



Governor Beshear's Blue Ribbon Commission on Tax Reform

Jerry Abramson, Lt. Governor, Chairman
Mary Lassiter, Secretary, Governor's Executive Cabinet

Senate Committee on Appropriations and Revenue
House Committee on Appropriations and Revenue

February 5, 2013

Why Tax Reform?

- Improve competitiveness to attract and retain jobs
- Revenues have not kept pace with the economy
- Modernize the tax code to keep up with changes in technology
- Update the tax code to broaden our narrow tax base to keep pace with changing consumption
- Financial issues facing the Commonwealth
- Summary of recommendations from the Governor's Blue Ribbon Commission on Tax Reform

Economic Consultants

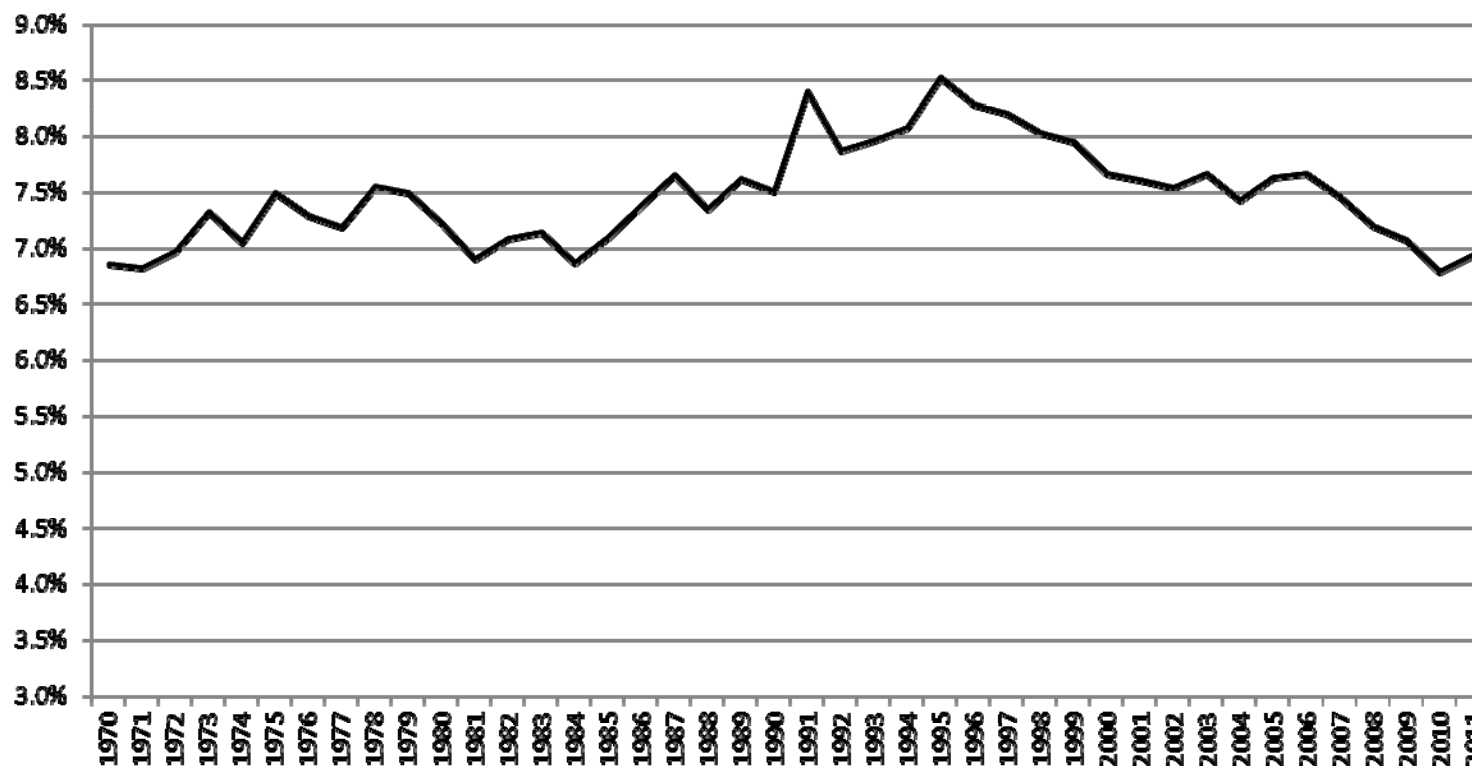
- University of Kentucky
Gatton College of
Business and
Economics; Center for
Business and Economic
Research
 - Dr. William Hoyt
 - Mr. Michael Childress
 - Mr. James Saunoris
- University of
Tennessee
 - Dr. William Fox

Two Primary Conclusions

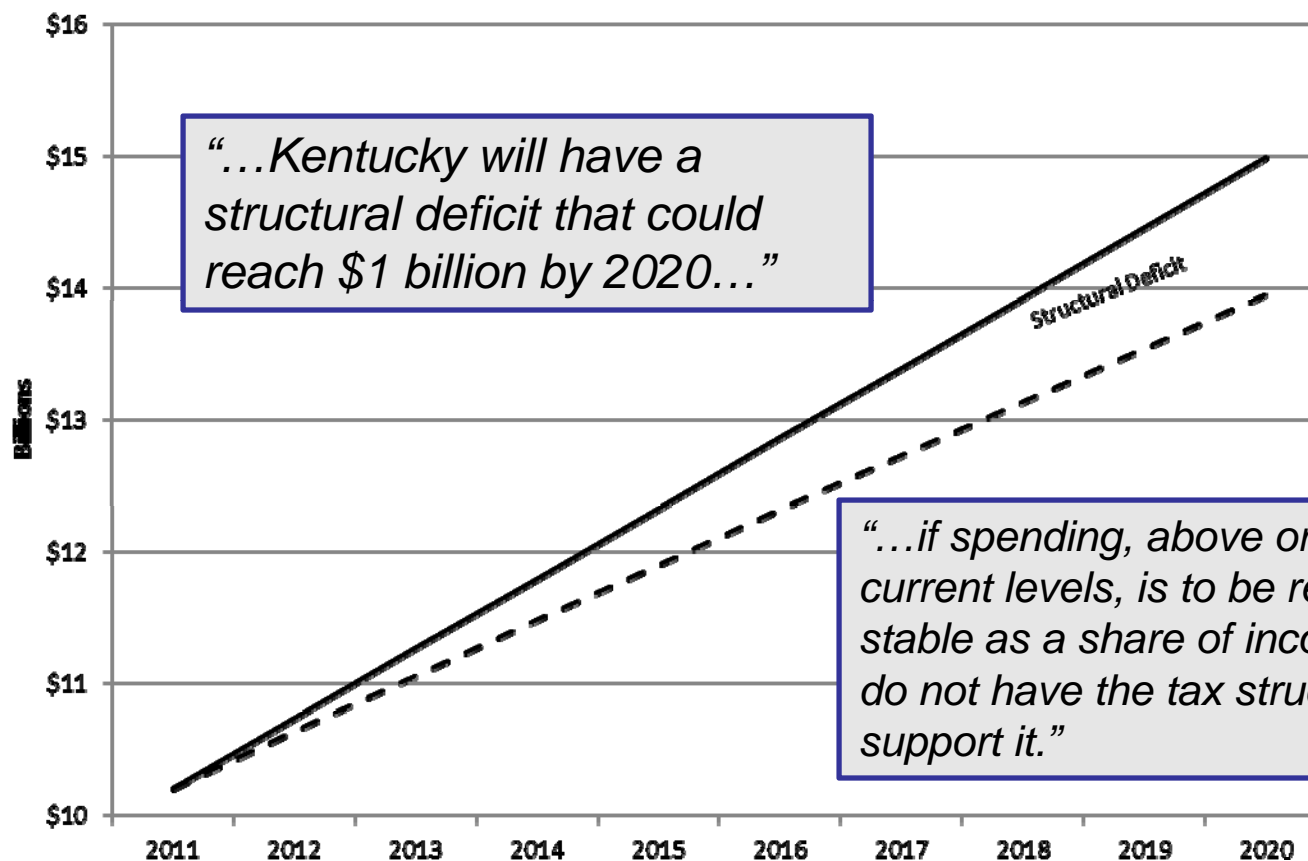
- A broader tax base is needed so that revenue can keep pace with future economic growth
- Changes are needed to improve Kentucky's economic competitiveness



Kentucky Total State Tax Collections (% Income), 1970-2011



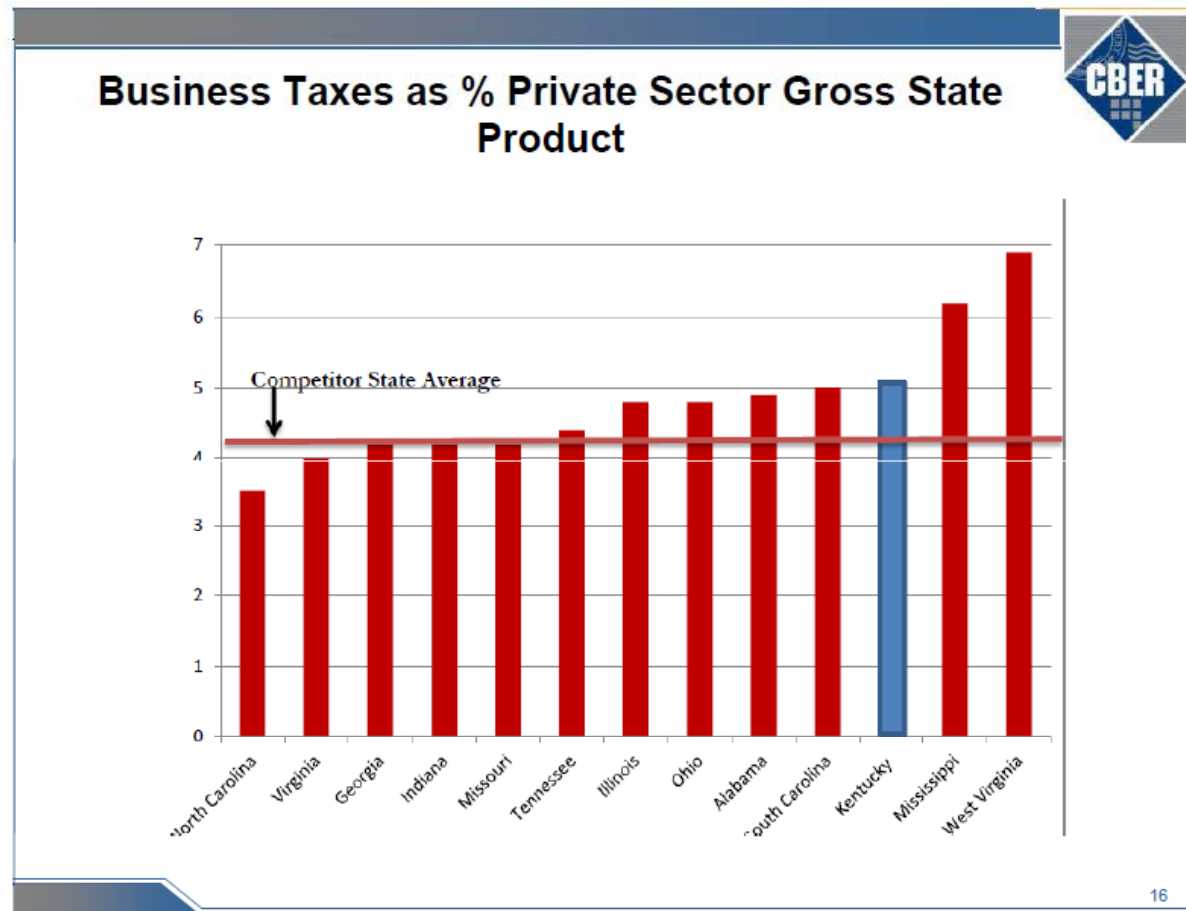
Adequacy & Elasticity: Simulated Kentucky Revenue



