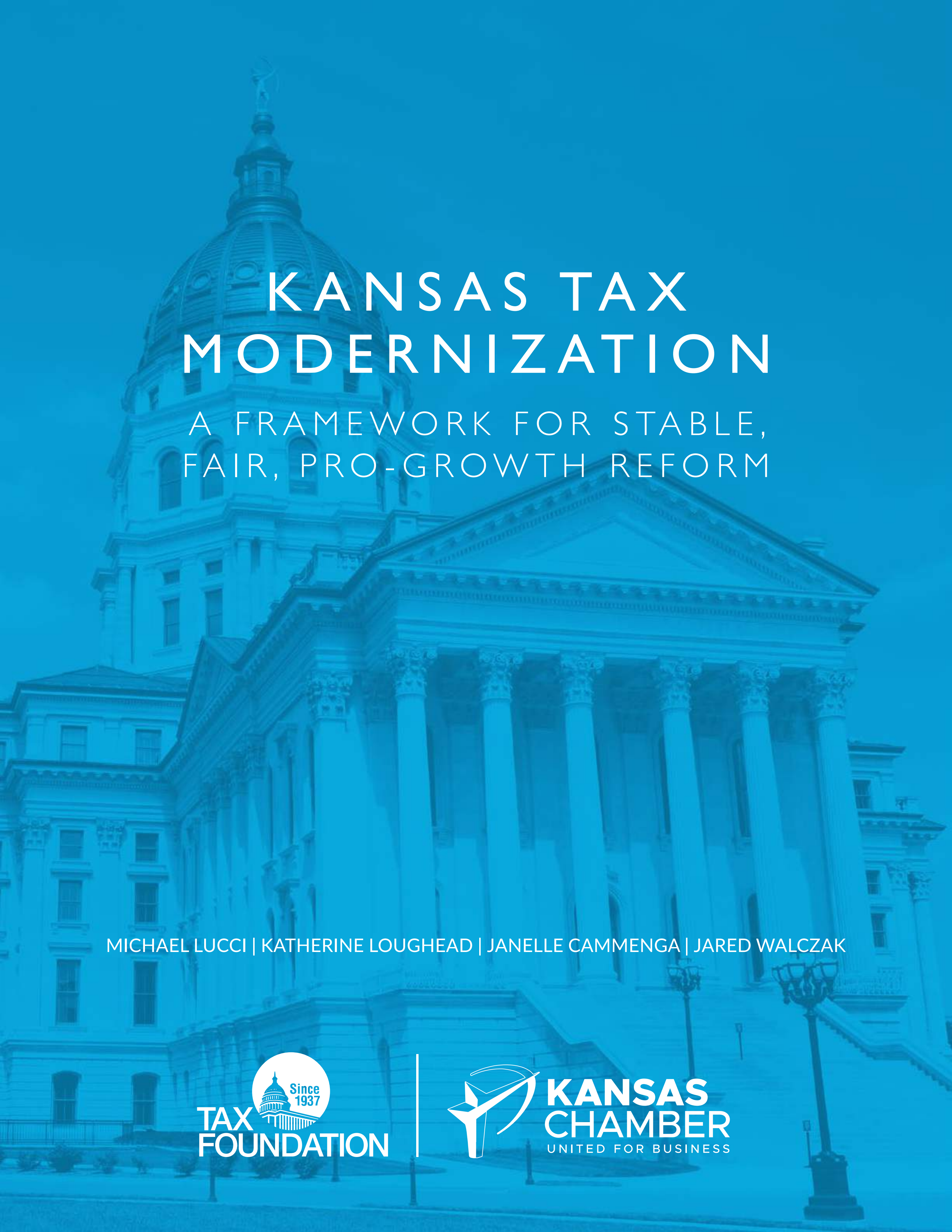

# KANSAS TAX MODERNIZATION

## A FRAMEWORK FOR STABLE, FAIR, PRO-GROWTH REFORM

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# TABLE OF CONTENTS

# INTRODUCTION

# Introduction

Kansas achieved a history of tax reform success throughout the 19th and 20th centuries, as evidenced by the dramatic evolution of Kansas' code over the state's 158-year history. The result is the current tax code, constructed primarily upon a relatively balanced three-legged stool of property, sales, and income taxes funding Kansas' state and local governments. While the majority of Kansans we met with are proud of this structure, they also agreed that the time has come to review certain provisions within each of these major taxes to achieve lasting tax reform for the 21st century.

In the course of producing the research for this book, we conducted dozens of interviews across the state, discussing tax reform options with hundreds of Kansans with an interest in tax reform. Several themes arose consistently in our meetings with citizens and stakeholders across Kansas. Those themes include an aspiration to make the state more competitive while ensuring stability, a willingness to learn from the past coupled with a desire to step forward into a better future, and a hunger for a thoughtful and comprehensive look at improving Kansas' tax code. Kansans we met with carry a shared desire for a balanced conversation to achieve successful tax reform for the people and businesses that call Kansas home.

It is our goal to meet these demands with the work contained in this book, and by serving as an educational resource for the people of Kansas. We seek to apply the lessons of Kansas' past, take a thoughtful and comprehensive look at Kansas' tax code, and be a resource for modernizing Kansas' tax code for the 21st century.

In the introductory text below, we summarize the recent history of Kansas' tax changes and then lay out our objectives and guiding principles for thinking about tax reform. In the *Executive Summary* we list the building blocks with which Kansas can construct an enhanced, simplified, modernized tax code. The first two chapters of this book look at Kansas' economy and budget. Chapters 3-7 build out the details to explain the building blocks of tax reform, with a view to creating structural improvements across the code over coming years.

Finally, we pledge to serve as a resource to lawmakers and stakeholders across Kansas as they fit and mortar together these building blocks into the architecture of comprehensive tax reform.

## Synopsis of Kansas' Recent Tax Changes

Few subjects are as fraught as is tax reform in Kansas. Unfortunately, "Kansas" has become a byword in many quarters, shorthand for the dramatic fight over what has been dubbed the "Kansas tax experiment" and its consequences. Although many of the tax changes adopted in 2012 and subsequent years have since been reversed, the issue remains fresh for many—and unresolved.

Some proponents of the 2012 tax changes feel that the efforts were cut short, or that tax changes were not allowed to proceed as intended. Many opponents feel that the reversals to date are incomplete. What cannot be disputed is that the past few years have been tumultuous, and that few policymakers would care to repeat that experience.

Kansas' tax rate cuts that began in 2012 reduced revenues without commensurate reductions in expenditures to the point that the state struggled to meet its obligations. Reducing the tax wedge can certainly promote economic growth, but such growth is not sufficient to close the resulting revenue gap. Businesses became understandably wary about Kansas' fiscal instability. When the state could neither meet its obligations within given revenues nor reduce expenditures in kind, it became inevitable that the tax changes begun in 2012 would be reversed, as they approximately were in 2017.

The tax debate that took course over the last several years is still raw for many Kansans.

The 2012 tax changes yielded uncertainty rather than greater competitiveness. The changes might well have kept business investment at bay, not because companies don't like lower taxes—they do—or don't have increased investment opportunities when tax burdens are lower—again, they do—but because they understood that the situation was unsustainable.

The 2012 tax changes were mostly focused on rates, not structure. The signature structural change from the 2012 law, the exemption of pass-through income from the individual income tax, was nonneutral in that it favored certain sorts of economic activity over others and created opportunities for tax arbitrage. Suddenly, a dentist's income was likely to be tax-exempt, but her hygienist's income was not. An independent consultant to corporations incurred no individual income tax liability in Kansas, but someone performing the same job responsibilities but as a corporate employee paid full freight.

The subsequent reversals were not particularly attentive to structural improvements either, focused as they were on fiscal sustainability. Retroactive tax increases—a usually highly undesirable policy move—were hastily enacted to close the revenue gap. Policymakers pushing the rollback and rate increases were impelled by a sense of urgency, and doubtless believed that it was no time to undertake a broad tax study.

So why even consider tax reform?

Because, in short, addressing the structural inadequacies of Kansas' tax code is now more important than ever. In recent years, Kansas policymakers have cut rates and they have raised them. They have created exemptions and repealed them. What they have not done is take a serious look at the actual scaffolding upon which the tax code is built and considered a plan to improve that scaffolding for a 21st century economy.

Now that the dust has begun to settle, the time has come to review the tax code, not with an eye either to slim or to grow revenues—the optimal revenue target is a policy choice outside the scope of this project—but to make sure that the state is raising the revenue it needs in the most neutral, efficient, transparent, and pro-growth way possible. It's time to ask what's working and what isn't—to evaluate whether incentives are achieving their objectives, to identify ways to reduce compliance costs, and to better align the tax code to promote economic growth.

Furthermore, there is an issue at stake beyond simply reforming Kansas' tax code. The Sunflower State's brand will gain as much as its tax code from a successful tax reform. Kansans can come together, put the past behind them, and build a better future. The purpose of this book is to provide the tools and trajectory for the structure of Kansas' tax code to be significantly improved. This book will address ***how*** those revenues should and should not be collected, and we leave it to Kansans to decide ***how much*** revenue should be collected.

## Our Purpose

To be clear: this is not a book about tax cuts. All else being equal, lower rates and lower tax burdens will incentivize investment and spur economic growth. However, the real world is complex, and all else is not always equal, in particular in a state that has undergone the significant tax and revenue changes Kansas has enacted since 2012. Regardless of how much revenue will be collected, Kansas can modernize the structure of its tax code to ensure that collections are made in a way that will encourage growth.

It's time to turn the page on the debates of the past decade and chart a new course, one that makes Kansas a different kind of watchword. We are excited by the prospect that, a few years hence, "Kansas" will cease to be a word of warning and instead be a word that connotes reform and renewal. In recent years many states, including regional competitors like Iowa and Indiana, have modernized their tax codes to become more competitive and are enjoying the benefits of those reforms. It is time for Kansas to join their ranks. Wherever you stood in 2012 and wherever you are now, if you believe that Kansans deserve better than the state's current tax code, this book is for you.

The following pages contain both an analysis of the state's tax code and concrete recommendations for improving it. We will begin with the corporate tax code, given that the corporate tax is Kansas' most inefficiently structured major tax, and therefore offers the greatest opportunity for reform and renewal.

We hope that you will find yourself agreeing with many of the recommendations in this book, but perhaps you will disagree with a few of them as well. We are eager to begin a robust and bipartisan conversation about modernizing Kansas' tax code to suit a 21st century economy. Imagine a world where people talk about the lessons learned in Kansas that illuminated the path to Kansas' modernized tax code and reinvigorated future. We're imagining it. We invite you to join us.

# A Menu of Tax Reform Solutions

## Corporate Income Tax

Kansas' income tax is functionally a two-rate tax, with most corporate income taxed at 7 percent. Some firms face little or no liability under the corporate income tax, but for others, structural deficiencies in the state's approach to corporate taxation can lead to uncompetitive burdens and penalize in-state investment. Our recommendations would create a more neutral corporate tax environment which encourages long-term investment in the state.

**Removing International Income from the Tax Base.** Inaction on the part of policymakers has Kansas poised to tax international income, with corporations potentially facing significant in-state liability for the activities of their foreign subsidiaries or related corporations, which would make Kansas far less attractive to multinational corporations. Lawmakers should reaffirm the state's traditional position (in line with other states) of not taxing international income.

**Locking in Full Expensing of Capital Investment.** Commendably, Kansas conforms to the new federal policy of allowing corporations to fully deduct the cost of their machinery and equipment purchases in the first year. But with the current federal treatment scheduled to expire, Kansas would be well-advised to lock in the current system, decoupling from future changes to federal law and instead providing permanent full expensing.

**Repealing the Throwback Rule.** Kansas' throwback rule punishes businesses that sell out of state, encouraging them to relocate to—or at least locate distribution facilities in—other states. With studies suggesting that, over time, tax avoidance strategies eliminate most or all revenue gains from throwback rules, repealing the throwback rule would be a sound investment in Kansas' economy.

**Shifting to Market Sourcing of Service Income.** Kansas' tax code treats companies more favorably when they produce and sell tangible goods than when they sell services or other intangibles. This distinction lacks economic justification and should be eliminated.

**Conforming to Federal Treatment of Net Operating Losses.** Federal law now provides for unlimited net operating loss carryforwards, capped at 80 percent of tax liability in any given year, while Kansas offers a relatively stingy 10-year carryforward. Policymakers might consider increasing the length of the carryforward period, or, alternatively, conforming to federal treatment for simplicity's sake.

**Reviewing Business Tax Incentives.** A growing number of states have established panels, commissions, or *ad hoc* committees to review tax incentives periodically. With a new tax incentives database in the works, policymakers should formalize a regular evaluation process to assess the return on investment from the state's economic development incentives.

## Individual Income Tax

Kansas' individual income tax is in the middle of the pack for rates and collections, but opportunities exist for structural improvements affecting individuals and pass-through businesses. The state's failure to respond to changes in the federal tax code, moreover, yields higher taxes on many Kansans, an unlegislated and nonneutral tax increase that policymakers may wish to address. Our recommendations are focused on creating a more regionally competitive individual income tax.

**Indexing Income Tax Provisions for Inflation.** To avoid bracket creep, where inflation leads to greater income tax liability even when real income remains constant, Kansas should index the major provisions of its individual income tax—the brackets, standard deduction, and personal exemption—to inflation.

**Enhancing the Standard Deduction.** Because it is not inflation-indexed, Kansas' $3,000 standard deduction has lost half its value since it was created in 1988, an erosion even more notable now that the federal standard deduction stands at $12,400. Kansas also offers both marriage bonuses and penalties in its standard deduction. The joint filer standard deduction is more than double the single filer deduction, but the additional standard deduction is less generous for married filers than for single filers. Kansas policymakers should consider increasing the standard deduction and eliminating these bonuses and penalties.

**Allowing an Independent Choice of Itemization.** Under the new federal tax law, far more taxpayers find it advantageous to take the more generous federal standard deduction than to itemize, but this decision currently increases their Kansas tax liability, creating an unlegislated tax increase. Kansans should be allowed to itemize on their state return even if they claim the standard deduction on their federal return.

**Rolling Back Excessive Credits.** Some of Kansas' tax incentives are barely claimed at all, and others fall far short of their objectives, but they create administrative costs by their mere existence. While individual income tax credits only carve out the tax base slightly, a cleanup of the existing credit structure is appropriate.

**Eliminating the Social Security Tax Cliff.** Kansas excludes Social Security from the taxable income of those whose federal adjusted gross income is $75,000 or under, but taxes it in full once a taxpayer earns a single additional dollar. Policymakers should explore the implementation of a gradual phaseout of the benefit to avoid this steep tax cliff.

## State and Local Sales Taxes

Kansas' sales tax is imposed on a narrow base that exempts many goods and most services, a holdover from an earlier era, while the state's approach to remote sales tax collections raises serious legal questions and imposes significant compliance costs. Our proposals would simplify and modernize the sales tax, bringing it in line with today's economy.

**Broadening the Sales Tax Base.** A well-structured sales tax applies to all final consumer purchases, both goods and services, while exempting business inputs. Kansas' sales tax falls far short of this goal, and in an increasingly service-oriented economy, it erodes further each year. We offer a menu of base-broadening options to enhance the stability of the sales tax and generate additional revenue that could be used to reduce the sales tax rate or pay down reforms elsewhere.

**Excluding Business Inputs.** Kansas policymakers have long recognized the importance of excluding business inputs from the sales tax base to avoid pyramiding, but little progress has been made in expanding the scope of these important exemptions. Policymakers should consider exemption certificates and the adoption of better definitions of business inputs to reduce the impact of this hidden tax.

**Removing Barriers to Interstate Commerce.** Nearly all states have responded to their newfound authority to require collection and remittance of tax on remote sales, but Kansas is alone in imposing these requirements without a safe harbor for small sellers, which is likely unconstitutional. Policymakers should enact legislation providing such a safe harbor, disavowing retroactive collections, providing clear statutory language regarding marketplace facilitators, and eliminating Kansas' legally dubious click-through and affiliate nexus provisions.

## Property and Related Taxes

Kansas' property tax ranks above average in its structure, and the state has a laudable system of property tax administration. Further improvements can be made that will benefit homeowners and businesses. Property tax controls can be improved to increase transparency and taxpayer involvement in the process of increasing property taxes. The property tax base should be focused on land and its improvements, insofar as possible, and the administration of property taxation for retail properties should be improved. Finally, Kansans should thoughtfully study and consider options for consolidating local governments.

**Restructure Property Tax Lid in the Mold of Utah's "Truth in Taxation" Requirements.** Kansas passed a property tax lid into law in 2015. It took effect in 2017. The lid has caused dissatisfaction with both local government officials and advocates of property tax restraints. Kansans can restructure this lid in the mold of Utah's Truth in Taxation law, creating a property tax cap system that thoroughly informs and engages property owners in any decision to increase property taxes while not unduly constraining local governments.

**Reduce Reliance on Tangible Personal Property Taxes with Potential Offsets.** Kansas' taxation of tangible personal property is a nonneutral and inefficient part of its property tax code. Kansas has recently moved to exempt various forms of business tangible personal property from taxation and should continue to move forward in removing all tangible personal property from the tax code, thus circumscribing the property tax to land and its improvements.

**Preempt Local Governments on Taxation of Gross Earnings from Intangible Property.** The local taxation of earnings from intangible personal property is one of the more peculiar and anachronistic provisions of Kansas' property tax code. This tax is levied by a small share of local governments. The state legislature should preempt the taxation of earnings from intangible personal property.

**Direct County Appraisers on Proper Methodologies for Appraising Big-Box Retail Properties.** The volatile appraisals of big box retail properties cause instability for both businesses and local governments. However, the Kansas Board of Tax Appeals and Supreme Court have consistently ruled that retail properties should be appraised on the value of their land and improvements, and that appraisal formulae should not be based upon the income-potential or lease-potential of a retail property. The Director of the Division of Property Valuation should thus provide clear guidance to county appraisers for valuing big-box retail properties.

**Revisit the Requirement for Partial Payment of Tax that Is under Appeal.** Kansas can also reconsider the requirement for the payment of the disputed portion of a tax that is under appeal. This change would improve Kansas' property tax administration, and if structured properly, reduce volatility for local government finances that is the result of disputed appraisals.

**Study and Consider Ways to Achieve Local Government Consolidation.** Kansas should formalize an effort to study the need for local government consolidation and consider options for the same. Local government consolidation frequently arose in our discussion of property taxes across the state. However, such changes require a careful, well-thought analysis of where opportunities exist to improve the efficiency of local governance through consolidation.

## Other Tax and Revenue Considerations

Although income, sales, and property taxes make up the bulk of state and local taxes in Kansas, other taxes (like excise and severance taxes), as well as revenue- and budget-related provisions like the Budget Stabilization Fund, merit consideration. Our recommendations promote certainty and stability for the state and taxpayers alike.

**Shoring up the Rainy Day Fund.** Kansas was one of the last states to implement a rainy day fund, with the 2016 enactment of legislation creating the Budget Stabilization Fund. Currently, however, deposits are only required for a few years, the calculation of mandatory deposits is fairly arbitrary, there are no specifications of when funds may be withdrawn, and there is no replenishment provision for when a withdrawal has been made. If the rainy day fund is to provide a buffer in the next recession, policymakers must establish it on a firmer basis.

**Maintaining the "Border War" Truce.** Kansas and Missouri recently implemented a ceasefire in the "border wars" in which both sides offered incentives to lure companies back and forth across the border dividing Kansas City, Kansas from Kansas City, Missouri. This truce is not binding on localities, however, so policymakers should do what is in their power to encourage or induce local governments not to defect.


CHAPTER 1

# KANSAS' ECONOMY

# Introduction

Kansas rests in the very heart of the United States both geographically and economically. The geographic center of the contiguous 48 states is pinpointed in rural north-central Kansas, 2.6 miles northwest of Lebanon and just 12 miles south of the Kansas-Nebraska border.[1] This chapter will detail several of Kansas' economic metrics. These metrics generally put Kansas in the middle among regional competitors and the 50 states, though Kansas shows below-average growth trends in many metrics related to economic activity, personal income, and population. These trends should induce policymakers to consider sustainable options to enhance economic growth and population retention.

The Sunflower State's economic activity per person ranks securely in the middle of the country. Kansas' Gross Domestic Product (GDP) per capita is 25th among the states at $57,373, meaning that Kansas' economic production per person is right in the middle among the 50 states, although it falls below the national average. Kansas' total GDP growth has trailed the national average over the last 20 years (2.2 percent vs. 1.7 percent), 10 years (1.8 percent vs. 0.9 percent), and five years (2.4 percent vs 1.6 percent).

Kansas has consistently performed near the middle of the pack compared to its regional competitors, with per capita income and GDP numbers that are similar to competitor states. Nebraska and Iowa have closely mirrored Kansas in personal income per capita since 1929, the first year that data became available. Colorado, Kansas' neighbor to the west, generally outperforms Kansas in most metrics, including income per capita, while Oklahoma, Kansas' neighbor to the south, generally underperforms, although Oklahoma has achieved relatively better growth rates over recent years. The story for GDP per capita is similar: Kansas outperforms Oklahoma and Missouri and trails Nebraska and Colorado. However, every state in the region is below the U.S. average GDP per capita except for Colorado, so Kansas' competitor states are mostly below average nationally, and generally have slower growth rates than the national average.

The Great Recession arrived a quarter later in Kansas than for the U.S. economy generally, but then hit Kansas harder than most states. Kansas' annualized GDP growth rate was -4.1 percent from Q1 2008 to Q2 2009, compared to a national average of -2.8 percent over the same period. Total nonfarm employment declined from its April 2008 peak by a total of 78,100 jobs, or 5.6 percent, before bottoming out in February 2010. Nonfarm employment finally recovered to Kansas' prerecession April 2008 peak in January 2015.

Kansas is predominantly a non-metropolitan state. The largest Metropolitan Statistical Area (MSA) by far is Kansas City, but significant portions of Kansas City lie in Missouri. The Kansas City MSA's GDP ranks 33rd among U.S. cities, with GDP of $131 billion in 2017. The rest of Kansas' MSAs have a smaller GDP than average among the 383 MSAs recorded by the Bureau of Economic Analysis. However, the average GDP for the MSAs recorded is skewed upwards by megacity MSAs like New York, Los Angeles, and Chicago. The Wichita MSA is Kansas' only other metro area that is in the top half of the 383 MSAs recorded by the Bureau of Economic Analysis, coming in at 79th largest by GDP.

1 U.S. Department of the Interior, *Geographic Centers of the United States*, 1964, https://pubs.usgs.gov/unnumbered/70039437/report.pdf.

Personal income per capita varies significantly between Kansas' metropolitan areas and non-metropolitan areas. Annual per capita income is $10,000 greater in Kansas' metropolitan areas than in non-metropolitan areas as of 2017. This per-capita income gap has been widening over time, from an average per capita differential of $3,300 across the 1970s to a differential of $10,000 per capita in 2017 (in constant dollars). The income gap is likely a contributing factor to the eastward shift in Kansas' population from more rural to more urban areas, and in particular to Kansas City on the state's eastern border. Kansas also faces a net outflow of population for the state as a whole; Kansas has seen net outbound migration every year since 1999. Within the State of Kansas, there is significant migratory flow away from rural counties along with Wyandotte County and Sedgwick County. The lion's share of net migration gains is enjoyed by Johnson County, along with small gains in Leavenworth, Miami, Butler, Linn, and Pottawatomie.

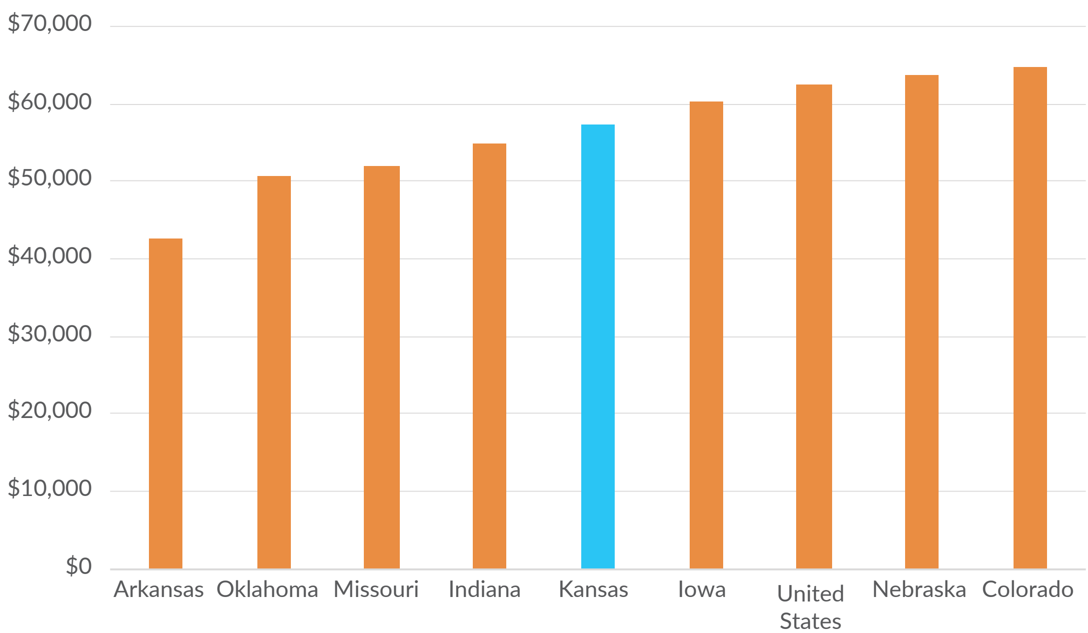
## State Gross Domestic Product (GDP)

Kansas' GDP per capita of $57,373 ranks in the middle among U.S. states at 25th nationally, although it is below the national average of $62,641 in 2018. Kansas outpaces regional competitors Arkansas ($42,498), Oklahoma ($50,716), Missouri ($51,865), and Indiana ($54,799). However, Kansas' per capita GDP trails Nebraska ($63,737) and Colorado ($64,751), as well as the average United States per capita GDP of $62,641 (Figure 1.1).

FIGURE 1.1.

**State Gross Domestic Product per Capita**

*Kansas, Regional Competitors, and the U.S. Average (2018)*




Source: Bureau of Economic Analysis, Regional Economic Accounts, "Gross Domestic Product (GDP) by State"; Bureau of Labor Statistics, "Consumer Price Indexes (All Urban Consumers)."

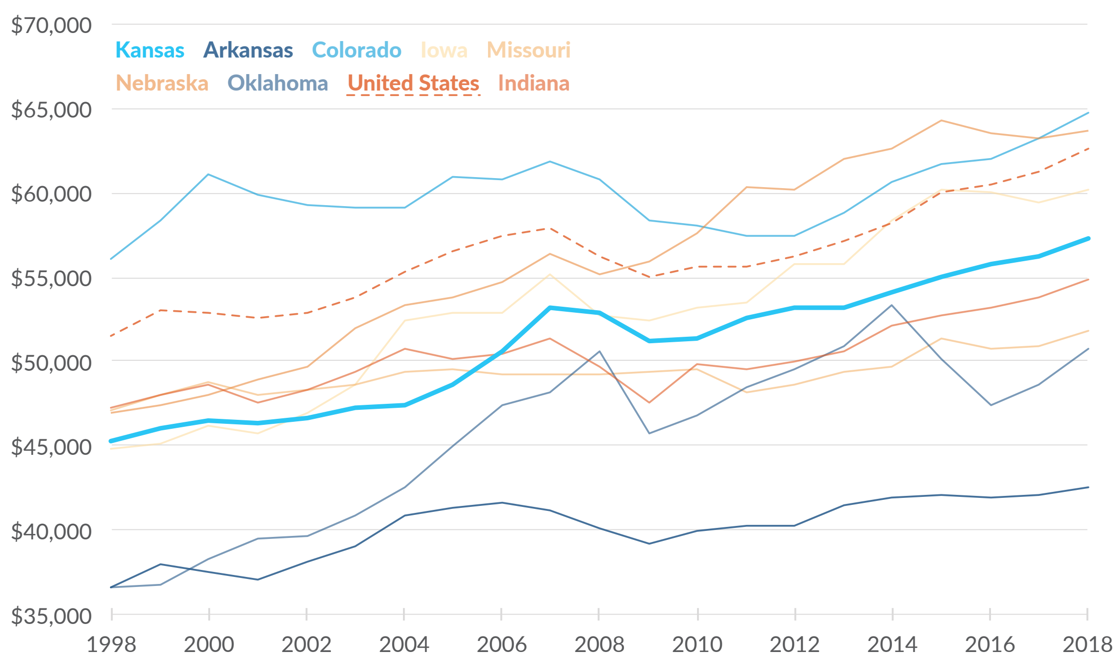
Figure 1.2 shows Kansas' GDP per capita growing steadily over the last two decades. Iowa surpassed Kansas for per capita GDP in 2002 and has increased its advantage over Kansas since then. However, Kansas has avoided both the volatility of energy-dependent Oklahoma and the relative stagnation of Arkansas and Missouri.

Figure 1.3 compares Kansas to the U.S. in annual real GDP growth. Kansas trailed the U.S. in annual real GDP growth in 15 of the past 21 years. For four consecutive years (from 2005-2008), Kansas exceeded the U.S. growth rate, peaking at 3.4 percentage points above the national average in 2007 during the first year of economic downturn. However, Kansas' economy slid into recession soon after the U.S. as a whole did, and 2009 hit Kansas hard. Since recovery, Kansas' growth rate has fairly consistently been below the national average growth rate.

FIGURE 1.2.

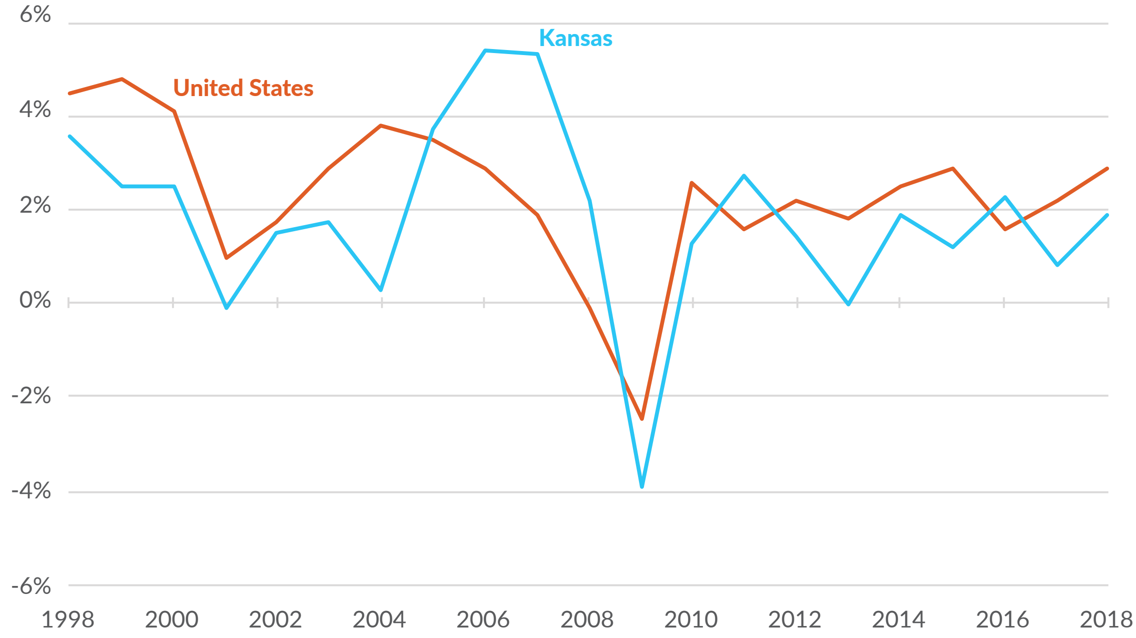
## State Gross Domestic Product per Capita over Time

*Kansas, Regional Competitors, and the U.S. Average (1998-2018, in 2018 Dollars)*




Source: Bureau of Economic Analysis, Regional Economic Accounts, "Gross Domestic Product (GDP) by State"; Bureau of Labor Statistics, "Consumer Price Indexes (All Urban Consumers)."

FIGURE 1.3.
## Annual Percent Change in Real GDP
*Kansas and the U.S. (1998-2018)*




Source: Bureau of Economic Analysis, Regional Economic Accounts, "Gross Domestic Product (GDP) by State."

## Personal Income

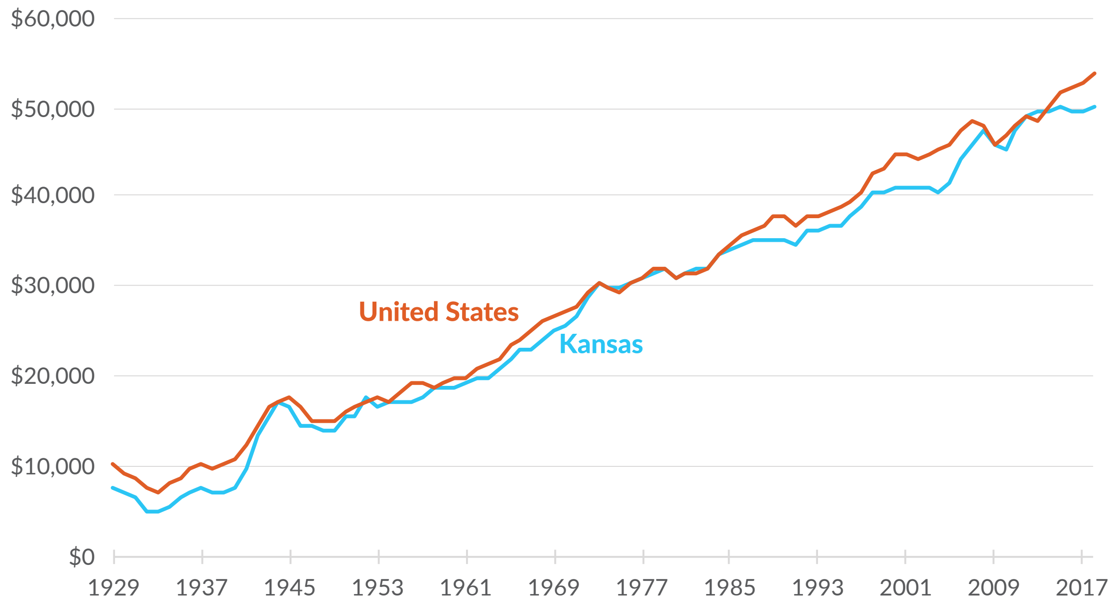
Kansas' personal income per capita has consistently trailed the national average, exceeding the U.S. figure in only seven of the years between 1929 and 2018. Kansas' per capita income gap compared with the broader United States narrowed significantly in the 1970s, then widened in the early 2000s, peaking in 2005 at $4,582 (in 2018 dollars). During the Great Recession, this income gap closed again, and Kansas exceeded the U.S. average in 2012 and 2013. However, in the post-recession era, U.S. per capita income has again begun to pull away from Kansas', with a current per capita income gap of $3,600. (See Figure 1.4.)

Among its regional competitors, Kansas has consistently performed near the middle of the pack for personal income per capita, as shown in Figure 1.5. Kansas' per capita income as a percentage of the U.S. average has closely tracked Nebraska's over the span from 1929 to 2017, though Nebraska has outpaced Kansas in recent years. Kansas caught and surpassed Missouri in the post-World War II era. In every year surveyed, Oklahoma has trailed Kansas in personal income per capita. Since the end of World War II, Kansas per capita income has held steady between 90 and 100 percent of the U.S. personal income per capita, avoiding any major swings in either direction.

FIGURE 1.4.

## Personal Income per Capita

*Kansas and the U.S. (1929-2018, in 2018 dollars)*

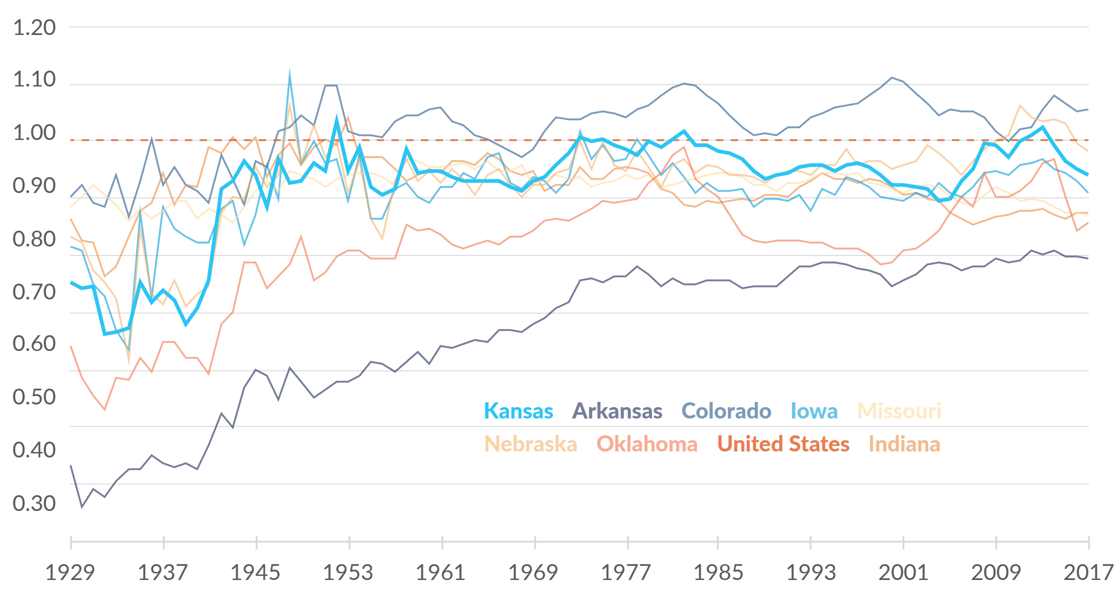



Note: Dollar amounts were adjusted for inflation and expressed in 2018 dollars prior to calculating percentage changes using the Consumer Price

FIGURE 1.5.

## Personal Income Per Capita as a Percentage of U.S. Average

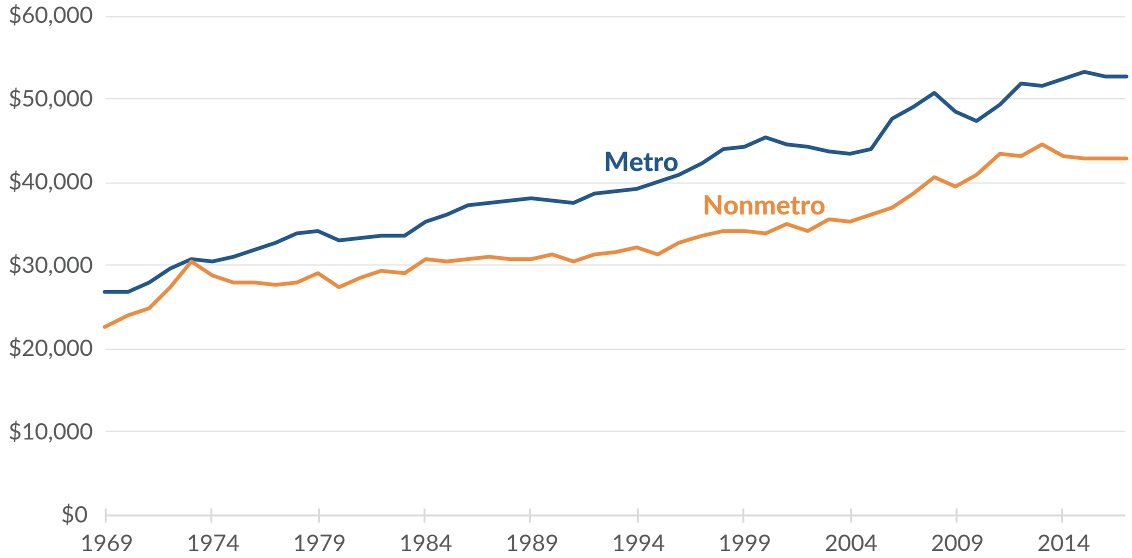
*Kansas, Regional Competitors, and the U.S. (1929-2017)*




Source: Bureau of Economic Analysis, Regional Economic Accounts, "Personal Income Summary: Personal Income, Per Capita Personal Income (Table SA1)."

The gap between metro and nonmetro per capita personal income in Kansas has increased since the early 1970s, when incomes in urban and rural areas last equaled each other. The gap grew widest in 2000 at $11,407 (in 2018 dollars), and the income gap has hovered steadily since 2015 at around $10,000 (also in 2018 dollars), as shown in Figure 1.6. This income differential highlights a potential incentive to move to cities for those Kansas workers who can achieve a high-paid career path in a metropolitan area either in Kansas or outside of Kansas.

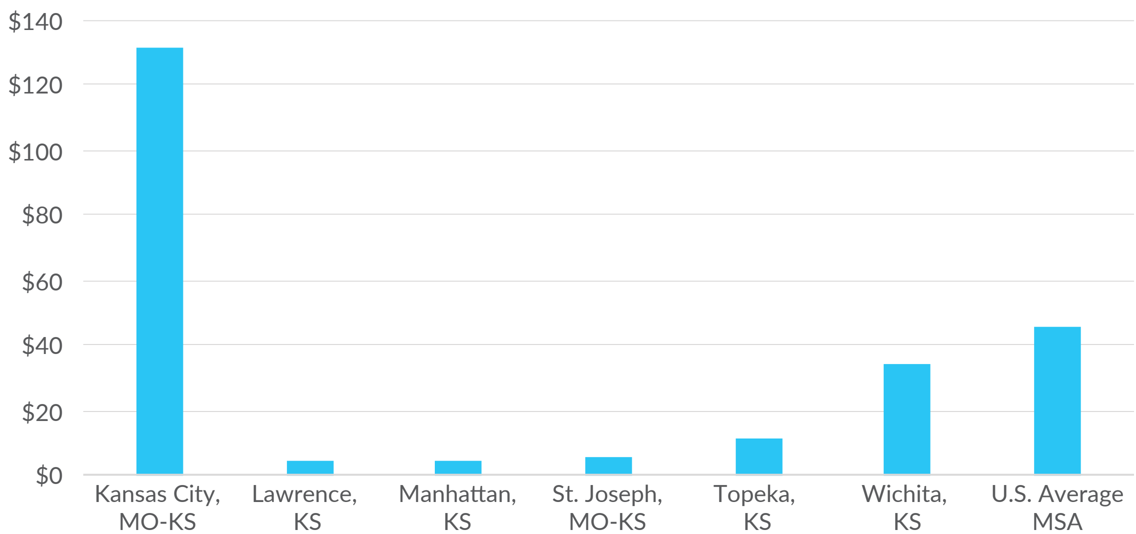
FIGURE 1.6.
## Personal Income per Capita of Metro and Nonmetro Areas
*Kansas, 1968-2017 (2018 dollars)*




Note: Dollar amounts were adjusted for inflation and expressed in 2018 dollars using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics.
Source: Bureau of Economic Analysis, Regional Economic Accounts, Personal Income Summary: "Personal Income, Population, Per Capita Personal Income (Table SAINC1)"; Bureau of Labor Statistics, "Consumer Price Indexes (All Urban Consumers)."

Figure 1.7 compares the GDP of Kansas' Metropolitan Statistical Areas (MSA) as defined by the U.S. Office of Management and Budget (OMB). The Kansas City MSA is 33rd largest in the country and by far the largest MSA in the state, although significant portions of the Kansas City MSA lie in Missouri. All other MSAs in Kansas are smaller than the average of the 383 U.S. MSAs defined by the U.S. OMB. The next largest MSA, Wichita, is the 79th largest in the U.S. with $33.8 billion in GDP. Topeka is 196th at $10.7 billion, Lawrence is 335th at $4.6 billion, and Manhattan is 364th at $3.8 billion. The St. Joseph metro area, which is split between Kansas and Missouri, has the 296th largest metro GDP at $5.6 billion.

FIGURE 1.7.
## Kansas GDP by Metropolitan Statistical Area
*2017 (in billions of 2017 dollars)*

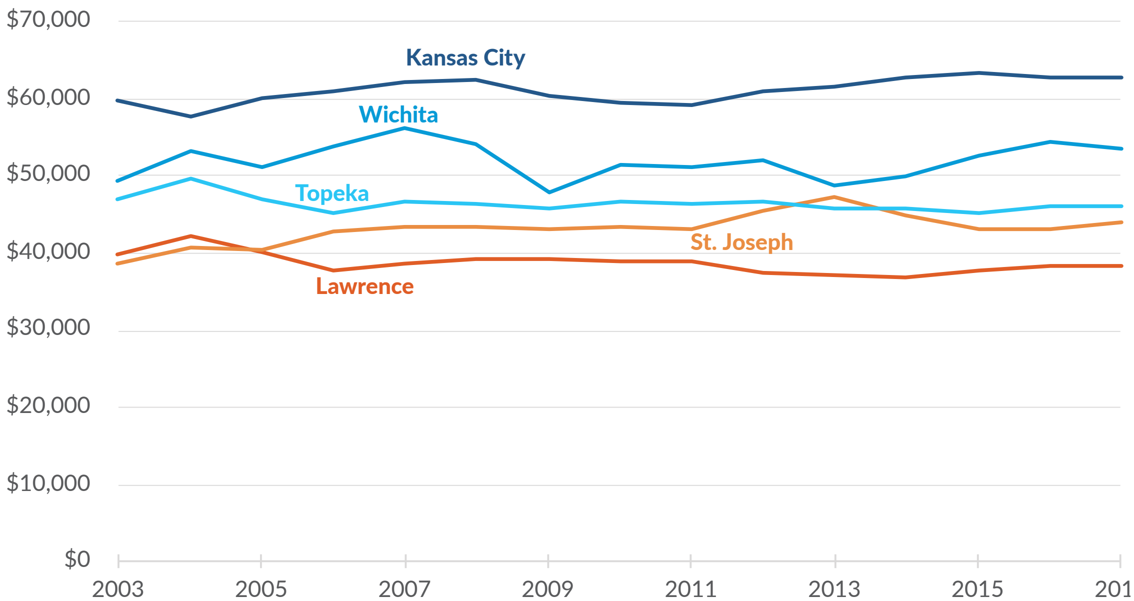



Source: Bureau of Economic Analysis, "Gross Domestic Product by Metropolitan Area, 2017."

For most Kansas MSAs, GDP per capita has remained relatively steady over time; volatility in Wichita's GDP likely reflects volatility associated with Wichita's relatively high dependence on cyclical industries such as manufacturing and energy. Kansas City and Wichita have seen the most significant production gains per person over the last 15 years.

FIGURE 1.8.
**GDP Per Capita by Metropolitan Statistical Area**

*2003-2017 (in 2018 dollars)*




Note: Dollar amounts were manually adjusted for inflation and are expressed in 2018 dollars.
Source: Bureau of Economic Analysis, *Regional Economic Accounts*, "Gross Domestic Product (GDP) by Metropolitan Area."

