

Kentucky Chamber

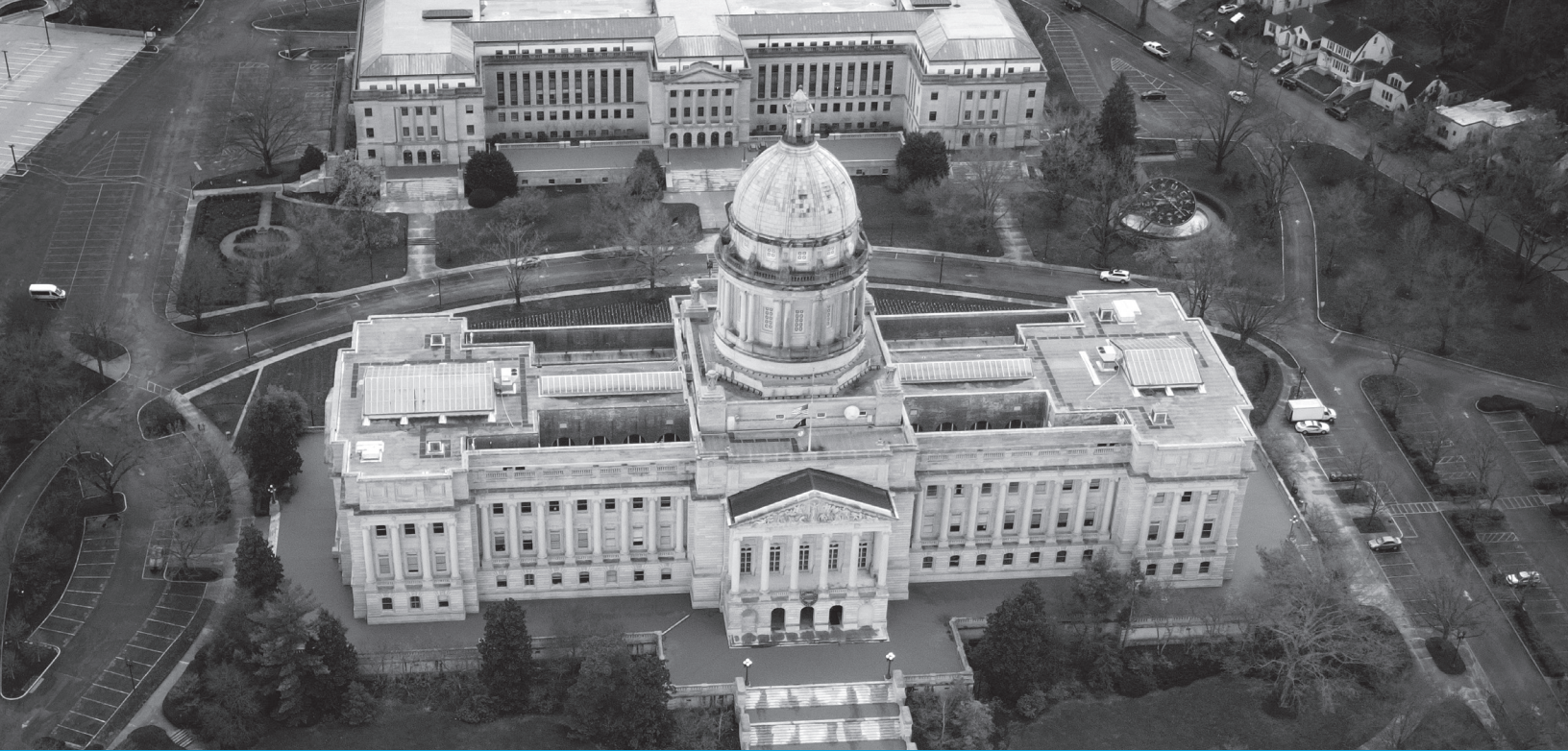
Uniting Business. Advancing Kentucky.

WHY TAX REFORM: KENTUCKY'S OPPORTUNITY FOR GROWTH



KENTUCKY CANNOT AFFORD TO STAND STILL.

NOW IS THE TIME FOR KENTUCKY TO BUILD A GLOBALLY-COMPETITIVE TAX CODE TO ATTRACT NEW RESIDENTS AND SUPPORT WORKING FAMILIES, KEEP OUR KIDS FROM MOVING TO OTHER STATES AFTER GRADUATION, INCREASE OUR SKILLED WORKFORCE, AND ATTRACT AND RETAIN BUSINESSES, INVESTMENTS, AND OPPORTUNITY FOR ALL.



IT'S TIME TO COMPETE

Debating tax reform is almost as quintessentially Kentucky as rolling hills, basketball, horses, or bourbon. Studies have been conducted. Proposals have been put forth. Legislation has even been passed and enacted. Yet the economic competitiveness of the tax codes in neighboring states and elsewhere throughout the nation have continued to outpace Kentucky's.

This is not to say that lawmakers have not made important progress in recent years. Far from it. In 2018 and 2019, the Kentucky General Assembly enacted a series of important pro-growth reforms to the Commonwealth's tax code.

SOME OF THE KEY PROVISIONS OF THE 2018 & 2019 REFORMS:



Eliminating income tax brackets and reducing Kentucky's individual and corporate income tax rates from 6 percent to 5 percent.



Adjusting how the state determines taxable income for businesses.

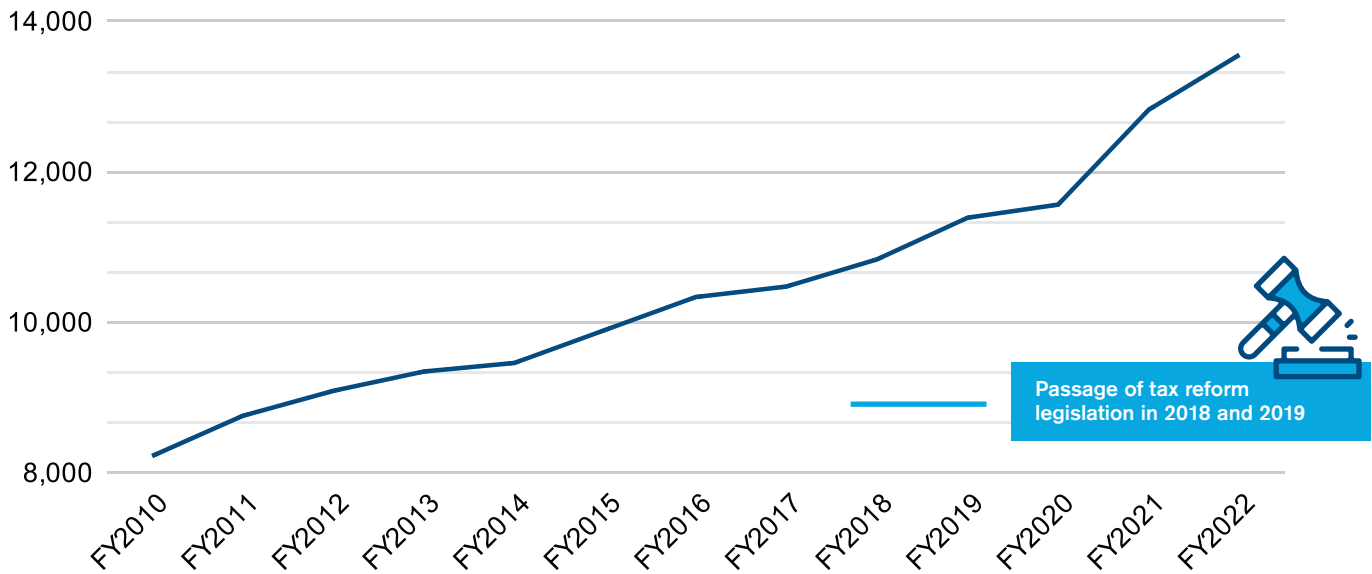


Creating a credit for businesses to offset economically-harmful taxes on inventories.



