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Kentucky's Tax Modernization: Does it Increase the State's Risk of a Structural Deficit?

On March 18, 2005, Kentucky Governor Ernie Fletcher signed into law the tax reform and modernization package he championed. House Bill 272, called *JOBS* (Jobs and Opportunity Bipartisan Solution) *for Kentucky* was a series of changes to Kentucky tax law with the stated purpose of creating a more "stimulative economic environment for revenue generation." The major goals for the tax reform package were to better attract and retain jobs and spur economic growth.

As presented by the governor and the state budget director, Brad Cowgill, *JOBS for Kentucky* was projected to be revenue neutral, but would have two key advantages over the prior tax structure. First, the stimulative effect of the tax changes was projected to generate additional jobs and resulting additional tax revenues. In the static model projections presented by the governor, changes in receipts resulting from the plan between FY 2004 and FY 2008 would be almost non-existent. However, the governor claimed the tax changes would provide the stimulus for an additional 10,325 jobs and that these additional salaries, combined with the additional economic growth resulting from these tax changes would result in nearly \$50 million in additional tax revenues between enactment and FY 2008.¹

Secondly, the new tax structure was purported to be more stable and responsive to changes in the economy than the existing tax code. It was not made clear exactly how or why *JOBS for Kentucky* presented a more stable revenue stream than preceding tax law, but the outline provided by the governor stated:

*[JOBS for Kentucky] will provide a stable revenue source, so Kentucky can prevent situations like making \$1 billion in unanticipated budget cuts, which occurred over the last four years. Families can't plan to send their children to college or buy a house without knowing what their income will be. Similarly, government can't budget effectively for education, Medicaid, road improvements and other necessary programs when the antiquated tax system doesn't provide the anticipated amount of revenue.*²

Since long-term adequacy of tax revenues is one of the supposed strengths' of Governor Fletcher's tax modernization initiative, it is fair to ask to what degree these policy changes secure future revenue growth. In the recent short term, Kentucky's tax revenues have grown at a fairly healthy rate. Both FY 2005 and FY 2006 saw general fund revenues expand by 9.6% over the prior year. Thus far, FY 2007 revenue growth appears to be substantially slower, just 1.8% through April 2007.³

However, tax policy experts realize that short-term improvements in state revenue generation can quickly vanish if the growth in tax receipts cannot keep up with the natural growth in state expenditures. Now, more than two years after Kentucky's tax modernization was signed into law, it is a good time to ask, does Governor Fletcher's tax modernization plan truly improve the security of Kentucky's tax revenues in the long-term? In other words, does Kentucky have, or is it in risk of developing a "structural deficit"?

Structural Deficit Defined

In order to understand what a structural deficit is, it is helpful to make clear what it is not. It is not simply when state expenditures exceed state revenues. That is the definition of a budget deficit, but not all deficits are the result of structural deficiencies. For example, a state may, on average, find its tax receipts match its expenditures but that surpluses or deficits arise as the overall level of economic activity changes. This situation – where budget surpluses arise during periods of economic expansion and deficits appear during economic downturns and recessions – is referred to as a cyclical deficit.

Additionally deficits may be the result of reductions in taxes without making changes to underlying state programs or, alternatively, increases in expenditures without making changes to tax policy to fund these new or expanded programs. The resulting deficits are not the result of structural deficiencies but one-time policy changes. This situation is referred to as a revenue inadequacy problem

By contrast, a structural deficit is a long-term, chronic predisposition to a deficit position resulting from a gap between the normal growth in tax receipts and the normal growth in state expenditures. The normal growth of receipts refers to changes in tax revenues that would naturally occur even if there are no changes to tax rates, tax bases or other aspects of state tax policy. Even with no changes in tax regulations, revenues would be expected to change as a result of demographic and economic changes. For example:

- Population growth would lead to more individuals being taxed;
- The aging of the population would lead to more individuals being subject to favorable tax treatment afforded seniors;
- The purchase of tobacco, alcohol and other products subject to special taxes may change over time;
- Lottery and other state gaming expenditures may change over time;
- Expected long-term economic growth would lead to increases in sales and income taxes; and
- Changes in economic conditions and consumer preferences may lead to changes in the rate of purchasing cars, houses and other assets subject to property taxes.

