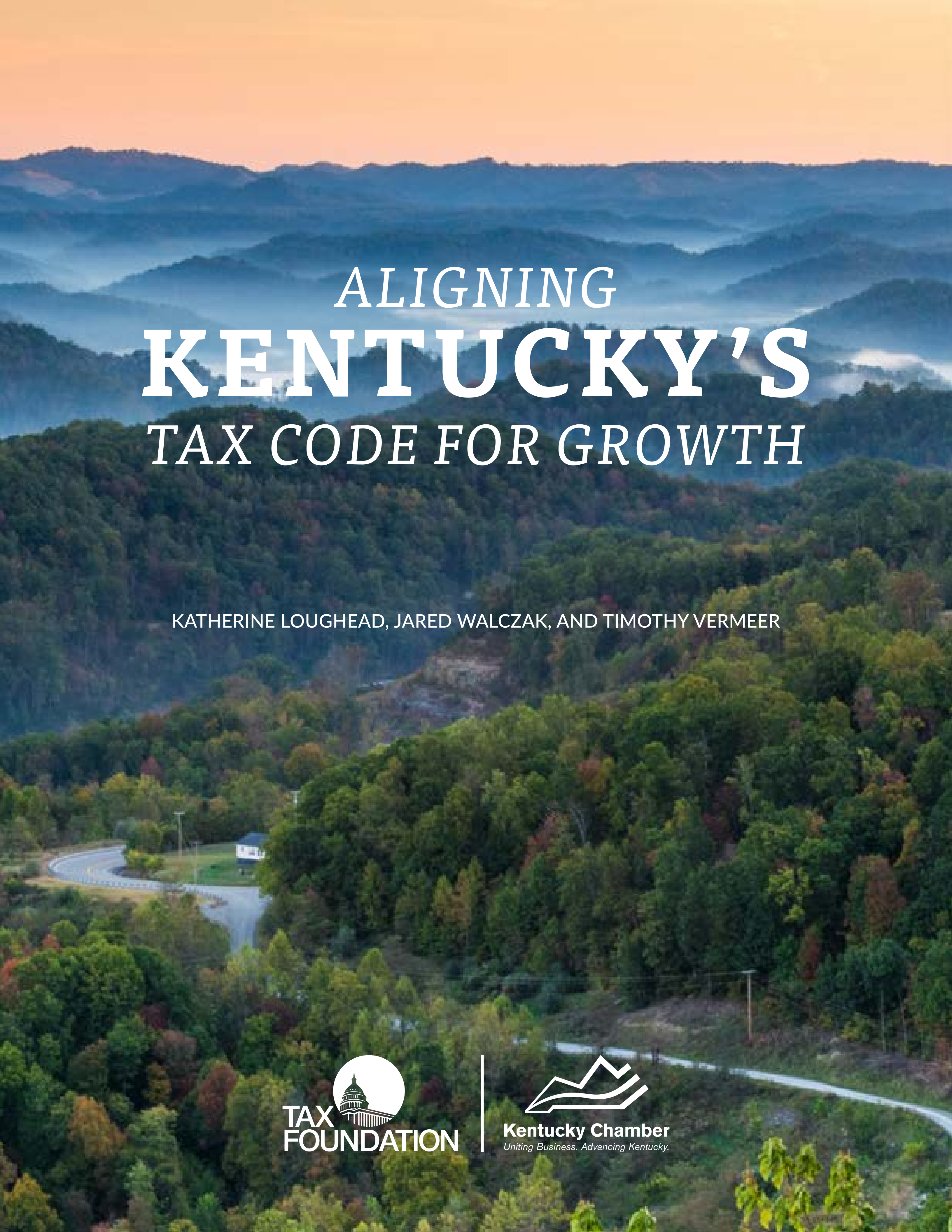

# *ALIGNING* **KENTUCKY'S** *TAX CODE FOR GROWTH*

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Kentucky Chamber
Uniting Business. Advancing Kentucky.

This report was researched, written, and produced independently by the Tax Foundation and was supported by a grant from the Kentucky Chamber of Commerce.

# EXECUTIVE SUMMARY

## Overview

Tax reform has been on Kentucky lawmakers' minds for years, and while significant progress has been made recently, substantial work remains to be done. In 2018, the General Assembly made important strides in creating a more neutral, pro-growth tax structure even while generating a net increase in revenue. With its reduction in income tax rates, consolidation of brackets, and modest sales tax base broadening, Kentucky put itself on the map as a state that is serious about reorienting its tax structure to enhance productivity and promote economic growth.

Much has changed in the world since 2018, with taxpayers and governments everywhere confronting new challenges on top of the old ones. There's more motivation than ever to remove barriers that for too long have stood in the way of individuals' and communities' ability to thrive.

Kentucky's challenges are many—the state continues to lag the national average in terms of personal income growth, gross state product growth, and state inbound migration—but the Commonwealth's opportunities are greater. In this new era of increased workplace flexibility, where many people are leaving high-tax, high cost-of-living states in favor of more affordable alternatives, Kentucky holds a competitive advantage.

Many similarly situated states are seizing opportunities to make their states more attractive to individuals and businesses alike, and pro-growth tax reforms have been central to those efforts. In 2021 alone, 12 states enacted laws reducing their income tax rates, with more expected in 2022.

Kentucky is projected to experience robust revenue growth over the next few years, presenting a valuable opportunity for policymakers to pursue reforms. Ultimately, the goal of tax reform should be to enable the state and local governments to raise sufficient revenue to fund government services in a manner that avoids hindering business productivity, job growth, and personal wage growth.

In the pages that follow, we identify numerous structural deficiencies in Kentucky's tax code and outline a series of reform solutions. Several of these reform solutions could be implemented on their own because their revenue impacts would be minimal, while others would be possible through revenue triggers that tie future reforms to future growth, and still others could be accomplished through tax swaps that reduce reliance on economically harmful taxes by increasing reliance on less harmful alternatives. (Pay-fors, where appropriate, are discussed throughout the publication.) All of these reforms—whether taken a few at a time or more comprehensively—would make the state's tax code more structurally sound and more conductive to fostering long-term economic growth.

## Menu of Tax Reform Solutions

### *Business Taxes*

Kentucky has relatively well-structured and competitive corporate and individual income taxes at the state level but is held back by substantial taxes on business and personal productivity at the local level, as well as a complex state gross receipts tax on limited liability businesses. Kentucky also has room for improvement in its treatment of business investments and in its heavy reliance on incentives that add complexity to the tax code. The following recommendations would create a more competitive environment for businesses and encourage long-term investment in Kentucky.

- **Repeal the Limited Liability Entity Tax (LLET)**, imposed on C corporations and limited liability pass-through entities based on gross receipts, thus burdening startups, low-margin businesses, and companies experiencing losses.

- **Reduce the corporate income tax rate**, particularly given the continued existence of local net profit taxes which raise the overall burden of this harmful tax well above the 5 percent state rate.

- **Improve treatment of business capital investments**, raising the Section 179 expensing allowance for small businesses and offering permanent full expensing like that available under IRC Section 168(k) to reduce the tax code's bias against investments in machinery and equipment.

- **Evaluate and streamline incentives**, empowering the Legislative Research Commission to evaluate the economic impact of these incentives and convening a commission or committee to study the LRC's findings.

- **Use revenue triggers to phase in reforms**, ensuring revenue stability and reducing uncertainty while phasing in rate relief or pro-growth structural reforms.

### *Individual Taxes and Municipal Income Taxation*

In 2018, the General Assembly significantly improved the individual income tax by consolidating six brackets into one and reducing the rate, using modest sales tax base broadening as an offset. While these reforms significantly improved the Commonwealth's competitiveness and mitigated its overreliance on income taxes, there remains work to be done. Over the past two decades, Kentucky has lagged its competitors in terms of growth in gross state product, personal income, and inbound migration. States with no or low income taxes perform well on these metrics, and other states are increasingly taking notice and reducing taxes on productivity as a way to improve their competitive standing in an increasingly mobile economy.

- **Pay down individual income tax rate reductions with sales tax modernization**, creating a more stable and pro-growth tax system.

- **Shift from local income taxes**, granting localities the authority to levy less harmful taxes in lieu of occupational license and net profit taxes, which are uncommon elsewhere.

- **Shift to single sales factor apportionment of local net profit taxes**, ensuring that local taxation aligns with state-level apportionment.

### *Sales and Use Taxes*

Kentucky has one of the lower sales tax rates in the country and is among a minority of states prohibiting local governments from using a sales tax as part of their revenue toolkit. Kentucky's under-reliance on sales taxes leaves state and local governments turning to more economically harmful alternatives. In addition, despite valuable reforms undertaken in 2018, the sales tax base still falls short of capturing modern personal consumption patterns. If policymakers are to pursue comprehensive tax reform that rebalances Kentucky's revenue sources toward growth, sales tax modernization is a critical piece of that puzzle.

- **Modernize the sales tax base**, capturing more final consumption to generate additional revenue that can be used to reduce reliance on more economically harmful taxes.

- **Allow a local option sales tax**, permitting municipalities to levy sales taxes in lieu of more economically harmful taxes, including net profit and occupational license taxes on business and personal income, inventory, and other taxes on tangible personal property.

- **Consider raising the state sales tax rate**, using rate increases to offset income tax rate reductions that would yield a highly competitive income tax environment while keeping Kentucky's sales tax in line with, or more competitive than, regional peers.

### *Property and Inheritance Taxes*

Kentucky is one of a few states that uses property taxes as both a local and state revenue source, but the Commonwealth's real property tax collections are quite modest, due in large part to rate and levy limits that have been in place for decades. However, taxes on business inventory, machinery, and equipment, as well as inheritance taxes on individuals, introduce complexity and economic distortions into the property tax code. Kentucky has an opportunity to rebalance its revenue sources away from economically distortive taxes on tangible property and toward far less economically harmful taxes on real property.

- **Repeal the inventory tax or improve the inventory tax credit**, ensuring that a 2018 policy intended to blunt the impact of the inventory tax actually provides relief for business taxpayers.

- **Create a *de minimis* exemption for tangible personal property (TPP) taxes**, eliminating compliance costs for businesses with minimal liability.

- **Modify the local property tax recall provision**, replacing it with a more straightforward system of voter ratification of increases above the cap.
- **Permit one-time property tax rate adjustment in excess of limits to rebalance local tax bases**, should an effort be made to shift local governments away from municipal income taxation.
- **Raise the state real property tax rate to offset income tax rate reductions**, providing a stable source of revenue that could be used to yield highly competitive income tax rates even as combined property tax burdens remain at or below national averages.
- **Repeal the inheritance tax**, an outlier tax (only six states tax inheritances) which drives people out of Kentucky while generating only $48 million in revenue in FY 2020.

### *Other Taxes*

While it is understandable that Kentucky's largest sources of state and local tax revenue—income, sales, and property taxes, respectively—have been the primary focus of public discourse, other taxes have important fiscal and economic implications and deserve policymakers' attention. Kentucky's gas tax—a critical source of revenue for the Road Fund—has been raised infrequently, has failed to keep up with inflation, and has lost much of its purchasing power over time. Likewise, the unemployment insurance (UI) tax, which is paid by businesses and funds Kentucky's unemployment compensation (UC) trust fund, has numerous structural deficiencies that ought to be reexamined.

- **Reform the gas tax** by converting from a variable-rate to a specific tax, raising the gas tax rate, and indexing it for inflation to ensure that it remains a viable revenue stream for transportation expenditures going forward.
- **Use federal funds to replenish the UC trust fund**, beginning to build up a fund that has been insolvent for decades.
- **Charge employers UI tax according to base period wages**, to avoid disincentivizing the hiring of laid off workers.
- **Further reform UI taxes by shortening experience rating qualifying periods and repealing the solvency tax and administrative surtax,** allowing businesses to more quickly earn the lower tax rates associated with keeping layoffs to a minimum and reducing the degree to which UI taxes rise when they are likely to have the most adverse effect.

# INTRODUCTION

In 2018, Kentucky adopted substantial revenue-positive tax reforms over a gubernatorial veto, pairing a need for additional revenue with a desire to improve the efficiency and simplicity of the state's tax code. These efforts were not without controversy, as they paired structural changes—sufficiently noteworthy in their own right—with an overall increase in collections, which never goes unremarked. But policymakers handled the situation well: if it was necessary to raise taxes, they were prudent to insist that the tax code be modernized and improved at the same time.

Today, tax collections are more than 14 percent higher than they were before the 2018 reforms, in real (inflation-adjusted) terms, growing particularly robustly in FY 2021, when they rose over 9 percent year-over-year even after accounting for above-average inflation.[1] Unlike a few years ago, the Commonwealth's financial condition is strong.

The whole world has changed since Kentucky adopted those reforms, and while the tragedy and devastation wrought by a global pandemic cannot be minimized, the opportunities arising from the nation's forced experiment with remote work are good news for states like Kentucky, which boast a lower cost of living than the high-tax, high-cost environments that many individuals and businesses are fleeing in an era of greater workplace flexibility. Kentucky has an opportunity to capitalize on this development, embracing tax competition and aggressively positioning the entire Commonwealth as an enticing place to start, expand, or relocate a business, and an attractive place to call home.

There is a cost to standing still. Kentucky's population growth has been stagnant, increasing at less than two-thirds the national average over the past two decades. Like many states, Kentucky has acutely felt the "brain drain" of top graduates earning a degree in the state's educational institutions, then taking their talents elsewhere. Kentucky has to compete with neighboring Tennessee, which forgoes an individual income tax, and nearby North Carolina, with its highly competitive tax environment and booming Research Triangle.

Further afield, states like Texas attract innovators and their investments. In this highly competitive landscape, personal income in Kentucky has grown 6 percent slower than the national average over the past two decades, and substantially slower than some of its most prominent peers, like Tennessee (8 percent), North Carolina (13 percent), or Texas (21 percent). This represents a combination of lower income and population growth in the Commonwealth compared to competitor states. Neighboring Indiana is also growing at a faster rate than Kentucky now, following a series of tax reform efforts in the early years of the last decade. Had Kentucky's personal income grown at Texas rates since 2001, it would be $55 billion per year higher than it is today, or $19 billion higher under Tennessee's rate of income growth.[2]

1 U.S. Census Bureau, "Quarterly Summary of State & Local Tax Revenue (QTAX)," https://www.census.gov/programs-surveys/qtax.html.

2 U.S. Bureau of Economic Analysis, "Regional Data: GDP and Personal Income Data," https://apps.bea.gov/itable/iTable.cfm?ReqID=70&step=1; U.S. Census Bureau, "Annual Survey of State and Local Government Finances," https://www.census.gov/programs-surveys/gov-finances.html; Tax Foundation calculations.

State policymakers want Kentucky to stand out like these highly competitive peers. They want to better position the state to attract and retain businesses—and particularly to become a more popular location for corporate headquarters. They want to capitalize on the new reality of a more mobile workforce that no longer feels the pull of coastal cities and great metropolises quite so strongly. Policymakers understand the importance of economic diversification, and that while the tax code cannot yield that diversification on its own, it can be improved to eliminate impediments to economic growth.

The economy is changing. Today, the aerospace and agritech industries are a vital part of Kentucky's economy. The Commonwealth's bourbon and horse racing industries continue to generate income and attract visitors. But other industries, like coal, are in decline, and the next great industry—or, better, industries—for Kentucky may have yet to be identified.

Businesses and individuals need a simple, predictable, pro-growth tax code. Government officials value stability. Everyone benefits from a tax code that is nimble enough to respond to—rather than dictate or impede—economic transformation. But Kentucky's tax code remains outdated and unnecessarily complex, relying on a multitude of uncompetitive revenue sources and hindering economic growth by imposing above-average combined state and local individual income tax burdens. In this publication, we explore several options for Kentucky officials who wish to capitalize on the present opportunity to better position the Commonwealth for a fast-changing world.

From reforming or even eliminating some of the deadwood in the state's tax code, like inventory and gross receipts taxes, to turning around one of the nation's worst and least dependable unemployment insurance tax regimes, to beginning to grapple with Kentucky's outlier status in municipal taxation, to shoring up transportation revenues, to ensuring that state tax rates remain competitive as other states implement their own reforms, this publication seeks to inform deliberations in Frankfort and across the state. It provides a menu of options, some of which can be selected *a la carte* and others which benefit from being considered comprehensively, all designed to enhance the Commonwealth's competitive standing and flip the conversation, so that lawmakers elsewhere are asking how they can keep up with Kentucky.

Where appropriate, we indicate how Kentucky would fare on our *State Business Tax Climate Index* were certain reforms implemented.[3] The *Index*, published every year, is a measure of state tax structure—the *how*, not the *how much*. Kentucky ranks 19th overall in the 2021 edition of the *Index*, substantially improved from its rank prior to the 2018 reforms. Since many states adopt changes to their tax code each year, it is difficult to predict how Kentucky will rank in a future year. Instead, however, we can project how Kentucky *would have* ranked for 2021 if certain proposed reforms had been in effect.

Many of the reforms proposed in this publication provide Kentucky a place in the top one-third of states, and some combinations of reforms could place the Commonwealth in the top 10. Such improvement would not just be numbers in a report; it would reflect an embrace of a more competitive, pro-growth environment that lets individuals and businesses alike flourish in Kentucky.

3 Jared Walczak and Janelle Cammenga, *2021 State Business Tax Climate Index*, Tax Foundation, Oct. 21, 2020, https://www.taxfoundation.org/2021-state-business-tax-climate-index/.

# BUSINESS TAXES

Kentucky imposes a flat state corporate income tax at a rate of 5 percent that matches the individual income tax rate imposed on pass-through businesses. While the 5 percent state income tax rates paid by corporations and pass-through businesses are competitive, state income taxes are just one of several income-related taxes businesses pay. They are often also responsible for local business income taxes, commonly called net profit taxes or net profit license fees, which significantly add to their overall tax burden. In addition, businesses face a gross receipts-based minimum tax, the Limited Liability Entity Tax (LLET), which can create meaningful tax burdens for businesses with low margins or which experience losses.

While Kentucky's corporate income tax avoids harmful features that are present in some states, like throwback and throwout rules that add complexity and expose more income to taxation, Kentucky has room for improvement in its treatment of business capital investments, as the state's expensing provisions—for both C corporations and pass-through businesses—are less generous than those offered by the federal government and many other states. Additionally, Kentucky relies heavily on corporate tax incentives that, while well-intended, provide relief to some firms while leaving others on the hook to bear a heavier burden. Streamlining some of these incentives would free up revenue that could instead be used to offer full expensing or reduce the corporate income tax rate for all firms.

Revenue triggers are a tried and tested option for returning a share of future revenue growth to taxpayers in the form of rate reductions or other reforms. The case for triggers, and considerations for their design, are considered here, though they could be applicable to a range of taxes, including both corporate and individual income taxes. Conversely, municipal income taxation, though applicable to businesses and individuals, is discussed in the individual income tax section.

## Corporate Income Tax

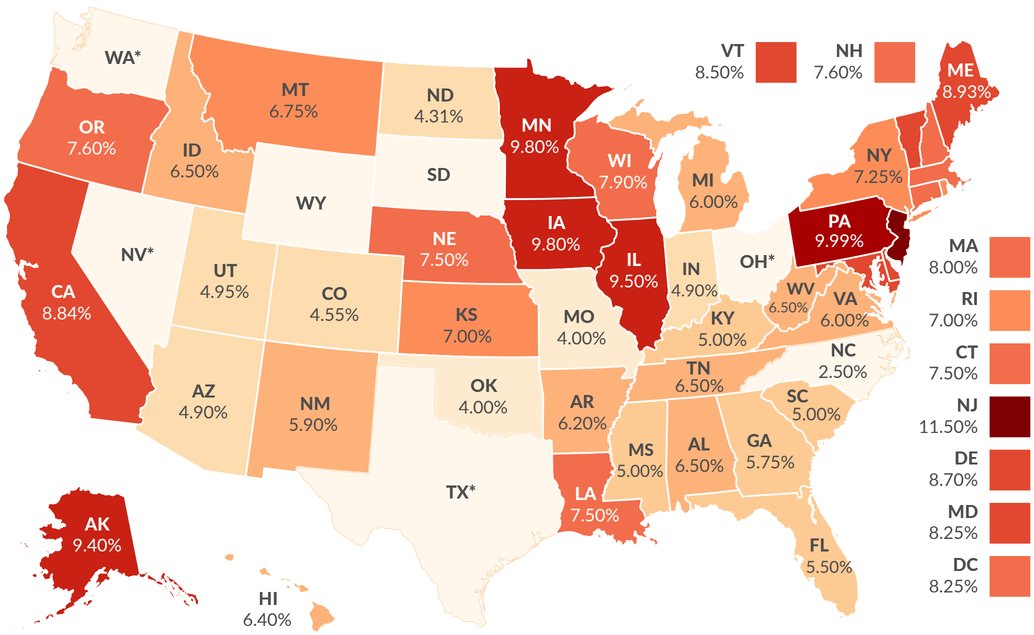
Kentucky's flat state corporate income tax rate of 5 percent is significantly lower than the national median rate of 6.925 percent, among states with corporate income taxes. Among Kentucky's bordering states, only Missouri has a lower state corporate income tax rate.

Likewise, Kentucky's corporate income tax collections per capita are below the national average. In FY 2019, Kentucky brought in $130 in state corporate income tax collections per capita, below the national average of $147.[4] Even when state and local corporate income tax collections are combined, accounting for local net profit taxes, Kentucky's $172 in collections per capita are below the national average of $200. Prior to the 2018 reforms that consolidated three state corporate income tax brackets into one and reduced the rate to 5 percent, Kentucky's corporate income tax collections per capita were higher, hovering closer to the national average. Compared to many alternative revenue sources, corporate income taxes are especially harmful to a state's economy. While the legal incidence of the corporate income tax falls on corporations, the economic incidence of the tax falls on a firm's employees, shareholders, and consumers in the form of lower wages, lower dividends or share values, and higher retail prices on goods and services sold.

4 U.S. Census Bureau, "Annual Survey of State and Local Government Finances (FY 2019)," https://www.census.gov/programs-surveys/gov-finances.html.

**FIGURE 1.**

## Top Marginal State Corporate Income Tax Rates (as of January 1, 2022)




Note: In addition to regular income taxes, many states impose other taxes on corporations such as gross receipts taxes and capital stock taxes. Some states also impose an alternative minimum tax and special rates on financial institutions.
(*) Nevada, Ohio, Texas, and Washington do not have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. Delaware, Tennessee, and Oregon have gross receipts taxes in addition to corporate income taxes, as do several states like Pennsylvania, Virginia, and West Virginia, which permit gross receipts taxes at the local (but not state) level.
Georgia's corporate income tax rate will revert to 6% on January 1, 2026.
Illinois' rate includes two separate corporate income taxes, one at a 7% rate and one at a 2.5% rate.
In New Jersey, the rates indicated apply to a corporation's entire net income rather than just income over the threshold. A temporary and retroactive surcharge is in effect from 2020 to 2023, bringing the rate to 11.5% for businesses with income over $1 million.
Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.

Top State Marginal Corporate Income Tax Rates as of January 1, 2022

Lower Higher

In a series of Organisation for Economic Co-operation and Development (OECD) working papers, OECD-affiliated economists concluded that corporate income taxes are the most harmful to economic growth, followed by individual income taxes, while consumption and property taxes are less economically damaging.[5] In a study of state tax sources and their impacts on employment, Harden and Hoyt (2002) found that among the taxes levied by state and local governments, the corporate income tax has the most significant negative impact on the rate of growth in employment.[6]

In 2021, six states—Idaho, Louisiana, Nebraska, New Hampshire, North Carolina, and Oklahoma—enacted laws to reduce their corporate income tax rates, making their business tax landscapes that much more competitive, a trend that is expected to continue.

## Treatment of Business Capital Investments

The corporate income tax is meant to be a tax on net income, or corporate revenues less the costs of doing business. Similarly, the individual income tax falls on profits (in addition to any wage income) distributed to the owners of pass-through businesses, after business expenses. In practice, however, when businesses make capital investments in machinery, equipment, and other assets, the Kentucky tax code requires them to deduct most of those costs over time according to a depreciation schedule

5 Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, "Tax and Economic Growth," OECD Economics Department Working Papers No. 620, 2008; Jens Arnold, "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries," OECD Economics Department Working Papers No. 643, 2008.

6 J. William Harden and William H. Hoyt, "Do States Choose their Mix of Taxes to Minimize Employment Losses?" *National Tax Journal* 56 (March 2003): 7-26.

rather than deducting them in the year the costs are incurred. As a result, companies are forced to defer deductions for completed business expenditures into future years, effectively making a zero-interest loan to the government. A better system would permit full expensing, allowing businesses to write off the full cost of capital investment immediately in the year in which the expense is incurred. Full expensing was a historic practice until the need for accelerated revenue during World War II brought about expensing according to depreciation schedules.[7]

Depreciation is an accounting practice, not an economic principle. A bookkeeper records an expense in one column and the value of the acquired asset in another, then depreciates the new equipment over its expected life to better capture the real state of a company's assets, liquid and illiquid. The expense, however, is fully realized in the year of purchase. Spreading out business expenses over many years artificially increases the cost of equipment by overstating business income early, accelerating a business's tax liability long before the value of the investment can be realized.[8]

### *Section 179*

Section 179 of the Internal Revenue Code serves as an important stopgap for small businesses by somewhat bridging the gap between accounting practices and actual business expenses. Under the federal provision, businesses may deduct up to $1.05 million on their first $2.62 million in qualified investments bought and placed in service in the year those expenses are incurred. These amounts are adjusted annually for inflation each year.[9]

The deduction is available for both pass-throughs and C corporations, limited not by their organizational form but by the amount of their investment. For businesses with more than $2.62 million in qualified investments, the $1.05 million deduction phases out dollar-for-dollar. This means that a business with $3 million in capital investment expenditures in 2021 would be able to deduct $680,000 of those expenses under Section 179, and a business with $3.67 million or more in qualified investments in 2021 would not be eligible to claim the Section 179 deduction at all.

