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One-Dimensional Reports Overlook Well-Documented Revenue Problem

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Summary

In 2009 and again in July 2011, the Kentucky Chamber of Commerce issued reports suggesting an overly narrow method of addressing Kentucky’s fiscal challenges that would compromise the state’s ability to meet rising public needs and make the investments that would move Kentucky forward. The Chamber’s “Leaky Bucket” reports dismiss well-documented problems with Kentucky’s tax system to focus entirely on reducing the growth in spending. But containing cost growth in particular areas will have limited impact if the pie of available revenue continues to get relatively smaller due to an outdated tax system that cannot keep pace with needs. And while some forms of cost cutting are appropriate, others harm Kentucky’s economy, health and quality of life.

Kentucky’s tax system has well-known structural problems

The Kentucky Chamber of Commerce’s “Leaky Bucket” report states that Kentucky’s persistent revenue shortfalls “have led some people to conclude that revenue collections are not keeping pace with the economy and that Kentucky needs to modernize its tax system to address that situation.”\(^1\) The report dismisses that concern by asserting that state General Fund spending has remained consistent at around five-to-six percent of the economy over the last twenty years. It includes a graph that suggests stability in spending over time, and the graph is repeated in the Chamber’s new report, “Building a Stronger Bucket.”\(^2\)

However, the Chamber’s focus on trends in state spending ignores the troubling trend in state revenue that publicly-available data sources and several previous studies clearly document. Figure 1 shows historic General Fund revenues as a share of the economy measured in two ways—percentage of state personal income and of gross state product. Since 1991, revenue as a share of personal income has dropped from 7.4 percent to 5.8 percent; as a share of gross state product it has fallen from 6.2 percent to 5.2 percent. The graph begins in 1991, immediately after the state passed the Kentucky Education Reform Act alongside increases in the sales tax and corporate income tax to help pay for better schools.

The gap between state spending and revenues, which Kentucky has filled with various one-time monies over the past decade, is a growing problem that the Chamber appropriately criticizes in its new report but without acknowledging the state’s revenue deficiencies.

To put the revenue problem in context: if state revenue in 2010 had simply been the share of the state economy it was in 1991, Kentucky would have between $1.6 billion and $2.3 billion more in 2010. That is more than enough money to completely erase the state’s $780 million 2010 budget shortfall, roll back service cuts enacted over the last few years and more strongly support education, transportation, human services and other investments that address needs and help build the economy.

A number of studies have documented the structural inadequacies in Kentucky’s tax system that prevent revenues from keeping pace with needs. A $2.3 billion shortfall is almost exactly the gap for 2010 that Dr. William Fox predicted nine years ago in a report to the Kentucky legislature.\(^3\) Fox, a University of
Tennessee economist, noted that revenue from 1995 to 2001 grew only about two-thirds as fast as the state’s economy. He wrote that continuation along this path would mean “a huge decline in the Commonwealth’s ability to finance education and infrastructure investments in the future. By 2010, revenues would be more than $2.3 billion short of the demand for public services.”

The Kentucky Long-Term Policy Research Center (KLTPRC) confirmed the long-term trend Fox had identified in a 2010 research brief. The brief calculated the state’s revenue buoyancy, with a score of 1 indicating revenue growth in line with economic growth and a buoyancy of less than 1 suggesting structural inadequacies. For the past 10 years, KLTPRC found that buoyancy ranged from only 0.64 to 0.85 depending on the method used to calculate it. KLTPRC linked Kentucky’s recurring budgetary problems to this gap and stressed the systemic nature of the challenge. The brief notes that “the long-term decline in General Fund revenue buoyancy will likely continue in the absence of revenue modernization.”

**Figure 1: Kentucky General Fund Revenues as Share of Personal Income and Gross State Product**

![Graph](source_url)

Sources: Author’s calculations, Office of the State Budget Director, Bureau of Economic Analysis
Other studies also have highlighted the structural problems with Kentucky’s tax system. A 2002 state report titled “An Assessment of Kentucky’s Fiscal Condition” said that “Kentucky’s tax code is outdated and produces revenue erratically and inadequately. Comprehensive tax reform is needed to keep the situation from getting worse.” A 2003 report, “Securing Kentucky’s Future,” reiterated the case. The need for tax reform to ensure long-term revenue sustainability was also identified in the 1995 Tax Reform Commission convened by Governor Brereton Jones.

