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FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy Research Brief

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KENTUCKY STILL A LOW-INCOME STATE: ANALYSIS OF FEDERAL TAX RETURNS

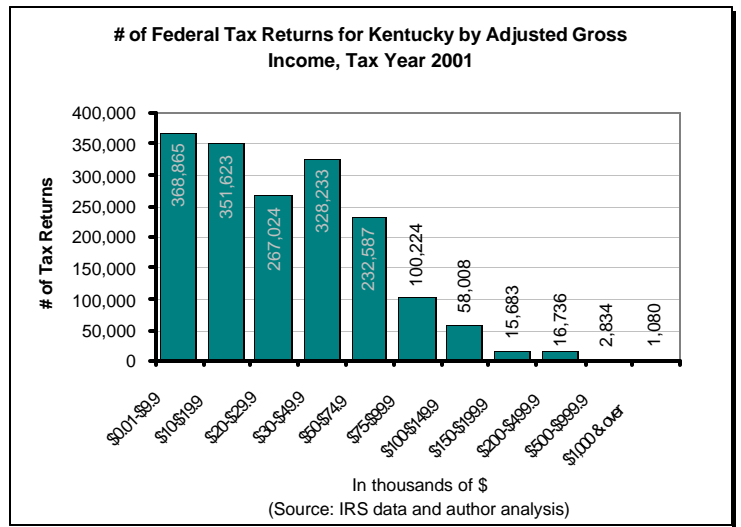
Purpose To examine the distribution of income in Kentucky and its implications for tax reform..

Kids Matter The well-being of children is largely dependent upon a family's income. In Kentucky, family incomes and well-being have been improving in recent years (see KYA's KIDSCOUNT book for details at www.kyyouth.org). However, Kentucky has a long way to go.

Summary Kentucky is still a low-income state. Average adjusted gross income (AGI) was \$38,300 in tax year 2001; for the nation it was \$46,900. Fifty-seven percent of Kentucky tax filers had an AGI less than \$30,000; the national average was 53 percent. The news wasn't much better at the top. Only 5.4 percent of Kentuckians had incomes greater than \$100,000; the national average was 8.3 percent.

Kentucky is a low-income state — at both ends of the spectrum. Most Kentucky families have annual adjusted gross incomes less than \$30,000. This is slightly worse than the national average and many neighboring states. Kentucky fares no better among tax filers who earn more than \$100,000, though. Compared to Indiana, Tennessee, Ohio, and Illinois, Kentucky had a smaller percentage of tax filers with such high incomes. The same is true when comparing Kentucky to the national average.

Graph 1



In this Money Matters paper the issue of how Kentucky's income is distributed

is examined. This information is important to Kentucky's policy-makers, especially the next governor. Both gubernatorial candidates have called for tax "modernization." If the next governor follows-through this commitment, one critical component of that plan must be updating the individual income tax code.



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Kentucky's current individual income tax structure pre-dates Neil Armstrong's landing on the moon.

Kentucky's current tax structure pre-dates Neil Armstrong's landing on the moon. Knowing how income is distributed, therefore, is vital to any tax modernization effort.

This paper begins by providing brief background information on the data used for this analysis. Then it provides a detailed and graphical look at how income is distributed in Kentucky—the results may surprise you. The article concludes by recommending ways to modernize Kentucky's income tax based upon the analysis provided here.

Background

This analysis is based upon United States Internal Revenue Service (IRS) data for tax year 2001. In tax year 2001, 1.7 million Kentuckians filed federal individual income tax returns. Those returns were filed by both single and married persons.

Married persons who filed jointly reported income from both spouses on one tax return. Married persons who filed separately reported each spouse's income on separate tax returns. Single persons reported income for themselves. Readers of this paper are reminded that the income figures used in this paper are from all types of tax filers—single, married couples, and head of household (an adult who took care of a dependent person).

All income figures should be read as "adjusted gross income" unless otherwise noted. Adjusted gross income (AGI) is the sum of all income and other

earnings that an individual receives during a year. (See box below for more detail.)

Kentucky's individual income tax returns are based upon the federal AGI. (If you think back to your April tax return, the first amount you entered on your Kentucky tax form was the federal AGI.) Because of this relationship, the IRS data presented in this paper also provide an important insight into income distribution and income taxes in Kentucky.

