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FEBRUARY 2017

the STATE FACTOR

A PUBLICATION OF THE AMERICAN LEGISLATIVE EXCHANGE COUNCIL

ALEC American Legislative Exchange Council

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# Lessons from Kansas: A Behind the Scenes Look at America's Most Discussed Tax Reform Effort

By Jonathan Williams and Ben Wilterdink

## Introduction

Positioned in the center of the United States, Kansas has often served as a stand-in for the preferences of non-coastal America. Perhaps this unique position is why a 2012 tax reform has garnered more media attention, both positive and negative, than just about any other recent state level tax reform effort. From a pure public finance perspective, the tax overhaul in North Carolina in 2013[1] or Nevada's imposition of a gross receipts style tax in early 2015[2] would likely warrant more attention than the 2012 Kansas tax reforms. While the exact causes behind the media flurry around the Kansas tax reform effort might not be clear, it is clear to most observers of state policy at this point Kansas was, and continues to be, a flashpoint in debates about state tax policy.

That flashpoint has served as something of a proxy war between big government advocates and those who would prefer to shrink the size and scope of state government. Both sides have continuously piled on with headlines that can sometimes miss important details, but it was not until the tax cuts were partially altered that Kansas became the poster child of the pro-tax Left. *New York Times* columnist, and former Enron adviser, Paul Krugman devoted a column to Kansas, claiming that those in favor of the 2012 tax reform efforts were "charlatans and cranks."[3] The *Los Angeles Times* published an editorial titled, "How Tea Party tax cuts are turning Kansas into a smoking ruin," which argues that the tax cuts have been severely detrimental to the Kansas economy.[4]



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"Positioned in the center of the United States, Kansas has often served as a stand-in for the preferences of non-coastal America."

Notwithstanding the far-Left commentators, the situation in Kansas is far less dire than it might appear on first glance. State spending, including education spending, continues to set records, and revenues look far better in context—these are Lessons from Kansas: A Behind the Scenes Look at America's Most Discussed Tax Reform Effort often the opposite of now popularly held beliefs. This is not to say there have not been some discouraging economic statistics, but the reality of the situation is more complex.

Perhaps the most important complexity to keep in mind is the Kansas tax reform plan—neither as initially proposed nor enacted in 2012—was never fully implemented. Spending reductions necessary to implement the plan were eschewed in favor of other tax increases, making any honest judgement of the original plan's success or failure impossible.

Hyperbolic *ad hominem* attacks aside, there is much that can be learned from the Kansas experience. With so much misinformation, or more often, selectively reported information, being promoted, it is well worth examining just what happened, how it happened, why it happened and what other states can learn from it.

## The 2012 Tax Reforms

Nearly the entirety of this debate centers on the tax reforms that were enacted in 2012. At the start of 2012, the top marginal personal income tax rate in Kansas was 6.45 percent and its top marginal corporate income tax rate was 7 percent. Both of these top rates were higher than neighboring Colorado (with a top marginal personal and corporate income tax rate of 4.63 percent) and Oklahoma (with a top marginal personal income tax rate of 5.25 percent and a top marginal corporate income tax rate of 6 percent).[5] Still recovering from the great recession like most other states, Kansas was still facing an unemployment rate of 6.1 percent, roughly the national average at the time.[6]

Additionally, Kansas ranked 26 out of 50 in economic outlook in this publication's 2012 index, beating out only Nebraska (31) in the region. The rest of the region, Colorado (8), Oklahoma (14), Missouri (7), Iowa (22), Arkansas (11), Wyoming (4), South Dakota (2) and Texas (16) all ranked more economically competitive.[7]

Politically, 2012 was the second year that Governor Sam Brownback was in office and after campaigning on tax reform, Governor Brownback found his efforts held up in the Kansas state Senate, which was dominated by left-of-center Republicans at the time. Although tax reduction proposals were being passed by the Kansas House of Representatives, the liberal Republicans in the Kansas Senate were blocking many of these reform efforts.[8] It was in this economic and political climate the now widely discussed tax reductions were first adopted.

Early in the 2012 legislative session, Governor Brownback did not get involved in the primaries of Republican state lawmakers. However, after encountering substantial opposition to tax reform proposals, he eventually decided to support primary opponents of some state lawmakers. "Because of the alliance in the State Senate between Democrats and some Republicans that join together to promote a Democrat agenda, the primary has effectively become the general," Brownback said in July of 2012. "Therefore, I am going to be involved in a limited number of primaries."[9]

Perhaps facing opposition from the Governor, the Kansas Senate eventually passed a tax reduction bill had already passed out of the Kansas House. However, before the Senate passed the bill, lawmakers amended the reform package to strip out the revenue raising offsets, such as the extension of a temporary sales tax increase and the removal of the mortgage interest deduction. By taking out the revenue offsetting measures from the tax reform proposal, the Senate passed a much more expensive tax reform package, likely thinking Governor Brownback would then be forced to veto the plan. But, calling their bluff, Governor Brownback signed the package into law with the expectation of adding back in the revenue offsetting measures in a future session with a more amenable Senate.[10]

The final tax reduction package that passed included several key points:

- Simplified personal income taxes from a three-tiered system to two
- Reduced the top tax rate on income over $30,000 (single) / $60,000 (joint) from 6.45 percent to 4.9 percent
- Income between $15,000 and $30,000 (single) / $30,000 and $60,000 (joint) that had been taxed at 6.25 percent in a middle bracket was reduced to the new maximum rate of 4.9 percent
- Reduced the tax rate on income below $15,000 (single) / $30,000 (joint) from 3.5 percent to 3.0 percent
- Exempted non-wage personal income from taxation entirely; effectively eliminating income taxes for pass-through business profits, estimated to be worth $160 million per year
- Enacted an estimated $4.5 billion in tax relief over five years, about 80 percent of which was for individuals and 20 percent for business pass-through income

These major changes were intended to get the ball rolling toward a goal of eventually eliminating the state's income tax. In a 2013 article, Representative Richard Carlson, the Chairman of the Taxation Committee, touted the state's reforms but also noted, "Legislators never get everything they want in a bill. The governor and I both made some compromises, but we believe we have accomplished our policy goals of dramatic tax reform in Kansas that will advance the agenda of limited government for years to come."[11]

Governor Brownback had repeated his overall goal of increasing the economic competitiveness of Kansas and the well-being of its citizens by eliminating this tax, one of the most damaging taxes for economic growth. With that goal in mind, the 2012 tax reform's key provision was the exemption from taxation of all non-wage income generated by pass-through business—businesses filing through the personal income tax code, such as sole proprietorships, partnerships and limited liability companies.

The exemption of non-wage pass-through income, termed the "Small Business Accelerator," quickly became one of the more controversial parts of the plan. Some groups praised the change as a way to spur small business creation and make it easier for Kansans to start and grow businesses[12] while others argued that the measure inappropriately tipped the scales in favor of pass-through business classifications over traditional C-Corporations, which are subject to the corporate income tax rather than the personal income tax.[13] The pass-through exemption was also criticized as being unfair to individuals who had to pay income taxes, but those businesses were not the first group to be exempt from state income taxes; state and local government

"The exemption of non-wage pass-through income, termed the "Small Business Accelerator," quickly became one of the more controversial parts of the plan."

retirees' pensions have been largely exempt from the state income tax for decades.[14] That fairness issue was oddly not raised as a concern by tax reform opponents.

