TAX FOUNDATION
FISCAL FACT
Mar. 2014
No. 418

Kentucky Tax Plan Fails to Improve Bluegrass State's Tax Competitiveness

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Key Findings

- Despite some positive elements, Governor Beshear's tax proposal as a whole includes several problematic components and neglects basic reforms to modernize the state's tax code.
- The plan includes a significant reduction of Kentucky's income tax rates accompanied with some base broadening but does not include key reforms such as regular inflation adjustments.
- Kentucky's combined state-local income tax rates would remain among the higher tax rates on middle-income households in the nation.
- Proposed changes to the corporate tax continue the erosion of the state's corporate income tax base through narrow tax incentives, while offering only a very limited rate cut.
- Sales tax changes include an attempt at broadening the base to include services, but unfortunately includes many business-to-business services, which can lead to tax pyramiding and harm the state's business tax climate.
- The proposed reduction in alcohol excise taxes is dwarfed by proposed increases in tobacco taxes, leading to an increased reliance on a narrow excise tax base.
- Positive proposals to phase out inventory and some tangible personal property taxes would make Kentucky's property tax code somewhat more competitive.

On February 4, Governor Steve Beshear (D) of Kentucky put forward a tax plan drawing from recommendations made by a 2012 tax reform commission.[1] We reviewed the commission's proposals at the time and concluded that although there were some positive reforms suggested, the overall plan lacked a central guiding theme and included many damaging policies. The Blue Ribbon Commission recommendations failed to address Kentucky's archaic income tax brackets while offering only modest cuts, proposed no meaningful sales tax base broadening, and included politically-motivated carve outs and a large cigarette tax increase, and had a range of property tax proposals. Overall, we described it as a "disappointing grab bag."[2]

Despite some positive elements, the governor's new proposal as a whole includes several problematic components and neglects basic reforms to modernize the state's tax code. Table 1, below, summarizes the main elements of Governor Beshear's proposal.

Table 1. Proposed Changes by Tax Type with Projected Revenue Effect

Individual Income Tax Changes	Revenue Impact (millions)
Reduce individual income tax rates	-$180.10
Enact a state EITC at 7.5 percent of the federal credit	-$72.75
Reduce retirement income exclusion for taxpayers with federal AGI over $80,000; phase out for AGI over $100,000	+$176.30
Phase out the $10 Individual Income Tax Credit	+$32.80
Require same income tax filing status for married couples at state level as federal level	+$72.80
Cumulative	+$29.05
Corporate Income Tax Changes	**Revenue Impact (millions)**
Lower top corporate income tax rate	-$6.40
Phase in single-sales corporate income apportionment and destination sourcing	-$154.50
Create an angel investor tax credit for small businesses	-$3.00
Expand the state's R&D Tax Credit to human capital	-$4.00
Double a community development tax credit	-$5.00
Create an income tax credit for the bourbon industry to offset property taxes on stored barrels of bourbon, with reinvestment requirement	-$13.30
Cumulative	-$186.20

1 Press Release, Governor Steve Beshear's Communications Office, *Gov. Beshear: Tax Reform Plan Vital to Kentucky's Future*, Feb. 4, 2014, http://migration.kentucky.gov/newsroom/governor/Kentucky%20Competes%20Tax%20Reform%20Proposal.htm.

2 Joseph Henchman, *Kentucky Tax Reform Commission Offers Disappointing Grab Bag*, Tax Foundation Fiscal Fact No. 348 (Dec. 27, 2012), http://taxfoundation.org/article/kentucky-tax-reform-commission-offers-disappointing-grab-bag.

Table 1. Proposed Changes by Tax Type with Projected Revenue Effect Continued

Sales Tax Changes	Revenue Impact (millions)
Exempt certain equine products from sales and use taxes	-$14.80
Exempt pharmaceuticals for food animals from the sales tax	-$4.80
Broaden sales tax to include include installation and repair services	+$143.14
Broaden sales tax to include some admissions and recreational activities	+$34.90
Broaden sales tax to include some personal and commercial services	+$101.85
Apply sales tax to all prewritten software, regardless of method of delivery	+$5.00
Apply sales tax and transient room taxes to entire hotel accommodation price	+$4.70
Cumulative	+$269.99
Excise Tax Changes	**Revenue Impact (millions)**
Phase in reduction of wholesale alcohol taxes	-$16.00
Repeal distilled spirits case sales tax	-$0.10
Increase tax rate on cigarettes to $1 per pack, increase other tobacco taxes in a commensurate amount, tax e-cigarettes at 20 percent of value	+$124.50
Restore cigarette rolling papers tax	+$0.80
Cumulative	+$109.20
Property Tax Changes	**Revenue Impact (millions)**
Exempt inventory from state property tax	-$7.20
Eliminate selected negligible state tangible personal property tax rates	-$5.00
Cumulative	-$12.20
Total Fiscal Impact	+$209.84

