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I have been asked to offer some thoughts on the current Kentucky tax system and how it might be improved. I start by stating two disclaimers. First, there are a lot of people in Kentucky who know a lot more about the Kentucky tax system than I. Second, I'm not here to tell Kentucky what it ought to do with its tax system. There's more to tax policy than economics, equity and lists of principles of taxation. These are, of course, important. But it is also important that a tax system be one that, as much as possible, the taxpayers of a state respect and can live with. Jean Baptiste Colbert, Controller General of Finances for Louis XIV of France, is reputed to have said "The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing." There's something to that.

That said, I have been working on state tax issues for 10 years. I've spent a lot of time with the numbers and the tax laws of many states. I've also been involved with various tax commissions, legislative battles and initiative campaigns. I hope to be able to provide you with some suggestions regarding ways to think about some of the issues and some context for your discussions.

I'll start by going over some ground you may have already covered. First, is Kentucky a low or high tax state? The best measure of overall tax level, in my view, is taxes as a share of personal income. By that measure Kentucky is close to the national average. Because there are many other states also close to the national average, Kentucky's rank among the states goes up and down with small tax changes and differences in economic performance relative to other states. But the center of gravity is about in the middle.

Another question is whether Kentucky is a fair tax state? Fairness is, of course, in the eyes of the beholder. Kentucky has a regressive tax structure--middle- and low-income families pay a greater share of their income in Kentucky state and local taxes than do the wealthy. Our 1996 study, Who Pays? found that middle- and low-income families paid about 10.5 percent of their income in Kentucky state and local taxes in 1995 while the best-off one percent, with an average income of over $500,000 per-year, paid 8.2 percent. That puts Kentucky in the wide middle band of state tax structures in regressivity. The fact that Kentucky has a lot of company in having regressive taxes, doesn't, of course, make it an attractive feature.

In general, tax systems are regressive or progressive because of two factors. The relative reliance on different taxes and the regressivity or progressivity of the component taxes. Consumption taxes, such as the general sales tax, gas tax and tobacco tax, are typically the most regressive taxes. Income taxes are usually progressive. Property taxes are in between and usually somewhat regressive.

Kentucky relies heavily on income taxes. This is usually a feature of a progressive tax system. But Kentucky's personal income tax isn't very progressive. Reliance on regressive consumption taxes is also above average in Kentucky, but that regressivity is moderated somewhat by groceries being excluded from the general sales tax. Property taxes are a relatively small component of Kentucky's overall tax system. Kentucky ranked 45th in the country in property taxes as a share of personal income in 1996. These components: a substantial but not very progressive income tax, substantial regressive consumption taxes mitigated by the groceries exemption, and low property taxes, add up to form Kentucky's somewhat regressive tax system.

The overall level of Kentucky's taxes and who pays them are the big picture items. Now I will turn my attention to some narrower issues. Kentucky has, since the Commission on Tax Policy in 1995, been focusing on tax policy and much of the ground has been well-discussed. Therefore, I will try to focus on aspects of tax policy that don't generally get enough attention and offer comments on some issues of particular moment in Kentucky.

The Personal Income Tax

Kentucky's personal income tax hits low-income people harder than most personal income taxes. In one respect, this isn't really a big problem. The income tax still takes substantially less from low-income families than do consumption taxes, and less than from the better-off. On the other hand, if the objective is to reduce taxes on the poor, cutting consumption taxes on everyone is not a very targeted approach and costs a great deal of revenue. Tax relief for low-income families can often be more efficiently accomplished through the income tax.

One way to redress the burden on low-income working people is through a state Earned Income Tax Credit. Ten states offer EITCs that are varying percentages of the federal credit. Because it piggy-backs on the federal credit it is relatively easy to administer. Since, however, the personal income tax isn't actually the tax that places the largest burden on low-income families it is important that the credit be made refundable--that any credit that exceeds the amount of before-credit personal income tax liability be paid the taxpayer.

In fact, one of the principles underlying the refundable nature of the federal credit is that it should not only reduce personal income tax liability, but also offset federal payroll tax for low-income working families. Similarly, a Kentucky Earned Income Tax Credit could be used to offset the other taxes low-income working families pay to Kentucky governments. Seven states offer refundable EITCs.

