

Tax Reform in Kentucky

Serious Problems, Stark Choices

Institute on Taxation and Economic Policy

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ITEP

Institute on Taxation and Economic Policy

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About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP's mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy are *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* and *The ITEP Guide to Fair State and Local Taxes*. ITEP's full body of research is available at www.itepnet.org.

EXECUTIVE SUMMARY

- The two tax measures to be presented to the Interim Joint Committee on Appropriations and Revenue in early June provide a stark choice for the future of the Commonwealth's tax system. Legislation proposed by Representative Bill Farmer – HB 51 PHS – would exacerbate the main problems facing Kentucky's tax system, while the plan put forward by Representative Jim Wayne – introduced as HB 262 in 2008 and as HB 223 in 2009 – would improve both the adequacy and the equity of that system.
- Kentucky's tax system currently faces two serious problems. It is simultaneously insufficient, as it fails to produce enough revenue to fund the public services on which Kentuckians rely, and inequitable, requiring low- and moderate-income residents to pay more in taxes relative to their incomes than wealthier individuals and families.
 - The Commonwealth's Consensus Forecasting Group (CFG) currently projects a \$996 million budget deficit for fiscal year 2010, while past experience suggests it may be five years or more before tax revenue in Kentucky rebounds.
 - In 2007, state and local taxes as a share of income were nearly twice as high for middle-class Kentucky taxpayers as they were for the most affluent. State and local taxes in the Commonwealth, including income, sales, excise, property, and business taxes, amounted to 10.3 percent of income, on average, for middle class Kentuckians that year; they amounted to just 5.8 percent, on average, for the richest 1 percent of state residents, after accounting for the interaction between the federal and state tax systems.
- HB 51 PHS – the bill backed by Representative Farmer – would repeal Kentucky's personal and corporate income taxes as well as its limited liability entity tax (LLET); would reduce the sales tax rate from 6.0 to 5.5 percent; and would subject a variety of services, such as home and automobile repairs and maintenance, to the sales tax. Data from the Legislative Research Commission suggest that, while HB 51 PHS may generate additional revenue in fiscal year 2010, it would likely lose revenue once fully implemented, perhaps as much as \$850 million on an annual basis. The impact of HB 51 PHS would be sharply tilted towards the very wealthy – had the measure been in effect in 2007, the poorest 20 percent of Kentuckians would have seen their taxes rise by \$136 on average, while the richest 1 percent would have received an average tax cut of \$40,910.
- HB 262 / HB 223 – the bill sponsored by Representative Wayne – would raise income tax rates for well-to-do Kentuckians; create a new income tax credit based on the federal Earned Income Tax Credit (EITC); reinstate a version of Kentucky's estate tax; and also subject a variety of services to the sales tax. Its impact would be quite different, as it would ultimately raise some \$250 million per year in additional revenue, while lowering taxes for poor Kentuckians by \$51 on average.

Introduction

Kentucky's tax system currently faces two serious problems. The first – and most immediate – is that Kentucky's tax system is insufficient, as it fails to produce enough revenue to fund the public services on which Kentuckians rely. Recent data from the Commonwealth's Consensus Forecasting Group (CFG) indicate that Kentucky faces a \$996 million budget shortfall for the coming fiscal year, due in part to declines in the principal taxes Kentucky levies. The second problem, while less pressing, is arguably more persistent. Kentucky's tax system has long been inequitable, requiring low- and moderate-income residents to pay more in taxes relative to their incomes than wealthier individuals and families. In fact, in 2007, state and local taxes as a share of income were nearly twice as high for middle-class Kentucky taxpayers as they were for the most affluent.

