Negative Testimony on HB2457
Providing an Income Tax Rate of 4.95%, Increasing the Standard Deduction, Increasing the Property Tax Exemption for Statewide School Levy and Zeroing Out Food Taxes

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Background and Summary:

I have served as the chief academic adviser to the Governor's Tax Reform Council starting in 2019. This testimony addresses the provisions of HB 2457 including the flat tax, increasing the standard deduction, increasing the property tax exemption for the statewide school levy, phasing out the income tax on Social Security, and the immediate elimination of the state sales tax on food among other provisions.

This testimony is **Negative** on House Bill 2457 because I have concerns about phasing out the income tax on Social Security and serious reservations about the flat income tax rate and the overall fiscal note of the bill. That said, I strongly endorse of the full repeal of the state sales tax on food, the increase in the standard deduction, and increasing the extent of the property tax exemption from the statewide school levy.

The *Governor's Council on Tax Reform Final Report* made several recommendations that are directly related to HB2457. These include:

The Council strongly endorses Governor Kelly's Axe the Food Tax proposal and calls on the state legislature to immediately seize this historic opportunity to eliminate the state sales tax on food.

Expand the $20,000 homestead exemption from the statewide mill levy to target property tax reduction to residential homeowners.

Expand the standard deduction to provide additional income tax relief. Expanding the standard deduction impacts the largest number of Kansas individual income taxpayers.

House Bill 2457 enacts these key recommendations, and I support these changes to the Kansas tax code. I am **neutral** on eliminating the income tax on all Social Security income, and **negative** on the flat tax.

My testimony discusses the specific provisions of the bill, and where there may challenges moving forward.

<u>Positive: Food Sales Taxes</u>

Kansas is one of 13 states that levies a sales tax on food, and the state currently taxes food at 4%, one of the highest rates in the country. Of the surrounding states, only Oklahoma charges a higher sales tax rate on food. These figures do not include local sales taxes. Six states (including Missouri) which totally or partially exempt food from state sales taxes allow for the imposition of local taxes on food, according to the Federation of Tax Administrators.

Grocery purchases in Kansas increase with family size and income. Lower income households spend a higher share of their total income on food and other goods that are more frequently taxed, and thus pay a higher share of their income on the food sales tax than high-income households. Food is a necessity, and Kansas households cannot avoid paying the food sales tax. Likewise, diapers are a necessity for young children and feminine hygiene products are a necessity for women. Lower income families will spend a larger share of their income on these products and pay a higher share of their income in taxes for these necessities. All sales taxes, and especially grocery sales taxes, are regressive, meaning that low-income families spend a larger share of their total income on food. The lowest income household considered spends 29% of their income on food, whereas higher income households spend closer to 6% - 8% of income. Thus, low-income households will spend more of their income on the grocery sales tax than higher income households.

Thus, the elimination of food sales taxes immediately at the state level will be good for all households.

<u>Positive: Increasing the School Levy Property Tax Exemption</u>

Property values have increased significantly in Kansas following the COVID-19 pandemic. According to Redfin, median Kansas housing prices have increased by almost 20% since 2020. HB 2457 would increase the residential exemption from $40,000 to $65,000 beginning in Tax year 2023. This would decrease State General Fund revenues by $55.6 million in FY 2024, $55.8 million in FY 2025, and $62.3 million in FY 2026. This provision would provide much-needed property tax relief to property owners whose valuations have increased dramatically these past three years.

<u>Positive: Increasing the Standard Deduction</u>

HB 2457 would increase the standard deduction annually by the amount adjusted by the cost-of-living adjustment published in the Internal Revenue Code beginning in tax year 2023. The Department of Revenue estimates that HB 2457 would decrease State General Fund revenues by $19.8 million in FY 2024, $28.6 million in FY 2025, and $38.3 million in FY 2026.

This would be one way to provide tax relief to Kansans who may be paying a higher income tax rate as a result of increased incomes.

