Superman, Wyatt Earp and Dorothy: The Story of Kansas

By Arthur B. Laffer

We join the story of Kansas in January 2011, when former U.S. Senator Sam Brownback takes office as Kansas' 46th Governor along with a Republican-controlled House (92 Rs and 33 Ds) and Senate (32 Rs and 8 Ds). The Kansas economy, while far from being a catastrophe, had been underperforming for a long time. The unemployment rate was 6.8%. Using IRS data of tax filers, in every single year from TY1992 through TY2012, Kansas has experienced a net loss of Adjusted Gross Income (AGI) to the rest of the nation. If, over the past 21 years before Gov. Brownback's tax cuts took effect, the net flow of AGI had been zero instead of what it actually was, the state of Kansas would now have almost $4 billion of additional AGI per year and all the derivative benefits that come with higher incomes. And perhaps worst of all, Kansas' pension system was ranked second worst in the nation in terms of solvency, with a funding ratio in the 50% range.

To propel the Kansas economy into prosperity, Gov. Brownback's proposed economic agenda would have reduced the highest income tax rate to 4.9% from 6.45% and all other income tax rates to 3%. He also proposed expanding standard deductions from $4,500 to $9,000 and exempting non-wage pass-through income (excluding capital gains, interest and dividends) reported by Partnerships, LLCs, LLPs, "S"-corporations and sole proprietorships from state INCOME taxes. Down the road, Gov. Brownback's intentions included further pro-growth tax rate cuts.

To "pay" for these proposed tax changes, Gov. Brownback also proposed keeping the 1% state sales tax increase that was set to expire and eliminating many tax credits and deductions, including the mortgage interest deduction, the earned income tax credit and the child tax credit. All in, Brownback's proposed legislation was scored as a tax cut of less than $90 million, which given total FY 2011 tax revenues of $5,693 million is far from "a radical tax cut." But for Gov. Brownback, nothing was as easy as it seemed.

The day Gov. Brownback took office, he was confronted by anti-Brownback Senators, many from his own party who delayed, deferred and obstructed his tax plan. As a final gesture of defiance, the Senate rushed passage of a substitute for House Bill 2117 on May 22nd, 2012, which stripped Gov. Brownback's bill of all of the "pay for" items to finance the income tax cut. The Senate bill was projected to initially cost over $230 million versus Gov. Brownback's proposal of $90 million, with that difference increasing in the out years. The Senate bill took precedence over the House bill, which had been passed some 15 minutes after the Senate bill was passed.

The anti-Brownback Senators expected Gov. Brownback to cower and then veto the Senate bill, thus giving up on his dream of a Kansas recovery. They were wrong; Gov. Brownback signed the Senate bill. But, just for the record, the budgetary costs of the actual bill compared to the bill the Governor had originally proposed had been increased by $140 million. Had the Governor's proposal taken effect at the beginning of his term—i.e. two years before it actually took effect—the story of Kansas growth would be much different.

In righteous indignation, allies of Governor Brownback sought retribution from the anti-Brownback Senators, and they got it. Eight incumbent Republican Senators were denied re-nomination in the Republican primary held on August 7th, 2012 including the anti-Brownback ringleader and Senate President Stephen Morris. Four open Senate seats in that primary were also captured by Brownback supporters and this episode of the anti-Brownback insurrection was dead in its tracks.

After the general election in November 2012, the composition of the Kansas legislature was completely revamped even though ostensibly the Republican Senate majority was little changed, 31/9 versus 32/8. But more was to come.

Concurrent with the political fireworks, unrelated budget forces were also in the works, causing shortfalls in revenues. Many political opponents have been quick to lay blame on the Kansas tax plan, but there are several reasons why this could not be further from the truth:

Every single year for the ten years, from FY2003 through FY2012, the legislature had suspended the requirement that the state have 7½% of total annual budget expenditures as an ending cash balance, but not for FY2013 or FY2014. Requiring higher ending cash balances alone absorbed some $200 to $500 million of funds. To respond to a state Supreme Court ruling, budget outlays for schools were increased by $65 million annually for FY2014 and FY2015. Additional funds—in the vicinity of $400 million—were also necessitated to reduce the substantial underfunding of state employee pensions. In fact, Kansas' needs

were sufficiently great that they bonded some $1 billion to tide the state over and increased employer and employee contributions.

In addition, there was a serious FY2014 tax revenue overestimate resulting from overestimating increases in Kansas' personal unearned income. President Obama had allowed the Bush tax cuts to expire January 1, 2013 on all sorts of unearned income, including dividends and capital gains. Anticipating these tax changes, investors and businesses accelerated realizations of capital gains and payments of dividends into calendar year 2012 from calendar year 2013. Thus, there was an abnormal, but easily explainable, surge in federal tax revenues in calendar year 2012 and a more substantial drop-off in calendar year 2013.