Another distinctive characteristic of the Kentucky personal income tax is that Kentucky relies heavily on it--ranking 7th among the states in 1997 in personal income tax as a share of personal income (up from a ranking of 12th in 1979). This includes Kentucky's earnings-based local taxes. Kentucky's top marginal rate of 6 percent is not, however, especially high by national standards.

It is controversial whether heavy reliance on personal income taxes is a bad thing or not. On the positive side is its progressivity, the fact that revenue grows more closely to economic growth than many other taxes, its conformity to taxpayers' ability to pay in good times and bad and its deductibility on the federal personal income tax. On the negative side is the claim that wealthy individuals, in particular, are less likely to personally live places that have high top personal income tax rates and will locate their businesses, and hence jobs, in low income tax places.

It is, however, hard to make a case that high personal income taxes do, in fact, damage a states economy. At different times, high-income tax states are sometimes doing well economically, low-income tax states poorly and visa-versa. Many of the places that have the most wealthy people have the highest income tax rates. In addition, executives of public corporations would be remiss in their responsibility to shareholders if they chose business locations based on how their personal taxes would be affected.

Furthermore, the differences between state income tax top marginal rates are not usually that great to begin with--typically a few percentage points. Certainly relative to the top federal rate of close to 40 percent, the differences between state top marginal rates is relatively small.

One important, and underappreciated, factor that limits the impact of state personal income taxes is the interaction with the federal income tax. Because the state personal income tax is deductible from the federal income tax, the differences between state top marginal rates are even smaller than they first appear.

Take, for example a state with a top rate of 6 percent and another state with a top rate of 4 percent. The difference is only 2 percentage points to start with. But, because those who itemize on their federal tax returns can deduct this tax, the real difference is even less. In other words, paying more state tax lowers taxpayers' federal tax, which makes the effective rate of the state tax less. For a top-bracket federal taxpayer, the 6 percent top state rate is really only about a 3.6 percent rate after accounting for the lower federal tax. The 4 percent rate equates to a 2.4 percent effective top marginal rate. So the difference between the tax rates in the two states, in terms of their real impact, is actually only 1.2 percentage points.

Of course, the differences between some states is somewhat greater than in this example. Nevertheless, given all the factors that go into the decision of a wealthy person on where to live and locate a business, it seems unlikely that state income tax marginal rates are a particularly significant criteria. After all, these are people who can afford to live anywhere they want.

A Single Rate?

An issue raised by the Commission on Tax Policy was whether Kentucky would be better off with a single rate, or "flat" personal income tax. Because Kentucky's top rate starts at only $8,000 of taxable income, going to a single rate would not be as dramatic of a change as in many personal income taxes. On the other hand, given the distribution of Kentucky's tax system, it would seem that maintaining the principle of a graduated rate personal income tax would have some value.

National polling shows that graduated rate income taxes are favored by the public over single-rate income taxes. This fact is sometimes clouded by polls that ask whether people favor a "flat tax" which closes loopholes and simplifies the tax code over the current system. This mis-characterization of the federal flat tax proposals, and the false choice presented, enables flat tax proposals to sometimes poll well. When given the choice between otherwise identical tax systems, one with a single rate and one with graduated rates, the public prefers graduated rates.

Simplicity

Simplicity in a personal income tax is a virtue that almost everyone agrees on. So why is it so hard to accomplish? There's a saying that may explain it: "No simplification makes a tax simple enough if it raises your taxes and no complication is too complicated if it lowers your taxes." In other words, people want simplification, but not so much that they're personally willing to pay for it. Why does someone have to pay for simplification? Because any tax change, even a revenue neutral one, has relative winners and losers.

That said, for states, the most obvious path to tax simplification is conformity to the federal system. We may not agree with many features of the federal tax system, but if requiring taxpayers to wade through the federal labyrinth is unkind, requiring them to do it again for the state personal income tax is cruel.

The simplest state tax systems are Vermont's and Rhode Island's where taxpayers pay a flat percentage of their federal tax liability (with some exceptions). For most taxpayers it's as simple as multiplying a number taken from their federal tax return by a percentage.