While the tax code would ideally allow immediate full expensing of all capital investments without limit, Section 179 is an important provision that encourages capital investment and promotes economic growth by allowing immediate expensing of some investments. All states conform to the federal Section 179 provision in some capacity, but some do so more generously than others. Kentucky's provision allows only the first $100,000 in expenses to be deducted in the year they are incurred. As of 2020, however, a notable bright spot in Kentucky's provision is that the state does not conform to the federal phaseout threshold. (Before 2020, in fact, Kentucky only permitted a $25,000 deduction, with phaseout.) As such, more Kentucky businesses are eligible to claim the state deduction than the federal deduction, but the amount any one business can write off on its Kentucky return is significantly less than the amount that business can write off on its federal return.[10]

7 Stephen J. Entin, "Washington Post Criticizes Good Tax Policy," Tax Foundation, Dec. 18, 2014, https://www.taxfoundation.org/blog/washington-post-criticizes-good-tax-policy.

8 Id.

9 Ascentium Capital, "2021 Tax Incentives: Section 179," accessed Oct. 13, 2021, https://www.ascentiumcapital.com/resources/section-179-calculator.

10 Ky. Rev. Stat. § 141.0101(16).

Since the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA) made Section 179 permanent and increased the expensing allowance from $500,000 to $1 million, numerous states have followed suit and conformed to the $1 million federal allowance. Currently, Kentucky is one of only 11 states and the District of Columbia whose Section 179 deduction is worth less than $1 million, and all of Kentucky's neighboring states except Indiana have a $1 million expensing allowance.[11] Iowa is among the states that recently increased its Section 179 expensing allowance, phasing it up over three years from $25,000 in 2017 to $1 million in 2020 as part of a broader tax reform package that reduced individual and corporate income tax rates and improved the income tax base.[12]

Kentucky policymakers should likewise consider conforming to the $1 million federal deduction limit, as this would stimulate business investment by reducing the user cost of capital, or the rate of return an investment must generate to break even, ideally while retaining the new policy of not phasing out the deduction.[13] It is difficult to evaluate the cost of such a change in the absence of data only available to the Kentucky Department of Revenue, but it is important to note that a significant amount of the cost would be a timing issue, bringing deductions forward rather than eliminating them altogether. As the Commonwealth's tax expenditure report notes for the current deduction, "The overall impact of this tax expenditure is associated with the timing of receipts from the tax, rather than the amount of tax ultimately remitted."[14]

This would promote economic growth in Kentucky by allowing business owners to reinvest those tax savings in their business, such as by increasing wages, buying more equipment, or increasing returns to shareholders.

### *Section 168(k)*

Because Section 179 is available only to businesses with qualifying annual investments below the specified level, it is generally only available to small businesses. However, under the TCJA, Congress extended similar treatment to businesses making larger annual investments. This provision, which is known as bonus depreciation or full expensing and is only available to C corporations, is found in IRC Section 168(k). Specifically, corporations that make qualifying investments in short-lived assets, including machinery and equipment, can deduct 100 percent of those costs in the year they are incurred.[15] The 100 percent write-off will be available through 2022, but starting in 2023, it is scheduled to phase down by 20 percent per year until it fully expires in 2027.[16]

Currently, 18 states follow the federal government in offering full expensing, while two offer "bonus depreciation" short of full expensing.[17] Kentucky, however, does not offer bonus depreciation, instead requiring businesses to deduct such expenses incrementally over many years. Kentucky would do

11 Jared Walczak and Janelle Cammenga, *2021 State Business Tax Climate Index*, 66.

12 Jared Walczak, "What's in the Iowa Tax Reform Package," Tax Foundation, May 9, 2018, https://www.taxfoundation.org/whats-iowa-tax-reform-package/.

13 Kentucky H.B. 351 (2020); Gary Guenther, Congressional Research Service, "The Section 179 and Bonus Depreciation Expensing Allowances," May 1, 2018, 11, http://www.fas.org/sgp/crs/misc/RL31852.pdf.

14 Kentucky Office of the State Budget Director, "Commonwealth of Kentucky: Tax Expenditure Analysis, Fiscal Years 2020-2022," Nov. 30, 2019, https://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202020-2022.pdf.

15 Erica York, "Toomey Introduced Legislation to Make Bonus Depreciation Permanent and Fix the Retail Glitch," Tax Foundation, Feb. 14, 2020, https://www.taxfoundation.org/toomey-introduces-bill-to-make-full-expensing-permanent/.

16 Stephen J. Entin, "Tax Policy to Bridge the Coronavirus-Induced Economic Slowdown," Tax Foundation, Mar. 18, 2020, https://www.taxfoundation.org/tax-policy-coronavirus-induced-economic-slowdown/.

17 Jared Walczak and Janelle Cammenga, *2021 State Business Tax Climate Index*, 59.

well to offer a bonus depreciation allowance, which would be one of the most pro-growth income tax base changes state policymakers could make because it reduces the tax code's otherwise punitive treatment of investment compared to other business expenses. Most business expenses can be deducted immediately for tax purposes, but investment—which states should want to see more of—is comparatively disadvantaged, with the deduction amortized over many years, and (due to inflation and the time value of money) never equaling the real cost of the investment.

Ideally, Kentucky would offer a permanent full expensing provision of its own that would stay in effect even if the federal provision phases out, as is scheduled. This is, however, a potentially expensive proposition, even if it is a highly worthy one. Many states rightly incorporate this deduction as a core component of their definition of corporate income subject to tax, but implementing it from scratch could have a short-run cost of $125 million to $150 million per year. The long-run costs are lower because a substantial portion (but not all) of this is a timing effect, where deductions are taken earlier than they would be otherwise. Short of full expensing, Kentucky could allow a given percentage of capital expenditures to be deducted in the year they are made, as is the law in North Carolina and Minnesota, where corporate taxpayers receive 15 and 20 percent of the value of the deduction, respectively.

All else being equal, conformity to provisions of the federal tax code aids taxpayers by simplifying compliance. Kentucky conforming to robust federal expensing provisions is the ideal, though should the federal government allow full expensing to lapse, Kentucky would be better served by offering it independently of the federal government rather than adopting a stingy federal treatment. Nonconformity through cost recovery provisions that are less generous than those in federal law, however, is the worst of both worlds.

## Limited Liability Entity Tax (LLET)

Kentucky levies a gross receipts tax (GRT), called the limited liability entity tax (LLET), on every C corporation and limited liability pass-through entity doing business in the Commonwealth, including S corporations, LLCs, limited partnerships, and limited liability partnerships.[18] The tax applies to corporations regardless of corporate or individual income tax liability. Thus, the LLET effectively functions as a minimum tax on gross receipts. The LLET is an inefficient revenue source and is time-consuming to comply with; it is subject to unpredictable revenue changes, and it contributes to structural inequities in the tax code. Additionally, the tax is disproportionately costly to small businesses and dissuades entrepreneurship. Revenue generated by the LLET is modest in the broader scope of state tax collections, and the costs do not justify keeping the tax on the books.

The LLET is an inefficient tax for two reasons. First, it requires calculating tax liability under two systems. The tax is calculated on gross receipts or gross profits, and the rate depends on which of three receipts or profits brackets the entity falls into. The amount due is determined by taking the lesser amount of two computed formulas. Certain exemptions and credits are available, but in no case will a non-exempt organization pay less than $175.[19]

18 Ky. Rev. Stat. § 140.0401(2)(a).

19 Ky. Rev. Stat. § 140.0401(2)(a)-(b).

Second, as a minimum tax, the LLET is designed to guarantee that businesses pay a tax on their receipts even in years in which they are not profitable, or when they otherwise have no income tax liability—as, for instance, when they are applying net operating losses (NOLs) accrued in prior years. Tax paid under the LLET, above a $175-per-entity minimum, can then be taken as a credit against corporate income tax liability (or individual income in the case of pass-through businesses), which avoids double taxation in instances when the company is sufficiently profitable.[20] In these cases, the LLET is an extra step in tax calculation that adds little to tax liability.

For businesses with little taxable income in a given year, however, the LLET becomes an inequitable alternative minimum tax on gross receipts. The harmful consequences of gross receipts taxes are why most states repealed their versions at some point during the 20th century. Since gross receipts taxes are assessed on a business's total transactions regardless of the stage in production, tax pyramiding occurs. At every stage of production, tax pyramiding adds another component to the price of the good. The accrued taxes are ultimately passed on to consumers in the form of higher prices. Pure gross receipts taxes give no consideration to the production costs of businesses or the effect the compounding taxation has on the final sale price of goods. Kentucky's exists in a modified form, allowing a deduction for a narrowly defined calculation of the cost of goods sold (COGS), but not for compensation or for other business expenses. It is this broader base, which is indifferent to profitability, that distinguishes it from the corporate income tax.

Two other states which impose GRTs also provide at least some COGS deduction. Texas is more generous, allowing companies to deduct their choice of either compensation or the costs of goods sold, while Oregon is stingier, allowing only a partial deduction of the taxpayer's choice of the two. Kentucky, which adopted the tax in 2007, is one of only eight states to levy a gross receipts tax at the state level, either as a stand-alone or a minimum tax.

The LLET violates the widely held principle of equity in taxation, because it gives no consideration to profitability or industry type. The added cost from the LLET acutely impacts firms that are highly price-sensitive or that operate in industries with very narrow profit margins.

The horizontal inequity of the LLET is amplified by the fact that its alternative minimum tax component applies irrespective of the firm's profitability. New startups are uniquely impacted by the LLET since many lose money in their first years of operation as they work to become established. It also falls heavily on struggling businesses attempting to recover, with liability imposed even though they are posting losses. Many family farms are structured as LLCs and are also impacted by the LLET, owing tax liability every year regardless of profitability. Taxing a company regardless of its ability to pay is inequitable, and it does nothing to incentivize entrepreneurs to take risks in Kentucky. Meanwhile, the state remains 317 establishments and 54,576 jobs below its position at the height of the pre-COVID-19 business cycle.[21]

20 Ky. Rev. Stat. § 141.0401(3)(a).

21 U.S. Bureau of Labor Statistics, "Business Employment Dynamics Data by States," Table 5 under Kentucky, https://www.bls.gov/bdm/bdmstate.htm#KY.

Revenue reports can provide an unintentionally misleading picture of how much the LLET raises. Annual reporting data show LLET collections, but because corporate income tax and LLET revenue are aggregated, they do not show how much of the revenue is offset by a corresponding credit against corporate income tax liability. Imagine, for instance, two businesses, both with $500,000 in LLET liability. One also has $1 million in corporate income tax (CIT) liability pre-credit, while the other has only $300,000 in CIT liability due to lower profit margins. In the absence of the LLET, these businesses would pay $1.3 million in corporate income taxes. With the LLET in place, however, they would pay $1 million in combined LLET liability but only $500,000 in corporate income taxes, for a total of $1.5 million in aggregate collections. The LLET would show up as generating $1 million, but it only increased tax collections by $200,000.

Although the Department of Revenue does not report this breakdown every year, it did so for FY 2017 in its tax expenditure report. That year, the LLET raised $245.6 million in revenue, but only netted $85 million, due to offsets against corporate—and to a far lesser extent individual—income tax liability.[22] In the absence of the LLET, CIT collections would have been about $140 million higher and individual income tax collections about $20 million higher, with the residual ($85 million) the actual net revenue of the LLET.

By definition, the revenue potential of the LLET varies inversely to the profitability of Kentucky businesses, meaning that net revenue is likely to fluctuate substantially from year to year. Nevertheless, extrapolating to revenue forecasts, it is reasonable to assume that the LLET will generate about $90 million a year in FYs 2022 and 2023—not an inconsequential sum, but just slightly over half of 1 percent of the general fund budget.[23]

In sum, the LLET is an inefficient and overly complicated means of funding state government. It requires calculating tax liability under two systems and undermines structural elements of the tax code, including net operating loss provisions and deductions for business expenses. In terms of revenue to opportunity cost ratio, the LLET is likely one of the most distortive and economically prohibitive taxes on the books in Kentucky. It is only responsible for a little over one-half of 1 percent of general fund revenue. In return, the LLET maintains structural inequities in the tax code and dissuades entrepreneurs from taking risks in the state. These are hinderances the Commonwealth can ill afford as it continues to recover from the COVID-19 pandemic.

Policymakers should prioritize repeal of the LLET. The Office of the State Budget Director projects general fund revenue will grow by nearly $1.6 billion between FY 2022 and FY 2026.[24] While some larger reforms may require offsetting revenues elsewhere, that growth is more than sufficient to cover the state's current obligations and repeal the LLET. Allocating a fraction of future growth to promote a sound, economically expansive tax policy is a worthwhile investment.

22 Kentucky Office of the State Budget Director, "Tax Expenditure Analysis, Fiscal Years 2020-2022."

23 Kentucky Office of the State Budget Director, "Official Revenue Estimates, FY 2022 – FY 2026," Aug. 24, 2021, https://osbd.ky.gov/Publications/Pages/Official-Revenue-Estimates.aspx.

24 Id.

## Incentives Reform

Like many states, Kentucky relies heavily on business tax incentives in an effort to attract jobs and investment to the state. While some of these incentives provide valuable tax relief to the businesses that qualify for them, they do so in a non-neutral manner. They can distort business decision-making by encouraging businesses to make second-best investments that are driven by the tax code rather than by broader market considerations. They can reward activity that would have taken place even in the absence of an incentive. And they add complexity to the tax system.

Even as they provide relief to qualifying businesses, they narrow the tax base, yielding a higher rate than would otherwise be necessary on businesses that do not qualify. Given, then, that tax incentives often fail to deliver the promised economic growth, policymakers should ensure adequate oversight and review of targeted tax credits, deductions, and exclusions to ensure that they are appropriately targeted, to assess whether they are delivering on their promises, and to evaluate them against competing options, including a more neutral system overall.

Tax incentives matter, because targeted incentives in the corporate tax code—for the CIT and LLET—reduce tax liability by about 25 percent. All else being equal, the LLET and a CIT rate of about 3.6 percent, without any targeted tax incentives, would raise as much revenue as the current system does with a 5 percent CIT rate.

Deductions, exemptions, and credits all serve to reduce tax liability, but they do so in distinct ways that are important to bear in mind while attempting any comparison. Deductions reduce taxable income by a given amount, whereas credits are a subtraction against tax liability. Imagine, for instance, a corporate taxpayer with $50,000 in Kentucky corporate income tax liability. A $5,000 credit will reduce tax liability to $45,000, whereas a $5,000 deduction would reduce tax liability to $49,750, as the reduction in liability will be equal to the tax on that $5,000. An exemption, meanwhile, excludes certain revenue from the tax rolls altogether.

Most of Kentucky's business tax incentives come in the form of credits. There are a few exemptions, which the Kentucky Office of the State Budget Director judges to have a minimal impact on tax liability, as well as an option for businesses to continue to use three-factor apportionment if it is in their interest. The remaining $217 million in targeted tax incentives taken in FY 2022 are all tax credits. Of these, nearly $100 million are broadly focused on business investment, $24 million are for energy production or recycling equipment, and $94 million are industry-specific, with the single largest expenditure being the $87 million tax credit for the film industry,[25] which is widely regarded as one of the least economically efficient tax credits that states offer.

Estimating the cost of credits is inherently difficult, but it is easier to estimate that cost over time than to anticipate the hit to the state budget in any given year, since credit utilization can vary sharply based on economic conditions or cycles of investment or business activity. The issuance of some credits is

25 Kentucky Office of the State Budget Director, "Tax Expenditure Analysis, Fiscal Years 2020-2022."

capped, which can aid estimates of issuance, but even if forecasters have a good sense of the value of credits likely to be generated each year, they may find it difficult to anticipate when they will be utilized, reducing tax collections. This revenue uncertainty is a further objection against overreliance on incentives.

**TABLE 1.**

### The Cost of Tax Credits in FY 2022

| Tax Credit | FY 2022 Value |
|---|---|
| Film Industry Tax Credit | $86.6 million |
| Kentucky Business Investment Credit (KBI) | $30.8 million |
| Recycling and/or Composting Equipment Credit | $11.7 million |
| Biodiesel Tax Credit | $10 million |
| New Markets Development Program Tax Credit | $9.3 million |
| Kentucky Historic Preservation Tax Credit | $3.7 million |
| Distilled Spirits Credit | $3.3 million |
| Railroad Maintenance and Improvement Tax Credit | $2.7 million |
| Industrial Development Act Credit (KIDA) | $2.1 million |
| Construction of Research Facilities Credit | $1.5 million |
| Small Business Tax Credit | $1.3 million |
| Industrial Revitalization Act Credit (KIRA) | $1.0 million |
| Reinvestment Act Credit (KRA) | $1.0 million |
| Rural Economic Development Act Credit (KREDA) | $1.0 million |
| Skills Training Investment Credit | $1.0 million |
| Transportation of Fossil Energy or Biomass Resources Tax Credit | $1.0 million |
| Investment Fund Act Credit (KIFA) | $1.0 million |
| Ethanol Tax Credit | $0.7 million |
| Job Retention Act Tax Credit (KJRA) | $0.4 million |
| Cellulosic Ethanol Credit | Minimal |
| Clean Coal Incentive Credit | Minimal |
| Coal Conversion Credit | Minimal |
| Hiring the Unemployed Tax Credit | Minimal |
| Incentives for Energy Independence Act Tax Credit (IEIA) | Minimal |
| Jobs Development Act Credit (KJDA) | Minimal |
| Voluntary Environmental Remediation Credit | Minimal |

Source: Kentucky Office of the State Budget Director, "Tax Expenditure Analysis."

Many tax credits appear to involve more paperwork than savings. The Kentucky Investment Fund Act (KIFA) Credit only yields $700,000 a year in tax savings, for instance, while Kentucky's Industrial Revitalization Act (KIRA), Reinvestment Act (KRA), Rural Economic Development Act (KREDA), and Skills Training Investment credits are only worth $1 million each. Other credits, like the Kentucky Job Retention Act (KJRA) and Jobs Development Act (KJDA) tax credits, have what the Department merely characterizes as "minimal" revenue impact.[26] Each of these programs must be administered, with its own regulations and eligibility guidelines, despite being so small as to have a negligible impact on attracting or growing businesses in Kentucky.

26 "Minimal" indicates that the state was unable to assign a dollar amount to the expenditure but has confidence that the impact is $1 million or less.

Kentucky's major incentives are the Film Industry Tax Credit ($86.6 million) and the Kentucky Business Investment Credit ($30.8 million), which together comprise 70 percent of all credit awards in the Commonwealth. Three other credits—for recycling and composting, biodiesel, and businesses exploiting new markets—combine for another $31 million, while all remaining credits for which estimates are available cost a combined $21 million.[27]

Major reforms, therefore, will involve a relatively small number of credits, but there can also be meaningful efficiency gains in clearing underutilized credits from the books, or rolling their salient features into larger credits to avoid administrative duplication.

Take, for instance, the KIFA credit, which is intended to encourage venture capital investments in small businesses. The credit has negligible uptake, which is understandable. The venture capital fund, to be eligible, must go through an approval process with the Kentucky Economic Development Finance Authority. The fund must have at least four unaffiliated investors and none can have an interest exceeding 40 percent. The fund must have at least $500,000, and qualified investments must be in businesses which have at least 50 percent of their assets, operations, and employees in Kentucky, while having no more than 100 employees and a net worth of $5 million or less. While encouraging the capitalization of Kentucky small businesses is desirable, it is doubtful whether much venture capital is flowing to Kentucky businesses due to this credit that would not have been similarly invested otherwise, and unlikely that such a credit would yield significant investment even if overhauled.

If the Investment Fund Act has a negligible impact, the Commonwealth's film tax credits, by contrast, are a boondoggle. This is not a comment on Kentucky's approach in particular, but on film tax credits everywhere. In a narrow sense, film tax incentives work: they attract studio activities to states that offer them. If, however, these incentives are judged not simply on bringing actors to the state for a few weeks, but by growing the state's economy, they are an abject failure everywhere they have been tried. Every year, states give billions of dollars to Hollywood and receive next to nothing in return.

Film tax credits have among the worst track records in tax incentives. In Massachusetts, for instance, the budget director's office found that the state spent more on credits than the film industry actually spent in the state, with Massachusetts only recouping 11 cents on the dollar in tax revenue.[28] In Michigan, lawmakers discovered that the new jobs created were ephemeral, with the average job lasting a mere 23 days.[29] Studies consistently show that these credits lose money for states—not only that they do not recoup the lost tax revenue, but that they generate less in overall economic activity than they forgo in tax collections.

Kentucky's film tax credit, which was shuttered for several years, will have the issuance of new credits capped at $75 million per year going forward,[30] but policymakers should consider bringing it to zero. While Kentucky's revived film tax credits include tighter definitions of qualified production in the Commonwealth than they did in a prior iteration, they also restore the refundability of these credits,

27 Kentucky Office of the State Budget Director, "Tax Expenditure Analysis, Fiscal Years 2020-2022."

28 Commonwealth of Massachusetts Department of Revenue, "Report on the Impact of Massachusetts Film Industry Tax Incentives Through Calendar Year 2012," Sept. 16, 2014, https://www.mass.gov/doc/dor-report-on-the-impact-of-massachusetts-film-industry-tax-incentives-through-calendar-year-1/download.

29 David Zinn, "Film Incentives in Michigan," Michigan Senate Fiscal Agency, September 2010, https://www.senate.michigan.gov/sfa/Publications/Issues/FilmIncentives/FilmIncentives.pdf.

30 Ky. Rev. Stat. § 141.383.

meaning that when production companies' incentives exceed their tax liability—as will frequently be the case—the Commonwealth writes them a check for the difference. To put the cost of the film tax incentives into context, if it were not on the books in the current fiscal year, that would fund the repeal of the entire LLET.

The next largest incentive is the Kentucky Business Investment Credit (KBI), which reduces tax liability for both new and mature businesses which choose to locate or expand their operations in Kentucky. Credit qualifications hinge on eligible costs, new jobs created, the hourly compensation of new employees, and other factors, but most of these thresholds are modest, so the KBI is properly characterized as a broadly available investment credit. As such, it is more economically efficient than most competing credits, as it largely avoids distinguishing between types of investments, and its reductions in the cost of capital are not very distortive given that federal and state tax codes discriminate against capital investment in other ways.

The credit is not available to all businesses, of course, including some of the smallest businesses whose investments may be too modest to qualify (some may qualify for the Kentucky Small Business Tax Credit), and the administrative compliance required to claim the credit is inferior to simply facing lower overall tax burdens on capital investment. Nonetheless, this is likely the most neutral of Kentucky's credits.

Similarly, some credits are designed to offset inequitable taxes imposed elsewhere. This is true, for instance, of the inventory tax credit, which is excluded from analysis here because it is a means—albeit an inefficient one, as explained elsewhere—to offset the burden of a particularly egregious form of local taxation. The Distilled Spirits Tax Credit is another such example, intended to offset a local tax on aging bourbon in barrels. It is best understood as an effort to fund the repeal of that non-neutral tax, though in its current form, it falls far short of this aim because it is nonrefundable and many distillers are unable to claim a sufficient credit to fully offset their local liability.

In 2018, a Task Force on Tax Expenditures was commissioned. It recommended sunsetting all but the largest tax expenditures and imposing a sunset of five years on all new expenditures, requiring them to be affirmatively extended by the legislature if they are to continue.[31] The commission also recommended better data and reporting requirements. This is a good start, but policymakers should go further to institutionalize the process of incentives evaluation.

Kentucky should, as the commission recommends, improve its evaluative toolkit by empowering the Legislative Research Commission (LRC) to better evaluate the economic impact, and not just the costs, of these incentives. In addition to expanding the focus from mere cost to one of proper economic evaluation, this would also house the estimating function in the legislature, and not just with the administration, as is currently the case with estimates from the Office of the State Budget Director. While budget and revenue analysis takes place within governor's offices in all states, many of those which have pursued incentives reform have found it advantageous to obtain estimates and analysis within the legislative branch, which can be more responsive to legislators' needs as they evaluate these programs.

31 Kentucky Legislative Research Commission, "Report of the Task Force on Tax Expenditures," December 2018, https://www.balancedhealthky.com/wp-content/uploads/2019/01/DRAFT-Task-Force-Report-12-13-2018-1.pdf.

Policymakers should also consider adding sunsets to all incentives, not just newer and smaller ones, with a commission or committee responsible for reviewing the LRC's findings to recommend tweaks to, or even abolition of, underperforming credits. Such a commission could meet every three years to do a full evaluation of the state's tax credits, but meeting more regularly, with a rotating schedule of incentives to evaluate, allows more time to be spent on each credit.[32] Lawmakers should be willing to repeal credits that do not provide a meaningful benefit.

Incentives can be effective, but they are not efficient. By lowering tax costs for targeted industries or rewarding specific business activities, they can yield higher employment or greater investment in those sectors, but these costs must be borne by other, non-favored businesses which bear a correspondingly higher tax burden. Ultimately, incentives involve picking winners and losers and seek to guide the economy in keeping with policymakers' (often competing) visions. A well-structured tax code with a broader base—eliminating many of the incentives—and a lower rate would do far more to encourage job creation and economic growth.

## Implementing Reforms with Revenue Triggers

Across the country in recent years, revenue triggers have emerged as an effective way to implement or phase in tax rate reductions or other tax reform measures as revenues permit. Tax triggers are a newer take on an old concept: contingent enactment of a legislative provision. States have long relied upon bills with contingent enactment clauses, providing that certain features of new legislation shall only be operative if certain conditions are met. Tax triggers build on this model, making tax reform measures contingent on state revenues meeting or exceeding established targets.[33]

Tax triggers can help ensure revenue stability and limit the uncertainty associated with changes to the tax code while providing an efficient way for states to dedicate some portion of revenue growth to tax relief. Their ability to do so, however, depends on their design. Poorly designed triggers can implement cuts when economic conditions do not warrant it or postpone reductions even when revenue growth would permit it. By contrast, properly constructed tax triggers are a valuable mechanism for providing meaningful rate relief.

States are the laboratories of democracy, and it shows in the many different approaches they have taken to the design of triggers. Some variation is appropriate, reflecting different aims. One state may, for instance, wish to focus exclusively on progressive reductions in the rate of a single tax, while another may harness triggers to phase in a series of discrete reforms across one or even several taxes. Nevertheless, while these details may vary, certain design principles are appropriate in all cases.

