Executive Summary

This study was commissioned by Kansas, Inc. to investigate the tax and business climate of Kansas and six states in the region (Missouri, Iowa, Nebraska, Oklahoma, Texas and Colorado).

This study provides a detailed discussion of three tax structures: corporate income taxes, sales and use taxes, and property taxes. The study also presents a comprehensive evaluation of factors which contribute to a healthy business climate including: business costs, regulatory environment, infrastructure and transportation, and workforce characteristics.

To compare the tax and business climates, this study investigates firms in four industry types: light manufacturing, heavy manufacturing, administrative back-offices, and professional services. Sixteen proprietary models are used to analyze business costs and tax structures for four typical firm-types in four separate scenarios. The study reports the results of an economic model and discusses policy considerations based upon these results and interviews with regional business leaders.

The most significant findings are:

- When analyzing total taxes, Kansas ranks as one of the highest tax states in the region, based on two measures: per capita income tax burden and taxes as a percentage of personal income.

- Kansas taxes are growing faster than state income. The Kansas *state* tax burden is quite competitive in the region; however, the growth in the *local* tax burden has kept Kansas in the "middle of the pack" in the nation and at the top of the region.

- Looking only at *corporate* tax burdens, the study uses a model firm approach and finds that the total tax burden on Kansas corporations is comparable to that of the other states within the region. In four scenarios across four firm-types, Kansas is consistently within 1 percent of the median tax burden in the region.[1]

- Kansas provides significantly more incentives to new firms than existing firms. A start-up high-tech manufacturer receives, on average, $2,900 more per employee annually in tax benefits than an existing high-tech manufacturer.

[1] Readers may be aware that these results contrast sharply with the Tax Foundation's business tax climate index, which ranks Kansas #35 and #6 (of seven) in the region studied. The Tax Foundation methodology penalizes states offering tax credits for investment, jobs, and research and development and makes no adjustments for differences between industries. The model used in this study incorporates industry differences and recognizes that credits are a significant tax savings for many firms.

- Kansas is highly competitive in overall business climate costs within the region. The model includes over 100 business input costs ranging from big-ticket items, such as real estate, equipment/machinery and labor, to smaller, but essential items such as utilities.[2]

- Overall, Kansas has a healthy tax climate for businesses. Significant tax incentives such as property tax exemptions for business equipment and machinery, sales tax exemptions on manufacturing inputs, and expanded income tax credits promote business activity in Kansas.

- A healthy business *tax* climate does not necessarily equate to a healthy business climate. While this study captures elements of the business climate (e.g., infrastructure, workforce, transportation), the analysis does not address how taxes are spent in each state, and this spending has important consequences for each state's business climate. The long-term success of a state's economy depends on long-term investments made by the state in activities that lead to innovation, entrepreneurship, and economic growth. Research suggests that investment in science, math and engineering education has a significant impact on the vitality of an economy.

Conclusion

This report describes the current tax system and the underlying policies that shape modern tax theory. This report also identifies areas of strength and opportunity in the Kansas tax and business climate.

The Kansas tax code provides a number of incentives to firms investing in the state which, along with low input costs, make Kansas quite competitive with other states in the region. Business taxes are in line with states in the region. But when considering all taxpayers and the total tax burden, Kansans fare poorly as the state imposes one of the highest total tax burdens in the region.

The findings of this report, just like citizens of the state, do not consider taxes in a vacuum. The strengths of the Kansas economy are the quality of the workforce, the investment in infrastructure and the regulatory support; no single tax policy can compensate for an uneducated workforce and poor roads. While these investments can withstand temporary cuts, policy makers are given the difficult task of maintaining a healthy business climate while enacting tax policy that encourages economic growth.

The tax law can be made simpler, fairer and more conducive to economic development; but often, all three objectives cannot be met and difficult trade-offs are necessary.

[2] These results are consistent with a recent Forbes.com survey which lists Kansas as the #10 state for business in the nation and third in the region. Of note, Kansas ranks #2 in the region for regulatory environment. Site Selection ranks Kansas #10 in the nation for competitiveness, second in the region to Texas.

Table of Contents

List of Figures

List of Tables

Chapter 1: Overview of State and Local Tax Revenues

Introduction

State and local governments fund the services they provide to their constituents in a number of ways. Funding patterns are complex, resulting from a mosaic of tax rates, tax bases, transfers among governments, fees and charges, and other sources. Decisions about revenues are made by counties, school districts, cities, special districts, states, and of course the federal government.

In some states, the responsibility for raising revenue is divided almost equally between the state-level government and local jurisdictions. In other states, the state-level government predominates. Furthermore, state and local governments vary substantially in how they choose to raise revenues–some states rely heavily on income taxes, while other states rely more on property and sales taxes.

Funding patterns are complex, resulting from a mosaic of tax rates, tax bases, transfers among governments, fees and charges, and other sources.

The decisions made by government entities tell only half of the story of revenue collections. Lurking in the background is the overall economic health of states and localities. A given income tax or sales tax rate produces more revenue in good economic conditions than in bad. Income taxes, and especially corporate income taxes, fluctuate widely over the business cycle. State and local governments have been hard-pressed to maintain services during the current economic downturn. Budgets have sometimes been trimmed, sometimes cut, and sometimes slashed. At the same time, tax rates have increased in many jurisdictions (sometimes on a temporary basis) and credits have been reduced.

The purpose of this chapter is to describe the general patterns of state and local finance, trends in those patterns, and responses to the current recession.

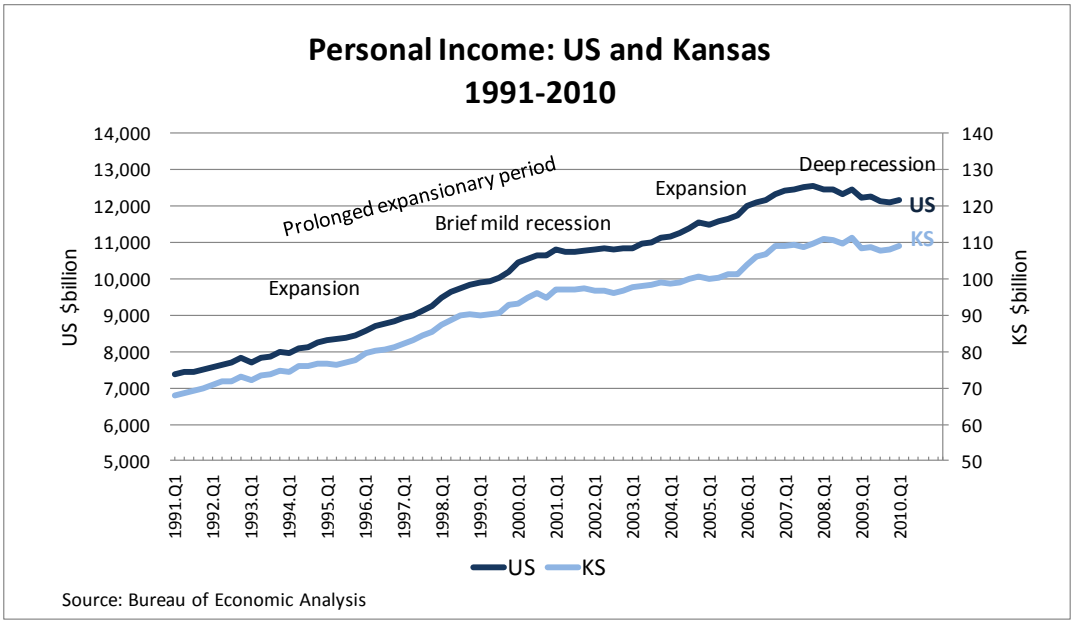
Some Caveats about the Data

The US Census Bureau collects and publishes data on state and local finances (State and Local Finance Series). The data are collected using a consistent set of definitions across all jurisdictions.

Unfortunately, the latest data are for fiscal year (FY) 2008, which ended just as the economy passed its peak and entered a recessionary period. Most economists date the onset of the recession to December 2007, about midway through the last year of published data for combined state and local governments.

Data on state-level governments are much more up-to-date: FY 2010 is available from the Census Quarterly State Tax Revenue series. But because the responsibilities of local governments vary by state, state-level government statistics provide an incomplete picture of taxes and spending. For this reason, the chapter emphasizes the combined data. However, state-level data are available through 2010. The study uses these data to discuss state-level responses to the recent recession.

Figure 1.1



Source: Bureau of Economic Analysis

The study generally looks at the last decade of tax data. FY 1997 (about 5 years into a long expansion) is compared with FY 2008, when the economy started to move into recession. See Figure 1.1 for a comparison of Kansas personal income to US personal income for the 1991-2010 time periods.

Where do state and local governments get their money?

State and local governments get their funding from three main sources: intergovernmental transfers, charges and fees, and taxes.

State and local governments both receive funding from the federal government. State-level governments receive very large transfers for Medicaid and for education. In turn, local governments receive funding from their respective states, particularly for education.

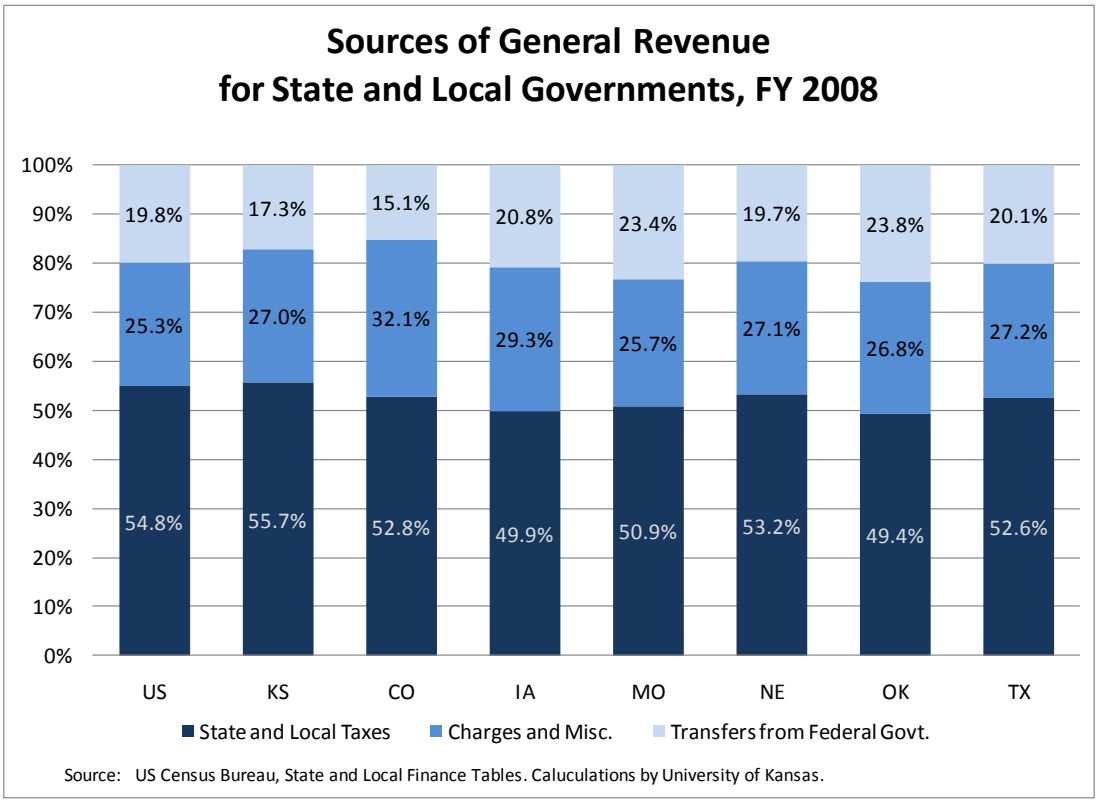
In Kansas, about 1/3 of local funding is transferred from the state level. Looking at combined state and local funding, the "state-to-local" figures net out (the revenue to the local governments is an expense to the state).

Kansas raises a slightly higher percentage of its funding from taxes than do the other states in the region. On the flip side, Kansas receives a lower-than-average percentage of funding from the federal government.

Figure 1.2 below provides the sources of Kansas revenue. Kansas raises a slightly higher percentage of its funding from taxes than do the other states in the region. On the flip side, Kansas receives a lower-than-average percentage of funding from the federal government.

In general, states rely on taxes for about 50-55 percent of funding, making up the difference with charges and federal transfers. Nationally, the share of revenue from taxes has fallen between 1997 and 2008 (56.5% to 54.8%). However the share has increased in Kansas (54.4% to 55.7%).

Figure 1.2



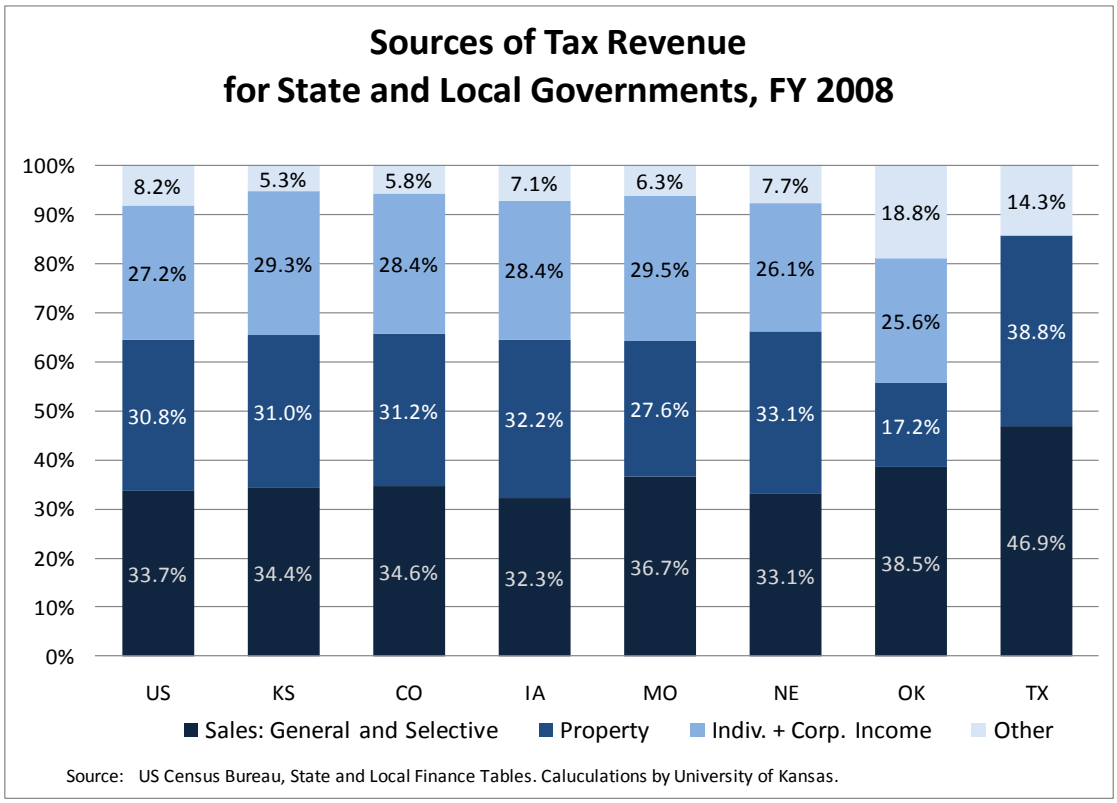
Within the tax component of revenue, there is again considerable state-by-state variation in the types of taxes employed. Figure 1.3 provides the breakdown of various tax revenues within the states studied.

Kansas, Colorado, Iowa, and Nebraska show similar structures, with sales and property taxes comprising almost equal shares of tax revenue and income taxes comprising a slightly smaller share.

Missouri, Oklahoma, and Texas rely much more on sales taxes than do the previously mentioned states, with Texas deriving almost 47 percent of taxes from this source. Oklahoma de-emphasizes the property tax, making up revenue instead from "other" sources, primarily a severance tax on oil and gas extraction.

Texas imposes no income taxes; a gross margins tax on businesses and severance taxes on natural resources fill out the "other" category.

Figure 1.3



How large are state and local taxes, and how have they changed over time?

What is the magnitude of state and local taxes? The study considers two measures: taxes per capita (see Figure 1.4) and taxes as a percentage of personal income (see Figure 1.5). By either measure, Kansas appears to be an average state compared with the US.

Both the overall tax level and the breakout between state and local components mimic those for the US as a whole. Kansas is similar to the US as a whole but is an outlier in the region. Kansas stands out as the high-tax state in the local region based on per capita state and local taxes.

Kansas stands out as the high-tax state in our local region based on per capita state and local taxes.

Tax collections average about $4,250 per capita or 10.9 percent of personal income in Kansas, followed by Nebraska ($4,200, 10.8%) and Iowa ($3,850, 10.3%).

Figure 1.4

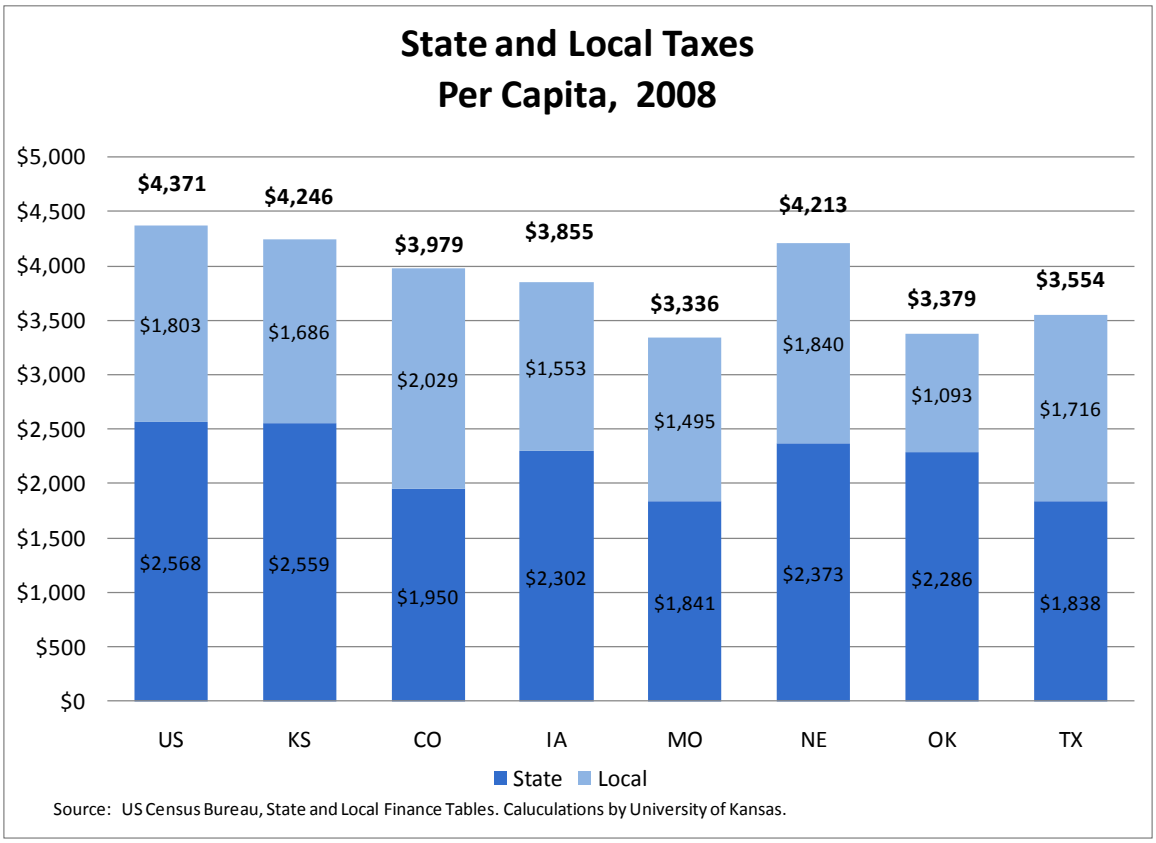
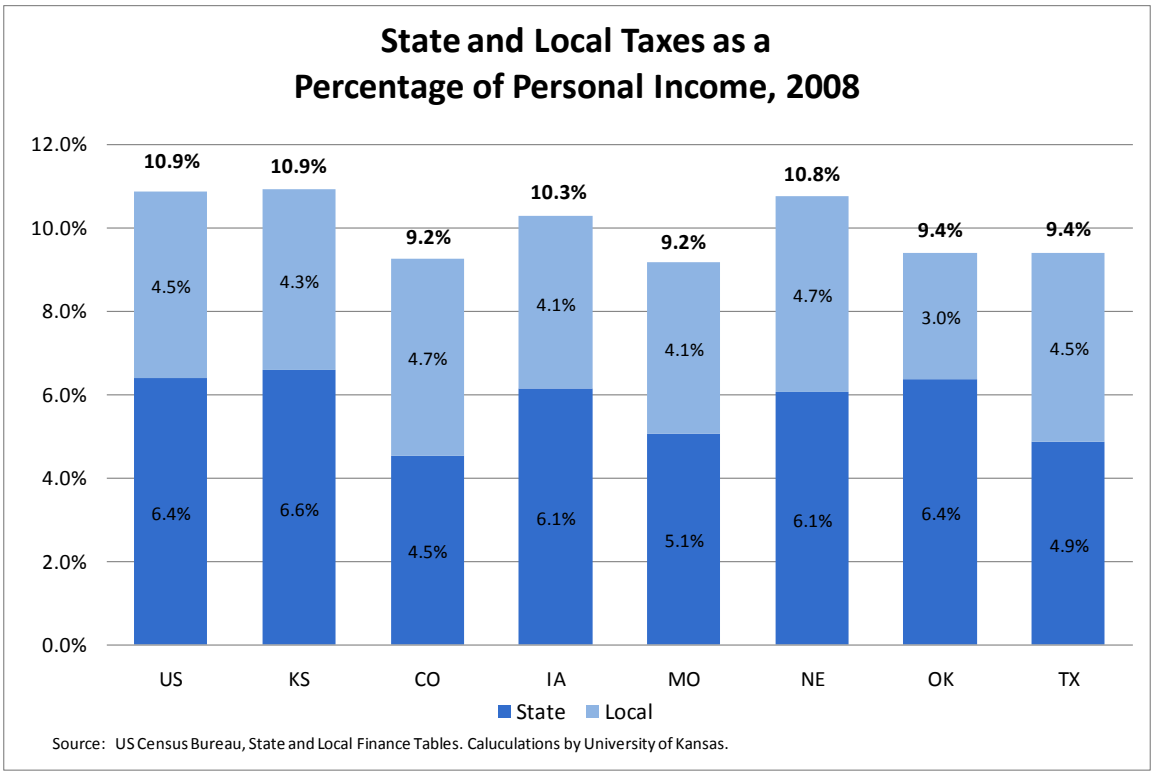


Figure 1.5



Kansas combined state and local taxes have grown about 7 percent more than income over the decade.

This study examines historical data for the last decade to assess whether taxes have grown in proportion to income. Kansas combined state and local taxes have grown about 7 percent more than income over the decade. See Table 1.1.

This figure is similar to that for the US but contrasts with other states in the region.

Other states had much more limited tax revenue growth. In fact, combined state and local tax collections over the decade grew more slowly than income in several states.

...local revenue growth exceeded income growth by 18 percent

Local revenues grew much more rapidly than did state revenues during the last decade.

In Kansas, state-level tax revenues grew at almost the same rate as income, whereas local revenue growth exceeded income growth by 18 percent.

Table 1.1
Growth of State and Local Taxes Compared to Growth of Income, 1997 – 2008

	Growth : 1997-2008				*Tax Growth minus Income Growth*		
	Combined Taxes	**State Tax**	**Local Tax**	**Income**	**Combined**	**State**	**Local**
US	82.6%	76.0%	93.0%	74.8%	7.8%	1.2%	18.2%
KS	75.6%	69.1%	86.5%	68.4%	7.2%	0.7%	18.0%
CO	94.4%	81.9%	108.1%	92.8%	1.6%	10.9%	15.3%
IA	60.4%	47.1%	85.3%	63.6%	-3.2%	16.5%	21.7%
MO	57.8%	40.3%	86.4%	63.9%	-6.1%	23.6%	22.5%
NE	67.1%	66.0%	68.7%	70.0%	-2.8%	-4.0%	-1.3%
OK	72.8%	64.6%	92.9%	85.9%	-13.1%	21.3%	6.9%
TX	98.3%	94.0%	103.1%	95.5%	2.8%	-1.5%	7.6%

The tax structure of a state has consequences for businesses. States that rely heavily on property taxes may place a higher-than-average burden on businesses that use large amounts of real estate and/or taxable equipment. States that de-emphasize the income tax will provide advantages for corporations with high profits and for employees with high income.

But when one type of tax is avoided, another tax generally arises to fill the gap. For example, businesses in Texas, while they pay no income tax *per se*, are subject to other taxes on business activity.

The same is true within a state; declining property taxes at the state level have been accompanied by spikes in local property taxes. Numerous jurisdictions within the state currently have property tax mills exceeding 200, which negatively impacts their ability to attract and retain businesses.

A further consideration is that overall tax data may not accurately reflect the business climate in a state. It is possible for per capita tax collections to be high while at the same time those taxes that most impact businesses are kept at a moderate level. However tax collections per capita and tax collections per dollar of personal income remain two general indicators of whether a state is highly taxed.

Chapter 2: Representative Firm-Model of Business Taxes and Costs in the Region

Introduction

Ranking the "business climate" of states is a growing cottage industry. Organizations such as the Tax Foundation create indexes based on taxes, basic business costs, and a number of other factors to arrive at an overall standing for each state (business rankings are reviewed elsewhere in this report).

An alternative, the "hypothetical firm" approach, models the overall cost of doing business at various locations (Tannenwald 1994; Fisher and Peters 2002).

Hypothetical firm studies are based on cost minimization theory and are disaggregated by industry. Some hypothetical firm approaches consider only the portion of costs imposed by taxes, while others include an array of other variable costs such as labor, energy, land, and construction. The model discussed in this chapter uses the latter approach to capture the tax and business climate.

This chapter reports the results of the "KU Tax and Cost Model," a hypothetical firm model constructed at the University of Kansas with the support of Kansas, Inc.

The results of the model show that both established and new firms face moderate taxes and costs in Kansas.

Kansas usually ranks at or below the regional median in terms of overall costs. Kansas is not the lowest cost state in the region, but business location decisions are not made on costs alone. Other Kansas advantages such as a productive labor force and a good educational system, combined with moderate taxes and costs, provide a competitive environment for established and new firms.

Model Industries

To run the model, the KU team worked with Kansas, Inc. to select four groups of industries– light manufacturing, high-tech manufacturing, administrative offices, and "exportable" services. These industry groups represent many of the types of industries that Kansas is trying to attract or retain. Consider, for example, some recent press releases from the Kansas Department of Commerce Website (2010):

- Schier Products, a company that produces plastic molding fixtures, will locate a new manufacturing facility in Wyandotte County (light manufacturing).
- General Motors will invest $136 million to retool its Kansas City, Kansas plant to build the next-generation Chevrolet Malibu (high-tech capital intensive manufacturing).
- US Bank will add more than 1,100 new jobs at a new service center in Overland Park (administrative back offices).
- Hoefer Wysocki Architects will move its headquarters to a new location in Leawood, Kansas, bringing 65 jobs and $5.1 million in initial capital investment (exportable services).

The model starts with a specific "baseline" industry for each industry group. For example, plastics manufacturing represents the light manufacturing group, and architectural and engineering services represents the exportable services group. Within each industry group, an array of possible revenues, wages, and investments are examined. The industries groups and specific representative industries are described in Table 2.1.

The "Scenarios"

The model considers four alternative scenarios to: 1) capture differences in costs to isolate the role of taxes and 2) determine the state tax differences between existing and start-up/expanding firms. See Table 2.2.

The first dimension of the scenarios is whether costs other than taxes are assumed to be fixed (at national averages) or variable by state. If non-tax costs are considered fixed across locations, then the impact of taxes is isolated. If costs are variable, the net results of the model co-mingle taxes and costs.

Consider, for example, a state in which labor costs are very high. The taxable income of the firm is likely to be low because costs are high. If income is low, income taxes will also tend to be low. So the overall level of taxes paid by the business is the combined effect of the income tax structure and the level of income to which the tax applies.

The second dimension of the scenarios is whether the firm is a new (or expanding) firm, or an established firm that simply maintains its current level of production and employment.

The new or expanding firm is eligible for special business incentives provided by states and localities.

The model considers only tax incentives, but it should be pointed out that grants, loans, and infrastructure support may also be available to new firms on a case-by-case basis.

The business and tax climate for a new firm may be quite different than that of an existing firm in the same state or locality.

The taxes faced by a new or expanding firm are often quite different than those of existing businesses. The business and tax climate for a new firm may be quite different than that of an existing firm in the same state or locality. The taxes of an established firm more accurately reflect basic tax base definitions and rates.

A comparison of the "new firm" scenario with the "established firm" scenario provides an estimate of the value of tax incentives given to the new firm.

