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TESTIMONY

RECOMMENDATIONS FOR TAX REFORM IN NEBRASKA

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Nebraska Revenue Committee
Hearing on LB452 — Impose sales tax on services and change income tax rates and personal exemption amounts

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Mr. Chairman and members of the committee, thank you for accepting my testimony on the features of economically sound tax policy. My name is Adam Millsap, and I am a research fellow at the Mercatus Center at George Mason University, where I study state and local public policy. My message today is that tax policy that is economically efficient and promotes economic growth has two important features: (1) low rates and (2) a broad tax base with few exemptions or deductions.[1]

In combination, these features reduce the number of tax-related distortions in the economy and maximize the amount of resources left in the hands of taxpayers, while still raising adequate revenue for government functions. They also reduce compliance costs, which are the costs associated with following the law. Reducing the amount of deductions and exemptions reduces the time and effort needed to sort through them to ensure compliance. A simple tax code also means less effort needs to be expended monitoring year-to-year changes in brackets and allowable deductions and exemptions.

Two common taxes are the income tax and the sales tax. Income taxes distort people's choice of how much to work by reducing the benefits of work. Low marginal income tax rates reduce this distortion. Limiting deductions and exemptions also allows rates to be lower by broadening the tax base. Keeping tax rates low is important because research shows that states that raise their income tax rates more than neighboring states experience slower income growth.[2]

1. Adam Millsap and Olivia Gonzalez, "State and Local Tax Policy," Economic Perspectives, Mercatus Center at George Mason University, January 2016.
2. Randall G. Holcombe and Donald J. Lacombe, "The Effect of State Income Taxation on Per Capita Income Growth," *Public Finance Review* 32, no. 3 (2004): 292–312.

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Numerous income tax brackets increase the complexity of the tax code and deter additional work near each bracket threshold since any additional income is subject to a higher tax rate than previous income. The more brackets there are, the more often workers confront changes in the incentive to work. Reducing the number of brackets encourages more work across the income distribution. Some progressivity in the tax code may be desirable, but it should be achieved with as few brackets as possible.

In addition to the income tax, a sales tax is a common way for governments to raise revenue. A sales tax is a tax on consumption; thus it discourages consumption and encourages saving. More saving means more investment and ultimately more economic growth. Alternatively, the income tax's main flaw is that it discourages work and production. This is why many economists prefer a comprehensive consumption tax over an income tax as a means of generating revenue.

However, a sales tax also has drawbacks, the primary one being that in its most common and basic form it is regressive. Since lower-income people spend a larger fraction of their income than higher-income people, a sales tax imposes a relatively larger burden on those with lower incomes. This undesirable feature can be mitigated by applying the sales tax to a broad base that includes both goods and services.

Applying a sales tax to all final goods and services allows the rate to be lower for a given revenue target, which reduces the burden on all consumers.[3] A broad base also reduces the tax's regressiveness, since higher-income people spend a larger amount of their income on services than lower-income people. If only goods are taxed, a sizeable portion of consumer spending, especially by higher-income people, will be unfairly exempt from taxation.

Product-specific sales taxes, commonly referred to as "sin taxes," are especially egregious since they are routinely applied to goods disproportionately consumed by lower-income people. The limited scope of sin taxes creates large welfare losses as consumers expend time and effort seeking tax-free alternatives.[4] They also invite lobbying from various interests, both for and against them, which wastes resources in a process called rent-seeking.[5] Product-specific or industry-specific sales taxes should be avoided for the above reasons.

Efficient and effective tax policy should have low rates that are applied to broad bases. Together, low rates and a broad base reduce distortions, decrease compliance costs, and ensure that the tax burden is shared equitably by all taxpayers.

3. Thomas Stratmann, "More Sales Tax Exemptions, Higher Sales Tax Rates," Mercatus Center at George Mason University, September 17, 2014.
4. Adam J. Hoffer, William F. Shughart, and Michael D. Thomas, "Sin Taxes and Sindustry: Revenue, Paternalism, and Political Interest," *Independent Review* 19, no. 1 (2014): 47–64.
5. Richard Williams and Katelyn Christ, "Taxing Sin" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, July 2009).