KCEP
KENTUCKY CENTER for ECONOMIC POLICY

WWW.KYPOLICY.ORG KCEP | 433 CHESTNUT STREET | BEREA, KENTUCKY 40403 | 859-986-2373

June 27, 2012

Kentucky's Income Tax: Protecting and Strengthening a Key to Growth

By Jason Bailey

Summary

The state individual income tax is essential to economic growth and quality of life in Kentucky and should be protected – even strengthened – as part of any tax reform package. It is the largest and most effective tool the state has to generate resources for crucial investments in schools, health care and other key services. It not only provides a huge portion of current revenues but is also more effective than other taxes at generating, over time, the revenues needed to keep pace with Kentucky's needs.

Additionally, the state income tax is the only major tax in Kentucky based on a person's ability to pay. It therefore plays a key role in making the tax system fairer. Claims that income taxes hinder state economic growth are inaccurate; on the contrary, the investments that the income tax makes possible are vital for job creation.

Kentucky should defend its income tax and improve it by closing loopholes, adjusting the brackets and rates to ensure that everyone pays their fair share, and introducing an earned income tax credit.

The Foundation of an Adequate State Budget

Established in 1936, Kentucky's state income tax is the single largest source of revenue for critical public services. In 2011, it raised $3.4 billion, or 39 percent of all receipts in the state's main account, known as the General Fund.[1] That compares to $2.9 billion for the sales and use tax, the second largest source. The income tax makes possible a huge portion of the state's investment in education, health care, human services, public safety, environmental protection and other services.

Almost every state has an income tax because it is critical to balanced, broad-based tax systems that can adequately fund needed services. Forty-one states have income taxes; two others, New Hampshire and Tennessee, tax only investment income. Many of the states without an income tax have unique economic characteristics that allow them to generate significant revenue through other means. Alaska and Wyoming, for instance, depend heavily on natural resource taxes with Alaska getting 77 percent of its state tax revenue from those sources and Wyoming 42 percent.[2] Nevada and Florida rely heavily on revenue from tourism. [3]

States without income taxes also tend to make up for the missing revenue by making other taxes higher. Those states' property taxes are 8 to 12 percent above the national average, and their sales taxes are 18 to 21 percent above the national average.[4] South Dakota, Tennessee and Washington lack an income tax but have very high sales taxes, and New Hampshire has a high property tax.

Because the individual income tax is such a huge funding source for Kentucky–and the state lacks a revenue alternative like Alaska or Florida—cutting or eliminating the tax would require massive increases in other taxes, huge service cuts or some combination of the two to make up for the lost revenue. Simply replacing Kentucky's income tax with a higher sales tax would require raising the sales tax rate to 13

percent or higher from the current 6 percent. The result would be by far the highest sales tax in the country.[5]

Long-Term Revenue Growth from Income Tax Crucial to Sustaining Services

Tax revenue needs to keep up with economic growth (often referred to as being "elastic") in order to maintain current investments in schools, libraries, health departments and other public services in the face of a growing population, inflation and other cost pressures. [6]

State income taxes are essential because they tend to be more effective at producing revenue over the long-term than other major sources. This helps to make up for slower-growing sales taxes and property taxes. According to one analysis by University of Tennessee economists Donald Bruce, William Fox and M.H. Tuttle, "the average long-run elasticity for income taxes is more than double that for sales taxes," meaning that income taxes produce substantially stronger revenue growth than sales taxes relative to growth in the economy over long periods of time.[7]

So any shift away from income taxes and toward sales taxes would limit revenue growth. Bruce and Fox note in a report on Ohio's tax system: "[S]ales tax revenues grow much more slowly than income taxes, meaning that maintaining investments in education and infrastructure is more difficult as sales taxes become more dominant."[8]

Income Tax Improves Fairness Because It Is Based on Ability to Pay

Another important benefit of the state income tax is that it can help make the overall tax system fairer. It is the only major state tax that can be based on a person's ability to pay—meaning it can be designed so that those with higher incomes pay a greater share of their earnings in income taxes than those with lower incomes.

