

# MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal Policy Research Brief  
By Kentucky Youth Advocates

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## Eleven Paths to Tax Fairness: Comprehensive Tax Reform and an Earned Income Tax Credit for Kentucky

### Introduction

We have been told repeatedly that the Kentucky budget is “full of holes”. There is a big Medicaid hole. There is a hole created by the Murphy Camera case, which exempts a large class of business equipment from sales tax. There is a hole created by shortfalls in projected tax revenues. These are serious matters that clearly require “fiscal prudence”. In the short run, these holes must be “patched”. Moreover, these situations highlight the need to pursue comprehensive tax reform no later than the 2002 General Assembly.

The Governor and legislative leaders apparently agree that tax relief for Kentucky’s working poor is a top priority. Kentucky has for too long held the distinction of having a tax system that places the highest burden in the nation on a family of four.<sup>1</sup> At the federal level, the earned income tax credit (EITC) has a proven track record at lifting people out of poverty. Championed by Ronald Reagan, and enjoying broad bipartisan support, the federal EITC provides tax relief to over 300,000 working families in Kentucky. A state level refundable EITC would provide relatively low cost, targeted, and highly effective tax relief to Kentucky’s working poor and near-poor families.

This research brief looks at many of the components of the Kentucky tax system in need of reform. Each of the eleven options presented here would pay for either all or part of a refundable EITC for Kentucky.

In keeping with the need for relief for the lowest income working families, these suggested options contribute to an overall system that is more progressive, providing relief for those least able to afford it, and asking more of those most able to afford it.

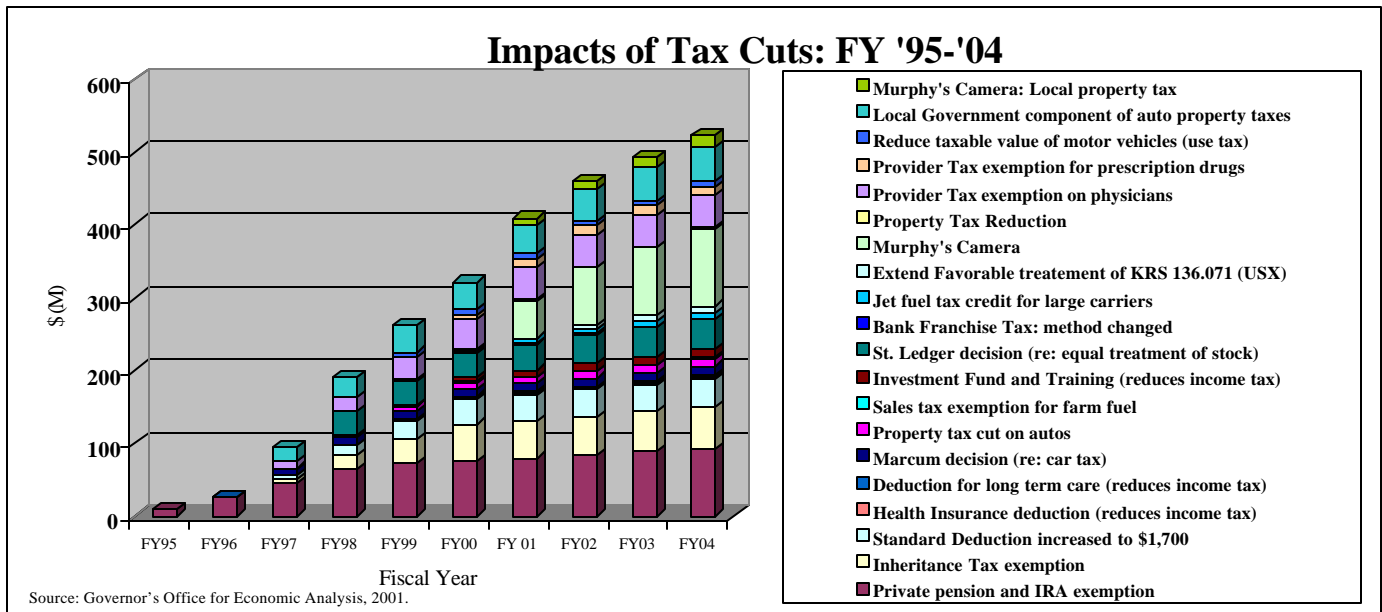
### An EITC for Kentucky

We provide here some ideas as to how Kentucky’s elected officials might choose to act on their stated convictions that Kentucky’s working poor need tax relief. Rather than advocating one or two specific alternatives, we examine here a range of tax and budgetary measures that merit further exploration.

