

# Governing Nebraska's Fiscal Commons: Addressing the Budgetary Squeeze

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## ABSTRACT

Nebraska is in a sound fiscal position compared to other states, but this situation is not likely to last. States are being asked to do more by both the local and federal levels of government, and the resulting budgetary squeeze needs to be addressed. States set budgets over short horizons, but these plans have lasting implications. Considering the task of writing a budget as budgetary commons highlights the need for clear priorities. At the same time, states' ability to raise revenue is being constrained by changing demographics, for example, retirement of the baby boomers. Unless states like Nebraska set their own priorities and reform large budget items such as education and pensions, the budget situation will get worse, even for states that currently show few signs of distress.

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**N**ebraska is in an enviable position relative to the other states in this country. Consider, for example, fiscal solvency: using data reported in the comprehensive annual financial reports of the 50 states and Puerto Rico, Eileen Norcross and Olivia Gonzalez show that Nebraska is performing among the top five states in 14 different categories important for fiscal solvency.<sup>1</sup> Nebraska is in a stronger long-term position thanks to both the state’s favorable budget situation and its economic prospects.<sup>2</sup> This good news is also borne out by Nebraska’s experience following the 2008 financial crisis. Nebraska had a less severe recession than other states because it was less exposed to bank failures and the bursting of the housing bubble.<sup>3</sup> The state also recovered from the slump more quickly than other states did. Standard economic indicators are favorable too; for example, unemployment is low at 3 percent.<sup>4</sup>

All these facts show that Nebraska’s prospects are favorable. But the state also faces underlying structural problems at both the state and local levels because of responsibility shifts between federal, state, and local authorities in the last 60 years, a situation that has resulted in more regulation. In fact, Nebraska faces a regulatory burden that is 26 percent higher than the US

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1. Eileen Norcross, “Ranking the States by Fiscal Condition” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2015); Eileen Norcross and Olivia Gonzalez, “Ranking the States by Fiscal Condition,” 2016 edition (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, June 2016).

2. In part, Nebraska’s enviable situation is due to its habit of putting budget surplus into a rainy-day fund. Georgia also does this, while other states put only a portion of their surplus into rainy-day funds. Pew Charitable Trusts, *Building State Rainy Day Funds*, July 2014.

3. Nebraska had three banks fail after 2008, one of which had more than \$1 billion in assets. Twenty-seven states had more bank failures and nineteen states had fewer bank failures, including nine states in which no banks failed. The worst case was Georgia, with 87 bank failures. “Map of Banks Failed since 2008,” Portal Seven, accessed January 26, 2017, [http://portalseven.com/banks/Failed\\_Banks\\_Map\\_Since\\_2008.jsp](http://portalseven.com/banks/Failed_Banks_Map_Since_2008.jsp).

4. Nebraska Department of Labor, accessed August 9, 2016, <https://dol.nebraska.gov>.

“Nebraska’s rosy outlook could become bleak . . . if trends in state budgeting continue and Nebraska adopts policies similar to those of other states.”

average.<sup>5</sup> Nebraska is a great case to consider for its state-level fiscal prospects owing to the relative transparency of state finances, its unicameral legislature, and its low corruption score.<sup>6</sup> Nebraska’s rosy outlook could become bleak, however, if trends in state budgeting continue and Nebraska adopts policies similar to those of other states—policies that caused the budgetary squeeze in other states (and which will be discussed below).

Each state faces its own economic circumstances. Nebraska lies comfortably in the middle of the pack on many per capita measures of well-being.<sup>7</sup> Unlike North Dakota or Alaska, Nebraska does not have the advantage of rich deposits of natural resources; therefore it does not get tax revenue from extraction or licensing to supplement other sources of state revenue.<sup>8</sup> But nor does Nebraska have the chronic problems that states like Illinois and New Jersey have with their budgets. As one report states, “Illinois has the worst unfunded pension liability of any state, an estimated \$85 billion.”<sup>9</sup> New Jersey suffered a greater decrease in economic activity in the last recession because of the state’s close economic links to Wall Street. But these developments only intensified 20 years of structural deficits, indicating a much deeper problem.<sup>10</sup> These economic realities have a

5. Patrick A. McLaughlin and Oliver Sherouse, *The Impact of Federal Regulation on the 50 States*, 2016 edition (Arlington, VA: Mercatus Center at George Mason University, 2016).

6. Kim Robak, “The Nebraska Unicameral and Its Lasting Benefits,” *Nebraska Law Review* 76, no. 4 (1997); Cheol Lui and John L. Mikesell, “The Impact of Public Officials’ Corruption on the Size and Allocation of US State Spending,” *Public Administration Review* 74, no. 3 (2014).

7. Russell S. Sobel, “Removing Barriers in Nebraska, Part One: Why Growing Nebraska Matters,” Platte Institute for Economic Research, 2016.

8. I am ignoring temporarily the idea of the resource curse, which would predict that these states are less likely to develop industry in areas unrelated to natural-resource extraction. For more on this topic at the country level, see Halvor Mehlum, Karl Moene, and Ragnar Torvik, “Institutions and the Resource Curse,” *Economic Journal* 116, no. 508 (2006).

9. State Budget Crisis Task Force, *Report of the State Budget Crisis Task Force: Illinois Report*, October 2012.

10. Eileen Norcross and Frederic Sautet, “Institutions Matter: Can New Jersey Reverse Course?” (Working Paper 09-30, Mercatus Center at George Mason University, Arlington, VA, July 2009).

lasting impact on state politics, and states like New Jersey and Illinois contrast with states like Nebraska that have historically avoided such fiscal irresponsibility through constraints on the complexity of their budgets.

This paper focuses on the trends that many states, including Nebraska, are facing as they write budgets for the next few years. Paying for schools, health care, and pension funds—to name only a few of the growing spending obligations—will strain states’ ability to tax enough to cover them. Whereas in the past the federal government has been a supplementary source of funding, it is now uncertain whether the federal budget will continue to aid state programs. States will need to either reform their budgets or continue to raise taxes as a proportion of income.<sup>11</sup> This decision could be game-changing for state budgets as well as for the practice of federalism in general.

To analyze the problem of a fiscal commons, policymakers and researchers need to be aware of how both economic issues and broad social changes affect politicians’ incentives. An emerging literature called institutional public finance seeks to bridge the gap between dynamic models and traditional static models of policymaking. This paper uses institutional public finance to identify strategies for addressing the looming budget crisis. Through a concept called the squeeze, section 1 outlines the pressure Nebraska and other states face as local and federal governments add more responsibility to and remove discretion from the state legislatures. Section 2 details the transferal of responsibility from the local to state level of government. Section 3 discusses problems created by the federal transferal of funds to states when they come with mandates about how to carry out those duties. Section 4 discusses possible avenues for reform, and the last section concludes.

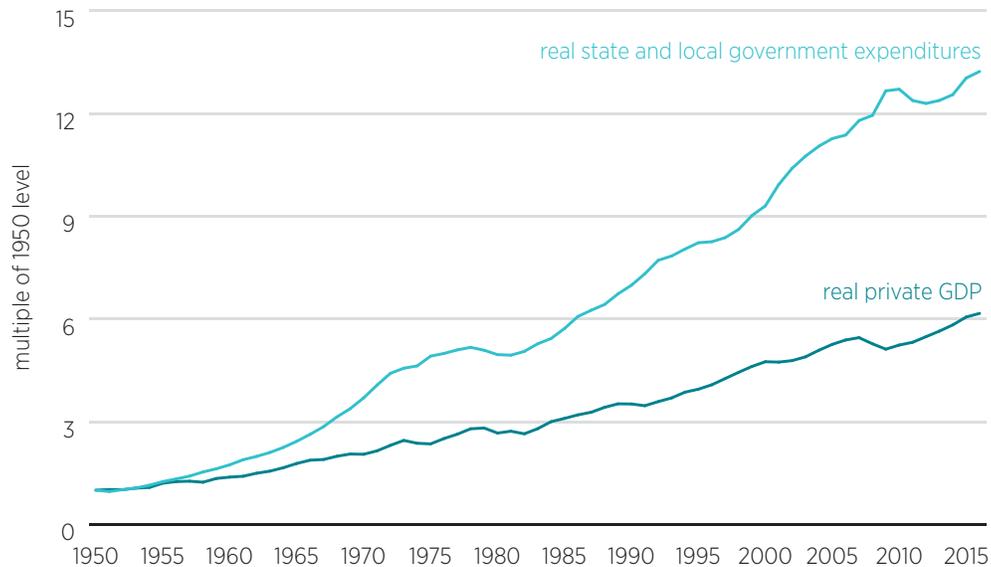
## 1. THE SQUEEZE DEFINED

This paper focuses on one particular application of public finance in Nebraska, but every state is facing budgetary pressures as part of a larger phenomenon that I refer to as the squeeze. Each of the three levels of government—local, state, and federal—has its own means of collecting revenue and setting spending priorities. To be effective, governments select priorities from an unlimited set. From 1867 to the present, local governments’ percentage of total government spending has decreased because federal and state spending has grown at a faster pace than

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11. Jared Walczak gives one example of reform, concluding that Nebraska should expand the tax base and lower the rates in order to retain revenue neutrality and promote growth. Jared Walczak, “A Twenty-First Century Tax Code for Nebraska,” Tax Foundation, August 18, 2016.