## Major Industries

According to the Bureau of Economic Analysis, Kansas' largest industries as a share of state GDP in 2017 were (1) finance, insurance, real estate, rental, and leasing (17.6 percent); (2) manufacturing (16.3 percent); (3) government (12.87 percent); (4) professional and business services (10.88 percent); and (5) educational services, health care, and social assistance (8.2 percent).

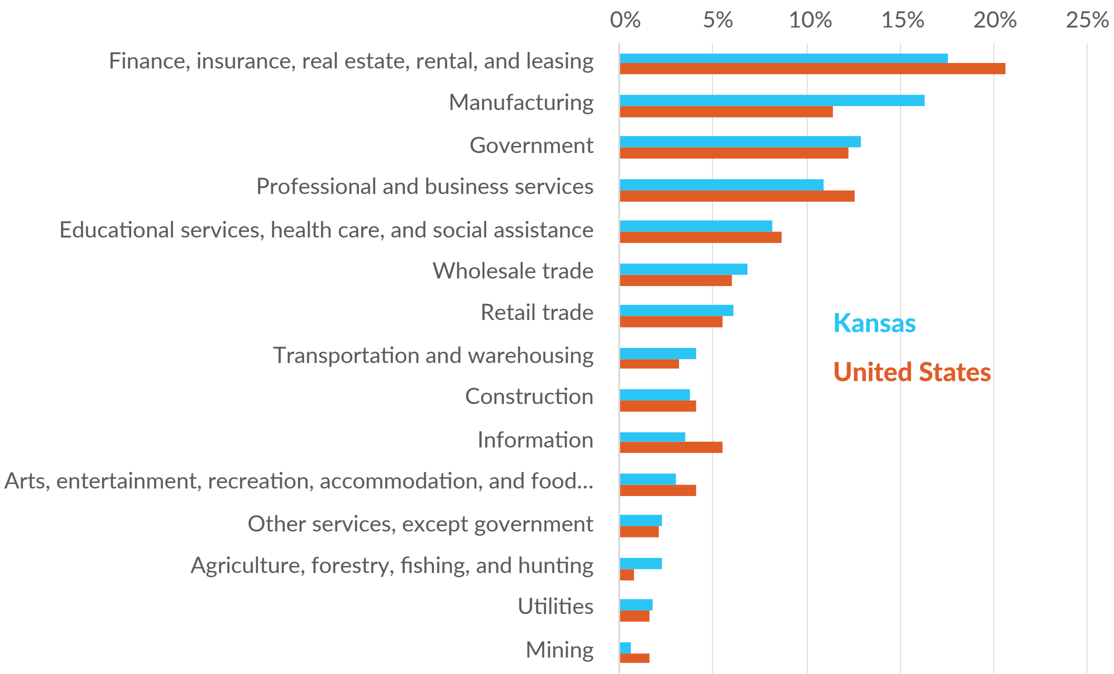
Kansas does not differ greatly from the U.S. as a whole except in a few areas (see Figure 1.9). Kansas' manufacturing sector is noticeably larger than for the U.S. as a portion of GDP, and its information sector is much smaller than the national average. Given the geography of the state, agriculture makes up nearly twice as large a portion of the Kansas economy as it does of the U.S. economy, and mining makes up only about one-third as much in Kansas as the portion for the U.S.

Kansas' three largest economic sectors are finance, insurance, and real estate (17.6 percent); manufacturing (16.3 percent); and government (12.9 percent), as shown in Figure 1.9. Combined, these three sectors make up nearly half the Kansas economy, with finance, insurance, and real estate consistently growing as a portion of Kansas' economy. Professional and business services (10.9 percent) is the only other sector that makes up more than 10 percent of Kansas' economy, and it has also been steadily growing as a portion of the economy, reflecting a longer-term trend towards the service sector. Despite Kansas' reputation as an agricultural state and its agricultural sector being larger than the national average, direct agricultural production (2.2 percent) makes up a relatively small portion of the state's total GDP.

FIGURE 1.9.

## Percentage of Total State GDP by Industry

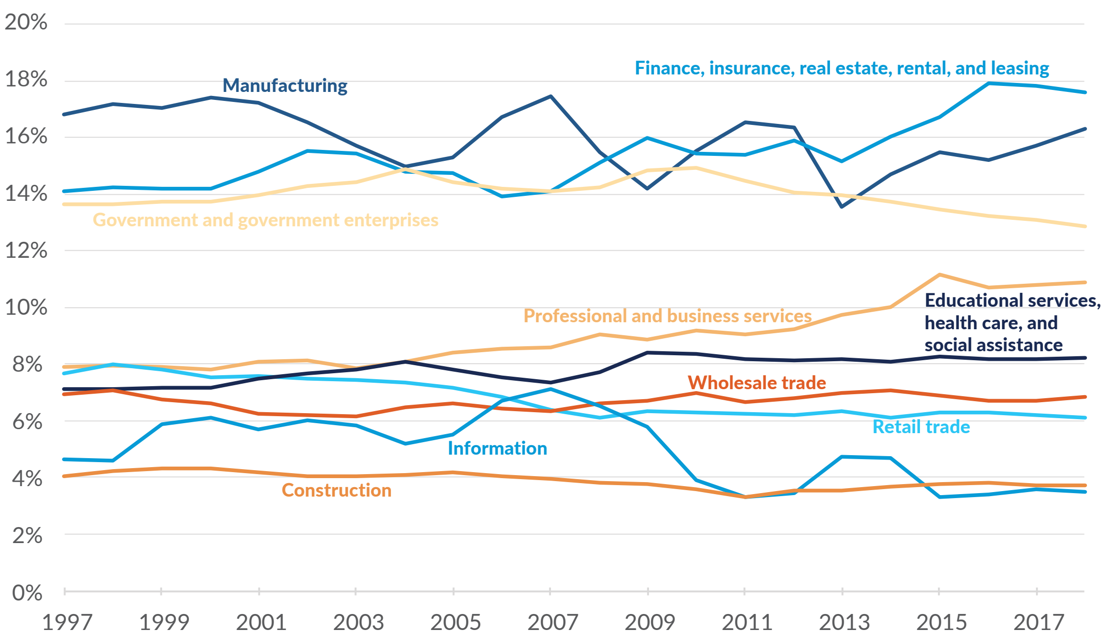
*Kansas and U.S. (2018)*




Source: Bureau of Economic Analysis, Regional Economic Accounts, "Gross Domestic Product (GDP) by State."

FIGURE 1.10.

## Percentage of Total State GDP by Industry (1997-2018)




Source: Bureau of Economic Analysis, Regional Economic Accounts, "Gross Domestic Product (GDP) by State."

## Employment

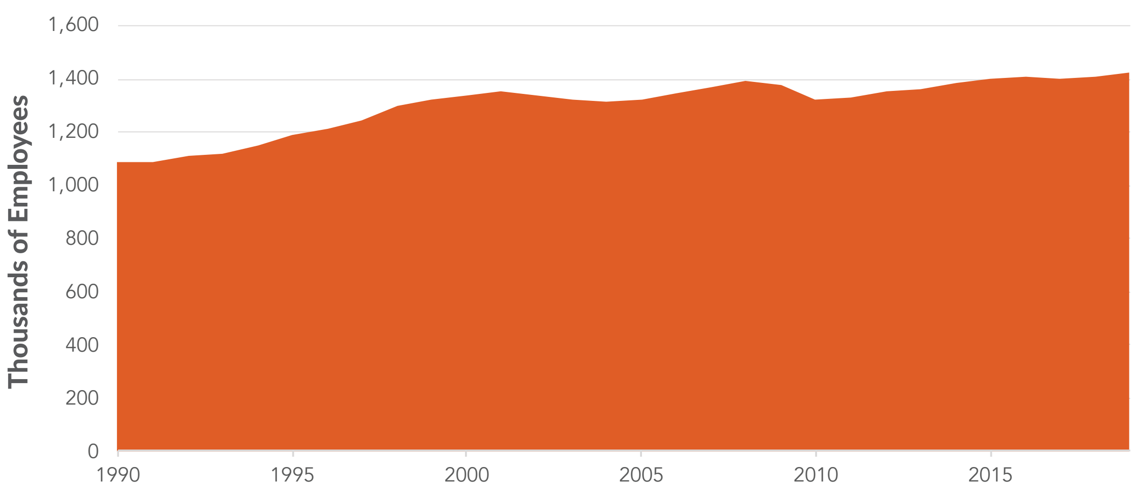
Total nonfarm employment in Kansas rose by 341,000 jobs from 1990 to 2019 (see Figure 1.11). Total nonfarm employment hit a prerecession peak of 1,398,400 in April 2008 before declining to a recession low of 1,320,300 in February 2010. During the recession recovery, employment finally regained April 2008 levels in January 2015. While Kansas has achieved steady growth, Kansas' rate of jobs gains has been below the national average.

A snapshot of employment across Kansas' industries as of June 2019 (Figure 1.12) shows five industries with more than 10 percent of Kansas' total nonfarm employment: trade, transportation, and utilities (19 percent); government (18 percent); education and health services (14 percent); professional and business services (13 percent); and manufacturing (12 percent). No particular industry dominates employment across Kansas' economy.

The types of jobs that make up the components of Kansas' nonfarm employment have evolved over the last three decades. The trade, transportation, and utilities sector has switched roles with government as the top source of employment in Kansas twice, with trade, transportation, and utilities currently leading as Kansas' top employer by sector. Other notable trends are the rise of service sector jobs and the relative decline of manufacturing and construction as sources for Kansas jobs.

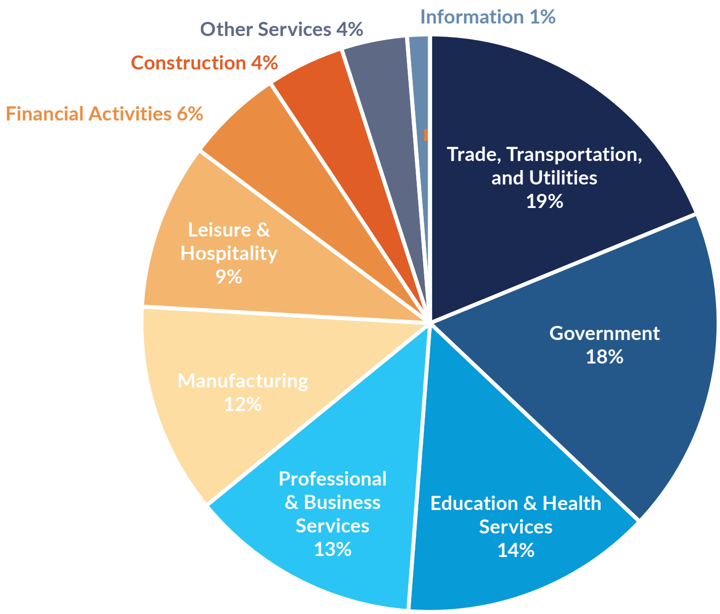
Manufacturing employment was surpassed by both education and health services and professional and business services in the last two decades, leaving the manufacturing sector fifth in terms of total employment by sector. Leisure and hospitality employment have also consistently risen, while construction, by comparison, has been relatively stagnant as a source of jobs. Information has steadily declined over the last two decades, a trend seen in many states as much of the information sector has become digitized, and information employment has been stronger in areas with high concentrations of tech work, such as California.

FIGURE 1.11.
**Total Nonfarm Monthly Employment**
*Kansas (January 1990-June 2019)*



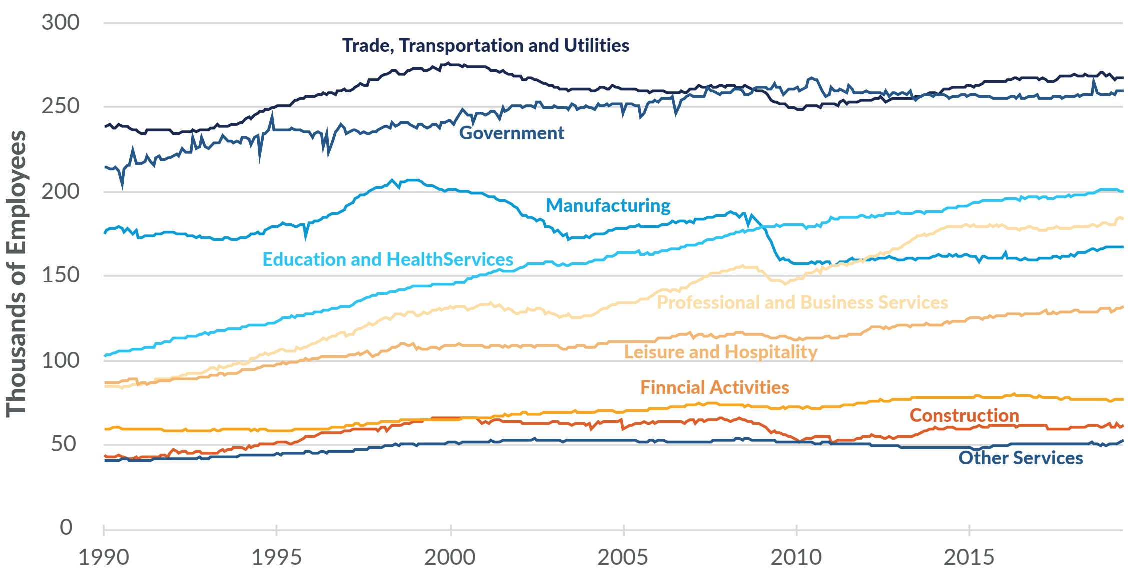

Source: Bureau of Labor Statistics, "All Employees: Total Nonfarm in Kansas."

FIGURE 1.12
## Percent of Total Nonfarm Employment by Industry
*Kansas (June 2019)*




Source: Bureau of Labor Statistics, "Economy at a Glance," Kansas.

FIGURE 1.13.
## Nonfarm Monthly Employment by Industry
*Kansas (January 1990-June 2019)*

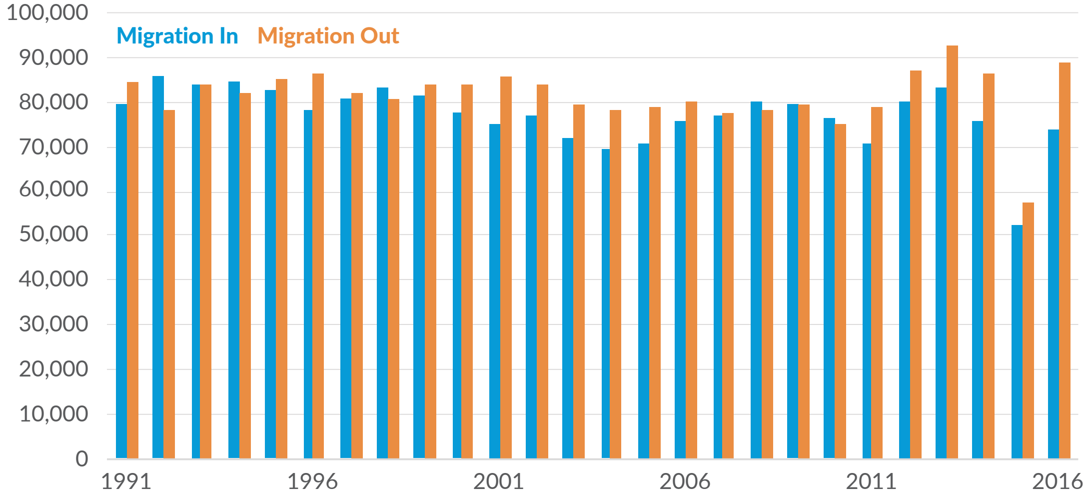



Source: Bureau of Labor Statistics, "State and Area Employment, Hours, and Earnings."

# Population Patterns

One way to evaluate migration between states is to examine the movement of individual federal income tax returns and the exemptions included on those returns between states over time. The Internal Revenue Service's State Migration Data shows the total number of tax returns (filers) and exemptions (people) entering and exiting a state each year based on the change in address for the tax filer. Kansas migration data is presented below in Figure 1.14.

FIGURE 1.14.
## Migration In and Out of Kansas (1991-2016)




Source: Internal Revenue Service: Exemptions from "Statistics of Income Tax Stats - migration Data, 'U.S. Population Migration Data.'"

Between 1991 and 2016, Kansas had consistently seen higher rates of outbound than inbound migration of tax exemptions, as Kansas experienced a net loss of tax exemptions in all years except 1992, 1993, 1994, 1998, and 2008. Kansas saw its largest net loss of tax exemptions in the most recent year of data (2016), with outbound tax exemptions outpacing inbound tax exemptions by more than 20 percent, giving the state a net loss of 15,416 residents due to migration. Since 1991, Kansas has experienced a total net loss of 113,088 residents due to outbound migration.

Kansas had 87,005 people leave the state in tax year 2016, according to IRS tax migration data. Kansas' seven regional competitors chosen for this book, plus nearby Texas, took in 53.5 percent (46,522) of Kansas' out-migrants. Florida (4,114), California (4,052), and Georgia (2,618) each gained at least 3 percent of Kansas emigrants, and the rest of the states gained the remaining 34.1 percent (29,699). (See Figure 1.15.)

Kansas gained 71,759 people from other states in tax year 2016, according to IRS tax migration data. The seven regional competitors chosen for this book, plus nearby Texas, are responsible for 53.7 percent (38,532) of Kansas' in-migration gains. California (4,005) and Florida (2,392) were each responsible for more than 3 percent of Kansas' migration gains, and the rest of the states are responsible for the remaining 37.4 percent (26,830). (See Figure 1.16.)

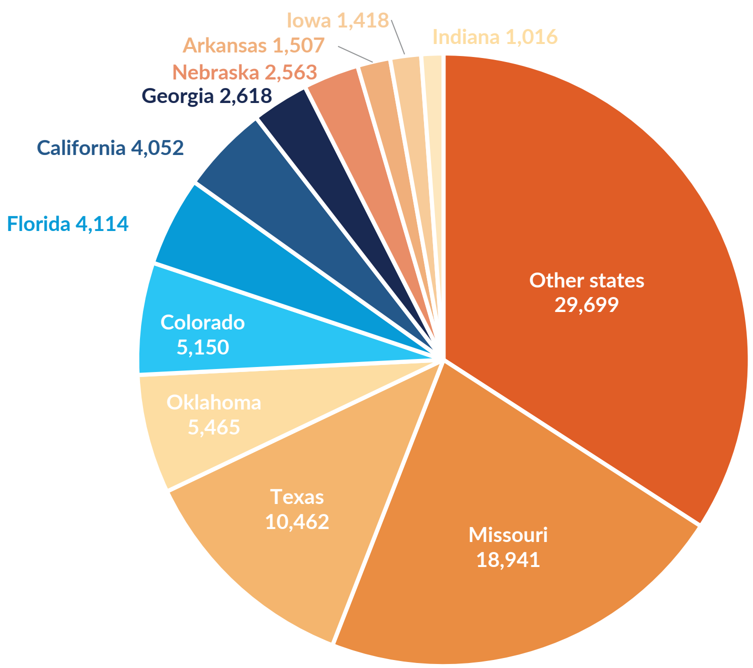
Kansas' 2016 losses (87,005) to other states exceeded its gains (71,759 ) from other states by 15,246 people. Kansas sustained a net loss of 5,308 people with the seven regional competitors chosen for this book, and had a net loss of people with each of those seven states individually.

Kansas' number of live births has been declining over the last decade (see Figure 1.17). Fewer live births and a net outflow of people to other states combine to limit Kansas' population growth. Between 1998 and 2007, the number of live births in Kansas climbed, peaking at 42,004 in 2007. Following the peak, the annual number of live births has steadily declined and has fallen below the 1998 number of live births, bottoming out at 36,519 live births in 2017. Slow population growth will limit the rate of Kansas' broader economic growth.



FIGURE 1.15.

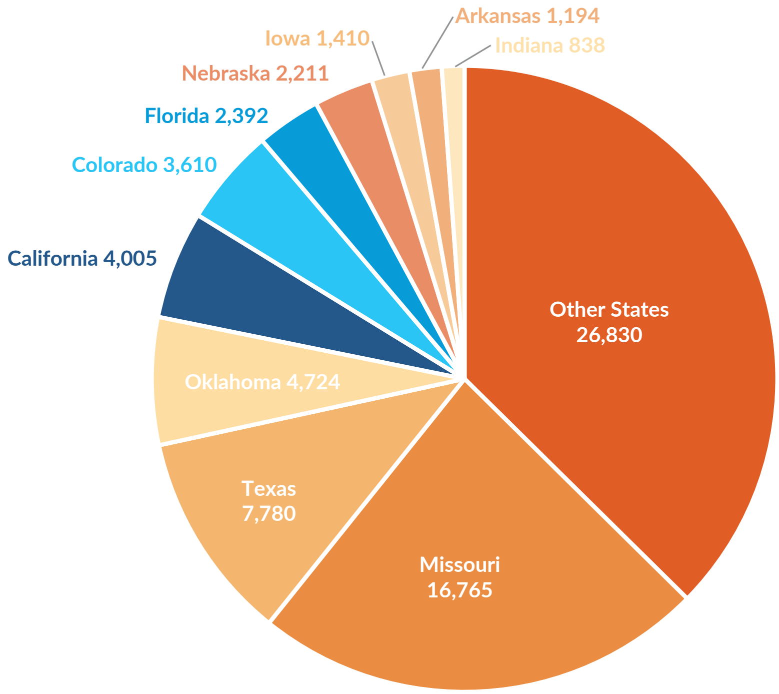
## Kansas Out-Migration by Destination State (2016)




Source: Internal Revenue Service: Exemptions from "Statistics of Income Tax Stats - Migration Data, 'U.S. Population Migration Data.'"

FIGURE 1.16.

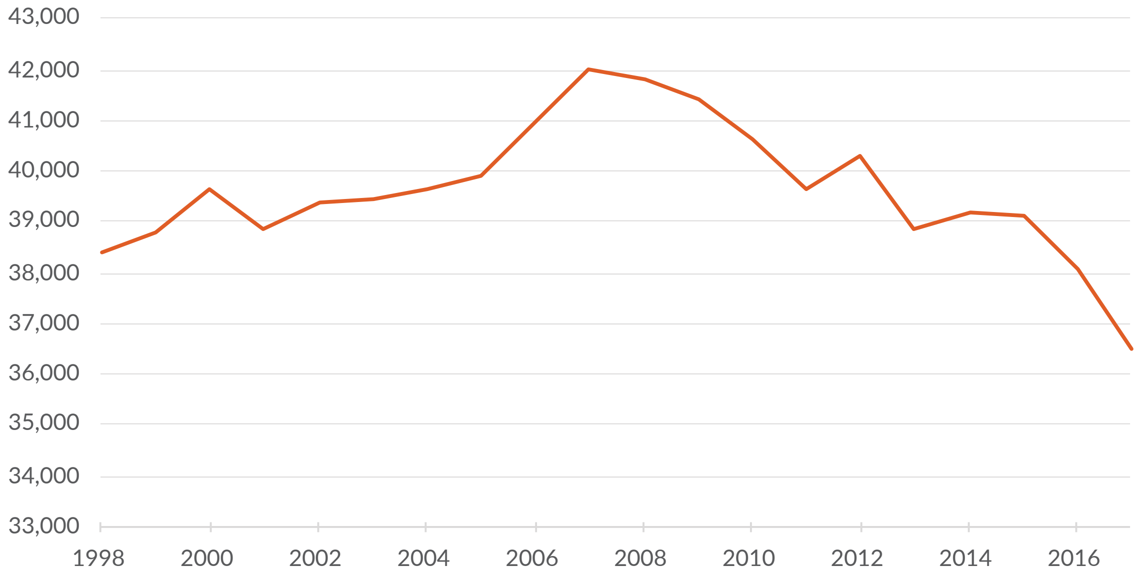
## Kansas In-Migration by Source State (2016)




Source: Internal Revenue Service: Exemptions from "Statistics of Income Tax Stats - Migration Data, "U.S. Population Migration Data.""

FIGURE 1.17.

## Number of Live Births in Kansas (1998-2017)



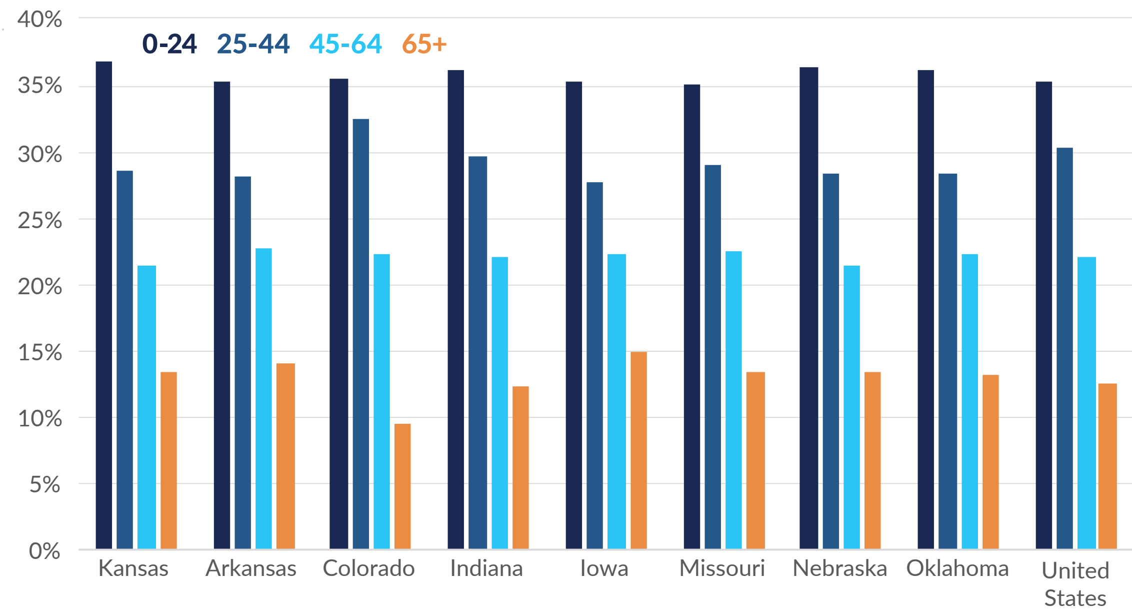

Kansas' population has been aging since the turn of the century, a normal phenomenon across states, and in particular across the Midwest and the Plains. In both 2000 and 2017, Kansas closely mirrored the U.S. in each of the four age strata, as displayed in Figures 1.18 and 1.19. Kansas' share of the population greater than age 65 has increased significantly since the turn of the century, as has occurred in the U.S. generally and among Kansas' regional peers in particular. Kansas is trending in the direction of having proportionately fewer young people and proportionately more senior citizens and retirees.

Kansas' demographic trends and migratory trends create meaningful though not overwhelming economic headwinds, ones shared by some peer states. However, it is noteworthy that Kansas is sustaining net migration losses with all seven competitive peers chosen for this book. Kansas' economic, income, and population growth have been below average for the country. These factors make it that much more critical that policymakers focus on policies that will help enhance economic growth and attract more job creation and population.

FIGURE 1.18.

## Age Groups as a Percentage of Total Population (2000)

*Kansas, Regional Competitors, and the U.S. (2000 and 2017)*

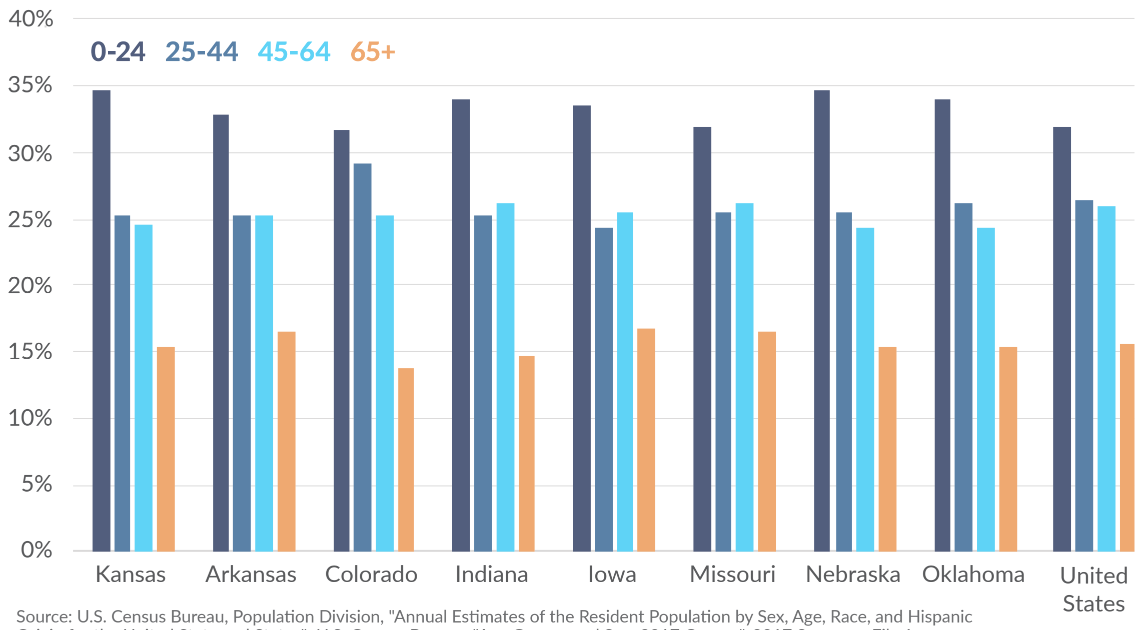



Source: U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population by Sex, Age, Race, and Hispanic Origin for the United State and States"; U.S. Census Bureau; "Age Groups and Sex: 2000 Census," 2000 Summary File 1.

FIGURE 1.19.

## Age Groups as a Percentage of Total Population (2017)

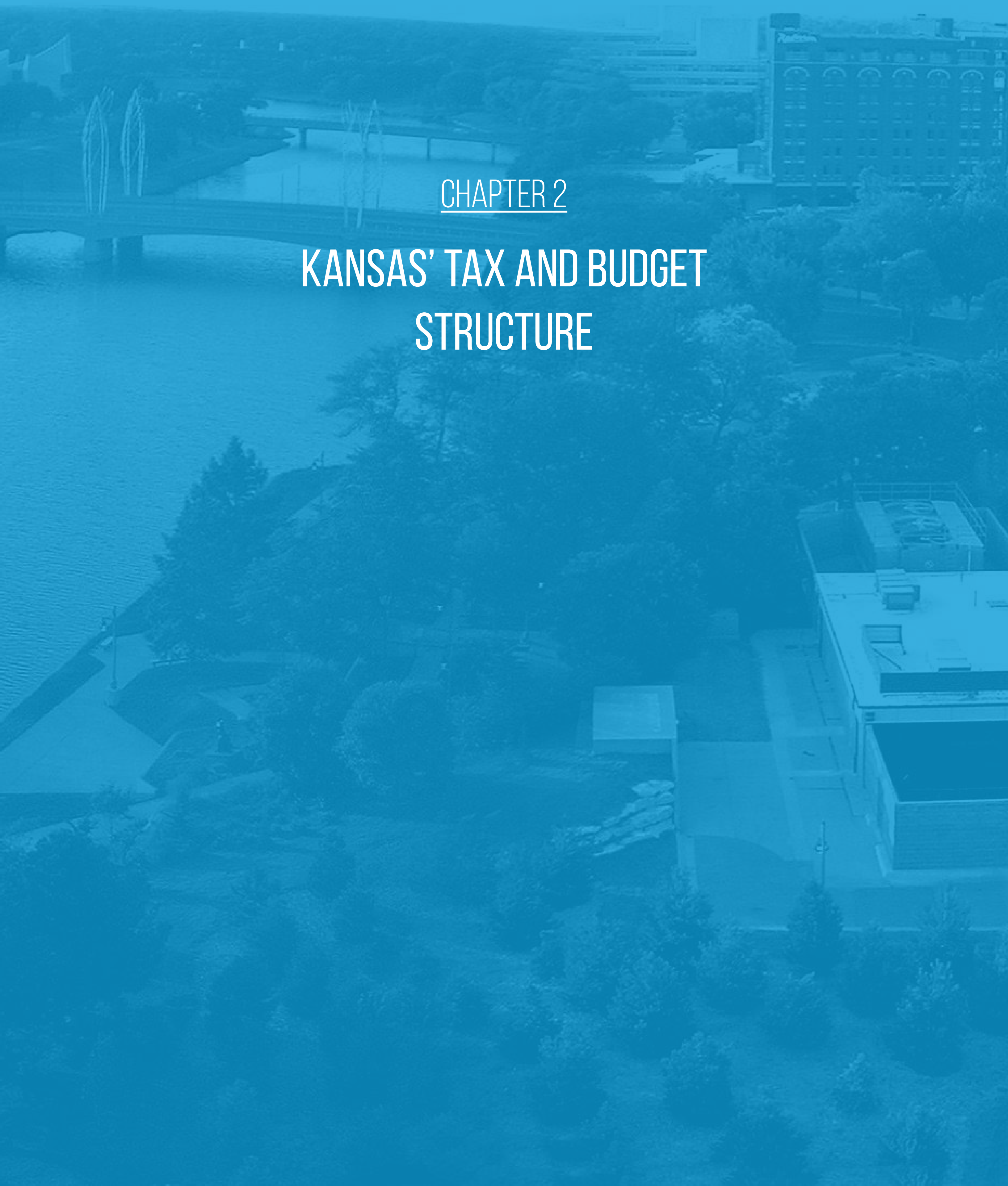
*Kansas, Regional Competitors, and the U.S. (2000 and 2017)*




Source: U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population by Sex, Age, Race, and Hispanic Origin for the United State and States"; U.S. Census Bureau; "Age Groups and Sex: 2017 Census", 2017 Summary File 1.

CHAPTER 2

# KANSAS' TAX AND BUDGET STRUCTURE



## Introduction

Both taxes and spending in Kansas have grown faster than inflation and population for the past two decades, even after taking into account tax cuts which, beginning in 2012, resulted in steep reductions in individual income tax collections. Revenue for Kansas government comes from many sources, including the federal government. However, much of Kansas' revenue must come from the state's own system of taxation, which has struggled to keep pace with the level of budgetary expenditures until recently. The design of Kansas' system of taxation, which raises the revenues for government operations and programs, is the focus of this book.

Subsequent chapters will examine each major tax type—individual and corporate income taxes, sales taxes, property taxes, and more—in turn. But first, this chapter provides a brief overview of the tax system as a whole, providing a framework for what follows. It also examines the state's performance on our *State Business Tax Climate Index*, a measure of tax structure. The *Index* considers the competitiveness of both the overall code and the *Index*'s constituent components (corporate, individual, sales, property, and unemployment insurance taxes). Following an overview of the state's budget and tax structure, this book will dive into the current code, highlighting uncompetitive policies and offering recommendations for improvement.

## Recent Tax and Spending Policies

State tax collections rose 35 percent in real terms between 2000 and 2017, but state spending grew almost twice as fast, increasing 69 percent. A sizable share of the spending increase, in Kansas and other states, has been non-general fund spending (like Medicaid) substantially funded by federal transfers, and augmented by investment returns. At times, however, Kansas has been forced to dip into reserve funds or otherwise engage in creative accounting to achieve balanced budgets.[2]

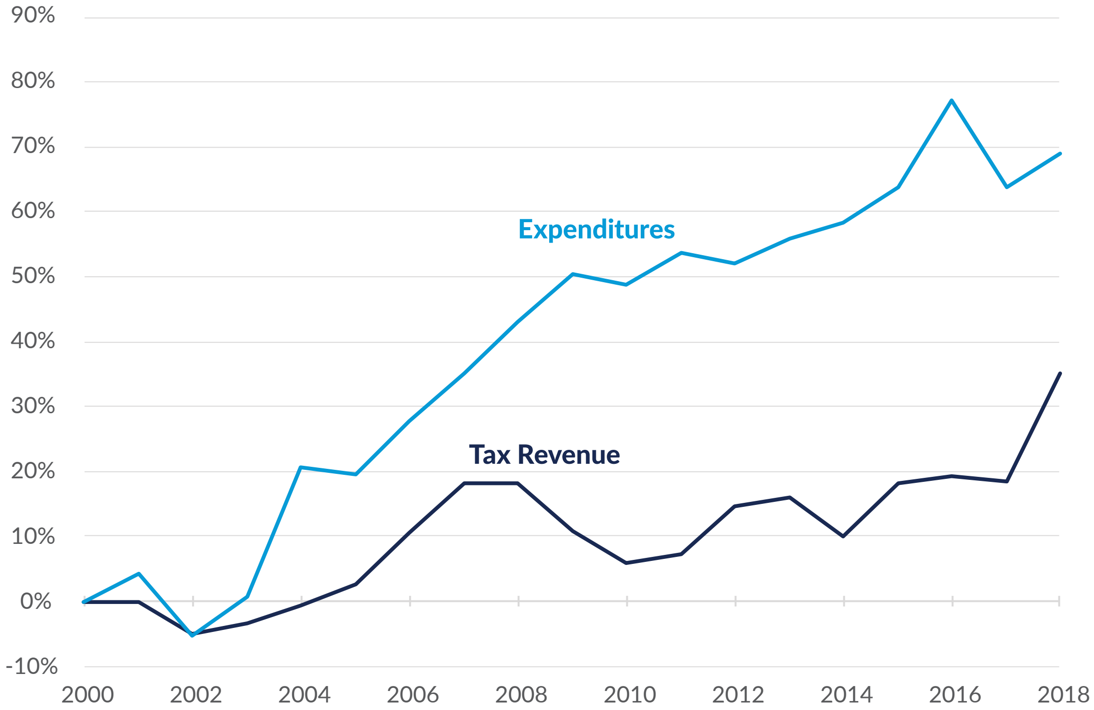
The Great Recession caused a slide in tax collections in Kansas and across the country, and the state did not return to prerecession tax collections (in real terms) until 2015. The largest year-over-year increase came in 2018, when Kansas saw a $1.19 billion increase, the result of tax increases intended to reverse some of the reductions made in prior years.

Structurally unbalanced tax cuts beginning in 2012 contributed to the yawning gap between spending and revenue rates of growth but did not inaugurate it. Rising spending on education, social services, and pensions plays a role here as in other states, but due to a series of school finance cases, primary and secondary education have emerged as particularly notable budget drivers.

2 U.S. Census Bureau, "Annual Survey of State Government Finances," 2017, https://www.census.gov/programs-surveys/state.html.

**FIGURE 2.1.**

## Inflation-Adjusted Growth of Spending and Tax Revenue Since 2000




Source: U.S. Census Bureau, "Annual Survey of State Government Finances."

The 2012 tax cuts and subsequent 2017 offsets and reversals are treated in the individual income and sales tax chapters. They were notable, however, both for their unbalanced nature—significant rate reductions absent offsetting revenue increases or spending cuts elsewhere—and an unusual provision, since repealed, which exempted pass-through business income from taxation. These rate cuts, as well as subsequent increases in income and sales tax rates in partial reversal of the prior reductions, are visible in Figure 2.1, above. Significantly, state expenditures continued to rise initially, despite cuts to some budget areas, followed later by a sharp course correction, reducing expenditures due to budgetary pressures.

Primary and secondary education are the largest expenditure category in Kansas' budget, and all told, education expenditures account for 63 percent of the general fund budget. Human services is next, at 11 percent of total expenditures (26 percent of general fund dollars).[3]

3 State of Kansas, "FY 2020 Budget Comparison Report," 2019, 99-102, https://budget.kansas.gov/wp-content/uploads/FY2020_Comparison_Report-7-10-2019.pdf.

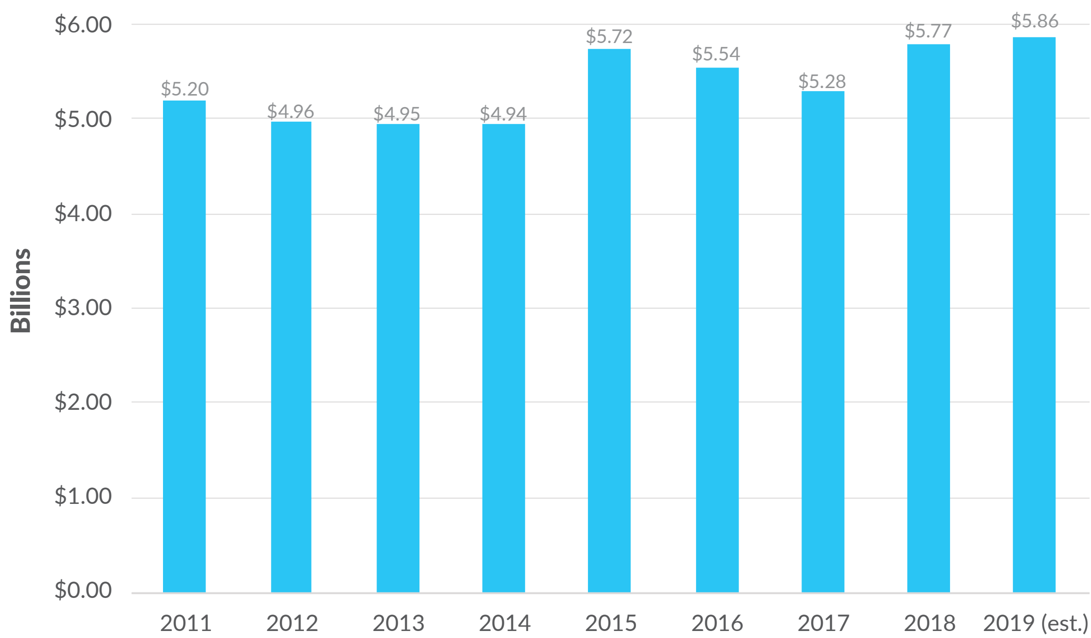
## School Funding Litigation and the State Budget

In recent years, education spending has driven much of the increase in Kansas' budget, increasing by almost a billion dollars in real (inflation-adjusted) terms since its low ebb (about $4.9 billion, including both current operating and capital expenditures) in fiscal year 2014. During that period, state primary and secondary education spending grew more than three times as fast as non-education spending.[4]

**FIGURE 2.2.**

### State Education Spending

*2011-Present (2018 Dollars)*




Source: Kansas Department of Administration.

Although most states enhanced their education budgets during this period, the acceleration of state education funding is largely a product of a series of court cases going back to 2002, and particularly to multiple iterations of one specific case, *Gannon v. Kansas*, that has been before the courts continuously for nearly a decade.

Kansas' state constitution provides that "[t]he legislature shall provide for intellectual, educational, vocational and scientific improvement by establishing and maintaining public schools, educational institutions and related activities," and stipulates that "[t]he legislature shall make suitable provision for finance of the educational interests of the state."[5] It is this latter provision, mandating "suitable provision," that lies at the heart of recent judicial involvement in school finance.

In Kansas and throughout the country, school funding litigation tends to address one or both of two distinct though sometimes entwined issues: equity and adequacy. The former is an equal protection claim, arguing that a given distribution of education funds is uneven

4 Id., multiple years. Note that these totals include so-called "non-expense items," such as transfers, loans, advances, and investments, that are inherently off-budget. The approved budget contains $4.18 billion in general fund aid for K-12 education for fiscal year 2020.

5 Kan. Const. art. VI, § 6.

and discriminatory, regardless of whether each district's funding is sufficient in its own right. The latter, adequacy, is based on the contention that state constitutions like Kansas' vest states with an affirmative duty to fund education to an adequate standard. At various times, the courts have ruled against Kansas on both grounds, though more recently, adequacy has been the prevailing concern.[6]

The first major school finance litigation in Kansas dates to 1972, to which legislators responded by adopting the School District Equalization Act. In the face of further legal challenges, this was supplanted by the School District Finance and Quality Performance Act (SDFQPA), which itself was initially upheld but later found unconstitutional in 2005, in the second of four decisions in the *Montoy v. State* case.[7] A subsequent series of cases, *Gannon v. Kansas*, began in 2010, with the state supreme court intervening again in 2014.[8]

Although adequacy was argued in *Montoy*, it was in *Gannon* that the state supreme court first addressed whether adequacy challenges were justiciable—that is, something the court had the authority to address, since separation of powers generally argues against involvement in what are often considered "political questions," particularly those related to funding levels. In the first *Gannon* ruling, the court concluded that adequacy was a question legitimately before the court, found against the state on those grounds, and adopted a seven-part test for what constituted adequate funding.[9]

The *Gannon* litigation remains with the state to this day, with a seventh ruling in June 2019 finding that the most recent funding increases met adequacy standards, though the high court retains the case and will continue to monitor spending for the present.[10] Along the way, the courts have overturned or superseded multiple state funding systems, prompted several rounds of appropriations increases, and even stipulated a necessary funding amount. State funding of education was only in substantial compliance with court determinations for three years between 2002 and 2018.[11]

School finance litigation exists in many states, but it is fair to say that the court decisions in Kansas have been unusually impactful. Critics have argued that the adequacy test violates separation of powers by encroaching on the legislative branch's power of the purse, particularly given the relatively constrained constitutional language ("suitable provision").[12] Proponents see a political system that has failed to prioritize education confronted by a constitutional system designed to require it. What is a near certainty is that education costs will continue to rise, spurred at least in part by the continued supervision of the judicial branch. This is not a tax issue as such, but it is a reality of budgeting in Kansas.

## Kansas' Current Budget Makeup

6 Richard E. Levy, "Gunfight at the K-12 Corral: Legislative vs. Judicial Power in the Kansas School Finance Litigation," *University of Kansas Law Review* 54 (2006), 1030-1031.
7 *Montoy v. State* ["*Montoy II*"], 278 Kan. 769, 102 P.3d 1160 (2005).
8 Robert Hoeven, "Kansas Public School Funding: Problems and Possible Solutions," *UMKC Law Review* 87:2 (2018), 412.
9 Alexandra Rose, "For the Kids: A Place for Equity in Kansas School Finance Litigation," *Kansas Law Review* 63:5 (2015), 1207.
10 Associated Press, "Kansas Supreme Court Signs Off on Increased Education Spending," June 14, 2019.
11 Hoeven, "Kansas Public School Funding: Problems and Possible Solutions," 433.
12 Rose, "For the Kids: A Place for Equity in Kansas School Finance Litigation," 1207.