That makes Kentucky's income tax more equitable than its sales tax. The poorest 20 percent of Kentuckians pay, on average, 1.3 percent of their income in state and local income taxes. The highest-earning one percent pay 4.8 percent.[9] Sales and excise taxes have a dramatically different impact. The poorest 20 percent of Kentuckians pay an average of 5.6 percent of their income in sales and excise taxes, while the highest-earning 1 percent pay only 0.9 percent (Figure 1).[10]

Figure 1

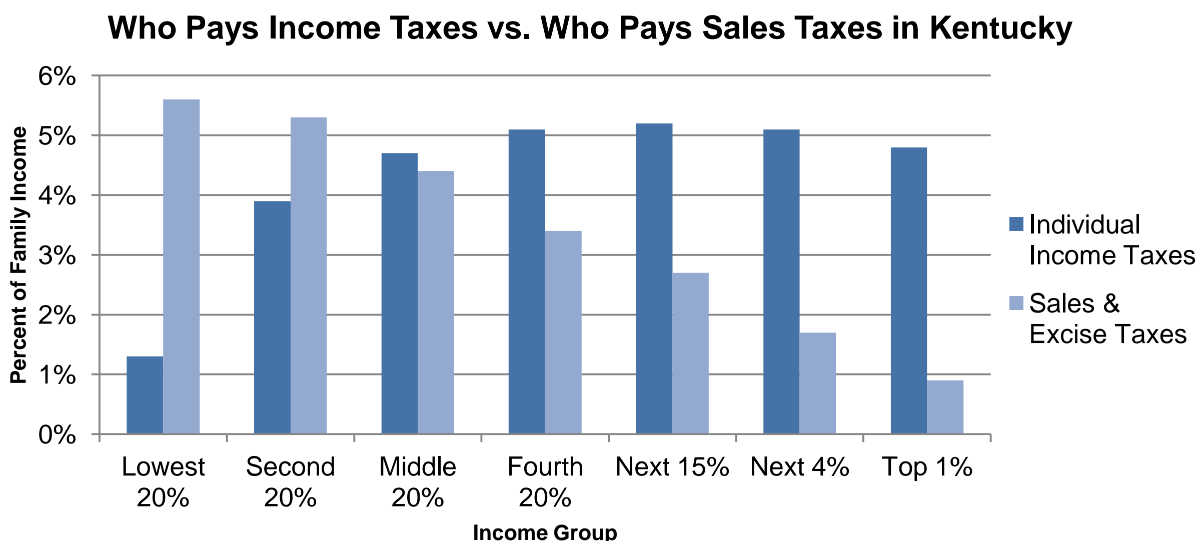


Chart presents individual income taxes and sales & excise taxes as share of family income for non-elderly taxpayers by income groups in Kentucky for 2007, the most recent year for which data are available. Source: Institute on Taxation and Economic Policy.

Moving to a "consumption-based" tax system with a greater reliance on sales taxes would radically shift tax payments away from the wealthiest people to low- and middle-income Kentuckians. That's because lower-income households, out of necessity, spend a greater share of their earnings on goods and services than do higher-income households. One proposal to shift to a consumption-based tax system, introduced in the 2011 Kentucky General Assembly (House Bill 196), would have eliminated the individual and corporate income taxes and expanded the sales tax to almost all types of services. Analysis shows it would have raised taxes for the poorest 60 percent of Kentuckians, left the next-highest 20 percent of earners basically paying what they are now, and cut taxes for the highest-earning 20 percent. The top-earning one percent, who earn more than $323,000 a year, would get an average tax cut of $27,851 under the bill.[11]

Kentucky and Tennessee provide a snapshot of the differences in who pays taxes in a state with an income tax versus one without an income tax. The poorest 20 percent of Kentuckians pay 9.4 percent of their income in all state and local taxes, while the richest one percent pay 6.1 percent. Tennessee's distribution is even less equitable. There, the poorest 20 percent pay 11.7 percent of their income in all state and local taxes while the richest one percent pay only 3.1 percent.[12]

