KANSAS POLICY INSTITUTE
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Testimony to House Taxation Committee
HB 2237 Income Tax and Gasoline Tax Increases
February 7, 2017
Dave Trabert, President

Chairman Johnson and Members of the Committee,

We appreciate this opportunity to testify in opposition to HB 2237, which would allegedly increase income taxes on individuals and small business by $4.1 billion over five years. The bill's sponsors – Kansas Action for Children, KNEA, KOSE and Kansas Contractors Association – ignored our request to share their calculations and in the absence of a fiscal note as this testimony was prepared, we have only their press release upon which to base the five-year cost.

We have been told that their calculations were prepared by the Institute for Taxation and Economic Policy, an organization that believe farmers and small businesses cheat on their income taxes; ITEP also believes it can estimate the degree to which Kansas farmers and small businesses cheat and adjusts reported incomes accordingly. Kansas Policy Institute asked ITEP to show us their calculations on a Kansas tax burden claim on October 14, 2014 and they declined, saying their methodology was proprietary. Their email response did, however, disclose their belief on tax cheating in Kansas.

"It's widely understood that taxpayers at all income levels tend to under-report certain income categories, especially capital gains, pass-through business income, rental income and farm income. For this reason, ITEP's model makes estimates of the amount of unreported income of each type. This unreported income is included in our "total income" estimates for each state."

The enormous tax increase proposed in HB 2237 is really an appropriations bill, designed to vastly increase spending that would mostly benefit the sponsors. The table below shows how the budget could be balanced without a tax increase and or a highway sales tax transfer in FY 2019.

The current year budget can be balanced mostly by using idle funds. Requiring K-12 schools to spend down excess cash reserves as recommended by Alvarez & Marsal would save at least $196.5 million next year, and perhaps even more. This estimate is based on the $853 million in operating reserves on hand at the beginning of the 2016 school year but schools had $911 million on hand at the beginning of the current year; once current year operating costs are known, the excess could be even more. The Governor's proposed Alvarez & Marsal efficiency savings from having school districts purchase health insurance from the State plan is another considerable factor.

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General Fund Budget Deficit (millions)			
Description	FY 2017	FY 2018	FY 2019
Adjustment needed per KLRD Nov. 2016	$ (349.1)	$ (582.6)	$ (172.3)
Nov. - Jan. revenue above estimate	$ 25.9		
Transfer idle funds per SB 115	$ 317.0	$ (54.3)	$ (54.3)
Gov. transfer & revenue adjustments	$ 18.4		
Gov. expense adjustment	$ 8.8		
Revenue above estimate or savings	$ 20.0		
Excess school cash reserves >15%		$ 196.5	
Gov. Medicaid caseload adjustment	$ (40.7)	$ (84.8)	$ (43.2)
Gov. A&M efficiencies		$ 47.2	$ 89.0
Performance-based budget savings		$ 200.0	$ 200.0
Highway transfers		$ 275.8	$ -
Remove LAVTR transfer			$ 54.0
Remove local revenue sharing			$ 72.6
Remove bioscience transfer			$ 60.0
Remove state water transfer			$ 6.0
Remove BOR infrastructure transfer			$ 7.0
Remove school funding increase		$ 78.6	$ 45.5
<Remaining adj> or Surplus	$ 0.3	$ 76.4	$ 264.3

The performance-based budget review in process could easily find 3 percent efficiency savings in non-K12 General Fund spending, resetting base spending going forward, and there are $199.6 million in transfers scheduled for FY 2019 that won't occur.

This table may not include every small expense or revenue adjustment reflected by Legislative Research, as their profiles are not all online, but it also doesn't include all cost reductions available (e.g., KPERS shifts) or transfer options. The point is that tax increases are not necessary.

We oppose tax increases because government has a spending problem, not a revenue problem, and we believe no taxes should be increased until government is making efficient use of taxpayer money. In addition to the findings of multiple independent efficiency studies on Kansas state government, there is also the fact that Kansas spends much more per-resident than many other states providing the same basket of services.