The Commonwealth is certainly not alone in needing to confront these two tax policy challenges. Recent surveys by the Center on Budget and Policy Priorities, the National Conference of State Legislatures, and the National Association of State Budget Officers all reveal that the large majority of states are experiencing serious funding gaps in the current and coming fiscal years.¹ All told, state budget deficits could reach as high as \$145 billion in fiscal year (FY) 2010 and \$180 billion in FY 2011.² Likewise, virtually every state in the union employs a tax system that is regressive, taking larger shares of income from poor families than from rich ones. This situation pervades since state and local governments tend to rely more heavily on revenue from sales and property taxes and less on revenue from personal and corporate income taxes.

Fortunately, policymakers in Kentucky may soon have an opportunity to begin to address both of the problems plaguing the Commonwealth's tax system. The Interim Joint Committee on Appropriations and Revenue is expected to hold a hearing in early June to discuss a number of issues, including two measures that would significantly reshape Kentucky tax policy. These two measures – versions of bills introduced in prior legislative sessions by Representatives Bill Farmer and Jim Wayne – provide a stark choice for the future of the Commonwealth's tax system. Representative Farmer's bill – HB 51 PHS from the 2009 regular session – would likely exacerbate both of the tax system's current shortcomings, reducing the amount of revenue the system yields over the long-run and imposing additional tax responsibilities on working Kentuckians. In contrast, the bill put forward by Representative Wayne – initially introduced as HB 262 in 2008 and reintroduced as HB 223 in 2009 – would shrink Kentucky's budget gap by upwards of \$250 million and do so in an especially fair manner, with the wealthiest five percent of Kentuckians shouldering most of the additional burdens imposed by the bill.

¹ Lav, Iris J. and McNichol, Elizabeth, *Current and Projected State Deficits: NCSL, NASBO, and CBPP*, Center on Budget and Policy Priorities, Washington, DC, February 4, 2009.

² Lav, Iris J. and McNichol, Elizabeth, *State Budget Troubles Worsen*, Center on Budget and Policy Priorities, Washington, DC, May 18, 2009.

This paper examines the two principal problems facing Kentucky's tax system in greater detail and analyses the impact that the Farmer and Wayne measures would have on each of them.

Serious Problems: Kentucky's Tax System Is Insufficient and Inequitable

On Friday, May 29, at the request of Governor Steve Beshear, the Consensus Forecasting Group (CFG), an independent group of economists from across the Commonwealth, issued its updated examination of Kentucky's fiscal outlook. The CFG projected that Kentucky now faces a \$996 million General Fund budget deficit for fiscal year 2010 (FY10), in addition to a \$239 million deficit in a separate transportation fund. According to the Governor's office, this marks the third successive year in which projected revenue has fallen short of anticipated spending needs.³

As if the projections from the CFG were not grim enough, recent research from the Rockefeller Institute of Government suggests that could it be more than five years before Kentucky tax revenue returns to its pre-recession levels. In a February 2009 report entitled *What Will Happen to State Budgets When the Money Runs Out?*, Donald Boyd, a Senior Fellow at the Institute, reviews the decline in state tax revenue during each of the last three recessions prior to the current downturn.⁴ Adjusting for legislative changes and other factors, he finds that, during the recession of the early 1980's, it took until fiscal year 1984 for state tax revenues to return to their fiscal year 1981 levels. As seen in Figure 1, the revenue recoveries during the recessions of the early 1990s and the early part of this decade were even slower, each requiring five years for state tax revenue to rebound. Based on these past experiences, Boyd projects that state tax revenue, in the aggregate, will not return to its FY 2008 levels until sometime around FY 2014. In other words, Kentucky policymakers can not reasonably expect that an economic recovery will immediately produce the tax revenue needed to fund vital public services. Rather, it will require affirmative changes in tax policy to meet the fiscal challenges now before the Commonwealth.