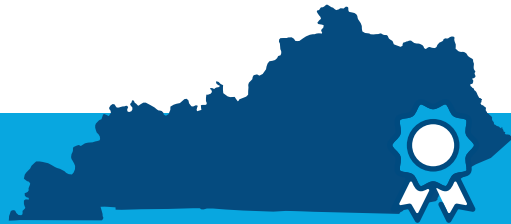
Initial steps to modernize Kentucky's sales tax base.

Kentucky General Fund Revenues, Fiscal Year 2010-2022 (in millions of dollars)



Source: Office of State Budget Director, KY Chamber Staff Analysis

The benefits of these reforms have already begun to materialize. Businesses have announced record-breaking investments in the Commonwealth, while rising state revenues have allowed the General Assembly to increase investments in services such as education, health care, public pensions, and economic development. These reforms even attracted national recognition. In the Tax Foundation's Business Tax Climate rankings, Kentucky's rank moved from 37th in the nation to 18th today.¹



KENTUCKY'S RANKING IN TAX FOUNDATION BUSINESS TAX CLIMATE INDEX

2018

37TH

2019

20TH

2020

19TH

**2021
& 2022**

18TH

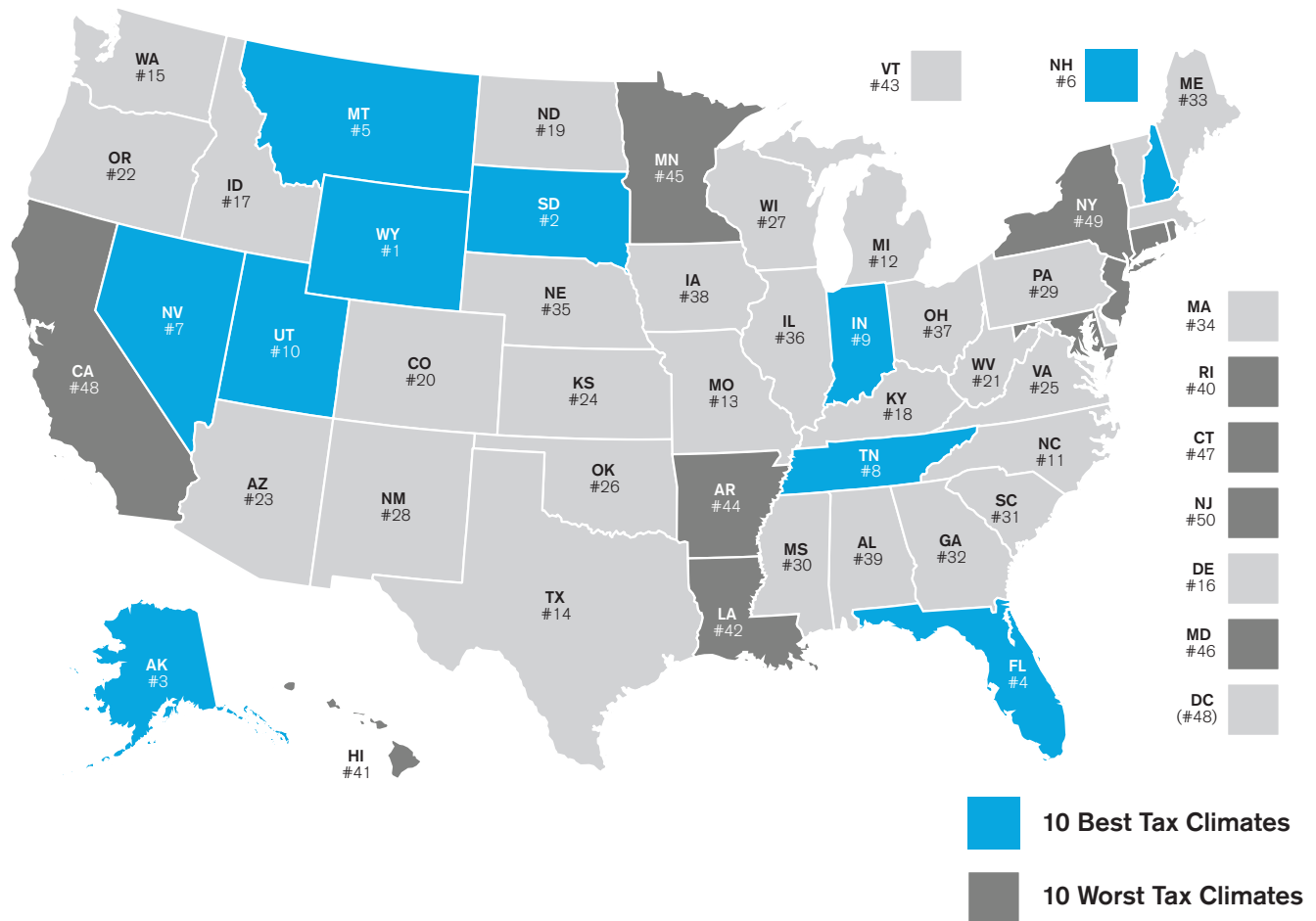
¹ Tax Foundation, "2022 State Business Tax Climate Index," December 16, 2021: <https://files.taxfoundation.org/20211215173528/2022-State-Business-Tax-Climate-Index.pdf>

The success of the 2018 and 2019 measures illustrates the positive impact of tax reform and underscores the urgency of taking further – and bolder – steps to truly reform Kentucky’s tax code and position the Commonwealth as a top-tier state for economic growth. More than that, tax reform should always be a process grounded in the principles of constant improvement and adaptation. Economies change. Consumer habits evolve. Business strategies shift. Two years ago, for example, remote work was mostly a novelty; as of September 2021, survey data showed almost 50 percent of full-time employees worked exclusively or partially from home.² It’s the job of policymakers to make sure that state tax policy is not only competitive for growth but also responsive to the realities and demands of a modern economy.

