

FORESIGHT

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Structural Economic Change Impetus for Tax Reform

By Michael T. Childress

The focus of more than one recent task force and unsuccessful initiative, the difficult issue of tax reform is likely to remain a priority for Kentucky policymakers and citizens. Recent revenue shortfalls and changing consumer behavior have raised questions about the adequacy of our current tax structure, just as a number of private non-profit organizations have repeatedly questioned its fairness to low-income taxpayers.

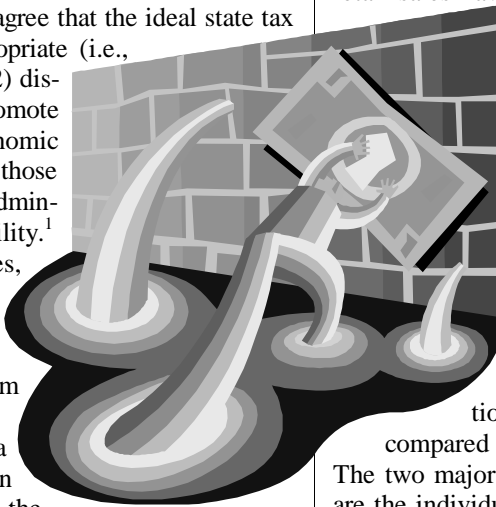
Generally, tax policy experts agree that the ideal state tax system should: (1) provide appropriate (i.e., adequate) and timely revenues; (2) distribute burdens equitably; (3) promote economic efficiency and economic growth (i.e., be competitive with those in nearby states); (4) be easily administered; and (5) ensure accountability.¹ Yet, because of economic changes, demographic shifts, and changing social priorities, a state and local tax structure can slowly evolve into a less-than-optimum system.

In this article we present data on the state and local tax system in Kentucky and discuss changes in the state's economy that are affecting this system. More than half of the combined state and local tax revenue in Kentucky comes from two sources: the individual income tax (or the occupational tax at the local level) and the general sales and use tax. However, the adequacy and efficiency of the state's tax system will be affected as structural changes in the economy unfold. These structural changes include:

- *The gradual shift in personal income away from taxable sources (e.g., wages, salaries, and proprietors' income) and toward mostly nontaxable sources (e.g., transfer payments and nontaxable employee benefits)*—Obviously, this shift is important because the state is highly dependent upon the individual income tax for general fund receipts (44 percent in FY 2000).² And at the local level, the occupational tax accounts for more than a quarter of tax collections.

Mr. Childress is the Executive Director of the Kentucky Long-Term Policy Research Center.

- *The transition from a goods-producing economy to a service-providing economy*—The mix of personal consumption among consumers has gradually shifted from goods to services. This is important because sales or use tax is due on most goods, but most services are not subject to taxation. And sales and use tax are the second most important source of state general fund revenue (35 percent in FY 2000).³
- *The rise of "mail order" or remote retail sales, which includes Internet and catalog purchases*⁴—These types of retail sales have steadily increased as a percentage of total retail sales, and it is widely believed that few people pay the taxes due on these purchases.



Sources of Tax Revenue for State and Local Government

Overall, the structure of state and local tax systems in Kentucky differs markedly from the average state.

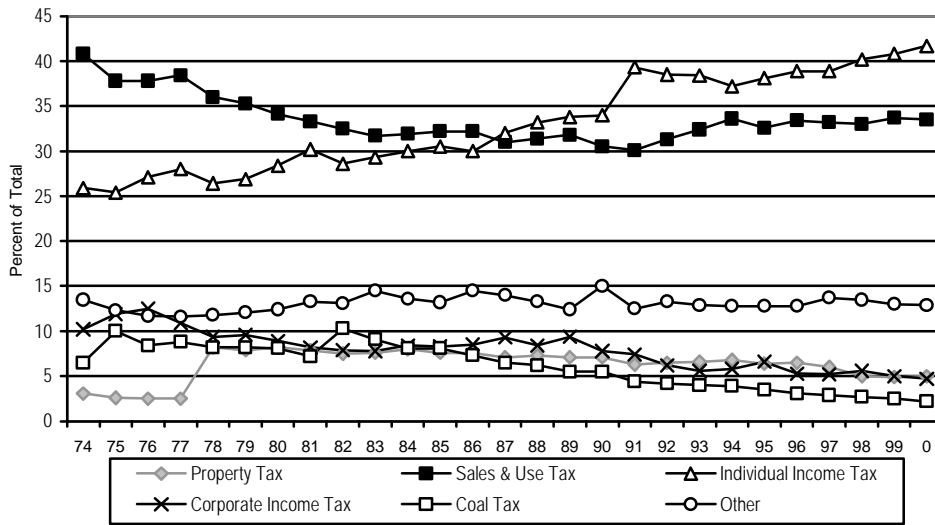
State General Fund Receipts. An estimated 77 percent of the total tax collections in Kentucky are made at the state level compared to an average of about 61 percent nationally. The two major sources of Kentucky's general fund receipts are the individual income tax and the sales and use tax. Between them, they account for about 75 percent of state general fund receipts. However, their relative importance has changed dramatically over the past 25 years.

Kentucky's general fund receives a smaller percentage from the sales and use tax and a higher percentage from the personal income tax than it did 25 years ago. In the mid-1970s the individual income tax comprised about 25 percent of general fund receipts while the sales and use tax accounted for around 40 percent. However, by fiscal year 1999-2000 the individual income tax comprised almost 42

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FIGURE 1
General Fund Receipts by Major Sources, 1974-2000



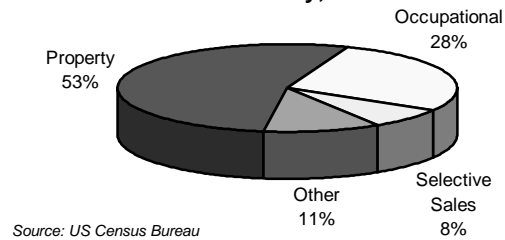
Source: Kentucky Finance and Administration Cabinet and Kentucky Revenue Cabinet

Local Tax Revenue. An estimated 23 percent of the total tax collections in Kentucky are made at the local level compared to a national average of about 39 percent. More than one half of the tax revenue for local governments in Kentucky comes from property taxes, around 8 percent is in the form of selective sales taxes,⁶ and more than a quarter issues from occupational or payroll taxes (see Figure 2).⁷

The extent to which these sources of state and local tax revenue remain robust into the future will be dependent upon changes in Kentucky's economy, the effects of these economic changes on Kentucky's tax system, and the response of policymakers.

percent of general fund receipts while the sales and use tax had declined to just over 33 percent (see Figure 1).⁵ And if the general sales tax rate had not been increased from 5 to 6 percent in 1990, the trend in sales tax revenue (as a percentage of total receipts) would no doubt have been a far sharper decline.