A state level earned income tax credit, modeled after the federal EITC, would provide meaningful tax relief. It would, however, cost a significant amount of money. Estimates for a fully phased in EITC for Kentucky vary with a number of factors. The most obvious variable is the proportion of the federal EITC. A state level EITC based on 15 percent of the federal EITC would cost Kentucky between **\$62 and \$73** million in FY2002.<sup>2</sup> Note, however, that because an EITC would be phased in over a period of two or three years, the revenue initially required would be much smaller (\$21 to \$24 million).

## 1990s Tax Cuts: Costly to the State, Helpful to the Wealthy

Revenue neutral tax reform implies the redistribution of taxes from one group to another. Providing tax relief to the working poor therefore requires shifting the burden to groups more capable of shouldering that tax load. A number of *ad hoc* tax changes over recent years have disproportionately benefited Kentucky's wealthiest citizens. Tax cuts enacted since 1995 have seen the wealthy benefit through reductions of the intangibles tax, reduction of the inheritance tax, and pension and IRA exemptions. For FY (fiscal year) 2000, these **cuts cost the state treasury over \$250 million**. The wealthy have had their cut. It's time to find a way to reduce the burden on Kentucky's working poor. Total impacts of cuts implemented since 1995 will surpass **\$500 million** annually by 2004!



## Eleven Funding Options for an EITC

### Income Tax

Some would argue that a refundable earned income tax credit should be paid for within the income tax stream of revenue. In the interest of creating a tax system that is more fair, a tax break for Kentucky's poorest working citizens could be achieved by modestly increasing the taxes paid by Kentucky's most wealthy citizens. Raising \$75 million to fully fund a 15% EITC could be achieved through one of the following:

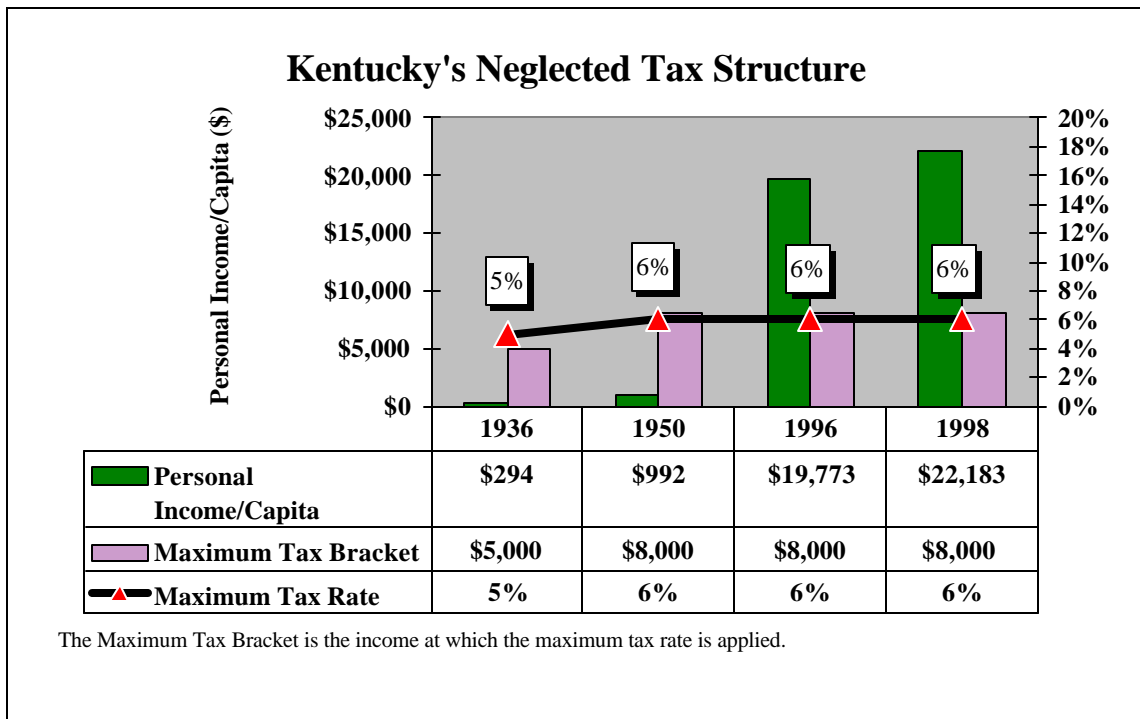
1. Assessing a tax **increase of 1.5%** on the **top 1% of tax filers**.<sup>3</sup>
2. Assessing a tax **increase of 0.8%** on the **top 5% of tax filers**.

