Testimony to House Taxation Committee

HB 2560 Income Tax

February 8, 2012

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Chairman Carlson and members of the Committee:

We appreciate this opportunity to present testimony on HB 2560. We support the overall concept of tax reform and believe HB 2560 has some unique and attractive aspects that provide a good starting point for a discussion of tax reform.

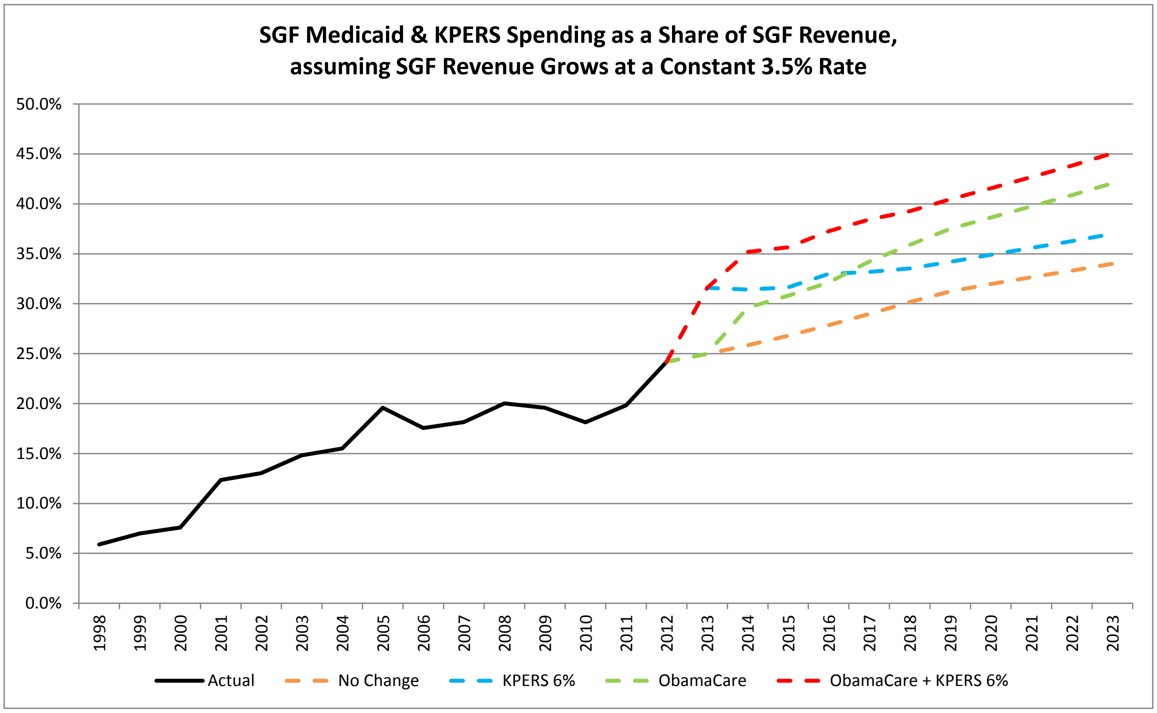
Kansas Policy Institute believes the State of Kansas is in desperate need of tax reform and we commend the efforts of Governor Brownback's administration and the many legislators who are working on several different proposals intended to make Kansas more competitive and create an environment that encourages job creation.

I realize that saying Kansas is in 'desperate need of tax reform' might sound like an exaggeration, but let me briefly explain our rationale.

KPI recently published "Major Structural Deficits Looming in Kansas" by Dr. Arthur Hall. The study projects General Fund spending under four spending scenarios and three revenue growth assumptions. Spending scenarios are based on alternate funding levels for KPERS, whether the Affordable Care Act (also known as ObamaCare) is implemented and assumes that all other SGF spending continues at the 1998 – 2012 average (about 1.9%). With average annual revenue growth of 3.5%, KPERS funded at a more realistic 6% assumed rate of return and implementation of ObamaCare, Kansas would incur SGF deficits totaling $5 billion over the next eleven years. Even in the unlikely event that KPERS' funding assumption holds at the current 8% assumed rate of return, deficits would still total $1.7 billion.

Alternatively, if all other spending is adjusted based on available revenue (assuming 3.5% annual growth) KPERS and Medicaid will consume up to 45% of SGF revenue by FY 2023 and have a considerable 'crowding out' effect on school funding and other SGF expenditures.

Kansas would need sustained annual private sector GDP growth of approximately 6% in order to withstand the quite probable $5 billion deficit scenario. That is very unlikely to occur under both the current tax system and any revenue-neutral system of tax reform.



