Erosion of the Tax Base

Improving family economic stability in Kansas

FISCAL FOCUS

Budget and Tax Policy in Perspective

PLAINTIFFS'
EX. 323

INTRODUCTION

The quality of life in Kansas is the foundation of our future prosperity. Our ability to educate and prepare the next generation of workers and consumers, and to maintain our state infrastructure will determine our success in attracting and retaining good jobs in our state. However, we cannot support that quality of life without a solid revenue system to pay for education and training, roads, public safety and other important public structures. The erosion of our tax base undermines the Kansas way of life and the future prosperity of our state.

PERMANENT TAX CUTS DURING GROWTH YEARS ARE WEAKENING THE TAX BASE

In the past 15 years, there has been a proliferation of tax loopholes, such as sales and income tax exemptions and income tax credits. This has resulted in a significant narrowing of the Kansas tax base which, coupled with tax rate and other reductions, have caused revenue shortfalls in recent years.

Kansas, along with the nation, experienced a period of great economic growth in the late 1990s. This was characterized by unprecedented rises in capital gains income and state revenues that exceeded estimates in several instances. For a short time, state policymakers could grant tax credits and exemptions, reduce tax rates and still afford to increase spending for state programs.

When the economy slowed to a more traditional pace and then entered into recession, Kansas was left with a significantly smaller tax base and an ongoing struggle to meet the spending needs of the state. In 2002, policymakers turned to a rate increase of regressive tax sources, such as the sales and use tax, in order to generate the amount of revenues necessary to fund Kansas government. However, this served to exacerbate the already regressive nature of our state tax structure.

Multiple rounds of budget cuts in recent years have raised concerns about the need to increase revenues in order to maintain adequate funding for public education and reduce waiting lists for essential services that children and families, senior citizens, and persons with disabilities rely upon. While the most obvious solution to the need for additional state revenues is to raise tax rates, this does nothing to address the long-term strength of the state's tax structure and its ability to withstand further economic downturns.

KANSAS TAX STRUCTURE COMPARES FAVORABLY TO OTHER STATES

Kansas compares favorably with other states in terms of the amount of revenues collected per person in the state. According to the Federation of Tax Administrators, Kansans paid an average of $4,088 per person in state and local taxes in 2008. This translates into a ranking of 22nd in per capita state and local tax collections.[1] The state portion is $2,555 which ranks 22nd in per capita state collections and 25th in per capita tax collections as a percentage of personal income.[2]

COMPOSITION OF THE REVENUE SYSTEM IN KANSAS HAS CHANGED

Composition of tax revenues

■ **Fiscal Year 1995**

In fiscal year 1995, state tax revenue in Kansas totaled $3.061 billion. Property tax accounted for 28 percent of those revenues, while income and privilege taxes accounted for 24 percent, and sales and use taxes accounted for almost 26 percent.[3] This structure provided a relative balance between our three major tax sources and thus a measure of stability to protect state revenues from economic downturn.

Fiscal Year 2009

In contrast, state tax revenue in Kansas for fiscal year 2009 totaled $5.408 billion. Property tax accounted for 35 percent, while sales and use taxes accounted for 28 percent, and income and privilege taxes accounted for 22 percent. It is clear that the balance of major tax sources that was present in 1995 is no longer present in 2009.[4] One problem with this shift is that the income tax, which now accounts for a considerably smaller portion of the state and local tax structure, is the most progressive of the three. The result is a tax structure that is more reliant on regressive taxes and places the highest tax burden on those Kansans least able to pay them. While the property tax is generally considered to be a local tax, a significant part of the property tax levied in Kansas is dedicated to school finance. Although this money is spent at the local level, it is deemed to be a state levy due to the nature of the school finance formula.

Changes in key tax sources

Sales Tax

In 1995, the Kansas sales tax rate was 4.9 percent. There were a total of 36 sales tax exemptions.[5] In fact, school finance legislation in 1992 repealed six sales tax exemptions in order to broaden the base. In comparison, the current state sales tax rate is 5.3 percent and there are 81 sales tax exemptions. According to the Tax Expenditure Report published by the Kansas Department of Revenue, sales tax exemptions cost the state more than $4 billion annually,[6] which is more than the amount collected in sales and use taxes each year.