Well-designed triggers require selecting a baseline revenue figure—either a given year's revenue or a statutorily-established amount—and then establishing benchmarks that reflect meaningful revenue growth. While this may sound simple, several states have ignored this principle, with legislatures forced

32 For an overview of best practices, see The Pew Charitable Trusts, "How States Are Improving Tax Incentives for Jobs and Growth: A National Assessment of Evaluation Practices," May 3, 2017, https://www.pewtrusts.org/en/research-and-analysis/reports/2017/05/how-states-are-improving-tax-incentives-for-jobs-and-growth.

33 Jared Walczak, "Designing Tax Triggers: Lessons from the States," Tax Foundation, Sept. 7, 2016, https://www.taxfoundation.org/designing-tax-triggers-lessons-states/.

to step in to prevent a trigger from misfiring, which undermines the whole purpose of an automated adjustment.

Some states, for instance, have focused on single-year revenue changes, triggering a rate reduction or other revenue-negative tax reform whenever one year's revenues exceed the previous year's revenues by a given amount. This, however, creates the possibility of a downward ratchet effect, where recovery from a year of revenue decline could trigger a tax cut even if revenue levels are stagnant or even down over a longer time frame.

For a variety of reasons, the COVID-19 pandemic did not yield the revenue losses many anticipated. Kentucky revenues were essentially flat between fiscal years 2019 and 2020, then rose almost 10 percent in FY 2021. Imagine, however, if revenues had slipped 10 percent rather than rising by a similar amount. If, the following year, revenues merely recovered to pre-pandemic levels, this would appear to be meaningful growth on a year-over-year basis, when it actually represents a revenue decline in real (inflation-adjusted) terms from a pre-pandemic baseline.

Implemented properly, however, revenue triggers are an effective way to phase in tax reforms in a responsible manner, committing to the dedication of a portion of future revenue growth to tax relief. They can be used to lower the rates of different taxes, like the individual or corporate income tax, or to phase down or implement the repeal of other tax provisions, like the LLET or what remains of the inheritance tax. Triggers adopted by the District of Columbia provide a good example of doing both, using a schedule of planned reforms, with each phase of reform triggered in its turn as revenue growth permitted.[34]

If Kentucky lawmakers use revenue triggers to implement tax reforms, then instead of using year-over-year revenue changes, they should establish a specific revenue baseline and employ benchmarks that measure real revenue growth, adjusted for inflation, over that base year amount. Ideally, reductions should not be tied to specific years, but instead triggered whenever real revenue growth is adequate to reduce rates by at least a given increment—say 10 or 25 basis points—with the actual size of the reduction based on a statutorily-established proportion of inflation-adjusted revenue growth.

Benchmarks may be set in terms of nominal dollars or as percentage growth and may optionally be adjusted for inflation. They may be serial (e.g., 2 percent growth in a given year) or cumulative (e.g., revenues at least 2 percent ahead of inflation-adjusted *ex ante* collections). For longer-term or open-ended triggers, a population adjustment may also be warranted, though such a provision is less pertinent for tax changes designed to be triggered over a small number of years. An optimal benchmark might rely on inflation-adjusted revenue growth measured as a percentage over an established baseline revenue figure.

All benchmarks require a baseline, whether implicit or explicit. Triggers which specify discrete revenue targets have an implicit baseline, while those relying on some measure of percentage growth must establish one explicitly. In either case, however, the measure of revenue must be defined. General fund revenue is the most common measure, though some states include non-general fund revenue or

34 DC ST § 47-181.

favor a measure of all tax revenue, while a few states use revenue projections rather than, or in concert with, actual collections. Most well-structured triggers rely on actual revenue collections for preceding years, avoiding the possibility that a mistaken—or possibly even politically-driven—estimate could result in implementation of tax cuts after a period of economic contraction, or prevent a cut when one is otherwise indicated.

Additionally, benchmarks for tax triggers can be tied to specific years or left date indeterminate. A number of states, including Kansas and Oklahoma, require benchmarks to be met by a given date.[35] Failure to achieve a benchmark on schedule could, in some states, derail remaining triggers. Conversely, other states have established specific revenue targets (like North Carolina)[36] or growth levels (like Massachusetts),[37] without a specific date by which the reform must be triggered.

Tax triggers linked to specific years risk forestalling long-term reform if benchmarks are not achieved in a single year, while the benchmarks established for open-ended triggers can erode in value over time. An ideal tax trigger design avoids linking benchmarks to specific years but employs inflation indexing to ensure that legislative intent is preserved through the passage of time.

Finally, policymakers must determine what, if any, exclusions to build into their triggers. Most tax triggers adopt some threshold requirement before revenue growth is adequate to activate any tax provisions, but states differ in whether a tax cut, once triggered, is designed to dedicate all or some portion of new revenue to tax relief. It is easiest to envision exclusions as separate from adjustments for inflation, as these seek to maintain neutrality across years, whereas exclusions are intended to retain some portion of new revenue, after adjustments. A state could, for instance, adopt a policy of retaining a certain annual percentage growth of revenues above inflation, and only using the residual amount above that threshold for tax relief. Exclusions which ensure that funding formulae for rainy day funds are untouched are also appropriate.

In Kentucky, it may be possible for lawmakers to make certain revenue-negative reforms, like fully repealing the LLET ($90 million) or the inheritance tax ($48 million, discussed later) without phase-ins or triggers, simply adopting these reforms when economic conditions permit, particularly given that the Commonwealth is projecting $1.6 billion in general fund revenue growth between FY 2022 and FY 2026. But lawmakers could also incorporate these into a triggered schedule in which these taxes are repealed once the state has experienced adequate revenue growth to cover them—plus any growth factor retained by the state—after which future excess growth could be dedicated to individual and corporate income tax rate reductions, ideally in tandem.

Tax triggers are increasingly proving a highly valuable mechanism for those seeking tax reform coupled with revenue stability. As Kentucky tackles tax reform, they deserve to be part of the toolkit.

35 Jared Walczak, "Designing Tax Triggers: Lessons from the States."

36 N.C.G.S.A. § 105-130.3C.

37 M.G.L.A. 62 § 4.

## Business Tax Reform Solutions

### *Repeal the LLET*

As a minimum tax on business gross receipts, Kentucky's LLET is economically harmful to C corporations and pass-through businesses alike, but the revenues generated are modest and do not justify keeping this administratively complex tax on the books. The LLET can be expected to generate only about $90 million a year in FY 2022 and 2023. Meanwhile, Kentucky's general fund revenues are expected to grow by nearly $1.6 billion between FY 2022 and 2026, more than sufficient to cover the state's current obligations and repeal the LLET without requiring a revenue-positive offset elsewhere in the code.

Repealing the LLET would improve Kentucky's ranking on our *State Business Tax Climate Index* to 16th overall.

### *Reduce the Corporate Income Tax Rate*

Following the 2018 reforms, Kentucky's state corporate income tax rate and collections per capita are substantially more competitive, but the corporate income tax remains one of the most economically harmful taxes Kentucky levies, as it is borne in large part by a firm's employees, shareholders, and consumers. Kentucky should continue to prioritize reducing the state corporate income tax rate while working to curtail local net profit taxes (discussed in the individual income tax section).

Reducing the corporate income tax, whether out of already-realized revenue growth, using revenue triggers, or through offsetting revenue increases elsewhere—options discussed later—can help enhance the Commonwealth's attractiveness for businesses. Each full percentage point reduction in the corporate income tax would forgo about $135 million in revenue, assuming the LLET remains unchanged. This estimate is based on FY 2022 projections, but it is worth noting that the Office of State Budget Director estimates corporate income tax and LLET revenue will grow by nearly one-quarter by FY 2026.[38]

### *Improve Treatment of Business Capital Investments*

Net income is defined as revenues less expenses, but when it comes to business income taxation, Kentucky's tax code contains a bias against business expenses associated with investing in machinery, equipment, and other assets. Instead of those expenses being deductible in the year they are incurred, the Kentucky tax code requires most of those expenses to be deducted over time according to a depreciation schedule. Section 179 and Section 168(k) of the IRC help mitigate this bias against investment, but Kentucky offers only $100,000 in immediate expensing of Section 179 property and does not conform to Section 168(k) at all.

Policymakers should consider increasing the deduction available under Section 179, ideally bringing it

38 Kentucky Office of State Budget Director, "FY 2022-FY 2026 Budget Planning Report Revenue Estimates," Aug. 24, 2021, https://osbd.ky.gov/Publications/Documents/Official%20Revenue%20Estimates/FY%202022%20-%20FY2026%20Budget%20Planning%20Report%20Revenue%20Estimates.pdf.

into conformity with the $1 million federal deduction allowance while maintaining nonconformity to the federal phaseout threshold. Separately, since the 100 percent bonus depreciation allowance under Section 168(k) is scheduled to begin phasing out in 2023, Kentucky would do well to offer a permanent full expensing provision of its own, or, short of that, to allow a given percentage of the federal deduction.

If lawmakers adopted best practice expensing policies for both pass-through businesses and C corporations, Kentucky's rank on the *State Business Tax Climate Index* would improve three places to 16th overall, with an improvement of seven places on the corporate tax component and two places on the individual income tax component. If these reforms were adopted in tandem with a repeal of the LLET, Kentucky would have the eighth-best corporate tax structure in the nation.

### *Evaluate and Streamline Incentives*

Kentucky's tax incentives provide valuable relief to qualifying businesses, but they do so in a non-neutral manner, narrowing the tax base while yielding higher rates on businesses that do not qualify. As recommended by the 2018 Tax Force on Tax Expenditures, Kentucky should empower the Legislative Research Commission to better evaluate the economic impact—not just the revenue costs—of these incentives and convene a commission or committee to study the LRC's findings.

Policymakers should consider adding sunsets to all incentives, not just newer and smaller ones, and be willing to repeal incentives that do not provide a meaningful economic benefit. Ultimately, streamlining Kentucky's incentives would free up revenue to provide tax relief to businesses more broadly, such as by repealing the LLET, reducing income tax rates, and offering more generous expensing provisions to mitigate the tax code's bias against investment.

### *Use Revenue Triggers to Phase in Reforms*

Revenue triggers are an effective way to implement or phase in tax rate reductions or other tax reform measures in a manner that ensures revenue stability and limits uncertainty associated with changes to the tax code. Well-designed triggers are based on a statutorily established amount that reflects meaningful revenue growth.

Given the Commonwealth's anticipation of robust revenue growth in the years ahead, policymakers should consider making relatively modest revenue-negative reforms, like fully repealing the LLET ($90 million) or the inheritance tax ($48 million) without phase-ins or triggers. Lawmakers can, however, incorporate these reforms into a triggered schedule that also reduces individual and corporate income tax rates once a certain level of real revenue growth has been achieved. As Kentucky tackles tax reform, triggers are a valuable part of policymakers' toolkit.

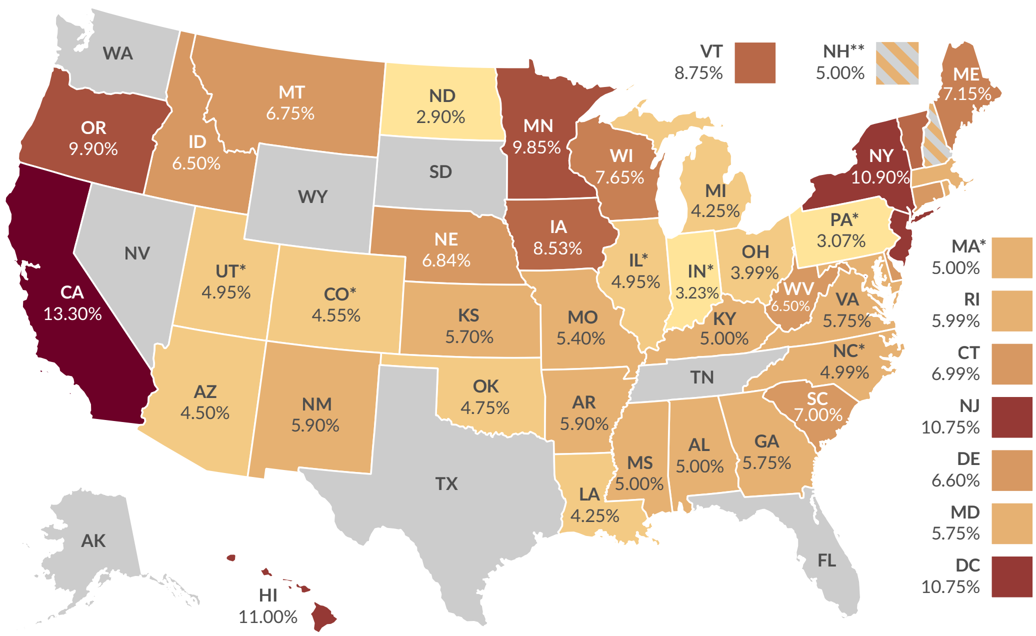
# INDIVIDUAL TAXES AND MUNICIPAL INCOME TAXATION

## Individual Income Tax Rate and Collections

Kentucky has a flat individual income tax at a rate of 5 percent, the product of the 2018 reforms that consolidated six brackets into one and reduced the top rate from 6 percent.[39] Kentucky's 5 percent rate is relatively competitive and an improvement compared to prior law, but the state continues to face stiff competition from neighboring Tennessee, which does not levy an individual income tax, as well as Indiana, Ohio, and even Illinois, each with lower rates.

FIGURE 2.

**Top Marginal State Individual Income Tax Rates (as of January 1, 2022)**




Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included. Missouri's top marginal rate will be reduced to 5.3% if certain revenue triggers are met.
(*) State has a flat income tax.
(**) State only taxes interest and dividends income.
Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.

In FY 2019, individual income taxes generated more than $4.6 billion, nearly 36 percent of Kentucky's state tax revenue, making it the state's most heavily-relied-upon tax.[40] Unlike most states, Kentucky also levies local income taxes (occupational license taxes), which generated close to $1.6 billion (or 26 percent of local tax revenues) that same year. When state and local tax collections are combined, Kentucky generates approximately 34 percent of its total tax revenue from individual income taxes, significantly higher than the national average of 24 percent.[41]

39 Morgan Scarboro, "Kentucky Legislature Overrides Governor's Veto to Pass Tax Reform Package," Tax Foundation, Apr. 16, 2018, https://www.taxfoundation.org/kentucky-tax-reform-package/.

40 U.S. Census Bureau, "Annual Survey of State and Local Government Finances (FY 2019)."

41 Janelle Cammenga, *Facts & Figures 2021: How Does Your State Compare?* Tax Foundation, Mar. 10, 2021, https://www.taxfoundation.org/publications/facts-and-figures.

While Kentucky's municipal income taxes fall on both individuals (occupational license taxes) and businesses (an extension of those taxes, often called the net profit tax), they are both considered in this section.

## The Economic Implications of Income Taxes

### *Migration and National Trends*

Nine states forgo broad-based individual income taxes, including neighboring Tennessee, which has seen its economy grow 60 percent faster than Kentucky's over the past two decades. In real (inflation-adjusted) terms, Tennessee's gross state product grew almost 36 percent between 2001 and 2020, while Kentucky's economy increased at a much more modest 22 percent, significantly below the national average of 35 percent growth for the period. Gross state product is nearly 13 percent higher per capita in Tennessee than in Kentucky, and personal incomes are 11 percent higher.

Tennessee is not an outlier in this regard. Over the past decade, states that forgo income taxes have seen their populations grow at twice the national rate, and gross state product grew 56 percent faster in states without an income tax than it did in those with one over that period. In 2018 (the most recent year for which data are available), the 41 income tax states lost a net of 285,000 residents to the nine states without an income tax. Furthermore, Tennessee's population has grown at nearly twice the rate of Kentucky's over the past two decades. Kentucky's population grew a modest 10.5 percent between 2000 and 2019, less than two-thirds the national growth rate of 16.3 percent, while Tennessee's population burgeoned by 20 percent, well over the national rate of population growth. It is little wonder that the Tennessee model—and that of other no- or low-income tax states—is highly attractive.

Moreover, the ongoing migration from high- to low-tax states, and particularly states with low income taxes, is likely to accelerate with the growing viability of telework post-pandemic. Increasingly, many people will be able to live wherever they wish. Those who are highly sensitive to taxes will find it easier than ever to relocate to jurisdictions with lower tax burdens, regardless of where their employer may be located. Those who want to remain close to family will increasingly be able to do so with less sacrifice to job prospects. And employers themselves will have more location flexibility as geography becomes less of a constraint on their workforces.

Ten states enacted laws in 2021 to reduce their individual income tax rates, the most in two decades. In the early days of the coronavirus pandemic, the notion that 2021 would be a year of long-term tax relief would have been almost unthinkable, but states closed out FY 2021 with substantially more revenue than they anticipated and recognized an opportunity for tax relief. Many policymakers, moreover, saw it not just as an opportunity but as a necessity, a way of demonstrating their state's commitment to tax and overall economic competitiveness in an increasingly mobile world.

Neighboring Ohio was among the states that reduced individual income tax rates during the 2021 legislative session, with rate reductions retroactive to January 1, 2021. Specifically, Ohio's five brackets were consolidated into four, the top rate was reduced from 4.797 to 3.99 percent, and the lower marginal rates were reduced by 3 percent across the board. The income level at which the first rate kicks in was also increased to provide targeted tax relief to lower-income individuals.[42] It is worth noting that taxes are even lower for pass-through businesses, as Ohio's business income deduction exempts the first $250,000 in business income from taxation (depending on filing status) before a preferential rate of 3 percent applies.[43] North Carolina—another economic competitor of Kentucky's—as been a leader in pro-growth tax reform over the past decade and continued building upon those reforms this year, reducing the individual income tax rate and initiating the phaseout of the corporate income tax.[44] As of this writing, North Carolina lawmakers are considering legislation reducing the state's flat individual income tax rate from 5.25 to as low as 3.99 percent and phasing out the state's 2.5 percent corporate income tax entirely, among other pro-growth reforms.

Taxes are far from the only factor that influences location decision-making, but with job availability likely to become less salient as remote work arrangements increase in popularity, they are an important factor, and just as importantly, they are a factor that policymakers can control.

### *Comparison with Consumption Taxes*

All taxes are not created equal. Any tax creates a certain amount of economic drag; this is unavoidable. There is truth to the adage that "whatever you tax, you get less of"—so it makes sense for policymakers to think carefully about what they choose to tax, and how. Individual income taxes fall on labor; on the margin, they lower the payoff to work, decreasing the supply of labor while increasing its cost.

An income tax can be conceptualized as a tax on consumption plus the change in savings, while a well-structured sales tax is a tax on income less the change in savings (that is, on both the income spent now and on income saved to be spent in the future). An income tax reduces capacity for future consumption; economically, it acts like a sales tax that increases the cost of future consumption, with each additional hour of labor producing fewer goods in the future. Consumption taxes are much more economically neutral by comparison, and the economic literature consistently finds that sales taxes are less of an impediment to economic growth or location decisions than are income taxes.[45]

Consumption taxes, like income taxes, do fall on suppliers of labor and capital, but they do so neutrally and—at least when well-designed—avoid double-taxing these factors. (Kentucky, like all states, taxes some intermediate transactions in its sales tax, creating tax pyramiding and diverging from the model of a pure consumption tax.) Kentucky's sales tax is, appropriately, destination-sourced, meaning the tax is imposed where a good or service is consumed, not where it is produced. Thus, unlike income taxes, the sales tax does not discourage investment or job creation.[46] This is, however, only true insofar as the tax falls on final consumption; when the tax falls on business inputs, it increases the cost of investing in-state.

42 Katherine Loughead and Jared Walczak, "States Respond to Strong Fiscal Health with Income Tax Reforms," Tax Foundation, July 15, 2021, 13, https://www.taxfoundation.org/2021-state-income-tax-cuts/.

43 Ohio Department of Taxation, "Income – Business Income and the Business Income Deduction," accessed Oct. 26, 2021, https://www.tax.ohio.gov/wps/portal/gov/tax/help-center/faqs/income-business-income-and-the-business-income-deduction.

44 Nicole Kaeding and Jeremy Horpedahl, "Help from Our Friends: What States Can Learn from Tax Reform Experiences across the Country," Tax Foundation, May 15, 2018, https://www.taxfoundation.org/state-tax-reform-lessons-2018/.

45 See Joseph Bankman and David A. Weisbach, "The Superiority of an Ideal Consumption Tax over an Ideal Income Tax," *Stanford Law Review* 58:5 (April 2010); and Jens M. Arnold, Bert Brys, Christopher Heady, Heady, Åsa Johansson, Cyrille Schwellnus, and Laura Vartia, "Tax Policy for Economic Recovery and Growth," *The Economic Journal* 121:550 (February 2011).

46 Douglas L. Lindholm and Karl A. Frieden, "After Wayfair: Modernizing State Sales Tax Systems," *State Tax Notes*, May 14, 2018, 667, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/after-wayfair-modernizing-state-sales-tax-systems.pdf.

Evidence of the adverse impact of individual income taxes has been documented at the local, state, federal, and even international level. OECD-affiliated economists found that a 1 percent shift of tax revenues from income taxes to consumption and property taxes would increase gross domestic product per capita by as much as 1 percent in the long run, and that income taxes were more strongly associated with lower incomes than were sales or consumption taxes.[47] A Canadian study, meanwhile, found that increases in sales taxes are generally associated with increases in economic growth, because they often replace income taxes and other taxes on investment.[48]

One interesting local tax study concluded that a 1 percentage point increase in a state individual income tax rate reduces annual population growth rates by 0.81 percentage points, while a similar 1 percentage point increase in local sales tax rates actually increases the annual growth rate by 0.83 percent,[49] evidently because residents favor the services provided by sales taxes more than they dislike the tax, whereas the opposite is true for local income taxes. The study's authors also speculated that residents considered the sales tax to be more exportable, though the degree to which this is true may be greater for a locality than it is for a state.

Because a well-structured sales tax is more efficient than income taxes, using revenue from sales tax rate increases to pay down income tax rate reductions is economically competitive, as is generating revenue for the same purpose from sales tax base broadening, provided that the base is broadened to previously untaxed final consumption and not to intermediate transactions.

Sales taxes also offer greater stability than income taxes, as can be seen in aggregate state tax collections during and immediately after the Great Recession. By 2010, general sales taxes were down 8 percent from their 2008 peak, while individual income taxes fell 16 percent and corporate income tax collections plummeted a full 25 percent.[50]

The relative stability of sales taxes compared to income taxes was not unique to the Great Recession, and indeed, it makes logical sense. While most of us curtail some expenditures during an economic downturn, there is only so much we can—or are willing to—cut. Even those with no wage income continue to consume, supported by savings and governmental assistance, while those whose incomes decline are likely to reduce savings rates more drastically than consumption. Corporate income tax collections are the most volatile because, even in a deep recession, most individuals earn taxable income, whereas corporations may post actual losses and thus have no net income to tax.

Both income and consumption fall when the economy contracts, but not in tandem, with personal expenditures representing a greater share of income during a downturn. The coronavirus pandemic was the exception that proved the rule, however: sales tax collections were indeed stable, with revenues growing at a steady pace after an initial dip during stay-at-home orders. Rather than declining, however,

47 Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, "Tax and Economic Growth"; Jens Arnold, "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries."

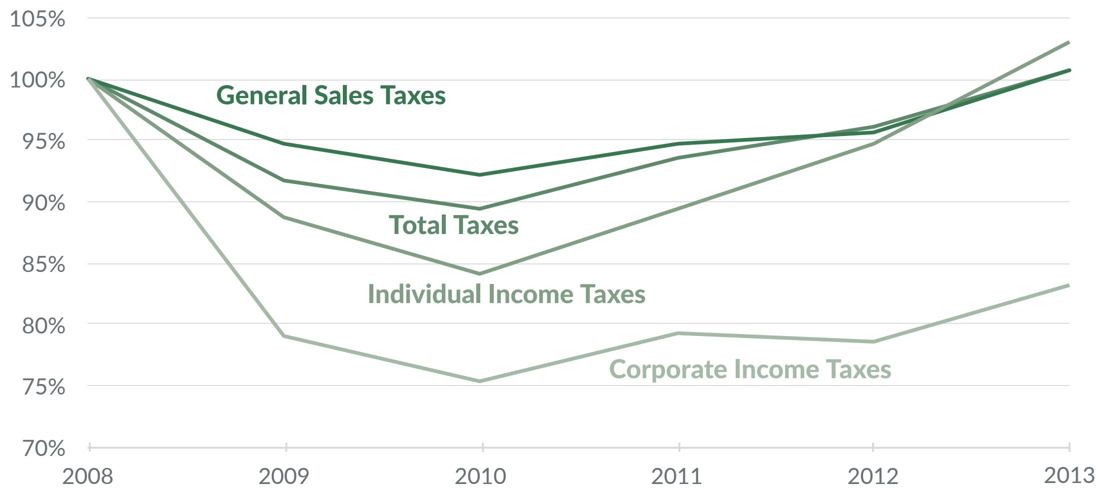
48 Ergete Ferede and Bev Dahlby, "The Impact of Tax Cuts on Economic Growth: Evidence from the Canadian Provinces," *National Tax Journal* 65:3 (September 2012).

49 Stephen T. Mark, Therese J. McGuire, and Leslie E. Papke, "The Influence of Taxes on Employment and Population Growth: Evidence from the Washington, D.C. Metropolitan Area," *National Tax Journal* 53:1 (March 2000), 114-116.

50 Jared Walczak, "Income Taxes Are More Volatile Than Sales Taxes During an Economic Contraction," Tax Foundation, Mar. 17, 2020, https://www.taxfoundation.org/income-taxes-are-more-volatile-than-sales-taxes-during-recession/.

**FIGURE 3.**

## Volatility of State Tax Collections During the Great Recession




Sources: U.S. Census Bureau; Tax Foundation calculations.

income tax collections actually rose as fast or even faster than sales tax collections in many states, thanks to generous income infusions from the federal government that drove personal income to all-time highs. In the absence of such extraordinary intervention, consumption taxes provide a better buffer against the vicissitudes of the business cycle.

### *Impact on Pass-Through Businesses*

Nearly 97 percent of all Kentucky businesses are pass-through businesses, where business income is taxed on ("passes through to") the individual income tax returns of the owner or owners, rather than being taxed at the entity level like a traditional C corporation.[51] Pass-through businesses are often thought of as small businesses, but this is not always the case; some pass-throughs are large businesses, while some C corporations are small. Regardless of whether they are structured as pass-throughs or C corporations, over 99 percent of Kentucky businesses meet the U.S. Small Business Administration's definition of a small business, and small businesses—the vast majority of which pay through the individual income tax—employ nearly 44 percent of the state's workforce.[52]

The individual income tax is therefore extremely important to businesses, because it is the tax that most businesses pay. And while the roughly 13,000 C corporations subject to the state's corporate income tax[53] are also exceedingly important to the state's economy, and punch substantially above their weight in share of the total state workforce, many of their suppliers and clients are subject to the individual income tax, so they too have a stake in lower individual income taxes.

