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Testimony on Local Option Sales Tax
Interim Joint Committee on Local Government
Jason Bailey, Director, Kentucky Center for Economic Policy

Thank you for the opportunity to speak with you today. My name is Jason Bailey and I am director of the Kentucky Center for Economic Policy. The Center is a program of MACED, the Mountain Association for Community Economic Development, and is based in Berea.

My presentation today will cover some of the context and considerations that should be kept in mind as you look at the proposal for a local option sales tax. The context is very important because the notion of a local option sales tax should be judged in light of broader challenges with the state and local tax system. After looking at some of that context, I’ll come back to some specific considerations about the local option sales tax idea.

First I think it’s important to acknowledge that local governments play very important roles in Kentucky. Those roles include public safety (e.g. police, fire, emergency medical services), sanitation, recreation, libraries, public health, transportation, community development, housing, social services and youth services. Local governments need dollars to provide those services. Expectations for local governments have increased at the same time that their resources have been reduced by state and federal budget cuts.

Local governments in Kentucky also face challenges generating the revenues they need. Those challenges include constitutional and statutory limits such as property tax limits, limits on the types of taxes that local governments can levy, and limits on general revenue sharing. Other challenges include the rising role of business tax incentives in Kentucky and their impact on local revenues, the lack of a commercial and business base in some localities to make occupational and sales taxes very viable, as well as the loss of local taxes due to industry declines—such as the decline in coal severance tax revenue and its impact on localities that are dependent on those resources.

One issue that I specifically want to spend a little time on is the property tax. Historically, the property tax is a key source of revenue for local governments and is also a universal source that all localities in Kentucky—urban, rural and small town—depend on. Kentucky is much less reliant on property taxes than elsewhere in the country. Our property taxes as a share of our economy are 42 percent lower than the U.S. average. Kentucky ranks 45th among the states in property taxes as a percentage of state personal income.

House Bill 44, which the legislature passed in 1979, plays a big role in that. HB 44 generally limits property tax revenue growth to 4 percent per year. Although it is not a hard limit at the local level like it is at the state level (surpassing the 4 percent mark triggers a possible voter recall at the local level), it has often been treated as such by local governments. That has led to declining property tax rates for many localities over the years. There are other factors as well, including limits on the local taxation of tangible personal property due to constitutional and statutory exemptions. Also playing a role is the homestead exemption, which allows households with residents over 65, or with a disability, to exclude $36,000 (adjusted annually with inflation) from the value of their homes for the purpose of real property taxes. As the baby boomers age in the coming years—with the share of Kentucky’s population over age 65 expected to grow from 13 percent to 20 percent by 2030—the homestead exemption will have a growing effect.
The impact of declining real property tax rates, driven in large part by House Bill 44, can be seen by looking at Metro Louisville. Since 1978, Louisville’s real property tax rate has declined 35 percent and the county-wide rate has declined 42 percent. How big a decline is that? If Louisville/Jefferson County had simply maintained its real property tax rates over the years—if it had simply avoided cutting taxes—it would be generating in the vicinity of $60-$70 million more dollars a year for its General Fund—a good portion of what a 1 percent local option sales tax would generate.

So, I think we need to look at this new proposal for local revenue within the context of the existing local revenue options and what is happening to them. It’s important to consider a proposal for a new law to permit a new revenue source in light of the fact that an existing state law is helping limit an existing revenue source. This issue should be looked at comprehensively.

Business tax incentives are another growing, but largely hidden, local revenue challenge. The state’s tax incentive programs have grown over the years, and many of them include a component in which local taxes are abated for new companies, or the revenues are diverted to the company. For example, the state’s Kentucky Business Incentive program, created in the 2009 special session, includes a diversion of a 1 percent occupational tax from the locality to the company receiving the incentives. We’ve also seen growing use of tax increment financing at the local level, which diverts property, occupational and other taxes away from a city and toward paying back initial private investment in a project.

We don’t have good disclosure and reporting at the local level of the impact on revenue of awarding these incentives. Yet, if you look at the state’s database where disclosure is better, there are, for example, 126 companies in Jefferson County that have received state tax incentives, many of which have a local component. But we don’t have a good sense of the resulting revenue impact.

This should be a concern especially because there is a growing body of literature questioning the cost-effectiveness of business tax incentives. A study by Anderson Economic Group that the legislature commissioned in 2011 did not find evidence that the state’s business tax incentive programs are a cost-effective way to create jobs. Other studies like one done by the University of Kentucky’s Center for Business and Economic Research several years ago came to similar conclusions.

Turning back to the sales tax: there are a number of sales tax-specific challenges that need to be kept in mind. The first is that the sales tax is a regressive tax, meaning it takes up a greater share of income for low-income people than it does for high-income people. This is true even though Kentucky exempts food for home consumption, prescription drugs and utilities from the tax.

