REVENUE OPTIONS

THAT STRENGTHEN THE COMMONWEALTH

KCEP
KENTUCKY CENTER for ECONOMIC POLICY

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ABOUT US

The Kentucky Center for Economic Policy (KCEP) 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.

REVENUE OPTIONS

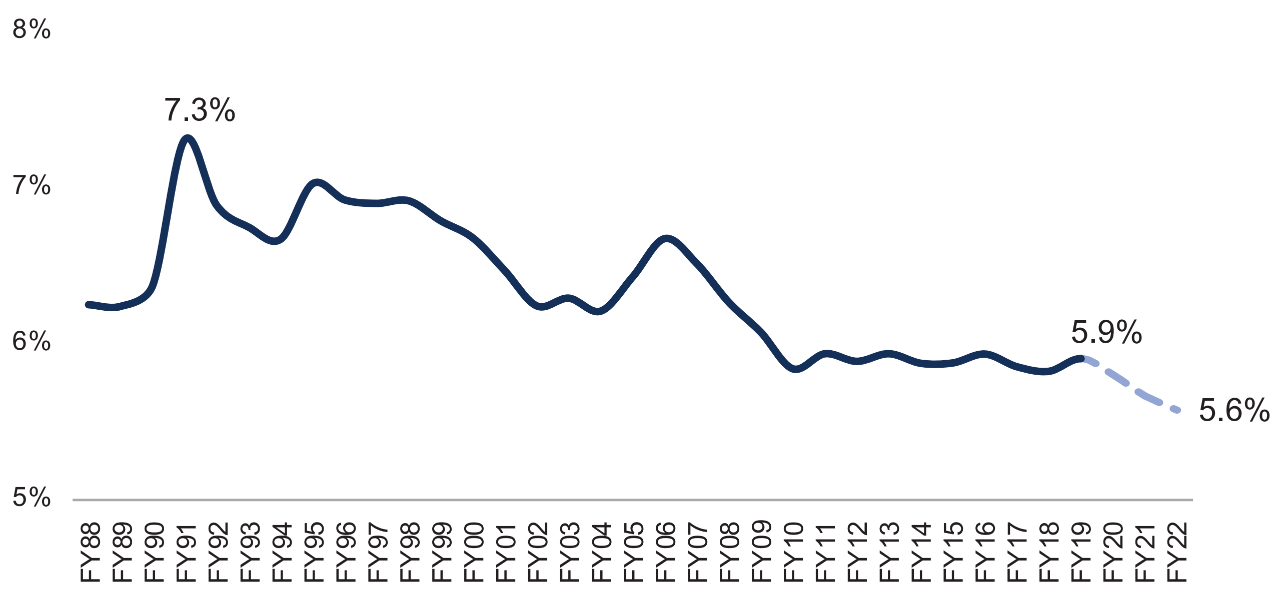
THAT STRENGTHEN THE COMMONWEALTH

This menu of tax reform options describes some of the ways to improve investments in our commonwealth. Currently, too many tax breaks 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 priorities. By generating new revenue to invest in the building blocks of our state and meet our obligations, cleaning up tax breaks will make Kentucky stronger.

Kentucky's fiscal challenges were exacerbated by the Great Recession, but structural problems with the tax code hold back revenue even when the economy is strong. Due to tax breaks growing in both size and number, the General Fund has deeply eroded as a share of our economy since the early 1990s after tax changes as a part of the Kentucky Education Reform Act (KERA) were passed. Following KERA, new General Fund revenues in 1991 exceeded $700 million — the majority from getting rid of income tax breaks. But as the graph below shows, today the General Fund is even smaller as a share of our economy than it was before KERA. If the General Fund were still 7.3% of the economy as it was in 1991 we would have $3.1 billion more in 2020 to invest in Kentucky.

As a Result of Growing Tax Breaks, Revenue Growth After KERA Did Not Last

Total General Fund Revenue as a share of Kentucky personal income, historical and projected

