Kentucky Chamber
Center for Policy & Research

A GUIDE TO HOUSE BILL 8

and Reducing Income Taxes for Kentucky Policymakers and Stakeholders

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In the 2022 legislative session, the General Assembly passed House Bill 8, which codified in state law a process to gradually and carefully phase out Kentucky's individual income tax (IIT). Passage of this legislation represents a watershed moment in the history of economic policy in the Commonwealth and positions Kentucky to join just nine other states that do not levy taxes on individual income. Phasing out Kentucky's IIT will keep more money in the pockets of working Kentuckians and will allow us to more aggressively compete with other states for jobs, workers, and economic opportunity.

But the success of House Bill 8 is not guaranteed. Instead, following through on this important legislation and phasing out the IIT will require persistence and commitment from lawmakers and all stakeholders involved. Decisions made in future legislative sessions could ultimately delay or even derail House Bill 8. It is critical that lawmakers fully understand how important this legislation is to Kentucky's economic future, how it works, and how they can help ensure its success.

Phasing out Kentucky's IIT will keep ***more money in the pockets of working Kentuckians***

This policy brief is intended to serve as a guide to House Bill 8 for policymakers and the general public alike and can be used to understand the ins-and-outs of this key state law.

Why is Reducing Individual Income Taxes Important?

Taxes are part of everyday life in modern economies and serve as the foundation for how governments fund important public services like education and public safety. But there are different types of taxes, and all of them affect economic growth and the decisions of individuals, families, and businesses in different ways.

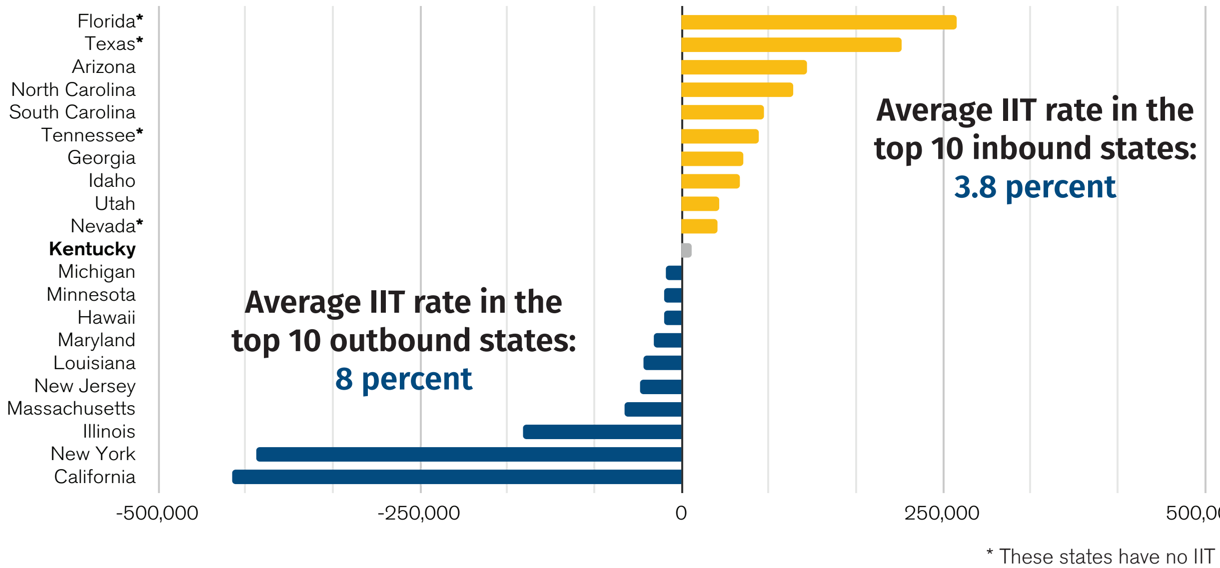
Researchers broadly consider taxes on individual income (what we earn from work or investments) to be more harmful to economic growth than other types of taxes such as taxes on sales or property. Individual income taxes are paid by everyday working Kentuckians and employers who structure their businesses as pass-through entities, including small business owners.