FIGURE 1. STATE AND LOCAL SPENDING VS. PRIVATE GDP, 1950–2016



Source: Matthew D. Mitchell, “State and Local Governments Outpace Growth of Private Sector,” Mercatus Center at George Mason University, June 11, 2012, using data from the Bureau of Economic Analysis.

local spending. Matthew Mitchell points to a sixfold growth in private-sector output since 1950,<sup>12</sup> but over that same time, state and local governments have grown by 13 times (see figure 1).

The first side of the squeeze comes from the shifting of responsibilities from local to state budgets. Since the mid-20th century, there has been a general push by the states to shift responsibility for revenue collection and spending from local government to the state level. Nebraska started this push in 1968 with a major change in taxing and spending.<sup>13</sup> The second side of the squeeze is the federal influence on state policy. This influence is the result of increased spending by the federal government on projects in each state that come with restrictions on how each state can manage these partially funded projects. This bargain of adopting federal priorities and receiving some funding accumulates a regulatory burden over time that limits the states’ ability to determine their

12. Matthew D. Mitchell, “State and Local Governments Outpace Growth of Private Sector,” Mercatus Center at George Mason University, June 11, 2012.

13. Walczak details the election of 1967 and the reform of Nebraska’s tax codes that followed. Walczak, “Twenty-First Century Tax Code for Nebraska.”

own priorities. Thus, the squeeze is produced by the simultaneous shift of local government responsibility for things like school funding to the state level and the increased oversight represented by federal mandates for the execution of state-administered programs.

Federal spending on things like infrastructure—for example, bridges and water pipes—is declining, as the American Society of Civil Engineers has pointed out in many of its past reports.<sup>14</sup> This decline is evidence that infrastructure spending is not as high a priority in the budget as other items, such as health care. Crises such as the one exposed in Flint, Michigan, in 2015 highlight the serious problems of failing infrastructure—in that case, failure to provide proper maintenance of water pipes.<sup>15</sup> Governments are squeezed, and political rhetoric offers only a choice to cut spending or increase taxes. A third alternative would be to set legislative priorities and focus on those priorities that can be done well. This approach requires thinking of state budgets as a common resource that must be well managed in order to be run efficiently.

By focusing on Nebraska, we can see how one state is experiencing this trend toward a fiscal tragedy of the commons. Nebraska also provides strategies that might help to eliminate the collective-action problem that prevents setting achievable priorities. It is important to first establish the trend before proceeding to the recommendations. Using George Mason University professor of economics Richard Wagner’s framework of institutional public finance, we can think about static and dynamic elements of public finance over time.<sup>16</sup> Wagner points out that public policy is excessively short-run oriented and leads to predictable pathologies on the “fiscal commons,”<sup>17</sup> discussed below.

One reason Nebraska’s government spending was constrained in the past was that the state had to fund all expenditures from a state property tax. Having a single source of government revenue provided clarity, and accountability acted as a disciplinary mechanism. Stanford University professor of political science Barry Weingast points to elements of federalism that preserved market institutions between state and federal governments by limiting the scope of government

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14. American Society of Civil Engineers, *2013 Report Card for America’s Infrastructure*, 2013.

15. Flint, Michigan, lead levels were extremely high; some reports noted that the measured levels had doubled. Yanan Wang, “In Flint, Mich., There’s So Much Lead in Children’s Blood That a State of Emergency Is Declared,” *Washington Post*, December 15, 2015.

16. Richard E. Wagner, *Deficits, Debt, and Democracy: Wrestling with Tragedy on the Fiscal Commons* (Cheltenham, UK: Edward Elgar, 2012). For a discussion of dynamic approaches to budgeting, see also Peter Bluestone and Carolyn Bourdeaux, *Dynamic Revenue Analysis: Experience of the States*, Center for State and Local Finance, Georgia State University, April 21, 2015.

17. Wagner, *Deficits, Debt, and Democracy*.

through firm rules.<sup>18</sup> This discipline can also apply to the relationship between state and local governments. Through much of Nebraska’s history, a straightforward fiscal model provided a strong constraint on revenue collection and spending. A two-tier property-tax scheme at the state and local levels divided spending priorities between these two sources of revenue. It also provided a clear limit that prevented the state from taking on tasks that were local in nature.

This constraint was broken, however, as the state took on more responsibilities and expanded its ability to tax by instituting an income tax and a sales tax. In the middle of the 20th century, concerns about equity—at both the federal and state levels—created revenue and spending models that put the budget on an unsustainable path. The next two sections define the two parts of the squeeze in more detail.

## 2. LOCAL TO STATE: THE FIRST PART OF THE SQUEEZE

From the very beginning of statehood, Nebraska placed a strong constraint on revenue and therefore on spending. A local property tax paid for things like schools and police, and a state property tax provided funds to operate the state government. To borrow from Wagner’s framework, this simplistic approach was useful in terms of disciplining the fiscal commons.<sup>19</sup> This transparent way of collecting revenue automatically attributed expenditures to either state or local spending. For example, schools were local expenditures, and paying for a state-capitol building was a state expenditure. But starting in the middle of the 20th century, and largely following trends both at the national level and in other states, Nebraska undermined this constraint as part of a large movement toward what became known as the Great Society programs associated with President Lyndon B. Johnson. In 1966, Nebraska, for its part, introduced an income tax, did away with the state-level property tax, and then had the income tax repealed in a November ballot referendum. The state rolled out the first version of sales taxes in 1967 and reinstated the income tax in 1968. At the time, this new revenue was sufficient to meet the increased expenditure. The Great Society programs, however, set commitments that 45 years later would be unsustainable in the face of baby boomer retirements.<sup>20</sup> This section presents the argument that

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18. Barry R. Weingast, “The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,” *Journal of Law, Economics, and Organization* 11, no. 1 (1995).

19. Wagner, *Deficits, Debt, and Democracy*.

20. “Following a recession in the early 1960s, the U.S. economy entered into a decade-long period of strong economic growth. This growth, coupled with a sharp increase in the number of

priorities have been changing in states like Nebraska since the mid-20th century. The attempts to keep revenue up with increasing spending obligations can be explained through the lens of the fiscal commons.

## Fiscal Commons

Richard Wagner explains the current crisis by relying on a standard argument in political economy that concerns the tragedy of the commons. Wagner discusses how each level of government sets its own budget, which he calls the fiscal commons.<sup>21</sup> In economics, a commons is a setting where many benefit and few have an incentive to pay the full costs they impose on one another.<sup>22</sup> Modeling the budget situation as a commons clarifies the task of governing. For example, even with Nebraska's relatively longer two-year budgeting period, each biannual budget is blind to long-term shifts in demographics that affect revenue and spending decisions.<sup>23</sup> Adopting new priorities during times of budget surpluses forces future budget makers facing a deficit either to end programs that they can or to find additional funds to pay for the ones that cannot be ended. The task of setting a budget can be characterized as a short-term or static approach to a long-term or dynamic problem. The dynamic problem is choosing from among the unlimited possible types of expenditures the ones that have the highest priority for constituents. Clarifying the process of governing the fiscal commons aids in

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women entering the workforce, fueled large increases in Social Security payroll tax revenue. . . . Expectations of large surpluses had a powerful impact on legislation. During the eight-year period 1965–73, seven across-the-board increases were enacted. Benefits were raised by 7 percent in 1965, by 13 percent in March 1968, by 15 percent in April 1970, by 10 percent in March 1971, and by 20 percent in October 1972. Two benefit increases totaling 11 percent were enacted in 1973. The cumulative impact of these increases was to raise benefits across the board by 83 percent. In addition, special benefits to widows, children, divorced spouses of primary workers, and the working elderly were significantly expanded." John F. Cogan, "The Congressional Response to Social Security Surpluses, 1935–1994," Hoover Institution, Stanford University, August 1, 1998.

21. Richard E. Wagner, "Fiscal Sociology and the Theory of Public Finance: An Exploratory Essay," *New Thinking in Political Economy* (Cheltenham, UK: Edward Elgar, 2007).

22. Commons problems occur when the manager of the commons cannot exclude people from taking from the commons if they do not put in resources and when the resources used in common are in limited supply such that not everyone can consume the same quality or quantity of the good. For the canonical work, see Elinor Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action* (Cambridge: Cambridge University Press, 1990).

23. Current budget conditions reflect a fall in revenue 2.2 percent below forecast. Governor Pete Ricketts issued a memorandum on July 14, 2016, to "all state agencies, boards, and commissions," calling for a 1 percent reduction in state spending. In addition, the cash reserves (surplus) would be spent to a lower reserve level than what was projected in the budget. Pete Ricketts, memorandum, July 14, 2016, <http://budget.nebraska.gov/assets/memo-to-abc-from-governor.pdf>.

setting priorities. Such a clarification moves the focus of the conversation from the static to the dynamic, enabling a sustainable combination of revenue and expenditure over time.

Elinor Ostrom, winner of the 2009 Nobel Prize in economics, gives eight design principles for governing a commons that clarify boundaries, collective choice, monitoring, and other important aspects of forming long-enduring institutions in history.<sup>24</sup> These general principles—for example, those concerning boundaries, monitoring, and sanctions—help solve time-inconsistency issues. For example, a budget decision that requires low expenditure in the short term should not cause a spike in spending in the longer term just because demographics change. The comparison between Ostrom’s “natural commons” and a fiscal commons is discussed by Tallinn University of Technology professor of economics Ringa Raudla.<sup>25</sup> Drawing specific parallels, Raudla challenges those seeking to use the language of the commons to incorporate more of Elinor Ostrom’s work. Such a move will require researchers to document and characterize successful and unsuccessful cases of fiscal restraint in order to correct the bias toward short-term planning in policy making.