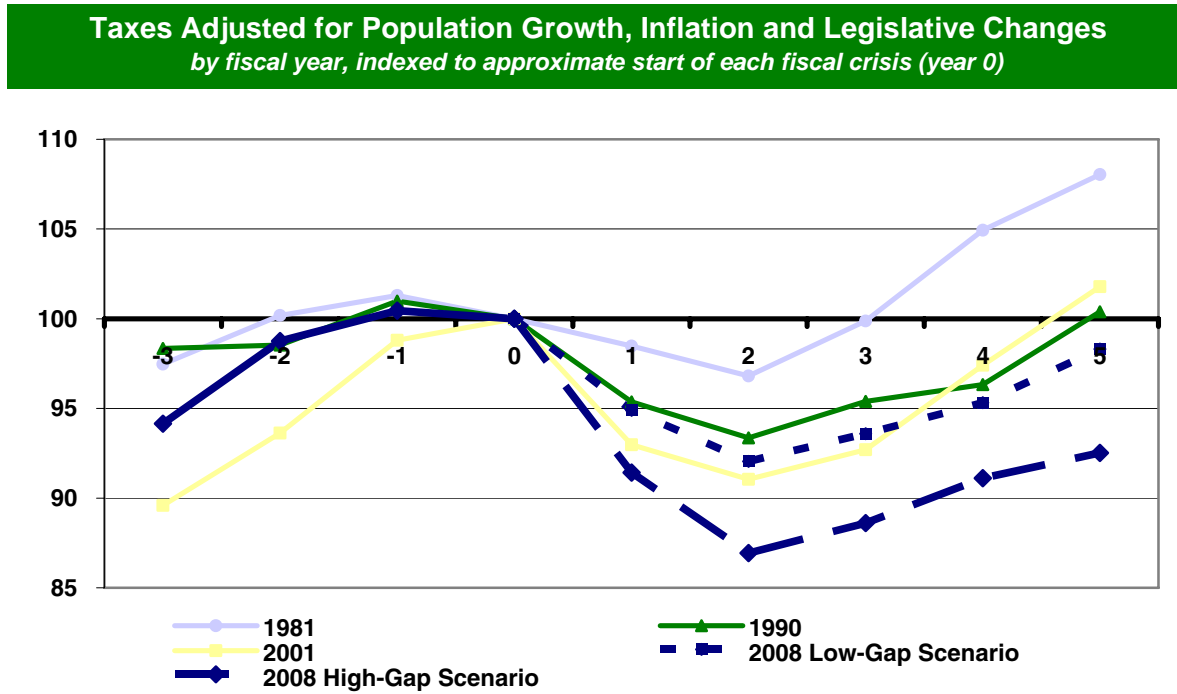
While the amount of revenue the Commonwealth's tax system produces is clearly a problem that policymakers must address in the very near future, the manner in which it generates those funds is equally in need of their attention. As Figure 2 below illustrates, Kentucky's tax system is regressive, placing greater responsibility for state and local taxes on low- and moderate-income families and individuals than on those with far greater ability to pay.⁵ More specifically, in 2007:

³ Biesk, Joe, "Kentucky Facing Third Year of Budget Shortfalls," *Lexington Herald-Leader*, May 31, 2009.

⁴ Boyd, Donald J., *What Will Happen to State Budgets When the Money Runs Out?*, Nelson A. Rockefeller Institute of Government, Albany, NY, February 19, 2009.

