This Week in Topeka

Overland Park Chamber

Business, Economic Development & Local Government News
from the Legislative Session Week of February 20-23, 2017 (and then some thru March 3)

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We saw the rush to consider bills in their house of origin before Turnaround Day on Thursday, Feb. 23. Both the Senate and House debated and voted on a number of bills on Tuesday, Wednesday and Thursday before the Senate adjourned around noon, with the House following suit at about 5:00 that afternoon. A bit unusual was the consideration of a comprehensive tax bill, HB2178, so relatively early in the session; such substantial issues are more typically addressed later in the session, but the state's fiscal troubles dictated moving taxes to the front of the line.

A couple of days ago I was planning on releasing this newsletter and simply apologizing for being so slow to get it out. However, as things continued to develop this past week, even though the legislature was not in session, it appears my tardiness might have a positive result in that I can include information here about the February revenue receipts and the Supreme Court's opinion in *Gannon.*

Taxes. HB2178, the comprehensive tax bill was sent to the Governor, and he immediately followed through on his promise to veto the bill. The Governor's veto message was read in to the House later that morning where the House successfully voted to override the veto, 85-40. On Wednesday afternoon, the Senate took up the veto and came up three votes short of the necessary 27 votes needed to override, voting 24-16, thus sustaining the Governor's veto and sending the tax issue back to the drawing board.

To again quickly summarize for your convenience, HB2178 would have been effective retroactively as of January 1, 2017, and was estimated to raise $1 billion or so over the next two years, approximately $590 million in FY2018 and $454 million in FY2019. The bill included the following provisions:

- Reinstatement of a third individual income tax bracket, setting rates at 2.7% for income up to $15,000 ($30,000 for married filing jointly), 4.6% for income between

$15,000 and $50,000 ($30,000 and $100,000 for joint filers), and 5.45% for income over $50,000 ($100,000 for joint filers);

- Repeal the pass through non-wage business income tax exemption;
- Reinstatement of the ability to claim certain non-wage business income losses as permitted under federal law;
- Repeal the glide path to zero; and
- Reinstatement of the individual itemized deduction for medical expenses at 100%.

A vote by a legislator to increase taxes is always a difficult one to make. In this case, many in the legislature made two difficult votes, one to pass HB2178 and a second one to override the Governor's veto of that bill, both with the intent of raising our income taxes in order to make a significant move toward achieving a structurally balanced budget and fulfill a campaign promise made by many in our delegation last fall. Although the override attempt was ultimately unsuccessful, you might consider contacting your legislator and thanking him or her for their vote. Here are the members of the Johnson County delegation who voted to override the veto of HB2178:

In the House:

Reps. Shelee Brim, Larry Campbell, Stephanie Clayton, Tom Cox, Linda Gallagher, Cindy Holscher, Jan Kessinger, Joy Koesten, Nancy Lusk, Patty Markley, Cindy Neighbor, Jarrod Ousley, Brett Parker, Melissa Rooker, Jerry Stogsdill, and Sean Tarwater

In the Senate:

Sens. Barbara Bollier, Pat Pettey, John Skubal, and Dinah Sykes

Why was the override attempt unsuccessful? Commonly offered reasons for voting to sustain the Governor's veto included "the tax cuts are working, don't hurt small business;" and "the bill would increase individual income taxes retroactively, that's difficult to implement and not fair;" and "this is an attempt to fix our fiscal problem with another tax increase and does nothing to address excessive state spending, which is our real problem."

HB2178 certainly was not perfect, particularly when examined on a piecemeal basis; however, looking at the provisions collectively and in the context of the state's current fiscal problems, it seemed to be a reasonable and good effort to make strides toward getting Kansas to a structurally balanced budget. However, if history offers any guidance, subsequent iterations of a tax bill are only likely to get worse as provisions are added, modified, and/or deleted in order to secure enough votes to pass (can you say "property tax lid").

The Kansas economy did not receive the shot of adrenaline promised in 2012; in fact, according to the Department of Revenue, individual income tax receipts have been reduced by a cumulative total of $2.717 billion from FY2013 (when the 2012 tax cuts began to take effect) through FY2016, with an additional reduction of almost $1.9 billion projected for FY2017 and FY2018.