One institutional problem is the short-sightedness baked into the writing of budgets. Florida Atlantic University professor of economics Keith Jakee and Stockholm University professor Stephen Turner recognize that institutional design could frustrate policy setting over a longer term.<sup>26</sup> They point out two types of problems in the standard approaches of public finance. The first of these is a cognitive one of understanding longer-term patterns and the incentive effects, both intended and unintended, associated with the implementation of policy.<sup>27</sup> With bad institutional design, state budgets suffer because policymakers, and the voters who evaluate the policymakers’ decisions, cannot recognize the commons problem. This is one possible explanation for increased spending beyond what is sustainable in the long run.

Nebraska’s constitution was initially strong on fiscal restraint. By focusing the taxpayer and the policymaker on two property taxes, the situation appeared

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24. Design principles illustrated by long-enduring common-pool resource institutions include (1) clearly defined boundaries, (2) congruence between appropriation and provision rules and local conditions, (3) collective-choice arrangements, (4) monitoring, (5) graduated sanctions, (6) conflict-resolution mechanisms, (7) minimal recognition of rights to organize, and (8) nested enterprises. Ostrom, *Governing the Commons*, 90, table 3.1.

25. Ringa Raudla, “Governing Budgetary Commons: What Can We Learn from Elinor Ostrom?,” *European Journal of Law and Economics* 30, no. 3 (2010).

26. Keith Jakee and Stephen Turner, “The Welfare State as a Fiscal Commons: Problems of Incentives versus Problems of Cognition,” *Public Finance Review* 30, no. 6 (2002).

27. *Ibid.*, 483.

simple, but the state did not deliver all the public services that voters wanted. With the expansion of the set of priorities given to governments at the local, state, and federal levels, policy became a wish list of items that voters wanted rather than a list of priorities to be executed with some consistent level of quality. Many voters got more spending with a less-than-proportional increase in the quality of services that were offered. Meaningful reform has to solve this dynamic problem and avoid setting policy through piecemeal reactions to short-run events.

## Fiscal Illusion

While the theory of the fiscal commons explains the problem of state budgets on the expenditure side, fiscal illusion helps illuminate the incentives policymakers face on the revenue side of government budgets. James Buchanan points out that, if taxes are collected in a more abstract form, people do not see them as taxes.<sup>28</sup> Going from a simple system of property tax to a more complex system of income and sales taxes creates for taxpayers cognitive costs of calculating the burden of the tax.

When Nebraska moved away from the state property tax, it did so completely.<sup>29</sup> The state government introduced an income tax in 1966 and again in 1968, and it introduced a sales tax in 1967. There are excellent reasons to reconfigure a tax code. One is to structure the tax more equitably.<sup>30</sup> Replacing

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28. James M. Buchanan, “La scienza della finanze”: The Italian Tradition in Fiscal Theory,” in *Fiscal Theory and Political Economy: Selected Essays* (Chapel Hill, NC: University of North Carolina Press, 1960), 59. Amilcare Puviani’s description of the maximizing behavior of political agents, as if they were just like any other rational actor, was a key to James Buchanan’s own formulation of public choice. James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Indianapolis: Liberty Fund, 1962).

It was important to Puviani’s thesis that fiscal illusion—“government acting to hide the burden of taxes from the public”—did not work as a “deliberate plan” on the part of the political actors (Buchanan, “La scienza della finanze,” 60). Rather these entrepreneurs discovered how to finance a given level of government in a way that minimized the “perceived burden” of what Wagner would later call the fiscal extraction device. Richard E. Wagner, “Revenue Structure, Fiscal Illusion, and Budgetary Choice,” *Public Choice* 25, no. 1 (1976): 49.

29. The 1966 Duis Amendment to the Nebraska Constitution abolished the state property tax and prevented new property taxes for state purposes. Mary Margaret Simpson, “A Profile of Nebraska’s Community College System,” Nebraska Technical Community College Association, US Department of Education, 1985, 4.

30. Generally, a tax on a particular item or class of items (like a property tax) will have distortive effects that increase with the elasticity of the tax. A property tax is largely considered an inelastic tax, meaning there are few substitutes that can be used to decrease one’s reliance on owning property. If property taxes are charged at the state level, the only way that someone could escape the tax is to leave the state. Equity concerns might influence a policymaker to broaden the tax base by including more things that are taxable and then lowering the rate so that the total tax bill is spread out over more items.

Nebraska's property tax with income and sales taxes did provide a broader tax base, but it also introduced another level of complexity in administering, collecting, and understanding the tax code. Because local property taxes did not decrease and the revenue from these local property taxes increasingly went to pension obligations for public employees, the move away from state property taxes amounted, not to a shift of the tax burden, but an addition to the tax burden. What is sometimes justified as a change in how a tax is collected ends up being a justification for an additional tax. In fact, the tendency for spending to go to higher levels of government (local to state, state to federal) while having less than a one-to-one decrease in spending at the lower level was pointed out by Jack Osman as early as 1966.<sup>31</sup>

Fiscal illusion helps to explain how over time in states like Nebraska, additional sums are being collected as taxes while the consumers of state services are less likely to be aware of where the revenue is coming from and to recognize the increased burden. Along with expanding revenue collection, a more complex tax code helps minimize the individual taxpayer's perceived cost.

## Education Policy and a Changing Revenue and Spending Model

In Nebraska, spending increased in the 1960s just as it did across all states. This came about because of a fortunate demographic shift: The first members of the baby boom generation were hitting employable age, and many more women were entering the workforce and taking jobs previously not held by women. Between the second quarter of 1961 and the fourth quarter of 1969, tax revenue was high and GDP growth was positive. In a system funded by a property tax, differences in property values in different jurisdictions created different revenue profiles. As a result, inequality in the provision of government services became more obvious. Nebraska adopted programs designed to treat this inequality, and in the process, started raising more revenue and contributing more to local priorities like schools. Even though the state of Nebraska took on more responsibility, local governments continued to collect taxes and found other priorities to fund. As a result, the combined tax burden on Nebraska's

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31. Jack W. Osman, "The Dual Impact of Federal Aid on State and Local Government Expenditures," *National Tax Journal* 19, no. 4 (1966): 362–71. Norcross and Sautet ("Institutions Matter") detail the same experience in New Jersey, where the Property Tax Relief Fund never replaced the property tax; it just became another tax. John Anderson and Eric Thompson discuss proposals to finally remove the as-yet-undiminished Nebraska property tax despite years of failed proposals to do so. John E. Anderson and Eric C. Thompson, "Property Taxes in Nebraska: Past, Present, and Future," Platte Institute for Economic Research, October 29, 2014.

taxpayers increased. To this day, Nebraska has a relatively high property-tax rate as a legacy of this early revenue model.

One of the circumstances driving the changes in Nebraska's budget picture is the political popularity of increasing educational funding. In 1967, the same Nebraska legislature that introduced the sales tax and the income tax passed another act, the School Foundation and Equalization Act (LB 448, 1967). This act was part of a broader movement across the states and at the federal level to create more equal schooling that would not be dependent on where students happened to live.<sup>32</sup> Governments financed school bus programs and programs for both gifted and relatively needy children. The tension underlying the School Foundation and Equalization Act continues to the present and is largely driven by Omaha, the one large metropolitan area in the state.

The Omaha Public Schools district was in crisis because of economic segregation.<sup>33</sup> Property values had been falling as residents fled downtown Omaha, preferring suburbs where school systems with good reputations increased home resale values. The Omaha district needed more help than the state or federal government were providing. With the district arguing that it could no longer expand because of geographic constraints, intervening to annex the surrounding school districts into one "Learning Community" seemed like a plausible way to help shore up local government revenue. Figure 2 outlines the Omaha "Learning Community," which is a union of the existing area districts to share expenditures.

