Approved: 1-23-96
Date

MINUTES OF THE HOUSE COMMITTEE ON TAXATION..

The meeting was called to order by Chairperson Phill Kline at 9:10 a.m. on January 18, 1996 in Room 519-S of the Capitol.

All members were present except: Rep. Graeber
Rep. Powell

Committee staff present: Chris Courtwright, Legislative Research Department
Don Hayward, Revisor of Statutes
Shirley Sicilian, Department of Revenue
Ann McMorris, Committee Secretary

Conferees appearing before the committee: None

Others attending: See attached list

Chair called on Chris Courtwright for report on the Governor's Equity Tax Task Force. Chris reviewed the findings of the committee contained in pages 1 thru 19 of the December 1995 Report of the Governor's Tax Equity Task Force. (Attachment 1)

Rep. Bruce Larkin, a member of the Task Force, gave the minority report contained on page 19.

The full report contained 278 pages. Pages 20 thru 278 contain 14 research papers and are not enclosed with the minutes.

The next meeting is scheduled for January 23, 1996.

Adjournment 10:10 am

Attachment - 1

# TAXATION COMMITTEE GUEST LIST

DATE: JANUARY 18 1996

| NAME | REPRESENTING |
|---|---|
| Karl Peterjohn | Kansas Taxpayers Network |
| Bill Fasnell | BOEING |
| TOM YOUNG | AARP |
| Martha Jenx Smith | KMHA |
| Byron Patton | Our Grand Children |
| SHELBY SMITH | RKTA |
| Jacque Oakes | SQE |
| FRANCES Kastner | Ks Food Dealers Assn |
| Mark Tallman | KASB |
| Dave Holthaus | Western Resources |
| Bob Corkins. | KCCI |
| Shirley Sicilian | KDOR |
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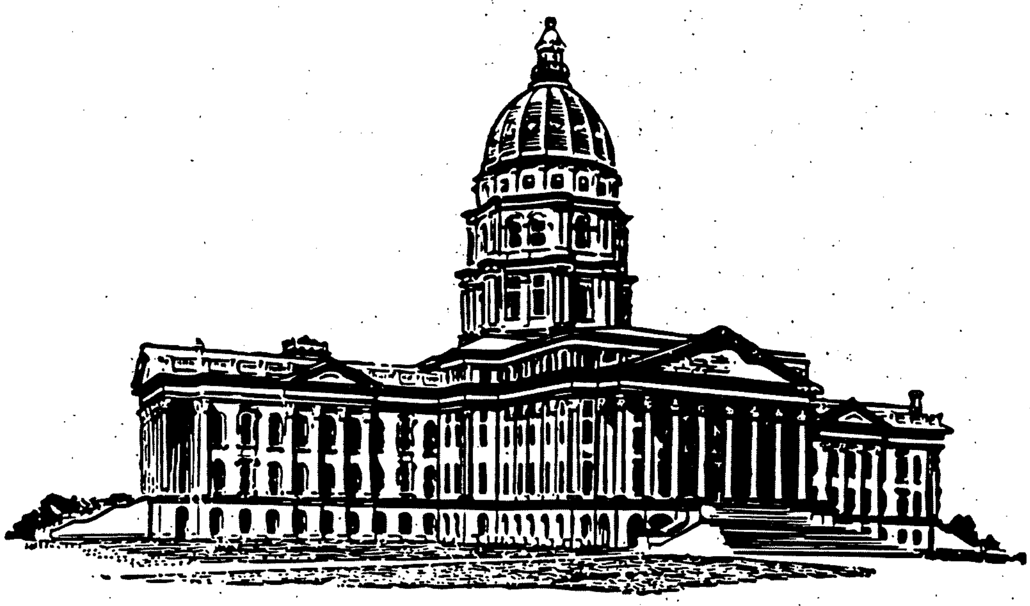
State of Kansas

Bill Graves, Governor

Report of the

# Governor's Tax Equity Task Force



December 1995

House Taxation
1-18-96
Attachment 1-1

# Governor's Tax Equity Task Force

Mr. Keith Roe, Chairman
*Mankato*

Mr. Robert Bennett, Vice-Chairman
*Overland Park*

Mr. Larry Barrett
*Colby*

Senator Phil Martin
*Pittsburg*

Ms. Nancy Burns
*Kansas City*

Mr. Bill Moore
*Topeka*

Mr. Jack Dicus
*Topeka*

Mr. Ed Nazar
*Wichita*

Representative Clyde Graeber
*Leavenworth*

Mr. Jim Pendleton
*Prairie Village*

Dr. W. Bartley Hildreth
*Wichita*

Senator Pat Ranson
*Wichita*

Mr. Matt Ida
*Fort Scott*

Ms. Shirley Martin-Smith
*Lawrence*

Mr. Dennis Jones
*Lakin*

Mr. David Strohm
*Augusta*

Representative Bruce Larkin
*Baileyville*

Mr. Ottis Vann
*El Dorado*

Mr. Murray Lull
*Smith Center*

Ms. Carol Wiebe
*Hillsboro*

Secretary of Revenue John LaFaver, Ex-Officio

## Task Force Staff

Mr. Chris W. Courtwright
*Kansas Legislative Research Department*

Mr. Daniel Hermes
*Division of the Budget*

Ms. Jill Crumpacker
*Office of the Governor*

Ms. Elizabeth Carlson
*Committee Secretary*

# Task Force Report

Executive Order No. 95-178, which established the Governor's Tax Equity Task Force, charged the group with conducting a comprehensive review of the Kansas state and local tax structure, including: (1) the current mix of statewide property taxes, sales taxes, and income taxes; and (2) the current reliance on statewide property taxes as a method of financing public education. The Task Force was charged with preparing a report on or before January 1, 1996, analyzing the fairness of the state's current tax policies and recommending any necessary improvements or revisions.

## BACKGROUND

Kansas enjoys a national reputation as a fiscally responsible state. This recognition reflects a longstanding commitment by Kansans to each other and their government. Each generation of taxpayers, however, must renew this fiscal legacy.

Taxes fund a variety of public services that citizens rely upon daily, including roads, public safety, and a community of educated citizens. Each tax dollar also carries a demand for wise public stewardship. While it is a political truism that no one likes to pay taxes, it is an economic truism that only people bear the ultimate tax burden. Kansans believe in fairness, and call upon taxes to reflect this principle, too.