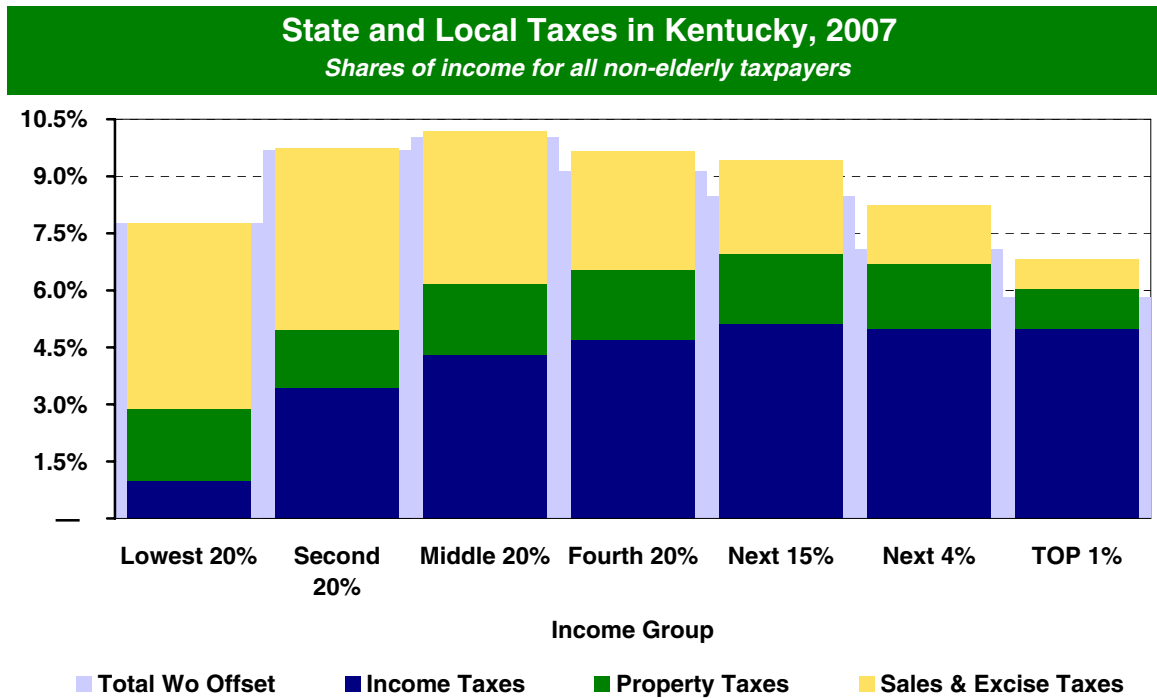
⁵ Figure 2 excludes elderly taxpayers, since Kentucky, like most states, treats such taxpayers much differently than the majority of taxpayers.

Figure 1.



Source: Rockefeller Institute of Government

Figure 2.



Source: Institute on Taxation and Economic Policy Microsimulation Model

- State and local taxes in the Commonwealth, including income, sales, excise, property, and business taxes, amounted to 7.8 percent of income, on average, for the poorest 20 percent of Kentuckians. These individuals and families all had incomes below \$14,000 that year.
- Middle-class Kentuckians – that is, individuals and families with incomes ranging from \$27,000 to \$45,000 – paid an average of 10.3 percent of their incomes in state and local taxes.
- The very wealthiest one percent of Kentuckians – whose average income was roughly \$933,000 in 2007 – paid only 6.8 percent of their incomes, on average, in state and local taxes. However, most wealthy taxpayers are able to use the state and local taxes that they pay to reduce the federal income taxes that they owe.⁶ When this interaction – commonly referred to as the federal offset – is taken into account, the effective state and local tax rate for the richest 1 percent of Kentuckians falls to 5.8 percent.

Consequently, low- and moderate-income Kentuckians, who are struggling to make ends meet in the midst of one of the most severe recessions in recent memory, find it even harder to get by because of the Commonwealth's tax system. Thus, any changes in tax policy that are adopted to help ease Kentucky's fiscal woes should not add to working families' financial difficulties.

