State and Local Taxes Are Only Half the Problem

By Dick Clark

High taxes make Nebraska less competitive than it ought to be both regionally and nationally. In the Tax Foundation's 2014 State Business Tax Climate Index, Nebraska ranked an abysmal thirty-four.[1] Nebraska's high level of taxation has driven away workers representing billions of dollars in income,[2] and despite modest tax reforms in the 2014 legislative session[3] that high tax burden continues to hamper Nebraska's ability to grow a more prosperous, productive economy.[4] That is why the Platte Institute has introduced the *Strong Roots Nebraska* plan for tax relief in Nebraska.[5]

But while state and local taxes represent a significant expense for Nebraska taxpayers, they are only half of the problem. That means that state and local tax relief are only half of the solution. Across the country, state taxes will total $1.6 trillion in 2014. Local taxes will add another $1.1 trillion. But the taxes collected by the federal government exceed all state and local government taxes combined, with 2014 direct revenues to the federal government estimated at $3 trillion.[6] All this taxation supports spending at all levels of government that in recent years has exceeded 40 percent of the national gross domestic product (GDP).[7]

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[1] Drenkard, Scott and Joseph Henchman. "2014 State Business Tax Climate Index." Tax Foundation. October 9, 2013. [URL: http://taxfoundation.org/article/2014-state-business-tax-climate-index]

[2] "State Taxation and Migration." Platte Institute for Economic Research. January 15, 2014. [URL: http://www.platteinstitute.org/research/detail/state-taxation-and-migration]

[3] Clark, Dick. "Legislative Update: Achievements and Room for Improvement on Taxes and Spending." Platte Institute for Economic Research. April 1, 2014. [URL: http://www.platteinstitute.org/research/detail/legislative-update-achievements-and-room-for-improvement-on-taxes-and-spending]

[4] Clark, Dick. "Coming Up Short in the Rankings: Why Nebraska Should Care." Platte Institute for Economic Research. April 22, 2014. [URL: http://www.platteinstitute.org/research/detail/coming-up-short-in-the-rankings-why-nebraska-should-care]

[5] Clark, Dick. "Building Strong Roots for Nebraska." Platte Institute for Economic Research. September 22, 2014. [URL: http://www.platteinstitute.org/research/detail/building-strong-roots-for-nebraska]

[6] "Total Government Revenue in the United States: 2014." USGovernmentRevenue.com. [URL: http://www.usgovernmentrevenue.com/total_2014USrt_15rs1n]

[7] Clark, Dick. "State and Local Spending versus Economic Growth." Platte Institute for Economic Research. July 23, 2014. [URL: http://www.platteinstitute.org/research/detail/state-and-local-spending-versus-economic-growth]

Federal taxes come in many flavors, but the principal source of direct revenues to the federal government is the personal income tax, which accounts for 47 percent of the total. The second biggest category of federal tax is that of payroll taxes, coming in at 34 percent. Corporate income tax places a distant third at 10 percent, with the federal estate tax and various excise taxes making up the remainder.[8]

Early proponents of income taxation publicly represented it as a means for making the rich bear more of the costs of government services. However, the new federal taxing power legalized by adoption of the Sixteenth Amendment in 1913 was quickly brought to bear on taxpayers who could not seriously be characterized as wealthy. Payroll taxes, the second biggest source of federal tax revenue today, are typically characterized as being borne by employers. However, the cost of employment — whether allocated by the employer to wages or taxes — is necessarily limited by the productivity contributed by the worker to the enterprise. This means that payroll taxes must ultimately diminish the earnings of rank-and-file workers, not just employers and corporations.

Similarly, the corporate income tax, while not paid directly by workers, slows gains in worker productivity and wages. By taxing business income at a high rate, government causes fewer resources to be available to enterprises for capital investments in technology that could make each worker more valuable. This ensures that the weight of federal government spending remains squarely on the shoulders of workers and employers alike, and prevents more rapid gains in standards of living for those who need them most.