FIGURE 2
Sources of Local Tax Revenue in Kentucky, 1997



Source: US Census Bureau

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KENTUCKY

LONG-TERM POLICY RESEARCH CENTER

111 St. James Court, Frankfort, Kentucky 40601-8486

Phone: 502-564-2851 or 800-853-2851

Fax: 502-564-1412 or 800-383-1412

E-mail: info@kltprc.net

www.kltprc.net

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Shifts in Personal Income

The composition of personal income can exercise a large effect on state and local revenue growth since the personal income tax combined with the occupational tax constitutes the largest portion of Kentucky's state and local revenue receipts.⁸ Over the last several years Kentucky has experienced a shift in the composition of personal income that has affected revenue adequacy, according to the 1995 Kentucky Commission on Tax Policy.⁹ And this shift is expected to continue into the future.

The percentage of total personal income by various types is shown in Table 1. In 1960, wages, salaries and proprietors' income comprised 76 percent of total personal income in Kentucky. Dividends, interest, and rent, which are generally subject to taxation, made up another 12 percent. The final two categories, other labor income and transfer payments, which are essentially nontaxable, made up the remaining 12 percent.

By 1999, however, wages, salaries, and proprietors' income had declined to just under 60 percent of total personal

income. Dividends, interest, and rent increased to about 18 percent of personal income, which was not enough to offset declines in wages, salaries, and proprietors' income. The remaining categories of other labor income and transfer payments nearly doubled as a percentage of total

TABLE 1
Sources of Kentucky Personal Income, 1960-1999

Year	Total Personal Income (\$ Millions)	Percentage of Total Personal Income				
		Wages and Salary	Proprietors' Income	Dividends, Interest, and Rent	Other Labor Income	Transfer Payments
1960	\$ 4,934,676	59.1%	17.2%	11.8%	3.2%	8.7%
1965	\$ 6,689,014	59.5%	16.1%	12.0%	3.8%	8.6%
1970	\$10,396,416	61.2%	12.5%	10.9%	4.9%	10.6%
1975	\$17,644,186	56.8%	10.9%	10.9%	6.9%	14.4%
1980	\$31,100,952	54.6%	9.4%	13.5%	8.2%	14.3%
1985	\$44,319,264	51.4%	9.2%	17.0%	7.9%	14.4%
1990	\$59,579,011	52.0%	7.6%	17.6%	8.0%	14.8%
1995	\$77,793,001	52.1%	6.2%	16.5%	8.3%	16.9%
1999	\$96,746,674	53.3%	6.2%	17.7%	6.7%	16.1%

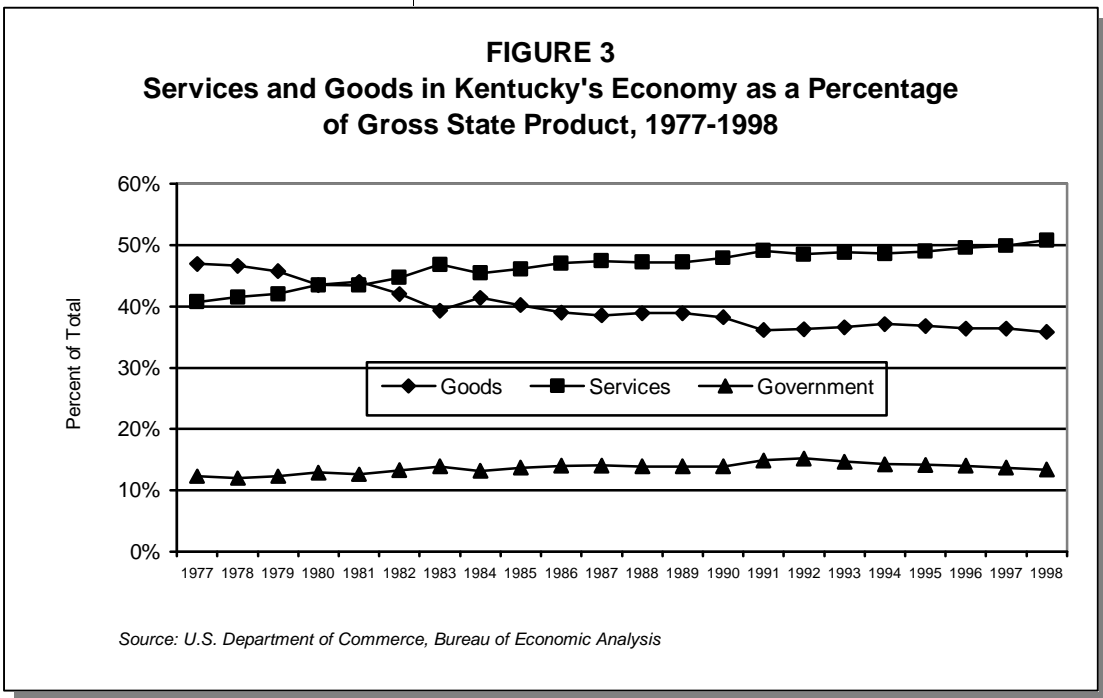
Source: U.S. Department of Commerce, Bureau of Economic Analysis, CD-ROM, State Personal Income, 1969-98. Data for 1960, 1965 and 1999 were obtained from the Bureau of Economic Analysis Web site. Refer to SA05 Personal Income by Major Source and Earnings by Industry—Kentucky, 7 Feb. 2001 <<http://www.bea.doc.gov/bea/regional/spi/>>.

personal income from 12 to 23 percent. Other labor income consists of employer contributions to health insurance, welfare and retirement funds, and transfer payments consist of government programs like Social Security, Medicare, Temporary Assistance for Needy Families (TANF), and Supplemental Security Income (SSI) payments (to name a few).

The changing nature of personal income is important because of the structure of Kentucky's tax system. As illustrated in Figures 1 and 2, the individual income tax is the most important source of state general fund receipts, and the occupational tax is the second most important source of local tax revenue. If the composition of personal income continues to shift toward nontaxable sources and the tax structure remains the same, then future revenue problems will likely develop.

economic output, but in the early 1980s the provision of services contributed more to the state's economy than the production of tangible goods. And by the late 1990s services accounted for over 50 percent of Kentucky's economy.