Kansas derives 19 percent of its revenue from federal transfers, generating the remaining 81 percent from its own sources, of which taxes comprise the largest share, responsible for 38 percent of all state revenue. The remainder comes from fees, fines, tuition, insurance trust revenue, and other nontax revenue sources. Additionally, at 19 percent of state revenues, Kansas' "current charge"—essentially, fee—revenue has an outsized role in revenue generation, vastly exceeding the 9 percent national average for fees as a portion of state revenue. Nationally, intergovernmental transfers tend to be worth more and fees and fines less. Taxes account for 46 percent of Kansas' general revenue (excluding trust revenue), compared to a national average of 48 percent.[13]

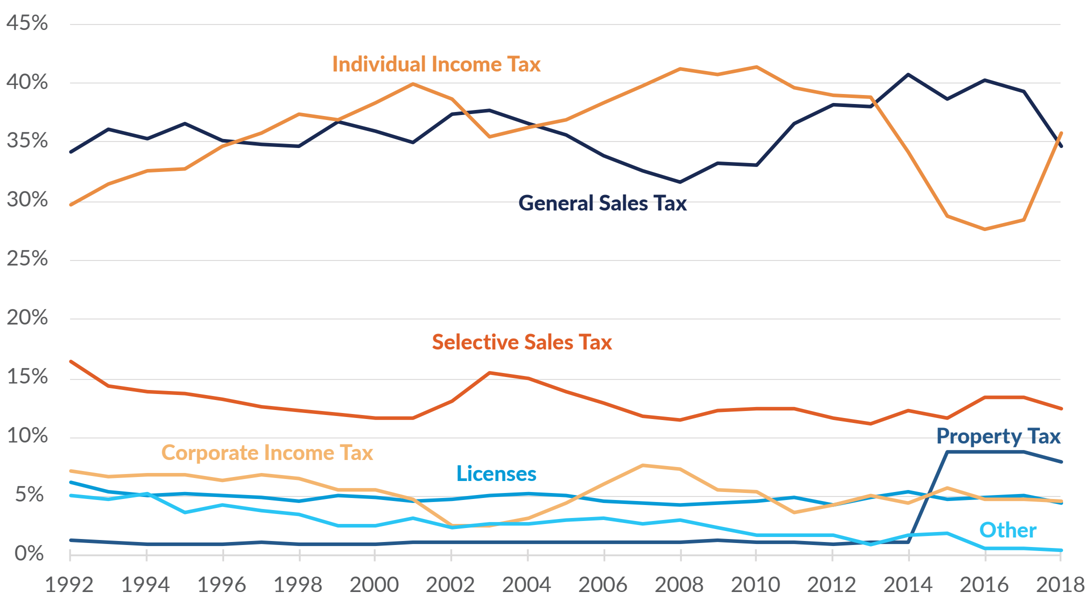
Within Kansas' state tax system, the individual income and sales taxes are the most significant revenue sources, generating 36 and 35 percent of state tax collections respectively in 2018. The income tax dropped below 28 percent of collections in 2015, with the sales tax maxing out above 40 percent, due to income tax rate reductions. Recent income tax rate increases have restored the income tax to levels at—and likely soon measurably above—sales tax collections. Sales tax revenue as a portion of state revenues can be expected to decline over time due to an eroding sales tax base.[14]

**FIGURE 2.3.**

Figure 2.4 compares year-over-year changes in revenue collections for individual income,

**Kansas State Tax Collections as a Percentage of the Total**

*1992-2018*

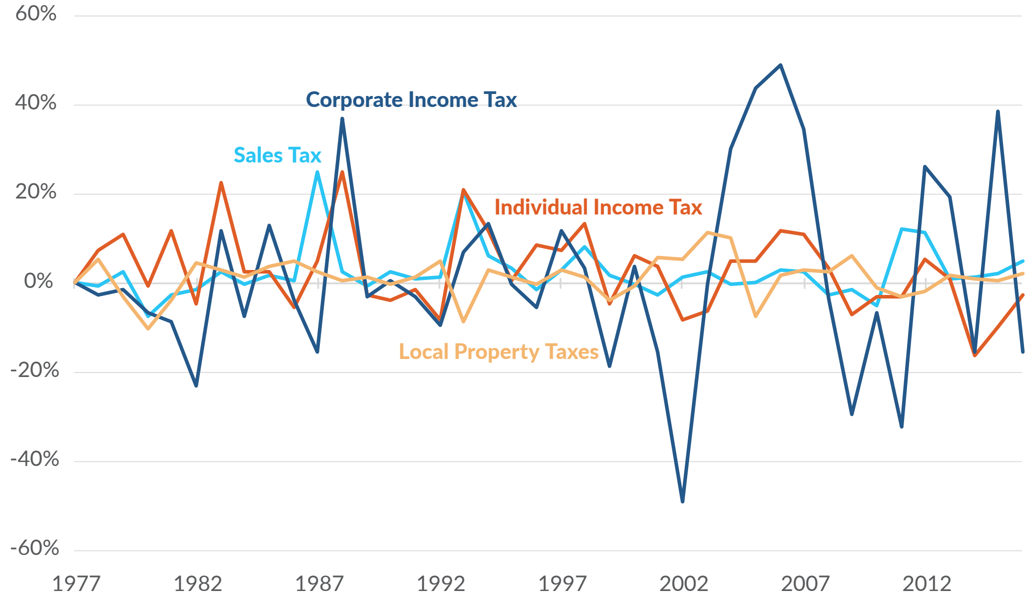



Source: U.S. Census Bureau, "Annual Survey of State Government Tax Collections," multiple years.

corporate income, sales, and—for sake of comparison—local property taxes.[15] The volatility of the corporate income tax is apparent immediately. While all taxes can be volatile, the corporate income tax is particularly so.

13 U.S. Census Bureau, "Annual Survey of State Government Finances," 2017.
14 Id.; "Annual Survey of State Government Tax Collections," 2018, https://www.census.gov/programs-surveys/stc.html.
15 Id.; "Annual Survey of State Government Finances," multiple years.

**FIGURE 2.4.**
## Volatility of Major Taxes




Sources: U.S. Census Bureau, "State and Local Government Finances"; "Consumer Price Indexes (All Urban Consumers)."

# Measure of State Tax Competitiveness

Tax reform can improve the budgeting process, making it easier, more stable, and more consistent. Tax reform can also reduce compliance costs for both individuals and businesses. Most importantly, though, tax reform can improve a state's competitiveness and thus enhance economic and income growth.

The structure of the tax code and the total burden of taxation both matter. In other words the *how* and *how much* of taxation are both critical issues for policymakers to consider. While tax burdens are an important consideration for competitiveness, it is also important to consider how those taxes are paid. Taxes vary significantly, with certain levies more harmful to growth, or more cumbersome in their compliance costs.

The Tax Foundation's *State Business Tax Climate Index* evaluates states on the basis of tax structure across more than 100 variables. We break down each state's tax code across five components: corporate income, individual income, sales and excise, property and wealth, and unemployment insurance taxes.

**TABLE 2.1.**
**Kansas' *State Business Tax Climate Index* Component Ranks**

| | |
|---|---|
| Overall | 34th |
| Corporate Income | 35th |
| Individual Income | 23rd |
| Sales and Excise | 38th |
| Property and Wealth | 20th |
| Unemployment Insurance | 14th |

Source: Tax Foundation, *2020 State Business Tax Climate Index*.

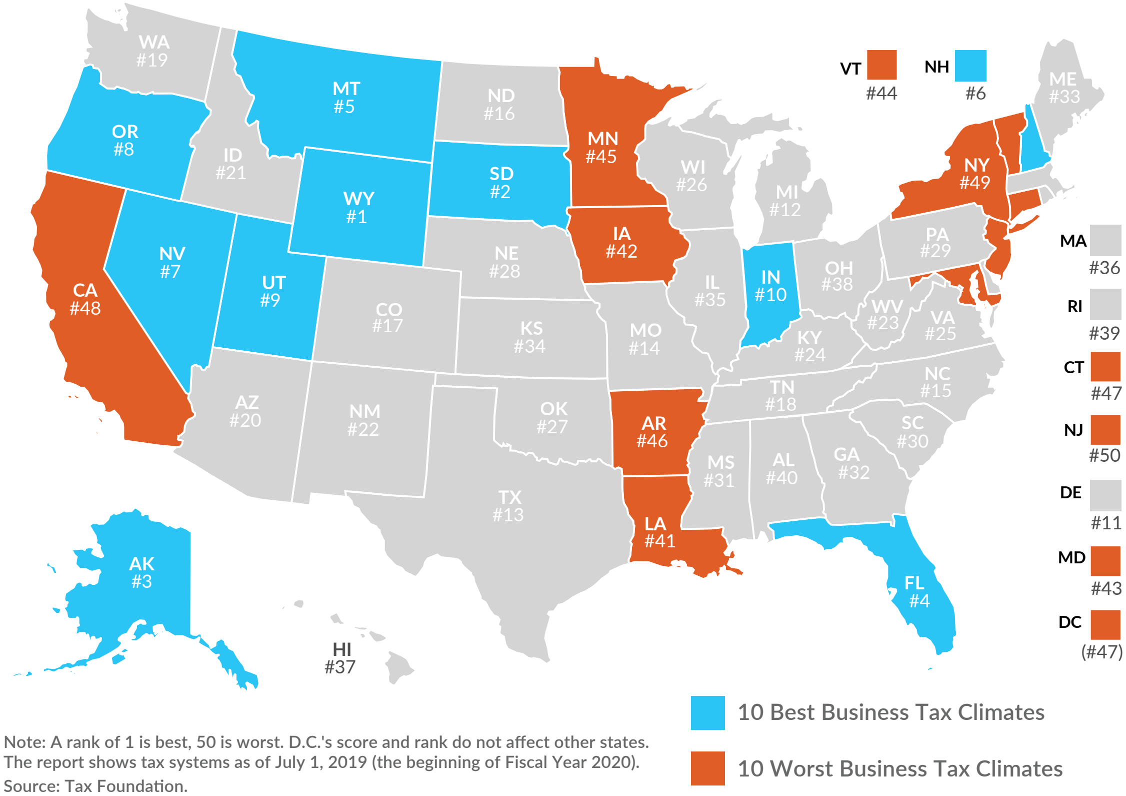
Kansas' overall tax structure ranking of 34th leaves much to be desired. The state's graduated-rate corporate income tax, in particular, is structurally flawed, weighed down by provisions which inaccurately measure taxable income and can lead to excessive tax liability and perverse economic incentives for some firms. Kansas' sales tax is increasingly misaligned with the modern economy, and the state's approach to taxing remote sales is legally fraught. The individual income tax lacks inflation indexing and other features common to many of Kansas' peers.

Tax reform is about improving these shortcomings so that Kansas can collect the revenue necessary for government services while maintaining a competitive position that allows the state's economy to grow. By broadening tax bases and lowering tax rates, the state can have a meaningful impact on Kansans' quality of life.

Throughout this book, we will compare Kansas to states that are regional competitors, as well as the country as a whole. Occasionally we will focus on neighboring states, but more frequently, the states chosen as peers for purposes of comparison are Arkansas, Colorado, Indiana, Iowa, Missouri, Nebraska, and Oklahoma.

**FIGURE 2.5.**

## *2020 State Business Tax Climate Index*




Note: A rank of 1 is best, 50 is worst. D.C.'s score and rank do not affect other states. The report shows tax systems as of July 1, 2019 (the beginning of Fiscal Year 2020).
Source: Tax Foundation.

CHAPTER 3

# CORPORATE INCOME TAXES

# Introduction

Outside of Kansas, Alf Landon, to the extent that he is remembered, is regarded as a statesman who, though a lackluster and at times indifferent campaigner in his presidential bid against incumbent Franklin D. Roosevelt in 1936, proved a force to be reckoned with in securing support for American entrance into World War II, and of finishing the job with the Marshall Plan after the war's conclusion. He was the governor who couldn't even carry his own state in his presidential bid, winning just Maine and Vermont—but he was also the man who poured his soul into unifying the nation behind the Allied cause.

Landon was not the best salesman for Alf Landon, candidate. But he was a magnificent salesman for causes he cared about, and before he toiled to ensure broad bipartisan support for U.S. intervention in World War II, he set his sights on something closer to home: modernizing Kansas' tax code by replacing state property taxation with both individual and corporate income taxes, while economizing to limit the need for new taxes. In the 1932 election, the voters chose Landon for governor and ratified an amendment granting the legislature the authority to impose taxes on both individual and corporate income. The era of Kansas income taxation had begun.[16]

Its origins were earlier, but not much earlier. Kansas had embraced the Populist movement early and with gusto, but its populist reformers, even once possessed of legislative majorities, were preoccupied with federal tax changes, not state ones. The state's first income tax proposal was advanced by Henry Allen, a Republican governor and newspaper owner who learned of his nomination for the office by reading a Paris newspaper while abroad. His mantle was picked up by Gov. Jonathan Davis, a Democrat, who advanced the issue no further than Allen.[17]

In 1928, Republican Clyde Reed won the governor's mansion campaigning on an income tax, but the voters evidently liked Reed better than income taxes and defeated a constitutional amendment that would have authorized income taxation. It was not until 1932, during the governorship of Democrat Harry Woodring, that voters gave their authorization, and when they did, they turned out Woodring in a bizarre three-way election and bestowed the income tax mandate on Landon, who wasted no time getting to work.

On the second day of the 1933 legislative session, Landon outlined his income tax proposal, urging the legislature to make use of the authorization granted them by the voters, but emphasizing his belief that revenues should be used to support a reduction in statewide property taxes. The legislature delivered, though not until the last day of the session, when lawmakers sent Landon a package with a graduated individual income tax and a corporate net income tax of 2 percent.[18] The simple, low-rate system they created lasted decades—but over time, the code has grown more complex, as has the world in which it operates.

16 Peter Fearon, "Taxation, Spending, and Budgets: Public Finance in Kansas During the Great Depression," *Kansas History* 28:4 (Winter 2005/2006), 234-235, https://www.kshs.org/publicat/history/2005winter_fearon.pdf.

17 H. Edward Flentje and Joseph A. Aistrup, *Kansas Politics and Government: The Clash of Political Cultures* (Lincoln, NE: University of Nebraska Press, 2010), 177-178.

18 Id., 178-179.

Corporate income tax rates have changed five times, and a surcharge was added in 1970 which functionally transformed the levy into a graduated-rate tax.[19] Incentives have been added, exemptions modified, provisions regarding multistate taxation tweaked. But in many respects, Kansas' corporate income tax hasn't kept up with a changing world or the rise of interstate (and indeed international) competition.

The corporate income tax was ushered in by a bipartisan coalition that recognized the shortcomings of the tax code they inherited. Today, a similar opportunity exists—not for anything quite so sweeping, but for reforms to take what was innovative in the 1930s and make it relevant again today. And more broadly, Landon's commitment to revenue-neutral tax reform holds a continued attraction to this day.

## Overview of Kansas Corporate Taxation

Kansas imposes what is functionally a two-rate corporate income tax, though it is implemented as a 4 percent rate, with a 3 percentage-point surtax on corporate taxable income in excess of $50,000. As structured, this is indistinguishable from a graduated-rate corporate income tax with a 7 percent rate on income above $50,000. There are circumstances when a surtax can yield different tax liability than an additional tax bracket, such as when the surtax is on baseline tax *liability*, but as a surtax on taxable income above $50,000, the surtax simply represents a top marginal rate of 7 percent by a different name.[20]

For more than two decades, the corporate income tax remained at its initial flat rate of 2 percent before rising four times between 1957 and 1970, culminating that last year in the adoption of a surtax of 2.25 percent on income above $25,000, atop a 4.5 percent base rate. Then, in 1992, the Kansas legislature reduced the base rate from 4.5 to 4 percent while increasing the surtax from 2.25 to 3.35 percent and raising the surtax threshold from $25,000 to $50,000.[21] The result was a higher combined rate—rising from 6.75 to 7.35 percent.[22]

In 2008, the legislature overwhelmingly approved a reduction in the surtax from 3.35 to 3 percent, with the House adopting the rate reduction on a vote of 109-14.[23] The 3.35 percent surtax was phased down in stages, first to 3.1 percent in 2008, then to 3.05 percent for 2009 and 2010, settling at its current rate of 3 percent beginning in tax year 2011.[24] The following table shows rate changes on the corporate income tax and the corporate surtax from 1933 to present.

19 Kansas Legislative Research Department, "Tax Facts," multiple editions and 2018 Supplement, http://www.kslegresearch.org/KLRD-web/TaxFacts.html.

20 When the surtax was first proposed, it was recommended as consistent with a surtax then present in the federal corporate income tax, though that surtax was on initial liability, not income above a threshold. See Kansas Legislature, Joint Committee on the State Tax Structure, "Final Report and Recommendations," Vol. I (1970), 28.

21 1992 Kansas Laws Ch. 280 (H.B. 2892).

22 Kansas Legislative Research Department, "Kansas Tax Facts," Eighth Edition, December 2010, 28, http://www.kslegresearch.org/KLRD-web/Publications/TaxFacts/2010TaxFacts8thEd.pdf.

23 Kansas Legislature, *Journal of the House*, 2008 Session (Topeka, KS: State Printer, 2008), 2595, http://www.kansas.gov/government/legislative/journals/2008/hj0507.pdf.

24 2008 Kansas Laws Ch. 182 (H.B. 2434).

TABLE 3.1.
### Corporate Income Tax Rate History

| Years | Base Rate | Surtax | Combined Rate |
|---|---|---|---|
| 1933-1956 | 2.0% | -- | 2.00% |
| 1957 | 3.0% | -- | 3.00% |
| 1958-1964 | 3.5% | -- | 3.50% |
| 1965-1969 | 4.5% | -- | 4.50% |
| 1970-1991 | 4.5% | 2.25% > $25,000 | 6.75% |
| 1992-2007 | 4.0% | 3.35% > $50,000 | 7.35% |
| 2008 | 4.0% | 3.10% > $50,000 | 7.10% |
| 2009-2010 | 4.0% | 3.05% > $50,000 | 7.05% |
| 2011-present | 4.0% | 3.00% > $50,000 | 7.00% |

Sources: Kansas Legislative Research Department; state statutes.

At either the old $25,000 or the current $50,000 kick-in of the surtax, the reality is that almost all income is subject to the combined rate, currently 7 percent. Almost 98 percent of all collections come from C corporations with $100,000 or more in taxable income, even though they represent only 7.5 percent of filers. In tax year 2016, 413 companies (just over 2 percent of corporate filers) with $1 million or more in taxable income accounted for 89.9 percent of all collections.[25]

Like most states, Kansas carves out its corporate base with a range of targeted tax incentives, which contribute to a higher overall rate to maintain collections. For many businesses, these credits may be enough to eliminate any liability under the corporate income tax; as of tax year 2016, an estimated 62 percent of filers had no liability, though many of these firms likely lacked taxable income with or without incentives.[26] (Many corporate entities are inactive, or nearly so, and some may post losses.)

Kansas' 7 percent rate is higher than the rates of most of the regional competitors we have selected for sake of analysis, but not all. Iowa stands out with a particularly high rate of 12 percent, though that rate is ameliorated somewhat by a deduction for federal taxes paid, and is scheduled to be reduced to 9.8 percent, with the repeal of federal deductibility, in the coming years. All other competitor states except Nebraska, feature lower corporate rates. In neighboring Missouri, the corporate rate will decline from 6.25 to 4 percent in 2020.[27]

25 Kansas Department of Revenue, "2018 Annual Report," January 2019, 29, https://www.ksrevenue.org/pdf/ar18complete.pdf.
26 Id., 6.
27 Janelle Cammenga, "State Corporate Income Tax Rates and Brackets for 2019," Tax Foundation, Feb. 27, 2019, https://taxfoundation.org/state-corporate-rates-brackets-2019/.

TABLE 3.2.

**Top Marginal Corporate Income Tax Rates**

*Kansas and Regional Competitors*

| State | Top Rate | No. of Brackets |
|---|---|---|
| Kansas | 7.00% | 2 |
| Arkansas | 6.50% | 6 |
| Colorado | 4.63% | 1 |
| Indiana | 5.50% | 1 |
| Iowa | 12.00% | 4 |
| Missouri | 6.25%* | 1 |
| Nebraska | 7.81% | 2 |
| Oklahoma | 6.00% | 1 |

* Missouri's corporate income tax rate will decline to 4 percent in 2020.
Source: State statutes.



Corporate income taxes tend to be complex and impose substantial administrative burdens for payers and government alike, and this complexity has not abated as the tax base has eroded. Revenue volatility necessarily follows from the nature of the tax, since in periods of economic distress, many companies may post losses and thus lack exposure to a corporate income tax. And corporate income taxes, which are imposed at the entity level, are essentially double taxation, since distributions from the company are subsequently taxed, as are salaries and income earned by owners and employees, whereas income from pass-through businesses is only taxed once, at the ownership level. It is little wonder that states are reducing their reliance on corporate income taxes, and Kansas could do well by shifting from this tax on investment and economic growth toward better sources of revenue.

## Comparing Kansas' Corporate Income Taxes Regionally and Nationally

Kansas ranks 35th in corporate income tax structure according to our *2020 State Business Tax Climate Index's* corporate income tax component ranking,[28] yielding poor marks for its relatively high top (surtax) rate, its throwback rule, its stingy net operating loss provisions, an uncertain treatment of international income, and a reliance on a combination of jobs, investment, and research and development credits in lieu of a more competitive tax structure. The *Index* measures tax structure, not collections, focused on the *how*, not the *how much*, of state taxation. This is why Kansas' rank is slightly worse than would be indicated by rates or collections alone. Notably, three of the regional competitors we consider in this book—Colorado, Missouri, and Oklahoma—rank in the top 10 states due to low, flat rates and competitive structures, while nearby Wyoming and South Dakota forgo corporate income taxes altogether (and are thus in a tie for first place).

TABLE 3.3.

28 Jared Walczak, *2020 State Business Tax Climate Index*, Tax Foundation, Oct. 22, 2019, https://statetaxindex.org/.

### *State Business Tax Climate Index* Corporate Income Tax Component Rankings
*Kansas and Regional Competitors*

| State | Component Ranking |
|---|---|
| Kansas | 35th |
| Arkansas | 34th |
| Colorado | 7th |
| Indiana | 11th |
| Iowa | 48th |
| Missouri | 5th |
| Nebraska | 31st |
| Oklahoma | 8th |

Source: Tax Foundation, *2020 State Business Tax Climate Index*.



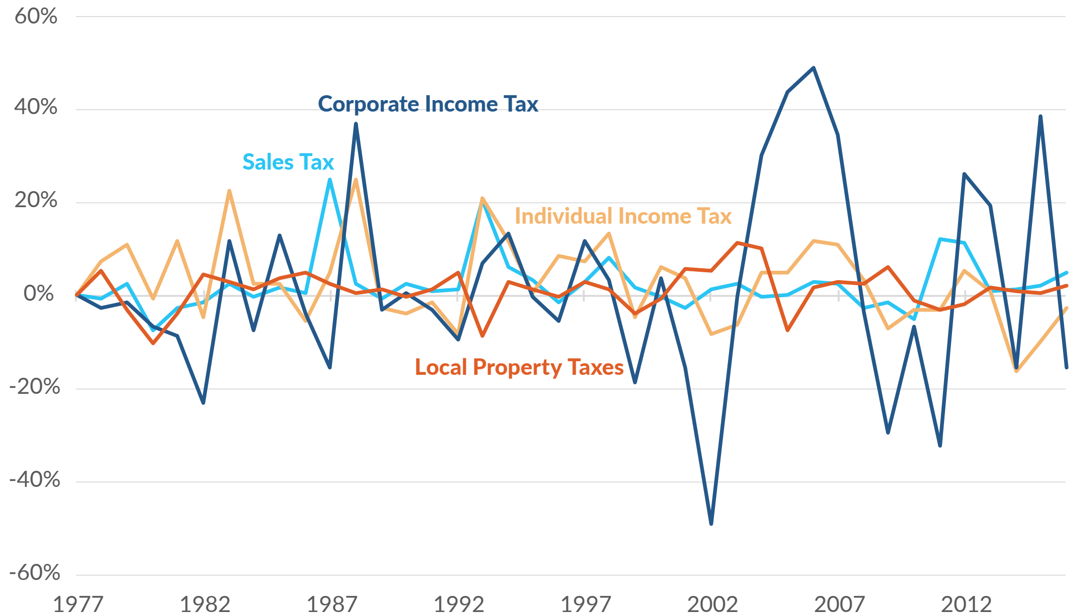
## Corporate Income Tax Collections

As previously noted, corporate income taxes are among the most volatile sources of state revenue, as many companies may generate little or no net income during economic downturns. While practically all revenue streams are cyclical, with collections lower during periods of economic distress, corporate income taxes experience particularly deep troughs. Property values may decline during a recession, but they are rarely wiped out, limiting how low property tax collections can go. Similarly, consumption patterns may decline, leading to lower sales tax revenues than when the economy is booming, but sales can only drop so far.

Even individual income tax revenue has a floor: layoffs can be significant, and wages might decline, but most Americans will still be gainfully employed. (Of course, Kansas experienced significant change in income tax collections due to corresponding rate changes, so individual income tax revenue swung significantly between 2013 and the present.) Many companies' net income, by contrast, can bottom out or even go into negative territory. As such, collections tend to be highly volatile, spiking sharply in good years and collapsing in bad ones.

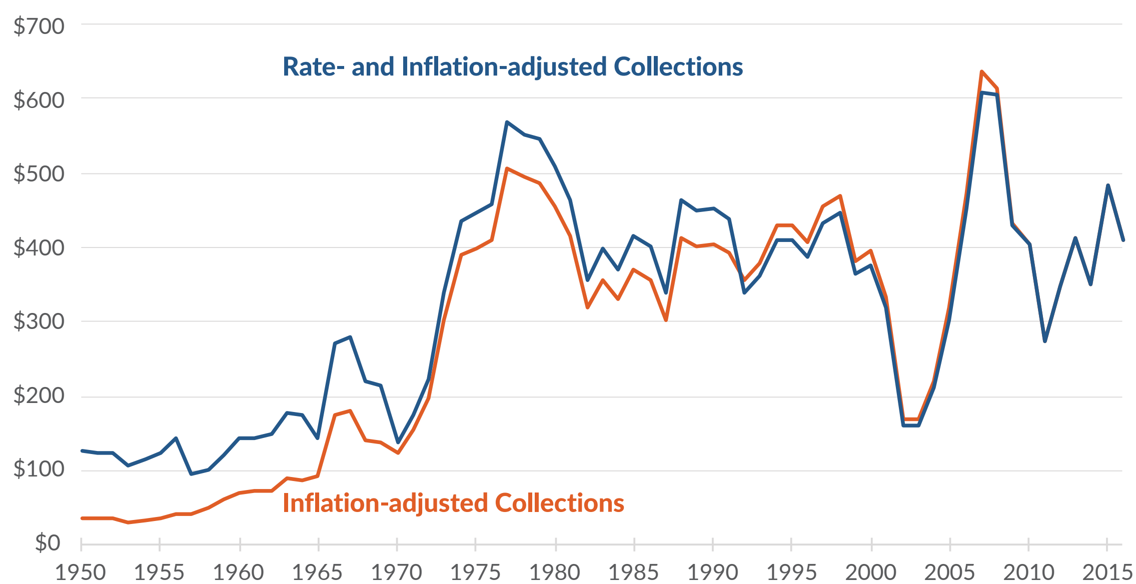
As demonstrated in Figure 3.2, corporate income tax collections took a major hit during the recession of the early 2000s, and again in the Great Recession, falling almost 50 percent in a single year in 2002, and sliding 55 percent between 2008 and 2011, when Kansas was in the greatest need of revenue stability. Over the past 20 years, inflation-adjusted collections per percentage point of the rate ranges from $23 million to $87 million—meaning that the best years for collections (2007 and 2008) brought in almost four times as much revenue as did the worst years (2002 and 2003). All revenue sources took a hit during the downturn, but not with this intensity.

FIGURE 3.1.
## Volatility of Major Taxes




Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2018 base year.
Sources: Census Bureau, "Annual Survey of State and Local Government Finances"; Bureau of Labor Statistics, "Consumer Price Indexes (All Urban Consumers)."

FIGURE 3.2.
## Corporate Income Tax Collections
*1950-2016 (in 2018 dollars)*




Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2018 base year.
Sources: Census Bureau, "Annual Survey of State and Local Government Finances"; Bureau of Labor Statistics, Consumer Price Indexes (All Urban Consumers

Kansas is middle-of-the-pack in its reliance on corporate income taxes, ranking 19th nationwide in state corporate income tax collections per capita and 24th in combined state and local corporate income tax collections per capita (Kansas does not allow local corporate income taxes, but a few other states do).[29] The figure above shows real (inflation-adjusted) corporate income taxes, both in actual collections and adjusted

29 Janelle Cammenga, "Facts & Figures 2019: How Does Your State Compare?" Tax Foundation, Mar. 19, 2019, https://taxfoundation.org/facts-figures-2019/.

as if the current rate structure has always existed, demonstrating that volatility from exogenous factors far outstrips revenue changes attributable to modifications to the rate structure over the years.

## Rate Structure Considerations

Forty-four states levy a corporate income tax, and of those, 27 have a single tax rate. Single-rate systems are more consistent with the principles of simplicity and neutrality. In contrast to the individual income tax, there is no meaningful "ability to pay" concept in corporate taxation. Jeffery Kwall, a professor at Loyola University Chicago School of Law, notes that "graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes."[30] Because Kansas' surtax kicks in fairly quickly, the amount of tax planning undertaken to avoid the higher rate is likely limited, but there is still little justification for the provision.

It should be noted, moreover, that not only may wealthy individuals have ownership stakes in small businesses, and lower-income individuals may own shares in larger businesses, but even large businesses can have modest taxable income in a given state. A large multinational firm might only have a small portion of its taxable income apportioned to Kansas, and thus reap a disproportionate benefit from the graduated-rate structure, while a much smaller business operating solely in Kansas may have a much smaller share of its net income subject to the lower rate. A two-rate system fails to meet its presumptive objective.

High corporate income tax rates discourage economic activity by reducing investment—particularly since fewer investments have favorable prospects once a higher tax wedge is taken into account—and putting the state at a competitive disadvantage against lower-tax peers. This economic drag is evident in studies on corporate income tax elasticities. For instance, a new Harvard study found corporate income tax elasticities of -0.4 to -0.5 percent for employment and corporate establishments, meaning that for every one percentage-point increase in the corporate income tax, there is a 0.4 to 0.5 percent reduction in employment and the number of corporate establishments.[31] This means that raising the next one percentage point on the corporate income tax will raise less money than the previous percentage-point increase, with returns continuing to diminish as rates rise. It also means that a lower rate is more competitive and, over time, generates more economic activity in Kansas.

This state learned the hard way that businesses and individuals care about far more than just tax rates. Businesses have long time horizons, and both businesses and individuals care about good governance, quality of life, and the eventual fiscal reckoning borne of unbalanced tax reductions that make it difficult for the state to meet its obligations. But

30 Jeffrey L. Kwall, "The Repeal of Graduated Corporate Tax Rates," *Tax Notes*, June 27, 2011, 1395.

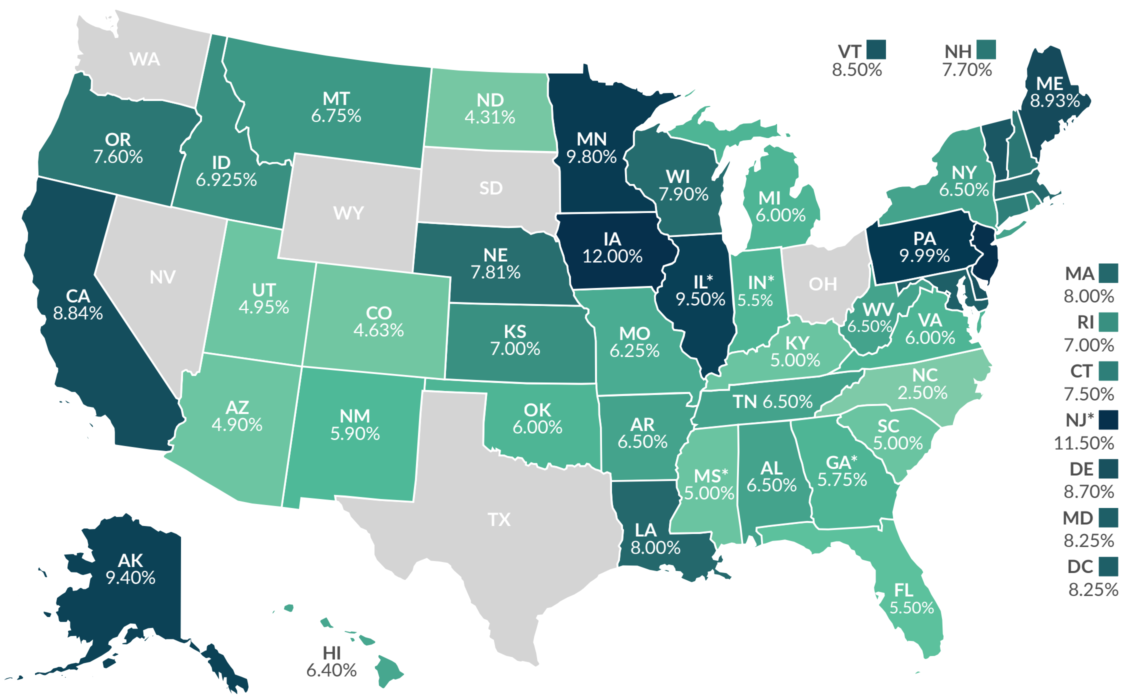
31 Xavier Giroud and Joshua Rauh, "State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data," *Journal of Political Economy* 127:3 (2019).

corporate income taxes, because they tax capital accumulation, are less efficient than most other forms of taxation, and reducing or eliminating the corporate income tax, if balanced with corresponding revenue increases elsewhere, could give Kansas a significant competitive advantage.[32]

Since 2008, 16 states and the District of Columbia have cut corporate income taxes (including Kansas, from 7.1 percent in 2008—itself a rate reduction from 7.35 percent), and Michigan shifted from a gross receipts tax to a traditional corporate income tax.[33] Reductions in corporate rates across the country reflect a trend toward decreased reliance on a highly volatile tax imposed on a declining amount of taxable income, and, in some instances, an effort to simplify the tax structure by broadening the base and lowering the rate.

FIGURE 3.3.

## Top Marginal Corporate Income Tax Rates as of July 1, 2019




Note: (*) Nevada, Ohio, Texas, and Washington do not have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. Delaware has gross receipts taxes in addition to corporate income taxes, as do several states like Pennsylvania, Virginia, and West Virginia, which permit gross receipts taxes at the local (but not state) level. Georgia's corporate income tax rate will revert to 6% on January 1, 2026. The state could see a drop to 5.5% in 2019, pending legislative approval. Illinois' rate includes two separate corporate income taxes, one at a 7% rate and one at a 2.5% rate. Indiana's rate will change to 5.5% on July 1, 2019. The rate is scheduled to decrease to 4.9% by 2022. Iowa's rate is scheduled to drop to 9.8 percent by 2021, subject to revenue availability. Mississippi continues to phase out the 3 percent bracket by increasing the exemption by $1,000 a year. By the start of 2022, the 3 percent bracket will be fully eliminated. Potential reform in 2020 will subject nearly all Missouri companies to a single sales factor appointment, permitting a rate reduction from 6.25% to 4%. In New Jersey, the rates indicated apply to a corporation's entire net income rather than just income over the threshold. A temporary surcharge is in effect, bringing the rate to 11.5 percent for businesses with income over $1 million. In addition to regular income taxes, many states impose other taxes on corporations such as gross receipts taxes and franchise taxes. Some states also impose an alternative minimum tax and special rates on financial institutions.
Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.

32 For a literature review, see Jens Arnold, Bert Brys, Christopher Heady, Åsa Johansson, Cyrille Schwellnus, & Laura Vartia, "Tax Policy For Economic Recovery and Growth," *Economic Journal* 121:F59-F80 (2011).

33 See Joseph Bishop-Henchman, "Trend #3: Corporate Tax Reductions, Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012," Tax Foundation, June 13, 2012, http://taxfoundation.org/article/trend-3-corporate-tax-reductions; Tax Foundation, *Facts & Figures: How Does Your State Compare?* multiple years.

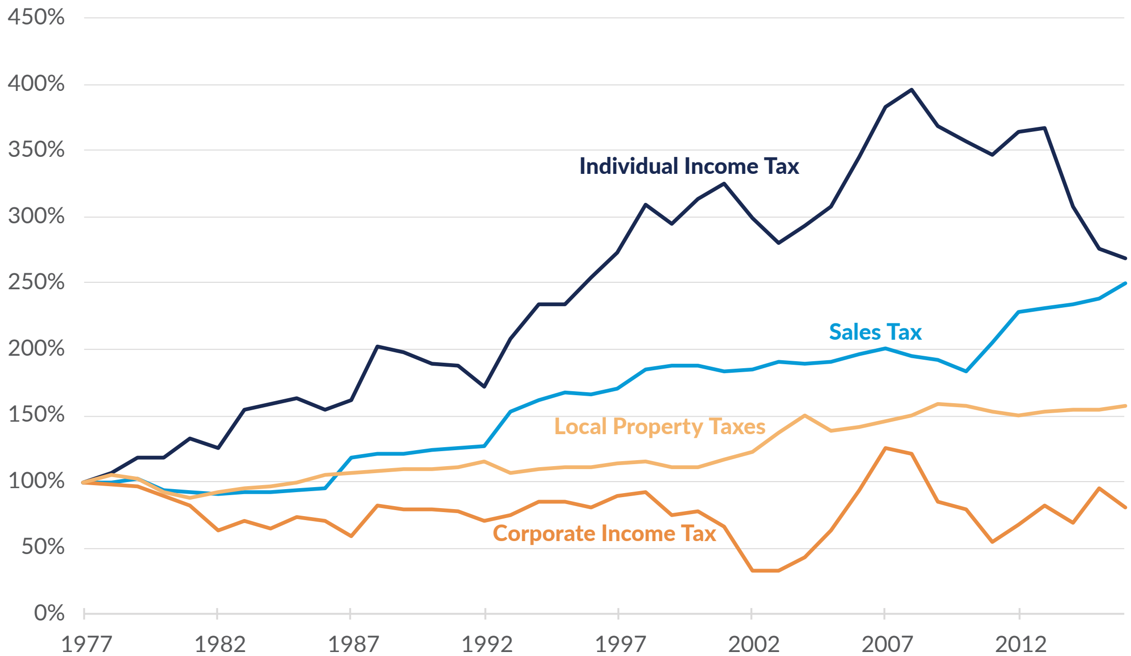
Corporate income tax revenue is in decline across the country as more businesses choose to structure as S corporations and limited liability corporations (LLCs), single sales factor apportionment schemes become more common (though here, Kansas retains three-factor apportionment), and states give away more of their tax base in special credits and deductions.[34] In Kansas, the corporate income tax generates less revenue, in real (inflation-adjusted) terms, than it did four decades ago, while other major taxes have seen substantial growth.

The figure below shows the poor performance of corporate income taxes compared to other major taxes. Of note, the recent decline in individual income tax collections is attributable to income tax rate reductions and base-narrowing provisions that have since been mostly reversed and does not suggest an innate downward trend in individual income tax revenue capacity.



FIGURE 3.4.

**Revenue Growth by Major Tax (Inflation-adjusted)**




Sources: U.S. Census Bureau, "Annual Survey of State and Local Government Finance"; Tax Foundation calculations.

## Structural Elements

Corporate income taxes are designed to tax the profits of a corporation attributable to a given state, which requires a calculation of taxable income that excludes the costs of compensation and business expenses, as well as the apportionment of that income to the states from which it is derived. Conceptually this is straightforward; in practice, it requires careful calibration, and in many respects, Kansas' code is worse than its peers in setting the base for corporate taxation. The result is a less competitive tax structure that can penalize certain industries or economic activities, unduly favor others, and in some cases drive activities out of state.

34 Scott Greenberg, "Pass-Through Businesses: Data and Policy," Tax Foundation, Jan. 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.

## Net Operating Loss Carrybacks and Carryforwards

Net operating loss (NOL) provisions exist to address one structural impediment to the proper treatment of profits and losses for tax purposes: the innate artificiality of any chosen tax period. Taxation, like accounting, requires dividing corporate activity according to given units of time, most commonly years. However, a yearly profit snapshot may not fully capture a corporation's true profitability, for while corporate income tax liability is determined on an annualized basis, business cycles do not follow the calendar. A corporation in a highly cyclical industry may look very profitable during boom years but post substantial losses during bust years. When examined over the entire business cycle, the corporation may actually have an average profit margin, or even a poor one.

By way of mitigation, states (along with the federal government) allow corporations to deduct losses from previous years and future years to offset current taxes owed. These net operating loss "carrybacks" and "carryforwards" smooth out tax obligations over time, ensuring that industries with cyclical income are not at a competitive disadvantage against industries with more consistent and stable revenue streams.

Under a well-designed system of net operating losses, businesses which experience a period of negative income but return to profitability have the opportunity to deduct their losses against future taxable income. The NOL deduction helps ensure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time.

There are two important variables of a state's NOL provisions: the number of years allowed for carrybacks and carryforwards, and caps on the amount of carrybacks and carryforwards. The maximum that any state allows for carrybacks is three years, with no cap (that is, an unlimited dollar amount allowed up to the entirety of current year taxable income). The five states which allow carrybacks—a number reduced by conformity to the new federal law—permit carrybacks of two to three years, typically with no cap.

Prior to the adoption of the federal Tax Cuts and Jobs Act, the maximum carryforward given in any state was 20 years, again with no cap (most states allowed either 15 or 20 years, though 20 is more desirable). The new federal law provides for unlimited years but caps the amount that can be deducted in any given year at 80 percent of tax liability, a convention many states now follow. The longer the overall time span, the higher the probability that the corporate income tax is being levied on the corporation's average profitability.

Kansas offers one of the country's stingier NOL provisions, disallowing carrybacks and only offering a 10-year carryforward provision.[35] Of the 45 states with corporate income taxes, 33 have either 20-year or unlimited carryforwards, while only seven, including Kansas, have carryforward periods of 10 years or fewer. Three of Kansas' neighboring states conform to the new federal standard; the fourth, Nebraska, offers a 20-year

35 K.S.A. § 79-32,143.

carryforward. Among regional competitors that we have identified, only one (Arkansas) has a worse treatment of net operating losses, and by 2021, Arkansas will match Kansas' current treatment.[36]

TABLE 3.4.
**Net Operating Loss Carryforward Provisions**
*Kansas and Regional Competitors*

| State | Years | Cap |
|---|---|---|
| Kansas | 10 | n/a |
| Arkansas | 5* | n/a |
| Colorado | Unlimited | 80% of tax liability |
| Indiana | 20 | n/a |
| Iowa | 20 | n/a |
| Missouri | Unlimited | 80% of tax liability |
| Nebraska | 20 | Unlimited |
| Oklahoma | Unlimited | 80% of tax liability |

* Phasing up to a 10-year carryforward by 2021.
Sources: State statutes; Tax Foundation research.



In tax year 2016, companies claimed about $1 billion in Kansas net operating loss deductions, worth about $70 million in reduced future tax liability. The Kansas Division of the Budget assumes that 98 percent of net operating losses are realized by the 10th taxable year, so the residual is small—worth, by their estimate, about $1.4 million a year in reduced tax collections once any new provision has an effect, starting in the 11th year after enactment. However, these savings would likely be concentrated in a few struggling firms and would prove—at very low cost—a far better lifeline than targeted incentives.[37] At the same time, the system would simplify accounting for all firms by following the federal schedule. Finally, adopting the federal system would also provide that NOLs cannot completely eliminate a company's corporate income tax liability in any given year.

## Treatment of Capital Investment

Another component of correctly calculating the corporate income base is the treatment of capital investment. As a tax on net income, the corporate income tax should exclude business costs, including investment costs. In a divergence from sound tax policy, however, businesses have not historically been able to deduct the cost of investment in the first year, which creates a bias against investment. Instead of claiming the full deduction immediately, businesses "recover" the cost across the depreciable life of the asset, which can run many years, deducting a portion of it each year.

Various federal policies have sought to attenuate this disincentive, and Kansas has largely followed them. The Modified Accelerated Cost Recovery System (MACRS) frontloads the deductions somewhat,[38] and a policy called bonus expensing—initially at 30 percent, later at 50 percent, and briefly at 100 percent—allowed a greater share of the deduction to be taken in the first year, with the remainder amortized over the rest of the depreciation schedule. Classes of assets are assigned different asset lives, with recovery periods for

36 Arkansas General Assembly, 92nd Reg. Sess. Gen. Acts. (2019), Act 822 (S.B. 576).
37 Kansas Division of the Budget, "Fiscal Note for HB 2417 by House Committee on Taxation," Apr. 17, 2019, http://www.kslegislature.org/li/b2019_20/measures/documents/fisc_note_hb2417_00_0000.pdf.
38 U.S. Department of the Treasury, Internal Revenue Service, "How to Depreciate Property," Publication 946, 2017, https://www.irs.gov/publications/p946.

tangible property ranging from three to 20 years.

As part of the federal tax overhaul adopted in late 2017, machinery and equipment purchases are now shifted to a policy called full expensing, meaning that the full cost can be deducted in the first year. Kansas, which previously adopted bonus depreciation in addition to its own supplemental expensing deduction for machinery and equipment purchases,[39] conforms to the federal policy,[40] which dramatically improves the treatment of capital investment and yields productivity improvements that lead to additional economic growth. (The state-specific deduction is suspended while the 100 percent federally-linked deduction is in place, because there is no additional value to deduct.)

Unfortunately, federal full expensing is temporary, and begins phasing out after 2022.[41] It need not do so in Kansas. Traditional depreciation schedules penalize capital investment, at least for firms with meaningful exposure to the corporate income tax. Companies have to pay tax up front on revenue reinvested in the company, only recovering those tax costs over a period of years as the property depreciates. Eighteen states, including Kansas, currently offer full expensing, while another two states offer a less generous form of bonus depreciation. If the federal cost recovery provisions are permitted to phase out, Kansas' provisions would also phase out due to the state's rolling conformity with the federal corporate tax code. In this case, Kansas policymakers would face the decision of whether to allow the simultaneous phaseout of full expensing in Kansas or whether to prioritize a neutral, structurally sound tax code by amending Kansas law to retain full expensing on its own.

Like most states, Kansas leans on targeted incentives to favor certain economic activities, but the lack of full expensing would constitute a marked disincentive to capital investment, cutting against the purpose of those credits. Tax credits for capital investment serve as a partial backdoor "fix," but are only available to certain firms. Instead of relying on selectively available credits, it would make sense for Kansas to ensure that full expensing of machinery and equipment purchases becomes a permanent feature of the state's tax code. The fact that the state already offers an additional deduction for periods when conformity yields a less than 100 percent first-year deduction suggests that lawmakers appreciate the importance of cost recovery. A logical next step is acting to make the current system permanent.

## Apportionment and Sourcing

Identifying the share of corporate revenue that constitutes the business's profits is necessary but insufficient for determining corporate tax liability in a given state. That is because when businesses operate in more than one state, income must be apportioned among those states for tax purposes. The legal term for whether a state has the power to tax is *nexus*—which typically requires a business to have some physical presence, either property or employees, in a state—and the determination of the amount of that business's

39 Kansas Department of Revenue, "Estimated Kansas Impact of the Federal Tax Cuts and Jobs Act," Feb. 14, 2018, 22, https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/State_Tax_Conformity_Documents/Kansas_-_Dept_of_Revenue_-_February_2018.pdf.

