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Blue Ribbon Commission on Tax Reform Holds Two Meetings in May

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Kentucky's Blue Ribbon Commission on Tax Reform ("Commission") held two meetings in May. The first meeting was in Frankfort on May 8, 2012 and the second meeting was in Paducah on May 29, 2012. The May 29th meeting was the first of six "public forums" at which the public may provide testimony.

<u>May 8, 2012 - Frankfort, KY</u>

This meeting began with introduction of the consultants selected to work with the Commission, and continued with testimony by professors from two state universities, and a presentation by Greg Harkenrider on potential options for tax reform. Sixteen of the twenty-three commissioners were present, including all but one member of the legislative delegation that serve as non-voting, ex officio commissioners.

Consultants Selected

Commission Chair Lt. Gov. Jerry Abramson introduced Michael Childress and William Hoyt from the University of Kentucky ("UK"). Messrs. Childress and Hoyt, together with University of Tennessee professor William Fox, have been retained as the consultants for the Commission. Dr. Hoyt explained that Prof. Fox was unable to attend the meeting due to a prior commitment.

Mr. Childress is a public policy advisor and analyst in the Colleges of Business and Economic Research and Communications and Information Studies at UK. Prior to joining UK in 2010, Mr. Childress was executive director of the Kentucky Long-Term Policy Research Center ("Center"), a state government agency created by the Kentucky General Assembly in 1992 to bring a future-oriented perspective to decision making in the Commonwealth. In that capacity, he participated in and oversaw significant research and publishing related to issues in Kentucky such as the future of agricultural production, entrepreneurism, technology use, electronic commerce, education, health, transportation and state and local taxation. Under Mr. Childress's leadership, in December 2001 the Center issued "*Financing [Kentucky's] State and Local Government: Future Challenges and Opportunities*". Mr. Childress graduated from UK (BA) and the University of California, Los Angeles (MA).

Prof. Fox is a well-known consultant on various public policy issues, including state and local taxes, having been retained by approximately 25 countries and 10 states. His current research is focused on improving tax structures and tax policies and enhancing regional economic development. Prof. Fox prepared the 2002 *"Report to the Sub-Committee on Tax Policy Issues"*, Committee on Appropriation and Revenue, Kentucky General Assembly. The forty page report examined characteristics of Kentucky's tax structure, performance of the tax system in financing Kentucky government, vertical and horizontal equity, business competitiveness and policy options for changes. Also, Prof. Fox provided consultation to the Fletcher Administration in its tax reform efforts. Dr. Fox is a graduate of Miami University (BA) and The Ohio State University (MA and PhD).

Dr. Hoyt is a highly-regarded economist whose research focuses on issues in public economics, with particular emphasis on state and local public finance. Dr. Hoyt's current research includes work on fiscal competition and the impacts of state and local tax policies on employment and housing markets. He has been published in *The American Economic Review, The Review of Economics and Statistics,* the *Journal of Public Economics,* and the *Journal of Urban Economics*, among others. He is a graduate of Carleton College (BA) and the University of Wisconsin (MA and PhD).

Dr. Hoyt presented a brief overview of the work the consultants will do and answered questions from the Commissioners. He stated that the consultants will examine each of the overall goals set by the Governor (adequacy, simplicity and compliance, fairness, competitiveness and elasticity), and will analyze the distribution of tax on individuals and others, the incidence of tax (legal versus actual), how Kentucky stacks up against other states, and how taxes impact location decisions. The consultants anticipate providing their report by August 31.

The Commissioners' questions indicate they are most interested in information regarding adequacy and competitiveness. Representative Wayne and Commissioners Bailey and Schuster appear to be seeking information that will inform them as to what is "adequate". Specifically, Dr. Schuster asked: What has Kentucky spent versus what should we be spending? How should we split the pie? What have expenditures been historically and before the recession? Dr. Hoyt said the consultants will look at the spending policy of Kentucky versus other states focusing particularly on expenditures viewed as investments. Mr. Childress pointed out that looking at adequacy vis–à–vis other states is very difficult because Kentucky has obstacles that other states do not have. As an example, Mr. Childress discussed the very high number of Kentucky school children that get free or reduced cost meals at school.