Alternatively, some combination of these options could be used, with perhaps the top 1% of tax filers shouldering half of the EITC cost, and the next 4% shouldering the remainder.

Assessing additional taxes on Kentucky's wealthiest citizens is entirely defensible due to the fact that the Kentucky tax structure has failed to keep pace with the times. Kentucky's

maximum tax bracket starts at \$8,000 income, just as it did over 50 years ago. During that same period of time, the per capita income in Kentucky increased by over 22 times!

We often hear from legislators that the administration has not been following “legislative intent”. Both legislators and the Governor need to address the fact that the legislative intent inherent in the income tax structure has been totally abandoned. Sound public policy decisions created a Kentucky income tax that was originally very progressive, with rates ranging from 2% to 6%. Because the highest bracket has not moved significantly in the intervening decades, the progressive aspect has largely been abandoned.



### 3. TANF Funds

The final federal TANF regulations make it clear that federal TANF dollars can be spent on the refundable portion of a state level EITC. In Kentucky, where approximately 40% of state level EITC costs are projected to be for refunds (rather than tax offsets), that would translate to **\$29 million in federal funds**.

### 4. Inheritance Tax – Find a way to keep it!

The Bush administration’s proposal to eliminate the federal inheritance tax will have a serious impact on state revenues. The Center on Budget and Policy Priorities estimates that Kentucky stands to lose approximately **\$40 million annually**. State Budget Director Jim Ramsey estimates that losses might be as high as **\$74 million annually**. Finding a way to keep that money for Kentucky by breaking the link between federal and state tax policies would preserve these funds for Kentucky.

### 5. Services Tax

2002 revenues foregone by excluding services from the tax base totaled **\$740.1 million!** The Governor’s original budget proposal for FY01/02 would have extended the sales and use tax to

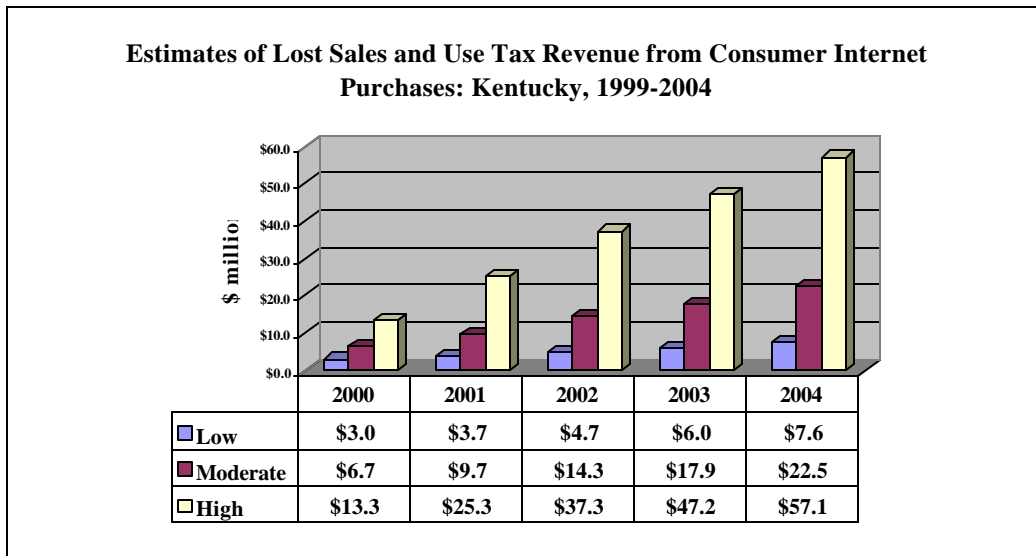
selected services, netting **\$203.2 million**. Clearly within a potential range of up to \$740.1 million, there is ample room to explore different combinations of service taxes that tap into the growth areas associated with the “new economy”, while avoiding placing additional tax burdens on those least able to afford it.

## 6. Remove Exemption of Corporate Dividend Income

There are many “corporate tax exemptions” that might reasonably be targeted. This exemption is offered as one example among many that might be considered, not necessarily as the “best” area to pursue. Currently, corporate dividend income is excluded from gross income for purposes of calculating corporate income tax. This tax expenditure is projected to cost the Commonwealth of Kentucky **\$26.8 million in FY2001, and \$28.2 million in FY 2002**. Eliminating this tax loophole would not fully fund an EITC, but it would provide a significant portion. Alternatively, this amount could fund a state level EITC that is based on less than 15% of the federal.