Source: Authors' calculations

Need to Improve Competitiveness

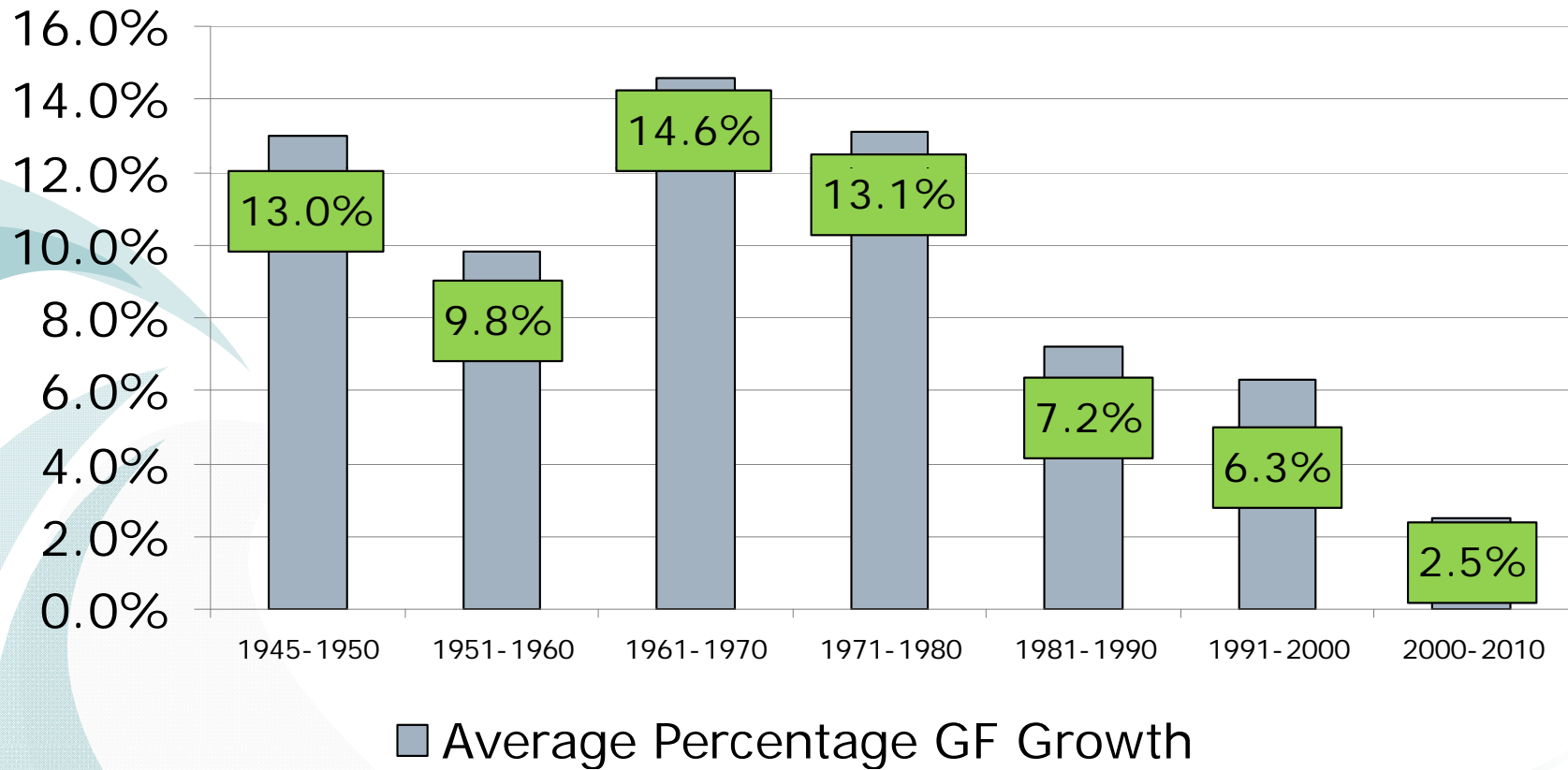
- According to the consultants to the Blue Ribbon Commission on Tax Reform, for FY11, the average competitor state had business taxes equal to 4.2% of gross state product. In Kentucky, it was 5.5%, ranking 3rd highest behind Mississippi and West Virginia.



Need to Improve Competitiveness

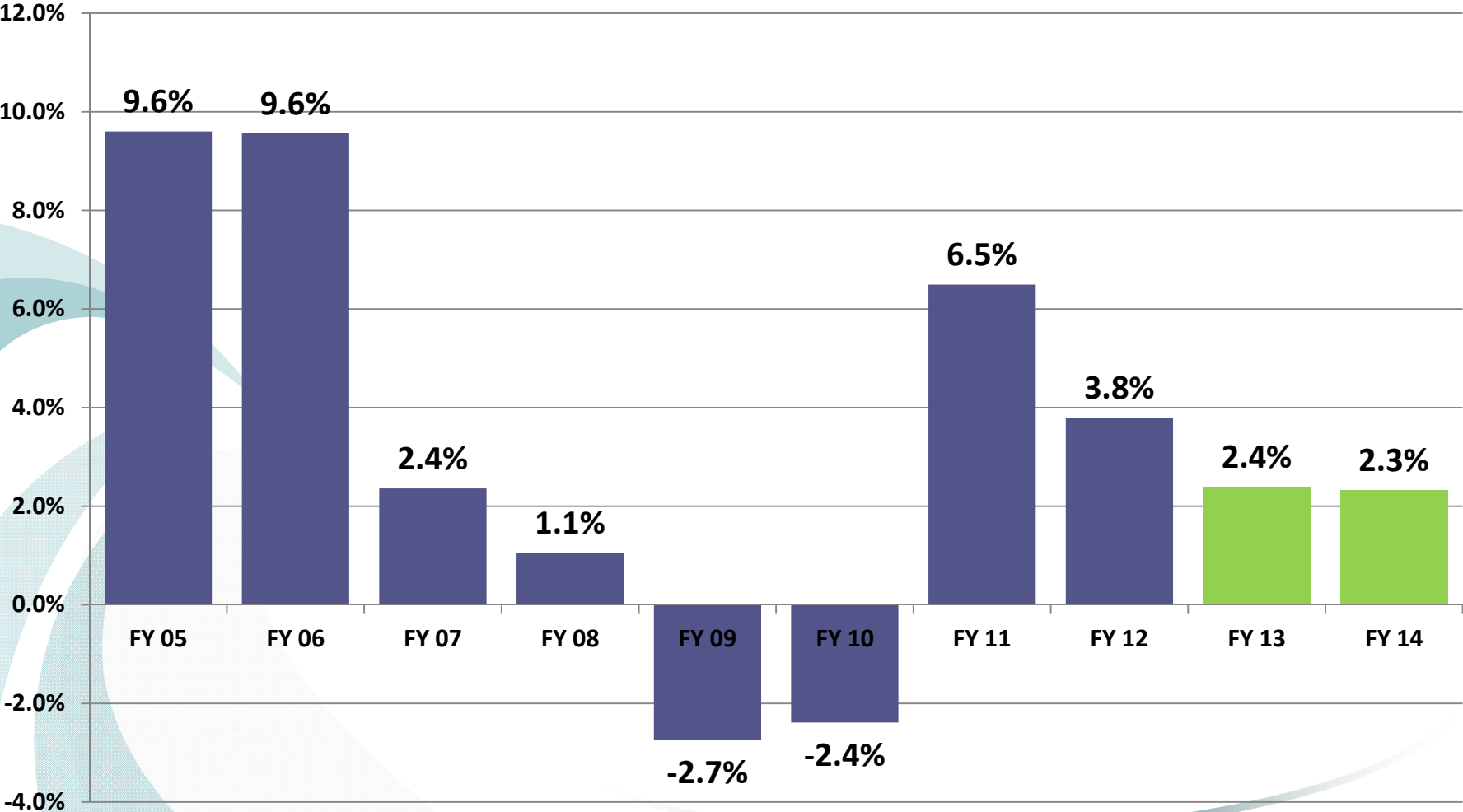
- Area Development magazine Fall 2012 named the top states for doing business. Kentucky did not make the top ten, but **seven of the top ten were states that Kentucky's Cabinet for Economic Development considers "competitor states."**
- In 2012, CNBC, with input from business groups including the National Association of Manufacturers and the Council on Competitiveness, ranked all 50 states on 51 measures of competitiveness. While Kentucky did well in a couple of categories – 1st in Cost of Business and 4th in Cost of Living – **overall Kentucky ranked 36th**. However, three of Kentucky's competitor states made the top ten.
- Forbes has released their 2013 best states for businesses and careers. **Kentucky ranks 26th, while three of our competitor states rank in the top ten.** In particular, we rank 45th for our Labor Supply.