Representative Farmer asked that when analyzing competitiveness the consultants look at states similar to Kentucky as opposed to just the contiguous states. He said that Kentucky is more similar to South Carolina, for example, than Illinois. Dr. Hoyt said they would look beyond the contiguous states and commented that Prof. Fox's 2002 report had included South and North Carolina, Michigan and other states. Lt. Gov. Abramson asked for an analysis of taxes that cost more to collect than revenue received from them. Commissioner Zion advised the consultants that they should look at the recent report produced by the Cabinet for Economic Development, which includes a 5-year blueprint for the Commonwealth. Dr. Hoyt agreed.

Testimony

Next, the Commission was addressed by Dr. Paul Coomes, a professor of economics from the University of Louisville, and Robert Salyer, CPA and Director of the Master of Accountancy Program at Northern Kentucky University.

Dr. Coomes stated he was wearing two hats – professor and consultant for the Kentucky Wine and Spirits Wholesalers Association. He distributed a paper titled *The Impact of Tax Increases on Kentucky Beer, Wine and Spirits Sales*. He noted that beer sales are approximately 2.1% lower and wine 3.4% lower than four years ago. He attributed much, if not all, of the decline to the increases in taxes on alcoholic beverages over the last few years. He commented that Kentucky is getting near the top in alcohol taxes and is finding it difficult to compete with the states along its borders. In his opinion, the borders about which Kentucky should be concerned are Illinois and Ohio because there is a much larger population residing on those borders than the border with Tennessee, for example.

Dr. Coomes then began discussing "Economic Geography Issues *and implications for fiscal policies in Kentucky*."[1] The report begins by noting that 2.4 million of Kentucky's 4.3 million residents live in a county bordering another state and that 44% of the population lives on the northern border. The *tax base* is even more geographically concentrated as 42% of the private sector jobs are located in just four counties – Jefferson, Fayette, Boone and Kenton. The conclusion of Dr. Coomes is that Kentucky cannot set tax and spending policies without considering the border states. The presentation also contains a number of slides showing the decrease in beer and wine sales, and concludes by showing the involvement of Kentucky state government in the Kentucky economy compared to the participation of other state governments in their states' economies.

Mr. Salyer presented an overview on gross receipts taxes. He noted that the advantages of a gross receipts tax is the ease of calculation (total receipts multiplied by the tax rate), but the disadvantages include pyramiding (i.e., applying tax at each level of a manufacturing process)[2], inequity between low volume/high margin companies such as manufacturers and high volume/low margin retailers; and the burden on new or start-up businesses as they are taxed regardless of profitability. Mr. Salyer stated that the Ohio commercial activities tax ("CAT") is controversial largely as a result of the disadvantages described. Additionally, the CAT has failed to meet revenue projections in each year of its existence. His paper includes an interesting discussion of gross receipts taxes by Professor John Mikesell of Indiana University. Finally, Mr. Salyer noted that New Jersey and Michigan recently abandoned their gross receipts taxes and that Indiana abandoned its gross receipts tax in 2002.

Options – Tax Reform Initiatives

The final speaker for the meeting was Greg Harkenrider of the Office of State Budget Director. Due to time limitations, Mr. Harkenrider's comments were limited in large part to potential changes in the sales tax. He began by stating that adding a penny to the existing tax would result in an increase in revenue of $510M annually. This increase is without any broadening of the tax base. After reminding the Commissioners that tax expenditures are *estimates*, he reviewed the following tax expenditures: food - $500M; purchases by charities - $370M; prescription drugs - $400M; residential utilities - $370M; and government purchases - $280M. Next, Mr. Harkenrider discussed services taxed by other states not subject to tax in Kentucky. A listing of the services and the approximate number of states taxing them are included in Mr. Harkenrider's presentation available on the Commission's website on the "Resources" tab.

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[1] The written presentations of Dr. Coomes, Mr. Salyer, and Mr. Harkenrider are available at at the "Resources" tab of the Commission's website - http://ltgovernor.ky.gov/taxreform.

[2] Mr. Salyer explained that the value added tax ("VAT") imposed in many European countries is levied on "increments" distinguishing the VAT from the gross receipts taxes levied by states in this country.