This economic shift from goods to services has also been manifested in the changing mix of personal consumption expenditures over the last several decades. Table 2 illustrates the changing consumption patterns for the typical American consumer. In 1960, durable and nondurable goods



Transition from Goods to Services

Despite recent reports of a "New Economy" in Kentucky, economic activity has been changing here for the last several decades. Figure 3 shows how Kentucky's economy has been shifting away from the production of goods and toward the provision of services. The data in this figure measure the major sectors in Kentucky's economy as components of the total gross state product (GSP).¹⁰ In the late 1970s, services accounted for about 40 percent of Kentucky's

accounted for 34 percent of personal consumption while services accounted for 25 percent. However, by 1999 services constituted 43 percent of personal consumption while durable and nondurable goods made up 24 percent.¹¹

Clearly, this economic shift has affected the amount of sales and use tax revenues. As described by the *Kentucky Commission on Tax*

TABLE 2
The Changing Mix of Personal Consumption Expenditures, 1960, 1990, and 1999
(percent of total consumption expenditures)

	1960	1990	1999
Food	25%	16%	14%
Housing	15%	15%	19%
Services	25%	42%	43%
Nondurables	21%	16%	12%
Durables	13%	11%	12%

Source: The 1960 and 1990 data are from the Federation of Tax Administrators, as cited in *Financing State Government in the 1990s*. The 1999 data are estimated by the author from the U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey data.

Policy, “Kentucky imposes a sales tax on the purchase of ‘tangible personal property,’ which applies to items like clothing, appliances, and furniture. But when the purchase is for a service, like a haircut, dental examination, car repair, or attorney services, the sale is not subjected to a tax.”¹² Obviously, if the state’s economy and consumption patterns continue to tilt away from goods and toward services, the sales and use tax base will slowly diminish unless the sales and use tax rate is increased or the sales tax base is widened to include some services. And economists observe that, in general, a lower rate on a wider base is better than a higher rate on a narrower base.¹³

The rise in remote sales has important tax implications. We have estimated that Internet purchases by Kentuckians will likely result in annual use tax losses that range from \$7.6 million to \$57 million by 2004.¹⁷ And the state is likely losing many times this amount as a result of non-Internet mail order sales like catalog purchases. For example, we estimate the cumulative amount of use tax owed on non-Internet mail order sales in Kentucky from 1998 to 2003 at nearly \$600 million.¹⁸ As more Kentuckians shop online and order from catalogs, policymakers will be challenged to develop new and better ways to increase the use tax compliance rate. While survey results show that over half of Kentuckians say they are very or somewhat likely to pay their use tax,¹⁹ other research suggests that no more than 16 or 17 percent of the use tax owed nationally is actually paid.²⁰

TABLE 3
Americans Are Spending More of Their Retail Dollar as Mail Order Purchases

Year	Mail Order (millions)	Purchases of Nondurable Goods* (millions)	Mail Order as a Percentage of Nondurable Goods
1990	\$ 98,190	\$ 471,597	20.8%
1991	\$ 107,970	\$ 485,439	22.2%
1992	\$ 110,740	\$ 519,230	21.3%
1993	\$ 118,970	\$ 553,046	21.5%
1994	\$ 129,740	\$ 594,247	21.8%
1995	\$ 141,810	\$ 624,389	22.7%
1996	\$ 151,300	\$ 654,999	23.1%
1997	\$ 169,500	\$ 683,245	24.8%
1998	\$ 185,000	\$ 727,160	25.4%

*In our nondurable goods category we include SIC codes 53 (general merchandise group stores), 56 (apparel and accessory stores), 57 (furniture group stores), and 594 GAF (stores which specialize in department store types of merchandise—general merchandise, apparel, furniture, and miscellaneous shopping goods stores).

Sources: U.S. Census Bureau, *Statistical Abstract of the United States: 1999*; National Mail Order Association, *Mail Order Sales Results* (various years); U.S. Bureau of the Census, *Annual Retail Trade Survey* (various years)

Conclusion

States that disproportionately depend on the sales tax or the income tax for general fund receipts are likely to feel the effects of structural changes underway in the economy sooner than most. For example, Tennessee and Washington are highly dependent on the sales tax while Oregon and Maryland rely heavily on the personal income and occupational tax. Kentucky, on the other hand, is not “overly dependent” (relatively speaking) on any one tax source. Yet Kentucky’s percentage of state and local tax revenue from the general sales tax, selective sales tax, and individual income tax is 68.9 percent (see Table 4), the fifth highest percentage in a ranking of all states and well above the U.S. average of 57.7 percent. This suggests that Kentucky’s state and local tax system will begin to feel the effect of these long-term structural changes in the economy before many other states.

Rise in Remote Sales

Complicating the mix of changes in consumer buying is the dramatic rise in remote shopping. Americans are buying more and more items from catalogs, the Internet, and home shopping networks on television. The National Mail Order Association along with Marketing Logistics Inc. estimate that in 1998 U.S. consumer mail order sales reached \$185 billion. Of this total they estimate that consumer Internet purchases accounted for \$5.6 billion.¹⁴ Mail order sales have been increasing faster during the decade of the 1990s than total retail sales and the subset of retail sales that closely approximates nondurable goods.¹⁵ Nondurable goods such as apparel are the items most likely to be purchased remotely. During the 1990s total U.S. retail sales increased at an average annual rate of about 5.1 percent while mail order sales increased by around 8.3 percent.¹⁶ As a result of this faster growth rate, mail order purchases comprise a higher proportion of total retail purchases today than in 1990. Table 3 illustrates how mail order purchases increased from about one fifth of nondurable goods to about one quarter during the 1990s.

TABLE 4
Percent of State and Local Tax Revenue by Tax Source, 1997

	General Sales Tax	Selective Sales Taxes*	Property Tax	Individual Income Tax	Corporate Income Tax	Other Taxes
Kentucky	21.2	16.5	17.2	31.2	3.3	10.6
US Total	24.5	11.4	30.0	21.8	4.6	7.6

*Selective sales taxes include: Alcoholic beverage taxes, amusement taxes, insurance premiums taxes, motor fuels taxes, pari-mutuels taxes, public utilities taxes, tobacco sales taxes, and other selective sales taxes.
Source: Calculations by author using U.S. Census Bureau data on state and local finances.

Notes

- ¹ *Financing State Government in the 1990s* (National Conference of State Legislatures and National Governor’s Association, 1993) 16.
- ² Kentucky Revenue Cabinet, *Annual Report 1999-2000*, 15 Dec. 2000, 14 Feb. 2001 <<http://www.state.ky.us/agencies/revenue/pdf/annualreport99-00.pdf>>.
- ³ Kentucky Revenue Cabinet.
- ⁴ Mail order sales include those placed by mail, phone, or electronically (over the Internet) without the person who places the order coming to the point of sale. Refer to Table No. 1288, *Statistical Abstract of the United States: 1999* (Washington, D.C.: U.S. Census Bureau, 1999).
- ⁵ These data are from two sources. The 1974 to 1991 data are from the Kentucky Finance and Administration Cabinet, as presented by William

Hoyt, "Trends in Kentucky Taxes and Their Implications for Future Tax Policy," in *Exploring the Frontier of the Future* (Frankfort, KY: Kentucky Long-Term Policy Research Center, 1996) 243-53. The data from 1992 to 2000 are from various Kentucky Revenue Cabinet annual reports (see note 2).

