

# We have to start somewhere, and we have to start now.

## Here's what the Brownback tax plan did in 2012:

Set Kansas on a "March to Zero," phasing out all individual income taxes over time while damaging Kansas' ability to make needed investments in the future.

Eliminated the top income tax bracket of 6.45%, cumulatively giving the top 1% of earners an average tax cut of \$25,000 while raising taxes on the bottom 40% of earners.

Eliminated income taxes altogether for 330,000 businesses like LLCs, S corporations, partnerships, farms, and sole proprietorships.

Eliminated or reduced essential tax credits and exemptions for Kansas families, like the home mortgage interest deduction and the child and dependent care credit.

Resulted in a \$308 million tax hike in 2013 and a \$430 million tax hike in 2015. Despite this additional revenue (and nine rounds of spending cuts), there is still a \$700 million gap between state revenues and expenditures in 2016.

## Here's a way to fix it in 2017:

End the "March to Zero," preventing the future phase out of individual income tax rates and restoring Kansas' ability to invest in schools, roads, public safety, and strong communities.

Reinstate the third income tax bracket of 6.45% for Kansans earning \$40,000 per year or more, while preserving current income tax rates for 70% of Kansans.

Close the "LLC Loophole," ensuring the state's 330,000 LLCs, S corporations, partnerships, farms, and sole proprietorships pay the same income tax rates as all other Kansans.

Reduce the Kansas food sales tax rate of 6.5% - the second highest in the nation - to 5.0%, putting nearly \$100 million more back into the pocketbooks of Kansas families who need it the most.

Enact a temporary, three-year sweep from the Kansas Highway Fund in order to avoid a sales tax increase, while simultaneously pairing the sweep with an \$0.11 increase in the Kansas gas tax. This will hold the state's critical infrastructure investment harmless for the first time since Governor Brownback took office.



# A Guide to Comprehensive Tax Reform in Kansas





# Rise Up, Kansas

BY DUANE GOOSSEN, KANSAS CENTER FOR ECONOMIC GROWTH

The morning after the election was tough. Half the country woke up feeling devastated, the other half awoke feeling excited. Regardless of who you voted for, it's hard to come back together when we feel so deeply divided.

In Kansas, however, we have a special opportunity to rise to the occasion.

The top of the ticket gripped our attention on Election Day, but down ballot races told another powerful story. That story began four years ago, when Governor Brownback set Kansas on a path to eliminate the state income tax. Despite worrisome headlines, he insisted we ignore anyone who projected a gloomy forecast.

Then, in 2014, economists correctly estimated his plan would create a minimum \$660 million deficit over two years. Bad news just worsened from there and Kansans could only cover their ears for so long. On November 8, 2016, they elected 56 new state legislators.

This marks the beginning of a hopeful new chapter in the Kansas story. It also presents a desperately needed opening for comprehensive tax reform.

Let's get it right this time.

**Job #1: Stop the bleeding.** The first year alone of the Brownback tax plan inflicted more damage to state finances than the entire Great Recession. Kansas continues to hemorrhage revenue, resulting in nine rounds of budget cuts, record-high debt, and three credit rating downgrades. Our struggling communities need relief, but Kansas can't start healing while still in triage mode. In 2017, we must immediately fix our structural revenue imbalance to prevent further cuts, accepting that significant re-investment is probably at least another year away.

**Secondly, we must broaden the tax base.** Taking a comprehensive approach means reviewing our entire tax code – not just the income tax. Kansas' sales and property tax structures are also antiquated and unfair. By modernizing all revenue sources, we can ensure all Kansans pay the fairest possible taxes at the lowest possible rates.

**Finally, we must repair the damage.** It will likely take a generation to fully recover from this horrible experiment. But once we get our fiscal house back in order, Kansans can embrace their aspirational, pioneering instincts yet again. Our vision should embody our state motto and aim for the stars, but it must begin with commonsense basics. This requires new priorities, like a plan to pay down the unprecedented debt the current administration intends to leave our children. It means re-investing in services essential to prosperous communities and good-paying jobs. It means lifting the burden the Brownback plan forced onto our lowest-earning Kansans. And it means establishing a responsible state savings account.