A state has its mix of taxes and services continuously tested in a competitive environment with other states and localities, and even with jurisdictions beyond our national borders. Responsible public policy, therefore, dictates a periodic examination of our state and local tax structure.

Aside from this broad and general review, another factor leading to the establishment of the Task Force was the major tax shift proposal embodied in the House Committee of the Whole version of S.B. 41. This legislation, which passed the Kansas House during the 1995 Session was not acted upon by the Kansas Senate. The proposal would have eliminated the mandatory school district general fund property tax levy over a three-year period and replaced it with revenues from sales, income, and privilege tax rate increases.

Governor Bill Graves therefore appointed the Governor's Tax Equity Task Force to examine thoroughly the Kansas state and local tax structure with an emphasis on equity issues, to analyze the tax shift proposal passed by the House, and to return whatever recommendations deemed appropriate to the Governor and the 1996 Kansas Legislature.

## KANSAS STATE AND LOCAL TAX STRUCTURE

Total state and local tax revenue increased by 2.8 percent from FY 1994 to FY 1995–from $6.114 billion to $6.288 billion. Local taxes increased by 6.3 percent and state revenues increased by 0.7 percent.

State taxes accounted for $3.815 billion, or 60.7 percent, of FY 1995 total state and local tax revenue. During that fiscal year, 82.8 percent of state tax receipts was credited to the State General Fund and 17.2 percent went to other funds.

Local units of government end up spending most of the state and local tax revenue. Including the $1.985 billion from state taxes allocated to or shared with local units, local units received $4.457 billion, or 70.9 percent, of total FY 1995 state and local taxes.

## The Tax Mix

General property tax levies and the in-lieu-of-property-tax on motor vehicles accounted for 33.52 percent of total FY 1995 state and local tax revenue. State and local sales and compensating taxes accounted for 27.43 percent of the combined total, followed next by income and privilege taxes at 23.99 percent. No other tax source produced as much as 5 percent of the total. The sales, income and property tax figures are now more evenly balanced than they were prior to the enactment of 1992 school finance legislation.

In FY 1992–prior to the impact of the 1992 school finance tax shifts–general property and motor vehicle taxes accounted for 38.73 percent of total state and local revenues. Sales and compensating taxes accounted for 22.58 percent in that year, and income and privilege taxes were about 21.13 percent of the total.

## The Tax Burden

At the same time, in spite of a number of major changes in Kansas tax policy in recent years (individual income tax changes in response to federal tax reform–1988 and 1989; implementation of reappraisal and classification–1989; enactment of comprehensive highway program–1989; school finance sales, income, and property tax shifts–1992; revised classification amendment–1993; continued proliferation of local sales taxes–1980s and 1990s), the ratio of state and local taxes to Kansas Personal Income (KPI) has remained fairly constant.

**Ratio of Taxes to KPI***

| Fiscal Year | State | Local | Total |
|---|---|---|---|
| 1988 | 6.90% | 5.02% | 11.92% |
| 1989 | 6.70 | 5.07 | 11.76 |
| 1990 | 6.86 | 5.15 | 12.01 |
| 1991 | 6.64 | 5.07 | 11.71 |
| 1992 | 6.64 | 5.16 | 11.80 |
| 1993 | 7.27 | 4.46 | 11.73 |
| 1994 | 7.52 | 4.61 | 12.13 |
| 1995 | 7.20 | 4.66 | 11.86 |
| **Exhibit:** | | | |
| 1940 | 6.04% | 8.78% | 14.82% |
| 1950 | 4.65 | 4.89 | 9.54 |
| 1960 | 4.62 | 5.87 | 10.49 |
| 1970 | 5.52 | 6.25 | 11.77 |
| 1980 | 6.24 | 4.43 | 10.67 |

* KPI estimates from U.S. Department of Commerce. The personal income figure is for the calendar year in which the fiscal year began.

Per capita state taxes remained flat at $1,494 in both FY 1994 and FY 1995, but per capita local taxes increased from $917 to $968–a 5.6 percent jump.

1-5

The class of property that is the biggest net statewide beneficiary as a result of school finance and the new classification amendment is commercial and industrial real property. Taxes on commercial and industrial real property declined from $444 million in 1991 to $360 million in 1994, a reduction of $84 million.

## AD VALOREM TAXES BY CLASS OF PROPERTY, 1991-1994

| | 1991 | % of Total | 1992 | % of Total | 1993 | % of Total | 1994 | % of Total | Change 1991-94 |
|---|---|---|---|---|---|---|---|---|---|
| Total Real | $ 1,332,713,087 | 72.72% | $1,147,469,058 | 71.37% | $ 1,149,475,203 | 67.76% | $ 1,234,477,581 | 67.44% | $ (98,235,506) |
| Total Personal | 258,966,644 | 14.13% | 228,385,567 | 14.21% | 279,429,757 | 16.47% | 302,233,802 | 16.51% | 43,267,158 |
| State Assessed | 240,974,214 | 13.15% | 231,874,107 | 14.42% | 267,462,910 | 15.77% | 293,660,637 | 16.04% | 52,686,423 |
| TOTAL | $ 1,832,653,945 | 100.00% | $ 1,607,728,732 | 100.00% | $ 1,696,367,870 | 100.00% | $ 1,830,372,020 | 100.00% | $ (2,281,925) |

1995 $1,922 billion

| Exhibit: | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Residential Real | $ 690,982,069 | 37.70% | $ 608,794,167 | 37.87% | $ 637,133,751 | 37.56% | $ 696,911,196 | 38.07% | $ 5,929,127 |
| Commercial and Indus. Real | $ 443,669,655 | 24.21% | $ 376,400,435 | 23.41% | $ 340,893,091 | 20.10% | $ 359,655,235 | 19.65% | $(84,014,420) |
| Ag. Land (Real) | $ 162,878,956 | 8.89% | $ 133,379,972 | 8.30% | $ 138,967,937 | 8.19% | $ 144,208,364 | 7.88% | $ (18,670,592) |
| Mineral Leasehold | $ 111,211,319 | 6.07% | $ 101,053,152 | 6.29% | $ 112,529,807 | 6.63% | $ 116,955,663 | 6.39% | $ 5,744,344 |
| Bus. Mach. & Equip. | $ 111,385,312 | 6.08% | $ 97,899,557 | 6.09% | $ 132,395,793 | 7.80% | $ 146,945,659 | 8.03% | $ 35,560,347 |

