THE PATH TO A STRONGER COMMONWEALTH

PRIORITIZING INVESTMENTS IN OUR COMMUNITIES OVER TAX BREAKS FOR THE POWERFUL

KCEP
KENTUCKY CENTER for ECONOMIC POLICY

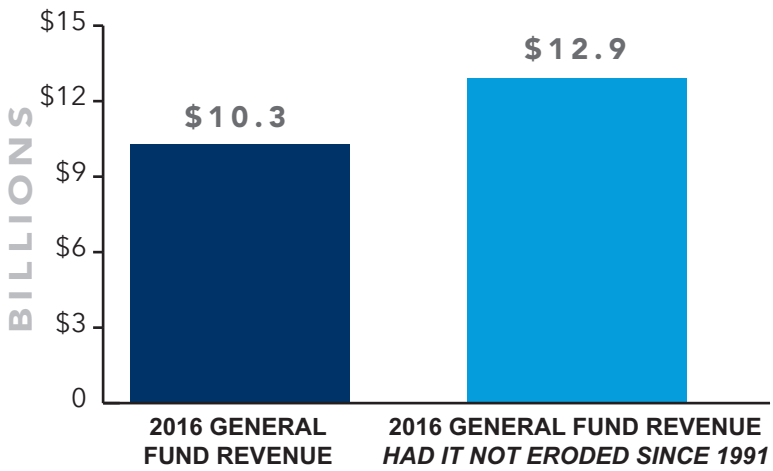
Kentucky faces a choice: Cleaning up our tax code of special interest tax breaks so we can invest in excellent schools, a healthy and skilled workforce, modern infrastructure and other building blocks of thriving communities in the Commonwealth; or continuing to allow our tax code to be manipulated for the benefit of just a few, while essential investments fall farther behind. This report explores these two choices and provides direction for the road ahead.

Moving forward means raising new revenue to invest in the foundations of thriving communities by cleaning up our tax code, eliminating breaks those at the top have managed to put there.

Moving backward means undermining investments in a stronger state by failing to clean up tax breaks and continuing with more tax giveaways for those at the top.

MOVING FORWARD: CLEANING UP TAX BREAKS FINANCES SMART INVESTMENTS

Kentucky has less than it once had to invest in the foundations of thriving communities. That's because out-of-control tax breaks and failure to keep up with a changing economy have drained revenue from our General Fund—causing erosion well before the Great Recession hit. If taxes had simply kept up with the economy since 1991 after the Kentucky Educational Reform Act was passed, we would have collected **$2.6 billion more in 2016 alone** (see graph). Cleaning up tax breaks to restore revenue could go a long way toward strengthening our state and communities, paying down debts and saving for a rainy day. For instance, new investments could:



- Offer high-quality early childhood education to more kids, attract and retain a first-rate teaching workforce and increase equity between K–12 public school districts.
- Enhance college affordability, boost supports for degree completion and invest in cutting edge programs that strengthen our workforce and economy.
- Ensure that people with behavioral and intellectual disorders or who are struggling with addiction have access to high-quality care.

LOSING GROUND: EXPANDING OUT-OF-CONTROL TAX BREAKS REDUCES INVESTMENT

Changes to the tax code that result in less revenue, on the other hand, hurt our ability to educate our kids, keep our families and communities healthy and safe, care for the aging and sick and make other important investments in the strength of our state and the ability of our economy to grow over time. Fiscally speaking, they make it harder to pay down debts, restore funding from **16 rounds of budget cuts in the last eight years** and invest in a brighter future for Kentucky.

"WE CAN'T GET SOMETHING FOR NOTHING."

Harmful tax changes reduce what we have to invest by expanding income tax breaks for individuals and corporations at the top while shifting taxation to everyone else through the sales tax.

Contrary to popular myth, this kind of shift does not pay for itself by stimulating the economy (we debunk this fiction on page 5). In fact, **sales taxes just don't grow as well as income taxes in the long term**. As a result, a so-called "revenue neutral" income-to-sales tax shift (a.k.a. wealthy-to-everyone else shift) would actually hurt our ability to generate revenue down the road.