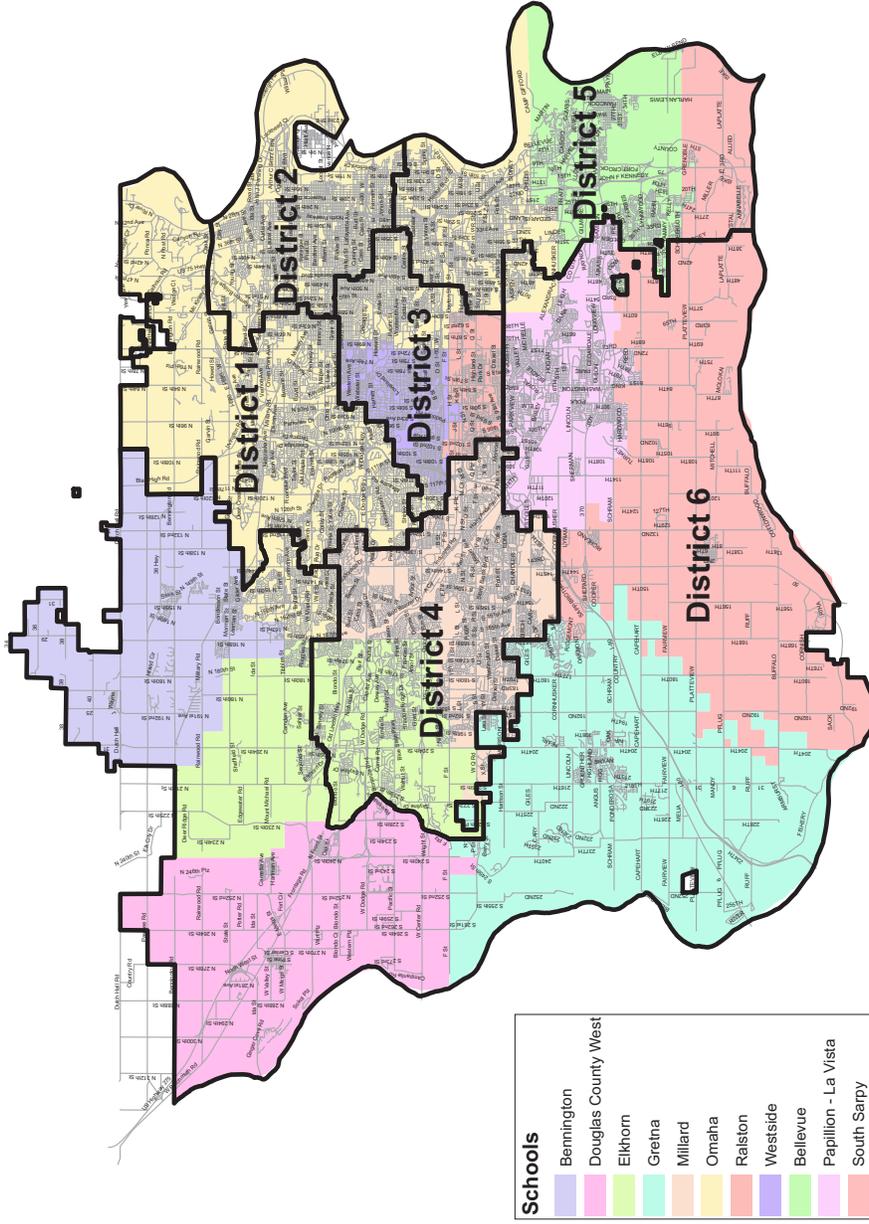
Omaha's public school district before the intervention (the yellow portion of figure 2), like many districts around the country, faced the twin pressures of increased enrollment and lower funds. The property-tax model of school funding does little for areas where property values are lower than in the surrounding areas. Areas of the Omaha public school district that before the intervention relied on higher property values were losing revenue without losing any of the population density that mattered for their expenditure on education. That was because the rise of the automobile meant that those who could afford to live in the areas to the south and west of Omaha were moving to suburbs where property values were rising quickly. The areas of town that they left behind saw property values tank. This amounted to a reduction of property-tax revenue for those schools where families could not afford to move. After a 1998 Nebraska

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32. The largest amount of federal funding came with the Elementary and Secondary Education Act (1965). Spending has increased by more than an order of magnitude (from \$2 billion to over \$25 billion) between 1966 and 2005.

33. For a contemporary view of segregation and schooling, see Paul A. Jargowsky, "Take the Money and Run: Economic Segregation in US Metropolitan Areas," *American Sociological Review* 61, no. 6 (1996).

FIGURE 2. CONSOLIDATION OF 11 OMAHA-AREA SCHOOL DISTRICTS INTO ONE LEARNING COMMUNITY



Source: Election commissioners for Douglas County and Sarpy County, Nebraska.

law added a cap on the property-tax levy at \$1.05 per \$100 of taxable property, city schools became desperate for funding.<sup>34</sup>

For the Omaha public schools, this was an inequality that required attention. The Omaha district invoked language from previous amendments to section 79-535 of the Statutes of Nebraska—“One city, one district”—and argued that the natural course of events would have allowed Omaha city schools to expand south and west as the city grew.<sup>35</sup> But the incorporation of new cities on the outskirts of Omaha meant that the city’s school district was “landlocked” and had to find a way to tax the people who had escaped into surrounding areas.

Previous moves by the legislature had decreased policymakers’ options, and the existing law that prevented sharing revenue between districts had to be challenged before Omaha Public Schools could move forward. In 1967, Nebraska’s legislature passed a funding bill, LB 448, which did not go as far as proponents wanted in redistributing income across the state. A general resistance to funding local schools with state money slowed the increase in the percentage of revenue that came from state and federal sources. Even in 1967, the proposed expenditure would have been huge, at \$67 million, and \$20 million of this was dedicated by the state to provide a basic level of funding for all schools per student.

In 1967, LB 448 grouped schools into districts with and without high schools (see table 1). Class IV and V, which are the largest districts, occurred where the population is greater, mostly in Omaha and Lincoln. Residents who were willing to shop among school districts for low property taxes were the ones most interested in learning about the classifications. A home in a class I district, for example, had lower property taxes because funding only an elementary school was cheaper. This caused problems because some property owners were treating the low property-tax districts as tax havens, giving some evidence to support Charles Tiebout’s model of tax-district shopping.<sup>36</sup> A 1987 law merged class I districts with districts that had a high school,<sup>37</sup> limiting the

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34. The property-tax levy limit itself is \$2.19 per \$100 of taxable property.

35. Leading up to 2005, the Omaha metro area’s 11 school districts operated in a traditional model of decayed center city and suburban flight. To push back on this model, the Omaha Public Schools announced that it would treat all 11 school districts in the area as a common school district in order to enact policy to redistribute from relatively well-off to less well-off districts. Matthew L. Blomstedt, “The Legislative Purposes and Intent of the Common Levy in Nebraska’s Learning Community,” PhD diss., University of Nebraska, 2013.

36. Charles M. Tiebout, “A Pure Theory of Local Expenditures,” *Journal of Political Economy* 64, no. 5 (1956).

37. Nebraska Council of School Administrators, “The Complete History of the Nebraska Tax Equity and Educational Opportunities Support Act (TEEOA): 1988–1989 Introduction,” School Finance, accessed January 31, 2017, <http://schoolfinance.ncsa.org/1988-1989-introduction>.

TABLE 1. NEBRASKA SCHOOL DISTRICT CLASSIFICATION, AS UPDATED IN 2015

Class	Definition
Class I	elementary school only
Class II	population below 1,000
Class III	population between 1,000 and 150,000
Class IV	population above 100,000 and in a primary city
Class V	learning community in a metropolitan area
Class VI	high school only

Note: School District Classification began when LB 448 passed in 1967. This table reflects the most recent change, in 2015.

Source: Neb. Rev. Stat. § 79-102 (2015).

Tiebout competition and increasing rigidity in the system. This law was the first move in homogenizing school districts in the state, and it continued the efforts to equalize outcomes for students.

The nationwide tendency to promote policies that equalize spending was the championed motivation of school financing reform from the beginning of reform in the 1960s and in successive reforms.<sup>38</sup> New Jersey is an example where reform simply led to dramatic increases in revenue collected. The additional taxes imposed in New Jersey are still called the “property tax relief fund,” even though the state did not eliminate the property tax.<sup>39</sup> Residents of Nebraska fear a similar outcome—specifically that the property tax will remain despite new taxes billed as replacement taxes. Since less revenue for Nebraska public schools comes from property taxes, Nebraska school districts have increased their appeals to the state government to bail the schools out.<sup>40</sup>

In 1988, Nebraska commissioned a report to study the efficiency of its educational spending. The Syracuse Report, named after the 1988 grant writer’s

38. Nebraska’s Tax Equity and Educational Opportunities Support Act (LB 1059, 1990) is the official mechanism the state uses to update equalization of aid among school districts. This legislation is an important part of the ongoing debate about school funding and how it is allocated. Mike Dulaney, “The History of the Nebraska Tax Equity and Educational Opportunities Support Act,” PhD diss., University of Nebraska, 2007.

39. Norcross and Sautet (“Institutions Matter,” 16) detail the history of property-tax relief in New Jersey, where a popular call to repeal the traditional funding became just another fiscal extraction device.

40. The purpose of the Tax Equity and Educational Opportunities Support Act is to correct for low property-tax revenue in some districts and to replace this revenue with a growing reliance on state aid to local areas. “State Aid Certification,” Nebraska Department of Education, February 16, 2016, <https://www.education.ne.gov/fos/Schoolfinance/StateAid/Index.html>.

university, found that Nebraska collected twice as much property tax per student as the US average (\$2,918 vs. \$1,570 annually) and gave half as much state aid to school districts (\$842 vs. \$1,675).<sup>41</sup> The study also suggested dramatically reducing the number of school districts (from 891 to 95 districts—there are 93 counties in Nebraska), increasing state aid to local areas, and supplementing the property tax with other sources of revenue. All these moves would help make districts less reliant on local property taxes, and they were expressly intended to make outcomes more similar for students in different districts.

The principal obstacle to carrying out these recommendations for Omaha public schools was the question of the constitutionality of collecting funds from one municipality and spending them in another. The Duis Amendment had been consistently interpreted as prohibiting spending across districts as a “state use” that could not benefit from local funds.<sup>42</sup> Schools on the outskirts of Omaha challenged the one-city, one-district notion based on this precedent. They lost the appeal in 2005.

One way to get around this problem was to consolidate by annexation. What was once eleven school districts governing properties of a variety of values has become one school district. First Omaha annexed the town of Ralston, and, as the threat of annexing Papillion and La Vista (both in Sarpy County) and Millard (in Douglas County) grew, Elkhorn, a city to the west of Omaha but still in Douglas County, began to annex smaller areas of the county and smaller municipalities in order to stave off annexation by Omaha by becoming too large to annex.<sup>43</sup>

Ultimately the issue was resolved as Omaha annexed Elkhorn and each of the school districts in Omaha was charged a common levy (\$0.05 per \$100 of taxable property, which is around \$75 a year for a home valued at \$150,000) to transfer funds from one part of the district to the now larger Omaha Public Schools district.