**Source:** Property Valuation Division Statistical Reports.

1-5

The following table provides 1991-94 data on levies by type of taxing district:

## STATEWIDE AD VALOREM LEVIES BY TYPE OF TAXING DISTRICT FOR 1991 TO 1994
(Amounts are expressed in millions.)

| | 1991 | 1992 | 1993 | 1994 | Percent of 1994 Total | Percent of Increase 91-92 | 92-93 | 93-94 |
|---|---|---|---|---|---|---|---|---|
| State | $ 21.95 | $ 21.90 | $ 22.31 | $ 23.25 | 1.27% | (0.23)% | 1.87% | 4.21% |
| County | 392.83 | 413.55 | 454.29 | 472.66 | 25.82 | 5.27 | 9.85 | 4.04 |
| City | 260.61 | 271.42 | 285.32 | 296.60 | 16.20 | 4.15 | 5.12 | 3.95 |
| Township | 23.44 | 24.05 | 26.45 | 27.83 | 1.52 | 2.60 | 9.98 | 5.22 |
| USD | 976.14 | 709.68 | 731.33 | 825.80 | 45.12 | (27.30) | 3.05 | 12.92 |
| Other Schools | 83.99 | 92.35 | 96.42 | 98.66 | 5.39 | 9.95 | 4.41 | 2.32 |
| Out District Tuition | 10.09 | 9.18 | 8.14 | 8.50 | 0.46 | (9.02) | (11.33) | 4.42 |
| Other Districts | 63.61 | 65.60 | 72.12 | 77.08 | 4.21 | 3.13 | 9.94 | 6.88 |
| Totals | $ 1,832.66 | $ 1,607.73 | $ 1,696.38 | $ 1,830.38 | 100.00% | | | |
| Percent of Increase | 10.8% | (12.3)% | 5.5% | 7.9% | | | | |
| CPI Increase | 4.2% | 3.0% | 3.0% | 2.8% | Est. | | | |

The levy data was taken from the Department of Revenue's publication *Statistical Report of Property Assessment and Taxation* with adjustments by the Kansas Legislative Research Department.

## Impact of School Finance and Reclassification

To illustrate some of the tax shifts brought about by 1992 school finance legislation and the 1993 implementation of the revised classification amendment, the first table provides 1991-94 data on the property taxes levied against selected classes of property:

Statewide property taxes in 1994 returned to nearly the same level–$1.83 billion–that they had been at in 1991 (prior to enactment of the 1992 School District Finance and Quality Performance Act).

## TASK FORCE ACTIVITIES

The Task Force held its initial meeting on July 12 at Washburn University in Topeka. Governor Graves outlined the challenges to the Task Force and lauded the expertise and diversity being brought to the group by the members.

The Task Force received a variety of information from staff reports at the August 14 meetings at the Statehouse in Topeka and at the September 6 meeting at Wichita State University. The Task Force also began to receive input through public testimony at the Wichita meeting. The Task Force then called upon a tax study team comprised primarily of faculty from Kansas universities to assist in providing valuable research as part of the comprehensive overview of Kansas tax policy. Dr. W. Bartley Hildreth, Regents Distinguished Professor of Public Finance at Wichita State University, was designated to coordinate the efforts of the tax study team.

During the week of September 18, the Task Force split into three subcommittees which met in Garden City, Fort Scott, and Topeka for the purpose of holding public hearings and receiving further citizen input regarding the Kansas tax structure.

The full Task Force met October 5 in Hays to receive additional public testimony. Draft copies of the research papers were presented to the Task Force on October 27 in Johnson County, and the public hearings were concluded.

The Task Force returned to Topeka on November 16-17 to make decisions with respect to policy options that had been discussed during the statewide public hearings and presentation of the research papers by the tax study team. The final version of all research papers are presented later in this report.

## RESEARCH PAPERS–SELECTED CONCLUSIONS AND HIGHLIGHTS

### *An Overview of Kansas State and Local Finance*

*Glenn Fisher*, Wichita State University

- Elasticity measures how fast receipts grow in response to growth in Kansas personal income (KPI). The elasticity of the individual income tax since 1988 is an unusually low .994 and the elasticity of the general sales and use tax is an unusually high 1.022. (Studies from other states have suggested that they have higher income tax elasticity and lower sales tax elasticity.) If these elasticities continue, it means that the yield of these taxes will grow at about the same rate as the growth in KPI.

- The elasticity of the appraised value of taxable property since 1989 is .509. This means that if appraisal practices, the classification system, and tax rates remain the same, property taxes will rise about half as fast as KPI.

1-7

- Projections that assumed that personal income continues to rise at a 5.19 percent annual rate and that state and local expenditures rise at the same rate as income indicate a year 2000 shortfall of more than $500 million in tax-financed state and local expenditures.

***State Budget Policy***

*Gloria Timmer*, State Division of the Budget

- The Kansas budget has had significant overall growth in the long term, with specific areas of government (especially K-12 education) accounting for most of the recent changes.

- Although there is a perception among some that higher education has accounted for much of the growth in the funding of the budget, data indicate that higher education's share of the SGF has actually declined from 1975 to 1995.

- The majority of the increases in the state budget can be attributed to the state's acceptance of activities previously funded through means or mandates by the federal government.

- The fairly rigid structure and statutory obligations within which the budget must be prepared constrain frivolous spending and revenue adjustments, but also have the effect of limiting the state's ability to respond to serious budget issues in a timely manner.

- While federal funding changes may represent an opportunity to allow the state to better address the needs of Kansas citizens, major funding reductions with only limited flexibility could mean that the state and its citizens will be forced to shoulder the responsibility of conducting business with far fewer resources.