As shown in Figure 1, Kentucky's income tax is almost flat for middle- and high-income people—taxing nearly an equal share of their earnings despite a greater ability to pay among those with high incomes. That's because the state's income brackets and rates have been adjusted only modestly since they were introduced in the 1930s. The only major change occurred in 2005, when people below the poverty line—currently $23,050 in annual income for a family of four—were exempted from the income tax through the use of a credit. The current rate structure is as follows:

First $3,000	2%
$3,001-$4,000	3%
$4,001-$5,000	4%
$5,001-$8,000	5%
$8,001-$75,000	5.8%
Over $75,000	6%

Another way a state income tax can create a fairer tax system is through the use of credits for low-income households, which can offset the impact of other levies, such as the sales tax. A state refundable earned income tax credit (EITC) is a particularly powerful tool to support working families, make the tax system fairer and put more money back into Kentucky's economy (a refundable tax credit means eligible taxpayers can receive a refund when the credit exceeds what they owe in taxes). Twenty-four states and the District of Columbia have earned income tax credits. Since 2005, Kentucky has had a Family Size Credit that eliminates income taxes for families below the poverty line and reduces income taxes for families slightly above the poverty level. But because it is not refundable and does not assist many of the working poor, it is not as helpful to low-income Kentuckians as an EITC.[13]

Tax Flight Is a Myth

A false claim often made about state income taxes is that cutting them attracts large numbers of people and entrepreneurs to a state, while raising income taxes – particularly on the wealthiest households – leads people to move away. In fact, relatively few people *ever* move from one state to another – only 1.7 percent of U.S. residents did so, on average per year, over the past decade. Those that do move are largely motivated by factors other than taxes, like job opportunities, family considerations, housing costs and the weather.[14] While taxes "matter on the margin. . . the magnitude of the impact is not economically meaningful. In other words, state income taxes are not a primary driving force in interstate migration decisions."[15] An important reason that taxes have little impact is that the tax differences between states are small when all forms of taxation are taken into account—particularly compared with other considerations like housing costs.[16]

High-income earners have many reasons that deter them from moving. They are more likely to be:

- Married and have children, and therefore hesitant to move because both spouses often need jobs and because of a desire for a stable environment for children.
- Homeowners, which makes it more costly and time-consuming to move.

- Older, while those most likely to migrate are between the ages of 18 and 24.
- Employed, while the unemployed are four times more likely to move from one state to another.
- In a position of community leadership, which makes them less likely to move and leave civic obligations.

Migration into and out of Florida and California is often incorrectly attributed to taxes. Migration to Florida was high when housing prices there were low in the early-to-mid 2000s, but people began to leave when housing prices increased and the state's economy collapsed. During the recession, more people left Florida than moved there for the first time since World War II. No changes in Florida's taxes over the last decade can explain the population shifts. Similarly, cheaper housing in Arizona was a far bigger factor than taxes in luring thousands of Californians to that state.[17]

The lack of a link between taxes and migration extends to tax preferences for seniors, which some states have created in the hopes of becoming retirement destinations. A recent study found no evidence that such tax preferences induce the elderly to move to a state.[18] Kentucky, however, provides among the biggest state tax breaks for seniors.[19] It exempts the first $41,110 of pension income from state income tax—even for seniors with high incomes. The state also provides a senior property tax homestead exemption regardless of ability to pay, and fully exempts Social Security income from the income tax (15 states partially exempt it).

Cutting or Eliminating the Income Tax Will Not Bring Growth

Proponents of tax cuts sometimes argue that states with high income tax rates have poorer performing economies than states without income taxes. But economic growth is primarily driven by other factors, including a state's ability to educate a skilled workforce, provide reliable infrastructure, and make other needed public investments. An income tax is essential to achieving all of this.