Thus public schools have been a major area of reform in Nebraska, challenging the status quo and threatening the distinct spheres of local and state spending. Omaha is currently straddling the most densely populated parts of two counties, Douglas and Sarpy. It contains just a little less than half of the state’s population. Omaha’s school district has some of the students who are most in need of transfer payments to fund their schools. The older system of funding

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41. Michael J. Wasylenko, “Nebraska Comprehensive Tax Study: Summary and Recommendations,” PhD diss., Syracuse University, 1988.

42. Simpson, “Profile of Nebraska’s Community College System.”

43. Elkhorn lost its state supreme court appeal in February 2007. *City of Elkhorn v. City of Omaha*, No. S-05-1006, January 12, 2007.

through property taxes is yielding to a newer system that is increasingly based on state-to-local aid. (Figure 3 shows the funding sources for all US public schools.) Omaha's size is driving much of the school policy. Because Omaha Public Schools is such a large district, its impact on state policy erodes the distinction between local governance and state-to-local aid. The rest of the school districts in the state face a different set of issues and priorities.

### 3. FEDERAL TO STATE: THE SECOND PART OF THE SQUEEZE

In addition to having responsibility transferred from local government for things like education, Nebraska's state government faces pressures from the federal government. This second part of the squeeze comes from the well-intentioned setting of priorities by the federal government, the one-size-fits-all approach of federal leadership. In this dynamic's best-case scenario for states, the federal government offers to pay for a new program as long as the states agree to run it in certain ways. Over time, however, funding for such programs tends to run out as the federal government's priorities shift to its longer-run burdens like entitlements and debt.<sup>44</sup> States are left with less ability to set their own priorities and must execute programs designed in Washington, not in places like Lincoln, Nebraska.

#### A Model of Federal Leadership

Nebraska gains several advantages by being a less populated state. For example, it ranks very low on corruption scores and its unicameral legislature is often associated with a level of transparency and accountability that makes it an exemplar for many other states. However, there are also problems with Nebraska's leadership, including the fact that its part-time legislative body pays its senators only \$12,000 a year (\$1,000 per month).<sup>45</sup> This part-time pay means that a senator's attention is divided, and, at least in theory, this limits lawmakers' ability to specialize. Leadership from the national level on policy issues such as healthcare,

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44. Ron Haskins, "The Federal Debt Is Worse Than You Think," Brookings Institution, April 8, 2015.

45. A Nebraska legislature exists for two years. Elections are every two years for four-year terms.

Nebraska's unicameral legislature meets for two regular 90-day sessions for each year and one 60-day session each two-year period. Nebraska Legislature, accessed January 31, 2017, <http://www.nebraska.gov/senators/senators.php>.

FIGURE 3. TOTAL REVENUE (BY SOURCE) FOR US PUBLIC SCHOOLS, 1920–2005



Source: Digest of Education Statistics, National Center for Education Statistics, table 162, July 2007, [http://nces.ed.gov/programs/digest/d07/tables/dt07\\_162.asp](http://nces.ed.gov/programs/digest/d07/tables/dt07_162.asp).

education, and transportation may provide a level of expertise especially useful for smaller states and part-time legislatures.<sup>46</sup>

But one problem with relying on national legislative experts is that state legislatures might actually have more insight into their constituents' priorities. There is often a disconnect between what a state might provide and the priorities that are set when looking at that state from a national level. In a previous study, Wendell Cox, a former urban planner and consultant, and I note different conditions that affect setting housing policy for the nation.<sup>47</sup> In setting policy, each state will face its own particular difficulties, depending on geography, weather, demographics, and cultural considerations. For example, solutions attempted for local air pollution in cities like Salt Lake City and Denver will have no corollary on the plains of Nebraska, Kansas, and Iowa.

Much of the progress in streamlining policy at the national level has taken advantage of best practices in areas such as education and health care. Local cooperation and input helps to get a higher level of adoption. Nebraska residents have largely resisted Environmental Protection Agency (EPA) policies, for example, policies on cleaner energy production. As the only state with publicly operated utilities, Nebraska faces some difficulty in rapidly adapting to higher EPA standards.<sup>48</sup>

Federal mandates have also been a problem at the local level. Omaha has benefited greatly from EPA dollars used to clean up a Superfund site resulting from lead contamination from smelting in the downtown industrial area near the Missouri River.<sup>49</sup> The Omaha City Council applied for the federal monies, but the EPA directed the cleanup. However, after 15 years, the EPA is turning control

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46. Only nine states have a full-time legislature: California, Illinois, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Wisconsin. The average pay of legislators in these states is \$68,599. Florida and Texas have part-time legislatures but notably large staffs. "States with a Full-Time Legislature," *Ballotpedia*, accessed January 31, 2017, [https://ballotpedia.org/States\\_with\\_a\\_full-time\\_legislature](https://ballotpedia.org/States_with_a_full-time_legislature).

47. Wendell Cox and Michael D. Thomas, "Expanding Housing Choices," in *Enterprise Programs: Freeing Entrepreneurs to Provide Essential Services for the Poor: A Task Force Report*, ed. Roger Koppl (National Center for Policy Analysis, Dallas, 2011).

48. Regarding the EPA's 2015 Clean Power Plan, Governor Ricketts stated, "I am concerned that the Clean Power Plan is yet another example of the EPA handing down burdensome regulation that will impose unnecessary costs on the family budgets of hardworking Nebraskans." Office of Governor Pete Ricketts, "Gov. Ricketts' Statement on President Obama's Clean Power Plan Announcement," press release, August 3, 2015.

49. The Superfund site was formed in 1999 after blood tests in 600 children showed elevated levels of lead. From 1999 to 2014, the EPA spent \$166 million on the cleanup. Brandon McDermott, "Where Does Omaha Stand after 15 Years of EPA Cleanup?," *KVNO News*, May 16, 2014; "EPA Superfund Program: Omaha Lead, Omaha, NE," EPA, last updated January 31, 2017, <https://cumulis.epa.gov/supercpad/cursites/csitinfo.cfm?id=0703481>.

over to Omaha, agreeing with city planning director James Thele that the city can do a better job of getting residents to sign up for the free cleanup program. “I think we’ll have a better opportunity because we’re Omahans,” he said. “We’re from Omaha. We talk the same language.”<sup>50</sup>

The increase in federal regulations for state governments came slowly, eroding the federal separation of powers over the last 60 years. Important changes in the power of federal agencies like the Environmental Protection Agency have been effected for good, albeit expedient, reasons. For example, in the 1960s, the EPA gained much more regulatory authority over states as a result of a political crisis over highly publicized environmental catastrophes.<sup>51</sup> The power that was authorized for a particular purpose—dealing with these catastrophes—became a general power to set preemptive standards in environmental law, and the rule-setting power of the EPA became largely unchecked.<sup>52</sup> As recently as the summer of 2015, the EPA unilaterally announced new rules for clean energy production. Nebraska is joining a coalition of 16 states that is challenging those rules in court.<sup>53</sup> If the new rules do go into effect, the costs of cutting emissions will be passed on to customers in Nebraska in the form of higher energy prices.<sup>54</sup>

Another example of the federal government exerting control over the states occurred in 1974 when it imposed

“One problem with relying on national legislative experts is that state legislatures might actually have more insight into their constituents’ priorities.”

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50. Roseann Moring, “City to Take Over from EPA on Lead Cleanup of Superfund Site across Eastern Omaha,” *Omaha World-Herald*, June 23, 2015.

51. John P. Dwyer, “The Role of State Law in an Era of Federal Preemption: Lessons from Environmental Regulation,” *Law and Contemporary Problems* 60, no. 3 (1997).

52. This trend is not without exception; the Supreme Court did rule on February 9, 2016, that Obama’s Clean Power Plan deadlines should be delayed, giving more time for states like Nebraska to adapt. Lyle Denniston, “Carbon Pollution Controls Put on Hold,” *SCOTUSBlog.com*, February 9, 2016.

53. Cody Winchester and Joseph Morton, “Nebraska Will Challenge the EPA Emissions Rule, Attorney General Says,” *Omaha World-Herald*, August 4, 2015.

54. Jessica Herrmann, “Unworkable and Unaffordable: The EPA’s Clean Power Plan in Nebraska,” Platte Institute for Economic Research, 2015.

a maximum speed limit of 55 miles per hour and established a drinking age of 21 years by tying these two items to federal highway funding.<sup>55</sup> The increase in mandates often comes as part of a quid pro quo, for example, with a funding bill that requires conditions for accepting the funding. Even if federal funding is discontinued, the mandates remain. However, this dynamic is changing as states anticipate a federal budget crisis. Sixteen states rejected the expansion of Medicare in the wake of the Affordable Care Act because of concern over the long-term ability of the federal government to help pay the bill.