***Individual Income Taxes in Kansas: Structure and Distribution***

*Dan Hermes*, State Division of the Budget

- In comparison with surrounding states, Kansas appears to be competitive in taxing individuals that comprise the bulk of income taxpayers–married joint filers and single filers below $50,000 in Kansas Adjusted Gross Income. These groups, where Kansas taxes are at or below the regional average, comprise 98 percent of the individual income tax filers. The only area where Kansas does not appear competitive is for single taxpayers with gross income above $50,000. The area where Kansas appears to be most competitive, with effective rates between 6 and 14 percent below the regional average, is for joint married filers between $25,000 and $50,000 in KAGI. This group of taxpayers comprises just under 19 percent of the total number of returns.

- Indexing income tax personal exemptions, standard deductions, and brackets may not be as great an issue in Kansas as it has been in other states, given the progressive nature of the Kansas individual income tax structure.

### *Should Kansas Substitute Sales Tax for Property Tax?*

*Edwin G. Olson*, Kansas State University

- Policy decisions involving proposals to increase the sales tax while decreasing the property tax should carefully consider: (1) responsiveness of tax revenues; (2) stability of the tax base; (3) who pays the taxes; (4) tax impact and incidence; (5) economic neutrality; (6) balance among tax bases; (7) fairness; (8) determination of the tax bases; and (9) cost of collection.

- An additional sales tax issue involves the loss of sales and economic activity along the border any time there is a major increase in the rate.

- Since a rapidly expanding share of expenditures for most families is devoted to services, Kansas could consider expanding the sales tax base as a way of increasing the elasticity of the tax. Although controversial, one proposal would be to begin taxing additional services (such as accounting and surveying) sold directly to consumers while at the same time exempting the sales of such services to business firms.

- School district option sales and income taxes would raise equity issues and may not be adequate in rural districts as replacement revenue sources for the property tax.

### *Taxing Oil and Gas in Kansas*

*James Richardson*, Louisiana State University

- The current oil and gas tax structure in Kansas, including the severance and ad valorem taxes, creates marginal tax rates on new revenues from oil and gas operations that are the highest of the selected states studied for oil activities and second highest for natural gas activities.

- The elimination of 35 mills from the property tax levy would reduce the marginal tax rate on oil revenues from 9.5 percent to 7.9 percent, making it lower than the marginal rates in Texas and New Mexico, but still higher than the marginal rates in Colorado, Illinois, and Oklahoma. The elimination of 35 mills would reduce the marginal rate for gas from 10.2 percent to 8.6 percent, again making it lower than the marginal rates in Texas and New Mexico, but still higher than the marginal rates in Colorado, Illinois, and Oklahoma.

- Improving the marginal tax rate on the oil and gas industry is not sufficient reason to pass S.B. 41. The state should examine carefully, however, alternative methods of reducing the marginal tax rates and the potential benefits and costs of each alternative.

### *History of the Property Tax in Kansas*

*Glenn Fisher*, Wichita State University

- Although the implementation of the classification amendment along with reappraisal in 1989 was relatively successful in preventing major tax shifts from one major class of property to another (agricultural, residential, business, utility), there were major shifts from subclass to subclass. The exemption of inventories and the favorable treatment of machinery partly offset

1-9

higher real estate taxes for the business sector as a whole, but there were large gains and losses for particular types of businesses. For example, manufacturing and retail firms gained at the expense of owners of commercial buildings who had little inventory.

- The shift from properties that were relatively over-appraised to those in the same class that were under-appraised was inevitable and desirable, but no less painful. Few taxpayers faced with large tax increases took time to give thanks for the years in which they paid less than their fair share.

- The imposition in 1992 of a uniform statewide school tax rate spotlighted the importance of statewide assessment uniformity and put new burdens on property tax administrators.

***Issues Related to Technical Reliability of Kansas Ratio Study***

*Ronald Wasserstein*, Washburn University

- The Kansas sales ratio study is a technically reliable method of evaluating the extent to which property in the state is valued on a uniform and equal basis. The methods for generating confidence interval estimates of the important quantities of median ratio, coefficient of dispersion, and price-related differential are state-of-the-art. Great care is taken by the state Property Valuation Department to insure that the data are accurate and based entirely on valid sales as defined by statute and principles of good practice.

- The ratio study is professional and reliable. Whatever the arguments may be for or against the property tax, the argument that it is impossible to determine whether property is fairly valued is negated by the ratio study.

***Use of Property Tax for Public School Finance in Kansas***

*Nancy McCarthy Snyder*, Wichita State University

- The 1992 School District Finance and Quality Performance Act had an immediate impact on property taxes–school district levies dropped $266 million between 1992 and 1993 and total mill levies statewide decreased an average of 14.8 mills.

- The effect on equalization of spending per pupil was less dramatic. Although low spending districts did increase spending significantly, it does not appear that high spending districts reduced spending.

- Because the low enrollment weighting provides substantial assistance to small school districts (those with less than 1,800 students), they are able to maintain relatively high spending levels without additional property taxation. On the other hand, the only way that the larger districts can maintain spending levels is by increasing the property tax burden. School districts accounted for 70.5 percent of the increase in property taxes levied in 1995.

- The move to state financing removes the local control that most school reformers advocate. While equalization may serve a worthy purpose–improving opportunities for students in poor districts, research has been unable to find any causal link between equalization and student achievement or between the share of state funding and student performance.

- Some analysts have argued that school district equalization was one of the major causes of California's 1978 tax revolt. When parents and citizens in affluent school districts lost the ability to tax themselves to pay for the kind of education system that they wanted, property tax limits became much more attractive. When there is no local revenue source to monitor and account for, citizens lose interest. Active civic involvement and public support are essential to good quality public schools.

- There is little doubt that the Kansas state government will continue to be heavily involved in education finance, if for no other reason than that the courts have ordered it. But further efforts to reduce local financing and local control should be viewed from the perspective of not only tax equity, but also of education achievement.

***Tax and Spending Limitations in Kansas***

*Nancy McCarthy Snyder*, Wichita State University

- It is impossible to know how high property taxes in Kansas would be in the absence of the tax lid. The property tax has been the slowest growing major source of state and local government revenue over the last 20 years because of its unpopularity.

- The effectiveness of the tax lid is weakened by the statutory exemptions built into it.

- A recent proposal calls for a constitutional amendment to limit the growth in state, city, and county spending to the rate of growth in total personal income. Although many Kansans would probably agree that government should not grow faster than the ability to pay for it, it is unclear whether it is necessary to impose this philosophy through the state *Constitution*. The proposal implies a lack of faith in elected officials at both the state and local level to promote the will of the public. The passage of such a constitutional amendment also could prove problematic at a time when the federal government is returning numerous governmental functions to the states.