## 7. Internet Sales and Use Tax Losses

The Kentucky Long Term Policy Research Center (LTPRC) estimates that in 2002, KY will forego between **\$4.7 million and \$37.3 million** because we do not collect sales and use taxes on internet sales<sup>4</sup>. Finding a way to collect taxes on this fast growing sector of the economy would move Kentucky’s tax system in the direction needed to deal with the evolving 21<sup>st</sup> century economy.



Source: Kentucky Long-Term Policy Research Center, 2001.

## 8. Mail Order Consumer Purchases

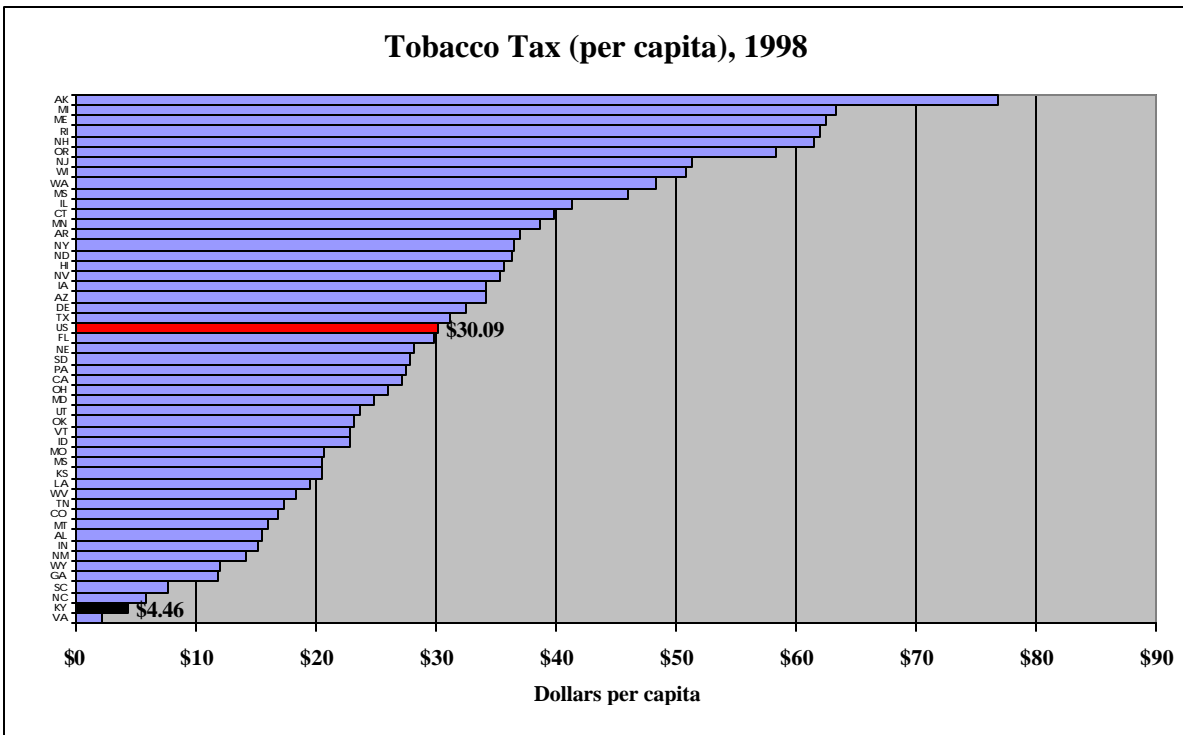
The Kentucky LTPRC estimates 2002 lost revenues through mail order consumer purchases at between **\$1.9 million and \$30.2 million**. Many Kentuckians are unaware of, or perhaps ignore, the single line on the personal income tax form on which the use tax for mail order purchases should be indicated. Kentuckians have both a moral and a legal obligation to pay the use tax associated with such purchases, and the Commonwealth of Kentucky has a corresponding obligation to ensure use taxes are fully collected.

**9. Communications Excise Tax**

The 2000 Patton budget proposal estimated that for FY 2002, a Communications Excise Tax would yield revenues of **\$64.9 million**. Given the continued growth of the communications sector, such an excise tax would yield a growing revenue base for the Commonwealth, compensating for such shrinking tax sources as the corporate income tax and the coal severance tax.