SMART POLICY: CLEANING UP TAX BREAKS IS KEY FOR THE COMMONWEALTH

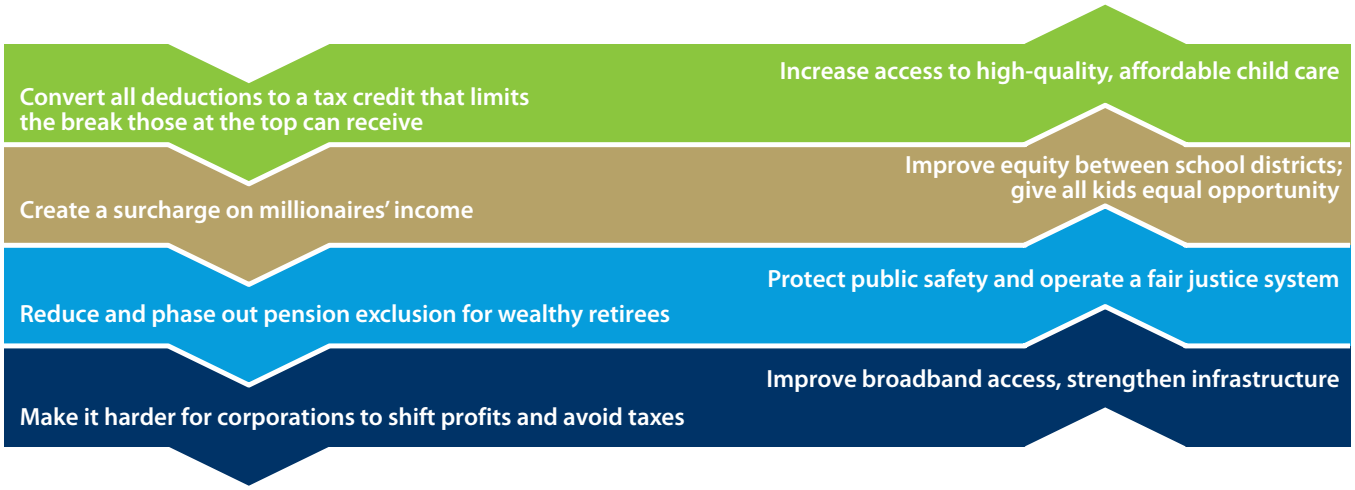
Healthy revenue systems reflect the virtuous relationship between the taxes we pay and economic growth, asking everyone to chip in towards the investments that benefit us all. In particular, Kentucky's individual income tax (IIT) is our largest and best growing source of revenue for investing in our common wealth.

Yet we are still spending more on income tax breaks overall than we are collecting: **in 2016, $6.3 billion in IIT tax breaks versus $4.3 billion in revenue**, and $328 million in breaks versus $528 million in revenue for the Corporate Income Tax (CIT). In an economy where most income growth is going to those at the top (since 1979 in Kentucky, real income has grown for the top one percent by 60.1 percent, while falling for everyone else) and corporate profits have been at record highs in recent years, good reform means cleaning up breaks that benefit a prosperous few at the expense of our investments in the common good. For example:

- Deductions cost Kentucky more than half a billion each year, with nearly 30 percent of all benefit going to those with incomes over $100,000.
- With today's extremely large pension exclusion, a married couple with pension and social security income could feasibly have $110,000 in untaxed income annually no matter how high their total income.
- Despite the great disparity in income growth in today's economy, income tax rates flatten out at relatively low levels of income.
- Profitable corporations can take advantage of loopholes to avoid taxation.