Distribution of Income

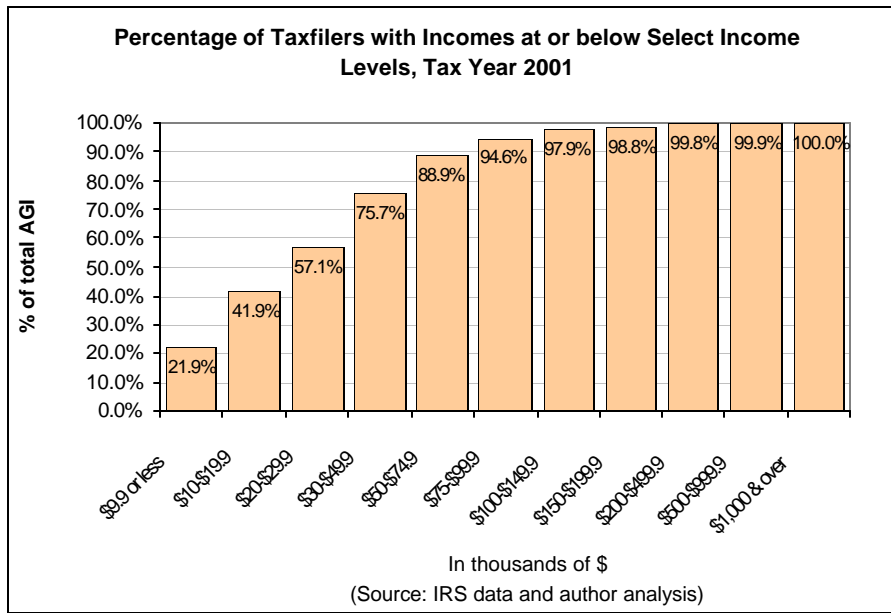
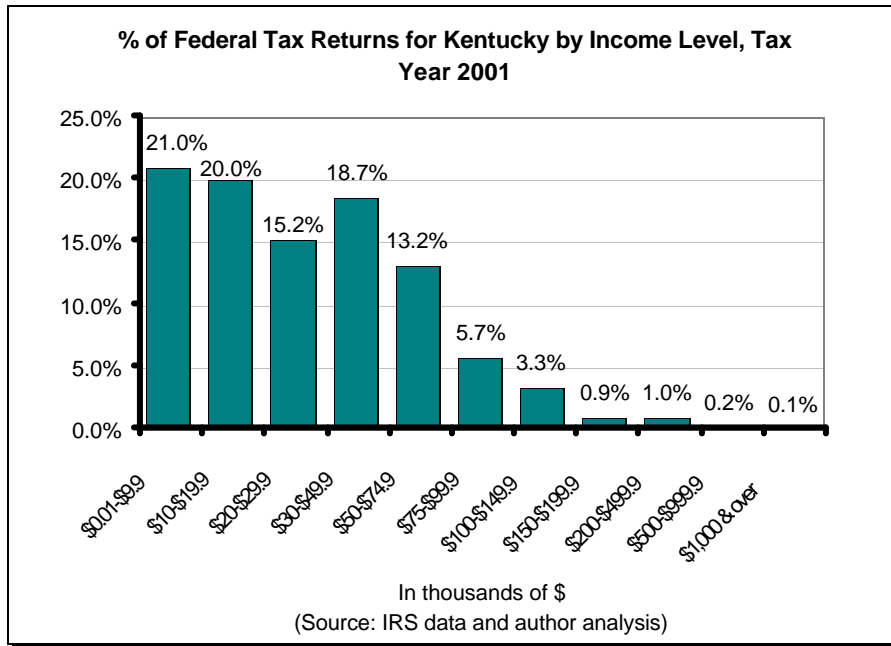
Income in Kentucky, like the rest of the country, is not equally distributed. Some people have very high incomes. Others quite low. Graphs 2 and 3 show how incomes are distributed in Kentucky.

Graph 2 shows the percentage of tax returns filed by income range. (Graph 1 on the first page shows the number of tax returns by income range.) For example, by looking at Graph 2 we know that 20 percent of tax filers had adjusted gross incomes between \$10,000 and \$19,999. Similarly, tax filers with incomes greater than \$1 million represented one tenth of one percent of all tax filers.