- Artificial taxing and spending rules create excuses for citizens, elected officials, and public employees alike to abdicate their civic responsibilities. It is the responsibility of elected leaders to make difficult choices between costs and benefits, to inform the public of those choices, and to accept input from the public about their preferences.

***Impact of Fiscal Policy on State Economic Performance***

*John Wong*, Wichita State University

- Based on a model including all business-climate variables and a model including only nonfiscal business-climate variables, Kansas has a more favorable business climate than neighboring states in the areas of manufacturing; retailing; and financial, insurance, and real estate; but has a less favorable business climate than neighboring states in the area of services.

- In terms of revenue effort, Kansas has the lowest sales and income tax effort compared with neighboring states, but has the highest corporate and property tax effort compared with neighboring states. The model including only revenue variables shows Kansas to be only average to below average in business climate relative to neighboring states.

- Kansas spends more on higher education and highways relative to neighboring states, and less on welfare. The expenditure model also shows Kansas to be average to below average in business climate relative to neighboring states.

- Kansas' competitive advantage, therefore, results from nonfiscal factors.

- Taxation alone does not appear to be a critical determinant of business location, but businesses do consider the relationship between the taxes they are paying and the services they receive in return. If state and local policy is a significant factor in business location decisions, then tax reductions could yield more than proportional increases in business activity. But taking this argument to the extreme, the optimal rate of taxation from the perspective of business would be zero. However, an environment without taxes is also likely to be a place without roads, schools, or sewers. If all states proceed under the assumption that they must lower their taxes or offer financial incentives to lure businesses, then the concerted actions of all the states mutually nullify any possible advantages from the action, and bestow upon the "winning" jurisdiction only diminished tax revenues.

### *Analysis of Tax Policy Impact on Corporations*

*Charles Krider and Pat Oslund*, University of Kansas

- Under the current tax structure, Kansas stands out as the state in the region with the highest taxes on mature business. The sources of the high overall tax level on Kansas businesses are the property tax and the corporate income tax. New or expanding firms in Kansas may be largely shielded from the underlying high Kansas business tax structure by income and property tax incentives.

- The income allocation formula can significantly alter a firm's in-state liability. The higher the weight given to sales, the lower will be the allocation fraction for export-oriented firms.

- The House Committee of the Whole version of S.B. 41 would produce an annual state and local tax savings of about $1,000 per employee for a mature capital-intensive firm, and of about $400 per employee for a less capital-intensive firm. About one-third of this impact would be offset by increases in federal income taxes. Additional offsets could occur if the tax changes tended to increase property values.

### *Small Towns, Economic Revitalization, and the Property Tax*

*Garry Mattson*, Kansas State University

- Many small Kansas towns because of their scale and limited economic and tax bases are struggling to survive into the next century. Businesses have a powerful bargaining advantage. Firms can bargain and choose between communities in order to minimize costs. Offering tax incentives and municipal services (known as "smokestack chasing") as an economic

1-12

development strategy may cause communities to strike Faustian bargains with prospective businesses, trading off their unique character for short-term economic gain.

- In terms of economic revitalization strategies, infrastructure improvements, which require considerable public financial investment in terms of bonds, is given top priority by many local officials. In terms of innovative fiscal incentives, loan guarantees, tax abatements, and IRBs are the most popular methods.

### *Impact of Kansas Tax Policy on the Farm Economy*

*Barry Flinchbaugh and others*, Kansas State University

- The average estimated tax paid by Kansas Farm Management Association farms is about $4,865. Of this liability, 15.0 percent was paid via income tax, 8.2 percent was paid via business sales tax, 21.7 percent was paid by personal sales tax, and 55.1 percent was paid via property tax. The average cash net farm income for these farms was $30,670.

- The average tax liability per farm would decrease by $349 assuming a 35 mill decrease in the property tax levy is offset with revenues coming 50 percent from increased sales taxes and 50 percent from increased income taxes.

### *Distributional Impact of Tax Policy Changes*

*John Wong and Nancy McCarthy Snyder*, Wichita State University

- A 0.5 percentage point increase in the income tax rate would be modestly progressive and would be borne primarily by taxpayers residing in metropolitan areas or counties adjacent to metropolitan areas.

- A 10 mill reduction in the mill levy would primarily benefit less densely populated rural counties in Western Kansas and counties in the greater Kansas City area.

- A 1 cent increase in the sales tax would be somewhat regressive, borne disproportionately by taxpayers in lower income groups.

## KANSAS TAX POLICY OBJECTIVES

The Task Force recommends that all tax legislation be evaluated with the following objectives in mind. The group notes that a tax system involves policy tradeoffs based upon the various tax criteria applied to each tax and the overall tax structure. There is no perfect tax or perfect tax package.

**Kansas should maintain its enviable reputation as a fiscally responsible state.** This hard-earned status reflects a longstanding commitment of Kansas taxpayers and their public officials to rational, well thought out taxing and spending decisions. This farsighted view has allowed Kansans to avoid massive tax increases or draconian spending cuts in response to tough times.

**A tax system should produce revenues that are adequate to finance an agreed-upon level of public services over time.** Inherently intertwined are taxing and spending policies. Taxes fund a variety of services that citizens rely upon daily, including roads, public safety, and a community of

1-13

5. Projections for the year 2000 reveal a projected structural deficit of about $500 million in combined state and local government tax financed expenditures, suggesting that a period of severe budget cuts or major tax increases may be on the horizon.

6. The state budget follows the fundamentals of sound state budgeting practice, highlighted by the use of the Consensus Revenue Estimate and a required 7.5 percent ending balance.

7. The state faces an increasingly harsh and competitive fiscal environment, including changes in federal fiscal policy, tax revolts, and the competition for jobs and growth.

8. The federal government is on the brink of turning over substantial responsibilities and authority for programs but backed by questionable funding levels, placing unprecedented uncertainty on state and local budgets that have grown enormously dependent upon this source of funding to provide programs that help Kansans.

9. Although Kansas is an average user of its available tax base when compared nationally, it is in a low tax region, with Oklahoma and Missouri even lower.