SPEND LESS
ON BREAKS BENEFITTING THOSE AT THE TOP

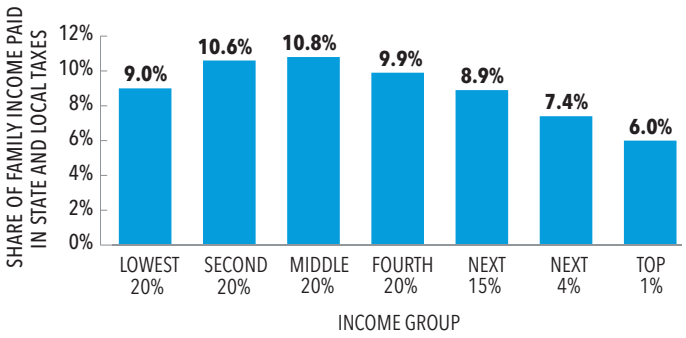
INVEST MORE
IN THINGS THAT BENEFIT US ALL



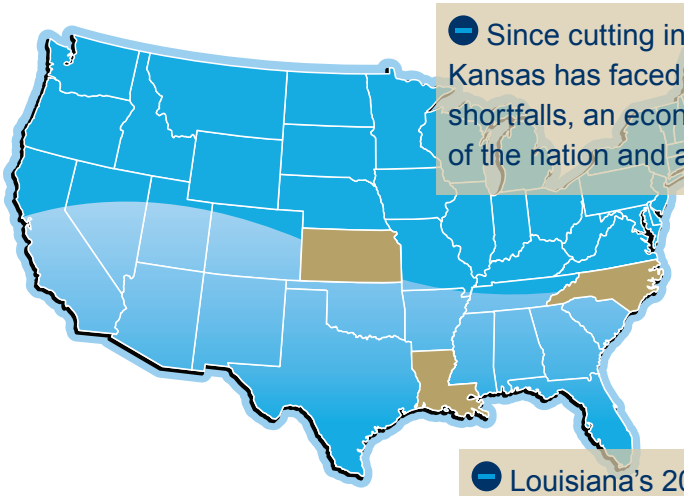
BAD CHOICE: TURNING TAXES MORE UPSIDE DOWN WILL REDUCE INVESTMENTS

Income tax cuts are often promised to lead to economic growth, but in fact they leave states with less to invest, deepen structural problems and make our tax system even more upside-down (asking the least of those with the most, see graph). While those at the top benefit the most from income tax cuts, either everyone else pays more through other taxes to make up the difference or we suffer the consequences of having less to invest. This extreme and misguided attempt to, in the words of Kansas Governor Sam Brownback, give the economy "a shot in the arm," is based on misconceptions about the way our economy works. The truth is:

In Kentucky's Upside-Down Tax System, Those at Top Pay Least



- **Income tax cuts do not encourage job creation.**
  Very few individuals employ others, meaning tax cuts are more for the wealthy than those who run businesses. As a result, tax cuts as economic development tools are not cost-effective.
- **Income tax cuts would not draw people and businesses to KY.**
  People move for work, family, climate and other personal reasons, not taxes. Since state taxes are such a small share of business expenses—typically two to three percent—they matter less than reliable infrastructure, a productive workforce and other things tax cuts undermine.
- **Lower income taxes do not generate more revenue in the long term.**
  There is simply no evidence that tax cuts pay for themselves. Rather, less revenue to invest means compounding fiscal problems and shrinking investments in thriving communities.



Since cutting income taxes in 2012–13, Kansas has faced devastatingly deep budget shortfalls, an economy lagging behind the rest of the nation and a credit rating downgrade.

North Carolina's "Great Tax Shift" in recent years has given the top one percent an average tax cut of $15,500, while people earning less than $12,000 a year have seen their taxes go up by $10. In recent years, NC's economy has lagged behind its neighbor states.

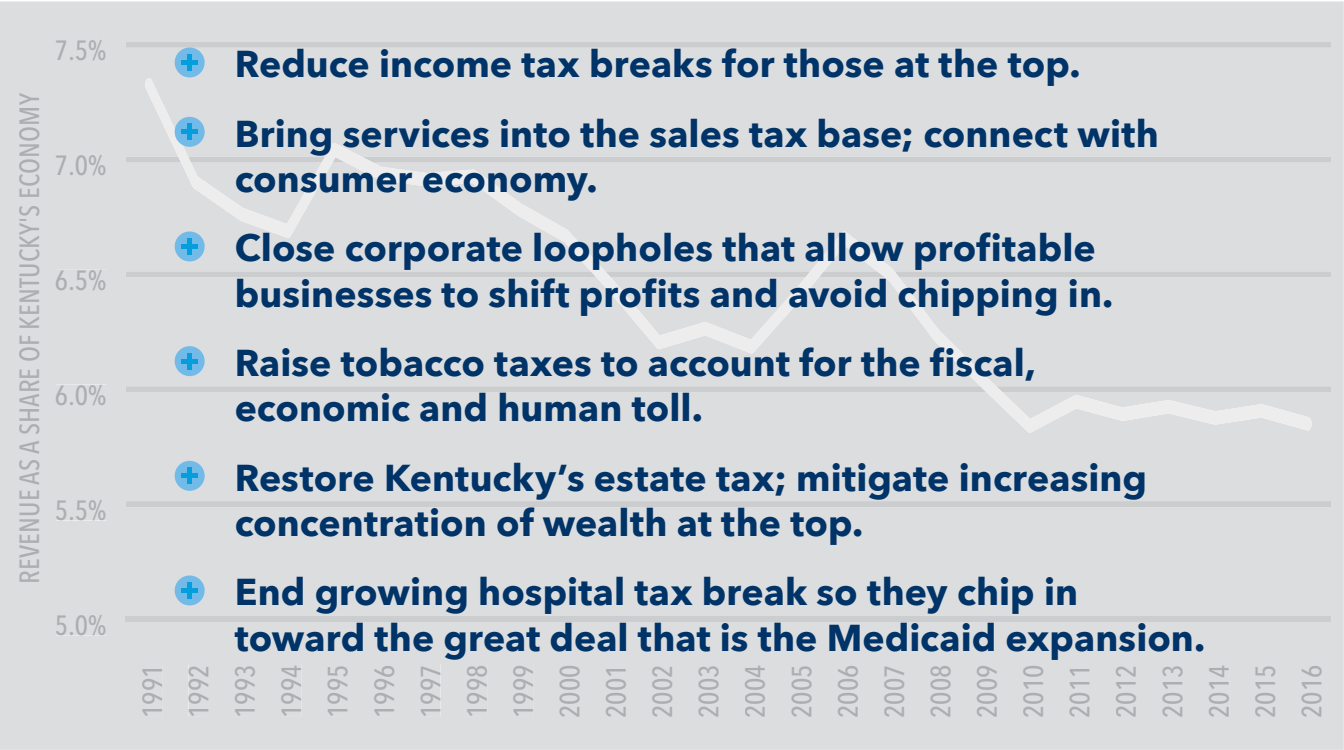
Louisiana's 2008 tax cut bonanza has led to a $2 billion shortfall and threats of drastic measures if new revenue is not raised. The fiscal crisis is worsening the state's ability to respond to its economic problems related to low oil prices.

