The Top 10
And Bottom 5% of
Tax Expenditures

Task Force on Tax Expenditures

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Top 10 Tax Expenditures
(by amount)

Sales and Use Tax

- Prescription Medicine & Medical Devices
- Food Items
- Charitable, Religious, and Educational Organizations
- Residential Utilities
- State, Cities, Counties, and Special Districts
- Various Livestock, Feed, Seeds, & Fertilizers

Other Taxes

- Individual Income Tax
  - Standard Deduction
  - Social Security Benefits
- Real Property Tax
  - HB 44 Annual Tax Rate Ceiling
- Corporation Income
  - Dividend Income

Prescription Drugs, Prosthetic Devices & Physical Aids Are Exempt – KRS 139.472

- Prescription drugs
- Over-the-counter drugs with a prescription *
- Medical oxygen and oxygen delivery equipment
- Insulin & diabetic supplies
- Colostomy, urostomy, or ileostomy supplies
- Prosthetic devices
- Mobility enhancing equipment with a prescription *
- Durable medical equipment with a prescription *

* Some items are now taxable if purchased without a prescription

These definitions are Streamlined Sales Tax definitions.

Effects of Expenditure Elimination

(of Sales Tax on Prescription Drugs, etc)

- As with all of the top-10 tax expenditures, the biggest positive effect is the positive fiscal impact, which can be used to reduce other tax rates or to fortify needs in the budget.
- Negative impacts include the following:
    - Arguably regressive
        - Would the tax apply to the 1.2 million people on Medicaid?
        - Can we tax VA and SSI patients?
        - Will the State be taxing itself as a self-insured entity?
    - Fierce opposition from:
        - Insurance companies
        - Pharmaceutical companies
        - Healthcare providers
        - Advocacy groups

Effects of Elimination – All Taxes in General

- Notwithstanding the approach used today, elimination of tax expenditures should involve a holistic approach which is a part of comprehensive tax reform
  - Regressivity is a consequence of undoing many of the top-10 tax expenditures
    - Examples: Prescription drugs, food, residential utilities, standard deduction
    - Eliminating all four expenditures would be quite regressive
  - Pick an overall tax strategy rather than individual expenditures
    - For example: If the strategy is to tax all final consumption, then expanding the standard deduction might be preferable to eliminating of that expenditure
    - Another example: If the strategy is to bring in more money for budget items, then it may be preferable to target the largest tax expenditures and avoid tackling the smallest expenditures
    - Every tax expenditure has a constituent that will lobby to keep that expenditure

Effects of Elimination – Sales Tax in General

- As a principle of optimal taxation, policy makers should consider the impacts of taxation on market distortions. Economists seek to minimize market distortions.
  - In general, especially for the sales tax, the market distortion from taxation is directly proportionant to the elasticity of demand for the taxed commodity
    - Example: Pharmaceuticals are necessities ► Necessities consumption is not as sensitive to price ► The quantity consumed will not change greatly with a change in price ► Smaller market distortion ► Optimal taxation
  - Market distortions within the Kentucky market are also sensitive to border effects
    - 52% of Kentuckians live in a border county
    - Example: Pharmaceuticals: Some purchases (especially expensive prosthetics) may leave the Commonwealth
    - None of our border states tax pharmaceuticals with prescriptions

Food and Food Ingredients Are Exempt – KRS 139.485

- Food and food ingredients are substances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value.
- Food and food ingredients do not include already taxable items:
  - Alcoholic beverages
  - Prepared food
  - Tobacco
  - Candy
  - Dietary supplements
  - Soft drinks
- All of these terms are Streamlined definitions

Effects of Expenditure Elimination

(of Sales Tax on Food)

- Positive effects include the following:
  - Easy to implement and administer
  - Fairly small market distortions (certain food has a lower elasticity of demand)
  - Large fiscal impact, depending on the chosen tax rate
- Negative effects include the following:
  - Arguably regressive, but …
    - Food stamp purchases would be exempt from the tax
  - May cause substitution with prepared foods
  - Subject to border transactions, but …
    - Ohio, Indiana – No tax
    - Illinois taxes at 1%
    - Missouri taxes at 1.225%
    - Tennessee taxes at 5.5%
    - West Virginia taxes at 5%
    - Virginia taxes at 1.5% state rate +1% local option
  - Fierce opposition from a variety of sources

