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## Kentucky's Structural Deficit:

### Well-Documented and Persistent

*The national recession and the resulting three consecutive state revenue shortfalls are not the only things hindering Kentucky's ability to provide the public services that individuals and businesses benefit from; services like education, state roads, and public safety. Kentucky's structural deficit – a built-in shortfall – was well-documented nearly a decade ago and has yet to be fully addressed. Policymakers need to understand that the end of the recession will not bring the end of Kentucky's financial challenges. This slow and persistent decline in the growth of state revenues can be remedied if state legislators intentionally balance the tax structure to provide adequate revenues that prove stable and predictable over time.*

#### A Structural Deficit is a Built-in Shortfall

When normal growth in state revenues fails to keep pace with normal growth in expenditures a structural deficit exists.

Normal growth in the cost of providing public services is largely based on two factors: 1) growth in the number of seniors, children, and others who use state services and, 2) the natural increase in the cost to provide these services because of inflation. Spending, based on these factors, can be expected to grow at the same rate as the economy. Therefore, if the design of the tax structure results in revenues that grow slower than the state's economy, a growing gap between available revenues and the cost to provide government services will result. This creates a shortfall that is built into the budget structure and forces lawmakers to decide each year how to balance the budget.

In his often cited 2002 study, Dr. William Fox, Professor of Economics at the University of Tennessee, examined the structural deficit in Kentucky.<sup>1</sup> Fox found that between 1988 and 2000 Kentucky's revenues kept pace with the economy, as measured by growth in personal income. However, upon further examination of the revenue trends Fox noted that in the latter half of the period studied, 1995-2000, Kentucky's revenue growth slowed considerably, increasing only two-thirds as fast as the economy at a time when the U.S. was experiencing robust economic growth. Fox predicted that Kentucky's revenues would continue to fall short unless policymakers adjusted the tax structure to better keep pace with growth in the economy.

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In 2005, some effort was made to modify Kentucky's tax structure and to reduce the existing structural problem. Then Governor Ernie Fletcher signed into law a tax modification package called *JOBS* [Jobs and Opportunity Bipartisan Solution] for Kentucky (HB 272). Major goals of the bill were to "better attract and retain jobs and spur economic growth." In 2007, Kentucky Youth Advocates examined the impact of the legislation to determine whether it would affect Kentucky's structural deficit.<sup>2</sup> The report concluded that the tax reform measures would have little impact on the factors identified as creating a structural deficit in Kentucky and if anything intensified the risk for future deficits.

Some assert that over the course of the most recent business cycle, occurring from 2000-2007, general fund revenues kept pace with economic growth in the state and, therefore, the state does not have a structural imbalance. An initial review of the data shows that revenues did grow at a rate equal to the growth of personal income over the same years. However, such a quick analysis fails to account for significant changes in the tax structure occurring in 2005 and 2006 that may have contributed to one-time increases in revenue that are not sustainable over time. Without a thorough analysis of the data that adjusts for the multiple changes in the tax code one cannot conclude that Kentucky no longer has a structural budget deficit to contend with. On the contrary, most of the recommendations to fix the structural deficit were not enacted, or were later repealed, suggesting the state still has fundamental flaws in the tax structure that need to be remedied.

## **Kentucky's Tax Structure is not Built for a Modern Economy**

A structurally sound revenue system provides adequate revenue to meet today's needs and grows with the economy to meet future needs. To do this efficiently, policymakers must first clearly identify the programs and services that the state seeks to provide based on the needs and preferences of citizens. Then a tax structure must be intentionally designed with the appropriate mix of taxes that: 1) maintain funding over the course of the business cycle and, 2) grow with the economy as it changes over time. A carefully designed tax structure that achieves these goals would be adequate for today and sustainable for the future. Tax rates would not need to be increased or decreased unless an explicit decision was made to change the mix of programs and services that the state offers.

Currently, Kentucky's tax structure is not designed to provide adequate revenue for today's needs and is not built to be sustainable for the future.

**Sales tax is naturally declining.** Across the nation, revenue from taxes on goods is in general decline for several reasons. First, today we spend more of our disposable income on the purchase of services than we do on the purchase of goods; goods are taxed and services generally are not. Second, we purchase many things on the internet where sales tax is not charged so the taxes we pay on the purchases of goods are further reduced. Finally, in line with broad policy goals that help ease the tax burden on the working poor and the elderly, certain goods like food items and prescription medications have been exempted from taxation, further reducing the state's revenue from the sales and use tax. Revenue from sales tax has been declining over time for all of these reasons.

Yet, Kentucky's tax structure relies heavily on this declining revenue stream. The sales and use tax made up roughly 33 percent of the state's tax collections, compared to the U.S. average of 32 percent. This average does

not reflect the fact that Kentucky taxes relatively few services compared to other states in the nation and to surrounding states (Table 1). Our heavy reliance on traditional sales tax deepens the structural flaws and makes the system less sustainable over time.

