G84-733 General Sales and Use Taxes in Nebraska (Revised March 1992)

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General Sales and Use Taxes in Nebraska

This is one of a series of NebGuides on financing state and local government. This publication describes how sales taxes support state and municipal government functions.

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A sales or use tax is a tax on consumption. It is paid by adding it to the price of purchased products.

Sales and use taxes in Nebraska (and most other states) have several dimensions.

First, a state *general sales* tax applies to the retail sale of most physical goods or products, but excludes most services. It is an *ad valorem* tax because the tax base is defined in terms of the monetary value of the purchased item or items.

The general sales tax is complemented with a *general use* tax. The use tax is applied to items purchased outside Nebraska for use within the state. It is intended to preclude Nebraska residents from escaping Nebraska sales taxes by out-of-state purchases of items that otherwise would be subject to the sales tax within the state. The use tax is levied on the same base and at the same rate as the sales tax.

Some municipalities also have a general sales and use tax which, except for the tax rate, has all the characteristics of the state general sales and use tax. For participating municipalities, this tax often has been used to provide property tax relief.

Nebraska, as well as other states and the federal government, also levies and collects *selective sales* or *excise* taxes. These are not *ad valorem* taxes because the tax base is defined by the number of units purchased (e.g., gallons of gasoline), not the value of the product. In addition to motor fuels, other examples of selective sales taxes are those levied on tobacco products and alcoholic beverages.

State general sales and use taxes go primarily into the state general fund for the support of a wide array of state government functions. A notable exception, however, is the sales tax on motor vehicles, which goes into the Highway Trust Fund and is used for the construction and maintenance of roads, streets and highways. In fiscal year 1990-91 (hereafter, FY 1991), sales taxes on motor vehicles amounted to about $64 million.

While some selective sales taxes also go into the General Fund, this is not always the case. Motor fuels taxes, for example, go into the Highway Trust Fund. Portions of the state tax on tobacco products go into several special funds.

The focus of the remainder of this NebGuide is on general sales and use taxes. Another NebGuide in this series will focus more intensively on selective sales taxes.

Historical Perspectives

Mississippi was the first state to enact a general sales and use tax. It did so in 1932 as a depression-era response to declining revenue from other sources, especially property taxes. Six years later, half the states had followed Mississippi's lead.

Although early sales tax enactments were intended to be temporary, they later became permanent as demands for public services increased and public officials faced the political difficulty of raising property taxes by amounts large enough to pay for such services.

Another surge of sales tax enactments occurred after World War II as states sought to catch up with infrastructure needs delayed by the war. Of the 45 states that presently levy a sales and use tax, Nebraska's adoption in 1967 was one of the most recent. Nebraska initiated state income tax collections at about the same time. Together these two new revenue sources replaced the previously existing state property tax.

City sales taxes in Nebraska also date to the late 1960s. Under the Local Option Revenue Act of 1969, the city of Omaha began levying a local sales tax in November of that year. By January 1, 1992, 44 other municipalities had joined Omaha in levying such a tax. Unlike some of the other 29 states with a local option sales tax, Nebraska's is authorized strictly for municipalities, not other local units of government. In addition, voters within a municipality must approve a local sales tax before it can be implemented.

The Sales Tax Base

Nebraska sales and use taxes, including local option taxes, apply to the following items:

- most items bought in retail stores;
- fuel, electricity and water used in the home (and in 1991, fuel and electricity used by businesses and power companies, with a $100,000 limit for businesses);
- restaurant meals;
- hotel and motel rooms;
- machinery, equipment and repairs bought by farm and non-farm business and industrial firms;
- assembly and production labor;
- repair labor not separately stated;
- gross receipts from admissions;
- certain portions of advertising service;
- computer software consulting fees that result in the modification of software.

Notably excluded from the list are most food products and prescription drugs. The latter never have been taxed in Nebraska, but food purchased for home consumption was taxed (albeit with a food sales tax credit allowed on the individual income tax return) until 1983, at which time the Legislature exempted any food product eligible for purchase with food stamps. This provision applies whether or not the retailer from which the food is purchased participates in the food stamp program. Foods exempted from the sales tax do not include those sold through vending machines, or meals prepared by retailers.

In general, despite some exceptions in the list above, services also are excluded from general sales and use taxes. For example, services performed by physicians, auto mechanics and cosmetologists are not subject to the tax. However, most products used in the performance of a service (e.g., auto repairs) are subject to the tax.

Other exemptions from general sales and use taxes fall in one of four categories:

1. **Certain sellers** -- meals and food items sold by schools and churches and their related organizations, unless open to the general public; meals, food products and rooms provided to patients in hospitals and inmates of public institutions.
2. **Certain property** -- motor fuels (subject to an excise tax); daily and weekly newspapers.
3. **Certain purchasers** -- federal, state and local government purchases, as well as those by schools, hospitals, orphanages, religious organizations and similar agencies.
4. **Producer goods** -- items that become an ingredient or component part of products made for ultimate sale at retail, such as livestock and poultry feed, and fertilizer and seeds. These products are excluded in an effort to avoid double taxation.