10. Unless neighboring states change their tax levels, there is little maneuvering room for Kansas to increase the rates of major tax sources (property, sales, personal income, corporate income, or oil and gas taxation).

11. Small, rural communities need more financial flexibility, not less, as they struggle for jobs, wealth, and growth against the increasingly stronger metropolitan areas.

12. Taxing and spending limits are economically ineffective tools for dealing with the distrust of government.

13. The distributional impacts of tax policy changes are predictable and reflect the value of a balanced tax system.

**Individual Income Tax**

1. Individual income tax collections since 1988 have grown at a rate less than the growth rate of the state's economy (an elasticity of .994), a finding contrary to traditional public finance and one that demands further analysis.

2. A significant amount of individual income tax revenue is business income, making the individual income tax an essential part of any policy on the level of business taxation.

3. The individual income tax is progressive, meaning that the effective tax rates increase as income increases.

4. The individual income tax treats some taxpayers with similar amounts of income differently, with higher effective tax rates paid by single filers and those who do not itemize.

5. An increase in the individual income tax would be modestly progressive and would be borne primarily by taxpayers residing in metropolitan areas or adjoining counties.

1-14

educated citizens. To provide this package of services, governments purchase goods and services in the marketplace, paying prices that may vary from the prices of items purchased by consumers. Each budget year forces policymakers to reconcile seemingly unlimited taxpayer wants with increasing taxpayer dissatisfaction over the level of taxation. Public officials, accountable for wise stewardship of tax dollars, also are responsible for adhering to public preferences.

**A tax system should produce adequate revenue during economic downturns and also respond to economic growth.** A revenue system must be able to weather economic recessions to preserve some stability in the funding of essential services. And, to the extent that a tax system's rate of growth matches the rate of growth of the economy, the relative size of government services may be maintained without tax rate changes or service reductions. The mix of taxes should help stability in times of economic uncertainty and avoid the need for hasty, unexpected tax increases or service reductions.

**State and local taxing and spending decisions should be consistent with economic growth and development.** Technology allows people to live in good living environments away from economic centers of activity. Relatedly, business tax policy must focus not only on corporate taxpayers, but also on business activity reflected in personal income tax returns. It is important to minimize any unintended impacts of tax structures on growth and development. Since businesses consider the relationship between the taxes they are paying and the services they receive in return, particular forms of public spending may enhance economic growth and development.

**Administration of the tax system should be efficient and fair.** Taxpayers deserve competent, consistent revenue administration, or else confidence in the tax system is eroded. A uniform statewide school tax rate spotlights the importance of assessment uniformity by the county tax appraisers. It is essential to have a technically reliable method of measuring adherence to the uniform and equal criteria. Some taxes, such as sales and income taxes, seem to benefit from state administration. The revenue system should minimize compliance costs for taxpayers and administrative costs of collecting taxes. Taxpayers should have access to an ongoing analysis of tax laws, structures, and burdens.

**Fiscal accountability should be strengthened by making taxpayers aware of their true tax liabilities.** A simple calculation or statement of actual tax liability makes people pause before paying. The property tax generates a yearly bill, even if paid in monthly mortgage payments. Although the personal income tax is subject to payroll withholding for most taxpayers, it also requires a yearly summary of tax liability. In contrast, the sales tax has illusive qualities because most consumers do not know how much they have paid during the year, but it is relatively convenient to pay. The same fiscal illusion happens with excise taxes, such as on gasoline, alcoholic beverages, and tobacco products. Moreover, federal income tax policy rewards taxpayers who itemize by lowering the after-tax effect of property and income taxes, but denies a similar deduction for the sales tax.

**Tax revision should not unduly erode the tax base.** A broad tax base allows the lowest possible rate, while also enhancing compliance, public acceptability, and the stability of the revenue source. But, there is a tendency to grant exemptions from a uniform or general treatment, and once granted they are hard to remove. It is poor public policy to erode the underlying tax base by granting unwarranted, gratuitous exemptions or exclusions. It is important to remove items from taxability, including but not limited to, economic development incentives, only upon meeting rational, economically meritorious criteria. Further, all exemptions and exclusions should be subject to systematic, continuing review.

1-15

**State fiscal policy should advance the interests of the state as a whole, while facilitating the fiscal autonomy of local governments including municipalities, counties, and school districts.** State fiscal decisions influence local governments. Yet, local officials can more appropriately respond to changing local preferences than can state policymakers. To meet these civic responsibilities, local officials require fiscal flexibility and discretion. Legal and electoral remedies, not state prescriptions, provide the needed accountability.

**Policymakers must recognize that tax policy influences economic behavior, and not always in the desired manner.** While it is a political truism that no one likes to pay taxes, it is an economic truism that only people bear the ultimate tax burden. A tax system should be fair, both to individual citizens and to businesses operating in the state. Tax reductions for one taxpayer only shift the burden to someone else. This redistribution of burdens can be by design, or occur as an unintentional side effect. If the goal is to redistribute the tax burden, the advocate of change should bear the burden of establishing why those who benefit from the change should do so at the cost of others. If, instead, the driving reason for a tax change is to achieve a stated principle, then compelling reasons must exist before adopting such changes because redistributed tax burdens can have undesirable and unexpected economic effects.

**Kansans should be able to rely upon a stable tax policy.** With its mix of taxes and services continuously tested in a competitive environment with other states and localities, and jurisdictions beyond national borders, Kansas must continuously review and evaluate its competitiveness. In an increasingly service-driven economy, changes in public responses to taxes may require a major tax restructuring, rate increases, or budget cuts. Frequent changes, however, disrupt business and individual tax planning and may occur before knowing the full economic and competitive effects of past actions.

**The state and local tax system should be balanced and diversified.** A diversified tax system offers a blend of economic tradeoffs. Because all revenue sources have their weaknesses, a balanced tax system will reduce the magnitude of problems caused by over reliance on a single tax source. It will also result in lower rates on each tax and reduce the pressure of competition from other states that have lower rates for a particular tax.

## TASK FORCE FINDINGS

### State and Local Finance

1. Kansas enjoys a rough balance between property, sales, and income taxes.

2. Property taxes will probably continue to decline as a share of state and local taxes because they have lower elasticity than income or sales taxes, thus moving the tax system in closer balance.

