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Kansas Follows Red-Ink Road With Brownback Tax Cuts: Muni Credit.

Kansas Governor Sam Brownback is touting tax cuts enacted in 2012 as the way to achieve the economic strength of oil-rich Texas. The question is whether his government will go broke first.

The reductions that the second-term Republican championed are producing hundreds of millions of dollars of deficits and placing the state of 2.9 million in a tightening fiscal vise. Brownback stayed the course in his 2016 budget Friday, while acknowledging the stress and altering his approach.

"We will continue our march to zero income taxes," Brownback told lawmakers Thursday night in Topeka, the capital.

Yet the march is about to slow. Responding to the fiscal crisis, Brownback, 58, proposed making the reductions more gradual and recommended raising taxes on tobacco and liquor.

His plan would lift the cigarette tax to \$2.29 per pack from 79 cents, while the alcoholic beverage levy would rise to 12 percent from 8 percent. The moves would raise an additional \$394 million over two years, helping close a gap of more than \$710 million for that period, according to the budget document.

Payoff Wait

As Kansas awaits the payoff from Brownback's Tea Party-inspired tax-cutting wager, the governor and legislature are racing time as the treasury runs out of money. Moody's Investors Service cut Kansas's credit rating in April and Standard & Poor's lowered it in August, potentially increasing borrowing costs for agencies and municipalities.

"The challenge for the state is in the interim — how do you make up for the shortfall?" said Dan Heckman, a senior fixed-income strategist in Kansas City at U.S. Bank Wealth Management, which oversees \$126 billion.

Because the tax cuts produced greater revenue losses than anticipated, the state faces a \$280 million shortfall for the remainder of this fiscal year, which ends June 30.

"We must acknowledge that the most recent data regarding state government revenue and expenditures present a clear challenge that must be addressed," Brownback said Thursday night.

While he repeated his conviction that states without income taxes grow faster than those with high levies, the slower pace of cuts and recommendations for higher consumption levies are a nod to the stress Kansas faces.

November Victory

The response will be instructive to states such as Oklahoma and Missouri that have followed suit

with tax cuts aimed at stimulating their economies.

While Republican governors as a group have advocated reductions, Brownback stands out for leading his state to the precipice, triggering the credit downgrades and the elimination of a \$700 million surplus.

Brownback won re-election in November in a race that was a referendum on the cuts. He offered oil-rich Texas, which has no income tax, as the model for Kansas.

"If lawmakers look at the situation and say they will try to cut their way out of it, then it is a dramatic turning point for the state because you're talking about significant downsizing of services," said Duane Goossen, a former budget director under Republican and Democratic Kansas governors.

Court Decision

There are more complications looming after a state court ruled that Kansas was unconstitutionally underfunding schools. While the decision is expected to be appealed, S&P said this month that the case "could require substantially higher education funding."

The company said next fiscal year's budget "will be an important component" of Kansas's credit quality.

Part of Brownback's solution to balance this year's spending plan is to cut the state's contribution to its retirement system by \$40 million. Kansas has the fifth-weakest pension among U.S. states, according to data compiled by Bloomberg.

"We'd like to see some sort of balance," David Hitchcock, an analyst at S&P in New York, said in an interview. One-time fixes won't address the longer-term structural deficit, he said.

In 2012, the legislature cut the top income-tax rates 26 percent, eliminated levies on about 191,000 small-business owners and increased standard deductions for married and single head-of-household filers. While revenue declines were anticipated, the degree was greater than state budget analysts forecast.

'In Trouble'

Brownback, a former U.S. senator and 2008 presidential candidate, has insisted the reductions will eventually spur growth.

Goossen, a senior fellow at the Kansas Center for Economic Growth, a nonprofit in Topeka that researches budget and tax policy, said Kansas can't wait.

"The state's in trouble right now," he said.

While Kansas doesn't issue general-obligation debt, the Moody's downgrade to Aa2, two steps below the top, affected \$2.8 billion of securities, including bonds for highway improvements. S&P dropped it to an equivalent AA.

"Governor Brownback does believe that eventually this will lead to greater economic activity and will bring additional revenue sources to the state," said Heckman at U.S. Bank. "But his time frame has to meet up with the revenue, and I think that's a bit of a mismatch."

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