Sadly, we'll never recover the opportunities we lost throughout this senseless era of crisis. But the Kansas election results offer hope that we can begin restoring those opportunities for future generations. Lawmakers must now rise above the political fray and find courage to make difficult decisions in 2017. They must not delay - we've lost too much already and there's too much more at risk.

Kansans are innovative, resilient people. Hopefully soon we will once more walk through the doors of the state capitol and imagine the possibilities, rather than fear what painful emergency lurks next around the corner.

## End The March To Zero

### What is the "March to Zero"?

In 2012, Governor Sam Brownback set Kansas on a path to eliminate the state income tax. By 2016, his tax plan resulted in nine rounds of budget cuts, two sales tax hikes, three credit rating downgrades, and record-high debt. There are numerous ill-advised and unfair components of this tax policy, but the lesser-debated "March to Zero" is actually the most dangerous provision.

The March to Zero (also referred to as the "buy down" or the "ratchet") begins in Fiscal Year 2020. It automatically caps state spending growth at 2.5% of the previous fiscal year's spending level – without accounting for costs that come with maintaining the same level of services. Any growth above 2.5% will then be used to automatically "buy down" income tax rates the next year. This will continue until all individual income taxes are eliminated. Once the individual income tax disappears, the same formula will be used to buy down corporate income tax rates until they also hit zero.

### Why is the March to Zero dangerous?

All Kansans want a thrifty, efficient state government. However, certain uncontrollable factors create new demands for additional public resources every year, regardless of any state-level policy. These factors include (but are certainly not limited to) population growth, inflation, and always-rising health care costs.

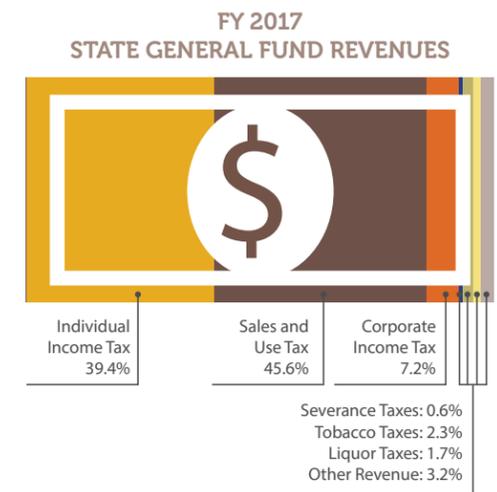
The March to Zero formula limits spending growth so drastically that it will prevent Kansas from fulfilling these very basic services. Furthermore, these are just the basic drivers of new government spending, without factoring in added investments in education, public safety, or other critical services.

Kansans need more costly things from state government than they did 50 years ago. For example, decades ago we did not require extensive cyber security. Schools did not need laptops. We did not have a fully developed interstate highway system to maintain. Kansans' needs will continue to change as new technologies emerge and our population evolves. Just like a private sector business, state government must adapt to remain competitive. This is why, in order to grow Kansas, we must invest in Kansas.

### What should we do?

The March to Zero formula must be eliminated from current tax law in order to prevent future budget crises and preserve Kansas' ability to invest in future generations.

When the 2012 tax plan passed, state income tax accounted for 50% of state revenue. Today, it still accounts for 40% of state revenue. The March to Zero is only approximately one-third complete, yet it has already wreaked havoc on Kansas. What will happen to our schools, roads, and communities when 0% of state revenue comes from income tax?



# Rebalance Individual Income Tax Rates

## What happened to Kansas' income tax brackets?

YEAR	TAX BRACKET	TAX RATE
2012	\$0-\$15,000	3.5%
	\$15,001-\$30,000	6.25%
	\$30,001 and up	6.45%
YEAR	TAX BRACKET	TAX RATE
2016	\$0-\$15,000	2.7%
	\$15,001 and up	4.6%

Source: Kansas Department of Revenue website.

