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Commonwealth Institute for Policy Issues and Civic Engagement

Commonwealth Institute for Policy Issues and Civic Engagement (CPI)

A FAIR AND ADEQUATE TAX STRUCTURE FOR THE TWENTY-FIRST CENTURY

A Report of the COMMONWEALTH INSTITUTE FOR POLICY ISSUES AND CIVIC ENGAGEMENT

"Taxes are the price we pay for civilization."

Oliver Wendell Holmes, Chief Justice, U. S. Supreme Court

PREAMBLE

Kentucky's tax structure is inadequate to support basic governmental functions.

While Kentuckians look to the private sector to create jobs and drive economic growth, they look to government to provide basic services critical to a properly functioning society, including education, public protection, health care, roads and others. Kentuckians recognize that government must have adequate revenue resources with which to provide these basic services.

Over a decade ago William Fox, a nationally-recognized expert on state taxation, predicted that Kentucky would experience a growing "structural deficit," or chronic revenue shortage, in the years ahead, because of its then existing tax structure.[1] His prediction has proven accurate. Thus, the state's need for adequate revenue is not a new phenomenon, and not simply a product of the current economic downturn. If left unaddressed, the structural deficit will remain when the economic crisis is resolved.

This report of the Commonwealth Institute for Policy Issues and Civic Engagement (Institute)[2] is one of the first in a series of reports to explore the facts and circumstances behind important public issues. The issue of taxation in particular drives heated public debate that makes achieving an adequate and fair tax system difficult. It is hoped that this report will contribute to a more reasoned dialogue and help policymakers establish a more stable tax structure for Kentucky's future.

INTRODUCTION

Citizens have many and varied views about taxation. These views tend to reflect their views about government.

Many people prefer a limited government, believing that informed individuals are capable of making economic decisions about their employment, their purchases, and their investments. In their view, the role of government is to protect basic rights, enforce contracts, and provide information. A government that goes beyond these functions violates personal freedom and inhibits economic growth.

Many others believe in a more responsive government, one that goes beyond basic functions to preserve the environment, protect us from manmade as well as natural disasters, enhance

[1] William F. Fox, "Report to the Subcommittee on Tax Policy Issues, Committee on Appropriations and Revenue, Kentucky General Assembly," Center for Business and Economic Research, University of Tennessee, February 27, 2002, pp. 8-9.

[2] The Institute was established by The Women's Network of Kentucky in 2010.

public safety, and prohibit discrimination and other forms of unfair treatment. They believe that businesses have more power than individuals, and therefore must be regulated to prevent workplace and environmental dangers, misleading advertising, and other deceptive practices.

This paper reflects the second of these views. The authors believe that government should provide a wide variety of important services essential to our quality of life and standard of living. Government regulates in myriad ways, small and large, ranging from deciding which side of the street we drive on to building and maintaining our interstate highway system. It protects us from environmental dangers, tainted meat, unsafe drinking water, dangerous cars, unsafe bridges, insider trading, and discrimination.

Believing thus in a government that more fully serves its citizenry, we support an adequate, fair, flexible and accountable system of taxation that makes such government possible. An examination of these aspects of taxation and how to achieve them follows.

BACKGROUND

Kentucky's system of taxation was set in place in the early 1900's.[3] While there has been occasional "tweaking" since, it has not been seriously overhauled in the last 60 years.[4] As society and the economy have evolved in many significant ways, the tax structure has not been amended to reflect those changes. As a result it is not adequate; it is not fair; it is not flexible; and it is not accountable.

A. Income Tax

Kentucky's individual income tax was established in 1936, with graduated rates that in 1950 topped out at 6% of all taxable income over $8,000. The top bracket has not been changed since then, except for an essentially cosmetic reduction to the rate of 5.8% on incomes between $8,000 and $75,000. Thus, the income tax is essentially a flat tax.[5] Increases in income resulting from inflation and economic growth are not taxed in a graduated manner. Low-income tax credits make the tax moderately fairer for low-income taxpayers. Itemized deductions, on the other hand, reduce the tax burden on high-income taxpayers to a larger extent. These deductions also exacerbate the adequacy problem.

