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Kansas' failed tax experiment offers economic lessons for Republicans at national level

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As President Trump and congressional Republicans ponder big tax cuts to boost the U.S. economy, Kansas has become a cautionary tale.

Prodded by Gov. Sam Brownback, a Republican, Kansas embarked on a major tax overhaul in 2012, reducing the top income tax rate from 6.45 percent to 4.9 percent and eliminating income tax on some businesses altogether.

Convinced they could turn the state into a heartland magnet for businesses seeking to flee high-tax states on the coasts, Republican lawmakers instead punched a huge hole in their budget. Facing mounting bills and shrinking revenue, the Legislature last month defied Mr. Brownback's veto and moved to reverse some of its cuts.

Whether the Kansas experiment is a referendum on conservative, low-tax policies is an open question. Obsession with tax rates often obscures other factors in businesses' decision-making, such as the availability of a good workforce, quality of life for employees, and proximity to airports and other infrastructure, analysts say.

"You can't just have the tax issue in isolation," said Richard C. Auxier, a tax policy researcher at the Urban Institute. "There's no clear link between tax cuts and growth."

With the next big round of gubernatorial elections looming next year, debates over competitiveness and supply-side tax policy are likely to heat up.

At the national level, the Trump administration is counting on a massive tax rate cut to pay for itself in the long run through accelerated economic growth. Mr. Brownback's office is rejecting complaints by liberals and centrist Republicans in the Legislature that the tax cuts did not attract enough business to the state to pay for themselves.

"In efforts to make Kansas the best state in America to raise a family and grow a business, Gov. Brownback cut income taxes for all working Kansans and completely lifted the income tax burden from small businesses. It worked," said communications director Melika Willoughby. "Kansas set a record for new businesses formed every year since the tax cuts, and the state's unemployment rate is under 4 percent — the lowest it's been in over 16 years."

Kansas is hardly the only state facing a budget impasse. Deep-blue Illinois is struggling with its own tax-and-spending problems, in part a legacy of generous pension promises to state workers that the state cannot meet.

But Mr. Brownback's critics say overall growth and job creation lagged behind the national average and even behind other Midwestern states despite the tax cuts in 2012 and 2013.

At the same time, the state was facing an estimated $900 million budget deficit over the next two years despite a series of spending cuts. The state Supreme Court ordered the state government to increase funding for lagging public schools by $293 million over the next two years.

"It's hard to celebrate because Kansas is in such shambles," state Rep. Melissa Rooker, a Republican from Kansas City suburb of Fairway, told The Wichita Eagle after the June vote to override Mr. Brownback's veto of tax hikes. "The magnitude of the problems that we have to correct is so great."

Adam Michel, a tax policy analyst at the conservative Heritage Foundation, said Kansas' problem wasn't the tax cut but how the state handled it. He said eliminating taxes for some corporations created an incentive for businesses to "recharacterize" income, which created an unsustainable financial picture.

"Their reform wasn't designed properly," Mr. Michel said.

Other commentators haven't been so kind. William G. Gale, an economist and senior fellow at the left-leaning Brookings Institution, noted that Mr. Brownback in 2012 promised that the tax cuts would represent "a shot of adrenaline in the heart of the Kansas economy."

Mr. Gale wrote in a blog post last month: "While the tax cut turned into a debacle, there is a potential silver lining: three clear messages for policymakers on federal tax reform. First, tax cuts won't boost growth. Second, special tax rates for businesses will surely generate tax sheltering and revenue losses, but will not produce much new business activity. And third, most important, when Americans see what their tax dollars buy, they choose higher revenues and more government spending over lower taxes and draconian program cuts."

Tax cuts and business decisions

Done right, however, tax cuts can draw businesses to states, Mr. Michel argued.

"We see in large, aggregate data that tax cuts would affect a company's decision," Mr. Michel said. "If you're going to build a factory in a low-tax state versus a high-tax state, you're going to pick the lower-tax state. It's not always the case that the company leaves a high-tax state, but their next factory or venture, the lower tax rate will be a factor."

General Electric Co., the technology conglomerate, faced such a choice.

GE officials warned Connecticut Gov. Dan Malloy in 2014 that the state's business tax was already high and the company would consider moving if it was raised.

Mr. Malloy, a Democrat, promised he wouldn't raise the tax. After winning his re-election bid in 2014, he announced $750 million in new business taxes. Massachusetts lawmakers swept in to offer GE $25 million in property tax breaks and $120 million in grants toward public works.

GE broke ground on its new headquarters in Boston this year. Boston offered more than tax relief, though.

GE Chairman and CEO Jeff Immelt cited the region's concentration of high-quality universities, Massachusetts' commitment to research and development, and the state's tech-savvy workforce.

"Boston was selected after a careful evaluation of the business ecosystem, talent, long-term costs, quality of life for employees, connections with the world and proximity to other important company assets," Mr. Immelt said in the press release announcing the move.

In a study of the move last year, Manhattan Institute fellow Aaron Renn said Boston has the right combination of workforce availability, accessibility and growth potential that draws companies to the area. With the right incentives, including tax breaks, companies can be enticed to move to such states.

It's all about finding a mix that fits a company, analysts said. Arizona and Florida have some of the lowest corporate tax rates in the nation, but they also have some of the lowest high school graduation rates in the country.

Wisconsin might have higher graduation rates, but its population migration continues to be net negative — meaning more people are moving out of than into the state.

Chris Edwards, an analyst at the libertarian Cato Institute warns that states can make only marginal changes because the federal government represents such large parts of their economies.

"State governments follow the national government," he said. "The federal government is so much bigger and overwhelms what states can do."

Amid global competition for businesses, there is only so much one state can do to affect outcomes, analysts said, and tax policy is just a small part of that.

"The federal government dominates everything states do," Mr. Edwards said. "The federal government is so much bigger and overwhelms what states can do."

Mr. Auxier said the federal government provides 30 percent of state spending through programs such as Medicaid and grants. Because states can't deficit spend like the federal government, they need to make tough choices if the federal government pulls back or if they want to cut state taxes.

As a result, economists say, the best state officials can do is diversify their economies and not depend on tax cuts to fix their problems.

"Federal tax and budget policy, and Federal Reserve policy, have much to do with the economy's growth rate," Mr. Fisher said. "And the best predictor of state economic growth — a result that I have found, and many others — is the mix of economic activity in the state."