

January 2011

For more information contact:

Kathryn Carter
kcarter@kyyouth.org

Switch to Sales Tax is a Bad Idea: It would Raise Taxes for Most Kentuckians while Reducing State Revenues

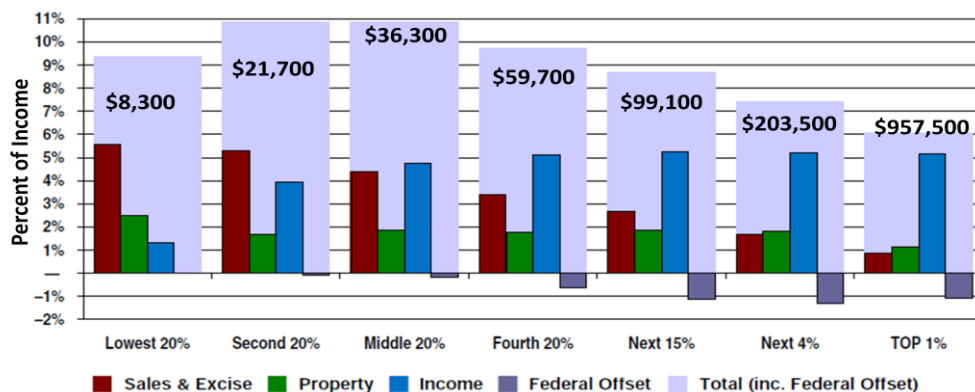
Switching from a balanced tax system to one that relies solely on sales taxes (formally known as a consumption-based tax system) is a bad idea. Proposals to replace Kentucky's income and business taxes with a higher and broader sales tax would threaten the state's ability to provide services benefiting children and families and would sharply increase the taxes the average Kentuckian pays. They would:

- **Reduce Commonwealth revenues by almost 10 percent.** A recent study indicates that after the first year of implementation, Kentucky revenues would drop by \$850 million a year.¹
- **Require significant and unsustainable sales tax rate hikes to maintain anything near a balanced budget.** For example, Tennessee has a 7 percent sales tax and even taxes food at 5.5 percent. Additionally, a local option sales tax allows cities and counties to charge up to 2.75 percent in sales tax. The average combined state and local sales tax rate is 9.4 percent. By comparison, Kentucky has a 6 percent sales tax, no local option sales tax, and does not tax food.
- **Levy those new, higher rates on transactions Kentucky has never attempted to tax, causing a number of political, technical and economic problems.** For example, suddenly taxing new home sales at a high percentage rate could seriously disrupt the housing market.
- **Undermine long-term revenue adequacy by eliminating the balanced revenue portfolio.** Diversification is the key to revenue growth and stability – a good tax structure grows with the economy and the needs of the state, while remaining stable through invariable business cycles. The best tax structure includes a mix of taxes to provide greater revenue stability when revenue from one tax declines because of changes in the economy. Eliminating Kentucky's income tax will disrupt its balanced portfolio.
- **Raise taxes on the middle class.** Kentuckians making an average of \$36,000 currently pay a larger share of their income in taxes than those making an average of \$957,500—nine cents on the dollar compared to six cents on the dollar—when sales and excise, property, and income taxes are all taken into account. Because people with lower incomes pay a larger percentage of their income in sales tax, eliminating the income tax and increasing the sales tax would increase that burden on the middle and lower income (see chart below).

KENTUCKY
YOUTH
ADVOCATES

11001 Bluegrass Pkwy
Suite 100
Jeffersontown, Ky 40299
502.895.8167
www.kyyouth.org

Who Pays in Kentucky? A distributional analysis of tax payments as a proportion of income



Institute on Taxation and Economic Policy, http://www.itepnet.org/wp2009/ky_whopays_factsheet.pdf

Lessons from Tennessee

Tennessee, a state frequently used as a point of comparison for Kentucky, operates under a consumption-based tax system. It relies on the general sales tax to generate over 63 percent of state revenue, with more revenues from additional sales taxes on tobacco, beer and mixed beverages. Income taxation makes up only 1.5 percent of state revenue.² Kentucky relies on its sales tax for about half as much revenue generation as Tennessee: Kentucky's general fund comes 34 percent from sales and use taxes and 38 percent from individual income taxes.³ Eliminating one-third of Kentucky's general fund revenue source would be a significant tax system experiment with huge risks.

Some of those potential risks were identified in a 2004 report from the Tennessee Tax Structure Study Commission established by the Tennessee General Assembly. The Commission, which included Dr. William Fox, the author of the iconic Kentucky tax structure study, concluded that Tennessee's tax structure has several flaws:

- Tennessee taxes are anti-competitive, causing businesses to set up shop in other states;
- the sales tax is too high;
- the tax structure lacks balance and stability because without a diverse tax base, revenues are more susceptible to economic fluctuations;
- the structure is regressive so that Tennessee's low- and middle-income families pay a higher proportion of their income in sales taxes than do high-income families; and
- the structure does not keep pace with economic growth because of its overreliance on a single revenue source.⁴

The Commission recommended that Tennessee reduce the sales tax rate, eliminate the local sales tax option and introduce a graduated income tax.

¹ Institute on Taxation and Economic Policy (2009). "Tax Reform in Kentucky: Serious Problems, Stark Choices." Available at http://www.itepnet.org/pdf/Serious_Problems_Stark_Choices.pdf. Accessed October 2010.

² Tennessee Tax Structure Study Commission (December 2004). "Final Report of the Tennessee Tax Structure Study Commission." Available at http://www.state.tn.us/taxstructurestudycommission/TSSC_Final_Report_Dec_2004.pdf. Accessed October 2010.

³ Kentucky Office of the State Budget Director, "General Fund and Road Fund Receipts for Fiscal Year 2010." Available at <http://www.osbd.ky.gov/NR/rdonlyres/112ED6BB-24DF-4F71-889C-83127034CEFB/0/1006TaxReceipt.pdf>. Accessed October 2010.

⁴ Tennessee Tax Structure Study Commission