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51 Internal Revenue Service, "Statistics of Income," Historic Table 2, https://www.irs.gov/statistics/soi-tax-stats-historic-table-2; State Tax Data FY 2018, https://www.irs.gov/statistics/soi-tax-stats-state-data-fy-2020.

52 U.S. Small Business Administration Office of Advocacy, "Kentucky," 2020 Small Business Profile, https://advocacy.sba.gov/2020/05/20/2020-small-business-profiles-for-the-states-and-territories/.

53 Internal Revenue Service, "SOI Tax Stats – State Data FY 2018," https://www.irs.gov/statistics/soi-tax-stats-state-data-fy-2018.

### *Impact on Migration and Remote Work*

In the waning days of the 2021 session, the legislature passed a bill that would have provided up to $15,000 in tax credits for remote workers moving to the Commonwealth, among other incentives designed to appeal to increasingly mobile high-income earners. The bill was vetoed,[54] but Lexington is considering providing $10,000 in moving allowances to a small number of high-wage remote workers,[55] and the city of Paducah has already established an incentive program valued at $6,500.[56] These programs are small, and their greatest impact may be as marketing rather than in the direct use of incentives to attract a new pool of high-earning remote workers, but they tap into something real and meaningful: a new work environment in which a growing number of people can work from just about anywhere.

Traditionally, employees have been tied to specific geographies. When almost all work is performed in physical offices, an employer engaged in locational decision-making must find an equilibrium representing the optimal balance of a variety of often competing factors. They must balance costs of doing business (tax burdens, operating costs, regulatory costs, and labor costs) with access to a qualified workforce and quality of life considerations (schools, research universities, transportation systems, housing markets, cultural amenities) that are important to both executives and the workforce they want to attract. Depending on their business model, they may also need to be located close to clients, suppliers, or their customer base.

Simplify the decision, for a moment, to a question of attracting a qualified workforce. Certainly there are plenty of companies that could locate in Louisville or Lexington, and which the state of Kentucky would love to attract to those locations. Tax policy is one way to bring in these employers. But for every business that is located elsewhere, there may still be some employees who would prefer to live in Kentucky. Previously, that option was not available to them. The workforce balance that is optimal overall is never optimal for each individual. Some employees will gladly pay a premium for what more expensive cities have to offer, while others take little or no advantage of their amenities—even though they are paying for them through taxes and a high cost of living—and would far prefer a different arrangement. Traditionally, however, individual preferences are in tension with each other: a person may not appreciate any of the amenities they are paying for but does appreciate working in a field which recruits heavily from people who do.

The rise of remote work changes the equation. To the extent that teams can operate virtually, employees can decide for themselves which bundle of amenities—priced in both cost of living and tax burdens—contribute to their quality of life and which do not, and choose where to live accordingly, knowing that their job will follow them there. Not everyone who takes advantage of this flexibility will do so in pursuit of financial savings. A highly compensated employee might abandon one high-cost, high-tax jurisdiction for another similarly costly locale because she prefers living in a resort destination

54 Joe Sonka, "Gov. Beshear Vetoes Bill Giving Tax Breaks to Remote Workers, Data Centers," *The* (Louisville) *Courier-Journal*, Apr. 9, 2021, https://www.courier-journal.com/story/news/politics/2021/04/09/beshear-vetoes-tax-break-bill-facebook-amazon-remote-workers-data-centers/7162991002/.

55 Beth Musgrave, "Kentucky City Debates Spending $3.4M to Lure Remote Workers," *Lexington Herald-Leader*, Sept. 30, 2021, https://www.govtech.com/news/kentucky-city-debates-spending-3-4m-to-lure-remote-workers.

56 Karla Ward, "Working Remotely? This Kentucky City Might Pay You to Relocate There," *Lexington Herald-Leader*, Aug. 18, 2021, https://www.kentucky.com/news/state/kentucky/article253556124.html.

to a major metropolitan area. Others, however, will move for lower taxes, a lower cost of living, or a higher (to them) quality of life—things that will often go together.

One of Kentucky's great challenges, of course, is its border with Tennessee, which forgoes an individual income tax. Getting to zero, like Tennessee, would make a bold statement, but Kentucky can be competitive on the tax front even without that. Furthermore, because Kentucky levies local income taxes (occupational license taxes), it is important to keep in mind that even if the state achieved the lofty goal of repealing its state individual income tax, it still would not join the ranks of the no-income-tax states without also repealing its local income taxes.

For Tennessee, high sales taxes are one of the trade-offs of forgoing an individual income tax. In fact, Tennessee is tied with Louisiana for having the highest combined state and average local sales tax rate in the country at 9.55 percent.[57] This combined rate is nearly 60 percent higher than the rate in Kentucky. This is a trade-off that has paid dividends for Tennessee, but also one that must be considered carefully.

## Local Income Taxation

Fifteen states tax either personal or business income at the municipal level, and only eight—including Kentucky—tax both. In Kentucky, these income taxes bear the unusual name of occupational license taxes, a holdover from a time before the creation of modern income taxes, when certain taxes were levied on the holding of specific occupations. Today, occupational license and net profit taxes in Kentucky serve as broad taxes on the net income of businesses and wage earners alike. As with local income taxes of a similar origin in Pennsylvania, the tax on individuals is limited to earned income, so it does not extend to investment income, inheritances, or other forms of unearned income.

Kentucky's occupational license tax has a statewide average effective rate of 1.4 percent of state adjusted gross income (AGI), making it the fourth-highest local income tax levy in the country, after Maryland (2.4 percent), Ohio (1.6 percent), and New York (1.6 percent). Only two other states—Pennsylvania and Indiana—even have effective rates in excess of 0.2 percent, making Kentucky an extreme outlier.[58]

57 Janelle Cammenga, "State and Local Sales Tax Rates, Midyear 2021," Tax Foundation, July 8, 2021, https://www.taxfoundation.org/publications/state-and-local-sales-tax-rates/.

58 U.S. Census Bureau, "Annual Survey of State and Local Government Finances"; Internal Revenue Service, "Statistic of Income by State"; Tax Foundation calculations.

**TABLE 2.**

### Local Individual Income Tax Effective Rates

*Aggregate Local Income Tax Collections as a Percentage of State AGI*

| State | Average Effective Rate |
|---|---|
| Maryland | 2.4% |
| Ohio | 1.6% |
| New York | 1.6% |
| Kentucky | 1.4% |
| Pennsylvania | 1.2% |
| Indiana | 0.5% |
| Missouri | 0.2% |
| Michigan | 0.2% |
| Iowa | 0.1% |
| Alabama | 0.1% |

Notes: Delaware, Kansas, and New Jersey have local income tax authority that is too limited to result in effective rates that round above zero percent. Oregon has recently implemented local income taxation in the Portland metro area that will show up in future data releases. Some Colorado and West Virginia jurisdictions have flat dollar-denominated wage taxes of up to a few dollars per week.

Sources: U.S. Census Bureau; Internal Revenue Service; Tax Foundation calculations.

Thirteen states allow municipal taxation of individual income (sometimes only negligibly, or in a single jurisdiction), while nine allow such taxes on business income. New York City's sizable corporate income tax dominates local business income tax collections nationwide, but Kentucky's local business taxes account for 16 percent of the remainder. Kentucky is clearly an outlier in giving income tax authority to local governments and has the fifth-most taxing jurisdictions of any state, at 213. Sixty-nine of Kentucky's 120 counties levy municipal income taxes, as do 138 cities, five school districts, and a mental health district.[59]

Sometimes these rates can be quite high. A resident of Covington, for instance, faces a 2.5 percent city tax rate plus a 1.05 percent county rate for a combined local rate of 3.55 percent, a substantial addition to the state's 5 percent income tax rate that places the all-in income tax burden closer to those of Vermont and New York (excluding New York City) than the rates that predominate in the south and Midwest. In Frankfort, the combined city and county rate is 3 percent, in Lexington the unified local rate is 2.75 percent (which includes a unified city-county rate plus a school district assessment), and in Louisville the rate is 2.2 percent.[60]

A resident of Kentucky's capital city faces an 8 percent state and local income tax. To put that in context, it is higher than the top combined state and local individual income tax rate in any jurisdiction in all but 10 states and the District of Columbia. This tax also applies to business income and is higher than the combined state and local corporate income tax rates of all but 13 states and the District of Columbia.

59 Jared Walczak, "Local Income Taxes in 2021," Tax Foundation, forthcoming.

60 Id.

**TABLE 3.**

**Frankfort's Corporate Income Tax Rate Is High Nationally**

*Frankfort, KY vs. the Highest Combined State and City Rates Outside Kentucky*

| City or State | Combined CIT Rate |
|---|---|
| New York, NY | 16.10% |
| New Jersey | 11.50% |
| Pennsylvania | 9.99% |
| Iowa | 9.80% |
| Minnesota | 9.80% |
| Illinois | 9.50% |
| Alaska | 9.40% |
| Maine | 8.93% |
| California | 8.84% |
| Delaware | 8.70% |
| Vermont | 8.50% |
| Maryland | 8.25% |
| District of Columbia | 8.25% |
| Frankfort, KY | 8.00% |
| *(tied with LA and MA)* | |

Source: Tax Foundation research.

In addition to hampering the Commonwealth's overall competitiveness by adding substantially to otherwise relatively competitive state corporate and individual income tax rates of 5 percent, the business tax component also adds complexity by taxing the net income of a business differently than the state does. At the state level, C corporations pay the corporate income tax, while income from pass-through businesses (S corporations, partnerships, LLCs, and sole proprietorships) flows through to the owners' individual income tax returns. For occupational and net profit tax purposes, however, pass-through businesses can have liability at the entity level, and this liability can be apportioned among jurisdictions as is done with corporate, but not individual, income taxes. Even for C corporations, moreover, apportionment at the local level is different than apportionment under the state's corporate income tax.

When businesses operate in multiple jurisdictions, it is necessary to apportion their net income across those jurisdictions for tax purposes. States do this by adopting an apportionment formula that looks at some combination of the share of the company's total payroll, property, or sales that are located within the state—or, increasingly, by focusing exclusively on the sales factor.

Kentucky uses single sales factor apportionment, meaning corporate profits are apportioned to Kentucky for tax purposes based on the percentage of the company's total sales into Kentucky. Single sales factor apportionment has increasingly been adopted by states in recent years, as it allows businesses to locate plants, equipment, and labor in the state without triggering higher corporate income tax burdens. The standard approach for local net profit taxes, however, differs from the state's formula. If a business has payroll in more than one Kentucky city or county, then a two-factor payroll and sales apportionment formula is used—a system not employed anywhere in the country at the state level. If payroll is located in a single Kentucky jurisdiction, then only sales factor apportionment is used, consistent with the state's approach.[61] The inclusion of payroll in local income tax apportionment formulas, particularly when not present in the state's apportionment formula, adds complexity while creating an extra disincentive for businesses to locate employees in cities or counties that levy local income taxes or to expand and operate in more than one local jurisdiction in Kentucky. The state could mitigate this by requiring all localities follow the state in using single sales factor apportionment.

Kentucky's constitution authorizes, but does not require, the legislature to grant occupational license tax authority.[62] With that power comes the ability to regulate and restrict it. Currently, Kentucky statutes simply extend this authority with very little restriction,[63] but the legislature could, by law, impose constraints on local taxing authority, like requiring the exclusive use of single sales factor apportionment for net income taxation to align with state taxing authority, or ensuring that pass-through business income is sourced to the owner and taxed where earned, as with individual income taxes, rather than being apportioned as is corporate income.

Additionally, some policymakers have advanced a constitutional amendment to grant local option sales tax authority. Thirty-eight states grant at least some local sales tax authority, making this form of local taxation significantly more common than local income taxes. It is also more economically efficient, for reasons discussed elsewhere. Were local governments granted sales tax authority, policymakers should consider pairing this with restrictions on occupational license tax reliance, which could be accomplished either in the constitution or by statute.

Ideally, Kentucky would shift from local income taxation altogether, as Kentucky is one of only 15 states that allow this as an option. Short of that, localities could be given the choice of levying either a local sales tax or a local income tax, but not both. For localities that would choose to replace their income tax with a sales tax, this could be accomplished incrementally, with the two taxes paired under a sort of levy limit that would require that any revenue raised under local sales taxes be used to offset a rate reduction in local incomes taxes until the income tax is phased out altogether.

Tackling local taxes, even antiquated and uncompetitive ones like Kentucky's occupational license taxes, is inherently difficult. Nevertheless, this tax, which yields high overall income tax burdens and undermines the Commonwealth's tax competitiveness, warrants scrutiny.

61 See Louisville/Jefferson County Metro Code of Ordinances § 110.06.

62 Ky. Const. §181.

63 Ky. Rev. Stat. § 92.281.

## Individual Income Tax Reform Solutions

Compared to many of its regional and national competitors, Kentucky overtaxes productivity and under-taxes consumption, despite income taxes being the more economically harmful and volatile source of revenue. Low- and no-income tax states across the country are experiencing robust growth and rapid in-migration, enhanced by increased workplace flexibility that is allowing more people to live in one state while working for an employer located in another. For Kentucky to keep up with its peers and gain a competitive edge, a highly competitive individual income tax will be essential.

### *Pay Down Individual Income Tax Rate Reductions with Sales Tax Modernization*

In 2021 alone, 11 states enacted laws to reduce their individual income tax rates, a trend that is expected to continue as states vie for competitive standing in an increasingly mobile economy. Kentucky legislators took the laudable step in 2018 of using sales tax base broadening to consolidate the state's individual income tax brackets and reduce the rate, and lawmakers should continue working to build upon these reforms by further reducing the state individual income tax rate to better compete with neighboring Indiana, which boasts a 3.23 percent rate, and Tennessee, which does not levy an individual income tax at all. In order to achieve a substantially lower individual income tax rate closer to Indiana's, Kentucky lawmakers will need to generate additional revenue from other, less economically harmful parts of the tax code, and the sales tax is a highly viable alternative.

With each passing year, Kentucky's sales tax becomes less representative of the state's economy, with sales tax bases across the country eroding as consumer spending patterns continue to shift. Modernizing the sales tax base by broadening it to additional consumer goods and services would generate substantial revenue for income tax relief, as is discussed in detail in the sales tax section. Done properly, this is a win for taxpayers, as it reduces reliance on an uncompetitive tax by raising more money from a less damaging one, while creating a more neutral—and thus less inefficient—tax base for the sales tax by eliminating economically unsound carveouts and exclusions.

Based on FY 2022 estimated individual income tax receipts and the sales tax base-broadening revenue estimates in Table 6, if personal services (all non-health or education-related services) were added to the sales tax base, the individual income tax rate could be reduced from 5 to approximately 4.69 percent, all else being equal. If personal services and groceries were added to the base, the rate could be reduced to approximately 4.19 percent. If the full list of sales tax base broadeners shown in Table 6 were added to the base, the individual income tax rate could be 1.23 percent. If the sales tax base were broadened to the full list in Table 6 and the state sales tax rate were increased to 7.64 percent, that would be enough revenue to eliminate the state individual income tax altogether. Table 4 shows how these and other sales tax base-broadening options could be paired with reductions to the individual income tax rate.

**TABLE 4.**

**Base-Broadening Options with Revenue Estimates and Revenue-Neutral Individual Income Tax Rates**

*Revenues in Millions of Dollars*

| Revenue-Neutral Individual Income Tax Rate | Revenue Generation | | |
|---|---|---|---|
| | Cumulative | Component | Base Broadener/Revenue Raiser |
| 5.00% | $0 | $0 | Current sales tax base |
| 4.69% | $326.0 | $326.0 | Untaxed personal services |
| 4.19% | $839.0 | $513.0 | Food |
| 3.81% | $1,239.0 | $400.0 | Residential utilities |
| 3.57% | $1,480.8 | $241.8 | Motor fuels |
| 1.23% | $3,886.2 | $2,405.4 | Health and education-related goods/services |
| 0.00% | $5,193.0 | $1,306.8 | Increase sales tax rate to 7.64% |

Sources: Commonwealth of Kentucky, Tax Expenditure Analysis, FYs 2020-22; BEA; USDA; Council on State Taxation, "The Impact of Imposing Sales Taxes on Business Inputs" (May 2019); Tax Foundation calculations.

An alternative, more incremental approach would be for lawmakers to use revenue triggers—discussed previously, in the context of business tax reforms—to return a portion of future revenue growth to taxpayers in the form of lower individual income tax rates. This approach would help keep Kentucky's income tax rate on a downward trajectory as other states work to lower their own.

### *Shift from Local Income Taxes*

While it is always difficult to tinker with local tax models, if the Commonwealth chooses to grant local governments sales tax authority—discussed in the relevant section—this presents an opportunity to tie the implementation of local option sales taxes to the repeal of municipal income taxes.

Were local governments granted sales tax authority, policymakers should consider pairing this with restrictions on occupational license and net profit tax reliance, which could be accomplished either through a constitutional amendment or by statute. Specifically, the state could consider requiring any locality adopting a local option sales tax to use that revenue to offset the repeal or phaseout of its occupational license tax. Ideally, any locality adopting a local option sales tax would repeal its occupational license tax altogether so as to reverse Kentucky's status as an outlier in this regard, as well as to remove these complex and economically harmful taxes from the books.

### *Shift to Single Sales Factor Apportionment of Local Net Profit Taxes*

As long as municipal income taxes are levied in Kentucky, those taxes will discourage businesses from locating or expanding in certain jurisdictions, especially given the fact that Kentucky's local income taxes use two-factor apportionment. Shifting to single sales factor apportionment at the local level would reduce complexity and slightly mitigate the disincentive these taxes create to locate or expand in certain localities.

# SALES AND USE TAXES

## Sales Tax History, Rate, and Collections

Kentucky's sales and use tax is imposed on gross receipts from retail sales of tangible personal property, digital property, and specified services. First enacted in 1934 as a 3 percent tax on retail gross receipts, the original tax was repealed in 1936 but reinstated in its modern form in 1960, again at a rate of 3 percent.[64] The rate increased to 5 percent starting in 1968 and to 6 percent starting in 1990 but has remained static ever since.[65]

In FY 2019, the sales and use tax generated just under $4 billion, or nearly 31 percent of Kentucky's state tax revenue.[66] As a share of total state tax revenue, Kentucky's reliance on sales taxes is on par with the national average. However, as a share of total combined state and local tax revenue, Kentucky relies less on sales taxes than the average state, since the state constitution does not grant localities the authority to levy sales taxes.

When considering the combined state and average local rates in other states, Kentucky's sales tax rate is among the lowest in the country and well below the national median rate of 7 percent.[67] Of the states that levy sales taxes, only six have combined state and average local rates that are lower than Kentucky's: Alaska (which has local sales taxes but no state sales tax), Hawaii, Maine, Virginia, Wisconsin, and Wyoming.

Table 5 shows the state, average local, and combined rates in each of the states that share a border with Kentucky, and Figure 4 shows the combined state and average local sales tax rate in every state. Among Kentucky's neighboring states, only Virginia has a lower combined rate.

**TABLE 5.**

**Sales Tax Rates, Kentucky and Neighboring States (as of July 1, 2021)**

| | State Rate | Average Local Rate | Combined Rate |
|---|---|---|---|
| Kentucky | 6.00% | 0.00% | 6.00% |
| Illinois | 6.25% | 2.58% | 8.83% |
| Indiana | 7.00% | 0.00% | 7.00% |
| Missouri | 4.225% | 4.03% | 8.25% |
| Ohio | 5.75% | 1.47% | 7.22% |
| Tennessee | 7.00% | 2.55% | 9.55% |
| Virginia | 5.30% | 0.45% | 5.75% |
| West Virginia | 6.00% | 0.51% | 6.51% |

Note: City, county, and municipal rates vary. These rates are weighted by population to compute an average local rate.
Sources: Sales Tax Clearinghouse; Tax Foundation calculations; state revenue department websites.

64 Commonwealth of Kentucky Tax Expenditure Analysis, "Sales and Use Tax," FY 2004-2006, https://osbd.ky.gov/Publications/Pages/Special-Reports.aspx.

65 *The New York Times*, "Kentucky Sales Tax Will Increase to 5%," Mar. 17, 1968, https://www.nytimes.com/1968/03/17/archives/kentucky-sales-tax-will-increase-to-5.html; and Mike Haydon, "Annual Report 1999-2000," Kentucky Revenue Cabinet, 6.

66 U.S. Census Bureau, "Annual Survey of State and Local Government Finances (FY 2019)."

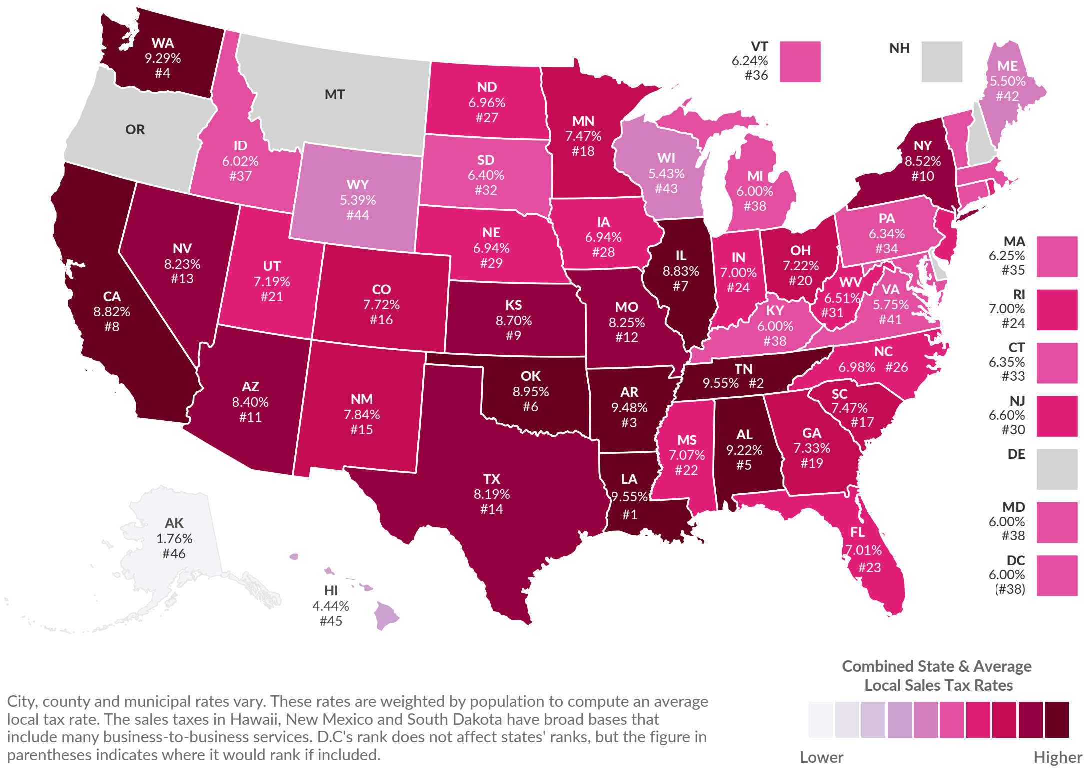
67 Janelle Cammenga, "State and Local Sales Tax Rates (as of July 1, 2021)."

Like its sales tax rate, Kentucky's sales tax collections per capita are on the low side regionally and nationally. In FY 2019, Kentucky brought in $892 in state sales tax collections per capita, below the national average of $967 per capita. When looking at state and local sales tax collections combined, only five states with statewide sales taxes had lower combined collections per capita than Kentucky.[68]

**FIGURE 4.**

**Kentucky's Sales Tax Rate is Low Regionally and Nationally**

*Combined State & Average Local Sales Tax Rates, July 2021*




City, county and municipal rates vary. These rates are weighted by population to compute an average local tax rate. The sales taxes in Hawaii, New Mexico and South Dakota have broad bases that include many business-to-business services. D.C's rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.

Sources: Sales Tax Clearinghouse; Tax Foundation calculations; State Revenue Department websites.

## Kentucky's Sales Tax Base Is Narrow and Has Eroded Over Time

In addition to having a below-median sales tax rate and below-average collections per capita, Kentucky's sales tax base—the basket of goods and services to which the sales tax applies—is narrower than is ideal and has eroded over time, despite modest base broadening adopted in 2018.

A well-structured sales tax applies to all final personal consumption, both goods and services, while excluding business inputs to prevent tax pyramiding. Tax pyramiding occurs when the sales tax is applied at one or more intermediate stages of the production process, raising the cost of the final good or service sold, with final consumers paying a tax on a tax.

In this search for a more modern sales tax base, policymakers should keep in mind several main principles and features of sales taxation that are broadly accepted by public finance scholars and tax policy researchers across the board, namely:

68 Janelle Cammenga, *Facts & Figures 2021: How Does Your State Compare?*

1. An ideal sales tax is imposed on all final consumption, both goods and services;

2. An ideal sales tax exempts all intermediate transactions (business inputs) to avoid tax pyramiding;

3. Sales taxes should be destination-based, meaning that tax is owed in the state and jurisdiction where the good or service is consumed;

4. The sales tax is more economically efficient than many competing forms of taxation, including the income tax, because it only falls on present consumption, not saving or investment;

5. Because lower-income individuals have lower savings rates and consume a greater share of their income, the sales tax can be regressive, though broadening the base to include additional consumer services (much more heavily consumed by higher-income individuals) represents a progressive change;

6. The sales tax scales well with ability to pay, because it grows with consumption and is therefore more discretionary than many other forms of taxation; and

7. Consumption is a more stable tax base than income, though the failure to tax most consumer services is leading to a gradual erosion of sales tax revenues as services become an ever-larger share of consumption.

In practice, policymakers are unlikely to opt for the inclusion of all personal consumption in the sales tax base, since this would include all education and health services.[69] Failing to make any realignment at all, though, risks a sales tax that no longer reflects sales and consumption in Kentucky.