B. Sales Tax

The evolution of our sales tax has followed a different but similarly problematic path. When the sales tax was established its tax base was comprised solely of goods, as the sale of goods constituted the vast majority of economic exchanges. But as our economy has matured, a large and growing share of our economic activity involves the sales of services, yet the sales tax base has not been expanded to include services.[6] As a result, sales tax revenues actually fell in FYs 2009 and 2010 before resuming growth in FY 2011.[7]

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[3] CPI Tax Restructuring Committee interview with Dr. Larry Lynch, Professor of Economics Emeritus, Transylvania University, and Chairman, Kentucky Consensus Economic Forecasting Group, September 16, 2011.

[4] Ibid.

[5] Ibid.; see also, www/tax-rates.org, 2011 State Tax Rates and Information.

[6] Michael T. Childress, "Structural Economic Change Impetus for Tax Reform," Kentucky Long-Term Policy Research Center, Vol. 8, No. 1, 2001, pp. 3-4.

[7] E-mail from Dr. Larry Lynch to Col Owens, 10/26/11.

C. Business Taxes

Tax revenues deriving from the business sector have steadily eroded over time. In FY 2011 business taxes produced an estimated $2.4 billion in General Fund revenue, or 27.5% of the total. This is down from 31.3% in FY 2001.[8]

The reasons for this decline are varied and not easily understood. Tax policy choices, including adoption of tax expenditures, or "loopholes," which primarily benefit the wealthy and the business sector, have substantially reduced business tax revenue.[9] At present the amount of revenue lost due to tax expenditures actually exceeds the amount of total revenue collected in a year.[10]

Secondly, changes in the taxation of business income under new business forms, such as subchapter S corporation, LLC and PLLC options, result in much business income being reported and taxed as individual income, not business income.[11] These developments make it difficult to determine with precision the decline in the business tax share of General Fund revenue.

Finally, business people express concern about the business inventory tax. This is largely a problem of local government policy. The state applies a modest rate of 5 cents per $100 to business inventories, whereas school districts, counties and cities levy much higher property tax rates.[12]

D. Total Tax Burden

As noted, it is difficult to determine the rate of decline in business tax revenue, given that much of it is now taxed as personal income.

What is much clearer, on the other hand, is the overall inequity in the distribution of the tax burden on Kentuckians of different income levels.

For example, in 2007, when combining all state and local taxes, the lowest 20% income group paid 9.4% of income on taxes; lower middle and middle income taxpayers paid 10.8%; while the top 5% paid 7.4% and the top 1% paid 6.1%.[13] See the following table.

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[8] Kentucky Department of Revenue, monthly tabulations of General Fund Revenue, Vol. 39, No. 12, and Vol. 50, No. 12.

[9] Tax Expenditure Analysis, Fiscal Years 2010-2012, Commonwealth of Kentucky, Governor's Office for Economic Analysis, October 15, 1999, pp. 45-51.

[10] Jason Bailey, "Reforms Needed to Bring Greater Scrutiny to "Tax Expenditures,"" Kentucky Center for Economic Policy, January 20, 2011, see at http://www.kypolicy.org/greater_scrutiny1.

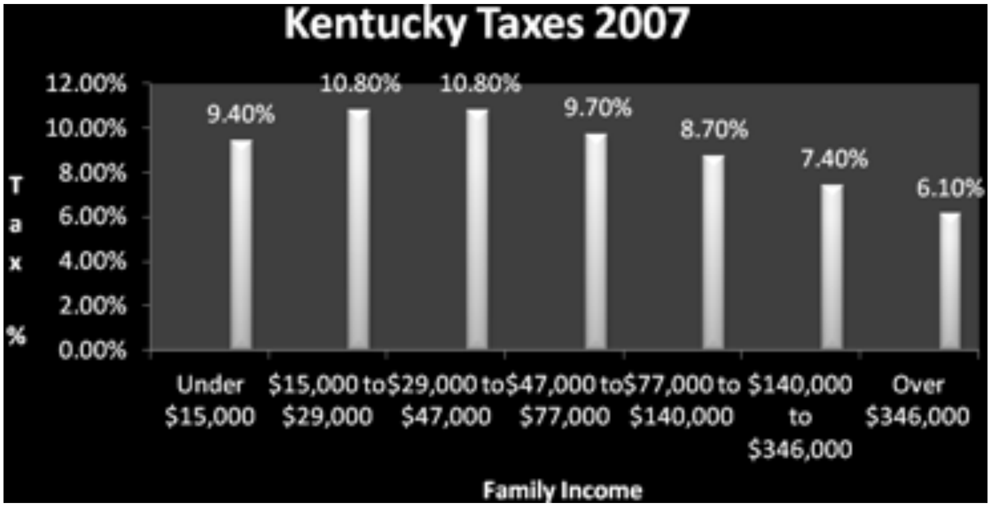
[11] Interview with Dr. Larry Lynch, op. cit., see footnote 3.