3. The relative importance of the property tax in Kansas is similar to that in Michigan <u>after</u> that state enacted a sweeping school finance reform program.

4. Kansas state and local taxes as a percentage of total personal income equals the level in 1962. However, Kansas state and local spending is a growing percentage of personal income, reflecting the influence of prices, federal aid programs, and user paid services, among other reasons.

1-16

## Sales Tax

1. A broad sales tax base is eroded through numerous tax exemptions, and the list expands frequently.

2. The Kansas sales and use tax, with an elasticity of 1.02, grows at the same rate as the state's economy, a better than expected result that deserves close monitoring.

3. Broad coverage of the sales tax to the goods and services sold to consumers has several potential effects: increasing the income elasticity of the sales tax, reducing somewhat its regressivity; and, possibly allowing a decrease in the sales tax rate to generate the same amount of revenue.

4. Rate increases reduce economic activity along the state's border as consumption migrates into the adjacent state.

5. Since sales taxes are not deductible on federal tax returns, but state and local income taxes and property taxes are deductible, the average effect on itemizing taxpayers is that $70 paid in state/local income or property taxes is equal to $100 paid in sales taxes.

6. An increase in the sales tax would be slightly regressive, and borne disproportionately by taxpayers in lower income groups.

## Property Tax

1. In the years following the 1989 massive increase in the appraised value of real estate, some property classes have experienced double-digit increases while others have had double-digit decreases.

2. Kansas has made major improvements in valuing assessments on a uniform and equal basis, and the state has a technically reliable method for measuring that quality.

3. The property tax on business machinery and equipment is the highest in the region, with Iowa recently eliminating its tax.

4. Not all taxpayers using machinery and equipment to produce income are treated the same in terms of taxation.

5. Contrary to the impression that local governments have rushed to take advantage of tax reductions created by the 1992 school finance program, the increased property tax collections of cities, counties, and townships are primarily the result of natural growth in the tax base rather than of increased mill levies; in contrast, school districts have made up most of the increases in property tax levies since 1992.

6. A dollar-level homestead exemption for owner-occupied residences shifts an undue share of the property tax burden to business and commercial property, introduces perverse tax appraisal incentives, and erodes the civic accountability of residents for programs funded from this source.

1-17

7. A reduction in the property tax would disproportionately benefit less densely populated rural counties in western Kansas and counties in the greater Kansas City area.

## School Finance

1. Kansas public school districts are increasingly reverting to the pre-1992 reform levels of wide spending variation, with unknown future budget implications.

2. For the state to keep pace with inflation-adjusted funding for public schools from property taxes will require that school expenditures stay at an inflation-adjusted level over time if the elasticity of the property tax remains at the 0.51 level.

3. State financing of public schools fosters a trend away from local responsibility and control of public education.

4. Michigan's new school funding program is based on a statewide property tax levy (6 mills on a different classification and assessment scheme), significant local option capability, and property taxes contributing 32 percent of K-12 spending (compared to 33 percent in Kansas).

5. A big step was taken in 1992 in reducing the amount of property taxes used in public education, but the long-term impact is unknown.

6. To continue current state policy will require the Legislature to enact the uniform school levy in 1996.

7. Of concern, a large number of local option budgets expire at the end of the 1996-97 school year. Renewal of these budgets will be subject to protest petition and election.

## Business, Mineral, and Farm Taxation

1. Taxation alone is not the major determinant of business location in Kansas; businesses consider the relationship between the taxes they are paying and the services they receive in return.

2. While new and expanding firms can receive tax incentives, mature firms face not only the full tax burden but the highest taxes in this region.

3. The Kansas business tax structure is not as favorable a climate for the state's export industries as exists in many other states.

4. Personal income tax returns include a significant amount of business income, therefore, requiring a new focus on what is business tax policy.

5. Kansas farms face a tax burden that is predominantly one of property taxation, but the average tax per acre and average tax per $100 of market value are among the lowest in the region.

6. Existing oil and gas taxation (especially the personal property tax on mineral leasehold interest) hinders productive use of the numerous low producing wells that predominate in Kansas.

1-18

## CONCLUSIONS AND RECOMMENDATIONS

**The task force recommends that the state tax system reduce its reliance on the uniform school finance levy over time.** The task force has not recommended any specific approach to accomplish the reduction in the relative reliance on the property tax but has noted that, given the current tax structure, the property tax will continue to decline as a proportion of total state and local tax revenue given the inelasticity of the property tax. Sharply in contrast to the sales and income tax, the property tax is likely to grow slower than the growth in the economy, given current tax structures and rates for all three of the major tax sources for state and local government. Therefore, absent any action by policy makers, the mix of taxes in Kansas is likely to further converge, producing a system with closer balance among the three major tax sources for financing governments in Kansas.

**The task force recommends that the state should not increase the rate of the uniform mill levy for public school finance.** In recognition of the necessity of local governments other than public school districts to finance required public services from the property tax, the group recommends that the state should not increase the 35.0 mill levy required for financing of local school districts. Increases in this rate may reduce the ability of other local governments to provide locally required services by increasing pressure on the property tax system.

**The task force concludes that the state should not accomplish property tax reductions by increasing income, sales or any other state tax rates.** This conclusion specifically rejects concepts of public policy such as those embodied in the House Committee of the Whole version of 1995 S.B. 41. Findings recognized by the task force indicate that the state has little room to increase either the sales or the income tax rates in the state without creating potential competitive disadvantages with neighboring states. Further, the group has adopted a tax policy objective that requires those advancing a goal of redistributing the tax burden to explain why those who benefit from the change should do so at the cost of others. If, instead, the tax change is to achieve a stated purpose, then compelling reasons must exist before adopting the change because of potential undesirable and unexpected economic effects. The task force judged tax shifts to achieve across-the-board property tax reductions through increases in other taxes to meet neither criterion.

**The task force concludes that the state cannot eliminate the uniform school finance levy for public school finance over a seven-year time frame through "natural" growth in state revenues.** The task force examined and rejected a proposal to eliminate the basic school finance levy over a seven-year time frame without increasing other state or local tax rates or reducing necessary state services. Information on impending budget pressures such as changes in federal financing, rising prison populations, and increasing needs for local government aid to alleviate pressure on other areas that rely on the property tax directly led to this conclusion. A budget crisis of great magnitude would result from not enacting the existing uniform school finance levy for 1996.