Prior to the passage of Governor Brownback's signature tax plan, Kansas utilized three income tax brackets. The Governor's plan eliminated the top income tax bracket of 6.45%, moving multi-millionaires to the same tax bracket as Kansans earning \$15,000 per year (a rate of 4.6%).

Much scrutiny of current tax policy focuses on business exemptions,

but cuts to individual income tax rates actually contributed most to Kansas' revenue problems. In fact, **individual rate cuts account for 70% of the tax plan's unaffordable price tag.** That's because, at the time it was enacted, income tax accounted for 50% of Kansas' revenue. Economists correctly warned that eliminating the revenue stream Kansas needs to fund half the state budget would create an immediate fiscal crisis. The first full year of the Brownback tax plan damaged state finances more than the entire Great Recession.

## Why are the current tax brackets dangerous?

**The Kansas economy can't supplement lost income tax revenue.** Other no-income tax states like Florida, Texas, or Wyoming supplement their budgets with revenue from robust industries like tourism, oil, and gas. Kansas has nothing to fill the gap, which is why the state has endured nine rounds of budget cuts since the tax plan took effect.

**It's a tax shift, not a tax cut.** Without income tax revenue, Kansas relies more heavily on the state sales tax to pay its bills. Two state sales tax hikes totaling almost \$740 million have been enacted since 2012, hurting low-income Kansans the hardest. Despite income tax cuts, **the combined impact of all tax policy changes since 2012 resulted in a net tax increase for 40% of Kansans.**

**Individual income tax cuts failed to spur population growth.** Kansans were promised that individual income tax cuts would stop population decline and lure new people to the state. According to the United States Census Bureau, more individuals left Kansas than moved to Kansas overall since the tax plan took effect.

## What should we do?

Kansas needs at least three income tax brackets to restore stability and generate the support necessary to invest in schools, strong roads, and safe communities. Re-instating the previous top income tax bracket of 6.45% for Kansans earning \$40,000 or more per year would accomplish this simply and straightforwardly. It would enable 70% of Kansans to avoid any income tax increase while expanding the brackets more evenly across the income spectrum.

# Close the LLC Loophole

## What is the LLC Loophole?

The immediate elimination of income taxes for Kansas' 333,000 LLCs, S corporations, partnerships, farms, and sole proprietorships garnered more controversy than any other provision of the Brownback tax plan. Originally touted as the plan's signature feature, proponents promised it would result in a "shot of adrenaline to the heart of the Kansas economy," spurring unprecedented job creation and prosperity. Four years later, the LLC exemption is now most commonly referred to as an unfair "loophole" that enables business owners to avoid paying any income tax at all, while all other Kansans pay income tax on every dime they earn.

## Why is the LLC loophole dangerous?

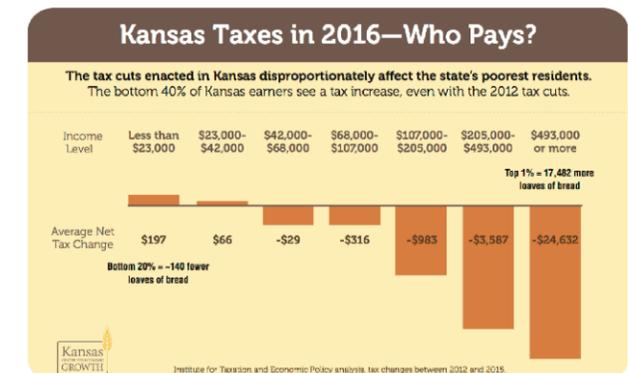
**The LLC loophole is expensive.** According to the Institute on Taxation and Economic Policy, the LLC loophole costs Kansas nearly \$290 million per year. While closing the loophole will not solve all the state's fiscal woes, it would significantly improve Kansas' ability to make strategic investments in the economy. These investments (like education and infrastructure) provide fundamental things businesses need to be profitable, such as a well-educated workforce and high-quality roads to transport goods to market.

### The LLC loophole is unfair.

Under the Brownback tax plan, the state's top 1% of earners received an average tax cut of nearly \$25,000, while Kansans earning less than \$25,000 per year received an average tax *increase* of nearly \$200.