### Dynamic Problem in Federal Leadership

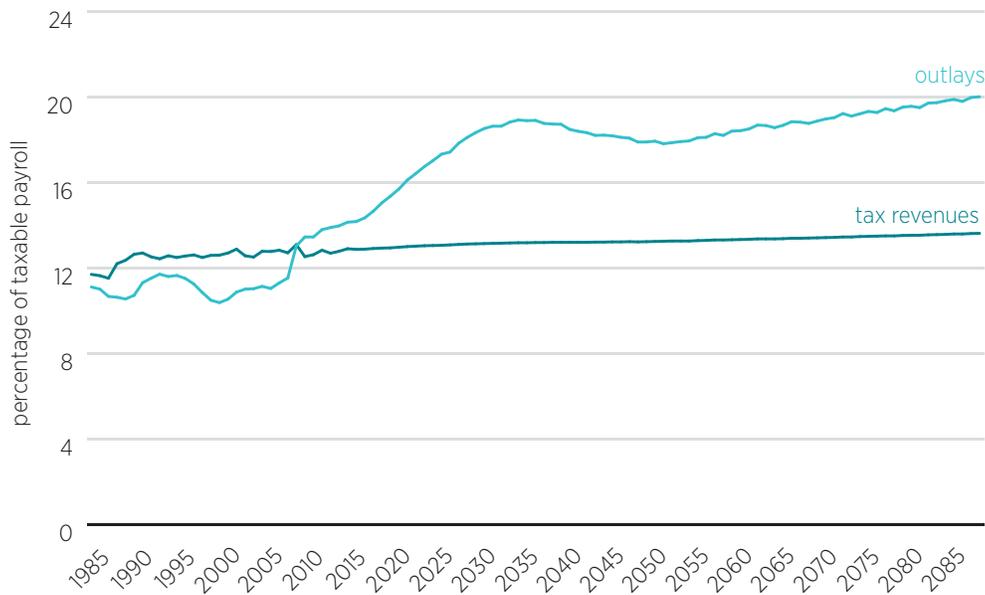
Even if the federal government justifiably fills the role of expert, the ability of this model to continue is suspect. The federal government has spending and entitlement issues. It has benefited for some time from extremely low interest rates on sovereign debt, allowing it to spend much more freely than it would if it were paying a higher rate to borrow funds that will obligate future taxpayers. In addition, a demographic shift is occurring as the baby boomers enter retirement: the largest number of retirees in the country's history will be taking funds from Social Security. As the population ages, the use of Medicare and Medicaid will also increase, and the relatively longer average life span of retirees means that cost containment can only do so much to control spending. Combine this with an increase in rates paid on sovereign debt, and the burden balloons. Increases in these four categories of expenditure threaten to push beyond the historical high in terms of percentage of national income collected in federal taxes. This is an increase in government spending in percentage terms. Unless the federal government dramatically increases revenue collection or unless economic growth increases at an unprecedented rate, the tax base cannot expand enough to finance projected expenditures on Social Security, Medicare, Medicaid, and interest on federal debt. This situation leaves states not only short of federal funding for mandated programs but also searching for ways to pay for infrastructure, education, and other priorities that have fallen off the federal government's list of priorities.

Without some change in policy, the current situation of outlays exceeding revenue, which started in 2010, will continue in the future. Figure 4 shows the Congressional Budget Office's (CBO) 2015 projections, based on current policy,

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55. Paul M. Sommers, "Drinking Age and the 55 MPH Speed Limit," *Atlantic Economic Journal* 13, no. 1 (1985).

FIGURE 4. SOCIAL SECURITY REVENUES AND OUTLAYS, 1985-2089



Source: Congressional Budget Office, "CBO's 2015 Long-Term Projections for Social Security: Additional Information," December 2015, [www.cbo.gov/publication/51047](http://www.cbo.gov/publication/51047).

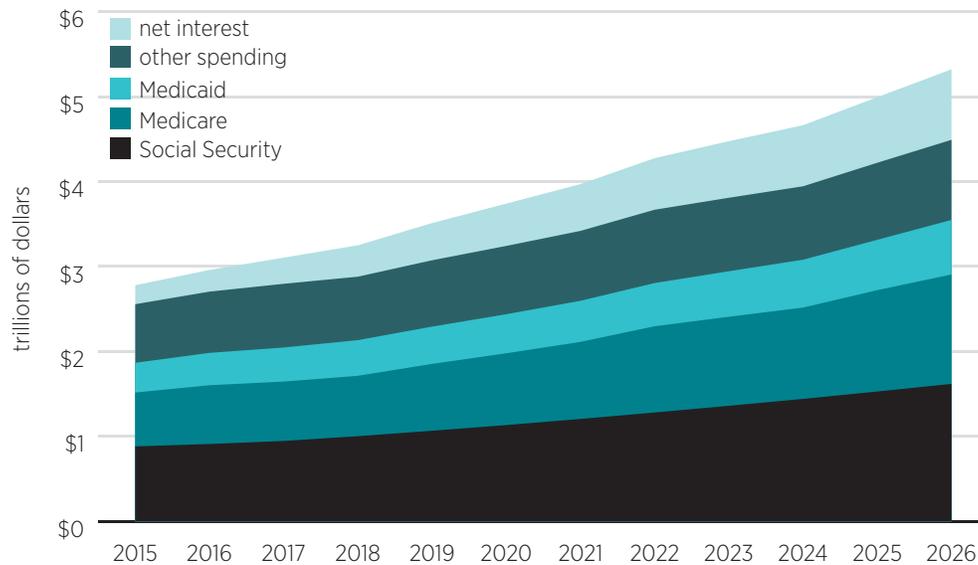
extending out until 2089. If outlays continue to exceed revenue, the existing Social Security trust fund will be exhausted in the year 2029. At that point, the Social Security law requires that benefits paid do not exceed revenue.<sup>56</sup>

Social Security is not the only program suffering from this demographic problem. In figure 5, the CBO numbers show Medicare and Medicaid totals exceeding Social Security spending in every year through 2026, for a cumulative total of over \$3.5 trillion in 2026 for these three programs alone. The CBO estimates \$5 trillion in tax revenue in 2026 based on an estimate of tax revenues that year of 18.2 percent of GDP.<sup>57</sup> In the current year, the three programs cost \$1.865 trillion, and tax revenue was \$3.249 trillion. This represents an increased share of total federal tax revenue from these three programs from 57.4 percent to 70.0 percent by 2026. Defense spending is expected to grow by 23.5 percent

56. By 2025, outlays will exceed revenue by 30 percent, and by 2040, they are expected to exceed revenue by 40 percent. Congressional Budget Office, *CBO's 2015 Long-Term Projections for Social Security: Additional Information*, December 16, 2015.

57. Congressional Budget Office, Table 4-1, *The Budget and Economic Outlook: 2016 to 2026*, January 25, 2016.

FIGURE 5. CONGRESSIONAL BUDGET OFFICE PROJECTED OUTLAYS, 2015-2026



Source: Congressional Budget Office, “CBO’s 2015 Long-Term Projections for Social Security: Additional Information,” December 2015, [www.cbo.gov/publication/51047](http://www.cbo.gov/publication/51047).

to \$719 billion by 2026. Interest payments on outstanding debt are projected to increase by 372 percent to \$830 billion by 2026.

These numbers paint a very dark picture for the prospect of the federal government helping states fund necessary infrastructure projects. Even before this crisis, the American Society of Civil Engineers’ 2013 Report Card for America’s Infrastructure suggested that \$3.6 trillion is needed to improve the existing infrastructure in order to maintain its designed condition.<sup>58</sup> Failures to improve this infrastructure have been observed in episodes such as the 2006 lead crisis in Flint, Michigan (discussed above). The squeeze whereby all levels of government ignore infrastructure problems will continue to get worse as the federal government’s fiscal situation worsens to the point of not being able to provide emergency funds.

### Unfunded Mandates

For the last several decades, federal borrowing has been financing a historically high level of state and local government spending. As long as interest rates stay low, this

58. American Society of Civil Engineers, *2013 Report Card for America’s Infrastructure*.

has been a great way for the federal government to provide aid to states in exchange for their acceptance of federal mandates. While the number of mandates has grown, however, the long-term fiscal position of the federal government has changed. By 2039, the US budget will require taxes equal to 21 percent of GDP, according to the Congressional Budget Office.<sup>59</sup> Therefore the quid quo pro of adopting federal mandates in exchange for receiving federal aid is eroding. Since the early 1990s, unfunded mandates have been an important discussion topic in the literature on public finance; however, the practice continues despite the criticism of it.<sup>60</sup>

The exchange of new federal dollars for adopting more restrictive federal standards was enough of an issue leading up to 1996 that it was studied extensively by the Congressional Budget Office and resulted in the Unfunded Mandates Reform Act (UMRA 1996). The term “unfunded mandates” refers to federal guidelines that are either underfunded from the start or become underfunded over time as federal resources initially given to get states to accept the guidelines erode as a result of either inflation or budget cuts. Examples of unfunded mandates include the Clean Air Act, the Americans with Disabilities Act, Medicaid, and the No Child Left Behind Act of 2001. States have sometimes been skeptical about the likelihood that the federal government will continue to fund mandates over time. In 2014, for example, some states did not accept federal funding for Medicaid expansion under the Affordable Care Act because they anticipated that federal funding would not keep pace with the additional expenditure.

Nebraska is facing the squeeze in its relationship with the federal government. The state recently raised the gas tax as a means of taking more control of its own infrastructure and relying less on the US Department of Transportation to administer the construction of new roadways. The federal gasoline tax is still in place but the states are beginning to raise the additional revenue internally for maintaining or increasing road miles. This means the states are taking responsibility for servicing and building roads, despite the original intent of the Highway Trust Fund. States that do not raise state gas taxes will have to find other revenue to fund these projects.

Nebraska has been a net recipient of federal tax dollars according to a Tax Foundation report covering 1981–2005.<sup>61</sup> The \$1.10 received per \$1 spent places

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59. Congressional Budget Office, *The 2014 Long-Term Budget Outlook*, July 2014, 18.

