



## Testimony to House Taxation Committee on HB 2430

### Income Taxes

May 7, 2014

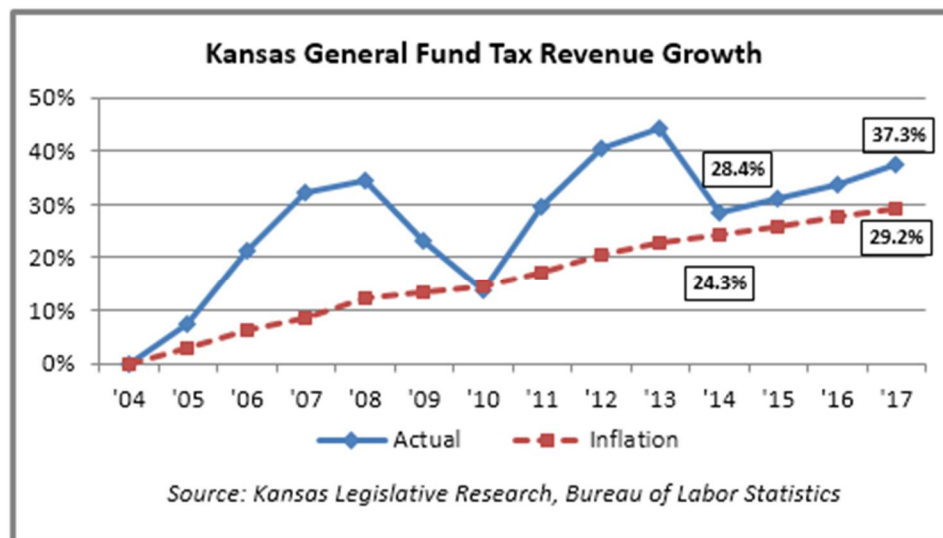
Dave Trabert, President

Chairman Kleeb and members of the Committee:

We appreciate this opportunity to provide testimony on the merits of HB 2430. We oppose HB 2430 because we do not believe that any tax increase is necessary, as Kansas has a spending problem instead of a revenue problem.

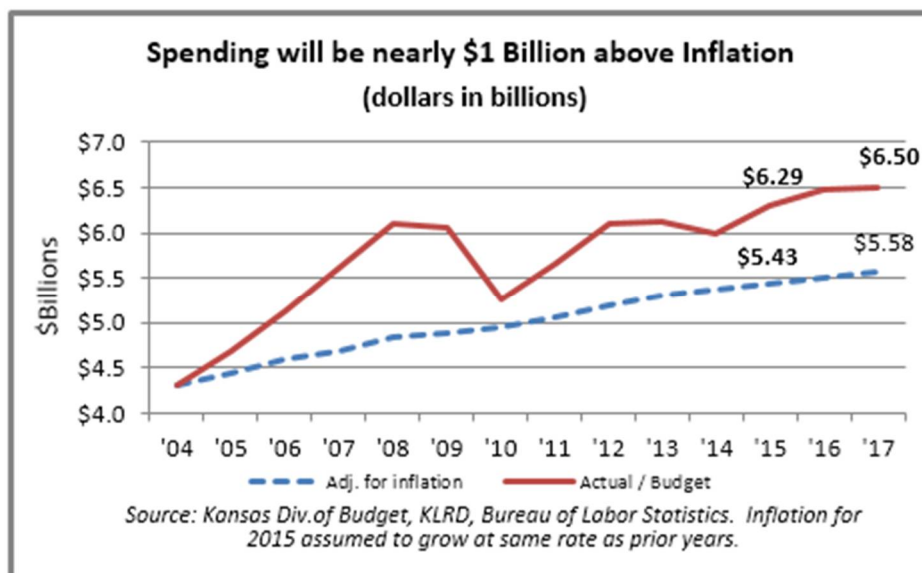
Contrary to 'sky is falling' claims, the new Kansas revenue estimates show that tax revenue will continue to be well ahead of the inflation-adjusted historic trend. Tax revenue increased by 28.4 percent over the last ten years, or 4 points more than the increase in inflation (Midwest Urban Cities calculated on a fiscal year basis). The April 2015 Consensus Revenue Estimates put total General Fund tax revenue at \$5.743 billion this year and growing to \$6.025 billion over the next two years.

Inflation would be 29.2 percent higher in FY 2017 than in FY 2004 if it continues at last year's pace, but tax revenue would be 37.3 percent higher.



The problem with the Kansas budget is that the cost of government was not reduced when tax reform was enacted.

While tax revenue has remained ahead of inflation since 2004, proposed spending in FY 2017 will be nearly \$1 billion higher than 2004 spending adjusted for inflation. But that's not the only evidence of a spending problem.