The breadth of a tax base is important because it determines how much revenue can be raised with a given sales tax levy. A given amount of revenue can be raised with a lower levy on a broad sales base than can be raised if the base is more narrowly defined.

Sales Tax Rates

The Nebraska Legislature is responsible for determining state sales and use tax rates (as it does the base). In general, sales and use tax rates are a function not only of the base, but the state general fund budget and alternative revenue sources for the general fund.

(The Legislature is required to plan for revenues large enough to cover expenditures fully and leave at least a three percent budget reserve at the end of the two-year budget cycle.)

Initially, the state sales and use tax rate in Nebraska was 2 1/2 percent. As in many other states, however, the rate has had to be adjusted upward a number of times to meet revenue needs. In July 1990, the tax rate was raised to five percent. This amounted to a full percentage point increase as the state assumed greater responsibility for funding elementary and secondary schools.

Municipal tax rates may be set at one of three levels: 1/2, 1 or 1 1/2 percent. The base is the same as for the state sales and use tax. Retailers collect municipal sales taxes along with state sales taxes and submit receipts to the Nebraska Department of Revenue. Later, the municipality's share is returned to the city or village in which it was collected, minus a small processing fee.

Administration and Collection of Sales and Use Taxes

Sales taxes are collected from consumers by retailers doing business in the state. Each retailer, in turn, must obtain a permit from the Nebraska Department of Revenue, keep appropriate records and remit taxes collected each month. If the volume of tax collected is below a set minimum, it may be remitted quarterly or, in the case of seasonal businesses, annually.

Traditionally, the retailer has been allowed to keep three percent of sales tax receipts to cover collection costs. In 1991, the retailer's fee was reduced, at least temporarily, to 1 1/2 percent.

Sales taxes on motor vehicles are handled differently in that the buyer pays the tax to the county treasurer when applying for vehicle registration. In this case the county treasurer, not the retailer, has responsibility for remitting sales tax collections to state government.

Use taxes are easily collected on motor vehicles because Nebraska residents who purchase vehicles out of state cannot obtain a registration on the vehicle without paying the use tax. However, administration and collection of use taxes on other items presents a much greater challenge for revenue officials.

Buyers may pay the Nebraska use tax to out-of-state retailers who are willing to remit the tax to the Nebraska Department of Revenue; otherwise, the buyer is required to pay the tax directly to the Department of Revenue. Many use tax obligations go undetected and unpaid, not an insignificant problem for Nebraska and most other states with use taxes.

Sales taxes imposed by other states may be used to offset the Nebraska use tax when a receipt of payment is obtained.

Sales and Use Taxes as a Revenue Source

In FY 1991, net receipts for the general fund from general sales and use taxes totaled $547.3 million (*Table I*). This was an increase of about $103 million over the previous fiscal year, largely because of a 25 percent increase in the general sales and use tax rate for FY 1991. The proportion of general fund revenues represented by sales and use taxes also inched up to 40 percent for FY 1991.

Table I. Net receipts from state general sales and use taxes, selected fiscal years.

Fiscal year	Millions of Dollars	As a percent of all receipts state general fund
1970	61.6	34
1980	219.4	35
1990	444.2	39
1991	547.3	40

Source: Unpublished data, Nebraska Legislative Fiscal Office.

In FY 1991, municipalities generated $103.3 million from the local option sales tax (*Table II*). This amounted to about one-third of all taxes generated from their own sources. Most of the remainder came from property taxes.

Table II. City sales taxes returned to municipalities, selected years.

Fiscal year	Millions of Dollars	No. of participating cities
1970	2.7	2
1980	40.9	7
1990	94.8	35
1991	103.3	44

Source: Unpublished data, Nebraska Department of Revenue.

The role played by local option sales taxes is especially significant in Nebraska's two largest cities, Omaha and Lincoln. About 85 percent of all municipal sales taxes generated in Nebraska in FY 1988 were for Omaha and Lincoln. For both cities, sales tax levies now finance a larger portion of the annual budget than property taxes.

The number of municipalities levying the local sales tax increased from 25 on October 1, 1988 to 45 on January 1, 1992. Several municipalities also have either increased their tax rates or sought to do so. In total, it is an indication of the increasing importance of local option sales taxes in the state.

Until FY 1991, general sales and use taxes for state and municipal governments in Nebraska were generally less than for adjacent states and the average of all states. In FY 1988, for example, only Iowa collected less among the adjacent states, both on a per capita basis and as a percentage of personal income (*Table III*). However, the state rate increase in July 1990 likely will push Nebraska higher in both regional and national rankings when complete data for FY 1991 and subsequent years become available.