60. Jeremy Horpedahl and Michael D. Thomas, “State Mandates: How Do They Impact Property Taxes?,” Platte Institute for Economic Research, December 30, 2014, <http://www.platteinstitute.org/research/detail/state-mandates-how-do-they-impact-property-taxes>.

61. “Federal Taxes Paid vs. Federal Spending Received by State, 1981–2005,” Tax Foundation, October 19, 2007.

“The last 60 years of adding priorities for the state legislatures to accomplish while simultaneously restricting their discretion to do so has effectively left the state without priorities, since everything demands urgent attention.”

Nebraska squarely in the middle of the states receiving tax transfers from other states. This is a good position to be in at the moment, but as the federal budget position weakens (through increased entitlement spending on programs like Social Security, Medicare, and Medicaid), the pressure increases on states to fund greater amounts of these programs. This pressure has the likely effect of lowering transfers to net-tax-recipient states. In the budget section, I will also explore unfunded or underfunded federal mandates for Nebraska, for which, as time goes on, the state’s share of funding is likely to grow.

#### 4. REFORM

Addressing the problem of the squeeze on the fiscal commons will require reform. Sorting out the dynamic problem from the existing method of responding to short-term priorities will require fiscal constraints governing what are justified in terms of long-run priorities. While Nebraska is currently in a good fiscal position, there is some cause for concern. The growing dependence on federal transfers has left Nebraska administering programs that came with promises of increased funding. One element of reform will be to take advantage of knowledge inherent in the system in order to set spending priorities. The last 60 years of adding priorities for the state legislatures to accomplish while simultaneously restricting their discretion to do so has effectively left the state without priorities, since everything demands urgent attention.

Reform is possible, and Nebraska has many options for reform. The dynamic approach to the fiscal commons points out that all the pathologies were arrived at one step at a time and therefore can be corrected one step at a time. The most important things are to get the institutions right and the incentives correctly aligned. The goal of this paper has not been to suggest cutting funding but rather to encourage fiscal constraints on new priorities. State governments are on a path with ever-smaller room to set their

own priorities while facing ever-greater responsibilities. The result is a broad failure to discharge their responsibilities well. State governments have shown some progress by being generally more innovative in two major areas: creating more choice in schools and providing health care. With these two major budget items, Nebraska will see increased budget pressure and an opportunity to be creative with reform.

## Schools and Choice

School choice is a great opportunity to get more out of every dollar spent on education. Moving away from thinking of schools as geographic monopolies can help solve the school funding problem. Duke University professor of economics Thomas Nechyba suggests that the attempt to increase the percentage of students in public schools has unanticipated consequences.<sup>62</sup> One example of how school choice can be a benefit is the case of underfunded districts that have private schools. Parents in these districts have increased flexibility and more options, giving them an incentive not to flee the districts. Encouraging diversity in schooling options weakens the priority of school quality for those purchasing a home, which should allow for more income diversity in a district. In addition, parents who are paying taxes for public school but whose school-aged children are not attending a public school in their district will be helping to increase the per-child resources. In Nebraska, there have been many school-choice proposals that could improve the situation for some of the most threatened school districts.

The historical trend to equalize school funding as a solution to income inequality has been a static approach. A static approach that focuses solely on income attempts to top off a low-income person's earnings, enabling a type of dependency. A dynamic approach empowers low-income people to change outcomes. In school choice, income diversity in a given area increases outcomes. It is more promising to think of this as a dynamic problem (cultivating assets) than as a static problem (transferring goods and services to those with low income).<sup>63</sup> Thinking this way fits into the conversation about institutional public finance quite well: dealing with how to fish rather than focusing the thrust of policy on

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62. Thomas J. Nechyba, "What Can Be (and What Has Been) Learned from General Equilibrium Simulation Models of School Finance?," *National Tax Journal* 56, no. 2 (2003).

63. James P. Bailey, *Rethinking Poverty: Income, Assets, and the Catholic Social Justice Tradition* (Notre Dame, IN: University of Notre Dame Press, 2010).

the lack of fish. As an example of this principle in application, Cox and I have looked at the problem of housing policy through this empowerment lens.<sup>64</sup>

Nebraska can follow the lead of several other states in adopting school-choice proposals. The trick here is to take advantage of programs that allow choice in order to make more efficient use of the existing resources that have been allocated for schooling. Nebraska is currently facing federal sanctions with regard to No Child Left Behind mandates. In 2013, the total number of schools on the federal “needs improvement” list had reached 287, or “two-thirds of the state’s public schools.”<sup>65</sup> By the fall of 2015, that number had risen to three-quarters of Nebraska’s schools despite a waiver application.<sup>66</sup>

Other well-intended school programs focus on health outcomes. One such program is the Let’s Move campaign, which has worked through the Department of Agriculture to improve exercise and promote healthy eating habits. Similarly, the Healthy Hunger-Free Kids Act intended to change standards for school meals, increase enrollment, and provide information about food choices to children.<sup>67</sup> The very noble intention to improve diet is just one of many priorities that have been forced on schools, and as discussed earlier, school performance is already struggling. We are never out of good ideas, but it takes resources to carry out good ideas well and the competition among so many great priorities leaves us doing none well.

School-choice reform would help, but it faces obstacles. Nebraska was one of 38 states that adopted an amendment to the state constitution that prevented state funds from being used at “sectarian schools.” This is one example of well-intentioned policies to support public schooling in Nebraska that would put the public schools at the center of civic life. The downside of this legacy is that Nebraska trails many other states in creating charter schools, tax credits, vouchers, and other pieces of a comprehensive school-choice approach. None of these options currently exist in Nebraska.

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64. Cox and Thomas, “Expanding Housing Choices,” 158. Our paper was part of a report that received a Templeton Award: *Enterprise Programs: Freeing Entrepreneurs to Provide Essential Services to the Poor*. In addition to school choice, housing choice can provide motivation for parents to provide for their children through Section 8 rental certificates instead of policies aimed at creating clusters of poverty under the housing project approach. The goal should be to end programs that create economic ghettos.

65. Joe DeJka, “No Child Left Behind Law: Even Top Schools in Nebraska Now Getting Flagged,” *Omaha World-Herald*, September 27, 2013.

66. Margaret Reist, “No Child Left Behind Requirements Still a Factor in Nebraska Despite Waiver Application,” *Lincoln Journal Star*, October 16, 2015.

67. “Agriculture Secretary Vilsack Statement on Passage of the Healthy Hunger-Free Kids Act” (Release No. 0632.10, US Department of Agriculture, December 2, 2010).

Half of Nebraska's population is rural; the other half lives in the vicinity of the two largest cities, Omaha and Lincoln. Consequently, Omaha dominates policy in Nebraska. The movement for school-policy reform is largely taking place in Omaha; it is more difficult to raise concern for school choice in some rural districts where there are fewer schools. Innovative technological reforms can help in some cases; for example, distance-learning options bring choice to schoolchildren whose interests are not currently met by their schools' curricula.<sup>68</sup>

Recently in Nebraska, Senator Bob Krist introduced legislation that would provide tax credits for scholarships.<sup>69</sup> An individual can donate money to a general scholarship fund at any private school and then receive 60 percent of that amount as a tax credit, increasing the amount of educational funding for each student by the difference between what is donated and what is credited. This is a great first step toward increasing educational choice, and it has been adopted by 16 states.<sup>70</sup> Iowa's 65 percent tax-credit program, capped at \$12 million, led to 12 scholarship organizations awarding places to 10,848 students in 139 participating schools during the 2015/16 school year.<sup>71</sup>

School-choice programs provide an opportunity to upset the status quo funding model and give schools greater ability to set their own priorities. This trend promises that existing resources will be used more efficiently, and it prevents spending growth that does not translate into better outcomes. By helping schools focus on what they can do to better serve their own districts' populations, the hope is that this trend can change from an enabling to an empowering paradigm. Policy moves from dependency to creating the opportunity for students to flourish.

## Health Care

The theory of the fiscal squeeze presented in this paper suggests that Nebraska will eventually have to take on a much bigger role in setting priorities in health care as federal funding wanes. With so many healthcare priorities and such limited funds, the state is already making decisions about which obligations to

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68. Associated Press, "Nebraska Panel Eyes K-12 Online Courses," *Lincoln Journal Star*, October 3, 2011. 69. LB 26, 104th Legislature, 1st Session, 2015.

70. These states are Alabama, Arizona, Florida, Georgia, Indiana, Iowa, Kansas, Louisiana, Montana, Nevada, New Hampshire, Oklahoma, Pennsylvania, Rhode Island, South Carolina, and Virginia. "School Choice in America," EdChoice.org, accessed August 17, 2016, <http://www.edchoice.org/school-choice/school-choice-in-america>.