Individual Income Tax Changes

The governor's plan significantly restructures the state's income tax by eliminating several brackets and slightly lowering rates, as shown in Table 2. By reducing the number of brackets and cutting rates across the board, the plan simplifies the tax rate structure. Including the proposed state Earned Income Tax Credit, the plan simplifies and partly flattens the income tax, giving tax cuts to all individual taxpayers. By phasing out archaic brackets dating back decades and lowering rates, these changes would improve Kentucky's tax code and deliver $250 million in total tax cuts.

Table 2. Proposed Income Tax Rates

Current Rate Structure		Proposed Rate Structure	
Income	Rate	Income	Rate
>$0	2.0%	>$0	4.00%
>$3,000	3.0%		
>$4,000	4.0%		
>$5,000	5.0%	>$10,000	5.50%
>$8,000	5.8%	>$50,000	5.75%
>$75,000	6.0%	>$100,000	5.90%

The plan also raises new income tax revenues by including some retirement income in the income tax base, phasing out a small tax credit, and harmonizing some state and federal filing statuses. The bulk of these new revenues ($172 million) comes from subjecting non-Social Security retirement income over $80,000 to income taxation. Broadening the base in order to lower the rate is sound tax policy and is good for economic growth, though the plan could go farther by including all retirement income.

However, Governor Beshear's plan does not address Kentucky's relatively high local income taxes, which give Kentucky one of the higher tax rates on middle-income households in the nation.[3] With local income tax reform off the table, and inflation-indexing provisions not included, this plan offers improvements in Kentucky's tax code, but probably not a long-run solution to several key issues. Kentucky's overall rates will remain relatively high compared to the nation and the region and, over time, its bracket thresholds will become increasingly obsolete. Adding proposals to address those issues would much improve the governor's plan.

Corporate Income Tax Changes

In 2013, Kentucky raised about $400 million from corporate income taxes.[4] Governor Beshear's plan offers a cumulative $186 million cut, which would represent nearly a 50 percent revenue reduction. This cut, however, would be accomplished through base erosion and narrow incentives (as well as a very small rate reduction from 6 to 5.9 percent).

The bulk of the revenue losses in this provision come through changes in apportionment rules, which determine how much of a business's income Kentucky treats as in-state, or subject to taxation. More and more states have been adopting rules subjecting less and less corporate income to taxation, which contributes to the decline of the corporate tax as a revenue source for states. Ultimately, corporate taxes hurt states' economic competitiveness and are hard for states to apply well. Base erosion like that proposed by Governor Beshear shows why.[5]

Another key component of Governor Beshear's plan is to expand narrow incentive programs. The proposal includes a total of over $25 million a year in new carve-outs for "angel investors," research and development, community reinvestment, and the bourbon industry. Kentucky's tax incentive programs already give out hundreds of millions of dollars a year,[6] and expanding those

3 Lyman Stone, *A Response to Kentucky Gov. Steve Beshear's State of the Commonwealth Address*, Tax Foundation Tax Policy Blog, Jan. 08, 2013, http://taxfoundation.org/blog/response-kentucky-gov-steve-beshear-s-state-commonwealth-address.

4 Governor's Office for Economic Analysis, Office of State Budget Director, *Quarterly Economic & Revenue Report: Fourth Quarter, Fiscal Year 2013*, http://www.osbd.ky.gov/NR/rdonlyres/76920B89-4DED-45DF-A3E8-B5FF8C580D22/0/1307_4thQtrRpt2013.pdf.

5 William McBride, *What is the Evidence on Taxes and Growth?*, Tax Foundation Special Report No. 207 (Dec. 18, 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.