A growing body of academic research supports the argument that income taxes negatively affect economic growth, and more recent research has demonstrated that individual income taxes can affect the decisions of individuals and families on where to live, work, or start a business.

A quick look at Census Bureau data helps illustrate this latter point:

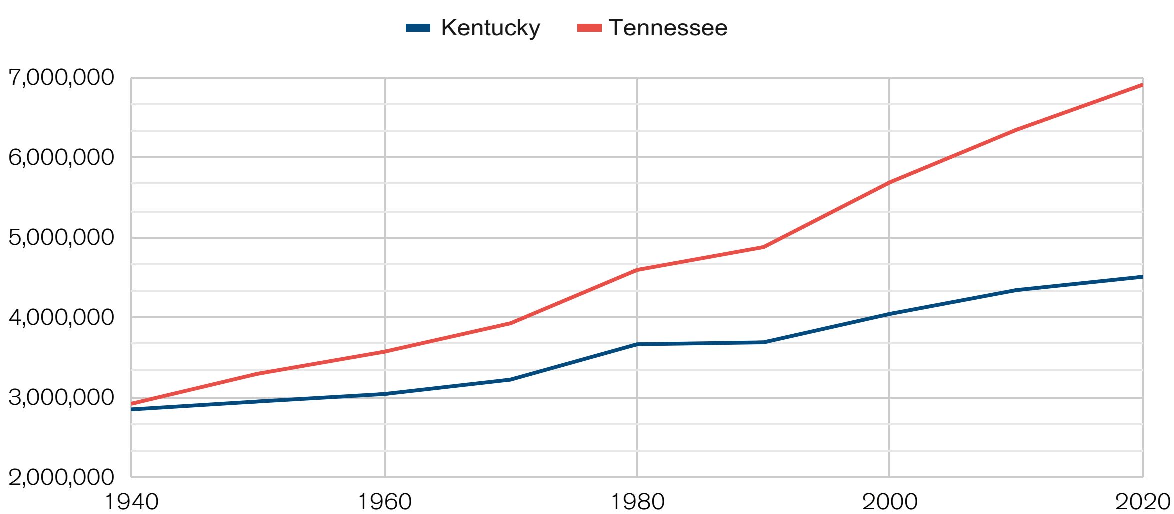
- The total population of no-income tax states grew twice as fast as the nation as a whole between 2010 and 2020.
- Between 1940 and 2020, Tennessee - our no-income tax neighbor to the South - saw its population grow more than 100 percent, while Kentucky's population increased 53 percent. Kentucky's modern income tax began in 1936.
- Between April 2020 and July 2021, the top ten states for inbound domestic migration (people moving from one state to another) had an average IIT rate of 3.8 percent and included four zero-income tax states. The top ten outbound states (states that lost net population to other states) had an average IIT rate of 8 percent and included some of the highest tax states like New York and California.

Net Domestic Migration, Cumulative April 1, 2020 to July 1, 2021
Top 10 Inbound and Top 10 Outbound States .vs Kentucky