Graph 3 takes the data in Graph 2 and shows the cumulative total. By looking at Graph 3, therefore, we can tell the percentage of people who earn a given income or less. For example, look at the second bar. The label reads "41.9%." This means that 41.9 percent of all Kentucky federal income tax filers had incomes less than \$20,000.

Adjusted Gross Income (AGI) is the sum of all salary and wages, interest income, and other earnings (e.g., unemployment compensation, certain retirement income) less certain deductions (e.g., student loan interest payment). Adjusted gross income is the basis for determining your federal and Kentucky taxable income.

Graphs 2 & 3



Almost three out of every five Kentucky tax filers had incomes below \$30,000.

Similar observations can be made from looking at the other income ranges. For example, Graph 3 shows that a majority of tax filers, 57.1 percent, had incomes less than \$30,000. That is, almost three out of every five Kentucky tax filers had incomes below \$30,000. The national average, which is not shown, was 53 percent. Only 5.4 percent, or about 94,000 Kentucky tax filers, had incomes

greater than \$100,000. The national average, which is not shown, was 8.3 percent.

Compared to several neighboring states, Kentucky position looks about the same. Tables 1 and 2 on the following page show Kentucky's income distribution compared to Indiana, Tennessee, West Virginia, Ohio, and Illinois.

Tables 1 and 2

% of Tax Filers by Income (in thousands of \$) for Kentucky & Select Neighboring States							
State	\$0-\$9.9	\$10-\$19.9	\$20-\$49.9	\$50-\$74.9	\$75-\$99.9	\$100-\$199.9	\$200 and up
Kentucky	0.210	0.200	0.338	0.132	0.057	0.042	0.012
Illinois	0.191	0.161	0.323	0.144	0.077	0.073	0.023
Indiana	0.203	0.170	0.335	0.152	0.070	0.050	0.012
Ohio	0.193	0.174	0.366	0.142	0.060	0.045	0.013
Tennessee	0.203	0.199	0.350	0.125	0.055	0.044	0.014
West Virginia	0.225	0.213	0.336	0.129	0.050	0.032	0.008
U.S. Ave.	0.192	0.179	0.329	0.135	0.068	0.064	0.020

Numbers in BOLD denote highest percentage for that column.
 (Source: IRS data and author analysis)

Kentucky's Ranking (1=highest %, 6=lowest %):							
	\$0-\$9.9	\$10-\$19.9	\$20-\$49.9	\$50-\$74.9	\$75-\$99.9	\$100-\$199.9	\$200 and up
Kentucky Rank	2	2	3	3	3	4	5

(Source: IRS data and author analysis)

Kentucky has relatively more low-income people and relatively fewer high-income people than neighboring states. Basically, this represents the worst of both worlds.

Table 1 shows that Kentucky has significantly fewer tax filers with high incomes than most neighboring states or the United States as a whole. All states have fairly small populations of people with incomes of \$1 million and over. However, Kentucky's percentage is generally lower. For example, 1.2 percent of Kentucky tax filers had incomes of \$200,000 or more. The national average was two percent.

On the other end, Kentucky has a higher percentage of low income tax filers than most neighboring states—the exception being West Virginia. Looking at the first column, those with incomes between zero and \$9,999, we can see that 21.0 percent of Kentucky tax filers had incomes within this range. Illinois had 19.1 percent; Indiana, 20.3; Ohio, 19.3; Tennessee, 20.3; and West Virginia, 22.5. This means that among these states Kentucky had the second highest percentage of tax filers whose incomes fell within that range. (See Table 2.)

These two points show that Kentucky has relatively more low-income people and relatively fewer high-income people than most neighboring states. Basically, this represents the worst of both worlds.