Further, while it may be accurate to say many new businesses have been formed since the passage of the tax cuts in 2012, one of the three tasks given to the Governor's Consensus Revenue Estimating Working Group that was formed and met in 2016 was to consider the "effect of tax policy on consensus revenue estimating," and, as part of that consideration asked the question "[i]s the number of pass through entities growing due to the implementation of the tax policy?" referring to the income tax cuts enacted by the legislature in 2012 and implemented beginning in 2013. In its Final Recommendations dated October 4, 2016, the Governor's own Working Group concluded that the "growth in pass through entities after the tax policy was implemented is consistent with the growth prior to the tax policy change." And, notwithstanding an unemployment rate that fell from 4.3% to 4.2%, the Kansas Department of Labor reported that Kansas actually lost 9,400 private sector jobs in 2016, that after a gain of 9,300 jobs in 2015, not a good trend and a definite setback for the 2014 campaign promise of creating 100,000 new jobs over the ensuing four years.

And with respect to economic growth generally, GDP in Kansas grew by 2.9% from 2011 through 2015, while the national GDP grew by 9.2% over the same period. A material part of that gap certainly can be attributed to the downturns in oil and gas and agriculture, major contributors to the Kansas economy, but those are not the only factors.

Raising taxes is not easy for any legislature and raising them with a retroactive effective date as was proposed in HB2178 is even more difficult; however, legislators must deal with the situation as it exists, and without retroactivity, the projected revenue to be generated would not be enough to balance the budget, leaving a shortfall of more than $100 million in FY2018 before the increases in individual income taxes kicks in. Making the increase retroactive was discussed and, while not a desirable option, a majority of the legislators (and seemingly supported by a majority of Kansans) concluded that it was the better of the available options and necessary to deal with the challenge of putting together a structurally balanced budget.

Two issues regarding retroactivity are key to the discussion. One is the practical aspect of changing the system for payroll withholding. Such a change does take some time to implement and, when done to accommodate a retroactive income tax increase, must also include a "catch up" or "over-withholding" for the remainder of the year in order to account for the increased payroll taxes not withheld during the period from January 1 through the date on which the changed system takes effect. This can be done, however, and the sooner an increase becomes law (i.e., a successful veto override would have already put the wheels in motion), the shorter the "catch up" period will be, mitigating its effect.

The other consideration is the argument that it's just not fair to raise taxes retroactively. While that may be a valid argument, it has not prevented previous income tax increases from being implemented retroactively. For example, in both 2013 and 2015, the legislature passed changes in the law that reduced some Kansas itemized deductions and completely eliminated others; in both instances, those changes were made retroactive to the first of the calendar/tax year in which the law was changed. Granted those changes were not of the general magnitude as proposed under HB2178, but the principle is the same – individual income taxes were retroactively increased.

And finally, at least for purposes of this newsletter, the "we don't have a revenue problem, we have a spending problem" argument continues to be made. To that argument, what we have consistently heard, and continue to hear, from our members and other Johnson Countians is that they are generally frustrated with much of the debate. They feel that they were not asked if they liked the government services and quality of life amenities they were receiving, that they understood it takes revenue to provide those services and amenities, and for the most part did not believe that they were being "overcharged" by taxes being too high. While those beliefs seemed to have been further reinforced by the outcomes of last fall's elections, they continue to be told that the tax cuts are working, and that Kansas has a spending problem, not a revenue problem.

It is one thing for someone to simply assert by responding to a survey question or otherwise that he or she would like to see the cost of government reduced rather than pay higher taxes; however, the question issue becomes much more difficult when the follow-up is presented and the respondent is asked to list those specific programs and services that should be cut, especially when those programs and services that represent a large enough part of the state general fund budget to make a difference, such as K-12 education, K-12 education, KDOT's highway fund, KPERS, public safety, and social services.

That is a lot of discussion concerning a bill that is now dead, but I wanted to give you some detail about the Chamber's positions on issues and elements of proposed tax increases based on input from our members, particularly since those same issues and elements will reappear in new tax bills that will be considered as the session continues. For example, HB2370 was introduced and passed out of the House Taxation Committee in a brief meeting at the rail last Thursday, and it is essentially identical to the vetoed HB2178. It sits there giving the House something to work from. Also in the mix is SB215, again patterned after HB2178, the difference being that the individual income tax increases would not be retroactive, instead being effective on January 1, 2018. Both Chambers also have the Governor's tax plan (i.e., freezing current individual income tax rates for 2018 that were otherwise scheduled to undergo a slight reduction and increases in tobacco and liquor taxes and franchise fees) in bill form, SB215 and HB2315, which were passed out of their respective tax committees without recommendation. While both bills are on general orders in their respective chambers, there remains little appetite for this approach to increasing revenue.

