KANSAS POLICY INSTITUTE
ADVOCATING FOR FREE MARKETS AND THE PROTECTION OF PERSONAL LIBERTY

Testimony to Senate Assessment & Taxation Committee
SB 192 Income Tax
March 14, 2017
Dave Trabert, President

Chairperson Tyson and Members of the Committee,

We appreciate this opportunity to present written testimony in opposition to SB 192, which would increase income taxes.

First of all, budgets for the current and next two years can be balanced without a tax increase. The adjacent table is a modified version of the Governor's Budget Proposal. It uses the Governor's budget proposals except for the school funding increase this year, the KPERS changes, his tax increases and defers replacing idle funds until FY 2020. We also add our recommended use of school cash reserves, performance-based budget savings, the actual revenue variance above estimates for November through January and assumes a similar positive variance for the last five months. The February variance alone was more than we allowed for the remainder of the year.

Kansas General Fund Budget Plan (millions)			
Description	FY 2017	FY 2018	FY 2019
Beginning balance	$ 37.1	$ 71.5	$ 310.6
Nov. - Jan. revenue above estimate	$ 25.9		
Feb - June revenue above estimate?	$ 25.0		
Revenue Estimate November 2016	$ 5,980.1	$ 5,536.4	$ 5,575.4
Transfer idle funds	$ 317.0	$ -	$ -
Tobacco securitization		$ 265.0	$ 265.0
Gov. transfer & revenue adjustments	$ 18.4	$ 443.3	$ 483.0
Available Revenue	$ 6,403.5	$ 6,316.2	$ 6,634.0
Expenditures - Approved Budget	$ 6,357.5		
Medicaid caseloads	$ 40.7		
Gov. expense adjustment	$ 8.8		
Expenditures - Governor Budget Report		$ 6,261.9	$ 6,154.8
Don't use governor's KPERS changes		$ 140.2	$ 198.6
Excess school cash reserves >15%		$ (196.5)	
Performance-based budget savings		$ (200.0)	$ (200.0)
Lapse school finance reappropriation	$ (75.0)		
Adjusted Expenditures	$ 6,332.0	$ 6,005.6	$ 6,153.4
Ending Balance	$ 71.5	$ 310.6	$ 480.6
Changes to Governor's Budget Plan (millions)			
Description	FY 2017	FY 2018	FY 2019
Governor's Budget Ending Balance	$ 99.6	$ 216.5	$ 538.7
Adjust for prior year variance		$ (28.1)	$ 94.1
Delay repayment of idle funds		$ 45.0	$ 45.0
School finance adjustments	$ 6.9		
Assumed revenue estimate variance	$ 50.9		
Not using KPERS change	$ (85.9)	$ (140.2)	$ (198.6)
School cash reserves		$ 196.5	
Performance based budget savings		$ 200.0	$ 200.0
Not using Governor's tax increase		$ (179.1)	$ (198.6)
Revised ending balance	$ 71.5	$ 310.6	$ 480.6

Source: Kansas Division of Budget

To arrive at the excess school cash reserves, we calculate each district's operating cash

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reserves (excluding federal, capital and debt) as of July 1 2016 as a percentage of its operating costs (total less capital and debt) for the 2016 school year. The amounts of operating cash reserves in excess of 15% of operating expense across all districts totaled $196.5 million for the 2016 school year. Our calculation of operating cost excludes any Capital Outlay that was allocated to Instruction or other operating costs (since we exclude Capital Outlay carryover funds) but federal spending is still layered through operating costs; removing federal operating costs would produce a higher carryover ratio since the denominator would be reduced and therefore result in more carryover reserves being 'swept' next year. One might consider that a hedge against unknown changes for the 2017 school year. There are other ways to do the calculation of course (e.g., excluding funds in Gifts & Grants) but the process is the same…reflecting the percentage of carryover funds at the beginning of the year as a percentage of the expenditures out of those funds for the year.

The estimated savings from the performance-based budget review is roughly 6% of non-K12 expenditures.

Kansans Oppose Balancing the Budget with Personal Income Tax Hikes

The Fiscal Note on SB 192 shows a $2.4 billion tax increase over five years; subtracting the $974 million from the Fiscal Note on the repeal of the pass-through exemption in HB 2023 , the balance of this proposal – $1.4 billion falls on individuals.

Balancing the budget primarily with a hike on personal income taxes is not what citizens want, however, according to scientific market research. Asked how legislators should close the budget shortfall over the next two years, a plurality of Kansans (38 percent) say to reduce the cost of government, followed by increasing the tax on cigarettes and alcohol (25 percent). Only 4 percent of Kansas say increasing income taxes on individuals should be the primary approach.