Taken together, to total cost to the state general fund of these three provisions would be $329.5 million in FY 2024; $210.1 million in FY 2025; and $100.6 million in FY 2026. The cost to the state general fund drops over time because the food tax is being eliminated immediately.

<u>Neutral: Social Security Phase Out</u>

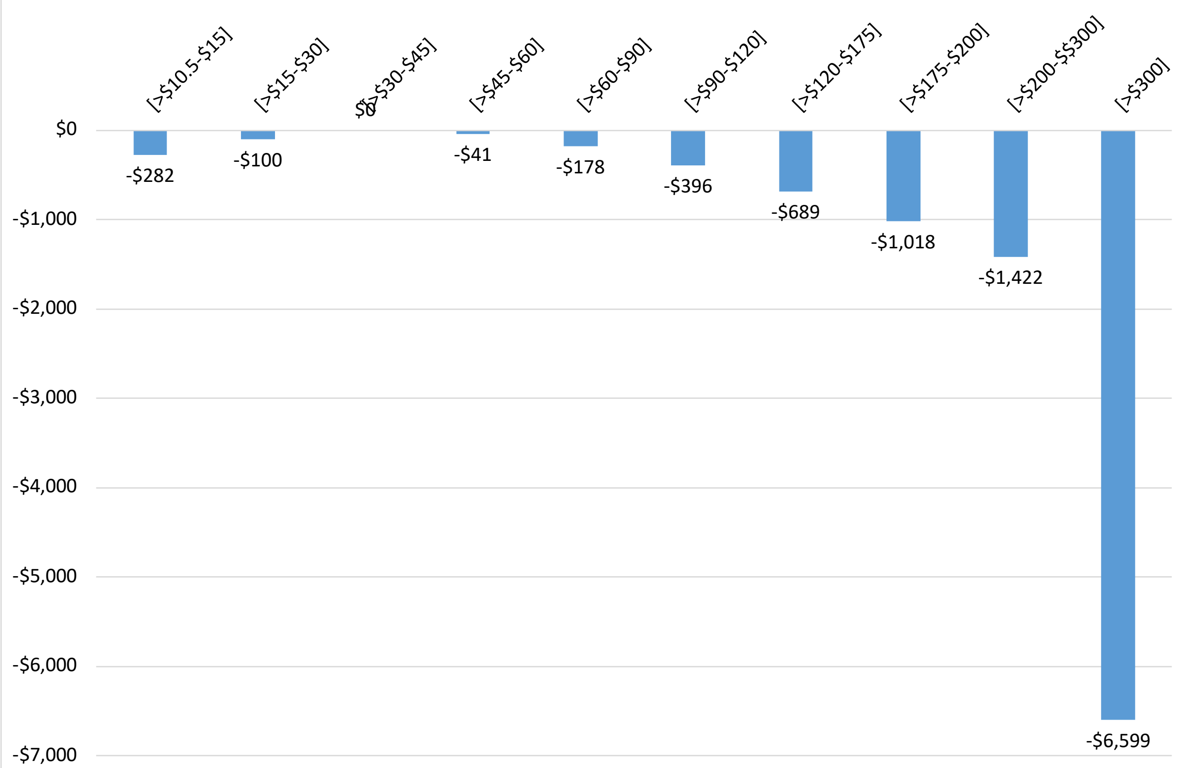
Kansas completely exempts Social Security income from taxation for most senior taxpayers. Kansas employs a taxable-nontaxable switch for Social Security income. If federal adjusted gross income (AGI) is less than or equal to $75,000, none of the Social Security payment is taxable. If AGI exceed $75,000, the amount of Social Security taxable at the federal level is also taxable in Kansas. A difference of even $1 in federal AGI can mean a difference of several thousand dollars in Kansas AGI. The sudden jump in Kansas AGI income is known as a tax “cliff.” A tax cliff will exist for any AGI cutoff level because the Kansas tax system does not ease in the taxability of Social Security income. Clearly the legislature should consider adjustments to ameliorate or eliminate the Social Security tax cliff.

