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Deep Business Tax Cuts Are Not the Key to a Stronger Kentucky Economy

By Anna Baumann

Governor Beshear's tax reform proposal includes a substantial amount of new business tax cuts aimed at making the state more competitive—even more than were included in the Blue Ribbon Commission report. But tax cuts are not the most effective way to grow jobs and build our economy. Instead, by leaving Kentucky with less revenue to invest in education, health and other public services that businesses rely on, more business tax cuts weaken the foundation of the state's economic growth. The Governor's plan would:

- eliminate property and payroll from the formula that determines corporate income taxes, meaning that businesses would pay taxes based solely on in-state sales;
- lower the top corporate income tax rate from 6.0 to 5.9 percent;
- create an angel investor tax credit;
- double the existing New Markets Tax Credit;
- expand the research and development tax credit;
- exempt inventory from the state property tax;
- create a tax credit for the bourbon industry;
- exempt certain products that support the equine industry from the sales and use tax;
- exempt agricultural pharmaceuticals from the sales tax;
- lower wholesale taxes on alcohol and repeal the distilled spirits sales tax.

Less Revenue for Important Investments

Fully implemented, these tax breaks would cost the state $229 million per year. The large price tag is one reason the overall fiscal impact of Governor Beshear's plan—$210 million in new General Fund revenue each year—is less than the Blue Ribbon Commission recommended. The net new revenue in the governor's plan would only modestly address deep underfunding in Kentucky's P-12 schools, health and human services, state police and other budget areas.[1]

By far the most costly of the proposed cuts would shift Kentucky to a "single sales factor" formula for corporate incomes taxes, draining about $155 million a year from the General Fund upon full implementation—a third of total corporate income taxes in Kentucky.[2] While providing a windfall to a handful of very large, profitable corporations that make most of their sales out of state, the legislation would not obligate the benefitting businesses to create jobs with tax savings or even maintain the jobs they have now.

Tax Cuts Are Not Effective Strategy to Grow the Economy

Although the stated purpose of the proposed cuts is to attract and grow business in Kentucky, decades of research questions the relationship between state taxes and economic growth.[3]

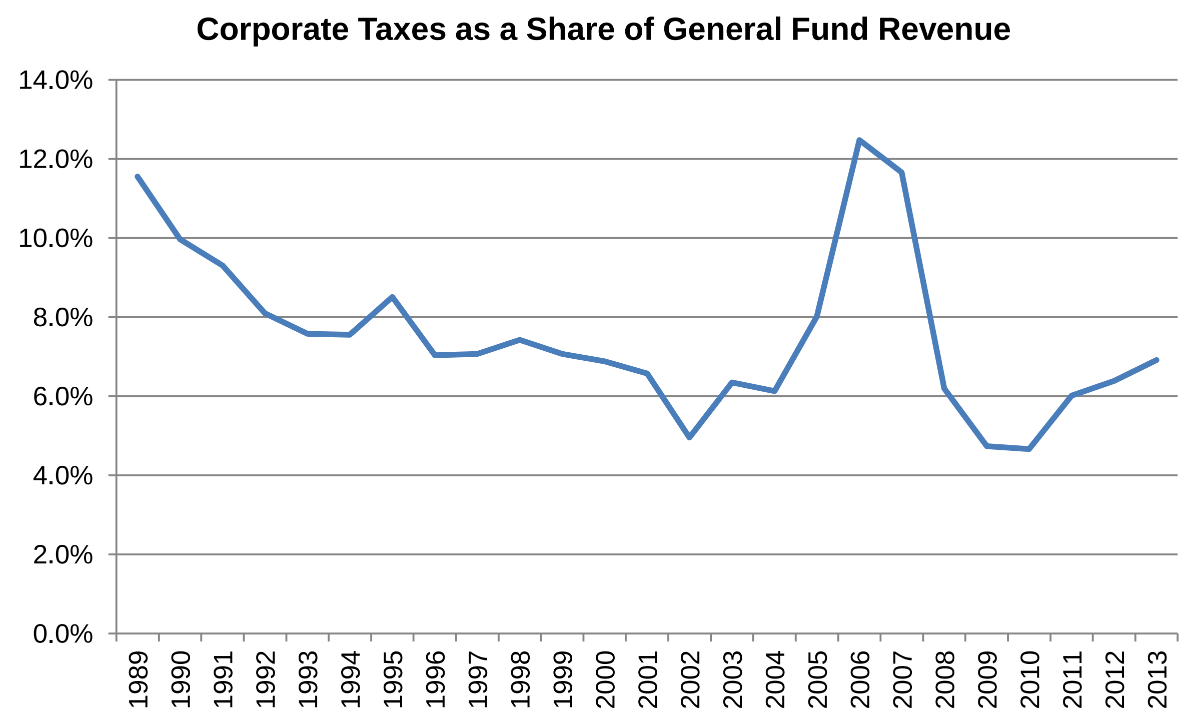
The reason is twofold: state business taxes are a very small portion of business costs—less than 0.3 percent.[4] Thus, they factor much less in decisions about where to locate or expand business than access to a skilled workforce, proximity to markets and suppliers, and the quality of infrastructure and public services. As a result, tax breaks or tax cuts often reward companies for choices they would probably make regardless of incentives.