But while this largely technical debate was raging among traditional allies of pro-growth tax reform, proponents of more government programs and higher taxes began attacking the reforms as radical and the ultimate embodiment of so-called "voodoo economics." Objections raised by the proponents of higher taxes were distinct from the objections raised by those concerned with the possible misaligned structural incentives, but both objections were unfortunately many times lumped together to give the impression that a wide variety of experts opposed decreasing income taxes generally.[15]

As media attention around the Kansas tax reform effort grew, starting what is now a well-known back and forth, these nuanced differences began to give way to larger narratives about whether or not states should reduce taxes more generally, especially taxes on income. Every new data point on the Kansas economy and revenue situation became another skirmish between proponents of pro-growth tax reform and advocates for high taxes and big government programs.

With Kansas' tax reform in the spotlight, commentators and policy experts began to analyze the preliminary results of the plan. The initial results were very positive. In 2012, Kansas had more than 15,000 new small business filings; more than in any other year."

## Kansas in the Spotlight

With Kansas' tax reform in the spotlight, commentators and policy experts began to analyze the preliminary results of the plan. The initial results were very positive. In 2012, Kansas had more than 15,000 new small business filings–more than in any other year.[16] Furthermore, Kansas began 2013 with an unemployment rate of 5.5 percent and finished the year with the rate dropping to 4.9 percent. This was a full percentage point lower than the 5.9 percent unemployment in Missouri at the end of 2013.[17] Additionally, the Kauffman Foundation, an organization that rates the small business climates of states, gave Kansas an "A" in 2013. Neighboring Missouri received a "C" in the same year.

With these early signs of a healthier Kansas economy and the 2012 elections providing a more free market oriented legislature, Governor Brownback and Kansas lawmakers moved ahead with the "March to Zero" plan to phase out the income tax by passing more tax reductions, the greatest impact of which occurred in later years, along with some revenue offsets that went into effect immediately. Additional cuts to the personal income tax were set to phase in over five years to lower the rate to 2.3 percent on the first $30,000 of income and 3.9 percent on income over that. In terms of revenue offsets, the legislature allowed a sales tax increase to only partially expire rather than fully expire, setting the overall rate at 6.15 percent, down from 6.3 percent, but not the scheduled drop to 5.7 percent. The 2013 tax plan also repealed a portion of the increased standard deduction that was included in the original 2012 tax plan.[18]

The final piece of the 2013 tax package was a nod to the goal of eliminating the state's personal income tax by setting up revenue triggers. After 2018, when the statutory personal income tax rate reductions would have been completely phased in, if general fund revenue exceeded what it had been in the previous year by at least 2 percent, that would trigger an additional personal income tax rate reduction. It is important to note at this point that the revenue increasing offsets included in the 2013 tax plan were nowhere near as comprehensive as the revenue raising offsets in Governor Brownback's original 2012 tax reform proposal. It was this discrepancy in revenue raising offsets and the failure to rein in state spending that would ultimately lead to revenue problems for Kansas down the road.

By mid-2013, things had taken a turn for the worse in Kansas. State revenues were down, partially because of the tax reductions without sufficient revenue raising offsets or spending restraint, but also because of changes in federal tax law at the time. The end of 2012 brought the "fiscal cliff" negotiations that resulted in the Budget Control Act and the Sequester, among other things. One notable compromise from the fiscal cliff negotiations was an increase in the capital gains tax rate, scheduled to take effect in 2013.

In May of 2013 the Congressional Budget Office noted that, "The large increase in payments accompanying people's income tax returns probably reflects the fact higher-income taxpayers, anticipating changes in tax law, realized more income in 2012."[19] In fact, this was noted as a likely outcome of the fiscal cliff negotiations by several experts before the disappointing revenue figures came in.[20] As far as revenue shortfalls go, Kansas was hardly alone in this time period. Oklahoma, Connecticut and Kentucky also had revenues far below projections, even without significant tax reductions.[21]

Unfortunately, it was also during this time that Kansas received a credit downgrade from *Moody's*. With disappointing revenue figures and a debt downgrade, commentators pounced, promoting a narrative that tax reductions are detrimental to the economy. Contrary to this popularly reported narrative, *Moody's* cited much more than just recent tax cuts as the rationale for a downgrade, specifically failure to reduce spending to offset tax cuts, pension liabilities and state debt.

Notwithstanding, the misleading narratives about the Kansas fiscal situation progressed and grew beyond expectation, perhaps due to the impending 2014 re-election campaign of Governor Brownback. By mid to late 2014, there were rumors that Kansas was experiencing massive budget shortfalls, slashing education spending and ballooning deficits. In the lead up to the 2014 elections, the election that would essentially serve as a referendum on Governor Brownback and the 2012 tax reforms, the media focused on Kansas with doomsday headlines. This coverage was no doubt in part an attempt to oust Governor Brownback, to scare other governors away from proposing bold tax reduction plans and to discourage other state candidates from campaigning on tax reform. With the benefit of hindsight, and the economic evidence, these myths deserve to be addressed each in turn.

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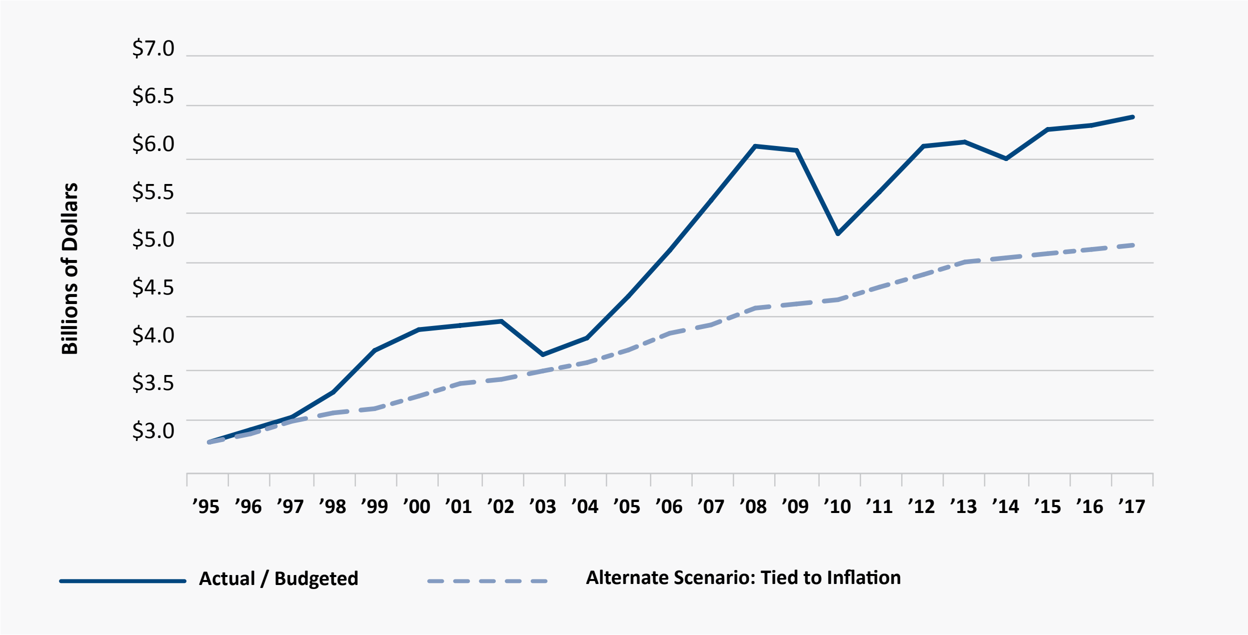
## Revenue Shortfalls and Budget Deficits