Short of this level of simplicity, however, many states conform closely to federal taxable income or at least federal Adjusted Gross Income as their tax base. This type of conformity also lessens the amount of additional work faced by taxpayers in completing their state tax returns.

Kentucky could certainly get much closer to the federal system than it is. Conforming more closely to federal definitions of income--either "taxable" or "adjusted gross"--would obviously be an advance. Another reform would be to require Kentucky married couples to file under the same status as on their federal returns and create a Kentucky rate schedule for married couples that would ensure that there was no marriage penalty. Most states either require couples to file under their federal status or have a rate table that makes such filing advantageous.

Consumption Taxes

Kentucky's consumption taxes are regressive. Excluding groceries, however, makes the general sales tax less regressive than it would otherwise be.

In addition to regressivity, another problem with consumption taxes is that they are not deductible from the federal personal income tax. This is an important, and underappreciated, difference between consumption taxes and property and income taxes at the state and local level. Every dollar of consumption tax paid by Kentuckians comes directly from their pockets with no offsetting reduction in federal income tax. For those who itemize on their federal tax returns, however, between 15 and 40 percent of their state and local income and property tax is, in effect, paid for by reduced federal income tax payments. This not only has a taxpayer-by-taxpayer impact, but an impact on Kentucky's economy as a whole. The less money leaving Kentucky in federal tax payments, relative to other states, the better it is for the state's economy.

Many have pointed out that most consumption tax systems in this country, as presently constituted, are taxing a smaller portion of total consumption than they used to. This is largely attributed to a shift in consumption to services, which are typically not taxed as consistently under sales taxes as are the sale of tangible goods. This observation has lead to calls to tax more services. Expanding the sales tax base to include more services is, however, easier said than done.

The services which would add the most revenue to the tax base are, typically, services used by business and healthcare. In fact, much of the shift in consumption that has eroded the classic sales tax base has been the result of increases in medical costs. Yet, precisely because healthcare has been increasing in cost, and is an essential service, few have the stomach to suggest that taxes be raised on medical care. Kentucky has chosen to head in the other direction with reductions in the taxes on healthcare services and products.

Taxing business services causes other difficulties. For one thing, it treats different industries and businesses differently. For example, if legal services are taxed, companies that have in-house counsel do not pay the tax but businesses that hire law firms do.

Similarly, if some services are taxed, and others are not, inefficiencies are created by favoring the users of the untaxed services over the users of taxed services. These sorts of inequities, that undermine free-market choices, are to be avoided in tax policy.

Finally, to the extent that consumption taxes on business inputs are on businesses competing with other businesses in the state, they are likely to be passed through to retail customers in a regressive way. On the other hand, businesses who compete nationally are unlikely to be able to pass the tax through to customers.

Despite these concerns, there is a case to be made for taxing business services. This is particularly true in a state such as Kentucky where corporate income tax revenues have been in decline. It is important that corporations carry an appropriate share of the tax burden in a state. Although taxing business services may not be the first choice, if other avenues are foreclosed, it may be better than barely taxing businesses at all.

Business Taxation

Corporate income tax revenues in Kentucky have fallen dramatically over time. Kentucky ranked 17th among the states in corporate income tax as a share of Gross State Product (the best way to measure the level of corporate income tax in a state relative to other states) in 1979 and had fallen to 33rd by 1997. As a share of GSP the corporate income tax has fallen by over a third. Taken in conjunction with Kentucky's low property taxes on homes and businesses, the overall business tax burden in Kentucky would appear to be quite low. In addition, Kentucky is well-known for its aggressive economic development subsidies for corporations.

Of course, all of this could be viewed as a good thing if low business taxes and economic incentives are helping the state's economy and the people of Kentucky. But there is little evidence that the low-tax strategy of economic development is the best one.

At the extreme, it is easy to see that economic development subsidies can actually hurt an economy. If Kentucky offered businesses moving into the state reimbursement of all initial capital investment costs, reimbursement of half of the business's payroll costs in perpetuity and a million dollar bounty to each of the corporate officers, the state would no doubt attract a substantial number of corporate immigrants. Of course, the state would also have a very difficult time paying for these incentives at the same time as providing other government services. The price of victory in interstate competition might be poorly maintained roads and parks, inferior schools, cuts in police protection and ineffective social programs.