Table 2.1
Industries in the KU Tax and Cost Model

	Light Manufacturing	High-Tech Capital Intensive Manufacturing	Administrative Back Offices	Exportable Services
Baseline Industry	Plastics products	Telecommunications equipment manufacturing	Administrative services	Engineering and architectural services
Annual Revenue per Employee				
Baseline	$150,000	$500,000	N/A: office does not generate revenue directly	$165,000
Range	$112, 500-$187,500	$375,000-$625,000		$124,000-$206,000
Average Annual Wages				
Baseline	$38,000	$64,000	$28,000	$74,000
Range	$27,500-$47,500	$46,000-$67,000	$21,000-$37,000	$55,000-$81,000
Investment per Employee				
Baseline	$128,000	$350,000	$35,000	$79,000
Range	$96,000-$160,000	$262,500-$437,500	$26,000-$45,000	$52,500-$87,500
Characterization	Moderate wage, moderate capital intensity	High wage, high capital intensity	Low-to-moderate wage, low capital intensity	High wage, low-to-moderate capital intensity
Location of sales, property, and payroll	Single establishment firm. 10% of sales, 100% of property, and 100% of payroll in state of location.	Single establishment firm. 10% of sales, 100% of property, and 100% of payroll in state of location.	Multi-establishment firm. 12% of sales, 10% of property, and 10% of payroll in state of location.	Single establishment firm. 100% of services performed in state of location. 10% of customer sales in state of location. 100% of property and 100% of payroll in state of location.
Examples of firms in industry	Pitt Plastics Pittsburg, KS	Cisco Systems	Back office operations of Scottrade, Denver.	Black & Veatch

Table 2.2

Description of Scenarios Used in Model

Scenarios		Established Firm	New or Expanding firm
		Comparison of Scenarios 1 and 2 shows the value of incentives	
Other costs set constant at US levels	*Comparison of Scenarios 1 and 3 shows the overall impact of basic cost differences across states*	*Scenario 1. Isolates the impact of taxes on an established firm. This is the "baseline" scenario.*	*Scenario 2. Shows the impact of incentives on a new or expanding firm.*
Other costs vary by location		*Scenario 3: Shows the impact of variations in costs such as labor, energy, and construction on an established firm's overall cost of doing business.*	*Scenario 4: Shows the impact of variations in costs such as labor, energy, and construction on an established firm's overall cost of doing business.*

Model Assumptions

To run the KU Tax and Cost Model, a number of assumptions about the nature of the firms and about the incentives that are offered to them are made.

Assumptions pertaining to the types of firms have been discussed briefly above. Assumptions are spelled out in more detail here.

Assumption #1. In selecting a business location, firms consider which location will minimize total costs.

Assumption #2. The firms are "export oriented," meaning that they make most of their sales outside the state in which they locate.

Assumption #3. The firms construct new facilities (rather than renting).

Assumption #4. The establishments are moderate in size: 100 employees.

Assumption #5. Once the firm's choose a location, they operate in that location for 20 years. Many states have incentives that run for 10 years or even longer, so a 20-year time horizon to assess incentives was chosen.

Assumption #6. The firms do not replace their buildings during the 20-year period, but they do have annual repairs.

Assumption #7. Machinery is replaced as it is fully depreciated for tax purposes.

Model Exclusions

Many state and local governments may "sweeten the deal" through negotiated benefits if they are not the lowest cost sites. This possibility is not quantified in the model.

Furthermore, this model does not include intangible considerations such as quality of life or whether the business climate promotes innovation and entrepreneurship.

Model Inputs

The model relies on several types of data inputs: the cost structure of industries, federal taxes, state taxes, local taxes, and prices of inputs such as labor. Each of these types of data is stored in

a separate spreadsheet. The major data and sources are listed below:

Industry data. Data from the US. Census Bureau (2007) are used to construct key ratios such as sales, wages, benefits, capital stock, and inventories per employee. Data from the input-output tables of the U.S. Bureau of Economic Analysis (2008) are used to approximate the detailed composition of raw materials, business services, and utilities used by the firms.

Federal taxes. Data on federal rates and brackets were taken from downloadable publications on the IRS website. A critical issue is the treatment of so called "bonus depreciation," which allows firms to expense a portion of their capital purchases. Current bonus depreciation provisions expire at the end of 2010 and the replacement (if any) for bonus depreciation has not been decided as of the writing of this report. It is assumed that bonus depreciation does *not* continue over the 20 year period of time considered by the model.

State taxes. Data on state income tax rates, brackets, and incentives were downloaded from respective state websites. In general, economic development websites of individual states were consulted to get an overview of business incentives. Corporate income tax instruction booklets for each state and state statutes provided further insight into the rules under which various incentives can be claimed.

State sales tax information (rates, base, and exemptions) were obtained from state web sites. Where necessary, state statutes were examined to clarify exemptions. Additional information was provided by RIA Checkpoint®, a subscription database of tax and accounting information.

Local Taxes and Costs. Local sales taxes for the "statewide average" calculations were downloaded from the Tax Foundation web site (2010).

Data on local (and state) property taxes generally were obtained from state government websites. Often county-wide average property tax rates were available, but no statewide average. In that case, researchers created a weighted average using assessed value (if available) or population as weights for the county-level data.

Local wages were provided by the Bureau of Labor Statistics Quarterly Census of Employment and Wages (2010).

Building costs were downloaded from an online database compiled by RSMeans (2010), a construction estimating firm.

Data from the National Agricultural Statistics Service (2010) provided local land costs.

Model Operation

The model program was designed to incorporate the tax and business costs for the different firm types. The program retrieves thousands of data points, imputing income, sales, property and other taxes. Each output relies upon hundreds of calculations, based upon differences in business operations and locale. The program then creates tabular results for analysis, such as in Tables 2.3 and 2.4.

Model Results

The model was run for all of the industry groups and ranges (for sales, wages, and capital intensity) within the industry groups. However for the sake of brevity, results are reported only for the "baseline" industry configuration within each of the four groups. For example, $150,000 in sales per employee and $38,000 in wages per employee are the inputs used for the light manufacturing group.

All model results are annual averages over the 20 years. All results are shown as "dollars per employee."

Scenario 1: Established Firm Receiving NO Incentives, Other Costs at National Levels

In this scenario, all differences in costs are due to state and local tax structures. Overall, Kansas provides a fairly neutral tax environment for an established manufacturing firm. Kansas ranks as the median (the middle) state in the region for light and capital intensive manufacturing, as seen in Table 2.3. The exemption of manufacturing equipment from the Kansas property tax improves the tax (cost) environment.

The tax environment is less favorable for an established administrative back office facility. In fact, Kansas appears as the highest tax state in the region, although only by a small dollar amount. Administrative offices have much less capital equipment than manufacturers, and hence they benefit less from the Kansas property tax exemption.

Kansas provides a neutral tax environment for the exportable service firm. On the positive side, such firms benefit from the Kansas property tax exemption for machinery and equipment. On the negative side, Kansas applies "performance based" sourcing for services (discussed in detail Corporate Income Tax chapter). This means that sales of services to customers out-of-state are taxed just as if they were sold to Kansas customers. Within the region, Oklahoma and Iowa apply an alternative market-based sourcing, which may provide some tax savings to service firms.

Table 2.4 provides more detail behind the overall findings by looking at an analysis for one of the firm categories, the high-tech capital intensive manufacturer (such as a telecommunications equipment manufacturer).

Income Tax. As shown in Table 2.4, state taxes fall into two groups, with taxes in Colorado, Iowa, Nebraska, and Texas appearing to be very low. Note that the "gross margins" tax for Texas is shown on the income tax line.

Because the model firms are export-oriented, manufacturers have only a small portion of sales in the state where they locate. States that apportion income based on "sales-only" have very little income base to tax. That does not mean the income of the firm is not taxed in some other state where sales are made, such as New York or California or Maine. But that is outside the scope of this model. It is assumed that the firm would have been taxed in the state where it makes sales regardless of where it chooses to locate within the region. Again, the Corporate Income Tax chapter addresses this issue in more detail.

Property Tax. The treatment of machinery and equipment for the purposes of property taxation is especially important to the outcomes of the model. For a capital intensive firm like a telecommunications equipment manufacturer, Kansas provides a distinct advantage–Kansas exempts new purchases of machinery and equipment.

The established firm still makes substantial equipment purchases as worn out or outmoded equipment is replaced; hence the firm realizes substantial savings due to the exemption.

In contrast, some states like Texas place high property taxes on an established manufacturing firm. Rates are higher than average, and, more importantly, inventories (which can be substantial for a manufacturer) are taxed as personal property. Texas and Oklahoma are the only states in the region to tax inventories. Both of these states do offer limited "freeport" exemptions for goods that enter and leave the state fairly quickly.

Sales and Use Tax. All the states in the region exempt manufacturing equipment used in the manufacturing process from sales and use taxes. Other exemptions, such as electricity, vary by state. Differences in tax rates drive the differences in the bottom line sales and use tax liabilities. For example, combined state plus local rates average 7.95 percent in Kansas but only 6.39 percent in Nebraska.

Scenario 2: New Firm Receiving Incentives, Other Costs at National Levels

Scenario 2 considers the situation of a new firm that qualifies for economic development tax incentives. Tax incentives often overlap: a state may have three or four different programs that give credits for additional jobs and investment. It is assumed that the firm takes advantage of the program that gives the largest credits for which the firm qualifies.

However it is assumed that the firm does *not* limit its location to an enterprise zone, usually located in depressed areas of a state. The exception is Colorado, where enterprise zones blanket most non-metro areas of the state, and where enterprise zones are available in major cities such as Denver and Pueblo.

As seen in Table 2.5, the tax climate for new manufacturing firms is favorable in Kansas.

Recall in Scenario 2, all costs except taxes are held constant across locations, so differences in costs are due solely to tax structure.

Kansas is the third lowest tax state in the region for both the light manufacturing and the capital intensive manufacturing firms. Kansas combines generous property tax abatements with the PEAK (Promoting Employment Across Kansas) program, which allows qualified employers to keep a portion of employee withholding taxes. The PEAK program requires that employees be paid at least the average county-level wage, which reduces its value for lower-wage industries.

… the tax climate for new manufacturing firms is favorable in Kansas.

Table 2.3
Total Costs Including Taxes
Scenario 1: Established Firm Receiving NO Incentives, Other Costs at National Levels
Total Cost per Employee, Annual Average

	Light Manufacturing	High-Tech Capital-Intensive Mfg.	Administrative Back Offices	Exportable Services
Colorado	$132,353	$451,052	$70,031	$156,229
Iowa	132,256	449,379	70,682	155,906
Kansas	132,769	451,101	70,919	156,500
Missouri	133,218	452,897	70,596	156,509
Nebraska	132,291	451,127	70,068	156,461
Oklahoma	132,800	453,082	70,429	156,102
Texas	133,274	453,535	70,392	157,128
Regional Median	$132,769	$451,127	$70,429	$156,461
Kansas as % of Reg. Median	100.0%	100.0%	100.7%	100.0%

Source: Calculated by authors using KU Tax and Cost Model.

Table 2.4
Tax Breakout
Telecommunications Equipment Manufacturing
Scenario 1: Established Firm Receiving NO Incentives, Other Costs at National Levels
Dollars per Employee

	Kansas	Colorado	Iowa	Missouri	Nebraska	Oklahoma	Texas	Regional Median	Kansas as % Region
Sales	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	100.0%
Non-tax Costs	416,064	416,064	416,064	416,064	416,064	416,064	416,064	416,064	100.0%
Taxes	35,037	36,834	33,316	36,834	35,063	37,019	37,823	36,834	95.1%
Federal Income Tax	25,345	25,264	26,106	24,351	25,200	24,299	24,299	25,200	100.6%
State Taxes	9,692	12,483	7,210	12,483	9,863	12,720	13,524	12,483	77.6%
State Income Tax	3,838	346	718	2,110	572	3,177	265	718	534.5%
Unemp, Wrk Comp	1,924	1,345	1,944	2,152	1,801	2,663	2,827	1,944	99.0%
Property	1,880	6,298	2,141	6,346	5,807	4,034	8,288	5,807	32.4%
Franchise	0	0	25	179	300	200	0	25	0.0%
Sales	2,050	1,736	2,382	1,696	1,383	2,646	2,144	2,050	100.0%

Source: Calculated by authors using KU Tax and Cost Model.

the Kansas tax situation is less favorable for the administrative back office establishment. Many of the reasons are the same as those for an existing firm (Scenario 1).

In addition, the wage rate is too low to qualify for the important PEAK tax reduction in many Kansas counties—it is assumed that PEAK does not apply for the administrative office firm.

Although taxes for the administrative office are slightly higher in Kansas than in other states, tax differences are small and might be compensated for by differences in quality of life or other factors.

Although taxes for the administrative office are slightly higher in Kansas than in other states, tax differences are small and might be compensated for by differences in quality of life or other factors.

Kansas ranks in the middle of the region for the exportable services firm. The firm's high wage levels make it eligible for PEAK incentives in Kansas. But at the same time, the firm's high wages make it eligible for performance-based incentives in other states such as Nebraska.

Kansas ranks in the middle of the region for the exportable services firm. The firm's high wage levels make it eligible for PEAK incentives in Kansas.

Property tax abatements and equipment exemptions may sweeten the deal in Kansas. Although the firm does not purchase as much capital per employee as a typical manufacturer, capital levels are much higher than for back office establishments.

Details on tax costs for a hypothetical capital intensive manufacturing firm are provided in Table 2.6. This scenario holds non-tax costs constant to isolate the role of taxes.

Kansas is below the median value for sales and use tax. Kansas is significantly below the median for property taxes for the new capital intensive manufacturing firm. The average property tax per employee in Kansas is $1,006, or 37.6 percent of the region median. The amount varies from $537 in Iowa to $4,784 in Texas. Kansas is 90 percent higher than the median state income tax; in absolute dollars, the difference is $342 per employee.

Unemployment and workers' compensation are the third highest tax cost for businesses in Kansas. The range in the region is $1,345 in Colorado to $2,829 in Oklahoma. Kansas' costs average $1,924 per employee per year.

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Table 2.5
Total Costs Including Taxes
Scenario 2: New Firm Receiving Incentives, Other Costs at National Levels
Total Cost per Employee, Annual Average

	Light Manufacturing	High-Tech Capital-Intensive Mfg.	Administrative Back Offices	Exportable Services
Colorado	$132,028	$450,261	$69,910	$155,989
Iowa	131,926	447,888	70,611	156,598
Kansas	131,343	448,185	70,629	156,084
Missouri	131,735	449,869	70,295	156,080
Nebraska	131,510	385,709	69,514	154,977
Oklahoma	131,596	450,570	69,989	154,390
Texas	132,394	451,230	70,180	156,709
Regional Median	$131,735	$449,869	$70,180	$156,080
Kansas as % of Reg. Median	99.7%	99.6%	100.6%	100.0%

Source: Calculated by authors using KU Tax and Cost Model.

Table 2.6
High-Tech Capital Intensive Manufacturer
Scenario 2: New Firm Receiving Incentives, Other Costs at National Levels
Dollars per Employee

	Kansas	Colorado	Iowa	Missouri	Nebraska	Oklahoma	Texas	Regional Median	Kansas as % Region
Sales	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	100.0%
Non-tax Costs	416,064	416,064	416,064	416,064	416,064	416,064	416,064	416,064	100.0%
Taxes	32,121	33,804	31,825	33,804	30,356	34,506	35,573	33,804	95.0%
Federal Income Tax	26,771	25,670	26,867	25,890	27,541	25,542	25,542	25,890	103.4%
State Taxes	5,350	7,914	4,958	7,914	2,815	8,964	10,031	7,914	67.6%
State Income Tax	722	263	380	1,257	-2,885	1,084	265	380	190.0%
Unemp., Wrk Cmp	1,924	1,345	1,944	2,152	1,801	2,663	2,827	1,944	99.0%
Property	1,006	5,183	537	3,170	2,675	2,600	4,795	2,675	37.6%
Franchise	0	0	25	175	300	200	0	25	0.0%
Sales	1,698	1,736	2,072	1,160	924	2,417	2,144	1,736	97.8%

Source: Calculated by authors using KU Tax and Cost Model.

Estimating the Value of Tax Incentives

The value of tax incentives for firms locating in Kansas can be seen by looking at the differences between Scenario 1 and Scenario 2. Scenario 1 models an established firm with no incentives. Scenario 2 models a new firm that receives incentives. The firms are identical in all other ways except tax treatment. Therefore, the difference between the scenarios estimates the value of incentives that are given to new firms.

Table 2.7 below shows the average annual value of incentives for a new firm locating in Kansas. On an annual basis, a firm in the light manufacturing receives about $1,400 on average per employee in incentives while a firm in the high-tech capital intensive industry receives over $2,900 on average per employee. The value of Kansas incentives for back offices averages about $300 per year, while the value for exportable services averages about $400.

In Kansas, incentives generally prevail for 10 or fewer years, so the incentives received are higher than average in early years and taper off in the remaining years.

The efficacy of targeted economic development incentives is disputed (Bartik 2005; Papke 1994; Shane 2009; Neumark 2010; Kolka and Neumark 2010; Schragger 2010; Wilson 2009; Liard-Muriente, C. F. 2007). Nevertheless, the models presented here confirm that established businesses pay higher tax costs in Kansas compared to new firms.

Table 2.7

Value of Incentives for Firms Locating in Kansas

Difference of Scenarios 1 and 2 – constant costs

Dollars per Employee, Annual Average

	Light Manufacturing	High-Tech Capital Intensive Mfg.	Administrative Back Offices	Exportable Services
Scenario 1 (established firm)	$132,769	$451,101	$70,919	$156,500
Scenario 2 (new firm)	$131,343	$448,185	$70,629	$156,084
Incentive Value = 1 – 2	$1,426	$2,916	$290	$416

Source: Calculated by authors using KU Tax and Cost Model.

Scenarios 3: Established Firm Receiving NO Incentives, Other Costs at Local Levels

This scenario builds upon Scenario 1 by introducing differences in wage rates, construction costs, land cost, and energy costs across states. Scenarios 3 and 4 are more realistic in this sense. But as mentioned previously, the impacts of taxes and tax incentives are comingled with the impacts of differential basic business costs.

When differential costs as well as taxes are taken into account, Kansas appears to provide a competitive environment for established firms in a range of industries.

When differential costs as well as taxes are taken into account, Kansas appears to provide a competitive environment for established firms in a range of industries.

Labor is a competitive value in Kansas and this improves the ranking of the administrative back office facility (compared with Scenario 1).

Administrative offices and exportable service firms use substantial amounts of labor (relative to capital). Facilities that are very labor intensive gain an advantage from locations where labor costs are low.

Table 2.8

Total Costs Including Taxes

Scenario 3: Established Firm Receiving NO Incentives, Other Costs at Local Levels

Total Cost per Employee, Annual Average

	Light Manufacturing	High-Tech Capital-Intensive Mfg.	Administrative Back Offices	Exportable Services
Colorado	$132,726	$452,332	$70,353	$157,167
Iowa	126,053	440,064	66,846	148,016
Kansas	127,879	443,237	67,667	148,572
Missouri	129,604	447,700	68,241	150,554
Nebraska	125,770	361,054	65,921	146,577
Oklahoma	126,897	445,034	66,573	146,722
Texas	132,712	452,781	70,126	156,827
Regional Median	$127,879	$445,034	$67,667	$148,572
Kansas as % of Reg. Median	100.0%	99.6%	100.0%	100.0%

Source: Calculated by authors using KU Tax and Cost Model.

Measuring the Impact of Input Costs

Scenarios 1 and 3 both show an established firm that receives few tax incentives. In Scenario 1, all costs are standardized at US average levels to isolate the impact of taxes alone. Scenario 3 adds back differences in selected input costs. Differences in basic costs impact tax liabilities, because many costs are deductable from revenues when calculating taxable income.

Table 2.9 presents the difference between Scenarios 1 and 3. Overall costs (including taxes) are affected by the basic business cost structure of the state in which the firm locates.

The impacts are large in dollar terms. For example, an established high-tech capital intensive manufacturing firm in Kansas would save almost $8,000 per employee on an annual basis compared with a similar firm in a state where costs were close to the US average.

The low cost structure of Kansas provides more economic benefits to firms than tax incentives offered to start-ups.

Substantial savings are also estimated for the other industries in the model.

Note that the impacts of low-to-moderate basic business costs, as are found in Kansas, are larger than the impacts of incentives that were spelled out in an earlier table. The low basic cost structure of Kansas provides more economic benefits to firms than tax incentives offered to start-ups.

Table 2.9

Value of Low Basic Business Costs for Firms Locating in Kansas

Difference of Scenarios 1 and 3

Dollars per Employee, Annual Average

	Light Manufacturing	High-Tech Capital Intensive Mfg.	Administrative Back Offices	Exportable Services
Scenario 1 (US standardized costs)	$132,769	$451,101	$70,919	$156,500
Scenario 3 (Local Costs)	127,879	443,237	67,667	148,572
Input Cost Value = 1 – 2	$4,,890	$7,864	$3.252	$7,928

Source: Calculated by authors using the KU Tax and Cost Model.

Scenario 4: New Firm Receiving Incentives, Other Costs at Local Levels

The final scenario looks at a firm that receives incentives and where basic business costs are set at statewide levels. Table 2.10 indicates that Kansas should be able to attract a variety of firm types, based on its incentives and basic business costs.

Costs are at or below the regional median. For manufacturers, particularly capital intensive manufacturers, property tax exemptions and abatements create a favorable business climate. Incentives such as PEAK also give Kansas an edge.

For administrative office establishments and exportable services, which are very labor intensive, moderate labor costs tilt the scale in favor of Kansas.

Table 2.10
Total Costs Including Taxes
Scenario 4: New Firm Receiving Incentives, Other Costs at Local Levels
Total Cost per Employee, Annual Average

	Light Manufacturing	High-Tech Capital-Intensive Mfg.	Administrative Back Offices	Exportable Services
Colorado	$132,408	$451,548	$70,235	$156,937
Iowa	125,744	438,633	66,778	147,852
Kansas	126,488	440,396	67,383	148,162
Missouri	128,147	444,729	67,930	150,115
Nebraska	125,079	365,362	65,439	144,838
Oklahoma	125,876	442,840	66,209	145,303
Texas	131,892	450,535	69,940	156,438
Regional Median	$126,488	$442,840	$67,383	$148,162
Kansas as % of Reg. Median	100.0%	99.4%	100.0%	100.0%

Source: Calculations by authors using the KU Tax and Cost Model.

Summary

The KU Tax and Cost Model provides a flexible tool for assessing the impacts of taxes and other business costs on the competitiveness of alternative business locations.

Although the model is based on average firms in select industries, it can be modified to account for the particular characteristics of a firm that might be considering a Kansas location.

The results of the model show that both established and new firms face moderate taxes and costs in Kansas.

Kansas usually ranks at or below the regional median in terms of overall costs. Kansas is not the lowest cost state in the region, but business location decisions are not made on costs alone.

Other Kansas advantages (discussed in Chapter 6) such as good infrastructure and a favorable regulatory climate, combined with moderate taxes and costs, provide a competitive environment for established and new firms.

Chapter 3: The Sales/Use Tax

Introduction

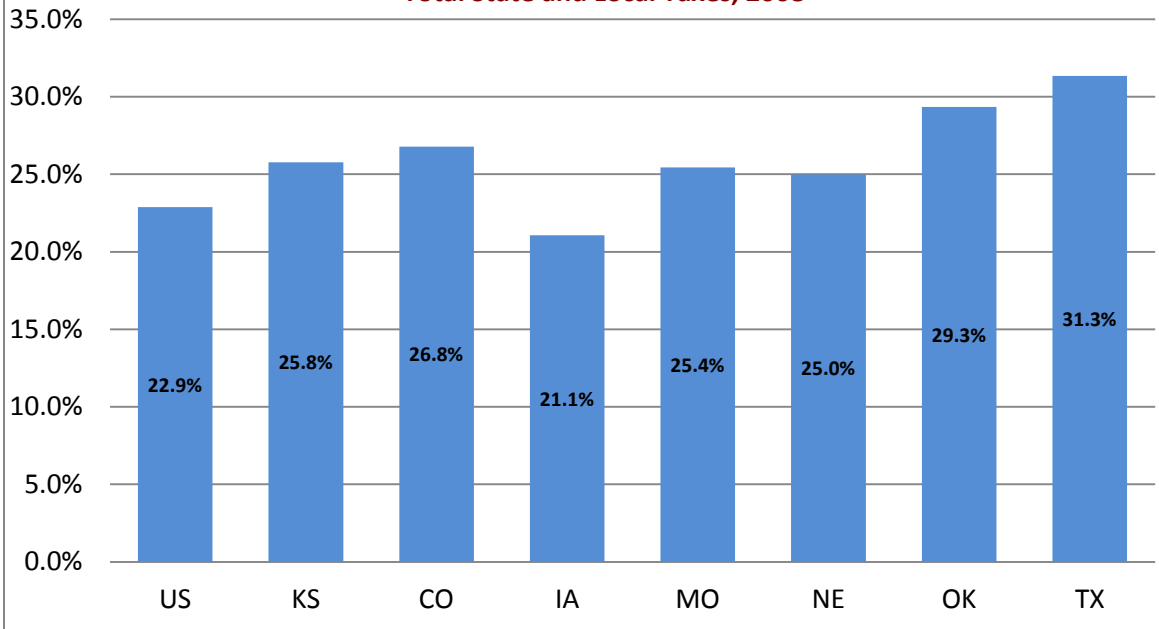
Sales tax collections comprise an essential part of state and local tax systems in the United States. Forty-five states impose a general *ad valorem* tax on retail sales, gross receipts, or some other similar tax base. Local governments in 36 states, including all of the states in this study, also impose some form of general sales tax.

Sales and use taxes are complimentary taxes; sales taxes are collected by all vendors with nexus in a state and use taxes are remitted by end-users if sales tax was not paid on goods and services used in a state.

In general, the tax rates and the tax bases are identical for sales and use taxes. Therefore, summary data in the tables and graphs in this chapter combine both revenue sources.

Sales tax revenues in Kansas made up nearly 26 percent of total state and local tax revenues in 2008, as shown in Figure 3.1. Kansas is fairly typical for the region, and its share of total state and local tax revenue attributable to sales tax revenue was nearly the same as the percentages in Colorado, Missouri, and Nebraska.

Figure 3.1
State and Local Sales and Use Tax as Percent of Total State and Local Taxes, 2008



Source: US Census Bureau, State and Local Finance Tables. Calculations by University of Kansas.

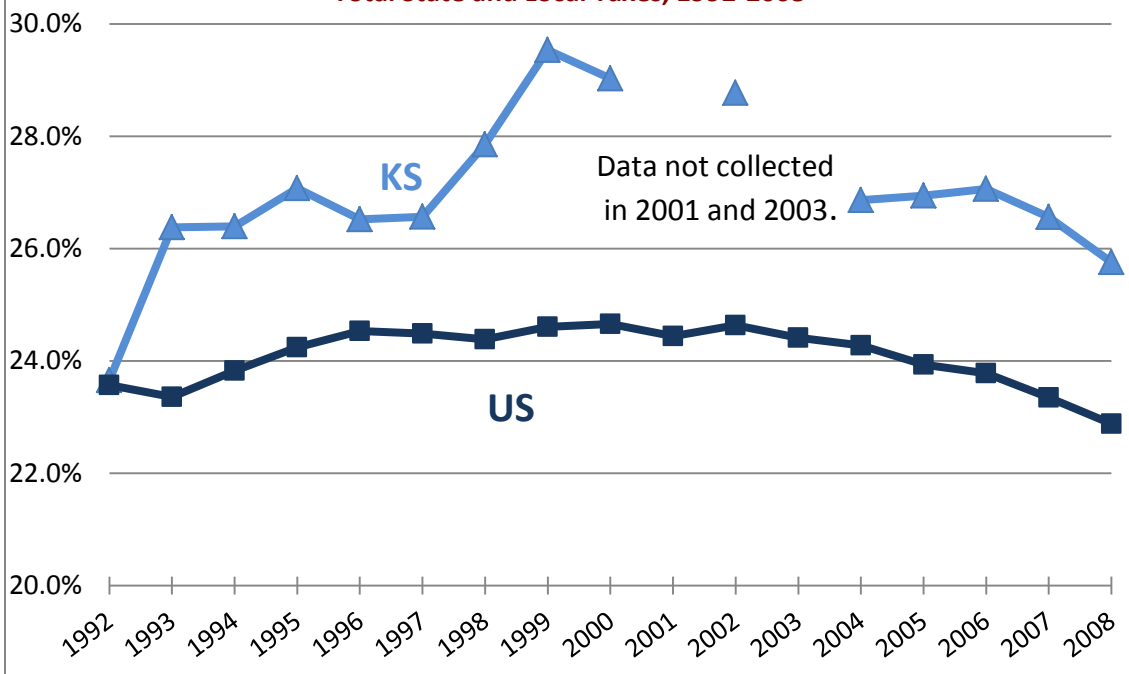
In 2008, the US average was 22.9 percent. In the region, sales and use taxes as a share of total taxes ranged from only 21.1 percent in Iowa to 31.3 percent in Texas, which had an extremely large reliance on sales tax revenues.