40 K.S.A. § 79-32,143a.

41 Amir El-Sibaie, "A Look Ahead at Expiring Tax Provisions," Tax Foundation, Jan. 18, 2018, https://taxfoundation.org/look-ahead-expiring-tax-provisions/.

income subject to a given state's corporate income tax is known as *apportionment*. States apportion business profits based on some combination of the percentage of company property, payroll, and sales located within their borders.

Kansas uses the traditional evenly-weighted three-factor apportionment method, where property, payroll, and sales are considered in equal measure. Increasingly, many states have shifted to single sales factor apportionment, where only a company's sales are taken into account, with the intention of benefiting in-state production while exporting more of the tax to out-of-state companies. Courts have granted states substantial leeway in adopting competing approaches to apportionment, provided that chosen approaches (1) have some rational relationship to companies' activities in the state (a very permissive standard) and (2) are internally consistent, meaning that, if every state chose a given apportionment formula, no more than 100 percent of a corporation's income would be taxed—even if, in practice, the interaction of competing standards can yield double taxation.[42]



**TABLE 3.5.**

**State Primary Apportionment Factors for Tax Year 2020**

| Three-Factor (6) | 50% Sales (8) | > 50% Sales Factor (3) | Single Sales (29) |
|---|---|---|---|
| Alaska | Alabama | Delaware | Arizona* |
| Hawaii | Arkansas | Maryland | California |
| Kansas | Florida | Tennessee | Colorado |
| Montana | Idaho | | Connecticut |
| North Dakota* | New Hampshire | | Georgia |
| Oklahoma | Vermont | | Illinois |
| | Virginia* | | Indiana |
| | West Virginia | | Iowa |
| | | | Kentucky |
| | | | Louisiana |
| | | | Maine |
| | | | Massachusetts* |
| | | | Michigan |
| | | | Minnesota |
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| | | | New Jersey |
| | | | New Mexico |
| | | | New York |
| | | | North Carolina |
| | | | Oregon |
| | | | Pennsylvania |
| | | | Rhode Island |
| | | | South Carolina |
| | | | Texas** |
| | | | Utah |
| | | | Wisconsin |
| | | | District of Columbia |

* State offers alternative apportionment factors as well, either as an optional election or as a requirement for select industries.
** Texas' Margin Tax, a gross receipts tax, uses single sales factor apportionment. Gross receipts taxes in other states do not follow corporate apportionment formulae.
Source: Federation of Tax Administrators.

There is not an obviously "correct" approach to corporate apportionment. Payroll and property factors are more closely related to a company's operations in the state, the costs they impose, and the benefits they receive from good governance, but all states include

42 See Charles McLure Jr., "Understanding Uniformity and Diversity in State Corporate Income Taxes," *National Tax Journal* 61:1 (March 2008); and Bradley W. Joondeph, "The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation," *Fordham Law Review* 71:1 (2002).

sales into the state as a factor, and the majority (29 states) use it as the sole factor. As noted, many states have gone to so-called single sales factor as a way to export the state's corporate income tax burden, with it falling onto sales into the state rather than on the decision to operate within the state. Kansas is one of only six states to still use the more traditional evenly-weighted three-factor apportionment method, and one of only five to use it exclusively. (North Dakota provides companies with an election for single sales factor.)[43] Interestingly, some, like Kansas, further divide treatment of in-state sales based on whether they constitute sales of goods or services.

Sales are generally destination-sourced. This is almost definitionally true for apportionment, since the concept is about taxing companies in proportion to their sales in the state, wherever the company is based. However, Kansas uses what is known as "cost of performance" for the sourcing of service-derived income,[44] meaning that the sale of services and intangibles is sourced to Kansas if the labor associated with providing the service occurs in Kansas. This is in contrast to the idea of sourcing on the basis of whether the service is received or used in Kansas. This is the inverse of how Kansas treats other sales, and essentially replaces the sales factor with additional weight on the other two factors for the sale of services and other intangibles.

Twenty-six of the 44 corporate income-taxing states emphasize, in varying ways, the location where a service's benefit is received, which is known as market or benefit sourcing and stands in contrast to sourcing rules emphasizing the location of the greater proportion of income-producing activity (IPA, or, as it is called in Kansas and many other states, cost of performance sourcing).[45] Having a sales factor but using cost of performance for service income puts these policies at cross-purposes. Whatever apportionment formula Kansas selects, it makes very little sense to have a different set of rules depending on whether a company sells tangible or intangible property.

Should Kansas ever consider following many of its regional competitors by shifting to single sales factor, Kansas' anomalous treatment of the service sector would take on particular importance. A shift to single sales factor can be seen as a preference for in-state business activity because it "exports" the tax liability Kansas currently imposes on corporations for holding property and payroll in the state to largely out-of-state corporations that have nexus and sales into Kansas. However, lawmakers should bear in mind the potential revenue consequences of any change in the apportionment formula. (States have undisputed authority to tax businesses with property and payroll in their states, but under federal law, states lack nexus to tax companies that sell into a state but have no other connections to that state. Therefore, an exclusive focus on sales may generate less revenue, since some companies otherwise captured by that apportionment formula are not, in fact, subject to taxation.) Whatever approach to apportionment the state takes, however, having one set of rules for sales of tangible property and another set of rules for the sale of services is counterproductive, and so long as sales are a factor in Kansas apportionment, they should be destination-sourced throughout.

43 Federation of Tax Administrators, "State Apportionment of Corporate Income," Jan. 1, 2019, https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf.

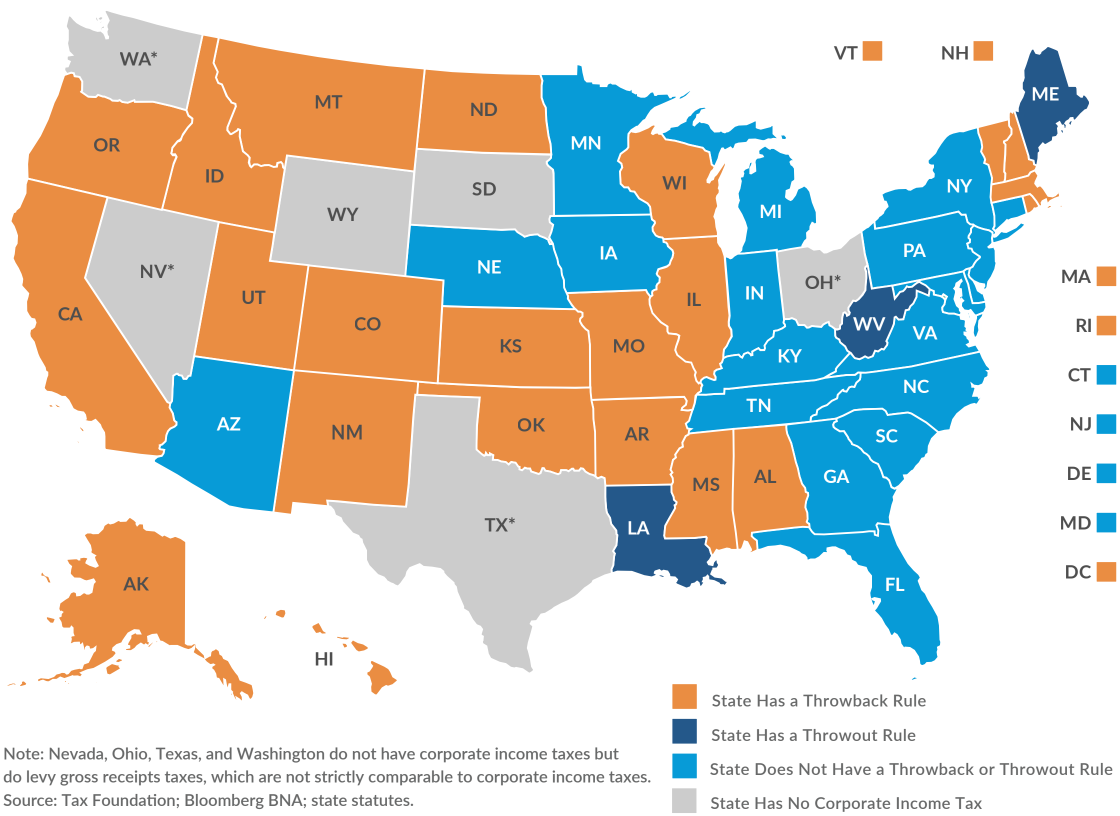
44 K.S.A. § 79-3287.

45 Deloitte, "State Tax Reboot—The Age of Multistate," 2019 National Multistate Tax Symposium, Feb. 6-8, 2019, 12, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-sales-factor-deep-dive-defining-todays-market.pdf.

## Throwback Rule

Because businesses sometimes make sales into states with which they lack sufficient connection (nexus) to be subject to corporate taxation, there is the potential that income earned in that state will not be subject to any state's corporate income tax, generating what is sometimes called "nowhere income." Twenty-five states and the District of Columbia have adopted throwback or throwout rules intended to expose income from outbound sales to their own corporate income taxes if, for whatever reason, it is not taxable in the destination state. Kansas is one of those states, as are many regional competitors—though Iowa and Nebraska forgo them, and of course several states in the region do not tax corporate income at all.

FIGURE 3.5.
### State Throwback and Throwout Rules




Note: Nevada, Ohio, Texas, and Washington do not have corporate income taxes but do levy gross receipts taxes, which are not strictly comparable to corporate income taxes.
Source: Tax Foundation; Bloomberg BNA; state statutes.

The goal of throwback and throwout rules is 100 percent taxability of corporate income, but the result is a complex, uncompetitive system that can drive businesses out of some states by yielding high—sometimes astronomically high—in-state tax burdens. Indeed, throwback rules have such an effect on business activity that multiple studies find that over the long term, their adoption drives out enough business to offset the revenue gains that would otherwise be anticipated from taxing additional business income, to the detriment of those states' economies. In short, throwout rules involve a long-term economic loss without a corresponding long-term revenue gain.

All taxes have elasticities. Doubling a tax rate does not double revenue, because there will be feedback effects: reduced investment, migration, tax arbitrage, and so forth. But while revenue may not double, it will almost certainly increase. It is easy to find relatively inefficient revenue-raising provisions that could be replaced by alternatives which raise the necessary revenue with less economic dislocation, but very rare to find an intended revenue-raiser that is so uncompetitive that it might not raise any revenue at all, or even cause revenue to decline. But the research suggests that the throwback rule could be such a provision, and it is almost certainly one of the least economically efficient options a state could adopt.[46] Throwback rules unquestionably raise revenue in the sense that revenue is generated from businesses subject to the rule, but the offsetting losses from businesses that make changes to avoid the tax—and in the process, reduce their overall footprint in the state—are considerable.

Under Kansas' throwback rule, any sales originating in Kansas are "thrown back" into Kansas' sales factor if the company lacks nexus for corporate tax in the destination state. Imagine a Kansas-based company that has all of its property and payroll in Kansas, but sells entirely out of state, without establishing nexus in those states. (Perhaps it sells services that are delivered electronically, or perhaps it ships its goods via a common carrier or has them picked up by customers—like large regional or national retailers with their own distribution networks—rather than shipping them to those states with their own vehicles and employees.)

Due to Kansas' throwback rule, that company would have 100 percent of its income apportioned to the state (one-third property, one-third payroll, and a throwback one-third sales), making its tax burden 50 percent higher (full apportionment to the home state rather than one-third property and one-third payroll, without a state claim on sales) than it would be in a similar state without throwback. This can create a strong incentive to either relocate to or route sales through a state without a throwback rule, as it can yield significantly higher effective tax rates.

TABLE 3.6.

### State Apportionment Factors and Throwback Rules

*Kansas and Regional Competitors*

| State | Apportionment Factor | Throwback Rule |
|---|---|---|
| Kansas | Three-Factor | Yes |
| Arkansas | Double-Weighted Sales | Yes |
| Colorado | Single Sales Factor | Yes |
| Indiana | Single Sales Factor | No |
| Iowa | Single Sales Factor | No |
| Missouri | Single Sales Factor | Yes |
| Nebraska | Single Sales Factor | No |
| Oklahoma | Three-Factor | Yes |

Sources: State statutes; Tax Foundation research.

46 See Harley Duncan and William F. Fox, "State Strategies for Dealing with Tax Sheltering and Planning," *The State and Local Tax Lawyer* 11:2 (2006), 90-91; and Donald Bruce, John Deskins, and William F. Fox, "On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning," in Alan J. Auerbach, James R. Hines Jr., and Joel Slemrod, eds., *Taxing Corporate Income in the 21st Century* (Cambridge: Cambridge University Press, 2007).

One study found that sensitivity of rates of profit to throwback rules was about double the response to investment subsidies and property tax abatements, meaning that having a throwback rule reverses the benefits of tax incentive packages—and then some.[47] In sum, the economic literature suggests that throwback rules do not actually expand corporate tax bases or increase state revenue, and may even decrease revenue in some states, even though they certainly increase collections—sometimes punitively—for certain taxpayers.[48] Ultimately, these nonneutral rules cost the state in terms of tax base erosion and diminished economic activity, while providing little to no state benefit.[49]

## Combined Reporting

As a mandatory unitary combined reporting state, Kansas requires that corporate entities file returns that combine all affiliated businesses into a "unitary group" and taxes them as if they constituted a single legal entity. Proponents of combined reporting see it as a way to undermine tax planning, where companies shift income to some subsidiaries and park losses in others to minimize tax exposure. Opponents point to high compliance costs, increased complexity, and taxation of legitimate business activity in no way associated with the state. Combined reporting is likely to remain a feature of Kansas taxation, but because it tends to be poorly understood, a brief summary of this important provision, and a short analysis of its effects, may be in order.

Kansas was one of seven states which adopted combined reporting not through statute but through the courts, based on determinations that combined reporting was inherent in the states' apportionment principles.[50] Eighteen other states and the District of Columbia have adopted combined reporting statutorily, though in phases; nine states shifted from separate to combined reporting since 2006; before that, it had been three decades since a state last took the leap.[51]

Of the regional competitors that we have identified, only Colorado and Nebraska require combined reporting, with others allowing separate reporting by each corporate entity.

47 James A. Papke, "The Convergence of State-Local Business Tax Costs: Evidence of De Facto Collaboration," *Proceedings from the Annual Conference on Taxation Held under the Auspices of the National Tax Association-Tax Institute of America* 88 (1995), 203.

48 For a brief literature review, see Jared Walczak, "Throwback and Throwout Rules: A Primer," Tax Foundation, July 2, 2019, https://taxfoundation.org/throwback-rules-throwout-rules-2019/.

49 It must be noted, however, that repeal would involve transitional costs, as the companies that currently pay more due to throwback would no longer incur that liability, while companies that took steps to avoid additional tax liability would not immediately return their operations to Kansas or unwind uncompetitive tax arbitrage strategies.

50 Joe Huddleston and Shirley Sicilian, "History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?" *The State and Local Tax Lawyer*, Symposium Edition (2008), 8, https://www.jstor.org/stable/24467472.

51 William F. Fox and LeAnn Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," NCSL Task Force on State & Local Taxation of Communications and Interstate Commerce, November 2010, https://www.ncsl.org/documents/standcomm/sccomfc/CombinedReportingFinalDraft.pdf.

**TABLE 3.7.**

**Combined and Separate Reporting Requirements**

*Kansas and Regional Competitors*

| State | Reporting Requirement |
|---|---|
| Kansas | Combined |
| Arkansas | Separate |
| Colorado | Combined |
| Indiana | Separate |
| Iowa | Separate |
| Missouri | Separate |
| Nebraska | Combined |
| Oklahoma | Separate |

Sources: State statutes; Bloomberg Tax.

Although combined reporting is often perceived as a revenue-raiser, that is not invariably the case. This should not be altogether surprising. In a hypothetical scenario where all net income, wherever taxed, was subject to the same tax rate, the total tax liability of any group of companies would be identical under combined or separate reporting. If a shift to combined reporting raised revenue in one state, it would have to reduce tax collections in others. The real world is considerably messier, but the fact remains that changing the method by which income and losses are tallied can only be guaranteed to yield a *different* total, not necessarily a *higher* one.

After shifting to combined reporting, Minnesota reviewed its projections in light of actual revenue after the shift to combined reporting, and actually discovered that combined reporting reduced corporate income tax collections.[52] Studies of revenue effects in other states have yielded equivocal results, with the authors of a leading study concluding that "combined reporting probably increases tax revenues, but by a relatively small amount and perhaps only for a short period as firms develop alternative planning arrangements or further change their operating behavior."[53]

Imagine two different companies. One parks its intellectual property in a Delaware subsidiary, with the Kanas parent company paying royalties to that subsidiary and posting losses in Kansas, even though the two companies are profitable taken together. This is the sort of tax avoidance activity that Kansas' combined reporting laws exist to prevent.

The second company, by contrast, is profitable and has significant sales in Kansas. It has an affiliate located in Colorado, which has no activity (including sales) in Kansas. Under combined reporting, the net income of the Colorado company is included in the potential taxable base for Kansas, apportioned on the basis of the percentage of sales made into Kansas by the unitary group as a whole. In this case, the justification is less apparent, as

52 Robert Cline, "Understanding the Revenue and Competitive Effects of Combined Reporting," Council on State Taxation, May 2008, 2, http://motaxpayers.com/finalcombinedreportingstudy.pdf.

53 William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis, and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," Report to the Tennessee Comptroller of the Treasury, Oct. 30, 2009, 35, http://cber.haslam.utk.edu/pubs/combrpt.pdf.

is the revenue implication. It is possible that the Colorado affiliate is highly profitable, and its inclusion will increase Kansas tax collections. It is also possible that the Colorado entity is in worse shape than the Kansas company, and its inclusion will reduce overall state tax liability.

Combined reporting, moreover, shifts tax liability among related firms in ways that have no connection to ability to pay. It assumes that all member companies have the same level of profitability per dollar of sales, payroll, and property, an assumption which cannot be borne out in the real world. Just because two companies are affiliated does not mean that each entity is in similar shape financially; increasing the tax burden on one company, which may be struggling, because a related company elsewhere is doing well, can be economically devastating.

Where differences in profitability are the result of tax planning, those strategies can be adjusted. Where, as is more often the case, those differences represent the actual financial standing of each company, splitting tax liability this way—much like a group of friends splitting a restaurant bill equally, regardless of their orders or finances—can be uniquely burdensome for some operations.

The challenges associated with combined reporting do not end—or even begin—with an inequitable distribution of tax burdens. The first step is calculating that tax liability, which can be complex, costly, and controversial under combined reporting. There is often no easy answer to the question of which affiliated businesses should be considered as part of the unitary group; in fact, answers to this definitional question can vary from state to state and even year to year.[54] Disputes can take years or even decades to untangle. In short, combined reporting increases complexity and can misallocate tax burdens, which is probably why statistical analyses demonstrate that combined reporting reduces gross state product.[55]

## International Income

Prior to the enactment of the Tax Cuts and Jobs Act (TCJA), states rarely attempted to tax international income. Ironically, federal legislation designed in part to reduce taxation of international income (which can discourage multinational companies from being based in the United States) has yielded a new interest in—and opportunity for—the taxation of international income at the state level. The legislative and executive branches did not reach an agreement on decoupling in 2018 or 2019, leaving Kansas on track to begin taxing international income, though the details have yet to be hammered out. Policymakers should seek to reverse course as soon as possible.

Under the new federal law, the United States has shifted from a worldwide system of taxation which taxed global earnings of U.S.-based companies (with a credit for taxes paid to foreign governments) to a mostly territorial one, which taxes income where it is sourced. The old worldwide system discouraged the repatriation of foreign profits, which companies could defer almost indefinitely, and spurred corporate inversions,

54 Fox and Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," iv.
55 Id., 36-40.

two outcomes policymakers almost universally regarded as undesirable. Policymakers also feared, however, that a "pure" territorial system would encourage shifting earnings activity to lower-tax countries—particularly intellectual property, which is inherently mobile. Consequently, the new international tax regime contains several anti-base erosion provisions targeted at high-return foreign profits, intangible income, and income stripped out of the United States.[56]

Chief among these is a provision for the taxation of Global Intangible Low Taxed Income (GILTI), which is intended to tax what are deemed the supernormal returns of foreign subsidiaries located in low-tax countries, though in practice this tax falls on other foreign economic activity as well.

When the federal government used a worldwide taxation regime, states generally did not include foreign income in their tax bases.[57] Now, under what is intended to be closer to a territorial system, Kansas is among a handful of states pushing in the other direction by taxing a sizable share of GILTI at the state level. This not only constitutes a reversal of the state's longstanding approach to foreign income, but also involves a much larger base subject to Kansas tax than is intended at the federal level. The federal provision is only intended to apply to income attributable to low-tax foreign jurisdictions, an outcome accomplished (imperfectly) through the application of foreign tax credits. States, however, do not have foreign tax credits, so adding GILTI to a state tax base transforms the provision from an anti-abuse tax into a much broader tax on foreign-derived income.[58]

Kansas has what is known as "rolling conformity," meaning that the state automatically adopts the current version of the Internal Revenue Code, incorporating the most recent definitions and provisions into its own tax code, at least to the degree that the state has not specifically decoupled from certain aspects of federal law. Most states with rolling conformity still adopted conformity legislation in the wake of federal tax reform to address new federal provisions that had not been anticipated by state tax codes—provisions like GILTI.

In Kansas, those efforts have not yet borne fruit. Consequently, Kansas will potentially take an aggressive approach to the taxation of foreign income where most other states do not, though as of this writing, the state has yet to issue formal guidance on the taxation of foreign income. The absence of any legislative response creates the potential that Kansas could tax GILTI without adopting what is known as factor apportionment for foreign source income, not only taxing income the state should not be taxing at all, but also potentially including a share that is disproportionate to the company's activity in Kansas.[59]

56 Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits Under the Tax Cuts and Jobs Act," Tax Foundation, May 3, 2018, https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/.

57 There are limited exceptions, including in Kansas, such as the taxation of foreign dividends in an otherwise "waters' edge" tax regime. See *In Re Tax Appeal of Morton Thiokol, Inc.*, 254 Kan. 23 (1993).

58 PwC, "State Tax Implications of Federal Tax Reform: Taxation of International Business," January 2018, https://www.pwc.com/us/en/state-local-tax/newsletters/salt-insights/state-implications-of-federal-tax-reform-international-business.html.

59 Factor apportionment of GILTI would require income included in the numerator of the apportionment factor to also be included in the denominator. See Karl A. Frieden and Joseph X. Donovan, "Where in the World is Factor Representation for Foreign-Source Income?" *State Tax Notes*, Apr. 15, 2019, https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/where-in-the-world-is-factor-representation-for-foreign-source-income.pdf.

Most states, including the majority of Kansas' regional competitors, have either decoupled from GILTI or classify GILTI as foreign dividend income, which is mostly or wholly deductible. Kansas follows the federal government in offering a 50 percent deduction under IRC § 250 but does not provide a further deduction of 80 to 100 percent for the remaining income by treating it as foreign dividend income, as many other states which have not expressly decoupled from federal law have chosen to do. Failure to mostly or wholly remove GILTI from the base will make doing business in Kansas considerably more costly for multinational businesses, for reasons having nothing to do with operations in Kansas, or even in the United States.

**TABLE 3.8.**

**State Treatment of GILTI**

*Kansas and Regional Competitors*

| State | Treatment of GILTI |
|---|---|
| Kansas | Taxable with § 250 Deduction |
| Arkansas | Decoupled from GILTI |
| Colorado | Taxable with § 250 Deduction |
| Indiana | GILTI Deductible as Foreign Dividend |
| Iowa | Possibly Taxable with § 250 Deduction* |
| Missouri | GILTI Deductible as Foreign Dividend |
| Nebraska | Taxable with § 250 Deduction |
| Oklahoma | GILTI Deductible as Foreign Dividend |

* As a separate reporting state, there remains a legal question of whether Iowa is permitted to tax GILTI, and the state has not begun doing so yet.
Sources: State statutes; tax department guidance; Council on State Taxation.



## Corporate Income Tax Expenditures

When states compete for businesses, they often turn to targeted incentives. Kansas is no different from its peers in this regard, and actually relies on tax credits somewhat less than many of its competitors. However, Kansas has the opportunity to revisit some of the credits the state does offer, many of which go unutilized, and create a more neutral, pro-growth tax code. Incentives, by definition, benefit select industries and favored business activities, or funnel growth into particular regions, none of which necessarily yields a larger overall economy. Some incentives can be modified to yield better results; some, through limitation or even repeal, could help pay down rate reductions for all taxpayers.

Incentives can be effective, but they are not efficient. By lowering tax costs for targeted industries or rewarding specific business activities, they can yield higher employment or greater investment in those sectors. Unfortunately, the cost of these incentives must be borne by other, non-favored businesses which bear a correspondingly higher tax burden. Ultimately, incentives involve picking winners and losers, and seek to guide the economy in keeping with policymakers' (often competing) visions. A well-structured tax code with a broader base—eliminating many of the incentives—and a lower rate would do far more to encourage job creation and economic growth.

All states rely on incentives to some degree, partly as an offset for high rates. Tax preferences, however, represent a poor approach to reducing burdens. In many cases, companies must navigate an application process to be approved for such incentives, and of course, some companies fail to qualify; this is true with Kansas' most significant business tax incentive, the Promoting Employment Across Kansas (PEAK) tax credit, which is actually applied against withholding taxes, and requires approval from the Secretary of Commerce. This uncertainty can make Kansas less attractive than a state with a lower overall rate but fewer incentives, even though firms that do decide to locate in Kansas may obtain approval for a number of credits and other incentives which reduce their overall tax burden.

Over the three most recent years for which data are available, tax incentives have reduced corporate income tax collections by 11 to 14 percent. Had Kansas offered no incentives during that period, it could have raised the same amount of revenue with a top rate of less than 6.2 percent, rather than the actual rate of 7 percent.[60] This, moreover, does not even take the PEAK credit into account, since it reduces individual income tax collections, though it reduced collections by an additional $33 million in fiscal year 2017 and $43.5 million in fiscal year 2018,[61] worth 0.6 to 0.7 percentage points on the corporate income tax rate. Of the 38 credits and deductions against corporate income tax liability in effect in tax year 2017 (the most recent year for which data are available), 22 were not claimed by a single taxpayer, while another eight were used by so few taxpayers that the amount claimed cannot be reported for confidentiality reasons.[62] Only eight credits had reportable utilization that year, with the High Performance Incentive Program (HPIP) credit leading the pack with 138 taxpayers claiming $37 million worth of credits. Other credits and deductions with somewhat significant take-up are the telecommunications credit, claimed by 17 companies at a cost of $1.4 million in tax revenue; the business machinery and equipment tax deduction, with 32 filers receiving $1.2 million worth of credits; the research and development credit, which reduced tax liability for 118 taxpayers by a total of $793,521; and two business job development tax credits, each with 15 claimants, worth a combined $377,397.[63] Many of these credits are utilized by pass-through businesses against individual income tax liability as well, and are discussed in this context in the individual income tax chapter.

The machinery and equipment expense deduction, which is not currently operable due to the temporary allowance for full expensing in federal tax law, with which Kansas conforms (which obviates the need for it), has merit as an attempt to come closer to the proper definition of corporate net income. Unlike other provisions considered here, it is not a subsidy or incentive, but rather an imperfect attempt at right-sizing the tax base. Its flaws are in its limitations: unlike the full expensing regime that has temporarily displaced it, this supplemental deduction has limitations on eligibility, requires repayment if property is disposed of before the end of its federal depreciable life (which can be as long as 20 years), and precludes claimant taxpayers from taking advantage of other



60 Author's calculations using Kansas Department of Revenue data.
61 Kansas Department of Commerce, "PEAK Data FY2010-FY2018."
62 The PEAK credit is excluded from this analysis, though it appears on the tax expenditure report, because it is not claimed against the corporate income tax.
63 Kansas Department of Revenue, "Tax Expenditure Report," calendar year 2017, 10, https://www.ksrevenue.org/pdf/taxexpreport17.pdf.

tax incentives that are available to their peers who do not need this deduction.[64] The machinery and equipment expense deduction serves a legitimate purpose, but full expensing is a far superior approach to the issue it seeks to address. If Kansas were to make its own full expensing provision permanent, this credit could be eliminated without consequence.

The High Performance Incentive Program offers a tax credit of up to 10 percent on qualified new capital investment beyond the first $50,000 in cost (or $1 million in five metro counties), but subject to eligibility standards including industry classification, average wages, and the percentage of payroll invested in job training, and unavailable to taxpayers taking the machinery and equipment expense deduction. This too is a patch for imperfect treatment of capital investment, but a flawed one, targeting select taxpayers for special treatment and encouraging companies to make potentially inefficient business decisions to qualify for the tax incentive. At a cost of $37 million in 2017, it takes off the books an amount equal to about a tenth of total corporate income tax collections.

Under the PEAK program, qualified businesses locating new jobs or expanding their existing operations within Kansas are permitted to retain 95 percent of payroll withholding tax from jobs designated as PEAK jobs over a period of five or 10 years, with admission into the program at the sole discretion of the Secretary of Commerce, who also determines the length of program eligibility (either five or 10 years). There are minimum standards for participation, including a requirement that at least five jobs be created (10 if in a metropolitan area) and that the median wage for PEAK jobs must be at least as high as the median wage of the county in which those jobs are located, or, alternatively, that average wages are as high as the county's average wage. Beyond that, however, participation is at the discretion of the Secretary, and the effective payout from state coffers is significant.

Companies are required to undertake both federal and state income tax withholding on behalf of their employees. Under the PEAK program, after the company withholds a portion of employees' wages to cover their state income tax liability, the company keeps 95 percent of it rather than remitting it to the state. In effect, the employee's income tax payments go to her company rather than state government.

An added wrinkle is that withholding taxes are only an approximation of an individual's federal income tax liability, though there are penalties for significant under-withholding (or otherwise paying estimated tax liability throughout the year), and employees have little incentive to overwithhold, but the prevalence of tax refunds indicates that many still do. If a taxpayer overwithholds, she gets a refund for the difference, but her company does not have to reimburse the state for the additional amount it kept.

64 Kansas Department of Commerce, "Summary of State Incentives for Kansas Manufacturers," 2018, https://emporiarda.org/wp-content/uploads/Summary-of-State-Incentives-for-Kansas-Manufacturers-2018.pdf.

Both the Kansas Department of Commerce and the Kansas Legislative Post Audit Committee have issued findings showing a strong return on investment from PEAK and other economic development incentives, but these findings should be approached with caution, as they are wildly out of line with independent research.

In 2013, in the early days of the program, the Department of Commerce commissioned a study touting the unbelievable benefits of PEAK. Based on deeply flawed assumptions, the study concluded that the program grows Kansas' economy by $960 for every $1 in forgone revenue awarded in tax credits.[65] This claim is not credible. It is based on unrealistic assumptions like, for instance, the assumption that every company that relocates to Kansas and receives PEAK credits would have otherwise stayed put in another state.[66] In reality, there are always businesses moving in and others moving out of any state. To put a finer point on it, if a 960:1 multiplier were correct, almost 30 percent of Kansas' gross domestic product would be attributable to this $43.5 million a year credit.

The PEAK analysis takes full credit for every job moving into the state, while ignoring those moving out, even if jobs are departing on net. Add in other methodological shortcomings and an unrealistic extrapolation from survey results about companies' job creation plans, along with extremely optimistic assumptions about indirect job creation, and the result is a claim that the credits would produce nearly $960 in additional economic activity for every dollar expended in a few years' time[67]—activity that cannot be identified when comparing the economic trajectories of Kansas and other states in recent years. And even in this report, the Department admits that (per survey results) about 80 percent of jobs subject to PEAK credits created by in-state businesses would have been created with or without the credit.

In 2014, the Legislative Post Audit Committee conducted its own analysis of PEAK and other incentives, concluding that PEAK had a 57:1 multiplier—about one-seventeenth of the Department of Commerce's findings, a disparity large enough to raise concerns, but still astonishing, if true. This multiplier is enough that, according to the audit, for every dollar the state spends on PEAK, it induces so much investment that it actually generates about $4.40 in additional revenue.[68] In fact, that study found that all six of Kansas' major tax credits programs resulted in an increase in tax revenue. The independent literature on tax incentives programs across the country is not consistent with these results.[69]

65 Preston Gilson and Gary Brinker, "Promoting Employment Across Kansas Program Evaluation and Economic Impact Analysis," Docking Institute of Public Affairs, Fort Hays State University, August 2013, 33, http://kanview.ks.gov/EcoDev/Documents/PEAK%20Docking%20Report.pdf.

66 Id., 16.

67 Id., 32.

68 Kansas Legislative Post Audit Committee, "Economic Development: Determining Which Economic Development Tools are Most Important and Effective in Promoting Job Creation and Economic Growth in Kansas, Part 3," December 2014, 17, https://www.kslpa.org/wp-content/uploads/2019/07/r-14-011-1.pdf.

69 See Terry F. Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," *Economic Development Quarterly* 15:1 (February 2001); Michael J. Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review* (March 1997); Timothy J. Bartik, "'But For' Percentages for Economic Development Incentives: What Percentage Estimates are Plausible Based on the Research Literature?" Upjohn Institute Working Paper 18-289 (2018), https://research.upjohn.org/up_workingpapers/289/; Robert S. Chirinko and Daniel Wilson, "State Investment Tax Incentives: What Are the Facts?" Federal Reserve Bank of San Francisco Working Paper 2006-49 (November 2006); and Sanjay Gupta and Mary Ann Hofmann, "The Effect of State Income Tax Apportionment and Tax Incentives on New Capital Expenditures," *Journal of the American Tax Association* 25 Supplement (2003), https://old.taxadmin.org/fta/meet/re_pres04/gupta_paper.pdf.

Nongovernmental review of PEAK helps make this point. An academic study found that recipients of the PEAK credit were statistically no more likely to create jobs than similar firms not receiving incentives, and that firms relocating to Kansas did not grow faster than existing companies, even with the benefit of PEAK credits.[70] These findings stand in stark contrast to the claims of government-sponsored study.

If a dollar's reduction in business tax liability really yielded an additional $960 in economic growth, then reductions in business tax liability would create an economic boom in Kansas the likes of which the world has never before seen. (Even $57 would be astonishing.) The reality is more prosaic: all else being equal, lower tax burdens increase economic activity, but not with multipliers such as this, and broad-based tax relief (like corporate rate reductions) is more economically efficient than benefits only available, somewhat arbitrarily, to select taxpayers.

This is not to say that the PEAK credit should be repealed. It should, however, receive scrutiny of a sort that is not presently possible. Lawmakers should soon have the tools at their disposal to conduct a proper legislative analysis of its benefits, and if the program is overly generous or not meeting expectations, they should consider rolling it back and using the revenue to pay down corporate income tax rate reductions.

Indeed, all states should scrutinize their incentives programs with a critical eye, as such programs routinely fail to meet their stated objectives. Regular evaluation helps ensure that tax credits are operating in line with their objectives and allows legislators to contemplate more economically efficient alternatives. Kansas will soon begin this evaluation process; it will be up to legislators to put the data to good use.[71]

70 Nathan M. Jensen, "Evaluating Firm-Specific Location Incentives: An Application to the Kansas PEAK Program," Ewing Marion Kauffman Foundation working paper, Apr. 1, 2014, http://dx.doi.org/10.2139/ssrn.2431320.

71 Kansas' new incentive evaluation legislation relaxes taxpayer confidentiality in ways that are likely unnecessary, and this could be an area for possible revision.

## Corporate Tax Solutions

Our corporate tax solutions simplify the state tax code, position Kansas for economic growth, and improve tax neutrality and revenue stability.

### Remove International Income from the Tax Base

Kansas' taxes are supposed to stop at the country's border (what is known as a "waters' edge" taxation regime), but confusion reigns regarding the state's taxation of GILTI, a class of international income. Corporations could potentially face significant in-state liability for activities of foreign subsidiaries or related corporations, which has major implications for the state's tax competitiveness. For now, it remains a source of uncertainty, since, due to the failure to adopt legislation addressing the issue, Kansas appears to tax GILTI but has yet to issue guidance to companies that may be accruing liability. Lawmakers should decouple from the provision, reaffirming the state's traditional position of not taxing international income.

### Lock in Full Expensing of Capital Investment

Kansas does well to offer full expensing of short-term capital investment in the first year, in line with the new federal law. Full expensing of capital investment is good policy, since a corporate net income tax, as the very name implies, should fall upon net income after expenses (including investment expenses). But with the current federal treatment scheduled to expire—and with the potential elimination of first-year bonus expensing instead of simply returning to the 50 percent bonus expensing regime in place before enactment of the Tax Cuts and Jobs Act—Kansas would be well-advised to lock in the current system for full expensing, decoupling from future changes to federal law, and instead providing permanent full expensing.

### Repeal the Throwback Rule

The throwback rule is counterproductive. It punishes businesses that sell out of Kansas, encouraging them to relocate to—or at least locate distribution facilities in—other states. The result is inefficient for businesses and the government, and in the long term shifts employment and other economic activity out of state for little to no revenue gain. There would be an initial cost associated with repeal of the throwback rule, since some businesses currently in Kansas are unable to avoid the additional liability, and those businesses which have adjusted their business model to avoid Kansas liability will not instantly unwind their decisions. Repealing the throwback rule is a sound investment in Kansas' economy.

## Shift to Market Sourcing of Service Income

Kansas has an inconsistency built into its approach to apportionment of corporate income that can be resolved by shifting to market sourcing of service income. The current code taxes inbound, but not outbound, sales of tangible property, but applies the opposite treatment to services and intangible property, sourcing service income based on the location of income-producing activity. This essentially puts additional emphasis on payroll and property for outbound sales of services, while failing to tax out-of-state businesses on the basis of their sales of services into Kansas.

Many questions of tax apportionment are not easily resolved by an appeal to basic tax principles. Income should only be taxed once, which argues against the states' current patchwork approach to apportionment, but it does not necessarily follow that one particular apportionment formula is best—just that it is best that all states use the same one.

The argument for shifting to a market sourcing approach is not so much that, as a matter of principle, the corporate taxation of services should be destination-based, but rather that the state's choices should be consistent and not undercut each other. For that reason, Kansas should consider shifting to market sourcing of service income.

## Improve the Treatment of Net Operating Losses

Kansas is a marked outlier in its treatment of net operating losses, with most states offering a 20-year or unlimited carryforward. The state should explore transitioning to a 20-year carryforward or aligning with the new federal tax law, especially in light of the additional revenues the state generates due to the broader tax base from federal tax reform, like the net interest limitation and a diminution of corporate tax credits. A more equitable treatment of net operating losses will make the state more attractive for business and would curtail the inequitable and counterproductive treatment of employers with longer business cycles.

## Review Business Tax Incentives

A growing number of states have established panels, commissions, or *ad hoc* committees to review tax incentives periodically. Often, they task a state fiscal or revenue office with conducting a rolling analysis of credits to estimate their return on investment. A forthcoming database can facilitate this review, but it is still up to legislators to actualize it; data without legislative attention goes to waste, and a formalized process of legislative review helps prioritize appropriate action. Particularly given the current lack of transparency in the PEAK credit, a formalized review process would help ensure that the credits on the books are actually achieving their stated purpose and could contribute to reforms where they fail to do so. To the extent that the state is able to reduce reliance on tax credits, these savings should pay down corporate rate reductions that benefit all taxpayers.

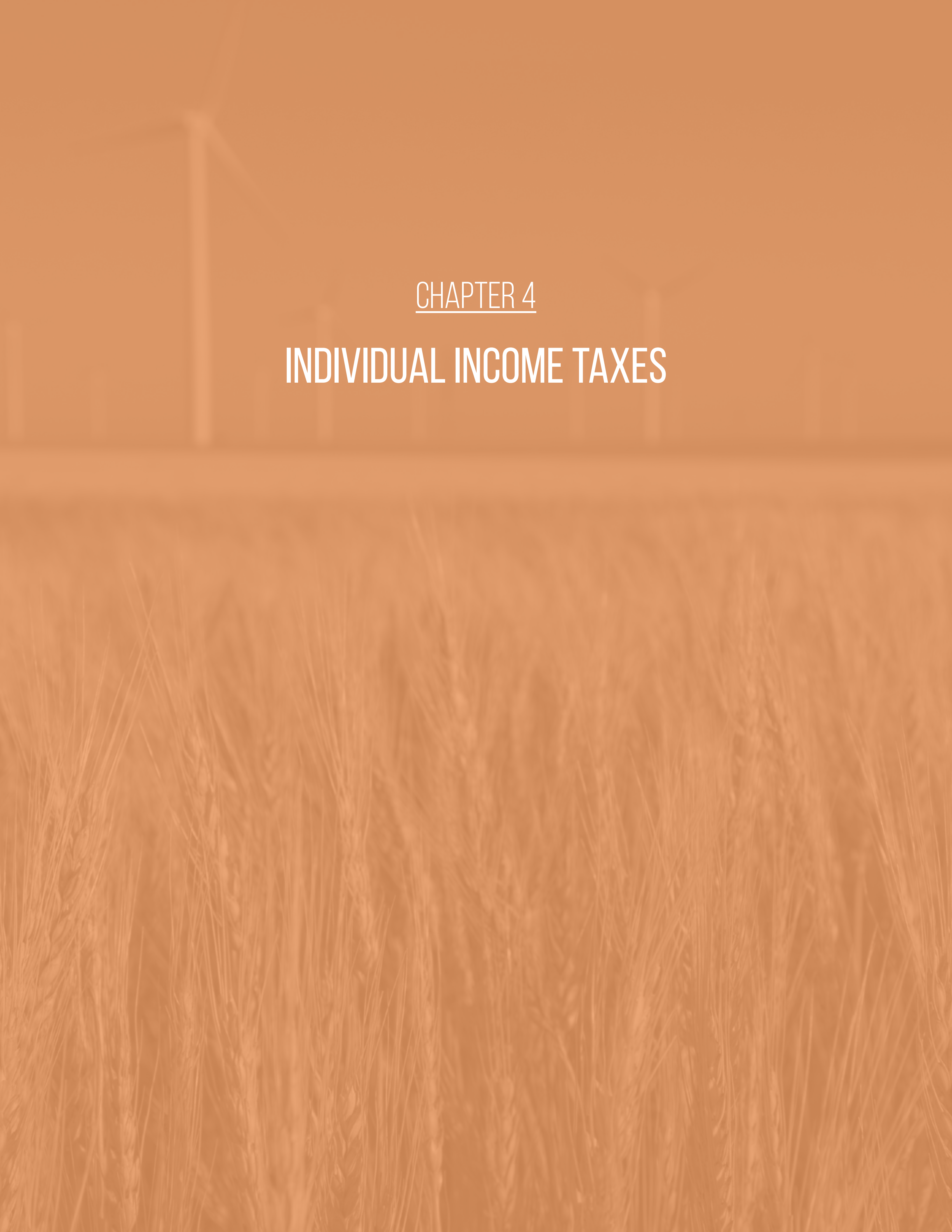
## Consider Rate Reform

In recent years, a percentage point on the top corporate income tax rate has been worth between $53 million and $65 million, all else being equal. Kansas' 7 percent top corporate rate is slightly worse than average, tied for 21st-highest among the country's 44 corporate income taxes. Three of Kansas' four neighboring states (Colorado, Missouri, and Oklahoma) have lower corporate income tax rates, and Missouri's corporate rate will decline to 4 percent in 2020. Subject to revenue availability, getting Kansas' rate to 6 percent or lower should be a priority for state lawmakers, with reductions paid down by some combination of incentive reform, sales tax base broadening, and economic growth.

Given that nearly all tax revenue comes from income to which the top rate (more accurately, the base rate plus the surtax) is applied, policymakers might consider simply creating a consolidated 6 percent rate, abandoning a graduated-rate system that has little economic justification and may not even benefit smaller businesses, since many companies with modest liability in the state will be larger companies with a small footprint in Kansas, not small Kansas-based C corporations.

If future economic growth is part of the pay-for to reduce corporate rates, tax triggers (which phase down the rate subject to revenue availability) are an option for phasing down rate reductions, but Kansas policymakers should learn the lesson from the previous triggers they were forced to abandon, which contained design flaws that could have reduced rates while revenues were recovering from a decline, rather than when revenues were actually growing. Well-designed tax triggers establish a static baseline rather than using year-over-year growth and (if intended to last longer than a couple of years) inflation-adjusted benchmarks, ensuring that they are measuring real growth, not volatility.[72] Combined with structural reforms, even a modest rate reduction could improve Kansas' overall attractiveness for investment and growth.

72 For more on the design of tax triggers, see Jared Walczak, "Designing Tax Triggers: Lessons from the States," Tax Foundation, Sept. 7, 2016, https://taxfoundation.org/designing-tax-triggers-lessons-states/.



CHAPTER 4

# INDIVIDUAL INCOME TAXES

## Introduction

Kansas' individual income tax has a three-bracket graduated-rate structure. The top rate of 5.7 percent kicks in at $30,000 in marginal taxable income for single filers and $60,000 for married couples filing jointly. As such, even after accounting for the standard deduction, personal exemption, and other policies which reduce taxable income, it is not unusual for Kansas wage earners to have income exposed to the top marginal rate.

Individual income taxes are not exclusively of interest to individual taxpayers, as many businesses (S corporations, LLCs, partnerships, and sole proprietorships) pay business taxes through the individual income tax code. Since individual income taxes impact Kansas employers, it is important to consider businesses as well as individual payers when contemplating changes to the individual tax code.

Kansas' tax rates and collections per capita are in the middle of the pack compared to the state's regional competitors and the nation at large. However, Kansas is outperformed by its peers on some structural measures of the individual income tax. In this chapter, we provide a broad overview of the state's individual income tax, outline issues with the current system, and discuss potential reform solutions.



## A Brief History of Kansas' Individual Income Tax

State income taxes became prominent during the Great Depression, and Kansas' adoption of a five-bracket individual income tax in 1933 aligned with the broader tax trend that was driving state tax policy at the time. Confronted with a steep decline in property tax assessments (and, consequently, property tax collections) during the Depression, states increasingly sought to diversify their tax collections. Income taxes proved to be a popular option for diversifying state tax revenue streams.[73]

In 1933, one year after voters ratified a constitutional amendment allowing the legislature to levy taxes on income, the state adopted both a corporate and an individual income tax.[74] That original tax, with five brackets and a top rate of 4 percent, stayed in place for over two decades. The top two rates increased slightly in 1957, followed by across-the-board 0.5 percentage-point rate increases the following year. In 1965, rates increased again, this time by a full percentage point, but in 1967, the bottom rate was lowered slightly.