Stark Choices: HB 51 PHS and HB 223

In early June, the Interim Joint Committee on Appropriations and Revenue will hold a hearing to receive testimony on several topics, including two measures that would significantly reshape Kentucky tax policy. These two measures – versions of bills introduced in prior legislative sessions by Representatives Bill Farmer and Jim Wayne – provide a stark choice for the future of the Commonwealth's tax system. Representative Farmer's bill – HB 51 PHS from the 2009 regular session – would likely exacerbate both of the tax system's current shortcomings, reducing the amount of revenue the system yields over the long-run and imposing additional tax responsibilities on working Kentuckians. In contrast, the bill put forward by Representative Wayne – initially introduced as HB 262 in 2008 and reintroduced as HB 223 in 2009 – would shrink Kentucky's budget gap by upwards of \$250 million and do so in an especially fair manner, with the wealthiest five percent of Kentuckians shouldering most of the additional burdens imposed by the bill.⁷

In brief, HB 51 PHS would:

⁶ Federal income tax filers have the choice of claiming a standard deduction (that varies by filing type) or a set of itemized deductions (for certain expenses incurred over the course of the year) in determining their taxable income. Upper-income taxpayers generally use the latter approach, which includes a deduction for state and local income and property taxes paid. For these taxpayers, then, state and local tax bills are partially "offset" by lower federal income taxes.

⁷ The analyses presented here are based on the versions of HB 51 PHS and HB 262 analyzed by the Legislative Research Commission in April and May of this year and in January 2008 respectively.

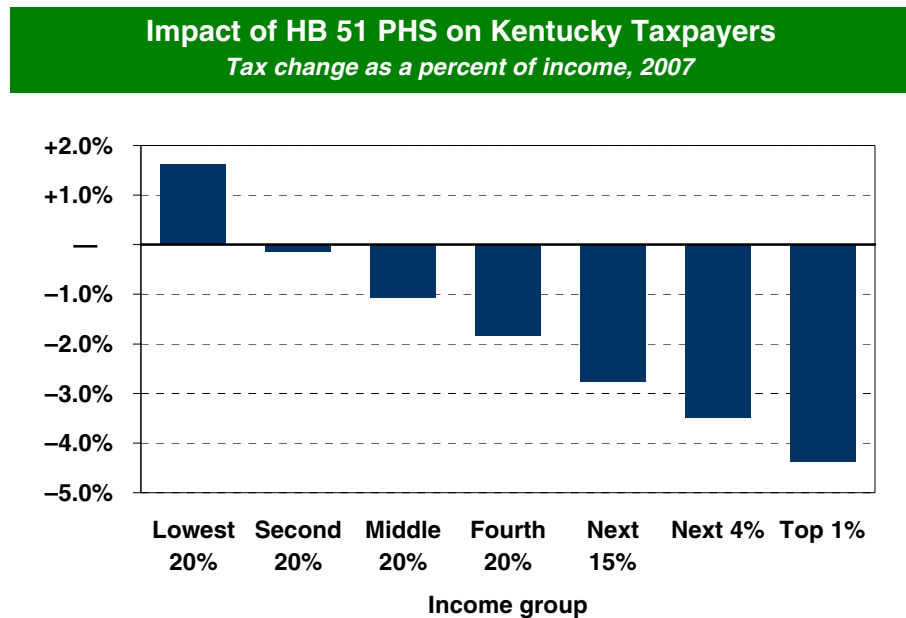
- Repeal the individual income tax;
- Repeal the corporate income tax;
- Repeal the limited liability entity tax (LLET);
- Reduce the sales tax rate from 6 percent to 5.5 percent;
- Expand the sales tax base to cover leases for commercial real estate as well as a variety of services, such as home and automobile repairs and maintenance, advertising, and other professional services, and;
- Repeal a number of sales tax exemptions, including those for residential utilities, for certain non-profits, for certain governmental entities, and for industrial machinery.

As Figure 3 below shows, had they been fully implemented in 2007, the provisions of HB 51 PHS, when taken together, would have:

- Increased taxes markedly for the very poorest Kentuckians. Families and individuals with 2007 incomes below \$14,000 would have, on average, paid \$136 more in taxes had HB 51 PHS been in effect; this is the equivalent of 1.6 percent of their income on average.
- Reduced the taxes paid by middle-class Kentuckians by roughly 1.1 percent of income on average. That is, Kentucky taxpayers with incomes ranging from \$27,000 to \$45,000 in 2007 would have seen their taxes go down by \$373 on average if HB 51 PHS had been made law.
- Reduced taxes dramatically for the very wealthiest Kentuckians. In 2007, the top 1 percent of Kentucky taxpayers consisted of individuals and families with incomes in excess of \$329,000. These taxpayers would have received an average tax cut of \$40,910 – or 4.4 percent of income – due to the changes contained in HB 51 PHS.