The normal growth of expenditures refers to changes in state spending that would naturally occur even if no programs or departments were added or expanded. The two most likely causes of expenditure growth, assuming no additional programs are established would be inflation and wage increases. Additionally, expenditures may increase as the result of demographic changes such that the population subject to a given government program expands. For example, as life expectancy increases, the number of senior citizens will increase. This will expand required spending on elderly care programs even with no legislated expansion in such programs. Similar demographic changes to other populations could potentially effect other state programs such as newborn care, public education, corrections, job training, Medicaid and others.

Because tax policies, state budget priorities, public perceptions of taxes and government programs, the economy and social trends are in a constant state of flux, diagnosing structural deficits can be extremely difficult and requires sophisticated analysis. Studies have come to mixed conclusions with regards to whether Kentucky has a structural deficit. A 2002 study prepared on behalf of the General Assembly by University of Tennessee professor William Fox argued not only that the state had a structural deficit but the budget gap he projected – 12.5% by 2007 and 17.4% by 2010 – was higher than studies conducted in other states.⁴ A 2004 report by the Kentucky Long-Term Policy Research Center also found evidence of a structural deficit⁵. A 1998 study by the National Education Association found Kentucky suffered from a slight structural gap.⁶ In contrast, both a 2002 study by Boston University in association with the U.S. Chamber of Commerce⁷ and a 2006 report by the National Conference of State Legislatures⁸ indicated that Kentucky was not suffering from a structural deficit.

Tax Modernization and the Risk Factors for Structural Deficit

Despite uncertainty over whether Kentucky has been or is in a structural deficit, there are numerous identifiable factors which can impact the likelihood that the long-term growth in revenues will meet or exceed the long-term growth in state expenditures. In 2005, the Center for Budget and Policy Priorities published a report studying the factors leading to structural deficits and rating each state as to its susceptibility to having a structural deficit.⁹ The study identified ten potential risk factors and classified states having eight or more of the factors as being at “High Risk” for a structural deficit. Eighteen states fell into the “High Risk” category, including Kentucky.

Kentucky was found to have eight of the ten factors identified by the CBPP.¹⁰ The study was published shortly after the tax modernization plan was signed into law, but its analysis relies on data from prior years. Looking at each factor, it can be determined whether, and to what extent, Kentucky’s tax modernization initiative has increased or reduced Kentucky’s risk of having a structural deficit. The factors are as follows:

Factor 1: Sales Tax Base

Issue: Kentucky’s sales tax primarily covers products rather than services. Of forty household services identified by the Federation of Tax Administration, Kentucky taxed only six of these services compared to a national average of sixteen. Since services have been and are expected to continue to be a growing part of the economy, Kentucky sales tax will cover less economic activity over time, hampering the growth in revenues from this source.

Tax Reform Impact: Minimal

Discussion: The Legislative Briefing accompanying the tax modernization proposal notes:

*Today’s technologically advanced economy generates new products and services at an alarming rate, but the tax code cannot incorporate them. As Kentuckians shift spending habits toward services rather than physical goods, and purchase an increasing amount of items remotely via the Internet and catalog sales, the divide between the tax code and consumption grows. Today the sales tax base is less than half of the state’s Gross Domestic Product, and its growth continues to lag behind the economy.*¹¹

Nevertheless, while recognizing the increasing importance of services to the economy, the *JOBS for Kentucky* package did little to expand sales taxes to cover services. The sole exception was applying the state sales tax to prepaid calling services.