Sales tax revenues in Kansas made up nearly 26 percent of total state and local tax revenues in 2008…

Looking at a 17-year trend in Figure 3.2, sales taxes are a growing part of tax collections in Kansas, and, to some extent, in the rest of the region. The share of total collections comprised by the sales tax for the United States as a whole changed little during the last decade.

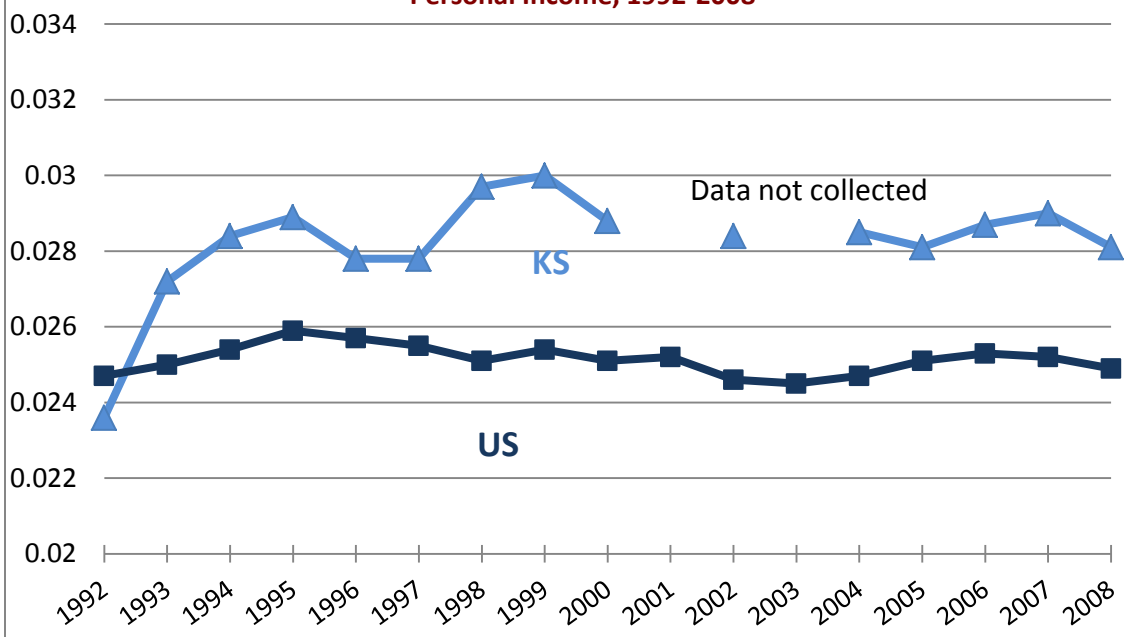
The percentage of state and local taxes from sales and use taxes increased rapidly in Kansas in the 1990s. It then declined in more recent years. This percentage rose from 23 percent (1992) to 29.5 percent (1999), and has since declined to 25.8 percent in 2008.

Figure 3.2
State and Local Sales and Use Tax as Percent of Total State and Local Taxes, 1992-2008



Source: US Census Bureau, State and Local Finance Tables.
Calculations by University of Kansas.

Figure 3.3
State and Local Sales and Use Tax as Percent of Personal Income, 1992-2008



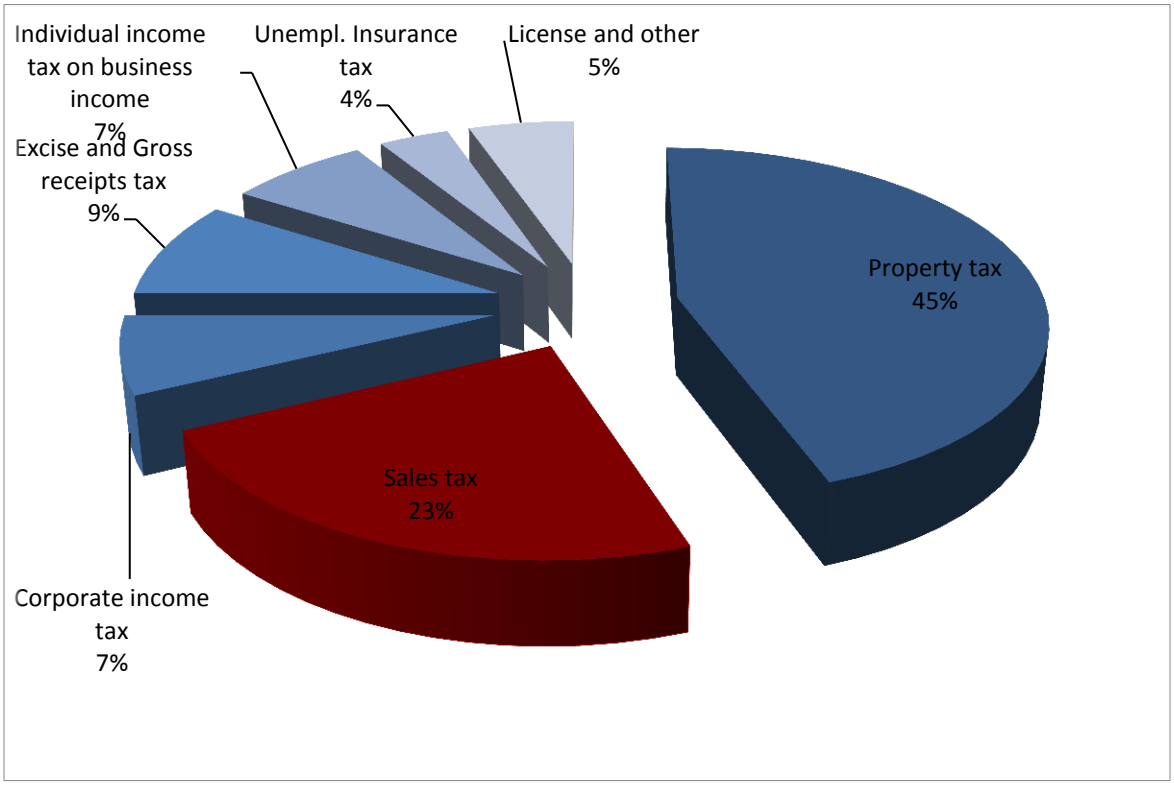
Source: US Census Bureau, State and Local Finance Tables.
Calculations by University of Kansas.
Note: State-level data not available for 2001 and 2003.

An alternative measure of a tax burden is to compare taxes to personal income. Figure 3.3 presents a 17-year analysis of Kansas and US sales tax burden as a percent of personal income. In all years since 1993, the Kansas average has exceeded the US average. In 2008, state and local sales/use taxes represented 2.8 percent of personal income in Kansas. The US average in 2008 was 2.5 percent.

A final measure of the tax burden is to examine the share of sales and use taxes as a share of the taxes shouldered by *businesses*. Figure 3.4 presents the total business taxes incurred by percentage. In 2009, sales/use represented 23 percent of Kansas business taxes, on average.

Figure 3.4

Kansas State and Local Business Tax Burdens



Source: Total State and Local Business Taxes (2010); Calculations by author.

Sales Tax Rates

State-level sales tax rates in the region range from a low of 2.9 percent in Colorado to a high of 6.3 percent in Kansas (see Table 3.1). Prior to July 1, 2010, the Kansas rate was 5.3 percent. When the state rate is combined with the average city and county sales tax rates, the region varies from about 6.4 percent in Nebraska to 8.3 percent in Oklahoma. The Kansas average is 7.95 percent.

Table 3.1

Sales/Use Tax Rates, 2010

	State ONLY Sales/Use Tax	Average Combined State/City/County
Nebraska	5.500%	6.390%
Colorado	2.900%	6.970%
Iowa	6.000%	7.000%
Missouri	4.225%	7.455%
Texas	6.250%	7.610%
Kansas	6.300%	7.950%
Oklahoma	4.500%	8.330%

Source: Tax Foundation. *State and Local-Option General Sales Tax Rates.* August, 2010.

Local sales taxes add to the tax burden, and in some jurisdictions, rival or exceed state taxes in magnitude. For example, local taxes in Colorado can be as high as 7 percent–more than double the state rate. Within the immediate region, combined county, city, and special district local taxes are imposed as follows:

- Kansas City, Missouri–3.25 to 5.00 percent
- Kansas City, Kansas–2.625 to 3.625 percent
- Overland Park (Johnson County, Kansas)–2.35 to 3.35 percent
- Topeka–2.65 percent
- Wichita–1 percent

Local sales taxes vary widely within individual states. In some states, including Kansas, Missouri, Texas, Oklahoma, and Colorado, local sales taxes are prevalent; in the remaining states, Iowa and Nebraska, local sales taxes average one percent or less. are negligible.

Sales Tax Base

Most states use a fairly broad concept of retail sales in defining their sales tax bases. In fact, the sales tax combines elements of a direct tax on:

- Consumption
- Investment
- Production

The extent to which each of these three activities is taxed depends on state-specific rules for sales tax exemptions and inclusions. Sales taxes also have a second round or indirect impact. For example, a tax on business inputs may increase the price of products purchased by households. This "cascading" or "pyramiding" of tax on inputs is a negative consequence of consumption taxes. Cascading is discussed in detail in Chapter 7: State Tax Considerations.

Consumption

States directly tax consumption when sales taxes are levied on purchases commonly made by households. Most tangible consumer products are included in the sales tax base, but states commonly make exceptions for food and drugs. Among the states in this study, Colorado, Iowa, Nebraska, and Texas exempt groceries, and Missouri reduces the state sales tax rate by 3 percent for food. However, Colorado has imposed the state sales tax on candy and soft drinks beginning in May 2010. In the past, efforts have been made in Kansas to repeal sales tax on food for human consumption–none of which has been successful. However, for qualifying low-income consumers, there is a food sales tax refund available, typically claimed as a reduction in state income taxes.

All the states in this study exempt medical services. States also include selected consumer *services* in the tax base. These may include the following services:

- Residential utilities
- Telephone bills
- Restaurant meals (sometimes considered a good rather than a service)
- Hotels
- Personal services (e.g., haircuts)

Investment

Sales taxes impact investment when states levy taxes on the purchase of machinery, equipment, tools, construction materials and construction services, or repairs. All of the states in this study make some provisions for machinery and equipment exemptions, and most make provisions for the exemption of construction materials. The specific requirements for exemption vary widely by state. Criteria by which these exemptions can be compared include the extent to which exemptions are:

- Limited to certain industries, particularly manufacturing
- Limited to direct use in the production processes and exclude auxiliary machinery and equipment
- Limited to new firms (broadened in enterprise zones or other distressed areas)

Kansas

The basic investment exemption in Kansas applies to machinery and equipment used directly in any of the following:

- Manufacturing
- Assembling
- Processing
- Warehousing
- In-plant distribution of goods intended for resale

In 1998, the exemption was extended to include the following investments:

- Replacement parts
- Components
- Accessories for machinery and equipment

Labor services for new construction (whether or not in manufacturing) are also exempt, as are the construction materials themselves, for qualified new or expanding business. *Note:* Building supplies and labor services used in remodeling are not exempt.

For qualifying new or expanding firms, the exemptions are much broader. They extend to all property, including the following:

- Machinery
- Equipment
- Building supplies
- Services used in constructing, expanding, or remodeling a facility

To qualify for the "new or expanding" designation, firms must add a certain number of jobs. The specific number varies by industry:

- Manufacturing industry firms must add two jobs to receive the designation.
- Non-manufacturing industry firms (i.e., any commercial enterprise other than manufacturing or retail) must add five jobs.
- Retailers must add two jobs and be located in communities with a population of 2,500 or less to qualify.
- Corporate headquarters, computer services firms, and firms in selected other business service industries may be granted a sales tax exemption if the investment leads to the creation of at least 20 new full-time jobs.

The new or expanding firm designation augments the basic machinery and equipment investment exemption in three ways:

1. Construction materials and construction labor services receive an exemption. Ordinarily, all building materials would be taxed, as would any labor associated with remodeling or repair.

2. Establishments, such as corporate headquarters and service-oriented businesses not covered under the basic investment exemption may qualify.

3. Machinery and equipment of manufacturers that does not qualify under the "direct use" criterion may receive an exemption.

Iowa

The basic investment sales tax exemption in Iowa applies to machinery, equipment, and computers, including replacement parts, that are used directly and primarily in:

- Processing
- Research and development of new products
- Manufacturing
- Recycling

The design and installation of such equipment is also exempt, and the exemption applies to insurance companies, financial institutions, or commercial enterprises when the equipment or computers are used in data processing or storage. In addition, most labor services related to new construction, remodeling, and restoration are exempt, but those related to structural repairs are not.

One of the business incentive programs Iowa offers is the New Jobs and Income program. For firms that qualify, businesses can claim a sales tax exemption for industrial machinery, equipment, and computers, if the equipment is directly related to the new jobs created by the location or expansion of the eligible business.

Missouri

Missouri's sales tax exemptions are somewhat less generous than the other states studied. The original purchase of machinery and equipment is exempt only for:

- New or expanding manufacturing firms
- When the machinery and equipment will be used directly in the fabrication of a product intended to be sold for final use or consumption.

However, for established firms that are not expanding, all replacement machinery, equipment, and parts are exempt, but again, only so long as they are used directly in the fabrication of a product intended to be sold for final use or consumption.

Oklahoma

Oklahoma has a broad machinery and equipment exemption: as long as the purchases are for use in a "manufacturing operation," they are not subject to sales tax. Before 1998, the machinery and equipment had to be directly *used* in the operation, which is similar to the exemptions in the rest of the states in this study. All tangible personal property sold to qualified manufacturers that is consumed or incorporated into a new and expanding

facility is exempt; this has the impact of adding construction materials and supplies to the exemption list. Oklahoma also extends sales tax exemptions to computer service firms, and firms that derive specified percentages of their sales from out-of-state customers.

Production

Production, in contrast to consumption or investment, is taxed to the extent that the following types of purchases enter the sales tax base:

- Materials
- Utilities
- Fuels
- Business services
- Other production-related purchases

Laws covering products that are consumed during production vary widely across the states.

The following are a few points to consider about production:

- All states with a sales tax include some items that are purchased by businesses. Examples often include office furniture, office supplies, and cleaning supplies.
- All states exclude, to some extent, materials that become incorporated into new goods. For example, the hard drive that goes into a computer manufactured in a state is not taxable to the computer manufacturer. The extent to which states tax these "intermediate goods" varies.
- Ingredients are also generally exempt, although whether a good is an ingredient is sometimes disputed.
- Laws covering products that are consumed during production vary widely across the states.

In addition, laws covering taxation of energy vary. All states in the study allow some exemptions for electricity, gas, and other energy. For most of these states, electricity, gas, and other industrial fuels are exempt when used directly in the manufacturing process. Several states extend exemptions beyond the narrow definition of manufacturing. For example, Kansas includes mining, irrigation, and service producing processes. On the other hand, some states provide a narrower exemption; Missouri, for example, exempts electricity only when it exceeds 10 percent of the overall production costs.

More States Consider Taxation of Services

Most sales and use taxes were enacted in the 1930's when the economy was primarily based upon the sale of goods. In the United States, a growing percentage of personal consumption is of services instead of goods. Examining Gross Domestic Product (GDP) at the national level, households decreased their consumption of durable and nondurable goods (except for groceries) from 30 percent of total consumption in 1970 to 22 percent in 2009. At the same time, consumption of services increased from 31 percent of total consumption to 48 percent.

To keep pace with these declining expenditures on sales-taxable goods, states

traditionally have raised sales tax rates rather than expanding the tax base itself, even though, in many cases, the base was defined decades ago before many modern-day services existed (e.g., the internet or cellular communications). However, states are increasingly realizing the inequity between taxing goods but exempting similar services. For example, a vacuum cleaner is subject to sales tax but housekeeping or janitorial services are exempt. It is becoming more common to examine services as a potential source of sales tax revenues.

A recent report by the Center on Budget and Policy Priorities (Mazerov, 2009) attempted to quantify what additional revenues states might expect if they extended their sales tax to what they call "readily-taxable" services. These are defined as all services consumed by households except for: housing, healthcare, education, transportation, banking, insurance, legal, and funeral services.

For Kansas, the estimate of revenues from sales taxes on services came to $749 million, an amount equal to nearly 33 percent of total 2007 sales tax revenues (Mazerov, 2009). Of course, few states could politically afford to tax all personal services, and in any case, *new* revenues would be less than the estimate provided because states (including Kansas) already tax some of those services.

Many states now include services sold to consumers and businesses in their sales/use tax bases. The Federation of Tax Administrators (FTA) provides a systematic overview of service taxation as of 2007. It remains the sole source of comprehensive data on state taxation of services, and is included here as an indicator of the general pattern among states of their differing levels of service taxation.

The organization examined taxation of some 160 services, including:

- Utilities (business and household)
- Consumer personal services
- Business services
- Installation and repair

The study found a great deal of diversity in the extent to which states include services in the sales tax base. Of the services covered by the FTA study, some states (e.g., Hawaii) taxed almost all services, while others (e.g., Oregon and Alaska) taxed relatively few. An overview of sales tax on services is presented in Table 3.2.

Among the states in the region covered by the study, the FTA reported that:

- Iowa stood out as taxing a high number of services, including 94 services in its sales tax base.
- Kansas also taxed a substantial number of services (74), but less than Iowa in the area of business services, personal services, and utilities.
- Colorado taxed the smallest number of services (14), limiting its sales tax base almost exclusively to material products.

Table 3.2

Number of Services Subject to Sales/Use Tax by State

	Utilities	Personal Services	Business Services	Computer Services	Admissions/ Amusement	Professional Services	Fabrication/ Repair	Other Services	Total
CO	4	0	2	1	2	0	3	2	14
MO	8	1	2	2	10	0	0	3	26
OK	9	3	4	1	10	0	0	5	32
KS	10	11	9	1	13	0	15	15	74
NE	14	9	14	3	12	0	13	12	77
TX	12	10	14	8	12	1	10	16	83
IA	13	15	18	1	14	0	13	20	94
Total	16	20	34	8	15	9	19	47	168

Source: Federation of Tax Administrators 2008. FTA Survey of Services.

Because retailers collect sales tax while many service providers do not, local governments may be incentivized to pursue retail establishments rather than attract businesses that provide non-taxable services.

Local governments do not have income taxes and are thus, more dependent upon sales/use taxes than the state government. Because retailers collect sales tax while many service providers do not, local governments may be incentivized to pursue retail establishments rather than attract businesses that provide non-taxable services.

Sales Tax Exemptions

Most states have codified the types of industries that receive tax-exemption for services (e.g., non-profits have sales tax exemption in many states). It is important to note that each exemption is equivalent to an expenditure because it is a direct subsidy to certain taxpayers.

Forgone revenue must either be replaced with revenue from another source, or state services and expenditures must be reduced. Cutting taxes versus cutting spending is a policy question left for elected officials and the citizens that they represent. Likewise, the decision of who receives the most benefits from a tax system is also left to policymakers.

Regardless of the size of the subsidy or its beneficiary, codifying the criteria for sales/use tax exemptions provides several benefits to businesses and taxpayers. First, businesses have clear guidance on exemptions and do not have to participate in the political process to receive exemptions; when laws are stable and clear, taxpayers incur fewer legal costs when doing business in a state. Second, taxpayers may also benefit from the codification of a single set of rules governing exempt entities. Such a regime change would require a public and open discourse about what tax expenditures (through exemption) the citizens support.

Some tax law provisions are designed to target only a single firm, group, or industry. These provisions often are held in low regard by taxpayers and citizens groups as they often are crafted in an opaque process and appear to provide private entities with public goods. For example, Steve Rose, a Johnson County publisher, criticizes the sales tax exemption granted to *Jazz in the Woods:*

"I may not make any friends by bringing this up, but fair is fair. This is a fundraising event held annually in Corporate Woods. Do you know how many other fundraising events are held in Johnson County that *do* collect sales taxes? Too many to count. (Rose, 2010)."

A codification would include a debate on the costs and fairness issues associated with sales/use tax exemptions; individuals would likely benefit if the debate led to broadening the tax base (with fewer exemptions) and reducing the overall rate.

As with the corporate tax, states are revising sales/use tax laws to reflect the current business climate in which services are often more valuable than goods and in which these big ticket services can be performed worldwide.

The corporate income tax represents a relatively small share of Kansas tax revenue, so any change to that tax regime would have only a marginal impact on tax collections. In contrast, revising the sales/use tax exemption laws could dramatically change total tax collections while harmonizing the disparate tax treatment of similarly situated groups.

Table 3.3 presents exemptions by category. This table does not identify the other exemptions for specific goods and specific entities, or the "single target" provisions as discussed above.

Potential U.S. Adoption of Value-Added Taxes Has Planning Implications for States

Another issue states may need to consider is the value-added tax (VAT), also called a Goods and Services Tax (GST). This is a system for collecting tax on the final sales price of goods and services as value is added at each step in the manufacturing and distribution process. Each processor pays VATs to their supplier and receives a credit for VAT when the good is resold. The VAT is destination based, but exports are tax-free.

The VAT has been adopted in about 140 countries. In many countries, the VAT has replaced other types of consumption taxes. The expansion of VAT across Europe is attributed to several factors including the fact that it:

- Raises considerable revenue
- Is broad-based (i.e., it includes goods and services)
- Avoids double taxation or cascading taxes
- May be less vulnerable to evasion
- Is required for European Union membership

Were the U.S. Congress to adopt VAT to achieve a budgetary goal, such as reducing corporate tax rates or reducing deficits, states would face a number of important decisions regarding the state tax regime.

Table 3.3

Goods and Services Subject to Sales/Use Tax by State

		CO	IA	KS	MO	NE	OK	TX
CLOTHING		T	T	T	T	T	T	T
COMPUTERS CANNED SOFTWARE		T	T	T	T	T	T	T
COMPUTERS CUSTOM SOFTWARE		E	E	E	E	T	E	T
COMPUTERS CUSTOM OF CANNED SOFTWARE		T	T	T	T	T	T	T
DIGITAL PRODUCTS		T	E	E	E	T	E	T
DROP SHIPMENTS*		Y	Y	Y	Y	Y	Y	Y
FOOD AND MEALS	Caterers	T	T	T	T	T	T	T
	Groceries	E	E	T	T	E	T	E
LEASES AND RENTALS	Vehicles	T	T	T	T	T	T	E
	Room/lodging	T	E	T	T	T	T	E
	Tangible personal prop	T	T	T	T	T	T	T
MANUFACTURING AND MACHINERY	Machinery	E	E	E	E	E	E	E
	Raw materials	E	E	E	E	E	E	E
	Utilities/fuel	E	E	E	E	E	E	E
MEDICINES, MEDICAL SERVICES AND DEVICES	Medicine	T	T	T	T	T	T	E
	Medical services	E	E	E	E	E	E	E
	Medical devices	E	E	E	E	E	T	E
NEWSPAPERS AND PERIODICALS	Newspaper	E	E	T	T	E	E	E
	Periodicals	T	T	T	T	T	E	T
OCCASIONAL SALES	Occasional sales	T	E	E	E	E	T	E
	Occasional sales-vehicles	T	T	T	T	T	E	E
OPTIMAL WARRANTY AGREEMENTS	Optimal maintenance contract	E	T	T	E	T	E	T
	Parts purchased for used in performing services	T	E	E	T	E	T	E
POLLUTION CONTROL EQUIPMENT	Provides Exemption (E)	E	E	E	E	E	E	E
SALES FOR RESALE**		MTC	MTC	MTC	MTC	MTC	MTC	MTC/BSC
SALES TO STATE AND LOCAL GOVERNMENT		E	E	E	E	E	E	E
SERVICES-REPAIR	Labor only	E	T	T	E	T	E	T
SERVICES-PROFESSIONAL PERSONAL		E	T	E	E	E	E	T
SERVICES-TRANSPORTATION		E	E	E	T	E	T	E
SERVICES-JANITORIAL		E	T	E	E	T	E	T
TRADE-INS	Included (I) or excluded (E) in sales tax price	E	E	E	E	E	I	E
VENDING MACHINE SALES	Food	E	T	T	T	T	T	T
	Merchandise	T	T	T	T	T	T	T

Source: Commerce Clearinghouse 2010.

E=Exempt and T=Taxable

*Drop Shipment rules allow a seller with nexus to claim a resale exemption on a transaction when it drop ships property to a consumer in the state on behalf of a customer/re-seller who is not required to collect tax in the state (Y). ** State follows the Multistate Tax Commission Uniform Multijurisdiction Exemption Certificate (MTC) and/or the Border States Uniform Sales for Resale Certificate (BSC).

States will need to consider whether they should:

- Piggyback on the federal VAT
- Continue with their current tax structures for sales and income and property taxes
- Do some combination of these

Although the VAT is widespread, not all nations have quickly or quietly adopted the VAT. In Canada, the Tories suffered their worst defeat in 1993, losing 149 of their 151 seats in parliament after imposing a VAT tax (GST).

The VAT has the potential to quickly outstrip the income tax in terms of government revenue collection. Many experts (for example Paul Volker, former Federal Reserve Chairman) believe that the U.S. should give the VAT serious consideration (Murphy, 2010).

Any state undertaking tax reform in 2010 should be aware that they may be back at the drawing board in a few years. States may strategically decide to be early adopters of a broad-based consumption based tax in anticipation of a federal VAT. But again, there is considerable political and economic risk if a state adopts an entirely new tax structure that is unpopular with businesses, localities, and voters.

Summary

Sales taxes comprise one-third of state and local tax revenue. The sales/use tax represents over one-fourth of the business tax burden. The impact of the sales tax falls on consumption, investment, and production.

States differ greatly in their definitions of the sales tax base and in the exemptions they allow for various goods and services. Exemptions on machinery and equipment, installation (construction) and repair, and energy stand out as providing significant cost savings to firms and impacting a state's competitiveness.

Combined state and local sales tax rates put Kansas in the middle of the region. Businesses benefit from generous Kansas sales tax exemptions on many investment purchases:

- Manufacturing
- Warehousing
- Processing equipment
- Original construction
- Most investment-type expenditures of new and expanding firms

Kansas has the opportunity to reduce the sales tax rate by eliminating exemptions and broadening the base through the taxation of services, out-of-state vendors, and digital goods.

Chapter 4: The Corporate Income Tax

Introduction

The Kansas corporate income tax shares many similarities with the federal corporate income tax.

Both federal and state corporate income taxes represent a diminishing cost to corporations. See Figure 4.1 for declining state and local income tax burden on corporations since 1992.

While taxes are necessary to raise sufficient government revenue, both the state and federal tax laws are often drafted to achieve social and economic goals. Both are complex, and most taxpayers are increasingly unable to comply without the assistance of a tax professional.

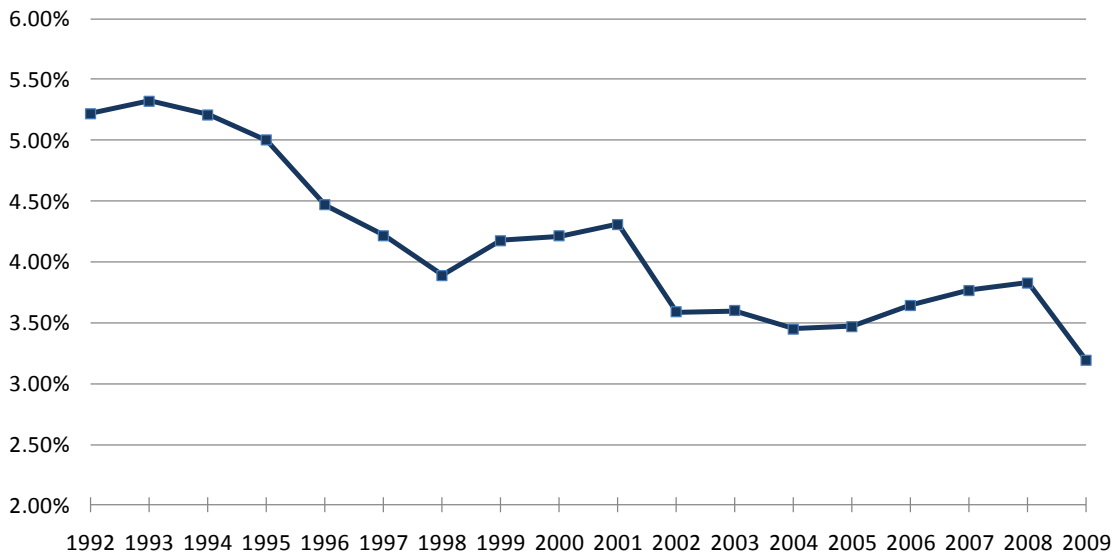
Finally, both are progressive taxes that impose lower rates on those with the least income and higher rates on those with a greater ability to pay.

When corporations' share of state and local taxes decreases, the state must choose between reducing the size of government or passing on tax increases to other taxpayers.

This chapter provides a detailed analysis of the corporate income tax. Because much of Kansas' economic development activity is in the form of credits, the chapter includes an analysis of various tax credits in the region.

Figure 4.1

State and Local Corporate Income Tax as Percent of Corporate Profits (US-level), 1992-2009



Sources: US Census Bureau, State and Local Government Tax Revenue and State and Local Finance Tables. Bureau of Economic Analysis, NIPA Tables (for corporate income). Calculations by University of Kansas.
Note: Comparable measure of corporate profits not available on state level.