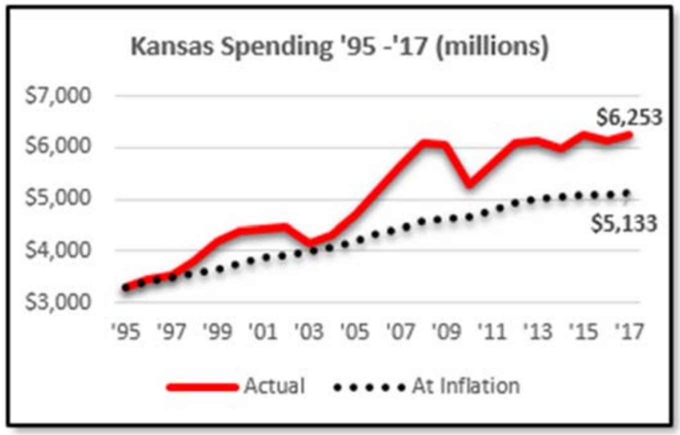
Spending data from the National Association of State Budget Officers shows that the states that tax income spent 42 percent more per-resident in 2015 than the states without an income tax; Kansas spent 27 percent more per-resident. It's not access to natural resources or tourism that allows states to keep taxes low; it's simply the spending. The more a state chooses to spend, the more it must tax.

Identifying the savings opportunities takes effort, as explained by former Indiana Governor and now President of Purdue University, Mitch Daniels. He said, "This place was not built to be efficient. [But] you're not going to find many places where you just take a cleaver and hack off a big piece of fat. Just like a cow, it's marbled through the whole enterprise." Governor Daniels was speaking of Purdue but his comment applies universally to government – and also to the private sector.

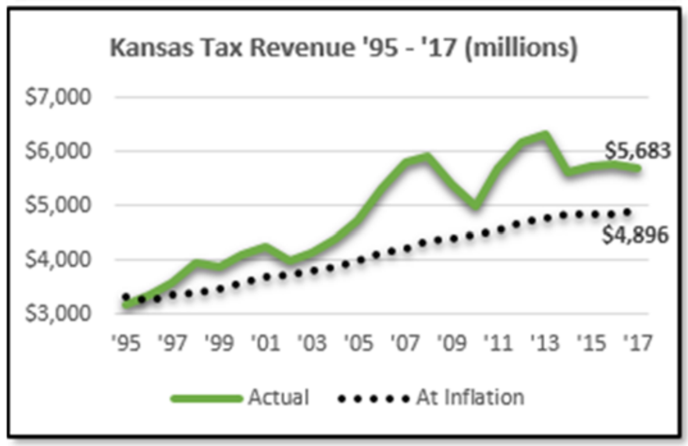
The Kansas budget problems primarily arise from lack of spending control. The budget could have been balanced following passage of the 2012 legislation by having government operate about 8.5 percent more efficiently; spending thereafter could increase as revenue grew and there always would have been healthy ending balances. The need to adjust spending was well-known, but Democrats and many Republicans refused to make government more efficient, so spending and taxes were increased in 2013...and again in 2015.

This fiscal year, General Fund spending is estimated at $6.253 billion, which is $155 million more than was spent in 2012 when tax relief was passed. Approximately $104 million of school transportation funding was also shifted from the General Fund to the All Funds budgets, so the real increase is even greater.

General Fund spending has also increased well above inflation-adjusted levels since 1995. Had 1995 spending been increased for inflation it would be $5.133 billion but actual spending was $1.12 billion more.



And even though Kansans have been allowed to keep more of their hard-earned money, General Fund tax revenue is also well above inflation-adjusted levels since 1995. Tax revenue is estimated to be $5.683 billion this year, which is $787 million more than if 1995 tax revenue had increased for inflation.



Fairness Issues

It's also unnecessary to raise taxes given the broad range of income, sales and property tax exemptions in Kansas. The income tax exemption on pass-through income creates a legitimate issue of fairness but the Legislature has long approved (and thus far declined to rescind) many other exemptions, including:

- Retirees of state universities and the Board of Regents participating in their 403(b) plan are exempt from state income tax on withdrawals. Private sector citizens are fully taxed on their pension and 401(k) withdrawals.

- Retirees of other state agencies, school districts and local government participate in the Kansas Public Employees Retirement System (KPERS). They are taxed on their personal contributions to the pension program but are never taxed on the majority of their withdrawals, which come from employer contributions and earnings on all contributions.