For Kansas (and many other states), the surge in capital gains and dividends in calendar year 2012 came as a surprise and resulted in a surge in tax revenues for FY2013. As most states do, future tax revenue projections in Kansas are basically extrapolations of past changes, so Kansas not only missed the retrenchment of revenues in 2014, but also incorrectly projected large increases for 2014. In TY2012, for example, the Standard & Poor's rose 13% and capital gains income in Kansas grew 47.7%. In TY2013, the Standard & Poor's gained 30%, but Kansas capital gains income fell by 19.2%. In all, the forecast error left a shortfall from the state's budget of some $300 million.

A reporting error from the Kansas Department of Finance had it that in 2012 there were 180,000 pass-through entities whose taxes were reduced to zero and in 2014 this number increases to 330,000 resulting in a $50 million underestimate of tax receipts. Governor Brownback critics hailed this as a give-away to the rich causing all sorts of regular businesses to file as pass-throughs. In point of fact, when proposed, the number of pass-through entities was 330,000, the number actually filed was 339,000

Additionally, discrepancy between projected revenue and actual revenue can be largely attributed to the rural recession that most of Western Kansas experienced. Because of national headwinds, oil prices dropped precipitously, with crop prices dropping 40-60%, and cattle prices dropping 23%. With farmers and ranchers receiving far less for their crops and cattle, they in turn aren't purchasing new equipment, making upgrades, or hiring new farm hands.

And lastly, if you look at the numbers, we can quickly identify the prime culprits of the revenue shortfall—corporate taxes, which weren't touched in the Kansas tax plan, were down in Kansas as they are nationally and sales tax revenues, which the legislature raised, were down as well. Yet, individual income taxes, which were cut, were <u>up</u>.

While the fact is that Kansas had a large negative shock to its overall budget in 2014 and 2015, the underlying causes were only peripherally related to Brownback's tax bill. But such a shortfall always causes an uproar: warnings of school closures, fears of lessened police protection and threatened lack of funds for the needy. 2014 being an election year, the normal hype was greatly magnified by 1.) the disgruntled anti-Brownback former Senators who had been thrown out of office and now sided with Brownback's Democratic challenger, 2.) a vulnerable Senator Pat Roberts running for reelection and 3.) the reelection campaign for Governor Brownback himself. It was the perfect storm, attracting nationwide attention, including numerous editorials even from *The New York Times* and N.P.R., no less.

The truth of the matter is that, according to the U.S. Census Bureau, the number of Missourians moving to Kansas tripled after Gov. Brownback's tax cuts. According to the IRS, Kansas reversed 19 years of financial losses to Missouri in the first year of the tax plan alone, with further gains in 2014; according to the U.S. Labor Department, Kansas had a near record number of private sector jobs following the tax cuts; and according to the Department of Revenue, during the first two years of the tax plan alone, 18,000 brand new small businesses sprouted up under the pro-growth tax plan.

Therefore, in November 2014, in spite of all the national backlash, Gov. Brownback was easily re-nominated and reelected, along with U.S. Senator Pat Roberts. After the elections, the Kansas House and Senate were even more Republican than they had been when Brownback took office, with 97 Rs to 28 Ds and 32 Rs to 8 Ds, respectively—hardly a wholesale repudiation of Brownback, his slate of legislators or supply-side economics. Apparently, the electorate really doesn't want to balance the state's budget by unbalancing the budgets of everyday Kansans.

Kansas is back, Toto. As of March 2016, Kansas' unemployment rate is 3.9%, the 11th lowest in the nation. Kansas' private sector employment is growing faster since the tax cuts took effect than all of its neighbors, save for steroidal Colorado. Kansas City, Kansas is adding more private sector jobs than is Kansas City, Missouri. Income taxes for individuals, families and small businesses have been reduced by

30%. Kansas' pension funding is now 22nd best in the nation—a vast improvement from the state's second-worst in the nation ranking back when Governor Brownback took office. The pension system's funding ratio is now 62% and projected to soon rise to 66%—considered well into the "safe zone" as far as funding ratios go. And, lastly, Superman, Wyatt Earp and Dorothy are cheering like mad in heaven.

And one observation appears very much in order. Because of Gov. Brownback's policies, the legislature in Missouri passed a 10% income tax rate cut, which the less than enlightened Missouri Governor Jay Nixon quickly vetoed. But not to be put off, Missouri's legislature then passed the tax cut over the Governor's veto. Imitation is the sincerest form of flattery. Just wait and see what happens when these pro-growth policies have had sufficient time to have their full supply-side effects materialize.

Superman

Wyatt Earp

Dorothy and Toto

A Few Great Residents of Kansas