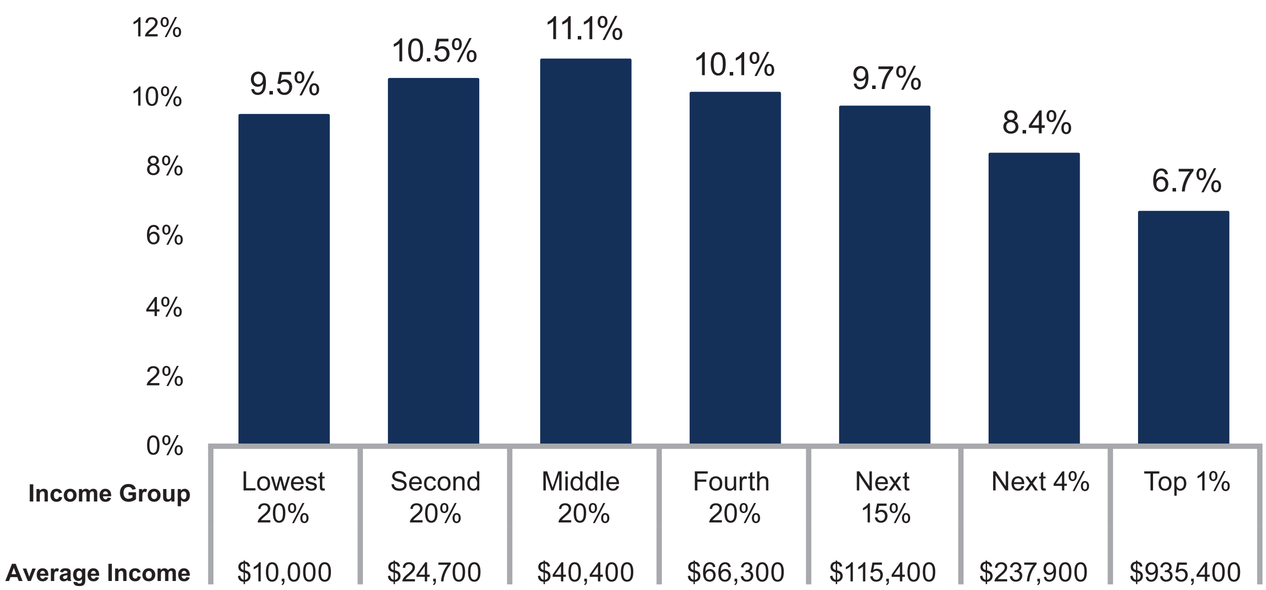


Source: KCEP analysis of data from the Office of the State Budget Director and the Bureau of Economic Analysis.

We can restore the ability of revenue to keep up with the economy by cleaning up tax breaks—particularly, tax breaks that disproportionately benefit the wealthy and special interest groups. Because of vast inequalities in our economy today, those at the top are taking home the lion's share of growth. Yet by taxing those at the top the least as a share of income, our tax system does not adequately track this growth. As the graph below shows, Kentucky's tax system is mostly upside-down (regressive), with the wealthiest Kentuckians (who take home about $900,000 a year on average) paying less as a share of their income in state and local taxes than all other Kentuckians; and moderate- to middle-income Kentuckians paying the most. Improving fairness in our tax code will also improve the ability to sustain revenue over time.

Kentucky's Tax System Asks the Least of the Wealthiest Residents

State and local taxes paid as a share of family income



Source: Institute on Taxation and Economic Policy.

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Conversely, changes like those made during the 2018 and 2019 legislative sessions that make our tax system more upside-down will weaken revenue growth needed to invest in thriving communities. Asking more of low- to middle-income Kentuckians through a further shift to "consumption," or sales taxes, and asking less of wealthy Kentuckians by further reducing income taxes, will make our tax system even less fair and reliable. Furthermore, evidence does not support the theory that lowering income taxes spurs states' economic and revenue growth.

The following pages provide concrete options for raising revenue and strengthening investments in Kentucky. The next page provides a worksheet for listing options and estimating their combined impact. A caveat is that, due to interactions between various options, simply adding individual estimates together will provide an incomplete picture of the potential fiscal impacts.

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WHAT REFORMS WOULD YOU CHOOSE TO MOVE KENTUCKY FORWARD?

REFORM	FISCAL IMPACT

RESTORE PROGRESSIVITY TO THE INCOME TAX AND LIMIT INCOME TAX BREAKS

During the 2018 session, significant changes were made to the individual income tax, including the repeal of many itemized deductions. However, the revenue generated by these positive, base broadening changes was used to reduce the income tax rate to a flat 5%, a change that was very expensive and primarily benefited those at the top. The following recommended changes will make our income tax more progressive — asking more of those who have more — and 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. Contrary to what opponents of the income tax say, these reforms would not drive people away from Kentucky: the overwhelming evidence shows few people move across state lines, and when they do, it's for jobs, family, climate and other quality of life factors — not taxes.

- **Simplify filing by having married couples file joint returns — $39 million**

  Source: Institute on Taxation and Economic Policy (ITEP)

  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. Very few states allow this filing status and removing it would simplify tax filing.