Figure 2 compares the growth rate since 1995 of major revenue sources compared to the state economy. All significant sources have grown more slowly than the state economy over this period. Since Fox’s report, the state has made only minor tax changes that have not addressed the system’s fundamental problems, and the economic troubles of recent years have only further reduced the ability of the tax system to keep up with needs.

**Areas of needed reform are widely recognized**

These reports and others also identify clear reasons why Kentucky’s tax system does not allow even steady funding of existing levels of services. They include:

**Sales tax hasn't been updated for today’s economy**

When the state sales tax was initiated in 1960, Kentuckians spent more on goods than services. Today it is the other way around; in 2008, the Kentucky sales tax applied to only 41 percent of purchases compared to 54 percent in 1979. Kentucky taxes 28 of 168 services taxed by at least one state, making...
it one of the states with the fewest services covered. Modernizing the sales tax is a key part of tax reform, and should be accompanied by evaluation of other sales tax exemptions that may not be warranted.

**Almost-flat income tax with too many deductions and exclusions**
Revenue growth in Kentucky’s income tax is limited for two main reasons. First, its rates are almost flat for those with middle incomes and above. Income growth is disproportionately among higher-income people both in Kentucky and in the United States, but Kentucky has never adjusted its income tax brackets and rates to reflect a higher ability to pay at the upper end. Second, the income tax includes a number of significant deductions and exclusions. Unlike 10 states, Kentucky generally follows the federal government in allowing itemized deductions that disproportionately benefit higher-income people. Other big holes exist, like the fact that the first $41,110 in income from private pensions and IRAs is excluded from the income tax regardless of income level, costing Kentucky over $200 million a year.

**Eroding corporate tax with too many loopholes and tax breaks**
Kentucky has yet to adopt a common-sense corporate tax reform that helps stop large multi-state corporations from shifting profits between states to avoid taxation. Half of the states with corporate income taxes mandate “combined reporting,” which requires corporations to calculate all their profits together rather than assigning various amounts to subsidiaries and other entities in order to avoid taxes in particular states. Kentucky also has provided growing amounts of corporate tax incentives, resulting in a significant amount of lost revenue. Such tax breaks are often written into law with the claim that they will bring jobs to Kentucky, but the legislature has no mechanism to regularly evaluate or understand their effectiveness.

**Limitation on property tax growth**
House Bill 44, passed in 1979, limits real property tax revenue growth at the state level to no more than four percent a year (it also applies in a different way to local taxes). When revenue would exceed four percent growth, the property tax rate is automatically lowered. That mechanism has reduced the state real property tax rate from 31.5 cents per $100 in 1979 to 12.2 cents per $100 today, meaning over $400 million in lost revenue. In 2005, the state excluded newly-developed property from the calculation, which somewhat reduces the pressure of House Bill 44 but will not stop the basic downward rate trend in many years.

**If the pie is getting smaller, cost control only goes so far**
The Chamber’s analysis is predicated on the idea that spending growth has been high in certain areas, and that getting that growth under control should be Kentucky’s fiscal priority. But if the revenue pie is getting relatively smaller, controlling cost growth will only go so far. Smart spending is critical to good governing, but must be accompanied by attention to making sure revenues are stable and adequate and can pay for desired services over time. There is no reason why Kentucky cannot pursue both priorities simultaneously.

Cost control must be carefully targeted, however, to focus on improving efficiencies and targeting dollars to their best use. Certain types of cost control can harm Kentuckians through reduced availability and quality of needed public services.

In two of the three issues that the Chamber identifies—public employee health benefits and Medicaid—the cost growth issues relate primarily to larger challenges with the American health care system (and in the case of Medicaid, rising eligibility due to workers losing their jobs in the economic downturn). Health cost growth is not just a problem for the public sector, but for the private sector as well. Private insurance costs have in fact been growing at an even faster rate than Medicaid. The increasing cost of private health insurance in Kentucky has a large and growing impact on state revenue because employer-provided health benefits are exempt from the state income tax. The cost to Kentucky in 2012 is estimated at $579 million, up from an estimated $197 million in 2000. That is growth of 194 percent over that period, which is comparable to the 190 percent growth indicated in the Leaky Bucket report over that period for public employee health care and higher than the 117 percent calculated for Medicaid.
A major challenge of the next generation is to restructure the entire health care system so that it focuses more on wellness, prevention and disease management; coordinates care better; promotes the appropriate use of medical technology; reduces administrative costs; and generally leads to better health outcomes. But such efforts are complex and will take time to identify and implement. Making unreasonable cuts in the meantime for employees or Medicaid recipients simply to save costs in ways that do not improve health would move Kentucky backward, especially for a state with such serious health challenges.