- Legislators get an even better deal. In addition to preferential tax treatment, their pensions are based on having worked a full year and earned about $85,000 instead of what they are actually paid – less than $10,000 per year.

- The Legislature allows local government to exempt chosen businesses from state and local sales tax with the use of STAR bonds and Industrial Revenue Bonds, which results in others being taxed more to make up the difference.

- The Legislature provides sales tax exemptions to a wide array business activities, services, retail purchases and many non-profit organizations (for the record, KPI pays sales tax) totaling more than $5 billion dollars annually. Some of the exempt entities even came to the Legislature one at a time asking for special treatment.

- The State of Kansas' HPIP program exempts businesses selected by government from sales tax and provides income tax credits. The PEAK program allows businesses chosen by government to keep 95 percent of their eligible employees' state income tax withholding for up to 10 years.

Economic Damage

Reversing the exemption on pass-through income will negatively impact economic growth and job creation. Extracting money from the private sector will always have a negative impact on private economic growth; every new dollar paid in tax is a dollar not available for investment or hiring. Some claim that pass-through entities didn't create any jobs because the average tax savings isn't enough to hire anyone, but no such assumption can be made from a business's taxable income as taxable income is merely what is left over after expenses for hiring and investments.

To the contrary, U.S. Census data shows that 82 percent of new jobs in 2013 and 2014 came from pass-through businesses; 2015 data has not yet been published. The County Business Database tracks employment by legal form of organization at the state level since 2010 and shows a remarkable change in the growth of pass-through employment relative to C-Corporation employment since the pass-through exemption went into effect.

Kansas Employment by Legal Entity Type							
Entity Type	Number of Employees on March 12			2010-12 Change		2012-14 Change	
	2010	2012	2014	# Jobs	Percent	# Jobs	Percent
Corporations	535,839	530,567	537,948	(5,272)	-1.0%	7,381	1.4%
Pass-Through	418,544	428,593	464,728	10,049	2.4%	36,135	8.4%
Non-profits	143,726	143,815	145,355	89	0.1%	1,540	1.1%
Other	10,834	11,788	10,994	954	8.8%	(794)	-6.7%
Private	1,108,943	1,114,763	1,159,025	5,820	0.5%	44,262	4.0%
Source: U.S. Census, County Business Patterns database							

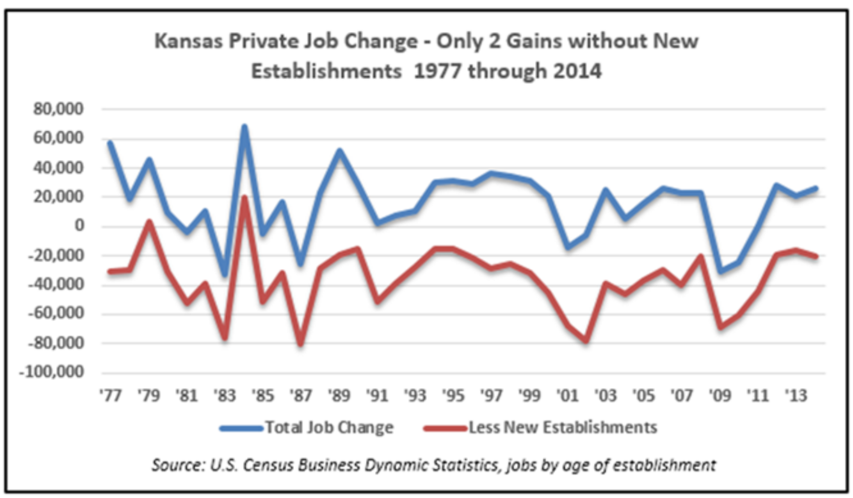
Pass-through entities (businesses not organized as C-corporations) added 36,135 jobs and grew by 8.4 percent compared to C-corporation growth of just 1.4 percent and 7,381 jobs. Some of the pass-through job additions are attributable to C-corporations that converted to pass-through status but most likely fewer than the number of new proprietors added, which aren't included in the Census database; their employment data is provided by the Bureau of Labor Statistics which excludes proprietors and farm workers.[1]

The Kansas Department of Revenue reports that only 3.3 percent of C-corporations converted and the total number of W2s for all C-corporations declined by 10,396. Even if every W2 decline resulted from a conversion, the job transfer would still be less than the 15,134 new proprietors reported by the Bureau of Economic Analysis.[2]

Kansas' pass-through job growth rate of 8.4 percent is slightly lower than the national average of 9.5 percent but much more competitive than before tax reform, being at 88 percent of the national average (8.4 percent compared to 9.5 percent) versus 52 percent (2.4 percent compared to 4.6 percent).