[12] Ibid.

[13] "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, November 2009.

KENTUCKY STATE & LOCAL TAXES 2007

Share of family income for non-elderly families paid in taxes after federal deductions



Source: "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, November 2009.

This distribution of the tax burden is a perversion of the concept of a fair and graduated tax structure.

ACTIVITY IN THE KENTUCKY GENERAL ASSEMBLY

In response to these problems, a variety of tax reform plans have been put forward in the Kentucky General Assembly. The two most prominent ones are H.B. 196, sponsored by Rep. Bill Farmer, R-Lexington; and H.B. 318, sponsored by Rep. Jim Wayne, D-Louisville.

A. H.B. 196, sponsored by Rep. Bill Farmer, R-Lexington

Rep. Farmer's bill eliminates the personal income tax, the business income tax, and the alternative minimum tax. It leaves the property tax intact. It expands the sales tax base to include most services, with exemptions for food, medicine, residential housing, and medical services. Because of the expanded tax base the tax rate is lowered to 5.5%. Finally, the bill is revenue neutral, i.e., it does not result in any increase in revenue collected.[14]

A recent analysis done by the Institute on Taxation and Economic Policy for the Kentucky Center for Economic Policy shows that the net effect of Rep. Farmer's bill is to lower significantly the tax burden on high income individuals while increasing the tax burden on low income individuals.[15] More specifically, it concludes that the wealthiest 1% of taxpayers would receive an average tax cut of $27,851, while the poorest 20% of taxpayers would on average pay $382 more in taxes.[16] These changes would further exacerbate existing inequities in the percentage of income paid in taxes by different income groups, as shown above.[17]

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[14] CPI Tax Restructuring Committee interview with Rep. Bill Farmer, January 8, 2011.

[15] Jason Bailey and Melissa Fry Konty, "Farmer's High-Risk Overhaul Creates Imbalance in Kentucky's Tax System," Kentucky Center for Economic Policy, February 15, 2011, pp. 3-4, incorporating analysis of the bill by the Institute on Taxation and Economic Policy. CPI Tax Restructuring Committee interview with Jason Bailey, Executive Director, Kentucky Center for Economic Policy, May 21, 2011.

[16] Ibid.

[17] See footnote 12 and accompanying text.

B. H.B. 318, sponsored by Rep. Jim Wayne, D-Louisville

An alternative approach has been put forward by Rep. Jim Wayne. His bill makes the income tax more graduated, and less flat, in two ways: it enacts modest changes in the taxation of income under $8,000, and between $8,000 and $65,000; and it creates a new modestly higher tax bracket for higher income earners, those earning $65,000 or more. It also expands the sales tax base to a small group of services that benefit higher wage earners such as armored car services, limousine services with drivers, etc., while leaving the sales tax rate of 6% unchanged.[18] It increases the cigarette tax by 50 cents per pack, with corresponding increases on other tobacco products; de-couples the Kentucky estate (inheritance) tax from the federal estate tax; reduces the cap on the current pension income exclusion; and establishes a state Earned Income Tax Credit (EITC) equal to 15% of the federal EITC.[19]

Rep. Wayne's proposed changes to the tax structure would distribute the tax burden more equitably among income groups. They would also generate $200-250 million in additional revenue.[20] The new top bracket of the income tax introduces not only greater fairness but also greater flexibility into the tax code, by insuring greater revenue from income increases resulting from future inflation. His sales tax changes also provide greater flexibility, by re-structuring the tax base to adjust to the state's movement toward a more service-dominated economy.