Jobs and taxpayers have been migrating to states with the lowest tax burdens for years. Between 1998 and 2011, the ten states with the highest state and local tax burden (as ranked by the Tax Foundation) experienced just 2.6% growth in private sector employment, whereas the ten states with the lowest tax burdens grew employment by 11.0%.

At the same time, Kansas' private sector employment declined by 1.1%. Kansas' private sector employment may have finally stopped falling in 2011 but average annual employment was still less than in 1998. It's also noteworthy that Kansas had the second-worst private sector job creation record in the country for 2011, adding a mere 2,000 jobs on an average annual basis.

Kansas lost 90,400 private sector jobs between April 2008 and February 2011, an 8% decline from peak to trough. It took 70 months to return to peak employment following the last recession, when private sector employment 'only' dropped by 4.6%. Recovery will likely take much longer this time, and not just because employment fell nearly twice as much.

Comparative Performance of the States

		Personal Income Tax		Tax Burden	
Private Sector Category	**Kansas**	**Without**	**With**	**Lowest**	**Highest**
Employment (1998-2011)	-1.1%	11.1%	1.0%	11.0%	2.6%
Wages & Salaries (1998-2010)	46.8%	62.2%	47.3%	62.2%	50.7%
Domestic Migration (2000-2011)	-2.7%	5.1%	-1.3%	3.5%	-4.3%
GDP (1998-2010)	61.0%	80.1%	61.7%	81.1%	64.3%

Source: Bureau of Economic Analysis, Tax Foundation and Census Bureau; domestic migration is 2000-2009 plus 2010-2011 on a July-June basis; all other measurements are calendar year.

The state and local tax burden has a significant impact on economic growth and Kansas is especially uncompetitive among regional states. Low-burden states have higher job creation, their Gross Domestic Product and population grow faster and their citizens enjoy stronger payroll gains.

Kansas' poor job creation record over the last 13 years should come as no surprise, knowing how the tax burden impacts these performance measures. Kansas' state and local tax burden has been getting progressively worse as evidenced by the Tax Foundation's annual rankings:

- 25th highest based on 2005 taxes.
- 23rd highest based on 2008 taxes.
- 19th highest based on 2009 taxes.

Since then, Kansans have been hit nearly $500 million more in sales, unemployment and property taxes. When the rankings on 2010 taxes are released, Kansas could conceivably have one of the 15 highest burdens, as most states did not choose to increase taxes as did Kansas.

<u>The State of Kansas is facing unprecedented economic and budgetary challenges in the near future and the best option for successfully dealing with those challenges is to have a tax system that reduces the tax burden and is thereby capable of encouraging rapid, robust job creation and economic growth.</u> Proposals that are revenue-neutral do not reduce the tax burden. They may be better tax systems than we currently have but competitive pressures from regional states and our research shows that Kansas needs to be much more aggressive. Oklahoma and Nebraska are aggressively reforming their tax systems and Missouri wants to join them.

We need to dramatically and quickly reduce the tax burden to prepare for the challenges ahead, and that means we need to reduce spending. I realize that calling for spending reductions will not be well-received by some, but controlled spending is the secret to having low taxes and the economic prosperity they deliver.

<u>Having a low tax burden is not about having access to unusual revenue streams</u>. Florida may benefit from tourism, Texas from oil, etc., but they could still have a high tax burden if they spent more. <u>The secret to having a low tax burden is to control spending</u> and that's exactly what those states do. According to the National Association of State Budget Officers (NASBO), the states with no income tax spent an average of $2,444 per-resident in 2010 (total state funds); the rest of the country spent $3,572 per-resident or 46% more. Kansas spent $3,216 per-resident, or 32% more than the states with no income tax. (Spending from total state funds excludes spending related to federal funds or from the sale of bond proceeds.)

As noted on "Controlled Spending is the Secret to Low Taxes," Kansas spent 16% more per-resident (General Fund) than states without an income tax in FY 2010 and the gap may be more than 20% this year, as FY 2012 General Fund spending in Kansas is $861 million (16.3%) higher than just two years ago.

Responding to Concerns about Income Tax Reform

There are a number of understandable concerns about this or any proposal to change the income tax system. Our responses to some frequently raised concerns follow:

- **It weakens the so-called 3-legged stool** – actually, government is far better off being less dependent upon the income tax as it is the most volatile of the three. For example, Kansas individual and corporate income taxes collectively fell 20.6% between 2008 and 2010 but sales and use taxes only declined 5.1%

- **Sales and property tax will increase** – sales tax <u>revenue</u> will increase as a result of greater economic activity but the rate does not need to change (as noted earlier, it should be allowed to decline). Property taxes will only increase if local elected officials choose to do so in order to spend more money and/or avoid efforts to operate more efficiently. (The proposed new K-12 funding formula contains a provision that would remove the cap on what local school boards can charge in property taxes but that also would be their choice in deciding to spend more money; for the record, KPI does not believe it is wise or necessary to lift the current property tax limits on local option budgets).