Income Tax

Apart from the standard income tax credits for amounts paid through withholding and estimated tax and taxes paid to other states, Kansas had nine income tax credits in 1994.[7] The rate structure has changed since that time to equalize the rates for married and single taxpayers, and we now have more than 20 income tax credits. Standard deduction and personal exemption amounts also were increased in the past decade.

Property Tax

By the mid-1990s, the property tax structure in Kansas had undergone substantial change. A new series of property tax assessment levels became effective in 1989, and school finance reform in 1992 resulted in a uniform statewide property tax mill levy. Since then, significant reductions have been made to motor vehicle tax rates as well as general property taxes. Unlike the reductions in sales and income taxes, the property tax reductions were generally rate reductions as opposed to narrowing of the base. Nonetheless, the impact of the reductions on state revenues was significant.

A WEAKENED TAX BASE RESULTS IN BUDGET SHORTFALLS

Significant reductions in the tax base have resulted in a reduction in collected revenues to support our state infrastructure. In fact, total state tax collections declined from one year to the next several times in the past 15 years, a situation which was all but unheard of prior to this time. As a result of slow and negative growth in Kansas revenues, budgets have been increasingly tight in recent years. In both fiscal year 2009 and fiscal year 2010, the governor was forced to take a drastic step in allocating budget cuts in the middle of the fiscal year. While the narrowing of the tax base was not the sole cause of the budget shortfalls, a cumulative $9.6 billion dollars has been removed from the Kansas tax base through tax reductions, exemptions and credits since fiscal year 1995. This translates into an additional $1.2 billion in revenues that would have been received by the state in fiscal year 2010 alone absent the tax breaks.[8]

Summary of key tax reductions by tax type

A number of tax credits, exemptions and reductions were made in the past decade. Several of these resulted in a minimal impact. Provisions with more significant impact are detailed below.

Income Tax Reductions

Some of the most notable reductions in the income tax base over the past 15 years include:

• *Adoption Credit.* In 1997 an income tax credit was enacted providing a Kansas tax credit equal to 25 percent of the amount of the credit allowed under the federal tax code for adoption expenses. An alternative credit of $1,500 also was enacted for adoptions of children with special needs or who are in the custody of the Department of Social and Rehabilitation Services. The 25 percent credit was increased to 50 percent in 2006.

• *Endangered Species Tax Credit.* In 1997 an income tax credit was enacted for property owners who entered into an agreement with the Secretary of Wildlife and Parks to protect a portion of their property designated as a critical habitat for an endangered species. The credit only applied to tax years 1998 through 2002.

• *Income Tax Reduction.* In 1998 lawmakers adopted a number of changes to the Individual Income Tax, including reducing the rate paid by single taxpayers, increasing the standard deduction and increasing personal exemptions.

• *Tax Credit for Business Machinery and Equipment.* Enacted in 1998, this credit offsets property taxes paid on business machinery and equipment by providing a credit equal to 15 percent of the property tax paid on time.

• *Earned Income Tax Credit (EITC).* First enacted in 1998, then increased in 2002 and again in 2006, this credit provides a Kansas tax credit equal to 17 percent of the credit allowed under the federal tax code. The EITC is designed to assist low-income families.

• *Agricultural Loan Privilege Tax Credit.* From tax year 2000 to tax year 2003, qualified lenders making reduced-interest loans for agricultural productions received a credit against their income

• *Food Sales Tax Rebates (FSTR).* Although not an income tax credit, the FSTR is administered with the income tax. In 2002 the amount available in rebates increased to either $36 or $72 per household member depending on income eligibility. Lawmakers passed legislation to index the FSTR for inflation annually beginning in 2006.

• *Oil Property Tax Credit.* In 1999 a refundable income tax credit was enacted for a portion of property taxes paid on certain low-producing oil leases.

• *Alternative Fuel Credit.* Enacted in 1999, this provision provides an income credit for taxpayers who make expenditures for alternative fuel fueling stations and alternative fueled motor vehicles.

• *Education Savings Credit.* Income tax credits were enacted in 1999 for certain contributions to the Kansas Postsecondary Education Savings Program.

• *Farm Loss Carrybacks.* In 2000 a tax provision was enacted allowing farm net operating losses to be claimed in Kansas going back the same length of time as the federal tax code.