C. Interest Groups

Interest groups vary in their approach to taxation issues. The Kentucky Center for Economic Policy and the Kentucky Long-Term Policy Research Center (now defunct) have endorsed the approach of Rep. Jim Wayne, to make the income tax more graduated and to apply the sales tax to selected services, as ways to make the tax system more equitable and to address the state's growing structural deficit.[21]

The Kentucky Chamber of Commerce, on the other hand, focuses exclusively on spending cuts, and not at all on tax re-structuring, as the appropriate pathway toward a balanced budget and elimination of the structural deficit.[22] The Chamber would limit spending to 6% of the state's gross state product; would limit borrowing to 6% of the state budget; and would eliminate the structural deficit by adopting a five-year plan to spend only recurring revenues for recurring obligations.[23]

The Chamber has not historically opposed all tax increases. It supported the $1.3 billion tax increase in 1990 to implement the Kentucky Education Reform Act (KERA). It has also supported aggressive increases in the cigarette tax. Its greatest concern regarding taxation is how it affects Kentucky's competitiveness in the global economy. It supports more aggressive recapture of tax expenditures if their purposes, such as jobs creation, are not achieved. This would increase accountability in the tax system as well as increase overall revenue.[24]

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[18] CPI Tax Restructuring Committee interview with Rep. Jim Wayne, February 26, 2011.

[19] Ibid.

[20] "Tax Reform in Kentucky: Serious Problems, Stark Choices," Institute on Taxation and Economic Policy, June 2009, p. 1, discussing the impact of HB 223, Rep. Jim Wayne's predecessor bill.

[21] See footnotes 6, 9, and 14 and accompanying text.

[22] "The Leaky Bucket," Kentucky Chamber of Commerce, February 2010. CPI Tax Restructuring Committee interview with David Adkisson, President and CEO, Kentucky Chamber of Commerce, June 25, 2011.

[23] Ibid.

[24] Ibid.

INSTITUTE ANALYSIS AND RECOMMENDATIONS

After reviewing research findings and interviewing knowledgeable key informants (see Appendix), the Committee chose four central components of the tax system on which to focus: fairness; adequacy; flexibility; and accountability. Additional considerations that surfaced during the course of our interviews were diversity and competitiveness. Following are our findings and recommendations.

A. Fairness

1. Income Tax

a. Findings

Kentucky's present state and local tax system, in its totality, imposes an inequitable distribution of the tax burden on different income groups of taxpayers.[25] The greatest burden falls disproportionately on the middle class and the working poor. Those in the lowest 20% income group, earning less than $15,000 annually, pay 9.4% of their income in taxes; those in the lower middle and middle income groups pay 10.8%; while those in the top 1% income group, those earning in excess of $346,000 annually, pay only 6.1%. For all practical purposes, Kentucky's income tax functions as a flat tax. The availability of itemized deductions, which disproportionately benefit upper-income taxpayers, reduces even further the percentage tax burden for upper-income taxpayers.[26]

b. Recommendations

The flat-tax aspect of the income tax contributes to unjustifiable inequities in the tax burden. Therefore the income tax must be made more graduated. Adding a new higher bracket to more adequately tax increased income resulting from growth and inflation, both current and historical, is necessary. Adoption of a state Earned Income Tax Credit (EITC) would provide additional economic support to taxpayers working in low-wage jobs as well as help spur demand for goods and services. Itemized deductions, which disproportionately benefit upper-income taxpayers, could be capped, eliminated, or phased out at higher income levels, as could the retirement income exclusion.

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[25] See footnote 12 and accompanying text.

[26] See footnotes 3, 4 and 5 and accompanying text.

A. Fairness (cont.

2. Sales Tax

a. Findings

The existing Kentucky sales tax is both inadequate and regressive, due primarily to the exemption of services from the tax base.[27] Lower income consumers tend to purchase mostly goods, which are taxed, while upper income consumers tend to purchase more services, which are not taxed. The exemption of food and prescription drugs does ease the burden on low income consumers.

b. Recommendations

The sales tax should be expanded to at least some services, to reflect the shift of economic transactions in society from goods-based to services-based. The appropriate number and type of services to which it should be applied would lie between the broad approach advocated by Rep. Farmer and the narrow approach offered by Rep. Wayne. Ideally, services to be taxed should be those used primarily if not exclusively by higher-income taxpayers. Increased burdens on small businesses to collect and account for these taxes should be minimized or avoided to the extent possible.

