deskins, and William F. Fox, *On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning*, in Alan J. Auerbach, James R. Hines, Jr., and Joel Slemrod, Editors, "Taxing Corporate Income in the 21st Century" (Cambridge University Press: 2007); and J. William Harden and William H. Hoyt, *Do States Choose Their Mix of Taxes to Minimize Employment Losses?* (National Tax Journal: March 2003). The studies that do find that state corporate income tax cuts can sometimes have a small positive effect on state economies over a long period of time (5-20 years) also tend to find that this only occurs if state services benefitting businesses are not cut and other state business taxes are not increased to keep state budgets in balance. It would of course be extremely difficult to meet this condition and still balance the state budget. And in the case of LB

whose owners live outside Nebraska.[20] That means about 84 percent of the benefit of a corporate income tax cut would go to out-of-state residents who are investors or shareholders.[21] State corporate income taxes were not even in the top 10 site selection factors listed in a survey of consultants who help businesses choose where to locate.[22]

Cost

Nebraska would lose about $3.6 million in revenue if the threshold to pay the higher corporate income tax rate were raised to $200,000, the Institute on Taxation and Economic Policy (ITEP), a non-partisan research group, estimated. If Nebraska were to index its corporate income tax brackets for inflation, ITEP estimates it would cost the state about $92,000 annually. If the state were to set its corporate income tax brackets and rates at the same levels as its individual income tax brackets and rates, it would give up $22 million in revenue.[23]

Conclusion

The state shouldn't cut its corporate income tax since such a move would not help the economy and could even hurt by draining revenue needed to support key services. Instead, the state should examine the tax in conjunction with a review of subsidies it offers businesses. It is hard to tell if subsidies or corporate income tax cuts actually affect business location decisions, particularly based on the relatively low amount of money involved in such measures, Georgia State University Professor David Sjoquist told the Tax Modernization Committee in August. An examination of changes to the corporate income tax and the state's business subsidies would help Nebraskans learn if the revenue the state spends on business development is a worthy investment.

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405 and LB 406, the proposals increase sales taxes on businesses to offset the revenue loss from corporate income tax repeal, so this pre-condition for a positive impact will not be met.

[20] See Nebraska Department of Revenue, "Analysis of Corporation Income Tax Returns for 2004," http://www.revenue.ne.gov/ann_rept/06an_rep/Inc12-13.pdf. A rough estimate is that 80 percent of Nebraska corporate income taxes are paid by these out-of-state shareholders and owners.

[21] Institute on Taxation and Economic Policy

[22] Area Development Magazine, *8th Annual Consultants Survey* (2012), http://www.areadevelopment.com/AnnualReports/Winter2012/8th-site-selection-consultants-RE-survey-results-28282888.shtml.

[23] 2013 Nebraska Legislative Bill 328, http://www.nebraskalegislature.gov/FloorDocs/Current/PDF/FN/LB328_20130219-141559.pdf

Issue: Social Security Income

Recommendation: Do not increase the tax exemption for Social Security benefits.

Analysis

Most Social Security income is exempt from Nebraska income taxes. On average, Nebraskans who receive Social Security benefits pay income taxes on only 41 percent of it, but the exact amount that is taxed by the state depends on a person's income. Nebraskans with incomes less than $75,000 pay state income tax on about one-fourth of their Social Security income on average, while those earning less than $30,000 pay tax on less than four percent of their benefits. No more than 85 percent of Social Security income is taxable regardless of income level.

Exemption Would Not Attract Seniors to Nebraska

Proponents of completely exempting Social Security income from state income taxes often claim that it will help encourage out-of-state seniors to move to Nebraska and keep seniors who already live here. Research fails to find any connection between where the elderly move and taxes. For example, a paper titled, "Do State Tax Policies Drive Away the Elderly?" found that state-to-state movement among the elderly remained stable from 1970 to 2000 despite changes in state tax laws. "State tax policies towards the elderly have changed substantially while elderly migration patterns have not," the paper's authors wrote.[24]

Cost

Exempting all Social Security benefits from state income taxes would cost the state about $82 million per year.[25] Exempting Social Security benefits only for filers with incomes below $80,000 for married couples and $60,000 for single people would cost about $31 million per year.[26] There are other, less expensive options but they still would lose revenue for the state. Also, the cost of exempting Social Security will only grow more expensive as more baby boomers move into retirement.

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[24] Conway and Rork (2011), p. 3.
[25] 2013 Nebraska Legislative Bill 74: http://nebraskalegislature.gov/FloorDocs/Current/PDF/FN/LB74_20130319-135204.pdf
[26] 2013 Nebraska Legislative Bill 17: http://nebraskalegislature.gov/FloorDocs/Current/PDF/FN/LB17_20130129-134953.pdf

Conclusion

The state should not increase the exemption for Social Security benefits as it would give preferential treatment to seniors without a good policy rationale for doing so. Instead, Nebraska should give seniors more help with their property taxes through a "circuit breaker," which provides targeted property tax assistance based on the amount paid in taxes related to a person's income.