### The LLC loophole did not create jobs.

Job creation was the core "selling point" of the Brownback tax plan. Unfortunately, Kansas has consistently lagged the region and the nation in most measures of economic performance since the tax plan took effect, including personal income growth, gross domestic product, and job growth. In 2015, Kansas ranked 46th in the country in job growth.



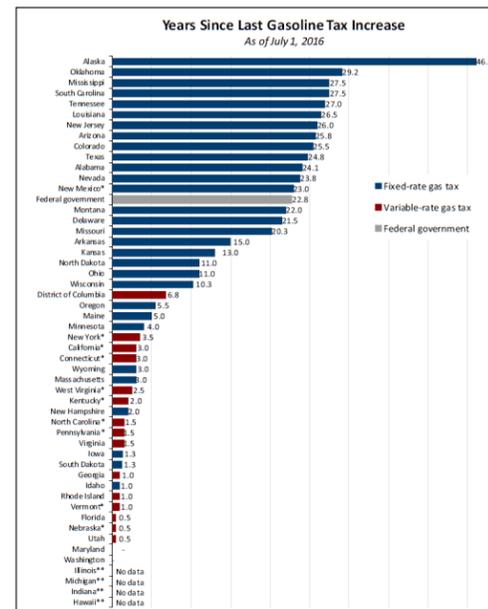
## What should we do?

The LLC loophole did not create jobs, and no indicators suggest it will in the future. Business owners will not hire a new employee simply because they received a hefty tax cut. Business owners hire employees when demand for their goods or services increases.

Lawmakers must close the loophole immediately, **but only as part of a comprehensive tax reform plan.** The loophole is just one part of a much larger problem. The reduction in individual income tax rates has inflicted far greater damage, accounting for nearly 70% of the tax plan's unaffordable and unsustainable price tag. In dollars and cents, closing the loophole without fixing other provisions of this failed tax policy merely moves 330,000 Kansans from the loophole (where they pay no income tax) to the "March to Zero" with the rest of Kansans (where they will eventually pay no income tax again).

# Modernize the Kansas Gas Tax

## What is the Kansas gas tax?



The state highway fund serves as the sole source of funding for Kansas' vital infrastructure and transportation systems. Its revenue comes from a variety of places, but relies most heavily on two streams: the gas tax and a portion of the state sales tax.

Kansas taxes the sale of fuel at a rate of \$0.24 cents per gallon. This rate has not been adjusted in more than 13 years. Over that time period, the costs of repairing and building roads and bridges increased by 31%. Additionally, almost 190,000 more Kansans live here now than did in 2003. This means \$0.24 per gallon gets less mileage in 2016 because more people use our highway system, requiring increased maintenance and preservation.

Kansas' roads and bridges are essential to the state economy. When the legislature enacted a statewide transportation plan in 2010, three different economic studies confirmed it would create over 175,000 Kansas jobs over ten years.

Governor Brownback has all but de-funded this program to pay for failed tax policy. As a result, Kansas lost the highest number of construction jobs in the nation last year. In 2016, Kansas spent less on highway maintenance than we have in at least the last decade.

## What does the gas tax have to do with tax reform?

The Kansas highway fund has been carelessly used as a slush fund to fill the perpetual budget hole created by failed tax policy. In total, over \$1 billion has been taken from the highway fund since Governor Brownback took office.

Income tax changes created the current budget crisis, which is why 2017 tax reform efforts should focus heavily on repairing that segment of the tax code. Unfortunately, even if commonsense income tax reforms pass in 2017, it will take a full year to generate new revenue because most Kansans only pay income taxes once a year. Kansas will require immediate revenue in order to avoid a tenth round of devastating budget cuts. Unless lawmakers enact a third sales tax hike, the highway fund is the only remaining stopgap.