71. "Iowa—School Tuition Organization Tax Credit," EdChoice.org, accessed August 17, 2016, <http://www.edchoice.org/school-choice/programs/iowa-school-tuition-organization-tax-credit>.

fulfill.<sup>72</sup> The major entitlement programs that Nebraska—like all other states—must fund are Medicare, Medicaid, and extensions of these programs required by the Affordable Care Act. Medicare enrollment is increasing because of baby boomer retirements. More Nebraskans will be moving from employer-based plans to traditional Medicare and Medicare Advantage. National growth estimates for these programs are around 3.0 percent per year until 2020 and 2.4 percent per year after that until 2030. This growth will expand the coverage of Medicare to 81 million by 2030, roughly double the number in 2000.<sup>73</sup>

Concerning other healthcare expenditures, Nebraska continues to reject Medicaid expansions, voting against expanding most recently on March 29, 2016, citing concern over the federal government’s ability to fund 90 percent of the additional cost in perpetuity.<sup>74</sup> Medicaid expenditures in two categories are much higher than in the other categories; these categories are disability assistance and nursing facilities. Spending on disability waivers has been growing in recent years.<sup>75</sup> Nebraska is struggling with continued pressure to extend healthcare expenditures beyond what current revenue sources can meet. Like other states, Nebraska could find itself quickly ramping up both spending and revenue collection to dedicate more of the budget to health care. Nebraska and the other states need to set priorities in health care and work on reforming spending. Reforms such as telemedicine that are focused on cost are a wise but small start.<sup>76</sup>

## Highway Funding

Nebraska in 2015 increased expenditure on highways and has passed a gasoline tax that would help fund its own maintenance of roads in the state.<sup>77</sup> Dollars spent

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72. Phillip Rosoff anticipates that it will be necessary to discuss ethical rationing. Phillip M. Rosoff, *Rationing Is Not a Four-Letter Word: Setting Limits on Healthcare* (Cambridge, MA: MIT Press, 2014).

73. Board of Trustees for Medicare, *2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, 2016, 186, <https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2016.pdf>.

74. Fred Knapp, “Nebraska Again Rejects Medicaid Expansion,” Nebraska Educational Television, March 29, 2016.

75. Department of Health and Human Services, *Nebraska Medicaid Reform Annual Report*, December 1, 2015.

76. “Telemedicine,” Medicaid.gov, accessed January 31, 2017, <https://www.medicaid.gov/medicaid-chip-program-information/by-topics/delivery-systems/telemedicine.html>.

77. Nebraska LB 610 (2015) has a half-cent increase in the state gasoline tax going to the Department of Roads each year from fall 2015 (when the law took effect) through January 2019. The tax increases from 7.5 cents per gallon in 2015 to 9.5 cents by the end of the period.

on contracted road projects in the fiscal year beginning July 1, 2016, are estimated at \$520 million.<sup>78</sup> According to the *2015 State Highway Needs Assessment* report, spending in 2020 will be more than \$656 million in today's dollars, and the projected total in 30 years will rise above \$1,051 million.<sup>79</sup> Nebraska's economy has to grow to match that total outlay. The state also has to have a plan to keep expenditures from growing as a percentage of state production.

### Pensions

Government-employee pension obligations are growing and will eventually become a major portion of local expenditures. They are not a current concern because the state has raised taxes substantially. The nature of the long-term commitment, however, means the obligation will become unfunded unless more tax revenue is committed to these pensions. At some point, however, these obligations will grow beyond the ability to levy new taxes. Some fear that taxes are already at distortionary levels. In hopes of reducing the obligations' growth, the city of Omaha implemented reforms for public unions starting in late 2014 and continuing into 2015.

First, the city announced a major pension reform that would apply to new hires for the Omaha City Employees Union beginning in November 2014. This change would create 401(k)-type plans rather than defined benefit pension plans. Then, in February 2015, the public-safety workers made a similar move, binding new hires to a 401(k)-type plan. Employees hired before these dates must contribute more to the retirement programs they signed up for when they were hired. Switching from defined benefit plans to defined contribution plans relieves cities of a growing fiscal burden on their budgets. Pensions for state-level workers

“Switching to a [pension] system that allows more flexibility increases the attraction of public-service jobs.”

78. Martha Stoddard, “Nebraska Department of Roads Unveils \$520 Million Worth of Highway Projects,” *Omaha World-Herald*, July 13, 2016.

79. Nebraska Department of Roads, *2015 State Highway Needs Assessment*, 2015.

are facing a similar problem. Nebraska's contributions to pension plans for state workers have increased "from \$14.2 million in 2003 to \$57.7 million in 2013."<sup>80</sup>

Tensions remain among those workers subject to the old rules who feel they are owed their defined benefit on the terms originally promised. These workers are asking the state to contribute greater amounts to their plans. In addition, retired workers who are currently receiving benefits are costing more than expected because of faulty assumptions about how long they would be drawing benefits. On the positive side, switching to a system that allows more flexibility increases the attraction of public-service jobs.

## Taxes

Nebraska can do quite a bit to reform its current tax code while avoiding pitfalls that other states have fallen into as the political pressures from voters change. Joseph Henchman and Scott Drenkard<sup>81</sup> and Jared Walczak<sup>82</sup> point out some systemic problems with the tax code in Nebraska and some meaningful reforms. The state income tax is doing much of the heavy lifting in Nebraska because all the taxes have a fairly narrow tax base. The sales tax can be reformed to include services as well as goods and therefore broaden the base. Property taxes also face some idiosyncratic problems that make them distortive to a neutral tax code.

The corporate tax rate is relatively higher in Nebraska than in neighboring states. One reason is that up to one-third of the potential revenue is forgone by "tax carve-outs and incentives."<sup>83</sup> This sets up a perverse incentive favoring incumbent corporations. For a corporation to be competitive in Nebraska, it must first secure a favorable tax decision, which creates incentives for lobbying and generally causes the overall efficiency of firms with headquarters in Nebraska to fall when new entrants face higher relocating costs. It creates artificial protection for incumbents with tax advantages; new entrants must actively rent-seek to get the same advantages.

For mostly historical reasons, the sales tax falls primarily on goods and has not been extended to most services.<sup>84</sup> There is a final-sale tax as well as a value-

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80. Andrew G. Biggs, "Protecting Omaha's Future: Confronting the Challenge of Public Pension Reform," Platte Institute for Economics Research, June 2014.

81. Joseph Henchman and Scott Drenkard, *Building on Success: A Guide to Fair, Simple, Pro-growth Tax Reform for Nebraska*, Tax Foundation and Platte Institute, October 2013.

82. Walczak, "Twenty-First Century Tax Code for Nebraska."

83. Henchman and Drenkard, *Building on Success*, 23.

84. For a list of the services that have a sales tax, see the Nebraska Department of Revenue's website, [http://www.revenue.nebraska.gov/question/services\\_faq.html](http://www.revenue.nebraska.gov/question/services_faq.html).

added tax. There are quite a few distortions in the goods taxed, as many different groups have managed to get exemptions at particular stages in the production process. One of Henchman and Drenkard's recommendations is that the sales-tax base be extended to services as well, which, they argue, would reduce pressure on any individual item in the tax base and increase the revenue generated, even at a lower tax rate.<sup>85</sup>

The last tax reform concerns property taxes. A property tax credit program decreases funding for schools, requiring an increase in Tax Equity and Educational Opportunities Support Act (TEEOSA) state aid to schools. The spending for TEEOSA will increase by 4.8 percent in fiscal year 2018 and 2.5 percent in fiscal year 2019, and there is continued pressure to reduce the level of property taxes.<sup>86</sup> A short-term fix has been for the state to transfer, in the form of a tax credit, some of its excess revenue from a rainy-day fund to taxpayers, based on how much property tax they have paid. Introduced in 2007, the tax credit has been raised each year. The state certainly benefits from collecting taxes and then refunding part of them. This money bears some implied interest rate between the time it comes in as sales or income tax and the time it is spent on the property-value-based transfer. One solution to this double taxation problem might be to lower the property taxes at the local level and increase state aid to local governments. This approach would ultimately undermine the constitutional distinction between state and local governments, but it would avoid the double taxation problem. Another solution would be to reduce the state revenue and expenditure on traditionally local government priorities. The current system relies on a periodic renewal of the tax-credit program by the legislature; failure to renew the program would act as a tax hike.

Nebraska should take on two reforms: reducing the tax rates so the extra revenue is not collected in the first place and creating a clearer distinction between state and local spending. If indeed the state is going to take on a larger role in financing local spending, it has to either eliminate or cap property taxes so that the local governments are not encouraged to simply use the additional revenue on other priorities. If states continue to spend on local issues, fiscal illusion suggests that the state will be financing expenditures that would be lower priorities for voters if they saw that these priorities required higher property taxes. If more spending is kept at the local level, cities could set property taxes that reflect the quality of service they are providing. Improving the feedback loop

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85. Henchman and Drenkard, *Building on Success*.

86. *State of Nebraska FY2015-16 / FY2016-17 Biennial Budget: As Enacted in the 104th Legislature—First Session*, August 2015.

in either of these ways would reinstate an appropriate restraint on both state and local spending.

## CONCLUSION

Nebraska faces a looming fiscal problem, as do many other states. It has long benefited from a relatively good financial position, but the expansion of the scope of tasks the state now manages has undermined the constraints that limit states' priorities. This is occurring around the country as a result of two pressures. The first pressure is for more spending at the state level that has traditionally occurred at the local level. This development is a response to concern over inequality in spending between local jurisdictions, particularly with regard to schools. The second pressure comes from the federal government, which encourages the states to take on ever-increasing priorities by partially funding them for a while and then backing off. This reduction in federal support for state spending is likely to continue as growth in entitlement spending increases pressure on the federal budget. The way forward for states is to set realistic priorities for spending at the state level. Nebraska is in a better position to manage this task than other states. Reforms that increase efficiency are possible, including setting priorities in health care and exploring school-choice options. These reforms will help keep Nebraska's fiscal house in order while other states face the looming budget crisis brought on by changing budget circumstances.

## ABOUT THE AUTHOR

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