One of the most enduring myths about the Kansas 2012 tax reform saga has been the often comically hyperbolic claims regarding Kansas' budget deficits. It is certainly true that in the years following the tax reductions, Kansas did experience lower revenue collections, even lower than what had been projected. But, part of the goal of the Kansas tax reform was to reduce the amount of money taken in by state government and enhance the resources available to the private sector. Importantly, however, was the resistance to any meaningful spending reductions. Even as the 2012 tax reductions were projected to let Kansans keep $4.5 billion more of their own money, the state *increased* spending in 2012 by $432 million.[22]

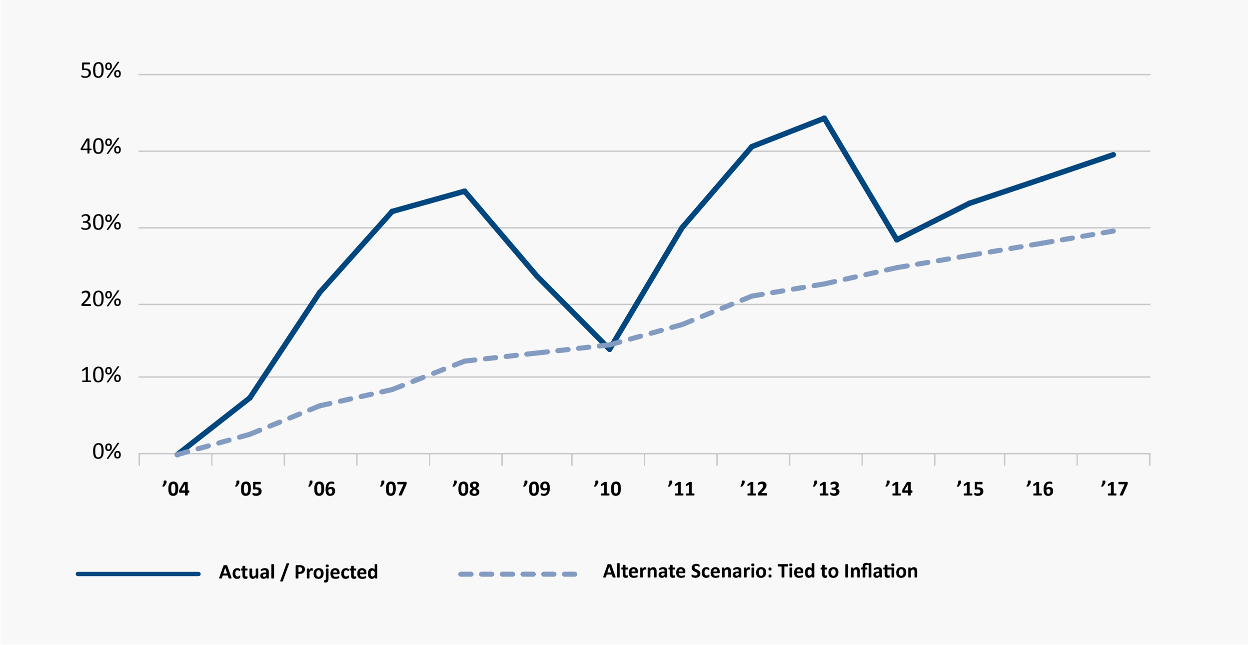
A budget deficit occurs when a state's proposed budget expenditures surpass the state's total anticipated revenue collections and available cash reserves in a given year. Kansas, like 48 other states, has a state law mandating that the state end the year with a balanced budget. However, the cautionary tale from the

## FIGURE 1 Kansas State Spending




*Source: Kansas Policy Institute*

## FIGURE 2 Kansas General Fund Tax Revenue Growth




*Source: Kansas Policy Institute*

Kansas reform package comes from the fact that the state coupled a reduction in state revenues with a significant increase in overall state spending. Spending and taxes are two sides of the same fiscal coin, and ultimately, if taxes are going to be dramatically reduced, spending must also be prioritized. A state simply cannot have a conservative tax plan while maintaining a liberal spending plan.

Of course, there are dynamic economic growth effects associated with lowering taxes, but these can too often be overestimated in the short term. The vast majority of economic literature confirms that taxes negatively impact economic growth and reducing taxes will very likely increase economic growth in the long term; but does not mean every tax cut will "pay for itself." In a late 2012 literature review on this topic, William McBride, former Chief Economist for the Tax Foundation, found that of 26 peer-reviewed academic studies since 1983, only three fail to find a negative effect on economic growth from taxes.[23]

Furthermore, not all taxes affect economic growth equally. A comprehensive 2011 study from the Organization for Economic Cooperation and Development (OECD) found that taxes on capital are the most damaging to economic growth, such as taxes on capital gains, corporate income or personal income. Researchers also found that taxes on property and on consumption were far less damaging to economic growth overall.[24] From an economic growth-maximizing perspective, capital-based taxes provide the most "bang for your buck" in terms of expected increases in economic growth. There is no magic formula, however. Some proponents of the Kansas tax reform were far too eager to overpromise immediate substantial economic growth as a result of the tax changes. This overselling was certainly a contributing factor to the narrative that the tax reforms had "failed" despite some encouraging economic trends.