Economic data and research tell us that to compete in a rapidly-changing 21st century economy and to set the Commonwealth on a path for long-term sustainable growth and prosperity the work of tax reform must continue. Other states know this and are positioning themselves for reform and growth. Indiana and Tennessee, for example, have aggressively positioned their tax codes to be among the top 10 most competitive in the nation. As this report demonstrates, states like these with highly competitive tax codes have seen strong economic and population growth, which lead to greater opportunities and prosperity.

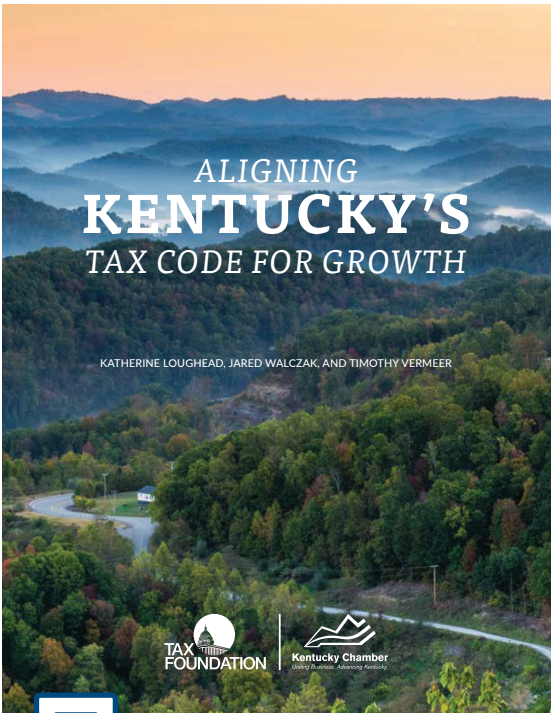
Kentucky cannot afford to stand still. Now is the time for Kentucky to build a globally-competitive tax code to attract new residents and support working families, keep our kids from moving to other states after graduation, increase our skilled workforce, and attract and retain businesses, investments, and opportunity for all.

2022 Tax Foundation Business Tax Climate Rankings



Source: Tax Foundation

² Gallup, "Remote Work Persisting and Trending Permanent," October 13, 2021: <https://news.gallup.com/poll/355907/remote-work-persisting-trending-permanent.aspx>



To help drive the conversation of tax reform in Kentucky, the Kentucky Chamber announced a new partnership in the summer of 2021 with the Tax Foundation, a nonprofit think tank specializing in tax policy at the state and federal levels. The Tax Foundation was instrumental in major tax reform legislation such as the Tax Cuts and Jobs Act signed by President Trump in 2017 and has worked successfully in states such as North Carolina, Louisiana, and Wisconsin to guide those states and provide decision-makers with reliable data and context to enact pro-growth tax reform decisions that work for their economies and residents.

A key part of this new partnership, the Tax Foundation conducted an independent analysis of the strengths and weaknesses of Kentucky's tax code and provided a menu of potential reform options for policymakers to review and consider. The Tax Foundation published their independent analysis in a critical report titled "Aligning Kentucky's Tax Code for Growth," released in November 2021. Since the report's release, the Kentucky Chamber has closely studied it, discussing reform options with business leaders from all corners of the Commonwealth and building consensus on which reform options make the most sense for Kentucky and need to be prioritized.

 Join the Conversation. Read this full Report at kychamber.com/reports



AT A TIME OF RAPID EXODUS FROM HIGH-TAX, HIGH COST-OF-LIVING STATES, KENTUCKY HAS A UNIQUE OPPORTUNITY TO BUILD A NAME FOR ITSELF AS A HIGHLY SOUGHT-AFTER DESTINATION TO LIVE AND WORK, AND **STRUCTURAL TAX MODERNIZATION WILL PLAY A CRITICAL ROLE IN ANY SUCH EFFORT.**

— The Tax Foundation's Report on Kentucky



KEY CHAMBER PRIORITIES FOR KENTUCKY TAX REFORM

Tax reform is complex, multi-faceted, and evolves over time based on economic and societal trends. While Kentucky policymakers will inevitably need to address multiple issues with any tax reform package, there are several key reforms and guiding principles that should be prioritized to truly position the Commonwealth for long-term, sustainable growth.

SOME OF THE CHAMBER'S TOP TAX REFORM PRIORITIES INCLUDE:



Reduce and Phase-out Kentucky's Individual Income Tax to Support Population Growth and Economic Growth



Repeal the Limited Liability Entity Tax to Improve Kentucky's Business Competitiveness