The second, related reason is that corporate tax cuts leave the state with less money to invest in the public services that are important to businesses: research suggests a positive relationship between expanded public services and economic growth.[5] By reducing private sector costs with safe, reliable roads and bridges for instance, and by increasing productivity through investments in a healthy, educated workforce, improving public goods and services can be a more cost-effective method of growing the economy.

For example, a 2007 study found that, compared to tax incentive programs which cost Kentucky $26,775 per job created, a state job training program cost just $2,510 per job.[6] Unfortunately, Kentucky falls behind many other states in terms of an educated, skilled and innovative workforce.[7]

Corporate Taxes Are Already Low

Instead of closing loopholes and asking businesses to pay their fair share toward the public services that benefit them, Governor Beshear's plan would cut corporate taxes further—and they are already low, both by historical standards and compared to other states. As a share of the General Fund, corporate taxes declined from 11.6 percent in 1989 to just 6.9 percent in 2013.[8]



Source: Office of the State Budget Director, Kentucky Department of Revenue.

This general downward trend can be explained by numerous business tax cuts and the aggressive expansion of tax incentives over the years.[9] In 2005, the General Assembly made some progress by closing certain loopholes and requiring limited liability entities (LLE) to pay corporate taxes through an alternative calculation (the resulting temporary bump in corporate taxes corresponds with a dip in individual income taxes since, prior to the legislation, profits were reported on individual income tax returns).

However, the state also lowered the top rate from 8.25 to 6 percent and, in a special session in 2006, replaced the alternative calculation with a separate LLE tax and increased the number of businesses exempt from it. Corporate taxes decreased rapidly at that point, and after a special session in 2009 which expanded the state's tax incentive programs, fell to just 4.7 percent of the General Fund in 2010. In 2012, an additional tax break was created for large manufacturers. Corporate tax revenues have increased the last few years because corporate profits are at record heights, but receipts still have not returned to their prior levels and are expected to flatten and decline as companies reinvest profits in production.

In addition to becoming a smaller piece of Kentucky's revenue pie, Kentucky's business taxes are low compared to other states as shown in research shared with the Blue Ribbon Commission. For example, Kentucky ties with Virginia for the lowest top corporate income tax rate among neighboring states.[10] Other findings include:

- A report that looks at how states tax new private investment ranks Kentucky fourth best out of 13 comparison states, without even accounting for Kentucky's numerous tax incentives.[11]
- According to the Tax Foundation and KPMG, Kentucky ranks third best of 13 states in its taxes for new firms and in the top half for mature firms. Comparing all states, Kentucky ranked 7th best for new firms and 18th best for mature firms.[12]
- Only one study included in the commission's consultant report could be interpreted as suggesting that Kentucky's business taxes are less competitive: a comparison of 13 states that assigns Kentucky with the 3rd highest share of business taxes as a percentage of private sector gross state product. But the report clearly states that the measure "does not provide sufficient information to evaluate a state's competitiveness." One reason is that the study's definition of business taxes includes severance taxes, which makes states with coal and other natural resources like Kentucky and West Virginia seem to have higher business taxes than they actually do.[13]