General Fund Revenue Growth by Decade

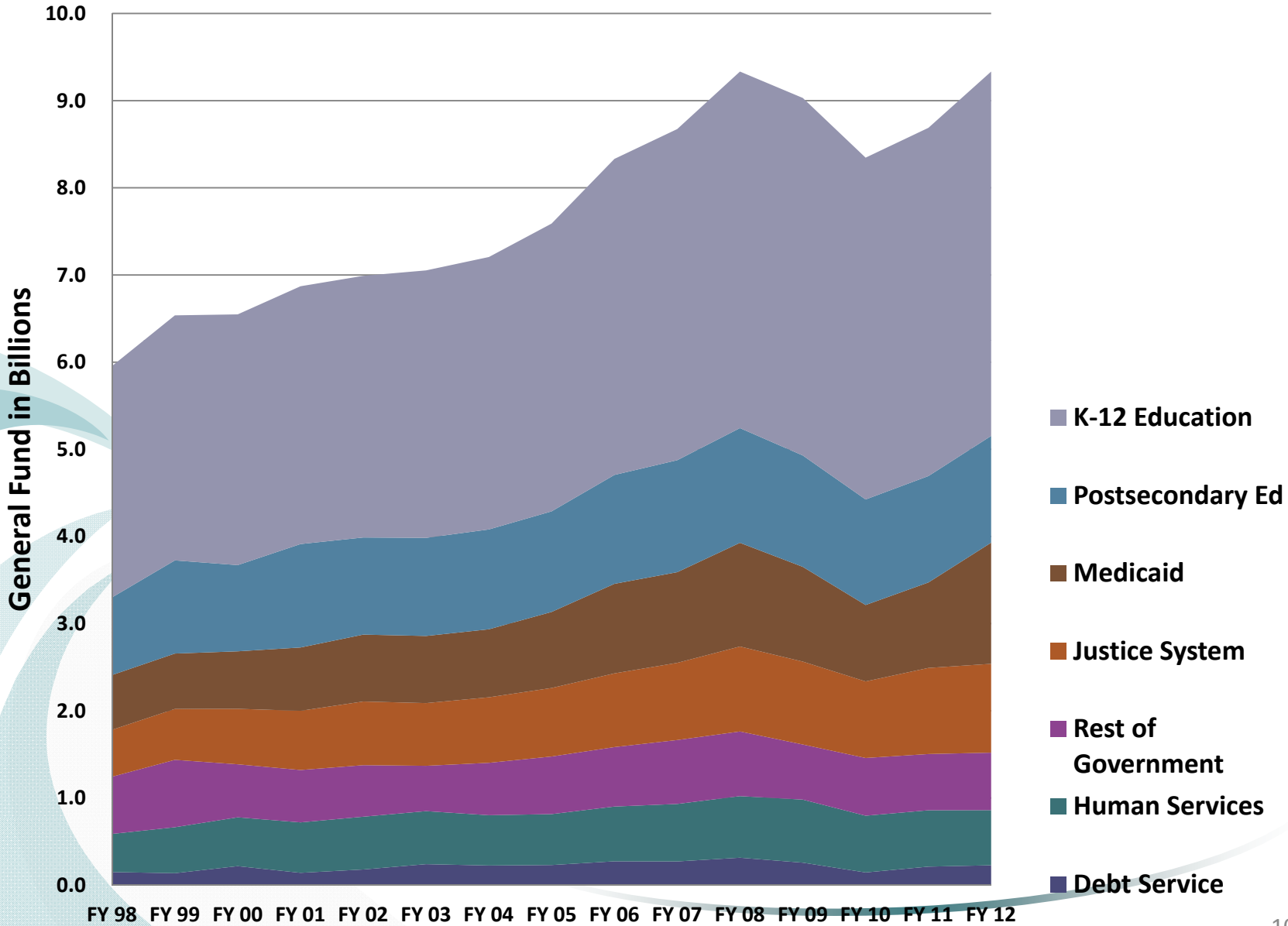


Modest Revenue Growth Predicted

(percent change from prior fiscal year)

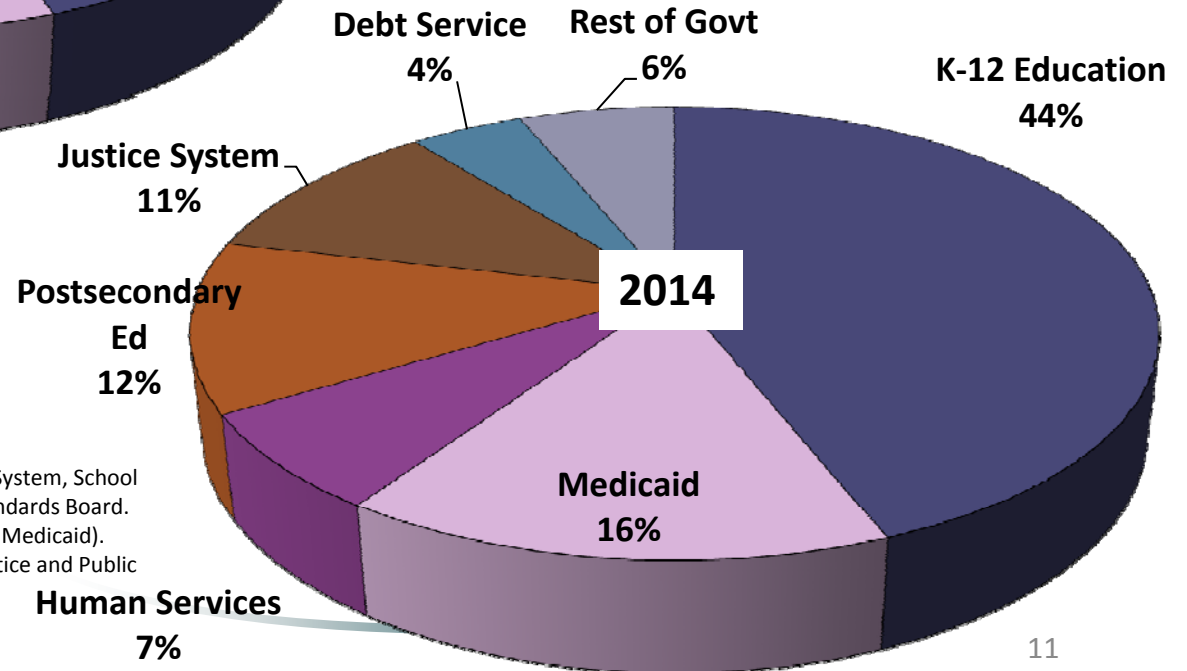
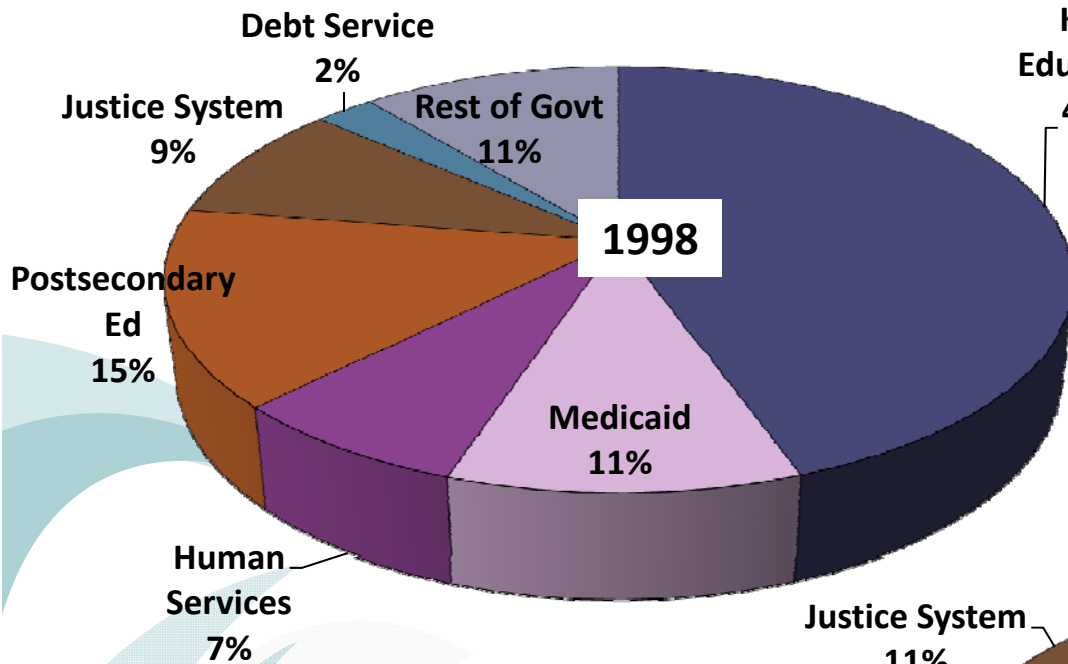