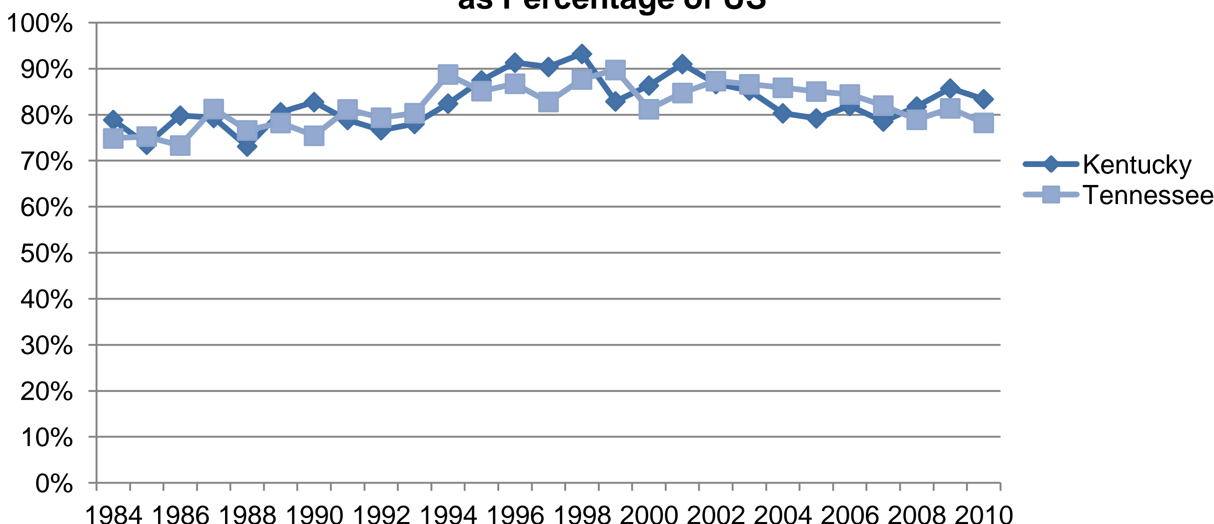
Because Texas lacks an income tax and has had job and population growth in recent years, it is held up as an example by those seeking to cut income taxes. But Texas' growth results from other factors. The Texas economy has benefitted from cheap and abundant land and low housing prices, a location that has led to significant immigration from and trade with Mexico and Central America, and abundant oil and gas resources.[20]

Despite these advantages, Texas has serious problems. Its poverty rate is well above the national average, and it has the highest share of minimum wage workers of any state. One-quarter of Texans lack health insurance, compared to 16 percent of Americans nationally. And Texas ranks 40th among states in per pupil education spending, 40th in highway spending and 41st in health care spending per person.[21] Because it lacks an income tax, Texas is not able to pay for the level of essential public services needed to make progress.

Proponents of cutting Kentucky's income tax often cite the supposedly superior economic performance of Tennessee, which lacks an income tax except on investment income. But the argument fails in the face of statistical comparisons between the two states. In fact, Kentucky and Tennessee are very similar on most economic indicators. In 2010, median family income was 17 percent below the U.S. average in Kentucky and 16 percent below that average in Tennessee. The poverty rate was 19 percent in Kentucky and 18 percent in Tennessee, compared to 15 percent for the nation. The unemployment rate in both states for that year was 11 percent.[22]

Figure 2 shows how median household income as a percentage of US median household income for the two states has not diverged between the mid-1980s and today.

Figure 2



Source: Author's analysis of US Census data from the Current Population Survey as provided by the Economic Policy Institute.

What's more, the lack of an income tax in Tennessee results in low levels of public investment. Tennessee ranks last among states in per capita state and local spending for education, while Kentucky ranks 42nd. Relative to the size of its economy, Tennessee's state and local education spending is 47th, while Kentucky is tied for 15th.[23]

Income Tax Supports a Growing Economy

Tax cut proponents often cite the allegedly poor economic performance of nine "high-rate" income tax states to support their claims. Those states are California, Hawaii, Maine, Maryland, New Jersey, New York, Ohio, Oregon and Vermont. But in fact those nine states have seen higher economic growth per capita over the past decade than the nine states that do not have a broad-based income tax.[24] The worst state for job creation in the country since the recession began is Nevada, which lacks either an individual or a corporate income tax.

North Carolina is an example of a state heavily dependent on an income tax that has generally outperformed other southern states over the last 30 years. While North Carolina still has substantial economic challenges, it performs well on a number of economic indicators, and its top income tax rate of 7.75 percent (compared to 6 percent in Kentucky) has not been a deterrent to the growth of an innovative, entrepreneurial economy, particularly in the Research Triangle area of Raleigh-Durham-Chapel Hill. On the contrary, the investments in higher education made possible by the income tax have made a significant contribution to North Carolina's economic success.