Broader revisions came in 1977, when the state retained the five existing rates and brackets but supplemented them with three additional brackets. The new top rate of 9 percent kicked in at $25,000 in taxable income, the equivalent of about $104,000 in today's dollars. Those rates stayed in place for a little over a decade, until major tax reform was enacted in 1988, marking Kansas' most significant tax changes of the 20th century. This new law, which was Kansas' response to the federal Tax Reform Act of

73 Ronald Snell, "State Finance in the Great Depression," National Conference of State Legislatures, March 2009, 3, http://www.ncsl.org/print/fiscal/statefinancegreatdepression.pdf.

74 Peter Fearon, "Taxation, Spending, and Budgets: Public Finance in Kansas During the Great Depression," *Kansas History* 28:4 (Winter 2005/2006), 234-235, https://www.kshs.org/publicat/history/2005winter_fearon.pdf.

1986, enhanced Kansas' conformity with the federal tax code, and in so doing broadened Kansas' tax base. Kansas lawmakers responded by using the increased revenue from these base-broadening provisions to pay off some of the state's debt and improve the state's tax structure.[75] Specifically, Kansas consolidated eight individual income tax brackets into two, and lowered rates in both 1988 and 1989.

In 1992, the state modified its rates and brackets and added a new top rate,[76] and in 1997, the lowest rate was adjusted downward. Rates were reduced again for tax year 1998, and those reductions remained in place through 2012.

The tax cuts of 2012 not only consolidated three brackets back into two while reducing rates, but also completely eliminated income tax for businesses structured as pass-through entities. As a result, households and traditional C corporations remained subject to the income tax, while income earned by S corporations, LLCs, partnerships, and sole proprietorships became exempt. This unprecedented move was enacted with the intention of spurring business formation and investment, but there is little evidence of success, with businesses having seemingly been wary to the sustainability of the broader changes to taxes and spending, notwithstanding the tax break that some received.[77] Indeed, our discussions with pass-through business owners across the state provided anecdotal evidence that few considered the pass-through income tax exemption to be sustainable. Because these income tax changes were made without spending reductions or sufficient revenue offsets, the 2012 tax cuts resulted in significant and persistent revenue shortfalls for the state.[78]

The standard deduction was reduced for married couples in 2013, and many itemized deductions were made less generous in order to reduce rates further. However, the state's budget woes continued. In 2017, the legislature passed Senate Bill 30 and then overrode the governor's veto of the same bill to unwind most of the tax changes of preceding years. The pass-through exemption was repealed in 2017, and rates and brackets were increased for tax year 2017 and again for tax year 2018. Table 4.1 shows how Kansas' individual income tax rate schedule has evolved since the inception of the state's income tax in 1933.



75 Governor John Michael Hayden, *Answering the Challenge* (State of the State address), Jan. 9, 1989, https://kslib.info/DocumentCenter/View/1124/John-Michael-Hayden---Governors-Message-1989.

76 Chris Courtwright, Tom Severn, and Richard Ryan, *Kansas Tax Facts*, Sixth Edition, Kansas Legislative Research Department, November 1993, http://www.kslegresearch.org/KLRD-web/Publications/TaxFacts/1993TaxFacts6thEd.pdf.

77 Jason DeBacker, Bradley T. Heim, Shanthi P. Ramnath, and Justin M. Ross, "The Impact of State Taxes on Pass-Through Businesses: Evidence from the 2012 Kansas Income Tax Reform," *Journal of Public Economics* 174 (June 2019), 1, https://www.sciencedirect.com/science/article/abs/pii/S0047272719300386.

78 Liz Malm and Joseph Bishop-Henchman, "Kansas May Face Budget Problems as Senate Again Strips Tax Reform Out of Tax Cut Bill," Tax Foundation, Mar. 15, 2013, https://taxfoundation.org/kansas-may-face-budget-problems-senate-again-strips-tax-reform-out-tax-cut-bill/.

TABLE 4.1.

**Kansas' Individual Income Tax Rate History**

*1927-2018 (Single Filers)*

| 1933-1956 | | | 1957 | | | 1958-1964 | | |
|---|---|---|---|---|---|---|---|---|
| 1.0% | > | $0 | 1.0% | > | $0 | 1.5% | > | $0 |
| 2.0% | > | $2,000 | 2.0% | > | $2,000 | 2.5% | > | $2,000 |
| 2.5% | > | $3,000 | 2.5% | > | $3,000 | 3.0% | > | $3,000 |
| 3.0% | > | $5,000 | 3.5% | > | $5,000 | 4.0% | > | $5,000 |
| 4.0% | > | $7,000 | 5.0% | > | $7,000 | 5.5% | > | $7,000 |

| 1965-1966 | | | 1967-1976 | | | 1977-1987 | | |
|---|---|---|---|---|---|---|---|---|
| 2.5% | > | $0 | 2.0% | > | $0 | 2.0% | > | $0 |
| 3.5% | > | $2,000 | 3.5% | > | $2,000 | 3.5% | > | $2,000 |
| 4.0% | > | $3,000 | 4.0% | > | $3,000 | 4.0% | > | $3,000 |
| 5.0% | > | $5,000 | 5.0% | > | $5,000 | 5.0% | > | $5,000 |
| 6.5% | > | $7,000 | 6.5% | > | $7,000 | 6.5% | > | $7,000 |
| | | | | | | 7.5% | > | $10,000 |
| | | | | | | 8.5% | > | $20,000 |
| | | | | | | 9.0% | > | $25,000 |

| 1988 | | | 1989-1991 | | | 1992-1996 | | |
|---|---|---|---|---|---|---|---|---|
| 4.8% | > | $0 | 4.50% | > | $0 | 4.40% | > | $0 |
| 6.1% | > | $27,500 | 5.95% | > | $27,500 | 7.50% | > | $20,000 |
| | | | | | | 7.75% | > | $30,000 |

| 1997 | | | 1998-2012 | | | 2013 | | |
|---|---|---|---|---|---|---|---|---|
| 4.10% | > | $0 | 3.50% | > | $0 | 3.0% | > | $0 |
| 7.50% | > | $20,000 | 6.25% | > | $15,000 | 4.9% | > | $15,000 |
| 7.75% | > | $30,000 | 6.45% | > | $30,000 | | | |

| 2014 | | | 2015-2016 | | | 2017 | | |
|---|---|---|---|---|---|---|---|---|
| 2.7% | > | $0 | 2.7% | > | $0 | 2.9% | > | $0 |
| 4.8% | > | $15,000 | 4.6% | > | $15,000 | 4.9% | > | $15,000 |
| | | | | | | 5.2% | > | $30,000 |

| 2018 | | |
|---|---|---|
| 3.10% | > | $0 |
| 5.25% | > | $15,000 |
| 5.70% | > | $30,000 |

Sources: Kansas Department of Revenue; Kansas Legislative Research Department; Tax Foundation research.

## Comparing Kansas' Individual Income Tax Regionally and Nationally

Compared to other state individual income tax systems, Kansas' has an average ranking on our *State Business Tax Climate Index*. The *Index* provides a measure of a state's tax structure, not its collections. Kansas has average rates and moderate collections per capita (the 33rd highest state income tax collections per capita in the US). The *Index* highlights how Kansas' individual income tax structure is also average in terms of its competitiveness compared to other states.

For example, unlike many states, Kansas does not index its brackets, standard deduction, or personal exemption for inflation. As a result, *de facto* tax increases occur when inflation shifts a greater share of taxpayers' income into higher brackets. Table 4.2 shows Kansas' individual income tax component rankings on the *Index*, in addition to the rankings of select regional competitors.

TABLE 4.2.

## *State Business Tax Climate Index* Individual Income Tax Component Rankings

*Kansas and Regional Competitors (2020)*

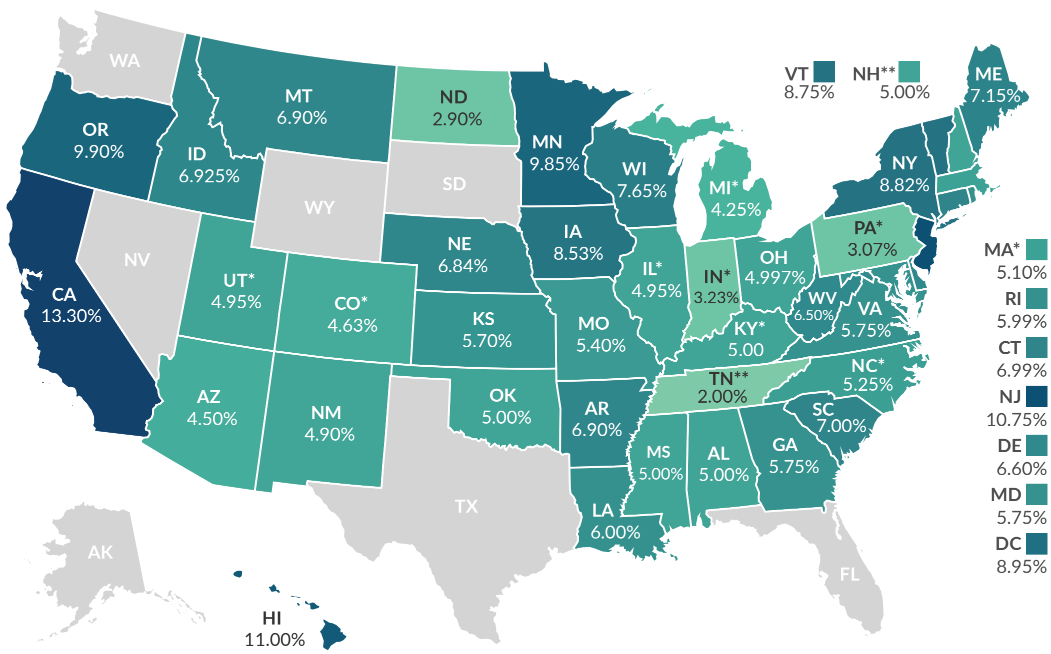
| State | Component Ranking |
|---|---|
| Kansas | 23rd |
| Arkansas | 40th |
| Colorado | 14th |
| Indiana | 15th |
| Iowa | 42nd |
| Missouri | 24th |
| Nebraska | 21st |
| Oklahoma | 33rd |

Source: Tax Foundation, *2020 State Business Tax Climate Index*.

Kansas' top marginal rate, at 5.7 percent, is the median among the regional peers we considered (see Figure 4.1). While Iowa, Nebraska, and Arkansas have higher top rates, Missouri's top rate is lower, and Colorado and Indiana each have flat taxes with lower rates.

FIGURE 4.1.

## Top State Marginal Individual Income Tax Rates (as of July 1, 2019)




Note: (*) State has a flat income tax. (**)State only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

Source: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

Top State Marginal Individual Income Tax Rate

Lower Higher

# Individual Income Tax Collections

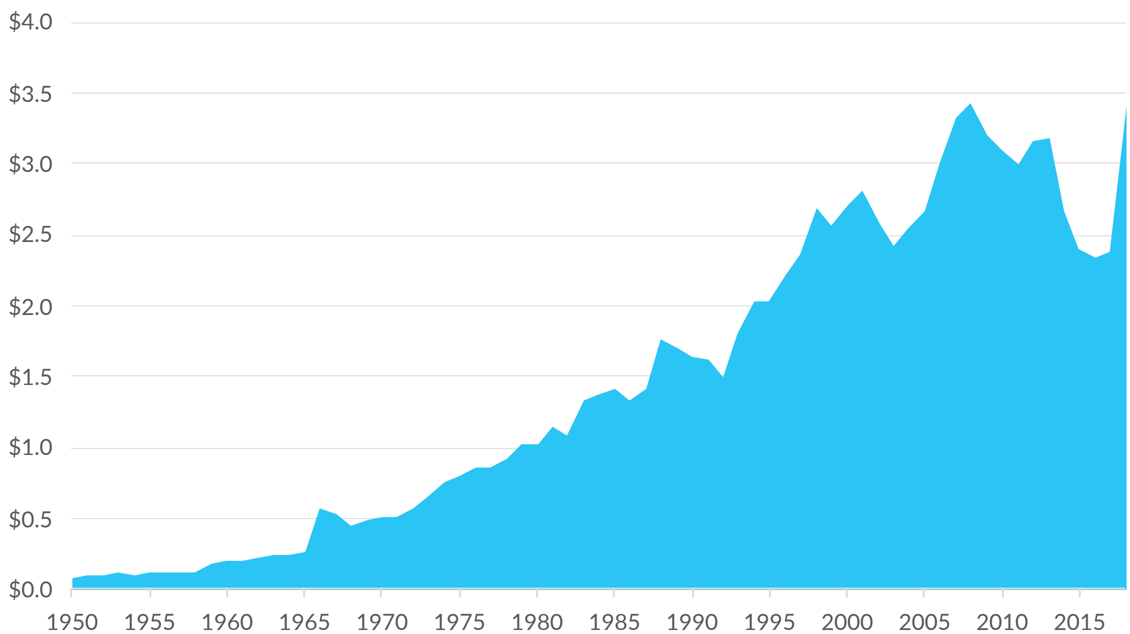
Individual income tax collections have grown significantly through the years, but have also experienced considerable volatility, dipping notably during recessionary periods. The most dramatic reduction in income tax collections occurred after the 2012 tax cuts, with collections dropping by almost 25 percent (in real terms) between fiscal year 2013 and fiscal year 2015. After most of the tax cuts were reversed in 2017, collections increased dramatically. In fiscal year 2018, the individual income tax brought in $3.4 billion, more revenue (in real terms) than in any year before the cuts.

Before the 2012 tax cuts took effect, the individual income tax was the largest single source of state tax revenue. Between fiscal years 2014 and 2017, however, the sales tax surpassed the individual income tax as the largest state tax revenue source, with the gap widening by as much as 10 percentage points in fiscal year 2015. (The sales tax brought in nearly 40 percent of state tax collections and the individual income tax brought in only 29 percent that year.) Today, the individual income tax is once again the largest single source of state tax revenue, generating 35.8 percent of Kansas' state tax collections in fiscal year 2018.[79]

FIGURE 4.2.

**Kansas Individual Income Tax Collections**

*1950-2018 (in billions of 2018 dollars)*




Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U).
Source: U.S. Census Bureau, "Annual Surveys of State and Local Government Finances"; Bureau of Labor Statistics, "Consumer Price Indexes (All Urban Consumers)."

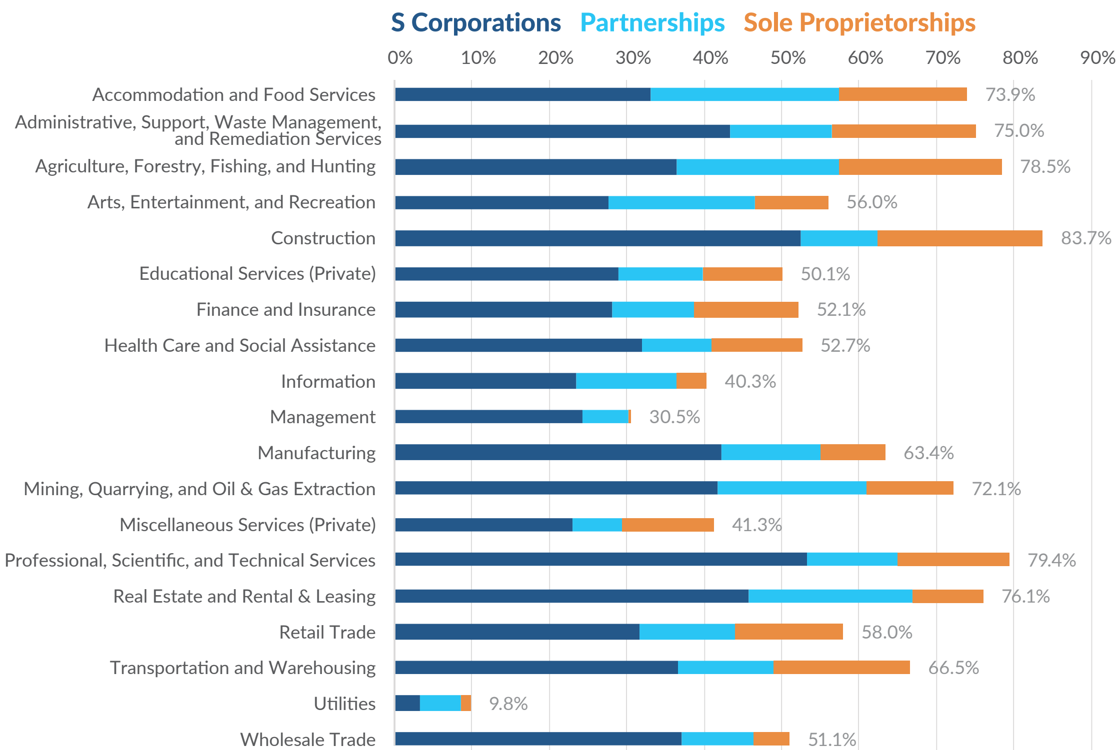
79 U.S. Census Bureau, "Annual Survey of State Government Finances (FY 2018)," https://www.census.gov/data/tables/2018/econ/stc/2018-annual.html.

## Impact of the Individual Income Tax on Kansas Businesses

Individual income taxes are of considerable importance to pass-through entities, which are non-corporate businesses that pay the individual income tax in lieu of the corporate income tax. The earnings for such businesses "pass through" to the income tax form of the owners or shareholders rather than being remitted by the business entity itself. Because S corporations, partnerships, sole proprietorships, and limited liability companies (LLCs) remit their income tax payments through the individual income tax, the individual code impacts the majority of Kansas businesses. Figure 4.3 shows the share of employer firms in each sector that pay individual income taxes in Kansas (separated by business type).[80]

FIGURE 4.3.

**Kansas Employer Firms Subject to the Individual Income Tax**




Note: Does not include non-employer firms.
Source: U.S. Census Bureau, "County Business Patterns."

## Structural Elements

Kansas' three bracket, graduated-rate income tax structure with a relatively low top marginal income threshold looks similar to the rate schedules in several southeastern states. While states like Alabama and Mississippi have even flatter rate structures (at least in the sense that more income is subject to the top marginal rate), Kansas' graduated rate structure is still relatively simple, with the top rate kicking in at $30,000 for single filers (Table 4.3).[81]

80 U.S. Census Bureau, "County Business Patterns, Geographic Area Series: County Business Patterns by Legal Form of Organization," 2016.

81 See Katherine Loughead and Emma Wei, "State Individual Income Tax Rates and Brackets for 2019," Tax Foundation, Mar. 20, 2019, https://taxfoundation.org/state-individual-income-tax-rates-brackets-2019/.

TABLE 4.3.

**Kansas' Current Individual Income Tax Rate Schedule (Tax Year 2019)**

| Single Filers | | | Married Filing Jointly | | |
|---|---|---|---|---|---|
| 3.10% | > | $0 | 3.10% | > | $0 |
| 5.25% | > | $15,000 | 5.25% | > | $30,000 |
| 5.70% | > | $30,000 | 5.70% | > | $60,000 |

Source: Kansas Department of Revenue.

The tax is, nevertheless, clearly progressive for low-income earners. Those earning less than $25,000 are responsible for 8 percent of Kansas income but only 0.2 percent of tax liability, while filers with between $25,000 and $49,999 in federal adjusted gross income (AGI) face a share of tax liability that is about two-thirds what would be proportionate to their income. Those earning between $50,000 and $100,000 in taxable income have a share of tax liability roughly proportionate to their share of state income, while those with the highest incomes pay commensurately more in income taxes than what is proportionate to their share of state income. In addition to the progressivity of the rate schedule, the refundable Earned Income Tax Credit (EITC) contributes to the low share of tax liability for those earning under $25,000 (Table 4.4).

TABLE 4.4.

**Share of AGI and Tax Liability by Income Group for Resident Taxpayers (Tax Year 2016)**

| AGI Class | Share of AGI | Share of Tax Liability |
|---|---|---|
| $0 - $24,999 | 8% | 0.20% |
| $25,000 - $49,999 | 16% | 11% |
| $50,000 - 74,999 | 14% | 13% |
| $75,000 - $100,000 | 14% | 14% |
| $100,000 - $250,000 | 32% | 39% |
| $250,000 + | 18% | 23% |

Source: Kansas Department of Revenue, "2018 Complete Annual Report," 22.

Taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive review of international econometric tax studies, Arnold et al. (2011) found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The authors found that consumption and property taxes are the least harmful to economic growth.[82]

The economic literature on graduated-rate income taxes is particularly unfavorable.[83] The Arnold et al. study concluded that reductions in top marginal rates would be beneficial to long-term growth, and Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the efficiency advantage embedded in the precept of broad

82 Jens Arnold, Bert Brys, Christopher Heady, Åsa Johannsson, Cyrille Schwellnus, and Laura Vartia, "Tax Policy for Economic Recovery and Growth," *The Economic Journal* 121:550 (February 2011).

83 See William McBride, "What is the Evidence on Taxes and Growth?" Tax Foundation, Dec. 18, 2012, https://taxfoundation.org/what-evidence-taxes-and-growth.

bases and low rates.[84] Marginal tax rates, defined as the rate on the last dollar of income earned, matter because they are the rates at which decisions are made.

Table 4.5 uses three different example income levels to show how Kansas' income tax burden compares to the income tax burden in various states in the region. Notably, at all three sample income levels shown, the state tax burden in Kansas is lower than the burden in Arkansas, Iowa, and Nebraska, but higher than the state tax burden in Colorado, Indiana, Missouri, and Oklahoma. However, it is important to point out that several of these states allow local governments to levy local income taxes that are not reflected in this comparison, while Kansas does not allow its municipalities to levy local income taxes.

TABLE 4.5.

**State Individual Income Tax Burdens at Different Levels of Taxable Income**

*Kansas and Regional Competitors (Single Filer, Tax Year 2019)*

| State | $75,000 | $150,000 | $250,000 |
|---|---|---|---|
| Kansas | $3,518 | $7,793 | $13,493 |
| Arkansas | $3,909 | $9,084 | $15,984 |
| Colorado | $2,908 | $6,380 | $11,010 |
| Indiana | $2,390 | $4,813 | $8,043 |
| Iowa | $4,261 | $10,649 | $19,179 |
| Missouri | $3,210 | $7,260 | $12,660 |
| Nebraska | $3,726 | $8,856 | $15,696 |
| Oklahoma | $3,194 | $6,944 | $11,944 |

Note: Assumes single filer claiming the standard deduction and one personal exemption. Some states adjust their brackets for inflation and may be subject to change. Arkansas, Colorado, Indiana, Iowa, and Missouri's local income taxes are not included, although these can be substantial.
Source: Author's calculations.

## Internal Revenue Code Conformity

States frequently seek to conform many elements of their state tax codes to the federal tax code for reasons of administrative simplicity, though no state conforms on all elements. This harmonization of definitions and policies reduces compliance costs for individuals and businesses with liability in multiple states, and it limits the potential for double taxation of income.[85] No state conforms to the federal code in all respects, and not all provisions of the federal code make for good tax policy, but greater conformity substantially reduces tax complexity and has significant value.

In Kansas, as in 28 other states and the District of Columbia, the income tax base begins with federal AGI,[86] though some adjustments (such as the addition for public employee retirement contributions and the subtraction for public employee retirement benefits) diverge from the federal treatment of income.

84 John K. Mullen and Martin Williams, "Marginal Tax Rates and State Economic Growth," *Regional Science and Urban Economics* 24:6 (December 1994).

85 Jared Walczak, "Toward a State of Conformity: State Tax Codes a Year After Federal Tax Reform," Tax Foundation, January 2019, 9, https://files.taxfoundation.org/20190201130844/Toward-a-State-of-Conformity-State-Tax-Codes-a-Year-After-Federal-Tax-Reform-FF-631.pdf.

86 Another six states begin with federal taxable income. See Id.

For example, contributions to the Kansas Public Employees' Retirement System (KPERS), Kansas Police and Firemen's Retirement System, and the Justice and Judges Retirement System are considered taxable income at the state level but are not subject to federal income taxes. While retirement contributions are subject to state taxation, Kansas public employee retirement benefits are not.

Kansas also differs from the federal government in its taxation of Social Security benefits. Under the federal tax code, Social Security benefits may be taxable depending on the taxpayer's filing status and "combined income" (defined as the taxpayer's AGI plus nontaxable interest earnings plus half of the taxpayer's Social Security benefits).[87] In general, if a taxpayer has other sources of income and combined income of at least $25,000 (single filers) or $32,000 (married filing jointly), Social Security benefits are treated as income for purposes of taxation. Kansas offers a more generous exemption, whereby Social Security benefits are not treated as income for state income tax purposes if a taxpayer's federal AGI is $75,000 or less (regardless of filing status).

## Inflation Adjustments

Inflation indexing is an important facet of a well-structured individual income tax code. When an income tax system does not adjust tax brackets for inflation, a phenomenon known as "bracket creep" can occur. Higher incomes can bump a taxpayer into the next tax bracket, even if that higher income is merely keeping pace with inflation. A lack of inflation adjustment can also push more of a taxpayer's income into the highest marginal income tax bracket for which they qualify. This phenomenon, combined with bracket creep, can lead to a higher average tax rate.

Bracket creep is problematic because Kansans' inflation-increased incomes haven't risen in real terms—they've only grown nominally. In other words, bracket creep means that taxpayers' tax bills increase even though their purchasing power does not. Thus, Kansas' tax code has a default tax increase every year which is minor in any individual year but which becomes a meaningful increase in tax burden when considered over several years. Bracket indexing addresses this by adjusting each bracket level each year based on the level of annual inflation. Ideally, inflation adjustments should apply to more than just tax brackets. The standard deduction and personal exemption should be adjusted annually for inflation as well.

Currently, Kansas does not adjust its brackets, standard deduction, or personal exemption for inflation, but many of the state's regional competitors do make such adjustments. Arkansas, Iowa, and Nebraska index their brackets, while Colorado and Indiana avoid bracket creep entirely due to their single-rate structure. In addition, Arkansas, Colorado, Iowa, Missouri, and Nebraska each index either their standard deduction, personal exemption, or both, for inflation (Table 4.6).

87 Internal Revenue Service: "Publication 915: Social Security and Equivalent Railroad Retirement Benefits," Jan. 9, 2019, https://www.irs.gov/pub/irs-pdf/p915.pdf.

TABLE 4.6.
**Inflation Indexing of Individual Income Tax Brackets, Standard Deduction, and Personal Exemption**
*Kansas and Regional Competitors (as of July 1, 2019)*

| State | Brackets | Standard Deduction | Personal Exemption |
|---|---|---|---|
| Kansas | No | No | No |
| Arkansas | Yes | No | Yes |
| Colorado | Flat Tax | Yes | n.a. |
| Indiana | Flat Tax | n.a. | No |
| Iowa | Yes | Yes | No |
| Missouri | Yes | Yes | n.a. |
| Nebraska | Yes | Yes | Yes |
| Oklahoma | No | No | No |

Source: Jared Walczak, "Inflation Adjusting State Tax Codes: A Primer," Tax Foundation, Oct 29, 2019.

## Deductions, Exemptions, and Credits

### Standard Deduction and Personal Exemption

Kansas offers a standard deduction of $3,000 for single filers, $7,500 for married couples filing jointly, and $5,500 for those filing as head of household. In addition, taxpayers with one or more dependents may claim a standard deduction for each dependent of $500 or the amount of the dependent's earned income up to $3,000, whichever is greater.

Additional standard deductions are available for taxpayers who meet certain qualifying conditions. Specifically, taxpayers age 65 or older may claim an additional deduction of $850 (single filers) or $700 per qualifying person (married couples filing jointly). Taxpayers who are blind may claim an additional standard deduction of $850 (single filers) or $700 per qualifying person (married couples filing jointly).

Between 1988 and 2012, the standard deduction was $3,000 for single filers and $6,000 for married couples filing jointly. However, starting in Tax Year 2013, the standard deduction for married couples filing jointly was increased to become more than the amount that would otherwise be available if each spouse were filing as a single individual. As a result, the standard deduction for married couples contains a $1,500 *de facto* "marriage bonus." At the same time, the additional standard deduction for those who are blind or 65 and older contains a *de facto* "marriage penalty," as it is $150 higher for single individuals than for those who are married filing jointly.

For example, if a married couple files jointly and both spouses are 65 or older, they can claim a total of $1,400 in additional standard deductions, which is $300 less than the $1,700 in combined additional standard deductions they could claim if filing as two single individuals. While the marriage bonus in the standard deduction and the marriage penalty in the additional standard deduction somewhat offset each other, it would make more sense to avoid such discrepancies altogether by determining the deduction for married couples by simply doubling the amount that is available to single filers.

In addition to the standard deduction, Kansas offers a personal exemption of $2,250 per qualifying individual. Kansas taxpayers may claim the same number of personal exemptions on their state return as they are permitted under federal law, but the state offers an additional exemption for those filing as head of household. One of the base-broadening provisions in the federal Tax Cuts and Jobs Act (TCJA), enacted in 2017, was the temporary "zeroing out" of the federal personal exemption. Specifically, through tax year 2025, taxpayers calculate the number of personal exemptions for which they are eligible, but the value of those exemptions is $0. This was done intentionally, instead of repealing the exemptions outright, to allow states which mimic the federal personal exemptions in their own tax code to continue offering those exemptions despite the federal government's decision to suspend them.

## Itemized Deductions

Kansas offers five itemized deductions that are all linked to the itemized deductions available for federal income tax purposes.[88] Kansas taxpayers may only claim itemized deductions on their state return if they claim the deductions on their federal return. The state provides itemized deductions for qualified medical and dental expenses, real estate taxes, personal property taxes, qualified residential interest and mortgage insurance premiums, and charitable contributions.

In tax year 2018, the charitable contribution deduction was offered at 100 percent of the amount available at the federal level, while the other deductions were offered at 50 percent of the federal amount. Under current law, however, these amounts increased to 75 percent of the federal amount in tax year 2019 and will be at parity in tax year 2020.

During conversations we had with Kansans in the course of researching and writing this book, many taxpayers expressed their interest in seeing the state allow taxpayers to claim itemized deductions at the state level even if they do not itemize at the federal level. One of the reasons for this sentiment is that many taxpayers who historically claimed itemized deductions under the federal tax code are now better off claiming the federal standard deduction. The TCJA increased the federal standard deduction from $6,350 (single filers) and $12,700 (married couples filing jointly) in tax year 2017 to $12,000 and $24,000, respectively, adjusted annually for inflation, effective starting in tax year 2018.[89]

Many Kansans benefit from claiming the higher federal standard deduction but would prefer to be able to itemize at the state level rather than claiming Kansas' much lower standard deduction, which does not conform to the new higher federal deduction. In tax year 2018, when the higher federal standard deduction took effect, over 90,000 Kansas filers switched from itemizing to claiming the standard deduction on their federal returns, thus forcing them to also claim the state standard deduction. Data from the Kansas

88 *Form K-40 Kansas Individual Income Tax (2018)*, https://www.ksrevenue.org/pdf/k-4018.pdf.
89 Jared Walczak and Amir El-Sibaie, "Details of the House Tax Cuts and Jobs Act," Tax Foundation, Nov. 2, 2017, https://taxfoundation.org/details-tax-cuts-jobs-act/.

Department of Revenue and the Kansas Legislative Research Department show a 1.7 percent increase in the Kansas AGI of these taxpayers, from tax year 2017 to tax year 2018, but a 15.8 percent increase in tax liability.[90] While some of that increase is due to the rate increases that took effect in 2018, much of it is attributable to the inability of those taxpayers to make an independent itemization decision at the state level.

## Section 179 and the Kansas Expense Deduction

As we met with Kansans—policymakers and taxpayers alike—in the course of the research for this book, it quickly became apparent that few tax topics have engendered more confusion than the status of the Section 179 small business expensing deduction. Kansas' conformity with Section 179 is good and should be preserved. However, since so many misconceptions have arisen about whether and how Kansas implements Section 179 for pass-through businesses, the subject may merit a brief synopsis.

Federal law contains two provisions which allow certain investments in machinery and equipment to be expensed in the first year. The first provision, the temporary full expensing offered under Section 168(k), was discussed in the corporate tax chapter. The second provision, Section 179, is specifically designed for small businesses and is available to small C corporations as well as pass-through businesses. Immediate expensing is good policy, as discussed in the previous chapter, and Section 179 extends the provision—with restrictions—to many small businesses.

Under the TCJA, businesses can expense up to $1 million in machinery and equipment purchases each year (up from $500,000), though the provision begins to phase out when purchases exceed $2.5 million a year. All 43 states with individual income taxes (including the two which only tax interest and dividend income) provide Section 179 deductions. Thirty of them, including Kansas, adopt the federal expensing allowance and investment limit. Meanwhile, two states conform to a stated percentage of federal levels, and 11 states offer small business expensing regimes with their own expensing limits.[91]

In addition to implementing the expensing regimes authorized under Sections 168(k) and 179, however, there was a state-specific Kansas expense deduction which was intended to further enhance first-year depreciation at a time when the Section 168(k) cost recovery regime was not as generous. When initially adopted, this expense deduction applied to both corporations and pass-through businesses. Its value was reduced for corporate taxpayers based on the amount of expensing available through the Section 168 depreciation rules, but it stacked on top of Section 179, such that businesses claiming a Section 179 deduction received an additional Kansas expense deduction even if the Section 179 deduction was enough to allow the full cost of investments to be expensed in the first year.

When, as part of the 2012 tax law, Kansas exempted pass-through business income from the individual income tax, this bonus expensing deduction became inoperable for pass-

90 Data provided by the Kansas Department of Revenue and Kansas Legislative Research Division. Calculations by Dave Trabert and the Kansas Policy Institute.

91 Walczak, "Toward a State of Conformity: State Tax Codes a Year After Federal Tax Reform," 21.

through businesses, since there was no income tax liability against which a deduction could be taken. When pass-through income was restored to the tax base, the Kansas expense deduction was disallowed for these businesses, preventing the double counting of investment that was previously permitted.[92]

This chain of events appears to have left many Kansans, including policymakers, with the impression that an omission in legislation reversing the pass-through exemption inadvertently denied small businesses the Section 179 deduction to which they had always been entitled. This is not the case. Small businesses in Kansas may take full advantage of Section 179, whether they are organized as a pass-through business or a C corporation. They simply cannot deduct *more* than the full cost of their investment, as was once possible.

## Individual Income Tax Credits

Although tax credits narrow the state's individual income tax base, the overwhelming share of expenditure spending is either structurally necessary to reach a proper definition of income or represents social welfare spending likely to enjoy high levels of political support. For example, in tax year 2011 (the most recent year for which a full accounting of tax credits is available while pass-through businesses were subject to the individual income tax),[93] tax credits reduced collections by nearly $503 million, but over $382 million of this was subsumed by a credit for taxes paid to other states (necessary to avoid double taxation, with two states claiming the same income). The next largest credit was the Earned Income Tax Credit (EITC), which resulted in $89 million in forgone revenue for Kansas that year.

Like the federal EITC, the Kansas EITC is refundable. Under current law, if a Kansas taxpayer is eligible for the federal EITC, he or she can claim 17 percent of that amount against any Kansas income tax liability. If the credit amount exceeds that taxpayer's liability, the taxpayer is granted a refund in the form of a check. In general, the EITC can be a valuable tool for providing low-income families with assistance structured in a way that rewards and facilitates work.

The remaining credits, many of them intended for pass-through businesses for economic development purposes and available (to a far greater effect) against the corporate income tax, merit scrutiny, though their reduction of individual income tax collections is modest. As a result, any reduction in credits would not suffice to offset major rate or other tax changes. In tax year 2011, these credits amounted to at least $31 million in forgone revenue for the state (although certain expenditure amounts were kept confidential, for privacy purposes, in cases in which fewer than five filers claimed the credit).

Economic development tax credits tend to be inefficient and diverge from principles of

92 Kansas Department of Revenue, "Creating an Environment for Entrepreneurial Success in Kansas," Oct. 2, 2012, 1-2, https://www.ksrevenue.org/pdf/SB196ExpensingDeduction.pdf.

93 The pass-through exemption was repealed in 2017, effective retroactively to the beginning of tax year 2017, meaning pass-through businesses only claimed credits in tax years 2013 through 2016 if they were carried forward from a previous year. The Kansas Department of Revenue's most recently published "Tax Expenditure Report" encompasses tax year 2016, so, as of this writing, the report for tax year 2011 provides the best available data about tax credits typically claimed by pass-through businesses in Kansas, despite being significantly out of date.

tax neutrality. Because these credits only play a modest role in individual income taxes, discussion of the credits is primarily reserved to the corporate income tax chapter, though the same principles apply here. In tax year 2011, 41 preferential credits were offered and 25 were claimed, costing the state $120 million or more in income tax collections. Several credits offered in 2011 are no longer offered or are offered only as carryforwards for amounts not claimed in prior years. However, several new credits have been created. Table 4.7 lists credits offered against the Kansas individual income tax as of Tax Year 2018. An up-to-date list of expenditure amounts is not yet readily available.

TABLE 4.7.

**Kansas' Individual Income Tax Credits (Tax Year 2018)**

| |
|---|
| Adoption Credit |
| Angel Investor Credit |
| Business and Job Development Tax Credits** |
| Community Service Contribution Credit |
| Credit for Child and Dependent Care Expenses |
| Credit for Taxes Paid to Other States* |
| Declared Disaster Capital Investment Credit** |
| Disabled Access Credit |
| Earned Income Tax Credit (EITC) |
| Electric Cogeneration Facility Credit** |
| Farm Net Operating Loss* |
| High Performance Incentive Program (HPIP) Credit |
| Historic Preservation Tax Credit |
| Individual Development Account Credit |
| Kansas Center for Entrepreneurship Credit |
| Low Income Student Scholarship Credit |
| Owners Promoting Employment Across Kansas (PEAK) Credit |
| Plugging Abandoned Gas or Oil Well** |
| Research and Development Credit** |
| Storage and Blending Equipment** |
| Venture and Local Seed Capital** |

Note: *Structural credits are critical to the proper functioning of the tax code and should be preserved.
**Credit is offered only as a carry forward for amounts not claimed in prior years.
Source: Kansas Department of Revenue, Tax Expenditure Reports.

# Individual Income Tax Reform Solutions

Our individual income tax solutions would improve Kansas' competitiveness by enhancing neutrality and preventing bracket creep. While we do not recommend specific rate changes in this chapter, a broad-based, low-rate tax system is most conducive to the state's long-term economic competitiveness and growth, and individual income tax rate reductions and bracket consolidation would improve Kansas' tax competitiveness with states like Colorado and Indiana, which have low, flat rates.

## Index Income Tax Provisions for Inflation

To avoid bracket creep, where inflation leads to greater income tax liability even when real income remains constant, Kansas should index the major provisions of its individual income tax—the brackets, standard deduction, and personal exemption—to inflation. Absent inflation adjustments, higher incomes can bump more of a taxpayer's income into the next tax bracket, even if that income increase is merely nominal, keeping pace with inflation. This yields a higher effective rate even though the taxpayer's income has not increased in real terms. The adoption of indexing provisions, used by the federal government and 25 of the 41 states with wage income taxes, precludes these unintended tax increases.[94]

In designing an inflation adjustment mechanism, the most straightforward approach would be to establish a base year and make cumulative cost-of-living adjustments against the base year in each subsequent year, using the Consumer Price Index (CPI) or some similar measure. Whatever approach is taken, Kansas should apply it to all three major provisions, not brackets alone, to ensure that inflation does not increase taxpayers' liability.

## Increase the Standard Deduction and Eliminate the Marriage Bonus/Penalty

During Kansas' major tax reform in 1988, the state standard deduction increased to $3,000 to match the federal standard deduction.[95] While the standard deduction for married filers has increased slightly since that time (and is now $7,500), the standard deduction for single filers has remained stagnant at $3,000.

Because it is not indexed for inflation, Kansas' standard deduction has lost over half of its real value over time, as $3,000 in 1988 is the equivalent of over $6,000 today. This loss of value, together with the TCJA's significant increase in the federal standard deduction, leads to higher state tax liability for many Kansans if they claim the standard deduction on their federal returns.

94 Jared Walczak, "Inflation Adjusting State Tax Codes: A Primer," Tax Foundation, Oct. 29, 2019, https://taxfoundation.org/inflation-adjusting-state-tax-codes/."

95 *Kansas Tax Facts*, 38.

An increase in Kansas' standard deduction would help reduce this discrepancy, while creating an opportunity to remedy the marriage bonus that exists in the standard deduction and the marriage penalty that exists in the additional standard deduction for those who are blind or have reached the age of 65. While it would ultimately make sense to bring Kansas' standard deduction into greater alignment with the federal amount, a reasonable short-term solution would be to incrementally increase Kansas' deduction for individuals from $3,000 to $3,750 so that it is half the amount that is currently available to married couples filing jointly ($7,500). Policymakers can remedy the marriage penalty in the additional standard deduction for those who are blind or who have reached the age of 65 by simply increasing the married filing jointly amount from $700 to $850 per qualifying person. To avoid the reintroduction of a marriage penalty or marriage bonus in the future, any further changes should be made in such a way that married couples receive double the deduction amount that is available to single filers—both in the standard deduction and additional standard deduction.

## Allow an Independent Choice of Itemization

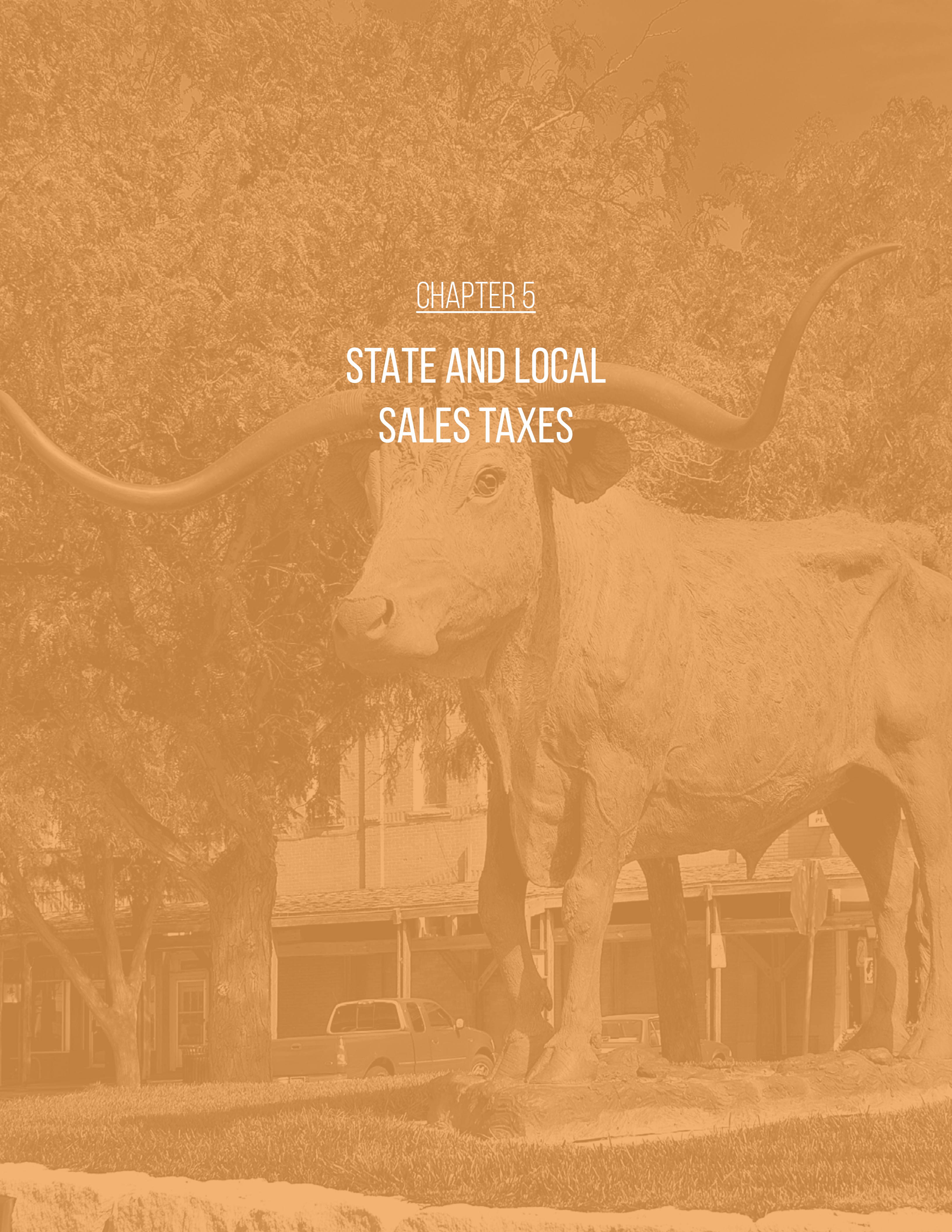
In addition to increasing the state standard deduction and indexing it for inflation, it would be reasonable for the state to allow Kansans to itemize on their state return even if they claim the standard deduction on their federal return. Allowing Kansans to itemize at the state level while claiming the standard deduction at the federal level would result in additional forgone revenue for the state, but it is worth bearing in mind that this is a return to the *status quo*, the reversal of an unlegislated tax increase effected on Kansas taxpayers by the state's inaction after federal tax reform.

## Roll Back Excessive Credits

Tax credits reduced individual income tax collections by approximately $503 million in tax year 2011. While some credits (like the credit for taxes paid to other states and the farm net operating loss credit) are structural in nature and are therefore important to the proper functioning of the tax code, the remaining credits, worth about $120 million in tax year 2011, are preferential in nature. Kansas' preferential credits, intended to promote certain social objectives (like the EITC and the adoption credit) or economic development goals (like the angel investor credit), added up to only about 5 percent of the amount the state brought in in individual income tax collections that year. It is safe to assume that this tax expenditure is modestly higher today. For reasons discussed at greater length in Chapter 3, there is little reason to believe these credits induce significant investment or promote meaningful economic growth. Benefits accrue to industries and activities favored by the legislature, a state of affairs which is likely to encourage economic decision-making different from the choices that would be made under a more neutral regime. Although the revenue gains would be modest, reducing reliance on targeted tax incentives can help pay down more meaningful structural reforms.

## Eliminate the Social Security Tax Cliff

While intended as a way to reduce tax burdens for those on the lower end of the income spectrum, the design of Kansas' tax treatment of the Social Security benefits has unintended consequences. By excluding from taxable income the Social Security benefits of those whose federal AGI is $75,000 or under, a tax cliff is created, whereby a taxpayer with combined income of $75,000 will have none of their Social Security benefits taxed, while someone with $75,001 in combined income will have all of their Social Security benefits taxed. This tax cliff creates a disincentive to increase income from other sources while collecting Social Security benefits. Short of taxing all Social Security benefits equally (which would generate an additional $21 million), the state might implement a gradual phaseout to avoid this steep tax cliff.