**The task force concludes that adoption of a residential homestead property tax exemption would be poor public policy.** Recent proposals have suggested that the state adopt a dollar value property tax exemption for owner occupied residences. The task force specifically rejects such proposals as presenting major tax policy problems documented by the following six observations:

1. Homeowners facing little if any tax burden can vote additional taxes on other property owners.

2. Renters of property pay annual rents that must include property taxes, whereas owner occupied homesteads are exempt from a portion of the property tax.

3. A dollar specific exemption sets up assessment incentives to under assess higher valued property and over assess lower valued properties

4. Once placed on the exempt list, a property tends to stay there, even if it is used in part for commercial or profit making purposes.

5. Once established, not only it is difficult to remove the exemption, but the political incentive is to advocate increases in the exemption over time.

6. Homestead exemptions greatly reduce the tax burden of residential property, but increase the burden on rental property, commercial property and industrial property.

**The task force recommends that the state should increase the income criteria for the current homestead property tax rebate.** A consistent theme of testimony presented to the group was the inability for elderly and other individuals on fixed and limited incomes to meet the tax burden imposed from increased property values and increased levies. To address this problem the task force recommends that the state examine increasing the income eligibility for qualification for the current homestead property tax rebate program that is now part of the Kansas personal income tax.

**The task force recommends that the state develop a cost-benefit model to use for future proposed sales tax exemptions to determine whether the exemptions make sense from an economic standpoint.** Consistent with the objective of limiting gratuitous exemptions and exclusions from the sales tax base, the task force recommends that the state develop cost-benefit models to evaluate the economic reasonability of exemptions proposed in the future.

**The task force recommends that the job investment tax credit be reexamined to potentially include all forms of business organization, coupled with a review of the structure and effectiveness of the current credit.** Information generated by research conducted for the group indicated that various forms of business organizations comprise a significant portion of the tax paid through the individual income tax. The job investment tax credit stands out as the only credit in current law that discriminates based on the form of business organization. This recommendation may significantly increase the state cost of the credit if the current credit and the expansion of the credit is not refined to apply to businesses and firms that create significant additional jobs and investments for the Kansas economy.

**The task force recommends that the state carefully examine a restructuring of the current business income allocation formula.** The task force received significant research documentation that the state has high corporate tax burdens relative to the surrounding states. The group recommends that the state examine the existing equal business apportionment formula of sales, payroll and property with a focus on increasing the weight on sales to increase the state's competitive advantage as it relates to export oriented firms.

**The task force recommends that the state consider tax policies that reduce the effective tax rate for low producing oil wells.** Evidence presented to the task force indicates that Kansas has significantly higher effective tax rates than other energy producing states for oil production. The task force recommends the lowering of the effective tax rate on low producing wells to allow these wells to be more competitive and prevent additional shut-downs.

1-20

## MINORITY REPORT

While Kansas has a sound national reputation as a fiscally responsible state, tax issues can be some of the most contentious and most volatile. Kansas, like most states, has a mix of taxes to fund the services our citizens rely on daily. Kansas tax policy is tested regularly in the competitive environment for business expansion with other states in the region.

Governor Bill Graves appointed the Governor's Tax Equity Task Force to examine Kansas' state and local tax structure with an emphasis on equity, to analyze tax shift proposals, and to make recommendations to the Governor and Kansas Legislature on those issues.

The Governor is to be commended for forming the Tax Equity Task Force. And, similarly, the members of the Task Force are to be commended for their diligence and hard work on behalf of the citizens of Kansas.

We agree with some of the findings and recommendations of the majority of the Task Force. We agree that all Kansans–its private and corporate citizens alike–should be able to rely on a stable tax policy. The only consensus reached was to reduce the state's reliance on property taxes. The Task Force looked at a number of alternatives to the current tax structure, but didn't come to a consensus on supporting any plan which would reduce property taxes. We wholeheartedly agree with the Task Force recommendation that Kansas **must** reduce its reliance on property taxes. Historically, property taxes have been used more by local governments. However, we must respectfully disagree with the Task Force's rejection of a proposed plan to phase out the statewide property tax levy used to fund Kansas' elementary and secondary schools.

We believe that property taxes are one of the most regressive taxes available to government. Under the current tax structure, Kansas has the highest taxes in the region on mature businesses. An established, mature firm in Kansas will pay higher taxes than would be paid if that same facility were located in another state in the region. For machinery and equipment, Kansas has the highest tax rate in the region. Iowa totally exempts machinery and equipment from property taxes. And Kansas ranks the second highest in the region in taxing commercial and industrial real estate.

State and local governments many times offer property tax abatements to attract new and expanding business. But many mature businesses do not benefit from those policies.

Retaining the current businesses in Kansas does not receive the same amount of attention as does attracting new business to the state. From the information received by the Governor's Tax Equity Task Force, it is clear that mature businesses in Kansas are adversely affected by the current tax structure and do not receive the same tax incentives as do new or expanding businesses.

A property tax reduction of 35 mills would result in a significant savings for mature Kansas businesses. One tax model estimates that a 35 mill reduction would save capital intensive manufacturers $1,056 per employee in state and local taxes. Savings for less capital intensive businesses would be approximately $400 per employee. If the 35 mills currently collected by the state to fund the school finance plan were phased out, Kansas would no longer rank as the highest business tax state in the region. With the 35 mill reduction, a mature, export-oriented firm in Kansas would be closer to the average for the region.

We encourage the Governor and the Kansas Legislature to support a 35 mill reduction in property taxes similar to the plan outlined in Senate Bill 41. The phase out of the 35 mills for funding Kansas' elementary and secondary schools would, for all intents and purposes, end Kansas' reliance on property taxes as a major funding source.

We believe fair taxation is a very important economic development issue for the mature businesses in Kansas which employ thousands of Kansans. And it is equally important for the overall health of the Kansas economy and for this state to remain competitive economically in the region.

SUBMITTED BY TASK FORCE MEMBERS:

Senator Phil Martin, Representative Bruce Larkin, Mr. Dennis Jones, Mr. Matt Ida

1-21