Even with the positive impact of increased economic growth from the tax changes, Kansas still failed to reduce spending to a point where there would not be a projected budget deficit. An August 2012 dynamic analysis from the Kansas Policy Institute projected that a one-time adjustment to state spending of just 8.5 percent would put the state on a viable path toward balanced budgets and sustainable revenue growth.[25] These spending adjustments, however, were never enacted and the state continued to spend more than it had and was projected to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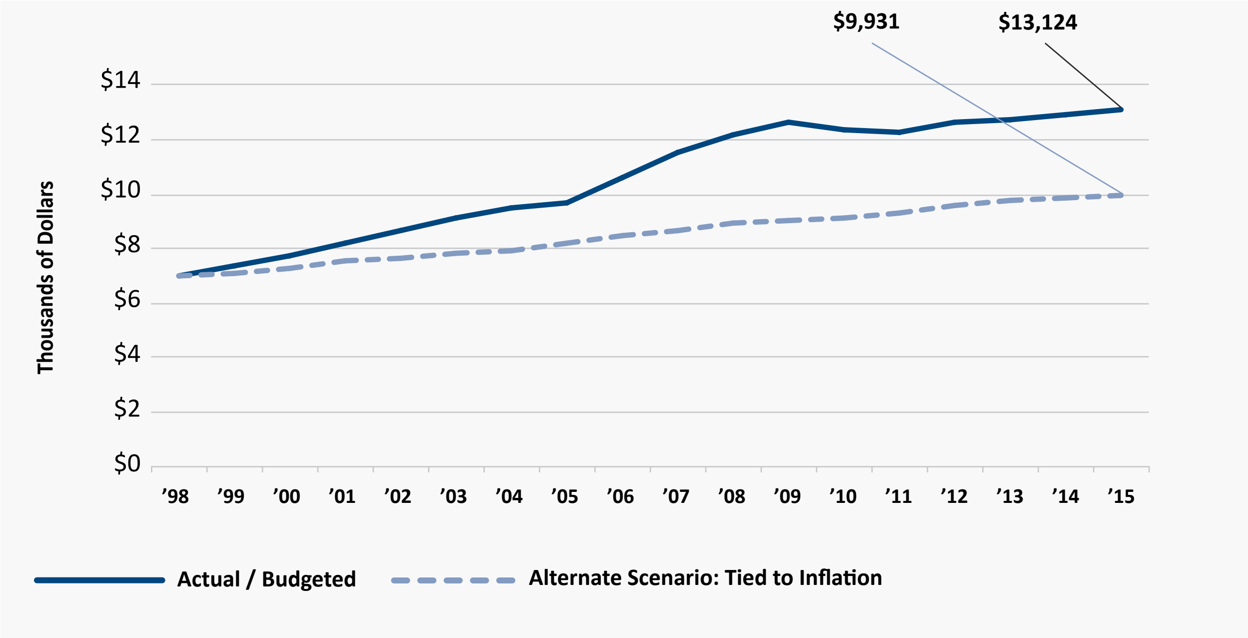
collect in taxes; bolstering the narrative that the tax reductions alone "caused" the budget deficits. This was not new behavior either. As Figure 1 shows, Kansas has increased actual annual spending by more than $2.94 billion since 1995–much more than the rate of inflation.[26]

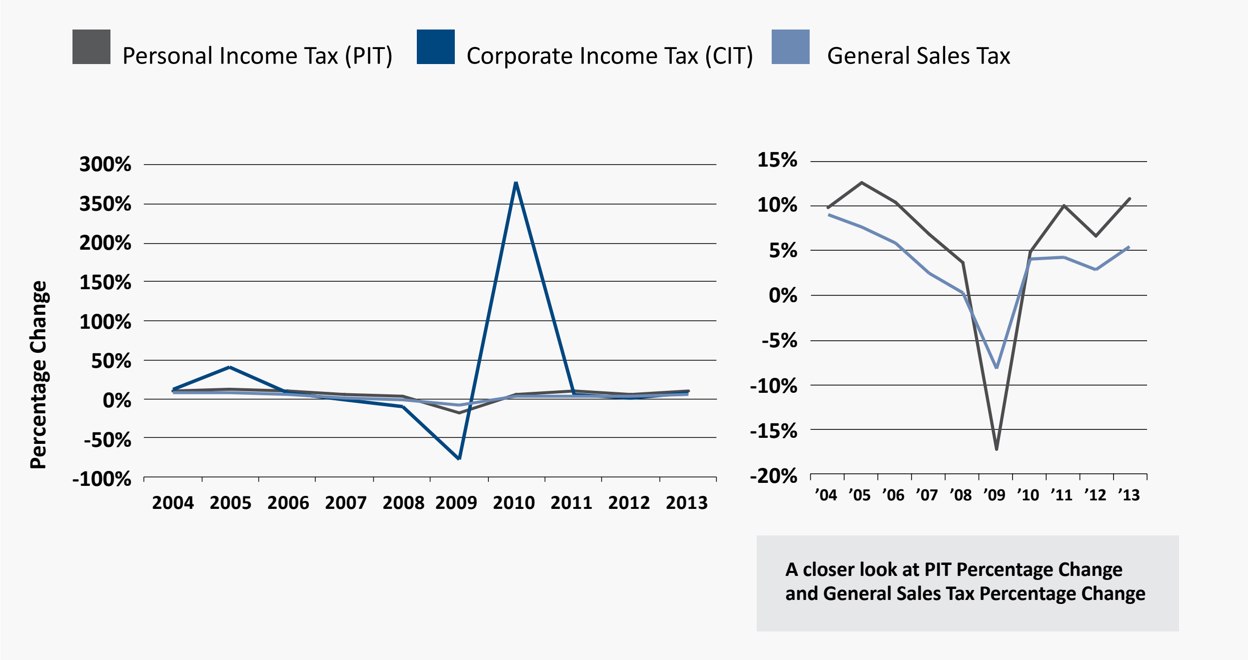
If Kansas had kept state spending more in line with the rate of inflation, state revenue would have been able to cover that level of increased spending. As Figure 2 demonstrates, even with the effect of the 2012 tax reforms, state revenue collections have been above the rate of inflation overall. Tax revenue grew 28.4 percent between 2004 and 2014 while inflation was only 24.3 percent; official revenue estimates from April 2015 (based on then-existent law) had tax revenue continuing to outpace inflation.

**FIGURE 3** Total Kansas Education Aid per Pupil




*Source: Kansas Policy Institute*

**FIGURE 4** State Tax and Revenue Volatility




*Source: Center for State Fiscal Reform, American Legislative Exchange Council*

It is an often overlooked but crucial point that both state spending and general fund tax revenues in Kansas had been growing consistently more than inflation; spending just grew much faster. Perhaps the most significant lesson states can learn from the Kansas experience is that taxes cannot be dramatically reduced while spending continues to dramatically increase. However, lawmakers' reluctance to reduce state spending is certainly understandable. Even small reductions in spending, or in some cases just reductions in the rate of spending growth, can lead to cries of "draconian" slashes to state spending. Nowhere was this more prevalent in the Kansas context than in the area of state education spending.

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## Education Spending

To those following state fiscal policy, and especially the Kansas tax reform saga, claims like these will be commonplace: "Education is the newest target of Kansas Budget Cuts,"[27] or even, "Slashing Income Taxes and Slashing Education Funding."[28] Headlines like these give the impression that Governor Brownback and the legislature took a sledgehammer to education funding. Here again, however, baseline budgeting and rhetorical tricks help to obscure the reality of education funding.

As in most other states, education funding in Kansas did slightly decline as a result of the recession; average per-pupil funding dipped 3 percent over two years, to $12,283 for the 2011 school year. However, contrary to claims of "dramatic cuts," per-pupil funding increased each year since.

Furthermore, per-pupil education spending in Kansas, which was $13,124 in 2015, set a new record for per-pupil funding—for the third year in a row.[29] In fact, *total* state education spending in 2015 was $6.08 billion in 2015, setting a new record for education spending for the fourth consecutive year. Figure 3 shows these record levels of spending are far above what spending simply tied to inflation would reach.

