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2011 Revenue Results a Reminder of Importance of State Income Taxes

By Jason Bailey

The $166 million in state revenues above projections for the fiscal year that just ended are helping prevent additional cuts to critical state services. They are also a reminder of the advantages of a broad-based tax system and in particular the importance of Kentucky's individual and corporate income taxes.

Personal income tax revenue ended the fiscal year 8.3 percent higher than 2010, and corporate tax revenue is 34.6 percent higher.[1] High growth in those areas is helping offset lower growth in the sales tax, from which revenue grew 3.7 percent for the year.

Kentucky has had very serious budget challenges over the last few years, but other states have faced even deeper challenges in part because Kentucky's relatively broad-based tax system (which includes an income tax, sales tax, property tax, corporate taxes and severance taxes) means more resiliency in the face of diverse economic conditions. Other states have had to lay off teachers and other state workers, drop beneficiaries from Medicaid and make other cuts beyond what Kentucky has experienced.[2]

Yet some Kentucky legislative leaders have argued for the elimination or reduction of the state's individual and corporate income taxes. The result would be a narrower tax base, and Kentucky would miss out on the higher growth of income tax revenue during typical periods of economic recovery and robust growth. If all General Fund revenue had grown in line with Kentucky's sales tax over the last year, the state would have $233 million less in revenues than actually received, which would've likely triggered more cuts to services like education and health care.

Table 1: Individual Income and Corporate Taxes Key to Revenue Growth

	2010	2011	Percent Change	Dollar Change
Sales Tax	2,794,057,329	2,896,251,816	3.7%	102,194,487
Individual Income Tax	3,154,488,000	3,417,778,504	8.3%	263,290,504
Corporate Taxes	383,815,824	516,523,521	34.6%	132,707,697
Total General Fund	8,225,127,620	8,759,442,646	6.5%	534,315,026

Source: Office of the State Budget Director

The slower growth this year in the sales tax relative to the income tax is mirrored in other states. Twenty-eight states have end-of-year revenues that are greater than expected. On average, income taxes grew 9 percent over the last year in those states, more than double the 4.4 percent growth that was anticipated. Sales taxes, in contrast, grew only 4.4 percent, slightly above the 2.9 percent that was projected.[3]

The Center on Budget and Policy Priorities notes that slower sales tax growth generally fits a pattern of previous recessions, where the incomes of the wealthy demonstrate growth before that of low- and middle-income people. That makes the income tax grow faster than the sales tax, which depends on consumer spending. In the current period, wages are growing very slowly while income from business ownership, rental property and investment dividends are growing more rapidly, and capital gains have risen due to the recovery in the stock market.[4] Corporate profits have also been high—the profits of private corporations were 21.7 percent higher at the end of 2010 than before the recession.[5]

Sales tax recovery in this period is especially challenged by the nature of the downturn. Depressed housing prices across the country mean that households have less wealth to spend, and many people are using income to pay down debt rather than spend.

The importance of the individual income tax to revenue growth was a feature of the 2002 Fox report to the Kentucky legislature. Dr. William Fox, an economist at the University of Tennessee hired by the state, measured the elasticity of Kentucky's tax system—meaning its responsiveness to growth in the economy—and found that the personal income tax was the most elastic of Kentucky's major taxes.[6] The Institute on Taxation and Economic Policy notes that "in the long run, virtually any income tax, whether flat or graduated, will outperform sales taxes in keeping pace with the cost of funding public investments."[7] This is particularly the case if the individual income tax is progressive, meaning higher marginal rates for those with higher incomes.

Another advantage of income taxes is that they apply based on ability to pay. The poorest 20 percent of Kentuckians pay 1.3 percent of their income in income taxes, while the wealthiest 1 percent pay 5.2 percent. In contrast, the poorest 20 percent pay 5.6 percent of their income in sales taxes at the same time that the wealthiest 1 percent pay only 0.9 percent.[8] Representative Bill Farmer's tax proposal to eliminate Kentucky's individual income and corporate taxes and replace them with a broader sales tax would result in the bottom 60 percent of Kentucky families paying more in taxes on average while the top 40 percent pay less. The highest-earning one percent in Kentucky would receive an average tax cut of $27,851.[9]

The sales tax is also an important part of Kentucky's diverse tax system, and it needs to be modernized to better fit the service economy. But proposals to broaden the tax while also eliminating income taxes are one step forward and at least two steps back.

While the year's excess revenues are relatively good news, they must be put into context. Revenues still have not caught up to pre-recession levels in real, inflation-adjusted dollars, and recent job reports have been disappointing. The next biennial budget will be tight. Kentucky should take a balanced approach to this challenge that includes new revenues from tax reforms that make further needed changes to Kentucky's tax system, thereby helping address the current budget challenge and better preparing Kentucky for economic challenges in the future.

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts 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. Launched in 2011, the Center receives support from foundation grants and individual donors and is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website at www.kypolicy.org.

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[1] For this calculation, corporate taxes include the corporate income tax and the limited liability entity tax.
[2] Kentucky also has not had as serious a housing slump as other states, which has helped revenue.
[3] Elizabeth McNichol, Michael Leachman, and Dylan Grundman, "Better-Than-Expected State Tax Collections Highlight Importance of Income Taxes," Center on Budget and Policy Priorities, July 11, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3530.
[4] McNichol et al, "Better-Than-Expected State Tax Collections."
[5] Lawrence Mishel, "We're Not Broke Nor Will We Be," Economic Policy Institute, May 19, 2011, http://w3.epi-data.org/temp2011/BriefingPaper310.pdf. EPI analysis of Bureau of Economic Analysis data.
[6] William F. Fox, "Report to the Subcommittee on Tax Policy Issues," Committee on Appropriations and Revenue Kentucky General Assembly, February 27, 2002.
[7] Institute on Taxation and Economic Policy, "The ITEP Guide to Fair State and Local Taxes," 2011, http://www.itepnet.org/state_reports/guide2011.php.
[8] Carl Davis, et al., "Who Pays? A Distributional Analysis of the Tax System in All 50 States," Institute on Taxation and Economic Policy, November 2009, http://www.itepnet.org/state_reports/whopays.php.
[9] Analysis by the Institute on Taxation and Economic Policy. Jason Bailey and Melissa Fry Konty, "Farmer's High-Risk Overhaul Creates Imbalance in Kentucky's Tax System," Kentucky Center for Economic Policy, February 15, 2011, http://kypolicy.org/farmers-high-risk-overhaul-creates-imbalance-kentuckys-tax-system-2/.