Source: *U.S. Census Bureau*

Kentucky and Tennessee Population Growth, 1940-2020



Source: *U.S. Census Bureau*

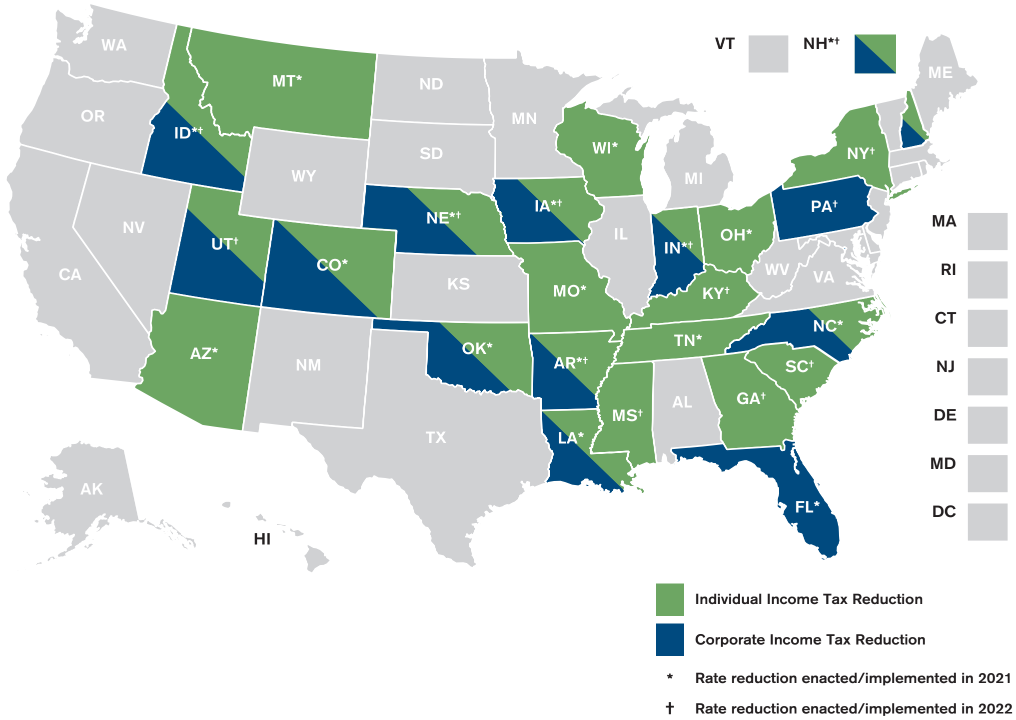
Increasing Kentucky's population – especially the number of high-skilled workers – is important to the state's economic future. The Commonwealth has seen stagnant population growth in recent years and has one of the top ten lowest workforce participation rates in the nation. *Phasing out the state's IIT will not solve these challenges alone*, but it is a key factor in supporting economic growth and making the state more attractive to workers and entrepreneurs.

*The Commonwealth has one of the **top ten lowest workforce participation rates in the nation.***

More and more states are recognizing the benefits of reducing taxes on income. In 2021 and 2022, roughly two-dozen states implemented or enacted IIT rate reductions. As more states reduce income taxes, this places added pressures on a state like Kentucky that is sandwiched between Indiana - one of the lowest income tax states in the nation - and Tennessee - a state with no income tax.

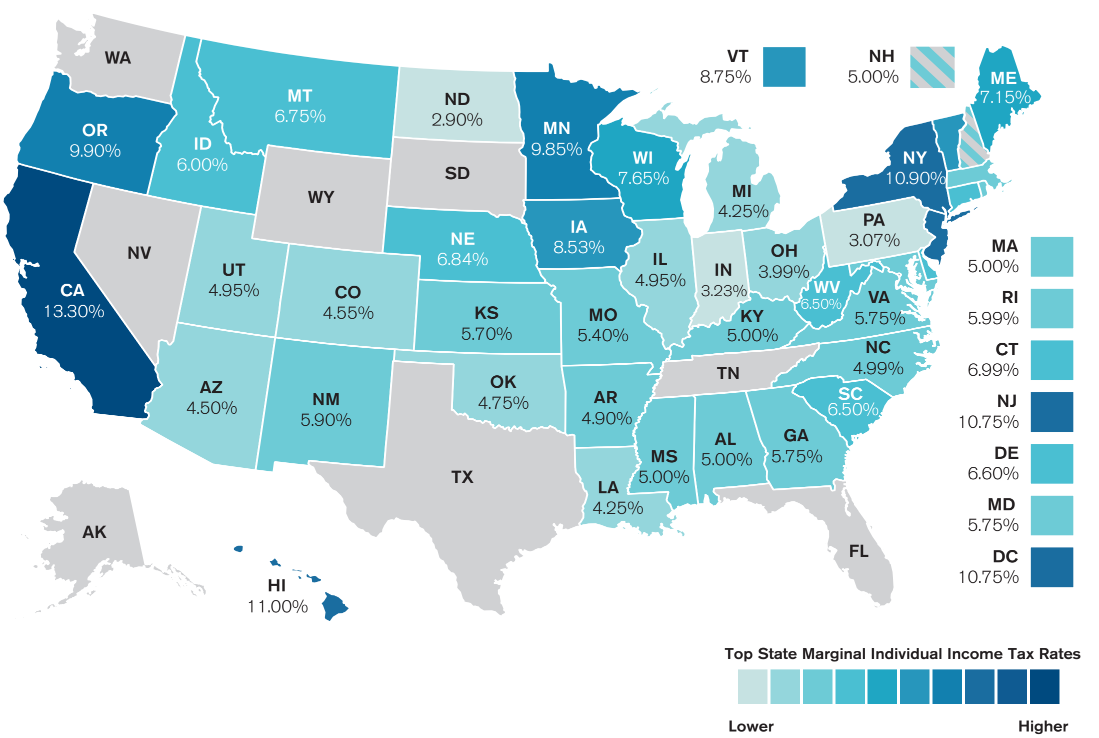
Income Tax Rate Reductions Enacted or Implemented in 2021 and 2022