Multiple factors contribute to HB 51's regressive impact. While some are quite obvious – repealing progressive taxes like the personal and corporate income taxes clearly benefits better-off Kentuckians – one is less immediately evident. While many of the changes contained in the bill appear to be designed to affect the sales and use taxes paid by businesses

Figure 3.



Source: Institute on Taxation and Economic Policy Microsimulation Model

operating in the Commonwealth, those changes will likely be passed along to Kentucky consumers. For instance, while subjecting professional, scientific, and technical services to the sales tax or removing the current exemptions for industrial machinery and supplies would seem to constitute a tax increase borne solely by businesses, those businesses will likely respond to such changes in tax policy, to the extent that they are able to do so, by raising the prices they charge for the goods and services they sell. Depending upon the type of good or service being produced, this could lead to the sales tax being passed along multiple times, with retail purchasers essentially paying sales tax on top of sales taxes that have already been built into the cost of the product.⁸ Consequently, Kentucky policymakers should proceed with caution before imposing sales and use taxes on the goods and services that businesses sell to one another.

Figure 4.

Short- and Long-Term Revenue Impact of HB 51 PHS

	<u>FY 2010 Impact (\$B)</u>
Additional Sales Tax Revenue from Base Expansion	3.657
Loss of Sales Tax Revenue due to Rate Reduction	-0.256
Loss of Income Tax Revenue	-2.014
Loss of Corporation Income Tax Revenue	-0.506
Loss of Limited Liability Entity Tax Revenue	-0.113
TOTAL CHANGE	0.768
	<u>Annual Long-Term Impact at FY 2010 Levels (\$B)</u>
Additional Sales Tax Revenue from Base Expansion	3.657
Loss of Sales Tax Revenue due to Rate Reduction	-0.256
Loss of Income Tax Revenue	-3.630
Loss of Corporation Income Tax Revenue	-0.506
Loss of Limited Liability Entity Tax Revenue	-0.113
TOTAL CHANGE	-0.848

HB 51 PHS would also likely have a negative impact on Kentucky’s long-term fiscal outlook. Analyses of the bill conducted by Kentucky’s Legislative Research Commission (LRC) indicate that it would generate additional revenue in FY 2010, but data included in those analyses suggest that the bill could lead to substantial revenue losses in the years that follow. These differing short-term and long-term effects occur because the provisions of HB 51 PHS that would generate additional revenue – by broadening the base of the sales tax – would be in effect for all of FY 2010, but many of the provisions that

would reduce the amount of tax revenue Kentucky collects – by eliminating the personal and corporate income taxes and the LLET – would only be in effect for a portion of FY 2010. As a result, as Figure 4 (based on information included in the LRC’s analyses and on subsequent

⁸ This phenomenon, often referred to as “pyramiding”, is a well-recognized problem in states that impose consumption taxes on the goods and services that business use as part of the production process. Washington’s business and occupation (B&O) tax is a chief example. A November 2002 evaluation of Washington’s tax system – entitled *Tax Alternatives for Washington State: Report to the Legislature* and conducted by the independent Washington State Tax Structure Study Committee – found that the B&O tax “pyramids” 2.5 times on average. The Study Committee’s full report is available at http://dor.wa.gov/content/aboutus/statisticsandreports/wataxstudy/Final_Report.htm

communication with LRC staff) illustrates, enactment of HB 51 PHS could yield nearly \$770 million in additional revenue in FY 2010, but could lead to annual losses of close to \$850 million, once the repeal of the personal and corporate income taxes and the LLET is fully implemented. Indeed, as the LRC acknowledges in its analysis, “In years after FY 2010 ... the additional revenues from the sales tax are estimated to be somewhat less than the revenues lost from eliminating the income and LLET taxes.” Should personal and business income grow faster than consumption as the Kentucky economy recovers, the potential revenue loss would be even greater.⁹