Charles McLure, a leading tax scholar, has outlined several reasons governments should avoid taxing business inputs.[70] For one thing, taxing business inputs creates high effective tax rates for certain businesses and industries that rely heavily on various inputs that happen to be taxable. This exacerbates non-neutralities in the tax code, since some businesses—especially those with long chains of production—are impacted substantially more than others. Imposing sales taxes on business inputs creates an incentive for businesses to vertically integrate—even when purchasing from suppliers or utilizing contractors might otherwise be a more economically efficient choice—in order to avoid exposure to taxable business-to-business transactions.

McLure also points out that taxing business inputs causes "the perceived cost of government to be understated," as it keeps tax rates "artificially low," since consumers see only the tax amounts printed on their receipts and have no way of knowing how much they are paying in taxes that are embedded *within* the retail price of the goods or services they purchase.[71]

69 For documentation of the taxability of services in Kentucky and other states, see Federation of Tax Administrators, "FTA 2017 Services Taxation Survey," https://www.statetaxissues.org/services/2017/.

70 Charles E. McLure Jr., "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" *BYU Law Review* 2000:1 (Mar. 1, 2000), 83, https://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=2052&context=lawreview.

71 Id.

In this way, the taxation of business inputs has something in common with certain excise taxes. Among other industry-specific taxes, for instance, Kentucky's bourbon industry pays an aging barrels tax, literally imposed on the process of aging bourbon. Consumers do not see this tax on a receipt, but much of it is ultimately embedded in the price of bourbon. To the extent that this Kentucky tax may drive some consumers away from Kentucky bourbon toward other alcoholic beverages on the margin, moreover, some of the cost will be borne by producers in the form of lower profits. The same thing happens with the sales taxation of business inputs, except that the effect is typically less concentrated within a specific industry.

While sales taxes on business-to-business transactions should be avoided, McLure asserts that sales taxes should apply equally to all final personal consumption—including tangible goods, intangible goods, and services—to achieve better neutrality, simplicity, and horizontal equity in the tax code.[72]

Most state sales tax bases fall far short of this ideal structure, capturing many business inputs that should be excluded while exempting a great deal of household consumption that should be taxable. A 2019 study from Ernst & Young and the Council on State Taxation (COST) found that in FY 2017, an estimated $157 billion, or nearly 42 percent of state and local sales tax revenue, was attributable to sales taxes on business inputs rather than on household consumption, and that share was slightly higher in Kentucky.[73] Meanwhile, only about 21 percent of household spending is subject to the sales tax.[74] The study also found that in the aggregate, state and local governments raise about 2.5 times more revenue from imposing sales taxes on business inputs than from levying corporate income taxes.[75]

While every state falls short of the ideal sales tax structure, some states do better than others. Apples-to-apples comparisons of state sales tax bases are difficult since exemptions vary widely from state to state, but one method of approximating sales tax breadth is to calculate the total value of taxed transactions as a percentage of total state personal income. This calculation yields a sales tax breadth of 39 percent for Kentucky for fiscal year 2020.[76] While this is slightly greater than the national median of 36 percent, it is far narrower than is ideal. A robust, well-structured sales tax base would not reach 100 percent of personal income, as not all personal income is consumed in any given year, but a tax on all final personal consumption would result in a sales tax breadth equal to approximately 75 percent of personal income.[77]

It is important to keep in mind that Kentucky's sales tax base has not always been this narrow. In 1970, Kentucky's sales tax breadth was 58 percent, meaning roughly 58 percent of the personal income of Kentucky residents was spent on purchases that were subject to the sales tax. Today, only 39 percent of personal income is spent purchasing goods or services that are subject to the sales tax. Figure 5 shows how Kentucky's sales tax breadth has narrowed over time.

72 Id.

73 Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," EY and COST, May 2019, 7-8, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf.

74 Id. at 4.

75 Id. at 7.

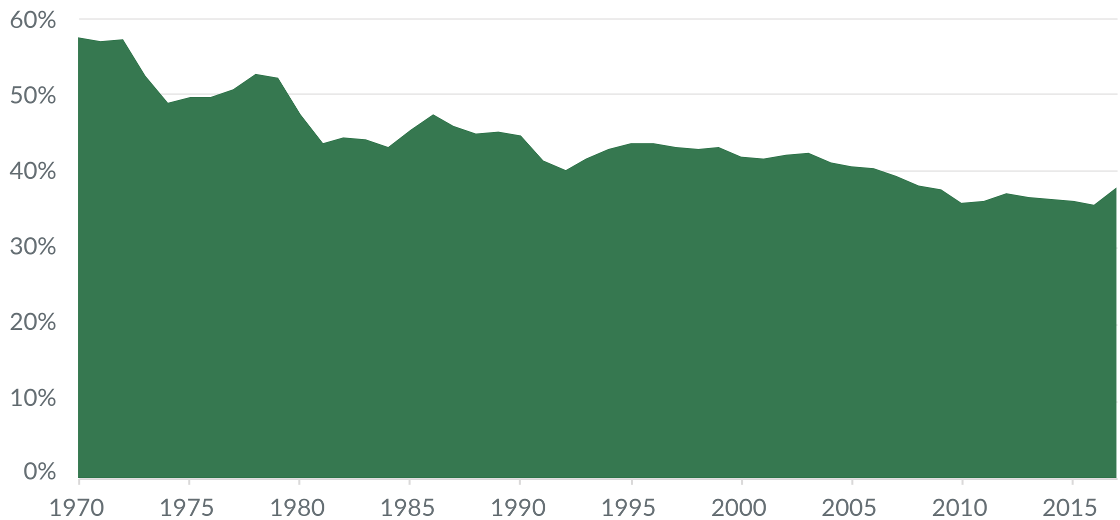
76 Janelle Cammenga, *Facts & Figures 2021: How Does Your State Compare?*

77 Tax Foundation calculations using Bureau of Economic Analysis data on personal consumption expenditures.

**FIGURE 5.**

## Kentucky's Sales Tax Breadth Has Declined Over Time

*Value of Taxed Transactions as a Percentage of State Personal Income (1970-2017)*




Source: Late Prof. John Mikesell, Indiana University.

One factor contributing to the erosion of Kentucky's sales tax base is the creation of new exemptions over time, often for social policy reasons rather than for reasons pertaining to the tax structure itself. For example, food for home consumption and prescription drugs were subject to Kentucky's sales tax until 1972.[78] The base-narrowing effect of the creation of these exemptions is visible in Figure 5.

Another major factor contributing to declining sales tax breadth in Kentucky and elsewhere is that American consumption habits have shifted over time. When states first began adopting sales taxes in the 1930s in response to revenue declines triggered by the Great Depression, the U.S. economy was heavily goods-oriented, with goods representing close to 60 percent of total U.S. personal consumption expenditures. Today, that has flipped, with goods representing only about 33 percent of personal consumption expenditures and services representing the other 67 percent.

While a tax on the sale of tangible personal property once captured the majority of personal consumption, it now falls short, capturing only a small share of personal consumption. As sales tax bases have eroded over time, states have repeatedly turned to sales tax rate increases or alternative taxes to recoup lost revenue. In Kentucky's case, the result was a 1 percentage point sales tax rate increase that took effect in April 1968 and again in July 1990, the consequence of a school funding case decided by the state supreme court in 1989.[79] This trend of rate increases and more reliance on other more economically harmful taxes can be expected to continue until states meaningfully reexamine and modernize their sales tax bases.[80]

78 William Hoyt, William Fox, Michael T. Childress, and James Saunoris, "Report to Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants, University of Kentucky, Sept. 19, 2012.

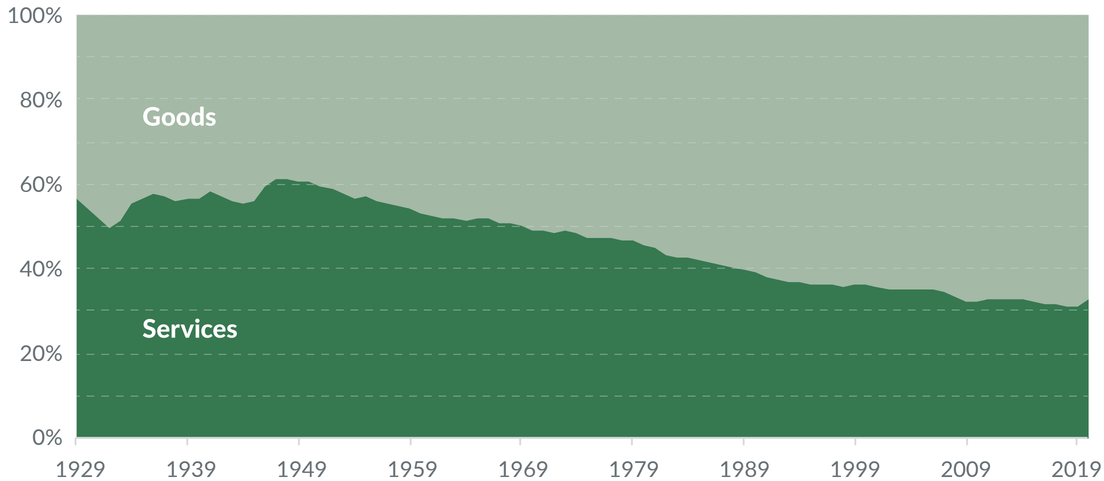
79 *The New York Times*, "Kentucky Sales Tax Will Increase to 5%"; Mike Haydon, "Annual Report 1999-2000"; *Rose v. Council for Better Educ., Inc.*, 790 S.W.2d 186 (1989).

80 Jared Walczak, "State Sales Tax Breadth and Reliance, Fiscal Year 2020," Tax Foundation, Feb. 9, 2021, 2, https://www.taxfoundation.org/sales-tax-base-reliance-2020/.

**FIGURE 6.**

## Goods Have Declined as a Share of Personal Consumption

*Percent of Total Personal Consumption Expenditures, Goods vs. Services, U.S. (1929-2020)*




Source: Bureau of Economic Analysis, National Income and Product Accounts.

The sales tax should also be broad-based in service of tax equity.[81] Sales taxes have two potential sources of regressivity: one, the propensity of lower-income individuals to consume a greater share of their income, and two, a scope of taxable consumption that is more likely to fall on the sorts of transactions which dominate the consumption of lower- and middle-income individuals.

Policymakers often exempt or lower rates on certain classes of consumption as a progressive reform. Excluding groceries from the sales tax base, or taxing them at a reduced rate, is one such example—though there is reason to believe it may not be terribly effective. Prepared foods are taxed at the standard rate and most of the regressivity of taxing unprepared foods is addressed by the exemption for SNAP (food stamps) and WIC purchases, while the exemption is enjoyed by high-income earners as well—who often spend considerably more on groceries.

In fact, while not enough work has been undertaken to establish a consensus, there is research finding that lower-income taxpayers would actually be better off if groceries were fully included in sales tax bases (while retaining the federally indicated exemption of SNAP and WIC purchases) and revenue-neutral adjustments made to the tax rate.[82] The lower grocery rate is designed to create progressivity but largely fails to do so—at a cost of about $520 million a year, which, on its own, would be enough to reduce the individual income tax rate by about 0.4 percentage points.

Kentucky's sales tax exemption for residential utilities is responsible for another $400 million in forgone sales tax revenue. It is true that utilities—unlike groceries—are subject to other taxes, but those taxes are specific to the impact of utility use and are separate from consumption itself. If utilities were included in the sales tax base as a way to offset more economically inefficient taxes, Kentucky taxpayers could benefit.

81 See generally, Nicole Kaeding, "Sales Tax Base Broadening: Right-Sizing a State Sales Tax," Tax Foundation, Oct. 24, 2017, https://www.taxfoundation.org/sales-tax-base-broadening/.

82 Steven M. Sheffrin and Anna L. Johnson, "Rethinking the Sales Tax Food Exclusion with SNAP Benefits," *State Tax Notes*, Jan. 11, 2016, 157, https://pdfs.semanticscholar.org/6f18/cca38dfaa9591be264e4bff539573dae6d7c.pdf.

Notably, at the same time that policymakers have preserved the grocery exemption as a dubious means of addressing sales tax regressivity, and excluded utilities (presumably because they are taxed in other ways), they have only just begun to work on a more straightforward way to promote equity within the sales tax by broadening the base to additional consumer services in 2018.

Consumption of personal services tends to be more discretionary than consumption of goods. Consequently, higher-income individuals tend to spend a greater share of income on services, which are frequently untaxed. Expanding the sales tax base to additional services rights an accidental wrong in the sales tax as currently formulated, one that presently favors wealthier individuals.

In recent years, Kentucky has taken several important steps to begin modernizing the state's sales tax base. In 2009, certain digital property became subject to taxation, including music downloads, audiobooks, digital newspaper and magazine subscriptions, and video games, among others.

In 2018, the Kentucky General Assembly took another significant step toward right-sizing the state's sales tax base, broadening it to select additional services, including labor and other services related to the repair, installation, or maintenance of personal property; landscaping services; janitorial services; pet grooming and boarding services; small animal veterinary services; fitness and recreational sports; bowling; golf courses and country clubs; nonmedical diet and weight loss centers; laundry, dry cleaning, and linen supply services; industrial (uniform) laundry services; limousine services; overnight trailer campgrounds; extended warranties; pollution control facilities; and other personal services.

While most of these newly taxable services are primarily purchased by households, the law did bring in some business inputs that should have remained exempt, such as janitorial services and industrial laundry services. Similarly, landscaping services are purchased by businesses and households alike, but the law does not currently distinguish between business and household purchases when designating these services as taxable.[83] The law does, however, exempt from the sales tax any separately stated labor charges associated with the sale of "services to apply, install, repair or maintain tangible personal property directly used in the manufacturing or industrial processing process" of tangible property and alcoholic beverages.[84]

## Well-Designed Sales Taxes Are an Economically Efficient Revenue Source

Moving forward, if Kentucky's sales tax is to function efficiently and effectively as a major source of revenue in the years and decades ahead, lawmakers should continue working to right-size the base in order to maintain a low or moderate rate and avoid having to increase reliance on other, more economically harmful taxes.

A retail sales tax that applies broadly to final personal consumption but excludes business inputs is far superior to most alternative tax types, including income taxes. As stated elsewhere, consumption taxes are less of an impediment to economic growth and location decisions than are income taxes.[85] While

83 Kentucky Tax Answers, "Landscape Services Frequently Asked Questions," https://taxanswers.ky.gov/Sales-and-Excise-Taxes/Pages/Landscape-Services-FAQs.aspx.

84 KRS 139.470.

85 See Joseph Bankman and David A. Weisbach, "The Superiority of an Ideal Consumption Tax over an Ideal Income Tax."

consumption taxes do fall on suppliers of labor and capital, like income taxes, they do so neutrally and—at least when well-designed—avoid double-taxing these factors.

Kentucky's sales tax, as discussed previously, is destination-sourced, meaning it is levied where the good or service is consumed, not produced. Thus, unlike income taxes, sales taxes do not discourage investment or job creation when they are levied on final consumers.[86] They can, however, increase the cost of doing business in the state when they are inappropriately levied on business inputs.

## Kentucky Should Right-Size Its Sales Tax Base

Given that sales taxes are less economically harmful than most alternative sources of revenue, Kentucky lawmakers should modernize the sales tax base to final consumer goods and services that are currently untaxed. This would generate revenue that would allow the state to reduce its reliance on more harmful taxes. Kentucky lawmakers have already taken significant steps in the right direction, but many consumer goods and services currently go untaxed that could be added to the base. Table 6 shows several options for sales tax base broadening, with the estimated revenue impact for each good or service shown.

The revenue estimates in this table are primarily based on the Kentucky Tax Expenditure Analysis for fiscal years 2020-22, which was produced by the Office of State Budget Director.[87] The Tax Expenditure Analysis acknowledges several data limitations that make the accuracy of the report's estimates difficult to confirm, so any policy changes considered based on these estimates should be approached cautiously to avoid overestimating the amount of revenue that could be generated from broadening the sales tax base to various services that are currently untaxed.[88]

It is also important to keep in mind that while the services listed in Table 6 are purchased primarily by final consumers, there are some instances in which these services are purchased as business inputs. The sales tax should not be applied when the purchaser of a good or service is a business, but the revenue estimates shown below do not attempt to quantify the extent to which each service is purchased by households versus businesses. As such, the revenue that would be generated from broadening the sales tax base in a structurally sound manner would in many cases be presumed to be lower than the amount shown in the table. (The one exception is legal services, where the estimated revenue impact of broadening the sales tax base to consumer purchases but not business-to-business purchases is shown.)

86 Douglas L. Lindholm and Karl A. Frieden, "After *Wayfair*: Modernizing State Sales Tax Systems."

87 Kentucky Office of State Budget Director, "Tax Expenditure Analysis, Fiscal Years 2020-2022."

88 Id. at 190-91.

**TABLE 6.**

## Sales Tax Base Broadening Options with Revenue Estimates

| Good or Service | Revenue Estimate |
|---|---|
| Drive-in motion picture theaters | $93,994 |
| Photofinishing | $162,862 |
| Water softening and conditioning services | $282,436 |
| Admissions to historical sites | < $500,000 |
| Investigation services | $513,108 |
| Barber shops | $568,732 |
| Tour operators | $687,473 |
| Nail salons | $804,247 |
| Consumer electronics repair and maintenance | $887,343 |
| Septic tank and related services | $1,414,678 |
| Parking lots and garages | $1,835,533 |
| Locksmiths | $1,902,433 |
| Photographic services | $2,335,169 |
| Carpet and upholstery cleaning services | $2,665,057 |
| Private mail centers | $2,723,330 |
| Personal and household goods repair and maintenance | $4,695,691 |
| Textbooks | $6,000,000 |
| Sales by elementary and secondary nonprofit, school-sponsored clubs and organizations | $6,100,000 |
| Home and garden equipment and appliance repair and maintenance | $6,326,283 |
| Travel arrangement and reservation services | $7,162,846 |
| Tax preparation services | $7,221,195 |
| Exterminating and pest control services | $7,612,685 |
| Tombstones and other grave markers | $7,700,000 |
| Architectural services | $10,340,329 |
| Transit and ground passenger transportation | $11,228,353 |
| Beauty salons | $13,350,862 |
| Ambulance services | $16,433,959 |
| Medical and diagnostic laboratories | $16,730,644 |
| Admissions to nonprofit civic, governmental, or other nonprofit organizations; fundraising event sales | $18,300,000 |
| Funeral homes and funeral services | $22,575,901 |
| Child day care services | $23,702,103 |
| Home health care services | $38,958,823 |
| Legal services* | $39,406,129 |
| Offices of other health practitioners | $56,599,072 |
| Offices of dentists | $70,871,457 |
| Outpatient care centers | $73,256,886 |
| Financial service charges, fees, and commissions | $179,252,445 |
| Nursing and residential care facilities | $182,121,293 |
| Motor fuels | $241,757,121 |
| Offices of physicians | $356,851,928 |
| Residential utilities | $400,000,000 |
| Food items (excluding SNAP and WIC purchases) | $513,000,000 |
| Prescription medicine, prosthetic devices, and physical aids | $690,000,000 |
| Hospitals | $841,798,774 |

*The Council on State Taxation estimates legal services are consumed 32 percent by households and 68 percent by businesses. Revenue estimate shown represents the estimated household share only.

Note: With the exception of legal services, revenue estimates do not distinguish between consumer purchases and business-to-business purchases. As such, some revenue estimates are overstated—including architectural and tax preparation services—since some services shown are purchased by both households and businesses.

Sources: Commonwealth of Kentucky, Tax Expenditure Analysis, FYs 2020-22; BEA; USDA; Council on State Taxation, "The Impact of Imposing Sales Taxes on Business Inputs" (May 2019); and Tax Foundation calculations.

Table 7 provides a more granular list of services that are mostly or entirely purchased by households but that are not yet subject to the sales tax in Kentucky. Many of these services are, however, already taxed by one or more of Kentucky's neighbors. In fact, each of Kentucky's neighbors taxes some consumer services the Kentucky code exempts.

As previously mentioned, in any expansion of the sales tax base, care should be taken to ensure the tax is expanded only to household purchases, not business-to-business transactions. Expanding the base to additional business-to-business purchases would further exacerbate the underlying structural issues that currently exist, such as tax pyramiding.[89]

Taxing business-to-business services, in particular, would be especially burdensome for small businesses that tend to rely heavily on outsourcing. While many large corporations are vertically integrated and are able to hire their own programmers, product engineers, in-house counsel, and accounting, human resources, and advertising departments, smaller businesses are more likely to outsource these services.[90] If the sales tax were applied to business purchases of legal services, for instance, businesses would be penalized for outsourcing and would face a strong incentive to instead hire in-house counsel even if they would otherwise prefer to retain outside counsel. Since Kentucky's sales tax is destination-sourced, any taxation of such inputs would put in-state businesses at a competitive disadvantage compared to their out-of-state competitors in states that avoid taxing those inputs.

Under an ideal sales tax structure, exemptions could continue to be written into the tax code for purchases that are exclusively or overwhelmingly purchased as business inputs rather than as household consumption. For example, many goods that are exclusively or nearly exclusively purchased as business inputs are already exempt from Kentucky's sales tax—everything from charter bus replacement parts to coal used to manufacture electricity. Similar treatment could be extended to services that are purchased almost exclusively as business inputs, such as advertising services.

However, in cases in which a good or service is regularly purchased by households *and* businesses, sales tax exemptions could be tied to the identity of the purchaser rather than the nature of the good or service itself. For example, Kentucky exempts livestock, seeds, feed, and fertilizer when they are sold in the course of doing business or "to a person regularly engaged in the business of farming." However, a household consumer buying a packet of seeds or a bag of fertilizer for hobby gardening would pay sales taxes on those purchases. A similar principle could be applied to the sale of services, whereby exemptions are granted based on the identity of the purchaser (when the purchaser is a business). For example, legal and accounting services could be included in the sales tax base when purchased by households, but businesses could be given sales tax exemption certificates to present when purchasing legal and accounting services. Again, this is not to provide special treatment to businesses but to avoid further exacerbating the tax pyramiding problem that is already occurring.

Exemption certificates are already widely used by nonprofit organizations and agricultural purchasers to grant sales tax exemptions based on the identity of the purchaser rather than by the good or service being sold. While exemption certificates create additional administrative responsibilities for the state,

89 Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," 2.

90 Id. at 11.

**TABLE 7.**

## Services Subject to Sales Tax in Neighboring States but not in Kentucky

| Taxable Service | IL | IN | MO | OH | TN | VA | WV | Total |
|---|---|---|---|---|---|---|---|---|
| Repair labor, generally (if stated separately from sales of taxable TPP) | | | ✓ | ✓ | ✓ | | ✓ | 4 |
| Digital audio-visual works (digital movies, videos)* | | ✓ | | ✓ | ✓ | | ✓ | 4 |
| Cable and satellite TV* | | ✓ | | | ✓ | ✓ | ✓ | 4 |
| Gift and package wrapping service | | | | ✓ | ✓ | ✓ | ✓ | 4 |
| Automotive storage | | | | ✓ | ✓ | | ✓ | 3 |
| Marina service (docking, storage, cleaning, etc.) | | | | ✓ | ✓ | | ✓ | 3 |
| Other residential fuel (including heating oil)* | ✓ | ✓ | | ✓ | | | | 3 |
| Garment alterations | | | | ✓ | ✓ | | ✓ | 3 |
| Swimming pool cleaning & maintenance | | | | ✓ | ✓ | | ✓ | 3 |
| Interior design and decorating (residential) | | ✓ | | | ✓ | | ✓ | 3 |
| Window cleaning | | | | ✓ | ✓ | | ✓ | 3 |
| Automotive washing and waxing | | | | ✓ | ✓ | | ✓ | 3 |
| Automotive towing and/or road services | | | | ✓ | ✓ | | ✓ | 3 |
| Automotive painting & lube | | | | ✓ | ✓ | | ✓ | 3 |
| Pari-mutuel racing events* | | | ✓ | | ✓ | | ✓ | 3 |
| Shoe repair | | | | ✓ | ✓ | | ✓ | 3 |
| Household goods storage | | | | ✓ | | | ✓ | 2 |
| Mini-storage | | | | ✓ | | | ✓ | 2 |
| Electricity (residential)* | ✓ | ✓ | | | | | | 2 |
| Water (residential)* | | ✓ | | | ✓ | | | 2 |
| Natural gas (residential)* | ✓ | ✓ | | | | | | 2 |
| Upholstery cleaning | | | | | ✓ | | ✓ | 2 |
| Fishing and hunting guide services | | | | | ✓ | | ✓ | 2 |
| Water softening and conditioning | | ✓ | | | | | ✓ | 2 |
| Exterminating (includes termite services) | | | | ✓ | | | ✓ | 2 |
| Private investigation (detective) services | | | | ✓ | | | ✓ | 2 |
| Parking lots & garages | | | | | ✓ | | ✓ | 2 |
| Taxidermy | | | | ✓ | | | ✓ | 2 |
| Remote access to hosted software (personal use) | | ✓ | | | ✓ | | | 2 |
| Taxis | | | | ✓ | | | | 1 |
| Fur storage | | | | | | | ✓ | 1 |
| Marine towing service | | | | | | | ✓ | 1 |
| Travel agent services | | | | | | | ✓ | 1 |
| Real estate title abstract services | | | | | | | ✓ | 1 |
| Cosmetology services | | | | ✓ | | | | 1 |
| Dating services | | | | | | | ✓ | 1 |
| Debt counseling | | | | | | | ✓ | 1 |
| Laundry and dry cleaning services, coin-operated | | | | | | | ✓ | 1 |
| Massage services | | | | ✓ | | | | 1 |
| Personal instruction (dance, swimming, tennis, etc.) | | | | | | | ✓ | 1 |
| Tax return preparation | | | | | | | ✓ | 1 |
| Coin-operated video games | | | | | | | ✓ | 1 |
| Accounting and bookkeeping | | | | | | | ✓ | 1 |
| Land surveying | | | | | | | ✓ | 1 |
| Chartered flights (with pilot) | | | | ✓ | | | | 1 |
| Labor charges on repair or remodeling of real property | | | | | | | ✓ | 1 |

*Subject to an excise tax but not the sales tax in Kentucky.