Next, the tax expenditures related to the individual income tax were touched on: pension income - $350M; capital gains transferred at death - $700M; disability income - $400M; and home mortgage interest - $1.3B. Finally, Mr. Harkenrider reviewed recent changes to taxation of corporations. He noted that *total* corporate income tax expenditures are approximately $300M; two-thirds of which relates to dividend income ($150M); the NOL deduction ($40M); and charitable contributions ($10M). Commissioner Williams asked whether there is horizontal equity in the corporate income tax. Mr. Harkenrider responded that the most equitable way to tax corporations is to tax gross receipts. Commissioner Williams suggested that another option would be to eliminate the corporation income tax. Commissioner Bailey suggested that loopholes in apportionment be closed. It is not clear to what Commissioner Bailey was referring -- a throw-back rule?

The meeting ended with a brief discussion of the protocol for the public meetings.

<u>May 29, 2012 - Paducah, KY</u>

Paducah, the county seat of McCracken County, is located in the southwest corner of the Commonwealth at the confluence of the Ohio and Tennessee Rivers. The area is often called the Four-Rivers Area due to the proximity of the Ohio, Tennessee, Cumberland, and Mississippi Rivers. The meeting was held in the auditorium of Paducah Tilghman High School. Approximately seven voting members of the Commission were present and four non-voting, legislative Commissioners were in attendance. Twenty-one individuals spoke to the Commission on a variety of subjects including the lack of funds for public schools (5 speakers) and mental health (3) and public health (1) services.

Twelve speakers made comments regarding taxation. The specific suggestions included increasing the cigarette tax by at least $1.00 per pack; moving to single sales factor apportionment for corporation income tax; maintaining the status quo regarding taxes on real property; replacing the individual income tax with a gross receipts tax; maintaining all existing sales tax exemptions for agricultural businesses; maintaining that portion of HB 44 requiring voter approval of any property tax increase in excess of 4%; and conforming Kentucky's calculation of depreciation to the federal calculation. Others made more general comments regarding taxation.

Amy Barkley spoke on behalf of the Campaign for Tobacco-Free Kids. She noted that the Illinois legislature had just approved a $1.00 per pack increase in cigarette taxes. This increase likely will raise the national average, which is currently $1.47 per pack. Kentucky's cigarette tax is currently $0.60 per pack. Ms. Barkley stated that tobacco companies are able to offset increases of less than $1.00 per pack with coupons, discounts or other measures. Thus, to impact teens and pregnant women an increase of $1.00 or more is important. She stated that twenty-four percent (24%) of pregnant women in Kentucky smoke compared to ten percent (10%) nationally. She claimed that an increase in cigarette taxes is a proven deterrent to smoking by pregnant women and teens. Ms. Barkely acknowledged that the revenue from a cigarette tax increase will decline, but she noted that the decline is predictable at approximately three to five percent (3-5%) per year. She also testified that long-term health care savings start to grow as the revenues decline. At the conclusion of the meeting, the Commissioners asked Mr. Childress, one of the consultants to the Commission, to quantify the long-term health care savings if possible.

Jessica Carlson, Sr. Tax Analyst for Computer Services, Inc. ("CSI"), spoke to the Commission about taxation of the company. CSI rose to prominence performing core processing for banks and other companies. The business has its headquarters in Paducah. The company was founded by John Williams, Sr., who is a member of the Commission. Ms. Carlson said that CSI has approximately 30% of its workforce in Kentucky (300 employees) and has thousands of dollars of investment in property and equipment. However, based on the company's calculations, the company's 2011 corporation tax burden would have been 29% lower in Illinois and 87% lower in Ohio than it was in Kentucky. The company seeks equality between Kentucky and out-of-state taxpayers and specifically advocates single sales factor apportionment.[3]

A local attorney, Mary Potter, spoke about the hardship on individuals and small businesses when trying to comply with Kentucky's business laws. She noted that there are numerous agencies with which a small business may have to interact and this should be simplified. Also, she requested a simplified sales tax return (as opposed to the current return which includes three pages of exemptions) and a matrix that small businesses could use to pay taxes.

Ron Hughes, a local realtor for 18 years, asked the Commission to be sensitive to any additional taxes on real property. (Previous legislative proposals have included imposing sales tax on real property sales and leases.) He noted that homeowners currently pay property taxes, premium taxes and sales tax.

