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BUDGET BRIEF

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# Farmer's High-Risk Overhaul Creates Imbalance in Kentucky's Tax System

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## Summary

House Bill 196, sponsored by Representative Bill Farmer, proposes to overhaul Kentucky's tax system by eliminating income taxes on individuals and corporations while greatly expanding the sales tax base. The bill is an example of a shift to a consumption-based tax system. Kentucky needs to reform its tax structure, and HB 196 considers ways to broaden an outdated and too-narrow sales tax base. But taken as a whole, HB 196 is a risky and troubling experiment. It turns the tax structure upside down by dramatically shifting responsibility for funding government away from high-income Kentuckians. And by eliminating the income taxes that currently make up 43 percent of General Fund revenue, the bill would create imbalance in our revenue system that could harm our ability to invest in the public structures essential to future prosperity.[1]

## HB 196: Heavy reliance on a single tax

As summarized in Figure 1, House Bill 196 proposes to eliminate all state income taxes: the individual income tax, the corporate income tax and the limited liability entity tax.[2] The bill raises the sales and use tax rate from six percent to seven percent and greatly broadens the sales tax base. The base broadening includes a range of services, including repair and maintenance services; advertising, legal, accounting and real estate services; admissions to events; and accommodations such as hotels. The bill does not add medical services or educational services to the sales tax base.

**The poorest 20 percent would pay an estimated $382 more in taxes under Farmer's plan, while the wealthiest one percent of earners would receive an average tax cut of $27,851.**

Farmer's plan also eliminates a number of sales tax exemptions that currently exist. It ends the exemption for the residential purchase of utilities including electricity, natural gas and fuel oil as well as water and sewer services. It removes the exemption on purchases by local governments and by non-profit organizations (including charities as well as religious institutions) with the exception of educational institutions. And it removes the exemptions on industries' purchase of industrial supplies, tools and machinery. The bill maintains sales tax exemptions on the purchase of groceries and prescription drugs.

# Figure 1: Summary of House Bill 196

House Bill 196 proposes the following changes to the Kentucky tax system:

- **Eliminate the individual income tax, corporate income tax and limited liability entity tax.**

- **Expand the sales and use tax base to include:**
    - A broad range of services:
        - Admissions and accommodations.
        - Labor included in installing or applying a service.
        - Real estate agents and broker services.
        - Legal services.
        - Accounting, tax preparation, bookkeeping, and payroll services.
        - Advertising, public relations, and related services.
        - Marketing research and public opinion polling services.
        - Photographic services.
        - Translation and interpretation.
        - Day-to-day business and other organizational support services.
        - Document preparation services.
        - Call center services.
        - Business service centers, including copy shops.
        - Investigation and security services.
        - Packaging and labeling services.
        - Septic tank and related services and miscellaneous waste management services.
        - Repair and maintenance services.
        - Personal care services.
        - Dry cleaning and laundry services.
        - Other personal services.
    - Residential purchase of utilities:
        - Energy used for residential use.
        - Sale of sewer services and water to residents.
    - Non-profit and local government purchases:
        - Purchases by counties, cities and special districts.
        - Purchases by 501(c) charitable, nonprofit and religious institutions **except** for institutions of higher education or resident nonprofit kindergarten, primary or secondary schools.
        - Purchases by out-of-state agencies, organizations or institutions exempt in their own states.
    - Some business purchases of goods:
        - Clarifies exemption for manufacturers to include raw materials incorporated into a product but not supplies or tools.
        - Purchase of machinery for new and expanded industry.
        - Energy and energy-producing fuels that exceed more than 3 percent of costs.
        - Purchase of property that is an alcohol production facility or certified fluidized bed energy facility.
    - Lease or rental of commercial real estate.
    - Sale, lease or rental of shelf space to display items for sale.