Table III. General sales and use taxes collected, per capita and as a percentage of total receipts, FY 1988, selected states.[1]

State	General sales tax per capita	As a percentage of personal income
Nebraska	326	2.33
Colorado	435	2.78
Iowa	306	2.19
Kansas	397	2.65
Missouri	437	3.01
South Dakota	458	3.71
Wyoming	395	3.01
U.S. AVERAGE	428	2.79

[1]Includes collections for both state and local governments.
Source: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1990 Edition.

Sales and Use Tax Critique

Sales and use taxes fall short of meeting either of the two most frequently cited standards of tax equity--ability to pay or benefits received.

With respect to ability to pay, some sales tax proponents argue that the ultimate measure of a person's income is what that person consumes. This argument overlooks the reality that consumers pay the same percentage in sales and use taxes for a given purchased item, regardless of their respective incomes. The tax paid amounts to a smaller relative percentage of income for a high-income person than for a person with a lower income. In broadest terms, sales taxes are regressive.

Regressivity is reduced in Nebraska by excluding most retail food items and prescription medicines from sales taxes. These tend to be areas where low- and moderate-income consumers spend a higher proportion of their incomes than those with the highest incomes. However, this does not offset greater spending on services and investments--thus avoiding sales taxes--by those with higher incomes.

When all factors are taken into consideration, a 1991 study by the Nebraska Tax Research Foundation found that Nebraska taxpayers with an annual income under $13,000 incurred average sales tax obligations amounting to 3.88 percent of income in 1988. Reductions in tax obligations occurred for successively higher income classes. Those with incomes over $50,000 paid sales and use taxes that averaged 1.37 percent of income.

The benefits-received principle suggests that those who receive benefits from the public sector should pay in proportion to benefits received. State sales taxes paid on motor vehicles meet this standard quite well because all such revenues go directly to roads, streets and highways. The thinking is that if you purchase a motor vehicle and pay the sales tax, you need the "benefit" of adequate roads, streets and highways.

For other items, such as clothing and utilities used in the home, the relationship between sales taxes levied and public benefits received is less clear. Sometimes it is argued that those who make large purchases in the private sector, e.g., to support a large family, are more likely to need the benefits of the public sector and therefore sales taxes can be justified on a benefits-received basis. The linkage is tenuous. Too many exceptions exist to make the argument convincing.

A more direct argument is that everyone should pay some taxes, even if the two fundamental principles of tax equity must be at least partially set aside. A general sales and use tax makes sense under that pretense because it is sure to tap virtually every citizen, including those who do not pay property or income taxes.

Another point made by sales tax proponents is that the tax yield is more stable than from income taxes (or even the property tax in an economic depression such as the 1930s). It is paid bit by bit as consumers make purchases. Even in the worst of times consumers will need to make some purchases (and pay sales taxes), no matter how limited their income may be. In tax parlance, it also is convenient because there is no specified time during the year that a large payment must be made.

From the standpoint of state government, the sales tax is relatively easy to administer. Most of the collection effort is assigned to retailers who make sales, although administrative support and monitoring are essential. Local sales taxes probably could not be effectively and efficiently administered in most municipalities without piggy-backing on the state system.

State government and municipalities must be aware that sales taxes are not as "revenue elastic" as income taxes. This means sales tax receipts do not go up as quickly as income tax receipts as incomes move higher. Two factors are involved:

1. All additional income is taxed with an income tax; a sales tax captures only that portion of increased income spent on taxable items.
2. Higher incomes may push additional income into higher income tax rate brackets.

The relative lack of revenue elasticity has potential political implications for policy makers who must make upward adjustments in sales tax rates to meet expanding revenue needs. An alternative is to expand the base, although this may be equally undesirable.

One possibility for base expansion is to subject food to sales taxes. In October 1991, estimates were that this would have generated an additional $131 million. However, to reduce regressivity, an income tax credit might be allowed in much the same manner as existed prior to 1983. Such a credit could significantly reduce the net increase in revenue.

Another possibility is to extend sales taxes to services. This could increase state revenues by up to $150 million annually (based on 1991 estimated expenditures for services and a five percent sales tax rate) if all services except those for medical care were taxed. This may reduce the regressivity of the sales tax. Generally, it's thought that upper income taxpayers use legal, architectural, accounting, investing and cleaning services more than lower income taxpayers.

Finally, it is sometimes suggested that the sales tax base should be expanded by levying taxes not just at the retail level, but at the manufacturing level, as well. Opponents argue, often vociferously, that to do so would burden Nebraska's manufacturing sector compared with competitors outside the state. In addition, complications may arise concerning interstate commerce. This may not be a practical alternative for generating more revenue at the present time.

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