

FISCAL FOCUS



Budget and Tax Policy in Perspective

**THE KANSAS BUDGET GAP:
HOW DID IT HAPPEN AND WHO GETS HURT?**

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Introduction

Every day, we rely upon the public infrastructure that our state's founders put into place. The school system that educates our next generation, the roads and highways that enable interstate commerce, and the justice system that mediates our business disputes are all a part of that infrastructure. As a state, we take pride in the quality of our public infrastructure — our schools educate some of the best and brightest students in the nation, and our highway system allows Kansas companies to remain competitive alongside those in neighboring states.

But, our ability to maintain the infrastructure upon which we rely depends on our capacity, as a state, to generate adequate revenues.

When our founders built the public infrastructure in Kansas, it was built upon a tax system that relied heavily on revenues from our state's agricultural industry. Though the face of agriculture has changed significantly over the years, our tax system has not.

This publication will explore three aspects of the budget gap:

- The root of the budget gap problem in Kansas;
- How the budget gap is impacting the viability of our state;
- And, options for getting state finances back on track.

How Did The Budget Gap Happen?

As is the case in any state, Kansas revenue and budget circumstances vary from year to year depending on a number of factors, including the health of the economy, the cost of providing state services and unforeseen expenses due to natural disasters or litigation. However, the budget shortfalls seen in Kansas recently are the result of more than just typical factors. The root of the problem is that the state tax structure is outdated to the extent that it no longer reflects the state's economy and the revenues generated are insufficient to fund the state's spending needs.

A budget gap, at its core, is comprised of two parts: revenues and expenditures. Kansas has been on a collision course for some time because of the combination of a decreasing tax base and increasing costs for services.

REVENUES

The state tax system does not reflect the current economy.

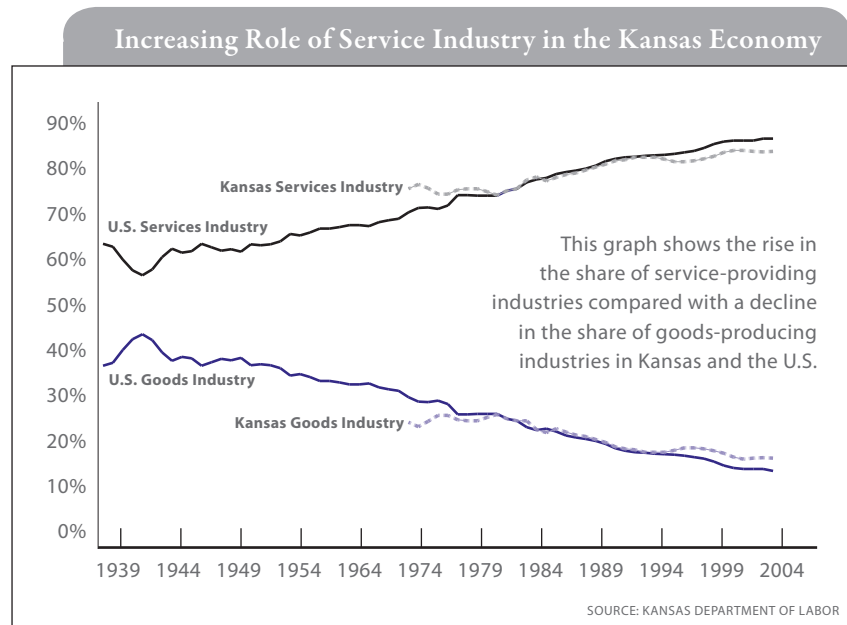
The property tax was adopted in Kansas in the mid-1800s as a tax on wealth. The other major components of the Kansas tax system were developed in the 1930s. At that time, the state economy was largely based on agriculture and manufacturing. It was logical to base state revenues on the value of property, the sale of goods, and income because it captured the key wealth-generating activities at that time.

However, in the current economy, more and more of the manufacturing sector is operating overseas while the service sector has become a larger and more sophisticated part of the state economy. As a result, the state loses a great deal of potential tax revenue by not applying the sales tax to the sale of services. This also creates an unfair system where purchases of goods are taxed while services are not.¹

Though taxes make up the majority of State General Fund revenues, the rate of taxation in Kansas falls well below most other states. Kansas ranks 23rd per capita when it comes to state tax revenue and 26th in terms of state tax revenue as a percentage of personal income.²

The passage of tax breaks is eroding the tax system.