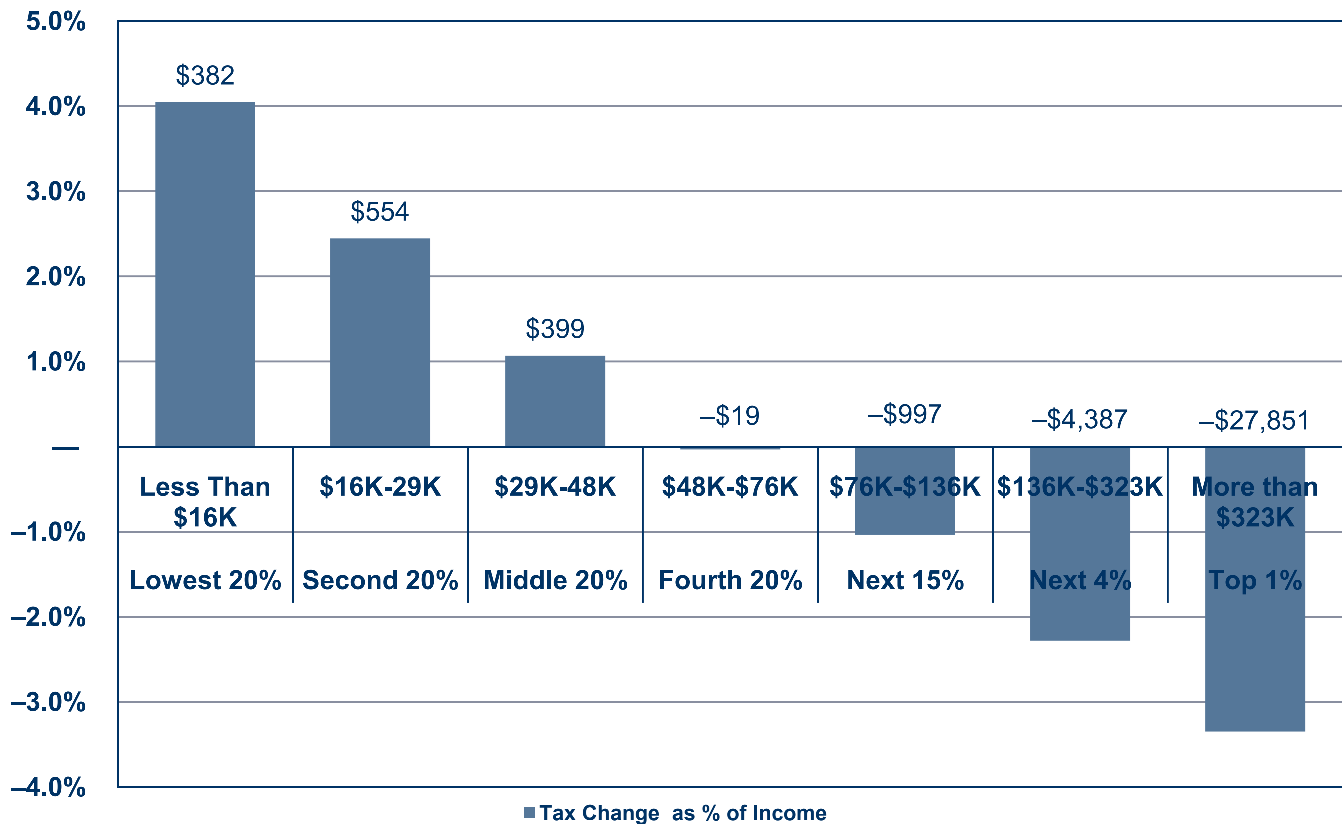
- **Raise the sales and use tax rate to 7 percent (from the current rate of 6 percent).**

# House Bill 196 Lessens Tax System's Equity, Balance and Long-Term Revenue Adequacy

HB 196 has a troubling overall impact on Kentucky's revenue structure for its negative impacts on tax equity, revenue balance and Kentucky's ability to invest in needed services and systems. This proposal:

**1. Increases imbalance in our tax structure.**

Kentucky's current tax system is regressive: in 2007, the wealthiest one percent of Kentuckians paid approximately 6.1 percent of their income in state and local taxes while the poorest 20 percent paid 9.4 percent.[3] That distribution would be worse if it weren't for the individual income tax, which increases equity in the tax system by distributing taxes based on ability to pay. The Farmer bill illustrates what happens to tax equity through a dramatic shift to a consumption based-tax system. Such a shift removes the balancing effects of the income tax, and turns the revenue structure on its head. According to an analysis of the bill by the Institute on Taxation and Economic Policy, the poorest 20 percent of Kentuckians (who make less than $16,000 a year) would pay $382 more a year on average in taxes under Farmer's plan, while the highest-earning one percent of Kentuckians (who make more than $323,000 a year) would receive an average tax cut of $27,851 (Figure 2).[4]



This shift occurs because low-income households out of necessity spend a greater share of their income on consumer goods and services and therefore pay a greater share of their income in consumption based taxes than higher income households. Taxes on necessities including water and sewer services are particularly regressive. Limiting exemptions can be an important piece of a well-designed tax structure. But HB 196 includes no compensating policy to address challenges low-to-moderate income households would face in meeting their basic needs.

