PEGASUS INSTITUTE

PRIMER ON TAX REFORM

Two Bold Plans to Build a 21st Century Tax Code

POLICY BRIEF

Two Bold Plans for Tax Reform

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Abstract

The tax code is the number one way that a state can dictate the direction of its economy. While states around us have made decisions that promoted growth, Kentucky's tax structure has remained an economic burden. The result for our Commonwealth is decades of anemic growth, restricting our production, limiting employment opportunities, and reducing household incomes. A pro-growth tax code will not fix these problems overnight, but it is a critical component on our pathway to a more prosperous state.

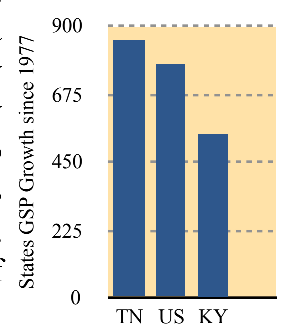
We at Pegasus Institute have developed two separate strategies. The first is built on three simple flat rates, which we call the **3-3-6 plan.** This puts a flat rate on the income tax, corporate tax, and broadens the sales tax base, transitioning our economy. It is long past time to end the progressive income tax, an antiquated vestige of the past that sends all of the wrong signals. **This plan puts nearly $1,000 a year back into the pockets of Kentucky families**, and leaves more money with businesses of all sizes, allowing them to decide how to spend their money, while keeping our general fund revenue stable.[1]

The second plan looks at what would be required to eliminate the income tax, which should eventually be the goal for Kentucky. Doing so is financially possible, but will require a significant broadening of the sales and service tax bases. Legislators should give both options very serious consideration.

Kentucky's Economic Growth Crisis

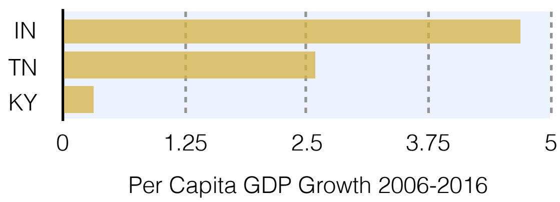
There is more impetus than ever before to achieve bold tax reform, but it is not for the reason that has often been discussed. Though solving Kentucky's pension crisis is of significant importance, Kentucky's economic growth is an equal scourge with an even broader impact. Kentucky's continued failure to grow its economy, coupled with the positive changes of our neighbors, will continue to negatively impact every individual in the Commonwealth if we do not make significant changes.

Since 1977, according to Bureau of Economic Analysis data, Kentucky's economic growth in gross state product is 30% below national average.[2] That ranks 44th in the United States during that time period. The last 10 years have not been any better. Between 2006 and 2016, Kentucky per-capita GDP growth was only 0.3%.[3] By nearly every metric one might use to gauge a state's economic health, Kentucky is in a state of crisis.



Unfortunately, this is not a regional problem. Our neighbor to the South, Tennessee has grown at 102.5% to national average since

1977, ranking it 21st in the nation during that time period. In the last decade, Tennessee's per-capita GDP has increased by 2.58%, or $1,090 per person. Indiana's per-capita GDP has grown even faster at 4.7% as it has taken advantage of economic mistakes in Kentucky and Illinois. This growth represents over $2,000 in additional income per person.



The broader impact of this problem is demonstrated by statewide household income and our poor labor force participation. Kentucky's household income is 18% below national average, equal to approximately $9,000 per year. That ranks the Commonwealth 45th in the United States. Interconnected is our labor force participation rate, which as of May 2017 is only 60%.[4] This ranks 43rd in the United States.

The most important question then is how do we fix it? There are two basic theories about economic growth that stand in contrast to one another. The first is a consumption based theory, or Keynesian theory, that proposes that economic growth emerges from additional consumption. Therefore, the economic system should free up the demand side. A separate theory is a production based theory, that believes economic growth will be achieved by liberating the production side of the economy so that businesses can prosper and shape the direction of economic activity. Indicators like Labor Force Participation Rate tell us that this is a problem in Kentucky, and that businesses need the burden of taxation shifted onto the consumption side of the economy, allowing them to growth.

Key Figures

- Since 1977, Kentucky is a whopping 30% below national average in GSP growth, or 44th in the United States.
- In that same period, Tennessee is 21st in GSP growth.
- The last ten years have looked no better. Per-capita GDP growth between 2006 and 2016 was 2.58% in Tennessee, and 4.7% in Indiana, but only 0.3% in Kentucky.
- Per Capita GDP growth equates to $1,090 per person in Tennessee, $2,038 in Indiana, and only $129 in Kentucky.
- Household income in Kentucky is stagnant, more than 18% below national average, ranking it 45th in the United States.
- In May 2017, Kentucky's labor force participation rate was only 60%, ranking it 43rd in the US.