Factor 2: Corporate Income Tax Erosion

Issue: In 1989, Kentucky's corporate income tax provided 7.6% of state revenues. By 2002, the corporate income tax supplied only 3.8% of revenues. Nationally, state corporate income tax receipts have grown at a slower rate than federal receipts, suggesting corporations are exploiting loopholes to avoid state taxation. Kentucky was found to have significant loopholes in its corporate income tax laws.

Tax Reform Impact: Closing Certain Loopholes; Adopting AMC

Discussion: The CBPP report identifies the three most significant actions for closing loopholes to be 1) adopting a "throwback rule" (a method to re-allocate sales of multi-state corporations that attempt to allocate sales to states where the sale is untaxed); 2) nullifying the use of PICs ("passive investment company" subsidiaries located in tax haven states that charge royalty and interest expenses to other subsidiaries to reduce their state income tax); and 3) amending the definition of "apportionable business income" to include certain irregular sources of income that currently go untaxed. The report also advocates adopting "combined reporting," a method of tax filing that considers all U.S. income and expenses for multi-state entities, thus eliminating the benefits of shifting profits expenses between states.

The *JOBS for Kentucky* plan closes certain corporate loopholes, but there appears to be little overlap with the major issues identified by the CBPP. *JOBS for Kentucky* disallows net operating loss carrybacks, changes the income tax nexus from a "physical presence" standard to a "doing business" standard, and changing the apportionment factors for limited liability entities. The only change which has some overlap with the three major loopholes identified by the CBPP is a change to disallow the deduction of certain expenses paid to related parties. Although it appears the intent of this portion of the tax reform law is to eliminate the tax advantages of PICs and other profit-shifting devices, the effectiveness of the law as written is questionable.¹²

JOBS for Kentucky also changes the tax filing requirements of corporate groups. Previously such groups could file individual returns for each corporate entity or file on a consolidated basis. The new law requires such groups to file consolidated returns. This change has a minimal fiscal impact and fails to prevent the income shifting tax avoidance strategies used by many corporations to avoid state taxes.

One change that the tax modernization initiative made which is expected to have a positive impact on Kentucky’s risk of structural deficit is the passage of an alternative minimum calculation. By requiring an alternative minimum calculation, nearly every corporation must pay some amount of taxes even if they successfully shift profits out of state. In this way, it acts as a sort of safety net ensuring a minimum level of corporate receipts and aiding in the stability of those receipts. Partially as a result of the changes made by tax modernization, corporate income taxes have been a growing portion of the state’s total tax receipts¹³:

<u>Year</u>	<u>CIT as % of General Fund Receipts</u>
FY04	4.3%
FY05	6.3%
FY06	12.0%
FY07 (part.)	14.1%

Factor 3: Untaxed Electronic Commerce

Issue: Untaxed e-commerce has cost Kentucky a significant amount of revenue. One study estimated the annual revenue loss to range between \$250 and \$450 million annually. Kentucky’s proportion of revenue lost to Internet commerce is larger than most states.

Tax Reform Impact: Expanding Sales Tax Nexus

Discussion: While untaxed e-commerce transactions are a significant untapped source of state revenues, the ability to collect these revenues is largely a federal problem. In two separate decisions, the U.S. Supreme Court has barred states from requiring Internet and catalog retailers to collect and remit sales taxes unless the retailer has a physical presence in the state. Thus, many e-commerce sales will continue to go untaxed until Congress legalizes state taxation of e-commerce sales to the state’s citizens.

Until that happens there are relatively few remedies available to states. Kentucky has previously included a line for “use tax” on its income tax forms where individuals and businesses could voluntarily report out of state purchases of items subject to Kentucky sales tax. Some states have made changes to their procurement laws, requiring that any companies doing business with the state must agree to collect and remit sales taxes on sales made to state residents.