And, the state's economy might well end up worse off. No executive or corporation wants to be in a state with second-rate government services. High crime, poor infrastructure and an unskilled workforce are potentially significant barriers to economic development. Businesses already in Kentucky would lose government services they rely on and face new, subsidized, competition.

The point is that when government funds are used, either in the form of tax relief or spending to subsidize business, there is a cost--either in reduced government services or in higher taxes for others. Because, however, the benefits of business incentives tend to be concentrated while the costs dispersed, this tradeoff is sometimes hard to see. After all, if one teacher is laid-off in every elementary school in the state, the impact on education will not be immediately apparent. Over time, among the hundreds of thousands of children sitting in larger classes, there will undoubtedly be some for whom a little less personal attention will make a critical difference. But that impact will be impossible to isolate from all the other influences in their lives.

On the other hand, the 100 employees now working for a hypothetical company moving to Louisville from Peoria will be welcomed with a ribbon-cutting ceremony. It may be that, overall, the incentive that brought the business to the state does more harm than good, but that won't be the public face of it.

Not only are the costs of incentives often overlooked, but their positive impact is also frequently overstated. One never knows for sure, of course, whether there has been any economic benefit. Would the company have moved from Peoria to Louisville without the incentive? We'll never know for sure. One thing is clear, however. Some companies will receive the incentive for simply doing something they would have done anyway. In other words, a significant portion of business incentives are wasted.

Thus far, I have used the term "incentive" very generally. There is a continuum of incentives ranging from extremely targeted to very broad. The most targeted type of incentive is a provision that only benefits one company. An example of a very broad incentive is cutting the corporate income tax rate.

Broad incentives have the virtue of causing less economic distortion. If a state lowers its corporate income tax rate, all profitable companies benefit no matter what their industry, how many employees they have, whether they're new to the state, etc.. Thus, the market, instead of the tax law, is more likely to decide where capital is invested and which companies thrive. This makes for a better functioning economy overall.

On the other hand, broad incentives are a very inefficient use of government resources for the promotion of economic development. Most of the revenue loss from lowering the corporate income tax, for example, would go to companies that are already located in Kentucky, have no intention of leaving and would have made the same investments in the state with or without the tax cut. At best, only a small amount will go to inspiring companies to increase or start investment in the state. Thus, for the many dollars of reduction in government services, and the attendant negative economic and social impacts, only a very few dollars may go to changing corporate conduct in a way beneficial to the state.

The narrowest of incentives are more akin to a business deal than government policy-making. A benefit for a particular company can be either good or bad for the state. It depends on the terms of the deal. It is, however, highly unlikely that the state will ever get a *great* deal. Too many states and localities are bidding for business for there to be any bargains. In fact, some have argued that there is almost always at least one community that is willing to over-bid for the business. If this is true, and the high bid usually wins, most deals will cost the victorious community more in lost government services or higher taxes than it receives in benefits from increased private investment.

In between the very broad incentives and the single company deals, there are incentives that are targeted at specific types of companies engaged in specific conduct. These obviously create distortions in economic behavior in favor of certain conduct or types of companies, and create economic inefficiencies. Also, as is the case with broad incentives, a significant portion of the revenue loss will go to compensating activity that would have happened anyway.

The bottom line is that business incentives rarely are as good as they look. There are enormous hidden costs that will often outweigh the benefits of the private investment that such deals may attract.

Studies on these issues support this conclusion. In fact, they are nearly unanimous in concluding that low state and local taxes fail to attract business, create jobs or enhance economic performance. Factors other than taxes are generally found to be much more important. Even the small minority of studies that have found an impact have found that it takes a very large difference in tax burden from other states to improve economic growth, and even with a significantly lower tax burden, the increase in growth is insubstantial.

None of this means that incentives never accomplish their immediate objectives. But it does indicate that incentives and broad tax reductions are not a key to generally improved economic conditions.

The fact is that spending revenue or cutting taxes for the sake of economic development involves tradeoffs. A clear-eyed view of what is being sacrificed is imperative to making public policy decisions that are in the best interests of the people of Kentucky.

Gambling

Gambling is more and more a significant source of revenue for states. The gambling industry has been very successful in playing states against each other to achieve legalized gambling in more and more states.