⁶ Selective sales taxes include those on alcoholic beverages, amusements, insurance premiums, motor fuels, pari-mutuels, public utilities, tobacco sales, and other selective sales taxes.

⁷ Author's calculation based on data from *State and Local Government Finance Estimates, by State: 1996-1997*, U.S. Census Bureau, 6 March 2001. The 1995-96 data are available online at <<http://www.census.gov/govs/estimate/96stlss1.xls>>. Local governments includes counties, cities, school districts and special districts.

⁸ Refer to Table 4. The individual income tax, which includes the local occupational tax, comprises 31.2 percent of Kentucky's state and local tax revenue. The next largest category, the general sales tax, comprises 21.2 percent.

⁹ *Kentucky Commission on Tax Policy: A Blueprint for Comprehensive Reform*, 15 Nov. 1995: 22.

¹⁰ Goods-producing industries include agriculture, mining, construction and manufacturing. Service industries include: transportation and utilities; wholesale trade; retail trade; finance, insurance and real estate; and services. Data are from the Bureau of Economic Analysis, 8 Feb. 2001, <<http://www.bea.doc.gov/bea/regional/gsp>>.

¹¹ The 1999 data are estimated from U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey data, 14 Feb. 2001 <<ftp://ftp.bls.gov/pub/special.requests/ce/standard/1999/region.txt>>.

¹² *Kentucky Commission on Tax Policy*, 23.

¹³ Hoyt.

¹⁴ National Mail Order Association, *1998 Mail Order Sales Results*, 8 March 1999, 22 Feb. 2001 <<http://www.nmoa.com/Library/1998sale.htm>>.

¹⁵ In this category we include SIC codes 53 (general merchandise group stores), 56 (apparel and accessory stores), 57 (furniture group stores), and 594 GAF (stores which specialize in department store types of merchandise—general merchandise, apparel, furniture, and miscellaneous shopping goods stores).

¹⁶ Calculated by the author from Census Bureau estimates. U.S. Census Bureau, Table 2: Estimated Total Annual Retail Sales, 23 Feb. 2001 <<http://www.census.gov/svsd/retlann/view/artssal.txt>>.

¹⁷ Michael T. Childress, "Revenue Implications Grow As More Kentuckians Shop Online," *Foresight* (Kentucky Long-Term Policy Research Center) 7.4, 2000: 1.

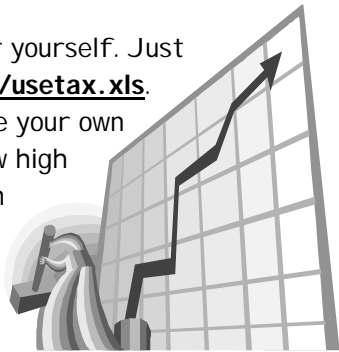
¹⁸ This is the amount owed, not the amount lost. Refer to Peter Schirmer, Kevin O'Neil, and Michael T. Childress, "The Internet as a Virtual Tax-Free Zone: Implications for the State Budget," in *Collecting Taxes in the Cyberage* (Frankfort, KY: Kentucky Long-Term Policy Research Center, 1999): 20.

¹⁹ Childress, "Revenue Implications ..." 3.

²⁰ The U.S. Advisory Commission on Intergovernmental Relations reports a rate of 16.5 percent in *Taxation of Interstate Mail Order Sales: 1994 Revenue Estimates*.)

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A Comparative Analysis of Kentucky's Tax Structure

Editor's Note: The following is an Executive Summary of a December 1999 report prepared by the Barents Group, a consulting arm of KPMG based in Washington, D.C., for the Office of Financial Management and Economic Analysis, Commonwealth of Kentucky.

This project for Kentucky's Office of Financial Management and Economic Analysis updates and extends Barents Group LLC's 1995 study entitled "Comparative Analysis of Kentucky's Tax Structure." The update includes more recent data, covers subsequent changes in legislation, and increases the number of industries and households analyzed. The main objective of this project, like the original 1995 project, is to provide a comparative tax study that focuses on the competitiveness of Kentucky's business and personal taxes, with balanced consideration of other important tax policy criteria such as equity and uniformity. Our inclusion of recent changes in tax law and more recent statistical data on industries and households produces results that are, in some cases, significantly different from those presented in the 1995 study: Indeed, such a comparison serves to illustrate the value of occasional updates to studies of this type.

Neighboring states and others continue to review and re-vamp their tax structures to attract investment, support job creation and eliminate obstacles to economic development. At the same time, state policymakers are challenged to maintain an adequate and stable revenue base, to ensure an accountable system of tax administration, to promote an economically efficient tax system, and to achieve fairness in the distribution of the tax burden. This study illustrates the need for and the consequences of finding an appropriate balance in these sometimes-competing objectives.

Tax Benchmarking

Kentucky depends less on general sales taxes than do either the selected comparison states or all fifty states. On average, Kentucky has a relatively greater dependence on selective sales taxes than the comparison states or all fifty states. Property taxes and corporate income taxes contribute a smaller percentage to total tax collections in Kentucky than in either the comparison states or the nation. In 1996, the most recent year for which we have reliable data, individual income tax collections represent 30.3 percent of total Kentucky tax collections, compared to a national average of 21.3 percent.

Business Taxes

We have updated and expanded the Kentucky Business Tax Competitiveness Model to perform the business tax analysis. The Model calculates pre-tax and after-tax rates of return on a hypothetical marginal investment made by a representative firm in each study industry. Balance sheets and income statements are developed based on actual financial data for each industry. Income and taxes are projected over a thirty-year period. Effective income,

property and sales tax rates are calculated as the measure of marginal tax burdens on investment for purposes of performing the analysis. The effective tax rate is computed as the difference between the pre-tax and after-tax rates of return divided by the pre-tax rate of return. For example, the effective tax rate is computed as 9.09 percent if the pre-tax return is 11 percent and the after-tax rate of return is 10 percent $[(11.0 - 10.0)/11.0]=9.09$. The effective tax rate is the marginal rate that applies to the additional income generated by the hypothetical investment, and is the widely-accepted measure of business tax burdens since it accounts for the time value of money over the life of an investment.