One change made by the tax modernization package is to expand the nexus standard for sales taxes to include remote retailers with in-state affiliates. For example, a bookstore chain may have stores in Kentucky and may also sell products over the Internet. Many retailers have structured their operations so that the physical stores and the Internet presence are housed in separate subsidiaries. Because the Internet subsidiary does not have a physical presence in Kentucky, its sales have gone untaxed. Under the expanded nexus standard, the presence of the affiliated retail store would be considered a sufficient nexus to tax sales of the Internet subsidiary to Kentucky citizens. While this would seem to be a significant improvement in Kentucky’s tax policy, in reality this effects a fairly small volume of sales. The governor’s office estimates the additional revenues resulting from this change will total only about \$1 million per year.

Factor 4: Tax Preferences for the Elderly

Issue: Kentucky provides sizable income and property tax advantages to the elderly. As the state’s population continues to age, a greater proportion of personal income and property will go untaxed.

Tax Reform Impact: Freezing the Pension Exclusion

Discussion: Thanks to modern health advances, Americans are living longer. In Kentucky, like most other states, one of the fastest-growing demographic groups is the elderly. Setting aside the issue of the elderly’s consumption of state resources, the growth in the number of senior citizens has significant consequences for state tax receipts. The elderly receive favorable tax treatment in a number of respects. As a greater and greater percentage of the state’s population joins the ranks of senior citizens and becomes eligible for these tax benefits, state tax receipts are likely to suffer.

A 2002 study found that only Michigan and Virginia gave more income tax breaks to the elderly than Kentucky.¹⁴ This is accomplished through a tax credit for those 65 and over, tax-free treatment of social security benefits, a tax

exemption on private pension income. Kentucky seniors additionally receive a homestead exemption to elderly homeowners.

JOBS for Kentucky addressed only one of these preferences, the exemption of private pension income. Noting that the exemption had been increased annually and was estimated to have excluded all benefits for more than 98% of the state's pensioners, the reform set the pension exclusion for future years at the 2005 level of \$41,110.

Factor 5: Growth of Expenditure Needs

Issue: Kentucky ranks 2nd in the nation in the population of disabled citizens as measured by the proportion of non-elderly SSI recipients. Additionally, Kentucky ranks higher than the national average in the population of special education students, growth in school-age population and growth in high school graduates. This indicates that Kentucky will see continued growth in health care and educational expenditures in the future that must be met by growth in tax receipts.

Tax Reform Impact: See Other Factors

Discussion: This factor deals primarily with the expenditure side of structural deficits and is not explicitly tied to tax policy. However, it does stress the importance of building a tax structure that can be counted on to provide robust growth in revenues over time. Kentucky's Medicaid, public health, K-12 and postsecondary education needs are greater than most states and will need significant investments for the foreseeable future. The success of tax modernization under this factor is based on its ability to enable the long-term growth of tax receipts to meet these needs.

Factor 6: Tax Policy Choices

Issue: Not all taxes are created equal. Receipts from income and estate taxes tend to grow at a faster rate than general sales taxes. Excise taxes on selective goods tend to grow at an even slower rate. A greater dependence on sales taxes over income taxes increases the risk of a structural deficit because they may constrict the state's ability to keep tax receipts on pace with normal growth in expenditures.

Changes made to Kentucky’s tax structure prior to the governor’s tax modernization initiative have tended to increase the reliance on sales taxes relative to income taxes, thus slowing the projected future growth rate in tax receipts. This includes the increase in the sales tax rate to 6% in 1990, raising the gasoline tax in 1994, broadening the sales tax base in 2000 and excluding pension income from the state income tax.

Tax Reform Impact: Tax Changes Increase the Risk of Structural Deficit

Discussion: Kentucky’s tax modernization initiative comprises a variety of changes to the state’s tax policy. It would be an oversimplification to say that *JOBS for Kentucky* amounts to a cut in individual income taxes paid for by a cigarette tax increase combined with a slight increase in business taxes. It would be an oversimplification, but it would be largely accurate.