- **Increase the retirement exclusion back to $41,110 and phase out the exclusion, dollar for dollar, above $41,110 — $181 million**

  Source: ITEP

  Retirees with up to $41,110 in adjusted gross income would still be exempted (and Social Security income would remain untaxed), 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 $82,220 and over would receive no exemption. This change would make this tax break no longer available for high-income individuals.

- **Increase the standard deduction to $4,000 for individuals and $8,000 for married filers; cap itemized deductions at 2.5 times the standard deduction, with the exception of charitable deductions; phase out itemized deductions for higher income individuals; re-establish graduated rate brackets, with a phase out of the lower brackets for higher income individuals; and expand the family size tax credit to 138% of the federal poverty level — $683 million.**

  Source: ITEP

  This group of changes will make our income tax more progressive by asking more of those who have more, while providing additional relief for those at the lower end of the income distribution. Establishing a graduated rate structure at 5% of net income up to $37,500, 6% of net income between $37,500 and $75,000 and 7% of net income over $75,000 (doubled for married individuals), with a phase out of the lower brackets for high income individuals, and a limit on the use of itemized deductions, combined with an increase in the standard deduction to $4,000 for unmarried individuals and $8,000 for married individuals will generate significant new revenues primarily from those at the top whose incomes are growing the most while holding the poorest 80% of Kentuckians harmless on average. Extending the family size tax credit from 133% to 138% of the federal poverty level will also help to make the tax more progressive.

  Note that the dollar amounts reflected above were determined assuming that each change builds on the change(s) listed above it. For this reason, caution should be used in relying on the estimates independently.

- **Repeal the postsecondary education tuition tax credit—$24.5 million**

  Source: Office of the State Budget Director (OSBD)

  Individuals may deduct a nonrefundable credit for tuition and related expenses of up to 25% 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.

CONTINUE TO MODERNIZE THE SALES TAX

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.

The sales tax base was expanded in 2018 to include several new services and to establish economic nexus thresholds for on line sellers. The law was amended again in 2019 to require marketplace providers like Amazon and E-bay to collect and remit sales taxes for sales made on their platforms. These were all positive steps that have generated additional new revenues, but there is still room to expand the sales tax base further while protecting low- and middle-income Kentuckians. 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 luxury and other services—$56 million**

  Source: OSBD

  These services include armored car and security, garment alteration, extermination and pest control services, marina services, non-coin operated vehicle washing and waxing services, swimming pool maintenance and cleaning services, residential interior decorating services, and photography and videography services.

- **Repeal exemptions for repair and replacement parts for large trucks and the purchase of trailers and semi-trailers—$8.6 million**

  Source: OSBD

- **Reduce or repeal jet fuel credit—up to $49.6 million (for full repeal)**

  Source: OSBD

  Currently certificated air carriers receive a credit against the sales tax for all taxes paid over $1 million. The amount of tax that must be paid before the credit applies could be increased, or the credit could be fully repealed. Note that additional revenues must be used to support airports and airport infrastructure under federal law.

- **Repeal the exemption for aircraft and repair and replacement parts—$17.1 million**

  Source: OSBD

- **Repeal the exemption for vessels and maritime supplies—$6.6 million**

  Source: OSBD

TIGHTEN CORPORATE TAX LOOPHOLES AND BRING BUSINESS TAX BREAKS 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.

In addition to the changes below, Kentucky could also generate additional revenue by adjusting its corporate income tax rate to correspond to the top rate of 7% identified above for individuals. Kentucky's corporate income tax rate was reduced to a flat 5% in 2018, leaving only three states out of the 44 that levy corporate income taxes with a lower rate. Kentucky's top corporate income tax was raised to 8.25% in 1990 to help pay for the Kentucky Education Reform Act.

- **Close loopholes by strengthening combined reporting language and enacting a throwback rule — Uncertain**

  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), capital real estate investment trusts (REITs), transfer pricing and other structures — to states or foreign nations with low or no corporate taxes. Kentucky enacted combined reporting in 2018 but with several carve outs and exceptions that significantly limit its effectiveness. The legislature then came back in 2019 and created even more loopholes to allow corporations to continue to shift profits and hide assets offshore. Removing the exceptions and exclusions so that the combined reporting statutes follow the uniform provisions developed by the Multistate Tax Commission would generate much-needed revenues.

  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.

- **Return to three factor apportionment rather than single sales factor — Uncertain**

  In 2018, the law establishing how multistate corporations apportion income to Kentucky was changed from a formula that considers property, payroll, and sales of the corporation both within and outside Kentucky, to a formula that considers only sales. This change favors corporations with infrastructure and employees in Kentucky — the very corporations that are more heavily using the resources of our state, and that should therefore pay more — and provides them with a significant tax break. Returning to the three factor formula would establish an allocation that more accurately represents the use of resources by corporations.

