Date: January 28, 2013

To: Nebraska Legislators and other interested parties

From: OpenSky Policy Institute

Re: Richard Pomp, Principles of Taxation

We have had several requests for a summary of the tax principles espoused by state and local tax expert Richard Pomp at OpenSky Policy Institute's January 17th policy symposium. Attached are the highlights from his presentation.

Also, a video of the symposium will be available to watch on our website early this week at www.openskypolicy.org.

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Principles of Taxation
State and Local Tax Expert, Richard Pomp, J.D.
OpenSky Policy Symposium, January 17, 2013

1. Don't look for the Holy Grail. There is no Holy Grail. Only tough decisions. Taxes are one of the things a legislature CAN control. Beware of people trying to seduce you with ideological fairy tales.
   - Operate based on evidence not on self-serving anecdotes.

2. Never use a shotgun if a rifle will do.
   - Narrow, tailored provisions are better than screwing up a tax system with broad measures to reach a small group. If after research it is decided that a particular group needs a special provision then deal with that with a narrow special provision. Don't give something away to reach a narrow group.

3. Be risk inverse. Don't put all of your eggs in one basket. A tax structure should be balanced with a variety of taxes.
   - Each tax has its own rewards, strengths and weaknesses. In a balanced system, you play the strengths of one off the weaknesses of another. You would never invest retirement income in one particular asset, and the same approach should be taken with tax system.
   - Spread the risk. Don't shoot craps with the state economy. It is not a coincidence most states have income tax, corporate tax, sales tax, property tax; this provides a balanced approach and covers the various bases.

4. The income tax is the only progressive element of a tax code.
   - A progressive tax takes an increasing percentage of income as income increases. Warren Buffett pays a higher percentage of income than the average person, that's progressive. The other way around is regressive. The overall tax structure in NE is regressive. Most states are regressive.
   - The only progressive element of the Nebraska tax structure is the personal income tax. The sales tax is regressive and takes a smaller percentage from the wealthy than the poor. Personal income tax is the one tax that brings some progressive features.

5. There is no free lunch.
   - A limited number of states through luck of the draw have some natural advantage to getting by without a state personal income tax – Alaska, natural resources, Texas natural resources, Nevada tourism/gambling, Florida tourism. It is hard to mimic states like that if you aren't endowed with a natural advantage.
   - In New Hampshire, there is no broad based sales tax, they do tax meals and hotel rooms, but there is no broad based personal income tax. In return they have a very low level of public services and poor schools. Many Dartmouth professors live in Vermont for good schools. There is no free lunch in this business. We tried with supply side

economics. We cut taxes at federal level, hoping for an outbreak of economic activity, that the tax cut would pay for itself. It didn't work.

- If we were to cut federal income tax, would people work harder? If you increase taxes, people won't work less hard, but will they work harder? Yes, they have to make up for revenue loss. It is a very empirically ambiguous question about whether lower taxes increases economic activity. At the state level it is probably insignificant. Be skeptical of a state tax system designed to encourage work or savings.

6. Do no harm. The law of unintended consequences will show up.
   - Unintended consequences are often greater than intended consequences. It is very hard to predict what consequences will be of changing a tax system. Beware of wholesale changes; there is a lot of money on the table.
   - Louisiana has a proposal to eliminate personal income tax, and so does Kansas. What happens if you eliminate personal income tax and shift to increased sales tax? Any kind of progressive taxation is eliminated. Right away tax is more regressive. Perhaps people don't care about that. Nebraska personal income tax has a lot of refundable tax credits, child care, earned income tax credit. What happens to low income checks if the personal income tax is eliminated?
   - If you put your eggs all in one basket, sales tax or some other tax, if the one tax turns out to be more volatile, you may have a problem. There is a long history of structural deficits in the Nebraska state tax system. Current taxes do not support the level of spending. If you were to shift to a sales tax, would you make the deficit worse, or cure it?
   - Sales tax is more volatile as a tax than the existing Nebraska tax structure. Having a lot of taxes, they tend to smooth out fluctuations. If you rely heavily on one tax, and you're wrong, and the revenue is less than anticipated, then what happens? Spending has to be cut. Your pattern in Nebraska is that school aid drops. When that happens, property taxes go up. And then you have a new round of unintended consequences especially in regard to agriculture. Moving from a broad base to a narrow base can be a high risk gamble.