General Fund Spending FY 1998-2012



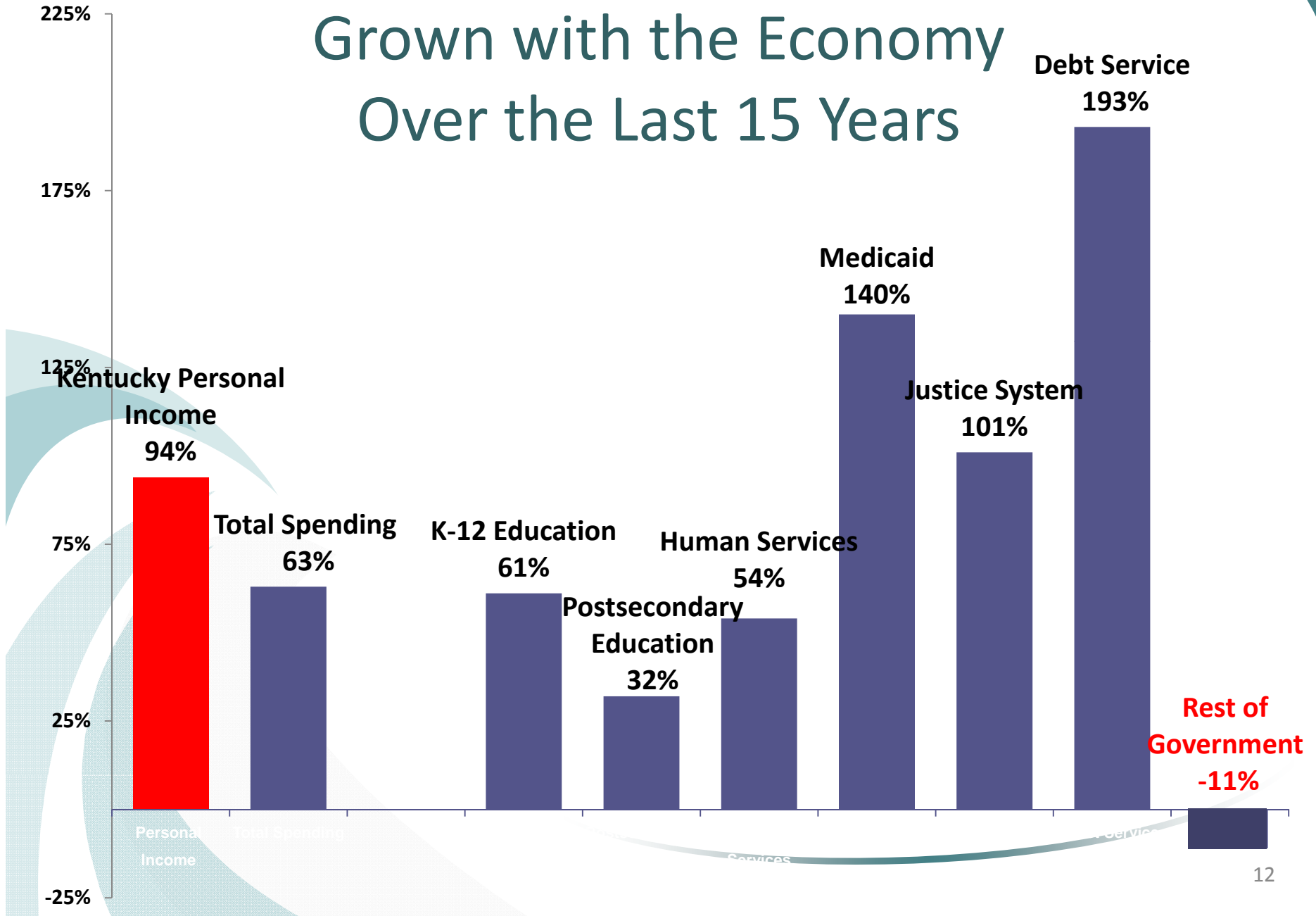
Changes in Spending from FY 98 to FY 14

General Fund

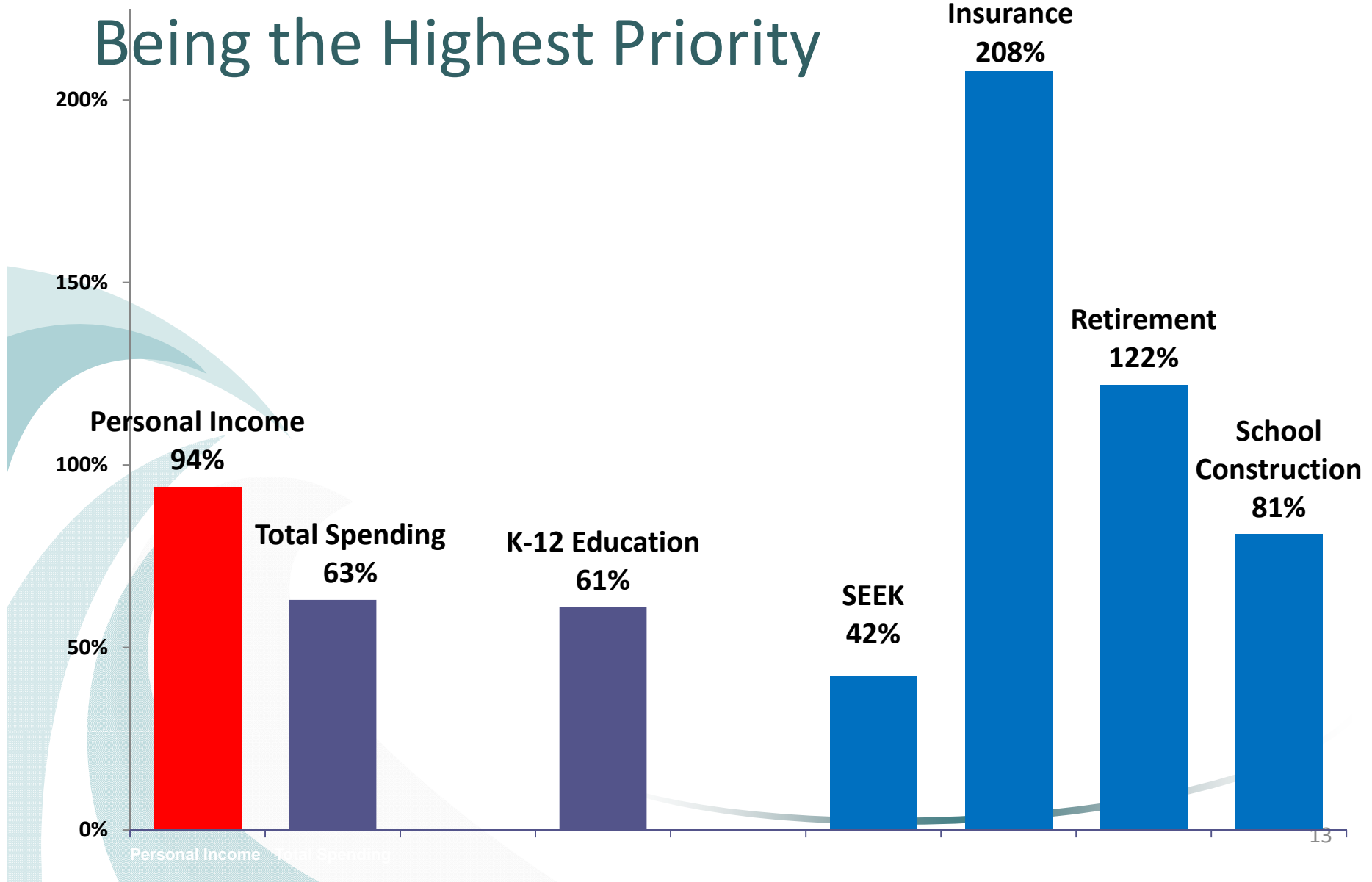


* Education includes the Department of Education, Teachers' Retirement System, School Facilities Construction Commission and the Education Professional Standards Board.
 ** Human Services include the Health and Family Services Cabinet (net of Medicaid).
 *** Criminal Justice System includes the Unified Prosecutorial System, Justice and Public Safety Cabinet and the Judicial Branch.

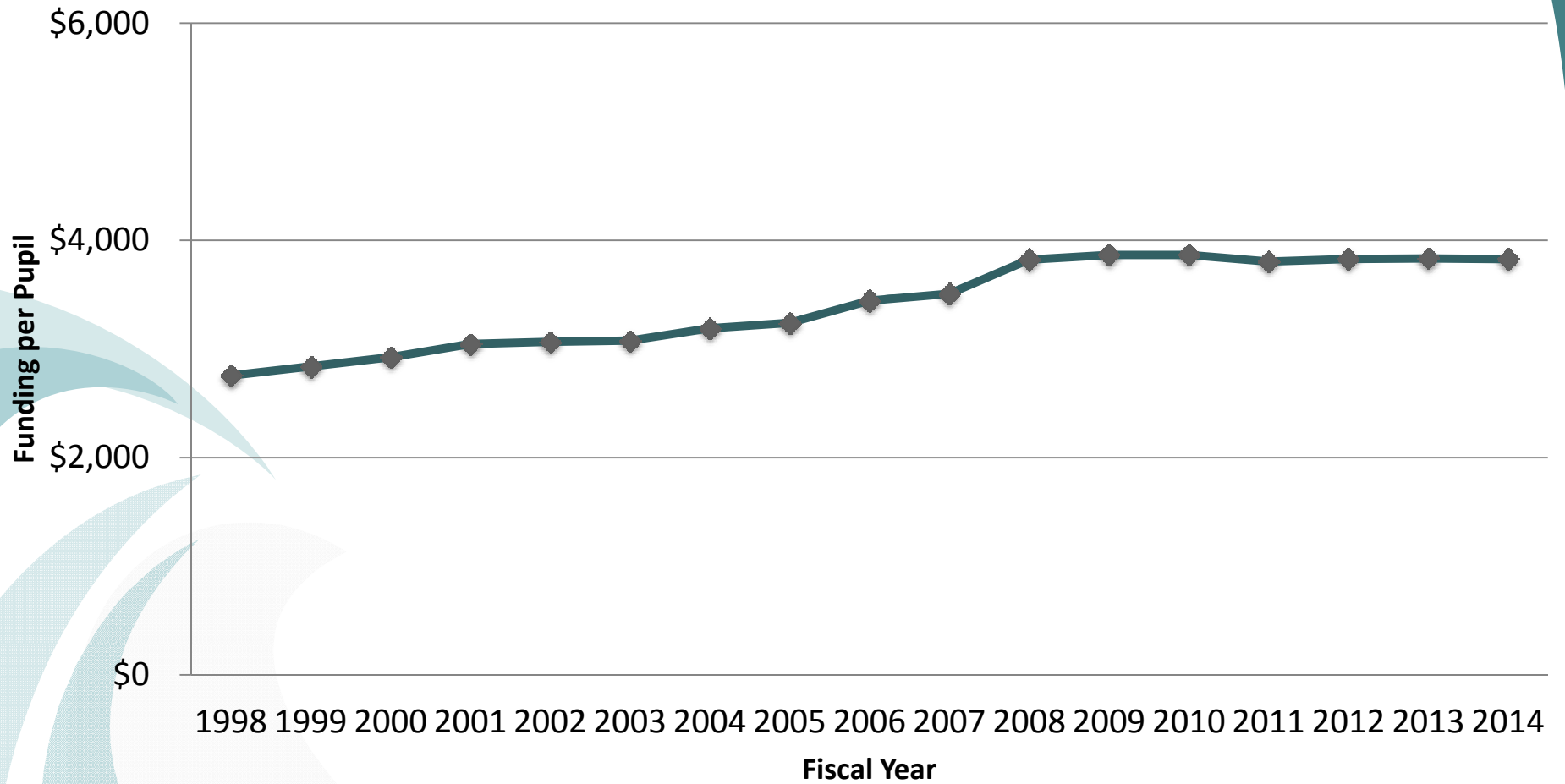
State Revenues and Spending Have Not Grown with the Economy Over the Last 15 Years