Note: State definitions of services vary, so the extent to which each indicated service is taxable may differ from state to state. Services shown as taxable only if taxed by the state; in some cases, localities levy their own sales taxes on services not taxed by the state.

Source: Federation of Tax Administrators; Kentucky Department of Revenue.

for sellers, and for purchasers, there is little reason to believe such a system would be too onerous. A policy of exempting transactions that are overwhelmingly or exclusively business inputs, while allowing exemption certificates to be used to avoid tax on mixed-use goods and services when the purchaser is a business, likely represents the best available policy option.

## The Case for A Local Option Sales Tax

Just as Kentucky's sales tax is superior to its income tax as a source of state tax revenue, so would a local option sales tax be a better source of revenue than the current complex array of local income taxes (occupational license taxes). Of the 45 states that levy a statewide sales tax, 36 allow local sales taxes to be levied in addition to the state rate.[91] It is worth noting, however, that while most states extend this local option sales tax authority to counties or municipalities broadly, a few states extend this authority only in limited circumstances, such as to specified localities or to those that meet certain population or other criteria.

Currently, the Kentucky constitution allows—to the extent authorized by the General Assembly—local governments to levy taxes on income, licenses, franchises, personal property (tangible and intangible), and activities (through excise taxes).[92] It also allows the General Assembly to establish the conditions under which localities may collect license fees on franchises, trades, occupations, professions, and breeding stock. The constitution does not, however, give the General Assembly authority to allow local sales taxes; in 2013, Kentucky Attorney General Jack Conway concluded that a sales tax is "an impermissible excise tax under Ky. Const. § 181."[93] In Kentucky, local sales tax authority could only be granted after amending the constitution, and a constitutional amendment requires approval by three-fifths of the members of both the House and the Senate, as well as a majority of voters at the next general election following approval in the General Assembly.[94]

Given that sales taxes are simpler, more neutral, and less economically harmful than income taxes, Kentucky would do well to extend local option sales tax authority to localities while reducing reliance on local net profit taxes and occupational license taxes. As stated elsewhere in this report, Kentucky's local occupational license taxes are economically harmful and make the Bluegrass State an outlier. Only 15 states tax personal or business income at the municipal level, and Kentucky is one of only eight that taxes both. Local income taxes are economically burdensome and add a great deal of complexity to Kentucky's tax structure. Kentucky would do well to move away from local taxes on income, and a local option sales tax would be a far less economically damaging alternative.

If legislators and voters were to approve a constitutional amendment allowing a local option sales tax, certain parameters would need to be put in place to maintain simplicity and ease of collection, remittance, and administration, such as ensuring all local sales and use taxes are collected and administered by the state and requiring the local tax base to match the state tax base, as is required by Kentucky's membership in the Streamlined Sales and Use Tax Agreement.[95]

91 The Sales Tax Clearinghouse, "Determine Sales and Use Tax Rates," 2021, https://www.thestc.com/.

92 Ky. Const. § 181.

93 Office of the Attorney General, "Whether a Local Option Sales Tax May Be Enacted Without a Constitutional Amendment," OAG 13-001, Jan. 11, 2013.

94 Ky. Const. § 256.

95 Streamlined Sales Tax Governing Board, Inc., "About Us," 2018, https://www.streamlinedsalestax.org/about-us/about-sstgb.

The vast majority of states that allow local sales taxes collect and administer all sales taxes at the state level and require state and local base uniformity. Uniform bases and single state-level administration help prevent undue burdens on out-of-state sellers who are required to collect and remit the appropriate sales tax amount based on the buyer's location.

The U.S. Supreme Court, in its majority opinion in the 2018 *South Dakota v. Wayfair* decision, signaled the importance of single state-level administration, uniform definitions of products and services, and a simplified rate structure in determining the constitutionality of a state's remote sales tax collection laws.[96] As of this writing, only three states that levy both state and local sales taxes—Alabama, Colorado, and Louisiana—lack uniform state-level sales tax administration, a practice that adds substantial complexity and therefore hurts those states' rankings on the *State Business Tax Climate Index*.[97] Policymakers may also want to consider setting a maximum local sales tax rate and requiring localities to receive voter approval before adopting a local sales tax.

Additionally, policymakers should consider putting in place certain safeguards to ensure a local option sales tax *replaces* revenue that is currently generated from other, more economically harmful local taxes—like occupational license taxes, inventory taxes, and the inheritance tax—rather than being levied *in addition* to those other taxes. For example, the legislature could require that any locality seeking to adopt a local sales tax use some or all of the revenue to offset its occupational license (income) taxes, or make the repeal of such taxes a condition of local sales tax authority. Policymakers should avoid creating a scenario in which local option sales taxes are levied in addition to local occupational license and business profit taxes, as this would increase business compliance burdens in the short term and could lead to higher overall taxes in the long run if local income taxes remain a part of the local revenue toolkit.

Another advantage of the sales tax as a revenue source is that it is paid by anyone making taxable purchases in Kentucky, including residents and nonresidents alike. The Kentucky Bourbon Trail® and the robust equine industry are major drivers of economic activity in Kentucky, attracting scores of tourists to many different parts of the Commonwealth each year. Sales taxes help capture the costs associated with the public services nonresidents benefit from while they are in Kentucky, but while the state directly benefits from those transactions, local governments benefit from state sales tax revenue only indirectly. A local option sales tax would allow cities and counties to benefit directly from the tourism and retail activity that is already occurring in their area. Furthermore, the desire to see sales tax receipts grow over time would be a powerful incentive for local governments to prioritize policies that promote continued economic growth and development.

96 Joseph Bishop-Henchman, Hannah Walker, and Denise Garbe, "Post-*Wayfair* Options for States," Tax Foundation, Aug. 29, 2018, https://www.taxfoundation.org/post-wayfair-options-for-states/.

97 Jared Walczak and Janelle Cammenga, *2021 State Business Tax Climate Index*, 36.

## Sales Tax Reform Solutions

The sales tax is one of the Kentucky's most neutral and stable revenue sources, yet the state under-relies on it compared to more economically damaging taxes. If Kentucky seeks to move away from more harmful and complex revenue sources, policymakers will need to give serious consideration to modernizing the sales tax base and allowing a local option sales tax. Depending on how much revenue lawmakers wish to generate to offset the repeal or reduction of more harmful taxes or to improve the tax base, lawmakers could additionally consider increasing Kentucky's state sales tax rate, which is lower than many of its peers.

### *Modernize the Sales Tax Base*

Any comprehensive tax reform plan seeking to shift the state from less economically efficient taxes will almost certainly require reexamination of the sales tax base. Like most states, Kentucky's sales tax applies to a relatively small share of final personal consumption while capturing many business inputs that should be exempt. Right-sizing and modernizing the sales tax base should be a priority for lawmakers, as this would make the tax code more neutral while generating additional revenue that can be used to reduce reliance on more economically harmful taxes.

Broadening the sales tax base to include more personal services would lead Kentucky to improve one place on the *State Business Tax Climate Index*, with a reform that generates more revenue while promoting greater tax neutrality. Were this additional revenue used to offset reforms elsewhere, the improvement could be larger.

### *Allow a Local Option Sales Tax*

Currently, many of Kentucky's local revenue sources are notoriously economically harmful, especially occupational license taxes on personal and business income, inventory and other tangible personal property taxes, and the inheritance tax. This is driven by the combination of the constitutional prohibition against local sales taxes and a low property tax environment, constrained by H.B. 44, which together impede cities' and counties' ability to generate sufficient revenue while fostering a business- and taxpayer-friendly environment. Amending the constitution to allow the General Assembly to authorize a local option sales tax would generate revenue that could be used for localities to repeal, phase out, or reduce reliance on more harmful taxes.

Any local option sales tax authority should—at the very least—be accompanied by a requirement that sales tax administration be centralized at the state level and that the local sales tax base match the state sales tax base. State policymakers should also consider requiring any locality adopting a sales tax to use that revenue to offset reductions to other more harmful taxes, especially occupational license and net profit taxes. Many states with local option sales taxes set limits on the maximum sales tax rate a locality can levy to keep future tax increases in check.

### *Consider Raising the State Sales Tax Rate*

In any reexamination of Kentucky's sales tax, priority should first be given to broadening the sales tax base and authorizing a local option sales tax. Should policymakers wish to generate additional revenue beyond what can be obtained through base broadening and local option sales tax authority, consideration could be given to raising the state sales tax rate, which in Kentucky is low compared to several of its peers and among the lowest in the country when state and average local rates are combined. Of the states that levy sales taxes, only six have combined state and average local rates that are lower than Kentucky's. If a rate increase offsets income tax rate reductions, that could leave Kentucky with a sales tax rate that is competitive with its regional rivals while offering an enviously low income tax rate that would have a more significant effect on economic growth and opportunity.

# PROPERTY AND INHERITANCE TAXES

The taxation of real property in Kentucky is quite modest, even with Kentucky being among the minority of states levying property taxes at both the local and state level. The combination of millages, assessment ratios, and competing approaches to valuation can often cloud our understanding of how property tax burdens compare across states, but one good way of cutting through the complexity is to compare the average effective rates on owner-occupied housing as a percentage of actual market value. In Kentucky, taxes on owner-occupied housing average 0.78 percent of market value per year, meaning that a $250,000 home would face, on average, a property tax bill of $1,950. This is almost 25 percent lower than the average effective property tax rate nationwide (1.03 percent), though some of the states bordering the Commonwealth also have low property tax burdens.

Property taxes predominate local tax revenue nationwide, so low property tax burdens typically correspond with moderate-to-high local sales tax burdens, which explains how Tennessee is likewise able to maintain modest property taxes. In Kentucky, however, these below-average property tax burdens are facilitated by significant municipal taxes on both personal and business income, which is far less common and ultimately far less competitive.

Property tax increases are constrained by a levy limit, with voters given the opportunity to object to any increase in collections in excess of 4 percent growth per year. This policy has been effective in constraining property tax increases, though if Kentucky were to rebalance its local taxes, some additional allowance might need to be made for one-time increases outside that limit.

While burdens on residential real property are light, the same cannot be said about every aspect of Kentucky's property tax code. Like most states, Kentucky's property tax base includes both real and business tangible personal property, the latter being a somewhat confusing name for business property that can be touched and moved—machinery, equipment, and fixtures—in addition to real property (land and structures). But where Kentucky diverges from most of its peers is in further extending its tax to business inventory, meaning that businesses pay property tax on items maintained for future sale. This highly distortionary practice has been abandoned in most states but survives in the Commonwealth—in part.

Recognizing how detrimental inventory taxes can be, lawmakers sought to blunt the impact of the tax while preserving local revenue by creating an income tax credit to offset companies' inventory tax payments. The effort is commendable, but the results to date have been underwhelming, with many businesses paying inventory tax but unable to benefit from the credit.

Even with machinery and equipment, moreover, Kentucky is more aggressive than many of its peers. While only a minority of states have made the economically advantageous decision to forgo taxes on tangible personal property altogether, many have *de minimis* exemptions to eliminate compliance burdens for small businesses, an approach that lawmakers here could borrow.

Finally, Kentucky still has an inheritance tax on the books, hollowed out by exemptions for lineal heirs. What remains of the tax, however, can break up businesses, penalize bequests to more distant relatives, and encourage wealthy individuals—or their beneficiaries—to move out of the Commonwealth to avoid this increasingly anomalous tax. The residual inheritance tax raises little while making Kentucky less attractive for wealthy individuals who, if they remained, would pay other state and local taxes.

## Inventory and Other Tangible Personal Property Taxes

Taxes levied on real property generally align with the "benefit principle" of taxation: the beneficiaries of services are the ones funding those same services. The taxes are ideally levied on real property, and the property owners that pay taxes benefit from local services like schools and fire departments. Additionally, landowners cannot move their land in order to avoid tax liability—it is an immobile asset.

However, property taxes start to diverge from the benefit principle and cause economic distortion when they are levied on more than just real property. This is the case in Kentucky and many other states which include tangible personal property (TPP) in their tax bases.

In contrast to real estate, TPP includes anything that can be touched or moved. Taxes targeted at TPP often fall on business inputs, as property such as machinery, equipment, and fixtures are part of a firm's production process, and their inventory—either of their own manufactured goods or those obtained at wholesale for sale to consumers—is part of their core business activity. Firms may pass along the tax in the form of higher prices when goods or services are sold in the production process, to the extent that their competitors are similarly disadvantaged. This may conceal the impact of the tax on consumers, as consumers may pay higher prices as a result of a tax on TPP. Companies competing in a multistate market against competitors not subject to such taxes are placed at a competitive disadvantage, as their peers elsewhere face lower tax costs on production.

As with a typical property tax, TPP tax liability is calculated by first determining the assessed value of the property and multiplying it by the assessment ratio for that class of property and finally by the millage (rate). However, determining the assessed value of TPP is much more complicated than determining the assessed value of housing or real estate. These taxes are "taxpayer active"—the person paying the tax is responsible for keeping careful records of their possessions and how much they owe to the state. They must know the initial acquisition price of an asset and when it was placed into service, and they must depreciate it according to published schedules for each asset type. This creates significant compliance burdens for taxpayers in addition to the actual cost of the tax.

Taxes on TPP are a source of tax complexity and non-neutrality, incentivizing firms to change their investment decisions or relocate to avoid the tax. Because they are levied on the value of a business's tangible assets, TPP taxes reduce the return that can be generated by those assets. This can dissuade firms from making marginal investments in their enterprises. They fall heavily on capital-intensive industries such as agricultural producers and manufacturers, and the costs of administration and compliance can be especially onerous. Compared to real property taxes, which are relatively neutral, TPP taxes significantly distort economic decision-making.

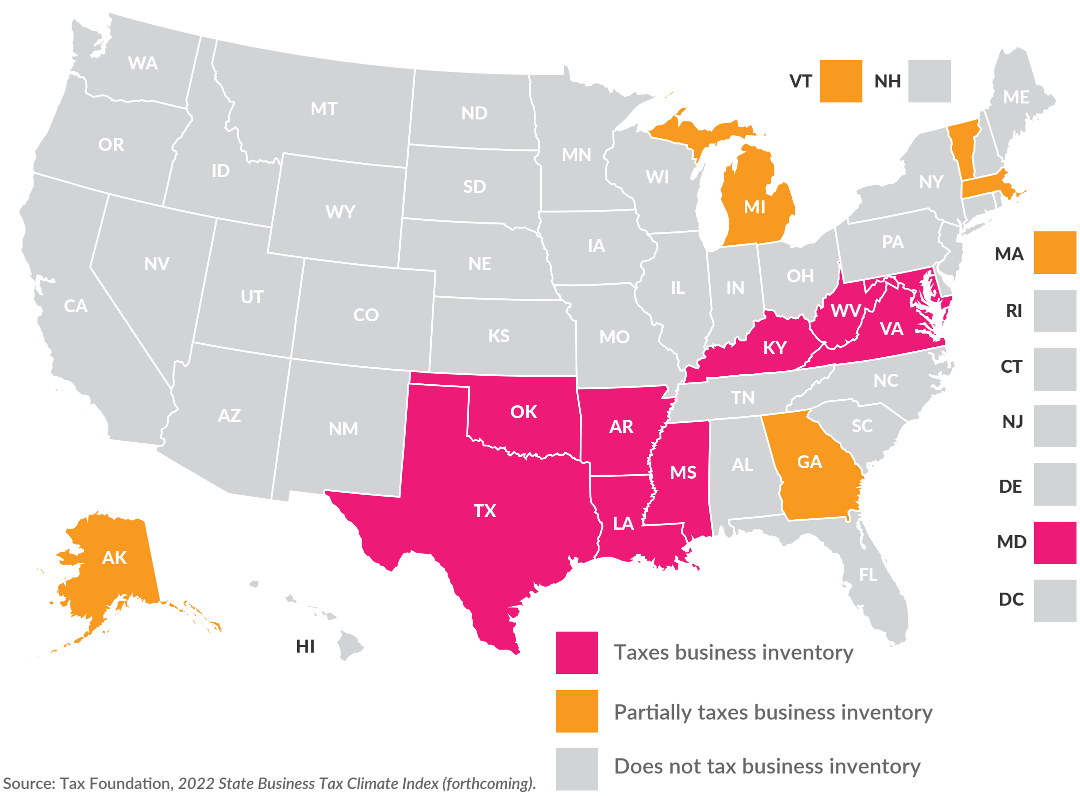
While most states tax TPP in some way, Kentucky is one of only 12 states[98]—along with Alaska, Arkansas, Georgia, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, Oklahoma, Texas, and Vermont—that tax some or all inventory. Taxes on inventory are non-neutral, as businesses with larger quantities of inventory, like manufacturers and retailers, are disproportionately burdened by such taxes. Businesses with little to no inventory escape this form of property taxation even if they use the same amount of government services as businesses with larger inventory tax bills.

In addition to being non-neutral, inventory taxes are highly distortionary, forcing companies to make decisions about production or stocking that are not entirely based on economic principles but rather on how to pay the least amount of tax on goods produced or held for sale. Inventory taxes also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes.

**FIGURE 7.**

**State Taxation of Business Inventory**

*Property Taxes on Business Inventory (as of July 1, 2021)*




Source: Tax Foundation, *2022 State Business Tax Climate Index (forthcoming)*.

In 2018, Kentucky took steps to mitigate the negative impact of the inventory tax by passing a law that enacted a nonrefundable credit against state corporate or individual income taxes or the LLET.[99] The credit was phased in over four years, offsetting up to 25 percent of inventory taxes paid in 2018, 50 percent in 2019, 75 percent in 2020, and 100 percent in 2021 and thereafter. The credit was intended to effectively eliminate inventory tax liability without actually repealing the tax, thus allowing local governments to continue to generate revenue on inventory. However, there is good reason to believe that take-up of the credit is much lower than expected, driven in part by the fact that the credit is

98 Ky. Rev. Stat. § 132.020

99 Kentucky H.B. 366 (2018).

nonrefundable and cannot be carried forward to future years. As a result, the inventory tax continues to work at cross purposes with Kentucky businesses.

A 2019 Tax Expenditure Analysis by the Office of the State Budget Director estimated that income tax and LLET expenditures attributable to inventory tax credits would be worth approximately $33 million in FY 2020—while the credit was still phasing in—and $155 million in FY 2022, once the credit was fully phased in. According to data from the Department of Revenue, however, these estimates were wildly high. In tax year 2018, less than $3 million in inventory tax credits were actually claimed by taxpayers. By tax year 2019, take-up of the credit had grown only marginally larger, to $4 million.[100] Even though the credits had not fully phased in during FY 2018 and FY 2019, these claims are still a fraction of what was expected. They also are not nearly on pace to approach future estimates in any meaningful way.

Two structural deficiencies in the inventory tax credit law are that the credit is nonrefundable and that unused credits do not carry over to subsequent years. If a taxpayer's income tax or LLET liability is low or zero because—for instance—the business is not currently profitable, is applying losses from previous years, or received tax incentives for particular investments, there is no way for the taxpayer to fully benefit from the inventory tax credit. This may be one factor contributing to the low take-up levels.

### *Inventory and Other Tangible Personal Property Tax Reform Solutions*

Kentucky lawmakers should focus on completing the job begun by the creation of the inventory tax credit. That credit was designed to mitigate the tax's economic burdens, but it is increasingly clear that it is falling short of this goal. If Kentucky wants to fully eliminate the economic distortion of the inventory tax, legislators should, at a minimum, make the inventory tax credit refundable or allow the credit to carry over to subsequent years. Even this solution, however, still requires Kentucky businesses to remit taxes on their inventory, to be recovered months or even years later. The better solution would be for Kentucky to repeal inventory taxes altogether and make localities whole through transfers. Furthermore, because the inventory tax credit is currently structured as a nonrefundable credit against individual or corporate income tax liability, if either income tax rate were reduced as part of a larger tax reform package, the inventory tax credit would simultaneously decrease in value as an unintended consequence of its structure.

According to the Commonwealth's 2019 Tax Expenditure Analysis, Kentucky was prepared to forgo nearly $155 million of income tax and LLET revenue in FY 2022 in order to fund inventory tax credits.[101] Instead of allocating the revenue for tax credits, the state could provide direct aid to county governments to offset inventory tax losses. One option could be to fold additional aid into the school funding formula. Each county's share could be determined by using the last several years of actual inventory data and extrapolating them to future years. Alternatively, the State could use Census Bureau data to estimate growth of capital inventory in the jurisdiction and then use that ratio to apportion aid, or use the continued tax on machinery and equipment to develop a proxy for the growth in inventory. Kentucky already budgeted to offset inventory tax costs; the system is simply underutilized due to its design.

100 Data received in response to an open record request by the Kentucky Chamber of Commerce.

101 Kentucky Office of the State Budget Director, "Tax Expenditure Analysis, Fiscal Years 2020-2022."

Lawmakers should also consider setting a *de minimis* threshold for tangible personal property taxes more broadly. This would exempt a certain amount of TPP from taxation, giving relief to businesses that would not have owed much anyway—and, in some cases, may have seen compliance costs higher than their tax payments. This will take many small businesses off the rolls at a minimal revenue loss. Many small businesses face negligible liability but are still forced to go through a tedious compliance process.

Any exemption threshold should also be a filing threshold. This reduces compliance costs for firms, as firms under the threshold may have to file in many localities if filing requirements remain in place even when companies' taxable property is under the *de minimis* threshold. Indiana, for example, previously required taxpayers to file a TPP tax return and pay filing fees even if they qualified for exemption. In April 2019, the state prohibited counties from collecting TPP tax filing fees but kept the filing requirement for exempt taxpayers.[102]

Revenue impacts from a *de minimis* threshold would likely be minimal. A 2015 study on the state of Connecticut examined the possible effects of various personal property tax thresholds, concluding that a $5,000 *de minimis* exception would decrease revenues by 0.006 percent, a $7,500 threshold by 0.01 percent, and a $10,000 threshold by 0.014 percent, not even a rounding error.[103]

The state has many examples to follow if it pursues this route. Indiana recently raised its *de minimis* exemption from $20,000 to $40,000 in business personal property per county and prohibited counties from collecting TPP tax filing fees from businesses that file but do not have a tax liability.[104] Indiana originally implemented its $20,000 *de minimis* exemption in 2015, and 89,749 taxpayers took advantage of the exemption.[105] An additional 28,300 exemptions were projected by the Indiana Legislative Services Agency as a result of the increase in the exemption threshold.

Utah, Colorado, Idaho, and Indiana have also enacted or expanded *de minimis* exemptions. Utah exempts individual items of TPP with an acquisition cost of $1,000 or less in addition to exempting TPP with a fair market value under $10,800.[106] In Colorado, the legislature added a state income tax credit to reimburse taxpayers' TPP tax between $7,001 and $15,000, effectively raising the state's $7,700 TPP tax exemption.[107]

If Kentucky decides to implement a *de minimis* exemption, it should index this exemption for inflation. Otherwise, while the nominal value of the exemption will stay the same, the real value will decrease, exposing progressively smaller companies to tangible personal property taxes.

Making changes to the property tax base may be more complex than making tax changes at the state level. However, removing inventory from the tax base and creating a *de minimis* TPP tax exemption would go a long way toward simplifying the state's property tax system. A property tax that avoids

102 Katherine Loughead, "Indiana Chips Away at Tangible Personal Property Taxes," Tax Foundation, Apr. 5, 2019, https://www.taxfoundation.org/indiana-tangible-personal-property-tax/.

103 Lawrence C. Walters, "The Business Personal Property Tax in Connecticut," Romney Institute of Public Management, Brigham Young University, Nov. 17, 2015, https://www.cga.ct.gov/fin/tfs/20140929_State%20Tax%20Panel/20151117/Business%20Tangible%20Property%20Tax%20Walters.pdf.

104 Katherine Loughead, "Indiana Chips Away at Tangible Personal Property Taxes."

105 Id., and Indiana Legislative Services Agency, "SB 233 Fiscal Impact Statement," Apr. 2, 2019, http://iga.in.gov/legislative/2019/bills/.

106 Utah Code Ann. § 59-2-1115; see also Utah Tax Commission, "Business Personal Property Taxes," January 2021, https://tax.utah.gov/forms/pubs/pub-20.pdf.

107 Colo. Rev. Stat. § 39-22-537.

penalizing businesses that rely heavily on inventory and other TPP will create an environment that is more welcoming to businesses both new and old.

Full repeal of the inventory tax would cause Kentucky to improve seven places on the property tax component of the *State Business Tax Climate Index*, and one place overall.

## Property Tax Limitations

Kentucky imposes limits on real property taxes at the state and local levels.[108] The state is constrained by a levy limit—a limit on revenue. The aggregate assessed value of real property throughout the state is allowed to change with market forces, but a greater than 4 percent increase in overall collections (excluding new property) will trigger the limit.[109] The state's tax rate on real property is automatically lowered to a level that will cap the new year's property tax revenue at 104 percent of the previous year's revenue.

In addition to the state limit, Kentucky also imposes limits on localities. In 1979, the Kentucky General Assembly passed House Bill 44, which makes use of rate and levy limits to limit the growth of property tax revenues in local taxing districts. [110] The law was a byproduct of the larger tax revolt movement where many taxpayers were concerned that tax liability was rising well above any possible increase in the value of government services.

The levy limit is the preferred form of property tax limitation because it avoids many of the non-neutral side effects of the alternatives. Levy limits stand in contrast with assessment limits, which decrease the turnover of homes, price certain groups out of the market for homes (lower income, new families looking for starter homes), and put more of the tax burden on people who recently purchased homes.

Kentucky also imposes rate limits on local governments. Generally speaking, county rates cannot exceed 5 mills, while school districts can tax up to 15 mills and municipalities face caps of 7.5 to 15 mills depending on population.[111] In reality, however, most rates fall well below these caps due to the levy limits under H.B. 44.[112] Rate limits are more neutral than assessment limits as long as they are applied uniformly. They cease to be neutral when selectively applied to certain properties and not others. Uniformity in property taxation is economically desirable. When rate limits are applied unevenly, say, to residential property but not to commercial property, this undermines business competitiveness and increases revenue volatility. Often, rate limits are applied out of a desire to keep homeowners' tax bills from increasing, but the rate is only one part of the equation. Tax bills on real property can still increase if the property appreciates due to market forces or the assessment ratio increases due to changes in policy.