Improve Tax Treatment of Business Investments in Kentucky to Create More Jobs



Fix Discriminatory Taxes on Business Inventories

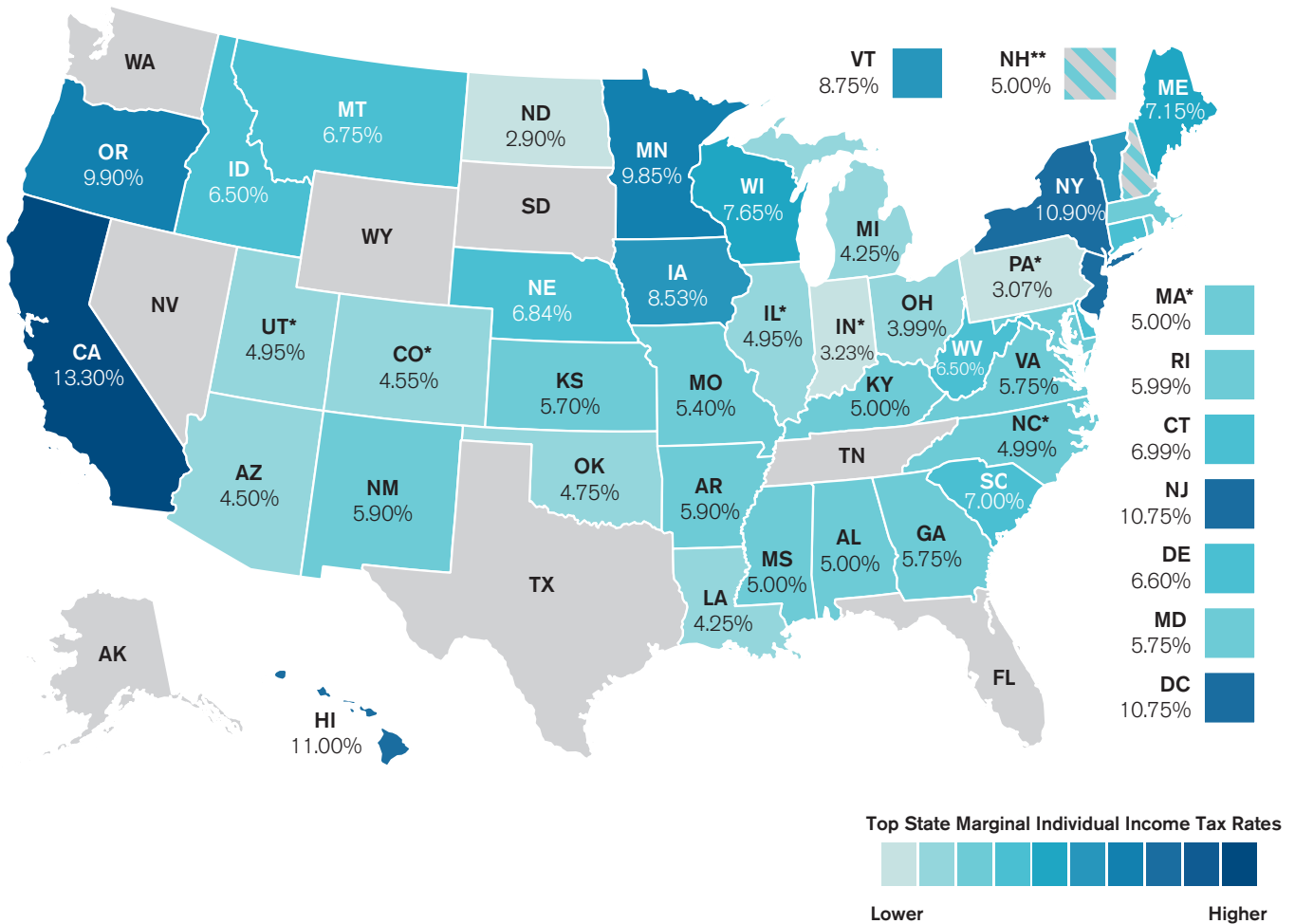


REDUCE AND PHASE-OUT KENTUCKY'S INDIVIDUAL INCOME TAX TO SUPPORT POPULATION GROWTH AND ECONOMIC GROWTH

Kentucky levies a 5 percent tax on individual income. This tax is paid not only by individuals but by many businesses as well. For a household making \$50,589 in a year – Kentucky's median household income – this amounts to \$2,260. With the exception of Tennessee - which has never had an individual income tax - every state that surrounds Kentucky levies an individual income tax. Their rates, however, vary considerably. Indiana and Ohio, for instance, both have rates that are lower than Kentucky - at 3.23 percent and 3.99 percent, respectively.³

³ Top marginal rates effective as of January 2022

Top Individual Income Tax Rates, 2022



Source: Tax Foundation

Individual income taxes make up the largest share of Kentucky's General Fund revenues, accounting for roughly 40 percent in FY2021. The General Fund is what the state uses to pay for services such as education, economic development, public safety, pensions, health care, and more. In its report, the Tax Foundation referred to this tax as Kentucky's "most heavily-relied-upon tax," noting, in fact, that Kentucky relies on individual income taxes for revenue far more than the national average.⁴

KENTUCKY'S TAX ON INDIVIDUAL INCOME

5%

⁴ Tax Foundation, "Aligning Kentucky's Tax Code for Growth," November 30, 2021, p. 23: <https://files.taxfoundation.org/20211124113340/Aligning-Kentucky-Tax-Code-for-Growth.pdf>

Kentucky General Fund, Fiscal Year 2021

Individual Income: \$5.1 Billion

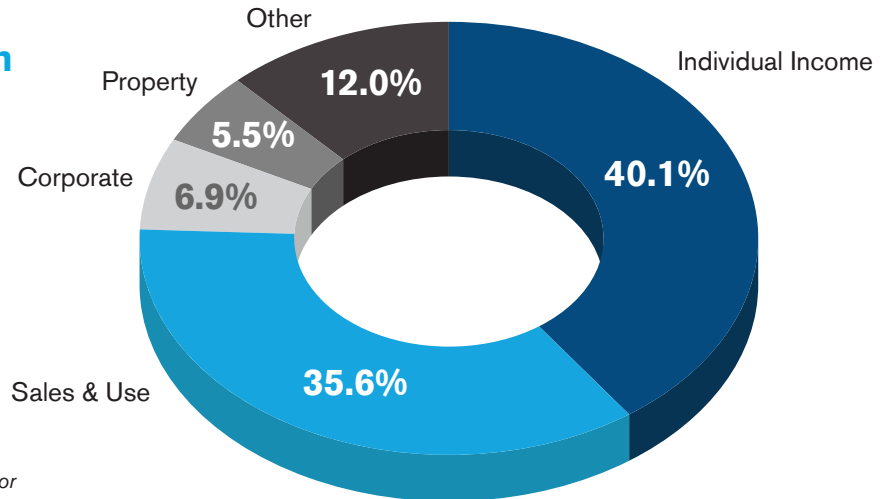
Sales & Use: \$4.5 Billion

Corporate: \$882 Million

Property: \$702 Million

Other: \$1.5 Billion

Total: \$12.8 Billion



Source: Office of State Budget Director

THE ECONOMIC BENEFITS OF REDUCING INCOME TAXES

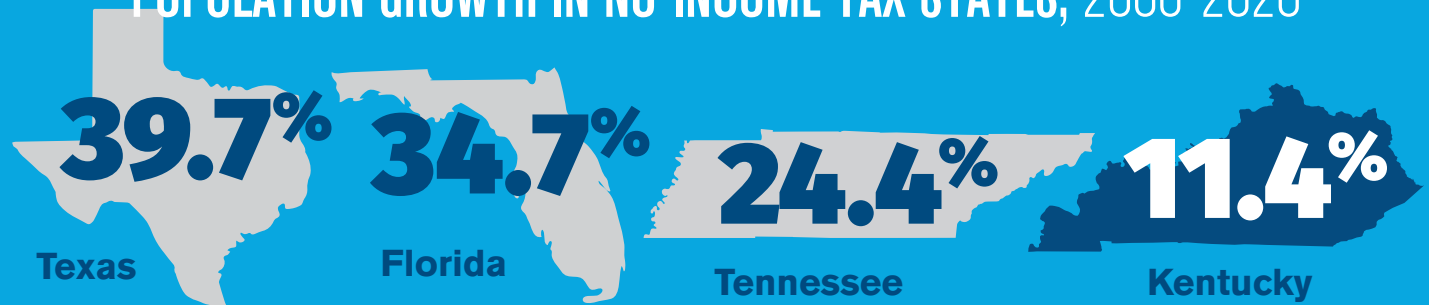
In its analysis of Kentucky, the Tax Foundation noted how income taxes are not only more economically harmful than consumption-based taxes but also serve as less stable sources of state revenues. Not surprisingly, when you look at economic metrics like population growth, GDP growth, workforce participation, and personal income growth, states with no- or low-income taxes generally perform better than states with higher income taxes.



POPULATION GROWTH⁵

- Between 2010 and 2020, states without individual income taxes had an average growth rate of 9.7 percent, outpacing the nation (7.4 percent) and Kentucky (3.8 percent).
- The combined population of no-income tax states grew at twice the national rate in the 2020 Census.
- The population of Tennessee, a no-income tax state, grew more than twice as fast as Kentucky's population over the past two decades.
- Growth in no-income tax states continued in 2021, and migration from high-income tax states to low-or no-income tax states is expected to continue with the rise of remote work.