Issue: Capital Gains

Recommendation: Tax capital gains as ordinary income and eliminate the Special Capital Gains Election.

Analysis

Nebraska taxes most capital gains -- profits from the sale of assets such as stocks, bonds, real estate and art – at the same rate as earned income. Evidence does not support claims that taxing capital gains at a lower rate than other forms of income like wages, salaries and small business earnings would boost economic growth.[27]

However, Nebraska does provide a special, one-time tax exclusion called the Special Capital Gains Election, which allows Nebraskans[28] to sell back stock in their employers' companies without paying taxes on the money earned from the sales. To qualify for the exemption, Nebraskans must have acquired the stock as a result of employment by the company or while employed by the company. LB 573 – passed earlier this year -- expanded the exemption to include Nebraskans who participate in Employee Stock Ownership Plans (ESOPs).

Most other states tax capital gains

The vast majority of states tax capital gains at the same rate as paycheck income while a handful of states allow for exemptions on certain capital gains. Nebraska's neighbors Colorado and Iowa have forms of exemptions for capital gained by investments inside those states. Nebraska's Special Capital Gains Election is one-of-a-kind nationally.

More about the Special Capital Gains Election

The Special Capital Gains Election started as part of the business incentive package passed by the Legislature in 1987. Several lawmakers rightfully expressed concerns that the benefit targeted a very small segment of the population, deemed one form of

[27] Institute on Taxation and Economic Policy report "A Capital Idea," http://itepnet.org/pdf/capitalidea0111.pdf
[28] This includes both full- and partial-year residents. A partial-year resident is defined by the Department of Revenue as "an individual who either establishes or ends his or her domicile in Nebraska during the tax year, or who resides in Nebraska for more than six months during the year."

income – capital gains -- preferable to others, and, furthermore, deemed some people's capital gains as preferable to others.

Prior to the passage of LB 573, about 87 percent of the tax break went to just 113 Nebraskans each year, all of whom earn more than $1 million annually. On average, those 113 tax payers each exempted more than $4 million of their income and received a tax break of $291,000. Nebraskans with incomes less than $200,000 received less than three percent of the total payout from the tax break. Furthermore, it's unclear whether the exclusion met its goal of retaining and attracting more high-income earners.

Cost

Between 1998 and 2012, Nebraska's Special Capital Gains Election cost the state an estimated $450 million,[29] an average of about $30 million per year. A 2007 bill that would have phased in a 30 percent deduction of any long term capital gains from federal adjusted gross income, would have cost the state an additional $37.4 million in Fiscal Year 2010-2011.[30]

Conclusion

Nebraska should tax capital gains in the same manner as other types of income. Doing otherwise would provide preferential treatment to one kind of income, benefit only a handful of Nebraskans and reduce resources available for important budget investments. For the same reasons, lawmakers also should discontinue the Special Capital Gains Election.

Issue: Agricultural Land Property Taxes

Recommendation: Nebraska should leave agricultural land assessment as it is, and focus on other ways to lower property taxes.

Analysis

Nebraska uses a "market value" approach to assessing agricultural land while most states employ a "use value" approach. In a market value system, land is valued at the price it would sell in a competitive market, while the use value approach assesses land based on a specific function, such as farming and agriculture. Agricultural land valuations likely would be lower under a use valuation approach.

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[29] Data are only produced by the Department of Revenue for even-numbered years, so odd-numbered years were estimated based on those data.
[30] Fiscal note from 2007 Nebraska Legislative Bill 23, http://nebraskalegislature.gov/FloorDocs/100/PDF/FN/LB23.pdf

Agricultural land in Nebraska has been given preferential taxation treatment since 1992 and is currently taxed at 75 percent of market value.[31] In contrast, business and residential property is taxed at 100 percent of market value. The average property tax levy on agricultural land is now $1.17 per $100 of market value compared to a statewide average $2.09 per $100 for residential real property.

Reliance on agricultural property taxes increasing

Despite assessing agricultural land at a lower rate for taxes, local governments are relying more and more on revenue from these taxes. The state's agricultural sector experienced a boom over the past decade, with the average inflation-adjusted value of an acre of farmland more than doubling from 2007 to 2012 and reaching an all-time high. As a result, Nebraska now leans on the agricultural sector for 29 percent of all property tax revenue, up from 24 percent in 2002.

Cost estimate

If the legislature were to assess agricultural land at a lower rate, it would be costly for local governments. A 5 percentage point reduction to agricultural land value would reduce local property tax collections by about $51 million. If local governments made up lost revenue through higher property taxes, statewide levies would rise by roughly 4 cents from $1.90 to about $1.94 per $100 of assessed property value. In this scenario, residential and business property owners would see their property taxes go up.