K-12 Education Funding Has Not Kept Pace – Despite Being the Highest Priority



SEEK Per-Pupil Funding is at 2008 Levels



Other K-12 Education Cuts Since 2008

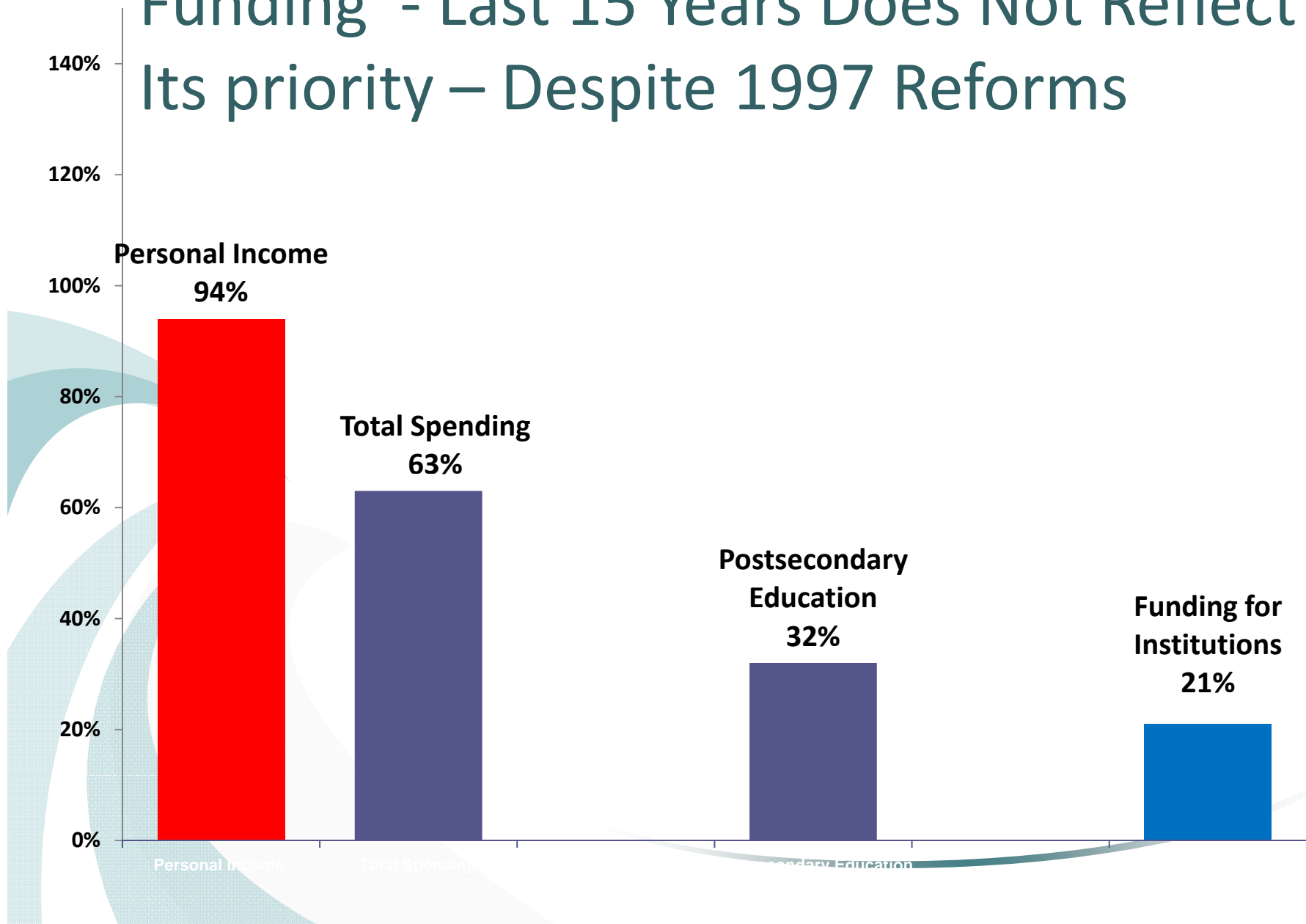
	\$millions			
	FY 08	FY 13	\$ Cut	% Cut
Textbooks	\$ 21.7	\$ -	\$(21.7)	-100%
Extended School Services	\$ 31.8	\$ 12.3	\$(19.5)	-61%
Professional Development	\$ 15.0	\$ 5.3	\$ (9.7)	-65%
School Technology - KETS & KEN	\$ 39.8	\$ 31.5	\$ (8.3)	-21%
Career and Technical Education	\$ 30.3	\$ 23.7	\$ (6.6)	-22%
Safe Schools	\$ 10.4	\$ 4.2	\$ (6.2)	-60%
Preschool	\$ 75.1	\$ 71.3	\$ (3.8)	-5%
Total	\$224.1	\$ 148.3	\$(75.8)	-34%

Education Week – Quality Counts 2013

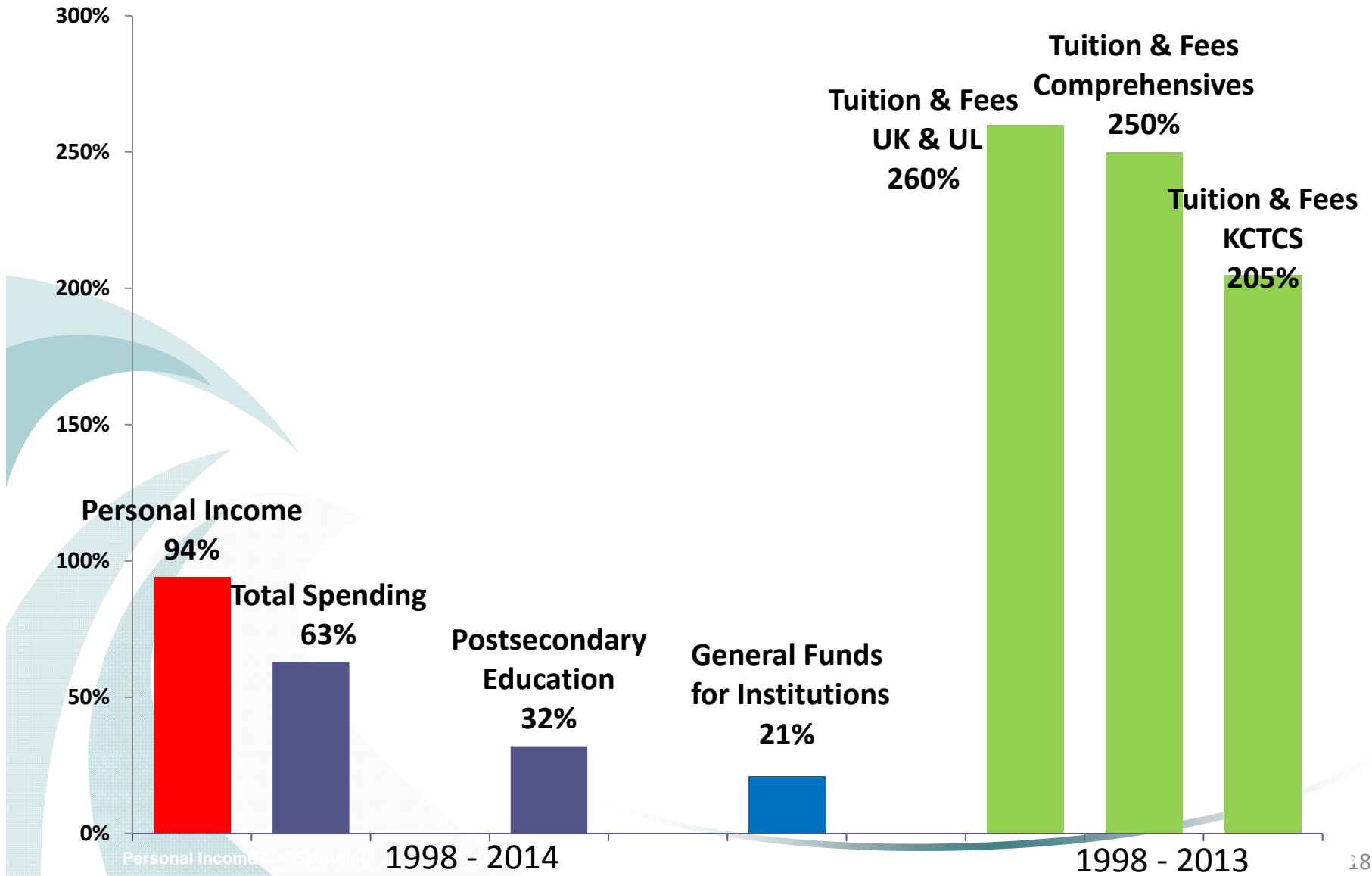
- Overall Grade -Education Quality and Performance B-
- National Average C+
- **Kentucky Moved from 34th to 10th over last two years**

- Chance for Success C
- K-12 Achievement C-
- Standards, Assessments & Accountability A-
- Teaching Profession B-
- Transitions and Alignment A
- **School Finance** C-
 - Equity B+
 - **Spending** **F**

Postsecondary Education Funding - Last 15 Years Does Not Reflect Its priority – Despite 1997 Reforms

