

Reexamining Kansas' Pass-through Carve-out

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Chairman Johnson, Vice Chairman Phillips, Ranking Member Sawyer, Members of the Committee,

Thank you for the opportunity to speak with you today. My name is Scott Drenkard, and I'm an economist and the director of state projects at the Tax Foundation. I am joined by my colleague Joe Henchman, Vice President of Legal & State Projects at the Tax Foundation. For those unfamiliar with our group, we are a non-partisan, non-profit organization that has monitored fiscal policy at all levels of government since 1937. We have produced the *Facts & Figures* handbook since 1941, we calculate *Tax Freedom Day* each year, and have a wealth of data, rankings, and other information at our website, www.TaxFoundation.org.

While we take no position on legislation, we hope to offer our insights and provide a national perspective on tax issues.

Kansas' pass-through exemption is costly and has forced other tax increases

In 2012, Kansas enacted a tax cut package that reduced income tax rates while completely eliminating income tax on pass-through entities like LLCs, S corps, partnerships, farms, and sole proprietorships. At the time, we warned that the pass-through exemption did not have good economic justification and would "encourage economically inefficient, though tax-reducing" restructuring activity. We also warned that the "tax reductions, while producing positive economic benefits, would cost revenue and ultimately need to be paid for either by cutting spending or increasing taxes elsewhere."

In 2013, revenue dropped by \$700 million (\$300 million more than predicted). Spending that year was only cut \$150 million. These numbers are quite large for a \$6 billion general revenue fund. The state delayed a planned cut to the sales tax, weakened the generosity of itemized deductions, and drew down reserves to make ends meet.

FY 2015 had a significant cash deficit, masked by draining the rainy day fund and beginning

balances, and helped by very slow spending growth (only 1.1 percent from the previous year).

At the beginning of FY 2016, budget deficits widened sufficiently and spending remained adequately high that hikes to other taxes were necessary to make the budget balance. The state hiked the sales tax rate from from 6.15 percent to 6.5 percent, giving the state the 8th highest sales tax in the country. The state hiked the cigarette tax rate from 79 cents per pack to \$1.29 per pack. A new tax was placed on vapor products (e-cigarettes). The state also eliminated many deductions in the individual income tax, and created a one-time tax amnesty program.

Governor Brownback's latest budget proposal includes a further \$1 cigarette tax increase, which for a state that borders Missouri is in my view untenable (Missouri levies a 17 cent per pack tax). This proposal is joined by a plan to securitize funds from the tobacco Master Settlement Agreement, which would dry up a future revenue stream to solve this year's budget issues.

This budget history is unsustainable in the long term.

The pass-through exemption encourages tax avoidance without generating desired growth

My judgment, which is shared by my colleagues, is that the pass-through exemption is an important reason for Kansas' revenue underperformance, and a carve-out which deserves reexamination. When the exemption was passed in 2012, it was projected that 191,000 entities would take advantage of the provision. As more and more people have realized the very sizeable tax advantage of being a pass-through entity in Kansas, the latest tally (2015) on that number has grown to 393,814 claimants, over twice as many as anticipated. The Department of Revenue's 2015 tax expenditure report shows that this deduction resulted in \$589,255,827 in foregone revenue.

It's important to note here that while decreasing taxes is generally associated with greater economic growth, the pass-through carve out is primarily incentivizing tax avoidance, not job creation.

If they passed a provision like this in Washington, D.C., where I live and work, I would benefit from going to my employer the next day and ask them to start paying me as an independent contractor. I would still be doing the same job and contributing the same value to the economy, I just wouldn't be paying any income taxes.

The individual income tax is one of the largest instruments in the Kansas revenue toolkit. Exempting pass-through income substantially narrowed the tax base of that instrument, and in a haphazard way.

The pass-through exemption is damaging the state tax reform conversation nationally

As a final comment, I think it may be instructive to share a story about the impact this policy is having on tax reform in other states. In 2014, I testified before the Nebraska Senate Finance Committee on a bill to gradually lower corporate and individual income tax rates. The plan was to reduce rates by small bits each year with a revenue trigger built in so that the cuts only occurred in

years with healthy revenue growth. It was a balanced proposal that was designed to cultivate bipartisan support. This is a state where the legislature is officially nonpartisan; members do not have a party affiliation.

I got multiple questions about Kansas's budget issues, with committee members not wanting to subject themselves to the kind of revenue shortfalls this state has experienced. The tax reform package in Nebraska didn't pass, and I'm pretty sure the feeling of trepidation about Kansas' tax cuts contributed to its failure.

I speak on tax issues in other states almost every week, and I often get questions from the audience along the lines of, "what happened in Kansas?" This is not good for state branding or economic development.

Tax reform is about broadening tax bases and lowering tax rates. This state has lowered tax rates in some spaces, but the pass-through exemption significantly narrows the tax base, and this has made for a less stable, productive, and competitive code.

Thank you, and I look forward to your questions.

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