Another substantial economic benefit of state income taxes is their deductibility against federal income taxes, meaning that the federal government helps pick up the tab for these taxes. The Institute on Taxation and Economic Policy (ITEP) estimates that Kentucky residents receive $510 million annually in lower federal taxes because of this deduction.

States like Tennessee that lack broad-based income taxes leave a huge amount of money on the table because the federal deduction for state sales taxes is much smaller (as the high-income people who claim itemized deductions pay less in state sales taxes than they do in income taxes). ITEP estimates that if Tennessee enacted a state income tax and cut the state sales tax in exchange, Tennessee residents would receive a huge federal tax cut: $82 million if Tennessee went with a flat income tax and $338 million if it put in place a graduated income tax.

Sources: ITEP email correspondence; ITEP, "Leaving Money on the Table," http://www.itepnet.org/pdf/leavingmoney.pdf

Research supports the importance of adequate public investment in education and other areas to economic development. In a widely-cited review of the literature, economist Robert Lynch notes that enhancing public services "can be the best way to spur the economy. By stimulating growth, creating jobs, and providing direct benefits to residents, improvements in state and local public services can be one of the most effective strategies to advance the quality of life of citizens."[25] An income tax is needed to make adequate investment possible.

Kentucky Should Strengthen its Income Tax

Kentucky needs stronger growth driven by ample investments in education and other services that promote a dynamic economy. Adequate, reliable revenue is the key to making those investments. Kentucky should maintain the individual income tax as the foundation of the state's tax system and bolster it in several ways:

Eliminate or limit itemized deductions

West Virginia, Indiana and Ohio are among the 10 states that generally do not allow itemized deductions. This approach makes the income tax fairer and simpler. Itemized deductions (including the home mortgage interest deduction) disproportionately benefit higher-income people; many low- and middle-income Kentuckians cannot claim enough deductions to make itemizing their taxes worthwhile. Itemized deductions also drain substantial amounts of revenue.

Repealing itemized deductions in Kentucky (and doubling the state's standard deduction) would provide a tax cut to 43 percent of people while raising an estimated $151 million a year. Such a change would either benefit or have no impact on low- and middle-income Kentuckians, while the highest-earning one percent, those making an average $779,000 a year, would pay only 0.3 percent more of their income in taxes.[26]

Adjust income tax brackets and rates to base them more on ability to pay

Kentucky has made very few changes to its individual income tax brackets since they were put in place in the 1930s. That has resulted in an almost flat tax rate. The top rate is 6 percent, but individuals begin paying at a 5.8 percent rate at only $8,000 of income. The outdated brackets limit the fairness of the overall tax system.

Kentucky should adjust its brackets and rates to better reflect modern income levels and the vast disparities in ability to pay between low- and high-income Kentuckians. Part of this adjustment should include a new bracket for the highest earners, above the current top rate of 6 percent, to help generate needed revenue. The median top income tax rate among states is 6.45 percent and the average is 6.675 percent.[27] As mentioned above, North Carolina's top rate is 7.75 percent, and 13 other states have top rates of 7 percent or higher.[28]

Create a state earned income tax credit (EITC)

The EITC is a powerful, proven tool to fight poverty. It supplements low wages, helps families through hard times and can improve children's prospects of future success.[29] The EITC reaches its maximum benefit for families earning around the minimum wage for the year and phases out for families with income around $45,000 depending on family size. Kentucky could, for example, put in place a refundable state EITC equal to 15 percent of the federal EITC, which 386,000 Kentuckians currently receive. That would mean a maximum state credit of over $700 to a family with two children making $15,000 a year.