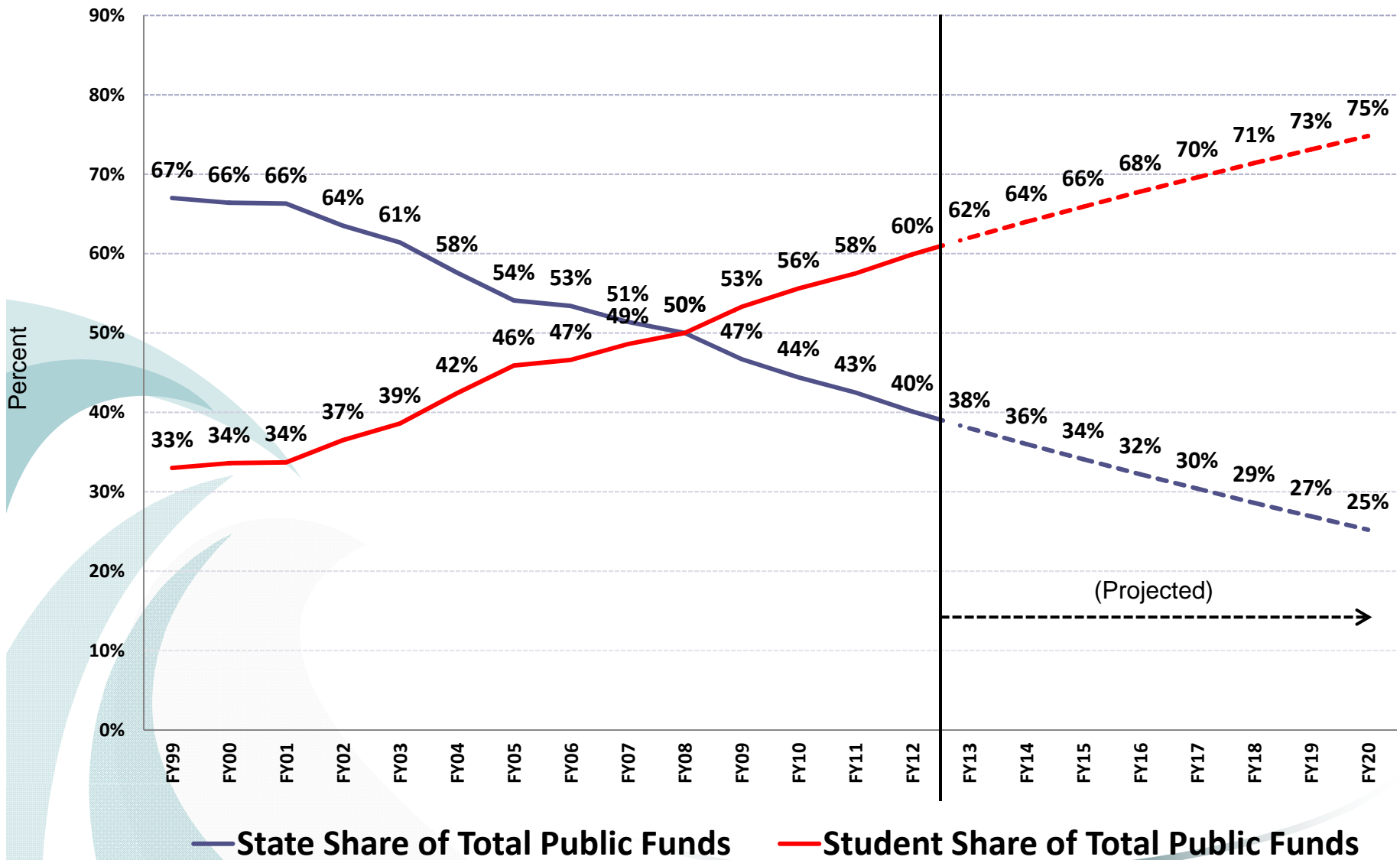


Tuition and Fees Have Grown Over Ten Times as Much as General Fund Support

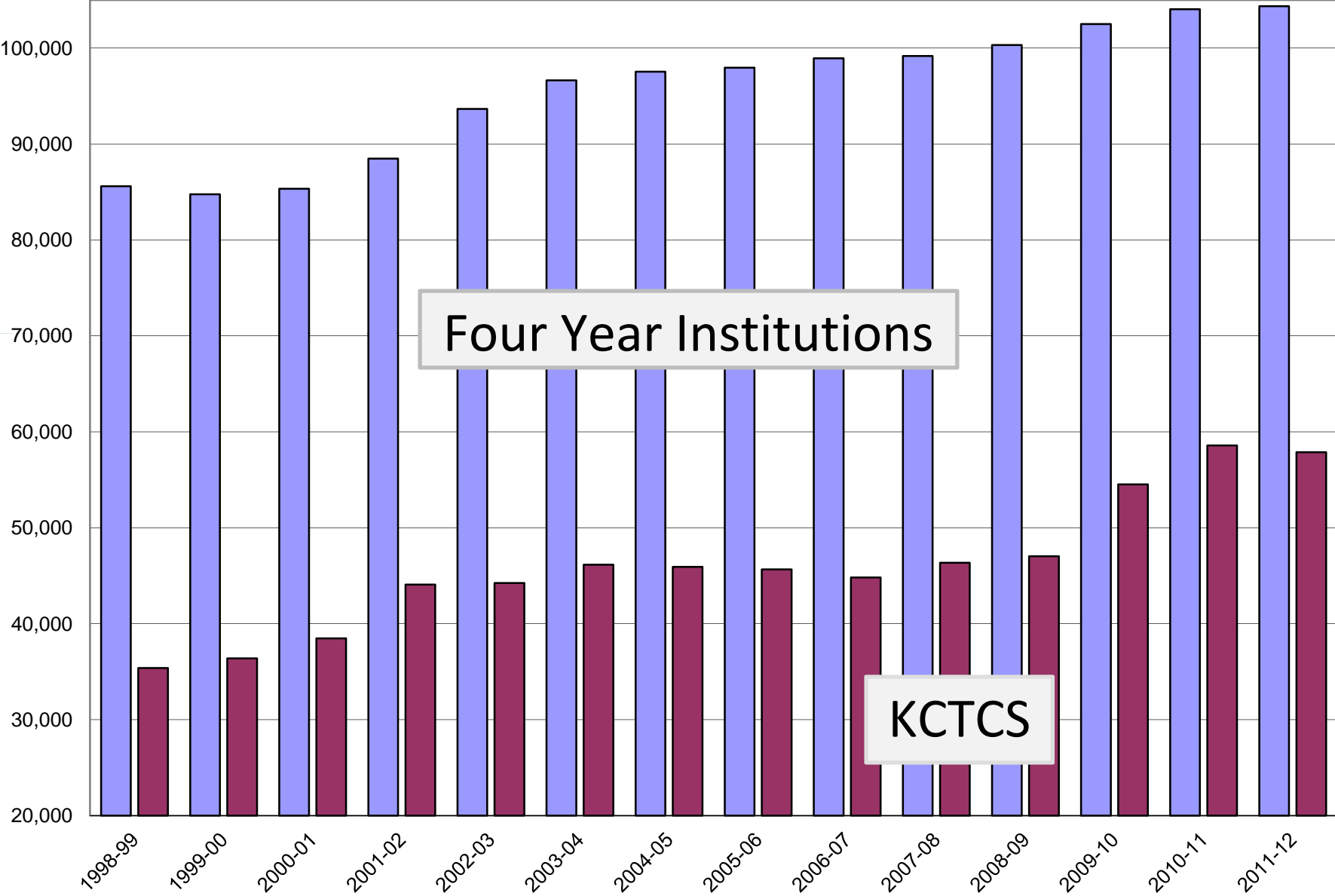


Kentucky Public Postsecondary System Change in State & Student Shares of Total Public Funds

