

# REVENUE OPTIONS

THAT STRENGTHEN  
THE COMMONWEALTH

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### ABOUT US

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the Commonwealth. Launched in 2011, the Center is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website at [www.kypolicy.org](http://www.kypolicy.org).



# REVENUE OPTIONS

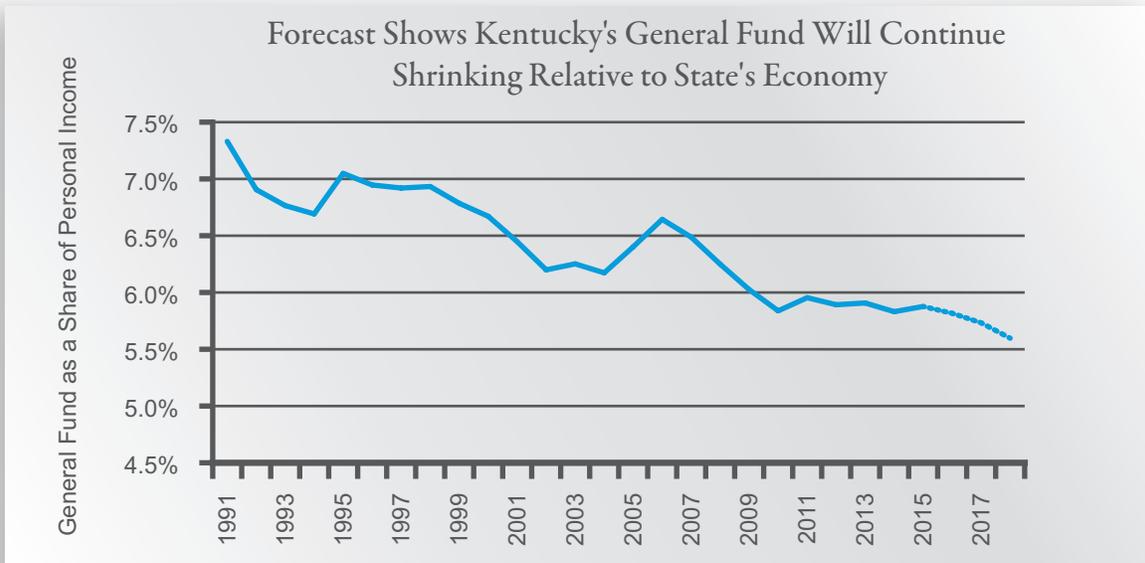
## THAT STRENGTHEN THE COMMONWEALTH

**By generating new revenue to invest in the building blocks of our state, good tax reform will make Kentucky stronger for all.** This menu of tax reform options describes some of the main ways to get there.

Currently, too many tax breaks and loopholes in the state's tax system drain money that is needed to shore up and sustain public schools, higher education and workforce development; teacher and state worker pension systems; preschool, child care and other family supports; health care, public and mental health; and other key areas. Cleaning up our tax code would generate revenue to address budget challenges holding us back. For example:

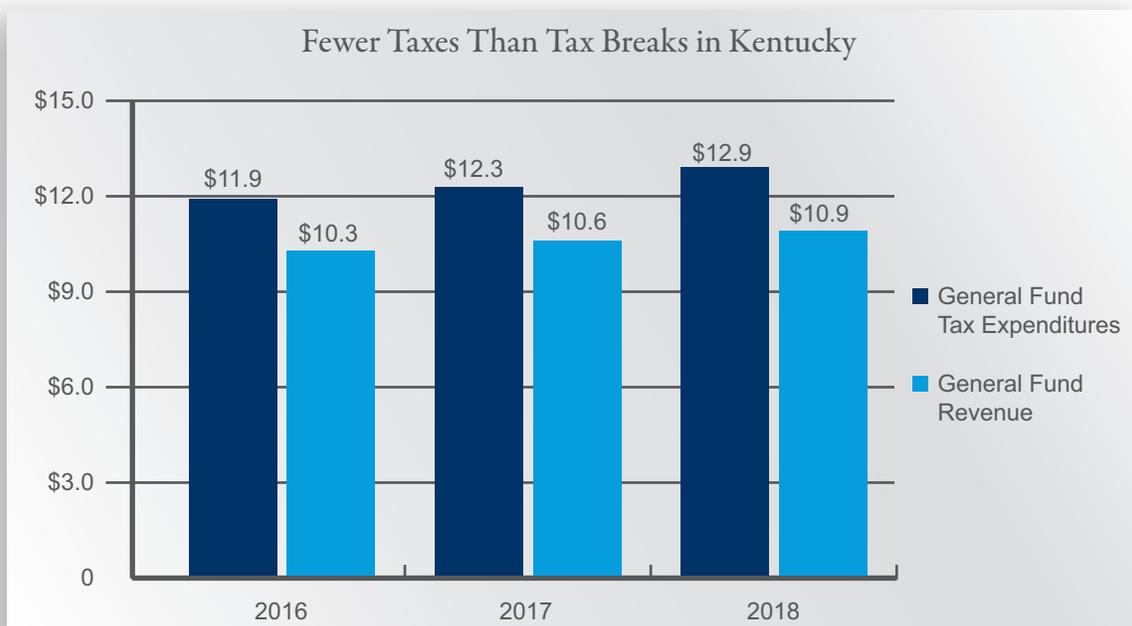
- Kentucky ranks 10th worst among states for cuts to overall state funding for K-12 education since 2008 and 6th worst when it comes to cuts to core formula funding for local schools (SEEK)—a decline of more than 10 percent when inflation is taken into account.
- Kentucky has one of the lowest eligibility thresholds for child care assistance in the country and frozen reimbursement rates to child care centers mean many are unable to stay afloat.
- We have cut more than one-fourth of state funding for higher education just since 2008, and tuition costs for students have skyrocketed from where they were just a couple of decades ago.
- We have failed to fund public employee pensions in recent years to avoid even deeper budget cuts, and as a result, it will take \$1.2 billion over the biennium to make actuarially required contributions to state worker and teacher pension plans.

The compounding problem of underinvestment in these and other areas was exacerbated by the Great Recession. But pre-existing, underlying problems with the tax code hold back revenue even when the economy is strong. That's a problem because as the economy grows, so does the cost of providing a certain level and quality of public services. The following graph shows that rain or shine, Kentucky will continue to have less and less of what it takes to invest in widespread prosperity.



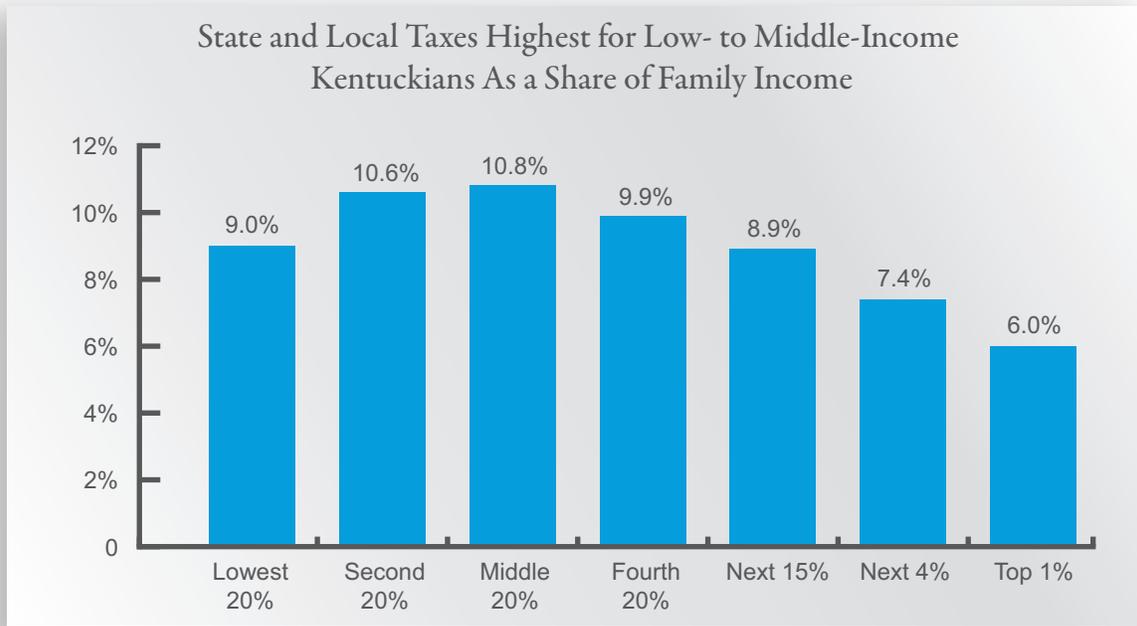
Source: Office of the State Budget Director, Bureau of Economic Analysis, Consensus Forecasting Group