An EITC would also help improve the fairness of the overall tax system—and partially mitigate the impact of the state sales tax on low-income families. While Kentucky's existing tax credit for low-income families eliminates income taxes for those below the poverty line, families earning slightly more than that pay some of the highest income taxes in the country. A two-parent family of four with income of only $28,773 pays more in income taxes in Kentucky than any other state.[30]

Phase out the pension exclusion

The exclusion of the first $41,110 of pension income from the individual income tax costs hundreds of millions of dollars in lost revenue.[31] And it is simply not fair that even wealthy individuals receiving pension income can pay no state income taxes while workers earning wages at a job and raising families must pay. Kentucky should phase out this exclusion for higher-income individuals. For each dollar of total income above $41,110, tax filers should lose $1 in the pension exclusion. That would eliminate the exclusion entirely for retirees with total annual income of more than $82,220.

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the Commonwealth. Launched in 2011, the Center is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website at www.kypolicy.org.

---

[1] Kentucky Office of the State Budget Director, "Quarterly Economic and Revenue Report Fourth Quarter Fiscal Year 2011," http://www.osbd.ky.gov/NR/rdonlyres/62222009-0040-4659-8DF9-A74E3B7A3DDF/0/1108_4thQtrRpt2011.pdf.
[2] U. S. Census Bureau, 2011 Annual Survey of State Government Tax Collections, http://www.census.gov/govs/statetax/.
[3] Institute on Taxation and Economic Policy, ""High Rate" Income Tax States Are Outperforming No-Tax States," February 2012, http://www.itepnet.org/pdf/junkeconomics.pdf.
[4] Nicholas Johnson and Erica Williams, "Without a State Income Tax, Other Taxes Are Higher," Center on Budget and Policy Priorities, March 22, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3718.
[5] California has the highest state sales tax rate at 7.25 percent. Federation of Tax Administrators, "State Sales Tax Rates and Food & Drug Exemptions (as of January 1, 2012)," http://www.taxadmin.org/fta/rate/sales.pdf.
[6] Dr. William Fox noted in his 2002 report to the Kentucky legislature that expenditures "can be expected to grow at about the same rate as the economy." William F. Fox, "Report to the Subcommittee on Tax Policy Issues," Committee on Appropriations and Revenue, Kentucky General Assembly, February 27, 2002.
[7] Donald Bruce, William F. Fox and M. H. Tuttle, "Tax Base Elasticities: A Multi-State Analysis of Long-Run and Short-Run Dynamics," *Southern Economic Journal*, 2006. (Bruce, Fox and Tuttle also find that, contrary to common understanding, income tax revenue is not more volatile in the short run than sales tax revenue.) A paper published in *National Tax Journal* also shows that the income tax "has a significantly higher long-run growth rate" than the sales tax: Russell S. Sobel and Randall G. Holcombe, "Measuring the Growth and Variability of Tax Bases Over the Business Cycle," *National Tax Journal*, December 1996. In addition, research on Kentucky has shown that the income tax has performed better than the sales tax. In Fox's 2002 report to the legislature, he reported that for the years 1988-2000 the personal income tax elasticity was 1.48 while the sales tax elasticity for that period was only 0.95. Fox, "Report to the Subcommittee on Tax Policy Issues."
[8] Donald Bruce and William Fox, "Revenue Options for Ohio's Future," Report prepared for the Education Tax Policy Institute, May 13, 2011, http://www.etpi-ohio.org/assets/Ohio-Tax-Structure-022211KEMfinallogo2.pdf. The Institute on Taxation and Economic Policy (ITEP) notes that "in the long run, virtually any income tax, whether flat or graduated, will outperform sales taxes in keeping pace with the cost of funding public investments." ITEP notes that individual income tax revenue grows even stronger when the tax is progressive—meaning that it applies higher rates to higher levels of income.
[9] The share of income paid in individual income taxes falls slightly at the higher end, to 4.8 percent for the highest-earning 1 percent compared to 5.1 percent for the income group immediately below the richest 20 percent. This is largely because high earners are better able to take advantage of itemized deductions. Eliminating deductions is included as a way to strengthen the income tax in the recommendations of this report.
[10] Matthew Gardner, et al., "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, November 18, 2009, http://www.itepnet.org/whopays.htm.
[11] Institute on Taxation and Economic Policy analysis reported in 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, http://www.kypolicy.us/sites/kcep/files/House%20Bill%20196.pdf.
[12] ITEP, "Who Pays?"
[13] Phil Oliff, Chris Mai and Nicholas Johnson, "The Impact of State Income Taxes on Low-Income Families in 2011," Center on Budget and Policy Priorities, April 17, 2012, http://www.cbpp.org/files/4-4-12sfp.pdf.
[14] Migration is also driven by people moving to attend college; to be closer to family members and friends; to serve in the armed forces; because of quality of life, amenities, or lifestyle characteristics of a location; and to leave places hit by natural disasters. Robert Tannenwald, Jon Shure and Nicholas Johnson, "Tax Flight is a Myth: Higher State Taxes Bring More Revenue, Not More Migration," Center on Budget and Policy Priorities, August 4, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3556.
[15] Bruce and Fox, "Revenue Options for Ohio's Future."
[16] Tannenwald, et al., "Tax Flight is a Myth."
[17] Other research has found no conclusive evidence that state income taxes affect the location of the wealthy, and no link between tax progressivity and actual interstate migration rates in the United States. Joel Slemrod and John Bakija, "Do the Rich Flee from High Tax States? Evidence from Federal Estate Tax Returns," Working Paper 10645, National Bureau of Economic Research, July 2004. Andrew Leigh, "Do Redistributive Taxes Reduce Inequality?" *National Tax Journal*, June 2008. A paper about a 2004 tax increase on high earners in New Jersey found virtually the same rate of net out-migration of those high earners affected by the income tax change as those not affected. Cristobal Young and Charles Varner, "Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment," *National Tax Journal*, June 2011.
[18] Karen Smith Conway and Jonathan C. Rork, "No Country for Old Men (or Women)—Do State Tax Policies Drive Away the Elderly?" *National Tax Journal*, June 2012.

