[LR566 LR571]

The Committee on Revenue met at 1:30 p.m. on Tuesday, December 9, 2014, in Room 1116 of the State Capitol, Lincoln, Nebraska, for the purpose of conducting a public hearing on LR571 and LR566. Senators present: Galen Hadley, Chairperson; Paul Schumacher, Vice Chairperson; Burke Harr; and Kate Sullivan. Senators absent: Tom Hansen; Charlie Janssen; Beau McCoy; and Pete Pirsch.

SENATOR HADLEY: Good afternoon. Do you know there are a lot of people that think we should make Nebraska more like Washington? So we thought we would have a hearing like Washington, where none of the senators show up. (Laughter) Have you ever noticed that in a Washington hearing? They get up and they leave. And then you watch the congressmen at night when they're pontificating about all this important stuff and they pan the rest of the chamber and there's no one there. I think that isn't a bad idea, have some of our...(laugh) anyway, my name is Galen Hadley, and I am the Chair of the Revenue Committee. And I represent the 37th District, which is Kearney and about a third of Buffalo County. And to my left is Senator Kate Sullivan from Cedar Rapids, and 30...

SENATOR SULLIVAN: 41st.

SENATOR HADLEY: ...41st, Kearney (sic). And she is the Chair of the Education Committee. Krissa Delka is the clerk of the Revenue Committee. Since I'll be leaving as Chair after...this will be my last meeting. One of the smartest hires I've made...I made two real smart hires: her and our first testifier. So after that, you can't blame me for anything else that's here. We're going to...we had some people that couldn't make it today because of illness and such as that. But we're going to have the hearing because I think it's important that we get this in the record and we talk about it. We talk a lot about taxes, what they do, what they don't do, what we should do, what we shouldn't do. So we have worked with the staff, and we have a great staff: Mary Jane Egr Edson, former revenue commissioner; and Bill Lock, who is retiring at the end of this year, who has been here about 35 years working on Revenue. So what we wanted to do today is just to talk about taxes in general and to talk about some alternatives that we might look at for taxes, because a lot of other states do things differently, have different results, and I think we constantly have to be looking at what other people do. Nothing wrong with copying a good program. And so what we want to do is just to talk about it today, come up with some ideas, so the Revenue Committee that starts again in January will kind of have a running head start, will have a report ready that says, this is what other states have done, this is what the pros and cons of different methods of taxing property, income, and sales tax, so that we can go ahead. With that, it is not a public hearing, meaning that we will not take testimony. We wore ourselves out a year ago going all over the state with 2,500 people showing up for hearings. But we've heard a lot from our new senators because they've just got back from the campaign trail and they've been telling us about what they've heard out from our citizens across Nebraska. And taxes are still an important part of the discussion that people have. With that, I would turn it over to Mary Jane Egr Edson to start out and we'll go from there.

MARY JANE EGR EDSON: (Exhibit 1) Thank you very much, Mr. Chairman. It's been awhile since I've been on this side of the table, but I guess I'll state my name and spell it for the record. It's Mary Jane Egr Edson, M-a-r-y J-a-n-e E-g-r E-d-s-o-n, and I am legal counsel for the Revenue Committee. I'm presenting the interim report or interim study today on LR571. And that resolution asked for three things: (1) an examination of the exclusions, deductions, and credits currently allowed under individual and corporate income tax in Nebraska; the second thing is a review of other states' income tax systems, particularly those that have recently revised or reformed their income tax systems; and then, thirdly, a review of potential federal income tax changes that may directly affect Nebraska's income tax system. I'll say right out front, I...there's nothing in the interim study about corporate income taxes. There just wasn't a whole lot out there to write about, with the exception of Rhode Island which just changed its corporate income tax to look exactly like ours. So I don't know if that's a good thing or a bad thing, but that's about the most recent thing that I've seen with respect to changes in the corporate income tax. There's always bills and other proposals afoot to try and move some of the states that still operate under what we call a separate entity reporting system, so another reason why I didn't put in anything on corporate income tax. It takes forever to explain and there's not much to say at the end of the day with the movement away from the separate reporting system to a combined reporting system, which, again, is what we have already in Nebraska. So none of those things would be particularly relevant I don't think at this point to...if anything in Nebraska, mainly, there have been movements to simply reduce the rates and to increase...we have a two-bracket system for corporations, so the first $100,000 of income is taxed at one rate. Everything over that amount is taxed at the higher rate. And maybe there's some opportunity in there for reducing those rates and making it more attractive. So there's not...there's nothing in here on the corporate stuff. I also didn't put much...I didn't put anything in here with regard to any potential federal changes because, as the Chairman noted, things may or may not happen with regard to some of the tax laws in...at the federal level. We just don't know. They have this thing right now that they're referring to as "CROMBUS," which is the "continuing resolution omnibus" bill. There were a number of tax cuts and tax changes that are collectively referred to as the Bush tax cuts that have been set to expire each year over the last couple of years. And usually, towards the end of the year, Congress will come up with a continuing resolution to save those tax cuts for at least another year or two. They thought they had agreement on a bill. Then I heard yesterday that they don't have agreement on the bill. So we don't know whether or not any of those tax cuts will be extended. Even if they are, what they're saying right now on the Hill is that they would be extended at most through the end of calendar year 2014. So then, come January, with the new Congress they'll have to fight all over again about whether or not they're going to let them expire or extend them yet again. So there's not a whole lot to report about what's going on in Washington right now other than a lot of wrangling. So with that being said, the bulk of the report focuses primarily on the individual income tax. And I guess I'll just start by way of background. I guess I'll note for the record that we've been joined by Senator Burke Harr, who represents the 8th

District, from Omaha. [LR571]

SENATOR HARR: Thank you. [LR571]

MARY JANE EGR EDSON: By way of general background, there are 41 states plus the District of Columbia that impose a broad-based individual or personal income tax. And a survey of those states shows that at least eight have changed their income tax rates at least once or multiple times since the year 2000. Of the remaining 34 states, 32 did not change their rates or the number of brackets over this time period. And you do have in your packets a spreadsheet that looks like this. And it shows you all states from 2000 through current on those two pages. And it shows you what their rates are, how many brackets they have, whether they use a flat tax, because there are, if you include North Carolina, there are now eight states that have a flat rate, single-rate system that they use. It has blacked out completely the states that do not impose an individual income tax. And then, shaded in gray, for each state it shows you...that's when the changes were made in the rates and in the number of brackets. And there was some movement, you know, in the early 2000s and mid-2000s. But in the last year or two, we've seen a number of states moving to reduce the number of brackets or go to a single flat-rate system or to do something totally different. [LR571]

SENATOR HADLEY: Mary Jane, would you just quickly explain what a flat-rate tax system is? [LR571]

MARY JANE EGR EDSON: A flat-rate system would be where you just...there's just...there's no brackets. Like, Nebraska works off a four-bracket system where we have the different bands or layers of income and as you move up in those brackets you pay a higher marginal rate of tax. Some states did away or never had those brackets and they just had a single rate. For example, Colorado has a flat rate. And once...and what they do is they take what your federal taxable income is, your federal taxable as opposed to your federal adjusted gross. They take federal taxable, apply their rate, and move on down the line, very few credits or exemptions or deductions. [LR571]

SENATOR HADLEY: SO it would make income tax not progressive then if you use a flat... [LR571]

MARY JANE EGR EDSON: You can make it...you can make a flat-tax system progressive, and I have something about this in the report. You can make it progressive depending on how you structure your standard deduction versus itemized deductions and depending on the number and amount of credits and whether you make them refundable or nonrefundable. So there are ways to make a flat system progressive, but they typically are not very progressive in nature. Okay. The report focuses on the significant changes, recent changes in other states. It gives you a brief history of Nebraska's tax, a basic overview of both federal and Nebraska individual income tax systems, a review of these other states' approaches to modernizing or reforming their systems, and then a brief look at legislative proposals that have been previously introduced but not enacted in Nebraska. And then it concludes with a few common observations regarding these recent reforms of the individual income tax. And again, by way of background, in Nebraska in particular, the individual income tax is our largest state-level tax in Nebraska. We collected nearly $2.2 billion in individual income taxes during fiscal year 2012-2013, and slightly less than $2.1 billion in fiscal 2013-14. By comparison, the next largest tax is the sales tax which totaled just over $1.5 billion in 2013-2014. I'm not going to go through the history of how we went from a percentage of federal liability to what we do today, which is start with federal AGI and then make modifications from there. I'll skip over that. And you three have certainly heard this phrase more than you care to remember over the last year or so, but it's "base times rate." Any time you start talking about reforming an income tax or a property tax or a sales tax, you have to start with base and rate because they are the fundamentals of the system. The base is simply which items get taxed, and the rate is at how much. So if you're going to talk about reform, you have to talk in terms of base and rate, and you'll see that as we go through here. The committee members have also heard numerous times over the last year, year and a half, that most economists would argue that in a, quote unquote, perfect tax system, you would have an income tax. You would have a very broad base, any kind of system, a broad base and very low rates. But as you all know, over time and over the years, those bases have been eroded by certain deductions, exclusions, exemptions, and credits so that you have a somewhat shrinking base, in which case the rates have to rise proportionately in order to compensate for the loss in the base. Most of the states, the vast majority of the states, like I said, that have an individual income tax, aside from the ones that use the single-rate system, use brackets, which I was explaining before, where you have levels of income that increase as you go through the brackets and then you have progressively higher rates as you go through each of those brackets. All of the states vary, as you can see on the spreadsheet, you know, but there are...Missouri is an example of a state. They have ten brackets in Missouri. Hawaii has a high of 12. Nebraska uses four, which is pretty...I guess it's pretty close to the median, I would say. Progressive income tax systems have been very popular at the federal level and at the state level for a number of years for the reason that it allows for more equitable application of the tax. It's much easier from an administrative standpoint to equitably apply the tax and make sure that people on the lower end of the income scale are not paying a higher rate than people who are making more money than they are, although it does somewhat increase the complexity of complying. As an example, Senator Hadley, you brought up the flat system. I mean, if I have a flat tax that I just take my taxable federal income and apply a state rate to that and I don't get any deductions or credits or anything else, that's a very, very simple system to comply with. That's almost like a postcard return. But as far as how equitable it is--and we talked in Tax Modernization (Committee) about vertical equity and horizontal equity within the tax system--it's very difficult to embed that type of equity and to fairly distribute the tax burden if you're just doing a flat rate with no...a flat tax with no adjustments to it. [LR571]

SENATOR HADLEY: Mary Jane, just a quick point. When we're talking about brackets, would you just spend just a minute or two talking about what we did in the past session to index? Or are you going to get to that later? Okay. [LR571]

MARY JANE EGR EDSON: Yeah. (Laugh) [LR571]

SENATOR HADLEY: Forget I asked. Okay. [LR571]

MARY JANE EGR EDSON: Okay, I'll move along. [LR571]

SENATOR HADLEY: I ask questions every now and then of her just to make sure she's on the (inaudible)... [LR571]

MARY JANE EGR EDSON: I'll move along. I'll move along more quickly. Something else about the progressive income tax systems that are in use around the country today is that if the differences in...you know, say you have four brackets and the differences aren't very great--you know, like it's $1,500 in the first bracket and $3,000 in the second and $4,500 in the third--your brackets, there isn't much difference and they're too close together and what happens is it ends up operating more like a flat tax than a progressive income tax even though you haven't built in those things you need to make it equitable and fair. So that's...we're going to see Missouri as an example of that later when we go through. During Tax Modernization (Committee), you know, we relied an awful lot on the "Characteristics" article by Cline and Shannon, and I saw no reason not to rely on it again for this report. And Kleine and Shannon didn't go into a lot about this issue, but they did make an observation that marginal rates, those four marginal rates in each of the four brackets in Nebraska's case, in a progressive tax system they may be losing some of their appeal because they may be perceived as being detrimental to economic development if the rates are too high. And we've heard this before, that if you look at Nebraska on a regional basis with our regional neighbors, with the exception of Iowa, we do have one of the highest marginal rates. So there is some argument out there amongst the economists that perhaps the progressive income tax systems are losing some of their luster. And as I noted, Senator Sullivan, I believe, if we...or maybe it was Senator Hadley. You can do a flat-rate system and still make it progressive, but you do have to be very specific about how you go about doing those things to make it more progressive. And they noted that in the Kleine and Shannon article. And then also, I think it's always important to note, as Kleine and Shannon did, that if you reduce state individual income taxes, you're going to pay more federal income taxes because your individual income taxes are deductible at the federal level. So it's about 30 percent is what you get to deduct at the federal level. And I mean it's not necessarily an argument against doing state income tax reform. But it's something to keep in the back of your mind at all times that, however much you reduce your state taxes, you're going to see some sort of proportional increase in federal. [LR571]

SENATOR HARR: If you don't have a state income tax, can you deduct your state sales tax? [LR571]

MARY JANE EGR EDSON: Right, that's what we were talking about earlier, about how there's nothing in the report, really, about the potential federal changes. But they are looking at trying to extend some of the Bush-era tax cuts. And one of those wasn't a cut. It was a change. For the states that--nine states--that do not impose an individual income tax, they...those folks are allowed to deduct their state sales tax. Actually, you can choose at the federal level if you want to deduct your state income tax or your state sales tax. And there is some debate. I believe Senator Reid was trying to keep that in the proposal for the extenders, and I don't know if it is still in there or not. So I don't know if that will continue and whether people will be able to deduct their sales tax. Going through the report, I just have kind of a quick overview of the federal tax system because we do...Nebraska doesn't piggyback off the federal system like we used to anymore, but we do still start, as most states do, with federal adjusted gross income as our starting point. So it is important to note in the report which things are removed before you get to your federal adjusted gross income. And there are a number of things that get deducted out before you arrive at AGI. But that's where we start. That's where most states start. I thought it was worth noting that once you start calculating the

Nebraska tax, once you get to federal AGI and you go to your Nebraska return to start filling it out, I'm not sure everybody knows this, but you are allowed to choose between the standard deduction and the itemized deductions, whichever is greater. But you are limited to the itemized deductions you claimed federally. You can claim those for Nebraska purposes or you can claim the standard deduction, whichever is higher. The standard deduction in Nebraska right now is $6,100 for single filers; $12,200 for married filing joint. And depending on the number of dependents you have, the standard deduction can go as high as $17,000 for married filing joint, or $9,100 for single filers. And then just a reminder again about itemized deductions, because I'll be talking about them when we get to the other states that I looked at, but generally the big itemized deductions are medical expenses, real estate taxes, home mortgage interest, charitable contributions, casualty or theft losses, and certain investment interest. Those are kind of the big ones. So we start with AGI. We do your standard deduction in Nebraska. Then we have adjustments increasing AGI and adjustments decreasing AGI, and you can see what those are. And that gets you to your Nebraska taxable income before nonrefundable credits, and I have the list there. And it's important to note, because we'll talk about them with regard to other states, you have: a credit for the elderly and disabled; a credit for child/dependent care; a credit for tax paid to another state--there's actually a case pending before the United States Supreme Court right now out of Maryland on that issue--community development credit; financial institution credit; Nebraska personal exemption credit, which is a very small amount; biodiesel facility investment credit; and then the nonrefundable credits under the Nebraska Advantage Act and its predecessor, LB775. Refundable credits in Nebraska, these are the ones where your tax liability can go below zero. In other words, your tax liability is zero but you still qualify for this refundable credit, so the state pays you this amount. And that's the Nebraska Advantage Rural Development (Act) program; Nebraska Advantage Microenterprise; Nebraska Advantage R&D; the credit for child and dependent care, there is a nonrefundable as well as a refundable credit for that; beginning farmer credit; of course, the earned income tax credit would be one of the largest; and then the angel investment credit. And then on page 7 you can see I have listed out there just what