The reason for this downward trend is that Kentucky has too many holes in its tax code, or what are called tax expenditures. These expenditures—which include exemptions, credits, deductions and loopholes—have grown in recent years as the General Assembly has passed bills that provide tax breaks and has failed to adjust the tax code for a changing economy. In fact, Kentucky spends more money through General Fund tax expenditures than it collects in General Fund revenue.



Source: Office of the State Budget Director

More generally, in the context of economic growth that is mostly benefitting the wealthy and leaving out low- and middle-income people, a tax code that asks the least of those at the top is problematic. If taxes are not levied where the economy is growing, revenue will erode. As the chart below shows, Kentucky's total state and local taxes are upside down, meaning they ask the least as a share of income of those with the most—an unfair but also financially unsound practice.



Source: Institute on Taxation and Economic Policy

**Good tax reform addresses these problems by:**

- Restoring the connection between our taxes and the economy so that we have what it takes, today and tomorrow, to invest in a better Kentucky;
- Expanding the base and closing loopholes to raise new revenue including from those who aren't currently paying a fair share.

Kentucky's biennial tax expenditure report is an essential tool for understanding opportunities to reform the state's tax code. Published by the Office of the State Budget Director each November preceding a budget session, it details the ways Kentucky's tax base has been narrowed over the years through various tax exemptions, deductions, credits and other breaks. These expenditures leave billions of dollars on the table, meaning less is available for schools and universities, public and mental health systems and other state priorities. Tax expenditures are not scrutinized for their cost-effectiveness, nor are they weighed against other types of spending. Instead, they automatically reduce the revenue the state has to meet its obligations and responsibilities.



## LIMIT INCOME TAX BREAKS

Kentucky's individual income tax exemptions and deductions are expensive and primarily benefit higher-income people who, overall, pay a smaller share of income in total taxes than middle- and low-income Kentuckians. Reducing these giveaways would enhance the capacity of the income tax to grow with the economy and provide adequate and sustainable funding for investments that benefit the entire Commonwealth. And contrary to what opponents of the income tax say, these reforms would not drive people away from Kentucky: the overwhelming evidence shows that few people move across state lines, and when they do, it's for jobs, family, climate and other quality of life factors—not taxes.

### DEDUCTIONS

Kentucky allows individual income tax filers to reduce taxable income by expenditures on home mortgage interest, charitable donations, state and local taxes paid, medical expenses and other costs. These deductions are costly and the tax breaks they provide are not well targeted: typically, only higher-income filers have enough qualifying expenditures to itemize and those with bigger homes and in higher tax brackets can claim more breaks. The home mortgage interest deduction is especially poorly targeted because it subsidizes homeowners but not renters and applies to interest on up to two homes.

- **Follow surrounding states and simplify filing by shifting from itemized deductions to standard deduction for all—\$367 million**

*Source: Institute on Taxation and Economic Policy (ITEP)*

In addition to saving money and making taxes fairer, this option would simplify filing. One out of four states with a broad-based income tax do not allow the majority of federal itemized deductions, and the majority of Kentucky's surrounding states don't allow any deductions at all—Indiana, Ohio, Illinois, and West Virginia. The top 20 percent of income earners would generate 66 percent of the revenue from this change, and the top 40 percent would generate 88 percent.