• *Military Recruitment Bonuses.* In 2005 a provision was enacted exempting military recruitment, sign-up or retention bonuses from income for tax purposes.

• *Homestead Program Indexing.* Lawmakers enacted a bill to annually index the upper income threshold to qualify for a Homestead Property Tax Refund based on the inflation rate.

• *Homestead Expansion.* The 2006 Legislature expanded the Homestead Property Tax Refund Act to increase refunds for recipients.

• *Social Security Exemption.* In 2007 a provision was adopted to exempt the first $50,000 of Social Security benefits from income for tax purposes. The exempt amount increased to the first $75,000 beginning in tax year 2008.

• *Historic Preservation Tax Credits.* The historic preservation tax credits were increased from 25 percent to 30 percent beginning in tax year 2007. A new credit also was adopted in 2007 providing a credit equal to 50 percent of the amount contributed to historic preservation projects owned by the state or a nonprofit for tax years 2007-2011.

• *IDA Tax Credits.* Tax credits to provide funding for Individual Development Accounts (IDA) were adopted in 2005. The credits are equal to 50 percent of a qualified contribution to an IDA.

COST OF SELECT INCOME TAX CREDITS

	FISCAL YEAR 2010	*CUMULATIVE SINCE 1995*
Earned Income Tax Credit	$66.2 million	$446.5 million
Single Income Rate Reductions	$64.1 million	$616.6 million
Food Sales Tax Rebate	$43.7 million	$356.6 million
Increase Personal Exemption	$39.1 million	$368.7 million
Franchise Tax Phase Out	$26.5 million	$23.5 million
Tax Credit for Business Machinery	$25.0 million	$210.4 million
Increase Standard Deduction	$17.9 million	$174.2 million
Social Security Exemption	$13.2 million	$18.0 million
Homestead Program Expansion	$11.6 million	$21.5 million
Various Tax Credits	$4.1 million	$8.2 million
Education Savings Program	$4.0 million	$36.0 million
Agriculture Loan Privilege Tax Credit	$0.8 million	$7.2 million
Military Recruitment Bonuses	$0.7 million	$2.6 million
Historic Preservation Tax Credits	$0.6 million	$1.2 million
Farm Loss Carrybacks	$0.4 million	$3.6 million
Tax Credit for Adoptions	$0.2 million	$4.5 million
Homestead Program Indexation	$0.1 million	$0.2 million
Oil Property Tax Credits	$0	$9.1 million
Endangered Species Tax Credit	$0	$6.0 million
Alternative Fuel Credits	$0	$0.3 million
INCOME TAX SUBTOTAL	**$318.2 million**	**$2.314 billion**

SOURCE: KANSAS DEPARTMENT OF REVENUE

Property Tax Reductions

Some of the most notable reductions in the property tax base over the past decade include:

• *Motor Vehicle Tax Reductions.* A package of motor vehicle tax changes was enacted in 1995, reducing the assessment from 30 percent to 20 percent of the vehicle's value. These changes were phased in over five years.

• *School Finance Mill Levy Reduction.* The uniform school district property tax levy was reduced from 33 mills to 27 mills, then to its current rate of 20 mills over the course of the past decade.

• *School Finance Homestead Provision.* A provision exempting $20,000 of the appraised valuation of residential property for purposes of the school finance levy was adopted starting in tax year 1997.

• *Business Machinery and Equipment Exemption.* In 2006 lawmakers enacted legislation exempting certain business machinery and equipment purchased after June 30, 2006, from the property tax.

COST OF SELECT PROPERTY TAX REDUCTIONS

	FISCAL YEAR 2010	*CUMULATIVE SINCE 1995*
General Property Tax Reduction	$497.9 million	$4.399 billion
Car Tax Reductions	$125.9 million	$1.422 billion
PROPERTY TAX SUBTOTAL	**$623.8 million**	**$5.821 billion**

SOURCE: KANSAS DEPARTMENT OF REVENUE

Sales Tax Reductions

Some of the most notable reductions in the sales tax base over the past decade include:

• *Residential Remodeling Labor Services.* In 1998 a sales tax exemption was enacted for labor services associated with the reconstruction, remodeling, repair or replacement of a residence.

• *Utilities Consumed in Production.* In 2000 the Legislature clarified that utilities consumed in production are exempt from sales tax.