Where HB 51 PHS would ultimately render Kentucky’s tax system less sufficient and less fair, the measure backed by Representative Wayne would enhance both adequacy and equity. It would do so by:

- Raising the tax rate on taxable income over \$75,000 from 6 percent to 7 percent and adding a new top income tax bracket, applicable to taxable incomes in excess of \$90,000, with a rate of 8 percent;
- Creating a state Earned Income Tax Credit (EITC), equal to 15 percent of the federal version of the credit;
- Reinstating Kentucky’s estate tax at an amount equal to the federal tax credit for state estate taxes that was in effect in 2003;

Taxation of Pension Income A Reform Worth Considering

In addition to raising rates, Kentucky could generate additional tax revenue by broadening the base of its income tax and ensuring that all income is subject to taxation, regardless of the form it may take. In particular, Kentucky now offers tax breaks for several different forms of retirement income, including Social Security and private and public pensions. In fact, according to the Office of the State Budget Director, “tax expenditures” (as such tax breaks are often called, since they amount to public expenditures achieved through the tax code) for retirement income are among the largest drains on the Commonwealth’s income tax.* Of the roughly \$3 billion Kentucky is expected to lose to tax expenditures embedded in the personal income tax in FY 2010, the failure to tax Social Security benefits accounts for \$176.7 million, while the existing exemption for private pensions and Individual Retirement Accounts (IRA’s) accounts for \$159.5 million.

Eliminating – or even just reforming – these tax breaks could help to improve Kentucky’s long-term fiscal outlook. One common sense approach would be to subject tax breaks for retirement income to a means test, so that the ability to use these tax expenditures would depend on one’s income level. After all, while many elderly residents live on fixed incomes and may thus be in need of more favorable tax treatment, some are still quite well-off and therefore should not receive tax breaks at the same time that younger families are struggling to make ends meet.

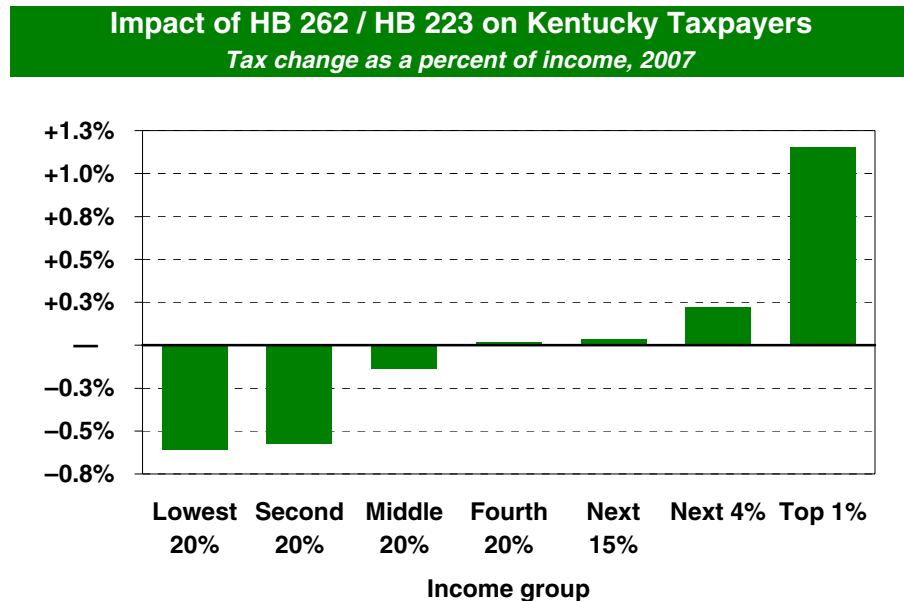
*Tax Expenditure Analysis, Fiscal Years 2008-2010, Office of the State Budget Director, available at <http://www.osbd.ky.gov/publications/specialreports.htm>.