- **Shift from itemized deductions to an increased standard deduction, and phase the standard deduction out for those at the top—\$205 million**

*Source: ITEP*

Increasing the standard deduction to \$4,000 and phasing it out for high-income earners between \$100,000 and \$200,000 would provide a tax cut to the bottom 40 percent of people on average, result in no tax change for the middle 20 percent and generate revenue from higher-income households.

- **Cap the total value of deductions a filer can claim at \$17,500—\$200 million**

*Source: Legislative Research Commission (LRC)*



- **Replace deductions with credit at 5 percent—\$115 million**

Source: ITEP

Instead of being able to deduct expenditures from AGI to reduce taxable income, under a (non-refundable) credit-based system, individuals would receive a credit worth a certain percentage of deductions (itemized or the standard) to reduce their tax liability.

- **Replace deductions with credit at 3 percent—\$323 million**

Source: ITEP

### **The Federal Offset:**

Any tax reforms that increase filers' state income and property taxes would be partially offset by the ability to deduct these taxes on federal income tax returns. The federal government therefore picks up a portion of the cost of some revenue-raising state tax reforms, reducing the net new taxes paid.

## **PENSION EXCLUSION**

Kentucky excludes the first \$41,100 of a retiree's income from taxation regardless of how high a person's total income is—far more generous than the vast majority of states including five of Kentucky's six neighbors. A married couple using the full exemption and receiving the average amount of Social Security income could have \$110,000 in untaxed income, annually.

Retirees should pay a fair share toward the state investments that benefit them, especially those who are higher income. Otherwise, the state must rely more heavily on working families raising children who pay income taxes. Reducing the exclusion would save money and make our taxes fairer. It would not impact the state's exemption of Social Security income. Research also suggests it would not affect the migration patterns of retirees. A repeal of the pension exclusion would generate more than \$500 million a year based on cost estimates from the state's tax expenditure analysis.

- **Reduce the pension exclusion to \$35,000 and phase it out dollar for dollar—\$220 million**

Source: LRC

Under this proposal, retirees with up to \$35,000 in adjusted gross income would still be exempted, but for every dollar in AGI above the threshold, the exemption would be reduced by a dollar, such that those individuals with an AGI of \$70,000 and over would receive no exemption.

- **Phase out the pension exclusion for federal AGI between \$80,000-\$100,000—\$176 million**

Source: Office of the State Budget Director (OSBD)

Retirees with an AGI of up to \$80,000 would still receive the entire \$41,110 exemption; for those with an AGI over \$100,000, no exemption would be available; and for those in between, the exemption is phased out by about two dollars for every dollar in AGI over \$80,000.



## INCOME TAX BRACKETS AND RATES

Kentucky's top individual income tax rate is 6.0 percent for filers with an adjusted gross income of over \$75,000. 19 states and the District of Columbia have a higher top rate, including West Virginia's (6.5 percent for income over \$60,000), and the national average is 6.62 percent. Adding a tax of a half-penny or penny on the dollar for incomes above six figures would generate significant new revenue from those whose income has grown the most in recent years.

- **Create a new top rate of 6.5 percent for income over \$100,000—\$62 million**

*Source: ITEP*

- **Create a rate of 6.5 percent starting at \$100,000 and 7.0 percent starting at \$250,000—\$96 million**

*Source: ITEP*

- **Create a rate of 6.5 percent at \$100,000 and 7.0 percent at \$250,000 and phase out lower rates for income from \$250,000 to \$300,000—\$130 million**

*Source: ITEP*

Phasing out their ability to run income through lower marginal tax rates would generate revenue from the wealthiest Kentuckians, requiring those at the very top to pay 7 percent on all income.

## OTHER IIT REFORMS

- **Repeal the postsecondary education tuition tax credit—\$18 million**

*Source: OSBD*

Individuals may deduct a nonrefundable credit for tuition and related expenses of up to 25 percent of the federal American Opportunity Tax Credit. Because people living below the poverty line owe no state income taxes, they receive no benefit from this program. Yet need-based financial aid programs are consistently underfunded. A state higher education work group recommended repealing this credit and diverting the funds to need-based aid.