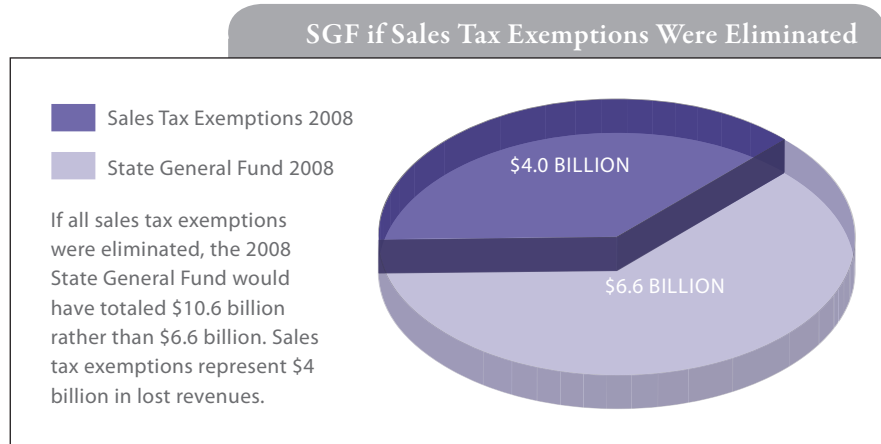
With few exceptions, the state's tax base is narrowed more and more each year when the Legislature creates new tax breaks. Although this may or may not have an immediate impact on state revenues, it is clear that this steady



erosion of the tax base is a significant factor in the state’s ability to fund public structures, such as roads, bridges and schools.

In the past five years alone, tax cuts have been created that represent more than \$1.1 billion in lost revenues through fiscal year 2013.³ Prior to the 2009 Legislative Session, 81 sales tax exemptions had been enacted by lawmakers. Even in the extremely difficult budget climate of the 2009 Session, lawmakers passed four additional sales tax exemptions.⁴

According to the Kansas Department of Revenue, sales tax exemptions cost the state more than \$4 billion in Fiscal Year 2008. To put this in perspective, if these exemptions were eliminated, the State General Fund would increase by almost two-thirds, from \$6.6 billion to \$10.6 billion.⁵



In addition to the sales tax exemptions, a number of income tax credits have been enacted in recent years. Two tax sources, the Estate Tax and the Corporation Franchise Tax, were repealed in the last five years and the Corporate Income Tax rate was cut by a total of 0.35 percent when fully phased in.

The diversion of tax dollars from the State General Fund is becoming more prevalent.

Another cause of the erosion of the state tax base is a number of measures that have been enacted that divert tax revenues from the State General Fund to other uses. Significant initiatives, intended to encourage economic growth in Kansas, divert either employee income taxes or state sales taxes from the State General Fund to private entities.

In the case of Sales Tax and Revenue (STAR) bonds, the state allows sales tax dollars to be diverted for up to 20 years (or longer in the case of special projects, such as the Kansas Speedway development in Wyandotte County) to pay for infrastructure costs associated with the development. While the motivation for this incentive is to create new commerce in blighted areas, it can have the effect of drawing commerce away from already established areas. This also draws additional tax dollars out of the State General Fund. A recent audit of economic development expenditures estimates that \$92 million in state funds were diverted away from the state — between Fiscal Year 2003 and Fiscal Year 2007 – because of STAR bonds.⁶

There are a number of incentives, created over the past decade, that allow corporations to keep their employee income tax withholdings instead of sending the money to the State General Fund. The first incentives of this nature were allowed for large manufacturers, but the policy has been extended to include smaller manufacturers.

In 2009, the Legislature passed the Promoting Employment Across Kansas (PEAK) Act, which allows a broad range of companies to keep their employee withholding taxes to relocate to Kansas. This act alone is expected to divert \$30 million away from the State General Fund between Fiscal Year 2010 and Fiscal Year 2014.⁷

A similar system is used to fund the Bioscience Authority by essentially allowing the income tax withholdings from employees of qualified bioscience firms to be diverted from the State General Fund and instead be used

to create a pool of money for attracting and retaining bioscience firms in Kansas. The Bioscience Authority estimates that it will generate more than \$580 million from the diversion of withholdings over a 15-year period.⁸

A recent audit found that, in spite of billions of dollars invested in economic development over the years, the effectiveness of Kansas economic development spending is unclear at best.⁹ For further analysis of the audit and effectiveness of economic development spending in Kansas, visit www.kac.org.

EXPENDITURES

State expenditures have remained fairly constant over the past 30 years when compared to personal income. However, both expenditures and revenues generally rise each year and, in some cases, the state does not have a great deal of discretion over those increases.

Level of spending has changed very little over time in comparison to personal income levels.

Kansas taxes, as a percentage of personal income, have remained largely unchanged over the past 40 years, typically ranging from 11 to 12 percent. This refutes claims that the level of spending has increased in Kansas, illustrating instead that the cost of maintaining public structures is increasing at generally the same rate as Kansas incomes.

Taxes as a Percentage of Personal Income ¹⁰

FISCAL YEAR	STATE	LOCAL	COMBINED
FY 1960	4.63%	5.88%	10.51%
FY 1970	5.46%	6.18%	11.64%
FY 1980	6.12%	4.34%	10.46%
FY 1990	6.58%	4.94%	11.52%
FY 2000	6.86%	4.24%	11.10%
FY 2008	7.11%	4.95%	12.06%

Some state expenditures are not optional.