- **Require telecommunications corporations to use the same apportionment formula as other corporations — $40 million**

  Source: OSBD

  If the current single sales factor formula is maintained, the legislature should at least roll back the carve out that allows certain communications services, cable services and internet access providers to use a three-factor formula instead, which was enacted in 2019.

- **Repeal the corporation deferred tax deduction — $44.5 million**

  Source: OSBD

  The 2019 General Assembly enacted a corporate tax deduction that allows publicly traded companies to offset the effects of tax changes brought about by combined reporting (2018 state law change) for financial reporting purposes; Companies had to report the amount they plan to deduct although the deductions do not begin until 2024 and will occur over a 10 year period.

- **Create a review process for all business tax break programs, require sunset dates and require the General Assembly to reauthorize programs — up to $361 million from sunsets**

  Source: OSBD

  Business tax breaks 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 programs 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: Legislative Research Commission (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 between $3 million and $6 million of gross receipts/income. Any LLE with less than $3 million in gross receipts or income pays the alternative minimum tax of $175. Because the exemption threshold is so high, an estimated 82% of LLEs pay the $175 minimum.

REMOVE REVENUE GROWTH CAP FROM PROPERTY TAX

Kentucky's total state and local per capita property tax revenue ranks 46th 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 Kentucky's law broadly suppresses revenue instead of only assisting those least likely to be able to afford property taxes. The 4% 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 — Indeterminable**

  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 $547 million more in 2020 if the rate were frozen in 1979 at 31.5 cents.

- **Restore state property tax rate to level of early 1990s — $106 million**

  Source: KCEP

  Restoring 5 cents of the 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 to support lower-income people.

OTHER PROPERTY TAX ENHANCEMENTS

Note that any changes made to the property tax that expand the base will generally not result in additional property tax revenues for the commonwealth unless the cap on new revenues is removed or the rate frozen.

- **Tax privately owned leasehold interests in industrial buildings and tangible property in such buildings at the regular rate rather than the current discounted rate — $4.3 million**

  Source: OSBD

The properties that qualify for this reduced rate on leasehold interests are typically part of a transaction where a local government issues bonds to finance the construction, renovation or improvement of the property and the title is transferred by the private entity to the local government for the specific purpose of removing the property from the tax rolls. This transfer and reduced rate on the leasehold interest results in a large tax benefit for the private entity.

- **Clean up requirements for qualification of property for agricultural valuation — Indeterminable**

  The statutes relating to the valuation of property for agricultural purposes have been interpreted differently by PVAs across the state, resulting in a lack of uniformity and in some cases qualification of property not used for agricultural purposes.

ADEQUATELY TAX GAMING ALREADY TAKING PLACE IN KENTUCKY

- **Increase the tax on Historical Horse Racing to 3.5% and direct all new revenue to the General Fund — $50–$80 million**

  Source: KCEP analysis of Kentucky Horseracing Commission data

  Instant racing is an electronic gambling system that allows betting on historical horse races. Though the legality of instant racing has been challenged and the issue is still in court, more machines are being installed at more racetracks each year. The current tax rate is 1.5%, and most of the proceeds flow back into the horse racing industry. Raising the rate to 3.5% would bring it up to the same level as live wagers at larger race tracks, and directing all of the proceeds from the additional 2% levy to the General Fund could generate an additional $50-80 million annually, as the number of machines installed at tracks continues to grow.

- **Increase the tax on advance deposit wagering (ADW) accounts to match the tax on live wagers — $8 million**

  Source: OSBD

  Advance Deposit Wagering allows bettors to deposit money in an account and use that money to place bets on-line or by phone from anywhere. Currently, these wagers are taxed at 0.5%, and 85% of the revenue is distributed back to the race tracks. Increasing the rate imposed against ADW wagering to 3.5% (the levy imposed against other forms of account and simulcast wagering), and directing all revenues from the new portion of the levy to the General Fund would generate an additional $8 million annually.

- **Regulate and tax sports gambling and fantasy sports — $5–$15 million**

  Source: KCEP

  Although not a big revenue raiser, regulating and taxing fantasy sports makes sense because it is already happening in Kentucky, sports gambling is now legal, and Kentucky already has facilities at race tracks that can accommodate sports betting.