As seen in Figure 4.2 below, the Kansas corporate income tax rate as a percent of personal income has ranged between .15 percent (2002 and 2003) and .51 percent (2007). Kansas' relative corporate income tax burden is below the US average for all years except 2008.

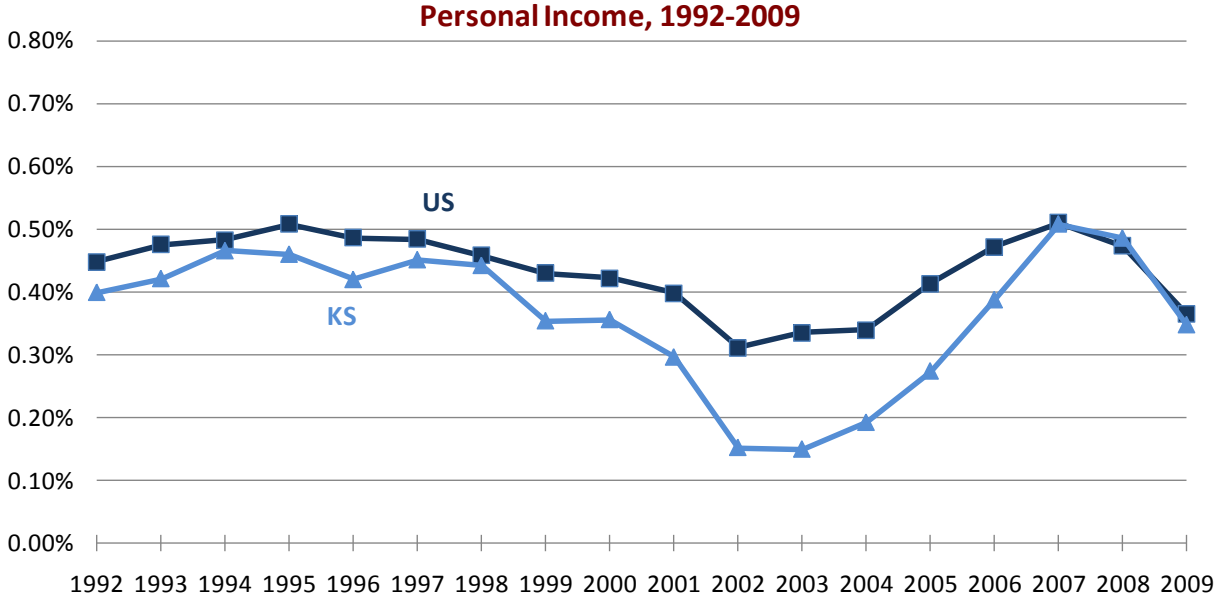
The trends presented in Figure 4.2 follow economic conditions in which downturns in the economy are reflected in the profitability of corporations, and thus the taxes on their net profits.

However, part of the decline in corporate income tax can also be attributed to federal income tax changes, which have decreased the federal and Kansas income tax base. The Kansas income tax "piggy-backs" on the federal taxable income base; in other words changes at the federal level affect the Kansas income tax base. When the federal income tax rules change, the state tax revenues are also affected, unless states choose to decouple from the federal tax rules.

For example, bonus depreciation and the expansion of expensing of capital investment contributed to the decline in state and federal income tax after 2001. Depreciation and state decoupling is discussed in more detail later in this chapter.

Figure 4.2

State and Local Corporate Income Tax as Percent of Personal Income, 1992-2009



Sources: US Census Bureau, State Government Tax Collections and State and Local Finance Tables. Calculations by University of Kansas.

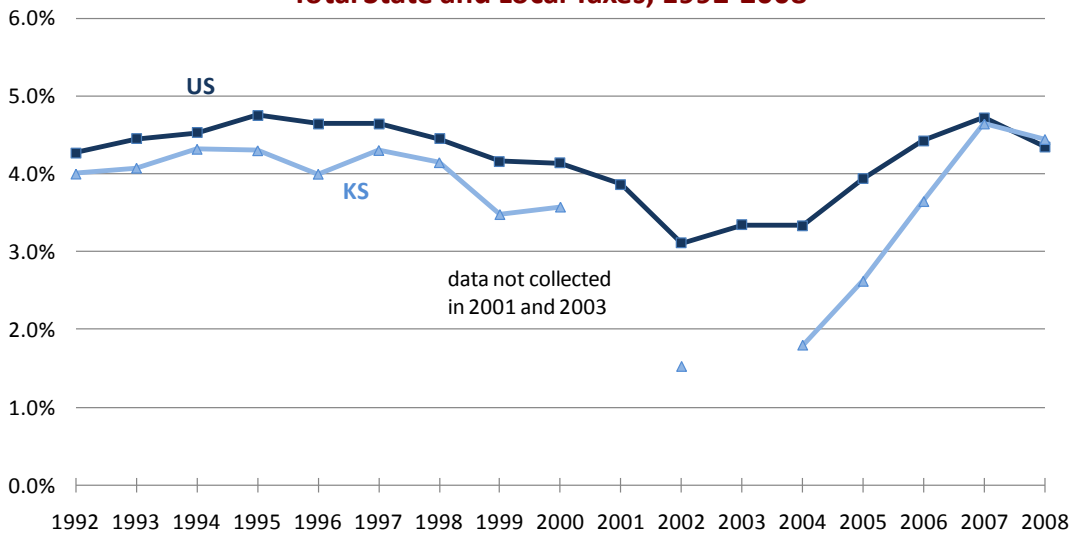
Figure 4.3 examines state and local corporate income tax as a percentage of total state and local taxes. Kansas follows the national trend in this analysis as well. In 2002 and 2004, Kansas corporate income tax burdens were significantly below historical trends for the state.

Based on Figure 4.3, Kansas corporate income taxes as a share of total state taxes is below the US average for all years except 2008.

Figure 4.4 demonstrates how states in the region compare in 2008. Texas has a gross margins tax (discussed briefly below), which accounts for the absence of the corporate income tax revenue in the state. Note that this Figure is a relative comparison of state revenues and not a ranking of corporate tax burden. Kansas's high percentage can potentially be attributed to a number of factors such as:

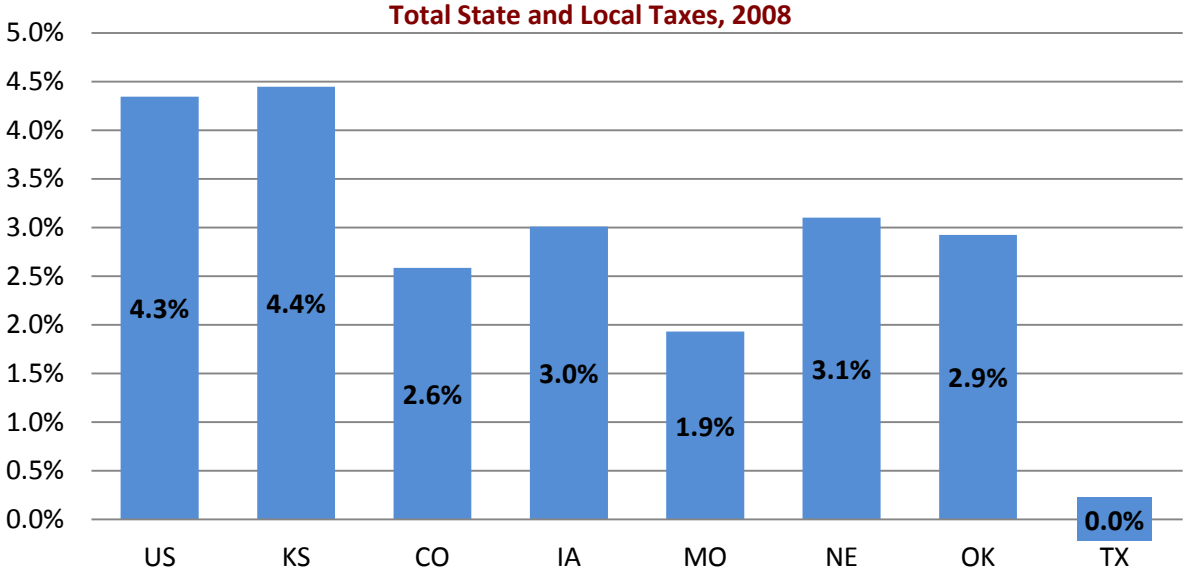
- Compared to neighboring states, Kansas tax revenues rely less on other taxes such as oil and as severance taxes, sales taxes and property taxes and excise taxes on cigarettes and smokeless tobacco.
- Compared to neighboring states, Kansas corporate income tax code allows for fewer tax planning opportunities than tax codes in neighboring states.
- Compared to taxpayers in other states, Kansas taxpayers use relatively fewer pass-through entities to escape corporate taxation.
- Kansas corporations may be slightly more profitable than those in neighboring states and thus have higher income tax burdens in Kansas.

Figure 4.3
State and Local Corporate Income Tax as Percent of Total State and Local Taxes, 1992-2008



Sources: US Census Bureau, State and Local Government Tax Revenueand State and Local Finance Tables.
Calculations by University of Kansas.
Note: Data not available for 2001 and 2003 at state level.

Figure 4.4
State and Local Corporate Income Tax as Percent of Total State and Local Taxes, 2008



Source: US Census Bureau. State and Local Finance Tables. Calculations by University of Kansas.

Figure 4.5
Kansas State and Local Business Tax Business Burdens

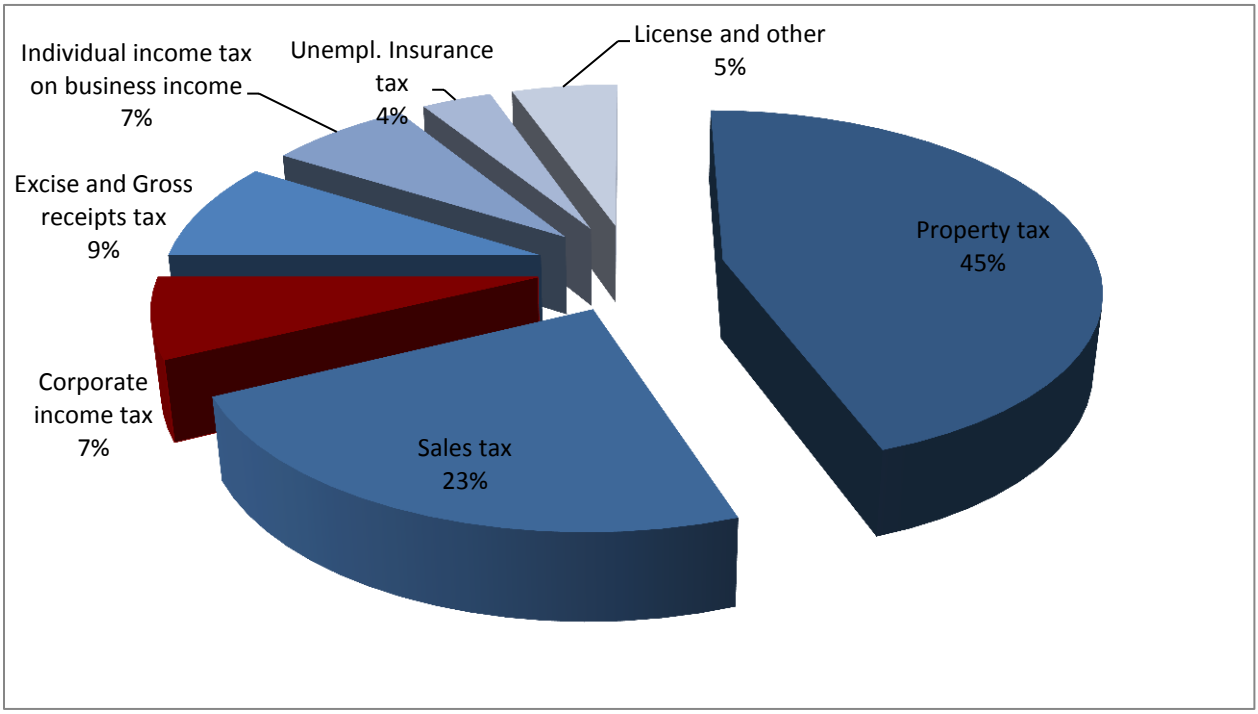


Figure 4.5 presents the total business taxes incurred by percentage. In 2009, corporate income tax represented 7 percent of Kansas business taxes, on average.

Factors Affecting Corporate Income Taxes

Table 4.1 provides an overview of the state corporate tax rates in Kansas and seven other states in the region. It should be noted that Texas has a gross margins tax, rather than a true income tax. Because the Texas gross margin is a modification of a corporate income tax, it is included in this discussion (see "Benefits of Gross Margins Tax Explained" for more information).

A number of factors affect the corporate tax burden in addition to the corporate tax rate. This chapter will discuss:

1. Federal definitions and state deductions;
2. Depreciation rules;
3. Income apportionment and allocation methods; and
4. Economic incentives.

Benefits of the Gross Margins Tax Explained

The gross margins tax is based on revenue less cost of goods sold. Tax structures based on gross margins are used in Texas and have been adopted recently by Ohio, Michigan, and Washington. Legislation adopting gross margins tax is being considered in several other states.

There are three benefits of basing tax structures on gross margins:

1. Steady stream of income. Gross margins tax provides a steadier stream of income to a state than taxes based on net income, as sales revenue is often less sensitive to downturns in the economy.

2. Reduced opportunity for firms to engage in tax minimization techniques. Planning strategies hinging upon transactions that lack economic substance, such as transfer payments between subsidiaries, are severely limited.

3. Lower tax rate. The tax rate for gross margins taxes is much lower, because the tax base is broader.

Federal definitions and state deductions

In general, state definitions of taxable income start with federal definitions. All of the states in the study generally follow federal depreciation rules, with two exceptions:

1. Texas limits cost recovery of assets through cost of goods sold to certain situations.[3]

2. Many states have decoupled with the federal income tax code with respect to bonus depreciation.

Federal income is then modified through state specific additions and deductions.

Once all the effects of federal taxation have been accounted for, the marginal tax rates are much more homogeneous (with the exception of Texas), with net effective rates generally between 3 percent and 5 percent.

State deduction for federal taxes

One major deduction impacting corporate income taxes is federal taxes paid. Within the region studied in this report, only Missouri and Iowa allow a deduction of up to 50 percent of federal taxes paid.

The marginal federal rate on corporate income is currently 35 percent for firms in the highest tax bracket; hence federal deductibility generally reduces a firm's state marginal tax rate by 35 percent multiplied by the percentage deductibility (e.g., in this case 50 percent in Missouri and Iowa). The "Marginal Gross Effective Rate" column in Table 4.1 shows how the federal deduction reduces the effective tax rate in many states.

Key point: Kansas does not allow a deduction for federal taxes paid. In an economic downturn, introducing this deduction would provide negligible benefit for many Kansas businesses. All else being equal, such a deduction provides the most benefit to the most profitable companies but no benefit for firms in a net operating loss position. For example, start-up companies generally do not show a profit for several years, so there would be no federal tax liability to deduct on the state return. Likewise, this deduction does not provide an incentive to produce more goods in a state with the deduction or to expand operations.

Deduction of state taxes from federal income tax

The state-level corporate tax is deductible from the federal corporate tax. This leads to a net reduction in the burden of the state tax, which is referred to the "federal offset." Similarly, all other state and local taxes are deductible from the federal corporate tax and have corresponding federal offsets. However, the state corporate tax is noteworthy because its reciprocal deduction for federal taxes leads to complicated interaction effects.

Combined effects of cross-deductibility

The last column of Table 4.1 quantifies the impact of cross deductions between state and federal corporate taxes. A static and simultaneous model is assumed. In reality, there are complicated lags between effects of state and federal taxes. It is also assumed that the corporation has over $18,333,333 in total U.S. income, so that the marginal federal tax rate is 35 percent.

In the seven-state region studied, the statutory tax rates in the top brackets cover a fairly wide

[3] A detailed discussion of the calculation of the Texas Gross Margins tax is beyond the scope of this report.

range–from about 5 percent to 12 percent. Kansas' top statutory rate is 7.05 percent.

The marginal tax rate is used for investment decisions. The marginal rate is the rate applied to the next dollar earned, or the next deduction received. The state rate is adjusted by federal income tax deductions allowed to arrive at the net effective marginal tax rate. The highest rates are on Iowa's tax on corporate income over $250,000 and then Nebraska tax, with marginal net effective rates of 6.57 and 5.08 percent, respectively. Kansas' net effective marginal rate is 4.58 percent.

With all effects accounted for, regional/state plus federal marginal rates cover a relatively narrow range: between 35.33 percent and 41.57 percent. Again, note that the Texas results are distorted because the amount of income subject to the gross margins tax is much larger than in the other states in the study.

In our region, the statutory tax rates in the top brackets cover a fairly wide range–from about 5 percent to 12 percent. Kansas' top statutory rate is 7.05 percent.

Other state deductions

The most important differences between state and federal income have to do with the allocation formula, discussed separately below. Some states have deductions that serve purposes more commonly addressed with credits, which will be discussed below along with other tax credits.

Depreciation Rules[4]

Depreciation of real and personal property is a deduction from taxable income. Traditionally, states in this region, as well as most other states, have followed federal rules for determining the amount of depreciation. However, recent changes in federal depreciation rules have provided "bonus depreciation."

Bonus depreciation allows for an immediate write-off of new tangible personal property in the year of purchase. The rates have varied over time from 30 percent to 50 percent, and are 50 percent through 2010.

Bonus depreciation does not apply to real estate or used property. Taxpayers may also take regular depreciation and the expensing election under Internal Revenue Code §179 in addition to bonus depreciation. During 2010, taxpayers may expense $500,000 of equipment purchases under §179. In 2011, 100 percent of certain assets may be expensed.

The bonus, §179, and regular depreciation deductions combine to provide a large incentive to purchase new equipment.

The following example demonstrates how the federal tax provides for expensing nearly 100 percent of the asset acquisition price in some situations.

[4] Excerpted from Alexander 2005.

Table 4.1

State Corporate income Tax Rates, Federal Deductibility, and Effective Tax Rates, Tax Year 2009

State	Bracket	Marginal Rate	Deductible Federal Income Tax	Marginal Gross Effective Rate[1] (after state deduction for federal tax)	Marginal Net Effective rate (after federal deduction for state tax)	Marginal State Plus
Colorado	Flat	4.63%	No	4.63%	3.01%	38.01%
Iowa	$0 - $25,000	6.00%	50%	4.95%	3.25%	38.25%
	$25,001 - $100,000	8.00%	50%	6.60%	4.35%	39.35%
	$100,001 - $250,000	10.00%	50%	8.25%	5.46%	40.46%
	Over $250,000	12.00%	50%	9.90%	6.57%	41.57%
Kansas	$0 - $50,000	4.00%	No	4.00%	2.60%	37.60%
	Over $50,000	7.05%	No	7.05%	4.58%	39.58%
Missouri						
State	Flat	6.25%	50%[3]	5.16%	3.39%	38.39%
State/Local[2]	Flat	7.25%	43%[3]	6.16%	4.05%	39.05%
Nebraska	$0 - $100,000	5.58%	No	5.58%	3.63%	38.63%
	Over $100.000	7.81%	No	7.81%	5.08%	40.08%
Oklahoma	Flat	6.00%	No	6.00%	3.90%	38.90%
Texas[4]						
On entities with > $300,000 in Total Revenue	General entities	1.00%	No	1.00%	0.65%	35.65%
	Retail/Wholesale entities	0.50%	No	0.50%	0.33%	35.33%

[1] This calculation assumes a marginal federal tax rate of 35%.
[2] Additional 1% tax on net profits in Kansas City and St. Louis. Federal tax is not deductible against the local taxes.
[3] Only on Federal tax paid on Missouri source income
[4] Rates imposed on lesser of 70% of total revenues or 100% of gross receipts after deductions for either compensation or cost of goods sold. Businesses with less than $1M total revenue ($0.6M starting 2012) pay no tax. Discounts apply to businesses with revenue under $0.9M.

Consider a purchase of $650,000 of various assets with a five-year tax life. The taxpayer makes no other purchases during the year. Assume the taxpayer expenses $500,000 under §179. The depreciable basis is reduced to $150,000 ($650,000-$500,000), and bonus depreciation would be $75,000 ($150,000 x 50%). Regular tax depreciation is based upon the unrecovered amount of $75,000 ($150,000-$75,000). Table 4.2 depicts the cost recovery pattern of this asset.

In this example, the taxpayer purchased assets for $650,000 and is able to immediately write-off $590,000 of the acquisition cost ($500,000 in §179 expenses + $75,000 bonus depreciation + $15,000 for regular depreciation). This equates to 90.7 percent of the original purchase price.

For taxpayers that finance equipment purchases with debt, expensing deductions provide an income tax arbitrage opportunity; taxpayers receive the immediate deduction for the acquisition cost, along with the interest deduction.

Because expensing exempts the normal or competitive return on capital assets from taxation, expensing as a method of capital cost recovery is appropriate if the objective is to tax consumption instead of income.

Thus recent proposals for replacing the income tax with a consumption-based flat tax have allowed outlays for new capital to be expensed. Similarly, a consumption value-added tax would allow outlays for new capital to be deducted when computing the tax base (or "value-added"). If, however, the objective is to tax income instead of consumption, the appropriate method is to require the taxpayer to spread out deductions for the cost of the asset, based on the rate at which the asset depreciates in value over its useful lifetime (i.e., its economic depreciation).

Table 4.2
Example: Depreciation of a Five-Year Property

Recovery Year	§179 Expense	Bonus Depreciation	Regular Depreciation
2010	$500,000	$75,000	$15,000
2011			$24,000
2012			$14,000
2013			$8,640
2014			$8,640

Source: Calculations by author.

Under an income tax, allowing the expensing of assets thus becomes a form of tax preference or tax expenditure, because it allows the competitive investment return of assets to go untaxed. In this case, opportunities for tax arbitrage can arise if taxpayers are allowed to expense the cost of assets, while at the same time deducting the interest on the debt incurred to acquire these assets.

The economic impacts of the two expensing provisions of the IRC are disputed. Supporters of the §179 expense expansion and bonus depreciation suggest several advantages:

- Capital formation and employment rates would increase and provide a short stimulus to the economy because these provisions lower the cost of capital and increase cash flow (Guether 2003).
- More small business owners would benefit from the expanded expensing incentives as the §179 investment limitation increases.
- Accounting would be simplified as businesses could maintain fewer tax depreciation records (Guether 2003).

However, opponents of the §179 expense expansion and bonus depreciation suggest the following disadvantages:

- Equipment investment incentives lead to substituting capital for labor and may result in increased national productivity without employment growth (Guether 2003).
- During times of slow economic growth, temporary incentives are more effective than permanent ones. Business executives will accelerate capital acquisitions only if they believe that the §179 expansion and bonus deprecation will expire. So long as doubt exists, the incentives' efficacy as economic stimuli is unclear. If made permanent, the economic inefficiencies introduced by favoring investments in equipment relative to structures would increase (Gravelle 2003).
- In the future, taxpayers will question whether other "temporary" measures will also become permanent, thereby undermining future fiscal policy (Gravelle 2003).

Bonus Depreciation

As noted above, bonus depreciation deductions provide a very generous deduction at times when many states are suffering from revenue shortfalls.

Consequently, a majority of states choose not to conform with the changes to the federal bonus depreciation rules, or to conform only in part. The changes made in this region are summarized in Table 4.3.

Kansas follows the federal rules, resulting in a substantial income tax break to firms acquiring assets. It should be noted that for firms that operate in multiple states, the tax deduction does not require that the equipment be purchased in Kansas or placed in service in Kansas.

States conforming to federal bonus depreciation rules are often subsidizing an out-of-state company's purchase of equipment in a competing state.

Table 4.3
Conformity with Federal Bonus Depreciation, Tax Year 2009

State	Treatment of Bonus Depreciation	Other Considerations
Iowa	0% of Federal	
Colorado	100% of Federal	
Kansas	100% of Federal	
Missouri	100% of Federal	Add back 30% bonus depreciation, no add back for 50% b bonus depreciation
Nebraska	100% of Federal	No addition after 2005
Oklahoma	20% of Federal	80% of bonus depreciation addition, subtract add-back over next 4 years
Texas	100% of Federal 0% of Federal	Corporations <$1M in taxable capital All other corporations, add back 100%

Division of Corporate Income

Perhaps the most challenging single issue in understanding corporate taxation is the division of income for firms that do business in several states or nations. Each state is limited to taxing the portion of income actually generated in that state.

However, the individual states exercise considerable freedom in deciding what income to claim as their own. Consequently, there is no assurance that exactly 100 percent of income (no more and no less) will be taxed overall by the states in which a firm operates. Depending on the firm's circumstances, multiple states may claim the right to tax the same income, while other income may go untaxed.

Key concepts in the division of income include:

- **Nexus:** the level of connection with a state necessary to subject the firm to tax liability;
- **Apportionment:** the method of distributing income and deductions between multiple taxing jurisdictions;
- **Allocation:** the method of directing specific and undivided streams of income to a taxing jurisdiction; and
- **Unitary businesses:** affiliated groups with a number of shared corporate functions or operations may be treated as a single business entity.

The following is a more detailed discussion of each of these concepts.

Nexus

Federal law guides the states in determining nexus. In particular, Public Law 86-272 is a Federal statute defining activities that, in and of themselves, *do not* give a state the right to impose the income tax. These activities include:

- solicitation of orders for the sale of tangible personal property in a state when those orders are approved and filed from a location outside the state, and
- maintenance of an office by an independent contractor who makes sales or solicits orders for the sale of goods.

While P.L. 86-272 does provide companies some protection from triggering nexus, the statutes related to income tax and nexus have not evolved as quickly as the business environment. For example, P.L. 86-272 does not apply to the sale of services.

Court cases have further defined the operational meaning of nexus, in determining how much activity can take place within the state before the corporate income tax is triggered. States defend their right to tax a business operating and selling goods and services in a state by asserting *economic nexus.*

States are moving past the 20th century business model of taxing based only on physical presence in a state and using the concept of economic nexus to impose income taxes. For example, major law firms are outsourcing legal work to workers in India (Economist 2010). Without economic nexus standards, an increasingly large share of business activity will escape state taxation.

Under a *physical presence* standard, these firms would not be subject to income tax on returns prepared for taxpayers located in the state. Under an *economic nexus* standard, the state may assert that foreign firms providing in-state services are subject to income tax.

States have prevailed in economic nexus claims against financial service firms in several recent cases. In *Capital One Bank v. Comm. Of Revenue* (433 Mass. 1, 899 N.E. 2d 76) (2009), the taxpayer had substantial nexus because it deliberately solicited credit card business and used Massachusetts banking and credit facilities.

In addition, several states such as Wisconsin, Oregon, and New York have recently passed legislation to codify economic nexus (see Nellen, 2010 and Baker Tilly, 2010 for summaries).

Under an economic nexus standard, the state may assert that foreign firms providing in-state services are subject to income tax.

The benefit of expanding nexus definitions to an economic nexus standard is that in-state businesses are not harmed. Because resident firms have already established nexus under the physical standard tests, they will not be subject to additional tax. The additional income tax revenue would be paid only by those firms without in-state employees and facilities.

Apportionment

When a firm does business in several states, it is often difficult to say precisely where the firm's income is earned. The firm may have its labor force in one state, own property in a second state, and sell to customers in a third state. States rely on formulas based on percentages of in-state property, wages, and sales to clarify state tax compliance and collection.

States may pass legislation to define apportionment formulas and to classify sales definitions—there are no federal mandates. However, many states voluntarily have agreed to a set of standards known as UDITPA (Uniform Division of Income for Tax Purposes Act).

UDITPA defines an apportionment formula based on evenly-weighted property, payroll, and sales factors, and provides clarification on how each factor should be calculated.

The example in Table 4.4 shows a simple case of a UDITPA-type taxable income calculation for a multi-state firm in Kansas.

The firm has most of its production facilities in Kansas, 90 percent of payroll and property but only 15 percent of sales. Applying even weights of 1/3 to each of the payroll, property, and sales factors results in an overall allocation factor of 65 percent; hence, Kansas would tax 65 percent of the firm's income.

Rules for the division of income across states are far from uniform, despite UDITPA. Many states do not use UDITPA-type apportionment rules, and even those that do may offer an alternative formula. Within the region, three states use the equal weighted three-factor formula in most (but not all) situations. Colorado, Iowa, Nebraska, and Texas use one-factor sales formulas.

Most of the adopted alternatives to the UDITPA apportionment formula weigh sales or receipts more heavily than other factors. A state with a heavily-weighted sales factor will provide a locational advantage to firms that sell most of their products out-of-state (Mazerov, 2001).

Table 4.4
Example of Income Apportionment

Factor	Amount in All States	Amount in Kansas	Share in Kansas
Sales	$4,000,000	$600,000	15%
Payroll	$2,000,000	$1,800,000	90%
Property	$3,000,000	$2,700,000	90%

Income Apportioned to Kansas

Sales		Payroll		Property			
15% x 1/3	+	90% x 1/3	+	90% x 1/3	=	Kansas Income	
5%		30%		30%		65%	

For example, consider a firm that concentrates the bulk of its payroll and property in a single state, but sells to a national market (mostly out-of-state). The apportionment factors are, in essence, a tax on each of the inputs: payroll, property and sales.