Nebraska's four brackets are right now for the different filing statuses--individuals, married filing joint... [LR571]

SENATOR HADLEY: Mary Jane, just a quick question. Maybe you'll get to this later. [LR571]

MARY JANE EGR EDSON: Okay. [LR571]

SENATOR HADLEY: One of the concerns with term limits is that we're not around very long. Do you know, have we taken a long, hard look at the adjustments increasing and decreasing federal adjusted income? And has it been awhile since we've done that? [LR571]

MARY JANE EGR EDSON: I would have to say it has been, because I think these are pretty much standard adjustments. Long-term care savings plan recapture and long-term care savings plan, I think that came into law sometime towards the end of my tenure as tax commissioner. So maybe around 2005 might have been the last time that we looked at this, and then the special capital gains exclusion, which we've talked about in the past but hadn't made any changes really. [LR571]

SENATOR HADLEY: Well, you know, we're trying to give a road map for future Revenue Committees, and that might be something that an interim study, like we did on tax incentives this year, would be to go back and take a look at these because, again, we hear a lot that we don't go back and reexamine some of the exemptions and such as that, that we've given in the past. [LR571]

MARY JANE EGR EDSON: Right, right. [LR571]

SENATOR HADLEY: So it's just a suggestion for maybe next summer, to do a study on these as to see are they still needed, are they effective, what do they cost, what was the purpose, are they meeting the purpose,... [LR571]

MARY JANE EGR EDSON: Right. [LR571]

SENATOR HADLEY: ...as just a suggestion. [LR571]

MARY JANE EGR EDSON: Okay. Thank you. So on page 7 you can see what our marginal rates are on our four brackets. They vary from 2.46 up to the top rate of 6.84. And then I have in there a little bit of discussion and a table with regard to effective tax rates. And the best way to describe or to understand effective tax rates is the way they're defined by the Department of Revenue in their tax expenditure report. And their effective tax rates are defined as Nebraska individual income tax net of nonrefundable credits as a percent of federal AGI. So basically, what it is, it's the actual rate that you end up paying at the end of the day after you've taken out all your exclusions, all your deductions, and all your nonrefundable credits. And then, as a percentage of your adjusted gross income, it will show you what your actual effective tax rate is that you pay. Okay? And I failed to put the AGI numbers in here on this chart on page 7, but the Department of Revenue breaks down all the returns that are filed, individual returns, into ten different deciles or ten different groups. And the first seven deciles all get lumped together. But for the eighth decile, the starting point for AGI is $58,613. The ninth decile starts at $77,022. The tenth decile starts at an AGI of $105,937. And then the theoretical eleventh decile, which is the top 500 returns, the AGI starts at $1,856,509. And as you look at those different deciles and then go through the different tax years, you can see that, the effective tax rates paid by Nebraskans, in no case does it ever go over 5 percent. And that is because of the exclusions, the deductions, and the credits that nobody ever actually pays those marginal rates that you see up by the brackets. And I can see the Chairman has a question. [LR571]

SENATOR HADLEY: A couple questions, Mary Jane. Is this type of data available from other states as far as their effective... [LR571]

MARY JANE EGR EDSON: Some. [LR571]

SENATOR HADLEY: Some...because I think this is a very important point. When we do a lot a of...when we're compared to other states, if you're just comparing the marginal rates--i.e., the stated rates--they could be significantly different from the effective rates. So we want to compare apples to apples and... [LR571]

MARY JANE EGR EDSON: Right, but it's the marginal rates that always show up in the 50-state reviews or whatever, you know. These are their marginal rates. This is...and you don't get into what the effective tax rates are. And I've heard the argument made as well that people make decisions at the margins. They look at the marginal tax rate in a state and decide whether or not they think that's livable or doable. [LR571]

SENATOR HADLEY: But I sometimes wonder whether, you know, intelligent people who are making these decisions certainly understand the difference between a marginal rate and an effective rate. And, you know, if the effective rate is the one that's the most important one that people are making decisions on, all we have to do is get rid of all the deductions and exemptions and we could lower that effective rate, getting down to 3.26. And the question then becomes, is that a real positive thing for surveys and people across the country? They say, move to Nebraska, they have an effective rate of 3.26 percent. [LR571]

MARY JANE EGR EDSON: Yeah, I mean, you could actually reduce your marginal rates down to 5 percent and take away all the deductions, credits, and exemptions, and people would still be paying at a higher effective rate than they currently are. [LR571]

SENATOR HADLEY: Yeah, they still would be... [LR571]

MARY JANE EGR EDSON: Yeah. [LR571]

SENATOR HADLEY: The bottom line is the same. [LR571]

MARY JANE EGR EDSON: Yeah. [LR571]

SENATOR HADLEY: But the rate is different. [LR571]

MARY JANE EGR EDSON: Right, exactly. Okay, we're going to get over and get moving on the review of the other states. The first state we're going to start with, on page 8, is North Carolina, which recently changed from a three-bracket system to a single-bracket flat rate. Their law went into effect in this current tax year, 2014. Their old brackets, the three brackets, were 6 percent, 7 percent, and 7.75, and they've now reduced that to a single rate of 5.8 percent for the current tax year. Next year it's scheduled to drop a little bit more, down to 5.75. North Carolina, in order to reduce the cost of the reduction in rates, they expanded their base, if you will. Itemized deductions are eliminated now except for charitable contributions that are claimed on the federal return, and a total of no more than $20,000 for a combination of your mortgage interest and property taxes. So those are the only itemized deductions that are allowed in North Carolina. Other deductions that were eliminated, they eliminated their college savings plan deduction, their 529 plan deduction. By contrast, Senator Hadley, you sponsored the bill that increased the deduction here in Nebraska just recently for 529 plans. [LR571]

SENATOR HADLEY: You sure that wasn't Senator Harr? [LR571]

MARY JANE EGR EDSON: I'm pretty sure it wasn't. It was some senator whose name starts with an "H," so. (Laughter) We're going to come back to this one, too, when we talk about Kansas. But North Carolina had a deduction for what they called net business income, and this is primarily if you are the owner of a business that's structured as a flow-through entity. For instance, a limited liability company or an S corporation or something like that where the income, your income from that business, flows through to you rather than being taxed at the entity level, you could deduct the first $50,000 of that flow-through income on your return in North Carolina. They've eliminated that deduction. They had a $4,000 deduction for government retirement income. That's been eliminated. And the IRC Section 179 deductions, this is the case where, instead of having to amortize a piece of equipment over a period of years, the IRS will allow you to accelerate that and expense it all in the first year, the first year that you purchase it, and use that as a...you know, obviously, that offsets your income. North Carolina has reduced their 179 deduction from $250,000 down to $25,000. And in addition to all that, they eliminated the following credits. They eliminated their earned income tax credit. They eliminated their childcare expense credit, additional credit for the disabled, charitable contributions by nonitemizers. So unless you itemize on the federal return, you're not allowed to deduct your charitable contributions in North Carolina. Long-term care insurance is eliminated. Adoption expenses and education expenses are also eliminated, as are their personal exemptions. The revenue estimates that North Carolina put together for their individual income tax cuts...and I just have those, not the corporate rates, and there were some sales tax increases which I'll talk about later. But in July of 2013 they put out their original estimates of how much the tax cut would impact their revenue, and then they had to revise it again in July of this year. The original estimate for the current fiscal year was $475 million and then this July they had to increase that by $205 million, so the first year it's expected to cost them $680 million. Now, granted, North Carolina has a much larger budget than the state of Nebraska, so $680 million may not...you know, it sounds like a big number to us, but... [LR571]

SENATOR HARR: It's about a 33 percent increase, though, isn't it? [LR571]

MARY JANE EGR EDSON: Yes. [LR571]

SENATOR HARR: Yeah. [LR571]

MARY JANE EGR EDSON: Yeah. It's a large increase. They...yeah, they had a difficult time trying to estimate how much the tax cut was actually going to cost. The total cost in North Carolina is now projected to be nearly $5.3 billion over five years, and that's approximately $900 million more than the original estimated revenue loss. They were off by almost a billion dollars on their revenue estimate. [LR571]

SENATOR HADLEY: And so it will be necessary for them to cut... [LR571]

MARY JANE EGR EDSON: Make adjustments in their budget. [LR571]

SENATOR HADLEY: ...adjustment in North Carolina expenditures... [LR571]

MARY JANE EGR EDSON: Correct. [LR571]

SENATOR HADLEY: ...or to go back and potentially increase some taxes or something like that. [LR571]

MARY JANE EGR EDSON: They could increase the rates or they could go back and they could take away some more credits and deductions. [LR571]

SENATOR HADLEY: Secondly, from a political will standpoint, a number of the things that they've dealt with are difficult issues. [LR571]

MARY JANE EGR EDSON: Yes. [LR571]

SENATOR HADLEY: You deal with charitable deductions, home interest, college savings plan... [LR571]

MARY JANE EGR EDSON: Property taxes. [LR571]

SENATOR HADLEY: ...property taxes, retirement systems,... [LR571]

MARY JANE EGR EDSON: Earned income tax credit, yeah. [LR571]

SENATOR HADLEY: ...EITC. [LR571]

SENATOR HARR: The most vulnerable. [LR571]

SENATOR HADLEY: Every one of those groups have people that will be telling you that that's really an important deduction that is necessary. So I admire them for doing that. And now they've got to follow through and figure out how to cut the spending, which is a double whammy because they faced concerns when they did this, and now having to cut... [LR571]

MARY JANE EGR EDSON: And just as a final note on North Carolina, their income tax collections for the first quarter of this fiscal year are already $102 million behind forecast. [LR571]

SENATOR SULLIVAN: I presume we have data on what our changes that we made... [LR571]

MARY JANE EGR EDSON: Yes, ma'am. [LR571]

SENATOR SULLIVAN: ...have resulted in. [LR571]

MARY JANE EGR EDSON: Yes, ma'am. [LR571]

SENATOR SULLIVAN: Okay. [LR571]

MARY JANE EGR EDSON: Okay. So North Carolina was one of the more recent...as I said, this is...they're in the first year of...first full year of implementation, so it'll be interesting to see how things pan out the rest of the year and over the next year as well. I guess that's probably something you can say with...maybe with the exception of Utah, most of these changes are so recent that it's difficult to tell whether or not they accomplished what they were intended to accomplish. So Rhode Island is another state up in New England that had the highest...they had the highest marginal rate out of all their New England neighbors. So they reduced their brackets starting in...for 2011 tax year was their first year. They went from 5 to 3 (percent) and they reduced all the rates except the lowest rate. And then the top rate was reduced from 9.9 to 5.9 (percent). Rhode Island totally eliminated all itemized deductions and just went with a standard deduction, and everyone now has to use the standard deduction which, by the way, starts to phase out at higher income levels. So if you're married filing joint, you receive a $15,000 standard deduction. And then once your AGI exceeds $175,000, the standard deduction is reduced. That $15,000 standard deduction gets reduced. And once your AGI gets past $195,000, you get no standard deduction at all. They reduced their personal exemptions, and they also are phasing those out at the higher income levels and eliminated some credits such as their investment tax credit, jobs training credit, R&D credit, and employment tax credit. And similar to what you'll see with Utah, once taxpayers reach an AGI of $200,000 or more, they're essentially paying 5.9 percent, which is now the highest rate in Rhode Island, on their federal adjusted gross income without any deductions or credits, no itemized deduction, no standard deduction, nothing. They're just paying 5.9 once they get to $200,000 or more of AGI. [LR571]

SENATOR HADLEY: And roughly speaking, ours...people in the same income bracket would be at an effective rate of about 3.9. [LR571]

MARY JANE EGR EDSON: Four, four. Yeah, four. [LR571]

SENATOR HADLEY: Four percent, so our... [LR571]

MARY JANE EGR EDSON: And they're calling for further reductions in Rhode Island. They're still saying that it...they're still not...they're not recovering as quickly as some of the other states in their region, so they're looking to do more cutting in Rhode Island. Again, they did things a little differently in Rhode Island than...just, you know, slightly differently than they did in North Carolina in that they really went...going after the itemized deductions and totally eliminating them makes a huge difference--that significantly expands your base--and then phasing out that standard deduction. So their original estimate was that it would be revenue neutral, that their bill would be revenue neutral. And then they revised their estimate to say that it would result in a decrease of about $6 million in the first full year of implementation. And then since that year, their individual income tax receipts have steadily climbed each year, which I guess is maybe why they're calling for more tax cuts back there. Right now their tax collections are running ahead of forecast by about $8.2 million or 3 percent. Utah: Utah is not necessarily a recent reformer but an interesting reformer and I thought really was noteworthy and should be included in here. They did their big changes back in 2006 and 2007. And the way they describe their system now is that they moved from a deduction-based system to a credit-based system, which makes it sound like it's very simple but it's actually quite complicated. But with a couple of adjustments, your federal AGI equals your Utah taxable income, which is now taxed at a flat 5 percent. They have no brackets, just AGI, a couple modifications, taxed at 5 percent. Then you get to offset the amount of tax due by 6 percent of the standard deduction or itemized deductions plus a personal exemption. And that's referred to in Utah as the taxpayer tax credit. So it's 6 percent and you get to use that to offset your tax liability. [LR571]

SENATOR HADLEY: This is at the federal? [LR571]

MARY JANE EGR EDSON: No, this... [LR571]

SENATOR HADLEY: ...of the federal itemized or... [LR571]

MARY JANE EGR EDSON: Yes, yes. [LR571]

SENATOR HADLEY: ...of the federal itemized (inaudible)... [LR571]

MARY JANE EGR EDSON: Yeah, or a standard deduction, whichever... [LR571]

SENATOR HADLEY: ...or a standard deduction. [LR571]