The state has little discretion over spending on certain “entitlement programs” that are funded in partnership with the federal government. These include Medicaid Regular Medical, Medicaid Nursing Facilities, Temporary Assistance to Families (TANF), Nursing Facilities for Mental Health, and Reintegration/Foster Care. The state’s cost to fund these programs has increased by almost \$150 million in the past five years alone, growing from \$659 million of State General Fund in Fiscal Year 2005 to a budgeted \$806 million in Fiscal Year 2009.¹¹

Education spending has increased dramatically in recent years in response to litigation.

In 2005, the Kansas Supreme Court held that the level of funding for K-12 public education did not meet the standards of equity and adequacy of funding set forth in the Kansas Constitution. In addition to immediate increases required by the court in 2005, the 2006 Legislature addressed the constitutional issues by adopting a \$466.2 million three-year plan to increase funding for schools.¹²

Who Gets Hurt?

Kansas children and families depend upon the public infrastructure that our state’s founders put into place. When funding for public infrastructure falls short, the resulting impact on children and families, as well as on vulnerable populations in the state, can be significant.

Kansas law allows the governor to make budget allotments or reductions when it appears that expenditures will exceed the resources of the SGF in a fiscal year. When the balance of the SGF is estimated to be less than \$100 million at the end of the year, the governor is authorized to do across-the-board cuts to balance the budget.¹³

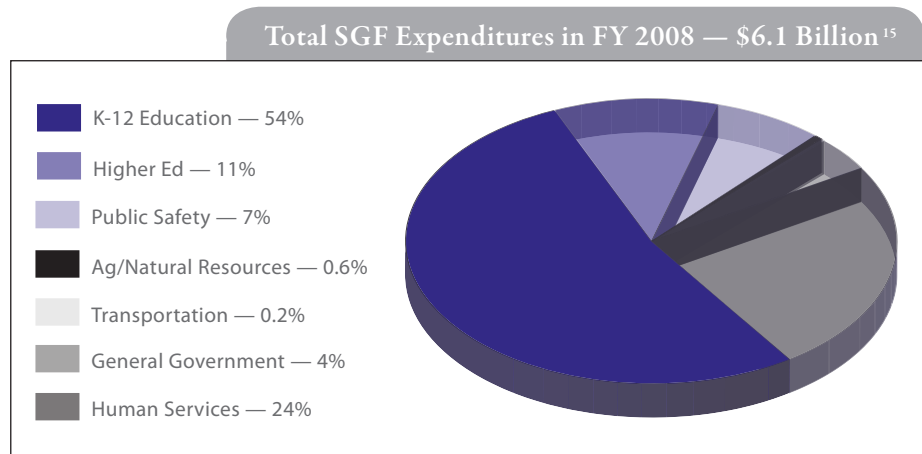
Past experience shows the impact of allotments on children and families. For example, in 2003, allotments caused the eligibility level for child care assistance to be reduced from 185 percent to 150 percent of the federal poverty level. As a result, more than 2,000 children of working families lost child care between January and March of 2003.¹⁴

A BREAKDOWN OF STATE SPENDING

More than half of the state budget is dedicated to spending on K-12 public schools. An additional 11 percent of the budget goes toward higher education, including the Regents’ institutions, community colleges and technical schools in Kansas.

The second largest area of state spending is human services, which includes funding for services provided by the Department of Social and Rehabilitation Services

(SRS), the Department on Aging, and the Kansas Health Policy Authority. It follows that across-the-board cuts to state agencies, due to a budget gap, produce the largest reduction in funding for education and human services.



The 2002 budget gap experience.

In 2002, the state of Kansas faced a sizable budget gap. The Legislature chose to address the budget gap that year by increasing taxes by \$242 million. These tax increases were all in the form of rate increases, as opposed to broadening the base, and the increases impacted some of the state’s most regressive taxes. The changes included a sales tax increase from 4.9 percent to 5.3 percent; a cigarette tax increase of 46 cents, from 24 cents a pack to 70 cents a pack; and a motor fuels tax increase of 2 cents per gallon, to 23 cents for gasoline and 25 cents for diesel. Corporate fees were also increased.¹⁶

The 2009 budget gap experience.

At the beginning of the 2009 Legislative Session, Kansas faced a budget gap of \$141 million for Fiscal Year 2009 and more than \$1 billion for Fiscal Year 2010.¹⁷ Lawmakers responded to the 2009 budget gap with three rounds of budget cuts and a reduction in tax credits paid out by the state. A number of key programs impacting children and families and other vulnerable communities in Kansas were hit particularly hard by the 2009 cuts.

