Tax Reform Bill Moving in Nebraska Legislature

By Scott Drenkard of the Tax Foundation

In October of 2013, in partnership with the Platte Institute, Joe Henchman and I authored a policy study titled Building on Success: A Guide to Fair, Simple, Pro-Growth Tax Reform for Nebraska. Our goal was to get the conversation started on sound tax reform ideas in Nebraska, and this last week that conversation percolated up in the Revenue Committee. The big bill to be watching is L.B. 1097, which would reduce Nebraska's corporate and individual income tax rates and index the individual income tax for inflation. Platte CEO Jim Vokal and I testified on the bill, which we argued would result in greater economic growth and a more prosperous Nebraska.

One major provision of the bill is a reduction of the top corporate income tax rate from 7.81 to 5.9 percent by 2017. A 5.9 percent corporate income tax would make Nebraska competitive with more of its neighbors: Colorado, Missouri, and Kansas all currently have lower rates, and South Dakota and Wyoming do not levy corporate income taxes at all.

More importantly though, corporate income taxes are generally found to be among the most harmful taxes to economic growth. The economic literature that distinguishes between types of taxes provides very compelling evidence that corporate income taxes hurt economic growth most, followed by personal income taxes, then sales taxes, and finally property taxes.

Add to this the fact that corporate income taxes represented just 2 percent of Nebraska state and local collections in 2011, and in many ways corporate tax reduction is a high "bang for your buck" strategy to increase growth without costing the government a lot of revenue.

Further, economists agree that corporate income taxes are not even borne by corporations themselves. While corporations cut the check to the department of revenue, the tax burden is actually passed on in one of three ways: to consumers in the form of higher prices, to workers in the form of lower wages, and to shareholders in the form of lower dividends.

Another element of L.B. 1097 lowers the top individual income tax rate from 6.84 percent to 5.9 percent by 2017. The bill cuts taxes on the lowest bracket immediately and then phases in reductions to the upper brackets. These upper brackets are often what matters most to business activity. It's important to remember that many businesses file through the individual code rather than the corporate code. In fact, nationwide, roughly half of all business income is filed through the individual income tax code, so these individual income tax cuts will work in concert with the corporate rate cut to promote job growth and a more attractive business locale.

In the economic literature, excessive taxes on income are found to discourage wealth creation. In a study of major articles on taxes and growth, a 2012 Tax Foundation report found personal income taxes are among the most destructive to growth, being outdone only by corporate income taxes.

For example, a 2011 OECD study by Arnold et al. found that reductions in the top marginal rate of individual income taxes raises productivity growth. Examining the period of 1969 to 1986, Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the principle of broad bases and low rates.

Reducing these rates will not only improve Nebraska's standing against other states, it will improve the well-being of Nebraskans today.

Finally, the proposal to inflation-index Nebraska's income tax brackets protects taxpayers against automatic tax increases that currently occur each year without a legislative vote. Without this vital measure, taxpayers will see more and more of their income subject to higher brackets of taxation as inflation increases wages on paper but not in purchasing power. This is one area where even the federal government has it right; the federal income tax has been adjusted for inflation every year for the last three decades.

One of the concerns of committee was that cutting rates too quickly would result in revenue streams drying up. This is a legitimate concern, but not an excuse to punt on tax reform.

An easy fix to assuage these concerns is to enact automatic rate cuts for future years that are based on the balance of the state's surplus or rainy day fund. Perhaps the most reasonable standard is to go forward with cuts if revenue is increasing above the rate of inflation plus population growth. West Virginia has been phasing down its corporate income tax using a revenue trigger method for the last 3 years, and North Carolina employed this method during their hallmark tax reform in the 2013 session. Because the cuts are contingent on stable revenue growth, this allows policymakers to make the state more competitive without fear of harming revenue streams.

In the end, tax reform is about crafting policy that is simple, neutral, and pro-growth. Regardless of what the unicameral settles on, Nebraska is ripe for reform and ultimately, income tax reform will lead to a more competitive state.