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Investing in a Future for Appalachian Kentucky: The Coal Severance Tax

Presentation at the Appalachia's Bright Future Conference

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Part of building a new economic future in Appalachian Kentucky involves figuring out where the financial resources to pay for needed new investments will come from. The coal severance tax is one of the largest pools of economic development resources in the region. In this presentation, I'll go over four questions about Kentucky's coal severance tax: What is it? How has it been used? What is its future likely to be? And what should we do?

Click here to view the presentation.

What Is It?

Severance taxes are taxes on the removal of a depletable resource, and are common around the country—about 36 states have them. The most common severance taxes are for oil and gas, but there are also severance taxes on timber removal, coal, fish, and minerals ranging from iron ore and phosphates to sand and gravel.

Kentucky has severance taxes on natural gas ($23 million in 2012), minerals ($13 million) and coal. The coal severance tax is placed on the gross value of coal severed or processed (washed and loaded) in Kentucky. Gross value is a function both of how much coal is mined (tons of coal) and the price at which it is sold. Its rate is set at 4.5 percent of the gross value. West Virginia's is at 5 percent, while Wyoming and Montana have higher surface mining severance taxes (7% to 10-15%) and lower underground taxes (3-4%). Kentucky also has a minimum tax of 50 cents a ton that would apply if the price of coal were down to around $11 a ton. Recently, the price has been more like $65 a ton.

The coal severance tax raises a substantial amount of money—$298 million in the most recently completed year (revenue is down in the current year, which I'll talk about in a minute). That's only about 3 percent of the state's General Fund. But it is the largest pool of public resources at least partially identified for economic development in eastern Kentucky. Compare that $296 million to the entire non-highway budget of the Appalachian Regional Commission to spend over 13 states, which is about $70 million.

The next chart shows the coal severance tax in real dollars back to 1988. In the mid-1990s, coal production started declining in eastern Kentucky and at that time the price was quite low. Coal severance tax revenue actually increased over the last dozen years or so (until this year), and that's for two reasons—first, western Kentucky coal production has been gradually increasing even while eastern Kentucky coal production has been declining; second, the price of eastern Kentucky coal has been elevated in large part because the cost of production is going up due to declining reserves.

How has it been used?

The state established a coal severance tax in 1972. In the region, surface mining had been happening since the 1950s and the cumulative health and environmental effects of large-scale mining were being felt. 1972 was the year of the Buffalo Creek Flood in West Virginia, in which a coal impoundment holding water from mining operations broke four days after it was deemed 'satisfactory' by an inspector, releasing 132 million gallons of water, killing 125 people and injuring 1,121.

The Kentucky legislature decided to put a tax on the severance of coal. Governor Wendell Ford championed the passage of the severance tax as part of a deal that eliminated two regressive taxes—two taxes that hit poor people harder—the sales tax on food and on prescription drugs. The severance tax was a way to put in place a more progressive state tax system initially rather than a way to invest in economic diversification for the coalfield regions.

There were efforts to try to send some of the money back to the coalfields in the early years, but in large part that didn't happen. In fact, only 7.6 percent of the $2.7 billion collected from the tax over its first 20 years (1972-1992) went back to coal counties.

That changed in 1992. A task force of the legislature made the recommendation that 50 percent go back to the coalfields, and Governor Brereton Jones ran for governor on a platform that included that proposal. And that year legislation passed in which half would go to the state's General Fund, and the remaining would be split into two streams. One stream was for revenue sharing with coalfield local governments that could be used for a wide range of purposes, but 30 percent of which was to go for coal haul road repair. And the second stream was an economic development fund. For that fund, each county was given an individual account and a separate account was reserved for multiple counties to cooperate together on projects.

Yet only one strategy for economic development was allowed with fund dollars: building industrial parks and sites to recruit businesses. Governor Patton coordinated the building of 11 regional industrial parks. There were dissenters at the time on whether industrial recruitment was the best strategy to diversify the economy. *Lexington Herald-Leader* columnist Bill Bishop wrote at the time:

> *Essentially, counties can only put their new coal severance tax money into land or buildings. . . It doesn't matter that the state is littered with empty parks. . . Nor does it make any difference that many rural communities have found that leadership development or worker training or technical aid to existing businesses are infinitely more profitable than pouring money into industrial parks. Lexington Herald-Leader, October 20, 1993.*

After a few years, it became clear that there is a limit on how many industrial parks can or should be built. A lot of the buildings were never occupied, or were occupied by companies that left after a few years. Without more industrial parks to build, money accumulated in the economic development fund accounts.

That led to a period from about the year 2000 to the present that could be called an "era of earmarks." Legislators have increasingly identified very specific programs and projects to fund with coal severance tax money. Those earmarks include:

- Education and social programs like education technology, reading in schools, the Robinson Scholars program, Pikeville Medical College scholarships, and Operate Unite;
- Coal-related programs concerning mine safety, energy-related economic development projects and research, workers' compensation for injured miners, and mining engineering scholarship programs;
- Projects like senior centers, cemeteries, ball fields, parks, tourism projects, community centers, library supplies, ambulances and fire trucks;
- Water and sewer projects for which bonds have been issued that will be paid back through future severance tax monies.