B. Adequacy

1. Findings

The "flat tax" aspect of the current income tax structure creates problems with adequacy as well as fairness and flexibility. The lack of higher tax brackets for higher levels of income means that increased income derived from economic growth and inflation is not taxed at a higher level. Thus the revenue system does not keep pace with inflation. Over time, this loss of income grows and compounds. As the need for governmental support for services and new investments grows, to better serve evolving public needs, revenues to provide that support are not available.[28] Thus, in times of economic duress, with decreased revenues, many vital services have been cut.

2. Recommendations

Modifying the income tax to secure increased revenue from increased income deriving from growth and inflation, along with expanding the sales tax base to some services, would generate additional revenues for the General Fund.[29] This new income should be retained, not offset by other tax reductions, in order to maintain government's capacity to provide essential services in an evolving economy, such as public education, public health, infrastructure, transportation, research and development, job creation, etc.

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[27] See footnote 6 and accompanying text.

[28] See William F. Fox, "Report to the Sub-Committee on Tax Policy Issues … ," op. cit., note 1, p. 9.

[29] Ibid.

C. Flexibility

1. Findings

The current income tax and sales tax structures are relatively inflexible: they do not provide for new revenue based on income growth over time or changes in the structure or content of economic transactions. An effective tax structure must have sufficient elasticity to account for these factors.[30] Retaining both the income and sales taxes would help to insure appropriate elasticity in varying economic circumstances such as periods of high inflation or of recession.

2. Recommendations

A higher income tax bracket for higher income taxpayers would help protect against inflation-related revenue losses in the future, by insuring that income increases resulting from growth and inflation are captured by a higher percentage tax rate. Such a higher bracket should be adopted. The income and sales taxes should both be retained. Maintaining a diversity of taxes protects against revenue loss from a specific tax in economic circumstances to which it is particularly vulnerable.[31]

D. Accountability

1. Findings

Tax expenditures ("loopholes") are granted on promises of social and/or economic benefits to be derived from some less-encumbered economic activity.[32] Such tax break contracts often include language requiring repayment if promised benefits are not realized. However, alleged confidentiality considerations restrict the information that citizens can obtain about the fulfillment of the contracts.[33] Without knowing if these benefits are achieved, it is impossible to know whether the expenditures are worthwhile. In the meantime, needed revenue is lost to the state.

2. Recommendations

All tax expenditures should be subject to a sunset provision, requiring that within a specified period of time they are evaluated to determine whether the stated purpose for their adoption has been achieved, or whether the circumstances that justified their creation in the first instance still exist. Where the promised benefits have not materialized, such expenditures should be subject to re-capture and allowed to expire if no long justified.

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[30] Ibid.

[31] CPI Tax Restructuring Committee interviews with Jason Bailey, May 21, 2011, and Rep. Jim Wayne, February 26, 2011.

[32] See footnotes 8 and 9 and accompanying text.

[33] CPI Tax Restructuring Committee interview with Dr. Larry Lynch, see footnote 3.

E. Cigarette and Other Tobacco Taxes

1. Findings

Kentucky's cigarette tax is very low, ranking 40th among the 50 states.[34] By forgoing tax revenue from sales of cigarettes Kentucky is giving up potential funding with which to address its high levels of smoking-related health problems and their attendant expense.[35] The state is also not doing everything within its power to deter smoking of its citizens, especially its young citizens whom research reveals are very sensitive to cost in deciding whether to continue smoking.[36]

2. Recommendations

Both Kentucky's cigarette tax and its tax on other tobacco products should be increased by significant amounts. Such action would deter smoking, especially youth smoking, and would raise revenues which could be applied to the costs of smoking-related health problems.

F. Inheritance Tax

1. Findings

Kentucky's inheritance tax is coupled with the federal estate tax.[37] The federal estate tax currently includes a $5,000,000 exemption. This results in a loss of revenue for Kentucky from very wealthy taxpayers. The Kentucky inheritance tax could be de-coupled from the federal estate tax to tax such very wealthy taxpayers, while at the same time being restructured to protect small business people and family farm owners.

2. Recommendations

The Kentucky inheritance tax should be de-coupled from the federal estate tax. It should also be restructured to insure that small business owners and family farm owners are protected while other very high income taxpayers pay a reasonable amount of tax.

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[34] Ann Boonn, "State Cigarette Excise Tax Rates & Rankings," Campaign for Tobacco-Free Kids, June 28, 2011; see http://www.tobaccofreekids.org.