In New Hampshire, where they were desperate for a state revenue source this year, video slot machines received serious consideration. That, in turn, started Massachusetts and Maine elected officials talking. After all, the puritan tradition isn't going to be maintained if there's gambling just across the border--so why lose the revenue to another state?

My home state of Maryland may not be quite the horse racing Mecca that is Kentucky. The industry, nevertheless, has a long history and is important to the state. In Maryland, the race tracks are pushing hard to allow video slot machines at their facilities. Their main argument, besides the fact they need the money, is that they are losing customers to the Delaware track where the slot machines are permitted. Of course, there are plenty of examples up and down the Mississippi River of states falling like dominoes to casino gambling.

It appears that many legislatures, and legislators, are getting backed into doing something that many don't really believe is right. Unless some states start taking a stand, perhaps working with other states, I expect that most states with any urban population will have casinos within the next 20 years.

Stability

Having reliable revenue sources is, of course, important. On the other hand, it isn't desirable for a state to have revenue sources that provide exactly the same revenue in times of economic distress as in times of economic success. During an economic downturn, the people of a state can't afford as much government as when the economy is good and shouldn't be asked to pay as much. Obviously, there's a balance to be had between the need to maintain essential public services and to provide a safety net for those adversely effected by an economic downturn, and the need for those in hard times to pay less in taxes.

One tax that is often criticized for its volatility is the corporate income tax. There can certainly be flaws in a corporate income tax that make it excessively volatile. On the other hand, there is also some sense in taxing companies more when they are profitable and less when they are not profitable. Personal income taxes have the same virtue for families and individuals.

There are other means for achieving stability in government services over economic cycles. Well developed rainy-day funds are an effective method. But just as important is how states spend their revenue in times of fiscal bounty. It is often tempting to give big tax cuts when times are good. And if a state really has more money than it can spend well, tax cuts are appropriate. On the other hand, most states have significant backlogs of investment needs. The time to update infrastructure, improve schools and invest for the future of a state is when the state has the funds to do so. Then, when the economy slumps, and there are fiscal shortfalls, the state is in a much stronger position to weather the storm. The "must-do" list will be shorter during an economic downturn if the state has taken care of its needs when the economy is doing well.

Tax Reform and Reality

Lastly, I would like to share some thoughts on the tax reform process in general. One thing I've learned is that it is hard to accomplish tax reform in one big package.

The problem is that tax reform almost inevitably involves raising the taxes of some and lowering taxes of others. In my experience, those whose taxes are raised get a lot more angry than those whose taxes go down are grateful. This dynamic makes it very hard, in the legislative environment, to enact large-scale tax reforms.

More often, tax change is accomplished in a piecemeal fashion. When the economy is good, taxes are cut, when times are bad, taxes are raised. But the taxes raised at one time are often not the same taxes cut at other times. So, over economic cycles, tax systems evolve.

There are, however, risks in this process. For one thing, when each tax change doesn't actually accomplish much, there is a tendency of elected officials to oversell what is being done. A change that only affects a quarter of taxpayers may be trumpeted as "tax simplification." Or a small property tax cut is claimed to be significant tax relief when it isn't. Little upsets taxpayers more than being told they are getting a break and then not seeing it on their tax form. In fact, some of the states where the most active anti-tax movements have arisen have been the states that have passed the most tax relief measures.

The other problem with tax reform in small bites is that it does not always stick to a consistent vision. More often the tax changes made are reactions to the politics of the moment not sound tax policy objectives.

What we hope is that, over time, when taxes are being cut or increased, it is with an eye to a broader vision of what the tax structure ought to look like. In this way, even if major tax reform is not achievable, if a state sticks to a vision, it can gradually work towards the tax system it desires.

This isn't to say that tax reform can only happen in baby steps. For some tax changes, grand compromises are necessary to achieve true tax reform. But most tax law is not made through major reform but through year-in and year-out legislative activity. If that activity is not undertaken with an eye to the state's long-term tax policy objectives major reform is irrelevant. It is either becomes too hard to accomplish because the system is so far askew or victories are frittered away over time. Hence, much as thinking big has its appeal, it is all for naught without a long-term commitment to a set of tax policy ideals embraced by state policy-makers.