POPULATION GROWTH IN NO-INCOME TAX STATES, 2000-2020



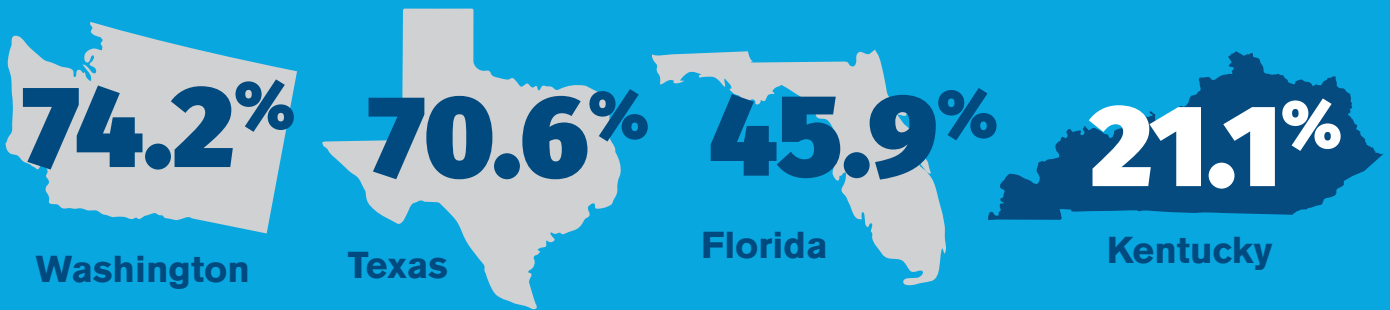
⁵ Based on Tax Foundation, "Aligning Kentucky's Tax Code for Growth," Tax Foundation, "Americans Moved to Low-Tax States in 2021, January 4, 2022, and Chamber staff analysis of Tax Foundation and Census Bureau data



ECONOMIC GROWTH⁶

- The economies of no-income tax states grew 56 percent faster than states with income taxes between 2010 and 2020.
- Tennessee's economy grew 60 percent faster than Kentucky's over the past two decades.
- Between 2000 and 2020, no-income tax states saw their economies grow 45.8 percent, on average, vs. 32 percent for states with income taxes.

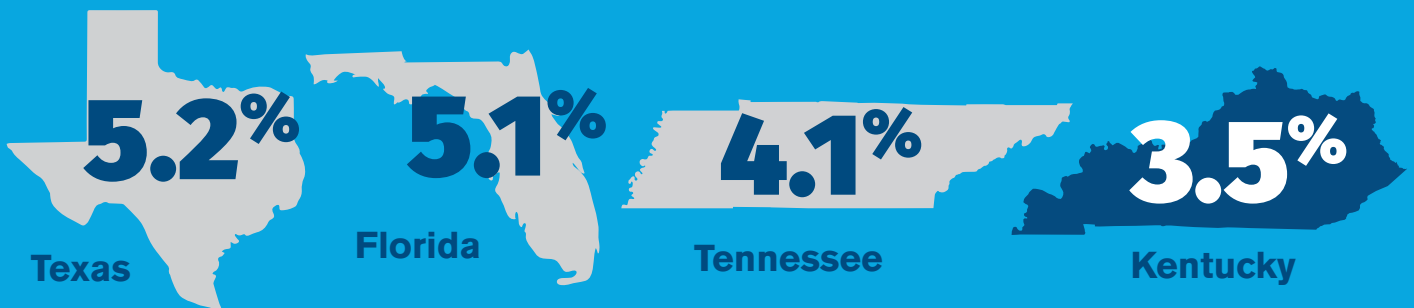
ECONOMIC GROWTH IN NO-INCOME TAX STATES, 2000 - 2020



PERSONAL INCOME⁷

- Personal incomes in Kentucky have grown 8 percent slower than personal incomes in Tennessee and 21 percent slower than personal incomes in Texas since 2000.
- If Kentucky's personal income had grown at the same rates as Texas since 2001, it would be \$55 billion per year higher than it is today and \$19 billion higher under Tennessee's rates of growth.
- Between 2010 and 2020, the average growth of personal incomes in no-income tax states was 4.45 percent vs. 3.9 percent for states with income taxes.

PERSONAL INCOME GROWTH, 2010-2020



⁶ Based on Tax Foundation, "Aligning Kentucky's Tax Code for Growth," and Chamber staff analysis of Tax Foundation and BEA data

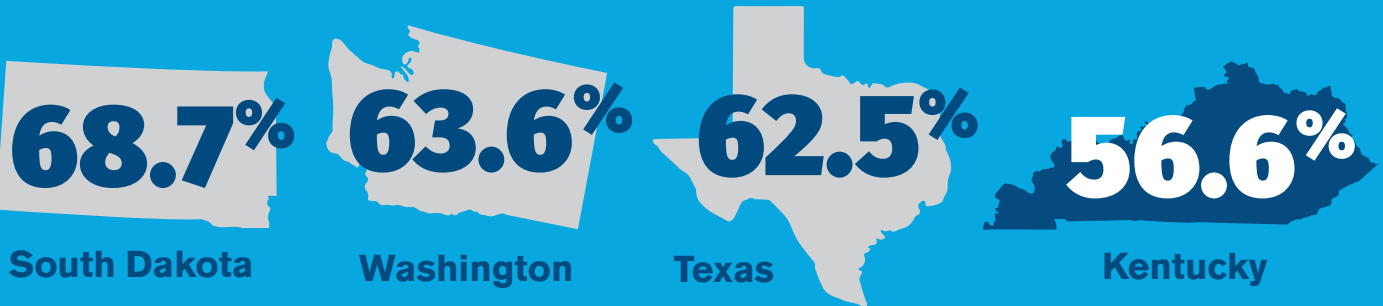
⁷ Based on Tax Foundation, "Aligning Kentucky's Tax Code for Growth," and Chamber staff analysis of Tax Foundation and BEA data; per capita, personal income, compound annual growth between 2010 Q1 and 2019 Q4



WORKFORCE PARTICIPATION⁸

- Kentucky has the third lowest workforce participation rate in the nation at 56.6 percent of adults.
- States with no-income taxes have an average workforce participation rate of 63.2 percent vs. 61.9 percent for states with income taxes.
- As President Ronald Reagan once said, "If you want less of something, tax it!"