Our Current Tax System

Kentucky's current tax structure is complex and out of date. The individual income tax, first imposed in 1936, during The Great Depression, has six tax brackets ranging from 2% to 6%.Today, the income tax makes up approximately 40% of general fund receipts.

The sales tax was first introduced in 1934, but was repealed in 1936. Democrat Governor Bert T. Combs reinstated it in 1960. Today it represents approximately 33% of General Fund Revenues.

The corporate income tax was also introduced in 1936. In 2005, the General Assembly made the most significant changes to the corporate tax in its history, adding LLC's to the definition of corporation, and closing loopholes to broaden the base. The corporate income tax makes up only 5% of revenue to the General Fund. Like the income tax, it is a progressive tax ranging from 4%-6%.

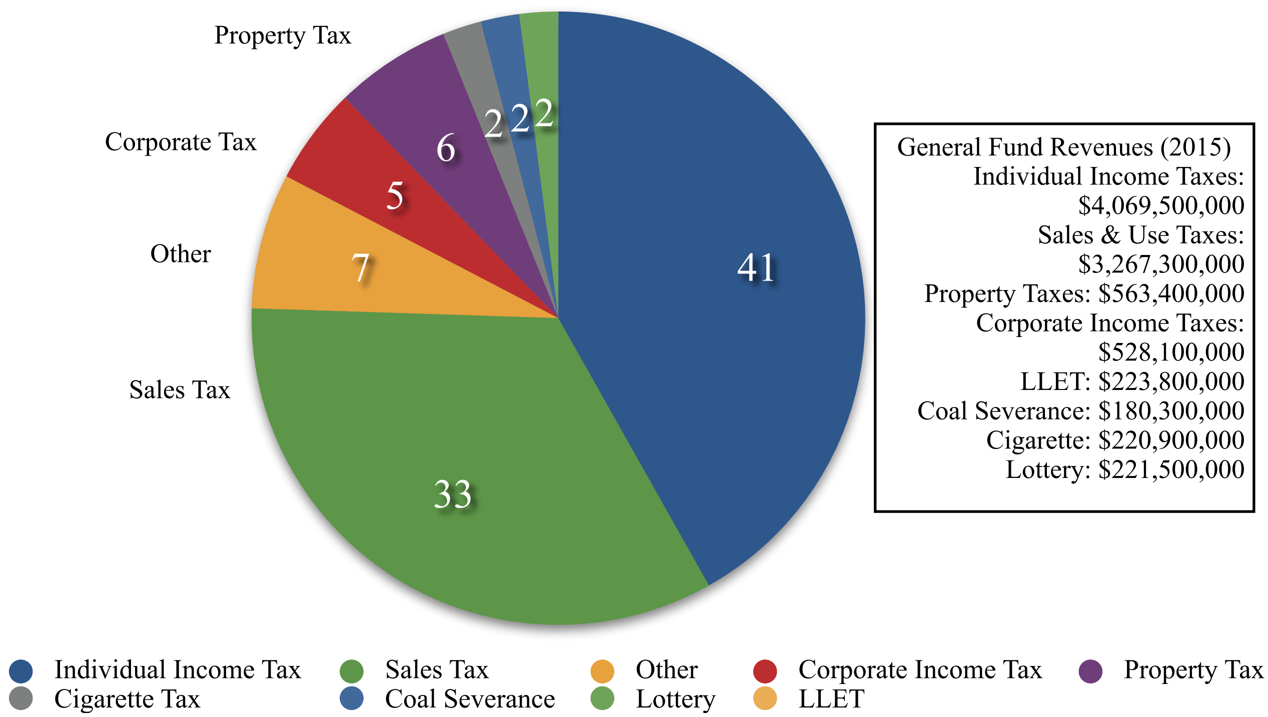
Individual Income	Tax Rate
0-$3,000	2%
$3,000-$4,000	3%
$4,000-$5,000	4%
$5,000-$8,000	5%
$8,000-$75,000	5.8%
$75,000 +	6%

What is Keynesian Theory?