Industries Studied

The updated study includes nineteen industries as follows: Agriculture; Coal Mining; Furniture; Printing; Industrial Chemicals; Plastics; Primary Metals; Metal Forgings; Metalworking Machinery; Electronic Components; Auto Parts; Trucking and Warehousing; Telephone Communications; Wholesale Trade; Computer Services; Business Services; Health Services; R&D; and Catalogue Retailers.

These industries were selected because of their significance to the economic development of Kentucky. Of course, our results are limited to the states and industries that are included in the study.

Study States

Fourteen states, in addition to Kentucky, are covered in the business portion of the study. They are: Alabama, Arkansas, Georgia, Illinois, Indiana, Michigan, Mississippi, Missouri, Ohio, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia.

Key findings from our development and use of the Business Tax Competitiveness Model analysis include:

- Kentucky's state and local business tax system ranks tenth highest of the fifteen study states in terms of overall tax competitiveness across all of the study industries.
- Kentucky ranks tenth highest of the fifteen study states in sales taxes, twelfth highest in property taxes, and second in combined income and net worth taxes.
- Across locations, trucking, coal mining, primary metals, telecommunications, and many services have a higher effective tax rate than most other industries. Traditional manufacturing industries generally are burdened with lower effective tax rates than others.
- Kentucky is generally more competitive than the other study locations for the agriculture, printing, industrial chemicals, and primary metals industries.
- Kentucky is generally less competitive than the other study locations for the wholesale, catalogue retail, business services, computer services, and health services industries.
- Kentucky is moderately competitive relative to the other study locations for the plastics, metal working machinery, auto parts and electronic components industries.

TABLE ES-1
Summary of Effective Business Tax Rates and Rankings
 (Rates in Percent)

	<i>All Taxes</i>		<i>Sales</i>		<i>Property</i>		<i>Income</i>	
	<i>Rank</i>	<i>Rate</i>	<i>Rank</i>	<i>Rate</i>	<i>Rank</i>	<i>Rate</i>	<i>Rank</i>	<i>Rate</i>
Kentucky	10	10.62	9	4.24	12	2.82	2	3.57
Mississippi	1	15.34	2	5.74	5	6.26	3	3.34
Ohio	2	14.44	4	5.14	3	6.73	6	2.57
Missouri	3	13.73	7	4.91	4	6.43	8	2.39
Michigan	4	13.11	13	3.63	1	7.40	11	2.08
Indiana	5	12.97	14	3.48	2	6.77	5	2.72
Tennessee	6	12.34	5	5.13	9	4.08	4	3.13
Arkansas	7	11.06	3	5.58	11	3.36	10	2.12
N. Carolina	8	10.89	1	5.92	14	2.58	7	2.39
Georgia	9	10.69	8	4.28	8	4.75	12	1.65
S. Carolina	11	10.35	11	4.09	7	4.82	14	1.45
Virginia	12	10.03	15	3.25	6	5.28	13	1.50
Illinois	13	9.87	6	5.08	10	3.44	15	1.35
W. Virginia	14	9.50	10	4.09	15	1.73	1	3.68
Alabama	15	8.68	12	3.78	13	2.62	9	2.28
Region		11.57		4.55		4.60		2.42

TABLE ES-2
Summary of Overall Individual Tax Burdens and Rankings

<i>State</i>	<i>Two-Parent, Two-Child, \$30,000 Income</i>		<i>Two-Parent, Two-Child, \$75,000 Income</i>		<i>Two-Parent, Two-Child, Poverty Level</i>		<i>Single-Parent, Two-Child, Poverty Level</i>	
	<i>Total</i>	<i>Rank</i>	<i>Total</i>	<i>Rank</i>	<i>Total</i>	<i>Rank</i>	<i>Total</i>	<i>Rank</i>
Kentucky	\$2,399	3	\$6,262	4	\$1,315	7	\$1,018	6
Alabama	1,911	9	4,010	12	1,103	9	861	10
Florida	824	16	2,105	16	752	16	785	13
Georgia	2,241	5	6,055	5	1,594	4	1,204	4
Illinois	2,779	2	6,438	3	2,467	2	1,816	2
Indiana	3,300	1	8,399	1	2,901	1	1,947	1
Louisiana	1,716	11	3,826	14	875	13	949	8
Mississippi	1,550	13	3,890	13	772	15	609	15
Missouri	2,010	7	4,947	10	1,070	11	837	11
North Carolina	1,453	14	4,872	11	846	14	576	16
Ohio	2,391	4	6,884	2	1,995	3	1,392	3
Oklahoma	1,868	10	5,282	8	1,082	10	900	9
South Carolina	1,371	15	5,038	9	985	12	738	14
Tennessee	1,599	12	3,055	15	1,290	8	975	7
Virginia	1,944	8	5,387	7	1,403	5	792	12
West Virginia	2,142	6	5,948	6	1,374	6	1,050	5
16 State Average	\$1,969		\$5,150		\$1,364		\$1,028	

Figure ES-1
All State and Local Taxes

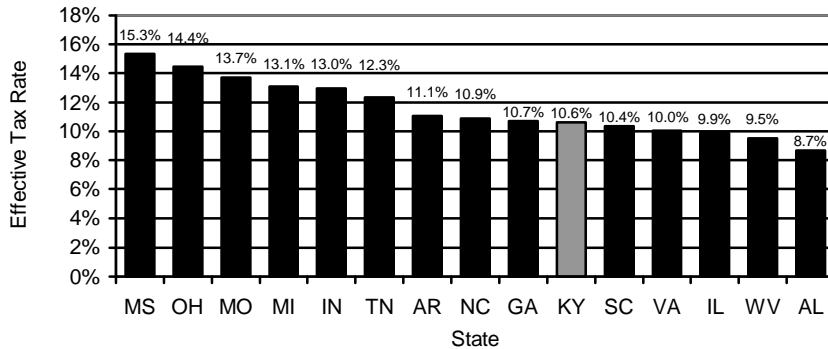


Table ES-1 presents a summary of Model results for all study industries.

Figure ES-1 illustrates the combined effective tax rates presented in Table ES-1.

Household Taxes

A state's household taxes can also have an effect on economic development. For example, small business owners, professional and executive personnel may consider personal as well as business taxes in assessing options related to business and household location decisions. In a broader sense, the state income tax is a key component that influences the performance of the Kentucky tax system overall. The individual income tax is the primary tax type that introduces progressivity into a state tax system and thus affects the perception of fairness in the distribution of the tax burden.