States that seek to encourage net exporters to stay or expand in-state may consider reducing the weight on property and payroll and increasing the weight on sales.

But like all tax incentives, the benefits may be temporary. For example, Iowa was an early adopter of reducing the payroll and property tax factor weightings to entice a major appliance manufacturer from relocating out of state. The firm has since been acquired, and facilities in Iowa have been closed.

As with most tax changes, some taxpayers are winners and other are losers. A move to reducing the weighting of payroll and property makes the sales factor more heavily weighted; firms that have a large sales presence in Kansas would see their tax liability increase.

Research is inconclusive on the efficacy of apportionment changes as an economic development strategy. Further, economic principles suggest that any state gains from switching apportionment methods went to the early adopters of this strategy.

Kansas started to move away from the exclusive use of the UDITPA apportionment formula in 1988. At that time, the state offered a new option by which a taxpayer could choose to drop payroll from the apportionment formula. The option remains open to taxpayers for whom the payroll factor is at least twice the average of the property and sales factors. Table 4.5 presents the income apportionment and allocation methods for states in this study.

Table 4.6 contrasts the percentage of income taxable in a state under the two alternative formulas used in Kansas – one with a sales factor of 1/3 and one with a sales factor of 1/2. Firms that have few sales in Kansas would have their Kansas taxable income reduced under a method that more heavily weights sales.

Services performed in one state and sent to another state often are treated differently than goods in determining the location of the sale. States generally use one of two approaches: Cost-of-performance or Market-based.

1) **Cost-of-performance approach.** Kansas, Missouri, Colorado, and Texas use the cost-of-performance rule for determining if a service is in-state or out-of-state. Under this rule, states include only the revenue for services performed in the state. For example, an architectural firm in Omaha may generate revenue from Kansas clients but because the service was performed in Omaha, Kansas does not tax this service revenue.

2) **Market-based approach.** This cutting-edge approach, known as market-based or benefit-based, apportions income based upon where the service is sold. This method has been adopted by Iowa and Oklahoma.

States that are net importers of high-value services might consider using a market-based standard to apportioning services.

Significant advances in global communication technology have changed the business environment. Personal services performed by out-of-state providers run the gamut from programming, accounting, radiology, and legal advice to telemedicine. States that are net importers of high-

value services might consider using a market-based standard to apportioning services.

Many states also use the market-based approach for financial institution transactions and apportion revenue based upon the client location, rather than the financial institution's physical address. A tax system works best when it reflects modern business practices.

Allocation

Allocated income of a multi-state firm is defined as that portion of income assigned to one state directly, rather than the business income divided by an apportionment formula.

UDITPA provides guidelines for income that should be allocated rather than apportioned:

- Income, such as rents and royalties, from tangible personal property utilized in the state
- Capital gains and losses from real estate
- Interest and dividends of firms that are incorporated in the state

Among the states in the study, Colorado, Kansas, and Missouri follow UDITPA or similar rules for allocation.

States are split evenly with respect to use of UDITPA definitions of factors to be allocated. As Table 4.5 shows, Kansas uses UDITPA definitions.

States also differ with respect to "throwback" rules– that is, treatment of income from states without a corporation income tax in apportionment formulas (see the columns in Table 4.5 on sales of goods shipped in- and out-of-state).

Because of differences in apportionment formulas and in the definitions that states use in calculating what goes into the formulas, "non-taxed and double-taxed sales are almost inevitable" (Vandenbush and Worcester, 1990).

Unitary business

As noted above, businesses operating in more than one state must apportion and/or allocate income between taxing jurisdictions. The question of income apportionment is difficult enough when it arises in the context of a single firm.

Modern corporate structure is often a complex web of subsidiaries, affiliates, flow-throughs, and special purpose entities. Taxing jurisdictions sometimes require affiliated entities that have interrelated activities to file as a *unitary business*. They are, in essence, treated as a single firm for the purposes of income apportionment.

States show great differences in how they treat the income of a unitary business. Among the states in the study, all except Iowa allow combined reporting (i.e., treating the entire group as a single entity), and most require it. Iowa requires that the affiliates that actually do business in the state file a consolidated return, but does not allow an affiliate's income to be "mixed" with income of other members of the group.

Unitary filing minimizes state tax planning strategies focused on intra-company payments that lack economic substance. Tax practitioners have created a number of planning strategies to continue to realize the benefits of intra-company transactions in unitary states. However, a description of these tax reduction techniques is beyond the scope of this report.

Table 4.5

Apportionment and Allocation Methods for Income of Multi-State Firms

Tax Year 2009

State	Choice of Apportionment Formulas	Factor Weights			Substantially UDITPA Allocation	Includes Sales Shipped	
		Revenue or Sales	Property	Payroll		In	Out
Colorado	No	1			No	100	[1]
Iowa	No	1			No	100	0
Kansas	Sometimes	1/3	1/3	1/3	Yes	100	[1]
		1/2	1/2		Yes	100	[1]
Missouri	Yes	1/3	1/3	1/3	Yes	100	[1]
		1			Yes	50	50
Nebraska	No	1			No	100	0
Oklahoma	Sometimes	1/3	1/3	1/3	No	100	[1]
		1/2	1/4	1/4		100	[1]
Texas		1			No	100	0

[1] The "throw back" rule applies.

Table 4.6

Income Apportionment under Alternative Formulas

Factor	Amount of Factor in All States	Amount of Factor in Kansas	Share in Kansas	Contribution Under Three-Factor Formula[1]	Contribution Under Two-Factor Formula[2]
Sales	$ 4,000,000	$600,000	15.0%	5.00%	7.50%
Payroll	$2,000,000	$1,800,000	90.0%	30.00%	45.00%
Property	$3,000,000	$1,800,000	60.0%	20.00%	0.00%
KS Taxable Income %				55.00%	52.50%

[1] Three-Factor Formulas: 1/3 x sales share + 1/3 x payroll share + 1/3 x property share
[2] Two-Factor Formula: 1/2 x sales share + 1/2 x payroll share

Tax Incentives

States offer a number of tax incentives to encourage or reward certain firm behavior. Survey respondents (in a survey done for this report) commented that Kansas had some of the most generous credits in the region. The inability to use some credits generated by one subsidiary to reduce the tax liabilities of another entity in a consolidated group (cross-crediting) was mentioned as a limitation on the attractiveness of Kansas credits. The overall efficacy of the credits was questioned as it relates to incentivizing new investment/hiring by a firm. Specifically, many business respondents indicated that the credits did not increase investment overall but instead only rewarded certain taxpayer behavior.

Most income tax incentives fall into one of four categories:

1. Research and development incentives;
2. Rebates of property taxes paid;
3. Job and investment credits;
4. Enterprise zone incentives.

The specific programs and policies of each state are presented in detail below.

Research and development incentives

Within the region, Colorado, Kansas, and Iowa all offer income tax credits or deductions based on research and development (R&D) expenditures (See Table 4.7).

Oklahoma has new incentives that can exempt 10 to 100 percent of an inventor's royalties from the tax base.

Colorado legislated tax credits for R&D expenditures made within enterprise zones in 1988. The law grants a credit of 6.5 percent of increased R&D expenditures.

Iowa allows a 6.5 percent credit on increased spending on research activities—with the ability to get another 6.5 percent if the corporation participates in the New Jobs and Income Program, and the corporation is in an enterprise zone. Thus Iowa businesses are provided up to a 13 percent credit. Credits in excess of a firm's tax liability are refundable.

Rebates of property taxes

Property taxes on business assets, particularly machinery and equipment, are sometimes thought to discourage investment in a state. At the same time, property taxes on businesses form an important part of the local property tax base.

Five states in the region offer property tax rebates through income tax credits (see Table 4.8) and leave the local tax base held harmless. Those states include Kansas, Oklahoma, Colorado, and, in some cases, Texas. The Colorado rebate is applicable only when the state has a budget surplus.

Kansas offers a credit against personal and corporate income tax in the amount of 25 percent of the property tax paid on industrial machinery and equipment (note, however, that the property tax on *newly acquired* industrial machinery and equipment has been eliminated). If the amount of the credit exceeds the taxpayer's income tax liability, the taxpayer is entitled to a refund for the amount in excess of the taxpayer's income tax liability.

Most states also have property tax abatement and exemption programs for investment that are not directly tied to the corporate income tax.

Table 4.7

Research and Development Tax Credits, Tax Year 2009

State/Program	Rate	Basis	Limitations/ Carryover	Eligibility Requirements
Colorado				
Research and Development Credit	3%	Excess over average R&D for two previous years	Credit earned this year becomes available in equal parts over 4 years.	Must be in Enterprise Zone (EZ)
Iowa				
Basic Research Activities Credit	6.50%	Excess over R&D for previous year (alternative formula available)	Fully refundable. Carryover to following year.	All Iowa
Research activities under New Jobs and Income Program	6.5% (additional)	As above	As above	Participation in New Jobs and Income Program
Kansas				
Research and Development Credit	6.5%	Excess over average R&D for two previous years	Credits earned this year become available in equal parts over 4 years. Unlimited carryforward. Limited to 90% of earned or claimed credit.	All Kansas
	2.5% on excess		Refundable after 2009	Alternative credit with same 5% and 2.5% rates available for firms in Biotechnology and Health Research Zones.
Missouri				
None	*Previous Credit Sunset in 2005*			
Nebraska				
Research and Development Credit	15%	Federal credit allowed under IRC §41(c)	Credit claimed over 5 years. No first time claims after 2010.	
Oklahoma				
Technology Transfer Income Tax Exemption	10%	Gross royalties received (deduction, not a credit)	First 10 years	Technology transfer to qualified small business in Oklahoma
New Products Development Income Tax Exemption	100%	Gross royalties received (exemption, not a credit)	First 7 years	Products developed and manufactured in Oklahoma and registered
Texas				
None				

Source: RIA Checkpoint.

Table 4.8
Property Tax Rebate Credits, Tax Year 2009

State	Rate	Basis	Limitations/ Carryover/Qualifications	Revenue Pool
Colorado	100% of first $700 16% over $700	Business personal property tax paid		State tax receipts less expenditure limit less $170M. **Only when state has a surplus.**
Iowa	None			
Kansas	25%	Property tax on M&E	Fully refundable	Unlimited
Missouri	None			
Oklahoma	100%	Local real property tax exemption	E.Z. only; 10-year carryforward	$200,000
Texas	Varies	Property tax paid to school district. Apply for limit on appraised value to school district.		

Source: RIA Checkpoint.

Job and investment credits

Job and investment credits are some of the largest state tax credits. All of the states in the region offer job and investment credits in some form, both to attract new industries and, in some cases, to encourage the expansion of established firms (Tables 4.9 and 4.10).

The amount of credit that a firm receives depends directly on the amount of new or expanded activity it undertakes in the state. In many states, credits may be claimed for several years, provided that a firm keeps its new employees and investment in place.

Job and investment credits vary widely from state to state. The programs can be analyzed along the following dimensions:

1. Do the credits target specific types of jobs, particularly those paying high wages?
2. Do the credits target specific industries such as manufacturing?
3. Do the criteria by which a firm qualifies for credits emphasize jobs, investment, or a mixture of the two?

4. Are the credits provided for both new and established firms, or are they targeted to new firms only?

5. Are the credits limited to enterprise zones and other specified geographic areas?

Enterprise zone incentives

There is a key difference between enterprise zone programs and other economic development programs: enterprise zone programs attempt to stimulate development in limited geographic areas and to bring jobs and investment to declining or disadvantaged regions while other programs are available statewide.

Some of these credits are linked both to new jobs or investment and to workforce training. Most states have other workforce training incentives that are not specifically linked to the income tax. Those incentives will not be described in this report.

A high-level summary of the credits available in this region are found in Tables 4.9 and 4.10. Table 4.9 presents the credits available only in enterprise zones. Table 4.10 presents broad jobs and investment credits.

Table 4.9

New Job, Training, and Investment Tax Credits in Enterprise Zones, Tax Year 2009

State	Program	Rate and Basis
OK	All EZ credits are on moratorium until 2012.	
CO	EZ Investment Tax Credit	3% machinery and R&D costs
	EZ New Business Facility Employee Credit	$500-$1,000 per job
	Job Training Program Investment Credit	10% of training costs
IA	Economic Development EZ Incentives	10% real and personal property
KS	Income Tax Credits	$1,500-$2,500 per new job
NE	None	
MO	EZ Credits	$400-800 per new job; 2-10% of investment
	Relocation in Distressed Community	40% of income tax liability
TX	EZ Program	up to $7,500 per employee

Source: RIA Checkpoint.

Table 4.10

New Job, Training, and Investment Tax Credits, Tax Year 2009

State	Program	Rate and Basis
OK	All job, investment and enterprise zone credits on moratorium until June 2012.	
CO	New Investment Tax Credit	1% of Investment
	Investment in School-to-career Program	10% of employer internship costs
	Colorado Works Program Credit	20% select employee expenses
	Innovation Investment Credit (new in 2010)	15% of investment in qualified small business
	Job Growth Credit	50% employers' share of social security and Medicare paid
IA	High Qualify Job Program	10% of investment in business and real property
KS	Income Tax Credits	$1,500 per job; 1% of investment
	Job Expansion and Investment	$100 per job per year; 1% of investment
	High Performance Incentives Program	10% of investment; 100% of training expenses up to 2% of payroll
	Peak Act	95% of withholding taxes
TX	Texas Enterprise Fund	Varies based upon competitive process.
MO	Individual Training Account Program	50% of classroom training
	New or Expanded Business Facilities	$75 or $125 per job per year; .075%-.15% of investment
	New Market Development Credit	7% of adjusted purchase price of equity
	Quality Jobs	100% payroll
	Small and Expanding Business	100% payroll
	Technology Business	6% of withholding taxes
	High-Impact Project	3-4% of withholding taxes
	Job Retention Project	50% of withholding taxes
	Small Business Job Retention	100% of withholding taxes
NE	Microbusiness Investing and Hiring	20% investment in business or new employees
	Nebraska Advantage Act	50%-100% of sales/use tax on purchases and rentals; 3-6% of new employee wages; 3-10% of investment in qualified property.

Source: RIA Checkpoint.

Disclosure of State Tax Credits

Kansas provides a number of business incentives through corporate income tax credits. Currently, the amounts and beneficiaries of the credits are confidential. In addition, Kansas citizens have little information about the tax savings provided from these credits. Other states have addressed the public's concerns about state budget transparency by publicly disclosing credit information at the taxpayer level.

For example, North Carolina provides a number of tax credits; the credits granted and taken by taxpayers are posted by year on the North Carolina Department of Revenue Website. A sample is excerpted below in Table 4.11.

Texas takes a similar approach by providing detailed listing of taxpayers receiving credits and the amount of credits provided. A sample report is listed in Table 4.12.

Table 4.11

NCDOR Tax Credits for Growing Business

Excerpts of Credits Processed during Calendar Year 2009

Taxpayer	Creating Jobs ($)	Business Property Investment ($)	Real Property Investment ($)	Total Taken ($
ABB, Inc.	6,557	0	0	6,557
Advanced Digital Cable, Inc.	21,875	0	0	21,875
AKG of America, Inc.	2,813	0	0	2,813
Alan Clayton Enterprises, Inc.	0	35	0	35
Alfiniti, Inc.	409	0	0	409
Alray Tire Center of Statesville	0	142	0	142
Altec, Inc.	0	23,547	0	23,547
American Roller Bearing.	66,538	1,072	0	67,610
Barker, James C.	0	2,773	0	2,773
Bekaert Textiles USA, Inc.	0	6,234	0	6,234
Bishop III, Leland B.	8,270	0	0	8,270
Boon, Henry G.	161	246	0	407
Bourne, Kimberly J.	563	50	0	613
Bradford Products, LLC	64,750	0	0	64,750
Brass-Craft Manufacturing Co.	0	1,445	0	1,445
Brenner, Ann L.	13,524	14,028	0	27,552
Brenner, Frank	3,506	3,636	0	7,142
Brenner, Michael	3,506	3,636	0	7,142

Source: http://www.dornc.com/publications/growing_businesses_10/credits_taken.pdf

Table 4.12
Excerpted Disclosure of Texas Enterprise Zone Credits
Sample Projects Approved

Community Name	Project Investment	Capital New Jobs	Announced Jobs	Retained Date	Approval
Central Texas					
Austin	Otis Spunkmeyer, Inc.	$17,800,000	60	123	9/4/2007
Austin	Spansion LLC	$280,000,000	0	1,271	12/3/2007
Travis County	Golfsmith International, L.P.	$5,581,000	0	331	6/1/2009
East Texas					
Cass County	International Paper Company	$150,000,000	0	765	12/1/2008
Center	Tyson Farms, Inc.	$5,000,000	0	1,100	3/3/2009
Corrigan	Georgia-Pacific Wood Products South, LLC	$46,882,000	0	402	3/3/2009
Harrison County	General Cable Industries, Inc.	$5,400,000	0	327	3/3/2009
Huntsville	Weatherford US, LP	$15,381,000	35	226	12/1/2008
Jacksonville	eTelecare Global Solutions - AZ, Inc.	$1,929,312	401	0	9/2/2008
Limestone County	NRG Texas Power, LLC	$150,869,159	0	243	12/1/2008
Mount Pleasant	Sweet Shop Candies, Inc.	$4,400,000	90	0	6/2/2008
Polk County	Georgia-Pacific Wood Products South, LLC	$65,590,000	0	642	3/3/2009
Tyler	Delek Refining, Ltd.	$30,830,000	0	245	6/1/2009

Source: http://governor.state.tx.us/files/ecodev/EPxRegionListA.xls .

Other states, such as Virginia, are considering moving away from credits to direct grants. Grants have the advantage of providing businesses greater confidence in the incentive (e.g., they are not subject to income tax audits). Further, grants are not subject to income limitations as opposed to many income credits which are not refundable. From a policy perspective, grants provide more flexibility in budgeting and more transparency to taxpayers.

Chapter 5: Property Taxes

Three major taxes–income, sales, and property–provide the bulk of funding for state and local governments. Each of these taxes depends upon a different base. Property taxes are levied on the wealth of households and businesses. Depending on the jurisdiction, taxable assets may include land, buildings, business equipment, inventories, household durable goods, and, in a few cases, intangible assets such as cash and bonds. In contrast, sales taxes are levied on current transactions and income taxes on earnings or profits.

Current and Historical Comparisons

Although property taxes are levied by both state and local governments, by far the largest dollar amounts are collected at the local level. Local property taxes provide the single largest source of tax revenue for local governments in the United States and are used to support schools and other local public services. Property taxes comprise about 76 percent of total local tax revenue in Kansas and about 72 percent of local tax revenue for the nation as a whole. Looking at *combined* state and local taxes, property taxes provide approximately 31 percent of revenues in Kansas and in the US (Figure 5.1).

The states in the seven state region show substantial variation in their reliance on the property tax. Two states stand out. Oklahoma collects only about 17 percent of state and local taxes from property tax sources, with other taxes such as the severance tax filling in the gap. In contrast, Texas collects almost a 39 percent share from the property tax (note that Texas does not levy an income tax).

In per capita terms, Kansas property taxes are in the mid-range for the region and are very close to the national average. In 2008, Kansas levied approximately $1,318 per capita (Figure 5.2).

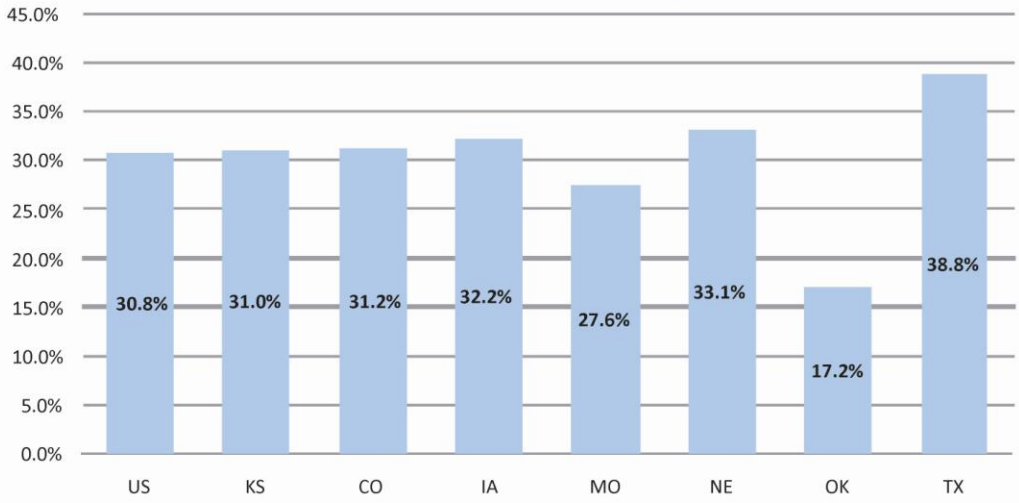
In per capita terms, Kansas property taxes are in the mid-range for the region and are very close to the national average.

As seen in Figure 5.3, Kansas reduced its reliance on the property tax in the early 1990s, as the state assumed a larger role in school finance. In Kansas, reliance on the property tax rose temporarily during the early 2000s but recently decreased to about a 31 percent share.

Nationally, property taxes have comprised a stable share of state and local tax revenues over the last two decades, fluctuating within the narrow range of 29 to 32 percent (Figure 5.3). In general, property tax shares rise during business downturns (see 2000-2002), not so much because property taxes increase, but because other tax sources decrease much faster than the property tax.

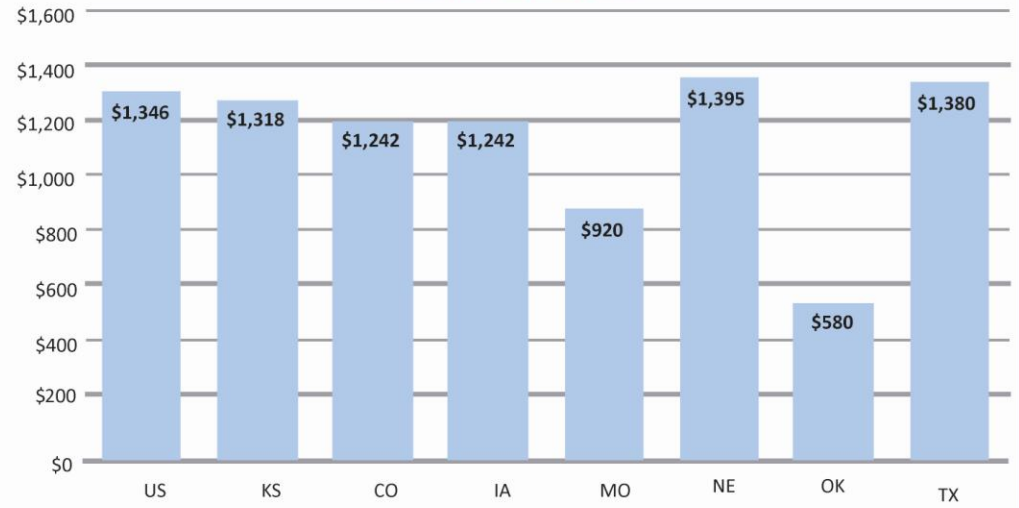
Historically, the property tax base in the US and in Kansas has been somewhat recession-proof. Public finance expert John Mikesell, writing in the mid-1980s, presented evidence that "property taxes do not appear to be cycle sensitive, showing but minimal differences between growth in expansion and recession." (Mikesell, 1984)." His study supported the conventional wisdom that property taxes were a stable revenue source. In good times, new residential and commercial construction added additional tax revenues; in bad times, real estate held its value, and sometimes even increased slightly.

Figure 5.1
State and Local Property Tax as a Percent of Total State and Local Taxes, 2008



Source: US Census Bureau, State and Local Finance Tables. Calculations by University of Kansas.

Figure 5.2
State and Local Property Taxes: Dollars per Capita, 2008



Source: US Census Bureau, State and Local Finance Tables. Calculations by University of Kansas.

Recently, however, this conventional wisdom has been proven otherwise. Existing residential and commercial real estate has fallen in value, and new construction has fallen dramatically since its 2005 peak (Table 5.1). Kansas experienced a decline in total assessed value of about 2.2 percent between 2008 and 2009. Property tax rates needed to rise just to maintain current collection levels (Table 5.2).

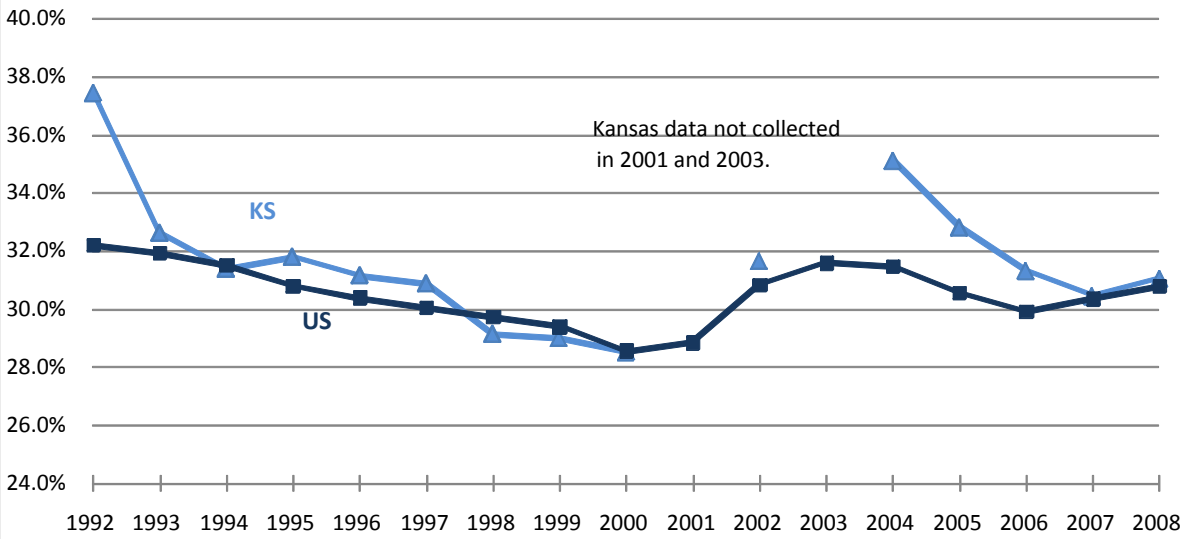
Comparing Property Taxes across States

Aggregate measures of property taxation such as those shown in Figures 5.1 through 5.3 provide an incomplete picture of the level of property taxation facing an individual firm or homeowner. Figure 5.4 demonstrates that property taxes are a significant burden for the average Kansas business.

The actual tax paid by a property owner results from a complex interaction of tax rates, the type and amount of property owned, the definition of the tax base, assessment practices, and whether the property qualifies for special tax incentives. The concept of *effective property tax rate* provides a key to understanding property taxation and comparing taxes across states.

The definition of an effective tax rate is straightforward: it is the annual tax bill divided by the true market value of a piece of property. Effective rates vary not only across states and municipalities, but also among the major categories of property: residential real estate, commercial real estate, business machinery and equipment, and inventories.

Figure 5.3
State and Local Property Tax as Percent of Total State and Local Taxes, 1992- 2008



Source: US Census Bureau, State and Local Finance Tables.
Calculations by University of Kansas.

Table 5.1
Building Permits for New Housing Units
2004-2009

Year	US	Kansas
2004	2,070,077	13,301
2005	2,155,316	14,048
2006	1,838,903	14,619
2007	1,398,415	11,473
2008	905,359	8,188
2009	582,963	6,677

Source: US Census Bureau. New Privately-Owned Housing Units Authorized by Building Permits in Permit-Issuing Places.

Table 5.2
Kansas Assessed Valuation and Taxes
2004-2009

Year	Valuation ($M)	Kansas ($M)
2004	25,398	2,964
2005	27,019	3,175
2006	28,964	3,418
2007	30,087	3,600
2008	31,000	3,770
2009	30,312	3,793

Source: Kansas Department of Revenue. Statistical Report of Property Assessment and Taxation, 2009.

Effective Tax Rates for Real Estate

The effective tax rate depends mainly on three components: the applicable mill levy, the statutory assessment ratio, and the actual ratio between appraised and market property values.

Mill Levy: The first component of the effective rate is the mill levy, defined as the dollar amount of the property taxes due per $1,000 assessed property valuation (some states use percentages rather than mills–conversions were made to a common unit of measurement for this study). The total mill levy on a piece of property generally results from a combination of state-level taxes, county taxes, city taxes, school district taxes, and taxes for special service districts such as water or hospitals.

Assessment Ratio: The second component of the effective rate is the statutory assessment ratio. The statutory ratio defines the percentage of a property's appraised value that is entered on the tax rolls. Most states in the region classify property and assess different types of property at different ratios. Kansas is among the states with a classified system. The following sections review the assessment ratios and adjustments for all seven states in the region.