MARY JANE EGR EDSON: Whichever you used federally, yeah. Okay. So after they do that, after they take their 6 percent credit, if the remaining amount of the tax exceeds what they call their base phaseout amount--singles, it's $13,000; married filing joint, it's $26,000--then your taxpayer credit is actually going to start to decrease proportionately. Okay? So in effect, what happens is that once you get to an AGI of $300,000 in Utah, you get no taxpayer credit and you just pay at the flat 5 percent rate, no deductions, no credits, no nothing. So you get that 6 percent credit to apply against your tax liability. Okay, it's not a deduction from AGI or anything like that. But they make a couple of adjustments to AGI, come up with your tax liability. You get a 6 percent credit. And as your income starts to increase, that credit starts to decrease until you get to about $300,000, and then nothing. They did convert some of their credits...some of their deductions, I should say. Traditional deductions were converted to credits, but they made them nonrefundable so that in no case can the taxpayer liability go below zero. And they just said straight out when they introduced their bills that the intention of the bill was to reduce income taxes in Utah by $110 million. This is an example of a flat system that remains progressive by using those phaseouts on the taxpayer credit. So even though it's a flat system, you're still being somewhat progressive. They had some challenges during the recession, I would say, but most...the last couple of years, Utah's receipts have come back very, very strong and they're collecting more in individual income tax now than they were before the changes. I thought it was interesting to note here, too, that--this is very unusual--Utah's individual income tax, and then I think the corporate income tax and maybe one other tax, are...go directly to the education fund and are used exclusively for funding the schools in Utah. So the individual income tax is used for nothing else other than funding schools. [LR571]

SENATOR HADLEY: Can you say that again now? [LR571]

MARY JANE EGR EDSON: The individual income tax is used exclusively for funding schools in Utah. That was a constitutional amendment that they put in. It's the individual income tax, corporate income tax, and then some smaller...one of their severance taxes on minerals. But those... [LR571]

SENATOR SULLIVAN: So is that pooled or does that go based on... [LR571]

MARY JANE EGR EDSON: It goes into an education fund, and then the schools are paid for out of the education fund. [LR571]

SENATOR SULLIVAN: But it's not allocated based on the income that is generated. [LR571]

MARY JANE EGR EDSON: I didn't get that deep into their formula, Senator. [LR571]

SENATOR SULLIVAN: Okay. All right. Okay. That's fine. [LR571]

MARY JANE EGR EDSON: Senator Harr, are you... [LR571]

SENATOR HARR: What's their corporate income tax rate, if you know? [LR571]

MARY JANE EGR EDSON: I don't know off the top of my head. [LR571]

SENATOR HARR: Okay. [LR571]

MARY JANE EGR EDSON: Sorry. [LR571]

SENATOR HADLEY: I think it's fairly low. I just...I've read a little bit about Utah, and they're trying to get...bring companies in from California and such as that. And I think they have a fairly low... [LR571]

MARY JANE EGR EDSON: Yeah. I think it's fairly low. Yeah, it's a fairly low rate. Missouri, here is what I was telling you about as an example of the state that has so many brackets that are so close together that it really operates more as a flat tax. They have a ten-bracket system with rates that range from 1.5 to 6 percent. But by the time you get to the top bracket, it kicks in at $9,000 of taxable income. So think about trying to squeeze ten brackets underneath that $9,000 cap. You know, it really kind of boggles the mind. But that's how their system was working originally. And now they've passed legislation during the past session. It does not go into effect until...2017 would be the first year that it would go into effect. But they would reduce the top rate by 0.1 percent per year for 5 years beginning in 2017. They would start indexing their brackets for inflation like we do. They increased their personal exemption and then they created a new exclusion or deduction of up to $25,000 for business income. So again, if you're getting business income through a flow-through entity or some other sort of business entity, you would now get a deduction for that in Missouri. Missouri's changes are also predicated on what they call revenue trigger. It's a revenue-triggered cut. And the actual language of the bill is on the top of page 13: "...if the amount of net general revenue collected...in the previous fiscal year exceeds the highest amount of net general revenue collected in any of the prior years by at least $150 million." So if you get $150 million or more increase in one fiscal year over a prior fiscal year, then it triggers the rate reductions. So it'll be interesting to see how this is going to pan out. The fiscal note that was prepared by their committee on legislative research and oversight noted that the bills would reduce net general funds by about $621 million in the fifth year, which would be the first year that it's fully implemented because it's a five-year phase in. So that's what Missouri has proposed. It hasn't gone into effect yet, so really nothing to tell.

[LR571]

SENATOR HADLEY: M. J., just...and maybe you'll talk about this later. When you talk about exclusion of income of $25,000 in business income on... [LR571]

MARY JANE EGR EDSON: Of the business income. [LR571]

SENATOR HADLEY: Is that ever taxed then? Is the $25,000... [LR571]

MARY JANE EGR EDSON: Not if it's coming from a flow-through entity because there would be no...yeah. [LR571]

SENATOR HADLEY: If it's from a flow-through entity, it's just...no tax is paid on it, right... [LR571]

MARY JANE EGR EDSON: Right, right. [LR571]

SENATOR HADLEY: ...because it's not a corporate tax or... [LR571]

MARY JANE EGR EDSON: Nope. [LR571]

SENATOR HADLEY: And if it's a partnership or a... [LR571]

MARY JANE EGR EDSON: The entity does not pay tax on that income, and the income gets distributed to the shareholders or the partners or the owners and they pay. They report it. It gets distributed. You see it on the...what they call the Schedule K-1. For, say, a partnership or an LLC, the K-1 is the schedule of all the owners and what their ownership interest is and how much their distribution is in earnings from the entity that year, and that has to be filed with the IRS as well as with the state. And so then that amount of income flows through to the owner and I have to report it on my individual return. Now, in Missouri, if...in that situation, I'll be able to exclude $25,000. Say I made $100,000. I can exclude $25,000 of that from the tax. [LR571]

SENATOR HADLEY: So it effectively...it's a tax break for... [LR571]

MARY JANE EGR EDSON: Yes, for small...well, for flow-through entities. [LR571]

SENATOR HADLEY: ...closely held. Pretty significant, too, isn't it? I mean... [LR571]

MARY JANE EGR EDSON: Well, it gets bigger in Kansas. As we move into Kansas, you're going to see just how big it gets, so. [LR571]

SENATOR HARR: So if I'm an associate in a CPA firm... [LR571]

MARY JANE EGR EDSON: An associate? [LR571]

SENATOR HARR: An associate, not an owner. [LR571]

MARY JANE EGR EDSON: Not an owner. [LR571]

SENATOR HARR: ...and I made $100,000, I'd pay $100,000 in taxes. [LR571]

MARY JANE EGR EDSON: Well, you'd pay tax on $100,000, yeah. [LR571]

SENATOR HARR: Let's say AGI, AGI of $100,000. [LR571]

MARY JANE EGR EDSON: Right. [LR571]

SENATOR HARR: Next year, I make partner. [LR571]

MARY JANE EGR EDSON: Right. [LR571]

SENATOR HARR: And my AGI is still $100,000. I'd only pay on $75,000. [LR571]

MARY JANE EGR EDSON: Correct. [LR571]

SENATOR HARR: Because...? What's the public policy reason for the... [LR571]

MARY JANE EGR EDSON: Because now you're an owner. You're a business owner, so you get a business income deduction. [LR571]

SENATOR HARR: So now I'm a job creator. [LR571]

SENATOR HADLEY: You're...the risk, maybe you have a reward for the risk you're taking as an entrepreneur. [LR571]

MARY JANE EGR EDSON: Right. [LR571]

SENATOR HARR: All right. [LR571]

MARY JANE EGR EDSON: Well, Kansas, which is the next state that we have here in the report, made some very significant changes, as you all know, and they've been debated ad nauseam in the press over the last couple of years. They did two rounds of changes. The first bill was passed in 2012. They had three brackets. They eliminated the middle one, so now you have two brackets that are at 3.5 percent and...or, I'm sorry, at 3.5 and 6.45. And then they're set to be reduced again in 2018 down to 2.3 and 3.9. So they're set to that top...they're both set to be reduced pretty significantly in 2018. Kansas eliminated some deductions in credits, the Section 179 deduction that I mentioned earlier. Kansas is different in their sales tax treatment of food, groceries. They tax groceries, unlike Nebraska and a lot of other states. They did, however, provide a refundable low-income credit for sales tax paid on groceries, and they eliminated that in their 2012 income tax reform. They eliminated the refundable low-income credit on groceries. They eliminated the deduction for adoption expenses, child and dependent care expenses, and child day-care expenses. The most notable thing that Kansas did is they passed a total exclusion for business income. So you can see there, on the bottom of page 13 going over to the top of page 14, any of the flow-through income payments they...and they say payments received as an independent contractor or as a statutory employee or as the owner of a single-member LLC, the income you receive from that entity, all of that income is exempt for Kansas purposes. If you have income from certain sources, including rental real estate, royalties, net farm rental, and net farm profit, are all excluded, and then anything received from a flow-through entity, such as an "S corp," an LLC, or a partnership. So all of that income is exempt now in Kansas. So if I were running my own business, just me all by myself, and I made $100,000, I would normally pay tax on $100,000. But if I create a single-member LLC and now it flows through to me from my LLC, I can deduct it all as a business income deduction in Kansas. Needless to say, they've had some issues with regard to their tax receipts in Kansas and we're still... [LR571]

SENATOR SULLIVAN: Should have printed this in red. [LR571]

MARY JANE EGR EDSON: ...still not entirely sure how this is all going to pan out. After the first year, after...those were all the changes that they made in 2012, by the way. And then during the 2013 legislative session, they made some additional changes. Itemized deductions, except for charitable contributions, are reduced by 30 percent in 2013 and 5 percent each year until by 2017 when you can only deduct 50 percent of your itemized deductions. So they're taking away 50 percent of your itemized deductions. The food credit that was originally taken away has now been partially restored, but it's no longer refundable. And they decreased their standard deduction from $7,500...or, I'm sorry, from $9,000 to $7,500 in order to try to offset some of their lost revenue. If you go over to page 15, the consensus forecast for Kansas was just revised on November 17 and it states that the fully annualized impact of the tax cuts was $730 million for tax year 2017. And for fiscal year 2014, individual tax receipts were 24.3 percent below the previous year. So their income tax receipts dropped off by almost 25 percent one year over the next. For the next three fiscal years--2015, 2016, 2017--individual receipts are estimated to be lower by an additional...in addition to the original lowered projections, they're now saying an additional reduction of $153 million, $113 million, and $101 million, respectively. [LR571]

SENATOR HADLEY: Mary Jane, you know, obviously, if you're interested in taxes, you've read about Kansas and such as that. And as a defense of Governor Brownback when he put this together, my understanding is the legislature did not follow through with cuts in expenditures, which is a signal to us that, if we're going to work on lowering tax revenues, we have to take the second step and be willing to look at what we spend our money for and say we're going to cut X, Y, and Z out of our expenditure budget because, if we don't, we end up the same place that Kansas is: not being able to balance their budget because they've cut revenues but their expenditures are still at their old rates. So that's what puts them in a terrible situation. So often we talk about cutting taxes and we don't also then talk about what we need to reduce in the way of expenditures to make the budget balance yet. [LR571]

MARY JANE EGR EDSON: Right. Oklahoma is the last state that I reviewed. Similar to Missouri, they have passed legislation that is predicated on a revenue trigger--again, if future revenues are X amount over previous year revenues. So that one has not been implemented yet. They're estimating that it will cut revenue by about $200 million a year. And I guess probably the most notable things that...their highest marginal rate kicks in at $8,700 for individuals and $15,000 for married filing joint. So again, it's...it looks more like and operates more like a flat system because those highest marginal rates kick in so early. Now, Senator Hadley, I'm going to get to some of the changes that were made after... [LR571]

SENATOR HADLEY: Sorry I jumped the gun... [LR571]

MARY JANE EGR EDSON: No, that's quite all right. [LR571]

SENATOR HADLEY: ...because the crack staff always has this stuff right at their fingertips. [LR571]

MARY JANE EGR EDSON: (Laugh) Well, I'm not crack staff, but whatever. The next part of the report gives you a quick overview of the changes that have been adopted by the Legislature within the last couple years, and I'm talking since 2012. It hasn't been...it's only been over the last couple years that these have been done, most notably, LB987 this past session where you indexed the brackets for inflation. And I think everybody now understands what indexing means. It means take the inflationary rate and you adjust your brackets accordingly so that, instead of taxing the first amount of income that's at $6,000, now it's going to be $6,102. It avoids...what oftentimes happens in a progressive income tax system is that, even though people are not seeing a real growth in personal income, they could see themselves flopping into the next highest marginal rate simply because of a cost-of-living increase or something like that. And so indexing helps you keep pace so that you don't have people paying a higher rate of tax when they haven't really seen an increase in their personal income that mirrors that same amount. It's kind of a hidden tax increase if you don't index the brackets. [LR571]

SENATOR HADLEY: I believe the head of the Legislative Fiscal Office made a comment that the single most item that will have an impact on future revenues of the state of Nebraska is exactly this, the indexing. It's something that kind of flies under the radar but will have a significant impact on total revenues for the state of Nebraska. After ten years it will be $100 million in less revenues. And we have to be very honest. The Legislature in the past, this has been kind of a hidden tax increase that we've had that have allowed us to have funds to do things, and we basically took that away last year.