Every state provides the same basket of basic services (education, social service, etc.) but some states do so at a much lower cost and pass the savings on in the form of lower taxes. In 2012, the states that tax income spent 49 percent more per-resident providing services than the states without an income tax, and they don't do it by pushing spending to local government; the ten states with the highest combined state and local tax burden spent 43 percent more per resident than the ten states with the lowest burdens. Kansas, by the way, spent 37 percent more per resident than the states without an income tax.

Let's put that in perspective. Kansas' 2012 spending of \$6.098 billion was 37 percent higher than

2012 Actual Spending Per-Resident		
State Grouping	Amount	Variance
No Income Tax	\$2,491	
Income Tax	\$3,702	49%
Lowest State/Local Tax Burden	\$2,726	
Highest State/Local Tax Burden	\$3,901	43%
Kansas	\$3,409	

Source: National Association of State Budget Officers, Census. State spending totals exclude federal funds and bond issue proceeds.

the per-resident spending of states without an income tax. This year Kansas is expected to spend \$191.5 million more than in 2012 and the budgets under consideration in the Legislature will add another \$210.1 million in the next two years.

There may not be sufficient interest in the Legislature and the Governor's office to reduce the cost of government, but the opportunities are ample.

Here is a short list opportunities to reduce the cost of government:

- ✓ Kansas has 22% more state employees than the national average, on an employees-per-10,000-residents basis.
- ✓ State agencies spent \$17 million on overtime in the 2014 calendar year. It may not be possible to eliminate overtime but it can be controlled; state agencies spent \$10 million in 2011.
- ✓ K-12 funding will set a 4<sup>th</sup> consecutive record this year at \$6.145 billion and contrary to false statements made by some superintendents, state aid with the new block grants will increase by \$142 million this year...not counting KPERS, Bond & Interest, Special Education and a few minor funding areas.
- ✓ While K-12 funding continues to set records, every Legislative Post Audit study has found schools to be organized and operating inefficiently.
- ✓ While K-12 funding continues to set records, schools have used over \$400 million of state and local tax dollars to increase their operating cash reserves. That money was intended to operate schools, not increase bank accounts. If every district had maintained the same carryover ratio that they each had for the 2006 school year, their collective reserves would be \$320 million less this year. FYI, there is no record of school administrators complaining about not have enough cash reserves in 2006...or 2007...or 2008...or 2009.
- ✓ State agencies also have carryover reserves that have increased, including Regents universities.
- ✓ The University of Kansas spends 26% more per-student on Educational Programs than Kansas State University; KU spends 40% more per-student than Wichita State. Emporia State spends 18% more per-student than Pittsburg State and 50% more than Fort Hays State. Using Wichita State as the benchmark for research universities and Fort Hays State for the others, annual savings would total \$170 million.
- ✓ The Department of Administration often overcharges agencies for services that could be provided at lower costs in the private sector. For example:
  - The FY 2016 Budget Instructions shows agencies are charged \$19.40 per square foot for office space; that's a 27% increase over last year, which was higher than market prices. Charges to the federal government are much lower.
  - The price KPI paid to duplicate this testimony at Office Max was slightly less than the price state agencies are charged.

- ✓ The Department of Education annually forgoes about \$21 million in federal reimbursement because no invoice is submitted for the KPERS cost of school employees performing federally-funded functions. Other states do get reimbursed for these costs.
- ✓ The last time we ran the numbers (in 2010), state spending on employee insurance was \$29 million higher than it would be if employees were paying the same portion as the national average. Kansas was paying 94% of the cost of single coverage and averaged 77% for non-single coverage; the national average was 81% and 70%.

Proposals to raise taxes while ignoring these and other glaring inefficiencies is effectively telling citizens that many legislators prefer to raise their taxes than to deal with the backlash from the bureaucracy and special interests that profit from excess government spending.

That said, if raising taxes is the preferred method of balancing the budget, the lesson of the last recession is that the State is better able to fund necessary services with a steady revenue stream from consumption taxes rather than income taxes.

Tax revenue declined in FY 2009 and FY 2010 but the magnitude of the decline was much greater for income taxes, which dropped 21% over two years or about \$702 million. Retail sales tax was fairly steady, dropping just \$59 million or 3% over the same period. Imagine how differently the budget processes of those two years would have been if Kansas had had more reliance on consumption taxes and less on income taxes. The income leg of

Decline in Income and Retail Sales Tax During Last Recession				
Tax Type	2008	2009	2010	2-Year Chg.
Income	3,361,891	2,948,450	2,659,663	-21%
Retail Sales	1,711,398	1,689,516	1,652,037	-3%

Source: Kansas Legislative Research

the so-called 3-legged stool may satisfy the political / social desire of those who want to tax income but it is not is government's best interest of having a steady tax stream to fund necessary services.