<b>State</b>	<b>Number of Services Taxed</b>
West Virginia	37
Tennessee	25
Ohio	22
Missouri	8
Indiana	7
<b>Kentucky</b>	<b>6</b>
Virginia	4
Illinois	3
<b>State Average</b>	<b>17</b>

Source: Center on Budget and Policy Priorities

**Individual income tax is not balanced to grow with the economy.** The income tax is generally the fastest growing revenue option in most states and is also the most responsive to changes in the economy. However, the growth in the individual income tax is determined not only by the rate but also by the cost of the exemptions and deductions on the tax. In other words, if the tax rate is flat – meaning everyone pays the same rate and there are no exemptions and/or deductions – the revenue growth of the tax would equal the growth in personal income in the state. When exemptions and deductions are enacted, often as broad policy decisions to reduce the tax burden on certain groups of people, the structure of the income tax must be adjusted to compensate for the loss in revenue presented by the exemptions and deductions.

Kentucky relies heavily on the individual income tax as a revenue source. This revenue stream makes up roughly 34 percent of all state tax collections, which is slightly lower than the U.S. average of 36 percent. Even so, as part of the 2005 tax restructuring package the state’s overall individual income tax revenue was reduced. *Jobs for Kentucky* exempted many of Kentucky’s poorest families from paying income taxes through the Family Size Tax Credit and slightly reduced the income tax rate to 5.8 percent for individuals making between \$8,000 and \$75,000 annually. Yet, the top income tax bracket of 6 percent for individuals making more than \$75,000 a year stayed the same – making the net result negative. Such adjustments to the income tax structure that lessen the tax burden on some groups, without a general recalibration of the structure to maintain revenue growth, contribute significantly to Kentucky’s structural deficit. It’s important to note that exemptions generally reduce the revenue from the tax but, some exemptions, particularly those that benefit low-income taxpayers like the Family Size Tax Credit, can result in increased future growth of the tax; whereas exemptions at the top end reduce both the current tax revenue and the future growth rates.

In addition, Kentucky allows significant exemptions on pension income regardless of ability to pay taxes. This issue will become increasingly significant as the population ages and more Kentuckians rely on retirement as income.

**Corporate income tax is eroding.** As the traditional way of doing business changes and becomes increasingly multi-state, state tax collections can be negatively impacted if laws are not updated to ensure all business activity is appropriately taxed. First, many small businesses not categorized as corporations, such as limited liability entities, may pay only a nominal tax compared to larger, in-state corporations, when both benefit from state services. Second, loopholes in state corporate tax laws allow multi-state businesses to avoid paying Kentucky taxes. Third, increased catalog and internet sales reduce the sales tax that is collected by corporations allowing the purchase of many goods to go untaxed. Finally, the growing popularity of business tax exemptions, deductions, and credits proves to significantly reduce state revenue from business taxes.

Governor Fletcher's 2005 tax modification plan tried to improve the equity of the corporate income tax structure by including small businesses, like limited liability entities, within the definition of "corporation". As the number of these entities in existence increases, it is becoming increasingly important to treat them like other businesses. The plan also tried to close certain tax loopholes and established an Alternative Minimum Calculation, to ensure all corporations would be responsible for paying some taxes on their profits.<sup>4</sup>

While the adoption of these corporate income tax changes was considered to be a step toward fixing the structural deficit, both the Alternative Minimum Calculation and the inclusion of limited liability entities were repealed during the 2006 special legislative session.<sup>5</sup> Later that year, a limited liability entity tax was established by law that taxes these small businesses at a much lower rate than if they were under the corporation income tax law. In addition, the repeal of the Alternative Minimum Calculation means some businesses, particularly those shifting profits to other states, can legitimately pay no business income taxes in Kentucky.

Also in 2005, the General Assembly passed legislation to require a study of business tax breaks to identify the net benefit to the state. To date the study has never been done.

**Property tax growth is restricted.** House Bill 44 (1979) limits the annual growth of revenue from real property taxes to four percent for both state and local government.<sup>6</sup> If property values increase greater than four percent, based on local assessments, then the tax rate on the property will decrease to remain within the four percent limit. This prevents property tax revenue from naturally keeping pace with economic growth. Therefore, if the growth in the economy exceeds four percent it would be necessary for another revenue stream to grow at a higher rate than the economy to effectively counter balance the underperforming property tax. In his 2001 study, Fox recommended all new property be excluded from the four percent cap. In 2005, the General Assembly passed HB 272, which excluded new property from the four percent calculations but, existing property remains under the cap. This keeps a significant amount of property tax revenue from growing with the economy, particularly in areas of the state that are not growing.