[LR571]

MARY JANE EGR EDSON: It averages right around $10 million a year. So that, combined with the changes that you made with regard to Social Security income...LB987 also increased the amount of Social Security income that's exempt from tax here in Nebraska, and then also the military, the partial exemption for military retirement income. All three of those items were in LB987, and total fiscal impact over four years is $125 million--not bad. LB970, which was Senator Cornett back in 2012, a lot of the changes from LB970 are...were being phased in and this year was the last year that we were phasing them in, so they're all now fully phased in. And what it did was it expanded the bracket amounts. Those dollar amounts in the brackets got expanded and pushed upwards anyway, so you had that action going on under LB970. In addition, LB987 does the indexing. That bill's total cost over three years was $97 million. And then LB308, which was Senator Schumacher, was the one where we eliminated the alternative minimum tax and extended net operating loss carryforward for businesses from 5 years to 20 years, which puts us in...makes us conform to the federal. And so that fiscal impact was about $24 million. So if you add all of those up without double counting, my understanding is that all of those changes add up to about $246 million in tax cuts from 2012 through '17-18. So there have been some very, I would say, very significant changes made to the Nebraska income tax system in the last couple years. I also have in here...and I'm not going to go through them in excruciating detail because I don't want to drag this out any longer. I think my time is pretty close to being up. Senator Harr introduced a bill just this past session that would have reduced the brackets from four to three and then reduced the rates over a period of time. And if you flip over to page 18, you can see what the estimated revenue loss was, and that was without making any adjustments to the base, making no changes to credits, deductions, exclusions, or whatever the case may be. There were a couple other bills that were introduced back in 2007 by Senator Ray Janssen and by Senator Ron Raikes. And one of the more interesting ones on page 19 is LB398 which was introduced in 2003 by Senator Pam Redfield and Senator Ron Raikes. And it would have taxed all income at a flat rate of 5.1 percent, eliminated all itemized deductions and credits, and increased the standard deduction and personal exemption credit. And it would have generated roughly about $3.5 million extra per year if you just eliminated every...all the credits and all the deductions, went with the standard deduction and a flat rate of 5.1 percent. It was almost, in terms of a state budget, revenue neutral, which I think is fascinating. So if you wanted to do a single-rate system, that might be something to look at. Some common observations from having done this review: I think the main thing to take away from this is that you can slice and dice an income tax system and reform it any way you want to. You could reduce the number of brackets. You could go to a single-rate system, single bracket, single rate. You could just reduce rates. You could reduce brackets and rates. You could do some sort of a revenue trigger, although we haven't seen how those are working just yet. But there's any different ways that you can approach this, and different states are taking different approaches. And it strikes me that it makes a difference what your goals are. Why are you reforming your tax? Is it because you simply want to reduce rates? You simply want to reduce the total amount of revenue that's being generated? Do you want to...you're doing it because you want to make the state more attractive as far as the marginal rate to bring in more workers? Are you trying to be more competitive with your neighboring states? Are you trying to simplify the system? Are you trying to make it more balanced and fair? And I put in there, on page 20 you can see, some of the excerpts that were attributed to various proponents of the tax cuts in the other states as to what they were trying to accomplish. I thought Utah's was very succinct and very direct. What problems were they trying to solve? They didn't want to rely on federal AGI anymore. They were tired of relying on federal AGI as their starting point. The income tax, as you know from Tax Modernization Committee, is volatile. It is what they call elastic. It ebbs and flows with your economy. And they also had tax rates higher than their neighboring states in Utah at the time. And one of the largest impetuses was that the state had surging revenues. They had $1.6 billion--$1.6 billion--surplus in a $10 billion budget. So that was a pretty big...that was a very large motivational factor for them to make some of their changes. Rhode Island, on the other hand, specifically said right from the outset that theirs was designed to be revenue neutral. The principal objective was to reduce the state's top rate, which was 9.9 percent, to a level that was more competitive with neighboring states and with the national averages. So I guess one of the takeaways that I came away with was that it makes a difference, what you're trying to accomplish, in how you go about reforming or modernizing your income tax system. You know, some of the states--North Carolina to a certain extent, Rhode Island, Utah--they wanted...they looked to base broadening as a method of reducing the revenue impact because we know that if you do nothing and you just reduce the rates, it's going to have a significant impact. And so if you want to reduce or cushion that blow a little bit, you can look at expanding your base. And that includes things like capping the itemized deductions, eliminating itemized deductions, eliminating certain credits or deductions or a combination of all of those. One thing that I did notice that was...and you were asking...you asked me earlier, Senator Hadley, about whether or not there was any analysis done of the tax burden and how it's shifted or how it could shift. I guess two things: first of all, I've noticed several of the...some of these states really didn't make an attempt to analyze very closely how much it was going to cost them in revenue let alone how the tax burden was going to be redistributed. Utah did a stellar job in doing their analysis of how their tax changed, and this is at the back of your report, the lovely colored charts that are at the back there. And these are all from Utah and they can...they show you exactly how many...what percentage of filers in Utah were going to see a minimal decrease, were going to see no change, were going to see a minimal increase, and then those that were going to see large...or increases or decreases because, as you know, every time you change your income tax system, no matter how hard you try, there are going to be winners and losers. Somebody somewhere will end up paying more. And most people will end up paying less, but there will be some people who end up paying more. They show their...you asked about effective tax rates. One of the charts back there shows you Utah's effective tax rate change by income, and you can see on the chart that, you know, essentially everyone's effective tax rate went down except for the 75th and 95th percentile, the highest income earners. The next chart, which has the blue...kind of blue cloudy dispersion--I think these are really interesting--that shows you the dollar amount of change by taxpayer and by income. And you can see the zero and you can see that there...you know, the vast majority of people saw a decrease, you know, saw a change in the amount of tax, again, except with the very high income earners. And then the very last page is the effective tax rate by taxpayer and income, and you can see the darker blue-gray dispersion is the effective tax rate in 2005. And then the green is the effective tax rate in 2008. And you can see how the effective tax rate was changed based on the amount of income. So one of the things Utah was able to do that some of their folks noted in an article postmortem on the tax reform, they were able to get cleaned data from their department of revenue that was cleaned and scrubbed of all...you know, any potential identifiable information. And they were able to really do some significant data mining to make determinations to make an analysis of how much it would...how much the cuts would cost, how the burden would be disbursed differently, or if at all differently, throughout the system. And so they were able to tweak it to find just the right amount because again, remember, Utah does that credit. You know, they calculate your liability, and then you have that 6 percent of your itemized deduction or standard deduction that's your credit against your liability. And in determining that 6 percent amount, they did an awful lot of modeling, and that's how they came up with the 6 percent. It was because they modeled it out and saw what effect it would have. I think that's pretty much my observations on this report. [LR571]

SENATOR HADLEY: Are there questions for Mary Jane? In another life being a CPA, I would like to make it as complicated as possible, because the more you make it complicated, the more people have to...they call it the "CPAs and tax lawyers relief act" every time Congress changes things to make it... [LR571]

MARY JANE EGR EDSON: It's a job security act. [LR571]

SENATOR HADLEY: Well, seriously, the one takeaway that I do take from this, and I think it's a great report to talk about what other states have done, is that as we go into this and look at it, we have to be very careful of examining not only the tax cuts but what we need in...if we're going to have tax cuts, are we willing to make the expenditure cuts that will make it balance? Unless you're just going to shuffle the chairs and make it revenue neutral by taxing some people more and some people less to make it revenue neutral, if your overall goal is to reduce the revenues of the state through tax decreases, then we've got to take a serious look at our expenditures and figure out where we need to reduce those. [LR571]

SENATOR SULLIVAN: And I know that this wasn't the subject of your research, but any indication from what is going on in Kansas and what they are suffering from as a result? [LR571]

MARY JANE EGR EDSON: I haven't really focused on it too much other than those...mainly, I was focusing on, you know, the mechanics of what... [LR571]

SENATOR SULLIVAN: Right. [LR571]

MARY JANE EGR EDSON: ...they had actually done. I mean I read the newspapers. I read The Kansas City Star as much as anybody else just to keep tabs. But it would appear that they continue to go downward, that it's getting more and more...it's costing more and more money than they anticipated it would cost. [LR571]

SENATOR HADLEY: Thank you. [LR571]

MARY JANE EGR EDSON: Thank you. [LR571]

SENATOR SULLIVAN: Thank you, Mary Jane. [LR571]

SENATOR HADLEY: Mr. Bill Lock. As I mentioned earlier, Bill has been with the...in the fiscal areas for the state of Nebraska for many, many, many years, and Bill will be retiring December 31 of this year. We will greatly miss him. His knowledge and counsel to the Revenue Committee and the Revenue Chairs over the years has been exceedingly great, and we're going to lose that connection to people like Jerry Warner and such as that because of Bill leaving. So we thank you very much, Bill, for all of your work. [LR571]

BILL LOCK: (Exhibit 2) You're welcome. Should have brought another one of these, I think. My interim study report is on ag land valuation practices and policies in Nebraska and the other states. I was going through my notes...I'm going to try to mainly use the executive summary, which is on page 2 of what you've been provided. But I was going through my notes, and I noticed at some point I had put some dates in this report. And one of them was 1985, and I was citing my own work. (Laughter) And I said to myself, that was 29 years ago. And I thought to myself, I've been working on this for 29 years and it's fascinating. I'm not sure that it's spellbinding, but I'll try to do some work to make it at least interesting. And I want to thank M. J.--Mary Jane--because she introduced the whole concept of base times rate equal taxes...is so important to tax policy that you have to keep...every time you start talking about taxes, you have to remind yourself that what we're really talking about is what we tax, at what rate, to get some dollars. Okay? And in property tax...income tax is complicated. I'm glad Mary Jane understands it as well as she does. She's taught me some things the last couple of years, and it's been an enjoyable experience. Property tax is equally complicated. The base of the property tax--what you tax, how you establish value--is incredibly important and done differently in every American state. You can't pick up a text on property tax that says, here's how the American property tax works, because the book that you pick up will say, here's how the American property tax works in each of the 50 states as best we can understand it. And there is a rather good new book out written by one of our faculty members at UNL, John Anderson. The book is entitled <u>Use-Value Assessment in the 50 States</u> (sic). And I cited it in here. It's excellent. If you want to learn how other states tax and...well, excuse me, value and tax--but mostly value--ag land, that's an excellent resource. He just finished it last year. I relied on it to a certain extent to learn how many states are doing things. But I tended to focus on the states that border Nebraska, which are Iowa, Missouri, Kansas, Colorado, Wyoming, and South Dakota. So I focused my efforts to review what those states were doing differently from the state of Nebraska and from each other. And I'm going to go over the high points on page 2. I called it an "Executive Summary." And the first thing I wanted to do was remind you of what your current policy is. In Nebraska, your state constitution contains what's called a uniformity clause. A uniformity clause is common to most of the states. The only state in our region that doesn't have one in their state constitution is Iowa. Typically, what the states were doing when they established a uniformity clause in their constitution was seeking equal treatment of all their taxpayers. And since...when they were established as states, most of them were only taxing property. It was very fairly recently that most states began to tax income and sales tax or use income and sales tax mechanisms. So they were taxing property and they wanted to guarantee their citizens that they would be taxed fairly. And they would establish a uniformity clause that said, I'm going to make sure that you're all treated the same. And one way they would go about that is to say you have to be treated uniformly. You have to find a way to determine what your value is and, therefore, what tax responsibility you have. Nebraska's uniformity clause has gotten a lot longer since it was originally established. You've amended it in the agricultural land area on six different occasions by vote of the people. On three of those occasions, the amendments gave effect to the idea that you could tax agricultural land in a nonuniform manner from other types of real estate. Okay? And there's three of those changes that are pretty important. But the most important observation for you to take away from this report on that and that issue is that, when you amended it finally, in 1990, to allow nonuniform treatment of agricultural land value--i.e., I can value land that is determined to be agricultural differently than I value a house or a commercial business--okay, when you finally amended it in a way and given a language that the court has given credence to, you also left intact the idea of uniformity within the class of agricultural land so that if there are different types of agricultural land out there, and Nebraska recognizes five different types--grazing land or grassland, irrigated land, dryland crop ground, wasteland, and other ag land, which is a rather minor category but becomes important in some cases--within those five groupings, within the exception to the uniformity clause, between those five types of ag value you have to maintain uniformity between those types. In other words, I can't assess irrigated land at 75 percent of its actual value and grassland at 50 percent. I have to find that they're assessed at the same ratio to their actual value. So it's important to remember that because it's sometimes difficult to satisfy that continued uniformity principle. And quite frankly, in some states, states have invented valuation systems which taxpayers protest and find are not uniform and it's because of the method they use. And that actually happened in Nebraska back in the 1980s. I'm going to move forward through the executive summary. The second part of it...the second part of the report is policies of other states. I think the most important thing to think about here is, although we're looking at how agricultural land is valued in other states...and it's valued differently than Nebraska and those states all have different uniformity clauses in their constitution, they've been amended to allow different treatment of different classes of property. Iowa has no uniformity clause, so they have experimented broadly in how to value and tax things. But the other observation I want to make about that is that they've also in those other states amended their uniformity clauses not just to value agricultural land differently than other property, but to value residential property differently from other property. And typically, if you go look at how they're taxing or valuing--excuse me--property in a state...and I'll use Colorado as an example. Colorado right now, if you went and looked at their reports on what their value...their percentage value of market value for housing is, it would be slightly less than 8 percent. So a $100,000 house would have an $8,000 taxable value. Agricultural land looks like it has about a 2 percent value level. And business property has a 29 percent value level. So when someone suggests that, well, okay, I'm...this is only valued at 30 percent, but if there's another class that's valued at 11 and another class that's effectively valued at 2, you've established a preference system, even though each are subject to what's called fractional assessment. Okay? Nebraska's policy on determining value and basing their value system was a fractional assessment system right up until 1980. I was actually working here back then when we changed it, and we used to value property at 35 percent of its actual value. In 1980 we switched to 100 percent. So the 100-percent standard became the standard for everybody. The policy having an effect on ag land says it can be different and nonuniform from that 100-percent standard. Your statutes say it can be 75 percent. We've had bills the last two years, two sessions, on changing that ratio, the 75 percent assessment ratio. So...but it's important to observe that if you look at the other states and how they're taxing ag land, you also have to look at whether that's actually a preference or not. It could look like a preference. Their state constitutions might make it look like a preference and their statutes might effectively make it a preference or a lower value or a nonuniform value. But it's complicated to figure that out, and I spent some time this summer and deeply enjoyed figuring that out. [LR571]

SENATOR HADLEY: You need to get a life, Bill. [LR566]

BILL LOCK: And I'm not joking. I mean it was interesting to discuss this issue with people in other states. [LR566]

SENATOR HARR: Maybe you should stick around then. (Laughter) [LR566]

BILL LOCK: No. Maybe it's time to do something more amusing, I think. There...the second...the page 2 executive summary...and this I think is probably the central and most important observation in this report. When you're trying to compare valuation systems between states, if your ultimate objective is to say, well, do they wind up with a different tax burden than we have on agricultural land...and the way that we've devised in the public finance arena of measuring that is what's called an effective tax rate. And on agricultural land, for a very long period of time the USDA would calculate what they called a set of effective tax rates for every state in the nation. I went back to 1967 in this report and looked at it starting there, and there's a table in the report I'll show you later. In 1995, they stopped doing that. In 1998 the Nebraska Legislature, under Senator George Coordsen's leadership, decided that they would try to replicate that effective rate study to see whether Nebraska was taxing agricultural land at a higher effective rate than other states. Dr. Bruce Johnson did that study for the Legislature. It showed that we were taxing agricultural land at a higher effective rate. An effective rate is calculated by saying, how many dollars of taxes did we collect from taxing agricultural land, and what was the market value statewide of that agriculture land? And you divide and you get the effective tax rate. Nebraska's is much higher than other states', has been for some time, wasn't back in 1967 but is today. Dr. Johnson, actually, who had done the 1988...1998 study, helped me on this one because we had to kind of agree what common standard of judgment we were going to use on market value. And we wind up using some USDA numbers and making sure that each of those for each of the states matches up with how those were determined. What I said here in the exec summary is that typically Nebraska's effective rate of taxation on agricultural land is two to three times higher than border states to Nebraska. And the difference in effective rates has been growing in recent years and it's grown since. The difference in the effective rates has grown since Dr. Johnson's study. So all of that has an impact on Nebraska local governments, particularly if you change your ag land valuation policy. I didn't spend a lot of time on this, but I did try to raise what I think are the major issues, which is that when you change your valuation policy, whether it's for ag land or for residential property or if it's to exempt a certain class of property, you affect the base, the value base of each local government. And it's important to know how you're going to affect that base, and the composition of that base makes a great deal of difference as to what effect that change has on taxpayers. If agricultural land is a minor part, a tiny percentage of the whole base of that school district or county, the difference that you make in the ag land value change, changing what that level of value is, it has very little impact on other taxpayers. It has a great impact on the person who is a small part of the base, the ag land owner who...where that sector represents 5 percent of the base and you decide to lower the value, you don't shrink the base enough to have the government change its rate. So it applies the same rate to a lower value level. The corollary of that, of course, is that if I'm 5 percent of the value in my school district--and I think Senator Hadley's home school district of Kearney is fairly typical of this--and I'm the value class that's seeing a 25 percent increase in value, as ag land has in many school districts and counties in Nebraska these past two years, if I'm a very small part of the base and such a small part of the base that my growth in value doesn't grow the base that much, say it grows...the whole base grows 3 or 4 percent, the school district says, well, I can apply the same rate I did last year and I'll have 4 percent more money. They apply the same rate. They apply it to everybody's value. Your value grew 20 percent. You're going to pay 20 percent more taxes. On the other hand, if I was in the school district down the road--and pretty far down the road in your case, Senator Hadley--but if I was in a school district that had 75 percent of the base being agricultural land and that value went up 20 percent, the school district can fairly easily lower its rate and have a lot more money. And you can see that in the impact on each individual school district and you can see it in county groupings. I tried to illustrate it in this study in the tax burden portion of it and then the table that's later in the report. But it's really important to understand what people have experienced in this area. If your ag land value had been going up 20 percent and you were in a school district where that was a smaller share of the value, your taxes could have been going up 20 percent because the rate didn't change. If you were in a county where you were half the value, you know, yeah, maybe your rate might change a little bit because they didn't need that much growth. But the rest of the value base and how fast it grows really matters. So if you go look at an urban school district that has some ag land, and I'll take Omaha Public Schools--Senator Burke Harr represents them--they do actually have some ag land in the school district, not very much and not very much as a percent of value. But that ag land goes up 20 percent and the rate stays the same. Those ag land owners on the edge of the state's largest city do experience a 20 percent increase in tax. On the other hand, if you take the ag land value down, as was proposed in two bills this last...last couple of years we've had bills proposed to take the assessment for sales ratio or the ratio down from 75 to 65. In that case, that taxpayer does get a very dramatic tax reduction. It could be as much as 13 percent. Senator Hadley. [LR566]