U.S. Employment by Legal Entity Type							
Entity Type	Thousands of Employees on March 12			2010-12 Change		2012-14 Change	
	2010	2012	2014	# Jobs	Percent	# Jobs	Percent
Corporations	51,829	53,510	53,961	1,681	3.2%	450	0.8%
Pass-Through	43,387	45,374	49,697	1,987	4.6%	4,323	9.5%
Non-profits	15,020	15,238	15,591	218	1.5%	353	2.3%
Other	532	530	539	(3)	-0.5%	10	1.8%
Private	110,768	114,652	119,788	3,884	3.5%	5,137	4.5%
Source: U.S. Census, County Business Patterns database							

There is no way of knowing how many of the new pass-through jobs were created solely because of the pass-through exemption but we do know that the rate of growth jumped significantly after implementation of the exemption and C-Corporation employment grew much slower. We also know that job creation from the formation of new establishments is essential to the Kansas economy.



Source: U.S. Census Business Dynamic Statistics, jobs by age of establishment

As explained in A Thousand Flowers Blooming – Understanding Job Growth and the Kansas Tax Reforms, "Job growth is critically dependent on new business formation. Several studies have found that start-ups and young firms drive overall job creation.[3] A key academic study found that "firm births contributed substantially to both gross and net job creation.[4] To see how this has played out over time in Kansas, [the adjacent chart] shows the trend of total job creation and jobs created excluding those created by new establishments from 1977 through 2014, the most current data available from the Census Bureau."

Census defines an establishment as "a single physical location where business is conducted or where services or industrial operations are performed;" they define a firm as "a business organization consisting of one or more domestic establishments that were specified under common ownership or control, with the firm and the establishment being the same for single-establishment firms." For example, new establishments could be a new bio-tech startup, a proprietor opening a new restaurant or even a new Walmart location. In Kansas, with the exception of 1979 and 1984, the total number of jobs created would actually have been negative if not for the job creation from new establishments."

Some of the jobs from new establishments come from C-Corporations but given the recent disparate growth for pass-through jobs and the record number of new business filings from Kansans, it's reasonable to expect that pass-through business filings and employment will be negatively impacted by an unnecessary tax increase on those businesses.

And how is it fair to the people who will likely lose their job or have fewer employment opportunities as a result of this unnecessary tax increase?

Conclusion

The damage done to citizens and the economy by HB 2237 will be extensive. And all so that the proponents can profit from higher spending, government can continue to be inefficient and others (including government retirees and legislators) can keep their preferential tax treatment.

We oppose HB 2237 and encourage the Legislature to do so as well.

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[1] A small number of proprietors listed in the Census database are IRS designations, which says it treats LLCs "…as either a corporation, partnership, or as part of the LLC's owner's tax return (a "disregarded entity"). Specifically, a domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it files Form 8832 and affirmatively elects to be treated as a corporation. And an LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 and affirmatively elects to be treated as a corporation." https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc

[2] BEA report of new proprietors per SA25N downloaded November 28, 2016

[3] For a review of this literature, see Stephen J. Davis, John Haltiwanger, and Ron Jarmin, "Turmoil and Growth: Young Businesses, Economic Churning, and Productivity Gains," Ewing Marion Kauffman Foundation, June 2008, available at:
http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2008/06/turmoilandgrowth060208.pdf

[4] John Haltiwanger, Ron S. Jarmin, and Javier Miranda. "Who Creates Jobs? Small Versus Large Versus Young," *The Review of Economics and Statistics*, Vol. XCV, No. 2, May 2013, available at:
http://www.mitpressjournals.org/doi/pdf/10.1162/REST_a_00288

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