SOUND REFORM: RESTORING ABILITY OF REVENUE TO KEEP UP WITH ECONOMY ENSURES FUTURE

Good reform cleans up tax breaks to generate revenue for investments that benefit us all. Also, because those at the top are taking home a bigger and bigger share of economic growth, this kind of reform makes our taxes more reliable going forward. In other words, good tax changes restore the connection between our taxes and economy.

Fiscally sensible policy changes make sure revenue keeps up so we can reliably invest in our school kids, college affordability, healthy communities, modern infrastructure and more. In addition to ending income tax breaks at the top, another example of good reform is bringing services into our sales tax base: In an increasingly service-based economy, Kentucky currently fails to tax the vast majority of services. Adding more services to the sales tax base will enhance revenue performance, as well as put businesses providing goods and services on equal footing.

How to Repair Erosion, Reliably Fund Investments, Today and Tomorrow



HARMFUL SHIFT: ASKING MORE OF THOSE LEFT BEHIND IN TODAY'S ECONOMY IS UNFAIR AND UNSOUND

Especially in the context of an economy where the vast majority of income growth is going to those at the very top, it just doesn't make good fiscal sense to lean more heavily on low and middle income Kentuckians to finance investments in our state. But that's exactly what "shifting to a consumption based tax system" does: It gives those at the top a break by cutting individual or corporate taxes or eliminating inheritance taxes, for example, and asks more of the Kentucky families and individuals who largely spend what they earn to get by. As noted, Kentucky's tax system is already upside-down—it asks the least of those at the top and the most of those toward the bottom and middle. A heavier reliance on sales taxes to make up for cuts to the income tax would deepen that unfair and unsound distribution. It would also exacerbate after-tax income inequality.

Because sales taxes just don't grow as well as income taxes—including because as more income is concentrated at the top, a larger portion is likely to be saved, not spent and therefore not subject to sales taxes—a shift from income to sales taxes that seems revenue neutral at first will lose money over time, requiring the state to increase sales tax rates even more to keep up.

CONVERSION TO CONSUMPTION BASED SYSTEM = TAX BREAK FOR WEALTHY, HIKE FOR LOW AND MIDDLE INCOME KENTUCKIANS

2016 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	Revenue Impact
Average Income in Group	$11,000	$27,000	$44,000	$71,000	$115,000	$225,000	$904,000	
One Penny Sales Tax Hike (Increase from 6% to 7%)								
Tax Change as % of Income	0.6%	0.6%	0.5%	0.4%	0.3%	0.2%	0.1%	+$559 Million
One Penny Income Tax Cut (Top Rate Decrease from 6% to 5%)								
Tax Change as a % of Income	−0.0%	−0.2%	−0.3%	−0.4%	−0.4%	−0.5%	−0.7%	−$554 Million
Average Net Tax Change	**$59**	**$90**	**$61**	**$2**	**−$189**	**−$815**	**−$5,396**	
Net Tax Change as Percent of Income	**0.6%**	**0.4%**	**0.2%**	**0.0%**	**−0.1%**	**−0.3%**	**−0.6%**	

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