- **Repeal the \$10 individual income tax credit—\$33 million**

*Source: OSBD*

Kentuckians receive a \$10 credit against individual income taxes. Repealing it would not significantly affect filers' ability to pay since the Family Size credit supports low-income Kentuckians.

- **Simplify filing by having married couples file joint returns—\$73 million**

*Source: OSBD*

Requiring married Kentuckians to use the same filing status they do for federal income taxes would remove their ability to run each spouse's income through the entire marginal rate schedule, as is currently allowed under the option to file a combined return. Very few states allow this filing status and removing it would simplify tax filing.



# BRING SALES TAX INTO THE 21ST CENTURY

Kentucky's sales tax has not kept up with a changing economy in which a growing share of consumer spending goes to services. Bringing the sales tax up to date would generate revenue to invest in a stronger state, including in a workforce with better-paying jobs and more disposable income to buy goods and services.

## BROADEN SALES TAX BASE TO INCLUDE MORE SERVICES

Compared to other states, Kentucky taxes very few services—only 28 of the 168 services that at least one state taxes. Bringing more services into the base will generate new revenue, increase the sustainability of sales tax revenue over the long term and end the distorting effect of discounting services over goods. In the same way that Kentucky exempts goods such as food and prescription drugs from sales taxes that otherwise would fall heavily on low-income Kentuckians, taxation of services should be as progressive as possible.

- **Expand the base** to include such luxury and other services as country club and golf club membership fees, janitorial services, armored car and security, pest control services, landscaping, car washing, limousine and commercial linen services—**\$115 million**

*Source: LRC*

- **Expand the base** according to these principles: “household-consumption based, luxury items, services that have a clear nexus to Kentucky, ties to physical products already taxed, services with an inelastic demand [and] sensitive to border state sales taxes”—**\$176.4 million**

*Source: Blue Ribbon Commission on Tax Reform (BRC)*

- **Expand the base** to include “the labor associated with the installation and repair of taxable goods, certain recreational activities, certain commercial and residential services, and several personal services”—**\$279.9 million**

*Source: OSBD*

## OTHER SALES TAX REFORMS

- **Clarify that the sales tax is applicable to all prewritten software, regardless of method of delivery (i.e. that it applies to internet downloads)—\$5 million**

*Source: OSBD*

- **Clarify that sales tax and transient room taxes are applicable to all costs of hotel accommodation, including payments to online booking agents—\$5 million**

*Source: OSBD*



# CLOSE CORPORATE INCOME TAX LOOPHOLES AND BRING INCENTIVES UNDER SCRUTINY

Current laws allow large corporations to escape taxation through a variety of accounting strategies that small businesses can rarely use. Profits sheltered from corporate taxation often go to out-of state shareholders and executives, circumventing Kentucky's General Fund and its economy altogether. Kentucky tax laws also give many tax breaks to businesses promising to create jobs in Kentucky. Even though the cost-effectiveness of these incentives is questionable, they are not routinely scrutinized by state lawmakers or weighed against other types of spending.

As a result, many businesses that profit from Kentucky's public investments are not paying a fair share and the responsibility to fund state priorities falls more heavily on individuals and families. Addressing these problems would not hurt our economy or our ability to grow jobs. Corporate taxes account for a very small portion of business expenditures, and therefore factor little in businesses' decisions about where to locate and hire employees especially compared to skills of the workforce and quality of the infrastructure.

## ■ **Close loopholes by enacting combined reporting and throwback rule—\$66 million**

*Source: LRC*

Combined reporting requires large corporations to include profits from all related subsidiaries on state tax returns, eliminating their ability to shift profits—through passive investment companies (PICs), real estate investment trusts (REITs), transfer pricing and other structures—to states or foreign nations with low or no corporate taxes. Twenty-four states, or more than half of states with corporate taxes, have enacted combined reporting and five list well-known tax havens.