Levy limits are the best way to accomplish what the other limits cannot. Instead of manipulating the rates or the assessment, levy limits serve as a kind of allowance for government. Like rate limits and

108 Ky. Rev. Stat. § 132.020(2).

109 Ky. Rev. Stat. § 132.020.

110 Kentucky Department of Revenue, "Property Tax Rates,"https://revenue.ky.gov/Property/Pages/PropertyTaxRates.aspx.

111 Ky. Rev. Stat. § 68.245; § 68.090; and § 160.475.

112 David R. Agrawal, "Kentucky," Lincoln Institute of Land Policy, November 2016, https://www.lincolninst.edu/sites/default/files/ky_nov_2016.pdf.

unlike assessment limits, levy caps do not necessarily protect all taxpayers individually from substantial tax increases. Policymakers remain free to adjust rates and assessment ratios within the overall revenue cap. At the same time, the limit does not introduce the distortions of an assessment limit. It allows property values to increase or decrease in accordance with market conditions, it does not favor a particular demographic, and it does not warp business competitiveness by favoring one class of property over another. If only certain properties or classes of properties appreciate substantially in value, the owners of those properties may experience tax increases considerably in excess of any limitation on the increase in levies as a whole.

Under H.B. 44, if a local taxing district opts for the status quo and the aggregate assessed value of property in the taxing district decreases or remains flat, the tax rate will remain unchanged. If the aggregated assessed value of property increases, the district automatically calculates a compensating rate that ratchets the rate down to a level at which current year real property tax revenue would remain unchanged from the previous year.[113]

Alternatively, if a local taxing district wants or needs more revenue than afforded by the compensating rate, Kentucky law allows the district to increase rates by up to 4 percent more than the compensating rate without obtaining voter approval. A public hearing must precede the tax increase. This serves to alert taxpayers to the change and allows them to submit comments.[114]

A third option allows local taxing districts to exceed the 4 percent threshold provided the higher millage survives voter scrutiny. In all districts except where the tax increase is levied by a consolidated local or urban-county government,[115] any portion of the rate increase above the 4 percent threshold is subject to recall for 45 days.[116] If enough voters support the recall effort via petitions, the excess tax increase is referred to voters at the next election.[117] Voters have often rejected these proposed increases.

### *Real Property Taxes and the Alternatives*

Real property taxes are an ideal revenue source for local governments. They are among the more economically neutral taxes and demonstrate a much smaller influence on economic decision-making than most alternative modes of taxation.[118] As an immobile asset, tax competition and tax avoidance activities arising from their taxation are less pronounced than they would be from other available tax options.[119] Property taxes are also comparatively easy to administer. The assessor values the property for taxation, the tax office sends out the bill, and the taxpayer pays it. If the taxpayer is delinquent, a lien is placed on the property, and if the property is sold, the locality collects what is owed from the proceeds.

Alternative revenue sources, such as income and capital taxes, are often difficult to realize at the local

113 The assessment and levy on new construction is not included in the calculation and is not subject to discount.

114 Ky. Rev. Stat. § 68.245(5)

115 Consolidated local or urban-county taxpayers have 50 days to initiate a recall on the tax increase.

116 Ky. Rev. Stat. § 132.017(2)(a)2.

117 Ky. Rev. Stat. § 132.017.

118 Jens M. Arnold, et al., "Tax Policy for Economic Recovery and Growth."

119 For a discussion of strategic competition in property tax regimes, see Jan K. Brueckner and Luz A. Saavedra, "Do Local Governments Engage in Strategic Property-Tax Competition?" *National Tax Journal* 54:2 (June 2001): 203-230.

level. Kentucky is unusual in terms of the taxation latitude it affords localities. For advocates of home rule and fiscal federalism this may appear optimal. However, as noted elsewhere in this report, many locally levied taxes (e.g., individual income taxes, corporate income taxes, etc.) have serious efficiency shortcomings that cannot be ignored.

In contrast to real property taxes, many local tax bases are highly mobile. At the margin, moreover, income taxes discourage labor and investment and may induce inefficient efforts at avoidance. Many other taxes pick winners and losers by favoring or disfavoring a range of economic activities. Property taxes, by contrast, tend to be more economically neutral.[120] The costs generated by an inefficient income tax may be avoided by the predictable, stable, and immobile qualities of a well-crafted tax on real property.

Kentucky is somewhat unique in that it levies a statewide property tax in addition to the local levies. As such, it is both a local and a state revenue source.[121] The state constitution requires that any non-exempt property be assessed at its full fair cash value. Currently, the state tax rate on real property is 12.2 cents per $100 of assessed valuation (1.22 mills), a decline of more than 60 percent from its high of 3.15 mills.[122] The state property tax is projected to generate $711 million in revenue in FY 2022.[123]

If, hypothetically, the state property tax was raised to its former level of 3.15 mills, that would generate sufficient revenue to reduce individual and corporate income tax rates from 5.0 to about 4.1 percent.[124] Were it raised to the point of bringing Kentucky's combined state and local property tax burdens on owner-occupied housing to the national average, this would be sufficient to pay down a full percentage point reduction in income tax rates, to 4 percent.[125] Even significantly more modest increases in statewide property taxes, however, could offset meaningful reforms elsewhere, taking advantage of Kentucky's status as one of the few remaining states to levy a statewide property tax to shift a somewhat greater share of state tax burdens to one of the more economically efficient taxes available.

### *Impact of H.B. 44*

H.B. 44's property tax limits are not necessarily problematic. Those concerned with too much government spending already have a levy limit as the default position of local government. Conversely, if a local taxing district perceives a need to raise real property tax revenues, it may do so by way of a simple majority of the local board. As long as local governments can balance their budgets and inflation stays below 4 percent, the 4 percent rate increase should be sufficient to fund obligations.

Since H.B. 44 was passed, the majority of property tax recall efforts have succeeded. However, what may be framed as a positive development by taxpayers concerned with restraining fiscal excess can be quickly upended if governments turn to more damaging local option taxes to finance programs. The system also bends toward inefficiency when courts become involved in tax recalls.

120 Bruce Wallin and Jeffrey Zabel, "Property Tax Limitations and Local Fiscal Conditions: The Impact of Proposition 2½ in Massachusetts," Lincoln Institute of Land Policy Working Paper, 2010, http://www.lincolninst.edu/sites/default/files/pubfiles/1885_1200_wallin_zabel_wp11bw1.pdf.

121 Ky. Rev. Stat. § 132.020(2).

122 Kentucky Department of Revenue, "Property Tax Rates."

123 Kentucky Office of the State Budget Director, "Official Revenue Estimates, FY 2022 – FY 2026."

124 Id.

125 Tax Foundation calculations using data from the Kentucky Office of the State Budget Director and the U.S. Census Bureau.

## *Real Property Tax Reform Solutions*

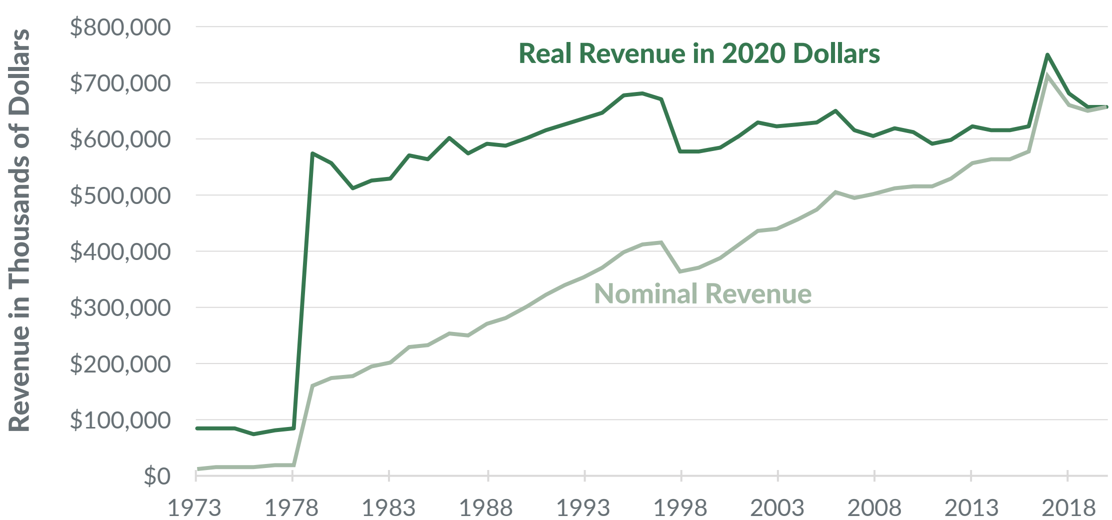
### Modify the Recall Provision

Simplicity, stability, and transparency are important components of sound tax policy. Most of H.B. 44 meets those requirements. The recall provision, however, muddies an otherwise structurally sound tax policy. It can result in a chaotic reality for taxpayers and an unpredictable revenue stream for local governments. In many states, local lawmakers are required to go to the voters for approval of increases above the levy limit, rather than adopting them subject to a possible recall. Kentucky policymakers could consider converting the recall provision into a requirement that any increases beyond the levy limit be proactively approved by voters. This would alleviate some of the volatility that exists under the current system when tax increases are adopted and then commonly repealed shortly thereafter.

### Permit One-Time Property Tax Rate Adjustment in Excess of Limits to Rebalance Local Tax Bases

At present, Kentucky must also contend with the negative interaction between local tax policies and state tax policies. This is inefficient because it complicates the process of building a cohesive, competitive tax plan. Rebalancing real property taxes and local option taxes can go a long way to streamlining Kentucky's tax code. In exchange for voluntarily curtailing the various local option taxes—for instance, using a combination of higher property taxes and, if authorization is extended, newly-permitted local option sales taxes to eliminate occupational license taxes—the state could permit localities a one-time property tax rate adjustment in excess of 4 percent without voter recall.

**FIGURE 8.**
**Kentucky State Property Tax Collections, 1973-2020**




Sources: U.S. Census Bureau; Tax Foundation calculations.

### Raise the State Real Property Tax Rate to Offset Income Tax Rate Reductions

In real (inflation-adjusted) terms, Kentucky's real property tax revenue has stayed relatively flat over the past few decades. Ultimately, whatever solution policymakers choose, the goal should be for localities to self-fund primarily through property tax revenue (and, if granted, a sales tax), and not less efficient alternative forms of taxation.

The same could be true for the state itself. Given Kentucky's low reliance on property taxes, and the existence of a statewide property tax levy, there is room for the state to increase its own millages to pay down tax reforms elsewhere, such as to state income tax rates.

## Inheritance Tax

Kentucky is one of only six states to levy an inheritance tax, although a dozen others impose an estate tax. These taxes bear important distinctions, but many people understand them to be practically synonymous. Both are commonly referred to as death taxes—taxes assessed on a person's property after they die. More specifically, an estate tax is assessed on the net value of an individual's estate—his or her accumulated wealth after accounting for any debts and earlier gifts—prior to those assets being transferred to an heir. An inheritance tax, on the other hand, is levied on the fair market value of any property as it is transferred to a beneficiary. Some classes of beneficiaries are completely exempt from inheritance taxation. In Kentucky, these include direct lineal relatives and nonprofit organizations.[126] Technical distinctions notwithstanding, all death taxes are characterized by the same undesirable consequences: inefficiency, instability, and non-neutrality.

Inheritance taxes are inefficient for several reasons. First, the tax's share of Kentucky's overall revenue has steadily declined over the years. Real revenue generated by the inheritance tax is lower than it has ever been.[127] At its high-water mark in 1998, the inheritance tax netted nearly $168 million in today's dollars. By FY 2020, that number had dropped to just over $48 million, an 83 percent decline.

A second inefficient aspect of the tax is the potential for forced sales of illiquid assets. The recipient of capital acquired through inheritance may suddenly find herself property rich and cash poor. The problem she faces is that the inheritance tax does not care what form her new assets are in. The tax must be paid, even if she must sell the newly inherited property to generate the cash to do so.

Illiquidity concerns become especially problematic for beneficiaries that receive a share of a family business, farm, or other joint business venture. Whereas the federal estate tax exemption level is $11.7 million, Kentucky's Class B inheritance tax exemption is only $1,000.[128] A recipient need only inherit property valued at $1,001 before incurring tax liability. Consider the impact this could have on joint small business owners operating out of a lone building. Does the surviving partner mortgage the store to pay the tax on the inherited share? Does the inheritor liquidate the inherited property simply to pay the tax? The forced sale, or the premature destruction, of capital does more harm than good to a state's

126 Ky. Rev. Stat. § 140.080.

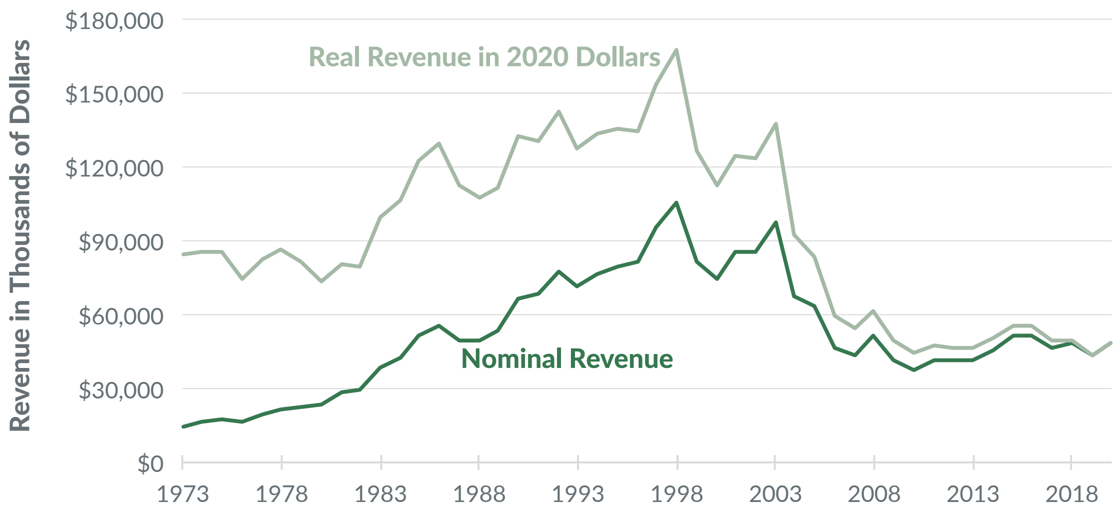
127 U.S. Census Bureau, "Annual Survey of State Government Tax Collections," https://www.census.gov/programs-surveys/stc/data.html.

128 Ky. Rev. Stat. § 140.070.

economy. A capital asset has the potential to generate returns for a business many years into the future, but a fire sale disrupts those operations and hampers productivity by curtailing returns to labor and capital.

**FIGURE 9.**

**Kentucky Inheritance Tax Collections, 1973-2020**




Sources: U.S. Census Bureau; Tax Foundation calculations.

Many people and organizations expecting to be the beneficiaries of an inheritance go to great lengths to avoid taxation of those assets, often for the reasons noted above. The avoidance strategies can be costly in terms of time, money, and forgone opportunities.[129] In some cases recipients may proactively move out of the state.

When state inheritance and estate taxes induce individuals—chiefly wealthy retirees—to relocate for tax purposes, states lose out not only on anticipated estate or inheritance tax revenue, but potentially also on years of general tax revenue.[130] Economists Jon Bakija and Joel Slemrod calculated that if the typical wealthy retiree who would otherwise be subject to state inheritance and estate taxes moves out of state five years prior to death, the state's revenue losses could be as much as 1.73 times as large as the tax revenues that might have been collected from that person's estate.[131]

It is difficult to accurately measure how many people have left Kentucky prior to receiving inheritances. It is likewise difficult to know how many people have avoided settling in the Commonwealth because of expected asset receipts. Nevertheless, these considerations are real and are something the General Assembly should consider as it makes decisions about maintaining the inheritance tax in the future. When taken together, the decline in real revenue attributable to the inheritance tax and the predictably negative effects of tax avoidance strategies result in a highly unstable form of revenue and deadweight loss for Kentucky's economy.

129 Jared Walczak, "State Inheritance and Estate Taxes: Rates, Economic Implications, and the Return of Interstate Competition," Tax Foundation, July 17, 2017, https://www.taxfoundation.org/state-inheritance-estate-taxes-economic-implications/.

130 Id.

131 Jon Bakija and Joel Slemrod, "Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns," NBER Working Paper No. 10645 (July 2004), 35, http://www.nber.org/papers/w10645.

Under Kentucky law, bequests of nonresident decedents are subject to the inheritance tax if they constitute (1) intangible property that has acquired a business situs within the state; (2) real property within the state; or (3) tangible personal property that has acquired a situs in the state and that is not taxable elsewhere.[132] Therefore, even though Kentucky's inheritance tax does not tax the decedent or his estate directly, it nevertheless incentivizes the estate's owner to dispose of or proactively remove assets from Kentucky in order to shield future benefactors from taxation. In Kentucky, this planning would take place where the recipients are not direct lineal relatives and cannot benefit from complete inheritance tax exemption.

The non-neutrality of the inheritance tax is an additional cause for concern. Currently, the tax incorporates numerous exemptions of varying scale and application. Usually, they are determined by the relationship between the recipient and the decedent. All immediate family members (parents, a surviving spouse, a child by blood, etc.) are designated Class A beneficiaries completely exempt from inheritance taxation. Nonprofit organizations are likewise exempt.[133]

Non-lineal family members (e.g., a niece, nephew, son-in-law, great-grandchild, etc.), designated Class B beneficiaries,[134] are the single largest class of benefactor that is not exempt from Kentucky's inheritance tax. It is hard to explain why a son-in-law or daughter-in-law would be subject to the inheritance tax when that in-law's spouse would be exempt. In cases where families are estranged, it is entirely possible that the decedent could have been closer to a daughter-in-law than to a daughter, and in the event that a son or daughter has passed away, their parents may wish to leave a bequest to that child's surviving spouse, which would be treated differently than had they left it to their child. Similarly, if a parent chooses to bequeath her assets to her son-in-law instead of her son, why should the son-in-law have to pay taxes on the property when the son would not have? The argument here is not for establishing an equal relationship between a parent, child, and an in-law. Rather, it questions why—for the purpose of taxing property—one relationship is more sacred than the other.

The motivation of the inheritance tax is also worth considering. Some scholars have estimated that compliance costs of death taxes may approach revenue yield,[135] with George Cooper writing for the Brookings Institution that "because estate tax avoidance is such a successful and yet wasteful process, one suspects that the present estate and gift tax serves no purpose other than to give reassurance to the millions of unwealthy that entrenched wealth is being attacked."[136] Other experts have disputed these estimates,[137] but what we do know is that damage from death taxes is not limited to the wealthy. The inheritance tax creates deadweight loss. The cost to society from taxation is not equal to the benefit received.

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132 Ky. Rev. Stat. § 140.010.

133 Ky. Rev. Stat. § 140.060.

134 Ky. Rev. Stat. § 140.070.

135 Alicia Munnell & C. Nicole Ernsberger, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review* (Nov. 1988), 3-28.

136 George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance* (Washington, D.C.: Brookings Institution, 1979), 82.

137 William Gale and Joel Slemrod, "Rhetoric and Economics in the Estate Tax Debate," Brookings Institution Report (May 22, 2001), 17-18, https://pdfs.semanticscholar.org/5c6b/b77e5a4800de692019d0dc8a6d8f22323751.pdf.

### *Inheritance Tax Reform Solutions*

The inheritance tax should be prioritized for repeal after the LLET. A similar method can be used to compensate for the marginal revenue losses from the inheritance tax as was used to account for the losses of the LLET. Since the inheritance tax only accounted for $48 million of revenue in FY 2020, repeal could likely be absorbed into the estimated $1.6 billion of general fund revenue growth between FY 2022 and FY 2026, even given the Commonwealth's need to address an underfunded pension system and rising health-care costs with some of that growth. Like the LLET, the cost of repeal is a small price to pay for the elimination of an inefficient, unstable, and non-neutral tax.

Repealing the inheritance tax would yield an improvement of one place on the *State Business Tax Climate Index*, from 19th to 18th overall, and if combined with inventory tax repeal, these two property and wealth-related tax reforms would yield an overall improvement of three places, to 16th, while giving Kentucky the eighth most competitive property tax system in the nation.

# OTHER TAXES

Kentucky's unemployment insurance taxes are among the nation's worst-structured, failing to provide adequate solvency while still managing to unduly penalize many employers at the worst possible time. Meanwhile, the state's motor fuel taxes continue to erode and are increasingly insufficient to the task of funding the state's transportation infrastructure. While these are very different kinds of taxes, they have one thing in common: a desperate need for stability-enhancing modernization.

## Gasoline and Special Fuels Tax

Kentucky's statutory gas tax rate has been raised infrequently during its century in existence, and the tax is not indexed for inflation. As a result, the gas tax has lost much of its value over time. Today, Kentucky's gas tax has half the purchasing power it had in 1968 and only one-quarter of what it had at its peak. When Kentucky became the fifth state to adopt a gas tax, in 1920, the tax was a flat one cent per gallon (cpg). Today, the state-levied gas tax is a factor of the average annual wholesale price (AWP) of gas. The AWP is taxed at 9 percent and is subject to a "floor" under which the wholesale price is treated as never falling any lower than $2.177.[138] That threshold has kept the tax from dropping below its present rate of 26 cpg.[139]

Currently, the Bluegrass State is one of only 11 states tying its motor fuel tax rate to the price of fuel. Under Kentucky's variable-rate gas tax structure, the state adjusts its gas tax annually based on changes in the AWP of gasoline. In other words, there is a direct relationship between the gas price and the gas tax rate. When the gas price rises or falls, the tax rate does likewise. In this way, it functions as an *ad valorem* tax—more like a sales tax—than like most excise taxes, which are more commonly specific taxes, imposed by volume.[140]

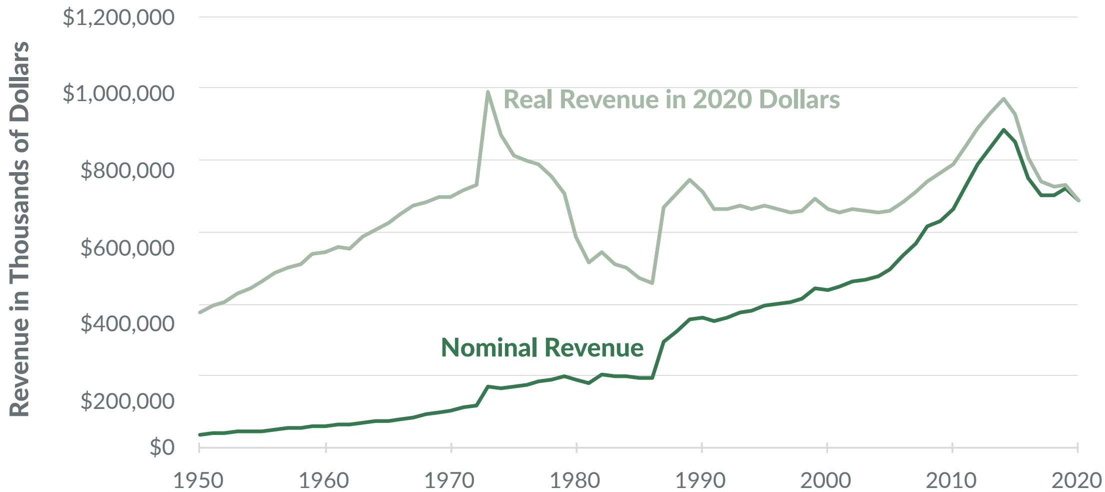
At present, Kentucky's gas tax revenues are outpaced by inflation, unstable, and relatively unpredictable. Some argue that tying tax rates to the price of gasoline ensures the tax adjusts with inflation. However, many other factors besides inflation impact gas prices. Stabilizing the real value of gas tax revenue by tying it to a volatile commodity price achieves the end state like a Rube Goldberg machine: inefficiently or not at all. Some inflation adjustment is bound to occur, but using the present method to fully compensate for inflation is nearly impossible. Therefore, gas prices alone should not be trusted to hold the tax's purchasing power constant.

138 Ky. Rev. Stat. § 138.210.

139 The 26 cpg total rate includes a flat five cent motor fuel user tax, a 9 percent tax on the average wholesale price of fuel (subject to a statutory floor), and a 1.4 cpg Petroleum Storage Tank Environmental Assurance Fund (for remediation costs or damages in the event of an underground fuel storage leak). See American Petroleum Institute, "Notes to State Motor Fuel Excise and Other Taxes," July 1, 2021, https://www.api.org/-/media/Files/Statistics/State-Motor-Fuel-Notes-Summary-july-2021.pdf.

140 Per Ky. Rev. Stat. § 138.228(3)(c), AWP increases and decreases, for tax purposes, are limited to 10 percent per year.

**FIGURE 10.**
## Kentucky Gas Tax Collections, 1950-2020




Sources: U.S. Census Bureau; Tax Foundation calculations.

Adjacent to inflation-linked revenue erosion are the concerns that Kentucky's variable rate gas tax is an unstable and erratic source of revenue as a function of reliance on the wholesale gas price. The federal government, for instance, recognizes that energy and food prices are notoriously volatile. Oil prices are subject to adverse supply and demand shocks resulting from weather, wars, cartel negotiations, crises at strategic chokepoints, and untold other conditions. Similarly, prices may be depressed by increasing fuel efficiency, new extraction technology, or a change in consumer behavior. Accordingly, the Bureau of Labor Statistics maintains multiple consumer price indices from which to estimate inflation. One version includes food and energy prices while a second excludes them to control for their noise in the measure.

It takes a significant change in the price of gasoline to affect the quantity of gasoline demanded by American consumers.[141] Consequently, unstable revenue flows will occur as market forces drive pricing changes while the quantity of gasoline demanded is held relatively constant. This issue came to the forefront when gas prices fell sharply in 2015, bringing Kentucky's gas tax rate down by about 6.5 cpg between 2015 and 2016. To prevent the tax rate from dropping further, Kentucky lawmakers in 2015 adopted the wholesale price floor and a 10 percent limit on annual adjustments.[142]

The annual AWP adjustment enacted in 2015 smooths the revenue stream to a degree, but due to the enduring relationship between the tax rate and market prices, the state still contends with more uncertainty than necessary. As a rule, revenue streams should be as predictable as possible. When unpredicted revenue shortages arise, states are often forced to turn to less efficient, more distortive funding methods to make up the difference. Just as importantly, the cost of fuel is a very poor proxy for a vehicle's contribution to road wear and tear. What matters is how much fuel is used, not how much that fuel costs, which argues for a specific tax denominated in cents per gallon and indexed for inflation.