WORKFORCE PARTICIPATION RATES FOR NO-INCOME TAX STATES, 2021



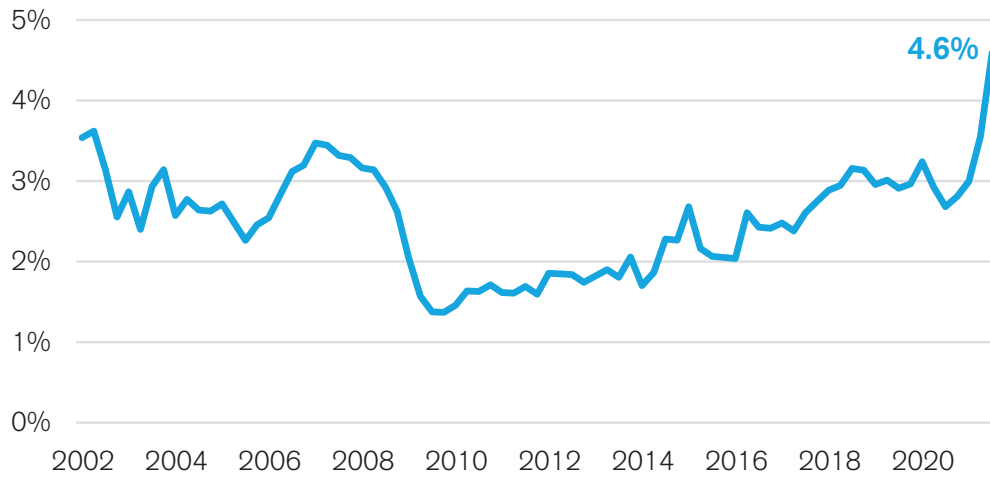
Current economic conditions further stress the importance of reducing income taxes in Kentucky. With inflation continuing to rise and hitting the pocketbooks of Kentuckians harder and harder, lower income taxes means more hard-earned dollars in working Kentuckians' bank accounts. While some might attempt to argue that reducing income tax rates is regressive and would only benefit high-income earners, an across-the-board rate cut would, in fact, give all working Kentuckians a well-deserved raise. In addition, because many small businesses pay individual income taxes as passthroughs, lower income taxes can allow these employers to meet the demands of higher wages and more competitive benefit packages. Through tax reform, lawmakers can directly help taxpayers cope with rising prices on everyday goods and support small businesses in competing for workers.



WITH INFLATION CONTINUING TO RISE AND HITTING THE POCKETBOOKS OF KENTUCKIANS HARDER AND HARDER, LOWER INCOME TAXES MEANS **MORE HARD-EARNED DOLLARS IN WORKING KENTUCKIANS' BANK ACCOUNTS.**

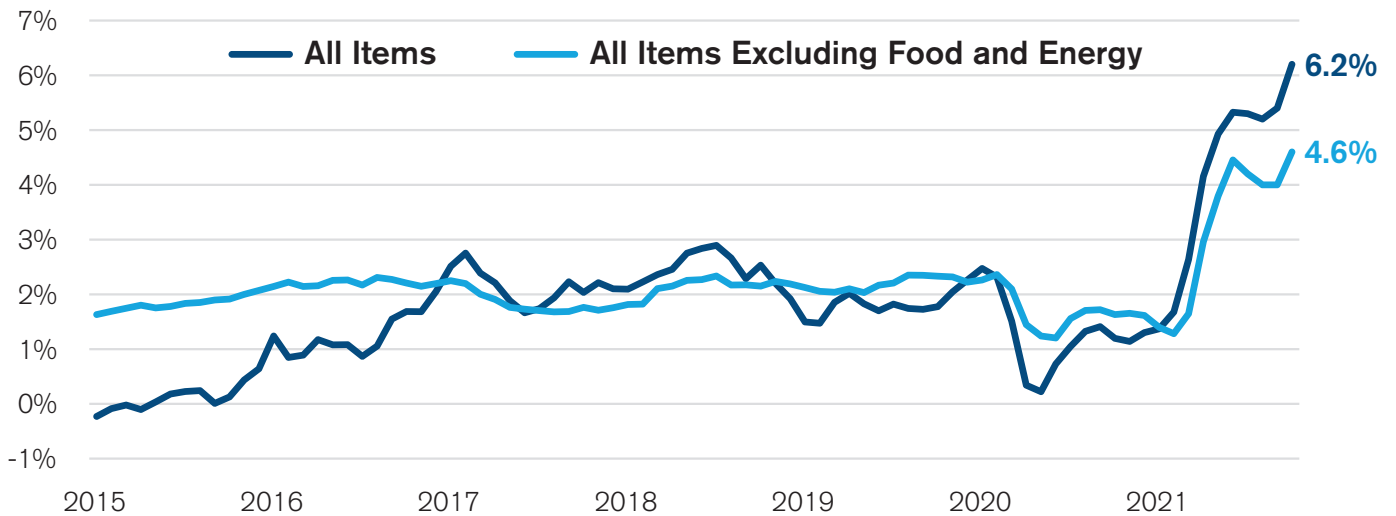
⁸ KY Chamber staff analysis of Tax Foundation and Bureau of Labor Statistics data

US Employment Cost Index, Wages & Salaries, All Private Industry Workers, 12-month Percent Change



Source: Kentucky Chamber's Quarterly Economic Update Report: Q4 2021

Consumer Price Index, 12-month Percent Change

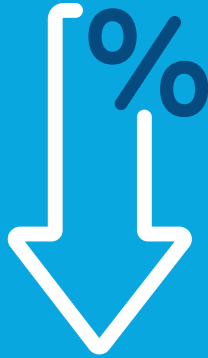


Source: Kentucky Chamber's Quarterly Economic Update Report: Q4 2021

OTHER STATES ARE ALREADY IMPLEMENTING REFORMS

States throughout the nation have taken notice of the economic and fiscal benefits of reducing their reliance on income taxes. According to the Tax Foundation, “In 2021 alone, 12 states enacted laws reducing income tax rates, with more expected in 2022.”⁹ Several states took steps to reduce both individual and corporate income taxes.

EXAMPLES OF INCOME TAX REDUCTIONS IN OTHER STATES IN 2021



North Carolina: 5.25% to 4.99%

Ohio: 4.79% to 3.99%

Missouri: 5.4% to 4.8%

Oklahoma: 5% to 4.75%

Wisconsin: 6.27% to 5.3%

Louisiana: 6% to 4.75%

RECENT HEADLINES FROM STATES CUTTING INCOME TAXES IN 2021

“North Carolina OKs massive tax cut package,” WRAL.com

“Wisconsin Assembly approves budget with \$3.4 billion in tax cuts,” Madison.com

“Louisiana’s tax reform breakthrough,” The Wall Street Journal

“Ohio doles out \$1.6 billion income tax cut in budget,” Bloomberg Tax

“Tax cuts put Oklahoma on a better path,” Oklahoma City Sentinel

Taking concrete steps to reduce taxes on individual income is an opportunity to keep more hard-earned wages in the pocketbooks of working Kentuckians, support small businesses, and more aggressively compete with other states for jobs and workers. As noted by the Tax Foundation, “Low- and no-income tax states across the country are experiencing robust growth and rapid in-migration, enhanced by increased workplace flexibility that is allowing more people to live in one state while working for an employer located in another. For Kentucky to keep up with its peers and gain a competitive edge, a highly competitive individual income tax will be essential.”¹⁰