• *Property Consumed in One Year.* In 1999 the sales tax for property consumed in production was extended to include property consumed in one year, including certain petroleum products, lubricants, chemicals, solvents and other items.

• *Health Clinics.* In 1999 an exemption was enacted for the purchases of nonprofit primary care clinics or health centers providing services to the medically underserved.

• *Integrated Plant.* The "integrated plant" sales tax exemption was enacted in 2000. This provision served to expand the exemption for the purchase of items used in manufacturing.

• *Repair of Transmission Lines.* In 2007 lawmakers enacted a sales tax exemption for services related to the repair of certain electric transmission and distribution lines damaged due to a natural disaster or terrorism.

• *Charitable Organizations.* Lawmakers have adopted additional sales tax exemptions for various charitable organizations nearly every year for the past 15 years. These range from the Girls Scouts to the Rotary Club of Shawnee Foundation.

COST OF SELECT SALES TAX REDUCTIONS

	FISCAL YEAR 2010	*CUMULATIVE SINCE 1995*
New Construction Services	$27.9 million	$320.0 million
Miscellaneous Exemptions	$22.9 million	$185.1 million
Residential Remodeling	$21.9 million	$204.1 million
Utilities Consumed During Production Process	$19.6 million	$223.0 million
Sales Tax on Used Vehicles	$5.9 million	$26.8 million
Integrated Plant Exemptions	$4.9 million	$38.8 million
Repair of Transmission Lines	$3.5 million	$6.4 million
Major Component Parts Exemption	$2.1 million	$20.0 million
Property Consumed in One Year	$0.5 million	$5.0 million
Health Clinic Exemptions	$0.3 million	$2.2 million
Grain Storage and Transportation	$0	$1.9 million
SALES TAX SUBTOTAL	**$109.5 million**	**$1.031 billion**

SOURCE: KANSAS DEPARTMENT OF REVENUE

SEVERAL TAXES HAVE BEEN REPEALED ENTIRELY IN THE PAST 15 YEARS

A number of other tax reductions were made over the course of the past 15 years. It is estimated that repeal of these three taxes alone would result in a loss of $166.5 million in fiscal year 2010:[9]

- The Inheritance Tax was repealed in 1998.[10]
- Lawmakers began phasing the Estate Tax out in 2006, with the full repeal of the tax effective beginning January 1, 2010.[11]
- Lawmakers began phasing the Corporation Franchise Tax out in 2001, with the full repeal set for tax year 2011.[12]

CONCLUSION

In order to ensure the quality of life in our state, educate and prepare our next generation of workers and consumers, and maintain our state infrastructure, the state tax base must be strong and stable. A broad tax base allows for lower rates and more stability. Unfortunately, Kansas has been moving in the opposite direction. The annual narrowing of the tax base through the passage of tax credits, exemptions and reductions undermines the quality of life in Kansas. The state of Kansas can no longer afford to permit the erosion of the state tax base. In order to prevent chronic budget gaps and to protect the public infrastructure upon which our state was built, lawmakers must hold the line on new tax credits, exemptions and reductions and part of the solution must include a broadening of the tax base.

FOOTNOTES

1 2007 State & Local Revenue, Federation of Tax Administrators, *www.taxadmin.org/fta/rate/07stlrev.html*

2 2008 State Tax Revenue, Federation of Tax Administrators, *www.taxadmin.org/fta/rate/08taxbur.html*

3 Kansas Tax Facts, 1995 Supplement to the 6th Edition.

4 Kansas Tax Facts, 2009 Supplement to the 7th Edition.

5 K.S.A. 79-3606.

6 Tax Expenditure Report, Calendar Year 2007, Kansas Department of Revenue, p. 1.

7 K.S.A. Chapter 79, Article 32.

8 "Estimated Effect of Tax Reductions and Increases enacted since 1995," Kansas Department of Revenue, 1/10/10.

9 "Estimated Effect of Tax Reductions and Increases enacted since 1995," Kansas Department of Revenue, 1/10/10.

10 Kansas Tax Facts, Seventh Edition, Kansas Legislative Research Department, p. 128.

11 2006 Summary of Legislation, Kansas Legislative Research Department, p. 153.

12 2007 Summary of Legislation, Kansas Legislative Research Department, p. 150.

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