For purposes of this project, we have updated and expanded the Kentucky Household Tax Model to perform the household tax analysis. In addition to personal income taxes, several other taxes contribute to the direct tax burden on families. Household taxes covered by the Model include personal income taxes, residential property taxes and property taxes on motor vehicles, sales and use taxes on consumer purchases, excise taxes, gross receipts taxes on utility purchases, and intangibles taxes. The calculation of household tax liability reflects the differences in tax base definitions, as well as tax rates, across states. These results are limited to the specific households and locations included in the study. For purposes of the updated study, ten households were selected for study. These households include:

- ⇒ Two-parent family of four at the poverty level,
- ⇒ Two-parent family of four at twice the poverty level,
- ⇒ Single-parent family of three at the poverty level,
- ⇒ Single-parent family of three at twice the poverty level, and
- ⇒ Two-parent families of four with annual incomes of \$30,000, \$50,000, \$75,000, \$100,000, \$150,000, and \$200,000.

Specific characteristics for these households were generated using an IRS public-release file of U.S. federal income tax records that has been statistically augmented with wealth,

consumption, and property data from a variety of well-respected data sources. The wealth information was imputed using *Survey of Consumer Finance* data from the U.S. Department of Commerce; the consumption information was imputed using *Consumer Expenditure Survey* data from the U.S. Bureau of the Census, and demographic and property ownership data are available because the tax database was statistically merged with the Census' *Census of Population and Housing*.

Fifteen states in addition to Kentucky are covered by the study. These states differ slightly from those included in the business tax analysis. They are: Alabama, Florida, Georgia, Illinois, Indiana, Louisiana, Mississippi, Missouri, Ohio, Oklahoma, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia.

Key Household Findings

Key findings from the Household Tax Model analysis include:

- For the representative two-parent family of four at the federal poverty income level, Kentucky's household tax system ranks seventh highest of the sixteen study states for overall tax burden.
- For two-parent families of four at the \$50,000, \$75,000, \$100,000, \$150,000, and \$200,000 income levels, Kentucky's household tax system ranks fourth highest of the sixteen study states for overall tax burden.
- For the two-parent family of four at the \$30,000 income level, the two-parent family of four at *twice* the poverty level of income, and the single-parent family of three at *twice* the poverty level of income, Kentucky's overall tax burden ranks third highest of the sixteen study states.
- For the single-parent family of three at the poverty level of income Kentucky's overall tax burden ranks sixth highest.

Table ES-2 presents a summary of results for four of the ten representative families. The tax burdens presented in the table combine sales, property, income, excise, and intangibles taxes for each family.

Conclusion

In general, Kentucky has lower than average business tax burdens and slightly higher than average individual tax burdens. For businesses, the income and net worth taxes present the most significant tax burdens in comparison with other states. For households, individual income taxes are generally the source of the greatest burden relative to other states.

Among the industries included in the business tax analysis and the representative households analyzed in the household component of the study, there is significant variability. While Kentucky is near the average in overall comparisons, the differences between individual results can illuminate further discussions of Kentucky's tax competitiveness.}

Percent of State and Local Tax Revenue by Tax Source, 1997

	General Sales	Selective Sales	Property Tax	Individual Income	Corporate Income	Other
UNITED STATES	24.5%	11.4%	30.0%	21.8%	4.6%	7.6%
ALABAMA	31.5%	19.2%	13.0%	22.1%	2.8%	11.3%
ALASKA	4.1%	5.7%	28.5%	0.0%	13.7%	47.9%
ARIZONA	35.1%	10.5%	28.6%	16.0%	5.8%	4.1%
ARKANSAS	36.4%	13.1%	15.9%	24.3%	4.5%	5.8%
CALIFORNIA	26.6%	8.7%	25.6%	25.7%	6.4%	6.9%
COLORADO	28.8%	9.1%	29.4%	25.4%	2.2%	5.1%
CONNECTICUT	20.7%	12.6%	35.7%	21.7%	4.1%	5.1%
DELAWARE	0.0%	11.9%	15.9%	32.4%	8.0%	31.9%
DISTRICT OF COLUMBIA	18.3%	14.6%	26.5%	28.6%	6.7%	5.3%
FLORIDA	35.1%	17.1%	34.6%	0.0%	3.5%	9.7%
GEORGIA	30.1%	8.5%	27.2%	26.1%	4.0%	4.1%
HAWAII	37.9%	14.5%	15.8%	25.4%	1.8%	4.7%
IDAHO	22.9%	11.5%	26.2%	26.2%	5.1%	8.2%
ILLINOIS	19.0%	13.9%	37.7%	18.4%	5.3%	5.6%
INDIANA	20.7%	7.8%	34.6%	28.3%	6.1%	2.5%
IOWA	22.1%	10.7%	32.2%	24.3%	3.1%	7.7%
KANSAS	26.6%	9.5%	30.9%	22.4%	4.3%	6.4%
KENTUCKY	21.2%	16.5%	17.2%	31.2%	3.3%	10.6%
LOUISIANA	39.6%	13.9%	14.9%	16.2%	3.9%	11.4%
MAINE	19.2%	8.2%	42.8%	21.7%	2.7%	5.4%
MARYLAND	14.1%	12.5%	25.9%	38.6%	2.3%	6.6%
MASSACHUSETTS	14.3%	7.0%	32.9%	35.7%	6.0%	4.1%
MICHIGAN	26.8%	6.7%	29.0%	24.1%	8.4%	5.1%
MINNESOTA	20.0%	11.2%	27.2%	30.4%	4.4%	6.8%
MISSISSIPPI	35.7%	15.1%	23.4%	14.8%	4.2%	6.7%
MISSOURI	28.9%	12.3%	22.3%	26.2%	3.3%	7.0%
MONTANA	0.0%	14.3%	42.7%	21.0%	4.2%	17.7%
NEBRASKA	22.8%	10.3%	35.5%	20.9%	3.1%	7.4%
NEVADA	39.2%	25.6%	21.9%	0.0%	0.0%	13.3%
NEW HAMPSHIRE	0.0%	16.7%	66.0%	1.9%	7.6%	7.9%
NEW JERSEY	16.1%	10.2%	46.6%	17.7%	4.6%	4.7%
NEW MEXICO	39.0%	12.0%	12.4%	17.6%	4.1%	14.9%
NEW YORK	18.7%	7.9%	32.0%	29.2%	7.9%	4.4%
NORTH CAROLINA	22.5%	13.3%	21.5%	30.8%	5.5%	6.5%
NORTH DAKOTA	22.1%	19.2%	29.4%	10.3%	4.8%	14.2%
OHIO	21.2%	10.1%	28.8%	30.8%	2.5%	6.5%
OKLAHOMA	29.8%	10.6%	15.4%	23.8%	3.1%	17.3%
OREGON	0.0%	10.3%	31.4%	40.6%	4.8%	13.0%
PENNSYLVANIA	19.3%	10.5%	28.3%	24.4%	4.9%	12.5%
RHODE ISLAND	16.8%	12.4%	41.9%	21.9%	3.1%	3.9%
SOUTH CAROLINA	27.1%	9.9%	26.9%	24.8%	3.1%	8.4%
SOUTH DAKOTA	37.1%	13.7%	36.4%	0.0%	2.5%	10.2%
TENNESSEE	47.3%	14.0%	22.0%	1.2%	4.5%	11.0%
TEXAS	31.9%	18.1%	37.5%	0.0%	0.0%	12.4%
UTAH	33.0%	8.5%	23.5%	26.5%	4.2%	4.3%
VERMONT	11.4%	14.1%	44.6%	20.0%	2.8%	7.2%
VIRGINIA	16.3%	14.0%	31.2%	28.1%	2.5%	7.9%
WASHINGTON	46.1%	13.4%	31.8%	0.0%	0.0%	8.8%
WEST VIRGINIA	21.6%	18.9%	19.9%	20.4%	6.5%	12.7%
WISCONSIN	19.3%	8.9%	33.4%	29.0%	4.1%	5.2%
WYOMING	30.7%	6.2%	37.4%	0.0%	0.0%	25.7%