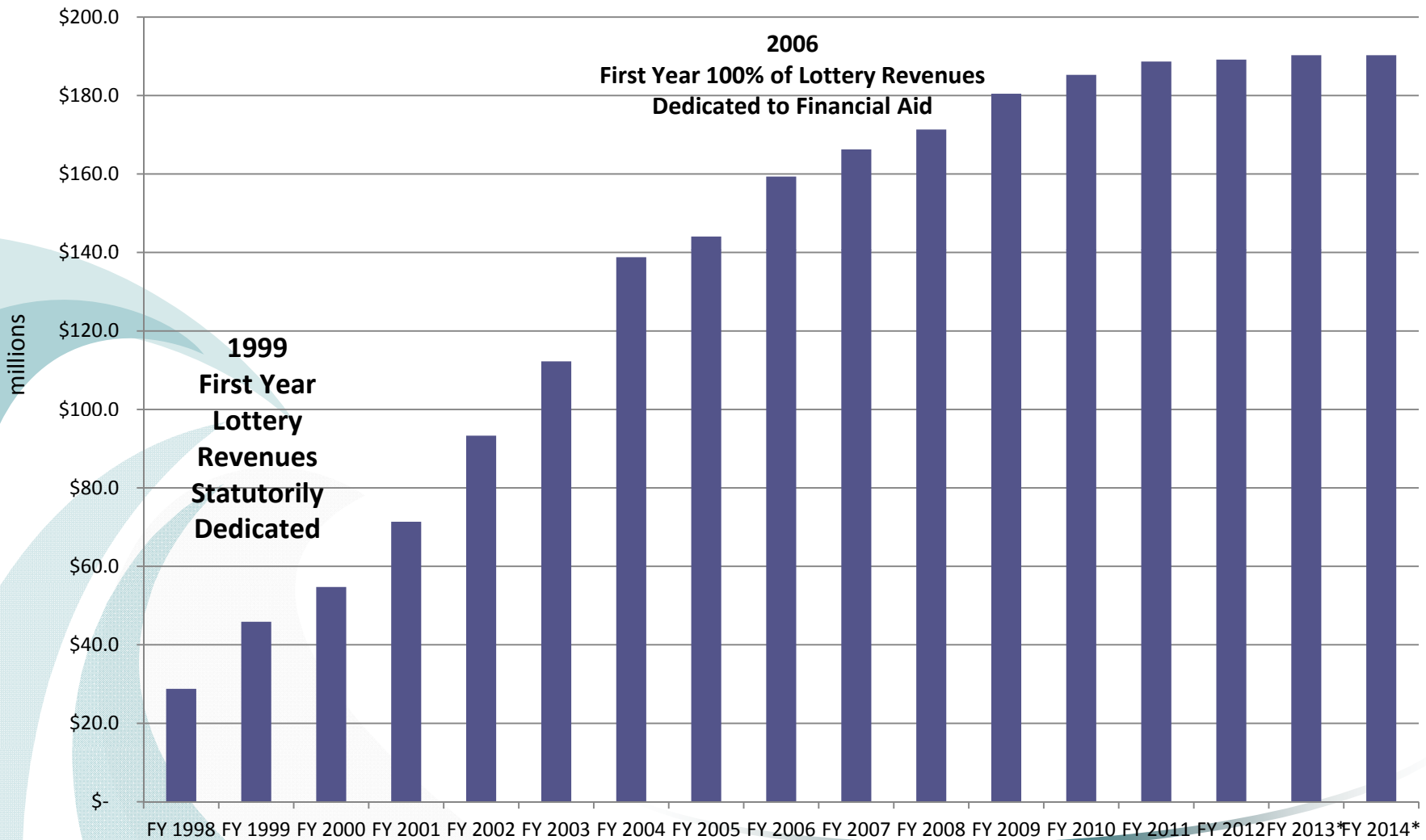
Fiscal Years 1999 - 2020



Full-Time Equivalent Enrollment -- Fall of Each Year

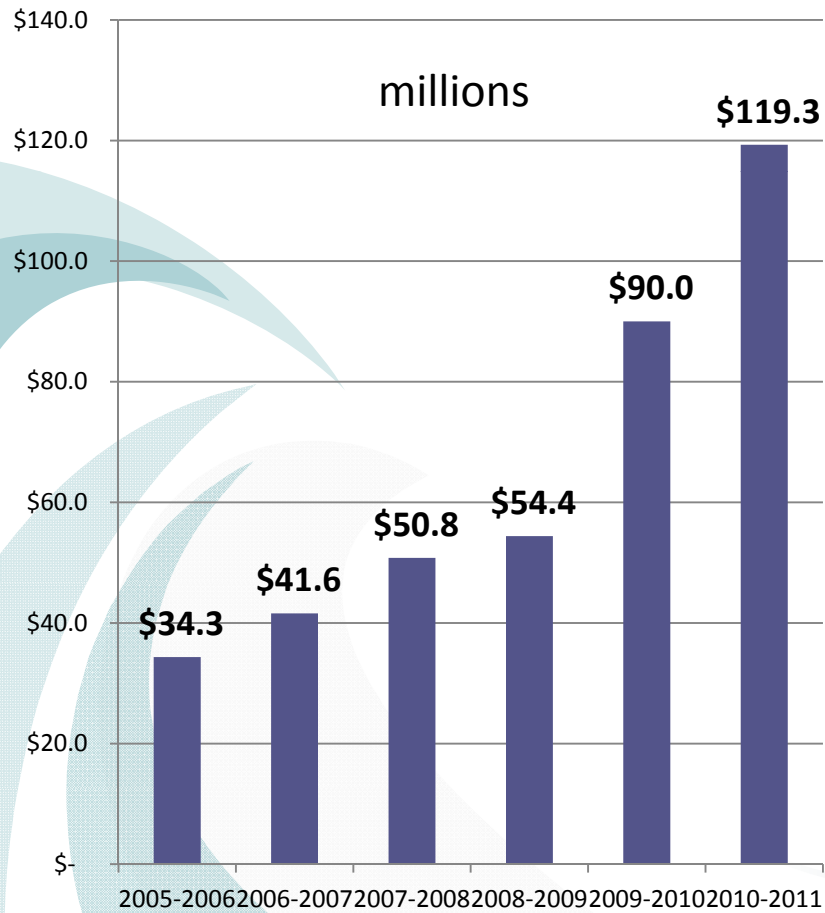


Financial Aid Funding Has Been Flat – Despite Growing Enrollment

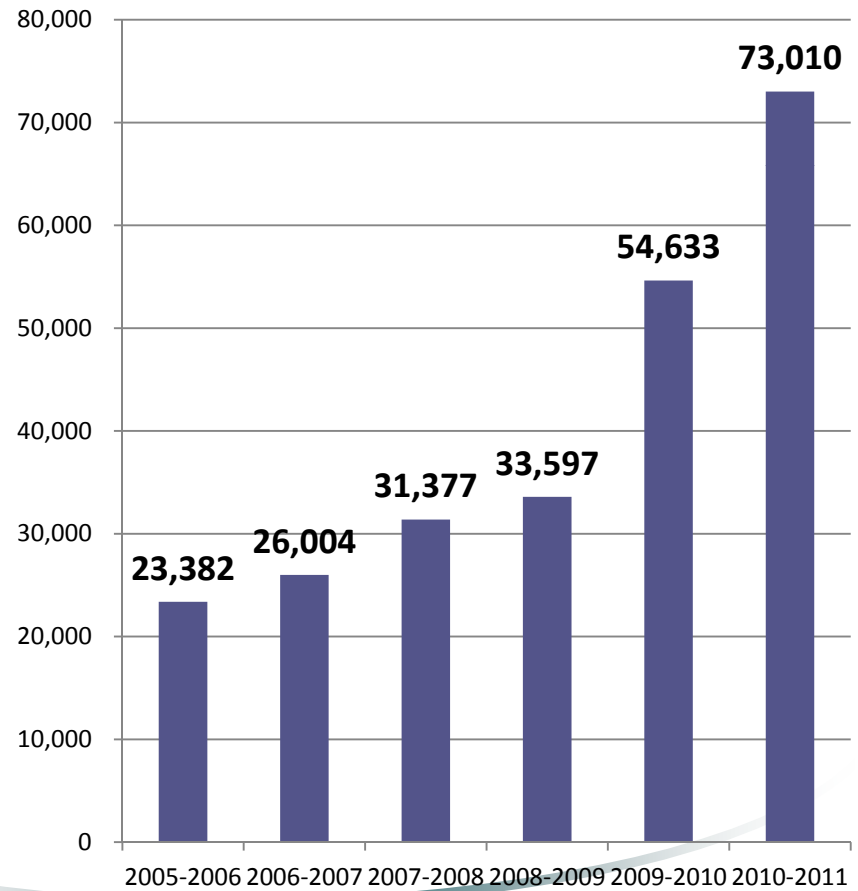


Unmet Need for Need-Based Aid has Exploded

Value of Denied Applications



Eligible Students Denied



Budget Balancing Measures During Beshear Administration

	Fiscal Year	Description	Amount (millions)	Most Common % Cut
1	2008	Budget Reduction	\$ 76	3.0%
2	2009	Enacted Reduction	\$ 176	12.0%
3		Mandated Budget Gap	\$ 180	4.5%
4		Budget Reduction	\$ 147	4.0%
5	2010	Budget Reduction - Round 1	\$ 273	4.0%
6		Budget Reduction - Round 2	\$ 49	3.0%
7	2011	Enacted Reduction	\$ 61	3.5%
8		Mandated Budget Gap	\$ 131	1.5%
9	2012	Enacted Reduction	\$ 81	1.0%
10		Mandated Budget Gap	\$ 169	2.0%
11	2013	Enacted Reduction	\$ 140	8.4%
12		Mandated Budget Gap	\$ 40	TBD
13	2014	Enacted Reduction	\$ 6	NA
Total			\$1.6 billion	38.4%

Cumulative Impact of Cuts – Various Agencies

Finance Agencies	30-38%	KET	27%
Labor	38%	Education & Workforce	23-27%
Area Development Districts	28%	CHFS Non-Medicaid	7-28%
Public Protection	30-38%	K-12 Non-SEEK	27%
Constitutional Officers	32-36%	Natural Resources	15%
Military Affairs	34%	State Police	15%
Environmental Protection	32%	Universities	15%
Tourism, Arts & Heritage	30%	Juvenile Justice	13%
Economic Development	29%	Veterans' Affairs	6%

Impact of Recent Cuts

- **Economic Development**

- Investment in Commercialization, Innovation, and Science and Technology programs has been reduced by almost half

- **Energy and Environment Cabinet**

- Department for Environmental Protection has seen an increase in backlogs for water permits
- Lack of enforcement/inspection staff has resulted in delayed or no enforcement actions regarding wastewater discharge of the Clean Water Act

- **Tourism and Parks**

- Reduced hours of operation
- Inability to perform needed maintenance and investment in facilities

Impact of Recent Cuts

- **Children's Services**

- Moratorium on applications for the Child Care Assistance Program in April and a reduction in eligibility for FY 14
- Moratorium on applications for Kinship Care Program
- Elimination of Diversion services in Community Based Services resulted in about 100 additional children entering the foster care system instead of receiving intensive services and remaining in the family home

- **Aging Programs**

- Meals on Wheels served 279,532 fewer meals from FY 2008 to FY 2010

- **Local Health Departments**

- Reduced funding for Local Health Departments has resulted in fewer women receiving prenatal care, fewer children receiving immunizations, and fewer Kentuckians with diabetes receiving comprehensive care

- **Community Mental Health Services**

- No increase from the General Fund since 1998. Medicaid reimbursement rates have been frozen since 2001