CHAPTER 5

# STATE AND LOCAL SALES TAXES

## Introduction

Kansas lawmakers amended the state constitution in 1936 to allow the state's full participation in federal Social Security programs.[96] Kansas then first adopted its Retailers' Sales Tax and Compensating Tax (use tax) in 1937, when it was levied at a rate of 2 percent, in large part to fund state social assistance and education.[97]

Kansas' sales tax was first imposed on the privilege of selling tangible personal property (TPP) in the state, providing certain utility services, serving meals or drinks, or selling admissions to amusement, entertainment, and recreational events.[98] Today, the tax is imposed on a base that consists of most goods, with some notable exceptions, and specific services enumerated in law.

The sales tax is a crucial part of Kansas' state and local revenue toolkit and is the state's second-largest source of state tax revenue. In the eight decades since the sales tax was first put into effect, the state sales tax rate has been increased eight times and decreased once (Table 5.1). The current 6.5 percent rate has been in effect since 2015, when it was increased from 6.15 percent. Prior to that, the sales tax rate had been on a downward trajectory, scheduled to be further reduced to 5.7 percent. In addition to the state sales tax, counties, cities, and special districts can also impose local sales taxes, which vary in rate from one jurisdiction to the next.

Kansas' sales tax faces challenges common to many of its economic competitors, including a tax base that is shrinking as a share of total consumption and limited taxation of the service sector. In 2017, legislators contemplated broadening the sales tax base to include additional consumer services, but this proposal failed to gain traction.

A challenge that persists in Kansas, despite having largely been addressed by most other states, is the taxation of remote sales following the U.S. Supreme Court's landmark decision in *South Dakota v. Wayfair*. Kansas policymakers were unable to revise the state's remote sales tax collections laws, despite the state's sales tax system otherwise being in prime position to do so. In the absence of legislation, the state chose to enforce sales tax collection requirements on remote sellers and marketplace facilitators without adopting protections for small sellers, setting the state up for a likely legal battle.

In this chapter, we provide a general overview of Kansas' sales tax system and offer recommendations for modernizing the sales tax base. We review the state's current sales tax structure, compare Kansas' sales tax to the state's regional competitors and the nation at large, examine Kansas' treatment of business inputs, explore options for expanding the base to include additional goods and services, and consider how the state can responsibly move forward with remote sales tax collection. We conclude the chapter by outlining proposals for improving the structure of the sales tax, including a menu of sales tax base-broadening options.



96 Kansas Department of Revenue, "Kansas Sales Tax and Compensating Use Tax," KS-1510, 2019, 3, https://www.ksrevenue.org/pdf/pub1510.pdf.

97 Peter Fearon, "Kansas History and the New Deal Era," *Kansas History: A Journal of the Central Plains*, 2007, 209, https://www.kshs.org/publicat/history/2007autumn_fearon.pdf.

98 John D. Wong and Nickolaus Hernandez, "Sales Tax Erosion in Kansas," Kansas Public Finance Center, December 2006, 4, https://www.wichita.edu/academics/fairmount_college_of_liberal_arts_and_sciences/hugowall/documents/Sales_Tax_Erosion_in_Kansas.pdf.

## Sales Tax Collections

The sales tax is a significant driver of state and local tax revenue in Kansas. It is the second-largest source of tax revenue for both state and local government, trailing the individual income tax at the state level and the property tax at the local level.

Kansas' reliance on sales taxes is slightly below the national average. In fiscal year 2018, the sales tax generated nearly 31 percent of Kansas' state tax collections.[99] For sake of comparison, that same year, sales taxes generated 32 percent of total state tax revenue in the nation at large.

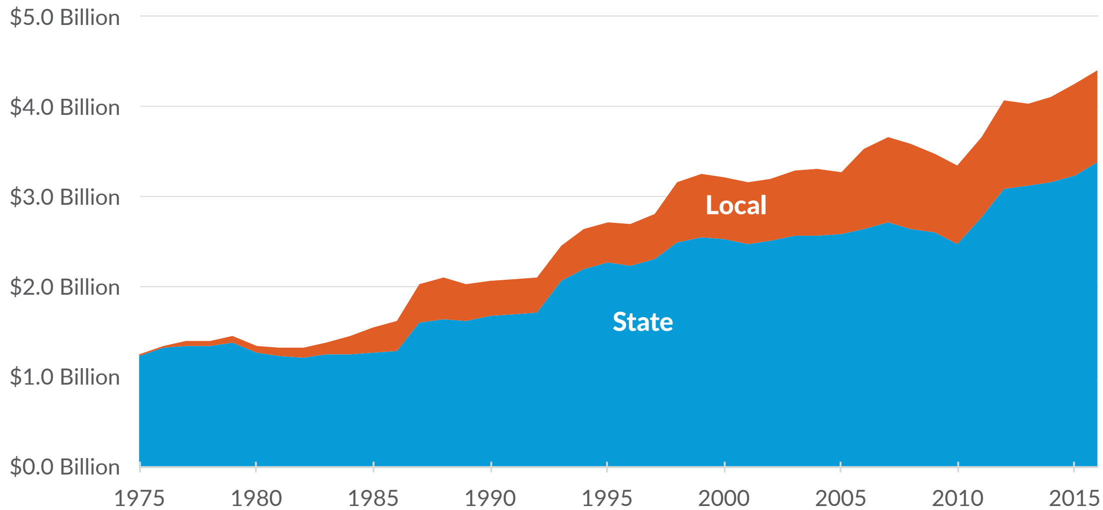
Most state sales tax revenue goes directly to the general fund, but 16.154 percent of general sales tax collections (plus all sales tax revenue from the state fair) is allocated to the state highway fund.[100] In addition, much of the state and local sales tax revenue collected from taxpayers doing business in a Sales Tax and Revenue (STAR) bond district is directed to the city bond fund. Over the past two decades, Kansas has seen $235 million in sales tax revenue used to pay off STAR bond principal, and another $465 million in principal remains to be repaid.[101]

Over the past four decades, state sales tax collections have risen from $1.23 billion in fiscal year 1975 to $3.39 billion in fiscal year 2016 (in constant 2018 dollars).[102] Local sales tax collections have risen from $18.2 million in 1975 (five years after the local option sales tax was adopted) to $1 billion in fiscal year 2016 (in constant 2018 dollars), reflecting the increased uptake of the tax among counties and cities.

FIGURE 5.1.

### State and Local Sales Tax Collections

*1975-2016 (in 2018 dollars)*




Source: U.S. Census Bureau, "Annual Survey of State and Local Government Finances," 1975-2016; Bureau of Labor Statistics, "Consumer Price Index" (All Urban Consumers).

99 U.S. Census Bureau, "Annual Survey of State and Local Government Finances (FY 2016)," https://www.census.gov/programs-surveys/gov-finances/data.html.

100 K.S.A. 79-3620.

101 Steve Vockrodt, Edward McKinley, and Kevin Hardy, "'Ultimate Pork Project': Kansas' Mega Tax Breaks Don't Deliver as Promised," *The Kansas City Star*, July 17, 2019, https://www.kansascity.com/news/politics-government/article232206457.html.

102 U.S. Census Bureau, "Annual Survey of State and Local Government Finances," Historical Data, https://www.census.gov/programs-surveys/gov-finances/data/historical-data.html.

Much of Kansas' growth in sales tax revenue has been contingent upon sales tax rate increases. After collections fell slightly during the recessions of the early 1980s, a sales tax rate increase in 1986 brought about a sharp collections spike. Another rate increase in 1989 yielded only a slight immediate increase in collections due to the recession of the early 1990s. Another rate increase in 1992, and the economic expansion of the mid-1990s, brought a collections influx that lasted until the turn of the century.

In 2002, the sales tax rate increased again, and collections grew slightly each year until the Great Recession, during which time collections fell by nearly a quarter of a billion dollars (in constant 2018 dollars). A full one percentage-point increase in the sales tax rate in 2010 (from 5.3 to 6.3 percent) helped recoup lost revenue, and collections have increased fairly continuously since that time, both in nominal and real terms, despite two years with a slight sales tax rate reduction (from 2013 to 2015).

Table 5.1 shows how Kansas' sales tax rate has changed over time. In the more than eight decades it has been in effect, the state sales tax rate has increased eight times and decreased only once.[103]

TABLE 5.1.
**Kansas State Sales Tax Rate History**

| Year | Rate |
|---|---|
| 1937 | 2.00% |
| 1958 | 2.50% |
| 1965 | 3.00% |
| 1986 | 4.00% |
| 1989 | 4.25% |
| 1992 | 4.90% |
| 2002 | 5.30% |
| 2010 | 6.30% |
| 2013 | 6.15% |
| 2015 | 6.50% |

Source: Kansas Department of Revenue, "Sales Tax and Compensating Use Tax."



103 Kansas Department of Revenue, "Kansas Sales Tax and Compensating Use Tax," 3.

## Comparing Kansas' Sales Tax Structure to Regional and National Competitors

Kansas ranks 38th on the sales tax component of our *State Business Tax Climate Index*. While Kansas outranks Arkansas and Oklahoma in terms of the competitiveness of its sales tax structure, Kansas' high sales tax rate makes it less competitive than regional competitors like Nebraska, Iowa, Indiana, Missouri, and Colorado. Kansas could achieve a tax rate that is more competitive with regional peers through a strategy of broadening the sales tax base to better reflect modern consumption patterns. Table 5.2 shows the *State Business Tax Climate Index* sales tax component rankings of Kansas and its regional competitors.

TABLE 5.2.

***State Business Tax Climate Index* Sales Tax Component Rankings**

*Kansas and Regional Competitors (2020)*

| State | Component Ranking |
|---|---|
| Kansas | 38th |
| Arkansas | 46th |
| Colorado | 37th |
| Indiana | 20th |
| Iowa | 15th |
| Missouri | 24th |
| Nebraska | 10th |
| Oklahoma | 39th |

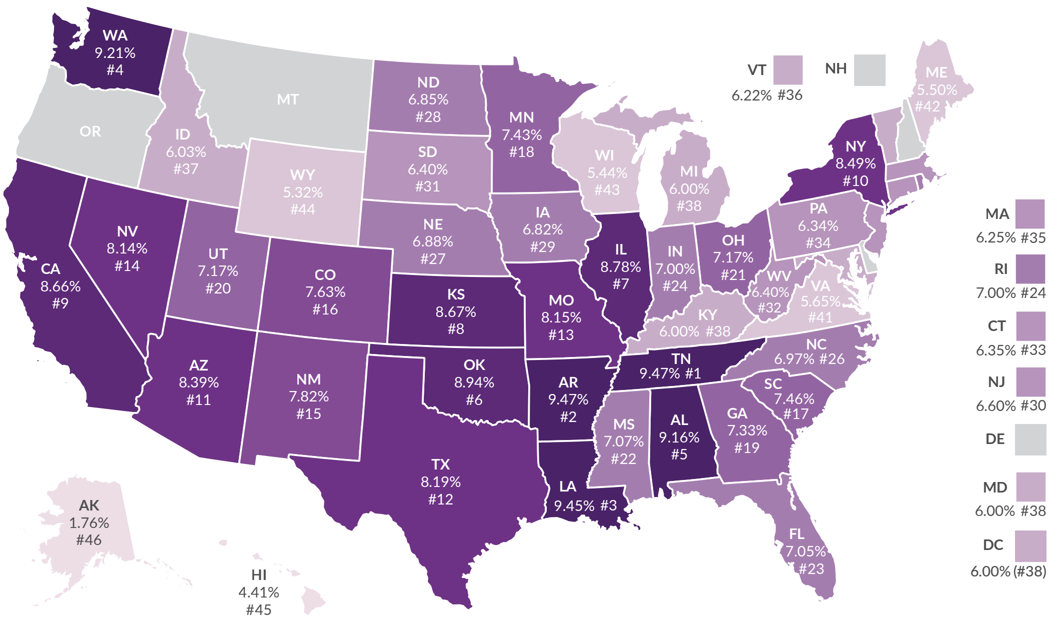
Source: Tax Foundation, *2020 State Business Tax Climate Index*.

## Sales Tax Rate Composition

Most states—Kansas and its regional competitors among them—have a two-part sales tax: a state-level rate that is levied throughout the entire state, and local option sales taxes that are levied in specific jurisdictions, like counties, cities, or special purpose districts. Kansas' sales tax consists of a 6.5 percent state rate, as well as local option sales taxes that vary in rate. Using a weighted average of local sales tax rates, Kansas' average local sales tax rate is 2.17 percent, bringing the combined state and average local sales tax rate to 8.67 percent, the eighth-highest combined rate in the country.

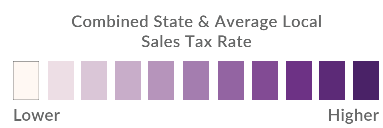
FIGURE 5.2.

## Combined State & Average Local Sales Tax Rates, July 1, 2019




Note: City, county and municipal rates vary. These rates are weighted by population to compute an average local tax rate. Three states levy mandatory, statewide, local add-on sales taxes at the state level: California (1%), Utah (1.25%), and Virginia (1%). We include these in their state sales tax. The sales taxes in Hawaii, New Mexico and South Dakota have broad bases that include many business-to-business services. Special taxes in local resort areas are not counted in Montana's rate. Salem County, N.J., is not subject to the statewide sales tax rate and collects a local rate of 3.3125%. New Jersey's local score is represented as a negative. D.C.'s rank does not affect states' ranks, but the figures in parentheses indicate where it would rank if included.

Source: Sales Tax Clearinghouse; Tax Foundation calculations; State Revenue Department websites.






As Figure 5.2 demonstrates, Kansas is in a high sales tax region of the country, but nevertheless, Kansas' combined state and average local sales tax rate is higher than that of several of its regional competitors, including Colorado, Indiana, Iowa, Missouri, and Nebraska.[104] Among Kansas' bordering states, only Oklahoma has a higher combined state and average local sales tax rate (8.94 percent).

TABLE 5.3.

## Average Combined State and Local Sales Tax Rates

*Kansas and Select Regional Competitors (as of July 1, 2019)*

| State | State Rate | Avg. Local Rate | Combined Rate |
|---|---|---|---|
| Kansas | 6.50% | 2.17% | 8.67% |
| Arkansas | 6.50% | 2.97% | 9.47% |
| Colorado | 2.90% | 4.73% | 7.63% |
| Indiana | 7.00% | 0.00% | 7.00% |
| Iowa | 6.00% | 0.82% | 6.82% |
| Missouri | 4.23% | 3.93% | 8.15% |
| Nebraska | 5.50% | 1.38% | 6.88% |
| Oklahoma | 4.50% | 4.44% | 8.94% |

Note: Average local rates are population-weighted.
Sources: Sales Tax Clearinghouse; Tax Foundation calculations.

104 Janelle Cammenga, "State and Local Sales Tax Rates, Midyear 2019," Tax Foundation, July 10, 2019, https://taxfoundation.org/state-sales-tax-rates-local-sales-tax-rates-midyear-2019/.

## Local Option Sales Tax

Kansas first granted counties and cities the option to levy their own local sales taxes in 1970.[105] More recently, this authority has been extended to multijurisdictional county districts, transportation development districts (TDD), and community improvement districts (CID), usually for the purpose of repaying bonds. The local use tax was originally imposed on motor vehicles in 1982, with watercraft added in 1987. Not until 2003 was the local use tax expanded to match the state sales tax base.[106]

When a county or city wishes to create a sales tax or change the sales tax rate, these changes must be approved by a majority of that jurisdiction's voters.[107] Counties may levy a sales tax in increments of a quarter of a percentage point up to a maximum rate of 1 percent. Cities may levy a sales tax in increments of five-hundredths of a percentage point up to a maximum rate of 3 percent (up to 2 percent for general purposes and up to 1 percent for special purposes). To exceed these maximum rates, specific authorization must be granted by state legislation.

Of the 105 counties in Kansas, seven counties levy a sales tax throughout the entire county, 79 counties levy a county sales tax in only part of the county (usually excluding areas within the city limits of a city that has its own sales tax), and 19 counties completely forgo a county-levied sales tax.[108] Among counties that do levy a sales tax, rates range from 0.5 percent (in parts of Phillips and Rooks Counties) to 3.25 percent (in part of Geary County). Of Kansas' more than 600 cities, nearly half levy a citywide sales tax, with rates ranging from 0.15 percent (in Garden Plain) to 4.0 percent (in Luray).

Most citywide sales taxes in Kansas are levied in lieu of, not on top of, any applicable county sales tax. In only 13 cities is the citywide sales tax levied on top of the county sales tax. Meanwhile, there are 42 cities in which consumers pay neither a city nor a county sales tax. In total, Kansas' various county, city, and special district sales taxes combine to form an estimated 378 sales tax jurisdictions.[109] This multitude of tax jurisdictions can make it challenging for online businesses to determine the applicable sales tax rate in any given geographic location. Kansas mitigates much of this complexity, however, by collecting and administering all state and local sales taxes at the state level through the Kansas Department of Revenue.[110]

## Special District Sales Taxes

In certain areas, additional sales tax levies may be permitted for special purposes. For example, a Transportation Development District (TDD) might levy a special sales tax to repay bonds used to finance transportation-related projects, with developers reimbursed over time as sales tax revenues flow in.[111] In a Community Improvement District (CID),

105 Chris W. Courtwright, *Kansas Tax Facts*, Eighth Edition, Kansas Legislative Research Department, December 2010, 41, http://www.kslegresearch.org/KLRD-web/Publications/TaxFacts/2010TaxFacts8thEd.pdf.
106 Id., 49.
107 Kansas Department of Revenue, "Kansas Sales Tax and Compensating Use Tax," 3.
108 Data from Sales Tax Clearinghouse.
109 Sales Tax Handbook, "Kansas: Sales Tax Handbook," https://www.salestaxhandbook.com/kansas.
110 Kansas Department of Revenue, "Kansas Sales Tax and Compensating Use Tax," 3.
111 City of Lawrence, Kansas, "Sales Tax," https://lawrenceks.org/sales-tax/.

a special sales tax may be levied to help repay bonds used to finance locally-approved public or private developments, such as building and parking construction, infrastructure development, and the acquisition of property.[112]

### STAR Bond Program

In 1998, the Kansas legislature established the Sales Tax and Revenue (STAR) bond program, a tax increment financing (TIF) program that allows city governments to finance large development projects by issuing bonds that are repaid through state and local sales tax revenues generated by those attractions.[113] The STAR bond program was designed to finance major commercial, entertainment, and tourist attractions of state and regional significance. While the program has had certain successes (spurring tourism and specific development aims like the Kansas Speedway and Village West shopping center), it has also received criticism for pouring state taxpayer dollars into certain poor-performing projects (like the foreclosed Heartland Park Topeka motorsports complex) or projects of only local importance (like a local gas station).[114] Even "successful" projects, moreover, might have come at the expense of other development, or could have succeeded in the absence of state assistance.

## Sales Tax Base Composition

Like most states, Kansas imposes its sales tax on a base that consists of most goods—with economically significant policy carveouts—and relatively few services. Most state sales tax bases are narrower than economists would recommend, and Kansas sits in the middle of the pack among states with bases that are narrower than economists would recommend.

Under its state sales tax law, Kansas does not tax gasoline, prescription drugs, or residential utility services.[115] It thus exempts a sizable and stable portion of consumer spending. In fiscal year 2018, state sales tax exemptions on gasoline, prescription drugs, and residential utilities alone cost the state nearly $500 million in forgone revenue. The state also exempts select other goods, as well as most, though not all, services. By law, tangible personal property is included in the sales tax base unless expressly exempted, whereas services are only subject to tax if specifically enumerated.

Apples-to-apples comparisons of state sales tax bases are difficult, but one method that approximates the breadth of the sales tax base is to calculate the value of taxed transactions as a percentage of personal income. Hawaii, for instance, has a sales tax breadth of 105 percent of state income.[116] The state exempts some transactions that

112 Kansas Department of Commerce, "Community Improvement District," https://www.kansascommerce.gov/the-kansas-edge/exemptions-financing-incentives-taxes-unemployment/finance/community-improvement-district/.

113 Reed Holwegner, "B-2 Statewide STAR Bond Authority," *Kansas Legislator Briefing Book 2017*, Kansas Legislative Research Department, 9, http://www.kslegresearch.org/KLRD-web/Publications/BriefingBook/2017Briefs/B-2-StatewideSTARBondAuthority.pdf.

114 See Vockrodt, McKinley, and Hardy, "'Ultimate Pork Project': Kansas' Mega Tax Breaks Don't Deliver as Promised." See also Tim Carpenter, "Twenty Years of STAR Bond Investment in Kansas Reaps Big Rewards, a Few Flops," *The Garden City* (Kansas) *Telegram*, June 17, 2018, https://www.gctelegram.com/news/20180617/twenty-years-of-star-bond-investment-in-kansas-reaps-big-rewards-few-flops.

115 Secretary of Revenue Samuel M. Williams, *Tax Expenditure Report* (2017), Kansas Department of Revenue, 18-26, https://www.ksrevenue.org/pdf/taxexpreport17.pdf.

116 Calculation by Prof. John Mikesell, Indiana University, FY 2017.

arguably should be taxed, but double-taxes others. Kansas likewise exposes some transactions to multiple levels of taxation while omitting others altogether. Kansas' sales tax breadth, at 36 percent of state income in fiscal year 2017, is on par with the median state sales tax breadth.[117] A robust sales tax base would not reach 100 percent, as not all income is consumed in any given year, but in Kansas, it could tax as much as about 75 percent of state income.[118]

Much of Kansas' narrow base stems from its inclusion of relatively few services in the state's sales tax base. Services comprise a much larger share of personal consumption than they did it 1937, when the state sales tax was first adopted. The trend towards a more service-based economy, combined with pressure to exempt certain goods, makes base erosion inevitable. As the base shrinks as a portion of total consumption, lawmakers may continue to turn to rate increases for additional revenue. A better option is to broaden the tax base, which can allow for rate reductions even in revenue-positive scenarios.

## Taxation of Business Inputs

When contemplating broadening the sales tax base, it is important to maintain proper treatment of business inputs. A well-structured sales tax is imposed on all final consumer goods and services while exempting business inputs (goods and services purchased by businesses in the course of producing an output). This is not because businesses deserve special treatment under the tax code, but because applying the sales tax to business inputs results in multiple layers of taxation becoming embedded in the price of the good or service once it reaches the final consumer, an effect known as "tax pyramiding." The result is inequitably higher effective tax rates for industries and products with more stages of production, which is both nontransparent and nonneutral.

Ideally, "business input" status would be determined based on the identity of the purchaser, rather than the good or service itself. In practice, however, states generally make binary choices in determining whether a good or service is subject to the sales tax. These choices are not always clear-cut, though, since many goods and services are consumed by businesses and individuals alike. For instance, when a business retains an outside accounting firm, that is clearly a business input, but individuals sometimes hire accountants as well.

Sometimes this conundrum can be resolved, if only imperfectly, by considering typical use. It is true, for instance, that a select few individuals might occasionally rent a cold storage facility or take out advertising, but these services are overwhelmingly purchased by businesses, and the rare exception should not guide policy. A more interesting case arises with goods and services consumed by both businesses and individuals but which, when used by businesses, are not directly consumed in the production process.

117 Janelle Cammenga, *Facts & Figures 2019: How Does Your State Compare?* Tax Foundation, Mar. 19, 2019, Table 22, https://taxfoundation.org/publications/facts-and-figures/.
118 Tax Foundation calculation based on in-state personal consumption expenditures as a percentage of personal income.

For example, businesses and individuals both buy desk chairs and both procure landscaping services. If a company pays sales tax when ordering a thousand desk chairs, that raises the costs of doing business, and a certain amount of tax pyramiding can be expected to occur. In such cases, exemption certificates are optimal, as they can help prevent tax pyramiding while simultaneously maintaining a broad-based tax on final personal consumption.

In many states, exemption certificates are granted to certain entities, such as nonprofits and agricultural businesses, and this same process could be deployed for both business and nonprofit inputs in Kansas. Currently, Kansas offers different types of exemption certificates for manufacturers and certain tax-exempt projects, but a more widespread, streamlined approach would be optimal.[119] The chief shortcoming of exemption certificates is the administrative hassle they can create for the state, the seller, and the purchaser alike. However, when successfully integrated into a state's sales tax system, exemption certificates can help prevent tax pyramiding, and they carry the advantage of doing so without cluttering the tax code with an overabundance of *ad hoc* structural exemptions.

Unlike many states that offer exemption certificates for nonprofit organizations, Kansas currently exempts nonprofit inputs (and sales made by nonprofits) on a case-by-case basis. This adds unnecessary complexity to the tax code and results in similar organizations being treated differently simply because they have been unable (or have not yet tried) to secure their own specific exemption through the legislative process.

A policy of exempting transactions that are overwhelmingly or exclusively business or nonprofit inputs, while allowing exemption certificates to be used to avoid tax on mixed-use goods and services when the purchaser is a business or nonprofit, represents the best available option for avoiding the taxation of business inputs.

While most states make some effort to exclude business inputs from taxation, few do so consistently or uniformly. It has been estimated that 28 percent of total business taxes paid in Kansas are sales taxes, which is above the national average of 23.1 percent,[120] while another study estimates that 41 percent of all Kansas sales tax revenue comes from the taxation of business inputs, which is, unfortunately, in line with the national average.[121] In a perfectly structured tax code, that share would be zero. The state has taken steps to address the taxation of business inputs over the years, including creating exemptions for manufacturing machinery, equipment, ingredients, component parts, and catalysts, as well as agricultural inputs, such as livestock, seeds, and fertilizers.[122] Nevertheless, other inputs continue to be subject to the tax, undermining tax neutrality and allowing tax costs to be embedded in the final price of goods several times over.

119 "Exemption Certificate Welcome Page," Kansas Department of Revenue, https://www.ksrevenue.org/prpecwelcome.html.

120 Jason Horwitz and Judy Zhang, *2018 State Business Tax Burden Rankings*, Anderson Economic Group, June 13, 2018, https://www.andersoneconomicgroup.com/wp-content/uploads/AEGBusinessTaxBurdenStudy_2018_FINAL.pdf.

121 Andrew Phillips and Muath Ibaid, *The Impact of Imposing Sales Taxes on Busines Inputs*, State Tax Research Institute, the Council on State Taxation, and Ernst & Young LLP, May 2019, 8, https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf.

122 Joint Committee on the State Tax Structure, *Final Report and Recommendations*, Vol. 1, January 1970, 8.

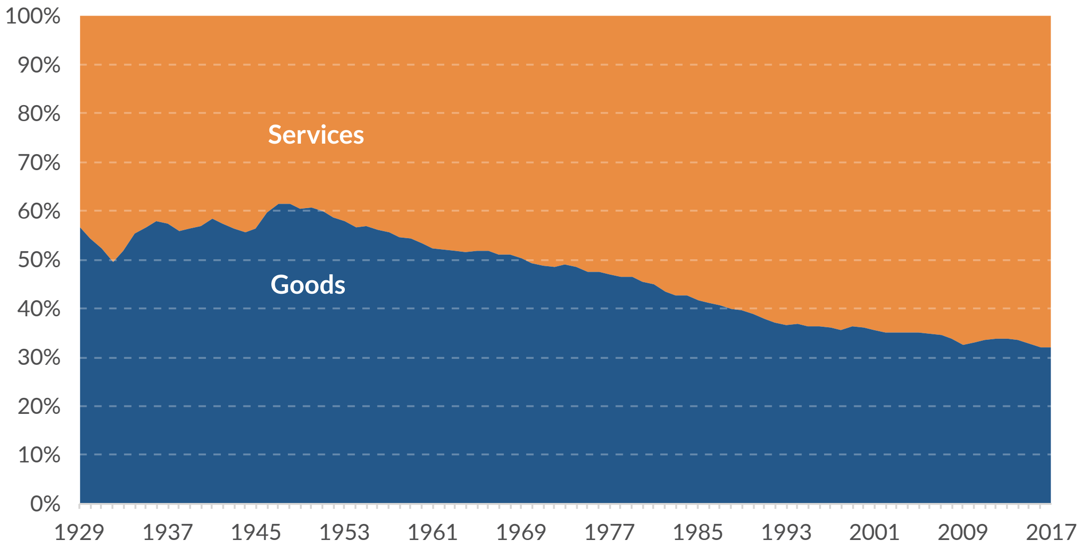
## Taxation of Services

One of the primary factors contributing to the shrinking of sales tax bases over time—in Kansas and elsewhere—is that American consumption habits have shifted over the years. Whereas the U.S. economy was heavily weighted toward goods when sales taxes were first levied, today the economy is increasingly service-oriented. Figure 5.3 shows the share of national consumption of both goods and services since 1929.

FIGURE 5.3.

**Percentage of Total Personal Consumption Expenditures**

*Goods vs. Services, U.S., 1929-2017*




Source: Bureau of Economic Analysis, "Regional Economic Accounts."

As previously mentioned, since 1970, Kansas' sales tax breadth—a measure of the broadness of the tax base—has fallen from an implicit sales tax base equal to 54 percent of personal income to a mere 36 percent of personal income in 2017 (see Figure 5.4). Even though Kansas taxes more services than some of its regional competitors, its failure to sufficiently modernize the state sales tax base presages continued erosion and commensurate pressure for rate increases.

TABLE 5.4.

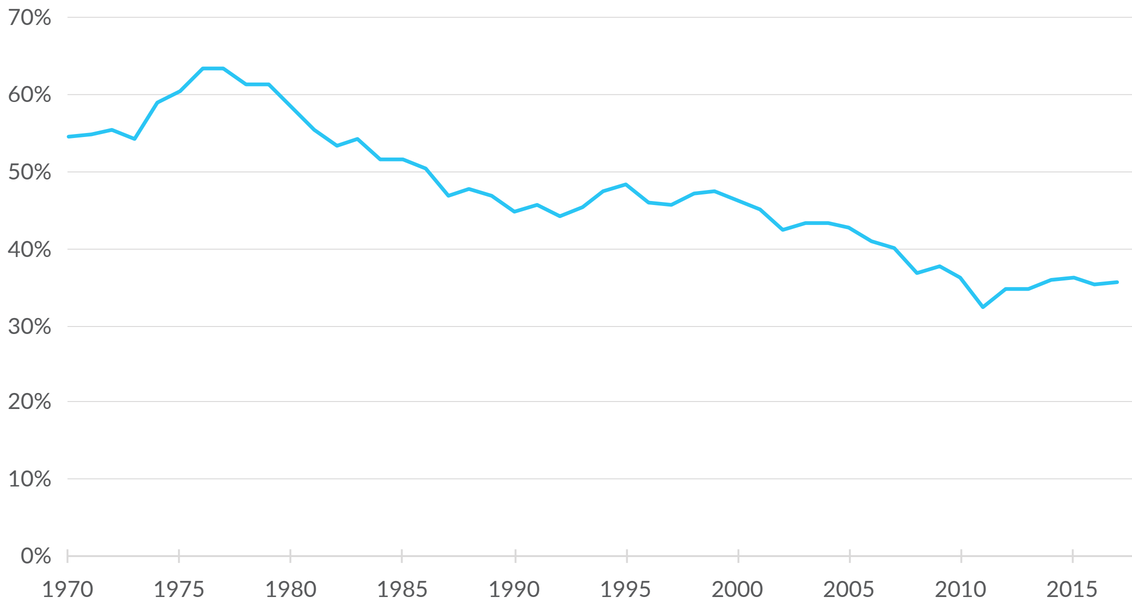
**Sales Tax Breadth**

*Kansas and Regional Competitors (Fiscal Year 2017)*

| State | Breadth |
|---|---|
| Kansas | 36% |
| Arkansas | 42% |
| Colorado | 34% |
| Indiana | 39% |
| Iowa | 37% |
| Missouri | 32% |
| Nebraska | 34% |
| Oklahoma | 32% |

Sources: Prof. John Mikesell, Indiana University; Tax Foundation, *Facts & Figures 2019*.

FIGURE 5.4.
## Kansas´Sales Tax Breadth (1970-2017)




Source: Prof. John Mikesell, Indiana University.

The Federation of Tax Administrators (FTA) periodically publishes a survey of services taxable under each state's sales tax, with the most recent data compiled in 2017. The survey includes both business-to-business services (which should be exempted under a well-structured sales tax, as discussed above) and final consumer services. Seventy-one of the considered transactions could be either business-to-business or consumer services, depending on the identity of the final purchaser.

Tables 5.5, 5.6, and 5.7 enumerate these service categories and note whether the Kansas sales tax applies to each service type. As of 2017, Kansas taxed only 81 of the 181 services enumerated in the FTA survey under the general sales tax. Of those, at least 21 should be exempted because they are business inputs.

In a very broad, ideal sales tax, all of the services outlined in Table 5.6 would be subject to the sales tax. The services in Table 5.5 (business input services) would all be exempt from the sales tax.

Taxing the services enumerated in Table 5.7 requires creative administration to ensure that these service transactions are taxed when purchased by consumers, but not when purchased by businesses. In these scenarios, a tax exemption certificate or business identification number registered with the Kansas Department of Revenue would be a reasonable solution.

TABLE 5.5.

## Kansas' Tax Treatment of Business Input Services

| Consumer Service | Taxed in Kansas? |
|---|---|
| Advertising, Billboards | |
| Advertising, Magazine | |
| Advertising, Newspaper | |
| Advertising, Radio & Television (Local) | |
| Advertising, Radio & Television (National) | |
| Advertising Agency Fees (Excluding Ad Placement) | |
| Armored Car Services | |
| Bulldozers, Draglines, & Construction Machinery Rentals (Long-Term) | ✓ |
| Bulldozers, Draglines, & Construction Machinery Rentals (Short-Term) | ✓ |
| Check & Debt Collection | |
| Commercial Art & Graphic Design | |
| Commercial Linen Supply | ✓ |
| Credit Information & Credit Bureaus | |
| Custom Fabrication Labor | ✓ |
| Data Processing Services | |
| Employment Agencies | |
| Financial & Tickertape Reporting | |
| Food Storage | |
| Industrial Sewer & Refuse Services | |
| Information Services | |
| Interstate Telephone & Telegraph | ✓ |
| Intrastate Telephone & Telegraph | ✓ |
| Labor Charges, Repairs to Commercial Fishing Vessels | ✓ |
| Labor Charges, Repairs to Interstate Vessels | |
| Labor Charges, Repairs to Intrastate Vessels | ✓ |
| Labor Charges, Repairs to Railroad Rolling Stock | |
| Lobbying & Consulting Services | |
| Mainframe Computer Access & Processing Services | |
| Maintenance & Janitorial Services | |
| Marketing | |
| Metal, Non-Metal, & Coal Mining Services | |
| Mini-Storage | |
| Oil Field Services | ✓ |
| Online Data Processing Services | |
| Packing & Crating | ✓ |
| Process Server Fees | |
| Public Relations & Management Consulting | |
| Rental of Films & Tapes by Theaters | |
| Rental of Hand Tools to Licensed Contractors | ✓ |
| Secretarial & Court Reporting Services | |
| Security Services | |
| Seismograph & Geophysical Services | |
| Sign Construction & Installation | ✓ |
| Software, Material Custom Programs | |
| Software, Modifications to Canned Programs | ✓ |
| Software, Professional Services Custom Programs | |
| Soil Preparation, Custom Bailing, & Other Agricultural Services | |
| Swimming Pool Cleaning & Maintenance | ✓ |
| Telemarketing Services (Contract) | |
| Telephone Answering Services | ✓ |
| Temporary Help Agencies | |
| Test Laboratories (Excluding Medical) | |
| Test Laboratories (Medical) | |
| Typesetting & Platemaking for Print Trades | ✓ |
| Utilities, Electricity (Nonresidential)* | ✓ |
| Utilities, Natural Gas (Nonresidential)* | ✓ |
| Utilities, Other Fuel (Including Heating Oil, Nonresidential)* | ✓ |
| Utilities, Water (Nonresidential)* | ✓ |
| Welding Labor (Fabrication & Repair) | ✓ |

*Note: Nonresidential electricity, natural gas, water, and other fuel utilities are exempt when used for qualified manufacturing purposes.
Source: Federation of Tax Administrators, using the "FTA 2017 Services Taxation Survey."

TABLE 5.6.

## Kansas' Tax Treatment of Consumer Services

| Consumer Service | Taxed in Kansas? |
|---|---|
| 900 Number Services | |
| Aircraft Rental to Individual Pilots (Long-Term) | ✓ |
| Aircraft Rental to Individual Pilots (Short-Term) | ✓ |
| Amusement Park (Admission & Rides) | ✓ |
| Bail Bond Fees | |
| Barber Shops & Beauty Parlors | |
| Billiard Parlors | ✓ |
| Bowling Alleys | ✓ |
| Circuses & Fairs (Admission & Games) | ✓ |
| Coin-Operated Video Games | ✓ |
| Cultural Events (Admission) | ✓ |
| Dating Services | |
| Debt Counseling | |
| Dentists | |
| Diaper Service | ✓ |
| Dowloading, Movies & Digital Video | |
| Downloading, Music | |
| Downloading, Other Electronic Goods | |
| Electricity (Residential)* | |
| Fishing & Hunting Guide Services | |
| Funeral Services | |
| Fur Storage | |
| Garment Services (Altering & Repairing) | ✓ |
| Gift & Package Wrapping Services | ✓ |
| Health Clubs & Gyms | ✓ |
| Horse Boarding & Traning (Excluding Race Horses) | |
| Household Goods Storage | |
| Laundry & Dry Cleaning Services (Coin-Operated) | |
| Laundry & Dry Cleaning Services (Non-Coin-Operated) | ✓ |
| Local Transit (Intra-City) Buses | |
| Massage Services | |
| Natural Gas (Residential)* | |
| Nursing Services (Out of Hospital) | |
| Other Fuel (Including Heating Oil, Residential)* | |
| Pari-Mutuel Racing Events | |
| Personal Instruction (Dance, Golf, Tennis, etc.) | |
| Pet Grooming | ✓ |
| Physicians | |
| Pinball & Other Mechanical Amusements | ✓ |
| Private Clubs (Membership Fees) | ✓ |
| Professional Sports Events (Admission) | ✓ |
| Rental of Video Tapes for Home Viewing | ✓ |
| Residential Sewer & Refuse Services | |
| School & College Sports Events (Admission) | ✓ |
| Shoe Repair | ✓ |
| Tanning Parlors & Salons | ✓ |
| Tax Return Preparation | |
| Taxidermy | ✓ |
| RV Parks (Overnight) | |
| Tuxedo Rental | ✓ |
| Water (Residential) | |

Note: Residential electricity, natural gas, and other fuel services are taxable at the local, but not the state, level.
Source: Federation of Tax Administrators, using the "FTA 2017 Services Taxation Survey."

TABLE 5.7.

## Kansas' Tax Treatment of Other Service Types

*(in which type of service–business input or consumer—depends on identity of final purchaser)*

| Service | Taxed in Kansas? |
|---|---|
| Accounting & Bookkeeping | |
| Architects | |
| Attorneys | |
| Auto Service (except Repairs, including Painting & Lube) | ✓ |
| Automobile Rental (Long-Term) | ✓ |
| Automobile Rental (Short-Term) | ✓ |
| Automotive Road & Towing Services | ✓ |
| Automotive Rustproofing & Undercoating | ✓ |
| Automotive Storage | |
| Automotive Washing | ✓ |
| Automotive Waxing | ✓ |
| Banking Service Charges | |
| Cable TV Services | ✓ |
| Carpentry, Painting, Plumbing, & Similar Trades | ✓ |
| Carpet & Upholstery Cleaning | |
| Cellular Telephone Services | ✓ |
| Chartered Flights (with Pilot) | |
| Cold Storage | |
| Construction Contracting Labor | ✓ |
| Construction Service (Grading, Excavating, etc.) | |
| Custom Meat Slaughtering, Cutting, & Wrapping | ✓ |
| Custom Processing (on Customers' Property) | ✓ |
| Direct Satellite TV | ✓ |
| Downloading, Books | |
| Engineers | |
| Exterminating | ✓ |
| Hotels, Motels, & Lodging Houses | ✓ |
| Installation Charges by Persons Other than Seller of Goods | ✓ |
| Installation Charges by Persons Selling Property | ✓ |
| Insurance Services | |
| Interior Design & Decorating | |
| Internet Service Providers, Dialup | |
| Internet Service Providers, DSL or Other Broadband | |
| Interstate Air Courier (Billed In-State) | |
| Intrastate Courier Service | |
| Intrastate Transportation of Persons | |
| Investment Counseling | |
| Labor Charges, Repairs Delivered Under Warranty | |
| Labor Charges, Repairs or Remodeling of Real Property | ✓ |
| Labor Charges, Repairs to Aircraft | |
| Labor Charges, Repairs to Motor Vehicles | ✓ |
| Labor Charges, Repairs to Other Tangible Property | ✓ |
| Labor Charges, Repairs to Radio, TV, and Other Electronic Equipment | ✓ |
| Land Surveying | |
| Landscaping Services (including Lawn Care) | ✓ |
| Limousine Services (with Driver) | |
| Loan Broker Fees | |
| Marina Service (Docking, Storage, Cleaning, & Repair) | ✓ |
| Marine Towing Service (including Tugboats) | |
| Parking Lots & Garages | |
| Photo Finishing | ✓ |
| Photocopying Services | ✓ |
| Printing | ✓ |

TABLE 5.7, CONTINUED.

**Kansas' Tax Treatment of Other Service Types**

*(in which type of service–business input or consumer—depends on identity of final purchaser)*

| Service | Taxed in Kansas? |
|---|---|
| Private Investigation & Detective Services | |
| Property Sales Agents (Real Estate or Personal) | |
| Real Estate Management Fees (Rental Agents) | |
| Real Estate Title Abstract Services | |
| Repair Labor (Generally) | ✓ |
| Repair Material (Generally) | ✓ |
| Service Contracts Sold at the Time of Sale of Tangible Personal Property | ✓ |
| Software, Downloaded | ✓ |
| Software, Package or Canned Program | ✓ |
| Storage of Personal Property (Long-Term) | ✓ |
| Storage of Personal Property (Short-Term) | ✓ |
| Taxi Service | |
| Tire Recapping & Repairing | ✓ |
| Travel Agent Services | |
| Veterinary Services | |
| Water Softening & Conditioning | ✓ |
| Water Well Drilling | ✓ |
| Window Cleaning | |

Source: Federation of Tax Administrators, using the "FTA 2017 Services Taxation Survey."

## Existing Sales Tax Exemptions

The Kansas Department of Revenue releases periodic tax expenditure reports, the most recent covering calendar year 2017. A tax expenditure is something that would normally be taxed under the broad definition of the tax base but was specifically exempted or abated for a policy reason. As a result, Kansas' Tax Expenditure Report only quantifies the loss associated with exemptions from the existing sales tax base (which largely exempts services); it does not quantify the loss associated with the majority of services not appearing in the tax base. Nevertheless, this report serves as a good starting point for understanding the state's system of sales tax exemptions.

Kansas forgoes about $568 million in revenue each year from exempted consumer goods, ranging from gasoline to prescription drugs to dietary supplements. Among those services which, as broad categories, would normally be taxable under Kansas' sales tax (such as labor, utilities, laundry, and telecommunications services), there are $147 million in documented exemptions, including exemptions to residential utility services and coin-operated laundry services (see Table 5.8). The broad range of other excluded services does not have estimates for lost revenue in the tax expenditure report, since they are not, by default, included in the initial tax base.

In an ideal sales tax base, all the goods and services found in the Tax Expenditure Report that are listed in Table 5.8 would be subject to Kansas' sales tax. In practice, some of these goods and services are commonly exempted in many states, and the policy rationales for many of these exemptions are understandable. They do, however, carve away the sales tax base, forcing the total rate to be higher in order to raise the same revenue on a smaller base of transactions.

TABLE 5.8.

**Kansas' Sales Tax Exemptions for Consumer Goods and Services, FY 2018**

| Exemption | Value |
|---|---|
| Motor fuels and items already taxed by sales or excise tax and not subject to a refund (except cigarettes, e-cigarettes, alcohol greater than 3.2% beer, tires, and dry cleaning and laundry services) | $371,020,000 |
| Labor services of installing or applying tangible property in conjunction with the original construction of a building or facility, or the construction, reconstruction, restoration, replacement, or repair of a residence, bridge, or highway | $124,990,000 |
| Prescription drugs | $109,960,000 |
| Customized computer software | $53,900,000 |
| Lottery tickets and shares | $21,840,000 |
| Natural gas, electricity, heat, and water delivered through mains, lines, or pipes (residential) | $18,120,000 |
| Prosethetic or orthopedic appliances prescribed by a doctor; hearing aids, parts, and batteries; mobility-enhancing equipment | $6,420,000 |
| Sales of bingo cards, bingo faces, and instant bingo tickets | $4,180,000 |
| Coin-operated laundry services | $2,190,000 |
| Interstate and international 800 or 900 services and private communications services | $1,610,000 |
| Insulin dispensed by a pharmacist for treatment of diabetes | $850,000 |
| Game birds for use in hunting | $70,000 |
| Dietary supplements dispensed by prescription order | Minimal |
| Admission to any cultural and historical event which occurs triennially | Minimal |
| Total | **$715,150,000** |

Sources: Kansas Department of Revenue, *Tax Expenditure Report – Calendar Year 2017*; Federation of Tax Administrators, "FTA 2017 Services Taxation Survey."

Beyond the items listed in Table 5.8, Kansas' Tax Expenditure Reports lists numerous sales tax exemptions for sales made by specific nonprofit organizations. Such exemptions are granted on an *ad hoc* basis in Kansas' code, such that the sales made by nonprofits not listed as exempted in the code (or future nonprofits yet to be established) would be considered taxable. Further, because most (but not all) of the nonprofits listed by name are granted exemptions for both their *purchases* (business inputs) and their *sales*, it is difficult to quantify the total value of sales tax revenue forgone in exemptions on nonprofit *sales* alone. While exemptions for nonprofit sales in many cases may be granted to prevent imposing excessive administrative burdens on organizations making occasional charitable sales (such as baked goods or raffle tickets or otherwise), there is a reasonable argument that if certain goods and services, such as gym memberships, are taxed when furnished by a business, they should also be taxed when furnished by a nonprofit, whereas input purchases for nonprofits should be exempt from sales taxation.

## Groceries Included in the Sales Tax Base

One of the most common topics that came up in our research for this book was Kansas' application of the sales tax to groceries. While many in Kansas have proposed removing groceries from the sales tax base or creating a special, lower rate for groceries, finding revenue to replace forgone taxation of grocery sales has proven incredibly challenging.

Currently, Kansas is one of seven states which tax groceries at the full sales tax rate. Alabama, Hawaii, Idaho, Mississippi, Oklahoma, and South Dakota are the other states that tax groceries at the full sales tax rate. Six additional states tax groceries at a lower, preferential rate.[123] In recent decades, many states have created sales tax exemptions for groceries, and in most of Kansas' recent legislative sessions, bills have been introduced to reduce Kansas' sales tax on groceries.