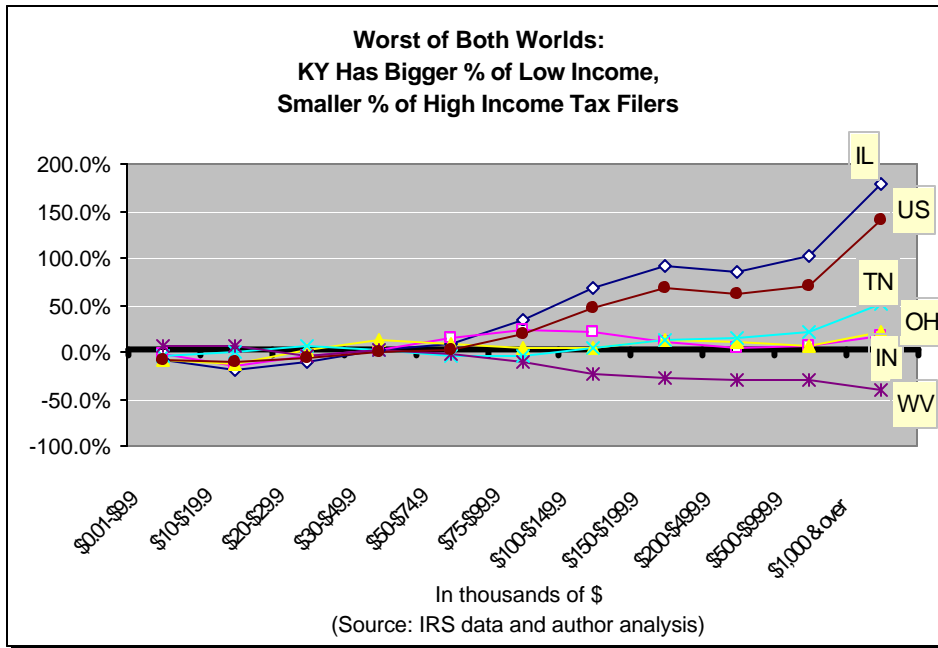
How large is the income gap between Kentucky and its neighboring states? Graph 4 maps the data from Table 1.

With the exception of West Virginia, Kentucky has a greater percentage of low-income tax filers and a lower percentage of high-income tax filers. For the comparison with West Virginia, this is shown by the West Virginia line being slightly above Kentucky for the percentage of low-income tax filers and slightly below for the percentage of high-income tax filers.

Here's another way to think of it. When looking at Graph 4, Kentucky is represented by the horizontal zero percent line. The neighboring states, therefore, are compared to Kentucky and graphed in one of three ways.

First, points above the zero percent line indicate that another state has a relatively larger percentage of tax filers within that income range than Kentucky. For example, in the \$1 million and over income category the line for Illinois is almost at 200 percent. This means that Illinois has nearly triple the percentage of tax filers with incomes of \$1 million and over compared to Kentucky. Indiana, Ohio, and Tennessee also have higher

Graph 4



percentages, but not nearly as large.

Second, points below the zero percent line indicate that another state has a lower percentage of tax filers within that income range than Kentucky. Again, let's look at the \$1 million and over range, only this time look at West Virginia. Here the line drops below zero, at almost negative 50 percent. This means that West Virginia has half the percentage of tax filers with incomes of \$1 million and over that Kentucky does.

Third, points exactly on the zero percent line mean that another state has the same percentage of tax filers for that particular income category as does Kentucky. Although the lines never align exactly, Indiana tax filers with incomes between \$200,000 and \$999,999 come fairly close to Kentucky. You can make similar observations by looking at various other income categories and states.

AGI and Income Distribution

Another important item to consider is the percentage difference between the num-

ber of tax filers in a particular income category and the percentage of income they earn. Graphs 5 and 6 look at this issue.

It is likely no surprise that income is distributed unequally. However, it may surprise you to know that low income tax filers make up a majority of tax filers in Kentucky, but have total incomes that are significantly less than 50 percent of total statewide income. Middle- and upper- income Kentucky tax filers show the opposite effect—smaller percentages of tax filers, but larger percentages of total income.