Looking at the projected impact of each element of the tax modernization package, 80% of the total changes – both increases and decreases in tax receipts—come from the following eight provisions¹⁵:

<u>Provision</u>	<u>Change (\$mil.)</u>
Cigarette tax increase	\$615.6 increase
Reduce/repeal corporate license tax	610.8 decrease
Reduce top individual income tax rate	574.7 decrease
Apply corporate income tax to limited liability entities	371.5 increase
Institute alternative minimum calculation for corporate income taxes	334.4 increase
Reduce top corporate income tax rate	270.2 decrease
Expand sales tax to off-premise alcohol sales	126.4 increase
Replace telecom taxes with single excise tax	124.1 increase

The alternative minimum calculation and the expansion of the corporate income tax to limited liability entities are positive changes in terms of warding off a structural deficit because they represent increases in income taxes which tend to grow at a higher rate. The telecom tax change probably has little long-run impact as it replaces a hodge-podge of state and local sales and property taxes and franchise fees. The remaining changes on this list however, representing the largest portion of changes to Kentucky’s tax structure, trade higher-growth taxes on income and corporate wealth for increased cigarette and alcohol taxes.

Taxes on specific goods tend to generate the least amount of growth in future state receipts, in part because sales of the item being taxed are not growing rapidly anyway and in part because the tax increase discourages would-be purchasers who may choose not to purchase the product at all, purchase a similar, untaxed product, or make the purchase in another state.

Kentuckians use tobacco products at a greater rate than the citizens of nearly every other state. If increasing the cigarette tax discouraged tobacco use, it may be a positive change for the state, improving and lengthening the lives of its citizens and reducing the strain on health care resources. However, since the enactment of the cigarette tax increase under the tax modernization plan, average monthly cigarette sales have actually increased slightly. Moreover, seen through the prism of long-term state fiscal health, trading income taxes for cigarette taxes is a poor deal. If the tax were successful in discouraging smoking, it would come at the price of reducing state revenues.

Even though this punitive effect has not been seen to date, cigarette sales are still expected to grow at a much slower rate than the growth in personal income. Because the state's tax structure now relies more heavily on slower-growth sales and excise taxes and less heavily on income taxes, the tax modernization package as a whole puts the state in greater risk of future deficits.

Factor 7: Process Barriers

Issue: Kentucky has a limit on local property tax revenues and requires a supermajority to increase taxes in off-budget years. This limits the state's ability to raise revenues in response to unforeseen increases in needed spending.

Tax Reform Impact: None

Discussion: Artificial limits on the state legislature's ability to raise taxes are often seen as a control mechanism to limit growth in government spending. While the idea that limiting the state's ability to raise taxes may lead to tighter controls on government spending may be inviting, it is ultimately misguided. The majority of state programs are results of the democratic process. The cost of these programs demanded by the public are likely to grow more expensive over time simply through inflation, wage increases and growth in the populations served by these programs.

Artificially restricting the state's ability to pay for these programs does nothing to control their costs and can lead to poor policy-making. Restrictions on the ability to control tax policy decisions may lead the legislature to employ short-term fixes, off-budget accounting or other gimmicks to "kick the can down the road" rather than make constructive fixes in tax policy.

Kentucky has two main restrictions on tax policy. First, although Kentucky's legislature has met annually since 2000, sessions occurring in odd-numbered years require a three-fifths majority for any bill raising revenue or appropriating funding¹⁶. Secondly, property tax rates for municipalities are limited to 1.5%, with lower limits for smaller municipalities, and property tax receipts are generally restricted to an annual growth rate of no more than 4%¹⁷. Neither of these restrictions was addressed by *JOBS for Kentucky*.

Factor 8: Links to Federal Tax Statutes

Issue: Kentucky's estate tax is linked to the federal phase-out of this tax, eliminating a rapidly growing revenue source.