While reducing the sales tax on groceries, or removing them from the base altogether, may sound like an appealing way to cut taxes, it would dramatically narrow the sales tax base and would create a significant amount of additional administrative complexity that the state currently avoids. Furthermore, such a change would not yield the targeted benefits for low-income consumers that proponents often anticipate.

Senate Bill 76, as introduced during the 2019 legislative session, proposed reducing the sales tax rate on groceries by one percentage point each year until it reaches 3.5 percent in fiscal year 2023. According to the bill's fiscal note, those rate reductions would decrease general fund revenues by $59.8 million in fiscal year 2020, followed by reductions of $126.6 million, $195.7 million, and $204.6 million, respectively, in subsequent fiscal years.[124] Removing groceries from the sales tax base altogether would not only impact the state's bottom line, but would also cut off a major source of local revenue, as the state's membership in the Streamlined Sales and Use Tax Agreement (SSUTA) requires considerable parity in state and local sales tax bases.

While many perceive an exemption or rate reduction for groceries to be a progressive reform, there is reason to believe it would not be terribly effective. Most of the progressivity of taxing unprepared foods is obviated by federally mandated exemptions for food purchased using specific low-income benefits. Specifically, purchases made through the Supplemental Nutrition Assistance Program (SNAP, commonly known as "food stamps") and the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) are exempt from state sales taxes in every state. If a preferential rate or exemption for grocery purchases were to be created, those tax savings would be enjoyed by low- and high-income earners alike, and for the purchase of both the basic staples and luxury foods. There is some research finding that lower-income taxpayers would actually be better off with groceries fully included in the sales tax base (while retaining the federally-indicated exemption of SNAP and WIC purchases) in order to keep a lower revenue-neutral tax rate rather than exempting grocery purchases from sales taxation and achieving a higher revenue-neutral rate.[125]

Under current Kansas law, qualifying low-income individuals may claim a Food Sales Tax Credit on their individual income tax return to help offset sales taxes paid on groceries. This credit is nonrefundable and is available to taxpayers with federal adjusted gross income of $30,615 or less who are age 55 or older, are blind or disabled, or have a

123 Janelle Cammenga, *Facts & Figures 2019: How Does Your State Compare?* Table 32.

124 Larry L. Campbell, "Fiscal Note for SB 76 by Senate Committee on Ways and Means," Kansas Division of the Budget, March 27, 2019, http://www.kslegislature.org/li/b2019_20/measures/documents/fisc_note_sb76_00_0000.pdf.

125 Anna L. Johnson and Steven M. Sheffrin, "Rethinking the Sales Tax Food Exclusion with SNAP Benefits," *State Tax Notes*, Jan. 11, 2016, 157, https://pdfs.semanticscholar.org/6f18/cca38dfaa9591be264e4bff539573dae6d7c.pdf.

dependent child under age 18.[126] The credit is available in the amount of $125 per person (including the taxpayer, the taxpayer's spouse, and dependents under age 18).

Should Kansas policymakers wish to further offset the sales taxes paid by lower-income individuals on their grocery purchases, making the credit refundable, or expanding eligibility criteria, would be a far more targeted and efficient approach than creating a preferential sales tax rate or exempting groceries from the sales tax base altogether.

## Kansas' Past Sales Tax Base-Broadening Efforts

Base broadening has occurred over the history of the Kansas sales tax, though never enough to offset the base erosion that is occurring as our economy increasingly tilts towards a greater service orientation. In 1957, two decades after the sales tax was adopted, the legislature expanded the base to include hotel and motel room rentals and isolated sales of motor vehicles and trailers. In 1961, the base was broadened to include cigarettes and beer, but newspapers and certain sales of water were simultaneously removed from the base.[127] Bills introduced in 1969 proposed eliminating most exemptions that existed at that time, as well as expanding to most personal and professional services, excluding physician and veterinary services.[128]

In 1968, the Joint Committee on State Tax Structure was created to study Kansas' various taxes in terms of their relationship to each other, to the economy, and to the public interest.[129] In 1970, that committee, chaired by Senator Frank S. Hodge, issued a report recommending several structural changes to the state sales tax. Specifically, the committee recommended adding newspapers back into the sales tax base, as well as expanding the base to include additional select services, including laundry and cleaning services, car washing and waxing, and sports participation charges.[130] The committee also recommended expanding the list of business input exemptions by exempting "consumables" as a class rather than listing specific categories of items consumed in the production process.[131] Many of the committee's proposed changes were adopted in 1970, the most notable being the adoption of several important exemptions for manufacturing and agricultural business inputs.[132] In 1977, many base-narrowing provisions were adopted, however, including the current exemptions for residential utilities, prescription drugs, and medical devices.



126 Nick Jordan and Richard Cram, "Food Sales Tax Credit," Notice 12-12, Kansas Department of Revenue, July 1, 2013, https://www.ksrevenue.org/taxnotices/notice13-12.pdf.
127 Joint Committee on the State Tax Structure, *Final Report and Recommendations*, 8.
128 Id.
129 Id., 1.
130 Id., ii.
131 Id., 10.
132 James D. Wong and Nickolaus Hernandez, *Sales Tax Erosion in Kansas*, Kansas Department of Revenue, December 2006, 38-44, https://www.wichita.edu/academics/fairmount_college_of_liberal_arts_and_sciences/hugowall/documents/Sales_Tax_Erosion_in_Kansas.pdf.

More recently, base broadening was again considered in 2017 as a way to generate additional revenue. House Bill 2384 would have expanded the sales tax base to select personal services to generate an estimated $51 million per year. Below is a list of final consumer services proposed by House Bill 2384 for inclusion in the sales tax base:[133]

- Hair styling, cut, and color services
- Manicures and pedicures
- Other personal services, including hair removal, massage, tanning, tattooing, nonmedical spa services, saunas/baths
- Nonprofit gym memberships
- Dating services
- Towing
- Parking garages/parking services
- Rental of equipment with operator, such as a limousine or cab
- Digital goods, automated services, remote access software
- Installation of customized computer software
- Detective services
- Pet care (excludes veterinary services)

While most of the services proposed by H.B. 2384 for inclusion in the sales tax base are services purchased primarily or exclusively by households rather than businesses, that legislation did also propose expanding the base to include certain services that are primarily business inputs, which should remain exempt. These inputs included security services, nonresidential cleaning services, and the rental of equipment used in construction. Ultimately, H.B. 2384 died in the House Committee on Taxation and was not referred to the full House for a vote.

133 Morgan Scarboro, "Kansas Looks at Filling Revenue Gap with Sales Tax Base Broadening," Tax Foundation, Mar. 17, 2017, https://taxfoundation.org/kansas-sales-tax-broadening/.

## Sales Taxes in the Modern Era

Over the past few decades, the rise of e-commerce has contributed to the additional erosion of state sales tax bases as many online retailers have historically not been required to collect sales taxes at the point of sale. Prior to the U.S. Supreme Court's June 2018 ruling in *South Dakota v. Wayfair*,[134] retailers were only obligated to collect and remit sales taxes in states in which they had a physical presence, defined as having property or employees within the state.

The geographic limitation on the scope of state sales tax authority that predated *South Dakota v. Wayfair* was defined by the Supreme Court in *Quill v. North Dakota*.[135] This limitation was designed with the intent of protecting the free flow of interstate commerce, and at the time, it seemed to many a fitting standard. After all, the *Quill* decision was handed down in 1992, at what was very nearly the low ebb of consumer remote sales. The great mail order businesses of the twentieth century, like Sears Roebuck, Montgomery Ward, and Bella Hess (itself the subject of a prior Supreme Court ruling on the taxation of remote sales), were either gone or on their last legs, while e-commerce was still entirely in its infancy and not yet a meaningful presence on the fledgling World Wide Web.

After the turn of the century and as a growing share of consumer purchases shifted to the internet, it became increasingly apparent to states that they were losing significant sales tax revenue to consumer e-commerce purchases. Today, online sales account for approximately 10 percent of all consumer transactions by value—this despite the fact that e-commerce has only begun to make a dent in some of our costliest consumer markets, like the automobile market.[136] In 2018, Americans spent $513.7 billion in internet retail purchases, representing a 13 percent increase over the previous year and comprising about 9.7 percent of total retail sales by value. This growth rate in e-commerce sales has been fairly steady and is expected to continue.

### The Limits of Use Taxes

Consumers are, as a point of law, required to pay a compensating use tax on any goods they purchase for which sales tax is not collected. In practice, this requirement is generally observed by businesses but only witnessed in the breach by individual taxpayers, few of whom track or pay use tax on transactions for which tax was not collected at the point of sale. This creates a disparity in the practical, if not legal, tax treatment of goods purchased online and those purchased in brick-and-mortar stores. Many taxpayers may not even be aware of this requirement, even though a self-reporting line is included on the individual income tax form.

134 *South Dakota v. Wayfair, Inc.*, 585 U.S. ___, slip op. (2018).
135 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
136 U.S. Census Bureau, "Quarterly Retail E-Commerce Sales (2nd Quarter 2019)," CB19-117, Aug. 19, 2019, https://census.gov/retail/index.html#ecommerce. This percentage continues to rise, hitting 10.7 percent of total sales in the second quarter of 2019, compared to 9.8 percent in the second quarter of 2018. Statistics are for sales of personal, not real, property, and thus exclude real estate transactions.

The solution is not as simple, though, as requiring all sellers to collect at the point of sale. As of July 2019, there are more than 11,100 sales tax jurisdictions across the country, with widely disparate sales tax rates, bases, and collection regimes.[137] As such, the prospect of remitting sales taxes in every jurisdiction nationwide is understandably daunting for many businesses, and without some degree of uniformity, perhaps even prohibitive. States, then, were not only historically constrained by the physical presence standard, but also by the need to avoid imposing incredibly high compliance costs on retailers.

## An Increased Push to Tax Online Transactions

Prior to the *Wayfair* decision, as states began seeing more and more erosion of their sales tax bases with the rise of e-commerce, many became increasingly creative, not to say aggressive, in their efforts to increase the share of transactions for which retailers were required to collect sales tax. Some probed the limits of *Quill's* physical presence standard, while others effectively ignored it, inviting legal challenges.

In 2013, Kansas mimicked New York in adopting a "click-through" nexus law imposing sales tax collection requirements on out-of-state sellers holding compensated referral agreements with in-state businesses if such agreements result in more than $10,000 in gross receipts into the state.[138] Under this law, which remains in place as of this book's publication date, nexus is presumed unless rebutted. As a result, many out-of-state sellers are required to collect Kansas' sales tax if they contract with an in-state business, even if the out-of-state business does not engage in maintaining an in-state market or flow of goods.

Due to the global nature of the internet, this click-through law applies broadly, encompassing not only retailers who target sales within Kansas, but also retailers who may not actually produce a sale in the state. Along with the click-through nexus provision, Kansas law contains an "affiliate nexus" provision, whereby a retailer is presumed to have nexus with Kansas if an "affiliated person," or a member of the same controlled group of corporations, has physical presence.

Kansas is one of at least 22 states to have enacted a click-through nexus-style law, and other states took even more aggressive approaches pre-*Wayfair*.[139] In the post-*Wayfair* landscape, however, several states have since dropped their aggressive tactics and instead opted to align their laws with the parameters set forth in the Court's majority opinion.

### *South Dakota v. Wayfair*

With the issuance of the *Wayfair* decision, the physical presence rule was overturned, and "economic nexus" became the new standard. A business, then, can be determined to have sufficient economic connection with a state to warrant sales tax collection even if that business does not have property or employees in the state.

137 Data from Vertex, Inc.

138 Sales Tax Institute, "Kansas Enacts Click-Through and Affiliate Nexus Provisions," April 29, 2013, https://www.salestaxinstitute.com/resources/kansas-enacts-click-through-and-affiliate-nexus-provisions.

139 Joseph Bishop-Henchman, "Should Congress Act Before SCOTUS on Online Sales Taxes?" Tax Foundation, Mar. 13, 2018, https://taxfoundation.org/congress-act-scotus-online-sales-taxes/.

Determining a precise definition of "economic nexus" was beyond the scope of the question at hand in *Wayfair*. Anticipating the question, however, Justice Anthony Kennedy, in his majority opinion, cited a list of provisions in South Dakota's law which, in the Justice's opinion, would likely insulate it from other constitutional challenges:

1. **Safe harbor:** Excludes "those who transact only limited business" in the state. (South Dakota's *de minimis* exemption is $100,000 in sales or 200 transactions.)

2. **No retroactive collection**.

3. **Single state-level administration** of all sales taxes in the state.

4. **Uniform definitions** of products and services.

5. **Simplified tax rate structure.** (South Dakota requires the same tax base between state and local sales tax, has only three sales tax rates, and has limited exemptions from the tax.)

6. **Software:** Access to sales tax administration software is provided by the state.

7. **Immunity:** Sellers who use the software are not liable for errors derived from relying on it.

Kansas, as a member of the Streamlined Sales Tax Governing Board (SSTGB), has adopted the uniformity and simplification rules in the Streamlined Sales and Use Tax Agreement (SSUTA), thus largely satisfying items 3-7 on this list. By simply adopting a safe harbor for sellers who conduct only limited business in the state, as well as ensuring collections requirements are not applied retroactively, Kansas could put itself in excellent legal standing to proceed with remote sales tax collection. Thus far, however, the state has rejected such an approach.

## Kansas' Response to *Wayfair*

On August 1, 2019, the Kansas Department of Revenue issued a notice declaring its intent to require all remote sellers and marketplace facilitators to collect and remit Kansas' state and local sales taxes, effective October 1, 2019.[140] This notice was issued without any post-*Wayfair* legal authorization from the legislature, instead citing authority to tax remote sales based on preexisting statute.

As a result, Kansas is the only state to enforce remote sales tax collection without a *de minimis* exemption for small businesses or retailers conducting only limited business in the state. Following the *Wayfair* decision, many states have adopted *de minimis* exemptions to provide safe harbor from sales tax collection requirements for small remote sellers who conduct fewer than $100,000 worth of sales or make fewer than 200 transactions into their state. Kansas has also implemented a marketplace facilitator regime, albeit an

140 Kansas Department of Revenue, "Sales Tax Requirements for Retailers Doing Business in Kansas," Notice 19-04, Aug. 1, 2019, https://www.ksrevenue.org/taxnotices/notice19-04.pdf.

ostensibly voluntary one, without specific statutory authority to do so. Without safe harbor protections, Kansas has the most aggressive remote sales tax collection regime in the country, a radical departure from the emerging consensus on states' constitutional authority post-*Wayfair.*

Kansas' approach, which its own Attorney General has called unconstitutional[141], is likely to draw a legal challenge due to the burdens it places on small remote sellers. Under the current regime, remote sellers, no matter their size or number of sales into Kansas, are required to obtain a sales tax permit before making sales into the state. While obtaining a Kansas sales tax permit does not come with a specific fee, it requires 3-4 weeks' advance notice, creating a significant administrative hurdle for small businesses. For sellers making only occasional sales into Kansas, obtaining such a permit and calculating the applicable state and local sales tax at any given address could prove unduly burdensome and a barrier to interstate commerce.

During the 2019 legislative session, Kansas considered but ultimately rejected legislation containing provisions to create a $100,000 *de minimis* exemption for retailers and marketplace facilitators, requiring marketplace facilitators to collect sales taxes, and explicitly prohibiting retroactive collection. Senate Bill 22 and House Bill 2033, which contained such provisions (along with broader tax changes), passed the House and the Senate but were both vetoed by the governor on grounds unrelated to the issue of sales taxation on e-commerce.



141 Kansas Office of the Attorney General, "Taxation—Kansas Compensating Tax—Definitions; Substantial Nexus," Attorney General Opinion No. 2019-8, Sept. 30, 2019, https://ag.ks.gov/docs/default-source/ag-opinions/2019/2019-008.pdf.

## Sales Tax Reform Solutions

Kansas' sales tax begins with a narrow base, which exempts many goods from taxation and applies to only a few services. As a result, the base is not positioned to grow with today's service-oriented economy, which puts upward pressure on the already high sales tax rate. While many retail goods and services are not yet taxable, they ought to be, and there are many business inputs that remain taxable but ought to be exempt to prevent nontransparent and nonneutral tax pyramiding.  Finally, Kansas' current sales tax structure is conducive to the taxation of remote sales, but this should only be done with legislation which includes a safe harbor for small sellers.

### Broaden the Sales Tax Base

A well-structured sales tax applies to all final consumer purchases, of both goods and services, while exempting business inputs. Currently, the Kansas sales tax specifically exempts a number of consumer transactions which, if included in the base, would permit substantial rate reductions (to the sales tax rate or other tax rates).

Among existing exemptions of consumer goods, the motor fuels exemption is the largest, worth approximately $371 million in fiscal year 2018. If motor fuels were subject to the state sales tax base, and all resulting revenues were put towards reducing the sales tax rate, the state sales tax rate could be brought down from 6.5 to 5.8 percent, while retaining revenue neutrality. Many other exemptions also contribute to the erosion of the sales tax base, yielding higher rates than would otherwise be necessary.

Residential and agricultural gas and electricity utility services are currently subject to local sales taxes but are exempt at the state level. While agricultural utilities, as a business input, should remain exempt, residential gas and electricity ought to be included in the state sales tax base. As residential gas and electricity are currently subject to local sales taxes, it would make sense (both from a policy and an administrative standpoint) to add these services to the state base. Additionally, residential water utilities, which are currently exempt at both the state and local levels, ought to be taxable. Existing exemptions for residential and agricultural gas and electricity, as well as water utilities, resulted in nearly $87 million in forgone revenue in fiscal year 2018.

Lawmakers should also consider expanding the sales tax base to include additional consumer goods and services, while exempting certain business inputs that remain subject to the tax. Table 5.9 shows three options for base broadening, where Option A adds a few additional consumer transactions to the sales tax base, and Option C is the broadest, adding a wide range of goods and services. While the revenue impacts of some of these currently untaxed goods are available in Kansas' Tax Expenditure Report, most are not publicly available, chiefly because services are not part of the implicit sales tax base, and thus their exclusion is not regarded as an exemption to be quantified in the tax expenditure report. As such, policymakers may wish to seek supplemental estimates from the Kansas Department of Revenue in exploring base expansion options.

When services could constitute either a final consumer transaction or a business input, depending on the identity of the final purchasers, the state should either define the categories in such a way so as to exclude business inputs or, preferably, provide a mechanism by which business purchases are exempted, in much the same way as purchases by nonprofits are exempted in many states.

In outlining these options, we do not attempt to quantify the political considerations that are bound to accompany any discussion of base broadening. Providing a number of base-broadening options allows lawmakers to decide how broad they would like to make the sales tax base, while still accounting for other policy considerations.

Sales tax base broadening could be used to pay down sales tax rate reductions, other reforms elsewhere in the tax code, or both. As discussed earlier in this chapter, Kansas has the eighth-highest combined state and average local sales tax rate in the country, making sales tax base broadening a potentially attractive policy option to reduce the sales tax rate. However, as discussed in previous chapters of this publication, Kansas' corporate and individual income taxes are more economically harmful than the sales tax (since they fall more intensively on capital and investment, as discussed elsewhere), so reducing the corporate income or individual income tax rates would be more pro-growth than simply reducing the sales tax rate.

## Exclude Business Inputs from Taxation

Kansas policymakers have long recognized the importance of excluding business inputs from the sales tax base to avoid tax pyramiding, but little progress has been made in expanding the scope of these important exemptions. At least 21 categories of services currently taxed in Kansas, ranging from construction machinery rentals to nonresidential utility services, are business inputs that ought to be exempt. A solution could involve either specific exemptions that are written for goods and services likely to constitute business inputs, or businesses should be granted the ability to claim an exemption from the sales tax for all business purchases.

Just as some states allow nonprofits to use tax exemption certificates when making purchases, similar provisions could be put in place for business purchases. This would allow the state to exempt business inputs without attempting to ascertain which goods and services are likely to constitute business-to-business transactions. While Kansas offers a plethora of exemption certificates for certain industries or entities, such as manufacturers, these certificates ought to be available to all businesses, not just those in the industries in which pyramiding is most obvious. Any business that purchases inputs and produces taxable outputs, whether goods or services, can be subject to tax pyramiding, with consumers bearing much of the burden of higher prices.

Taking this a step further, Kansas may wish to consider offering similar business input exemption certificates to nonprofit organizations. If Kansas chose to offer exemption certificates for purchases made by businesses and nonprofits in place of the current plethora of individually specified exemptions, the tax code would become more neutral and simpler as well.

TABLE 5.9.

## Sales Tax Base Expansion Options

| Good or Service | Large Option A | Medium Option B | Small Option C |
|---|---|---|---|
| Barber Shops & Beauty Parlors | ✓ | ✓ | ✓ |
| Dating Services | ✓ | ✓ | ✓ |
| Fishing & Hunting Guide Services | ✓ | ✓ | ✓ |
| Game Birds for use in Hunting | ✓ | ✓ | ✓ |
| RV Parks (Overnight) | ✓ | ✓ | ✓ |
| Customized Computer Software | ✓ | ✓ | ✓ |
| Admission to any Cultural and Historical Event which Occurs Triennially | ✓ | ✓ | ✓ |
| Fur Storage | ✓ | ✓ | ✓ |
| Horse Boarding & Training (excluding Race Horses) | ✓ | ✓ | ✓ |
| Household Good Storage | ✓ | ✓ | ✓ |
| Local Transit (Intra-City) Buses | ✓ | ✓ | ✓ |
| Massage Services | ✓ | ✓ | ✓ |
| Window Cleaning (Residential) | ✓ | ✓ | ✓ |
| Parking Lots & Garages | ✓ | ✓ | ✓ |
| Private Investigation & Detective Services | ✓ | ✓ | ✓ |
| Automotive Storage | ✓ | ✓ | ✓ |
| Carpet & Upholstery Cleaning | ✓ | ✓ | ✓ |
| Chartered Flights (with Pilot) | ✓ | ✓ | ✓ |
| Downloading of Digital Goods (including Movies, Music, Books, etc.) | ✓ | ✓ | ✓ |
| Labor Charges, Repairs Delivered Under Warranty | ✓ | ✓ | ✓ |
| Limousine Services (with Driver) | ✓ | ✓ | ✓ |
| Pari-Mutuel Racing Events | ✓ | ✓ | |
| Personal Instruction (Dance, Golf, Tennis, etc.) | ✓ | ✓ | |
| Lottery Tickets and Shares | ✓ | ✓ | |
| Motor fuels and items already taxed by sales or excise tax and not subject to a refund (except cigarettes, e-cigarettes, alcohol greater than 3.2% beer, tires, and dry cleaning and laundry services) | ✓ | ✓ | |
| Labor services of installing or applying tangible property in conjunction with the original construction of a building or facility, or the construction, reconstruction, restoration, replacement, or repair of a residence, bridge, or highway | ✓ | ✓ | |
| Natural gas, electricity, heat, and water delivered through mains, lines, or pipes (residential) | ✓ | ✓ | |
| Other Residential Fuel (including Heating Oil) | ✓ | ✓ | |
| Prosethetic or orthopedic appliances prescribed by a doctor; hearing aids, parts, and batteries; mobility enhancing equipment | ✓ | ✓ | |
| Sales of bingo cards, bingo faces, and instant bingo tickets | ✓ | ✓ | |
| Coin-operated laundry services | ✓ | ✓ | |
| Interstate and international 800 or 900 services and private communications services | ✓ | ✓ | |
| Insulin dispensed by a pharmacist for treatment of diabetes | ✓ | ✓ | |
| Dietary supplements dispensed by prescription order | ✓ | ✓ | |
| Goods or services purchased from nonprofits | ✓ | ✓ | |
| 900 Number Services | ✓ | ✓ | |
| Funeral Services | ✓ | ✓ | |
| Residential Sewer & Refuse Services | ✓ | ✓ | |
| Tax Return Preparation | ✓ | ✓ | |
| Travel Agent Services | ✓ | ✓ | |
| Interior Design & Decorating | ✓ | ✓ | |
| Veterinary Services | ✓ | ✓ | |
| Investment Counseling | ✓ | ✓ | |
| Loan Broker Fees | ✓ | ✓ | |
| Bail Bond Fees | ✓ | ✓ | |
| Banking Service Charges | ✓ | | |
| Debt Counseling | ✓ | | |
| Accounting | ✓ | | |
| Architects | ✓ | | |
| Prescription Drugs | ✓ | | |
| Real Estate Services | ✓ | | |
| Insurance Services | ✓ | | |
| Legal Services | ✓ | | |
| Dentists | ✓ | | |
| Physicians | ✓ | | |
| Nursing Services (out of Hospital) | ✓ | | |

Source: Federation of Tax Administrators, using the “FTA 2017 Services Taxation Survey.”

## Remove Barriers to Interstate Commerce

Finally, but arguably most urgently, Kansas ought to remove barriers to interstate commerce by proceeding with remote sales tax collection in a responsible manner.

As a Streamlined state, Kansas already abides by most of the Supreme Court's dicta regarding remote sales tax collection laws that are likely to pass constitutional muster. Specifically, the state has a single point of collections and administration for all state and local sales taxes, adopts uniform definitions of products and services used across all Streamlined states, uses an identical sales tax base at the state and local levels, and gives sellers access to sales tax collection software to simplify the collection process. As such, the state's remote sales tax laws could easily be adjusted to satisfy the other elements, namely, providing a safe harbor for small sellers and establishing clear guidance for marketplace facilitators, and codifying an explicit ban on retroactive collection. Such an approach would put the state in good legal standing following the *Wayfair* decision.

Thus far, however, the state has instead chosen the highly aggressive and likely unconstitutional approach of enforcing remote sales tax collections laws on all sellers (including small remote sellers as well as marketplace facilitators) without updating the statute or adopting a *de minimis* exemption. Instead of proceeding along its current path, Kansas ought to enact a law to adopt a safe harbor provision similar to South Dakota's, explicitly prohibit retroactive collection, provide clear statutory language regarding marketplace facilitators, and drop its existing legally dubious click-through nexus and affiliate nexus provisions.

## STAR Bond Program

The STAR bond program was designed to finance major commercial, entertainment, and tourist attractions of state and regional significance, but has often been used for projects of only local significance. This results in revenue shifting from the state to localities for some economic development projects that may be of dubious state importance. Enhanced oversight of this program may help ensure projects meet specifications outlined in law while improving the efficient use of state and local sales tax revenue.

CHAPTER 6

# PROPERTY AND RELATED TAXES

# Introduction

Kansas' property tax has evolved from being the overwhelming source of state and local revenues to playing a proportionately less significant role in government finance. However, the property tax remains the largest source of combined state and local revenue and plays a leading role among Kansans' tax concerns. Kansans with whom we met consistently reported the property tax as the state's primary tax irritant, echoing prior generations of Kansans who made efforts to improve the property tax system, provide property tax relief, and improve fairness in the tax code.

While many changes to Kansas' property tax system have been intended to make the system more transparent and less burdensome, Kansans today face a complex and sometimes opaque system. Kansas' property tax involves a variety of assessment ratios on different classifications of property, an income-based valuation system for agricultural land, and controversy related to the valuation of large retail properties. Kansans face an above-average property tax burden, perhaps intensifying concerns about structural and administrative issues. Local government finance and the state's education formula both rely heavily on property tax revenues, a reliance that is unlikely to change.

However, Kansas' multigenerational effort to create and administer an efficient system for property taxation has yielded structural and administrative strengths that can be built upon. There are substantial opportunities for additional reforms to improve efficiency and enhance taxpayer transparency. This chapter will review the history of Kansas' property tax system; analyze the current burden, structure, and competitiveness of the code; and then provide six ideas for property tax reform.

# A General Overview and Brief History of Kansas Property Taxes

The property tax is Kansas' oldest form of taxation and is the only leg of the state's three-legged tax stool that dates to the Wyandotte Constitution. In fact, the Kansas property tax predates the state constitution, and different versions of a property tax system were considered in the Topeka (1855), Lecompton (1857), and Leavenworth (1858) constitutions before territorial leaders drafted the Wyandotte Constitution (1859).[142]

At Kansas' founding, the property tax was structured as a broad-based *ad valorem* tax that was levied upon real estate, tangible personal property, and at least some kinds of intangible personal property. However, the task of valuing and taxing property of different types and in different locations across the state was a daunting challenge. Combine that natural challenge with the fact that the responsibility of assessing, levying, and collecting taxes fell upon locally elected officials, as it did in Kansas' early history, and the property tax struggled to deliver equality and fairness.[143]

142 Glenn W. Fisher, *The Worst Tax? A History of the Property Tax in America* (Lawrence, Kansas: University of Kansas Press, 1996), 77-78.
143 H. Edward Flentje and Joseph A. Aistrup, *Kansas Politics and Government: The Clash of Political Cultures* (Lincoln, Nebraska: University of Nebraska Press, 2010), 172-173.

Failed attempts to repeal the "uniform and equal" form of property taxation from the state constitution in 1914 and 1920 were followed by successful attempts to exempt mineral products and intangible properties (1924), household personal property (1963), and motor vehicles (1974) from uniform and equal assessment and taxation.[144] The move from "uniform and equal" accelerated with a 1976 constitutional amendment to value agricultural land based upon its "use value," and uniform and equal died with approval of a 1986 constitutional amendment to classify property based on use, with different assessment ratios for each class. Voters later approved an amended version of classification ratios in 1992.[145]

Thus, Kansas' property tax evolved heavily over the course of the 20th century, starting as "uniform and equal" in its general application to property, but ending the century with a very different structure. Separate classification ratios are now used based on use of property, and agricultural land is appraised based on use value rather than market value.

Whereas the local property tax was once the primary revenue tool used to fund schools directly, it is now a state revenue tool and school funding primarily comes from the state general fund. The Kansas legislature created a program to provide for equalization of education funding with the 1973 School District Equalization Act, which provided districts with per-pupil funding to compensate school districts for differences in property wealth. However, some of the equalization impact was undone by the fact that a portion of income tax revenue was dedicated back to the districts where it was generated, thus favoring districts with high property wealth.[146]

A statewide reappraisal that occurred in the early 1990s was followed by a series of lawsuits by school districts against the state, resulting in a 1991 court ruling by Shawnee District Court Judge Terry Bullock that kicked off school finance reform. In 1992, the Kansas legislature created a centralized system for school finance with the School District Finance and Quality Performance Act.

Prior to the 1992 law, school district property tax levies varied widely across the state, from 9.12 mills (Burlington) to 97.69 mills (Parsons). The law imposed a statewide general fund property tax mill levy of 32 mills in 1992, 33 mills in 1993, and 35 mills in 1994. The legislature began reducing the mill levy in 1997, bringing it down to the current level of 20 mills (plus one mill for construction). School districts can supplement the state general fund millage with additional millage for supplemental options such as a Local Option Budget and Capital Outlay.[147]

Kansas ranks better than average (20th) compared to other states' property tax systems in our *State Business Tax Climate Index*, although selected regional competitors—including Indiana, Missouri, Colorado, and Oklahoma—have competitive property tax codes. Kansas' strengths include the absence of an estate or inheritance tax, the absence of a capital stock tax, and the absence of an inventory tax. However, Kansas allows local

144 Id., 174-175.
145 Glenn W. Fisher, *The History of the Property Tax in Kansas*, Report of the Governor's Tax Equity Task Force, State of Kansas, 1995, 122.
146 Nancy McCarthy Snyder, *The Use of the Property Tax for Public School Finance in Kansas*, Report of the Governor's Tax Equity Task Force, State of Kansas, 1995, 134-137.
147 Kansas Legislative Research Department, "Tax Facts," Eighth Edition, December 2010, 3, http://www.kslegresearch.org/KLRD-web/Publications/TaxFacts/2010TaxFacts8thEd.pdf.

governments to levy a tax on earnings from intangible property, has relatively high property taxation as a percentage of personal income, allows for split-roll property taxation, and allows for taxation of tangible personal property. This combination makes the state tax code less competitive and hurts Kansas in the *Index* rankings. Kansas' collections per capita are close to average.

Table 6.1 shows Kansas' 2020 *State Business Tax Climate Index* property tax component ranking compared to regional competitors, along with each state's 2020 score, to give a sense of relative positioning.

TABLE 6.1.
***State Business Tax Climate Index***
**Property Tax Component Rankings**
*Kansas and Select Regional Competitors (2020)*

| State | Property Tax Component Ranking |
|---|---|
| Kansas | 20th |
| Arkansas | 27th |
| Colorado | 14th |
| Indiana | 2nd |
| Iowa | 35th |
| Missouri | 6th |
| Nebraska | 41st |
| Oklahoma | 19th |

Source: Tax Foundation, *2020 State Business Tax Climate Index*.



## Property Tax Rates and Collections

Property taxes made up 73 percent of Kansas' local government tax collections in fiscal year 2016, comprising three times more than sales taxes (24 percent) as a portion of local government tax revenues.[148] This puts Kansas in line with the nation as a whole. Across the United States, property taxes make up 72 percent of local government tax collections. Kansas' property tax also makes up 8 percent of state tax collections.[149]

Changes to the state's school finance formula have made significant progress in slowing the growth in property tax collections, with decreases in property tax collections after school finance reforms in the late 1970s and early 1990s, along with a reduction in the statewide school millage rate in the late 1990s. Between 1977 and 2000, property taxes increased from $2.865 billion to $3.162 billion in 2018 dollars for a total increase of $297 million in real terms, a compound annual growth rate of 0.43 percent. However, since 2000, property taxes have climbed from $3.162 billion to $4.521 billion in 2016, an increase of $1.359 billion in real terms, a compound annual growth rate of 2.3 percent.

Property tax rates in Kansas are expressed as mill rates. One mill represents one dollar of tax levied against $1,000 of assessed property value. The assessed property value

148 U.S. Census Bureau, "State and Local Government Finance," 2016, https://www.census.gov/data/datasets/2016/econ/local/public-use-datasets.html

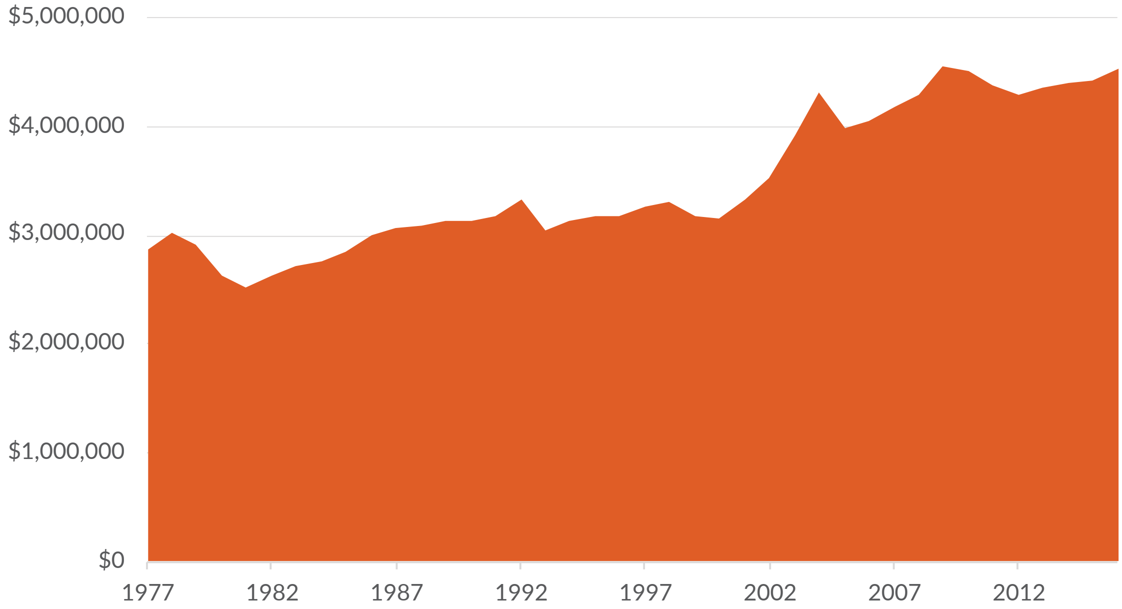
149 Id.

is arrived at by taking the appraised market value of the property and multiplying it by the appropriate assessment factor for that class of property. The classification and assessment factor ratios are considered in the next section.[150]

FIGURE 6.1.

## Kansas State and Local Property Tax Collections

*1977-2016 (in Thousands of 2018 Dollars)*




Note: Census Bureau collected limited data for 2001 and 2003. For the purposes of this graphic, the average of the preceding and following years were used to create imputed values for 2001 and 2003.
Source: U.S. Census Bureau, "State and Local Government Finance," 2016.

Kansas' property tax collections per capita were $1,490 in 2016, ranking Kansas 21st highest of the states, though slightly below the national average of $1,556. Kansas' property tax collections per capita are less than regional competitors Nebraska and Iowa and the U.S. average, but above Colorado, Missouri, Indiana, Arkansas, and Oklahoma.

TABLE 6.2.

## Property Tax Collections Per Capita

*Kansas and Select Regional Competitors, 2016*

| State | 2016 collections per capita | Rank |
|---|---|---|
| Kansas | $1,490 | 21 |
| Arkansas | $712 | 48 |
| Colorado | $1,425 | 25 |
| Indiana | $967 | 40 |
| Iowa | $1,582 | 15 |
| Missouri | $971 | 39 |
| Nebraska | $1,909 | 12 |
| Oklahoma | $699 | 49 |
| U.S. average | $1,556 | |

Source: Tax Foundation, *Facts & Figures 2019: How Does Your State Compare?*

150 Kansas State Department of Education, "How Mill Levies Are Computed," https://www.ksde.org/Portals/0/School%20Finance/budget/Online%20Budget%20Packet/mill%20levy.pdf?ver=2018-07-10-132519-867.

Kansas' property taxes paid as a percentage of owner-occupied housing value are above the national average and above most regional competitors. Kansas' property taxes stood at 1.28 percent of home value in 2017, compared to an average of 1.05 percent nationally, ranking 15th in the country and coming in higher than Missouri, Oklahoma, Indiana, Arkansas, and Colorado. Once again, Nebraska and Iowa are higher than Kansas on this metric of property tax burden.

TABLE 6.3.

**Property Taxes Paid as a Percentage of Owner-Occupied Housing Value**

*Kansas and Select Regional Competitors (2017)*

| State | 2017 property taxes as a percentage of owner-occupied housing value | Rank |
|---|---|---|
| Kansas | 1.28% | 15 |
| Arkansas | 0.63% | 38 |
| Colorado | 0.53% | 46 |
| Indiana | 0.82% | 30 |
| Iowa | 1.46% | 11 |
| Missouri | 0.97% | 22 |
| Nebraska | 1.61% | 8 |
| Oklahoma | 0.87% | 27 |
| U.S. | 1.05% | |

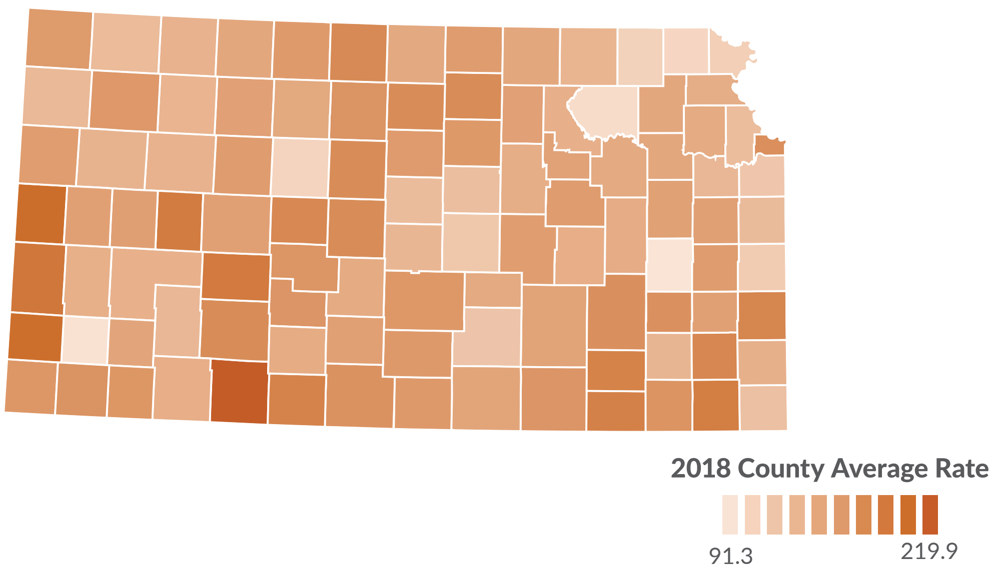
Source: Tax Foundation, *Facts & Figures 2019: How Does Your State Compare?*

Kansas properties are appraised to find market value, and then assessed based on property class. For example, residential properties are assessed at 11.5 percent of market value, and commercial and industrial properties are assessed at 25 percent of market value. The resulting assessed value is multiplied by a given millage rate per $1,000 of assessed value. This effectively means that the assessed value is divided by 1,000 and multiplied by the millage rate.

Millage rates depend on the assessed property values in the county relative to budget expenditures. Property taxes are levied by local governments such as counties, cities, townships, community colleges, school districts, fire districts, cemetery districts, watershed districts, library districts, and sewer districts.

Figure 6.2 shows the average millage rate in each county. Average millage rates vary across the state, from a high of 219.9 in Clark to a low of 91.4 in Coffey in 2018.

FIGURE 6.2
## County Average Property Tax Millage Rates (2018)




Source: Kansas Department of Revenue Property Valuation Division.

# Property Tax Structure

## Assessment Classifications

Kansas has seven classifications for real property and six classifications for tangible personal property, as defined in the state constitution, summarized in Table 6.4. The constitution also allows for the legislature to provide for the classification or exemption of recreational vehicles and watercraft. The legislature has adopted a 5 percent assessment ratio for watercraft.[151] The constitution does not apply its classification system to motor vehicles, mineral products, money, mortgages, notes, and other evidences of debts and grain.

TABLE 6.4.

### Real and Tangible Personal Property Classes and Assessment Ratios

| Real Property | | Tangible Personal Property | |
|---|---|---|---|
| **Classification** | **Assessment Ratio** | **Classification** | **Assessment Ratio** |
| Residential | 11.50% | Mobile homes | 11.50% |
| Commercial and industrial | 25% | Mineral leasehold interests and natural gas leasehold interests | 30% |
| Public utility except railroads | 33% | Public utility tangible personal property | 33% |
| Agricultural land | 30% | Motor vehicles not defined by public law enacted prior to January 1, 1985 | 30% |
| Vacant lots | 12% | Commercial and industrial machinery and equipment | 25% |
| Not-for-profit | 12% | All other tangible personal property not classified | 30% |
| All other not classified | 30% | | |

Source: Kansas State Constitution.

151 Kansas Department of Revenue Division of Property Valuation, "2019 Personal Property Summary," 2019, https://www.ksrevenue.org/pdf/ppsumm.pdf.

By law, all real and personal property in the state is taxable unless it is expressly exempted from taxation.[152] K.S.A. 79-201 creates the list of exemptions from property taxation, covered in the section on property tax refunds, credits, and exemptions to follow. This list of exemptions increases tax neutrality and economic efficiency to the extent that it removes tangible and intangible personal property from Kansas' property tax rolls. However, greater simplicity could be achieved by moving away from taxation of tangible personal property.

Watercraft are assessed at a rate of 5 percent by statute. Motor vehicle valuations are based off a valuation schedule developed annually by the Department of Revenue.[153]

Table 6.5 shows the appraised value, assessed value, and tax by property class for 2016. The table shows the effect of assessment ratios on property tax liabilities. For example, while residential properties make up nearly 70 percent of all appraised value, residential properties were responsible for less than half of all property tax revenue collected. In contrast, commercial and industrial properties are responsible for 17.4 percent of all appraised value but pay 27.5 percent of all property taxes. Of note is that oil and gas property appraisal levels were unusually low in 2016, with less than one-quarter the appraised value of just two years earlier.

TABLE 6.5.

**Appraised Value, Assessed Value, and Tax by Property Class**

| Property Class | Appraised Value (Billions) | Percent of All Appraised Value | Assessed Value (Billions) | Percent of All Assessed Value | Tax (Millions) | Percent of All Tax |
|---|---|---|---|---|---|---|
| Residential | $143.39 | 69.8% | $16.50 | 49.7% | $2,220.01 | 49.3% |
| Commercial & Industrial | $35.82 | 17.4% | $8.98 | 27.1% | $1,238.69 | 27.5% |
| Utilities | $12.78 | 6.2% | $4.22 | 12.7% | $550.67 | 12.2% |
| Ag Land | $7.53 | 3.7% | $2.26 | 6.8% | $320.65 | 7.1% |
| Oil & Gas | $1.59 | 0.8% | $0.46 | 1.4% | $68.62 | 1.5% |
| Other | $4.21 | 2.1% | $0.77 | 2.3% | $108.13 | 2.4% |
| Total | $205.32 | 100% | $33.19 | 100% | $4,506.77 | 100% |

Source: Kansas Department of Revenue Property Valuation Division.

## Agricultural Use Value

The Kansas constitution provides that agricultural land can be valued for *ad valorem* taxation based on its agricultural income or agricultural productivity. "Use value" for agricultural land attempts to determine value based on the production of the land without considering other factors that affect the market value of real estate. The "use value" metric is a response to agricultural concerns that farmlands shoulder an onerous property tax burden, and that land values can rise more rapidly than farm incomes. However, one study shows the use value metric has resulted in agricultural land being appraised at less than 12 percent of its market value.[154]

152 K.S.A. 79-101.

153 Kansas Department of Revenue, "Kansas Vehicle Property Tax Check – Estimates Only," 2019, https://mvs.dmv.kdor.ks.gov/vehiclepropertytaxlookup/.

154 Glenn W. Fisher, "Erosion of the Kansas Property Tax Base," Kansas Public Finance Center, Wichita State University, December 2006, https://www.wichita.edu/academics/fairmount_college_of_liberal_arts_and_sciences/hugowall/documents/Erosion_of_the_Kansas_Property_Tax_Base.pdf.

Kansas determines use value by calculating an eight-year average of yields, income, costs, and soil-production capabilities. The Department of Revenue's Division of Property Valuation is required to make a determination of value for each of the soils found in each county and provide these values to each county appraiser.

Kansas' agricultural use value appraisal system is highly complex and thus nontransparent. It is also nonneutral in that it appraises farmlands at values that are often significantly lower than market value. The agricultural use value system remains under discussion as the state population becomes increasingly urbanized.

### Property Tax Lid

The Kansas legislature passed its so-called "property tax lid" in the closing days of the 2015 veto session, with the lid taking effect in January 2017. The law has remained controversial both with advocates of strict property tax limitations and with those who opposed the bill in the name of allowing local government financial flexibility and autonomy. Furthermore, the lag between the bill's passage and effective date might have incentivized near-term property tax increases before the lid took effect.

The property tax lid requires counties and municipalities to call for an election to approve any property tax levies that increase faster than the prior year's inflation. The law provides allowances for changes such as new construction, increased personal property valuation, and new property added to a jurisdiction. The lid also does not apply to property tax increases that will be used for certain debt and interest payments, expenditures that are mandated by federal or state law or are the result of court judgments or settlements, or for funding law enforcement, fire protection, and emergency medical services.

