KCEP
KENTUCKY CENTER for ECONOMIC POLICY

BUDGET BRIEF

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Using the Federal Income Tax Cuts to Help Address Kentucky's Budget Challenge

Summary

The federal tax compromise passed by Congress in December resulted in extensions to a number of tax changes set to expire and provided a large tax break to the wealthiest Americans. Analysis by the Institute on Taxation and Economic Policy shows that the top 5 percent of Kentuckians will receive a tax cut of over $1 billion in 2011 from the enacted income tax extensions alone. Making state income tax changes to reinvest just a portion of these breaks in Kentucky would help protect public investments in education, health and other necessities.

Generous Tax Cuts to the Top at a Time of Budget Reductions

The federal tax cut compromise agreed to by President Obama and Congressional leaders in December included two year extensions to income tax cuts passed during the early 2000s. While President Obama originally proposed to let some of the tax cuts expire for those making over $250,000 a year, in the compromise reached with Congress he agreed to extend all of the tax cuts.

Analysis by the Institute on Taxation and Economic Policy shows that the extension of the income tax cuts is worth over $1 billion to the wealthiest 5 percent of Kentuckians in 2011 (Table 1). President Obama's original proposal provided $678 million in cuts for that group, while the final agreement added $378 million to the proposal. The highest earning 1 percent of Kentuckians, who have an average income of $817,173, will receive an average tax cut of $31,455. The next highest earning 4 percent, who have an average income of $198,419, will receive an average tax cut of $5,672.

Table 1: Highest Earning 5% of Kentuckians Receiving Large Federal Income Tax Cuts in 2011

	Average Income	Average Tax Cut	Total Tax Cuts
Top 1%	$817,173	$31,455	$613,817,000
Next 4%	$198,419	$5,672	$442,628,000
Total			$1,056,445,000

Source: Institute on Taxation and Economic Policy

These tax cuts come at the same time that federal assistance to the states is coming to an end. As KCEP described in a recent brief, Kentucky received $3.4 billion in assistance through the American Recovery and Reinvestment Act to prevent deeper cuts to Medicaid and education and support investments in transportation, public safety, energy and other areas. That money comes to an end this year at the same time the economy is only starting to climb out of a deep hole; revenues are just beginning to recover and unemployment is expected to remain high for some time.[1]

Kentucky could choose to make adjustments to its income tax brackets to reinvest a portion of those tax cuts for high-income Kentuckians into protecting critical state public investments. For example, making adjustments to reinvest just 10 percent of the tax cuts for the wealthiest 5 percent would raise $106 million. Such a change would increase state income taxes by 0.4 percent of income on average for the top 1 percent of earners and 0.3 percent of income on average for the next highest 4 percent of earners.

The economic benefits of protecting against deeper budget cuts far outweigh any potential economic impacts of very small increases in taxes for the wealthiest Kentuckians. High-income people tend to save a larger portion of their income than low- and middle-income people, who must out of necessity spend more to provide basic needs. An analysis of the compromise by Mark Zandi of Moody's Analytics found that the aspect of the compromise that extends high-end tax cuts would provide little or no short-term boost to the economy. Extending all of the Bush-era tax cuts creates only 35 cents of economic activity for each dollar of cost, Zandi estimates. By contrast, assistance to state governments provides $1.41 for each dollar of cost.[2]

In recent years, Kentucky has made damaging cuts to state investments needed to both help Kentuckians weather tough economic times and lay the foundation for growth and advancement in the future. A small portion of the generous tax cuts for the wealthiest Kentuckians could be part of a balanced approach to addressing the ongoing budget challenge.

The Kentucky Center for Economic Policy (KCEP) was founded in 2011 with the purpose of conducting research, analysis and education on important state fiscal and economic policy issues. KCEP seeks to create economic opportunity and improve the quality of life for all Kentuckians. The center is an initiative of the Mountain Association for Community Economic Development (MACED) and is supported by foundation grants and individual donors. Please visit KCEP's website at www.kypolicy.org.

[1] Jason Bailey, "End of Recovery Act Funds Could Mean Serious Budget Challenge for Kentucky," Kentucky Center for Economic Policy, January 10, 2011, http://kypolicy.org/end-recovery-act-funds-mean-serious-budget-challenge-kentucky-2/.
[2] Mark Zandi, "U. S. Macro Outlook: Compromise Boosts Stimulus," Moody's Analytics, December 8, 2010. Cited in Hannah Shaw and Chad Stone, "Zandi Analyses Show "Democratic" Measures in Tax Cut-UI Deal Boost Economy, "Republican Measures Add to Deficit Risk," Center on Budget and Policy Priorities, December 22, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3349.