[35] "Kentucky Chamber: Medicaid costs growing at twice the rate of state budget," Kentucky Chamber of Commerce, September 21, 2009.

[36] Ann Boonn, op. cit., footnote 33.

[37] Jennifer Hunter, "Estate Planning: Federal and State Estate Taxes," FCS5-427, Cooperative Extension Service, University of Kentucky College of Agriculture, Revised 3-2011.

G. Business Taxes

1. Findings

In FY 2011 business taxes produced an estimated $2.4 billion in General Fund revenue, or 27.5% of the total. This is down from 31.3% in FY 2001.[38] Reasons for this decrease include tax expenditures giving preference to businesses and other taxpayers to secure promised economic benefits, and adoption of new business forms that convert business income into individual income subject to individual taxation.[39] The amount of revenue lost due to tax expenditures exceeds the amount of revenue actually collected.[40]

The business inventory property tax, often criticized by business interests, is largely a problem of local government policy: the state applies a rate of only 5 cents per $100, or .05%; while school districts, counties and cities apply much higher rates.[41]

2. Recommendations

Tax expenditures should be reviewed on a regular basis, such as every five years, to insure that their original purpose is still relevant. Auditing to insure that promised economic benefits are actually realized should be mandatory. Cost caps could be imposed on such expenditures.[42] Consideration should be given to abolishing the business inventory tax.

CONCLUSION

Kentucky stands at a turning point. It can continue to go forward with an inadequate, antiquated tax system that guarantees a continuing structural deficit for the indefinite future, leaving it without adequate resources to make the investments necessary to ensure its quality of life. Or it can be bold and make the necessary adjustments to its tax structure to ensure a more certain future with adequate resources. The latter approach would allow for appropriate investments that not only maintain what we have but ensure continual growth in our standard of living and quality of life. The choice is ours.

This Institute has grappled with the issues and challenges facing the state in this critical area. Their complexity is eclipsed only by their importance. For government to be an effective partner with the private sector in pursuing a higher quality of life, it must have the means to ensure that basic and vital services are provided. This is critical to the success of our private sector, which can best perform its role of creating economic growth and jobs in a predictable setting of functions and services that can only be provided by government.

We submit this report with the hope that it will stimulate debate and action. The time for addressing these challenges is now.

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[38] See footnote 7 and accompanying text.

[39] See footnotes 8 and 10 and accompanying text.

[40] See footnote 9 and accompanying text.

[41] See footnote 11 and accompanying text.

[42] See footnote 9 and accompanying text.

APPENDIX

The Tax Restructuring Committee of the CPI was formed in the fall of 2010. It is comprised of the following members:

Col Owens, Chair – Senior Attorney, Legal Aid Society of Southwest Ohio, Ft. Mitchell
Lane Adams – community volunteer and retired educator, Louisville
Pat Esrael – retired small business owner, retired teacher, Lexington
Jane Graham – attorney, Of Counsel with Henry Watz Gardner & Sellars PLLC, Lexington
Joan Gregory – retired teacher, Ft. Thomas
George Mills – retired attorney, Of Counsel with Stites & Harbison, Lexington
Sara Porter – retired teacher, Midway
Len Press – retired Executive Director, Kentucky Educational Television, Lexington
Dr. Ernest Yanarella – Professor of Political Science, U of K, Lexington

The Committee determined, after initial discussion of members' concerns and issues, to undertake a series of meetings with "key informants" who could provide information and perspective on the tax system and its inadequacies. The Committee set out to secure a wide variety of perspectives. It met with and interviewed the following individuals:

Ron Crouch – retired Executive Director, Kentucky State Data Center, U of L, Louisville
Al Cross – Director, Institute for Rural Journalism and Community Issues, Frankfort
Rep. Bill Farmer – attorney, State Representative, R-Lexington
Rep. Jim Wayne – social worker, State Representative, D-Louisville
Jason Bailey – Executive Director, Kentucky Center for Economic Policy, Berea
David Adkisson – President, Kentucky Chamber of Commerce, Lexington
Dr. Larry Lynch – Professor of Economics Emeritus, Transylvania University, and Chairman of the Kentucky Consensus Economic Forecasting Group.

Following these meetings, the Committee reviewed data and materials provided by these experts, along with other resources identified by members, and settled on the above outline of a tax modernization and re-structuring agenda for Kentucky.