Expert alert: UNL’s Thimmesch on proposed state tax changes

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Thimmesch, Adam, "Expert alert: UNL's Thimmesch on proposed state tax changes" (2013). College of Law, Faculty Publications. 166.
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Thursday, February 7th, 2013

In January, Gov. Dave Heineman proposed big changes to the state’s tax system, including the elimination of the state’s corporate and personal income taxes. Other proposals would eliminate corporate taxes and make more limited changes to income taxes. Adam Thimmesch, assistant professor of law at the University of Nebraska College of Law, studies constitutional limitations imposed on state taxing power and instructs students on the structure and content of the tax system. As debate on the topic begins, we asked Prof. Thimmesch to analyze the proposals and provide us some food for thought.

Governor proposes dramatic changes to state tax system

In his State of the State address on Jan. 15, Gov. Heineman proposed sweeping changes to the Nebraska state tax system. One proposal would completely eliminate the state’s corporate and personal income taxes, while an alternative proposal would eliminate the corporate income tax but make more limited changes to the personal income tax. Both proposals include modifications to the state’s sales tax laws that are intended to offset the lost revenue from the income-tax reductions. The Governor should be applauded for putting tax reform at the forefront of this legislative session. With any major tax reform, however, many issues need to be considered. A few of those issues are discussed below.

Revenue Neutrality

The Governor has indicated that he wants his proposal to be revenue-neutral—meaning that the net taxes collected by the state after the modifications would be the same as they are today. The state’s income taxes currently raise approximately $2.4 billion, and, to achieve revenue neutrality, the Governor has proposed eliminating certain tax exemptions contained in the state’s sales tax laws. The particular exemptions that would be eliminated have been the focus of much of the early discussion regarding the Governor’s proposal. However, regardless of the specific exemptions ultimately revoked, it is assured that the proposal would result in certain Nebraskans paying less in state taxes and certain Nebraskans paying more in state taxes. How that burden would be allocated cannot be certain at this time, but we must be mindful of that factor. Any sales tax increase will impact both the constituencies that are directly paying the new tax and others who will be indirectly impacted by that tax.
For example, the Governor’s proposal focuses on sales tax exemptions for manufacturers, agriculture, medical equipment and medicine, and purchases by exempt organizations (charities, churches, etc.). It is easy for people who are not in those industries to perceive that those tax increases will not impact themselves. However, a sales tax increase on those organizations and industries would also impact their investors, employees, customers and the people that they serve—all of whom may be fellow Nebraskans. Like an income tax, the cost of a sales tax ultimately must be borne by some individual. Someone must pay for revenue neutrality. Thus, if the Governor’s proposal is enacted, it is clear that certain Nebraskans will end up paying more in state taxes even though they would be relieved of an income tax burden.

**Distributional Effects of any Changes**

One particularly sensitive aspect of the Governor’s proposal is how the additional sales tax burden would be allocated among Nebraskans of different income levels. Of the state’s three major taxes (income taxes, sales taxes, and property taxes), only the income tax is a progressive tax. The state sales and property taxes, alternatively, are generally regressive. (A progressive tax is a tax that consumes a higher percentage of a person’s income as his or her income increases. A regressive tax is a tax that consumes a higher percentage of a person’s income as his or her income decreases.) If the state is going to shift its tax burden away from income taxes and more heavily onto the sales tax, the tax system will likely become more regressive. When considering fundamental tax reform, then, we should be aware of the distributional effects of any changes and determine whether we are comfortable with those changes. We need to fund government with revenue some way. The question is how we want that burden distributed among our population. Do we want a state where lower-income residents pay a higher percentage of each paycheck in state taxes than do higher-income residents? Or do we not care about regressivity as long as those with higher incomes send more aggregate tax dollars to Lincoln than those with lower incomes?

**Structural Impacts of any Changes**

Eliminating the state’s income taxes would cause a systematic change to how we fund our government here in Nebraska. That proposal leads to several questions about the overall structure of our tax system.

*First, are there benefits from having an income tax?*

The state’s income taxes are certainly complex and impose costs on persons and organizations doing business in Nebraska. Eliminating those taxes would thus reduce compliance costs and out-of-pocket tax expenditures (ignoring, for the moment, the potential increased sales taxes paid by Nebraskans). Those are laudable goals, and economists and our legislators should analyze the likelihood of success for the Governor’s proposal on those metrics. However, regardless of those perceived benefits, we must recognize that the income tax does play a significant role in our current tax system. Two benefits are particularly of note.

First, having an income tax offers a broader base of taxation in the state, which gives it more flexibility in times of fiscal troubles. Eliminating the income tax would put more pressure on the
legislature to fund the state by raising sales taxes. That may be a difficult task in recessionary
times when consumer spending is down and the legislature otherwise wants to encourage
spending. Second, income taxes help to offset the general regressivity in our current tax system.
(This point is addressed more fully above.) Care should be given to determining how the
additional sales tax burdens from the Governor’s proposal would be allocated among Nebraskans
of different income groups and how that allocation reflects how we want to raise revenue in the
state.

Second, is our sales tax system healthy enough to shoulder the burden?

Eliminating the income tax in favor of higher sales taxes would place greater emphasis on the
proper functioning of our state sales tax. Therefore, another factor to consider is the overall
health of our sales tax system and whether it is well designed to shoulder that burden. Our state
sales tax was enacted in 1967. At that time, the economy was centered on the sale of tangible
goods, and our sales tax system reflects that history. Currently, the Nebraska sales tax applies to
the sale of goods and some services, but it does not apply to all services. This is one instance
where the sales tax picks “winners and losers,” something that the Governor has specifically said
that he wants to address with his reform proposal. If we are going to be serious about reforming
our tax system, and we are going to rely more heavily on sales tax, it makes sense to consider
shoring up this structural deficiency. The state should also consider what actions it will take to
protect its sales tax base from online retailers who do not collect and remit the state’s sales tax
and from increased sales of digital products. Modernizing those aspects of our sales tax system
could help the Governor to achieve his goal of revenue neutrality without wholesale eliminations
of sales tax exemptions that have adequate normative support.

On the latter point, it is worth noting that most of the exemptions currently contained in the
Nebraska sales tax laws are consistent with what tax experts would label an “ideal” sales tax and
with the sales taxes enacted in other states. Elimination of those exemptions would thus cause
our sales tax to diverge from those models. Consequently, in addition to the other issues
discussed herein, our legislators must consider whether they desire to further diverge from an
ideal sales tax system (and a system that provides exemptions like our neighboring states) to
fund an income tax reduction.

Finally, should state property taxes be included in these changes?

Property taxes are largely a local matter. However, state funding has an enormous impact on
state and local governments and the taxes that must be collected via property taxation. Any
reform discussion should also include a discussion of the role of property taxes in Nebraskans’
overall tax burdens.

Conclusion

The coming weeks and months will undoubtedly see significant discussion regarding the
Governor’s tax proposal. Much of that discussion will focus on the impacts of removing sales tax
exemptions for certain industries or products, but a range of other issues should be also
considered. Principally:
Who will ultimately bear the burden of higher sales taxes to fund the elimination of the corporate and personal income taxes?

Do we care about the regressivity of our tax system?

Should the sales tax be modified to become more modern and comprehensive rather than just eliminating exemptions (which may be normatively justified and allowed in other states)?

Should property tax reform be included in the discussion?

Should income tax reform, rather than elimination, be considered?

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