As writer Frank Chodorov observed in 1954,

> "At first it was the incomes of corporations, then of rich citizens, then of well-provided widows and opulent workers, and finally the wealth of housemaids and the tips of waitresses…. The national pay envelope contains more money than the combined treasuries of all the corporations of the country. The government could not for long overlook this rich mine."[9]

By the time that Chodorov penned those words, forty years had passed since the adoption of the Sixteenth Amendment. During that time, the federal government's reliance on personal income taxes for funding grew from approximately five percent of direct revenues[10] to more than 40 percent by 1954.[11] The expansion of the federal government's reliance on personal income tax has tracked a similarly explosive expansion in federal government spending. Federal spending in the early days of the Republic was typically less than two percent of GDP except during wartime. After the unprecedented costs and devastation of the Civil War, government

[8] "Policy Basics: Where Do Federal Tax Revenues Come From?" Center on Budget and Policy Priorities. March 31, 2014. [URL: http://www.cbpp.org/cms/?fa=view&id=3822]
[9] Chodorov, Frank. *Income Tax: Root of all Evil.* Devin-Adair. 1954.
[10] United States Census Bureau.
[11] "Federal Tax Revenue by Source, 1934 - 2018." Tax Foundation. November 21, 2013. [URL: http://taxfoundation.org/article/federal-tax-revenue-source-1934-2018]

spending still returned to low single digits as a percentage of GDP within less than a decade.[12] Even after World War I, with a permanent federal income tax already in place, spending declined from a high of almost a quarter of GDP to below four percent in the 1920s. But as the government came to increasingly rely on income taxation as its principal revenue source, federal spending more than doubled as a percentage of GDP, going from 4.29 percent in 1930 to more than 10 percent by 1935.[13] Not just a symptom of the federal response to the Great Depression, this trend continued in the decades to follow, leading to federal spending that has more recently ranged from 20 to 25 percent of GDP.[14]

Federal government spending in 2014 is projected to exceed $3.65 trillion dollars.[15] Those dollars are directed to numerous purposes, but this spending is largely funneled into just a few major programs. As of 2012, nearly 22 percent of federal outlays were for Social Security. Over 19 percent were for defense, with Medicare and other health spending exceeding 23 percent. Medicare is also the fastest-growing area of major federal spending, increasing by more than 63 percent between 2002 and 2012.[16] Six percent of federal spending is consumed by interest payments on the national debt.[17]

All this federal spending and the taxes that support it create tremendous opportunity costs in terms economic and workforce development and ultimately global competitiveness. Despite being a beacon to the world of the prosperity brought about by freedom and innovation, the United States has greatly declined in its ability to compete economically with other nations. In the 2014 International Tax Competitiveness Index, the collective American tax burden landed the United States the number thirty-two spot. The US trails behind countries from all over Europe, Asia, Oceania, and South America with less financially voracious governments, including many such as New Zealand which have recently enacted tax relief measures in order to enable sustainable economic growth.[18]

The *Strong Roots Nebraska* plan urges state policymakers to reduce Nebraska's state and local taxes in order to grow Nebraska's economy and better compete with neighboring states. But policymakers working in Washington, D.C. must also engage the problem of excessive government spending and the destructive taxation that pays for it. Setting a course for relief

[12] "US Federal Spending since the Founding." USGovernmentRevenue.com. [URL: http://www.usgovernmentspending.com/federal_spending_chart]
[13] *Ibid.*
[14] *Ibid.*
[15] *Ibid.*
[16] Boccia, Romina, Alison Acosta Fraser, and Emily Goff. "Federal Spending by the Numbers, 2013: Government Spending Trends in Graphics, Tables, and Key Points." Heritage Foundation. Special Report #140. 2013. [URL: http://www.heritage.org/research/reports/2013/08/federal-spending-by-the-numbers-2013]
[17] *Ibid.*
[18] Pomerlau, Kyle and Andrew Lundeen. "2014 International Tax Competitiveness Index." Tax Foundation. September 15, 2014. [URL: http://taxfoundation.org/article/2014-international-tax-competitiveness-index]

from harmful federal income taxes is the only way to ensure that the American Dream can still be a reality for generations to come.