A throwback rule would require corporations producing goods in Kentucky, but selling them in states without enough sales to be subject to corporate income taxes, to report that income on their Kentucky corporate income tax returns.

## ■ **Create a review process for all economic development incentive programs, require sunset dates and require the General Assembly to reauthorize programs—up to \$361 million from sunsets**

*Source: OSBD*

Economic development incentives rarely pay for themselves and take money away from more reliable strategies for strengthening the state like education and infrastructure. Reform would entail scrutinizing these incentives for their cost-effectiveness compared to other types of spending.

## ■ **Lower the exclusion for the Limited Liability Entity (LLE) Tax to \$1 million and phase it out to \$2 million—\$13 million**

*Source: LRC*

LLEs (businesses not organized as corporations but still receiving limited liability protection) can currently exclude their first \$3 million in gross receipts from taxable income. The exclusion phases out to \$6 million. If they do not reach the \$3 million threshold then they pay the alternative minimum tax of \$175. Because the threshold is so high, an estimated 82 percent of LLEs pay only the \$175 minimum.



# REMOVE REVENUE GROWTH CAP FROM PROPERTY TAX

Kentucky's total state and local per capita property tax revenue ranks 47<sup>th</sup> in the nation, meaning money is being left on the table that could go instead toward investments that benefit all Kentuckians, including property owners. A big reason is that Kentucky's law broadly suppresses revenue instead of only assisting those least likely to be able to afford property taxes. The four percent cap on state real property revenue growth has pushed the state tax rate down from 31.5 cents when it was enacted in 1979 to 12.2 cents today, preventing property taxes from growing with property values, and therefore, with the economy.

## ■ Freeze the state real property tax rate at 12.2 cents — undetermined

Freezing the real property tax rate at 12.2 cents would allow revenue to grow with the economy as the housing market recovers. According to the OSBD, the state would collect \$404 million more in 2016 alone if the rate were frozen in 1979 at 31.5 cents.

## ■ Restore state property tax rate to level of early 1990s — \$106 million

*Source: Kentucky Center for Economic Policy (KCEP)*

Restoring 5 cents of property tax rate cut due to House Bill 44 would mean clawing back only a small portion of the cuts and could be coupled with a property tax circuit breaker (see below) to support lower-income people.

## ■ Require businesses that rent or lease space to house boats, RVs, and private aircraft to report to the Department of Revenue for taxing purposes — \$3 million

*Source: LRC*

Reporting would lead to greater compliance with existing ad valorem tax laws for tangible personal property.

## OTHER REVENUE OPTIONS

## ■ Raise cigarette tax to \$1.60, add e-cigarettes to the OTP tax base and raise that tax commensurate with the cigarette tax increase — \$115 million

*Source: LRC*

Excise taxes on cigarettes and other tobacco products raise revenue and also act to discourage their purchase and use. That means a tax increase would have diminishing long-term revenue returns but also important health benefits, especially for pregnant women and children. Currently, Kentucky's cigarette tax is 60 cents per pack, well below the national average of \$1.46. And while there is a tax on "other tobacco products" (OTP) it does not include e-cigarettes and could also be raised significantly.

## ■ Re-establish the estate tax in accordance with federal law in effect on January 1, 2003, without any of the federal increases to exemption under the Bush tax cuts — \$25 million

*Source: LRC*

Taxes on the transference of wealth generate revenue for public investments that help all Kentuckians build capital, mitigate the concentration of wealth and provide a backstop to income tax losses through



unrealized capital gains. But because Kentucky's estate tax on wealth transferred at death is linked to the federal estate tax, federal changes in the 2000s eliminated the estate tax. By referencing a date in the statutes prior to the repeal, Kentucky can reinstate the tax.