- **Other governments have tried cutting taxes but didn't get much job growth** – the key is to cut the tax burden. Under President Bush, for example, government cut tax rates but also increased spending. Taxpayers understand that higher spending will eventually lead to higher taxes so they prepare for the inevitable.

- **Other factors like highways and quality of life are just as important as taxes** – having good infrastructure and a qualified work force are important, but in today's competitive environment states cannot afford to just be competitive in most areas; they have to be competitive on <u>every</u> major consideration. Other than Nebraska, Kansas has the least competitive tax structure in the region and as noted earlier, is rapidly moving toward having one of the least affordable tax structures in the country. <u>Not to put too fine a point on it, but if highways, schools and other factors were enough to be competitive, Kansas wouldn't have one of the worst private sector job records in the country.</u>

Improvements to HB 2560

We fully support the reduction of marginal tax rates for all taxpayers and the eventual elimination of the state income tax. We also circumstantially support the concept of not taxing non-wage income of business such as sole proprietorships, LLCs and sub-S corporations that are taxed under Individual tax rates. We believe current economic and long-term budgetary conditions necessitate taking the bold step of exempting non-wage income of such entities from income tax. Under more favorable economic conditions we would prefer to see this phased in over several years to allow for greater immediate reduction in marginal income tax rates for individuals and corporations.

We disagree, however, with increasing the income tax liability of a certain class of taxpayers while other taxpayers receive a reduction in their tax liability. 2009 simulations released by the Department of Revenue show that taxpayers with Adjusted Gross Income below $25,000 would have seen a net increase in their tax liability of $88.2 million, while those earning more than $25,000 would see net reductions in their liability.

The concept of a flatter, simpler tax system is appealing, but we are concerned about the elimination of deductions and tax credits. It is not clear how their elimination will affect other economic activity (e.g., whether fewer homes will be purchased if the mortgage interest deduction is removed) and doing so also introduces a fair amount of uncertainty for many taxpayers. Since HB 2560 allows for the eventual elimination of income taxes, it may be prudent to retain current deductions and tax credits until such time as income taxes are phased out, at which point they become moot.

We also believe the sales tax should be reduced to 5.7% as scheduled on July 1, 2013; tax reform can be effectively accomplished without breaking the promise to taxpayers that the rate increase was temporary.

Finally, we would encourage the Committee to also structure a plan that reduces the tax burden with appropriate reductions in spending. For all the intentions of HB 2560, it simply is not aggressive enough to avoid the billions of dollars in General Fund deficits likely facing Kansas over the next eleven years.

We commend the efforts of this administration and the many legislators pursuing tax reform for beginning this challenging but very necessary discussion. We may have differing opinions on some aspects of various plans but that should not detract from their authors' intent to create a stronger Kansas.

Controlling Spending is the Secret to Low Taxes

Some people think the states with No Income Tax can only do so because they have access to unusual revenue streams, but fortunately that's not true. Florida may benefit from tourism, Texas from oil, etc., but they could still have a high tax burden if they spent more. The secret to having a low tax burden is to control spending, and that's exactly what those states do.

According to the National Association of State Budget Officers, the states with no income tax spent an average of $2,444 per-resident (total state funds*) in 2010; the rest of the country spent $3,572 per-resident, or 46% more. Kansas spent $3,216 per-resident, or 32% more than the states with no income tax.

2010 General Fund spending per-resident averaged $1,590 in the states with no income tax; the other states spent $2,112 per-resident, or 33% more. At the same time, Kansas spent $1,843 per-resident, or 16% more than the states with no income tax.

2010 Spending Per Resident

	General Fund	Total State Funds*
States		
No Income Tax	$1,590	$2,444
With Income Tax	$2,112	$3,572
Kansas	$1,843	$3,216
Spending Difference		
With Income Tax	33%	46%
Kansas	16%	32%
Kansas Savings at No Income Tax Spending Rate	$723,237,045	$2,205,892,280

Source: National Association of State Budget Officers: 2010 State Expenditure Report, 2010 actual spending; US Census Bureau. Kansas Other State Funds as revised per Kansas Division of the Budget.

Key Take-Away: It's a spending problem, not a revenue problem

- Kansas would have saved $2.2 billion in 2010 by spending at the rate of No Income Tax States.
- Kansas General Fund Spending would have been $723 million less.

**Total State Funds excludes federal funds and expenditures from the sale of bonds.*