

Tax Expenditures

RECOMMENDATION:

Reform tax expenditures and broaden the sales tax base.

OVERVIEW

Good tax policy typically calls for broad tax bases and low tax rates. However, there are several aspects of Nebraska's tax code that could be working against this principle, including tax expenditures that may not be providing a good return on investment and a sales tax that doesn't reflect our modern economy. Combined, these features prevent our state from collecting the revenue needed to maintain important services like schools, roads and public safety and puts more of the onus to pay for such vital services on to local property taxpayers. Weaknesses in our tax base also play a role in deepening state budget shortfalls and increasing the need for service cuts. Examining our tax code and finding ways to broaden the tax base can lessen our budget struggles and our reliance on property taxes. Such efforts stand to be particularly important as a 2016 report by the U.S. Government Accountability Office found states may be entering a run of shortfalls that could last more than 40-years as health care and pension costs increase with our aging population.¹ Also looming are the effects of federal tax and budget changes, which could affect state revenues drastically.

REVIEW AND REFORM OF TAX EXPENDITURES PRESENT AN OPPORTUNITY

Reviewing and reforming the tax credits, deductions and exemptions Nebraska gives out can help legislators determine if these tax expenditures are a good use of taxpayer dollars. Tax expenditures function just like spending in that they represent money the state uses for some purpose. The difference is that, instead of tax revenue being collected by the taxing entity and then spent, the money is never collected. Nebraska's legislative process mandates that state spending be reviewed every two years to make sure the money is being well spent. Tax expenditures, however, aren't subject to this same level of scrutiny. Consequently, some may outlive their usefulness, become wasteful and turn into significant drains on the state budget and this means other taxpayers end up paying more to fund schools, health programs and other key services, often in the form of increased property taxes. The Legislative Fiscal Office released a list in 2016 that showed tax expenditures

More than 40 years of shortfalls

Nebraska and other states could face persistent revenue shortages for more than four decades, a 2016 report from the U.S. Government Accountability Office found. Rising health and pension costs related to our aging population will be a major contributor to these revenue gaps.

Going forward, it will be important for Nebraska lawmakers to ensure our revenue system is stable enough to sustain vital services in the face of long-lasting budget challenges.

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and other tax changes passed since 2006 reduced state General Fund revenue by about \$755 million in FY16 alone. That list did not include the Nebraska Advantage Act, which was initially projected to cost between \$24 million and \$60 million annually² but in FY17 reduced state revenue by \$160 million.³

SALES TAX NOT KEEPING UP WITH ECONOMY

Sales tax revenue is failing to keep up with growth in the economy, which in part, can be attributed to untaxed services and internet and catalog sales from remote sellers. Families in Nebraska and across the United States today spend much more on services than on goods that are traditionally taxed (see chart). Yet, many services remain exempt from Nebraska state sales tax. The 81 services taxed in Nebraska are less than half of the 176 services taxed in at least one other state.⁴ In fact, according to a survey by the Federation of Tax Administrators, Nebraska taxes about half of the 146 services taxed in South Dakota, a state with a broad sales tax base. Approximately 30 of the services exempted in Nebraska are taxed in at least two of our neighboring states. The Department of Revenue is required to include in its Tax Expenditures Report a list of services for nonbusiness use⁵ and it estimates the failure to include these services in the sales tax base results in hundreds of millions of dollars in forgone revenue annually.⁶ This loss in state revenue can result in the cost of funding key services being shifted onto local property taxpayers.

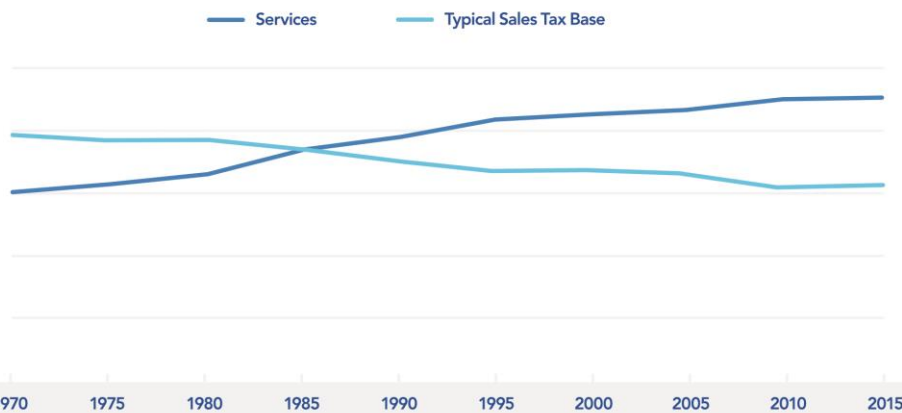
Past tax changes have big impact on revenues

Tax cuts and tax expenditures passed in prior years are having a significant impact on state revenues and by extension our ability to fund schools, roads, health programs and other services that are vital to our state and its economy.

In 2016, the Legislative Fiscal Office released a list showing tax changes passed in the 10 years prior would reduce state revenue by \$755 million in FY17 alone.

Consumption of Services Increasing

Goods and Services as a Share of Household Consumption (1970-2015)



Source: US Bureau of Economic Analysis, National Income and Product Accounts, Table 2.4.5U

ONLINE SALES TAX RULING GOOD NEWS FOR PROPERTY TAXPAYERS, LOCAL RETAILERS

Another issue preventing Nebraska's sales tax from keeping up with the times is the inability to collect the millions in sales tax revenue that is due from

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online purchases. A U.S. Government Accountability Office report found that Nebraska could collect between \$67 million and \$95 million annually in state and local revenue should it collect tax on all internet sales.⁷ While Nebraskans are legally required to remit sales tax for online purchases through their income tax return, compliance is low. Right now, Nebraska can only require sellers to collect these taxes if they have a physical presence in the state, putting local retailers at a competitive disadvantage with out-of-state online and catalog sellers who can't be required to collect sales taxes. A recent U.S. Supreme Court ruling, however, has cleared the way for states to begin collecting sales tax on all online purchases.⁸ The Nebraska Legislature likely will need to enact measures to require collection of these dollars but should that occur, the state will experience a broadening of its sales tax base.

EFFORTS TO REVIEW EXPENDITURES ALREADY UNDERWAY

Nebraska in recent years has increased efforts to review tax expenditures. For example, one measure passed recently requires the state to audit Nebraska's business incentive programs regularly. Other recent measures have resulted in the Department of Revenue annually presenting reports at joint Revenue and Appropriations committee hearings regarding our tax expenditures and tax incentive programs. Also, in 2017, several legislative measures were proposed to freeze and reform certain tax expenditures and tax breaks, but the measures did not advance from the Revenue Committee.

CONCLUSION

Reforming tax expenditures, expanding the sales tax to include household services and collecting tax from online sales can help our tax code keep up with our state revenue needs and help reduce our reliance on local taxes like property taxes to fund key services. Recent efforts to step up the state's review of tax expenditures are a positive sign. Further review and reform of Nebraska's tax expenditures can help ensure these taxpayer dollars are used in the most effective ways. Collecting tax from online sales also can help the state address its revenue concerns as well as help level the playing field for our brick and mortar retailers. These types of efforts are likely to be particularly important as the state moves into what could be a 40-plus year period where expenditures exceed revenues.⁹

Tax code does not reflect modern economy

Nebraska's sales tax applies to less than half of the 176 services that are taxed in at least one other state. Nebraska also doesn't collect sales tax on internet purchases, which represent an increasing share of sales.

Taxing few services and not collecting on online sales keeps the state's tax code from reflecting the modern economy and this has ramifications for funding schools and other key services.

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