As of July 13, 2022



Source: *Tax Foundation, https://taxfoundation.org/state-tax-reform-relief-enacted-2022/*

Top Individual Income Tax Rates, 2022



Source: *Tax Foundation, https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/*

At the end of the day, reducing individual income taxes will keep more money in the pockets of everyday, hardworking Kentuckians and small business owners. In turn, this will also put Kentucky on a firm trajectory for long-term, sustainable growth.

How Does House Bill 8 Work?

The IIT provisions of House Bill 8 now reside in KRS 141.020. To reduce the IIT rate, statute requires the state to meet certain “reduction conditions.” Specifically, in order for an IIT rate reduction to occur, the state must meet certain savings and revenue goals.

Other states like North Carolina have successfully used reduction conditions - also known as revenue triggers - to reduce or phase out certain types of taxes. It is a fiscally responsible method for Kentucky to shift away from income taxes. Some states have sought to move too fast in reducing income taxes and have paid economic consequences for doing so. House Bill 8 ensures that the state is both saving and bringing in enough revenues to continue making strategic investments in key services like education, public safety, and workforce development while at the same time prioritizing reducing income taxes.

Lawmakers should familiarize themselves with basic IIT reduction provisions in KRS 141.020.

The revenue conditions consist of two parts:

House Bill 8 “Reduction Conditions”	
Condition 1	The Budget Reserve Trust Fund must be equal to or greater than 10 percent of General Fund revenues* for the preceding fiscal year.
Condition 2	General Fund revenues* must exceed General Fund appropriations for the preceding fiscal year by an amount that is equivalent to a one percentage point reduction in the IIT rate for that year.

**General Fund revenues does not include tobacco dollars*

Every September, the law requires the Department of Revenue and Office of the State Budget Director to work together to determine if the reduction conditions have been met in the previous fiscal year and report their findings to the Interim Joint Committee on Appropriations and Revenue. If the reduction conditions have been met, then the General Assembly may act to reduce the IIT rate by 0.5 percentage points. It is important to note that the first analysis of reduction conditions took place in September 2022 and resulted in an automatic rate reduction in January 2023 from 5 percent to 4.5 percent. Under House Bill 8, all future rate reductions will require action by the General Assembly.

If reduction conditions are met consistently every year for the foreseeable future, Kentucky could phase out the IIT by 2032.

*If reduction conditions are met consistently every year for the foreseeable future, **Kentucky could phase out IIT by 2032***

What would happen if Kentucky met House Bill 8’s “Reduction Conditions” every year?				
2022	**2023**	**2024**	**2025**	**2026**
5 percent	4.5 percent	4.0 percent	3.5 percent	3.0 percent
2027	**2028**	**2029**	**2030**	**2031**
2.5 percent	2.0 percent	1.5 percent	1.0 percent	0.5 percent
2032				
Kentucky becomes the tenth state in the nation without an IIT.				