6 Lyman Stone, *Kentucky Publishes Magnitude of Newly Approved Business Incentives*, Tax Foundation Tax Policy Blog, Dec. 17, 2013, http://taxfoundation.org/blog/kentucky-publishes-magnitude-newly-approved-business-incentives.

programs is unlikely to make Kentucky more competitive, instead making the state's tax code more distortionary between industries. Rather than $25 million in incentives for a few companies, a more broad-based tax cut in the overall rate could help the state's economy more and provide tax relief for all corporate businesses, not just politically favored ones.

Sales Tax Changes

At first glance, the governor's plan seems to make a serious attempt at sound sales tax reform. The proposal appears to offer a significant expansion of the sales tax base to currently untaxed services, while exempting several categories of business inputs. However, the devil is in the details. While broadening the base to include final consumer services is an essential component of meaningful sales tax reform, the inclusion of business inputs can lead to damaging tax pyramiding, and the mix of tax provisions offered relies heavily on taxation of such inputs.

Several of the proposed sales tax expansions would specifically tax business inputs. For example, $143.1 million in new revenues would be raised from "installation, maintenance, and repair of taxable personal property." While $17.1 million of that comes from "repair services tied to consumer goods," $54.5 million comes from "installation, repair, and maintenance of all taxable machinery and equipment (personal and business)," which will disproportionately impact businesses. Other new taxes on business inputs include janitorial services, security systems, and industrial launderers. Meanwhile, a select few consumer services are being taxed, such as tanning salons, pet care, lawn care, many amusements, and automotive repair. Meanwhile, politically influential services like horse racing, lobbying and legal services, healthcare, and education were not subjected to taxes, despite being significant segments of the economy.

The main effect of this selective base expansion is to increase taxes on businesses that use a significant amount of equipment and a small set of non-essential personal services. Some limited improvements to the sales tax, like exempting certain business inputs for agriculture and livestock, are proposed but are quite small compared to the overriding effect of new taxes on business inputs and a few personal services.

Excise Tax Changes

Kentucky's alcohol taxes are quite high: 1st in the nation for wine, 7th for beer, and 17th for spirits.[7] Existing excise tax rates have little correlation with alcohol content or damage done to society by alcoholism. Furthermore, excise taxes have very high rates on very narrow bases, the definition of bad tax policy, so reducing, or entirely eliminating, alcohol excise taxes could make sense, especially for Kentucky, a state with more barrels of bourbon than people.

7 Tax Foundation, *Facts & Figures 2013: How Does Your State Compare?*, Tables 25, 26, and 27.

That said, the idea of increasing cigarette taxes in order to "create a healthier workforce"[8] while reducing alcohol taxes is untenable. Both taxes amount to targeting of politically expedient populations, levying high tax rates on very narrow bases. Both taxes punish industries in which Kentucky excels (tobacco and alcohol). Both taxes target goods that do have some health risks, especially when consumed to excess. But if Governor Beshear's intention is to use the tax code to decide what goods Kentuckians should and shouldn't consume to maintain a healthy workforce, it's odd that taxes on one good would be raised so sharply, while taxes on another would be cut. Rather, as both charge high rates on narrow bases, both are bad tax policy.

Property Tax Changes

None of the damaging property tax proposals included in the commission report made the cut into the Governor's plan, and the two property tax proposals that were included, while small in total value, are significant structural reforms. Both inventory taxes and tangible personal property taxes unnecessarily punish businesses for investment and for routine business activity, making it harder, more complex, and more costly to operate a business. Eliminating the inventory tax entirely is a step in the right direction. Phasing out several less-used tangible personal property tax categories is also an important reform, though only a very small improvement on a damaging and archaic business tax.

Conclusion

In sum, the governor's tax plan includes some positive elements, but many other elements would lead to economic distortions and eroded bases. The drastic increases in cigarette taxes and new taxes on business inputs undermine any positive effects of the modest improvements in income and property taxes this tax plan may have yielded. As it stands, Governor Beshear's plan doesn't meaningfully make Kentucky's tax code any more competitive, but instead just shuffles around a bit who bears the increasing cost of state government.

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8 Press Release, Governor Steve Beshear's Communications Office, *Gov. Beshear: Tax Reform Plan Vital to Kentucky's Future*, Feb. 4, 2014, http://migration.kentucky.gov/newsroom/governor/Kentucky%20Competes%20Tax%20Reform%20Proposal.htm.