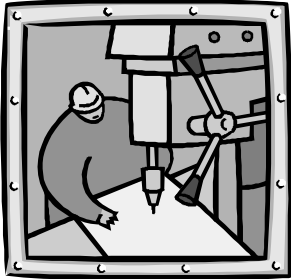
Selective sales taxes include taxes on alcoholic beverages, amusements, insurance premiums, motor fuels, pari-mutuels, public utilities, tobacco sales, etc.

Source: Calculations by Kentucky Long-Term Policy Research Center using U.S. Census Bureau data on state and local finances

Scanning Kentucky

Emerging trends likely to influence the Commonwealth's future

Manufacturing Losses Buffet North Carolina



Factories made North Carolina an industrial colossus, the state with the largest percentage of its workers in manufacturing jobs. Indeed, the state's path of economic development is often offered as an exemplar that Kentucky should follow. But the global economy is taking its toll on this envied manufacturing

base. *The New York Times* reports that North Carolina lost 27,800 manufacturing jobs last year alone—by far the largest such loss in the country. What's more, other industries may not be creating sufficient jobs to absorb displaced workers, particularly in rural areas that depend heavily on low-skill manufacturing jobs.

Over the past five years, North Carolina has been shaken by a drain of low-wage factory jobs overseas. One by one, the pillars on which the state's economy was built 20 years ago—textiles, furniture, apparel—have begun to fall to foreign competition, and its growing high-tech centers are often out of reach for laid-off workers. The loss of those jobs and 30,000 in the previous four years, along with the closing of the factories that provided them, contributed greatly to a revenue shortage that forced Gov. Michael F. Easley to declare a fiscal emergency earlier this year to close a budget gap of nearly \$800 million.

The erosion of North Carolina's manufacturing base has made the state all the more vulnerable as the national economy begins to slow, economists say. In that sense, it may offer an early warning signal to the rest of the country. A huge disparity remains between the economy of the state's growing metropolitan areas and that of its rural counties where more than 60 percent of the manufacturing layoffs have occurred. Many of the laid-off workers lack the education to compete in the new economy, and their counties lack the infrastructure and other resources to grow along with Charlotte and Raleigh-Durham.

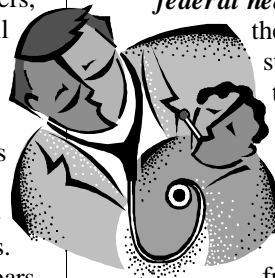
Implications for Kentucky. Long heralded as the example Kentucky should follow, North Carolina's recent losses to the forces of globalization have a far different story to tell. North Carolina's recent experience illustrates the potential weakness of an economic development strategy that relies too heavily on low-skill manufacturing, particularly as an antidote to rural unemployment and poverty. Indeed, too heavy a reliance on manufacturing in general is likely to prove an unwise strategy over time, as technology continues to eliminate jobs and globalization drives more low-skill, low-tech jobs offshore. Only modest manufacturing growth is expected in the United States over the coming decade but

only in the higher-wage durable goods sector. As the service sector comprises a growing component of the national economy, and information- and technology-based jobs offer the highest wages, a strong manufacturing base is no longer a solid foundation for the future. Indeed, as North Carolina's recent experiences show, it may be where future economic losses will most likely occur.

Education and training still offer the only reliable foundation for future development, giving individuals, communities, and the state the capacity and the flexibility to adapt to economic change and seize opportunities as they arise.

Parents of Most Uninsured Kids Uninformed About Options

About 7 million children who qualify for free or low-cost federal health insurance remain uninsured because



their parents don't know they are eligible, a study by the Robert Wood Johnson Foundation has found. *The Wall Street Journal* reports that the study found that 6 out of 10 parents of uninsured children think that because they work and aren't on welfare, their children don't qualify for federal programs. Other parents have become frustrated by often lengthy and complicated application forms and simply stopped pursuing the benefits.

Significantly, four out of five parents said they would enroll their children in federal health programs if they knew they were eligible, the study said. Children can receive low-cost or free health care from a state's Children's Health Insurance Program (CHIP). Created by Congress in 1997, CHIP has enough money to cover 5 million children, but only 2 million are enrolled.

Implications for Kentucky. One of just 10 states that has used the resources made available to it for insuring its poor and low-income children, Kentucky has done a commendable job of getting this federally funded benefit to the children it was designed to serve. While more can be done, the Commonwealth has created highly effective marketing campaigns that have reached the parents who ultimately are responsible for getting kids to the health care available to them. While slow to start, the Kentucky CHIP reached an estimated 70 percent of eligible kids. The anemic efforts of some other states could benefit from the know-how of Kentucky's network of KCHIP activists.

Natural Gas Costs Take Unexpected Budget Bite

Heating costs may strain the operating budgets of state agencies as the price of natural gas reaches historically high levels. The cost of natural gas is expected to remain at relatively high levels for the next



couple of years, the *Kentucky Energy Watch* reports. As a consequence, state budgets will have to absorb an unanticipated cost.

If we assume that cooler temperatures increased demand by 5 percent for the heating months of December through March, and that natural gas prices increased by 30 percent, overall natural gas utility costs for this year alone could increase by approximately 20 percent. In the case of the state-owned Capital Plaza Tower in Frankfort, for example, this could mean an additional \$30,500 over last year’s natural gas heating bill of \$145,459. If we apply the same percentages to 20 state-owned buildings that heat with natural gas, the impact on budgets becomes even more significant. Last year the state spent \$1.1 million to heat these 20 buildings with natural gas. Under these conditions, \$225,000 would be added to the bottom line.