SENATOR HADLEY: Well, I just wanted to emphasize that point because I remember a discussion we had last year in the committee, and I believe it was someone from Sarpy County in ag. And at that point in time, I believe the ag land was about 2 percent of the total valuation in Sarpy County. [LR566]

BILL LOCK: Sounds about right. [LR566]

SENATOR HADLEY: And we were talking the 75 to 65 and the fact that that probably...they would truly probably get a tax reduction in property taxes because they... [LR566]

BILL LOCK: That's exactly right. [LR566]

SENATOR HADLEY: ...they wouldn't change their levy because it's such a small amount. But if you go out to McPherson County, Cherry County, such as that, and lower it from 75 to 65, and if the taxing authorities have any ability to raise their levies, the person...the ag person is not going to get a tax break because so much of the valuation is in ag land that they can't do it. But I just remember the 2 percent from Sarpy County. Is that about... [LR566]

BILL LOCK: Well, I...you've got a handout that's attached to the back of the memo. And I opened it up to the page that shows the percent of value that is ag land of the whole tax base for Bellevue, Papillion, La Vista, Gretna, and Springfield. Springfield, which is...I've always referred to it as South Sarpy. I think it's Springfield Platteview now. Their ag land is...their value base is composed of 12.41 percent ag land. Bellevue's is point...well, is 3...well, let's call it .4 percent ag land. So, yeah, it does vary quite a bit within that county, and it does within counties, depending on how urbanized the county is. But, yeah, that 2 percent figure is probably right for the whole county, so. And you can see that in this very detailed examination. There are some things that happen when you change value to local governments. One of the things that happens is, because you have a state aid formula that measures valuation capacity and says, okay, how much is it and how much can they raise locally by capping that valuation capacity, when you reduce that capacity, you bring about the possibility that they'll receive more state aid.

We refer to them as equalized districts if their capacity is smaller than their needs by the way we measure it so that, if you shrank their capacity and they were already an equalized district, they'd get more equalization aid. That happens...it will happen automatically within the formula that we use. And the issue that presents itself is that it's been happening a lot these last five years. With the ag land value increases, we've seen a lot of school districts lose almost all their state aid because they had such a high growth in capacity and it outpaced their growth in needs. Okay? And that has had a dramatic effect on the state budget for state aid. In fact, I think in...I stated it this way in the report: The loss of equalization aid to districts with growing ag land value is the way that we balanced the state aid budget and were able to give more aid to districts that are not affected by that ag land value trend. In other words, we had some money that we could budget, and we had that money available because some of the school districts were losing a lot of the money that we do budget. I think that's as simple as I can make it. Does that ring true for Senator Sullivan? There is an impact on taxpayers--the next part of the page 2, "Exec(utive) Summary." When you change a value base...and the only way I could analyze this was to take the 2013 tax base information system that we have. We call it the certificate of taxes levy. And I...that handout that you have, that looks like this, is actually...I'm going to say there's 250 profiles in here that I built, and each one of them has to be done for a set of...a taxpayer who is in a set of taxing districts within a county. And there can be four combined total tax rates, or five or six, depending on how many school districts I chose to do this for. And when I did it for a taxpayer, it was in a school district. I did it...I performed the calculation, the reduction of value and the resulting change in rate, for everybody, including the other taxpayers who didn't have their value reduced. And I did it for each of the local governments that that person is taxed by. So I'm going through, starting with counties, and then I moved to schools. I actually did it for cities, although it doesn't have any impact on city government tax rates. City governments...cities do not tend to tax agricultural land because they don't have any. There's none within their boundaries. I ran the calculation the other day and I figured out that reducing the value from 75 to 65 would deplete a total of $21,000 in cities statewide. It's not a big number. [LR566]

SENATOR HADLEY: We could have had a problem in Kearney because our city council debated whether you could have chickens in your backyard in the city. And it was a close vote and a lot of debate. [LR566]

BILL LOCK: I don't know whether it's legal in Kearney to have chickens in your yard... [LR566]

SENATOR HADLEY: It is not. [LR566]

BILL LOCK: But it's not...technically, it's not permissible to classify land within the city boundaries as ag land by state law. [LR566]

SENATOR HADLEY: So if we...oh, okay. So I couldn't get chickens in my backyard and then consider myself ag. [LR566]

BILL LOCK: I'm not going to give you a tax break if you put chickens in the backyard, Senator Hadley, or at least I wouldn't. [LR566]

SENATOR SULLIVAN: (Inaudible). [LR566]

SENATOR HADLEY: Okay. Again, I'm... [LR566]

BILL LOCK: You know, someone else could interpret state law differently. [LR566]

SENATOR HADLEY: ...down the wrong track every time I start. [LR566]

BILL LOCK: Yeah. Well, the impact on taxpayers is analyzed. That's what this is. This is the impact...this handout is the impact on...I did this two different ways for 200...I think it's 250 different taxpayer situations. And I did it for two different types of farmers or ag landowners. I did one for a person or an owner who is simply the owner of ag land value only. I did another one for a category of taxpayer I call the owner/operator. And what I did there was I assumed, given my somewhat extensive knowledge of how farms work, because I grew up on a farm...an owner/operator--my brother, his neighbors--owns other taxable property. First of all, he has a house. A person who owns 160 acres of ag land without any improvements on it is in a different situation than my brother or his neighbors because they own a house. They also own a farm machinery shed. They own tractors, combines, and other implements that in the Nebraska tax system are valued and taxed as property. And that, by the way, is not common in the Midwest, but it is common...it is done here in Nebraska. So for that taxpayer, I said, well, the fair way to measure his change is to take into account that he has some other classes of property which I am not decreasing the value of and I may be increasing the rate on. So I balanced those two things out. Then what I did was I took that change and I modeled it for a person who owns only some other class of property that's not farm related. So that could be a person...in my examples, I used the county average house value and showed what the change would be in that taxpayer's situation. As I said in the report, I could have just as well used...and I think of this in the context of my hometown. The biggest taxable object in the town in which I grew up, which is a rural school district where my dad was on the school board, was a grain elevator, and it had a lot of taxable value. And it was owned by my dad and his fellow farmers because we were all members of the Aurora Farm Cooperative (sic). So the taxes removed from ag land will shift to the grain elevator, but they'll also shift to each of the houses in that town. They'll shift to the ethanol plant in Central City, which is nearby. The taxes shift to other classes of property and other types of value, and in rural communities that can be other assets that are owned by local farmers, like the grain elevator or the ethanol plant. It can also be any retail store. What I chose to use as an example here is...I just took it and I said, okay, if I take the average house value in that county and just change the rates and show what the impact is, that's on this one. Okay? And it's done for average house value in each of the 250 situations. It was done using 2013 information. I don't have 2014 information yet. But what it illustrates to you is that if you're in a place where ag land is a tiny share...if you're an ag landowner in a place where ag land is a tiny share of the tax base, you're going to get the most relief from a change in ag value. If you're in a place where ag land is a big share of the tax base, 75 percent or more, you're not going to get much change in your tax situation because the rate goes up and you're paying that higher rate, even on the reduced value. But the rate movement for the other person who is in your situation, the owner of the house that's a tiny fraction of your value base, they get a lot of rate movement and percentage increase in tax. So each one of these examples on the ag land side shows you what percent of the tax base...it shows you the total tax base and what percent of that base is ag land. So it starts out here...the first community on this sheet is Hastings. This is Hastings School District in Adams County. It's .2 percent of the total value base, ag land is. But it's 75 percent of the total tax base in the Silver Lake School District, which is...I've labeled it here "Roseland" because that's the community where it's based. [LR566]

SENATOR HADLEY: So, Bill,... [LR566]

BILL LOCK: So that's an important observation about the effect of this change. I went through the task of trying to figure out how it would affect people. Obviously, all the numbers that I used for 2013 change each year, including base composition and growth in the value, moving forward into '14, into '15. But you can see what happens under the change in policy, at least in the...in that switch at that point in time. [LR566]

SENATOR HADLEY: Bill, does that...breaking it down into kind of terms I can understand, basically we come up with winners and losers then, to an extent. Because if you live in an area...if you have ag land in an area that has a small amount of ag land, you're probably going to... [LR566]

BILL LOCK: Small percentage of value, yeah... [LR566]

SENATOR HADLEY: You potentially have the ability to benefit from this kind of change.

[LR566]

BILL LOCK: Yeah. [LR566]

SENATOR HADLEY: If you have ag land in an area that has a large percentage of ag land, the chances are you're not going to benefit. [LR566]

BILL LOCK: Not as much. [LR566]

SENATOR HADLEY: Not as much. [LR566]

BILL LOCK: Everybody whose value gets reduced would see some tax decrease in that scenario, but it would be larger if you were a small part of the value base and smaller if you're a big part of the value base in...on the ag land side. Now I also said in the report that most residential homeowners and most commercial and industrial value in the state, a very high percentage, almost two-thirds of it, is located in the state's three metropolitan counties--Douglas, Sarpy, and Lancaster--which means that there's very little impact on those taxpayers because there's very little ag land in those places. So in terms of the tax shifting to a residential homeowner, the vast bulk of residential homeowners in the state--those living in Douglas, Lancaster, and Sarpy--aren't going to see much change in their tax, even when you work it through the community college tax base, which is broader, or the natural resource district. The school district...there are school districts in the Omaha metropolitan area--Westside and Ralston--that do not appear to contain any agricultural land, so there's no shifting on the school district side. So, yeah, that's...the important observation about how this changes things is an observation about what the composition of the base is and how that will affect people. [LR566]

SENATOR HADLEY: Bill, just so we...a thing I think we as senators at times hear is, why should we as state senators working with the state budget, state revenues, why should we care about property taxes? We have often heard that, you know, you get your tax bill and every one of the taxing entities is a local entity that has a board that is elected by that district. So kind of in a general way, why should we be concerned about property taxes? [LR566]

BILL LOCK: My personal response to that question, having staffed for Revenue Committee for a really long time, is that you're state policymakers and you represent citizens across the state. And regardless of whether you control the school district's budget, you affect the school district's budget; and regardless of whether the state uses a property tax, which it does not do--it's actually prohibited from doing--the taxpayer is affected by your policies on how the property tax is administered and how it works. So as policymakers on a statewide basis, I think you have an equal responsibility to decide how the property tax is going to be administered and what its processes are going to be, what the citizens' rights in determining, what you've done in terms of determining value. All of those are important state policies, too important to be ignored, I think. Even though you don't control their local budgets, you're still responsible for what happens to them as citizens. That's my response. [LR566]

SENATOR HADLEY: Well, I think...but I think that is a good response because we do hear at times, why are you worried; why are you doing something about...you know, why are you concerned about what we pay in Kearney in property taxes? [LR566]

BILL LOCK: Yeah. Well, on a personal level, I can't impact the budget of the school district that taxes the ag land that myself and my family still own because I don't live in that school district. But my brother does and so, from a personal standpoint, I think it's our duty to understand what all of our fellow citizens experience and make sure that the laws are fair and that...make sure that uniformity means something, you know, if we're doing it. [LR566]

SENATOR SULLIVAN: With respect to uniformity, does that extend, or not, to how the...where the tax goes? What I'm saying then is, can you drop the value or change the value, for purposes of taxation, so that it goes to a specific entity? For example, school aid, drop the value...are you following me? [LR566]

BILL LOCK: Okay. I think I am, but let me see. I'll rephrase it and see if I'm getting your point. [LR566]

SENATOR SULLIVAN: Okay. [LR566]

BILL LOCK: Could I take a school district's value base and change it for purposes of value determination... [LR566]

SENATOR SULLIVAN: Um-hum, yes, yes. [LR566]

BILL LOCK: ...separately from the county's tax base? [LR566]

SENATOR SULLIVAN: Yes, yes, yes. [LR566]

BILL LOCK: I don't think so. [LR566]

SENATOR SULLIVAN: Okay. [LR566]

BILL LOCK: First of all, it wouldn't be good policy. [LR566]

SENATOR SULLIVAN: Okay, okay. [LR566]

BILL LOCK: Second of all, I think that somebody would throw it out pretty quickly. [LR566]

SENATOR SULLIVAN: Okay. [LR566]

BILL LOCK: You're supposed to obey a common set of standards and rules when you're valuing property, and one of the first struggles that Nebraska dealt with back in the 1950s--1954, to be specific--you amended the state constitution and gave the Legislature the power to set standards and methods and practices for valuing land because it was being done so badly and so differently that they felt they had to amend the constitution to say that they had the power to do that. I found that very odd, by the way. I thought that you could handle that in the statute, but they amended the constitution. It was the first time they amended the constitution to try to deal with this ag land issue. So I think it's important to maintain consistency. So, yes, if I said to you, okay, well, yeah, you could do it for school value but not do it for other value, I'd be giving you bad advice. Okay? Now, having said that, I've noticed in other states that have similar uniformity clause exceptions, that they implement the exception in a different way than we do, and I'll...and I didn't talk about it much in the report, but it's an interesting topic. South Dakota is the example that I can think of. South Dakota values ag land differently than it values other property, and they do have permission in their uniformity clause to do that. But they also set a classified...I'll call it a classified rate on ag land value for school purposes. You can only tax ag land at a specified school rate, and that can be different than the rate that you tax other property. And they're allowed to do that because they've made an exception to their uniformity clause, so you can impose a different rate under a uniformity exception, as well as varying the value. So that's an example of, I think, the concept that you're asking me about. Is it? [LR566]