[19] Elizabeth McNichol, "Revisiting State Tax Preferences for Seniors," Center on Budget and Policy Priorities, March 6, 2006, http://www.cbpp.org/cms/index.cfm?fa=view&id=149.
[20] Elizabeth McNichol and Nicholas Johnson, "The Texas Economic Model: Hard for Other States to Follow and Not All It Seems," Center on Budget and Policy Priorities, April 3, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3739.
[21] McNichol and Johnson, "The Texas Economic Model."
[22] 2010 American Community Survey 1-Year Estimates, "Selected Economic Characteristics," www.factfinder2.census.gov.
[23] Measures are "Per Capita Expenditures of State and Local Governments for All Education, 2008-09" and "State and Local Government Expenditures for All Education, 2008-09, Per $1,000 of Personal Income in 2009" from Census Bureau. Cited in National Education Association, "Rankings of the States 2011 and Estimates of School Statistics 2012," December 2011, http://www.nea.org/assets/docs/NEA_Rankings_And_Estimates_FINAL_20120209.pdf.
[24] Institute on Taxation and Economic Policy, ""High Rate" Income Tax States Are Outperforming No-Tax States," February 2012.
[25] Robert G. Lynch, "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development," Economic Policy Institute, 2004, http://www.epi.org/publication/books_rethinking_growth/.
[26] Institute on Taxation and Economic Policy, "Kentucky Can Help Balance Its Budget by Reforming Itemized Deductions," August 2010, http://www.itepnet.org/pdf/itemize0810/ky_factsheet.pdf.
[27] Bruce and Fox, "Revenue Options for Ohio's Future."
[28] Federation of Tax Administrators, "State Individual Income Taxes (as of January 1, 2012)," http://www.taxadmin.org/fta/rate/ind_inc.pdf.
[29] Nicholas Johnson and Erica Williams, "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2011," Center on Budget and Policy Priorities, April 18, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3474.
[30] Oliff, Mai and Johnson, "The Impact of State Income Taxes on Low-Income Families."
[31] The state tax expenditure report increased its estimate of the lost revenue from this exclusion to $916 million for 2012. Commonwealth of Kentucky, Tax Expenditure Analysis Fiscal Year 2012-2014, http://www.osbd.ky.gov/NR/rdonlyres/043EF3FC-B7DC-4B30-9204-53D590ECDE1E/0/2012_2014_TaxExpenditure_Doc.pdf.