Tax Reform Impact: None

Discussion: Historically, Kentucky, like most states, has not collected estate taxes on its own, but instead received credits from the federal government for the portion of federal estate taxes paid by Kentucky citizens. Between 2002 and 2005, however, the federal estate tax credit has been phased out. A simple change in Kentucky's revised statutes could "decouple" Kentucky's estate tax from the federal credit and allow Kentucky to once again generate revenue through the estate tax. *JOBS for Kentucky* did not address this issue. While there have been other proposals to make this change, they have not been enacted.¹⁸

Conclusion

On balance, *JOBS for Kentucky* increases Kentucky's risk of finding itself in a structural deficit. While the plan instituted two major changes to greater secure future streams of corporate income (the alternative minimum calculation and the expansion of the corporate tax to LLEs), these are overshadowed by the trade-off between increased cigarette taxes and reduced personal income taxes, as well as the repeal of the corporate license tax. These changes fundamentally alter the state's tax structure resulting in greater reliance on specific sales taxes and less reliance on income taxes. Because the tax base for income taxes is expected to grow at a more

rapid clip than sales taxes, Kentucky's tax modernization appears to have intensified the risk for future deficits.

¹ Fletcher, Ernie and Cowgill, Bradford L., *Governor Fletcher's Jobs and Opportunity Bipartisan Solution for Kentucky*, 2005 Regular Session, p. 3, 9.

² *Ibid.*, p. 2.

³ Per review of Monthly Tax Receipts Report, Office of State Budget Director

⁴ Fox, William F., "Report to the Sub-Committee on Tax Policy Issues", Committee on Appropriations and Revenue, Kentucky General Assembly, February 27, 2002. For a comparison to other state structural gaps, see Lav, Iris J., McNichol, Elizabeth and Zahradnik, Robert, "Faulty Foundations: State Structural Budget Problems and How to Fix Them," Center for Budget and Policy Priorities, May 2005, Appendix B.

⁵ Shirmer, Peter, Childress, Michael T. and Nett, Charles C., "\$5.8 Billion and Change."

⁶ Hovey, Hal, *The Outlook for State and Local Finances: The Danger of Structural Deficits to the Future of American Education*, 1998

⁷ Baker, Bruce, Besendorfer, Daniel and Kotlikoff, Laurence J., "Intertemporal State Budgeting," June 2002.

⁸ "State Budget Update: March 2006", National Conference of State Legislatures

⁹ Lav, Iris J., McNichol, Elizabeth and Zahradnik, Robert, "Faulty Foundations: State Structural Budget Problems and How to Fix Them," Center for Budget and Policy Priorities, May 2005. The "Issues" outlined for each factor below are also derived from this report.

¹⁰ The two other factors which identified by the CBPP which were not found to apply to Kentucky was having an unprogressive income tax structure and the presence of structural gaps found in other studies.

¹¹ Fletcher, Ernie and Cowgill, Bradford L., *Legislative Briefing: Governor Fletcher's Jobs and Opportunity Bipartisan Solution for Kentucky*, p. 2.

¹² *Ibid.*, p. 20.

¹³ Per review of Monthly Tax Receipts Report, Office of State Budget Director

¹⁴ Wallace, Sally and Edwards, Barbara, "How Much Preference: Effective Personal Income Tax Rates for the Elderly," April 2002. Note also that while Virginia had a more preferential tax structure towards the elderly than Kentucky, in 2004 Virginia instituted a tax reform that means-tested many of the benefits to the elderly, making it substantially less preferential than previously.

¹⁵ Fletcher, Ernie and Cowgill, Bradford L., *Governor Fletcher's Jobs and Opportunity Bipartisan Solution for Kentucky*, 2005 Regular Session, p. 22,61

¹⁶ Kentucky Constitution, Section 36.

¹⁷ Kentucky Constitution, Section 157 and HB 44, 1979 Regular Session.

¹⁸ See, for example HB 411 from the 2007 regular session.

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