Kansas: Kansas assesses residential property at 11.5 percent, commercial and industrial real estate at 25 percent and public utility property at 33 percent. Industrial and commercial machinery and equipment is exempt from property taxation if purchased since July 2006. The first $20,000 of value of a residential property is exempt from the Kansas 20 mill school levy.

Colorado: A 1982 constitutional amendment in Colorado requires that residential property provide no more than 45 percent of the tax base. To achieve this goal, assessment ratios of all other property are set at 29 percent and the residential ratio is adjusted by the Legislature (currently 7.96 percent).

Iowa: In Iowa, new industrial equipment has a zero assessment ratio versus 100 percent for business real estate and approximately 48.5 percent for residential property. The residential ratio is adjusted annually to keep the annual increase in residential property values at or

below four percent. This "rollback" applies to the entire residential class of property–an individual property may increase much more than the four percent limit for the class.

Missouri: Missouri assesses residential property at 19 percent, commercial real estate at 32 percent, and machinery and equipment at 33.3 percent. A surtax applies to commercial property. The surtax averages 1.02 percent or 10.2 mills.

Oklahoma: Oklahoma specifies a range of permissible rates for various property classes in Oklahoma, while the actual rates are chosen locally. Currently, rates between 11 and 13.5 percent apply to real property, while rates of 10 to 15 percent apply to personal property. Homeowners receive a $1,000 valuation exemption if they file for homestead status.

Nebraska: In Nebraska, the Constitution sets assessment ratios at a uniform 100 percent of market value. State level funds are used to reimburse taxpayers for some of the tax on real estate: the reimbursement currently stands at about $79 per $100,000 valuation.

Texas: Texas valuations are set at 100 percent of fair market value. However, Texas caps the allowable yearly increase in the taxable value of any *individual* parcel of residential property at 10 percent.

In Kansas, the 2009 statewide average appraised value to sales value stands at 98.4 percent for residential properties and 95.1 percent for commercial properties;

Appraisal and Market Value. The third component of the effective rate is the difference between statutory and actual assessment ratios. When property is reappraised frequently, appraisals generally come close to the market value of the property–the price at which the property could be sold. All of the states covered by this study make available statistics on discrepancies between appraised and market values for various categories of real estate. Such statistics are the result of so-called "ratio studies" that compare appraised values to sales prices for real estate transactions. In Kansas, the 2009 statewide average appraised value to sales value stands at 98.5 percent for residential properties and 95.1 percent for commercial properties; in Texas, comparable figures are 98.4 percent and 94.5 percent (Kansas Department of Revenue 2009a, pg.50).

In Nebraska, Iowa, and Texas, valuations in local taxing districts are "equalized," by adjusting for severe discrepancies in appraisal /sales ratios. The equalized values rather than the original appraisals are used for school funding calculations.

Effective tax rates for machinery and equipment

The concept of an effective tax rate for machinery and equipment is the same as for real estate: the tax divided by the true value of the property. However, some additional considerations figure into the case of machinery and equipment. The "true" value of machinery and equipment is an idealized measurement. In practice, states rely on various formulas and schedules to estimate machinery and equipment values. An identical piece of machinery with an identical age may have a different appraisal value in each state. The following questions are among the considerations that go into valuing machinery and equipment:

- How is depreciation estimated? Does the state use straight-line depreciation formulas, accelerated depreciation formulas, estimates of the value of used equipment (called the sales-comparison approach), or some other method?

- How does the state treat inflation? Is the appraised value of machinery and equipment increased to reflect inflation, or are appraisals based on the nominal purchase price of the property?

- Does the appraised value of an old piece of machinery or equipment taper off to zero, or is there a minimum appraisal value for any equipment still in use?

Summarizing Effective Tax Rates

Table 5.3 shows statewide average effective tax rates for various types of property in the region. Several assumptions lie behind the calculations:

- The residential and commercial real estate in the table are new sales, and hence not subject to inaccuracies in appraisals or valuation caps.

- The machinery and equipment in the table is newly purchased. The tax shown is for the first year the property is on the tax rolls.

Any homestead exemption that applies regardless of age or income is included. It is assumed that the homestead property is valued at $180,000.

Within the region surrounding Kansas, the states show a wide range of effective rates for various classes of real property. For residential property, Colorado averages the lowest tax rate (0.58 percent) while Texas averages the highest (2.18 percent). In Colorado, residences are assessed at approximately 27 percent of the ratio for businesses, accounting for the fairly low burden on residences (but note that the typical residential property in Colorado has a higher value than a similar property in Kansas). Kansas ranks in the midrange of the region for residential property, with taxes averaging 1.41 percent on a property valued at $180,000.

Iowa (3.42 percent) and Kansas (3.13 percent) impose high effective tax rates on commercial and industrial real estate (Calculation by authors). Note that both of these states exempt machinery and equipment. Businesses that purchase large amounts of capital equipment with only a modest amount of real estate will find an advantage in these two states.

All states, excluding Iowa and Kansas, tax machinery and equipment; effective rates range from 2.28 percent in Texas to 1.08 percent in Oklahoma. Oklahoma and Texas both include inventories in the tax base. However these two states do offer “Freeport” exemptions for inventory that remains in the state for a short time.

Table 5.3

Statewide Average Levies, Assessment Rations, and Effective Property Tax Rates, 2009

State	Av. Mill Levy	Property Type	Assessment Ratio	Assumptions	Effective Rate
Kansas	125.13	Residential Real Estate	11.5%	$200,000 property	1.42%
	125.13	Comm./Ind. Real Estate	25.0%		3.13%
	125.13	Business Mach and Equip	0.0%	new equipment	0.00%
	125.13	Inventories	0.0%		0.00%
Colorado	72.75	Residential Real Estate	8.0%		0.58%
	72.75	Comm./Ind. Real Estate	29.0%		2.11%
	72.75	Business Mach and Equip	29.0%	new equipment	2.11%
	72.75	Inventories	0.0%		0.00%
Iowa	34.20	Residential Real Estate	48.5%		1.66%
	34.20	Comm./Ind. Real Estate	100.0%		3.42%
	34.20	Business Mach and Equip	0.0%	new equipment	0.00%
	34.20	Inventories	0.0%		0.00%
Missouri	62.25	Residential Real Estate	19.0%		1.18%
	72.45	Comm./Ind. Real Estate	32.0%	levy inc. surcharge	2.32%
	62.25	Business Mach and Equip	33.3%	new equipment	2.07%
	62.25	Inventories	0.0%		0.00%
Oklahoma	93.96	Residential Real Estate	11.5% **	$1,000 homestead, $180,000 property	1.07%
	93.96	Comm./Ind. Real Estate	11.5%		1.08%
	93.96	Business Mach and Equip	11.5%		1.08%
	93.96	Inventories	11.5%		1.08%
Nebraska	19.48	Residential Real Estate	100.0%	includes credit	1.87%
	19.48	Comm./Ind. Real Estate	100.0%	includes credit	1.87%
	19.48	Business Mach and Equip	100.0%	new equipment	1.95%
	19.48	Inventories	0.0%		0.00%
Texas	22.80	Residential Real Estate	100.0%	$15,000 homestead, $180,000 property*	2.18%
	22.80	Comm./Ind. Real Estate	100.0%		2.28%
	22.80	Business Mach and Equip	100.0%	new equipment	2.28%
	22.80	Inventories	100.0%		2.28%

* The $15,000 homestead exemption applies to the school portion of the tax, assumed to be 12 mills.
** Oklahoma assessment ratios range from 11-13.5% for real estate and 10-15% for other property.
Sources: Calculations by University of Kansas based on information provided by state agencies and statutes.

Kansas Rates across the State

Within a single state, mill levies often vary widely from location to location (see Figure 5.4 and Table 5.4). In Kansas, some cities experience property tax rates more than twice the statewide average of 125 mills. High tax rates in rural locations may hinder the ability of these communities to attract and maintain jobs and investment. Rural areas must maintain public services, but often face low assessed valuations, requiring high tax rates to raise revenue. The persistence of high property tax rates in some areas of the state may hinder economic development.

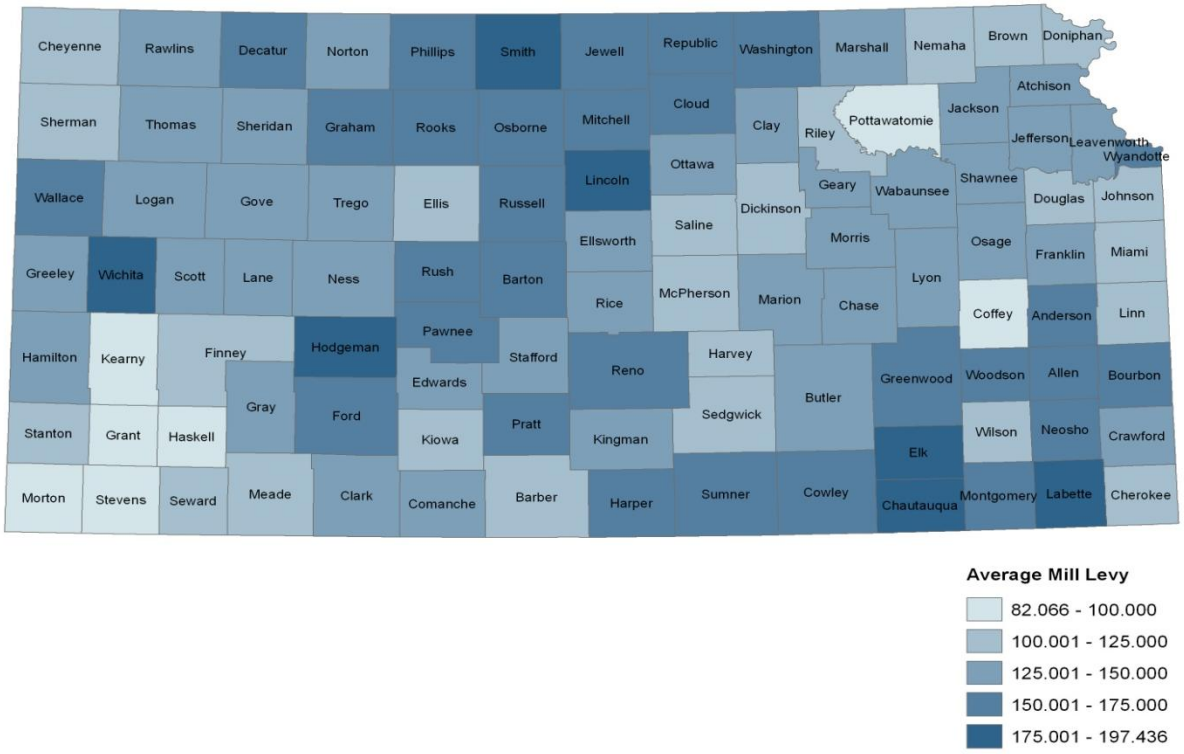
Table 5.4
Kansas Property Tax Rates 2009 by City Size and Mill Levy

City	Population	Levy	City	Population	Levy
Cities over 50,000			***Highest 10 Cities 2,000-10,000***		
Kansas City	142,562	167.110	Anthony	2,224	212.560
Topeka	123,446	147.028	Larned	3,599	200.837
Olathe	119,993	125.343	Pratt	6,397	199.716
Shawnee	60,954	121.186	Scott City	3,502	196.963
Manhattan	52,284	121.022	Ellinwood	2,035	194.755
Wichita	366,046	119.868	Russell	4,217	193.685
Manhattan	52,284	119.868	Phillipsburg	2,367	190.728
Lawrence	90,520	119.050	Eureka	2,559	188.482
Overland Park	171,231	109.817	Hoisington	2,883	188.379
			Concordia	5,208	187.939
Highest 10 Cities 10,000-50,000			***Highest 10 Cities 200-2000***		
Parsons	11,065	192.241	Grenola	215	308.985
Arkansas City	11,070	188.741	Lebanon	262	268.792
Dodge City	25,689	183.773	Moline	426	265.457
Coffeyville	10,312	182.062	Smith Center	1,644	263.261
Winfield	11,497	179.129	Longton	367	259.637
Hutchinson	40,889	165.162	Cedar Vale	617	253.704
Ottawa	12,850	163.744	Toronto	265	248.868
Atchison	10,402	162.250	Howard	757	241.709
Great Bend	15,564	159.521	Bison	208	232.806
Haysville	10,364	158.458	Jetmore	846	230.594

Note: Statewide average is 125.13 mills. The rates shown include counties, cities, school districts, and other special districts.

Source: League of Kansas Municipalities. Kansas Tax Rate and Fiscal Data Book on Disk (Excel Format), March, 2010.

Figure 5.4
Kansas Average Mill Levies by County, 2009



Property Tax Abatements and Exemptions

The previous discussion of property taxes examined the typical system of rates and valuations. However, state and local governments frequently offer property tax abatements as an incentive to attract new firms and encourage industry expansions. Arguably, property tax abatements provide the single most important tax incentive at the state and local level. Without abatements, property taxes often exceed state and local income taxes. When granted, tax abatements may amount to more than 50 percent of the tax liability. Therefore, property tax abatements may provide a substantial tax reduction.

Comparison of Property Tax Abatements

Despite the unresolved issues of effectiveness and efficiency, property tax abatements are common throughout the region surrounding Kansas. All states in the region except Nebraska offer significant property tax abatements. The percentage abatement allowed and the requirements for eligibility vary widely from state to state. Property tax abatements may be targeted to particular industries such as

manufacturing, or they may be more general, extending to services, wholesalers, and retailers. Specifics of property tax abatements are presented below.

Kansas: Kansas allows local governments to abate up to 100 percent of property tax liabilities for up to 10 years for new and expanding businesses. These "economic development" abatements are limited to the property used in manufacturing, research and development, and warehousing. Kansas law also allows most property financed with industrial revenue bonds (IRBs) to be exempt from local property taxes for up to 10 years, regardless of industry. Taxes may be abated on land, buildings, and improvements. New machinery and equipment is exempt from the property tax regardless of abatement status. In Kansas, communities must perform a benefit-cost analysis before granting abatements. Many individual communities have developed guidelines for whether abatements should be granted; however, there are no statewide benefit-cost criteria.

During 2009, the amount of Kansas commercial and industrial real estate exempted from taxation in Kansas totaled about $500 million under economic development abatement provisions and over $2.6 billion under industrial revenue bonds provisions (Kansas Department of Revenue 2009b; Tables VIIa and VIIb).

Together, these exemptions amounted to over 11 percent of commercial and industrial real estate in the state. Offsetting this to some extent, owners of some of the exempted properties have agreed to make some "in lieu of" payments to local governments. In addition, some IRB properties may have been exempt under other Kansas property tax provisions. Nevertheless, property tax abatements in Kansas are substantial.

Table 5.5
Kansas Property Tax Abatements in Place 2009

Appraised Value Exemptions ($mil)	
Economic Development Exempt	$496
IRB Exempt	$2,678
Appraised Value State-wide Total ($mil)	
Commercial/Ind. Real Estate	$28,040
Exemptions as % State-wide Value	11.3%

Colorado: Colorado makes two provisions for property tax abatements. First, local governments may exempt 50 percent of the value of machinery and equipment of new and expanding businesses for four years. Second, cities and counties (but **not** school districts, as of 2003) in enterprise zones may exempt all or part of a new or expanding firm's added property value for up to 10 years. The quality of jobs provided is a criterion that local governments use to help make abatement decisions.

Iowa: Iowa offers declining 5-year abatements on the construction of new industrial real estate. Under Iowa's Quality Jobs program, Iowa offers 100 percent abatements for up to 20 years on real estate for firms that meet a strict set of qualifications. New industrial machinery and equipment is not subject to tax in Iowa.

Missouri: Missouri offers two property tax abatement programs that have somewhat different purposes. 1) Missouri's "353" provisions provide tax abatements as high as 100 percent for 25 years within enterprise zones and blighted areas. These abatements are limited to improvements to real estate, and do not include

machinery or equipment. Almost any industry qualifies for exemption in Missouri. The purpose of these abatements is to promote growth in impoverished and economically challenged neighborhoods and regions. 2) Missouri's "Chapter 100" bonds program allows local governments to exempt real property and machinery and equipment financed with industrial revenue bonds.

Nebraska: Nebraska does not make use of property tax abatements on real property for economic development purposes. Nebraska allows a 100 percent property tax exemption on tangible business personal property for up to 10 years for high wage-high investment projects (over $10 million investment, with wages 200 percent of the county average or 150 percent of statewide average).

Oklahoma: Oklahoma abates real estate improvements, machinery, and equipment for qualified new and expanding manufacturing and selected service establishments for five years. Threshold levels of employment and investment must be met. Oklahoma stands out among the states in this study in that the abatement applies to firms that qualify under state law and is not a local decision. The state government reimburses the localities for their lost tax revenue. Local governments have the authority to abate property excluded under the state exemption.

Texas: Local governments may exempt all or a portion of the value of new real estate and business personal property of qualified businesses for up to 10 years. To do so, local governments must create "reinvestment zones" and conduct public hearings. School districts are not directly allowed to enter into property tax abatements. However, legislation passed in 2006 allows school districts to give taxpayers credits for a portion of the school district taxes paid on new property.

Property Tax Abatement Costs and Benefits

The overriding question about the fiscal soundness of property tax abatements is whether benefits outweigh costs. However, measuring benefits and costs is very imprecise. A primary concern is whether all the costs of growth associated with a firm are or even can be captured in a community's formal or informal benefit-cost calculations. A second concern is whether a firm would have chosen to locate in a particular community in the absence of the abatement. In that case, the abatement achieves no economic development purpose. A third concern is whether a firm actually holds to the promises made at the time the abatement is granted. Some communities cancel or threaten to cancel abatements if the original economic development goals are not achieved. A fourth concern is whether local funding of services, especially education, can be maintained if large amounts of business property leave the tax rolls. To address this concern, some states (for example, Colorado and Texas) limit the ability of school districts to enter into abatement agreements.

Summary

Property taxes provide an essential source of local revenues for all of the states examined by this study. Historically, the Kansas property tax has provided a buffer against economic downturns, maintaining schools and local services even when income is falling. However the recent recession has caused the Kansas property tax base to start to erode.

Effective Kansas property tax rates are in the midrange for the region for residential property. Tax rates on commercial and industrial real estate (before any special abatements) are near the high-end for the region. New machinery and equipment has been removed from the property tax base in Kansas, providing a substantial economic development incentive.

Communities frequently use property tax abatements as an economic tool, despite concerns about their effectiveness and efficiency. Kansas tax abatements are very generous: Kansas allows abatements of up to 100 percent for 10 years on most types of business property and for most industries.

In Kansas, as in most states, the decision to grant an abatement is made locally. Kansas local governments are required to perform a benefit-cost analysis before granting an abatement, but each community can decide how to tally benefits and costs.

An emerging concern is the impact of property tax abatements on school financing. Some states (but not Kansas) limit or prohibit the abatement of school levies.

Chapter 6: Business Climate

Introduction

This chapter provides an overview of the business climate in Kansas, the region, and nation-wide. Based upon an examination of both academic and applied studies that address the business and development communities, this chapter identifies factors which are commonly included in "measures" of the business climate. The chapter also reports on how the state ranks within the region on the most common measures.

While taxes are an important element of a business climate, they do not represent the entirety of a business climate. This chapter focuses on the non-tax factors that contribute to a vibrant business environment.

The assessment of a business climate is subjective and varies depending upon the industry targeted. There is no single ranking of taxes, costs and community attributes that applies equally well to all industry types.

Recently, Kansas has ranked highly in four business climate studies. These include: Pollina Top 10 Pro-Business States #7; CNBC's Top States for Business #9; U.S. Economic Freedom Index #10; Forbes Best States for Business #15.[5] Clearly studies that rank Kansas highly provide good advertising for the state. One criticism of these business climate studies is that these studies assess the structure of the business environment, rather than the economic burden or benefits such a structure imposes. For example, studies of regulatory environment might identify the number of professions regulated by the state, rather than focusing on how the regulatory burden is increased for a particular taxpayer in terms of labor hours or lost profit. These studies simply count and then rank based on an ad hoc weighting of different measures.

Other business climate studies focus on actual state performance such as income levels and employment rates (Pacific Research Institute State Economic Performance) or factors that might attract new business and foster the growth of existing business (New Economy Index). Still others focus on specific aspects of the business climate such as taxation (Tax Foundation). The Pacific Research Institute State Economic Performance ranks Kansas #34. The New Economy Index, which focuses on technology and emerging industries, ranks Kansas #26. The Tax Foundation ranks Kansas #35.

Different studies present disparate results, depending on the factors evaluated and the importance attached to each factor (through weighting). In the sections that follow, this report reviews not the specific studies of business climate, but rather the individual factors that enter into most business climate considerations. (Note that taxation has been covered throughout the report and is omitted from this chapter.)

[5] Refer to Chapter 8 for complete citation for each study.

Business Costs

In this section, the comparative costs of several types of business inputs are analyzed. These include: labor, unemployment insurance, energy, and construction costs.

Labor costs

"Labor Trumps Other Factors in the Location Decision" proclaims a recent article (Johnson et al. 2010). The Area Development 2009 Corporate Survey found that labor costs were ranked first in importance for business location decisions. Labor is generally the largest operating cost for manufacturing and service firms, and labor costs vary significantly across geographic locations. It is not surprising that labor costs drive facility locations.

Kansas labor costs compare favorably with the nation and the region. In 2009, wages averaged approximately $38,000 per employee, or 84 percent of the national average. Table 6.1 presents average annual wages in the region. Texas and Colorado have significantly higher wage levels.

Unemployment insurance

Associated with labor costs are mandatory benefits such as unemployment insurance. Unemployment insurance provides benefits to workers who lose their jobs. The average level of unemployment insurance payments depends on: 1) the condition of a state's unemployment insurance trust fund, and 2) state laws and regulations. Currently, Kansas rates exceed the regional and national average, as a percent of total payroll.

Table 6.1
Average Annual Wages, 2009

	Wage	Ratio to US
NE	36,644	0.80
IA	37,158	0.82
OK	37,238	0.82
KS	38,154	0.84
MO	40,022	0.88
TX	45,692	1.00
US	45,559	1.00
CO	46,861	1.03

Source: US Census Bureau. Quarterly Census of Employment and Wages.

Table 6.2
Unemployment Insurance Average Rate as Percent of Total Payroll, 2010

	UI Rate (%)
OK	0.22
CO	0.56
US	0.83
NE	0.87
MO	0.87
TX	0.83
KS	0.94
IA	1.28

Source: US Department of Labor. Significant Measures of State UI Tax Systems.

Energy costs

Energy comprises a significant share of operating costs for many manufacturing industries, especially heavy manufacturing. Commercial electrical rates are low throughout the region: 7 to 8 cents per kWh with the exception of Texas. The entire region offers commercial rates below the US average. Industrial electric rates range from a low of 5 cents per kWh (Oklahoma) to 7 cents (Texas). Most states in the region, including Kansas, offer industrial rates significantly below the national average. Natural gas provides a somewhat different picture. Kansas commercial rates greatly exceed the national average, while industrial rates are very competitive regionally and nationally. Table 6.3 provides electricity and gas costs for commercial and industrial consumers.

Construction costs

A business cost particularly relevant to expanding or relocating businesses is construction costs. Data on the cost of building a three story office was extracted from the RSMeans Cost Data Online cost estimation system. For each state, a single large city is used as a representative location to create an index of local costs to national costs. As seen in Table 6.4, construction costs in Kansas City Kansas exceed those for most of the region but fall below the national average. Construction costs are driven by material costs and wages. States that have lower wages for construction workers will have lower construction costs, all else equal.

Table 6.3
Energy Costs in Region, 2009

	Electricity: cents per kwh		Gas: $ per 1000 cf	
	Comm.	Indus.	Comm.	Indus.
MO	6.88	5.36	10.96	9.47
OK	6.90	5.00	10.61	14.32
NE	7.27	5.83	9.62	5.95
IA	7.45	5.18	7.84	6.00
CO	7.85	6.08	7.49	8.76
KS	7.93	6.21	10.18	4.22
TX	10.03	7.25	8.15	4.08
US	10.22	6.92	9.86	5.28

Source: US Energy Information Administration.

Table 6.4
Construction Costs, 2010

	Cost Index
OK: Oklahoma City	0.82
TX: Dallas	0.84
IA: Des Moines	0.90
NE: Omaha	0.92
CO: Denver	0.95
KS: Kansas City	0.98
US	1.00
MO: Kansas City	1.03

Source: RSMeans Cost Data Online.

Regulatory and Judicial Environment

Regulation can impose significant costs on businesses. The issue may be especially important for smaller firms. According to the National Federation of Independent Business, "regulations cost small firms almost 45 percent more per employee than large businesses" (NFIB 2010).

While the original purposes of many regulations are laudable – protecting safety of a firm, its workers, and the general public – many business owners believe that the goals may be achieved in ways that are unnecessarily costly and time-consuming.

While the original purpose of many regulations are laudable – protecting the safety of a firm, its workers, and the general public – many business owners believe the goals may be achieved in ways that are less costly and time-consuming. Kansas business owners and managers identified regulation as one of the three most important business climate issues. Other survey-based studies confirm that firms perceive regulation as a major issue. For example, 30 percent of respondents to a Colorado survey stated that regulation was one of the top three barriers to growing their businesses (Heilman 2009). In another recent study, 42 percent of respondents stated that regulation was a primary factor that put California companies at a disadvantage (Bain and Co. 2004).

State regulation is constrained by the federal regulatory environment. Beyond this, many regulations are industry-specific or are imposed at the local level. One respondent to this report's survey identified multiple layers of government as increasing the regulatory burden.

Despite its perceived importance to business, the overall regulatory environment of a state is a difficult concept to quantify. The Economic Freedom Index cites well over 100 regulatory factors, but most have little impact on a headquarters establishment in a major city.[6] Other indices measure the number of new regulations per year, without regard to the type (Bain and Co. 2004). But on all measures reviewed, the Midwest or Great Plains region has the lowest regulatory burden in the US.

While all levels of governments add to a business' regulatory burden, this study focuses on state-level regulations. Specifically, this report identifies three common components of regulatory environment indexes which impact a broad base of firms. These are:

1) Right to work laws and unionization

2) Worker compensation, and

3) Tort reform.

[6] Examples of factors included, by not particularly relevant to business climate include: minimum age for drivers, effective date of seat belt laws, terms of judges, and commodity cost of national school lunch program per participant in 2006.

Right to work laws and unionization

In right to work states, employees cannot be forced to join a union and pay dues, even if the workplace has a union in place. Employees may see this as enhancing their individual freedom. Employers perceive this as reducing the power unions have over the workplace. From the employer's point of view, the prevalence of unionization imposes costs to engage in collective bargaining and comply with agreements. As seen in Table 6.5, Kansas joins four other states in the region as a right to work state. The percentage of Kansas employees represented by unions stands at 8.4 percent, mid-range for the region and substantially below the US average of 13.7 percent.

Table 6.5
Right to Work and Percentage of Employees Represented by Unions, 2009

	Right to Work?	% Union Representation
TX	YES	6.2
OK	YES	7.3
KS	YES	8.4
NE	YES	11.4
IA	YES	13.3
CO	NO	8.3
MO	NO	10.6
US		13.7

Sources: US Bureau of Labor Statistics and National Right to Work Legal Defense Foundation

Worker compensation

Worker compensation systems require employers to insure their employees against the risk of accidents and injuries in the workplace. In return, employees turn to the worker compensation system when an injury occurs, rather than litigating directly with the employer. States vary widely in the range of worker compensation costs. Costs, in turn, depend on the characteristics of the workforce and, more importantly, on state regulation. As seen in Table 6.6, Kansas firms pay worker compensation insurance costs that are in the mid-range for the region and about 6 percent below the national average.

Table 6.6
Worker Compensation Cost Index for Manufacturing, 2009

	Cost Index
CO	0.647
IA	0.844
NE	0.906
KS	0.946
US	1.000
MO	1.022
OK	1.380
TX	1.213

Source: Actuarial and Technical Solutions. Reproduced with permission.

Tort Reform

Manufacturers, service providers, and distributors all operate in an environment in which their products and services may be perceived to injure a customer. Wronged parties seek resolution through the civil court system. Businesses have served as strong advocates of "tort reform," measures to limit the types and amounts of damage awards that plaintiffs may seek.

According to the National Association of Manufacturers, "Legal reform must be pursued to restore balance between plaintiffs and defendants, apply reason and sound science, discourage frivolous claims and place appropriate limits on liability and damages" (Heilman 2009). Firms operating in highly litigious states may incur additional liability insurance costs as well as litigation costs.

The American Tort Reform Association identifies more than a dozen issues associated with reform and summarizes how each state is progressing towards resolution of these issues. This report focuses on three issues that are of particular concern to businesses:

1) Noneconomic damages reform,
2) Punitive damages reform, and
3) Joint and several liability reform.

Noneconomic damages reform. Damages are awarded when an injury has taken place and liability has been established. Economic damages are intended to compensate the plaintiff for lost work time, lost property, medical expenses, and other items that can be measured in dollar terms. Noneconomic damages compensate the plaintiff for pain and suffering.