⁹ *Memorandum to Representative Bill Farmer*, Kentucky Legislative Research Commission, April 20, 2009 and *Memorandum to Jessica B. Hays Lucas*, Kentucky Legislative Research Commission, May 21, 2009. Two caveats from the LRC’s analyses should be noted here. The additional sales tax revenue resulting from the inclusion of certain services in the base may, in future years, be higher than the \$3.657 billion figure for FY 2010 included in the LRC’s memoranda, since that figure is based on 11 months worth of collections rather than a full year. Conversely, the LRC has expressed some uncertainty about its estimates for the impact of the sales tax changes contained in HB 51 PHS; thus, the LRC warns that “actual revenues collected through the sales and use tax expansion could be substantially less than projected. If this is the case, the fiscal impact would be negative and could be substantial.” In addition, communication with LRC staff indicates that the original memorandum to Representative Farmer failed to include the \$256 million impact of lowering the sales tax rate from 6.0 to 5.5 percent on the existing sales tax base.

- Expanding the sales tax base to include a number of services, such as landscaping, limousine, and chartered aircraft services.

These changes would lower taxes for the bottom sixty percent of the income distribution in Kentucky in the aggregate and raise them for taxpayers at the very top of the income spectrum. More specifically, as seen in Figure 5, had HB 262 / HB 223 been fully implemented in 2007, it would have:

Figure 5.



Source: Institute on Taxation and Economic Policy Microsimulation Model

- Reduced the taxes paid by the poorest fifth of Kentuckians by \$51 on average, an amount equal to 0.6 percent of income.
- Reduced the taxes paid by middle-class residents by a similar amount – \$48 on average. However, since the incomes received by middle-class Kentuckians are higher by definition, this change equates to a smaller share of income – just 0.1 percent on average.
- Increased, in the aggregate, the taxes paid by the wealthiest 5 percent of Kentuckians. In particular, the changes contained in HB 262 / HB 223 would boost the taxes paid by the wealthiest 1 percent of Commonwealth residents by nearly \$11,000 on average. As the average income for taxpayers in this group was approximately \$933,000, this works out to a change of close to 1.2 percent of income.¹⁰

Moreover, while the creation of an EITC would reduce the amount of tax revenue Kentucky would collect each year, on net, the changes contained in Representative Wayne’s legislation would have a positive impact on Kentucky’s balance sheet over both the short- and the long-run. Based on information included in the Fiscal Note Statement issued by the Legislative Research Commission when HB 262 was originally introduced, once each of the various elements of the bill is fully implemented, the Commonwealth could stand to collect up to \$250 million per year in additional revenue. The EITC is expected to reduce revenue by \$95 million

¹⁰ Figure 5 does not include the impact of the estate tax changes included in Representative Farmer’s legislation. However, such changes typically benefit the very wealthiest state residents, so this analysis likely understates the impact of Representative Farmer’s legislation on this income group.

annually, but the other changes are projected to yield roughly \$315 million to \$345 million on an annual basis.

Conclusion

The measures put forward by Representatives Farmer and Wayne provide a stark choice for the future of the Commonwealth's tax system. The approach recommended by Representative Farmer would likely reduce the amount of money flowing into the Kentucky treasury over the long-run and would clearly tilt the tax system to favor the most affluent Kentuckians. The path suggested by Representative Wayne would improve both the Commonwealth's bottom line and the economic position of low- and moderate-income residents. Given the problems that currently plague Kentucky's tax system, the choice between these two measures should be as obvious as it is stark.