## What should we do?

Because current tax policy damaged state finances so drastically, another cut to the highway fund will likely be unavoidable in 2017. However, the Kansas economy cannot withstand the continued de-funding of state infrastructure. The \$200 million the highway fund relies on from sales tax is equal to an \$0.11 increase in the gas tax. In order to protect these investments while also avoiding a third sales tax increase, lawmakers should pair any additional highway fund sweep with a corresponding gas tax increase. Although not ideal, it is the least harmful path out of a perilous budget crisis.

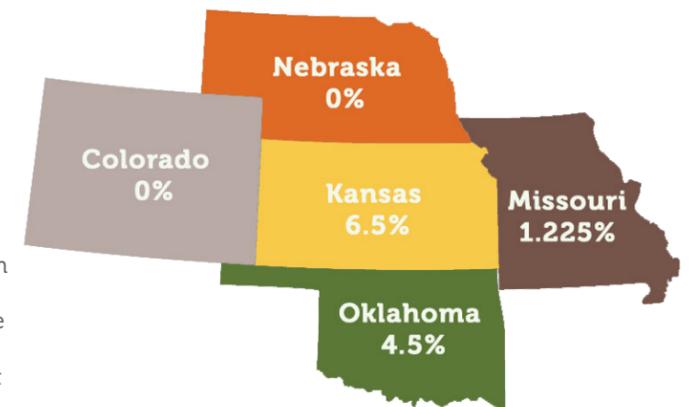
# Lower the Food Sales Tax

## What is the Kansas food sales tax rate?

Kansas is one of only seven states in the nation to fully tax the sale of groceries and, shamefully, holds the record for the second-highest food sales tax rate in the nation at 6.5%. County and city governments can levy additional taxes, bringing the total sales tax rate as high as 11% in some areas and pushing some Kansas communities to the highest food sales tax rate in the nation.

## Why is the food sales tax bad for Kansas?

**It hurts the Kansas economy.** Forty of Kansas' 105 counties share a border with a neighboring state that either imposes no sales tax on food or does so at a lower rate. Colorado and Nebraska charge no sales tax on groceries, while Missouri only imposes a 1.2% tax. It's both easy and prudent for Kansans to cross the state line to shop. According to a 2016 study released by KC Healthy Kids and the Kansas Public Finance Center at Wichita State University, this cost Kansas \$345.6 million in food sales in 2013, when Kansas' base sales tax was 6.15%. That, in turn, cost Kansas \$21.2 million in lost tax revenue. The price tag is likely to be much higher in 2017 as communities cope with an even higher sales tax rate of 6.5%.



**It hurts Kansas businesses.** The KC Healthy Kids report also found that sales tax on food costs the average rural Kansas grocer close to \$18,000 per year by reducing grocery sales and forcing customers to purchase cheaper, less nutritional items. Since rural counties typically aren't able to offer a variety of retail establishments, consumers are more likely to leave the area to buy goods in counties or states with more retail options and lower taxes/prices.

**It hurts Kansas families.** According to the Institute on Taxation and Economic Policy, the state's increasing reliance on sales tax hurts Kansas' poorest residents. The lowest 20% of income earners in Kansas pay an average of 11.1% of their income in state and local taxes, compared with 3.6% for the top 1% of earners.

## What should we do?

The cumulative impact of Kansas tax policy changes enacted between 2012 and 2015 not only devastated the state budget, but actually *increased* taxes for 40% of Kansans. In fact, the poorest 20% of Kansans - those with an average income of just \$13,000 - pay an average of \$197 more in taxes while the top 1% of Kansas earners pay nearly \$25,000 less in taxes. A reduction in Kansas' unacceptably high food sales tax rate can help ease the burden on working families.

Unfortunately, current tax policy has inflicted unprecedented damage to state finances. The first year alone of the Brownback tax plan drained more revenue from the state than the entire Great Recession. Every 1% reduction in the food sales tax costs approximately \$66 million. This means the food sales tax must be reduced gradually, and only as part of a comprehensive tax reform package that addresses Kansas' structural revenue imbalance. An initial reduction of 1.5% in the food sales tax rate will lower the current rate to 5.0%, putting approximately \$100 million back into the pockets of Kansas families who need relief most.