Implications for Kentucky. Rising energy costs could not come at a more inopportune time for the state—as well as the citizens it serves. With economic news as erratic as the stock market and the possibility of a recession still looming in the background, consumer confidence and spending are, not surprisingly, flagging somewhat. In turn, public sector revenues that are generated from sales and use taxes are down. If a recession were to materialize, incomes would also be depressed. The stock market’s downturn has already reduced the incomes of many households, which will, in turn, cut state and local revenues.

As a consequence of the rising cost of natural gas, future government budgets at every level, just like those of most households, will have to accommodate higher utility costs. At the same time, government agencies at every level, like the citizens they represent, are likely to begin confronting their inattention to energy conservation. As conservation advocates have long held, opportunities abound for infinitely greater efficiencies. Given the cost of heating alone, the time has come to explore ways of adapting public buildings to these costly new realities. Over the long term, citizens and taxpayers are likely to realize returns from natural resource conservation and bottom-line savings. Moreover, government can help facilitate such outcomes by educating consumers about conservation.

Governors Advocate Medicaid Changes

The National Governors’ Association has proposed radical changes in Medicaid that would permit states to provide health insurance to millions more, but the benefits would be less generous than those now guaranteed to poor people, according to a recent article in *The New York Times*. The new policy would still guarantee a comprehensive package of benefits for the poorest families, thus “maintaining the health care safety net for vulnerable populations.” But the draft policy statement says the present “all-or-nothing structure of the Medicaid program” must be changed so states can offer a more modest package of benefits for people with incomes that exceed Medicaid’s usually stringent guidelines.

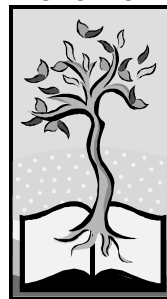


Gov. Parris N. Glendening of Maryland, who chairs the association, noted that most governors want to provide more citizens with health care, but their best intentions are being thwarted by rising health care costs and falling revenues. Double-digit increases in health care costs are predicted for this year following a year when these costs increased at double the rate of inflation. The statement calls for far greater flexibility in structuring optional benefits, a departure from what it calls “the current all-or-nothing structure of the Medicaid program.” Utah Gov. Michael O. Leavitt added that the goal of the association’s plan is “to provide some access to basic health care for everyone, rather than a rich plan of health benefits for just a small group of people.”

Implications for Kentucky. We know that the vast majority of the uninsured come from the ranks of the working poor, most of whom do not have access to affordable health insurance. The option of designing basic health coverage plans at the state level and expanding access to Medicaid could give many access to some level of health care coverage. In the interim, however, more can be done to ensure that all who are currently eligible for Medicaid are enrolled.

High School Courses Linked to College Graduation

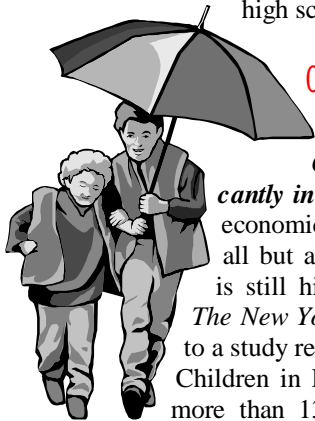
Rather than grades or test scores, an academically challenging high school course load, featuring laboratory science and several years of English, math, and foreign language, is the most important factor in predicting whether a high school student will eventually graduate from college, according to a new federal report. An online *usnews.com* report said that while earlier research stressed the importance of algebra as a “gateway course” that puts kids on track to college, the new study found that taking more advanced math in high school is a key predictor of college completion. Students who finished a class beyond Algebra II—either trigonometry, precalculus, or calculus—were more than twice as likely to earn a bachelor’s degree, even after holding constant other factors such as affluence.



Many students—especially those from low-income and rural communities—go to high schools that don’t offer classes like physics. A partial solution, the report says, is the growing practice of “dual enrollment” where high school students take classes at a local community college. A vice president at the College Board says many colleges already look beyond scores to see how much students have challenged themselves in high school.

Implications for Kentucky. Given the Commonwealth’s goals of dramatically increasing postsecondary enrollment over the next 20 years and simultaneously elevating the quality of elementary and secondary education, it is vitally important that we understand the levers that propel students into college and, perhaps more importantly, enable their completion of a degree. If the degree of challenge that high school courses pose to students is key to long-term educational outcomes, it may be necessary to re-evaluate KERA’s heavy reliance upon standardized testing as a measure of school

performance. And if, as some high school principals conclude, the rewards of KEES scholarships, the values of which are linked to grade point averages, are discouraging students from taking more demanding courses, we may need to restructure our rewards system. Finally, these findings suggest that policymakers may need to address any lingering inequities between rural and urban schools, to structure rewards that will help ensure broad student access to high-quality teaching forces and advanced courses, whether in high schools or local colleges.



Child Poverty Falls But Still Short of Historic Lows

Child poverty rates fell significantly in many states during the current economic boom, but nationwide, and in all but a handful of states, child poverty is still higher than it was 20 years ago. *The New York Times* reports that, according to a study released by the National Center for Children in Poverty at Columbia University, more than 13 million American children, 3 million more than in 1979, live in poverty.

The report does not say why some states, like Illinois and New Jersey, have seen significant reductions in child poverty

rates since 1970, and others have seen increases or relatively minor declines. But Robert Goerge of the Chapin Center for Children at the University of Chicago said Illinois' early welfare overhaul, with generous benefits, which began in 1993, helps explain why so many of the state's children have risen out of poverty. That program, for instance, allowed welfare recipients to continue receiving health benefits and food stamps while easing into full-time employment, long before other states allowed such a benefit. A spokeswoman for the New Jersey Department of Human Services said her state had used savings from cuts in welfare payments to help people who get off welfare. For instance \$100 million that had previously been spent on welfare checks was shifted to subsidies for child care. At \$125 to \$150 a week, child care often accounts for at least 40 percent of the take-home pay of a former welfare mother who has joined the workforce.

Implications for Kentucky. Again, the experiences of states that have designed generous incentives for parents leaving welfare rolls and plowed savings into support programs for former recipients appear to be the exemplars, showing that welfare reform policies make a difference in child poverty. By addressing the gaps in access to the very support services that enable low-income and poor parents to succeed in the workplace, namely child care and health care, these states appear to have measurably improved the lives of poor children, as well as their parents.}

FORESIGHT

KENTUCKY

LONG-TERM POLICY RESEARCH CENTER

111 St. James Court
Frankfort, Kentucky 40601-8486
Phone: 502-564-2851 or 800-853-2851
Fax: 502-564-1412 or 800-383-1412
E-Mail: info@kltprc.net
www.kltprc.net

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