Some of the justification for raising income taxes is being couched in terms of fairness, as in, 'why should one group be exempt from income tax but others must pay tax.' The focus of those discussions are the businesses organized as Limited Liability Corporations (LLCs), partnerships and other business entities that are taxed as Individuals instead of Corporations.

There is another group, however, that has been exempt from state income tax for decades – state and local government retirees' pensions. As explained in our 2011 publication of A Comprehensive Reform of the Kansas Public Employees' Retirement System ...

"KPERS benefits are not taxable for state income tax purposes. Employee contributions to the plan are after tax, so it's appropriate that distributions from employee contributions would be not be taxable to avoid double taxation. However, KPERS members never have to pay state income tax on the majority of their pension benefits, which come from employer contributions and earnings on employer contributions.

The cost to taxpayers of providing government retirees with these tax-free benefits is substantial. The exact amount of pension distributions from employer contributions and the applicable tax rate for each recipient would have to be identified to accurately calculate the benefit, but we can make a reasonable estimate. As noted in Table 4, in order to fully fund the state/school plan based on the market value of plan assets, the employer contribution rate would be 15.26% and the total employer and employee contribution rate would be 19.33%; the employer rate is therefore 78.9% of the total. For the KP&F plan, the employer rate would be 75% of the total (19.8% for the employer, 26.32% in total). The following estimate of a \$52 million income tax benefit to KPERS retirees is based on the lower employer rate of 75%.<sup>1</sup>

<b>Table 12 - Retirement Benefit Estimate for 2010 (millions of dollars)</b>	
Total KPERS distributions - Calendar 2010	\$ 1,108.6
Estimated portion from Employers	75%
Estimated employer funds distributed	\$ 831.5
Assumed state income tax rate (middle bracket)	6.25%
Estimated state income tax benefit to KPERS retirees	\$ 52.0
<i>Source: KPERS, 2010 distributions as listed at KansasOpenGov.org; Kansas Dept. of Revenue</i>	

Then-KPERS executive director Glenn Deck said our estimation of the tax benefit was reasonable. The current tax benefit should be similar; marginal tax rates have declined but pension distributions were \$1.329 billion in 2013. But regardless of the actual amount, state and local government retirees are exempt from paying income tax on the portion of their pensions funded by taxpayers.

There is certainly a discussion to be had about fairness in taxation, but anyone proposing to increase or charge a tax based on fairness should also be supportive of taxing government retirees the same as private sector retirees...and addressing the unfairness of setting the effective property tax rate on Commercial & Industrial real estate at 117% of the effective tax rate on Residential property...and giving away taxpayer money to a handful of businesses in the name of 'economic development'...and exempting select entities from sales tax...and so forth.

If we're not going to address all of the fairness issues in our tax code, let's not try to frame the proposal to raise income taxes as a matter 'fairness' and just acknowledge that it's about political expediency.

And let's also not try to call this fixing a 'loophole.' It was abundantly clear from the very beginning that the tax plan proposed by Governor Brownback and the final plan designed by the Steve Morris-led Senate would exempt non-wage income of LLCs and other non-C Corp businesses from income tax.

The tax plan was intended to reverse decades of private sector economic stagnation. States with no income tax and low tax burdens have superior economic performance. Kansas even trailed the inferior performance of high-burden states and in most categories of income-taxing states.



Long term stagnation cannot be reversed in a short time, especially Kansas began the process when the federal government imposed higher taxes and forced insurance costs higher with Obamacare. It will take several more years for the impact of the tax plan to be fully understood but the early signs of improving trends are encouraging.

Private sector jobs only increased by 2.2% between 1998 and 2012 (average annual jobs for 1998 and 2012, seasonally adjusted); that growth rate put Kansas at #38

Private Sector Job Growth and Rankings						
State	1998-12 Growth	2013 Growth	2014 Growth	1998-12 Rank	2013 Rank	2014 Rank
Kansas	2.2%	1.6%	1.9%	38	27	21
Missouri	-1.0%	1.3%	1.2%	44	35	39
Nebraska	9.8%	1.4%	1.4%	17	31	33
Oklahoma	8.5%	1.6%	1.5%	19	26	26
Colorado	10.6%	3.1%	3.8%	15	5	3
Iowa	4.0%	1.5%	1.5%	29	29	30
Source: Bureau of Labor Statistics, average annual jobs seasonally adjusted						

among the fifty states. In 2013, private sector employment grew 1.6% and Kansas was ranked #27 in the nation. Last year Kansas moved up to #21 with growth of 1.9%.