When examining public employee health benefits—as well as pension benefits, which the Chamber adds to its new report—it is important to look at such benefits within the context of overall compensation for public workers. Proposals that significantly reduce public employee health and retirement security and job quality will harm those workers, take resources out of the Kentucky economy, and threaten the ability of the public sector to attract the workforce needed to provide quality services.

The Chamber’s third issue, controlling the growth of prison costs, is important for many reasons. Kentucky locks too many people up for drug and other non-violent offenses, harming the ability of those who have been convicted from getting their lives back on track while also driving up costs to the state. Potential budget savings from these efforts are important but have to be put into context. Actual savings are limited as a share of the state budget in part because resources must be shifted from prisons to probation and parole and to investments like drug treatment. The projected net savings from HB 463—the prison reform bill passed in the 2011 General Assembly—is about 0.2% of the state’s General Fund.\textsuperscript{17} While further reforms will make more savings possible, all corrections expenses add up to only five percent of the state’s General Fund, putting a ceiling on the amount of potential new money for education and other investments from such reforms.

**Mechanisms should strengthen fiscal condition not limit needed investments**

Mechanisms or guidelines related to Kentucky’s budget should have the goal of strengthening Kentucky’s fiscal condition and not arbitrarily limiting needed investments. The Chamber makes solid recommendations about building the state’s rainy day fund and avoiding the use of one-time monies to plug holes in recurring spending. Kentucky’s rainy day fund, which is essentially a savings account to be tapped during bad times, did not have adequate resources going into the recent recession. The state should work toward guidelines that lead to a Rainy Day Fund equal to 15 percent or more of annual spending rather than the five percent outlined in current statutes.

The Chamber’s proposal to limit spending to six percent of the state’s economy is arbitrary and without justification. The rate of health care cost inflation can be moderated but will continue to be a strong pressure on public budgets for the immediate future as society as a whole works on strategies to restructure the system. The desirable size of Kentucky’s budget must be arrived at by understanding Kentucky’s public service needs and the cost of meeting those needs, rather than starting with an arbitrary number. Likewise, the Chamber’s proposal to limit debt service to six percent of the state budget is not accompanied by any analysis. Governments, families, and businesses borrow all the time to make investments that pay off down the road—some of those investments are wise, and some are not. A statement that Kentucky’s borrowing is too high must be based on an analysis of why specific capital investments are unwise.

The experience of limitations shows that if they are written into statute or constitutional amendment they severely limit a state’s ability to adjust to emerging needs or a crisis situation. Colorado’s TABOR provision has forced severe cuts in education and health and led to efforts by businesses and citizens to repeal the mechanism. Because of Colorado’s experience, voters have soundly rejected ballot measures in other states that would put in place similar limits.\textsuperscript{18}

The Chamber’s suggestion that the state prioritize education and economic development over all other areas ignores the range of investments that are important in a modern, complex economy and in a state with many needs. It also overlooks the important link between those other functions and improvements in
Kentucky’s economy and quality of life. Health and human services; libraries; arts and tourism; infrastructure development; assistance to the poor and elderly; protection for children and more are all critically important to moving Kentucky forward. Investment is education is essential, but is linked to a range of other needs.

Conclusion

The Chamber’s “Leaky Bucket” reports have been influential analyses that package state budget issues into a compelling metaphor. But their analysis is flawed and incomplete. By dismissing well-documented problems with Kentucky’s tax system and pinning our future solely on cutting spending the reports provide a one-dimensional and potentially harmful view of the challenges facing Kentucky’s future. It is imperative that Kentucky’s leaders recognize the need to reform our tax system to provide an adequate, sustainable flow of revenues while at the same time making smart decisions about how those dollars are best allocated.

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts 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. Launched in 2011, the Center receives support from foundation grants and individual donors and is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP’s website at www.kypolicy.org.

5 Buoyancy is different from the related concept of elasticity. While elasticity takes into account changes in the tax base or rates, buoyancy looks at the way actual revenues grow in relation to the economy.
14 Because of the depressed housing market of the last few years, House Bill 44 has not forced a decline in the state real property tax rate since 2008. However, declining rates will return once growth in property values recovers.