Some of the claims regarding "reductions" in education funding have centered on reductions in previously scheduled increases to one aspect of funding, without regard to increases elsewhere in the funding system. Government often portrays getting a smaller than desired increase as a "cut" but state funding of education increased every year since 2011. It is also worth noting that most research on the topic shows no actual link between greater education funding and student performance beyond a minimum baseline. Even if Kansas had reduced education spending as it did during the recession, there is no evidence the reduction would lead to worse outcomes in terms of student achievement.[30]

## Credit Downgrades

Another aspect to the Kansas tax reform controversy has been the downgrading of the state's debt. In late April of 2014, *Moody's Investors Service* downgraded the rating on Kansas bond debt, reflecting a perceived increased risk to investors in the state's bonds. Opponents of the 2012 tax reforms immediately jumped on the news as a time to reflect on the state's "mistake" and make plans to move away from the reforms by increasing taxes. Despite these immediate calls for tax increases, there is absolutely no evidence from the *Moody's* report that the tax reductions alone are to blame for the state's credit downgrade; rather, the issue is with pension costs and the state's spending being far above projected revenue collections.

Reliance on revenues that would only be collected in a single year or only a few years, a lack of spending cuts matching outlays to expected revenues, depletion of the rainy day fund, slow economic growth and the underfunded state pension system were all noted as budget problems facing the state. It is clear from their analysis Kansas can improve their bond rating by addressing spending issues and boosting economic growth, not just raising taxes.[31] *Moody's* even makes clear in their analysis of Kansas that they do not view the lack of a state income tax as a source of credit risk.[32] *Standard & Poor's* has gone as far as to call low reliance on income taxes a boon to strong credit ratings, stating, "Sales tax-based revenue structure that exhibits sensitivity to economic cycles, but to a lesser degree than those of states that rely primarily on personal and corporate income taxes."[33]

"States with lower taxes in general, and lower income taxes in particular, generally see higher economic growth. As we have consistently pointed out, the nine states with no income tax perform better on job growth, economic growth, migration and even tax revenue growth than their high-tax counterparts."

States with lower taxes in general, and lower income taxes in particular, generally see higher economic growth.[34] As we have consistently pointed out, the nine states with no income tax perform better on job growth, economic growth, migration and even tax revenue growth than their high-tax counterparts. However, spending must still be kept in line with revenue collections. Relying less on highly volatile revenue sources, such as corporate income and personal income taxes, makes revenue collections more stable and the budgeting process far more predictable. As Figure 4 demonstrates, broad-based consumption taxes, such as retail sales taxes, are among the least volatile sources of revenue, as sales generating the revenue generally do not fluctuate as much as capital-based taxes. In Kansas, for example, personal and corporate income taxes collectively declined 21 percent between 2008 and 2010, but retail sales tax only dipped by 3 percent.[35]

The combination of adopting a tax structure that relies less on capital-based taxes, such as taxes on income, capital gains or estates, in favor of more stable and less economically damaging consumption taxes would put states on a sustainable revenue path and make it easier to pay debt. The "ability to pay" metric is key when it comes to maintaining good bond ratings. Had Kansas lawmakers reformed their tax code and not continued to increase unsustainable spending, the state would almost certainly have maintained better bond ratings.

As was pointed out at the time of the Kansas debt downgrade, states with lower taxes tend to have better credit ratings overall. Table 1 compares the states with the highest and lowest tax burdens and their credit ratings with Moody's and Standard and Poor's, as of 2014. The pattern that emerges is clear; states that have lower taxes are generally outperforming their high tax counterparts.[36]

**TABLE 1** **2014 Credit Ratings: Highest Tax Burden States vs. Lowest Tax Burden States**

| State | Tax Burden Rank | Tax Burden as Percentage of Income | S&P Credit Rating | Moody's Credit Rating |
|---|---|---|---|---|
| New York | 1 | 12.6% | AA | Aa1 |
| New Jersey | 2 | 12.3% | A+ | A1 |
| Connecticut | 3 | 11.9% | AA | Aa3 |
| California | 4 | 11.4% | A | Aa3 |
| Wisconsin | 5 | 11.0% | AA | Aa2 |
| Minnesota | 6 | 10.7% | AA+ | Aa1 |
| Maryland | 7 | 10.6% | AAA | Aaa |
| Rhode Island | 8 | 10.5% | AA | Aa2 |
| Vermont | 9 | 10.5% | AA+ | Aaa |
| Pennsylvania | 10 | 10.3% | AA | Aa2 |
| Alabama | 41 | 8.3% | AA | Aa1 |
| South Carolina | 42 | 8.3% | AA+ | Aaa |
| Nevada | 43 | 8.1% | AA | Aaa |
| New Hampshire | 44 | 8.0% | AA | Aa1 |
| Tennessee | 45 | 7.6% | AA+ | Aaa |
| Louisiana | 46 | 7.6% | AA | Aa2 |
| Texas | 47 | 7.5% | AAA | Aaa |
| South Dakota | 48 | 7.1% | AA+ | Aa2 |
| Alaska | 49 | 7.0% | AAA | Aaa |
| Wyoming | 50 | 6.9% | NR | NR |

*Source: Center for State Fiscal Reform, American Legislative Exchange Council*

## The 2014 Election

Amidst all the commentary and analysis of the 2014 mid-term elections at the federal level, which gave Republicans the majority in the United States Senate, economists and public finance experts were watching the Kansas gubernatorial race closely. The race in Kansas was seen not just as a referendum on the 2012 tax reforms, but also a referendum on state-level tax relief more generally.