Kansas almost reached parity with its income-taxing peers last year, which is also a significant improvement in competitiveness. Kansas private sector jobs grew at just 61% of its income-taxing peers' 3.6% growth rate between 1998 and 2012, but 2013 and 2014 growth was at 78% and 95%, respectively. Kansas job growth was also better in 2014 than the neighboring states of Missouri, Oklahoma and Nebraska.

Private sector GDP isn't available yet for 2014 but Kansas outperformed the 50-state average of 4.0% in 2013, as well as its income-taxing peers and the ten states with the highest state and local tax burden (as ranked by The Tax Foundation). Kansas trailed each group in the fourteen years

Private Sector GDP				
State	1998-12 Growth	2013 Growth	1998-12 Rank	2013 Rank
Kansas	74.7%	4.3%	28	24
Missouri	55.9%	2.9%	48	40
Nebraska	99.6%	7.1%	12	6
Oklahoma	113.7%	7.1%	7	7
Colorado	88.4%	6.1%	16	9
Iowa	82.9%	6.4%	21	8
No income tax	100.6%	4.7%		
Income Tax	72.9%	3.8%		
Ten Lowest S&L burden	106.9%	4.1%		
Ten Highest S&L burden	76.0%	3.4%		
50-state average	77.9%	4.0%		
Source: Bureau of Economic Analysis, Tax Foundation rankings of state and local tax burdens				

preceding tax reform. Rankings among neighboring states didn't change; Kansas widened its lead over Missouri but was a little less competitive with other neighboring states in 2013. One year certainly doesn't qualify as a trend but it's encouraging to see Kansas more competitive on a national scale.

Data on Personal Income growth shows Kansas has improved in the two years since tax reform was enacted on several measures.

Total personal income (which includes dividends, interest, rent, wage and salary earnings, proprietor earnings, employer payments for payroll taxes, health care and retirement payments for government and the private sector) in Kansas increased by 5.67% between 2012 and 2014, ranking #24 in the nation and much better than its #33 ranking between 1998 and 2012. Kansas did slightly better than the states that tax income and was closer to the performance of the 50-state average. Kansas outperformed Missouri and Nebraska and was more competitive with Oklahoma.

Personal Income				
State	Percent Change		Rank	
	1998-12	2012-14	1998-12	2012-14
Kansas	78.2%	5.67%	33	24
Missouri	70.8%	4.88%	44	35
Nebraska	90.1%	3.97%	20	43
Oklahoma	109.8%	5.90%	5	20
Colorado	96.5%	8.59%	13	3
50-state average	82.8%	6.03%		
Ten lowest S&L tax burden	102.6%	7.19%		
Ten highest S&L tax burden	80.4%	5.78%		
States w/Income Tax	78.8%	5.65%		
States w/o Income Tax	101.2%	7.50%		

*Source: Bureau of Economic Analysis, Tax Foundation rankings of state and local tax burdens*

Kansas also shows improvement in Nonfarm Private Earnings, which includes all private sector components of Personal Income. Kansas trailed the 50-state average in the fourteen years prior to tax reform but its 9.5 percent growth over the last two years exceeds the 8.7 percent average of all states. Kansas also outperformed Missouri, and while not unusual, the margin of victory has widened. Kansas trailed Nebraska and Oklahoma in the past but has pulled ahead in the last two years.

Private Nonfarm Earnings % Change		
Geography	1998-12	2012-14
Kansas	67.1%	9.5%
Missouri	55.8%	7.6%
Nebraska	79.7%	7.7%
Oklahoma	106.0%	9.1%
Colorado	81.0%	11.5%
50- State avg.	69.3%	8.7%

*Source: Bureau of Economic Analysis*

Those who oppose tax reform will likely continue using misleading information to claim that the Kansas economy is not better off since tax reform. The Kansas City Star, for example, uses non-farm jobs, which includes government; the health of an economy is not measured by the growth in government...but in the private sector.

The Star and others use point-to-point comparisons (e.g., December to December) even though one or both points can be unusual spikes or declines. The Bureau of Labor Statistics also publishes average annual employment, which minimizes the impact of any single data point.

It's easy to make unchallenged claims sound legitimate, so we encourage the Committee to gather those with differing views and allow us to question each other's claims. We have a standing invitation to Duane Goossen and the Kansas Center for Economic Growth to join us in a public discussion but they refuse. Kansas Policy Institute stands ready to defend our work at any time.

The current tax plan is beginning to overcome inferior economic trends of past years and the momentum will continue to build if the plan is kept in place. Reversing course for political expediency will have a negative impact.

We encourage the committee to reject HB 2430 and use a combination of many other options to balance the budget.

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<sup>1</sup> <http://www.kansaspolicy.org/ResearchCenters/BudgetandSpending/BudgetandSpendingStudies/71799.aspx>