In addition, by eliminating the taxes on corporate and limited liability entity income, Kentucky misses the opportunity to export a portion of its taxes to out-of-state shareholders whose corporations benefit from the public investments and services those tax dollars pay for. Corporate income taxes are a nearly-universal part of state tax systems—45 states have them.[5]

**2. Broadens the tax base in one instance while radically narrowing it in another.**

Good tax reform includes broadening the base to which taxes apply, and a strong tax system includes varied revenue streams. A diversity of taxes helps make tax revenue more predictable in relation to different economic conditions and ensures that revenue grows in line with the cost of services. For example, in the current year high corporate profits and high coal prices are resulting in corporate income tax and coal severance tax revenues that are above the state's official projections. At the same time, the still-sluggish economy and slow job growth are leading to individual income and sales tax revenues that are below official projections.[6] If Kentucky had no corporate income tax, as Farmer proposes, it would have another new budget deficit to close this year. But Kentucky's diversity of taxes allows a good year in one tax to make up for a slump in another.

The bill appropriately broadens the sales tax base by taxing a range of services, which make up a growing share of the economy, and by narrowing existing exemptions. However, HB 196 more than undoes this base-broadening by eliminating taxes that make up 43 percent of Kentucky's current tax revenue. Rather than increasing the diversity of taxes, HB 196 narrows Kentucky's tax system to heavy reliance on a single tax.

Individual income taxes, in particular, are a cornerstone of Kentucky's tax system. The income tax generates roughly enough revenue to cover all General Fund spending on primary, secondary and postsecondary education. Removing the corporate income and limited liability entity taxes creates another significant hole. The revenue generated by the Corporate Income and Limited Liability Entity Taxes in 2010 ($383.8 million) could fund the entire Judicial Branch—a court system that citizens and businesses throughout the state rely on.

**3. Has a questionable short-term impact on revenue, and likely a troubling long-term impact.**

The stated intent of HB 196 is "to replace the lost revenues" from the repeal of all income taxes with an expanded sales tax.[7] However, it is difficult to predict with certainty what the total net impact will be on revenues. In a 2009 *Memorandum* outlining the possible fiscal impact of an earlier version of this bill, the Legislative Research Commission (LRC) warned that estimates of new sources of revenue are "subject to a substantial amount of error." The LRC further stated that there is "considerable risk that actual revenues could be much higher than

anticipated or much lower than anticipated."[8] These cautions suggest that eliminating the individual income tax and relying on new sources of revenue to fill the gap is a radical experiment that may fail, leaving the state unable to make needed investments.

In addition, expanding the sales and use tax will ignite serious efforts to exempt some of those purchases from the tax. Many of the new items and services included in the sales tax under Farmer's bill are controversial—including those that apply to the purchase of necessities and of business inputs as well as purchases by non-profit organizations, churches and local governments. Any exemptions that may be granted will require increases in the sales tax rate or other tax increases to make up the lost revenue. In the face of this demand, failure to generate adequate revenue would result in deep cuts in education, healthcare, transportation and other essential systems.

In addition, the income tax tends to decline the most during a recession but grow the fastest during good economic times. Enactment of a shift to a consumption-based tax system at this time would prevent Kentucky from taking advantage of the revenue bounce-back when the economy fully recovers. That means HB 196 would lock the state into a permanently lower level of revenue in the future.

**4. Creates economic development challenges.**

While some argue that eliminating income taxes will make the state more attractive to business and wealthy business owners, many studies conclude that, all other things being equal, taxes make little difference. A study by Professor Howard Chernick of Hunter College found that, once other factors are controlled for, the progressivity of a state's tax structure has no impact on state economic growth.[9] In the past few decades, states with less reliance on sales taxes and greater reliance on progressive income taxes, such as North Carolina, have seen substantial economic growth. In regard to corporate income taxes, it is important to note that all state and local taxes in combination make up only two to three percent of corporate expenses, on average, and the corporate income tax makes up only 10 percent of that already small amount.[10]

The relevant economic development literature suggests that "factors other than taxation, such as the education of the workforce, transportation systems, and the natural environment, play a very significant role" in business location decisions.[11] To the extent that HB 196 puts at risk our short and long-term ability to fund key public necessities and services, it could actually harm economic development.

# Conclusion

Kentucky needs tax reform that can raise the revenues to move Kentucky forward, assure that those revenues grow in line with the cost of needed services, and do so in a way that maintains balance and equity across income groups. An expanded sales tax base is an important part of tax reform. But HB 196 is a high-risk proposal that will create imbalance in our revenue structure, turn the structure upside down by shifting responsibility away from higher income earners, and threaten our ability to generate adequate revenue to meet Kentucky's current and future needs.