Many of these uses are valuable, while some have been controversial. In all, use of severance tax money has become a very political process where legislators play the central role in identifying projects. The process lacks a clear strategy and plan as to how all of these projects will add up to economic development.

Debate continues about how these monies should be allocated. Two years ago, the legislature considered a proposal to use some of the money to make the University of Pikeville a public higher education institution. When that idea didn't move, in part because of the deep cuts that have already been made to other universities, the proposal was modified to a bill that would provide scholarships for the completion of Bachelor's degrees by coalfield residents at institutions in the region.

What is its future likely to be?

Recent trends and existing forecasts related to the coal industry in eastern Kentucky raise important new questions about the economic future of the region as well as the future of coal severance tax. Any consideration of this issue must take into account declining eastern Kentucky coal production and decreasing eastern Kentucky coal severance tax revenues.

The Energy Information Administration releases official projections each year of coal production and coal prices through the next 20 or so years. We applied their projections to eastern Kentucky in a report we did last year and recently updated those estimates using new data.

The resulting graph shows that coal production has been declining since the mid-1990s in eastern Kentucky, and is expected to continue that trend through this decade before leveling off at around 20 million tons a year compared to around 120 million a year in the 1990s. That trend is driven by:

- Diminishing coal reserves in the region, which makes for lower productivity and higher prices;
- Increasing competitiveness of alternatives: natural gas, western coal including western Kentucky coal, and energy efficiency and renewable energy;
- Environmental rules that increase the cost of coal in general compared to other sources.

The decline is particularly steep this last year. In 2012 the region had 28% less coal production than it did in 2011.

That drop in production is translating into less severance tax revenue. So far this fiscal year, coal severance tax revenues for eastern Kentucky are about 33 percent less than the prior year. That decline may worsen and become permanent. Using the EIA projections to make a rough estimate, we may very well see $100 million in coal severance tax revenue a year from eastern Kentucky very soon compared to the over $200 million a year the region has generated in the recent past.

The decline in coal severance tax revenue is affecting the debate on how to spend it. Legislation passed this session allows counties that have experienced at least a 25% decline in their local severance tax monies to shift dollars from the economic development fund and project earmarks to help fill the holes in their county budgets.

What should we do?

The question of what we should do about the coal severance tax is tied to the bigger and broader question about what we should do about the region's economy. We think there are three main points to an overall approach.

First, we need a democratic regional planning body that can develop an overarching economic development strategy. One flaw in how severance tax dollars have been used through the years is that there has been no solid underlying strategy. We need a Kentucky Appalachian Commission that can involve eastern Kentuckians in a process of developing a smart plan for economic diversification, raise the profile of the need for investment in the region, gain the attention of public officials and generate new ideas.

Second, we need some development strategies that can create jobs and grow an economy. That means a greater commitment to supporting entrepreneurs and the identification of sector strategies in areas like health, energy efficiency, local foods, forest management, land remediation, tourism and more. It means figuring out promising ways to create livelihoods and employment for eastern Kentuckians through a variety of strategies. Underlying those strategies must be more targeted investment in the foundation of economic development through education, human services and infrastructure.

And third, we need to find short- and long-term sources of funds that we can invest in promising strategies. Since it is clear that the severance tax is likely to be a declining source, it cannot continue to be used for recurring expenses like basic local government services. We need to find a way to fund the basic infrastructure and other investments in the region and then identify monies that can be reserved for long-term economic development and diversification strategies. We need to be looking at a combination of state, local, federal and philanthropic dollars to create additional streams of money.

One of the proposals that we have written about is the idea of creating a permanent fund from at least a portion of coal severance tax dollars. Permanent funds are very common among states; Alaska has a famous one that pays dividends each year, but there are also funds in Montana, Wyoming and New Mexico. Utah created a fund in 2008 and North Dakota in 2010. And there's a lot of discussion in West Virginia about creating a fund particularly using natural gas severance tax related to shale development there.

The justification for a permanent fund is that a depletable resource will go away one day. So it makes sense to set aside at least a portion of the revenue from that resource into a fund that earns interest and can pay an annual dividend indefinitely. In our report, we used official forecasts to estimate that establishing a fund using a one percent coal severance tax (which could come from existing revenue, from partially raising the tax, or from the portion that goes to the General Fund) would result in an endowment of about $800 million (current dollars) by 2035.

As coal severance tax revenue declines, the conversation about how to use it becomes harder. There clearly must be additional financial resources. But despite its decline the coal severance tax still generates substantial funds, and how we spend those dollars over the next decade or so has big implications for the region's future. It's a critical conversation to have at this time.