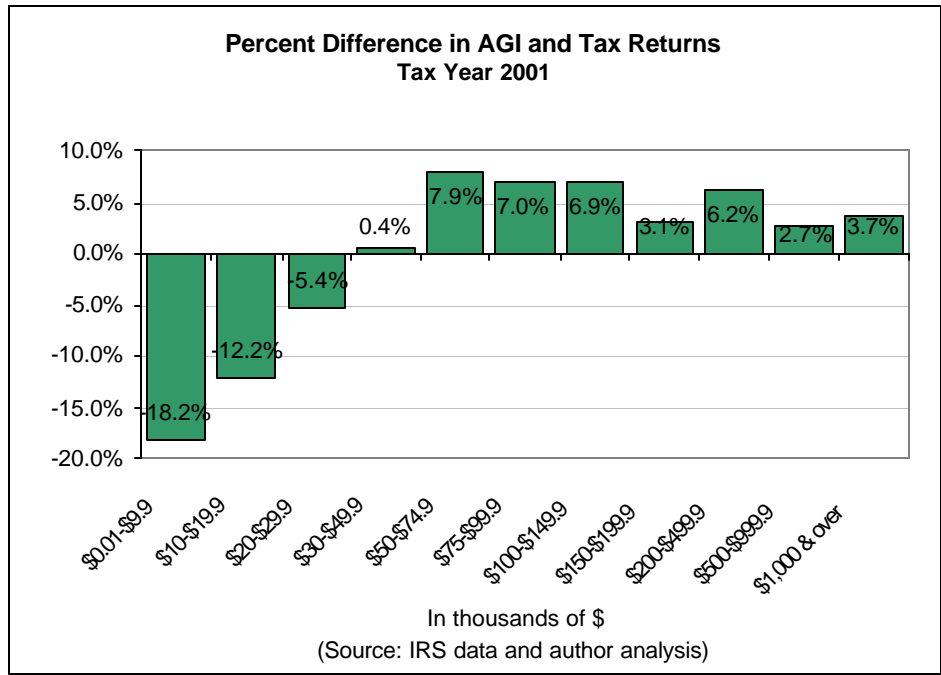
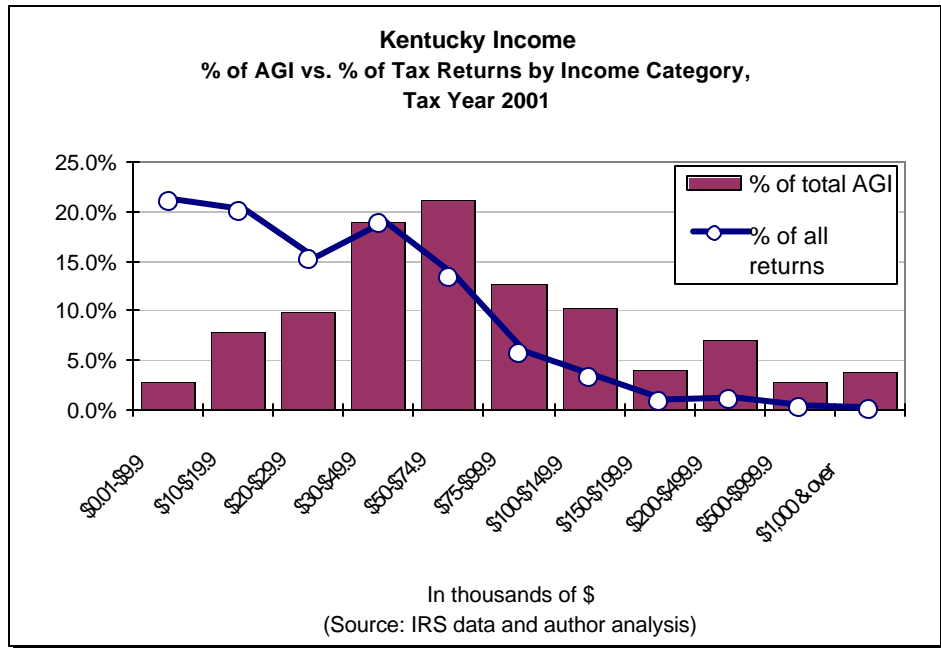
Here's how this looks in Graph 5. The shaded bars depict the percentage of income earned by each income range. Tax filers in the first income range, for example, earn about 2.5 percent of total income in Kentucky. They make up, however, 21 percent of total tax filers. The income/taxfiler difference then is 18.2 percent. (See Graph 6.)

Even if you suspected that low-income tax filers would earn a smaller

Low income tax filers make up a majority of tax filers in Kentucky, but have total incomes that are significantly less than 50 percent of total statewide individual income.

Graphs 5 and 6

The largest difference was with tax filers who had incomes between \$50,000 and \$150,000.



percentage of total income, it may surprise you to know that the largest positive difference was not with the highest income tax filers. The largest difference was with tax filers who had incomes between \$50,000 and \$150,000. This can be seen in both Graph 5 and 6.