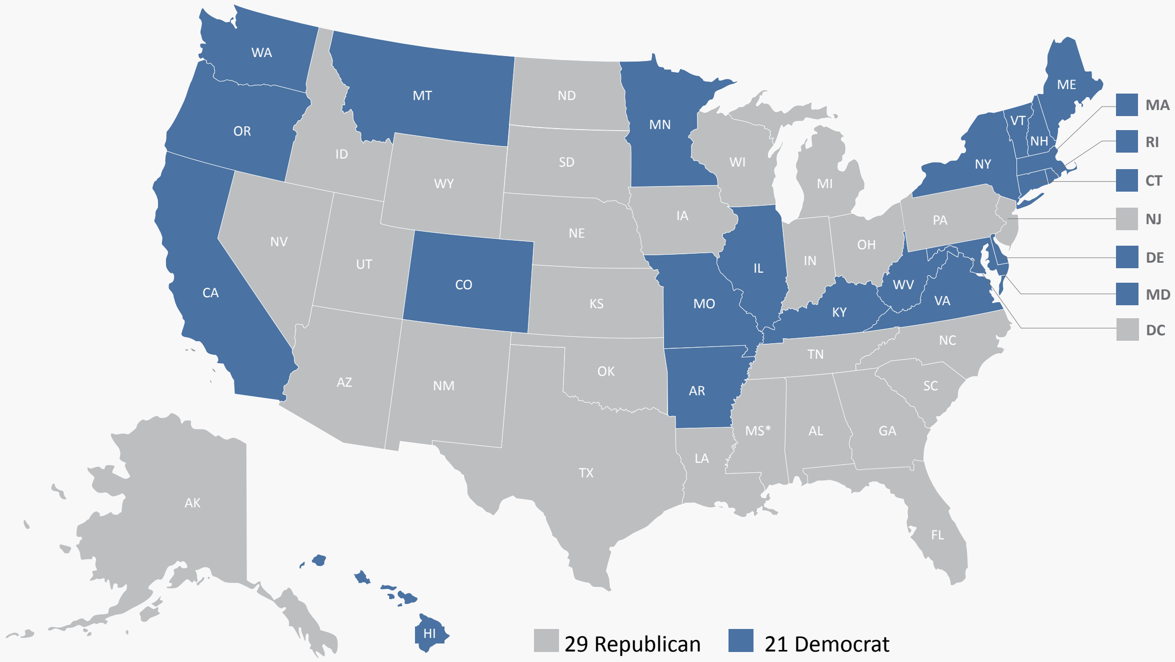
Governor Brownback's opponent was Democratic State Representative Paul Davis, who made the centerpiece of his campaign freezing the yet-to-be-implemented parts of the 2012 tax reductions and restoring the state's "decimated" funding for education and social programs.[37] The left-of-center Republicans that Governor Brownback targeted in the 2012 elections, after they failed to work seriously on tax relief proposals, were now coming back into the spotlight to support the Democratic candidate, Paul Davis. Even Steve Morris, the president of the Senate during the 2012 tax reform debate who lost in that year's election, campaigned with Davis in an effort to help him defeat incumbent Governor Brownback.[38]

Facing revenue shortfalls, hyperbolic media claims about the state of Kansas education funding levels, and attacks from prominent Kansas Republicans, Governor Brownback was considered a long shot to win re-election. Statistician and pollster Nate Silver of FiveThirtyEight.com projected that Davis would win by 2.5 points and had more than an 80 percent chance of winning the election and unseating Governor Brownback.[39]

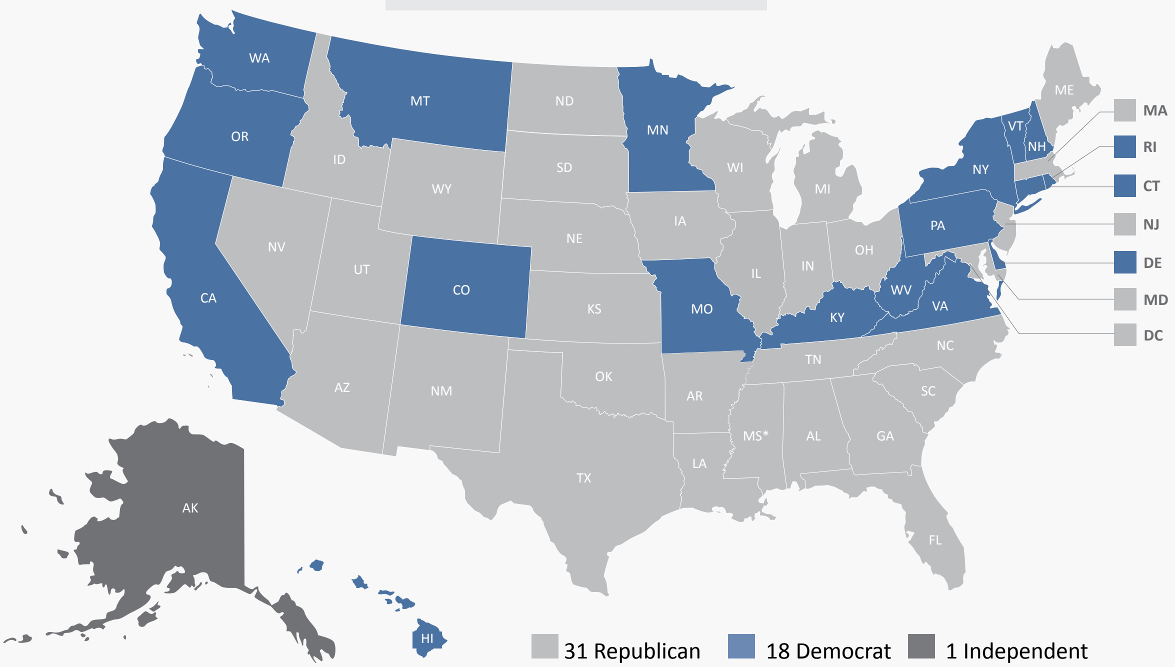
Despite the odds, Governor Brownback was re-elected to a second term, beating Davis by nearly 4 percentage points.[40] Indeed the gubernatorial race in Kansas was a referendum on

**FIGURE 5** Political Profiles of America's Governors

## BEFORE 2014 MIDTERMS




## AFTER 2014 MIDTERMS



the 2012 tax reforms, and voters made their support of lower taxes known. This trend carried through to gubernatorial races nationwide. As Figure 5 shows, other governors that pursued significant tax reductions were also re-elected. Governor Paul LePage of Maine, Governor Rick Snyder of Michigan and Governor John Kasich of Ohio all won their bids for re-election. Governor Scott Walker of Wisconsin cut taxes several years in a row and won his third statewide election.[41] Significantly, these purple states tend to alternate between Democrats and Republicans for their statewide elected offices. Victories of governors reducing taxes in these purple states are particularly significant. The message of lower taxes resonates even in states that are not by any means bastions of conservatism.

Arizona voters sent state treasurer and businessman Doug Ducey to the governor's mansion by a margin of more than 12 percentage points. Ducey had campaigned on reducing the state's personal and corporate income taxes and even saying that he wanted to get the state's 4.54 percent income tax rate "as close to zero as possible." The Arizona economy was a central part of his campaign and voters decisively approved of his pro-growth message.

In deep blue Illinois, Bruce Rauner defeated Governor Pat Quinn by almost five points. Governor Quinn had pushed for "millionaires" taxes, a move from a flat income tax to a tiered income tax and making temporary income tax hikes permanent. Rauner openly opposed Governor Quinn's tax hike proposals and made it clear that he favored returning tax rates to pre-hike levels.[42] The message sent by voters was clear: no more taxes.

In one of the biggest upsets of the year, Larry Hogan beat Lieutenant Governor Anthony Brown in the Maryland gubernatorial race. Lieutenant Governor Brown had served under Governor Martin O'Malley, who had raised taxes more than 40 times since he took office, totaling $9.5 billion in new or higher taxes for Maryland residents through fiscal year 2014.[43] Hogan campaigned on lowering taxes and making it easier to start and grow businesses in the state.