If agricultural land values drop

Lowering the property tax assessment rate would only exacerbate revenue losses if future land values fall from their historically high levels. If this happens, residential and business property owners would pay even higher property taxes or local governments would have to make cuts to vital services like schools and public safety.

Conclusion

Nebraska should keep the agricultural land valuation rate at 75 percent since lowering it likely would lead to higher property taxes for residential and business property owners and could cause local governments to make cuts to services, particularly if agricultural land values drop from their historically high levels. A better approach to lowering property taxes is to increase state aid to local governments or through tax credits, known as "circuit breakers", which give targeted property tax assistance to people whose property taxes are high relative to their incomes.

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[31] http://www.legislature.ne.gov/app_rev/source/narrative_proptaxhistory.htm. Agricultural land valuation was dropped to 75 percent from 80 percent in 2006.

Issue: Business and Agricultural Personal Property Tax

Recommendation: Nebraska should not change how personal property is taxed.

Analysis

Nebraska ranks 17th nationally in personal property tax collections per capita -- lower than Colorado, Kansas and Missouri but higher than Wyoming, South Dakota and Iowa.[32] Statewide, agricultural and commercial personal property taxes – which are levied against machinery and equipment used for business purposes -- account for less than 5 percent of property tax collections. In some counties, however, it's closer to 8 or 9 percent. In Fillmore County, for example, 9.41 percent of property taxes come from this personal property.[33]

For Nebraska businesses, state and local business taxes, including the personal property tax, are a small share of business expenses. All state and local tax payments combined compose less than 3 percent of the total expenses of the average corporation.[34]

Cost

In 2012, agricultural personal property taxes in Nebraska generated $57.1 million in revenue and commercial personal property taxes brought in $103.4 million.[35] If Nebraska provided a refundable income tax credit for those taxes, it would cost the state about $160.5 million per year. Similarly, if property tax exemptions were offered for those property types, it would cost local governments $160.5 million in property tax revenue.

Conclusion

Nebraska should not change the way personal property is taxed. Eliminating the personal property tax would shift a larger burden to residential property owners, who

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[32] Tax Foundation, *States Moving Away From Taxes on Tangible Personal Property,* http://taxfoundation.org/sites/taxfoundation.org/files/docs/bp63.pdf

[33] Nebraska Department of Revenue annual report,http://www.revenue.ne.gov/PAD/research/annual_reports.html

[34] Center on Budget and Policy Priorities, Michael Mazerov and Mark Enriquez, "Vast Majority of Large Maryland Corporations Are Already Subject to "Combined Reporting" in Other States," Center on Budget and Policy Priorities, November 9, 2010, Note 4. Available at http://www.cbpp.org/files/11-9-10sfp.pdf. The analysis there found that total state and local taxes represented no more than 2.3 percent of total corporate expenses. Updating the analysis to tax year 2009, using the most recent data available from the IRS, finds that state and local taxes represent no more than 2.7 percent of corporate expenses.

[35] Nebraska Department of Revenue Property Assessment Division.

already pay more than 48 percent of property taxes in the state. It would also cause local governments to lose revenue, which would mean significant cuts to services and/or increases in property taxes on real property. Better ways to lower property taxes are increasing state aid to local governments or implementing targeted assistance through property tax “circuit breakers.”

Section 3 -- Issue that needs further examination

Issue: A Progressive Property Tax System

Recommendation: Nebraska should conduct further research.

Analysis

A progressive property tax, which would mean people would pay higher property tax rates as they own more property, has not been used in other states but other countries are exploring it. A progressive property tax will be phased in on residential properties in Singapore in 2014. It will have nine tax brackets with rates that range from zero percent on the first $8,000 of property up to 16 percent on property values of more than $130,000 in Singapore currency. The rates are slightly different for non-owner occupied residences such as rental properties. Singapore officials anticipate that the majority of owner-occupied households will pay less in property taxes than they do currently.[36]

Tax avoidance issues

It's possible that if such a tax were enacted in Nebraska and applied to commercial and agricultural property, some businesses would avoid paying higher tax rates by dividing property up and placing it in the name of different corporations.

State administration may be necessary

Under a progressive property tax, localities with lower property values would likely collect less revenue as fewer pieces of property would fall into higher property tax brackets. Therefore, it may be necessary for the state to administer a progressive property tax in order to protect localities with lower property values.

Conclusion

A progressive property tax on residential property has the potential to generate new revenue and, if done at the state level, make our overall tax code more equitable. However, it would be important to ensure that a progressive property tax does not lead to less revenue going to low-property wealth districts and more revenue going to high-property wealth districts as this could further affect educational equity and impair already cash-strapped local governments with low property wealth.

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[36] The Straits-Times, "Budget 2013: More progressive property tax rates for Singaporean Households." http://www.straitstimes.com/breaking-news/singapore/story/budget-2013-more-progressive-property-tax-rates-singaporean-households