⁹ Tax Foundation, “Aligning Kentucky’s Tax Code for Growth,” November 30, 2021, p. 33: <https://files.taxfoundation.org/20211124113340/Aligning-Kentucky-Tax-Code-for-Growth.pdf>



REPEAL THE LIMITED LIABILITY ENTITY TAX TO IMPROVE KENTUCKY'S BUSINESS COMPETITIVENESS

The Limited Liability Entity Tax, or LLET, is an archaic tax on businesses that makes Kentucky an outlier, adds layers of unnecessary complexity, and harms business competitiveness. The LLET applies to a wide range of different businesses, including small businesses, and is a tax on a businesses' gross receipts - total revenues without accounting for costs or expenses. While once a relatively common tax, gross receipts taxes like the LLET have fallen off the rolls in most states, with the exception of a small group of states such as Kentucky. The Tax Foundation highlighted the LLET as one of Kentucky's most problematic taxes, writing:

The LLET is an inefficient revenue source and is time consuming to comply with; it is subject to unpredictable revenue changes, and it contributes to structural inequities in the tax code. Additionally, the tax is disproportionately costly to small businesses and dissuades entrepreneurship. ...the LLET is likely one of the most distortive and economically prohibitive taxes on the books in Kentucky... Policymakers should prioritize repeal of the LLET.

As noted by the Tax Foundation, while the LLET is economically harmful and difficult for businesses to comply with, it is estimated to produce little in General Fund revenues - roughly \$80 to \$90 million per year. Repeal of the LLET alone would move Kentucky's ranking on the Tax Foundation's Business Tax Climate Index to 16th in the nation.¹¹

10 Tax Foundation, "Aligning Kentucky's Tax Code for Growth," November 30, 2021, pp. 11-12: <https://files.taxfoundation.org/20211124113340/Aligning-Kentuckys-Tax-Code-for-Growth.pdf>

11 Tax Foundation, "Aligning Kentucky's Tax Code for Growth," November 30, 2021, p. 21: <https://files.taxfoundation.org/20211124113340/Aligning-Kentuckys-Tax-Code-for-Growth.pdf>



IMPROVE TAX TREATMENT OF BUSINESS INVESTMENTS IN KENTUCKY TO CREATE MORE JOBS

Investment in Kentucky is something we all applaud and want more of. While Kentucky has seen record levels of investment in recent years, there are improvements to how our tax code treats capital investments that could make Kentucky far more attractive to businesses, put us on a more level playing field when it comes to competing for high-paying jobs, and support critical industries like manufacturing and agriculture.

Businesses pay taxes on net income and profits - or revenues minus costs and expenses. Not all expenses, however, are treated the same. When businesses invest in major machinery, equipment, and other capital assets - for example, farming equipment or manufacturing machinery - Kentucky tax policy treats these investments differently by requiring business owners to deduct these investments over time instead of in the year in which the investment was made. This practice has the effect of increasing the overall cost of capital investments, disfavoring industries and firms that are capital investment-heavy, and making investments more expensive - or even cost-prohibitive - for businesses.



MOST OTHER STATES TREAT CAPITAL INVESTMENTS BY BUSINESSES **MORE FAVORABLY** THAN KENTUCKY DOES.

Most other states treat capital investments by businesses more favorably than Kentucky does. Nearly 40 states, for example, mirror federal provisions established by the Tax Cuts and Jobs Act (TCJA) that allow businesses to deduct up to \$1 million in qualified investments in the year in which the expense was incurred. The federal provisions in TCJA are designed primarily to support small and mid-sized businesses. Kentucky, unfortunately, only allows for \$100,000 to be deducted instead of the federal standard of \$1 million. Similarly, 18 states mirror federal rules allowing C corporations to fully deduct qualified investments in short-lived assets like machinery and equipment. Two states mirror this treatment on a more limited basis. Kentucky, however, provides no relief for these types of investments.

NEIGHBORING STATES TREATMENT OF CAPITAL INVESTMENTS FOR SMALL AND MID-SIZED BUSINESSES

Kentucky: Less than TCJA

Indiana: Less than TCJA

Tennessee: Same as TCJA

Ohio: Same as TCJA

Missouri: Same as TCJA

Illinois: Same as TCJA

Virginia: Same as TCJA

West Virginia: Same as TCJA



Source: Tax Foundation

The Tax Foundation stresses that improving Kentucky's treatment of business investments through adopting best practices in other states and aligning our tax code with federal rules could significantly enhance the Commonwealth's attractiveness for investment and job growth.¹²

¹² Tax Foundation, "Aligning Kentucky's Tax Code for Growth," November 30, 2021, pp. 8-11: <https://files.taxfoundation.org/20211124113340/Aligning-Kentucky-Tax-Code-for-Growth.pdf>



FIX DISCRIMINATORY TAXES ON BUSINESS INVENTORIES

It is common for states to levy taxes on businesses' tangible personal property – for example, desks and computers – but Kentucky is one of only 12 states (and only one of three in our region) that tax business inventories. The Tax Foundation views this aspect of Kentucky's tax code as highly concerning, writing:¹³

Taxes on inventory are non-neutral, as businesses with larger quantities of inventory, like manufacturers and retailers, are disproportionately burdened by such taxes. Businesses with little to no inventory escape this form of property taxation even if they use the same amount of government services as businesses with larger inventory tax bills.

In addition to being non-neutral, inventory taxes are highly distortionary, forcing companies to make decisions about production or stocking that are not entirely based on economic principles but rather on how to pay the least amount of tax on goods produced or held for sale. Inventory taxes also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes.