Named for John Maynard Keynes (1883-1946), Keynes challenged the ability of the free market to provide full employment, arguing instead that demand was the key to economic growth and stability. Governments should, he argued, influence and stabilize the business cycle by reducing interest rates, allowing more cash from central banks to enter the market, and through government spending. This would then grow the economy

Keynes' theory was challenged by Milton Friedman causing it to fall out of favor during the Regan Administration, but experienced a resurgence after the financial collapse of 2007-2008 and the Obama Administration.

Current General Fund Revenue



General Fund Revenues (2015)
Individual Income Taxes: $4,069,500,000
Sales & Use Taxes: $3,267,300,000
Property Taxes: $563,400,000
Corporate Income Taxes: $528,100,000
LLET: $223,800,000
Coal Severance: $180,300,000
Cigarette: $220,900,000
Lottery: $221,500,000

Existing Tax Loopholes

Central to Kentucky's antiquated structure is an extensive collection of loopholes and exclusions. Kentucky currently exempts over $5 billion in Individual Income, over $3 billion in Sales and Use Taxes, and more than $2 billion in service taxes.[5] Although the individual income tax makes up such a large percentage of our current revenue, these loopholes demonstrate that there is enough revenue potential available by closing existing loopholes.

Two Bold Plans for Tax Reform

Rather than arbitrarily determining which loopholes should be eliminated, the system should be built the other way. Kentucky should start fresh, determine what kind of tax structure it should have, and build the system accordingly. Every loophole and expenditure should be on the table, with a central mission of building a system for the commonwealth of the people, not just a few.

	Highest GSP Growth Since 1977	Top Marginal Income Tax Rate
1	Nevada	0%
2	Arizona	4.54%
3	Utah	5%
4	Florida	0%
5	Texas	0%
6	Colorado	4.63%
7	Georgia	6%
8	Washington	0%
9	New Hampshire	0%
10	North Dakota	2.9%

The 3-3-6 Plan

Legislators should seize this opportunity to eliminate the progressive income tax, and move to a more competitive flat-rate income tax. A rate of 3% will give nearly every working family in Kentucky a break in their income tax. For most income earners, this will provide a 45%-50% reduction in their state tax burden. For the average Kentucky household, this will mean an increase of nearly $1,000 per year in take home pay.

A flat tax of 3% would give Kentucky the second lowest top marginal income tax rate in the region (behind only Tennessee which has no income tax), and one of the ten lowest in the United States. It would make the income tax lower than Indiana's flat rate of 3.3%, and Illinois' flat rate of 3.75%. Coupled with a flat corporate rate of 3%, Kentucky would immediately be among the most friendly business climates in the country. A flat corporate rate of 3% would likewise make Kentucky second lowest in the region, only higher than Ohio, which has no corporate income tax rate, and equal to North Carolina, which has a flat rate of 3%.

A flat income tax of 3% would produce an estimated $2 billion in revenue, with a flat corporate rate producing another $250 million. This would leave a need of approximately $2.5 billion in revenue to be gained from expanding the sales and service tax bases. To be safe, the state should calculate for $3 billion in revenue to meet projected needs. This can be achieved using any combination of the loophole elimination listed above, and could include an increase of the sales tax to 7% to provide additional revenue.[6]

Sales Tax Loopholes to be Closed	Estimated Value
Groceries	$700 million
Prescription Medicine	$560 million
Residential Utilities	$700 million
Non-Profit, Educational, & Religious Purchases	$400 million
Labor of Services Used in Property Sold	$318 million
Machinery for New & Expanded Industry	$70 million
Energy & Energy Producing Fuels	$53 million
Kentucky Enterprise Initiative	$18 million
Tombstones	$8.5 million
Sales to Motion Picture Companies	$6 million
Textbooks	$3 millon
Revenue	$2,836,500,000

Service Tax Loopholes to be Closed	Estimated Value
Health Service	$750 million
Business Service	$290 million
Engineering, Accounting, Research Management	$280 million
Automotive, Miscellaneous Repair Service	$134 million
Computer System Design Services	$135 million
Legal Services	$120 million
Revenue	$1,790,000,000

Getting to 0%

Kentucky's ultimate objective should be to eliminate its income tax. Of the top 10 states for economic GSP growth since 1977, five (Nevada, Florida, Texas, Washington, New Hampshire) do not have an income tax. Of the remaining five, four have top marginal rates lower than Kentucky with only Georgia being equal at 6%.

Recent data suggests similarly favorable growth climates for states with a lower marginal income rates. A July 2017 listing, published by CNBC, measuring the best states to find a job found that five of the top ten states had no income tax, and eight of the top ten had a lower top marginal rate than Kentucky.[7] Not coincidentally, there was considerable overlap between the two lists.