HB 2457 slowly eliminates the income tax on Social Security income over four years. As a result, the fiscal note grows each year from $49.4 million in FY2024 to $63.5 million in FY 2025 and $93.4 million in FY 2026. When the tax on Social Security income is completely eliminated, the cost to the state general fund exceeds $100 million per year. Approximately 93,000 Kansans would have a tax break from this provision.

<u>Negative: Providing an Income Tax Rate of 4.95%</u>

First, the flat tax benefits the very top earners in Kansas compared to those with average income or below. Figure 1 shows the average tax cut by taxable income bracket for married couples filing jointly. The top 5% of married couples filing jointly (with Kansas taxable income in excess of $300,000 per year) receive an average annual tax cut of $6,599. This makes up 51.1% of the total tax cut from HB 2457. The bottom 50% of married couple households filing jointly receive only 10.9% of the total tax cut. Overall, we estimate that the 3% of households earning above $250,000 in Kansas Adjusted Gross Income would receive 44% of the benefits. Thus, the flat tax favors the richest filers in the state.

Figure 1: Average Tax Cut by Income Bracket, Married Filing Jointly. Brackets in Thousands of Dollars, Kansas Taxable Income



Second, HB 2457 is expensive. In FY 2025, the bill reduces the state general fund by $444.3 million. When combined with the food tax, property tax relief, indexing the standard deduction, and phasing out the income tax on Social Security, including corporate tax cuts and privilege tax adjustments, the total cost of HB 2457 in FY 2025 is $707 million.

Third, the Governor's Council on Tax Reform suggested the preservation of the three-legged stool of Kansas taxes, where the state should strive to balance revenues from the regressive sales tax, the moderately regressive property tax, and the progressive income tax. HB 2457 effectively eliminates the progressivity of the income tax, resulting in a highly regressive tax system. Regressive taxes mean that households with lower incomes pay a disproportionately higher share of their income in taxes relative to households with higher incomes. Thus, the flat tax provisions of HB 2457 are Robinhood in reverse, where tax cuts accrue to the rich, and the poor pay an increasing share of their income in taxes.