Tort reform proponents argue that noneconomic damages should be capped at a "reasonable" dollar figure. Kansas places strict limits on noneconomic damages–stricter than in most states in the region. From a business perspective, risk is reduced.

Kansas is unique in that it ties punitive damages to the defendant's ability to pay.

Punitive damages reform. Beyond economic and noneconomic damages, punitive damages are intended to punish the plaintiff for deliberate or malicious behavior. Tort reform advocates suggest limiting the amount of punitive damages so juries cannot capriciously award large sums to the plaintiff. Within the region, only Oklahoma and Texas impose strict limits. Kansas is unique because punitive damages are capped based on the *lesser* of: 1) $5 Million or 2) the defendant's annual income.

Joint and several liability reform. Often several firms and/or individuals have some responsibility for the plaintiff's injury. If some named defendants are bankrupt, a defendant who is only minimally responsible for the injury may be forced to pay the entire judgment. Tort reform advocates support legislation to limit the liability of parties who have only a small part in causing an injury. Joint and several liability may also cause plaintiffs to look for a "deep pocket."

Table 6.7 presents details on the three tort reform elements for each state.

Table 6.7
Elements of Tort Reform

	Non-Economic Damages
KS	Pain and suffering damages limited to $250,000.
CO	Noneconomic damages generally limited to $250,000. Limit $300,000 in medical cases.
IA	No limitations.
MO	Damage limit in medical cases is $350,000.
NE	No limitations
OK	Limited to $400,000 except in special cases. Limit is $200,000 in medical cases
TX	By Constitutional amendment, Texas legislature has power to set limits. In medical cases, limit is $750,000.
	Punitive Damages
KS	Limited to smaller of defendant's annual income or $5 million. Punitive damages are determined in a separate proceeding.
CO	Prohibited unless the plaintiff can show willful or wanton action.
IA	Requires that the defendant acted in willful and wanton manner. 75% of any punitive award goes to the state, not the defendant.
MO	Limits punitive damages to greater of $500,000 or five times the non-punitive amt.
NE	No limitations.
OK	Limited to $100,000, or $500,000 or twice actual damages if the defendant acted maliciously. Some exceptions to limits.
TX	Limited to $200,000 or less. Unanimous jury decision required.
	Joint and Several Liability
KS	Generally not allowed.
CO	Generally not allowed.
IA	Generally not allowed where defendant less than 50% at fault.
MO	Generally only allowed when defendant more than 51% at fault.
NE	Generally not allowed.
OK	Generally not allowed where defendant less than 50% at fault.
TX	Generally not allowed where defendant less than 50% at fault.

Source: American Tort Reform Association.

Two patterns emerge in the region: fewer defendants are allowed to be named in lawsuits and damages are limited. In Kansas, Colorado, and Nebraska, joint and several liability is not allowed. In the other states, this is allowed, but only if a defendant is approximately 50 percent or more responsible. In contrast, California applies joint and several liability for economic damages. In general, joint and several liability favors plaintiffs, whereas limiting joint and several liability favors defendants (often businesses). Kansas has the lowest cap in the region for non-economic damages and restricts punitive damages.

The indicators examined in this section show that Kansas has a favorable or at least neutral regulatory and judicial environment in comparison with other states. This finding is also borne out by studies that create weighted indexes of regulatory features. For example, the Economic Freedom Index ranks Kansas as having the 10th best regulatory and legal environment among states, while the Lawsuit Climate Index ranks Kansas as 14th best in legal climate.

Employment

Employment measures capture the type of work in a state, the educational attainment of employees and the workers attracted to the state, and the academic preparation of the workforce.

Knowledge Workers

The prevalence of knowledge workers is an indication of the vibrancy and entrepreneurial atmosphere of a state (ITIF 2010).

Information Technology (IT) Professionals. This measure examines employment in IT occupations in non-IT industries as a share of total jobs. This measure is particularly important for analysis of the entrepreneurial climate of a state. State economies based on natural resources or manufacturing will be relatively low scoring. This measure is a component of the State Knowledge Worker measure in the 2010 State New Economy Index (ITIF 2010). On this measure, Kansas performs in the middle of in the region and 17th in the nation. Of the states in the region, Oklahoma, Iowa and Nebraska have suffered a decline in the percentage of IT jobs since 2006.

Table 6.8
IT Employment as a Share of the Total Workforce

	Percentage of Jobs in IT	Rank in Region	Rank in Nation
Colorado	1.84%	1	7
Missouri	1.59%	2	11
Texas	1.43%	3	16
Kansas	1.36%	4	17
Nebraska	1.26%	5	22
Iowa	1.19%	6	27
Oklahoma	0.96%	7	35

Source: Bureau of Labor Statistics 2009.

Professional Jobs. This measure captures the percentage of jobs in the state held by professionals such as managers, professionals and technicians. In a knowledge-based economy with offshoring of low-margin jobs, economic vitality hinges on the professional sector. This sector has grown by 50 percent between 1999 and 2007. Colorado is the leader in the region; Kansas performs well considering several drivers in the current state economy are agriculture and natural resources. ITIN (2010) uses the measure presented in Table 6.9. Similar results are found from US Census Data, American Community Survey.

Workforce Education. The economy has an increasing need for skilled workers and the educational attainment of a state's workforce is another indication of the state's business climate. In 2009, 27.5 percent of Americans older than 24 years completed at least a bachelor's degree. As presented in Table 6.10, Colorado has the highest average with 35.9 percent of the population earning a bachelor's degree or higher. The average in Kansas is 29.5 percent.

Migration of Educated Workforce. Educated workers are highly mobile and respond to changes in the business climate by moving. The migration of educated workers demonstrates which states are able to attract the most skilled workers. Gottlieb and Fogarty (2003) demonstrate the strong relationship between a state's per capita income and the ability to attract knowledge workers.

Table 6.11 focuses on migration from both US and abroad for workers with an advanced degree. Kansas lags the region in attracting highly educated workers. Oklahoma is last in the region and second to last in the nation.

Table 6.9
Managerial, Professional and Technical Jobs as a Share of the Total Workforce

	Percentage of managerial, professional, and technical jobs	Rank in Region	Rank in Nation
Colorado	22.2%	1	12
Texas	21.1%	2	18
Kansas	20.3%	3	26
Oklahoma	20.3%	4	27
Missouri	20.2%	5	29
Nebraska	19.4%	6	35
Iowa	18.9%	7	40

Source: 2010 New State Economy Index (ITIN)

Table 6.10
Educational Attainment

	Percentage of population 25 years and older earning a bachelor's degree or higher	Rank in Region	Rank in Nation
Colorado	35.9%	1	3
Kansas	29.5%	2	17
Nebraska	27.4%	3	22
Texas	25.5%	4	31
Missouri	25.2%	5	34
Iowa	25.1%	6	35
Oklahoma	22.7%	7	43

Source: US Census, 2009 American Community Survey

Table 6.12 presents data on migration within the US. Within the region, Kansas is fourth in attracting workers with some college. Oklahoma is lowest in the region and lowest in the nation in the percentage of migrating workers with some college at 54.7 percent.

Kansas appears to be one of the most successful states in the regions for attracting highly educated, international workers.

Table 6.13 presents data on migration from abroad by workers with some college. Kansas appears to be one of the most successful states in the region for attracting highly educated, international workers.

Preparedness for Work

The quality of the workforce matters to site seekers. In a recent interview, Gov. Perdue (NC) stated "…executives looking at North Carolina want to know about the quality of the workforce around the state, workforce training and the quality of the public schools. They want to know if the schools are keeping up with global standards of excellence in science and technology" (Arend 2010). In the 2010 Annual survey of corporate real estate executives, work force skills was rated the most important factors in site location decisions (Arend 2010).

Table 6.11
Percent of Workers with Advanced College Degrees Migrating to the State, 2009

	Percent with Advanced Degrees	Rank in Region	Rank in Nation
Iowa	15.3%	1	23
Colorado	15.1%	2	25
Nebraska	13.4%	3	29
Texas	13.1%	4	32
Missouri	12.1%	5	36
Kansas	10.8%	6	41
Oklahoma	7.4%	7	49

Source: US Census, 2009 American Community Survey.

Table 6.12
Percent of Workers with Some College Migrating to the State from Another State 2009

	From Other States	Rank In Region	Rank In Nation
Iowa	72.0%	1	16
Colorado	69.9%	2	21
Missouri	66.7%	3	31
Kansas	66.7%	4	32
Texas	63.8%	5	36
Nebraska	60.0%	6	46
Oklahoma	54.7%	7	50

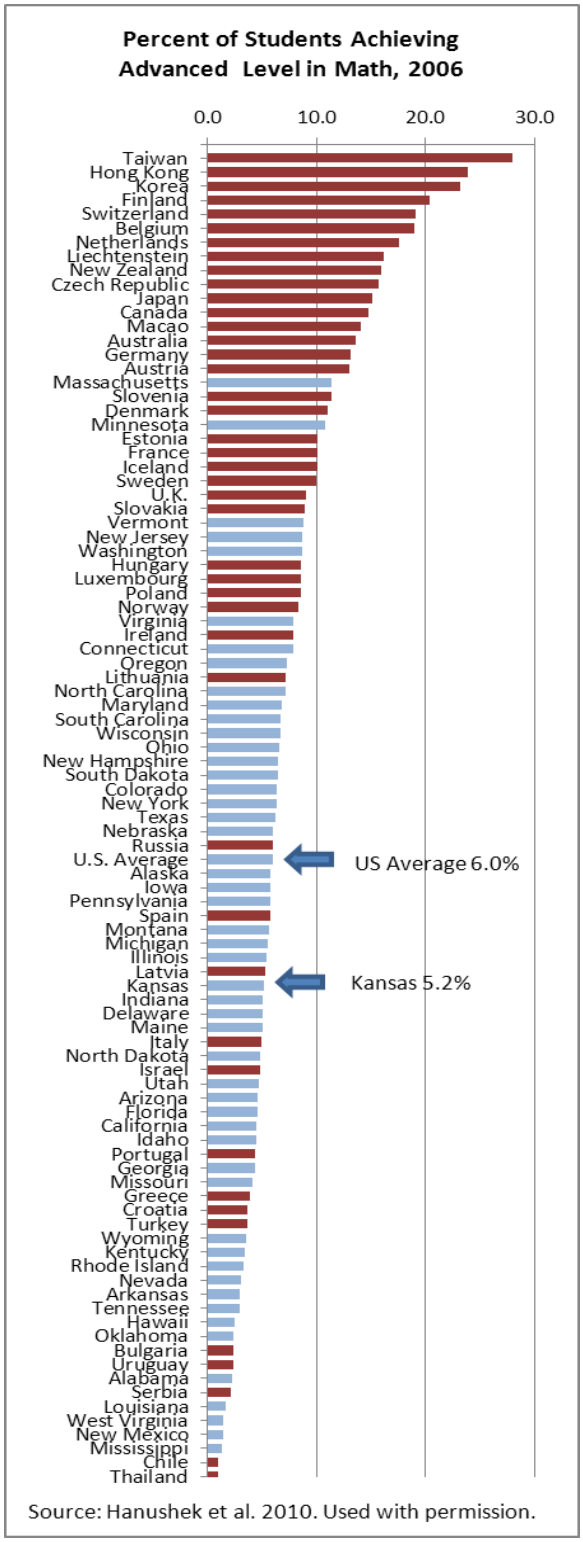
Source: US Census, 2009 American Community Survey.

Table 6.13
Percent of Workers with Some College Migrating to the State from Abroad, 2009

	From Abroad	Rank In Region	Rank In Nation
Nebraska	71.8%	1	9
Kansas	69.3%	2	16
Iowa	67.4%	3	17
Missouri	56.9%	4	39
Oklahoma	53.1%	5	44
Colorado	52.0%	6	46
Texas	51.8%	7	47

Source: US Census, 2009 American Community Survey.

Figure 6.1



Source: Hanushek et al. 2010. Used with permission.

Student Achievement in Mathematics. The mismatch between employers' needs and employees' preparedness for the workplace begins with K-12 education. A business climate that promotes high-tech, innovation, entrepreneurship and internationalization demands workers trained in mathematics. In a global marketplace, states are not competing within the region, but competing worldwide for workers, for businesses, and for economic growth opportunities. Even industries that would not traditionally be considered math-based, such as bioscience, have a foundation in mathematics.

Over the next 10 years, 62 percent of workers will need to be proficient in algebra, geometry, data interpretation, probability and statistics (Friedman 2007). Hanushek and Woessmann (2008, 2009) demonstrate that countries with students achieving at high levels in math and science have increased economic productivity, compared to similar countries with lower-performing students. Much focus has been on math performance, as research demonstrates that future earnings and economic outcomes are more closely linked to math skills than other skills learned in high school (Murnane, Willett and Levy 1995).

Figure 6.1 presents the ranking of states and counties based upon the percentage of 8th grade students achieving at an advanced level in math in the 2005 National Assessment of Educational Progress (Hanushek et al. 2010). With only 5 percent of students performing at advanced levels, Kansas is outperformed by 30 countries and 25 states.

Education Quality. Student test scores and educational attainment (for example, level of education achieved) assess educational quality by examining individual measures. Other measures assess the overall educational climate and educational quality of a state or locality. These measures often compare average teacher salaries, spending per pupil, incentive pay, teacher accountability and teacher qualifications as indications of quality of education (Swanson 2010).

This report recognizes that most executives and knowledge workers who are considering relocation compare school districts based on highly visible measures. As such, this report highlights the two measures listed first when searching for "top high schools in America" on a popular search engine: rankings of the best public high schools in America from US News & World Reports (USNWR) and Newsweek.

For the USNWR measure, researchers compile student test scores, demographic information, and participation in Advanced Placement and International Baccalaureate (IB) coursework. Kansas ranks #46 in the nation. Because of insufficient data, Oklahoma and Nebraska were not ranked. USNWR also identifies the number of gold, silver and bronze medal high schools.

Newsweek offers a similar ranking of public high schools nationwide. Of the over 2000 "best high schools," nine are from Kansas. Statewide economic development depends, in part, on the perception of a quality education available statewide.

6.14
US News & World Report State Rankings of High Schools, 2009

	No. of Gold Medal Schools	Rank In Region	Rank In Nation
Texas	11	1	14
Colorado	1	2	15
Missouri	1	3	34
Iowa	0	4	40
Kansas	1	5	46
Nebraska		Unranked	
Oklahoma		Unranked	

Source: US News and World Report (2009)

Table 6.15
Newsweek Ranking of Best High Schools, 2010

	No. of "Best High Schools"	Highest Ranked High School
Texas	136	#1
Colorado	33	#37
Missouri	14	#73
Oklahoma	11	#41
Kansas	9	#251
Iowa	6	#375
Nebraska	4	#847

Source: Newsweek (2010)

Readiness for Education. Recent research focusing on the national crisis in science, math and technology finds that students who are not able to perform at grade level by fourth grade are likely to never catch up (Balfanz 2010).

Early economic development efforts had a laser-like focus on trying to "land the big fish" – large headquarters of multinational corporations. However, much like individual investors, states are discovering that a balanced portfolio of investment in economic development efforts has higher returns with lower risk. An investment in early education as a long-term economic development tool offers similar diversification; states can invest in future workers to increase their educational outcomes and thus those of the state. Investing in early childhood also has near-term benefits: Kansas becomes more "family-friendly" to prospective transplants and improved educational outcomes can be quickly obtained at the elementary level; the results of a quality pre-K program can be seen within a few years at the 4th grade testing.

Children who are in high quality pre-K programs are less likely to be retained in first grade, less likely to need special education services, more likely to be literate by sixth grade, graduate high school, get a job, pay taxes and stay off welfare and 50 percent less likely to be in involved in criminal activity.

Children who are in high quality pre-K programs are less likely to be retained in first grade, less likely to need special education services, more likely to be literate by sixth grade, graduate high school, get a job, pay taxes and stay off welfare and 50 percent less likely to be in involved in criminal activity (Rolnick 2003, Barnett and Belfield 2006).

Nationwide, there is increasing emphasis on funding for early learning programs. The funding mechanisms to support quality early learning programs vary.

In this region, Oklahoma has a voluntary pre-K for all program in which serves 71 percent of four-year olds (National Institute for Early Education Research 2009). Iowa, Colorado, Nebraska, and Texas have targeted programs for pre-K (Pew Center on the States 2009). Texas' program serves 45 percent of four-year olds. Kansas, Colorado and Iowa have similar participation rates of around 16 percent. These programs are supported directly by the state.

Outside the region, one state struggling with educational achievement has implemented a market-based approach to improve the quality of private early learning programs. In 2007, Louisiana instituted programs to encourage child care providers to voluntarily participate in a quality rating and continuous improvement system. Because parents receive additional benefits if they select a quality-rated provider, the program uses market forces to incentivize parents to know and select high quality early childhood programs. Louisiana's school readiness program also provides incentives to child care providers to improve their quality rating by participating in the continuous improvement system. Finally, Louisiana rewards businesses that provide early learning programs to employee's children. This multi-pronged approach which supports working families, their employers, and strong and diverse childcare

businesses, differs from other states which focus on expanding state-provided services.

Quality of Life Factors

States desire to attract highly educated, knowledge-workers who have increasingly become more mobile because of: 1) greater job opportunities, and 2) the expansion of electronic communication. Thus, most business climate studies include measures of quality of life.

Applied studies often include the following factors:

- Crime rates
- Debt per resident
- Health rankings
- Hospitals per capita
- Cost of living measures

Foreclosure rates per household is a recent addition to quality of life indices (MainStreet 2010).

Gabriel et al. (2003) identify dozens of factors used in academic research to model differences in states' quality of life. These include:

- Climate: precipitation, temperature, humidity, wind speed, sunshine
- Recreation: coastal land, inland water, public land, state parks, national parks
- Environmental: hazardous waste sites, environmental "greenness," ozone levels, carbon monoxide levels
- Education: student-teacher ratios, higher education funding, K12 funding
- Other measures: commuting time, violent crime, highways spending, and cost of living.

In national surveys and studies, Kansas performs well on measures of personal debt, healthcare costs, crime, and cost of living (see for example, MainStreet 2010). Transportation, taxes and education are discussed in more detail in other sections of this report.

Transportation/Infrastructure

Transportation is consistently identified as a key factor in business climate (Bartik 1985, Padgitt 2010). Recent studies rank Kansas as third in the nation in overall highway performance. (Hartgen et al. 2010). This measure is based on road and infrastructure quality, controlling for budget differences in each state. Kansas has been ranked in the top five since 2004.

Expenditures per mile. Indices of transportation include measures of spending per mile. Kansas ranks 19st in the nation and fourth in the region in total disbursements per state-controlled mile. Table 6.16 presents the state spending per state-controlled mile in the region, along with the national ranking.

Recent studies on state transportation rank Kansas as third in the nation in overall highway performance.

Table 6.16
State Disbursements for State-Administered Roads per Mile, 2008

	Disbursements per mile ($)	Rank in Nation
Texas	192,885	#36
Colorado	147,169	#27
Oklahoma	117,153	#21
Kansas	112,042	#19
Iowa	92,978	#16
Missouri	64,633	#10
Nebraska	63,369	#9

Source: Highway Statistics 2008, FHWA

Road Quality. While spending is an indication of the states' commitment to infrastructure, businesses and taxpayers traveling the state are concerned with actual road condition. Table 6.17 presents rural interstate road condition; Federal Highway Administration (FHWA) defines rural as all areas outside an urban area with a population of 50,000 or more. The road quality measure is based on the percent of rural roads in poor "rough road" condition, as defined by and reported to FHWA. Kansas is tied for first in the nation in quality of rural roads under this measure. On average, 1.93 percent of U.S. rural interstates are in poor condition as of 2008.

The results for urban interstate mileage is reported in Table 6.18. Again, Kansas ties for first in the nation for lowest percentage of poor urban roads. On average, 5.37 percent of urban interstates were in poor condition as of 2008.

Road Quantity. Rounding out the metrics commonly used to assess transportation quality are measures of sufficiency: congestion and commute time. On both dimensions, Kansas performs well. Table 6.19 presents the percent of urban interstate roads considered congested using peak-hour volume to capacity ratios. Kansas is ranked 10th in the nation and first in the region with 22.9 percent of urban miles considered congested during peak hours. The study follows Hartgen et al. (2010) and uses a road volume/road capacity ratio of .70 as the cut-off for determining congestion. On average, 48.6 percent of urban interstates in the US are congested as 2008.

Table 6.17
Percent of Rural Interstate in Poor Condition 2008

	Percent Poor Miles	Rank in Nation
Kansas	0.00	#1
Missouri	0.00	#1
Nebraska	0.00	#1
Texas	0.05	#23
Iowa	2.23	#38
Oklahoma	2.63	#40
Colorado	2.64	#41

Source: Highway Statistics 2008, FHWA

Table 6.18
Percent of Urban Interstate in Poor Condition 2009

	Percent Poor Miles	Rank in Nation
Kansas	0.00	#1
Nebraska	0.00	#1
Missouri	1.30	#14
Texas	1.54	#19
Colorado	6.64	#37
Iowa	8.55	#43
Oklahoma	13.31	#46

Source: Highway Statistics 2008, FHWA

Table 6.19
Percent of Congested Urban Interstate Miles
2008

	Percent Miles Congested	Rank in Nation
Kansas	22.90	#10
Oklahoma	37.10	#17
Iowa	38.82	#19
Nebraska	40.98	#22
Missouri	43.93	#26
Colorado	47.58	#33
Texas	48.59	#37

Source: Highway Statistics 2008, FHWA

Table 6.20 presents the average commute time for states in the region. Based on US Census data, the average commute time for the states in the region is 20.9 minutes. Texans have the longest commute: 24.7 minutes on average. Kansans have, on average, an 18.5 minute commute, which is the third lowest in the region.

Table 6.20
State Average Commute Time in Minutes
2010

	Average Commute in Minutes
Nebraska	17.7
Iowa	18.2
Kansas	18.5
Oklahoma	20.2
Missouri	23.1
Colorado	23.8
Texas	24.7

Source: U.S. Census State and Metro Area Data Book: 2010

...for every one percentage point increase in broadband penetration in a state, employment is projected to increase by 0.2 to 0.3 percent per year.

Broadband. Broadband is the infrastructure of the 21th century. Recent research demonstrates the spillover benefits of broadband use. Crandall et al. (2007) report that "Non-farm private employment and employment in several industries is positively associated with broadband use. More specifically, for every one percentage point increase in broadband penetration in a state, employment is projected to increase by 0.2 to 0.3 percent per year."

A number of states have undertaken efforts to increase broadband penetration, particularly in rural areas. These include: Maryland, Kentucky, Tennessee, Missouri, California, Mississippi, Georgia, Vermont, Ohio, West Virginia and South Carolina.

According to FCC data, Kansas is at the national average for broadband connectivity (of at least 768 kilobits per second) at 60 percent (FCC 2010). Ten Kansas counties have less than 10 percent of the population served by broadband (FCC 2010). Table 6.21 presents the Kansas counties with the broadband service below the state and national average of 60 percent.

Table 6.21
Percent of Population with Broadband Coverage, 2010

County	Percent of Population With Broadband Coverage
Kansas	0%
Gove County	0%
Graham County	0%
Norton County	0%
Phillips County	1%
Comanche County	3%
Chase County	4%
Ness County	4%
Thomas County	4%
Rush County	8%
Rooks County	13%
Chautauqua County	19%
Logan County	23%
Lincoln County	40%
Marshall County	40%
Harper County	41%
Meade County	42%
Wabaunsee County	42%
Gray County	44%
Cheyenne County	47%
Hodgeman County	50%
Kiowa County	52%
Sheridan County	53%
Washington County	53%
Barber County	54%
Kingman County	54%
Cherokee County	55%
Rawlins County	56%
Wallace County	56%

Source: Federal Communication Commission 2010.

Summary

Overall, Kansas has a strong business climate. Notable strengths are the low business costs, the favorable tort climate, and the excellent transportation infrastructure.

Kansas performs moderately well on quality of life. The results are strong for debt levels, foreclosures rates, and healthcare costs but poorer for weather and geographic amenities.

One area with the most potential for improvement is in education. Several national rankings rate K-12 educational quality as moderate to poor in the region and in the nation. Kansas policymakers cannot change the location of mountains or oceans, or increase the number of days of sunshine. However, they can enact educational reform that leads to national prominence in student performance and achievement. Another area for improvement is expansion of broadband into rural areas to create an environment more conducive to economic growth.

Chapter 7: State Tax Considerations

Introduction

The model and results presented in Chapter 2 demonstrates that Kansas has a fairly stable tax regime that performs well in the region. Chapters 3, 4 and 5 provide a detailed overview of the three main types of taxes imposed on businesses: corporate income tax, property tax, and sales/use taxes.

This chapter presents a number of tax policy considerations to potentially:

1) Improve the business climate in the state,
2) Modernize the tax code to reflect business practices in the future,
3) Close loopholes, and
4) Restore equitable tax treatment between taxpayers and transaction types.

The considerations discussed in this chapter are not recommendations by the KU Institute for Policy and Social Research, the researchers responsible for this report, or Kansas, Inc. Rather, these considerations are presented to inform policy makers of trends in state taxation and to foster a thoughtful analysis and debate on how Kansas will tax businesses with activity in the state.

The chapter includes an executive summary of the considerations presented. The detailed discussion begins with the most sweeping change: new alternatives to the current tax regime. The chapter concludes by presenting state tax trends and considerations for revising the current tax regime if a wholesale state tax reform is not to be.

Summary of Considerations

This section summarizes the tax policy considerations discussed in more detail later in the chapter.

Wholesale revision of the tax code:

Kansas might consider a wholesale revision of the tax regime to eliminate income, sales/use, and/or property taxes. The national trend is for states to implement business activity taxes to reduce the tax rates and broaden the tax base. In the region, Texas and Oklahoma have implemented a Gross Margins Tax and Business Activity Tax, respectively. This chapter presents the types of business activities taxes enacted throughout the US and their policy implications in terms of tax neutrality, fairness, administrative and taxpayer convenience, and revenue generated. Overall, business activity taxes can increase tax neutrality, reduce administrative costs, and increase taxpayer convenience, but the trade-off is regressivity. Depending upon the structure of the business activity tax, the provision could be revenue neutral (simply generating enough to replace another tax) or revenue positive (generating additional state and local revenue).

Considerations for modifications of the current Kansas tax code:

In the event that policymakers choose to make reforms within the current tax system, rather than engage in a wholesale reform of the entire tax code, considerations for the corporate income tax, sales/use taxes and property taxes are discussed.

Corporate Income Tax Considerations

The report identifies four areas that tax policy makers might consider to eliminate economic inefficiencies created by the current income tax rules and to modernize the tax code to reflect current business climates.

1) Implement "economic nexus" rules. States can only tax businesses with nexus, or a connection to the state. A number of states have successfully argued corporations have "economic nexus" through access to the local market from its customer base and the receipt of significant benefits from state services. The courts found that this economic presence is sufficient to meet the substantial nexus requirement of the Commerce Clause of the U.S. Constitution. Accordingly, a number of states have adopted an economic nexus standard, with more states planning to adopt this standard as a way to expand their tax base.

2) Change income source for services to be based on the location of the market, rather than where the costs are incurred. For example, an Omaha engineering firm designing a stadium in Kansas would generate little Kansas income under the current law's cost-of-service approach. Under the market-based approach, the engineering services would be sourced to Kansas because this is where the services were provided.

   The market-based sourcing rules are cutting-edge state tax policy and address the changing business service practices: providing global services through internet-based technology. Significant advances in global communication technology have changed the business environment. Personal services performed by out-of-state providers run the gamut from programming, accounting, radiology, and legal advice to telesurgery. Firms with a national market for their services are tax-advantaged when located in a market-based sourcing state. Thus, this change might also encourage service activity within a state. This change also levels the playing field by eliminating the competitive advantage for out-of-state vendors who are not subject to Kansas income tax.

3) Require disclosures of uncertain tax positions (UTP) at the state level. Next year, large corporate filers will be required to disclose to the IRS all income tax positions for which the corporation creates a tax reserve for uncertain tax positions; firms create UTP reserves for tax positions that are likely to be lost upon audit. The UTP schedule will allow taxing authorities to expedite review of tax returns. States may also consider creating a state-level UTP to identify high-risk transactions at the state level and help detect tax shelters.

4) Increase the transparency of state credits. Kansas provides a number of credits to support economic, social and political objectives. Providing a tax credit is comparable to governmental spending in that it reduces funds available for other purposes. Yet unlike other government expenditures, taxpayers and their elected officials have little information on the amounts of the credits and the taxpayers who claim the credits. Other states such as Texas and North Carolina have responded to concerns about transparency by making credit information publicly available. (Examples of credit disclosures from North Carolina and Texas are provided in Chapter

4.) Kansas might consider adopting a similar approach to increase transparency.

Sales and Use Tax Considerations

The report identifies four national trends within the sales/use tax system and discussed their implications for Kansas.

