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Kansas 2013 Tax Reform Improves on Last Year's Efforts

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Kansas Governor Brownback has signed a H.B. 2059, modifying the tax reduction package passed last year.

Last year, the governor sought a comprehensive tax reform, lowering income tax rates while eliminating deductions. The plan, while raising the standard deduction and restructuring the income tax into two tax brackets (with rates of 3 percent on the first $30,000 of income and 4.9 percent above that), ultimately fell far short for two reasons. First, the bill (H.B. 2117) included no base broadening, leaving a large revenue hole of approximately $800 million per year with no spending cuts concurrently enacted to close this gap. Second, the bill completely exempted income earned from pass-through entities, an unjustifiable carve out which creates a significant likelihood of tax avoidance.

The plan enacted this year mostly addresses this gap. While the bill is a tax increase, the combined effect of both years' bills remains a net tax cut. Elements of this year's bill include:

- Lowering income tax rates even further (see Table 1), ultimately to 2.3 percent on the first $30,000 of income and 3.9 percent on income above that.
- Sets the sales tax rate at 6.15 percent beginning in July 2013. At first glance, this seems like a tax cut, as the sales tax was 6.3 percent. However, the tax had been scheduled to drop to 5.7 percent in July 2013.
- Reduces the value of itemized deductions by 30 percent this year and by 5 percent per year until 2017 when they will be reduced 50 percent permanently. The charitable deduction is an exception to this treatment and will remain fully deductible.
- Decreases the standard deduction for married filers filing jointly ($7,500) and heads of household ($5,500), down from $9,000. The amounts are still higher than pre-2012 law ($6,000 and $4,500, respectively).
- Restores the low-income food tax credit.
- Ends the itemized deduction for gambling losses.

Table 1: Tax Changes in Kansas, 2013 to 2018

	2013	2014	2015	2016	2017	2018
Income Tax Rate <$30,000	3.0%	2.7%	2.7%	2.4%	2.3%	2.3%
Income Tax Rate >$30,000	4.9%	4.8%	4.6%	4.6%	4.6%	3.9%
Amount Itemized Deductions are Clawed Back	30%	35%	40%	45%	50%	50%
State Sales Tax Rate	6.3%; 6.15% on July 1	6.15%	6.15%	6.15%	6.15%	6.15%

Source: Tax Foundation review of Kansas H.B. 2059.

Table 2: Revenue Impact of 2012 and 2013 Kansas Tax Law Provisions (millions of dollars)

	2013	2014	2015	2016	2017	2018
2012 Legislation	-$231	-$803	-$824	-$854	-$893	-$934
2013 Legislation (Total)		+$307	+$217	+$153	+$104	-$5
2013 Sales Tax Rate at 6.15%		+$193	+$219	+$227	+$235	+$244
2013 Itemized Deduction Clawback		+$114	+$107	+$127	+$148	+$167
2013 Standard Deduction Changes		+$56	+$59	+$62	+$65	+$68
2013 Income Tax Rate Reductions		-$35	-$145	-$238	-$317	-$459
2013 Other Changes		-$21	-$23	-$25	-$27	-$24

Source: Kansas Legislative Research Department.

After incorporating the 2012 and 2013 changes, as well as changes in state spending, the state now faces a budget gap of between $95 million and $182 million per year, a significant reduction from last year. Officials expect to cover these gaps by drawing down state reserves.[1]

This move toward a lower tax burden is supported as good policy by a wide body of empirical literature. We recently reviewed 26 peer-reviewed studies that have been written on the topic, and 23 of those studies find that increasing taxes hurts economic growth. The other three studies are inconclusive. What is more, all of these studies that were published in the last fifteen years conclude that higher taxes are associated with lower growth.[2]

A study by the International Monetary Fund analyzed 170 instances of fiscal consolidation across the developed world and found that spending cuts are much less damaging to economic growth than tax increases. They found that a 1 percent cut in spending had an insignificant effect on growth, while a 1 percent increase in taxes reduced GDP by 1.3 percent after two years.[3] The Kansas reforms over the last two years will result in hundreds of millions of dollars in tax cuts, and returning that money to the private sector will certainly produce long-term growth gains.

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[1] *See* Dion Lefler, *Senate Approves Latest Tax Plan; Bill Now Goes to House*, WICHITA EAGLE, June 01, 2013, http://www.kansas.com/2013/06/01/2828319/kansas-house-senate-negotiators.html.

[2] William McBride, *What is the Evidence on Taxes and Growth?*, TAX FOUNDATION SPECIAL REPORT NO. 207 (Dec. 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.

[3] International Monetary Fund, *Will it hurt? Macroeconomic effects of fiscal consolidation*, *in* WORLD ECONOMIC OUTLOOK: RECOVERY, RISK, AND REBALANCING (2010), http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf.

Of the studies we found that distinguish between types of taxes, economists find that corporate and individual income taxes are most harmful, while sales and property taxes are less harmful. This makes sense from an intuitive standpoint as well, because when you tax something, you get less of it. Taxes on corporate and individual income discourage investment in profitable activity—they are essentially disincentives to value creation.

The net effect of Kansas' last two attempts at tax reform is a lower individual income tax rate that is paid for largely by broadening bases. While the sales tax rate is also reduced, Kansas' tax code is now based more on consumption than it used to be and that will contribute to growth as well.

Good tax reform includes broadening the tax base while lowering the rate, which appears to be Governor Brownback's intention. While legislation ultimately passed in Kansas has been a mixed bag over the past two years, and the end result is still a code that has a large carve out for pass-through income, the positive elements outweigh the negative elements.

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