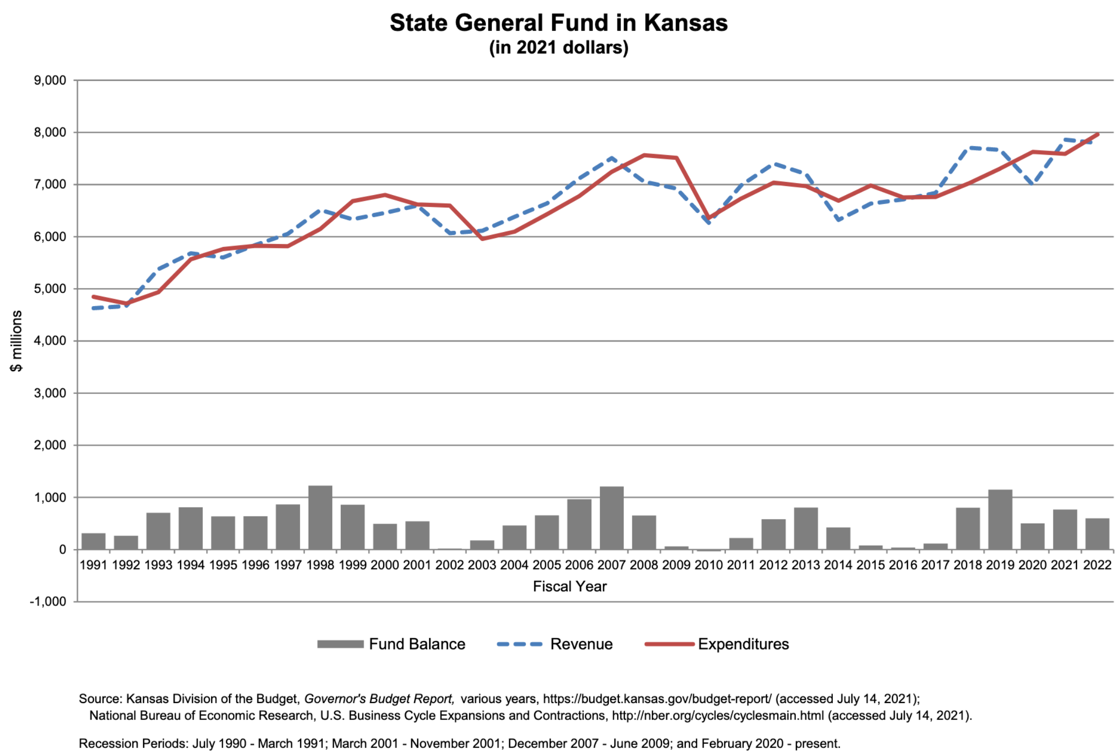


Figure 2: State General Fund Balances, Revenue and Expenditures. Source: The *Governor's Council on Tax Reform Final Report.*

Fourth, recent Kansas history illustrates the danger of extreme tax cuts like HB 2457. Figure 2, reproduced from the *Governor's Council on Tax Reform Final Report* shows the precipitous decline in the State General Fund after 2014 due to the Brownback Tax Cuts. Beginning in 2014, expenditures outstripped revenues and by 2017, the Brownback tax cuts were largely reversed. Given the problems with the State General Fund, to balance the budget, the Governor and Legislature would "raid the bank of KDOT" by eliminating previously scheduled transfers from the SGF to support the state's transportation program. Kansas ranks fourth in the nation in terms of roads and highways. It is estimated that as much as $2.6 billion dollars was swept from the

Kansas Department of Transportation (KDOT) budget to pay for the Brownback tax cuts.[1] It took four years for Governor Kelly to finally close the bank of KDOT.

Fifth, there is no evidence that tax cuts like the flat tax or the Brownback tax cut contribute to economic growth. Many economists have analyzed the economic impact of the Brownback tax cuts. DeBacker, Heim, Tramnath and Ross (2019) found no evidence that the Brownback tax cuts resulted in increased economic activity. Turner and Blagg (2018) examined whether the tax cuts resulted in increases in employment compared to states that did not enact tax cuts. They found that tax cuts did not result in any net increase in private-sector employment. Tax and budget policy analysts from groups as diverse as the Tax Foundation and the Center[2] for Budget and Policy Priorities[3] agreed that the "Tax Experiment" in Kansas was a failure in public policy. Furthermore, these tax cuts put Kansas' improved credit rating at risk, ultimately increasing debt service costs and costing Kansans more money.

Negative: Providing a Corporate Income Tax Rate of 3%

Many of the same arguments apply to imposing a flat corporate income tax rate of 3%. Whenever tax rates are flattened, the benefits accrue to the top of the income distribution. In this case, 92% of the benefit from the flat corporate tax would go to 3% of corporations that earn over $1 million in income.

Alternatives to Consider

Instead of exempting Social Security income or passing a flat tax that disproportionately benefits the wealthy, the legislature should consider increasing the standard deduction by more than the rate of inflation. This approach would preserve the progressivity and elasticity of the income tax while providing meaningful tax relief to all taxpayers.

References:

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[1] https://www.cjonline.com/story/news/politics/state/2019/01/18/gov-laura-kelly-offers-plan-to-gradually-downsize-bank-of-kdot/6255101007/

[2] https://taxfoundation.org/every-tax-cut-kansas/

[3] https://www.cbpp.org/research/state-budget-and-tax/kansas-provides-compelling-evidence-of-failure-of-supply-side-tax