With the *Gannon* decision out and sending legislators looking high and low for additional funds to spend on K-12 education, it will be interesting to see where they turn to find those funds. As discussed, they were unable to increase income taxes, although that should only be a matter of time. What that change will look like is the question. Certainly *Gannon* makes it much more unlikely than before to see tax increases paired with even small cuts in education funding, at least at the K-12 level. Whether the increased need that has now actually materialized with *Gannon* will work to change the minds of at least three Senators with respect to the acceptability of passing a retroactive income tax increase with a veto-proof margin remains to be seen.

Medicaid Expansion. Unlike the recent past when any thought of getting a Medicaid expansion bill to the full House was thwarted by leadership, last week when it became apparent that the Medicaid expansion bill, HB2064, would not be passed out of committee, House leadership allowed the contents of that bill to be offered on the House floor as an amendment to HB2044 for debate by the full House. That led to the passage of HB2044 that includes expansion of Medicaid by a vote of 81-44. The bill was sent to the Senate where it was referred to the Senate Public Health and Welfare Committee. While the bill could be worked in committee and sent to the full Senate where it would stand a reasonable chance of passing, it is certain to be DOA in the Governor's office. Both the Governor and Lt. Governor have been and continue to be strongly opposed to Medicaid expansion, and there are just not enough votes in both chambers to successfully override a veto by the Governor.

Kansas Tax Revenue. On Wednesday, the Kansas Department of Revenue released tax collections for the month of February; those revenues were approximately $40 million more than estimates. This is the fourth month in a row that collections have exceeded monthly estimates (remember that the state's Consensus Revenue Estimating Group further lowered its twice-yearly estimates last November), reducing the state's FY2017 budget shortfall to about $280 million. With luck, tax collections will continue to meet or, hopefully, exceed estimates for the remaining four months of this fiscal year. With the legislature apparently headed toward using $317 million from the Pooled Money Investment Board fund to offset the budget shortfall (the House has passed the bill, HB2161, authorizing use of those funds, the bill currently awaiting action in the Senate), it is even possible that the infusion of the PMIB funds could result in a positive ending balance on June 30 when FY2017 ends.

K-12 School Finance. The elephant in the room woke up on Thursday when the Supreme Court finally released its opinion on the adequacy portion of the *Gannon* case. To no one's surprise, the Court affirmed the lower court's holding that the CLASS (essentially, the block grants used for K-12 funding for two school years, 2015-16 and 2016-17) is constitutionally inadequate. The Court used two tests to determine the constitutionality of CLASS, structure and implementation. It found that structurally, the block grants did not constitute a school funding formula, but was merely a fund created by freezing school districts' funding at the 2014-15 level for two years. And, secondly, it did not meet the implementation requirement for constitutional adequacy, focusing largely on the fact that "not only is the State failing to provide approximately one-fourth of all its public school K-12 students with the basic skills of both reading and math, but this it is also leaving behind significant groups of harder-to-educate students" (i.e., those students generally included in the "at-risk" category).

While finding that there is a correlation between financing and successful outcomes, the Court also stated that total spending is not the touchstone for adequacy. It did not provide a funding level that it believed was necessary to satisfy the adequacy requirement, but left to the legislature to design a funding formula and appropriate the money to fund it; the Court would then review that plan to see if it met the requirements of Article 6 of the Kansas Constitution. However, the additional funding numbers being heard in the wake of the opinion range from something under $400 million, to possibly $535 million from the State Department of Education, all the way up to $900 million offered up by the plaintiffs' attorneys in *Gannon.* No matter which number you choose, it appears to require a large amount of new money, over and above what is already been identified as needed for a balanced budget in FY2018.

So far, much of the legislature's work on a new finance formula (at least the overt work) is occurring in the House's new-this-year K-12 Budget Committee, where several bills containing new or modified plans have been presented and information hearings on many of the aspects of school operation, financing and funding formulas have been conducted. Presumably, with a June 30th deadline looming, the pace of that work will escalate beginning next Monday when the legislature goes back to work following its break. Not only do they have to agree on a formula, but finding more money than is currently available, are both on the table.

Upcoming events:

Legislative Breakfast Series. The third and final breakfast in the **Johnson County Public Policy Council's series** will be Saturday, **March 25**, at the DoubleTree Hotel. Members of the Johnson County Delegation scheduled to participate on the panel are Sens. Barbara Bollier and Julia Lynn and Reps. Stephanie Clayton, Erin Davis, Nancy Lusk and Brett Parker.

Public Policy and Advocacy Committee Meeting. The next meeting of this committee will be noon-1:30 p.m. on Friday, **March 10**, at the Overland Park Chamber office.

Registration information for both events can be found at www.opchamber.org.