1) Taxation of digital goods. Historically, the sales tax has only applied to tangible property, yet most state statutes were enacted when digital transactions did not exist. A few statutes have special provisions for software, but these statutes were written prior to web hosting, cloud computing, and electronic transfers of software. Numerous states are modifying their statutes to broaden the tax base to include digital products regardless of the method of delivery. Significant issues still remain for sourcing products, such as software, that might be used in many jurisdictions.

2) Encourage voluntary sales tax collection with vendor compensation. It is well documented that sales tax bases are eroded by the shifting of sales to out-of-state vendors which do not have an obligation to collect and remit Kansas sales taxes. But regardless of the vendors' statutory requirements, the purchaser remains, in general, obligated to remit the compensating use tax for the Kansas purchase. The state might consider offering a significant incentive to vendors that are not otherwise obligated to collect and remit Kansas sales tax (for example, 25 percent vendors' compensation). Most purchases from out-of-state vendors are untaxed as purchasers underreport (or do not report) use tax. This strategy uses market forces and partners the state with businesses to increase business revenues and expand the sale tax base at relatively low cost to the state.

3) Evaluate sales tax exemptions. While exemptions often support worthy social and economic objectives, excessive or inconsistent sales/use tax exemptions can have negative consequences. Exemptions erode a diminishing sales tax base which reduces state revenues. Ad hoc exemptions increase inequities between similarly positioned taxpayers and introduce inefficiencies in the free market. Finally, exemptions granted through a political process to select entities undermine the tax systems' credibility and erode taxpayer confidence. State policymakers might consider a wholesale examination of sales/use tax exemptions to "clean-up" the sales tax code, broaden the base, and potentially reduce the rate.

4) Evaluate taxation of services. Kansas could consider expanding the sales tax base through taxation of services. This would have the short-term advantage of raising revenue and the long-term advantage of reducing sales tax revenue volatility. As the US and Kansas economies increasingly become service-based, taxation of services may need to be considered. (Chapter 3 of the report identifies services commonly taxed in neighboring states.)

Property Tax Considerations

The report proposes five considerations related to taxation of business property.

1) Maintain current exemptions for business equipment and machinery. Kansas has a very favorable property tax exemption on business equipment and machinery. A credit

on purchases prior to the exemption enactment is winding down. Eliminating the exemption would have a negative impact on the tax and business climate in the state. Eliminating the credit would have less of an impact.

2) Evaluate efficacy of abatements and TIFs. Real property tax rates are relatively high and numerous jurisdictions have total mills that exceed 200 which stifle economic development. While abatements are a solution to economic development for a single firm or industry, these policies erode the tax base and shift the burden to other property owners. Because states are evaluated on property tax rates, policymakers should consider limiting abatements and other mechanisms that shrink the tax base, and thus, require localities to increase rates.

3) Hold school tax revenues harmless from abatements/TIFs. Equal, fair and adequate funding has been litigated in 45 states and the District of Columbia. In the majority of the cases, the states have not prevailed. While school finance reform is outside the scope of this report, Chapter 5 discusses the interplay between abatements/TIFs and school taxes. Policymakers might consider adopting statutes similar to other states which prohibit the abatement of property taxes earmarked for K-12 funding.

4) Evaluate urban agricultural property valuation method. The property tax base is also eroded through valuation. In near-urban areas, many taxpayers avail themselves of the agricultural-use valuation for what amounts to a personal residence or investment property for a real estate developer. Because agricultural value is based on income generated, rather than market-value, these property owners pay considerably less in property taxes than similarly situated neighboring properties. Policymakers desiring to expand the base and promote tax neutrality might consider valuation alternatives of urban and near-urban agricultural property.

5) Maintain other current valuation practices. Overall, property valuation in Kansas is reasonable. Annual studies demonstrate that property sales have historically been within 95 to 98 percent of the valuation amount. Neighboring states undergo exhaustive equalization projects to remedy the efforts by local jurisdictions to "game the system" by undervaluing property, local jurisdictions attempt to receive additional state funds. Kansas' consistent and relatively accurate valuation rate speaks to the efficacy of the current system and also to the strong regulatory environment of the state.

Alternatives to the Corporate Income Tax for Kansas

Kansas, like many U.S. states, has seen its traditional income sources under pressure. One possible suggestion is to consider replacing all or part of existing taxes, including the corporate income tax, sales tax, and/or property tax, with a broad tax on business activity.

In this context, a business activity tax (BAT) is any tax that has as its tax base some broad measure of business activity rather than taxable income. The options include gross receipts taxes, addition and subtraction method value-added taxes, and options that combine elements of both, such as a gross margins tax or a net receipts tax.

Currently Ohio, Washington, and Delaware impose a gross receipts tax (GRT). New Hampshire operates the country's only subnational value-added tax (VAT), and Texas and Michigan have recently adopted hybrid taxes that fall between gross receipts taxes and a VAT. Kentucky also enacted legislation that imposes an alternative minimum tax if gross receipts or gross profits exceed $3 million.

At first glance, these taxes may appear to be dramatic departures from the traditional corporate income tax (CIT), and in some senses they are. However, the corporate income tax, as well as the alternatives, all begin with some broad measure of gross income and differ mainly with regard to the types of taxpayers subject to the tax (corporations versus all taxpayers engaged in business activity) and the type of deductions, if any, allowed to arrive at the taxable base.

These taxing options can perhaps best be thought of as a continuum. All begin with gross receipts[7] but allow for a variety of different deductions.

One possible suggestion is to consider replacing all or part of existing taxes, including the corporate income tax, sales tax and/or property tax with a broad tax on business activity.

On one end is the traditional corporate income tax with a large number of allowed deductions and credits, a *relatively small base, and high rates.*

On the other is a pure gross receipts tax that allows for no deductions, *a large taxable base, and very low rates of less than one percent.*

The other options fall somewhere between the two extremes. Figure 7.1 shows the difference in the breadth of the base and common deductions that are permitted, if any.

[7] In practice, states that retain a traditional income tax often exempt income derived from capital (e.g. interest, dividends, receipts from the sale of stocks and bonds) from the BAT base. If the state does not have an income tax, these receipts are generally included in the BAT base.

Figure 7.1
Types of Deductions Permitted for Various BATs
Narrow Base ⟷ Broad Base

Business Activity Taxes

Deduction	Corporate Income Tax	Net Receipts Tax/ Subtraction VAT	Gross Margin Tax	Gross Receipts Tax
Cost of goods sold	X	X	X	
Other purchases from third parties	X	X		
Labor Costs	X			
Depreciation	X			
Interest	X			
Other operating costs	X			

Policy Evaluation

The structure of these taxes varies from state to state, but the goal of these alternative taxes is to redefine and broaden the tax base. The adoption of these taxes has often been motivated by dissatisfaction with and reduced revenue performance of the corporate income tax, caused in part by the ability of firms to use arguably abusive techniques to reduce or avoid tax, as well as a desire to increase the fairness of business taxation.

The following section provides a policy evaluation based on four criteria:

(1) Revenue performance;

(2) Compliance and administration;

(3) Economic efficiency and neutrality; and

(4) Fairness.

Revenue Performance

The attractiveness of a BAT is the ability to greatly expand the tax base and allow states to replace existing taxes while using a very low rate. The final revenue potential will predominately hinge on the policy choices that define that tax rate and tax base.

The attractiveness of the BAT is the ability to greatly expand the tax base and allow states to replace existing taxes while using a very low rate.

As mentioned above, the primary distinctions between the corporate income tax and the various BAT options are the types of deductions allowed.

States that implement a BAT change the revenue potential of the tax by manipulating both the tax base (with exclusions and deductions eroding the base) and the rate.

BAT options typically apply to all business forms (including sole proprietorships, partnerships, LLCs, etc.) rather than only corporations, and all business activity without regard to profits. A gross receipts tax could conceivably tax all components of consumption.

In contrast, the state sales tax typically exempts sales to and from non-profit entities, along with a wide range of services, and often subjects other consumption items (like food or clothing) to reduced rates of taxation.

Furthermore, a transactions tax like the retail sales tax is limited in its ability to collect revenue from out of state vendors without physical presence, while the state corporation income tax cannot capture firms protected by U.S. Public Law 86-272. These constraints do not apply to a BAT because states characterize them as a privilege tax, to which lower nexus standards apply, rather than a transaction or net income tax. As such, a BAT can include a larger number of firms, and thus, more economic activity in the state tax base.

…a BAT can include a larger number of firms, and thus, more economic activity in the state tax base.

Of the BAT options, the GRT has the highest revenue potential because it allows no deductions for purchases from third parties, even those sales previously subject to GRT. This feature of the tax enhances revenue potential by creating a tax base that is in fact larger than state gross domestic product. Studies of Washington's B&O tax base, for example, estimated the tax base was 177 percent of state gross domestic product in 2005 (Washington DOR 2010).

Revenue potential will depend on the number of deductions allowed, or how far the state moves the BAT along the continuum towards the corporate income tax.

Compliance and Administration

The BAT options interact with compliance and administration in offsetting ways. The GRT, and to a lesser extent the subtraction method VAT, are simpler than the corporate income tax because they narrow the number of deductions. Allowed deductions, if any, are typically limited to components of cost of sales. These types of deductions (materials purchases in the case of the Texas Margin Tax, for example) are relatively simple to audit compared to the types of expenses businesses can use to shift profits under the CIT.

For those taxpayers currently dealing with the corporate income tax, BAT options should ultimately prove simpler and cheaper overall.

Furthermore, for the subtraction VAT and some net receipts taxes, depreciation is eliminated in favor of immediate expensing of capital purchases, and taxable income is no longer tied to inventory levels. For those taxpayers currently dealing with the corporate income tax, complying with the BAT options should ultimately prove simpler and cheaper overall.

While existing taxpayers may experience lower compliance costs, BAT options typically expand the pool of taxpayers subject to tax. As noted above, BAT options apply to all business forms (corporations, LLCs, sole proprietors, etc.).

Compliance costs will increase for taxpayers previously exempt from one or more of the existing taxes, and administrative costs for state revenue departments will increase to the extent that more returns from an expanded pool of taxpayers will need to be processed and examined. The overall compliance costs for taxpayers within a state will depend in large part on whether the activity-based taxes replace or supplement existing taxes, such as the CIT.

Economic Efficiency / Neutrality

One of the primary objections to the GRT is that the tax is imposed at each stage of production. This "pyramiding" yields a tax base that is larger than the output for production.[8]

Firms that can combine multiple steps of the production process within a single entity will reduce the overall tax on the final product; therefore, GRTs create an incentive for vertical integration. The lower the GRT tax rate, the lower the incentive to vertically integrate. Furthermore, service sectors will generally have fewer stages of production than the manufacturing sector. To alleviate the pyramiding problem, Washington, for example, imposes lower tax rates on industries that are known to pyramid more frequently.

When compared to the corporate income tax, the neutrality of the alternative taxes comes down to whether a low rate for the gross receipts tax is more distorting than the higher effective corporation income tax rate.

When compared to the corporate income tax, the neutrality of the alternative taxes comes down to whether a low rate for the gross receipts tax is more distorting than the higher effective corporation income tax rate.

GRTs and subtraction method VATs introduce distortions due to the differential treatment of imports and exports and may induce firms to change their location or purchase out-of-state inputs to avoid the tax.

These BAT options tend to favor imported goods over domestically produced products because imports from states without GRTs pass through fewer taxable stages of production. They are also not neutral with respect to exports because tax pyramiding embeds tax paid during the intermediate stages of production.

Therefore, exporters located in states with GRTs may be at a competitive disadvantage to firms located in non-GRT states. Overall, Kansas exporters under GRTs may still be better off than under the current income, sales/use and property tax structure in Kansas as the total tax costs to the firms are lower under GRTs.

[8] To see how this occurs, assume a simple example of a manufacturer selling its output to a retailer, which then sells the product to the final consumer. A GRT levies tax when the manufacturer purchases raw materials, when the finished good is sold to the retailer, and when the product is sold to the final consumer. The tax base is equal to the sum of the prices paid at each step, an amount that exceeds actual economic output, or the value of the good sold at retail.

Fairness

The taxation of business entities is generally based on the benefit principle where a firm receives public service or legal benefits from the state and taxes are the price businesses pay for those benefits. Thus, under a benefit principle, apportioned profits serve as the benefit proxy for businesses subject to the corporate income tax.

…the GRT and subtraction method VAT tax may be viewed as fairer than the corporate income tax because tax planning opportunities are reduced.

Profits are not likely to be a good proxy because it presumes that only profitable companies benefit from public services.

Under a gross receipts tax, a firm's sales serve as the base and are also unlikely to serve as a good proxy for the services received by the business.

One concern with the corporate income tax is the uneven application to a broad set of taxpayers. As stated above, the GRT and subtraction method VAT apply to all types of businesses, including partnerships, limited liability companies, and sole proprietors.

Further, the corporate income tax is afforded nexus protection with Public Law 86-272, which does not apply to BATs; states consider BATs privilege taxes. Thus, one reason the GRT and subtraction method VAT tax may be viewed as fairer than the corporate income tax is because tax planning opportunities are reduced. Tax minimization strategies are more difficult under the GRT and VAT.

While all firms may pay the tax, the effective rates will differ based on rate differentials as well as pyramiding. Firms that may not see a profit will also be subject to the tax.

Legislators are often concerned with the fairness of the gross receipt tax because firms with high volume but low profit margins (e.g., grocery stores) will have a high tax liability. However, firms pay other taxes such as property, sales, and franchise taxes, regardless of the cash flow or profitability. And because the tax is likely to be shifted forward to consumers, many economists do not view this as a problem. The economic incidence of GRTs and VATs would fall primarily on households and would increase the degree of regressivity in the tax system, especially if the GRTs and VATs replace the income tax.

Other State Policy Trends

The following section describes considerations for revising the current income tax, sales/use tax and property tax regime in Kansas.

Income Tax

While a wholesale change in the state tax climate may take several legislative sessions, several near-term considerations may help reduce budget pressures and update the tax code to reflect the business climate of the 21st century.

These considerations include:

1) Implement "economic nexus" rules;

2) Source service revenues based upon the market;

3) Require disclosures of uncertain tax positions (UTP) at the state level; and

4) Increase the transparency of state credits.

Each consideration is discussed further below.

Economic Nexus

According to the Commerce Clause of the U.S. Constitution, states may not assess a tax unless the taxpayer has "substantial nexus" with the taxing jurisdiction. In this context, nexus refers to a physical or other connection to the taxing jurisdiction.

The Constitution does not specify what "substantial nexus" entails, but the courts provide some guidelines. For example, in *Quill Corp v. North Dakota*, 504 U.S. 298 (1992), the court held that a nexus can only be established for sales tax purposes if the taxpayer has a physical presence in a state through property or payroll.

However, *Quill* only addressed nexus in the context of sales taxes, and most state courts have held that the bright-line physical presence requirement does not apply to income taxes and most other types of taxes.

In recent years, states have become more aggressive in asserting nexus on out of state businesses whose connection is economic, rather than physical. In *MBNA* (*Tax Comm. v. MNBA*, 640 S.E.2d (WV 2006)) and *Lanco* (*Lanco, Inc. v. Director*, 908 A2d 176 (NJ 2006)), West Virginia and New Jersey, respectively, expanded the reach of their corporate income tax by asserting nexus on businesses that did not have physical presence or employees in their state but did have a substantial customer base.

In both cases, the states argued that the corporation was exploiting the local market sufficient to meet the substantial nexus requirement of the Commerce Clause.

A number of states have adopted an economic nexus standard, with more states planning to adopt this standard as a way to expand their tax base.

Accordingly, a number of states have adopted an economic nexus standard, with more states planning to adopt this standard as a way to expand their tax base.

Sourcing of Service Revenue

Generally, states have taken two distinct approaches to situsing gross receipts derived from the performance of services; income-producing activity sourcing (cost of performance sourcing) or market-based sourcing.

Under the traditional UDITPA model, when a service is performed in more than one state, the services are generally sourced to the state where the greater cost of performing the income is incurred (i.e., cost of performance). The trend is towards attributing services to the market served rather than where the cost of performance occurred.

Currently, twelve states have adopted the market-based approach for situsing service revenue, including Iowa and Oklahoma. Other states, such as Virginia, are considering adopting this provision. States that are net importers of services (e.g., architectural design services) would increase the tax base by sourcing revenue to market location.

With an economy rapidly moving towards internet-based services (such as in the medical technology field), states that continue to use the cost of performance sourcing will see their income tax base erode. Further, in-state service providers will become increasingly disadvantaged as they will bear a greater state income tax burden than the out-of-state service providers.

For example, under the current cost-of-service sourcing rules, an architectural firm in Omaha may generate revenue from Kansas clients, but because the service was performed in Omaha, Kansas does not tax this service revenue.

The market approach provides a tax benefit to Kansas firms that provide services nationwide. And because the market approach includes in the Kansas tax base service income earned in Kansas, in-state service providers are placed on a level playing field with out-of-state service providers.

The trend is towards attributing services to the market served rather than where the cost of performance occurred.

Under the current cost of service approach, out-of-state vendors can charge a lower price (or earn larger margins) than in-state vendors when competing for Kansas contracts and states forgo tax collections on out-of-state service vendors.

For example, under the current cost-of-service sourcing rules, an architectural firm in Omaha may generate revenue from Kansas clients, but because the service was performed in Omaha, Kansas does not tax this service revenue. The market-based sourcing rules are cutting-edge state tax policy and address changing business service practices: providing global services through internet-based technology. Significant advances in global communication technology have changed the business environment. Personal services performed by out-of-state providers run the gamut from programming, accounting, radiology, and legal advice to telesurgery. States that are net importers of high-value services might consider using a market-based standard to apportioning services. Firms with a national market for their services are tax-advantaged when located in a market-based sourcing state. Thus, this change might also encourage service activity within a state.

Many states also use the market-based approach for financial institution transactions and apportion revenue based upon the client location, rather than the financial institution's physical address. A tax system works best when it reflects modern business practices.

States that are net importers of high-value services might consider using a market-based standard to apportioning services.

Schedule UTP

In September 2010, the IRS amended regulations that will require certain corporate taxpayers to disclose uncertain tax positions[9] on a new schedule (Schedule UTP) attached to their federal income tax return.

The purpose of the new UTP schedule is to identify and prioritize issues for audit. The UTP schedule requires a description of each uncertain tax position that the taxpayer recorded a reserve for in its financial statements (Forms 10-K and 10-Q). In the Forms 10-K and 10-Q, filed with the SEC, taxpayers must disclose tax reserves for those income tax return positions which they believe are more likely than not to be lost upon litigation. In making the assessment of how much tax reserves are necessary, taxpayers must assume that the tax position will be discovered upon audit.

On the Schedule UTP, taxpayers are also required to rank the tax position and check a box if the relative size of the tax position is greater or equal to 10 percent of all of the other positions reported on the schedule. Corporations with total assets of $100 million or more must file Schedule UTP for the 2010 tax year; there is a five year phase-in for corporations with assets under $100 million.

The purpose of the new UTP schedule is to identify and prioritize issues for audit.

Taxpayers' primary objection to the new schedule is that it will provide a "roadmap" to vulnerable positions. In Announcement 2010-76, the IRS announced that it would exercise restraint and forgo requesting documents that relate to the uncertain tax positions and the work papers supporting Schedule UTP.

State auditors will be interested in a number of federal UTPs, such as research credits, attribute limitations, and related party transactions. Kansas currently incorporates the latest version of the federal Internal Revenue Code and should have access to the Schedule UTP via their state income tax filings.

Alternatively, Kansas may want to consider creating a similar schedule of its own to focus on state-related UTPs relating to nexus, apportionment, state adjustments and others.

State Tax Credit Transparency

Kansas provides a number of credits to support economic, social and political objectives. Providing a tax credit is comparable to governmental spending in that it reduces funds available for other purposes. Yet unlike other government expenditures, taxpayers and their elected officials have little information on the amounts of the credits and the taxpayers who claim the credits. Other states such as Texas and North Carolina have responded to concerns about transparency by making credit information publicly available. Kansas might consider adopting a similar approach to increase transparency.

[9] An uncertain tax position is one that would result in an adjustment if the position is not sustained.

Sales Tax

Kansas consumers are subject to sales/use taxes from numerous jurisdictions: state, local, county, community improvement development, and transportation development districts. With the new taxing jurisdictions and the increase in the state sales tax rate, some Kansas cities have sales tax rates near 10 percent. This is higher than the rate in New York City (8.875 percent), Dallas, Houston and Charlotte (8.25 percent) and Las Vegas (8.1 percent).

One of the biggest trends in state sales and use tax laws involves taxing digital goods.

Many states have elected to increase the tax base instead of increasing the tax rate. Tax policymakers could consider the following options to increase the base and modernize the sales/use tax regime:

1) Tax digital goods;
2) Encourage voluntary sales tax collection with vendor compensation;
3) Evaluate sales tax exemptions; and
4) Evaluate taxation of services.

Digital Goods

One of the biggest trends in state sales and use tax laws involves taxing digital goods. Historically, the sales tax has only applied to tangible property, yet most state statutes were enacted when digital transactions did not exist.

A few states have special provisions for software, but these statutes were written prior to web hosting, cloud computing, and electronic transfers of software. Therefore, as the businesses of software sales and delivery transformed, states tried to tax digital goods either by arguing that they fit the definition of tangible personal property or software.

Now, many states have adopted the definition of digital goods set forth in the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA is a voluntary agreement that provides standard definitions for sales and use tax purposes in an effort to promote uniformity among the states.

Both SSUTA member and non-member states are modifying their statutes to broaden the tax base to include digital products regardless of the method of delivery. Significant issues still remain for sourcing products, such as software, that might be used in many jurisdictions.

Vendor Compensation

Many states allow vendors to retain a portion of sales taxes collected. With the downturn in the economy, many have reduced vendor compensation. Others, such as Colorado, eliminated vendor compensation entirely and require vendors to report purchasers to the state when taxes are not collected.

Kansas does not offer vendor compensation for retailers that collect and remit sales taxes to Kansas. It is well-documented that sales tax bases are eroded by the shifting of sales to out-of-state vendors which do not have an obligation to collect and remit Kansas sales taxes. But regardless of the vendors' statutory requirements, the purchaser remains, in general, obligated to remit the compensating use tax for the Kansas purchase.

The state might consider offering a significant incentive to vendors that are not otherwise obligated to collect and remit Kansas sales tax

(for example, 25 percent vendors' compensation). This innovative approach would likely:

1) Encourage vendors to voluntary participate in the Kansas sales tax system as they would increase their revenue;

2) Increase the sales/use tax base as the state would receive 75 percent of previously unremitted use taxes;

3) Provide the state with useful data on out-of-state vendors, which may be helpful in future tax policy revisions.

Sales Tax Exemptions

The lost tax revenue from sales tax exemptions has received considerable attention in the last round of budget cuts in spring 2010. The Kansas Legislative Division of Post Audit estimated that $4.2 billion in taxable sales were exempted. It should be noted that many of these exemptions are common nationwide (i.e., exemption for ingredients/components used in manufacturing) and removing certain exemptions may negatively impact the state's business climate.

While exemptions often support worthy social and economic objectives, excessive or inconsistent sales/use tax exemptions can have negative consequences.

While exemptions often support worthy social and economic objectives, excessive or inconsistent sales/use tax exemptions can have negative consequences. As noted above, exemptions erode a diminishing sales tax base which affects state revenues and the ability to provide services valued by businesses.

Ad hoc exemptions increase inequities between similarly positioned taxpayers and introduce inefficiencies in the free market. Finally, exemptions granted through a political process which benefits selected taxpayers undermine the tax system's credibility and erode taxpayer confidence. State policymakers might consider a wholesale examination of sales/use tax exemptions to "clean-up" the sales tax code, broaden the base, and potentially reduce the rate.

Taxation of Services

Kansas could consider expanding the sales tax base through taxation of services. This would have the short-term advantage of raising revenue and the long-term advantage of reducing sales tax revenue volatility. As the US and Kansas increasingly move towards a service-based economy, taxation of services may need to be considered.

Kansas could begin by taxing services subject to taxation in neighboring states such as:

1. Self Storage (IA);
2. Investment Counseling (IA);
3. Barber/beauty shops (IA);
4. Parking lots/garages (IA, OK, TX);
5. Pari-mutuel racing administration (IA, MO, NE, OK, TX);
6. Private limo services (IA, OK).

These services are purchased primarily by households, and thus, avoid the harmful "pyramiding" of taxing business-to-business sales of services.

Another feature of these services is that taxpayers are not likely to leave the jurisdiction

to purchase these services. Additional revenue could be raised by expanding the sales tax base to include professional services such as legal, engineering, and accounting, but taxpayers are more likely to cross-border shop for high value services.

Additional revenue could be raised by expanding the sales tax base to include professional services such as legal, engineering, and accounting, but taxpayers are more likely to cross-border shop for high value services.

Most states have taken an incremental approach to taxing services by focusing on particular service industries. However, South Dakota successfully undertook a comprehensive approach to revising sales tax on services, albeit in 1965.

Property Tax

Businesses are concerned with taxes on real estate and business property, such as equipment and machinery. This section discusses considerations for both.

Kansas has a very favorable property tax exemption on business equipment and machinery.

Business Equipment and Machinery

Kansas has a very favorable property tax exemption on business equipment and machinery. A credit on purchases prior to the exemption enactment is winding down. Eliminating the exemption would have a negative impact on the tax and business climate in the state. Eliminating the credit would have less of an impact.

Real Property

The property tax rates on real property can be stiflingly high in many jurisdictions within the state. Of the 25 cities of the first class (as identified by the League of Kansas Municipalities for 2009 rates), the total mills levied varies from 109.817 (Overland Park) to 192.241 (Parsons). Of the 93 cities of the second class, 13 have total mills greater than 200, or nearly 14 percent of the cities in this group.

Property taxes are imposed by a number of jurisdictions. In many cities and counties, K-12 property taxes are a significant portion of the total property tax bill. Taxpayers express concern that funds to directly support education (e.g., staff salaries and educational resources) are limited by statute, meanwhile, the schools have the ability to raise mills for capital improvements (e.g., football stadiums). The National Access Network reports that 45 states plus the District of Columbia were involved in litigation regarding school funding, and the states have lost a majority of the cases (http://www.schoolfunding.info/states/state_by_state.php3).

Steady funding sources and adequate support for education are essential for a healthy business climate, as discussed in Chapter 7. School funding is a complex topic, and suggestions for a wholesale reform are outside the scope of this

Taxpayers express concern that funds to directly support education (e.g., staff salaries and educational resources) are limited by statute, meanwhile the schools have the ability to raise mills for capital improvements (e.g., football stadiums).

report. Some recommendations to expand the property tax base, and thus reduce the total school mill levies, are related to abated properties and valuation methodologies.

Policymakers should consider the efficacy of abatements of real property taxes and the use of Tax Increment Financing (TIFs). With the general exemption of business equipment and machinery, Kansas is a property tax friendly state for businesses.

Currently, taxpayers may be eligible to abate property taxes, including the state USD fund. Businesses granted a TIF pay only 20 mills on the appreciated value to the state USD, while the remaining property taxes are returned to the taxpayer for reimbursement of eligible costs.

Although school districts have the opportunity to reject a TIF, it is likely that political pressures cause many school districts to participate in the TIF agreement. Further, an abatement or TIF project does not reduce the district's total tax revenue because the district can increase the mill levied to reach the legal limit. But because the mills increase to compensate for properties that are removed from the tax rolls, an abatement or TIF, in effect, increases the mill levy for other property owners in the jurisdiction. Many states, such as Florida, do not allow property taxes earmarked for schools to be abated. Kansas might consider similar legislation to protect the property tax base for schools.

The property tax base is also reduced through valuation. In near-urban areas, many taxpayers avail themselves of the agricultural use valuation for personal residences and investment property; agricultural value is based on income generated, rather than market-value. In some jurisdictions, property in the city center has received agricultural valuation when it was likely held for investment purposes as much as agricultural use. Kansas could consider revising statutes of the eligibility for agricultural valuation for property in and very near to urban areas. Kansas is an agrarian state and the tax code should support agricultural activities. However, taxpayers are increasingly skeptical of tax regimes that create loopholes for select property owners at the expense of others.

Kansas is an agrarian state and the tax code should support agricultural activities.

Overall, property valuation in Kansas is reasonable. Annual studies demonstrate that property sales have historically been within 95 to 98 percent of the valuation amount.

Conclusions

This report describes the current tax system and the underlying policies that shape modern tax theory. This report also identifies areas of strength and opportunity in the Kansas tax and business climate.

The Kansas tax code provides a number of incentives to firms investing in the state which, along with low input costs, make Kansas quite competitive with other states in the region. Business taxes are in line with states in the region. But when considering all taxpayers and the total tax burden, Kansans fare poorly as the state imposes one of the highest total tax burdens in the region.

The findings of this report, just like citizens of the state, do not consider taxes in a vacuum. The strengths of the Kansas economy are the quality of the workforce, the investment in infrastructure and the regulatory support; no single tax policy can compensate for an uneducated workforce and poor roads. While these investments can withstand temporary cuts, policy makers are given the difficult task of maintaining a healthy business climate while enacting tax policy that encourages economic growth.

The tax law can be made simpler, fairer and more conducive to economic development; but often, all three objectives cannot be met and difficult trade-offs are necessary.

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