Corporate Taxes Help Kentucky's Economy Grow

Making big cuts to business taxes would further compromise their most important functions: state corporate income taxes provide a channel by which businesses—as well as shareholders outside of Kentucky—help pay for the public services that benefit their companies. They are also an important part of a broad-based, diverse portfolio of taxes that grows with the changing economy; for example, in recent years during the economic recovery when corporate profits were high but consumer spending was down, growth in corporate taxes offset some of weakness in sales tax growth. Rather than pursuing an ongoing race to the bottom on business taxes, Kentucky should take a broader and more forward-looking approach based on building a stronger foundation for economic growth.

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1 Ashley Spalding, "Governor's Budget Provides Some Short-Term Help But Needs Revenue to Improve and Sustain," Kentucky Center for Economic Policy, February 2014, http://kypolicy.org/governors-budget-provides-short-term-help-needs-revenue-improve-sustain/.
2 Jason Bailey, "'Single Sales Factor' Would Cost Substantial Revenue Kentucky Needs for Investments that Work," Kentucky Center for Economic Policy, February 2014, http://kypolicy.org/single-sales-factor-cost-substantial-revenue-kentucky-needs-investments-work/.
3 Peter S. Fisher, "Corporate Taxes and State Economic Growth," Iowa Fiscal Partnership, February 2012, http://www.iowafiscal.org/2011docs/110209-IFP-corptaxes.pdf.
4 Michael Mazerov, "Cutting State Corporate Income Taxes Is Unlikely to Create Many Jobs," Center on Budget and Policy Priorities, September 2010, http://www.cbpp.org/files/9-14-10sfp.pdf.
5 Timothy Bartik and Ronald Fisher, reviewed in Robert G. Lynch, "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development," Economic Policy Institute, 2004.
6 William Hoyt, Christopher Jepsen, and Kenneth R. Troske, "An Examination of Incentives to Attract and Retain Businesses in Kentucky," University of Kentucky Center for Business and Economic Research, January 2007, http://cber.uky.edu/Downloads/BusinessIncentives_Final%20Report_01182007.pdf.
7 Christopher Jepsen, Kenneth Sanford, and Kenneth R. Troske," Economic Growth in Kentucky: Why Does Kentucky Lag Behind the Rest of the South?" University of Kentucky Center for Business and Economic Research, January 2008, http://cber.uky.edu/Downloads/CBER_Econ_Develop_Report_final_Jan2008.pdf.

[8] Calculation includes revenue from the corporate income tax, corporate license tax (which has been eliminated) and limited liability entity tax.

[9] Jason Bailey, "Corporate Taxes Important to Meeting Kentucky's Needs," Kentucky Center for Economic Policy, June 2011, http://kypolicy.org/corporate-taxes-important-meeting-kentuckys-needs/.

[10] Except Ohio, which replaced its corporate income tax in 2005 with a lesser commercial activity tax on gross sales, a move which has not resulted in better economic performance. Zach Schiller, "Tax Breaks for Business Owners Won't Help Ohio Economy," Policy Matters Ohio, April 2013, http://www.policymattersohio.org/wp-content/uploads/2013/04/BusinessTax_Apr2013.pdf. All states but Nevada, Wyoming, South Dakota, and Ohio have a corporate income tax or similar tax, and because corporate income taxes are deductible from federal corporate income taxes, the difference between states is very small.

[11] Robert Cline, Andrew Phillips and Thomas Neubig, "Competitiveness of State and Local Business Taxes on New Investment," Ernst & Young and Council on State Taxation, April 2011, http://www.cost.org/WorkArea/DownloadAsset.aspx?id=78442.

[12] Tax Foundation and KPMG, "Location Matters: A Comparative Analysis of State Tax Costs on Business," 2012, http://taxfoundation.org/sites/taxfoundation.org/files/docs/location%20matters.pdf.

[13] Andrew Phillips, Robert Cline, Thomas Neubig and Hon Ming Quek, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2011," Ernest and Young/ Council on State Taxation, July 2012, http://www.cost.org/Page.aspx?id=69654.