Stakeholders we met with, both in support of and opposition to the law, noted reasons why the lid approach was not the most effective method to keep the public informed and rein in property taxes. Advocates of local government autonomy and many local government officials disliked the state government imposing financial restrictions at a time when state financial support was uncertain. Furthermore, some local officials believed that the requirement to hold a referendum was unduly burdensome. On the other hand, those who supported more controls on local governments disliked the number of exemptions contained in the property tax lid law, and argued that numerous exemptions enabled local governments to recategorize spending into areas that were exempt from the cap.

## Property Tax Refunds, Credits, and Exemptions

Kansas' property tax refunds, credits, and exemptions are targeted towards homeowners based on income level, age, disability status, and presence of dependent children. While these programs narrow the property tax base and thus redistribute the tax burden to other taxpayers, they are not overly extensive. Kansas' property tax relief for low-income seniors does, however, allow for property tax refunds for owners of relatively valuable homes.

Kansas applies a number of effective exemptions against business tangible personal property to make the tax code simpler and more neutral, but also allows for discretionary tax rebates for downtown redevelopment, making the tax code less neutral and more complex.

## Homestead Refund

Kansas provides a homestead refund to rebate a portion of property taxes paid by qualifying homeowners. The maximum refund available is $700. To be eligible, Kansas residents must have a household income of $35,000 or less and either be age 65 or older, be blind or totally and permanently disabled, or have a child under age 18 living in the home.[155]

## Kansas Property Tax Relief for Low-Income Seniors

Seniors aged 65 and older with a household income of $19,800 or lower (2018) can qualify for a property tax refund equal to 75 percent of property taxes paid or to be paid in the prior year. However, such seniors who use this program cannot also receive a homestead refund. To qualify, the home cannot be valued at more than $350,000. This program allows for a fairly generous qualifying home value, especially compared to its low-income qualifications.[156]

## Downtown Redevelopment Tax Rebate

Cities may submit requests for the Secretary of Commerce to designate certain downtown areas as redevelopment areas. Once designated, investors in such downtown areas can receive a rebate on property taxes collected on properties that have undergone approved improvements. The property tax rebate is equal to the full incremental tax increase due to redevelopment for the first five years, and then phases out by 20 percent per year over the next five years. These rebates depend on inter-local government agreements among all relevant taxing jurisdictions.[157]

## School General Fund Exemption

Homeowners are allowed a $20,000 exemption from the market value of their homes in calculating tax liability for the 20 mill statewide general fund school property tax. This exemption essentially makes the statewide property tax portion of school finance more progressive. This exemption is not available for the millage levies for supplemental school funds.[158]

155 Kansas Department of Revenue, "Homestead Refund," https://www.ksrevenue.org/perstaxtypeshs.html.
156 Id.
157 Kansas Department of Commerce, "Kansas Downtown Redevelopment Tax Rebate," https://www.kansascommerce.gov/the-kansas-edge/exemptions-financing-incentives-taxes-unemployment/taxes/kansas-downtown-redevelopment-tax-rebate/.
158 Kansas State Department of Education, "How Mill Levies are Computed."

### Exempt Property

All property is defined as subject to tax unless specifically exempted. As a result, there are many exemptions from property tax in the state code. Important exemptions from tangible personal property include the exemption of business inventories, agriculture machinery and equipment, and business machinery, equipment, and materials from tax. However, this last exemption does not include motor vehicles, oil and gas leases, and their itemized personal property such as drilling equipment and piping. These exemptions generally comport with the principles of sound taxation, as tangible personal property taxes are known to distort economic decision-making and resource allocation.

In Kansas, county commissions and city boards have authority to provide generous property tax exemptions for business property. Qualifying business properties must exclusively be used for the manufacture of articles of commerce, conducting research, or storing goods or commodities that are bought or sold in interstate commerce. This exemption lasts for 10 years. Not only is this exemption nonneutral with respect to development in different industries, but it also can affect the distribution of the tax burden for the statewide school general funds tax levy.

Other notable exemptions include government property, religious, educational, and charitable organization property, hospitals, adult care homes, children's homes, homes for people with disabilities, clothing, household goods not used to generate income, graveyard land, certain farm products, inventories and properties stored in interstate commerce, business aircraft, and automobile manufacturing facilities purchased or constructed after December 31, 2011.

## Other Property Taxes Issues

### Tangible and Intangible Personal Property Taxes

Kansas continues to levy property taxes on a variety of tangible personal property, such as cars and watercraft, and levies taxes on the gross earnings of intangible property.[159]

Tangible property taxes are a source of complexity and nonneutrality in the tax code. They impose large compliance costs, and they do not generate significant tax revenue relative to these compliance costs.

In addition to the actual tax burden, tangible personal property taxes impose compliance and administration costs because the tax levy is "taxpayer active." This means that businesses and individuals must fill out forms identifying their personal property that is subject to taxation and detailing relevant attributes including, but not limited to, a physical description, the year of purchase, the purchase price, and any identifying information. The tax is to be remitted upon the depreciated value of each article of

159 Kansas Department of Commerce, "Intangible Property Tax," https://www.kansascommerce.gov/the-kansas-edge/exemptions-financing-incentives-taxes-unemployment/taxes/intangible-property-tax/.

personal property.[160] However, the provisions in the Kansas code which focus on durable assets with liquid secondary markets—such as motor vehicles and watercraft—are less administratively challenging than taxation of business machinery and inventories would be.[161]

Kansas has taken steps to reduce the burden of its tangible personal property tax, exempting most commercial and industrial machinery acquired after June 30, 2006.[162] The cutoff date limited the immediate impact on local tax bases, while encouraging economic growth by keeping new and expanding businesses from entering their commercial and industrial machinery into the system going forward.

Kansas' local taxation of the earnings of intangible property is highly anachronistic, complex, and nonneutral. The state outlines intangible property as including monies and credits such as gold and silver coins, U.S. Treasury notes, and stock certificates. It also includes written instruments that show a fixed obligation in favor of the owner, such as accounts receivable, notes, and bonds.

Counties can levy a tax of up to 0.75 percent on the earnings of intangible property, while cities and townships can levy a tax of up to 2.25 percent. Only one-third of counties, less than one-fifth of cities, and about one-third of townships levy such a tax.[163]

## Dark Store Theory

Big box retailers have traditionally had their real estate appraised on the basis of the value of their buildings and land. However, local government officials in Kansas, particularly in Johnson County, have advanced new valuation metrics that have led to significant year-over-year increases in big box retail property tax appraisals. The central issue at play is the controversy over the so-called "Dark Store Theory" of property valuation, and the local tax dollars involved are significant.

The core of the controversy in Kansas is whether the real estate of big-box retailers should be valued based upon the traditional standard of the value of land and its improvements, or whether the property can be valued based on an imputed or intangible value due to a lease that is in place or the income-producing ability of a business that occupies the property. Retail properties in Johnson County experienced a significant increase in valuation from 2015 to 2016,[164] kicking off a set of appeals and litigation that has brought into question how such properties are valued.

Johnson County officials have pushed for more of an income or intangible value component to retail property valuation. Thus far, the local governments that have pushed such valuation metrics have consistently lost before the Kansas Board of Tax Appeals and

160 Joyce Errecart, Ed Gerrish, and Scott Drenkard, "States Moving Away from Taxes on Tangible Personal Property," Tax Foundation, Oct. 4, 2012, http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property.

161 Garrett Watson, "State Should Continue to Reform Taxes on Tangible Personal Property," Tax Foundation, Aug. 6, 2019, https://taxfoundation.org/tangible-personal-property-tax/.

162 K.S.A. 79-223.

163 Kansas Department of Commerce, "Intangible Property Tax."

164 Brad Cooper, "Johnson County Appraisals Draw Scrutiny as Lawmakers Explore 'Dark Store' Theory," *Sunflower State Journal*, Feb. 28, 2018, https://sunflowerstatejournal.com/johnson-county-appraisals-draw-scrutiny-as-lawmakers-explore-dark-store-theory/.

the Kansas Supreme Court. The controversy will affect the potential refund of tens of millions of dollars in property taxes in Johnson County alone.[165]

While the seeds of the controversy over the dark store valuation approach go back at least to the 2008 Wisconsin case *Walgreens v. City of Madison*,[166] the issue quickly developed a footprint in Michigan and Indiana, then spread to several more states, including Kansas.

The issue threatens to create financial instability in the areas such as Johnson County that have collected taxes based on appraisals that have since been appealed to and rejected by the State Board of Tax Appeals. The valuation controversy creates instability for both the local governments and retail businesses that are affected.

## Units of Local Government

The issue of consolidation of units of local government was frequently raised in our meetings with stakeholders concerned about property taxes. A comprehensive analysis of arguments for and against consolidation, along with various consolidation options, is beyond the scope of this book. However, we present some relevant data below to provide a high-level comparison of Kansas with its peer competitor states.

To start with school districts: Kansas' count of students per school district is near the middle among regional competitors, though it's significantly below Colorado and Indiana.

TABLE 6.6.
**Students Per School District**
*Kansas and Select Regional Competitors*

| State | School Districts (2017) | Enrollment (2017) | Students Per School District |
|---|---|---|---|
| Kansas | 286 | 489,795 | 1,713 |
| Arkansas | 259 | 477,047 | 1,842 |
| Colorado | 178 | 905,019 | 5,084 |
| Indiana | 402 | 1,020,686 | 2,539 |
| Iowa | 333 | 510,932 | 1,534 |
| Missouri | 556 | 883,879 | 1,590 |
| Nebraska | 245 | 318,853 | 1,301 |
| Oklahoma | 512 | 693,710 | 1,355 |

Source: National Education Association, "Rankings of the States 2017 and Estimates of School Statistics 2018," April 2018.

However, Kansas has the highest number of state and local government employees per 100 residents compared to any of its select regional competitors. Kansas has 1.9 state government employees per 100 residents, which is normal for the region. Kansas has 6.1 local government employees per 100 residents, which is the highest in the region. However, Kansas has a significantly lower population density than any of its regional

165 Dia Wall, "State Board Ruling on 'Dark-Store Theory' Could Cost Counties Millions," KSHB Kansas City, July 2, 2019, https://www.kshb.com/news/local-news/state-board-ruling-on-dark-store-theory-could-cost-counties-millions.

166 *Walgreen Co v. City of Madison*, decided July 8, 2008, https://caselaw.findlaw.com/wi-supreme-court/1217117.html.

competitors other than Nebraska, which likely contributes to its relatively higher number of local government employees per 100 residents.[167] Combined, Kansas' 8.0 state and local government employees per 100 residents is the highest among regional competitors.

TABLE 6.7

### State and Local Government Employees per 100 Residents

*Kansas and Select Regional Competitors (2017)*

| State | Local Government Employees Per 100 Residents | State Government Employees Per 100 Residents | State and Local Government Employees Per 100 Residents |
|---|---|---|---|
| Kansas | 6.1 | 1.9 | 8.0 |
| Arkansas | 3.6 | 2.7 | 6.4 |
| Colorado | 4.7 | 2.2 | 6.9 |
| Indiana | 4.0 | 1.8 | 5.8 |
| Iowa | 5.5 | 2.1 | 7.7 |
| Missouri | 4.5 | 1.7 | 6.2 |
| Nebraska | 5.8 | 1.8 | 7.6 |
| Oklahoma | 5.2 | 2.1 | 7.3 |

Employment Source: Bureau of Economic Analysis, *Employment by State*, Total Full-Time and Part-Time Employment by NAICS Industry, 2017.
Population Source: U.S. Census Bureau, "American Fact Finder," 2017 Population Estimates.

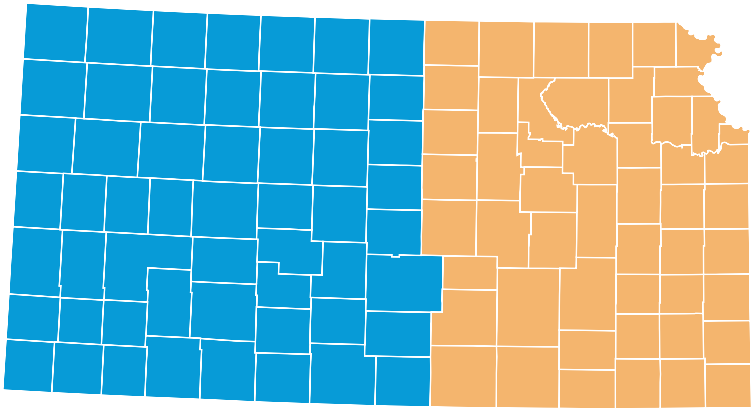
The issue of local government employees per 100 residents breaks down along regional lines. The eastern portion of the state has fewer local government employees per 100 residents compared to the western portion of the state. At least to some degree, this is the natural effect of larger units of government in more concentrated metropolitan areas achieving better economies of scale in providing government services.

To get a superficial look at how this looks across the state, we drew an artificial divider between east and west Kansas along county lines using the north-south route of I-35 as the divider. The number of local government employees per 100 residents ranged from a low of 4.1 per 100 residents in a more metropolitan county to a high of 24.2 in a more rural county. The statewide average is 6.1 local government employees per 100 residents. The average in the eastern portion of the state is 5.7 local government employees per 100 residents, while the average is 9.3 local government employees per 100 residents in the western portion of the state.

167 U.S. Census Bureau, *Resident Population Data*, "Population Density," https://web.archive.org/web/20111028061117/http://2010.census.gov/2010census/data/apportionment-dens-text.php.

FIGURE 6.3

## Local Government Employees per 100 Residents by Region



6.1 local government employees per 100 residents in Kansas counties, on average

**9.3 local government employees per 100 residents in western counties, on average**

**5.7 local government employees per 100 residents in eastern counties, on average**

Employment Source: Bureau of Economic Analysis, *Employment by State*, Total Full-Time and Part-Time Employment by NAICS Industry, 2017.
Population Source: U.S. Census Bureau, "American Fact Finder", 2017 Population Estimates.

# Property Tax Administration

Kansas' repeated efforts to improve its system of property tax administration have borne fruit, according to the Council on State Taxation (COST).[168] Kansas is tied with Georgia as the top-ranked U.S. states for property tax administration, with both states receiving a grade of B+. As COST notes, "Fair and efficient property tax administration is critically important to both individual and business taxpayers around the world." Kansans ought to be proud of the competitiveness of the Sunflower State's administration of their property taxes.

COST evaluates states on whether they have a uniform base and rates, efficient filing procedures, centralized review and uniform appeal procedures, and whether they limit payment requirements to the uncontested portion of valuations. COST provides each state with an Overall grade along with subcategories of Transparency, Consistency, and Procedural Fairness.

Kansas' B+ overall score is significantly better than its select regional competitors, with only Indiana also scoring in the B range with a B- overall. Kansas receives an A for Transparency, a B for Consistency, and a B for Procedural Fairness.

168 Nikki Dobay and Fred Nicely, "The Best (and Worst) of International Property Tax Administration," Council On State Taxation, June 2019, 5, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/2019-international-property-tax-scorecard—-final.pdf.

TABLE 6.8.

## Property Tax Administration Grades

*Kansas and Select Regional Competitors*

| State | Transparency | Consistency | Procedural fairness | Overall |
|---|---|---|---|---|
| Kansas | A | B | B | B+ |
| Arkansas | C | C | C | C+ |
| Colorado | B | B | D | C+ |
| Indiana | C | A | C | B- |
| Iowa | C | C | D | C- |
| Missouri | D | B | B | C+ |
| Nebraska | B | B | D | C+ |
| Oklahoma | B | C | D | C |

Source: Council on State Taxation, “The Best (and Worst) of International Property Tax Administration.”

Kansas is tied with Georgia as the best states for property tax administration. However, there are a few areas in which COST notes that the state could improve. Kansas is penalized for having multiple assessment ratios depending on the use of the property. Kansas is also penalized because taxpayers are required to pay a portion of a disputed tax that is under appeal, and interest rates are significantly higher for delinquent property taxes than they are for property tax refunds. The state is also penalized for only allowing 30 days to file an appeal after a valuation notice is sent, compared to COST’s recommended 60 days.[169]

169 Id.

## Property Tax Solutions

Property taxes tend to have less impact on economic decision-making than other forms of taxation such as income taxes. When well-administered, property taxes have a high degree of transparency and compliance.

Kansas has a highly effective system of property tax administration, and commendably forgoes estate, inheritance, and inventory taxes. However, Kansas does not take a neutral approach to taxable property and fails to circumscribe the tax base to land and its improvements. Both tangible personal property and the gross earnings from intangible personal property are in the tax base.

### Restructure the Property Tax Lid in the Mold of Utah's Truth in Taxation Requirements

Utah's "Truth in Taxation" (TNT) law contains provisions that Kansas lawmakers could consider as an alternative to the current property tax lid. The Utah law places softer constraints on local governments yet mandates a higher degree of taxpayer transparency. Utah allows local governments to raise levies provided they comply with a rigorous system of transparency and communication with the public.

Provisions from the Utah law could be imposed in place of the lid and extended to additional units of local government that have taxing authority in Kansas along with additional categories of expenditures. The goal of this change is to balance the interests of a voting public that wants a rigorous accounting for property tax increases with the interests of local governments that want to be able to raise revenues without the time and expense of running a voter referendum. Such a change would also make the property tax restraints apply to more categories of expenditures than under the current property tax cap. These provisions should be applied to units of local government beyond just cities and counties and should also be applied to broader categories of expenditures including police, fire, and emergency medical services that are currently exempt from the lid, as these are under the taxing authority's discretion.

Furthermore, increased revenues from the expiration of property tax abatements, tax increment financing districts, or any other tax rebate or redirection program should be subject to the constraints of the Truth in Taxation requirements for increased property tax revenues. These new revenues are currently exempt from the state's property tax lid. However, it makes sense to continue exemptions for court judgments and expenditures specifically mandated by federal or state law, or loss of federal funds where the unit of government is required to provide a service.

Utah has unique TNT requirements for fiscal year and calendar year taxing entities that Kansas could consider based on what would work best for local governments in the Sunflower State. Utah entities that align with the fiscal calendar must alert the county auditor of a proposed revenue increase. The auditor is then required to run newspaper ads at least two weeks before a public hearing and post notice of the intended increase on the state's public notice website and the county website.[170] The auditor is then required to send out a "Notice of Property Valuation and Tax Changes" listing the property tax change along with the date, time, and location of the public hearing to discuss the said change, which must be held at least two weeks after the first newspaper advertisement.

Calendar year entities are required to perform slightly more in the name of transparency and taxpayer awareness.[171] In addition to advertisements online and in the newspaper, calendar year entities must address the increase as a separate agenda item in a public meeting and send out a notice to each property parcel which lays out what the property owner's current estimated payment is and what it would be under the new levy—effectively informing property owners of the precise increased cost they will face for local government services. The notice also lists the date, time, and location of a public hearing about the issue, which, as with the fiscal year entities, is held at least two weeks after the first public advertisement.

After these steps, the entities are welcome to adopt their tax increases. Although there are no other official restrictions, the court of public opinion is a strong one: a taxing district will face significant pushback if it increases levies without sufficient justification, or if it increases rates beyond levels residents will accept. These guidelines seem to work well for the state: Utah has some of the lowest property taxes when taken as a percentage of owner-occupied housing value, and its property tax burden as a share of personal income has been falling relative to other states.[172]

There is much to learn from this model. Strict transparency standards do not shackle local governments, but instead engage the public to ensure full transparency about the costs and services of local government.

## Reduce Reliance on Tangible Personal Property Taxes

Kansas should move towards a more neutral tax code that circumscribes property taxation to real property (land, buildings, improvements, and fixtures). Currently, a significant amount of property tax revenue comes from taxation of tangible personal property such as automobiles. Kansas should move from taxation of tangible personal property by expanding and gradually raising the $1,500 *de minimis* threshold for tangible personal property that is subject to taxation.[173]

Reducing tangible personal property taxes will reduce tax complexity and simplify the property tax code. Kansas will become more competitive and taxpayer-friendly if it reduces reliance on tangible personal property taxes across the board.

170 Utah State Tax Commission, "Fiscal Year Entity Property Tax Increase Requirements (TNT)," https://propertytax.utah.gov/tax-rates/fy-tnt-reqs.pdf.

171 Utah State Tax Commission, "2020 Calendar Year Entity Property Tax Increase Requirements (TNT)," https://propertytax.utah.gov/tax-rates/cy-tnt-reqs.pdf.

172 Janelle Cammenga, *Facts and Figures 2019: How Does Your State Compare?* Tax Foundation, Mar. 19, 2019, https://taxfoundation.org/facts-figures-2019/.

173 For additional details regarding the state's tangible personal property taxes, see Kansas Department of Revenue, "2019 Personal Property Summary"; Kansas Department of Revenue, "2019 Personal Property Valuation Guide," https://www.ksrevenue.org/pdf/PPVG.pdf.

A more aggressive approach would be to move from the taxation of tangible personal property by exempting new purchases of tangible personal property that would otherwise be subject to taxation beginning after a certain effective date, in the same manner in which Kansas eliminated personal property taxation for certain business property purchased after June 30, 2006. This change would significantly simplify Kansas' property tax code.

### Preempt Local Governments on Taxation of Gross Earnings from Intangible Property

Kansas imposes a highly unusual and aggressive local tax on the gross earnings of intangible personal property.[174] This is an anachronistic, complex, and nonneutral form of taxation that affects economic decision-making and resource allocation. It is levied by a relatively small minority of Kansas local governments.

The state legislature should preempt local governments from imposing any taxation upon the earnings from intangible property. This should be done by first assessing local dependence on these tax revenues and then setting a schedule to gradually phase out the taxation on gross earnings from intangible property. Such a change will modernize Kansas' local tax codes and eliminate a small but highly nonneutral form of taxation.

### Direct County Appraisers on Proper and Improper Methodologies for Appraising Big-Box Retail Properties

Kansas has a praiseworthy system of property tax administration, tied with Georgia for the best system of property tax administration in the United States. However, advocates of changing the system for valuing retail properties have claimed that the traditional way Kansas has valued retail properties amounts to a so-called "dark store theory" of property valuation. They have argued that such big-box retail properties should be valued with some consideration for the intangible value of a successful business owning or leasing the property, thus breaking with Kansas tradition and negatively impacting the transparency, neutrality, simplicity, and stability of Kansas' system of property tax administration.

Kansas' constitution specifies that real property is to be taxed in a uniform and equal manner. Kansas' Board of Tax Appeals and Supreme Court have consistently interpreted this language to mean that retail properties should be appraised on the value of their land and improvements, and not on an imputed or intangible value due to a lease that is in place or the income-producing ability of a business that occupies the property. The Board of Appeals and Supreme Court have consistently ruled against local appraisers who created property valuations based on a lease in place or the income potential of a tenant or owner. Such appraisals, particularly in Johnson County, have introduced significant uncertainty for both businesses and local governments, affecting tens of millions of dollars' worth of property tax liability in Johnson County.



174 Kansas Department of Commerce, "Intangible Property Tax."

The Director of the Division of Property Valuation has significant oversight over local appraisers and should provide guidance on valuing retail properties in accord with Kansas law and repeated decisions from the Kansas Board of Tax Appeals and Kansas Supreme Court. Unless and until there is a legislative change in the method for valuing retail stores which is found to be constitutional, appraisers should rely on methods to determine the fair market value of land and its improvements without imputing any intangible valuation based on a lease that is in place or for the income potential of the retail tenant or retail owner.

## Revisit the Requirement for Partial Payment of Tax that is under Appeal

Kansas is penalized under COST's grading for property tax administration because taxpayers are required to pay a portion of a disputed tax that is under appeal. This problem is related to the controversy over the appraisal of retail properties, because local governments are able to collect a portion of the tax that is in dispute. This creates an incentive for governments to over-appraise property values and makes it more contentious when retailers win their property tax appeals given that the local government must then refund property tax money. In some cases, tens of millions of dollars are in dispute, which results in financial instability for local governments and the businesses involved.

The legislature should revisit whether local governments should be restricted from capturing property tax that is disputed under appeal, perhaps by having said tax dollars held in escrow. This would further polish Kansas' high grades in property tax administration, and remove a perverse incentive for local appraisers, enhancing stability for local government finances. However, any such change should create guardrails to prevent further instability from ensuing when appeals are large relative to the size of local budgets.

## Study and Consider Ways to Achieve Local Government Consolidation

Recommending a program of consolidation is beyond the scope of this book. However, data on Kansas' local governments suggests the potential for improved tax efficiency through shared services and consolidation. The Kansas legislature and executive branch should look at the issue of consolidation in greater detail. Research should assess the potential for improved government efficiency and thus property tax relief from consolidation, along with risks to the provision of government services.

CHAPTER 7

# OTHER TAXES

## Introduction

The four preceding chapters cover the core drivers of revenue and competitiveness in Kansas' tax code. However, Kansas' tax code includes more than just corporate, income, sales, and property taxes. This book would not be complete without a review of other taxes and tax-related issues, including the so-called Kansas-Missouri border wars, the state's rainy day funds, and excise taxes. In the following pages, we review several final tax considerations to create a more robust and accurate picture of taxation in Kansas.

## Border Wars

Tax competition is a good thing when it incentivizes states to improve the efficiency of their tax codes and creates a favorable tax climate for people and businesses of all types. However, Kansans living in the Kansas City area are all too aware of a less constructive form of tax competition: when competing states offer special deals to lure companies across a state border in a metropolitan area that straddles a state border.

The Kansas City area is not your typical metropolitan area. It has two mayors and two entirely different administrations thanks to a state line running straight through the city. Having a major metropolitan area like this creates some unique opportunities—but at times, it has also promoted economically inefficient efforts by each side to entice businesses across state lines, often using the two states' most generous incentives programs, Kansas' Promoting Employment Across Kansas (PEAK) credit and the Missouri Works program.

Over the years, both the city of Kansas City, Missouri and the unified government of Kansas City, Kansas have lured companies back and forth across the line, moves that do nothing to grow the larger region and sometimes do not even have workforce implications, since a company might only relocate a few city blocks. Officials on both sides have long recognized the futility of this "border war," but neither side was willing to stand down unilaterally.

To that end, policymakers on both sides of the border had long expressed interest in a truce, and that came to fruition in August 2019, when Kansas Governor Laura Kelly (D) signed Executive Order 19-09, reciprocating legislation enacted in Missouri a few months earlier. Both states have now agreed not to use their state tax credits to entice companies to relocate from border counties and seek to induce localities to play by similar rules.[175] These actions represent a significant step in the right direction towards ending a destructive cycle.

But it's hard to fully appreciate the importance of these recent agreements without understanding what was the norm for many years. The Hall Foundation has been tracking

175 Kansas Executive Order No. 19-09, https://governor.kansas.gov/wp-content/uploads/2019/08/EO-19-09_Executed.pdf; Missouri S.B. 182 (2019).

the incentives from both PEAK and Missouri Works.[176] It reports that Missouri has spent $151 million to move 5,526 existing jobs from Johnson and Wyandotte Counties (Kansas) to Jackson County (Missouri) since 2011. Kansas brought 6,729 jobs in the opposite direction for a total of $184 million. Perhaps this makes Kansas a "winner," but at the cost of more than $150,000 per net job shifted across the border, and no guarantee that a more aggressive push by Missouri might not turn the tables in the future.

Together, these border communities have spent $335 million not to create jobs, but simply to move them around a metropolitan area. "Border wars" like the one in the Kansas City area have high costs and limited benefits for taxpayers. The only winners are companies who can game the system—and most cannot do so. Poaching businesses across the border with generous tax incentives is a race to the bottom. And the tax incentives end up being paid for by the majority of taxpayers who aren't eligible for such largesse.

Leadership on both sides of the state line have seen this system as unproductive and unsustainable for a number of years, although previous efforts to stop the poaching did not succeed. In 2014, for example, Missouri tried to reach a truce by passing S.B. 635, with enforcement contingent on the requirement that Kansas adopt similar limitations.[177] The Sunflower State did not reciprocate, and the battle continued.

In 2019, that changed. The administrations in both states saw the issue as a priority and signed an agreement to that effect at the Kansas City Chamber's Governors Summit on August 13, 2019.[178] When Missouri passed legislation in June to end these incentives, Kansas followed suit with its executive order in August.

Such common-sense actions to limit destructive tax incentive competition should be applauded. However, since Order 19-09 is only advisory and not binding on local governments (and its state provisions could be rescinded at any time), both states will have to rely on their local governments to make sure the agreement is upheld. Both states have stipulations in place that dissolve the incentive truce if someone breaks the agreement. Thus, the agreement is only as good and as lasting as the parties who entered into it. But it at least creates an official cultural pivot towards more sound and fair tax policies.

The Kansas City area can be an example to other states of just how damaging tax incentive fights can be. Stacking up special tax credits at the expense of regular taxpayers is no way to create true job growth. Both sides are better off if they can stand down, and Missouri and Kansas are on a course to do just that.



176 The Hall Family Foundation has not published an official study, but has kept a list of relocations between Johnson and Wyandotte, KS, and Jackson, MO. The Foundation does not release the full spreadsheet in order to protect the names of companies, but they provide their total counts of relocations and incentive amounts. This information was obtained via email correspondence with Angela Smart, but the Foundation has also released its figures to a number of news agencies.

177 Missouri S.B. 635.

178 States of Kansas and Missouri, "Agreement between the State of Kansas and the State of Missouri for Promoting Economic Development in the Kansas City Region," 2019, https://www.kcchamber.com/sites/default/files/2019-08/2019%20Gov%20Summit%20Agreement.pdf.

## Rainy Day Fund

Economic cycles can have significant impacts on state revenue. But states don't necessarily have to bend their budgets to the fickle winds of the economic cycle; they can prepare for inevitable downturns during good times by putting away money in a revenue stabilization fund, often known as a rainy day fund. The funding levels may vary from state to state, but rainy day funds have increasingly emerged as a standard component of states' budgeting toolkits.

Kansas is a late entrant, adopting legislation in 2016 to create the Budget Stabilization Fund (BSF). Although the plan was to establish the fund in 2017, deposits were not scheduled to begin until fiscal year 2020, after the state accrues some revenue growth from the 2017 tax increases. Under this law, if revenue exceeds the projections under which the state operated when it adopted the budget, half of any surplus revenues must be deposited into the BSF. However, these deposits are only mandated for fiscal years 2020 through 2022, after which no further provision is made for BSF deposits.

This structure, moreover, calculates required contributions based on a relatively arbitrary factor—the accuracy of revenue forecasts—rather than a more meaningful metric like revenue growth. While states budget to their forecasts, making a sweep of a portion of any surplus seem like an attractive and relatively painless funding option for a rainy day fund, this approach can lead to perverse outcomes. A low forecast during an economic downturn could trigger a deposit, while a forecast that overshoots during a period of growth might eliminate any depository requirement at a time when the state should clearly be setting aside excess revenue. Using revenue growth is a better approach, and whatever changes Kansas makes, the state should certainly include extending the depository requirements indefinitely rather than letting them expire after fiscal year 2022.[179]

Kansas law does not specify when funds may be withdrawn. Fourteen states require a supermajority vote to tap into rainy day funds, or only permit the funds to be used during contractionary periods where revenues are down.[180] Similarly, Kansas' rainy day fund is one of only two in the country that lacks a replenishment provision which prioritizes deposits into the fund after conditions necessitating withdrawals have lifted.

Ten states require withdrawals to be repaid within a fixed period of time, but this can inadvertently require those states to start repaying their debts while they are still in an economic downturn.[181] A better technique is to tie rainy day deposits to above-average levels of economic growth so the state can rebuild its savings account at a time when it has the resources to do so.

What Kansas *does* have in law are provisions for across-the-board budget cuts for nonessential services in the case of fiscal crisis.[182] Kansas can find a better set of

179 K.S.A. 75-6707.
180 The Pew Charitable Trusts, "When To Use State Rainy Day Funds," April 2017, http://www.pewtrusts.org/~/media/assets/2017/04/when-to-use-state-rainy-day-funds.pdf.
181 Id.
182 K.S.A. 75-6704.

mechanisms to blend the budget stabilization fund with cuts to nonessential services. It should follow other states' examples by outlining provisions for the use and replenishment of its rainy day fund and ensuring that the state continues to save past fiscal year 2022, assuming there will be surpluses to be saved in the immediate years. Taking these small, important steps to save during economic upturns and lay down some ground rules for when stabilization funds can be expended and how they are to be replenished will have a significant impact on the state's stability during future economic downturns and, hopefully, its ability to withstand economic fluctuations without resorting to drastic tax changes.

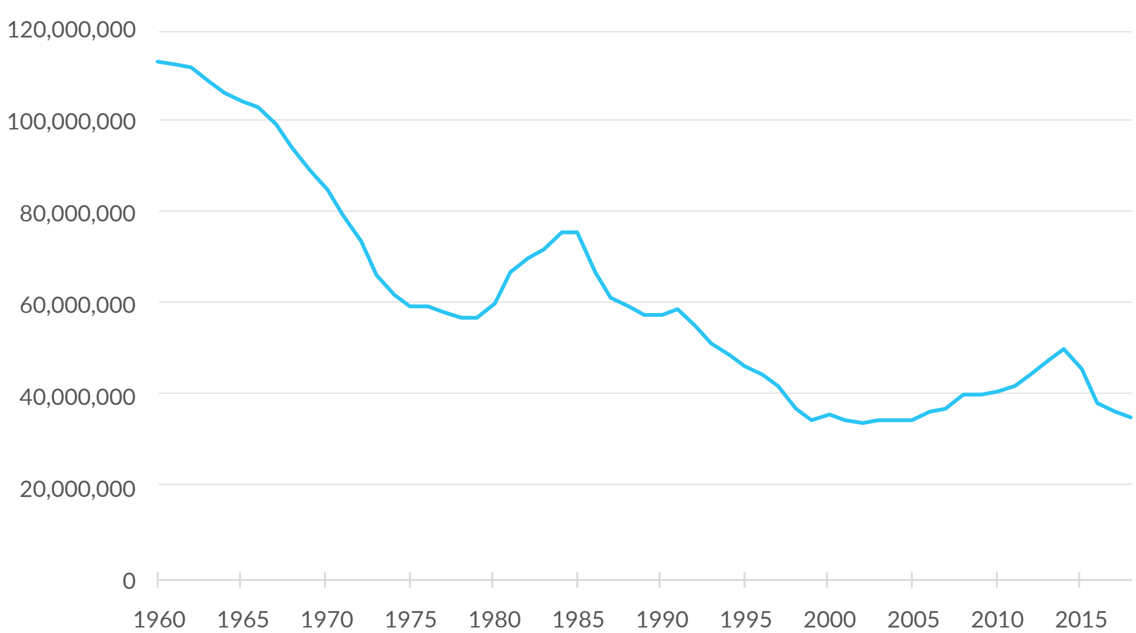
## Severance Taxes on Oil and Natural Gas

Historically, oil and natural gas extraction have played an important role in the Kansas economy. While that role has shrunk significantly in recent years, the industry and its related taxes are still worth addressing.

FIGURE 7.1.

**Kansas Oil Production**

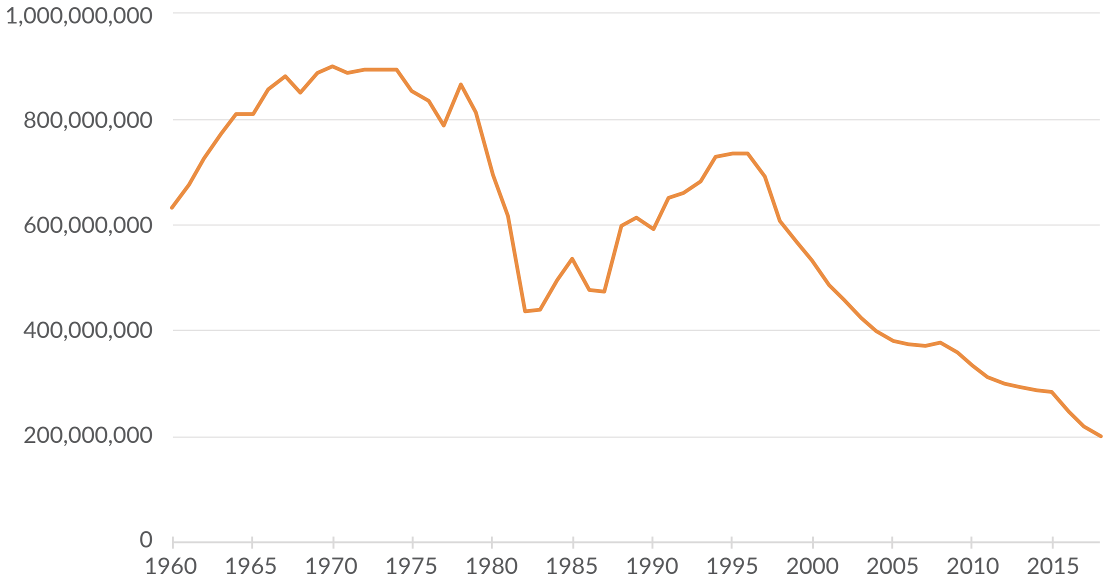
*1960-2018 (bbls)*




Note: 1 bbl = 1 barrel
Source: University of Kansas, Kansas Geological Survey.

In 1960, Kansas produced over 113 million barrels of oil and almost 633 million mcf of natural gas. With a few exceptions, oil production in the state has been on the decline ever since, with the state producing only 34.7 million barrels in 2017.

FIGURE 7.2.
## Kansas Natural Gas Production
*1960-2018 (mcf)*




Note: mcf = 1000 cubic feet
Source: University of Kansas, Kansas Geological Survey.

Natural gas saw significant growth in the 1960s and early 1970s, dropped off strongly around 1980, and made up some of that loss leading up to 1996. However, natural gas production has been falling steadily since then, with the state producing 202 million mcf in 2017. Much of this is due to the declining production in the Hugoton fields.[183]

While Kansas held about 1 percent of the nation's crude oil reserves in 1995, the state holds about 0.8 percent of those same reserves today.[184] Back in 1995, Kansas claimed 6 percent of the country's natural gas reserves, but the number has dropped dramatically, to only 0.6 percent as of 2016.[185]

Kansas levies an 8 percent tax on the gross value of severed oil and gas, while completely exempting small wells and those with a low daily production (stripper wells). The state also exempts natural gas consumed in the production process and that which was severed from stripper wells.[186] Perhaps most notably, while the state imposes property taxes on oil property (as do most peer states), there is a credit against that liability for 3.67 percent of the gross value of taxable severed oil, which dramatically reduces liability.[187] Accordingly, although 8 percent is a high statutory severance tax rate, one study finds that Kansas' effective rate is only 2 percent. This compares favorably to effective rates in many other oil- and gas-producing states.[188]

183 Kansas Legislative Research Department, "State General Fund Receipts Estimates for FY 2018 and FY 2019," Nov. 17, 2017, https://budget.kansas.gov/wp-content/uploads/CRE_Long_Nov2017.pdf.
184 U.S. Energy Information Administration, "Crude oil and lease condensate proved reserves, reserves changes, and production, 2017," November 2018, https://www.eia.gov/naturalgas/crudeoilreserves/pdf/table_6.pdf.
185 U.S. Energy Information Administration, "Total natural gas proved reserves, reserve changes, and production, wet after lease separation, 2017," November 2018, https://www.eia.gov/naturalgas/crudeoilreserves/pdf/table_10.pdf.
186 K.S.A. 79-4217.
187 K.S.A. 79-4219.
188 Colorado Legislative Council, "Effective Severance Tax Rates on Oil and Gas," Jan. 12, 2018, https://leg.colorado.gov/sites/default/files/interested_persons_memo_on_severance_taxes.pdf.

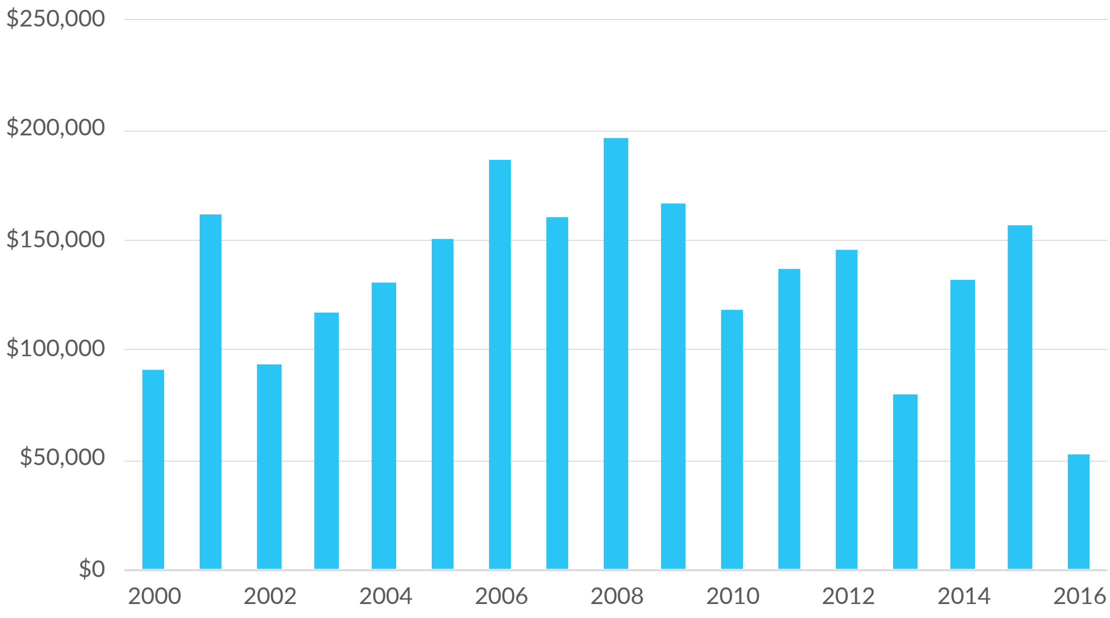
TABLE 7.1.
### Effective Severance Tax Rates on Oil Production

| State | Effective Rate |
|---|---|
| Colorado | 0.60% |
| Utah | 0.80% |
| Kansas | 2.00% |
| Oklahoma | 3.30% |
| New Mexico | 3.90% |
| Texas | 3.90% |
| Wyoming | 5.00% |
| North Dakota | 9.40% |
| Montana | 10.50% |

Source: Colorado Legislative Council, "Effective Severance Tax Rates on Oil and Gas."

On the state level, oil and natural gas collections, along with all other severance taxes, make up about 0.5 percent of the General Fund. Taxes on oil and gas property are also responsible for about 2 percent of local tax collections.[189]

FIGURE 7.3.
### State Severance Tax Collections
*2000-2018 (2018 Dollars)*




Source: U.S. Census Bureau, "Annual Survey of State Government Tax Collections."

Severance tax revenues began a precipitous decline in 2009, made a modest recovery, and fell again in 2016, tracking declines in global oil prices and shifts in demand for extraction in the state. Kansas cannot control global commodity markets, but since extraction is highly price-sensitive, policymakers *can* ensure that the severance tax never becomes a significant impediment to drilling, idling wells that could otherwise be profitable.

189 U.S. Census Bureau, "Annual Survey of State and Local Government Finance," 2016, https://www.census.gov/programs-surveys/gov-finances.html.

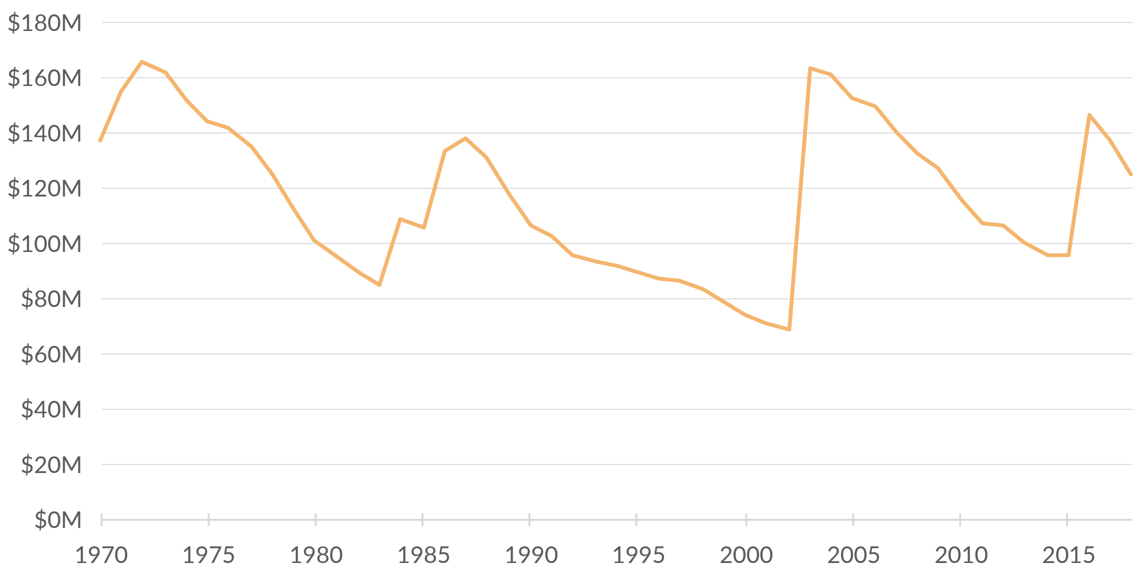
# Cigarette Taxes

Like the rest of the country, Kansas faces declining cigarette tax revenues, chiefly due to reduced incidence of smoking. However, in Kansas and elsewhere, cigarette smuggling also plays a role wherever there are rate disparities across state lines. While Kansas' rate of $1.29 per pack is not high, ranking 32nd nationwide, it exceeds the rates in several neighboring states. In 2017, Kansas had the 10th highest cigarette smuggling rate in the nation, with nearly 22 percent of all cigarettes purchased in Kansas coming from outside the state.[190] In its yearly calculations, the Mackinac Center for Public Policy estimates that such smuggling cost the state $36 million in revenue.

FIGURE 7.4.

**Cigarette Tax Revenue**

*1970-2018 (2018 Dollars)*




Source: Orzechowski and Walker, "The Tax Burden on Tobacco, 1970-2018."

TABLE 7.2.

**Cigarette Tax Rates (per pack)**

*Kansas and Neighboring States (2019)*

| | |
|---|---|
| Kansas | $1.29 |
| Colorado | $0.84 |
| Nebraska | $0.64 |
| Missouri | $0.17 |
| Oklahoma | $2.03 |

Source: Bloomberg Tax; state statutes.

Because smoking can be expected to continue to decline, policymakers should be wary of tying cigarette tax revenues to core government services or recurring expenses, as these revenues are likely to erode over time.

190 Michael D. LaFaive and Todd Nesbit, "Estimated Cigarette Tax Avoidance and Evasion by State, 2017," https://www.mackinac.org/smokes.