This is a graph from a study by the Institute on Taxation and Economic Policy (ITEP) that shows sales and excise taxes as a share of income in Kentucky by income group. As you can see, low-income Kentuckians are paying 2 to 5 times more in sales and excise taxes as a share of income than are the highest-earned 20 percent of Kentuckians. This can be contrasted with income taxes, where those with a greater ability to pay in Kentucky are paying more in income taxes as a percentage of their income than are the poor.

The role of the sales tax is a big reason why ITEP shows that Kentucky has a somewhat regressive tax system overall. Moderate and middle-income people pay a higher share of their income in state and local taxes than do those with high incomes. Any decision about tax policy has to take the distribution of taxes into account, especially given the growing inequality in our localities, state and nation.

If you look over the last four decades, the poorest 20 percent of Kentuckians have seen their real household income fall nearly 12 percent, while the richest 20 percent have seen their real household incomes rise over 60 percent. That divergence affects people’s ability to pay.

Other challenges with local option sales taxes include:
Sales taxes are generally not deductible against federal income taxes, like occupational taxes and property taxes. For many middle- and upper-income people, 25 percent to 39 percent of the local occupational and property taxes they pay come back to them in lower federal income taxes. That’s a huge federal subsidy of local occupational and property taxes that is not present in sales taxes.

Sales tax revenue growth is limited because the tax is not modernized. This is an important issue regarding the sustainability of the sales tax revenue stream that I’ll get back to momentarily.

Local sales taxes would result in a loss of state sales tax revenue because of border and consumption effects. The Governor’s Blue Ribbon Commission on Tax Reform estimated a $10 million loss in state sales tax revenue from the adoption of local general sales taxes. How much the loss would actually be depends, in part, on how many localities adopt the tax.

Local sales taxes are not a solution for localities without a sufficient commercial base. As a revenue source, a local option sales tax benefits localities in Kentucky much differently. It is not a sufficient solution for all localities struggling to pay for needed services.

Earmarking revenue from the local option sales tax for specific projects is problematic. The local option sales tax as proposed here is a temporary tax to be used for specific capital projects. However, such a structure privileges capital investments over operating programs, even if capital investments are not what’s most needed in a locality. Earmarking also provides less flexibility when there is a pressing need. According to a recent University of Louisville Urban Studies Institute report, 15 of 23 states surveyed by the report’s authors that have local option sales taxes use the monies for the General Fund rather than earmark it for a specific project.

The erosion of Kentucky’s sales tax base is a particularly important concern. Sales tax revenues are declining as a share of state personal income. A big reason is that we’re among the states with the fewest services in our sales tax base; Kentucky taxes only 28 of 168 services taxed in at least one state. Yet, services make up a growing share of the economy. In addition, Congress’ failure to pass the Marketplace Fairness Act (which would allow states to fully collect sales and use taxes due on internet purchases) harms revenue. Kentucky’s sales tax revenue has actually declined in three of the last five years, with the weak economy also playing a role.

There must be context for a decision about a local option sales tax. When the Governor’s Blue Ribbon Commission on Tax Reform considered this issue, it did so only within the context of comprehensive state tax reform that would include, among other things:

- Sales tax modernization to include more services in the sales tax base;
- A 15 percent refundable state earned income tax credit to better address the state’s tax fairness issue;
- Elimination of the recall option if local property tax rates exceed 4 percent growth in a year.

A second critical context issue is that a local sales tax cannot be used as part of a tax swap or include a tax offset—it cannot be put in place at the same time a locality lowers or cuts an existing tax, like the occupational tax, net profits tax or property tax. Because the sales tax is a regressive tax, such a swap would simply shift tax responsibility away from those most able to pay over to those least able to pay.

I’ll close with a few final considerations:

As a state, we need to take a comprehensive view of our revenue challenges. Kentucky seriously needs tax reform that encompasses both the state and the local revenue system, with the goal of making sure we have the revenue needed to make the crucial investments that would move Kentucky forward. Particularly given the recent work of the tax reform commission, it’s important not to take a piecemeal approach but to grapple with the broader set of reforms that will work for the long haul.
Tax fairness and revenue sustainability must be part of the conversation. Equity in who pays taxes and elasticity in revenue growth over time were two critical principles of the tax reform commission. They should be upheld in the legislature’s consideration of tax options.

Addressing the decline in property taxes must be part of the local revenue discussion. Besides eliminating the recall provision as recommended by the tax reform commission, Kentucky should look at joining 18 other states in creating a property tax circuit breaker. In those states, if property taxes exceed a certain percentage of a household’s income, they receive a credit on their income tax. That assures that low-income people and those on fixed incomes are able to afford their property tax bills at the same time that we look at the property tax as a stronger tool for sustaining local public investment. The state should look at possibly replacing the existing age-based homestead exemption with such a circuit breaker, while maintaining it for those with disabilities.

Create greater scrutiny and disclosure of business tax incentives. Corporate tax breaks at the local level are growing due largely to changes in state law, but we don’t have a good sense of their impact on local revenues. Greater scrutiny and disclosure of lost revenues from business tax incentives would help create a much-needed public conversation of whether those programs are worth what we spend on them.

That concludes my presentation. Thank you for the opportunity to speak.