■ **Unfreeze the hospital provider tax in recognition of the huge benefits to the healthcare sector from Medicaid expansion—\$100 million for each 1 percent increase**

*Source: KCEP*

A number of states are paying for their Medicaid expansion by raising the tax on health care providers, particularly hospitals, in recognition of the huge influx of dollars to those institutions because of expansion. Kentucky's provider tax has been frozen since 2007—prior to Medicaid expansion—so that hospitals currently pay only 2.5 percent of their 2006 gross receipts. The state has paid out \$2.9 billion in new payments to providers because of Medicaid expansion so far, about half of which has gone to hospitals.

## ROAD FUND REFORMS TO KEEP KENTUCKY'S INFRASTRUCTURE UP-TO-DATE

Along with the General Fund, Kentucky's Road Fund faces challenges. The gas tax—which is tied to the wholesale price of gasoline—has fallen precipitously over the last biennium, leaving the state with less to invest in good roads and bridges. But the bigger long-term problem is that Kentucky, like many other states and the federal government, lacks a source of revenue that 1) keeps up with the cost of building and maintaining a reliable transportation network and 2) is not eroded by rising fuel efficiency standards.

Roads in poor condition with potholes and uneven surfaces can be dangerous and cost Kentuckians more on car repairs. But failing to start and complete important transportation projects also holds the state's economy back. Lawmakers somewhat blunted the impact of gas price drops in the 2015 session with the passage of a bill that raised the gas tax floor and modified the rate-setting process. But further changes are needed.

■ **Raise gas and diesel rates by 4.3 cents to meet national average—\$125 million**

*Source: ITEP*

■ **Index the gas tax to inflation and vehicle fuel-efficiency—\$30-60 million more each year**

*Source: ITEP*

■ **Reduce dealer's compensation for collecting and remitting motor fuels tax to 1.00 percent from 2.25 percent—\$21 million**

*Source: BRC*

Compensation has not been reduced to reflect technological changes that have made dealers' job easier.

## ENACT COMPLEMENTARY POLICIES SUPPORTING LOW-INCOME KENTUCKIANS

One common element among the reforms discussed so far in this menu is that they all raise revenue—and many do so by enhancing tax fairness. Yet there are also key components of progressive tax reform that would provide greater support to low-income families, who pay a higher share of their income in state and local taxes than do higher-income people. A state EITC and property tax circuit breaker are important policies in their own right, and also as offsets to certain reforms included in this menu such as lifting the cap on real property revenue growth, increasing tobacco taxes and adding select services to the sales tax base.

### ■ **Create a refundable state EITC at 15 percent of the federal credit—(\$115 million)**

*Source: LRC*

A refundable earned income tax credit (EITC) helps low-income working families. Over 400,000 Kentucky families who receive the federal EITC would benefit. Families typically spend their credit on basic living expenses, paying off debt and investing in education. It is a proven anti-poverty tool that has lasting benefits for children, including higher rates of employment and earnings later in life. In addition to these policy reasons to enact a state EITC, linking it to the federal program would be administratively simple.

### ■ **Enact a circuit breaker—(no estimate available)**

A circuit breaker reduces property tax liability for people below a certain income level when property taxes exceed a certain portion of income. More than 33 states have circuit breakers. A circuit breaker would be much better targeted and less costly than Kentucky's current blunt cap on property tax growth.



## SOURCES

You can read more about policies in this menu and other tax reform options in the resources listed below.

- Blue Ribbon Commission, “Report by the Blue Ribbon Commission on Tax Reform to Governor Beshear,” December 17, 2012.
- “Kentucky Competes,” Governor Beshear’s 2014 tax reform plan, <http://migration.kentucky.gov/NR/rdonlyres/6D84D0C3-1826-4738-A573-6317263CE8DE/314367/KYCompetes2414FINAL.pdf>.
- House Bill 132, 2015 Kentucky General Assembly, <http://www.lrc.ky.gov/record/15RS/HB132.htm>.
- Office of the State Budget Director, “Commonwealth of Kentucky Tax Expenditure Analysis Fiscal Years 2016 to 2018,” November 30, 2015, <http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf>.
- Kentucky Reports and Information, [The Institute on Taxation and Economic Policy](#).
- State Taxes, [The Kentucky Center for Economic Policy](#).