**10. Cigarette Tax**

Currently, Kentucky’s 3 cents per package cigarette tax yields tax revenues (\$4.46 per capita) that are far below the national average of \$30.09. Doubling the cigarette tax to 6 cents a pack would virtually double tax revenues, yielding an additional \$15 million/year.<sup>5</sup> This would only move Kentucky from a state rank of 50<sup>th</sup> to 49<sup>th</sup> for tax rate per package. Adopting the national median of 34.4 cents a pack would yield almost ten times as much revenue, or an additional \$150 million per year. Even if higher taxes reduce tobacco purchases, a worth public policy goal, sufficient revenue would be generated to meet the costs of an EITC.



Source: U.S. Census Bureau, 1998 State Government Finance

**11. Motor Vehicle Tax**

Asking the citizens of the Commonwealth (or any other jurisdiction for that matter), if they would rather not pay a particular tax would surely almost always yield a positive response. Such has been the case with the motor vehicle tax, which Kentucky voters rejected in a constitutional amendment passed in 1998. Since that time, the Governor and legislators have introduced legislation that would remove the state portion (one third of the total tax) of the vehicle tax. This

tax reduction would amount to approximately **\$80 million each year**. Yet the “tax relief” for the typical car owner would be negligible. Moreover, the effects of the tax cut would return most of the break to the wealthy – those driving relatively new, and relatively expensive vehicles. Consider that an older vehicle, valued at \$3000, would face a state level tax of only \$13.50. Compare that to the upper middle class family driving a new \$52,000 SUV and a second vehicle valued at \$12,000. State taxes on their combined vehicles would yield a more significant \$288 (although not an amount likely to have much impact on such a family’s annual budget). The \$80 million needed to repeal the car tax could be used to much greater effect if targeted to low income earners through an earned income tax credit, resulting in savings of up to \$583 for working poor families. For Kentucky’s working poor, the choice between a \$583 refundable credit, and a \$13.50 savings on the car tax seems clear.

Utilizing the revenue for a state level EITC, a proven program that fosters self-sufficiency while returning the money to stimulate the local economy, would move Kentucky much farther forward than would the elimination state level of the motor vehicle tax.

## Conclusion

Despite the significant cost of a state level earned income tax credit, the real barrier to placing Kentucky among the states that treat the working poor fairly is not budgetary, but political. This research document has outlined a range of options for discussion. Most reflect the need to create a tax system that is more fair – that acknowledges that many of Kentucky’s hard working families cannot yet afford to contribute fully to the tax base. In other policy areas, these are people who we encourage to achieve self-sufficiency. Yet where income taxes in Kentucky are concerned, we instead burden them with a tax load that is arguably the most harsh of all states. Maintaining such inconsistent policies is both irresponsible public policy and simply unfair.

The many holes in Kentucky’s budget will likely be filled only when comprehensive tax reform is successfully achieved. Such reform must meaningfully address the needs of Kentucky’s working poor. This is the greatest shortcoming of the current tax structure.

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<sup>1</sup>Bob Zahradnik, Nicholas Johnson, and Michael Mazerov, *State Income Tax Burdens on Low-Income Families in 2000: Assessing the Burdens and Opportunities for Relief*, (Washington: Center on Budget and Policy Priorities, 2001).

<sup>2</sup>Typical “take up rate” for state level EITCs has been approximately 85% of eligible collectors. The lower number reflects this rate – the higher number assumes 100% participation rate of those collecting the federal EIC.

<sup>3</sup>Source: Legislative Research Commission memorandum, February 22, 2001. Note this is an increase of 1.5 percentage points, rather than a 1.5% increase in the taxes paid at this level. This distinction applies to the other income tax alternatives presented here.

<sup>4</sup>Kentucky Long Term Policy Research Center, “Revenue Implications Grow as More Kentuckians Shop Online,” in *Foresight*, Vol. 7, #4, 2000.

<sup>5</sup>Revenues would not quite double, since the additional cost might price some users, particularly youth, out of the market. It seems unlikely that a 3 cent increase would have much effect.

Any questions about this copy of *Money Matters* should be directed to KYA’s Senior Analyst, Douglas Hall, at (502) 875-4865, or at [dhall@kyyouth.org](mailto:dhall@kyyouth.org). Additional tax and Budget information can be found at [www.kyyouth.org](http://www.kyyouth.org).