Richard Heath, a local businessman, suggested the Commission look at states that are leading economically, such as Tennessee, Texas and Oklahoma, and follow their lead. He described the impact of the recession on his business. He suggested that government be "right-sized", workers compensation expenses be reduced and that certainty be created in the marketplace.

Mr. Heath's sentiments were echoed by Randall O'Brien, former City Administrator, Grand Rivers, Kentucky. Mr. O'Brien said Kentucky's system of taxation needed to be more individual and business friendly. It's his perception that Tennessee is doing better than Kentucky. He suggested a gross receipts tax for individuals to simplify taxation.

Wayne Elliott spoke on behalf of the McCracken County Farm Bureau. The Farm Bureau asked that the current sales tax exemptions on agriculture businesses remain in place as well as the statutory requirement that there be no increase in property taxes in excess of 4% in the absence of voter approval.

Paducah Mayor Bill Paxton asked that the Commission consider local taxes and specifically, the ability of localities to impose additional taxes. He cited a restaurant tax as an example. Under current law, some cities may impose a restaurant tax and others may not.[4] This comment was repeated by Bob Hopman, a local restaurant owner. He suggested that the present restaurant tax of 3% available to some cities is too high and that a 1% tax across the state would be more appropriate.

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[3] CSI recently litigated a claim for refund of Kentucky sales tax. *See Computer Services, inc. v. Dept. of Revenue, Finance and Admin. Cabinet*, Ky. Ct. of App. No. 2009-CA-002012-MR (Jan. 7, 2011)(holding sale of prewritten computer software subject to sales tax under pre-2004 sales tax statutes).

[4] KRS 91A.400 authorizes cities of the fourth and fifth classes to levy a restaurant tax not to exceed 3% of the retail sales by all restaurants doing business in the city. The funds from this levy cannot be used for general city purposes but must be turned over to the local tourist and convention commission.

Elaine Spaulding spoke on behalf of the Paducah Chamber of Commerce. She commented on Paducah's healthy and vibrant river and health care industries. She asked that the Commission "do no harm" and improve competitiveness with other states. She also said that the chamber supports the Kentucky Chamber of Commerce's "leaky bucket" white paper, in which the Kentucky Chamber advocates addressing spending in certain areas. The Kentucky Chamber posits that without cost containment no amount of taxes will ever be enough. For more information see http://www.kychamber.com/Dockycc1/governmentaffairs/LeakyBucket/LeakyBucketWhitePaper.pdf.

Two of the final speakers were local CPA Dean Owen and businessman Bill Usher. Mr. Owen stated he prepares business and individual tax returns in over 9 states and sees all types of taxes. He claimed Kentucky is not competitive when compared to Tennessee, and that while he has wanted businesses to relocate to Kentucky, the "numbers just don't add up". He suggested that Kentucky's tax code be changed so that depreciation is calculated in the same way in Kentucky as it is for federal income tax purposes.

Mr. Usher spoke briefly about the Road Fund. He noted that receipts from fuel taxes are in decline as a result of two factors: (1) lower number of vehicles on the interstate, and (2) vehicles getting better gas mileage. As a result, a change needs to be made to preserve the integrity of the receipts for the Road Fund and to ensure equality of taxation among people using the interstate; for example, someone driving an electric car should pay the same taxes as someone driving a gas powered car. Representative Wayne asked Mr. Childress to look into this issue even though the Road Fund is not part of the Commission's charge.

Lt. Gov. Abramson asked Commission members if they had any other items they wanted the consultants to take under consideration. He then personally asked for additional information on the CAT in Ohio and on Illinois taxes. Commissioner Williams asked that the consultants look at apportionment at the state, county and city level. As stated previously, Commissioner Bailey asked, together with Dr. Schuster, for information on what constitutes adequacy in the areas of education, mental health, public health, etc. Dr. Schuster also reiterated the request for information on the potential decline in health care cost related to a decline in smoking among teens and pregnant women.

The next meeting of the Commission will be its second, which is scheduled for June 19, 2012 at 6:00 p.m. central time at the Greenwood High School Auditorium in Bowling Green, Kentucky.