SENATOR SULLIVAN: All right. And then you mentioned that we had taxable value on ag land of 30 percent in the '80s or what...? [LR566]

BILL LOCK: On all value up until 1980, we have what's called fractional assessment, where we said, there's a concept of actual value, what something is worth in the marketplace, and all property is to be assessed at 35 percent of that market value. We have varied that ratio over the course of history. At one point, it was 50 percent, in the early 1950s, and then we took it down to 35. And then in 1980, we took it up to 100 for all classes of property. And at the time we did that--and I was part of this project; again, shows you how old I am--we had to go through all the statutes and change the levy limits because they were all oriented towards the former level of value. So we had to go through and sort of micromanage them all. And it was a task that the Bill Drafters Office actually performed. A bunch of us sat around and looked at the statutes. I'm going to walk through to the last part of this, if it's okay with you, on policy options. Senator Hadley asked me to include a list of policy options. I included the...what I think are the typical policy strategies for property tax relief. And above and beyond this strategy of reducing the value of ag land or reducing the value of any other class of property, the other strategies are: replacement aid to local governments; substituting a state-collected tax source for the property tax; direct credits--and I suggested here a little bit different variation on the credit system that we use; I suggested that you might want to consider direct credits to targeted high-rate residential and agricultural property owners--and, finally, what are called "circuit breakers," which is where you examine the burden of the tax on the income of the household or the farm operation. There are some states that have a farm circuit breaker. And if that exceeds a certain percentage of that household income or business income, the amount that it...over the threshold level that you set is reimbursed or refunded or credited. Those are called circuit breakers. But targeted high-rate tax credits are...I've seen them. I've seen them in Iowa. Iowa has four. I think they call this the farm homestead credit system. And what they do is they say if your school rate is above this level, above this specified rate, you're credited back the amount that's above that rate. So if you were paying...in Nebraska last year, the statewide average rate on ag land was 1.4733 or something like that. So if you were above that level...and say you were up at $1.75 or even $2. There are ag landowners in Senator Hadley's county that pay a $2 rate on their ag land, which is one of the highest in the state. So if you were...so 50 cents above the statewide average, you could design a system that credits back that amount of excess. Now you might have to run it through the income tax system, I think, but that's a topic for another day--and, actually, for you next session maybe. So I've walked through the Executive Summary. I'm going to breeze through the rest of it. There are some...they're important points, I think, about the practice in other states. People are interested in this, I think, and I tried to write about it. I did spend a lot of time on the phone and in the statutes and in the reports of other states on how they value ag land, and then what the results of their practices are. And I've already mentioned the effective rate calculation. That's on page 7 of the report. But I also thought what I put on page 6 was interesting, should be interesting to you. In other states, it's common to use a different approach to valuing agricultural land than we use. It's called either an earnings capacity approach or an income capitalization approach. It involves taking some determination of the amount of product that could be...the productivity of a piece of ag land, the price for the commodities that it produces or perhaps the rents that are charged, and then subtracting expenses, coming up with something called a net income, and then dividing that number--and I emphasize dividing; there's a numerator and denominator--dividing that number by what's called a capitalization rate. What the capitalization rate does is convert that income into current value of what you think the property should be valued at. That system is used in a lot of states. It's actually, in methodology, used by real estate appraisers. But in the states, and almost all the American states, they don't do it the same way a real estate appraiser would do. They put a cap rate in the statute. Iowa's is 7 percent, okay? Kansas' looks a little bit complicated. It's...as I remember it, they allow it to be as high as 12 and no higher, but then they add on what's called an effective tax rate to the end of that, which is the local property tax rate in the jurisdiction. So that becomes the cap rate. But it's basically a process set by law and by policymakers so that as you're designing your formula and you find that you want a certain result...and in Kansas' case...I had a friend from Nebraska. Mary Jane and I both knew the person who moved down there to become their property tax administrator back during the time when they were implementing their current formula. And I talk to him a lot on the phone and he said, well, they gave me the authority to vary the cap rate, and when my first...our first calculation done by the ag economist said, here's the income and expenses and here's the net and they said, okay, the cap rate is supposed to be derived from the Federal Land Bank interest rate, you know, divided by that, it turned out that that increased values, and they really hadn't intended to do that. So he was given authority to vary that cap rate and he was told to maximize his use of that authority. They gave him like a...I'll call it a bandwidth. And he said, so I used as much of it as I thought prudent to keep the values from increasing. And the next year they were going to increase again and he said, well, I guess I'll have to use more of that statutory authority that I've been granted as property tax administrator to increase it again, but they told me I couldn't increase it above 12 percent. And they haven't given him any more...anybody any more authority to do it. So it stayed around 12 with an add-on since that time. So that's typically how you see it done. Colorado does it that way. It's fixed in the statute. They don't even make any reference to interest rates or return on investment or any of the other financial concepts that you might examine if you were a real estate appraiser. Wyoming does it...they do target it to or use as a divisor an interest rate from the Omaha Federal Land Bank. And in their case, because interest rates are declining, when that cap rate goes down, value goes up. So it contributes to a value increase in Wyoming. But the table on page 6 is what I wanted to draw your attention to. Because the other states use a formula like that and we don't--we use the comparable sales approach--I was intrigued to look at Iowa's system in particular. And on page 6 in that TABLE 1 you see a series of percentages. And what they are is the annualized rate-of-value increase. And so for Nebraska, you see it's double digits since 2008 and 29...I made it 29.4. I think that's reasonably accurate for this past year based on what I've seen. In Iowa, they only reassess property every two years. And if you go look at the chart of their formula values and you see how they move through time, and especially recent time, they actually go up 40 percent every two years under their income productivity formula. And here is the reason for that: Prices drive their formula values. Their cap rate never changes, so prices drive anything, up or down. Corn prices--averaged out five years and lagged one year from current corn prices, by the way, because you have to wait a year for the data to come in, so you're looking six years into the past and averaging stuff--their experience with rapidly increasing corn prices has driven these formula values up at the rate that I show in that column. The interesting thing about Iowa, and they've been using this kind of formula since 1979, is that they also have another state law that supersedes this. So you take this whole formula value equation and say, oh, that's what the values ought to be under our formula, our ag land value formula, but we're not really going to do that because we don't want anybody, homeowners or ag land owners or anybody, to face more than a 4 percent annualized rate of increase in the value of their property. So they have a rollback law. So they go through the elaborate mechanism of measuring how much house values have gone up. And if they went up more than 4 percent, you just roll the assessed level back so that they don't go up more than 4 percent, and they call it the rollback law. Two years ago, they changed the 4 percent growth factor to 3, and they did it in response to this phenomena and the phenomena of...and because they were doing it for ag land, they did it for the other classes as well, so their rollback law is now it can't grow any faster than 3 (percent). Remember, and I stated this earlier but I'll emphasize it, Iowa doesn't have a uniformity clause, so they can do this. What happens is that ag land winds up being assessed at somewhere around 25 percent of its market value under this concept, and residential property somewhere around 50 percent of its market value. But because commercial and industrial property, they're subject to the same growth thing but their growth in value hadn't been as dramatic as residential value or ag value, and so they're assessed actually at 99 percent of their market value because they don't get rolled back. Okay? But they just keep growing upward towards that target or along that line. So what Iowa did in 2012, effective for 2013, is they budgeted for a "business property only" property tax credit which starts at $50 million and increases to $120 million this next fiscal year. And that's a direct-credit rebate back to the business property owners in Iowa. Because they felt like they had sheltered the ag land and the residential property classes from dramatic tax increases and value increases, they felt like they ought to essentially reduce the assessment sales ratio on business property, which they did. It's going to come down to 90 percent. But they also felt like they ought to credit them back that much in tax. Now that sounds like a lot of money to us but, remember, they're twice our size in terms of their budget, two-and-a-half times our size in terms of their budget. But they did do that. And what they're trying to do is redistribute the property tax burden, and they felt like they had overburdened their commercial property. I put a chart in here.

Let me flip to the page. I think it's 9. There is a system of measuring that degree of tax shifting. It's over on page 10. This is developed by the Minnesota Center for Fiscal Excellence in cooperation with the Lincoln Land Institute (sic). It's an annual survey they've been doing for 15 years. What they attempt to illustrate there is to what extent you've classified or preferentially valued your residential property, your houses, versus your commercial properties. And they say, okay, so our commercial property, is...are they shifting it over to the commercial properties, and how much do they shift? The largest shift in the nation is in New York State, in New York City, where their preference is for residential property. The ratio of the effective tax rate from commercial to residential is almost five. If you go down this list, I listed just the regional states. I showed the U.S. average. You see that Colorado has a fairly high shift to commercial property. Kansas does, as well. Iowa does. Missouri does. All of those are above the national average of the shifting. South Dakota is below the national average. And Nebraska, I showed them was ranked 50th. We don't shift. We value commercial property at 100 percent, houses at 100 percent. Okay? So this illustrates that we maintain uniformity within those classes or between those classes, excuse me. So what this shows you is that, in addition to this notion of base composition being important, it's also important how you comply with uniformity of treatment. And many of the states in our region, unlike Nebraska, take the residential class of property and the agricultural class of property and they say, well, we'd like to shift the tax burden away from them to the commercial class of property. And they do it and this chart helps to illustrate to what extent they do it. Colorado's is the worst in the region by this ranking system--one is worst--and here's why: They adopted something called the "Gallagher Amendment" many, many years ago, and it's completely distorted their shift...their structure of their property tax base. And along with other things, they're thinking about undoing it, but it's a constitutional amendment. It's a little bit difficult. But I wanted to illustrate that it is not just a matter of how you value and how you...what percent of value it is. The methodology of value is important as well. The...I want to go back to the table about the rate of growth and make an observation which I made in the Executive Summary and hopefully is important for your future policymaking endeavors. If you decide to shift your methodology to this income capitalization approach--and, actually, Nebraska did do that for a brief period of time back in the '80s--one of the things that you need to be cognizant of is that under these approaches in Kansas, in Colorado, in Iowa, in Wyoming, these darkly highlighted 2013 and 2014 numbers--see that those are double-digit and 18 percent in the case of Kansas?--what that's showing you is that if you use a ten-year average and you're using crop prices and you've been through the period of time that we've been through with rising crop prices, you're lagging so far behind that those...these current crop prices, which have now dropped, that you're going to be producing these high-percentage increases for several years in a row. The folk...the staff down in Kansas told me that when they saw the 8.78 percent and the 12.72...and I had that number and I called them and they said, well, we'll tell you what the number for this year is when we get it. They called me in November and said, it's 18 percent. And I said, so how are they reacting to that down there? And he said, well, on one side of the equation, they don't like it that their value is going up 18 percent. It's a very low value, you know, that they relish the fact that it's a low value. But once you've set it in motion as part of a system--you know, you're a tiny part of the value base or you're a low level of value--the change in the value produces...this is going to produce an 18- or 19-percent increase in their tax share by virtue of doing this. And I said, so what's their reaction, are they going to alter that? And he said, well, probably not, because there is some hope that rising ag land values will help us solve some of our state budget dilemma (laughter) because they'll reduce the demand on the state aid budget because they'll lose aid. And I thought, hmm, I think I've heard this story before. But you can see those high-percentage increase numbers in all those formulas. Iowa's begins sooner, actually, because they are using a five-year average and in particular because they use what they call a corn suitability system. They're very oriented towards the corn price driving their values, so that would affect them more so than if you were in a state like Wyoming where you'd be looking at cash rents on grazing land, something like that. But Wyoming's did experience a big increase, 20-percent increase this year. And it doesn't matter what level of value it is. Once it sorts itself out and you set a rate based on that pay structure, if your share...if your value goes up 20 percent and somebody else's goes up 1 percent and you're a tiny part of the base, it's just like the Nebraska situation. Your tax is going to go up that much because you're a small part of the base and it's not enough of an increase to change the rate of the government. I hope this all makes sense. [LR566]

SENATOR HADLEY: Bill, just so I understand it, ultimately, these increases and large increases can potentially mean the state puts less money into areas that they might have normally put in because the property taxes... [LR566]

BILL LOCK: If you're using a valuation capacity formula to distribute school aid, which all the states in the region are, yeah, they have that impact. They've had that impact on us. Senator Sullivan has watched as Chairman of the Education Committee. The ag land value increases have put capacity growing faster than needs for a lot of school districts, and they're losing equalization aid. And we don't...most of our aid is equalization aid. We have some other forms of aid that are not. But it's equalization aid, and these other states pursue those same policies because...and this I think is an important observation, but I need to make sure I'm answering your question first. Is that what you were asking me? [LR566]

SENATOR HADLEY: Well, I just wanted to be sure because, if...ultimately, when we're done with this, if the goal is to lower property taxes for the people of the state of Nebraska, if we don't look again at what we're using property taxes for, the expenditure of property taxes, the state would have to make up...the state would have to have additional funding to make those units whole. Is that a... [LR566]

BILL LOCK: To give them the equalization aid...their equalization aid amount would increase and the formula would say you need to put another 30...we've said in the fiscal notes on these six...75 to 65 bills that it's the $30 million increase in state aid, in equalization aid. And I think that's an accurate figure. It might be smaller next year because so many of them have now fallen out of equalization again this year that that number might actually be smaller. It's not a big cost for the state from the ag land value reduction. Thirty million dollars sounds like a lot of money; it sounds like a lot of money to me. But in the context of state aid, which is $930 million, it's not a very big percentage of your aid. You've got a question. [LR566]

SENATOR HARR: Yeah. So the last time we amended the constitution was 1990, for the ag? [LR566]

BILL LOCK: The...yeah, the last time, and that was the time we said you can make it nonuniform. The problem that the court had was that we'd amended it but we didn't specifically say it can be treated in a nonuniform manner. And we said it with great specificity in 1990. [LR566]

SENATOR HARR: And have we seen the same phenomena as Iowa as far as...has ag land grown at a higher percent over a 24-year, 25-year period compared to residential, compared to commercial? [LR566]

BILL LOCK: Well, I could go back. I'd like to see...1990, yeah, I could track it back to 1990. I can track it back 1995 and tell you that the trend I would observe, ag land versus residential from '95 forward--this is sort of a thing I have kind of in my head; I don't have it in table in front of me--but from '95 forward through, say, 2003 or '04, ag land value didn't increase very much and residential value did. Part of the reason the value of residential sector increased is because, as we moved through in the housing boom, we were building a lot more houses. Okay? In fact, 25...sometimes, 25 percent of the annual growth in a residential property tax base in a county would be from the construction of new houses because people were building a lot of new houses. So the sector is growing. The individual house values aren't growing that fast because they're...they may be being reassessed. But a lot of the growth--25 percent of it in some cases--is from building new taxable objects that are called houses. Then, you know, we go into that housing bust period... [LR566]