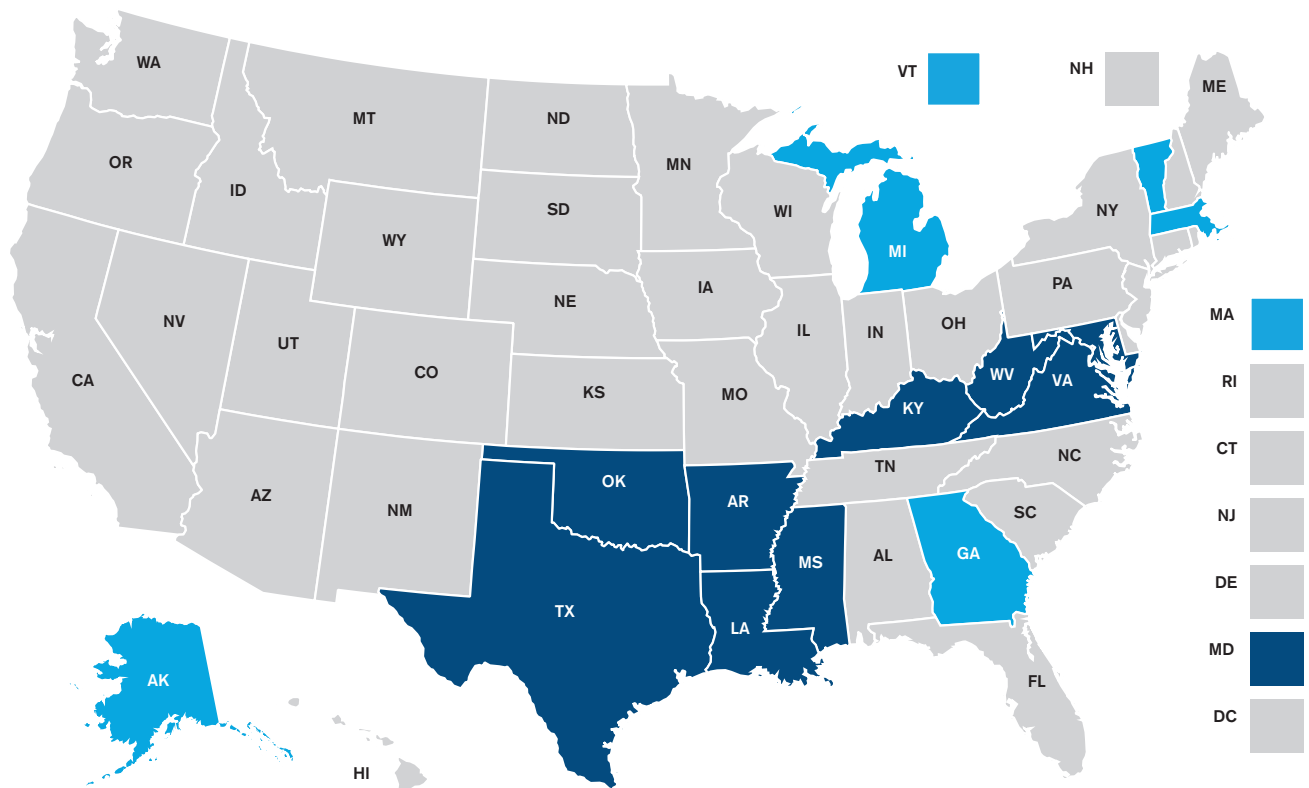
In many local communities throughout Kentucky, inventory taxes serve as an important source of revenue for funding schools. To prevent financial harm to local school districts while still seeking to mitigate the economic damage caused by inventory taxes, the General Assembly passed legislation in 2018 allowing businesses to claim an income credit for taxes paid on inventories. Because the credit is nonrefundable - meaning it is limited by a businesses' income tax liability in a given year - the credit has proven ineffective at offsetting inventory taxes. Few businesses have even been able to utilize it.

¹³ Tax Foundation, "Aligning Kentucky's Tax Code for Growth," November 30, 2021, p. 52: <https://files.taxfoundation.org/20211124113340/Aligning-Kentucky-Tax-Code-for-Growth.pdf>



KENTUCKY IS ONE OF ONLY 12 STATES (AND ONLY ONE OF THREE IN OUR REGION) THAT TAX BUSINESS INVENTORIES.

State Taxation of Business Inventory, 2021



Lawmakers could significantly improve the effectiveness of this credit - and largely nullify the negative economic impact of inventory taxes - by making it refundable. This would allow businesses to recoup the cost of paying inventory taxes while still holding local school districts harmless.

Source: Tax Foundation



HOW TO GET FROM HERE TO THERE?

HOW DO WE REFORM KENTUCKY'S TAX CODE FOR STRONG AND SUSTAINABLE GROWTH?

While the case for tax reform is simple, the process is not. Transitioning Kentucky's tax code from where it is today to where it needs to be for the Commonwealth to compete for jobs and workers in a 21st century will be a difficult task. All stakeholders involved will need to keep the broader goal of long-term, sustainable growth for all of Kentucky front-of-mind.

The process of tax reform should adhere to the following principles:

- Reforms should be implemented carefully and, when necessary, incrementally. As reforms are made, lawmakers will need to adjust other taxes - such as sales taxes - to ensure state revenues remain stable, consistent, and continue to grow. Moreover, as recommended by the Tax Foundation, policymakers should seriously consider sustained reforms through revenue triggers and tying reforms to future revenue growth. Several other states, such as North Carolina and Missouri, have used revenue triggers successfully to drive down income taxes.
- It is critical that tax reform works for all Kentuckians. While reducing income taxes will positively affect Kentucky's whole economy and workforce, lawmakers should give consideration to tax credit and rebate programs to support low- and fixed-income Kentuckians as well as our vital agricultural sector and farming communities. In addition, any efforts to broaden the sales tax base should be done in a way to ensure tax fairness and include a range of exempt goods and services to avoid disproportionately affecting single industries.

- As tax reform reduces Kentucky's overall reliance on production-based taxes like individual income, reforms to consumption-based taxes should be studied and examined closely. For example, any broadening of the sales tax base must avoid tax pyramiding and artificial inflation caused by taxing business inputs. As noted by the Tax Foundation, "in any expansion of the sales tax base, care should be taken to ensure the tax is expanded only to household purchases, not business-to-business transactions. Expanding the base to additional business-to-business purchases would further exacerbate the underlying structural issues that currently exist, such as tax pyramiding."¹⁴
- If lawmakers deem it necessary to increase the sales tax rate, care should be taken to ensure Kentucky's sales tax rate remains competitive with neighboring states and does not harm Kentucky's vibrant retail industry. This is especially important for communities that share a border with another state.



IT IS CRITICAL THAT TAX REFORM WORKS FOR ALL KENTUCKIANS. WHILE REDUCING INCOME TAXES WILL POSITIVELY AFFECT KENTUCKY'S WHOLE ECONOMY AND WORKFORCE, LAWMAKERS SHOULD GIVE CONSIDERATION TO TAX CREDIT AND REBATE PROGRAMS TO SUPPORT LOW- AND FIXED-INCOME KENTUCKIANS AS WELL AS OUR VITAL AGRICULTURAL SECTOR AND FARMING COMMUNITIES.

¹⁴ Tax Foundation, "Aligning Kentucky's Tax Code for Growth," November 30, 2021, p. 44: <https://files.taxfoundation.org/20211124113340/Aligning-Kentucky's-Tax-Code-for-Growth.pdf>



THE COST OF STANDING STILL

Kentucky has taken great strides in recent years to grow its economy and begin the hard work of fixing long-term systemic issues. But economic and demographic data make it clear that Kentucky has paid a price for standing still for so long. Other states, many within our own region like Indiana and Tennessee, have consistently outperformed and outcompeted us for jobs, people, and workers. In many cases, these states have even drawn Kentuckians away from home and made them into new residents. Tax reform will not fix every challenge confronting Kentucky. But it is an incredibly powerful public policy lever that states throughout the nation have pulled to position themselves ahead of the pack. Kentucky can no longer pay the price of standing still. The Commonwealth needs bold tax reform to set itself apart and outcompete neighboring states for growth.



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**THE COMMONWEALTH NEEDS BOLD TAX REFORM
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Kentucky Chamber

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