

Revenue Stabilization

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 breaks 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, putting more of the onus on 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 healthcare and pension costs increase with our aging population.¹ Also looming are the effects of federal tax and budget changes, which could drastically affect Nebraska state revenues as well.

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. However, instead of tax revenue being collected by the taxing entity and then spent, the money is not collected in the first place. 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, which 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

More than 40 years of shortfalls

Nebraska and other states could be faced with 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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tax expenditures 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 2016 reduced state revenue by \$148 million.³

SALES TAX NOT KEEPING UP WITH REVENUE NEEDS

Nebraska's sales tax is out-of-date in multiple ways and this contributes both to the state's struggles to fund key services like schools, corrections and healthcare adequately and to our high reliance on property taxes. One way the sales tax is outdated is that it doesn't apply to many services despite the economy moving from being primarily goods-based to primarily service-based. The 77 services taxed in Nebraska are less than half of the 168 services that are 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 that 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.

Another issue that prevents Nebraska's sales tax from keeping up with the times is the inability to collect the millions in sales tax revenue due from online purchases. A U.S. Government Accountability Office report found Nebraska could collect between \$69 million and \$97 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. Additionally, not collecting this sales tax can result in Nebraskans paying more in property taxes to fund vital services.

EFFORTS ALREADY UNDERWAY

Nebraska in recent years has increased efforts to review tax expenditures. For example, one measure passed in recent years requires the state to make regular audits of Nebraska's business incentive programs.

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 vital to our state and its economy.

In 2016, the Legislative Fiscal Office released a list that showed tax changes passed in the 10 years prior had reduced state revenue by \$755 million in FY17 alone.

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Other measures that have passed recently resulted in the Department of Revenue presenting reports annually at joint Revenue and Appropriations committee hearings to provide updates about our tax expenditures and tax incentive programs. Also, in 2017, several legislative measures were proposed to freeze and reform numerous tax expenditures and tax breaks, but the measures didn't advance from the revenue committee.

While Congress has yet to pass the Marketplace Fairness Act, which would give states the clear authority to collect online sales tax, other efforts are underway to help Nebraska collect revenue due from internet purchases. In late 2016, online retailer Amazon announced it would begin to collect online sales tax in Nebraska. The Department of Revenue estimates this will increase revenue by about \$11.2 million annually.⁸ It's important to note, however, that tax will only be collected on purchases of Amazon's own products. Tax will not be collected on purchases from Amazon's third-party vendors, which account for a major share of Amazon's business.⁹ In 2018, the Legislature considered but didn't enact a measure that would call on many businesses to remit sales tax or notify their customers that sales tax is due for their purchases. The measure also would have left Nebraska prepared to begin collecting tax on online sales should an upcoming U.S. Supreme Court ruling clear the way for such collections. Without the measure, which a Department of Revenue estimate showed would have increased state revenue between \$30 million and \$40 million a year,¹⁰ the state may have to wait until the 2019 legislative session to begin collecting sales tax should the Supreme Court ruling permit it.

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 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.¹¹

Tax code does not reflect modern economy

Nebraska's sales tax applies to less than half of the 168 services that are taxed in at least one other state. Nebraska also doesn't currently 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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