SENATOR HARR: 2008, yeah. [LR566]

BILL LOCK: ...and you can look at a taxpayer in Omaha, like yourself, and see maybe the last six years maybe your value hasn't changed at all on your house. And the value base of the school district that you're in probably hasn't grown much more than 1 or 2 percent a year for the last five years because there's not a lot of new houses being built. And the other phenomena in the ag land value increase, because it's an increase in the base as well as the increase in the individual properties, is that a lot of property in Nebraska, ag land property, has been converted from dryland cropland to irrigated cropland, a tremendous increase in the number and...well, the number of irrigated acres in Nebraska over the last decade. And as that property is converted from dryland to irrigated, it increases in value and that grows the base at a fairly fast rate because it's being converted. The other thing that happens with that, by the way, and I did make an observation in the report about this especially in the policy options section, when you convert dryland to irrigated in Nebraska, you're doing it these days by putting a center-pivot sprinkler system on that land because that's a more efficient way of irrigating the land. It's also expensive. It's...a center pivot can cost you as much as $100,000. And when you put it in place, it's taxed. It's valued and taxed. So you see, alongside the irrigation value going up, because you're converting from dryland to irrigation, you're also seeing the taxable agricultural personal property value go up, too, because that object is added to the tax rolls. Now that value goes away over time. It's depreciated. Our concept is called "net book value," and it eventually goes to zero on the asset. But it, you know, it goes up and then it goes down, but people keep adding center pivots. And during these times, they keep buying combines and tractors, and those also add to the personal property value rolls. So not only is the ag land value base growing, but the ag sector base is growing because you're buying lots of those objects that are taxable. That doesn't happen in some of our border states because they don't tax those objects of value. They don't tax combines and tractors and center pivots. They don't...some of them don't actually tax any business personal property value, but almost all of them don't tax agricultural personal property value. I think Missouri does in the border states. We do and it adds to the value...growth in the value base as you convert to irrigation. So... [LR566]

SENATOR HADLEY: Any questions that we have, like he wanted, you know, data and such as that, you have 21 days to do it. (Laughter) And we don't pay overtime, so I just wanted you to know that at this point in time. [LR566]

BILL LOCK: You know, that one is about 20 minutes on a spreadsheet. That's not that hard. Okay? [LR566]

SENATOR HADLEY: So this whole report took... [LR566]

BILL LOCK: Don't think you're loading me up before I walk out the door. [LR566]

SENATOR HADLEY: So this whole report took, what, an hour, hour and a half? [LR566]

SENATOR HARR: Yeah. (Laugh) [LR566]

BILL LOCK: Well, no, it was a little more time than that. But that question is about a 20-minute question, so. And I can answer it, okay, and I will. [LR566]

SENATOR HARR: I'd just be curious. I don't know...yeah. [LR566]

BILL LOCK: Yeah, well, there was a period of time when residential value growth was outpacing agricultural land growth, and then we went to the housing bust and now we're in the ag boom. [LR566]

SENATOR HARR: Well, and it goes to... [LR566]

BILL LOCK: And now we might be headed towards an ag bust. [LR566]

SENATOR HARR: Well, and, you know, you can always create more homes. [LR566]

BILL LOCK: Yeah. [LR566]

SENATOR HARR: And it's very seldom you go the other way and create more ag land, so that's why being... [LR566]

BILL LOCK: Well, you can't create more acres. [LR566]

SENATOR HARR: That's right, so... [LR566]

BILL LOCK: But you can change their use to a higher-valued use. [LR566]

SENATOR HARR: To a higher, better use, yeah. [LR566]

BILL LOCK: Yeah, and that's part of the phenomena as well. I see... [LR566]

SENATOR HARR: Yeah, which I hadn't thought about that part, yeah, being a "city slicker." [LR566]

BILL LOCK: Well, I do, because I live with it, you know, but...you know, back home. But, yeah, it's in the data. You can see it in the data too. [LR566]

SENATOR HARR: Yeah, that would be interesting. [LR566]

BILL LOCK: So if you're a data digger... [LR566]

SENATOR HARR: Thank you. I appreciate that. [LR566]

BILL LOCK: I think I've covered all the bases. I'm just going to skip ahead to the policy options... [LR566]

SENATOR HADLEY: Okay, good. [LR566]

BILL LOCK: ...and explain why I threw out this list of options if you want me to. [LR566]

SENATOR HADLEY: Yes, that would be good. I'd like to see the (inaudible)... [LR566]

BILL LOCK: The first thing I wanted to talk about was the ag land value reduction. We've had two bills: Senator McCoy's bill last year and Senator Brasch's bill which was introduced the year before. Both bills are fairly similar. They would shift the burden of property taxes away from ag land. And I tried to illustrate what the tax-shifting effect is. One of the things you have to think about when you're doing it is, if I'm going to reduce the value of current ag land, I can tell you what the impact is. If I'm going to reduce it in a future year, between the point I implement the...pass the policy and then actually implement it, the ag land value might grow, like this year it grew 29 percent. So if 75 to 65 is 13 percent, I might have cut the value growth in half. Okay? I actually tried to analyze that factor and made an attachment for you which will be in the report where I tried to analyze this taxable value base of all the school districts in Nebraska and see how much they had grown from '13 to '14. It's an exercise, and I considered it important. But it dawned on me as I was moving through the exercise that it really doesn't provide anything useful for you for the upcoming session, because here's the way you have to implement the policy: If you want to pick this policy option, which I listed, you can implement it...in the 2015 Session you pass the law. You implement the concept in the 2016 value year. Okay? The 2015 value year is coming up on you. Values will change again in 2015, and then they'll change again in 2016. They might be differently calculated if you change the assessment sales ratio in that future year. I tried to be clever about this in the report because, as I sat there and went through the exercise of saying, oh, what might happen, I said to myself...I think the quote is from Yogi Berra. I wish I could remember which page I put it on. [LR566]

SENATOR HADLEY: "It ain't over till it's over"? [LR566]

BILL LOCK: No. (Laugh) It's about the difficulty of prediction, especially about the future,... [LR566]

MARY JANE EGR EDSON: Yeah. [LR566]

SENATOR HARR: Yeah. The future isn't always what...I think it's: The future isn't always what we predicted it would be. Yeah. [LR566]

BILL LOCK: ...because, quite frankly, that's what you're dealing with. You're going to change a policy. You don't know what's going to happen out in the year 2016. I don't. I couldn't. I mean I could wave a magic wand and make something happen, maybe, if I was powerful; or I could look at a crystal ball. But I can't tell you what's going to happen to ag land values. I think that they're decreasing or flattening out, but that's what we think. We don't know. But if you change the assessment sales ratio in that...for that year, that effective year of 2016, and they flattened out, you've actually reduced the value base of the local government unit from what it was because you've reduced the assessment sales ratio and it didn't grow in that year. So you need to be cognizant of that as you make policy. My suggestion here was that, if you're going to do it and you're going to move to a lower assessment sales ratio...that may be Senator McCoy's design on his bill. The number is not coming to me. LB460, I think. He did a phase-in, a phase-in of over three years, I believe. [LR566]

SENATOR HADLEY: LB670. [LR566]

BILL LOCK: LB670. Thank you. I couldn't remember. There's a number I can't remember. Okay, so you're phasing it in and you say, I'm going to phase it in '16, '17, '18. You get to '16. You're meeting again as a Legislature. It turns out that the phase-in is going to actually decrease the size of the value base. You say, oh, I'm not going to phase in the second phase of that, I'm going to leave it as is, because I don't want to actually decrease their value base, because that forces rates up to generate the same amount of money and, if you decrease their value base, some of them would get more equalization aid. But so many of them that have ag land value are so far out of the equalization range. This year I think Tom...maybe Tom has given you this number. The number that I have in my head is, of the 240 or so, there's maybe 85 that are equalization aid recipients this year. Something like that? [LR566]

SENATOR SULLIVAN: Probably, um-hum. [LR566]

BILL LOCK: So they're so far out of range from being equalized you really have to crank the ag land value down a lot in order to get them to receive any equalization aid. And that would, of course, then result in a higher state budget cost for aid. And I want to make this observation: That's exactly what's happened in the other states. They took their property tax base...and in their case, I can see why you might do it for ag land if you were in Missouri, because it doesn't matter much. Missouri is viewed, I think, by some people as an agricultural state. But if you look at ag earnings as a percent of their statewide gross state product or anything else, it's 2 percent. Their ag land sector isn't as important to their economy as it is in Nebraska, as it is in Iowa, as it is in South Dakota. It's important in Kansas, but I think I used the term "mystical" or "mysterious" in reference to Kansas and their policy framework in my report, because I am mystified as to why they would do what they've done. But they've not just done it for ag land. They've taken their residential base and shrunk it. They've...when the...when they shifted it over to commercial property, one of the things that they also did was, as soon as they shifted it over to commercial and industrial property, the guys that were, you know, running those industries came back to them and said, hey, we're picking up the tab, a bigger and bigger part of the tab, we're not...I'm not going to build a new aircraft manufacturing plant in your state unless you exempt my plant from property valuation and taxes for the next 5, 10, or 15 years. And they did it; they granted abatements and exemptions, further shrinking the base. Every time you shrink the base, whether you're using the equalization aid concept, the valuation capacity concept, you increase the state's obligation to fill that gap created and increase the amount of the state budget that's committed to equalization aid, you also increase the share of the school district budget that is coming from the state. In Colorado, that runs 60 percent because they shrank the base a lot there, and they did it not just through valuation preferences and classification, which is what I call preferences. They did it by also...they also granted abatements and exemptions, and they used tax increment financing. And they allowed the value growth to be diverted to other purposes. They exempted personal property value. They took a base that was broad and strong and wide and could be, you know...run...generate the same amount of money, and they shrank it and shrank it and shrank it. And that increased their nominal rate of tax. But if you go look at an effective rate of tax on a house in Colorado, it's one of the lowest in the nation because the houses are assessed at 8 percent of their market value. So no matter how high their rate is, they still look like they have a low effective rate, so. [LR566]

MARY JANE EGR EDSON: Page 13. [LR566]

BILL LOCK: Hmm? [LR566]

MARY JANE EGR EDSON: 13. [LR566]

BILL LOCK: Page 13... [LR566]

SENATOR HARR: Predictions are... [LR566]

MARY JANE EGR EDSON: That's where your quote is. [LR566]

BILL LOCK: ...is what? [LR566]

SENATOR HARR: Predictions are difficult... [LR566]

MARY JANE EGR EDSON: That's where your quote is. [LR566]

BILL LOCK: Oh. [LR566]

SENATOR HARR: ...especially about the future. [LR566]

BILL LOCK: You know, these reports aren't really very entertaining for you to read, and I knew that. I mean this is not gripping. But it did strike me, while I was trying to go through this exercise, that sometimes we need to be humble about what we can do and say and what we can tell you about the future, and that's my humility quote, you know. I actually would have put it...attributed to Yogi Berra, but there's a dispute about who actually said it the first time. Somebody thinks it's a Danish physicist. Do you have a question, Senator? Senator Hadley did. [LR566]

SENATOR HADLEY: Yes. Yes, Bill. You know... [LR566]

BILL LOCK: I wanted to go back to policy options if you...if that's where you want to go next, but go ahead. [LR566]

SENATOR HADLEY: Yeah, I guess, a question, and maybe you're going to get to it. Are we better off having...I think you've said to us that some of our surrounding states have some structural problems in their property tax system. Is that a fair... [LR566]

BILL LOCK: Structural differences, yeah. [LR566]

SENATOR HADLEY: Okay. So are we better off having a sound property tax valuation system and then use something like the Property Tax Credit (Cash) Fund to get the state to take part of the burden away? In essence, you value it correctly and then we say that the amount we're raising is too much. So the state then comes in and says, okay, we will give every taxpayer 10 percent of their property taxes back. Does that make sense? [LR566]

BILL LOCK: Yeah. And if you're asking me my...as a policy analyst... [LR566]

SENATOR HADLEY: Yeah. [LR566]

BILL LOCK: ...what I think would be the best approach, I think the state aid approach is viable, I think the credit approach is viable, and they solve different problems. My career here has been, being involved in state aid--and that's called a fiscal equalization strategy--to make sure that there are local government units, primarily schools in our case, out there that don't wind up paying a property tax rate that's twice as high as their neighbor's to generate half as much money. And that's the problem you try to solve for in equalization or fiscal equalization aid. We did it for schools in 1990 and we've made, you know, progress pushing that concept forward. And we keep working on it to make it... [LR566]

SENATOR SULLIVAN: But did that really account for this dramatic increase that we've seen in value? Well, I mean, we've seen...in equalization... [LR566]

BILL LOCK: I missed the question. [LR566]

SENATOR SULLIVAN: In equalization theory, does that really anticipate these dramatic increases that we've seen in value? [LR566]

BILL LOCK: Oh. When we were designing it in 1989--because I was staffing the task force--and we were asked to project forward again, you know, being humble, you know, it's like we're going, okay, we don't know what's going to happen with value. But we always used this assumption that it might grow around 4 or 5 percent because that's the rate at which the economy was growing. Now it might grow differently from time to time for different classes of property or in different communities especially. Some communities are building houses like crazy. Some communities are converting dryland to irrigated like crazy. It'll vary. But as an economy, you don't necessarily think that you're going to see 20 percent increase in the value of property year over year over year. [LR566]

SENATOR SULLIVAN: That's right. [LR566]

BILL LOCK: And we have and it's because people have been out there paying a lot for land. But it's also in part as a base growth concept because they've been converting land from dryland to irrigated as well, which we view as being higher-valued land. Senator Schumacher has a question, I think. Or do you? [LR566]

SENATOR SCHUMACHER: Well, I mean, and there's...even though we were looking at Kansas...which the magic is because Kansas is the "Land of Oz." You need to get that in the report. [LR566]

BILL LOCK: Yeah, I almost threw that in the report, but I stopped myself. [LR566]

SENATOR SCHUMACHER: With the property tax problem, I mean, if that's the focus, agricultural property taxes, okay, and we've had huge increase in property values, also known as wealth...but it's a liquidity problem because there are some years where the money isn't there to pay because the crops are bad or prices have changed to pay the taxes. So isn't the property tax issue, as much as anything, a liquidity problem? And shouldn't we be looking at a time when there's lots of cash moving in the ag sector, as in right now, when we are transferring literally millions of dollars to heirs tax free and that's when the cash is moving and that's when the cash is available, and it's...this whole property tax thing is more of a liquidity issue than it is a fairness issue? [LR566]