7. Be wary of tax rankings.
   - You don't have a major problem with Nebraska personal income taxes. You are within the range of what you see elsewhere.
   - You have an unfavorable ranking with the Tax Foundation, but don't take the rankings seriously. Rankings are abstract. Nobody pays the aggregate of an abstract.   You pay what your situation dictates. Looking at the after- tax rate of return is the standard business school financial analysis. This takes into account labor, the cost of property, energy. The after tax rate of return tries to measure what can be measured, including taxes.
   - Nebraska has attractive features for bringing businesses to Nebraska. For example, single factor apportionment (the share of a corporation's total profit that is taxed is based solely on the share of the corporation's nationwide sales occurring in the state) and the lack of a throwback rule (sales of a multistate corporation shipped from

Nebraska to a customer in another state where the company has no nexus, and therefore cannot be taxed by that state, are not considered Nebraska sales for purposes of apportioning multistate income). Income tax doesn't seem to be an issue in Nebraska.

- Be careful putting too much stock into what one ranking says. Nebraska is the 1st in the nation for lowest business tax costs for new firms according to the Tax Foundation. AP says Nebraska is the third least stressed state economically. Forbes finds Nebraska has the 2nd lowest unemployment rate and 3rd lowest business costs.
- Businesses want to know, how does the tax structure affect us? In the end, they don't worry about what the Tax Foundation says. It's not about rankings, it's about specific situations. How are we with respect to their situation? What will be gained from changing the personal income tax? Will it change the rankings of the Tax Foundation? So what?

8. Taxes have little influence on where people live.
   - AARP lists Omaha as top 4th best place to retire. Is Nebraska competing with South Dakota, Wyoming where there are no income taxes? Is Nebraska competing with the Arizona and Florida's good weather? It is hard to do anything about the weather with a tax system.
   - There is very little empirical evidence that exempting retirement income makes any difference in where people live. A driving factor may be where the grandchildren are. There are all sorts of reasons outside of how are our pensions are taxed to determine where someone lives.
   - If someone receives only social security income, they aren't taxed in Nebraska, because they aren't taxed by the Federal government. And not everyone has pensions. Some people work part time, should their salary be exempt? Dividend interest income, should that be exempt? It's a slippery slope when you start to carve out exemptions for one group over another. Right now, Nebraska income tax isn't bad; it's pretty clean.

9. If you want to attract recent grads, or attract dot-coms, you have to create the conditions to encourage them to stay in Nebraska.
   - Replicate the conditions in Silicon Valley, Route 128 in Massachusetts, the research triangle in North Carolina, that make it attractive for recent grads. The University system is one of the keys to economic development. Make it attractive for people to stay.

10. Taxing business inputs will change the structure of a sales tax and is bad policy. Taxing services should be considered.
    - Every tax is intended to do something different. Don't go screwing around with what the tax is supposed to be doing. The essence of an income tax is to measure profit, and you can't measure profit if you can't deduct the cost of doing business.
    - A sales tax is intended to eliminate the tax on business inputs and be left with one tax on outputs. You don't want pyramiding; you don't want a disguised tax, a tax on a tax. You don't want to tax manufacturing, agriculture inputs, purchase of seed, livestock, and capital equipment. If you do tax those business inputs, you no longer have a sales tax,

but a turnover tax. Something that doesn't resemble the sales tax. There are legitimate exemptions that are part of the structure of the sales tax.

- Be sensitive to big business versus small business. If you tax business inputs that small businesses have to buy in the marketplace that big business don't have to pay because they produce it in-house, you stack the deck against small business. This is one reason that states have manufacturing exemptions, to prevent this problem. This is a correct exemption.
- One sales tax hole in Nebraska is the lack of taxation of personal services. Nebraska doesn't tax many personal services. Sales tax goes back to the Depression before we were a service economy, and Nebraska needed to put the sales tax into place quickly. Not taxing services is giving up a way to get progressivity in sales tax. If I rent a car I pay sales tax, if I rent a driver, I don't. If Nebraska is going to expand the sales tax, this area should be looked at.

11. Tax incentives result in waste in taxation and present a transparency issue.
    - Just as we ferret out waste on spending side of the budget, we need to ferret out waste in taxing side of the budget. Where is the potential waste in taxation? Large amount of special credits for corporations. Credits are so large in amount that in many cases, corporations wipe out what they owe.
    - Studies across the country have raised serious questions about whether these special credits can survive a cost benefit analysis. They cost a lot of money, but are they paying for themselves?
    - The problem in Nebraska is that you can't tell who is getting how much. In other states, you can. Nebraska gets a D- in transparency in corporate tax credits from Good Jobs First – big on transparency in government. Sunlight is the best disinfectant – you need transparency.

12. Taxes should be constantly monitored
    - Echoing a theme the Speaker struck, you need to constantly monitor taxes.
    - There should be a standing committee if possible, or an ad hoc committee if necessary. Are goals being furthered? It's like a dike. You always need to plug the holes.