141 U.S. Energy Information Administration, "Gasoline Prices Tend to Have Little Effect on Demand for Car Travel," Dec. 15, 2014, https://www.eia.gov/todayinenergy/detail.php?id=19191. "The price elasticity of motor gasoline is currently estimated to be in the range of -0.02 to -0.04 in the short term, meaning it takes a 25% to 50% decrease in the price of gasoline to raise automobile travel 1%."

142 Ky. Rev. Stat. § 138.228.

From the perspective of the Transportation Cabinet, when gas taxes and user fees are inadequate to finance vehicle infrastructure needs, the difference must be made up in the form of intragovernmental transfers, bond issuance, or an assortment of other patchwork fees.

Kentucky regularly funds significant amounts of its highway projects with Agency Fund revenue. Some of this revenue, most notably $17 million collected from license fees and permits, conforms to the benefit principle, but it represents only a fraction of the $112.4 million in Agency Fund revenue spent on highways in FY 2020.[143]

Infrastructure projects are often funded via Agency Fund or general fund revenues (e.g., sales taxes, property taxes, etc.) in lieu of targeted user fees because roads are thought of, at least implicitly, as public goods. A public good must, at minimum, conform to two principles. First, use of a public good by one does not preclude its use by another (nonrivalry). Second, people cannot be excluded from accessing the public good (non-excludability). An argument can also be made that the returns to social welfare—or the benefits accrued to society writ large—from a state's road network justify spending these additional monies. But even though, in some ways, we can certainly think of infrastructure as a public good, it is also a good enjoyed by different people in unequal measure, and there is a means for capturing those costs and assigning them to those obtaining the greatest direct benefit. In the case of vehicle-centric infrastructure—unlike with streetlights or national defense—a user fee is entirely feasible to implement.

The gas tax is currently the closest and most efficient form of user fee that can be applied to users of local streets, bridges, and state highways. Additionally, gas tax revenue must be spent on Road Fund projects. The funds supporting the Agency and general funds do not have the same restrictions. Thus, every dollar spent on roads or bridges that does not originate from the gas tax is a dollar that could have been spent on an alternative project. Therefore, the optimal source of revenue for building and maintaining Kentucky's road network is the gas tax—along with tolls—paid by the public in direct proportion to its use of the public good. Ideally, gas taxes and tolls should be adequate to cover the state's entire share of road expenditures.

In addition to problematic rate practices, Kentucky applies its gas tax policy to a non-neutral base. It does so by allowing taxicab and private bus companies annual gas tax refunds. This policy is damaging for two reasons. First, it violates the benefit principle on which the gas tax is premised—those who receive the benefits of a good or service should pay the supporting tax. Currently, 7/9ths, or just over 77 percent, of the gas tax is refunded to bus and taxicab companies operating within the state.[144] The gas tax is meant to be a source of funding for road maintenance and construction by the people who directly use the infrastructure. Taxicab and bus operators certainly fall into that category. Under the exemption these vehicles are allowed to impose 100 percent of their wear and tear on state and local roadways for only 23 percent of the cost relative to a non-exempted user.

143 Id.
144 Ky. Rev. Stat. § 138.446.

Second, the gas tax exemption is a form of protectionism that gives cab drivers an unfair economic advantage over their competition. Presently, cab companies are insulated from the true cost of doing business. By protecting one segment of an industry from competition, Kentucky impedes innovation and acts in an economically inefficient manner. Entrepreneurs who want to transport passengers independently through a ridesharing app, for example, must now pay a gas tax that is 334 percent higher than what their competitors face. This, despite inflicting the same proportionate share of damage to infrastructure as taxis. Non-neutral tax policy impedes a system of free enterprise.

It is important, in this context, to remember that the gas tax is not a sales tax, even if it is imposed as an *ad valorem* tax. Sales taxes are appropriately imposed on final consumption, and thus should exclude business inputs. Well-designed excise taxes are intended to either internalize an externality (like congestion or pollution) or as a user fee. The gas tax could theoretically serve both purposes, but given that it currently raises less than the state's cost of building and maintaining roads, it is best thought of as a partially subsidized user fee. Bus companies purchasing fuel are not engaging in final consumption, but they are undeniably benefiting from the use of roadways.

### *Gas Tax Reform Solutions*

To improve the Transportation Cabinet's ability to self-fund now and in the future, Kentucky should impose a specific (cents per gallon) excise tax on gasoline, repeal the statutory price floor and variable tax rate, make a one-time gas tax adjustment, and tie the new rate to inflation. As part of the gas tax reform, Kentucky can also take several steps toward a more neutral gas tax structure.

Instead of a variable rate tax, Kentucky should impose a specific excise tax on fuel. This tax structure avoids extremes while benefiting the Transportation Cabinet and consumers. Moving away from a variable rate will smooth gas tax revenues and improve the long-term predictability of Road Fund revenue. Instead of a revenue stream that rises and falls with the price of fuel, the specific tax revenue stream will move proportionally with consumers' purchase levels—a reliable proxy for vehicle-centric infrastructure use.

Kentuckians will also see greater stability in gas prices. Under this method, periods of low wholesale prices will reflect marginally higher prices at the pump than under a variable rate method. However, periods of high wholesale prices will reflect lower prices at the pump than under the variable rate. By adopting a specific rate, policymakers have an opportunity to avoid an inadvertent tax increase when fuel prices rise—the time when many can least afford to pay more. Conversely, the state has an opportunity to generate more revenue during periods of low gas prices—good economic times when consumers, on average, can most afford to pay it. In both cases, the state promotes certainty and stability, vital components of sound tax policy.

In conjunction with the adoption of a specific excise tax, the price floor and variable rate laws should be repealed. Since specific tax revenue is a function of the quantity of fuel demanded by consumers and not a function of price, there is no longer a need to maintain a statutory price floor. Unlike the variable rate, a specific rate requires neither monthly surveys nor quarterly or annual averaging of the wholesale price of fuel. In that way, a specific gas tax also offers benefits of simplicity and transparency.

Transitioning from a variable rate tax to a specific excise tax affords the legislature the opportunity to bring the gas tax in line with state funding requirements. In 2019, the American Society of Civil Engineers released a scorecard with grades for Kentucky's infrastructure. Kentucky received a C- and a D+ on bridges and roads, respectively.[145] Among the recommended solutions was increased funding.

Increasing the gas tax will help Kentucky make necessary investments in infrastructure on its own initiative. Additional grants or revenue sharing from the federal government can be helpful, but they can be unreliable and often come with strings attached. Self-funding gives the Commonwealth greater autonomy, initiative, and control over present and future projects.

Policymakers should also make reforms with an eye to the future. The specific excise tax is helpful for smoothing revenue streams in the short term, but it should be indexed to inflation to stabilize its purchasing power in the long term. Additionally, as more electric and hybrid vehicles begin to use the roads, policymakers should enact electric and hybrid vehicle user fees commensurate with the average amount paid in fuel taxes by the owner of a typical gas-powered vehicle. This contributes to a neutral system of taxation and protects against free riders.

A second step to a more neutral tax system is the repeal of the gas tax refund for taxicab and private bus companies, which is expected to cost approximately $1.3 million in FY 2022.[146] While the revenue loss is quite modest, its repeal would eliminate an inequity and signal the state's willingness to embrace competition and adapt to a gig economy that makes ready use of rideshare apps and vehicle-based on-demand services that do not receive gas tax preferences.

## Unemployment Insurance Taxes

State unemployment compensation (UC) systems, and the taxes that pay for them, are vitally important but often overlooked. The experience of the pandemic, however, which depleted state unemployment compensation trust funds and led 22 states (including Kentucky) to resort to federal loans to meet their payment obligations, turned a harsh spotlight on the system. The Commonwealth of Kentucky emerges, in this analysis, as a state which entered the pandemic with inadequate reserves but has smartly prioritized trust fund replenishment in recent months. The structure upon which the unemployment insurance tax code is built, however, leaves much to be desired, with a design that imposes the wrong tax on the wrong employer at the wrong time.

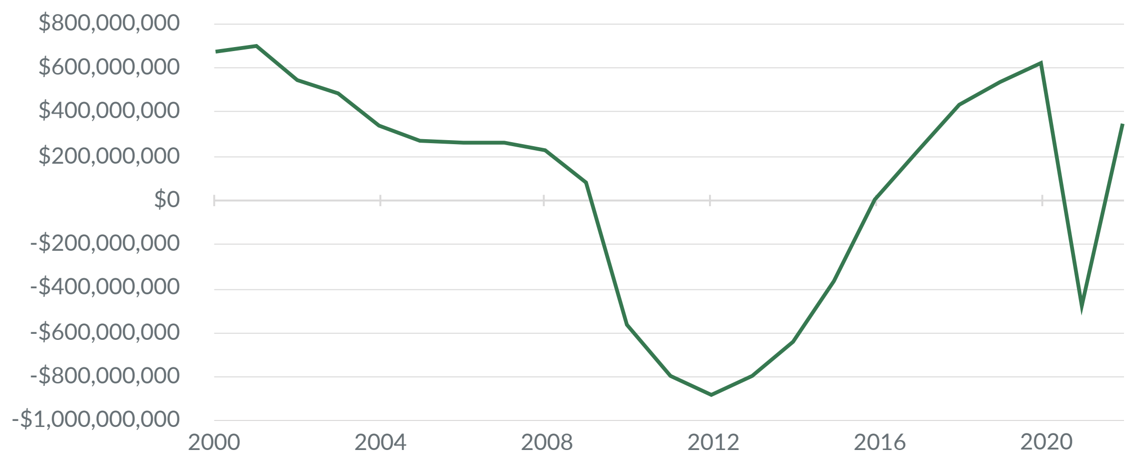
145 American Society of Civil Engineers, "Kentucky 2019 Report Card," https://www.infrastructurereportcard.org/state-item/kentucky/.

146 Kentucky Office of State Budget Director, "Tax Expenditure Analysis, Fiscal Years 2020-2022."

Kentucky entered 2020 with an unemployment compensation trust fund balance of $619 million, the highest initial balance in two decades, but still only 57 percent of minimum adequate solvency as defined by the federal government. The last time Kentucky's fund met the minimal solvency threshold—an estimate of the minimum reserves necessary to weather a recession—was in 1974. Only Pennsylvania has been insolvent for longer.[147]

**FIGURE 11.**

## Kentucky's Unemployment Compensation Trust Fund Balance, 2000-Present




Note: Current balance as of October 1, 2021.
Source: U.S. Department of Labor.

This puts Kentucky's trust fund in a backward posture, using years of economic growth to pay down debts accrued during the last downturn, rather than the appropriate social insurance model of using those good years to build up a reserve adequate to the needs of the next economic contraction. It also accentuates the countercyclical nature of unemployment insurance taxes, which tend to rise right at the point when businesses have the least ability to pay, and where any marginal increase in the cost of employment might accelerate the very layoffs that are generating the stress on the system.

Kentucky's challenges are not unique; many states were woefully unprepared for any economic downturn in 2020, let alone one the magnitude of a global pandemic. But while some of Kentucky's problems are common to other states, their severity is not. Kentucky ranks 49th for unemployment insurance taxes on the Tax Foundation's *State Business Tax Climate Index*, which measures tax structure; only Massachusetts performs worse. It is a major outlier in a broader state tax code that performs fairly well in the *Index*, with no other component—corporate, individual, sales, or property taxes—ranking worse than 21st.[148]

The Commonwealth's reserves are inadequate, the countercyclicality of its taxes unusually intense, and its employer cost mechanisms unfairly applied. The state's unemployment insurance tax system has been in need of reforms for decades. The latest crisis merely underscores the importance of resolving a lingering problem.

147 Five other states are tied with Kentucky in being last solvent in 1974. They are Illinois, New York, Ohio, Texas, and West Virginia. See Office of Unemployment Insurance, U.S. Department of Labor, "State Unemployment Insurance Trust Fund Solvency Report, 2021," March 2021.

148 Jared Walczak and Janelle Cammenga, *2021 State Business Tax Climate Index*.

**TABLE 8.**

### Kentucky's Neighbors Have More Competitive UI Tax Structures

*State Ranks on the UI Tax Component of the "State Business Tax Climate Index"*

| State | Rank |
|---|---|
| Ohio | 6 |
| Missouri | 7 |
| Tennessee | 16 |
| Indiana | 27 |
| West Virginia | 28 |
| Illinois | 43 |
| Virginia | 46 |
| Kentucky | 49 |

Source: Tax Foundation, 2021 *State Business Tax Climate Index*.

Unemployment compensation is a joint federal-state system of social insurance, with employers liable for payroll taxes on employees, which stock state trust funds. Because it is essentially an insurance program, moreover, the "premiums" go up on employers with a history of layoffs. Each employer has what is called an experience rating, based on the amount of benefits charged to an employer's account. The more benefits paid out to former employees, the higher the business's tax rate. In some states, different industries can face different rates as well, so unlike other taxes, unemployment insurance taxes are imposed in ranges, with each business's tax rate adjusted from the "standard" rate by industry and experience rating. Finally, the ranges within the rate schedules are often calculated based on trust fund balances, and the tax is only imposed on a given wage base—currently $10,800 in Kentucky.

In Kentucky, for instance, 2021 contribution rates range from 0.3 to 9.0 percent based on a business's experience rating using what is known as a "reserve ratio," yielding taxes of $32 to $972 per employee per year (assuming wages of at least $10,800) depending on the employer's experience. Under this system, charged benefits paid to laid off employees are subtracted from contributions made by the employer, and this figure is divided by payroll to calculate liability for benefits.

As of 2021, a business which paid exactly as much in UI taxes as was charged against its account in benefits would pay a 2.4 percent rate. As charged benefit payments exceed the amount paid in taxes in the previous year, rates rise to address the imbalance, to the current maximum rate of 9 percent.[149] The most common alternative approach is the benefit ratio, which looks exclusively at benefits charged as a percentage of payroll, without taking contributions into account. Two states, Delaware and Oklahoma, take statewide experience into account rather than focusing exclusively on individual employers' histories.[150]

149 Kentucky Office of Unemployment Insurance, "Tax Rate Schedules," 2021, https://kewes.ky.gov/Contact/UITaxInfo.aspx.

150 UWC – Strategic Services on Unemployment & Workers' Compensation, "Highlights of State Unemployment Compensation Laws," 2020.

When a state charges specific employers for benefits paid, it is important that the right employer be charged, and for the right benefits. Kentucky does well in defining the scope of benefits subject to charging. Any benefits paid out erroneously are not charged to the employer, and employees who leave voluntarily or are discharged for misconduct do not adversely affect an employer's experience rating. Similarly, if a former employee refuses suitable work, the employer experiences no continued charging. Where Kentucky diverges from many of its peers, however, is in *which* employer is charged. In most circumstances, Kentucky only charges the most recent employer,[151] whereas many states charge employers in proportion to base period wages.

The upshot of this is that if a Kentucky employer takes a chance on an employee and it does not work out—either because of the employee or because they are attempting to staff up in a volatile economic climate—they bear the full cost of any benefits paid out to that employee, even if they had recently been laid off by another employer as well. In many states, the charging of benefits is proportional to time with employers over a given period, reducing the risk to an employer taking a chance on a new worker.

Neighboring Tennessee is more typical of state treatment of employer charging, establishing a base period of one year, ending one full quarter before the one in which an employee files for unemployment.[152] In other words, if someone filed for unemployment benefits in April 2020, charging would be to their employers from January to December of 2019, in proportion to their periods of employment. This way, companies are not disincentivized from hiring during a downturn or from taking a chance on a laid off worker.

New businesses, of course, lack an experience rating and are assigned an initial rate, currently 2.7 percent in Kentucky. States vary in how long a business must be in operation before it is assigned its own experience rating. Fourteen use the business's own history of benefit charges after one year, and another 17 move companies off the initial rate between their first and second year of operation.[153] Three choose two and a half years, and finally, Kentucky joins 16 states and the District of Columbia in maintaining this less favorable—and less accurate—rate for a full three years.

All unemployment insurance tax rates on the schedule rise when necessary to replenish a depleted trust fund, but these increases preserve a range based on business experience. Separately, however, Kentucky maintains a solvency tax (currently at 0.2 percent of base wages) that is imposed on all businesses in equal measure—even those without a single layoff—when the Commonwealth is required to pay interest on federal loans.[154] Additionally, during years when UI tax revenues are strong, in lieu of a rate reduction, Kentucky slightly reduces the standard rate but fully offsets it with a commensurate surtax intended to fund system modernization efforts.[155]

When states are unable to pay claims through their own trust funds, they are entitled to receive loans from the federal government, called Title XII Advances, which must be paid back with interest. These interest charges are waived for the first full calendar year if the state's trust fund was solvent at the beginning of the year in which advances were first received, something that has not been true

151 Ky. Rev. Stat. § 341.530(2). The only exception is in cases where an individual has two employers in a span of 10 weeks.

152 Tenn. Code § 50-7-403(h)(4).

153 Jared Walczak and Janelle Cammenga, *2021 State Business Tax Climate Index*.

154 Ky. Rev. Stat. § 341.614(2).

155 Ky. Rev. Stat. § 341.243.

of Kentucky since 1974. Congress, moreover, chose to shield all states from interest payments at the height of the pandemic, with interest accrual only reinstated on September 6, 2021. Kentucky paid off its $508 million in pandemic-era Title XII Advances using federal aid dollars provided under the American Rescue Plan Act (ARPA),[156] but the state has recent experience with owing interest on UC debt, having racked up over $2 billion in debt during the Great Recession, which it paid off by 2016.[157]

It is commendable that Kentucky is one of the 15 states which has thus far used Fiscal Recovery Funds made available under ARPA to retire its federal debt before interest began to accrue, or before the outstanding debt resulted in penalties on Kentucky employers, either through the state's own surtax or, ultimately, higher federal UI tax rates that are imposed when state accounts are in arrears.[158] Ideally, however, Kentucky would focus on building up its trust fund during years of economic growth rather than automatically imposing a higher tax on all employers precisely when maintaining workforce levels is the most difficult. The Commonwealth could go further to put itself on the path to a healthy UC trust fund, moreover, by using additional ARPA dollars to not just pay off its debt but also replenish its fund.

Kentucky received almost $2.2 billion in Fiscal Recovery Funds,[159] of which it has committed $875 million as of October 2021,[160] with $1.3 billion yet to be appropriated. Because state revenues have far outperformed the pessimistic forecasts that informed congressional deliberations, policymakers across the country are struggling to identify uses for these funds that are both responsible and permitted under federal law. Since the depletion of UC trust funds is one of the few hits most states—including Kentucky—took, the replenishment of these funds deserves to be a top priority use of ARPA money.

These funds can be used for three UC-related purposes. First, to retire any federal debt, as Kentucky has done. Second, to restore the trust fund balance to its pre-pandemic level, defined as the balance as of January 27, 2020. And third, to cover the costs of ongoing benefit payments during the pandemic. Given these conditions, Kentucky could authorize another $250 million to bring its trust fund to its pre-pandemic balance, in addition to using ARPA funds for ongoing payments, allowing the fund balance to continue to grow.[161] Even though the Commonwealth's fund balance has now grown to about $350 million, that is still more than $1 billion short of minimum adequate solvency.[162]

156 National Conference of State Legislatures, "ARPA State Fiscal Recovery Fund Allocations," Oct. 4, 2021, https://www.ncsl.org/research/fiscal-policy/arpa-state-fiscal-recovery-fund-allocations.aspx.

157 Commonwealth of Kentucky, "Unemployment Insurance Trust Fund Annual Report, CY 2016"; Office of Unemployment Insurance, U.S. Department of Labor, "State Unemployment Insurance Trust Fund Solvency Report, 2016," February 2016.

158 Technically, the federal tax is 6.0 percent on a $7,000 wage base, but is typically offset by a 90 percent tax credit, functionally transforming it into a 0.6 percent tax. With each passing year in which a state fails to fully repay its Title XII Advance, however, that credit is reduced until, ultimately, it is eliminated. If a state maintained an outstanding balance for a decade, federal per-employee UI tax burdens on that state's businesses would increase from $42 to $420.

159 Jared Walczak, "State Aid in American Rescue Plan Act is 116 Times States' Revenue Losses," Tax Foundation, Mar. 3, 2021, https://www.taxfoundation.org/state-and-local-aid-american-rescue-plan/.

160 National Conference of State Legislatures, "ARPA State Fiscal Recovery Fund Allocations."

161 Jared Walczak and Savanna Funkhouser, "States Have $95 Billion to Restore their Unemployment Trust Funds—Why Aren't They Using It?" Tax Foundation, Sept. 22, 2021, https://www.taxfoundation.org/state-unemployment-trust-funds-2021/.

162 Tax Foundation calculations using U.S. Department of Labor data and methodology.

### *UI Tax Reform Solutions*

Kentucky should take several steps to improve the competitiveness of its UI tax system and to strengthen its UC system. First, officials should take full advantage of all ARPA funds available for trust fund replenishment, moving the fund closer to solvency. Second, policymakers should change how employers are charged for benefits, joining the majority of states in charging according to base period wages to avoid disincentivizing the hiring of laid off workers. Third, lawmakers should shorten the time period necessary for a new business to establish an experience rating, ideally to one year rather than three. And finally, legislators should explore the repeal of the solvency tax and administrative surtaxes, even if this means modestly higher rates during years of economic growth. The goal should always be to keep UI taxes low, but it is better to smooth collections than to require a sharp spike in taxes—either through surtaxes, excessively large automatic adjustments to the rate schedule, or both—precisely when businesses can least afford the burden, and when higher taxes can have an adverse effect on an already weak labor market.

If policymakers adopted a more typical method of employer charging and allowed businesses to earn their own experience rating in one year, these changes alone would improve Kentucky from 49th to 23rd on the unemployment insurance tax component of the *State Business Tax Climate Index*, and this rank could improve to 17th by eliminating solvency taxes and focusing instead on building up reserves during good years. These reforms would improve Kentucky to 16th on the *Index* overall.

# CONCLUSION

In 2018, Kentucky lawmakers made commendable progress reducing income tax rates and improving the state's tax structure, but more work remains to be done to remove additional underlying impediments to the Bluegrass State's competitiveness and growth.

Kentucky is emerging from the COVID-19 pandemic in a strong fiscal position, and many similarly situated states have responded by returning surplus revenues to taxpayers in a manner that improves their tax structure and makes their state more attractive. In this new era of workplace flexibility, states that stand still risk falling behind, and Kentucky is already lagging regional peers and the national average in terms of GDP growth, population growth, and personal income growth.

Where Kentucky has a distinct advantage is in its relatively low cost of living compared to many states. At a time of rapid exodus from high-tax, high cost-of-living states, Kentucky has a unique opportunity to build a name for itself as a highly sought-after destination to live and work, and structural tax modernization will play a critical role in any such effort. While Kentucky lawmakers may not be able to tackle every tax issue simultaneously, they should be encouraged by the example of regional competitors like North Carolina, Tennessee, and Indiana, which have all benefited by making steady, incremental pro-growth reforms over the past decade.

This report has outlined a menu of tax reform options to help lawmakers, taxpayers, and other stakeholders identify the areas of the tax code in most need of improvement. A top priority for lawmakers should be addressing the areas of the tax code in which Kentucky is an outlier, such as in its reliance on the gross receipts-style LLET, local occupational license taxes and inventory taxes, and an inheritance tax. There are likewise compelling economic reasons to shore up transportation funding with a more efficient gas tax and to modernize the unemployment insurance tax system to make it less burdensome and more stable.

Many of these reforms can be implemented independently, but some may benefit from more comprehensive solutions—for instance, curtailing tax incentives or broadening the sales tax base to pay down income tax rate reductions or pairing local option sales tax authority with mechanisms to reduce or eliminate municipal income (occupational license and net profit) taxation.

Even without rate reductions, a comprehensive plan could dramatically improve Kentucky's tax competitiveness. Adopting better business expensing policies, improving UI taxes by adopting the charging methods and experience rating eligibility standards of peer states, fixing the inventory tax credit, and repealing the LLET and inheritance tax would reduce general fund revenues by less than 2 percent—revenues that could be offset elsewhere, in more economically efficient ways—while making the Commonwealth's tax code substantially more pro-growth, and improving its ranking on our *State Business Tax Climate Index* from 19th to 8th overall.

**TABLE 9.**

**Kentucky Could Have the 8th-Best Tax Code with Comprehensive Reform**

*Current and Projected Ranks on the State Business Tax Climate Index*

| | Index Rank | |
|---|---|---|
| **Index Component** | **Current** | **Reform** |
| Overall | 19 | 8 |
| Corporate | 19 | 8 |
| Individual | 18 | 16 |
| Sales | 13 | 13 |
| Property | 21 | 8 |
| U.I. | 49 | 19 |

Source: *State Business Tax Climate Index*; Tax Foundation calculations.

By taking sensible steps to address these issues while keeping tax rates competitive, Kentucky may soon join the ranks of regional leaders in tax modernization, with lawmakers elsewhere asking how their state can become more like Kentucky.

# ABOUT THE TAX FOUNDATION

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and global levels. Our Center for State Tax Policy uses research to foster competition among the states and advises policymakers on how to improve their tax systems.

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Each year, many people flock to the Bluegrass State, drawn by horse racing, bourbon, or other attractions. But while the Commonwealth draws its fair share of tourists, new businesses and residents have proven more difficult to attract and retain. Kentucky's economic growth, personal income growth, and population growth all lag the national average.

The General Assembly made significant improvements to the tax code in 2018, but more work remains to be done. If Kentucky is to make a name for itself as a highly attractive destination for individuals and businesses, pro-growth tax reform must be part of the equation. In an increasingly competitive national landscape, Kentucky's tax code still contains too many outdated, complex, and inefficient provisions that penalize productivity and discourage in-state investment.

This guide examines Kentucky's tax code—from the Limited Liability Entity Tax to local occupational license and net profit taxes, to inventory taxes, the inheritance tax, and the structure of the state's income and sales taxes—and offers a menu of tax reform options for policymakers to consider. These solutions, if adopted, would promote economic growth while improving tax structure, enhancing Kentucky's competitiveness for years to come.

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