THE REAL IMPACT OF 2009 BUDGET CUTS

Most of the budget cuts enacted in 2009 were done at the agency level. As a result, state agencies have some latitude to determine which programs are impacted by the cuts and it is difficult to determine the exact nature of those cuts at this time. However, in some areas, the impact of the budget cuts is already apparent.

Cuts to K-12 education.

By May 1, 2009, even before the final round of budget cuts, a survey by the United School Administrators of Kansas reported that almost 1,300 school employees had already been laid-off for budget reasons. Other areas cut by Kansas school districts as a result of 2009 budget cuts include music and fine arts programs, vocational classes, library and media services, summer and afterschool programs, and new textbook purchases.¹⁸

Cuts to social services.

During the 2009 Legislative Session, the Department of Social and Rehabilitation Services issued a priority list of programs that would be cut based on the level of across-the-board cuts adopted. Some of the likely cuts include the reduction of grants for mental health, substance abuse, and family support for individuals with developmental disabilities.¹⁹

Options

The long-term solution to avoid increasing budget gaps is to update and modernize the Kansas tax system in a way that accurately reflects the current economy and generates sufficient revenues for state funding needs.

One of the most challenging aspects of tax change is generating broad support for a proposal. In fact, Kansas has convened a number of tax commissions over the years. Although the recommendations from these commissions represent sound tax policy, they have failed to produce real change to the tax system. An alternative approach is to create a commission modeled after the federal Base Realignment and Closure (BRAC) system that is outside of the political process, but has the authority to introduce legislation and lead the tax modernization process. This would allow for a study of the current tax system and would allow for improvement of the system to begin outside of the political process. It also would help ensure that the commission's proposals would be based on principles of good tax policy rather than political influence.

Some of the options that the commission could consider include the following:

Expand the sales tax base to include services.

The state could generate significant revenues and even the playing field by expanding the sales tax base to include some, if not all, services. The Kansas economy has shifted from a heavy reliance on manufacturing of goods to a new reliance on the service industry. As a result, the effectiveness of the sales tax as a major source of revenues to the State General Fund is strained. By including some services in the sales tax base, Kansas could strengthen this revenue source and ensure that it remains a viable source of state funding.

A study last updated by the Center on Budget and Policy Priorities in 2003 estimates that extending the sales tax to a range of 40 services commonly purchased by households, could increase Kansas sales tax receipts by almost 30 percent.²⁰

Reduce the number of tax breaks.

The Kansas Department of Revenue estimates that more than \$6 billion of potential revenues were foregone in Kansas due to tax breaks in calendar year 2007. Of this amount, nearly \$4 billion was attributable to sales tax exemptions alone.²¹ Lawmakers could broaden the tax base by eliminating existing sales tax exemptions and income tax credits. It is likely that many of these tax breaks no longer reflect the spending priorities of the state. However, tax breaks such as these are not scrutinized in the same way as direct appropriations each year. For this reason, the state should consider placing a periodic sunset on sales tax exemptions and income tax credits to ensure that each one continues to be a spending priority or is otherwise repealed.

Update personal income tax to account for higher earnings.

The Kansas personal income tax is relatively flat in its rate structure with only three income brackets. Under the current system, a taxpayer has reached the highest state income tax rate at \$30,000 of income for a single taxpayer and \$60,000 of income for a married couple filing jointly. While \$30,000 and \$60,000 may have been higher income levels at the time when the personal income tax structure was set, the per capita personal income in Kansas today is \$37,978.²²

Adding a tax bracket at the top of the Kansas personal income tax structure could bring significant new

resources to the state. A recent estimate by the Institute on Taxation and Economic Policy indicated that adding a one percent surcharge on adjusted gross income over \$250,000 for married taxpayers filing jointly (\$125,000 for single taxpayers) would generate \$88.8 million while impacting only 2.2 percent of Kansas taxpayers.²³

Conclusion

Unless the state economy makes a quick and unprecedented turnaround, Kansas is positioned to face another budget gap during the 2010 Legislative Session and in years beyond. The shortcomings of the Kansas tax structure, combined with current economic hard times, make it the perfect time to update Kansas taxes. Modernizing the tax structure in a way that reflects our changing economy would create a system that is both equitable and sustainable, and would maintain the public infrastructure upon which our state, our communities and our families rely.

Reactionary measures, such as the tax rate increases of 2002, are a temporary fix at best. This is the time to address the structural problems in the Kansas tax system. Addressing the tax structure could be accomplished by empowering a tax modernization commission to recommend ways to improve the system. It could also be done incrementally by broadening the sales tax base to include services or eliminating tax breaks like income tax credits and sales tax exemptions.

Regardless of the approach, the state of Kansas can no longer afford to ignore the shortcomings of its tax structure. In order to prevent chronic budget gaps and to protect the public infrastructure upon which our state was built, a change in tax policy must be a part of the solution.

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