Although taxes were certainly not the only issue that brought voters to the polls in 2014, the results show a clear message. Just days before the 2014 election, *The Economist* released a story with the headline, "Brownbackonomics on the Ballot: Voters in Kansas Will Pass Judgement on a Bold Experiment in Tax Cutting."[44] Ultimately, the voters supported Governor Brownback in a year when nearly every debate and soundbite focused around the controversial 2012 tax reforms. Indeed, the results of this referendum prove that people are tired of paying an ever increasing amount of taxes and sacrificing higher economic growth.[45]

## Where is Kansas Now?

After the surprising election results, lawmakers in Kansas still had work to do. The revenue projections that the state was producing were higher than the previous year but not enough to keep up with spending increases and a new budget gap began to be discussed. The recently re-elected governor and pro-growth lawmakers entered the 2015 session with a mixture of elation and disappointment as they began discussing how to move the state forward.

### The 2015 Kansas Budget Debate

The 2015 legislative session centered on a projected $400 million budget deficit lawmakers would have to fill. Factions quickly formed with lawmakers taking sides on how to solve the issue. A popular proposal floated early on was to roll back the 2012 tax reductions, especially the exemption of non-wage income of pass-through businesses, from the personal income tax. Other ideas included cutting state spending or increasing various "sin taxes" across the state.

Kansas, like many states, is a part-time legislature. However, the 2015 legislative session was uniquely contentious and went for 113 days in total, the longest session in the state's history. A block of legislators held out for reductions in the cost of government rather than tax increases but they were unable to get a majority. The session concluded with a close vote in the Kansas House of Representatives, where the final vote to pass a compromise package took place at about 4:00 A.M.[46] Some reports even claim that several lawmakers were moved to tears as they cast votes for one of the largest tax increases in state history.[47]

The final plan that passed both houses and was signed by Governor Brownback included two main tax increases. The state raised the cigarette tax by 50 cents per pack and increased the sales tax rate from 6.15 percent to 6.5 percent. The two tax increase proposals added up to $384 million in new state revenue and were bolstered by $50 million in spending cuts, although there was still a net increase in spending.[48] While several ideas were discussed during the record-length session, the final plan was largely considered a tough but workable compromise that preserved the exemption of non-wage income of pass-through entities from the personal income tax. Another provision of the final tax package was to freeze, rather than unwind, the scheduled reductions to the personal income tax. The lower income bracket would remain at 2.7 percent, while the upper income bracket would remain at 4.6 percent.

### What Does the Kansas Economy Look Like Now?

With a relatively close re-election bid, a record-length legislative session and a large tax increase, it would not be unreasonable for an outside observer to assume the worst about the 2012 Kansas tax reforms. These facts miss the larger picture, however, as the 2012 tax reforms were never intended to simply supply larger revenues to a growing government. Rather, the intent from the start was always to boost the Kansas economy and provide greater opportunity for the citizens of Kansas. It is certainly relevant and helpful to examine the effects of the Kansas tax reforms through this lens.

When evaluating such a large change to a state's tax code, there are various economic indicators that can provide insight into how the plan is working, or not working. One of the most controversial parts of the tax reform plan from 2012 was the exemption of non-wage business income of pass-through entities from taxation. It is noteworthy that 2012—the year this plan was discussed and eventually passed—was also when Kansas set a new record for most new business filings in a year with more than 15,000 new businesses registering.[49] The 2012 record was broken in 2013, and again in 2014, with 15,780 new filings.[50]

Furthermore, in 2013, when the tax cuts were beginning to take effect, the Kauffman Foundation rated the Kansas climate for small business as an "A." Meanwhile, neighboring Missouri received a "C" rating in the same year.[51] Similarly, since the 2012 tax reforms, Kansas has jumped up in *Rich States, Poor States*, from 26 in economic outlook, to 18 in the most recent edition. Although, before recent tax increases, Kansas ranked as high as 11 for economic outlook in the 2013 edition of this publication.

In October of 2014, Creighton University released an edition of *The Mainstreet Economy Report* detailing positive results of the 2012 Kansas tax reductions, especially in terms of personal income growth.[52] Since the fourth quarter of 2012, Kansas has experienced a growth rate of 2.92 percent in personal income, beating out the U.S. average of 2.85 percent and outperforming all of its neighbors except Colorado. Tellingly, Colorado is the only neighbor of Kansas that maintained a lower personal income tax rate, a flat 4.63 percent, at the time. *The Mainstreet Economy Report* also discusses average weekly earnings:

> *"Addition-ally [sic] in terms of average weekly earnings, Kansas experienced an increase of 4.82% which was almost four times that of the U.S., more than four times that of Missouri, approximately seven times that of Nebraska, and nearly four times that of Oklahoma. Of Kansas' neighbors, only Colorado with 4.82% average weekly wage growth outperformed Kansas."*[53]

The report concludes with a bold prediction about Kansas' neighboring states, saying that "Kansas' job and income data since the tax cut show that, except for Colorado, the state economy has outperformed, by a wide margin, that of each of its neighbors and the U.S. To remain competitive, expect Kansas' neighbors to reduce state and local taxes in the years ahead."[54]

Critics of the Kansas tax reform efforts are quick to note that the numbers cited by the Creighton report have since been revised downward. While this is true, and Kansas only experienced a growth in private gross state product (GSP) of 1.9 percent in 2013, the disappointing figure can be traced to other economic factors unrelated to the tax changes. Like many other states, Kansas was hit hard by the 2013 drop in oil prices and had some of its aviation sector continue to perform poorly. When these sectors are not taken into account, the rest of the Kansas economy grew by 5.5 percent, beating the national average of 4.3 percent. Rather than having a struggling economy with most sectors shrinking or performing poorly, Kansas has a growing economy with two unique sectors that are doing poorly for reasons unrelated to the 2012 tax reforms.[55]

The Kansas City metropolitan area also provides an excellent case study in what the 2012 tax reforms have accomplished. On the Kansas side of the metropolitan area, the top personal income tax rate is 4.9 percent, compared to a top rate of 7 percent on the Missouri side of the line. In May 2015, *The Wall Street Journal* noted that "Over the past two calendar years, private-sector jobs increased by 5.6 percent on the Kansas side and only 2.2 percent on the Missouri [side]. In the same period hourly wages grew $1.22 on the Kansas side, compared with $0.61 on the Missouri side."[56]

Another crucial metric to examine when measuring economic health and vitality is private sector employment. If more jobs are being added and more citizens are finding work, the result is a truly sustainable and growing economy. Critics will sometimes argue that Kansas' economic performance is lagging behind other states, but what these critics miss is Kansas *was already lagging behind other states* before the 2012 tax reform and that this lag was the reason for such dramatic and bold reforms.

The Kansas Policy Institute has looked at employment growth in Kansas and reached some interesting conclusions. Since the 2012 tax reforms were enacted, Kansas has improved its standing among fellow states that tax personal income, as Table 2 shows.

According to Table 3, employment statistics show that Kansas has increased private sector employment from 2013 to 2015 by 4.39 percent and is improving its rate of private sector job growth.