In Graph 5 the shaded bar stretches

the farthest above the line between \$50,000 and \$150,000. The shaded bar represents the percentage of total income by income range. The line represents the percentage of tax filers by income range. This means that tax filers with incomes between \$50,000 and \$150,000 earned a greater percentage of total income even though they comprised a smaller percent-

age of tax filers.

In Graph 6 the same can be seen by finding the tallest bars. That is, the 7.9, 7.0, and 6.9 percent bars.

Recommendations

Tax modernization appears on the horizon. Both gubernatorial candidates have committed themselves to some type of reform. Although it is not entirely clear what form such “modernization” will take, any serious, complete effort will need to update the individual income tax.

Based upon the analysis provided in this article, several important facts come to the forefront. First, Kentucky is still a low-income state. A majority of Kentuckians earned less than \$30,000 in tax year 2001. This was slightly higher than the national average. Second, Kentucky does not have a large percentage of high-income residents. Compared to several neighboring states and the nation as a whole, Kentucky has a smaller percentage of people earning more than \$100,000. Consequently, statewide income and tax collections relative to other states are lower.

In some respects, Kentucky is caught between a rock and hard place—a large low-income population and small high-income population. One of the benefits of this situation, though, is the fact that income disparity—the difference between high and low incomes—in Kentucky is actually smaller than the national average. (See Center on Budget and Policy Priorities, 2002.)

Given Kentucky’s situation, several policy options exist. Recently, several states (e.g., CT, NY) have explored or enacted income surcharges on high-income residents, particularly those with \$1 million or more in income. Given states’ current and persistent fiscal crisis (Kentucky’s budget shortfall for fiscal

year 2004, the current fiscal year, is almost \$275 million) this can be prudent. Higher income tax filers generally save more and spend less, making an income surcharge an economic driver.

In Kentucky, however, the ranks of tax filers with incomes of \$1 million or more is small; only about 1,000. That makes an income surcharge on this income group an unfeasible policy option.

An income surcharge on middle and upper-middle incomes would increase tax revenue. However, it would not modernize the Cold-War era income tax system Kentucky currently has.

Perhaps the best policy option then is to increase incomes for low-income Kentuckians and, at the same time, update the state’s aged income tax structure. The first can be done, in part, with a refundable state earned income tax credit (EITC). Modeled after the successful federal EITC that was established by President Richard Nixon, a state EITC would let lower-income taxpayers keep more of their earnings. Enacting a state EITC would also give a boost to families with children since the credit provides greater benefit to families with children.

Kentucky’s individual income tax structure must also be modernized. First, the marginal tax rates need to enter the modern age. Marginal tax rates should rise with income, but the highest marginal tax rates need to be significantly higher than the current \$8,000. Second, low-income families and children should not be treated unequally when it comes to paying individual income taxes. At the present, families with annual incomes less than \$12,000 pay a greater percentage of their income in taxes than any other income group. (Legislative Research Commission, “Comparison of State and Local Tax Burdens and Government Benefits for Low-Income Families.” 2001.)

The best policy option is to increase incomes for low-income Kentuckians and, at the same time, update the state’s aged income tax structure.

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Conclusions

Kentucky is one state with two income stories.

Kentucky has both a higher percentage of low-income tax filers and a lower percentage of high-income tax filers than most neighboring states and the nation.

- ? Approximately three-fifths of Kentucky tax filers have annual incomes below \$30,000; the national average is closer to fifty percent.
- ? About five percent of tax filers had annual incomes above \$100,000; the national average was over eight.

Kentucky also has an old individual income tax system. The current tax structure pre-dates Neil Armstrong's landing on the moon.

- ? The top marginal tax rate begins at just \$8,000; an income above average 40 years ago, but hardly reflective of today's wages.

- ? The current median income in Kentucky is \$38,300.
- ? An entry level teacher making \$20,000 will likely pay the highest marginal tax rate.

The best policy options are to increase incomes for low-income Kentuckians and update the state's aged income tax structure.

- ? The first can be done, in part, with a refundable state earned income tax credit (EITC).
- ? The latter can be done by implementing top tax rates that begin at incomes above \$8,000; and
- ? Implementing a tax system that does not unfairly burden low-income families and children.