

Revenue Options to Balance Kentucky's Budget

As a result of the national economic crisis, Kentucky's leaders are facing a budget shortfall of \$1.5 billion dollars as they work to balance a budget for the next two years. This shortfall comes on the heels of consecutive shortfalls in each of the last three fiscal years. To date the budgets have been balanced with recurring spending cuts, all of the "rainy day" fund, transfers from reserve accounts, and money from the federal Recovery Act. But the effects of the recession on state revenues will continue for a number of years.

Policymakers recognized the need for a balanced approach that included new revenue in 2009 when tobacco and alcohol taxes were increased. It's even more important now to ensure limited cuts to government services that have already been weakened by previous reductions. A responsible strategy will include new revenue to support vital services like education, healthcare, and public safety.

There are several options other than expanded gaming available to policymakers to balance the budget in a responsible manner. Such action in the current legislative session will ensure our continued growth as a state. The following are some revenue raising options available to legislators.

1. Increase Top Income Tax Rates

Increase the marginal tax rate on incomes over \$75,000

Kentucky has a graduated income tax rate structure with rates ranging from 2 percent to 5.8 percent on taxable income of less than \$75,000. Those making more than \$75,000 pay 6 percent on the portion of their income that is above \$75,000. By incrementally increasing the marginal tax rate on incomes above \$75,000, as proposed in HB 13, Kentucky would increase revenue by approximately \$250 million annually. Alternatively, adding a new top tax bracket that applied a rate of 7 percent to income above \$250,000 would increase income tax revenue by about \$76 million per year.

Tax increases on upper income residents are not harmful to the economy like a broad-based increase might be because the money to pay the taxes generally comes from savings and therefore does not reduce economic activity in the state. In addition, the revenues raised would allow the continuation of important services that strengthen the economy.

States that have recently taken this approach:

- Wisconsin enacted a new 7.75 percent income tax bracket on all incomes over \$300,000 for married couples and over \$225,000 for individuals.
- New York enacted new temporary income tax rates on households with income above \$300,000.
- North Carolina temporarily increased income taxes by two percent on incomes between \$60,000 and \$150,000 a year for individual filers and between \$100,000 and \$250,000 a year for joint filers. For incomes higher than these amounts the temporary increase is three percent.

2. Level the Corporate Tax Playing Field

Enact combined reporting to ensure proper corporate income tax payments

Multistate corporations doing business in Kentucky can easily shift taxable profits earned here onto the books of related companies in other states with lower tax rates. Kentucky can ensure an equitable corporate tax structure by closing these loopholes through a policy called “combined reporting”. It’s estimated that doing so would increase corporate tax revenue by 10 – 20 percent; a range of \$26.8 - \$53.6 million based on 2009 actual receipts.

Ensure business tax breaks result in a net benefit to Kentucky

In 2005, the General Assembly passed legislation to require a study of business tax breaks. A net benefit analysis of Kentucky’s tax expenditures should be performed at regular intervals in addition to the bi-annual tax expenditure analysis issued by the Office of the State Budget Director. Tax breaks not resulting in a clear net benefit to the state should be discontinued.

States that have recently taken this approach:

- Twenty-three states have already-mandated combined reporting, including Illinois and West Virginia.
- In 2009, Iowa placed limits on the size of five costly business tax credits, saving the state about \$18 million in fiscal year 2010.

3. Modernize the Sales Tax

Broaden the sales tax base to reflect a shift in consumption from goods to services.

Modernizing Kentucky’s sales tax to include a significant number of services would raise a considerable amount of money. Since the 1970’s consumption patterns have been shifting from a majority of purchases on goods to a majority of our purchases on services. Broadening the sales tax to include more services would bring the sales tax structure back in line with growth in the economy.

Of some 40 household services identified in a survey conducted by the Federation of Tax Administrators, Kentucky currently taxes only 6 services compared to the national average of 17. Currently the state is losing up to \$1 billion dollars per year because of the exclusion of services.

States that have recently taken this approach:

- In 2009, Tennessee extended the sales tax to include software maintenance contracts and limited an exemption on computer software.
- New York expanded the sales tax to certain transportation services and to companies selling tax-free on the internet.