OTHER REVENUE OPTIONS

- **Raise the cigarette tax to $1.60, add e-cigarettes to the OTP tax base and raise that tax commensurate with the cigarette tax increase — $218 million**

  Source: ITEP

  Excise taxes on cigarettes and other tobacco products (OTP) 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. Currently, Kentucky’s cigarette tax, which was increased by $0.50 per pack in 2018, is $1.10 per pack — 36th lowest among states and well below the national average of $1.81. The OTP tax, which includes snuff and chewing tobacco, was not proportionately increased in 2018, and Kentucky still does not tax e-cigarettes and other vaping products at all. Along with increasing the cigarette tax, the tax on OTP should be raised proportionately, and e-cigarettes and vaping products should be included.

- **Unfreeze the hospital provider tax in recognition of the huge benefits to the healthcare sector from Medicaid expansion — $100 million**

  Source: LRC

  A number of states are paying for the state's share of 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% of their 2006 gross receipts. Since then, hospitals revenues have grown an estimated 54%, dropping their effective tax rate to only 1.6%.

- **Restore the wholesale sales tax rate to 11% on sales of beer and wine and repeal the allowance for collecting and reporting the tax — $6.8 million**

  Source: OSBD

  The wholesale sales tax rate imposed against beer and wine was reduced from 11% to 10% over four years, beginning in 2015, while the wholesale sales tax rate imposed against distilled spirits remains at 11%. Restoring the rate imposed against wine and beer back to 11% will once again establish parity in the taxation of alcohol.

- **Disallow compensation for wholesalers who remit the tax on alcoholic beverages — $1.3 million**

  Source: OSBD

  Compensation for collecting and remitting taxes is sometimes provided if a retailer has been required to collect taxes from customers on behalf of the commonwealth, as is the case with the sales tax. The wholesale tax on alcohol, however, is actually paid by the wholesaler, so there is no burden or obligation regarding collection of the tax from a third party. There is therefore no reason that the wholesaler should receive compensation for simply paying a tax that is owed.

- **Regulate and tax of recreational marijuana — $73 million–$122 million**

  Source: Tax Foundation

  Legalizing and taxing recreational marijuana is increasingly discussed as a possible source of new revenue in Kentucky. The Tax Foundation has estimated, based on demand in Colorado and Washington, that in Kentucky a 15% tax on the retail sales price could generate $73 million, a 20% tax could generate $97 million, and a 25% tax could generate $122 million. These estimates do not consider revenues that would be generated by other state taxes that might apply such as the sales tax and income taxes. Based on ramp up time in other states, it would likely be at least two years after legalization before any revenues would be received.

- **Regulate and possibly tax medicinal marijuana — $0–$15 million**

  Source: KCEP

  Legalizing and regulating medicinal marijuana could provide a small amount of revenue. However, Kentucky currently does not tax the sale of prescription drugs, so if medicinal marijuana were treated consistently, retail sales would not be taxed. It is possible that producers could be taxed, or that fees could be imposed to register to grow or sell medicinal marijuana. Many states impose these types of taxes as a means of offsetting the cost of regulation and oversight, rather than as a revenue raising measure.

- **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 2000s 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.

- **Repeal the discount for early payment of the inheritance tax — $1.2 million**

  Source: OSBD

- **Ensure that all relevant taxes are applied to and collected from on-demand, internet-based services such as Airbnb, Uber and Lyft — indeterminable**

  One of the fastest growing areas of our economy is the on-line, on-demand sector, sometimes referred to as the "sharing economy" or the "gig economy." Large companies like Airbnb (which is already working to comply with Kentucky tax laws), Uber, Lyft and VRBO provide a centralized platform for individuals to connect and exchange payment for services provided. Existing laws should be reviewed and amended as necessary to ensure that revenues generated through this rapidly growing sector of the economy are subject to the appropriate sales taxes, lodging taxes, property taxes and income taxes at both the state and local levels.

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

Along with the General Fund, Kentucky's Road Fund faces challenges. Roads in poor condition with potholes and uneven surfaces can be dangerous and cost Kentuckians more on car repairs. Failing to start and complete important transportation projects also holds the state's economy back. The gas tax rate — which is tied to the wholesale price of gasoline — has stabilized recently due to changes in the law. However, precipitous drops prior to the stabilization have left the state with less to invest in good roads and bridges. Like many other states and the federal government, Kentucky faces a long-term problem because we lack 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. Legislation has been introduced the past two sessions that proposes comprehensive, reasonable increases in various taxes and fees to support the Road Fund now and in the future. The LRC estimated that 2019's HB 517 would have raised over $497 million in new revenues during the current fiscal year if it had passed.

SOURCES

You can read more about tax reform options in the resources listed below.

- Office of the State Budget Director, "Commonwealth of Kentucky Tax Expenditure Analysis Fiscal Years 2020–2022."
- The Institute on Taxation and Economic Policy, Kentucky Reports and Information.
- Kentucky Center for Economic Policy, Tax and Budget.