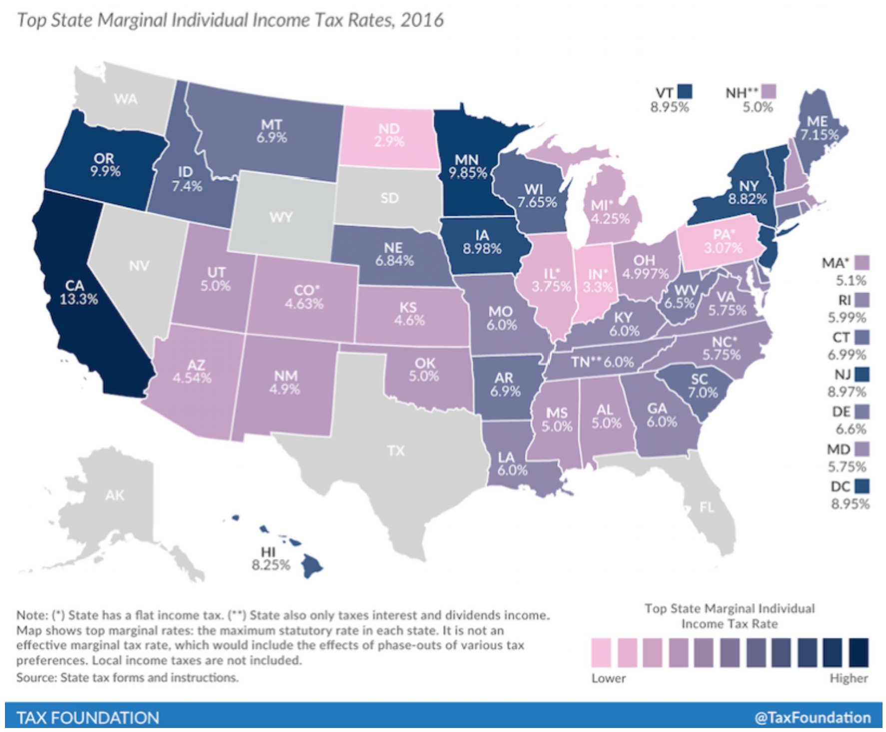
There is a pathway to eliminating Kentucky's income tax in 2017, that could allow the state's sales tax to stay at 6% by significantly broadening the base through eliminating loopholes. The income tax is estimated to bring in approximately $4.5 billion in 2017, meaning that all of this revenue would need to be made up through other sources.

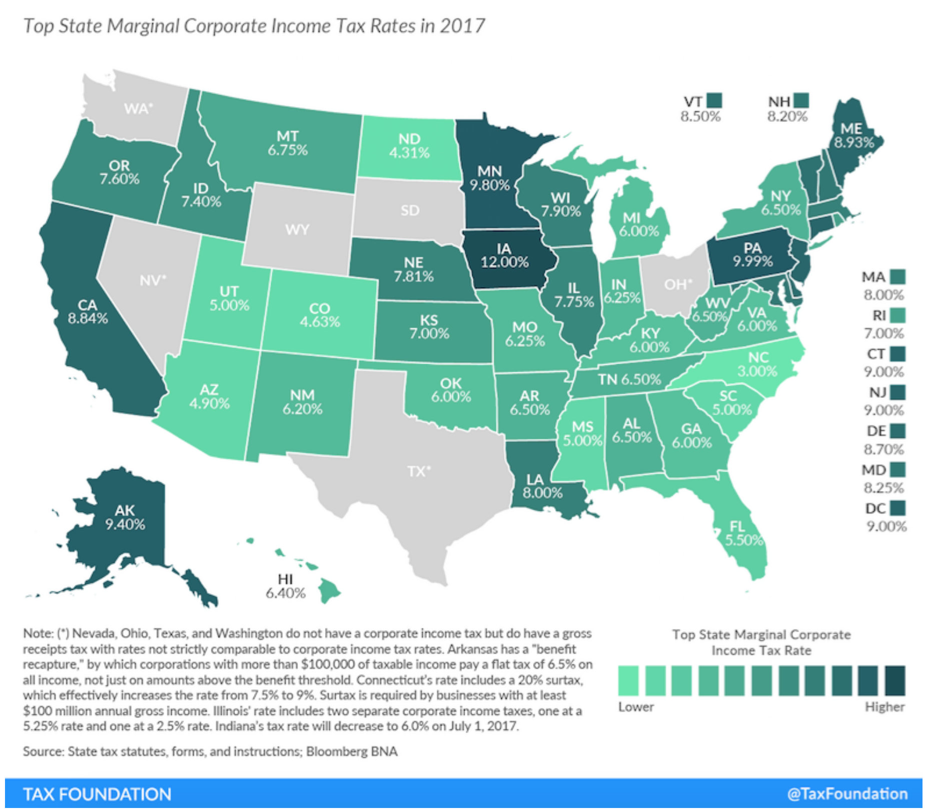
The $4.5 billion in needed revenue would have to come from removing loopholes in the sales and service tax expenditure. There are twelve items, current excluded from sales taxes, that could produce an estimated $2.836 billion in revenue. That would leave $1.664 billion in revenue needs that could be made up by applying the sales tax to currently exempted services. The services listed below, which are only a portion of the total services which currently have loopholes in Kentucky's tax code, represent $1.7 billion in potential revenue.[8]