*The Kentucky Center for Economic Policy (KCEP) was founded in 2011 with the purpose of conducting research, analysis and education on important state fiscal and economic policy issues. KCEP seeks to create economic opportunity and improve the quality of life for all Kentuckians. The center is an initiative of the Mountain Association for Community Economic Development (MACED) and is supported by foundation grants and individual donors. Please visit KCEP's website at www.kypolicy.org.*

[1] Using Fiscal Year 2010 revenues. Author's calculation. Office of the State Budget Director, "Quarterly Economic and Revenue Report: Fourth Quarter Fiscal Year 2010 Annual Edition," http://www.osbd.ky.gov/NR/rdonlyres/E17747E4-1C67-425A-AF9C-A18AACF24E3E/0/1008_4thQtrRpt2010.pdf.

[2] The limited liability entity tax is similar to the corporate income tax, but is paid by businesses that are not organized as corporations but whose owners receive the same legal protections as corporate shareholders. There are several forms of "limited liability pass-through entities" that are subject to the tax. Pass-through entities include partnerships, S-corporations, limited liability companies, limited liability partnerships, limited partnerships and similar entities that are not taxed for federal purposes at the entity level, but where tax liability passes through to each partner, member, shareholder, or owner proportionate to their share of income, deductions, gains, losses, credits, and other similar attributes. Limited liability pass-through entities are pass-through entities that afford any of its partners, members, shareholders, or owners, through function of the laws of this state or laws recognized by this state, protection from general liability for actions of the entity. Source: KRS 141.010 (26) and (28).

[3] Share includes the benefit of the federal offset for state and local income taxes paid. Institute on Taxation and Economic Policy, "Kentucky: State and Local Taxes 2007," "Who Pays? A Distributional Analysis of the Tax System in All 50 States," November 2009, http://www.itepnet.org/wp2009/ky_whopays_factsheet.pdf.

[4] Section 23 of HB 196 indicates that the intent of the bill is to "repeal the individual income tax, corporation income tax, and limited liability entity tax for taxable years beginning on or after January 1, 2010; to *replace the loss in revenues* by expanding the sales and use tax base to include a multitude of new services, the sale, lease, or rental of shelf space or any other area for the display of a product, and the lease or rental of commercial real estate located in this state, and by increasing the sales and use tax rate from six percent to seven percent, effective July 1, 2011; and by deleting several sales and use tax exemptions effective July 1, 2011 (emphasis added)." However, the actual net revenue impact of such a dramatic change to the tax system is difficult to predict. Inclusion of an increase in the sales tax rate to seven percent may result in a net revenue increase overall; the Institute on Taxation and Economic Policy estimates that the bill could raise approximately $850 million. The distributional analysis completed for this brief assumes that Rep. Farmer's intent is to raise the sales tax rate enough to make the overall bill revenue neutral, as indicated in the bill and in public statements Farmer has made. The Institute on Taxation and Economic Policy estimates that a revenue-neutral impact is achieved at a sales tax rate of 5.85 percent. The distributional impact of using a seven percent sales tax rate is very similar to using a 5.85 percent rate, only more regressive for its impact on low-income Kentuckians. At a seven percent rate, the bottom 20 percent of earners would pay $452 more on average, while the highest-earning one percent of Kentuckians would receive an average tax cut of $26,439.

[5] Federation of Tax Administrators, "Range of State Corporate Income Tax Rates," http://www.taxadmin.org/fta/rate/corp_inc.pdf.

[6] Office of the State Budget Director, "Quarterly Economic and Revenue Report: Second Quarter FY 2011," February 1, 2011, http://www.osbd.ky.gov/NR/rdonlyres/7CD70E7E-1FEF-4A32-BF17-D8208D132389/0/1101_2ndtQtrRpt2011.pdf.

[7] House Bill 196, Section 23.

[8] Mike Clark, *Legislative Research Commission Memorandum to Jessica B. Hays Lucas*, May 21, 2009.

[9] Howard Chernick, "Redistribution at the State and Local Levels: Consequences for Economic Growth," State Tax Notes, Vol. 36, No. 4, April 25, 2005.

[10] Michael Mazerov and Mark Enriquez, "Vast Majority of Large Maryland Corporations are Already Subject to "Combined Reporting" in Other States," Center on Budget and Policy Priorities, November 9, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3317#_edn4.

[11] Elizabeth C. McNichol and Nicholas Johnson, "'Fairtax' Proposals to Replace State Income and Business Taxes with Expanded Sales Tax Would Create Serious Problems," *Center on Budget and Policy Priorities,* September 7, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3285.