What Can You do to Ensure Kentucky Continues to Phase Out Individual Income Taxes?

1. Carefully consider the reduction conditions of House Bill 8 in decisions related to spending taxpayer resources. This means being extra sensitive to how much the General Assembly is saving and spending and how much tax revenue is coming in the door.

▪ **Savings:** Policymakers should closely watch the balance of the Budget Reserve Trust Fund. One of the reduction conditions requires its balance to be equal to or greater than 10 percent of General Fund revenues. For FY2022, this was $1.470 billion. The state surpassed this amount thanks to responsible decision-making and above-average revenue growth, but this may not always be the case. Policymakers will need to ensure the health of the state's savings account.

▪ **Spending and Receipts:** Policymakers should exercise fiscal responsibility and be strategic with appropriating taxpayer dollars. The second reduction condition in House Bill 8 requires state revenues to exceed appropriations by the equivalent of a one percentage point reduction to the IIT rate. For FY2022, this meant that revenues needed to hit $14.328 billion ($13.119 billion in appropriations + an IIT reduction equivalent of $1.209 billion). As with the Budget Reserve Trust Fund, the state surpassed the target for the fiscal year due to responsible spending and strong revenue growth, but hitting future targets will require fiscal discipline and prioritizing strategic investments.

2. Follow through on approving IIT rate reductions when conditions are met.

▪ While the initial rate reduction from 5.0 percent to 4.5 percent in January 2023 took place automatically based on the analysis required from the Department of Revenue and Office of State Budget Director, future reductions will require legislative action by the General Assembly. When the reduction conditions have been met, lawmakers should prioritize following through on House Bill 8 and voting in favor of IIT rate reductions.

3. Remain committed to phasing out the IIT for the long-haul.

▪ The reduction conditions in House Bill 8 set a high bar that may prove difficult to meet depending on economic conditions and other circumstances outside the control of Kentucky policymakers. Such instances may result in some years not allowing for a rate reduction. While far from ideal, this is part of the design of House Bill 8 and underscores the bill's careful approach to reducing Kentucky's IIT while ensuring fiscal stability and investments in key services. Following through on phasing out the IIT will require a long-term commitment from policymakers that may very well extend beyond the timeframe outlined earlier in this policy brief.

4. Advocate for improvements to House Bill 8 where possible.

▪ House Bill 8, for the first time in state history, codified into statute a plan to reduce Kentucky's IIT. As with any new policy, however, there are always ways to make it better.

▪ One improvement policymakers should consider is to create more transparency around the reduction conditions. In particular, policymakers should make sure that Kentucky taxpayers can look up the balance of the Budget Reserve Trust Fund just as easily as they can look up the balance of their personal savings account.

▪ Another improvement would be to create more flexibility within the amount of the annual IIT rate reduction of 0.5 percentage points. In instances where the state significantly surpasses reduction conditions, state law could trigger larger reductions in proportion to the amount of excess taxpayer dollars that are available. For example, if state revenues in a fiscal year exceeded appropriations by an IIT reduction equivalent of 1.25 percentage points instead of just 1 percentage point, this might trigger a 0.75 IIT rate reduction instead of 0.5.

▪ A third improvement would be to make all future rate reductions automatic instead of requiring action by the General Assembly. This would create more certainty for Kentucky taxpayers and prospective taxpayers and avoid any possibility of an IIT rate reduction not occurring despite reduction conditions being met.

Conclusion

Phasing out Kentucky's individual income tax puts the Commonwealth on a stronger path for long-term, sustainable growth and positions us to more aggressively compete with other states for jobs, workers, and economic opportunity. Passage of House Bill 8 in 2022 marked the start of this process, but its success will ultimately depend on the commitment and dedication of lawmakers who serve in the General Assembly over the next decade and beyond. Current and future Kentucky policymakers should become deeply familiar with the ins-and-outs of this legislation and work diligently to ensure its success.