BILL LOCK: The design problem, the policy problem with the property tax is that, regardless of how your income situation is, you have to pay it. Okay? So it's a cash-flow issue for a lot of people: My property taxes are going up but my household income isn't going up. Okay? So if you're the person...and take somebody in Senator Harr's district. Douglas County has gone through this cycle over the last 20 years of reassessing some of the houses every four years, only some of them. So somebody gets...so somebody goes three years without having their house value changed, and then it gets changed 20 percent. And it only gets changed 20 percent for them, so all of a sudden your house value changed 20 percent and your taxes changed 20 percent and you said, hey, you know, my income didn't grow 20 percent this year. But the other three out of four houses didn't get that 20 percent increase and it's not a problem for them because the rate stayed the same. It's a cash-flow problem. The property tax presents that difficulty as a tax. The way it's sometimes addressed as that type of issue...you call it "liquidity," and I'm not sure I'm exactly on the same page. But here is the problem with the property tax from my point of view: It changes for you regardless of how your income is changing. It might go up and you still have to pay it. You have to pay it or you're going to lose your property. So if it's a sales tax, which grows fairly steadily, it's pretty reliable tax. If your income goes up, fine, you can spend more money. If it goes down, you can economize; you cannot spend so much money; you can change your tax experience. If it's an income tax and you lose your job, you're going to pay less income taxes, probably. If you look at the property tax and what its features and problems are, that's the problem. You call it liquidity. I call it cash flow. For every property taxpayer, regardless of what property they own, if their tax amount is increasing dramatically faster than their incomes for the last five years, six years, I guess, and I'll be...I'll make this personal. I have a tenant on the ag land that my family owns, and he's a very good tenant. And he keeps increasing the rent that he pays me because he wants to keep me happy--okay, actually, my brother and I happy. And I go, okay, you're making more money. And he's got this rent-calculating factor and he's making more money and selling corn at $6 or

$7. And he says, okay, I'm paying you a higher rent. We've got that kind of a rental contract. I doubt I'm going to see that from him next year, you know, that modification of the rental contract. But the last five or six years, I've seen it from him. And as my property taxes have gone up on that piece of property, my rents have gone up. I think that's what you're talking about, is that there's a liquidity problem, or you call it a liquidity problem. I view it as a cash-flow problem for the property owner. His income isn't growing now and he has still got rising property taxes. And that's kind of like a lag effect in the ag land sector, but it is for homeowners as well. If your house value went up 20 percent in one year, your income isn't going to grow that fast. So if you're a homeowner who owns a house in Lincoln and you've borrowed money to pay for that house and you have an escrow account, you don't really notice it that much when your property taxes go up because the bulk of that is a frozen dollar amount of payment over...fixed over 15 years. People who have escrow accounts get it withheld, you know, in their monthly mortgage payment. They're not the ones who frequently call me. When you retire and you've retired your mortgage, that's when you call me and I get a phone call saying, hey, this is 4,000 bucks. Well, yeah, it's...it was 4,000 bucks or a little less last year. Well, now it's 4,000 bucks and it's not in my escrow account and I forgot to pay it because I didn't remember that my...it was being paid out of my escrow account. That's the people I hear from. It's a cash-flow problem for them because suddenly it is something they have to pay in two big installments and it's suddenly an amount that was budgeted in to some other account and was growing, but it was growing...it's a fraction of the mortgage payment and it might grow as that fraction. So I always have viewed this as, okay, the problem with the property tax is you may not have the income to pay it. That's why a lot of states use things they call circuit breakers. So a circuit breaker, and I didn't explain the concept very well, is I'm...let's say I'm making $50,000 and I have a $100,000 house and I'm paying a $2 rate. Okay? So I've got a couple thousand dollars I've got to pay in property taxes. I lose my job. Let's say there's two of us and I...one of us loses our job. My income that year is substantially reduced, but I still have to pay the $2,000. The $2,000 becomes a higher percentage of my household income. A circuit breaker says, once it exceeds some percentage...that percentage would be 4 percent, I guess. I think that's the way I thought it through. But if it rose above 4 percent, and say it was 5 or 6, the circuit-breaker concept on the part of the state policymaker would say, oh, when it rises to that level, I'm going to forgive that amount of property taxes, credit you that amount of property taxes, or refund you that amount of property taxes. When you get your job back and it drops back down to the level below the threshold, I won't be giving you that benefit. It's a very personalized, targeted program. [LR566]

SENATOR SCHUMACHER: But not uniform or proportional. [LR566]

BILL LOCK: Maybe not. (Laughter) At least the AG...remember that...and you and I have discussed this before and let me make this point because M. J. and I have been talking about this quite a bit. The AG wrote those Opinions that you and I have discussed in 1989. In 1990, we amended the constitution to allow us to treat ag land in a nonuniform manner. I think that might change their perspective on its use in that area. It might not change its...their perspective...and it...but it would change their perspective if you treated it somehow like an income tax credit because you (inaudible) can't hold the income tax system accountable to the uniformity clause. So we could talk about that for a long time, and maybe we should before I leave. [LR566]

SENATOR HADLEY: Bill, a crucial point that you just talked about: If we use a circuit-breaker approach and we suddenly say, instead of paying $2,000, you only have to pay $1,600, right... [LR566]

BILL LOCK: Yeah. [LR566]

SENATOR HADLEY: Okay, that four... [LR566]

BILL LOCK: You'd pay $1,600 and we'd pay $400. I...yeah. Is that what you're talking about? [LR566]

SENATOR HADLEY: That's the key point, is, is that the taxing authorities, the schools, ESUs, counties... [LR566]

BILL LOCK: They still get their money. [LR566]

SENATOR HADLEY: ...they're going to need their money and it's got to come from the state. [LR566]

BILL LOCK: Um-hum. [LR566]

SENATOR HADLEY: In essence, we've got to... [LR566]

BILL LOCK: That's the way our homestead program works too. [LR566]

SENATOR HADLEY: Yeah. So we've got to make up any of these systems that result in lower property tax monies going to the units means unless we want...of course, maybe Larry Dix would...doesn't care about NACO. Maybe the counties can get by on less. No, I don't...(laugh). [LR566]

BILL LOCK: I don't know. I've got a report due to you on that. How about I just walk through the rest of the options and then we can end this, maybe, my last time here at this table. [LR566]

SENATOR SULLIVAN: Are you anxious to leave? (Laugh) [LR566]

BILL LOCK: What? [LR566]

SENATOR SULLIVAN: Are you anxious to leave? [LR566]

BILL LOCK: Oh, no. I'm just... [LR566]

__________________: I am. [LR566]

SENATOR SCHUMACHER: The way he talks about ending it, you know... [LR566]

BILL LOCK: I thought I was starting to bore you, to be honest, you know. I mean, I spent the last 40 years doing this and I...and so I'm okay doing it but, you know, it might start to bore you after a while. It might be painful. I outlined what I thought were strategies that are, I would call, aid related relative to the ag land value decrease. And I estimated what the fiscal loss was using 2013 figures. So, like, for school districts, the General Fund tax loss for schools would be $70 million. It is actually possible to back into that number, and I proposed a way. [LR566]

SENATOR SULLIVAN: I'm not quite sure what you mean by a "different form of non-equalized aid could be developed to address school funding needs." [LR566]

BILL LOCK: Yeah, I would call...I wouldn't call if "foundation aid," like our old foundation aid concept, because it's not per pupil, the way we used to do foundation aid. What it is, is...I'd call it a base aid concept. The amount of your fiscal loss that you individually as a...you...the school district or the county experienced as a fiscal loss becomes your target for the aid. But you have to move that number every year because, if you don't, you have to grow it or it has to relate to something that's changing because we tried to do that back in the 1980s and the Supreme Court said that's a frozen class and, therefore, special legislation. It has to be a number that moves and changes. It can't be an unalterable allocation share that stays fixed forever. Okay? [LR566]

SENATOR SULLIVAN: Yeah. Right. Yeah. Sure. [LR566]

BILL LOCK: So it has to relate to some moving concept in order to avoid being a frozen class and special legislation. [LR566]

SENATOR SULLIVAN: Yeah. I've got you. [LR566]

BILL LOCK: So I said, you know, maybe what your strategy is, to take the annual change in their ag land taxable value maybe and relate it somehow to that, would be a way to do it. I would have to admit that I haven't run a spreadsheet on that one yet. I just ran a spreadsheet on what the loss would be. The same thing for community colleges. I suggested that we really didn't have a lot of need to do anything with cities because they don't contain any ag land and this is in the context of what would you do about the ag land value reductions. I also listed targeted property tax credit to agricultural landowners. I saw that in Iowa law. Despite the fact of all these other machinations they go through in their value system, and I mentioned already that property tax credit to businesses that they're now...they've got a budgeted property tax credit for ag landowners, too, the farmstead credit. You could do targeted property tax credits. The thing to remember about those policies in Iowa is they don't have a uniformity clause, so you don't have to obey any rules about how does that affect their effective tax rate. And quite frankly, I don't think you should in Nebraska either. This is distribution of state money. I think it's an odd concept to think that distribution of state income tax dollars is somehow held accountable to the uniformity clause. But that's me and not the Attorney General, at least not back in 1989. I suggested the same concept on residential landowners. I...on the...if you look at either of these, if you see shaded rates on here, on this presentation I gave you, that shading on the rate column indicates that that's an above-average rate for that taxpayer relative to the average rate other taxpayers face in that same value grouping or configuration. Same thing on the other one, so you see rates on residential property that are...I see one here, $2.50. It's higher than what's paid in Lincoln. The concept on a property tax rate credit for people who are over the average rate...and I kind of tried to estimate the cost of that on residential, and I realized that I would come up short so I tried to do a second analysis because here's what I did in this. I was looking at incorporated places and cities. I got to the end of this and I said, well, it looks like it would cost about $70 million. And then I made it $80 million because I went ahead and looked at what SID--sanitary improvement district--rates are and said, oh, wow, they're way above average. You'd wind up sending a lot of money that direction because they're way above average. So I added another $10 million. And then the circuit breaker I described briefly. Finally, I threw out an idea that, as I looked at ag land value taxes and ag economy, tax burdens in other states, the one thing I noticed time after time was that the other states were not taxing ag personal property. Business equipment and machinery are not taxed in some states, particularly ag machinery. When I was thinking about how the ag land person...ag land only person and the farm owner or operator person would experience the tax reduction, I said to myself, well, the one has got only ag land and the other one has got lots of personal property and a house and everything else. For a farmer with a couple hundred thousand dollars of personal property value and for a small business owner, if you were doing this, you would have to adopt this policy for all owners of personal property value. You can't discriminate between them. You can exempt for everybody who has personal property value. So a small business owner buying a bunch of servers to start a software company or a computer-related business has some personal property value obligation. My thought was, okay, take that authority to exempt, full or partially, personal property value, make it a uniform amount of first-dollar exemption for everybody, the first $25,000 of value. You could do it as just a complete exemption and force the local governments to do without that value. Or you could make it like we do the homestead program and say, send the state the bill for the taxes on the first $25,000 of value. You could do it either way. It's not that complex to administer because we do it with the homestead program, where we seek reimbursement or they seek reimbursement for us for the lost taxes that they would have otherwise received as local governments. So I threw that on there because I thought, well, if you're really trying to target, use your money in the most targeted and effective way, maybe what you want to do is reinforce the business activities of farm owner/operators and not the business income of absentee landlords like myself, because I don't own any personal property value. I don't own a center pivot or a tractor, so. [LR566]

SENATOR HADLEY: Potato picker? [LR566]

BILL LOCK: I hope that's enough of policy options. I don't know that we covered everything I thought we should cover. I tried to make what I thought were the most important points. I think my most important observation is: Be cautious about the future and about what will happen with ag land value because you run the risk of...budget implication flows to you, but also what happens is a very big budget implication for a local government and you have levy limits in place. If you start shrinking that base...in all the other states I've looked at, Kansas doesn't appear to have any levy limits, levy rate limits, at all. And in fact, you see rates down there that just stun you, and then you see them in Des Moines, Iowa, too. If you went to Des Moines, Iowa, and you talked to a friend of yours and you said, what rate do you pay on your house, and they said, $4.50, you'd say, what, you know. But that's because they're only paying that rate on half of the market value of their house. Okay? So the other important observation is if you're going to try to do something different with ag value, like an income capitalization formula, pay close attention to the design of it, not just for growth reasons but for fairness reasons. Dr. Bruce Johnson and I talked about this report several times. One of the things he kept coming back to, because I asked him his opinion on this, is...and he has testified in front of the Legislature on this question. The rates of return to ownership of ag land are not uniform by type of ag land. Grazing land tends to have a lower rate of return over time as an investment. If you use the same capitalization rate for both of those streams of income, you'll wind up overvaluing the rangeland. That's an important point. You don't want to do that. And your...the court in Nebraska, because of the way the constitution is now structured, uniform within the class of ag land, would probably not let you do it. They'd...if somebody challenged your assessment level as being too high, being a higher fraction of its actual value than another class of land, the court would say, yeah, you can't do that, you've got to stay uniform within the class. So it's a cautionary note about how you design any of these kinds of systems. Make sure you pay close attention to whether they result in uniformity within the class. And I'm done, I think. I'm almost talked out. [LR566]

SENATOR HADLEY: Thank you, Bill. Are there questions for Bill? Well, I think it...closing comments? It's a complicated...it's not an easy issue for any of us. And as we go on and look at these different options, we have to do it carefully, the same way we did income tax the last couple of years, without rushing in, trying to do things that we can sustain that are fair. So I appreciate these because I think they give us a basis for looking at how we're going to handle these. And I do come away with the idea that, unless you're just going to shift taxes, who pays them, you've got to figure out some way on the expenditure side to worry about...if we have tax cuts, if we have less money to work with at the state level, we're going to have to cut what we do. [LR566]

BILL LOCK: Senator? [LR566]

SENATOR SULLIVAN: Or if we give relief in the form of property tax and want to retain those services that have been supported by that, then we're going to have to pony up the money at the state level. [LR566]

SENATOR HADLEY: Absolutely. [LR566]

BILL LOCK: If I can make one last, final comment, I was thinking about this the other night as I stayed here late and wrote some of this stuff and ran a spreadsheet, because I have something laying in my office. If you're familiar with the drawings and depictions of machinery designed by Rube Goldberg, I think of the property tax system as a little bit like something designed by Rube Goldberg. It can...you can make it incredibly complicated. [LR566]

SENATOR SULLIVAN: For every action, there's a reaction. (Laugh) [LR566]

BILL LOCK: Yeah, there's something that changes over here, and that changes something over here, and that changes something over here. I think about the other states' property tax systems very much like something Rube Goldberg sat down and drew up and said, boy, this is fun, you know, because I'll change this over here. Our system is not one that Rube Goldberg would find much amusement in. It's not as...it's more straightforward. It has less interactive relationships, but it still has interactive relationships. Something goes down over here; it goes up over here. And you know that about equalization aid. But it's much less complicated...in fact, some...John Anderson at UNL has written a report recently, and he called your system exemplary, and he's a national expert on property tax. So there you are. [LR566]

SENATOR HADLEY: Thank you, Bill. [LR566]

SENATOR SCHUMACHER: We're number one in something. (Laughter) [LR566]

SENATOR HADLEY: We're number one in something. Thank you, all. That ends the hearing. Thank you for coming. If you have suggestions, comments, please let us know. [LR566]