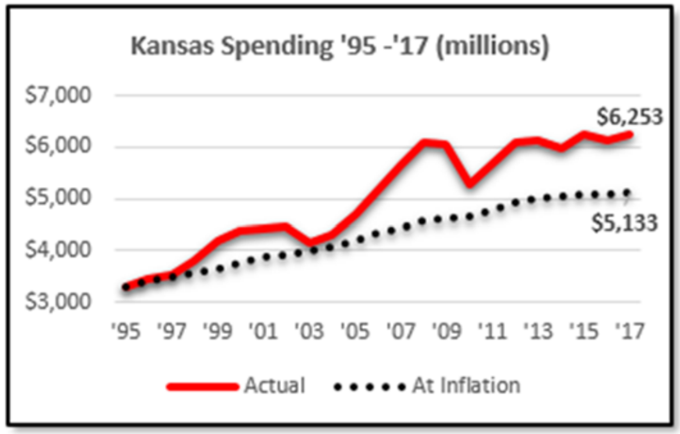
Q2: Which is the best way to close budget shortfalls over the next two years?								
501 Registered Voters	All	Region				Ideology		
Credibility Interval: ± 4.5 pct points		Western Kansas	Wichita Area	Kansas City Area	Eastern Kansas	Conserv	Mod.	Liberal
Increase income tax on citizens	4%	1%	4%	3%	6%	3%	6%	4%
Increase income tax on business	17%	28%	19%	13%	15%	15%	19%	19%
Increase the sales tax	5%	2%	9%	4%	2%	6%	3%	7%
Inc. tax on cigarettes & alcohol	25%	12%	22%	32%	26%	28%	26%	19%
Reduce the cost of government	38%	49%	36%	37%	38%	39%	38%	34%
Transfer from highway/other funds	2%	0%	2%	4%	1%	1%	1%	6%
Other	5%	5%	3%	4%	6%	4%	3%	7%
Not Sure	5%	3%	6%	4%	6%	4%	4%	5%

SurveyUSA conducted the study on behalf of Kansas Policy Institute between February 3 and February 8; with participation of 501 registered voters, the survey has a Credibility Interval of ± 4.5 percentage points.

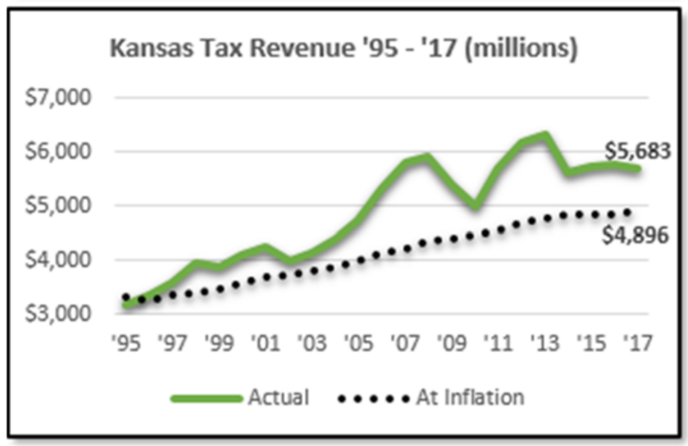
Inefficient Spending

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.

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.

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							

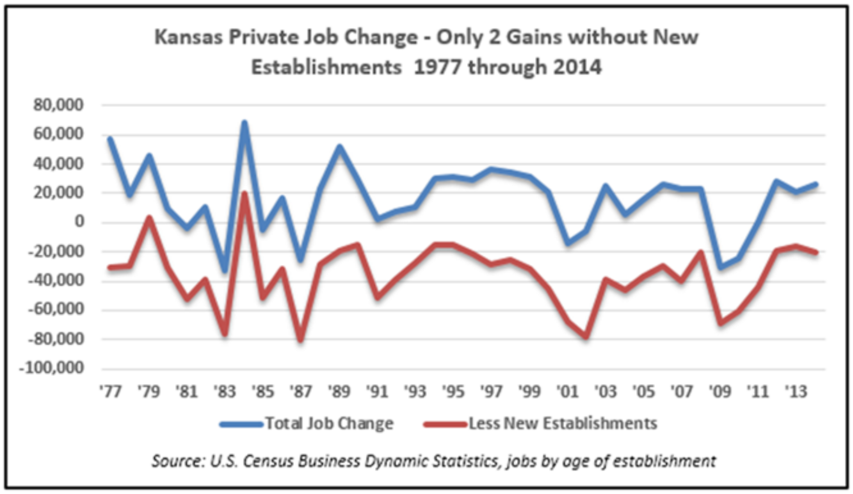
Pass-through entities (businesses not organized as C-corporations) added 36,135 jobs and grew by 8.4 percent compared to C-corporation growth of just 1.4 percent and 7,381 jobs. Some of the pass-through job additions are attributable to C-corporations that converted to pass-through status but most likely 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.



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 SB 192 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 SB 192 and encourage the Legislature to do so as well.

[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