Note: many states tax food at a rate lower than the general sales tax rate

Charitable, Religious, & Educational Organizations – KRS 139.495

- Resident, nonprofit educational, charitable, or religious institutions which qualify for exemption from income taxation under Section 501(c)(3) of the Internal Revenue Code
- The sales tax does not apply to:
  - Sales of tangible personal property, digital property or services *to* these institutions provided that the property or service is used solely in this state within the educational, charitable, or religious function;
  - Sales of food to students in school cafeterias;
  - Sales by school bookstores of textbooks, workbooks, and other course materials;
  - Sales by nonprofit, school sponsored clubs and organizations, provided such sales do not include tickets for athletic events.
- Sales *by* these organizations are subject to sales and use tax.

Effects of Expenditure Elimination

(of Sales Tax on Charitable Organizations, etc.)

- Positive effects include the following:
  - Easy to implement and administer
  - Fairly small market distortions (charities need to continue purchasing)
- Negative effects include the following:
  - Discourages the formation and operation of currently exempt organizations
  - Taxing educational organizations increases the cost of education
  - Taxing religious and charitable organizations curtails the supply of the many public goods generated by these entities
  - Economists generally support the provision of public goods

Residential Utilities Are Exempt – KRS 139.470(8)

- The gross receipts from the sale of electricity, sewer services, water, and fuel to Kentucky residents for use in heating, water heating, cooking, lighting, and other residential uses are excluded from the sales and use tax.
- The utility must classify the location as residential as accepted by the PSC or TVA, as applicable.
- Not included as residential property are bills issued to:
  - An owner or operator of a multi-unit residential rental facility;
  - A mobile home park; or
  - A recreational vehicle park.

Effects of Expenditure Elimination

(of Sales Tax on Residential Utilities)

- Positive effects include the following:
  - Easy to implement and administer
  - The absence of a sales tax on residential utilities sets Kentucky apart from at least 32 other states which tax utilities either by including utility services in its sales tax or through a gross receipts tax on utility providers. Kentucky, therefore, is considered a low-tax state for residential utilities.
  - Would level the playing field with commercial utilities.
  - Minimal market distortions due to consumption remaining stable
- Negative impacts include the following:
  - Arguably regressive. Lower-income households will pay a greater percentage of their income to the tax than higher-income households whose utility usage is a smaller percentage of their income
  - This tax would lead to an added increase in utility rates in areas where utility costs are already being significantly increased
  - Fierce opposition from a variety of sources

The Commonwealth, Cities, Counties, or Special Districts – KRS 139.470(7)

- Sales to any cabinet, department, bureau, commission, board, or other statutory or constitutional agency of the state
- Sales to counties, cities, or special districts
- This exemption applies only to purchases for use solely in the government function.

Effects of Expenditure Elimination
(of Sales Tax on Local Governments)

- Considerations include:
  - Budgetary impact of increased cost for local governments
    - Transfer of local property tax revenues to state sales tax revenues
  - Elimination would bring parity with businesses that provide similar services
  - Potential reduction in cost of record keeping and compliance
  - Some current purchases may push the limits of “necessary for governance”

Various Livestock, Feed, Seeds, & Fertilizers Are Exempt – KRS 139.480

- Livestock that ordinarily constitutes food for human consumption, provided that the sales are made for breeding or dairy purposes and by or to a person regularly engaged in the business of farming
- Poultry for use in breeding or egg production
- Embryos and semen used in the reproduction of livestock
- Farm work stock for use in farming operations
- Seeds, feed, and fertilizer, used for products of which ordinarily constitute food for human consumption or which are to be sold in the regular course of business
- Over time, the exemption has been expanded to include llamas, alpacas, aquatic organisms, buffalo, and cervids.

Effects of Expenditure Elimination

(of Sales Tax on Many Farm Inputs)

- Many items in this category are inputs into the production process of a final good
- In general, economists avoid taxing intermediate inputs into the production process when the final product is taxed
- However, in the case of the agriculture expenditure, many of the outputs of the production process are not taxed (food for consumption)
- Bullets 2 and 3 are somewhat in conflict with each other
- Elimination of this tax expenditure would certainly be adversely affect the farm community and others
- Elimination of this tax expenditure would also disproportionately affect rural areas versus urban areas of the state

Standard Deduction Is Allowed – KRS 141.081

- At the election of the individual, itemized deductions or the standard deduction may be taken.
- For 2018, the taxpayer will compare the total of home mortgage interest paid and charitable contributions made to the standard deduction amount of $2,530, and deduct the larger of the two.