Because of the potential revenue available by broadening the sales and services tax bases, the legislature could apply lower rates to specific items, or increase others. Increasing the sales tax on the existing tax base could yield approximately $500 million dollars, allowing for a lower rate on items like health services or residential utilities.

This system could be implemented over time, putting revenue triggers in place that provides safeguards for consumption changes and miscalculations.

Relevant Charts





Policy Recommendations

The purpose of the this primer is not to lobby for the removal of any specific loophole. It is instead to demonstrate the available pathway to a truly pro-growth tax structure. Both of these plans are not only considerable improvements on Kentucky's existing outdated tax structure, but would make Kentucky one of the most competitive tax climates in the United States. This coupled with recent right-to-work legislation and reductions in regulation can provide a shot of adrenaline for Kentucky's stagnant economy. *One can say with confidence that the adoption of either of these plans would be the most significant change to Kentucky's economy since 1936*.

- We recommend that legislators eliminate the progressive income tax, which sends the wrong signals to our beleaguered marketplace. At minimum, Kentucky should move to a flat income tax rate of 3%.
- Legislators should give serious consideration to removing the income tax. If existing fiscal challenges inhibit the state from completely removing the income tax at this time, it should aim to do so within the decade, allowing the 3-3-6 plan to serve as a bold transition in our tax climate.
- Consumption taxes, rather than production taxes, should make up the majority of our tax base. At present, corporate and income taxes make up 46% of general revenue funds, while sales taxes make up only 33%. This is an undue burden on businesses, preventing entrepreneurship, driving down wages, and limiting opportunities. Kentucky must build a system that place more money in the pockets of individuals and businesses, allowing them, rather than government drive our state's future.

About Pegasus Institute

Pegasus Institute is a free market oriented, state-based think-tank. Our mission is to provide public policy research and solutions that help improve the lives of all Kentuckians. Pegasus Institute operates as an independent, non-partisan, privately funded research organization focused on state and local policies.

About the Author

Jordan Harris is the Founder and Co-Executive Director of Pegasus Institute. Raised in Breckinridge County, Kentucky, Jordan graduated from Breckinridge County High School and received his undergraduate education from Penn State University. He attended graduate school at Harvard University, where he also served as a Research Assistant to Professor Harvey Mansfield.

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Document Endnotes

[1] Average household income in Kentucky is currently $45,215. The marginal rate on this income is 5.8% with an effective rate of 5.06%, making the average pay in $2,289. A rate of 3% would decrease this amount to $1,356 a year.
[2] Data taken from Bureau of Economic Analysis Data dating back to 1977. Data compiled by Pegasus Institute.
[3] Number calculated using Real GDP growth figures rather than nominal growth figures.
[4] Bureau of Labor Statistics Data
[5] All data taken from the 2016-2018 Tax Expenditure book.
[6] To remain revenue neutral, lawmakers will be forced to increase the sales tax rate based on every loophole that is kept in place.
[7] https://www.cnbc.com/2017/07/11/top-states-to-find-a-job-in-america-in-2017.html
[8] These estimates are based on available data from the 2016-2018 Tax Expenditure book, the 2014 Blue Ribbon Tax Commission, and other sources. These are only estimates. Because consumption changes can not be predicted once taxes are implemented, scoring possible revenue is challenging. Additionally, we analyzed ten years of tax expenditure booklets, finding wide variations in several estimates. For these reasons, we have worked to use the most conservative possible estimates in gauging the potential revenue available. In most instances, we have simply used the estimates made available by the Commonwealth. Additional information will be required before a final bill could be assembled.