## TABLE 2 Private Sector Job Change

| State Grouping | Pre-Tax Reform | | Post-Tax Reform | |
|---|---|---|---|---|
| | 1998–2012 | Kansas as a Percentage of State Groupings | 2013–2015* | Kansas as a Percentage of State Groupings |
| No Income Tax States | 15.03% | 14.78% | 9.00% | 48.29% |
| States with Income Taxes | 3.64% | 61.01% | 5.87% | 74.09% |
| Kansas | 2.22% | | 4.35% | |

**Average through August of 2015*

*Source: Kansas Policy Institute*

## TABLE 3 Private Sector Job Growth and Rankings

| State | 1998–2012 Rank | 1998–2012 Growth | 2013 Rank | 2013 Growth | 2014 Rank | 2014 Growth |
|---|---|---|---|---|---|---|
| Kansas | 38 | 2.2% | 27 | 1.6% | 21 | 1.9% |
| Missouri | 44 | -1.0% | 35 | 1.3% | 39 | 1.2% |
| Nebraska | 17 | 9.8% | 31 | 1.4% | 33 | 1.4% |
| Oklahoma | 19 | 8.5% | 26 | 1.6% | 26 | 1.5% |
| Colorado | 15 | 10.6% | 5 | 3.1% | 3 | 3.8% |

*Source: Kansas Policy Institute*

From 1998 to 2012, Kansas lagged behind all of its neighbors except Missouri in private sector job growth. Since the 2012 tax reforms were enacted, however, Colorado is the only neighboring state that can boast a higher level of private sector job growth. As an important side note, Colorado's top personal income tax rate is, and has been for some time, set at a flat 4.63 percent. Only recently has the Kansas top marginal personal income tax rate dropped to a slightly lower rate of 4.6 percent.

Unemployment rates tell a story similar to the narrative from private sector job growth.[57] The unemployment rate for the U.S. as a whole was 5.5 percent as of May 2015. As Table 4 demonstrates, Kansas' unemployment rate is 2 percentage points lower than the U.S. average.

Though the full effects of Kansas' bold tax reform will take years to materialize, the early signs are vastly more encouraging than critics would have the public believe. Assuming that Governor Brownback and Kansas lawmakers are able to preserve the key elements of the 2012 tax reforms, the potential for strong economic growth in the long term is very likely.

**TABLE 4** State Unemployment Rates

| State | 2012 | 2015 |
|---|---|---|
| Kansas | 6.1% | 4.3% |
| Nebraska | 4.0% | 2.5% |
| Missouri | 7.5% | 5.7% |
| Colorado | 7.8% | 4.2% |
| Oklahoma | 6.1% | 4.1% |

*Source: U.S. Census Bureau*

## Conclusion—Lessons for State Lawmakers

Ultimately, the story of the 2012 Kansas tax reforms provides some important lessons for state lawmakers across the country. In 2012, Governor Brownback and legislative allies set out to improve their state's economy, which had been trailing the national average. As time goes on with the new lower tax rates, economic evidence will continue to accumulate and give ever-increasing clarity to the question of to what degree the reforms succeeded. Economic theory and the experience of low-tax states suggest that they will, as long as anti-growth tax changes are not implemented in their place.

The first lesson to glean from the Kansas experience is that politics affects policy. The final reforms that passed in 2012 were not the reforms that anybody wanted. Specific tax reform ideas are easily diluted and changed, and without the political will to fix imperfect reforms, unintended consequences can be difficult to avoid.

The second important lesson that can be learned from the Kansas experience is economic growth resulting from bold tax reductions takes time. Governor Brownback's previous comments about the Kansas tax reforms being "a shot of adrenaline" to the state's economy continued to hound him throughout the ups and downs of revenue and economic reports. Setting expectations too high or too early can make pushing forward with future reforms nearly impossible, while setting unrealistic expectations can lead to the unwinding of sound economic reforms.

With these lessons in mind, it is certainly worth reiterating that if the desired result was to improve the Kansas economy and give the citizens of Kansas more opportunity and income, the case can certainly be made that the reforms are having a positive effect. However, that does not mean they were perfect. Even though the tax reductions improved economic growth, the lack of commensurate spending reductions led to trouble for the state's budget. Budget shortfalls and tough negotiations about possible tax increases mean uncertainty for businesses and families, which can hamper some of the positive economic effects of decreasing taxes.

Contrast the experience of Kansas with the experience of North Carolina. In 2013, North Carolina lawmakers undertook substantial, even historic tax reform of their own. The specifics of the bill are far ranging and have a significant effect on most areas of North Carolina's tax system, but some of the bill's highlights include:

- Moving the progressive income tax to one flat rate of 5.8 percent in 2014 and 5.75 percent in 2015
- Lowering the corporate tax rate to 6 percent in 2014 and 5 percent in 2015. Additional revenue triggers will lower the rate to 4 percent in 2016 and 3 percent in 2017, if revenue growth targets are met
- Eliminating the estate tax
- Expanding the sales tax to include some service contracts in an effort to move the state toward a consumption tax model
- Eliminating multiple gross receipts franchise taxes, privilege taxes and preferential sales tax rates

In all, the reform bill cut taxes more than $500 million in the first two years alone and more than $650 million a year by the 2017-2018 fiscal year.[58] The results for North Carolina's economy so far have been striking.

One of this report's authors, Stephen Moore, discussed some of the results of North Carolina's reforms in an editorial for *The Wall Street Journal* earlier this year:

> *"After a few months, the unemployment rate started to decline rapidly and job growth climbed. Not just a little. Nearly 200,000 jobs have been added since 2013 and the unemployment rate has fallen to 5.5% from 7.9%. There is a debate about how many of North Carolina's unemployed got jobs and how many dropped out of the workforce or moved to another state. But the job market is vastly improved and people didn't go hungry in the streets. On the Tax Foundation index of business conditions, North Carolina has been catapulted to 16th from a dismal 44th since 2013…*
>
> *An even bigger surprise—even to supporters—is the tax cut's impact on revenue. Even with lower rates, tax revenues are up about 6% this year according to the state budget office. On May 6, Gov. McCrory announced that the state has a budget surplus of $400 million while many other states are scrambling to fill gaps.*
>
> *This is the opposite of what has happened in Kansas, where jobs have been created but revenues have fallen since the top personal income-tax rate was cut from 6.45% in 2012 to 4.6% today and the income tax for small business owners who file as individuals has been eliminated. North Carolina's former budget director, Art Pope, says one difference between the two states is that 'we cut spending too. Kansas didn't.'"*[59]

The comment from Art Pope aptly demonstrates the most important lesson that state lawmakers can learn from the Kansas experience–states cannot significantly reduce taxes without also reducing spending. This lesson is evidenced by North Carolina maintaining a AAA bond rating, even while undertaking historic tax reductions and reforms.

As state lawmakers across the country continue to look for ways to improve their state's business climate and encourage more economic growth, Kansas provides examples of both reforms to strive for and pitfalls to avoid. As more economic evidence becomes available, there will certainly be much more written about Kansas and the effects of bold tax reforms. But, with the lesson of matching tax reductions with spending reductions firmly demonstrated, state lawmakers now have an opportunity to learn from both the successes and mistakes of others when proposing their own plans to provide better lives for their citizens through fundamental tax reform.

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