## Policy Recommendations

When a structural deficit exists, state lawmakers are forced to decide each year how to balance the budget amidst rising costs and stagnant revenues. Often lawmakers cobble together a budget with a combination of small spending cuts, use of one-time revenues, and holding some spending flat. Unfortunately, this underlying structural problem prevents policymakers from meeting emerging needs and providing essential services at the level necessary. Enacting the following recommendations would move Kentucky toward a structurally sound tax structure that provides adequate revenue for today's needs and sustainable revenue for future needs.

**Modernize the state sales tax by including services.** The U.S. economy, including the Commonwealth's, has been shifting from one based on goods to one based on services. Broadening the base of the tax structure based on consumption patterns would bring the sales tax structure back in line with growth in the economy.

- Extend the sales tax to selected services.
- Limit new sales tax exemptions.
- Support a standard for including the sales tax on remote and internet sales.

**Make the personal income tax more progressive.** While Kentucky's individual income tax structure is already considered to be relatively progressive, to make the tax grow more in line with the economy the structure of the income tax needs to be recalibrated to compensate for exclusions and deductions.

- Include additional tax brackets for high income individuals.
- Avoid enacting additional tax exclusions on income without an appropriate revenue offset.
- Re-examine unnecessary income tax exemptions.

**Ensure that Kentucky's corporate tax structure is equitable.** A corporate income tax with a relatively low rate on a broad base will have the least effect on business development in Kentucky, but in order to be an adequate revenue source the tax rate should be sufficient to cover the cost of public services from which businesses benefit. Corporate income tax burdens should be even across different industries and different sizes of businesses, so that each business is paying its relative share of the cost to provide a healthy and conducive business environment.

- Encourage the Kentucky Congressional delegation to support a new nexus standard that requires remote vendors with substantial activity in the Commonwealth to collect tax on behalf of Kentucky.
- Eliminate corporate income tax loopholes allowing multi-state businesses located in Kentucky to avoid paying state income taxes.
- Ensure that all corporations pay some taxes based on their profits, and that all entities are taxed equally.
- Require studies of tax breaks to ensure their effectiveness.

**Prevent the property tax rate cap from becoming more binding.** With revenues from property taxes making up 5.7 percent of General Fund Revenues in FY 2007, problems with the property tax structure are not a significant contributor to the Commonwealth’s structural deficit. However, the revenue growth rate cap does place an artificial constraint on the revenue stream – preventing it from keeping up with natural growth in the economy.

- Repeal HB 44 to allow the property tax to be a more adequate source of revenue.

**Require routine preparation of a current services budget.** To fully understand whether revenues are keeping pace with economic growth and the needs of Kentuckians, the state should publish a budget that reflects the cost necessary to maintain current services for the population. A “current services budget” or “continuation budget” with planning estimates would help to clearly identify if revenue levels are adequate and sufficient to cover the costs of established programs today and for the future.

Adequate tax policy requires careful planning and design – it does not happen magically. As the difficult economic times continue, the state legislature is going to face serious challenges during the 2010 legislative session. It is important that Kentucky’s policymakers recognize that the end of the recession will not fix all of the state’s financial woes. Kentucky’s structural deficit will continue until lawmakers adopt and enact true tax modernization that results in adequate and sustainable revenue.

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<sup>1</sup> Fox, William F. (February 2002) “Report to the Sub-Committee on Tax Policy Issues, Committee on Appropriations and Revenue, Kentucky General Assembly.” Legislative Research Commission. Available <http://www.lrc.ky.gov/ijcomm/a&r/taxpolicy/KYFINALREPORT.pdf>. Accessed September 2009.

<sup>2</sup> Herman, Tracy Goff (May 2007). Kentucky’s Tax Modernization: Does it Increase the State’s Risk of a Structural Deficit?” Kentucky Youth Advocates. Available [http://www.kyyouth.org/Publications/07pub\\_StructuralDeficit.pdf.pdf](http://www.kyyouth.org/Publications/07pub_StructuralDeficit.pdf.pdf). Accessed September 2009.

<sup>3</sup> Mazerov, Michael (July 2009) “Expanding Sales Taxation of Services: Options and Issues.” Center on Budget and Policy Priorities. Available <http://www.cbpp.org/files/8-10-09sfp.pdf>. Accessed September 2009.

<sup>4</sup> Herman

<sup>5</sup> Fletcher, Governor Ernie and Office of the State Budget Director. *Tax Expenditure Analysis: Fiscal Years 2008-2010*. Available [http://www.osbd.ky.gov/NR/rdonlyres/795A66EE-ED7E-430F-8EE9-C90B0B345316/0/0810TEA\\_TaxExpenditureDoc.pdf](http://www.osbd.ky.gov/NR/rdonlyres/795A66EE-ED7E-430F-8EE9-C90B0B345316/0/0810TEA_TaxExpenditureDoc.pdf). Accessed September 2009.

<sup>6</sup> Fletcher

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