Effects of Expenditure Elimination

(of the Standard Deduction on the Income Tax)

- During tax reform discussions, many people argued to raise the standard deduction
  - Several itemized deductions were eliminated in the 2018 federal and state tax reform
  - Raising the standard deduction would help low-income filers who lost the benefit of the progressive rate structure prior to tax reform
- Negative impacts of eliminating the standard deduction include the following:
  - Regressive
  - Will impose an extra burden on filers who now have to itemize to get any deductions

	740 Resident Taxpayers	%	740-NP Nonresident Taxpayers	%
Itemizers	967,990	46%	41,149	21%
Std Deducters	1,159,441	54%	150,630	79%
TOTAL	2,127,431		191,779	

Social Security Benefits – KRS 141.019(1)(e)

- Any portion of Social Security benefits taxed at the federal level are exempt for Kentucky income tax.
- For federal income tax purposes, if you and your spouse file a joint return with a combined income below $32,000, your Social Security benefits are not taxed.
- For incomes between $32,000 and $44,000, up to 50% of Social Security benefits may be taxable.
- Up to 85% may be taxed if combined the income is more than $44,000.

Effects of Expenditure Elimination

(on the Income Tax on Social Security Benefits)

- Proposal of elimination is to tax federally taxed Social Security, not the first dollar of benefits
- Means tested at federal level, so eliminating the state exemption on Social Security benefits would not be regressive
- All retirement income should arguably be taxed in a similar manner
- Only 13 states tax Social Security benefits
- AARP is a large and vocal political block

Real Property Tax Rate Increases are Limited – KRS 132.020(2)

- The state tax rate on real property shall be reduced to compensate for any increase in the aggregate assessed value of real property to the extent that the increase exceeds the preceding year's assessment by more than four percent (4%), excluding:
  - The assessment of new property;
  - The assessment from property which is subject to tax increment financing; and
  - The assessment from leasehold property which is owned and financed by a tax-exempt governmental unit, or tax-exempt statutory authority under the provisions of KRS Chapter 103 and entitled to the reduced rate of one and one-half cents ($0.015) pursuant to subsection (1)(b) of this section.

Effects of Expenditure Elimination

(on the Property Tax)

- Why is the tax expenditure so high?
  - Comparing statutory tax rate of 31.5¢ to the current rate of 12.2¢
  - Not practical to undo to preferential rate at a moment in time
  - More reasonable approach would be freezing the real property tax rate at a certain level
  - Freezing the rate below 31.5¢ would generate a smaller fiscal impact than is reported in the report

Dividend Income Received by Corporations Is Exempt – KRS 141.039

- All dividend income received after December 31, 1969, is exempt from corporation income tax.

Effects of Expenditure Elimination
(of the Corporation Income Tax on Dividends)

- The expenditure was put into place to avoid the double taxation of corporate dividends (taxed once as profits and then as dividends)
- Would make Kentucky less competitive in terms of business climate
- This exemption creates parity between single corporations and corporate groups
- This exemption does not apply to dividends received by pass-through entities such as LLC's, S corporations, partnerships, etc.

The Bottom 5% of Tax Expenditures

- Let's now focus on the back portion of the spreadsheet.
  - 29 with a minimal impact
  - 46 with zero impact
  - 33 costing less than $100,000 annually
  - 17 costing between $100,000 and $200,000
  - 18 costing between $200,000 and $500,000
  - 20 costing between $500,000 and $1 million
- 163 tax expenditures are listed, each with a cost of less than $1 million.

The Bottom 5% of Tax Expenditures

- Another 65 tax expenditures round out the bottom 5% of all tax expenditures, ranging in cost from $1 million to $12.1 million annually.
- These 228 which make up the bottom 5% include all taxes imposed by the Commonwealth and are comprised of all the various types of tax expenditures.

What's Left?
The Gap Between the Top 10 and the Bottom 5%

- 43 tax expenditures, ranging in cost between $12.4 million and $130 million annually.

Questions