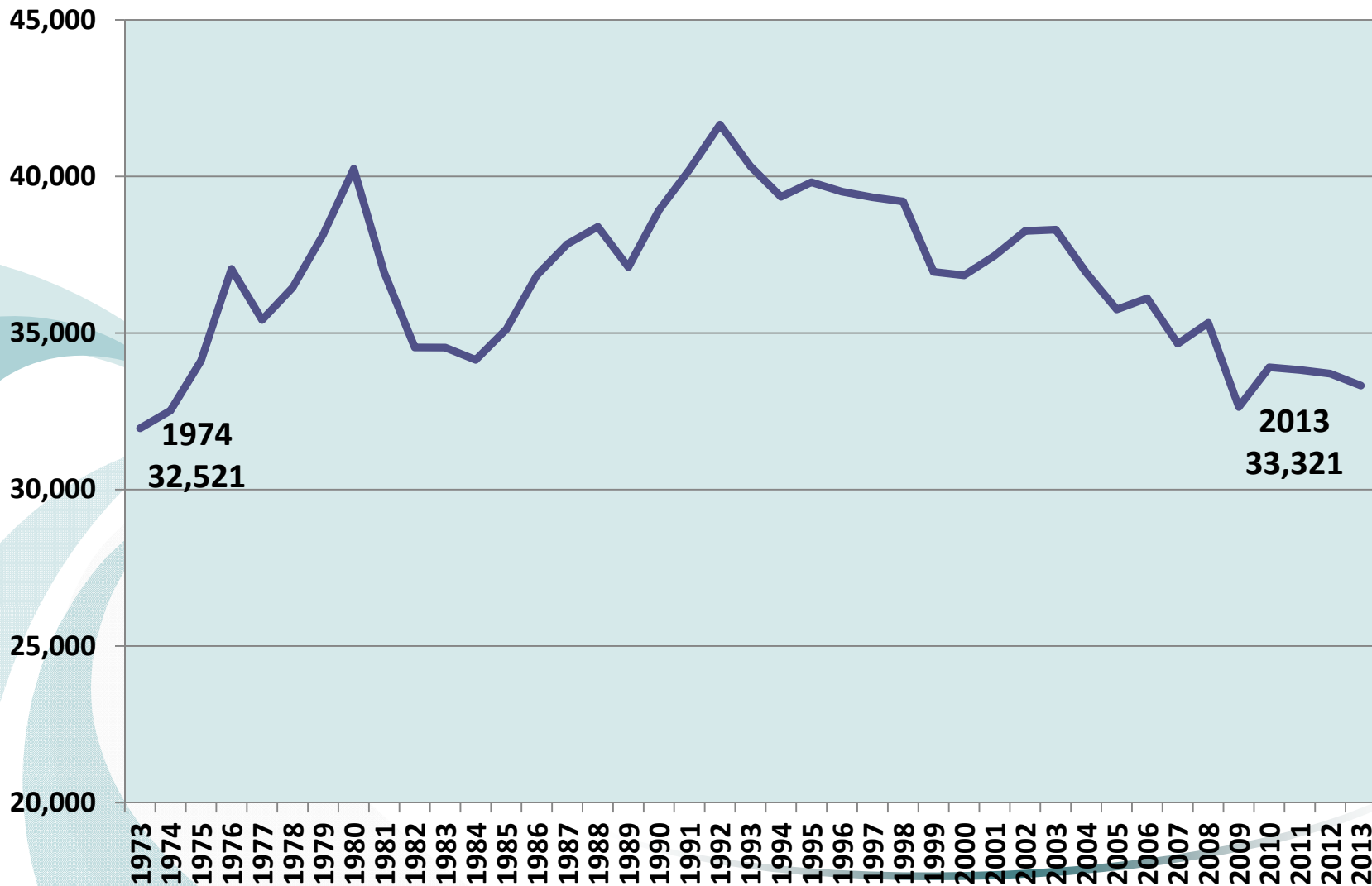
Impact of Recent Cuts

- **Rehabilitation to Work for Persons with Disabilities**
 - Reduced General Fund has resulted in a loss of \$11 million in matching Federal Funds – 8,900 fewer persons served
- **Aid to Localities**
 - Reductions impact local governments: libraries, jails, public transportation, area development districts
- **Maintenance of Physical Plant**
 - Operating budget cuts reduce funding for preventive maintenance

Cost Containment Measures in Major Program Areas

- **Medicaid**
 - Efficiency Measures
 - Managed Care Initiative
 - Estimated Savings of \$1.3 billion over 3 years (all funds)
- **Corrections**
 - House Bill 463 and other Reforms
 - Estimated Savings up to \$420 million over 10 years
- **Public Employee Pensions**
 - Increased Employee Contribution
 - Decreased Benefit Factor
 - Lengthened Time to Full Retirement
 - Decreased Final Compensation Calculation
 - Decreased Health Insurance
 - Decreased Cost of Living Adjustment (COLA)
- **Health Insurance for Public Employees**
 - Changed Plan Design
 - Increased Wellness Efforts
 - Efficiency Measures

Smallest State Workforce Since 1974



State Employees Have Not Had a Raise in Four Years, While Costs Have Increased

Fiscal Year	State Employee Raises	Inflation
FY 2002	5%	1.8%
FY 2003	2.7%	2.2%
FY 2004	\$1,080	2.2%
FY 2005	2% + 1% on Jan 1, 2005	3.0%
FY 2006	3%	3.8%
FY 2007	\$1,200 on average	2.6%
FY 2008	\$1,200 on average	3.7%
FY 2009	1%	1.4%
FY 2010	1%	1.0%
FY 2011	-2.3% due to 6 furlough days	2.0%
FY 2012	0%	2.9%
FY 2013	0%	2.0%
FY 2014	0%	2.0%
FY08-FY14	2.0%	11.8%

What Does the Future Hold?

- Short Term and Long Term Budget Challenges
 - Need to increase funding for education
 - Demand for government services goes up when the economy is down; the effects of the recession continue to elevate demand for services
 - Adequately fund pension obligations
 - Address infrastructure needs – education, water & sewer, parks, other
 - Impact of Federal budget cuts on K-12 Schools
 - Need to increase the Rainy Day Fund
 - Health care and justice system costs continue to increase faster than revenues
 - Aging population will require additional services

Early Look at the Next Biennial Budget

	FY 15 <u>(millions)</u>
Revenues	
Revenue Growth of 2.5% to 3%	\$238 - \$286
Budgetary Requirements	
Fund Recurring Expenses Supported by One-time Money	\$157
Pension Contributions for Teachers and State Employees- Under Current Schedule	\$28
Medical Inflation in Medicaid (5%)	\$75
Medical Inflation in Health Insurance for Teachers and Public Employees (5%)	\$40
Total	<u>\$300</u>

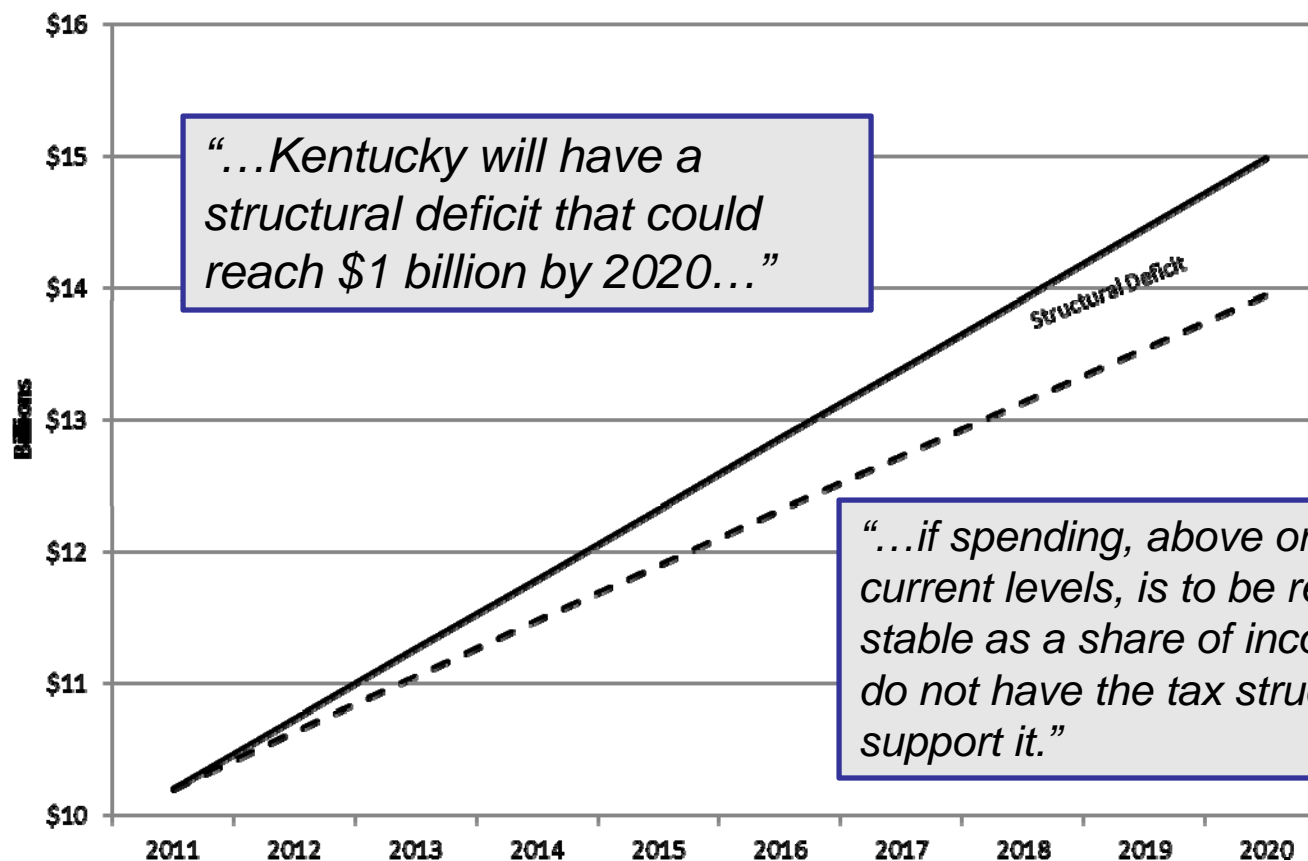
Early Look at the Next Biennial Budget

	FY 15 <u>(millions)</u>
Other Critical Needs	
Full Funding for the ARC for Kentucky Retirement Systems*	\$300
SEEK Funding (every 1% increase)	\$29
Teacher Raises (every 1%)	\$23
Restore Cuts to K-12 Programs like Textbooks, Professional Dev.	\$64
Increase Funding for School Safety	?
Increase Postsecondary Education Funding (every 1% increase)	\$9
Increase Funding for DCBS - Protective Services, Child Care Assistance	\$87
Debt Service for Any New Capital Projects	?
Salary Increment for State Employees (every 1% increase)	\$8
Increase Funding for Substance Abuse Treatment	?
Address Judicial Branch shortfall	?
Relieve Caseload levels for Public Advocates and Prosecutors	?

*Pension Task Force estimate; all funds; all employers in KERS



Adequacy & Elasticity: Simulated Kentucky Revenue



Source: Authors' calculations

About the Commission

- Governor Beshear established the Blue Ribbon Commission on Tax Reform by Executive Order in February 2012
- 23 Kentuckians served on the Commission – members from large and small businesses, education, health care and advocacy communities, as well as legislators from both the House and the Senate as ex officio non-voting members
- Gov. Beshear asked for recommendations to improve the tax code in five areas: Fairness, Competitiveness, Simplicity and Compliance, Adequacy and Elasticity

Tax Reform Process

- Economic consultants were hired to assess our tax code, our competitor states, and identify options for how to improve inadequacies in our revenue structure
- A total of 15 public meetings took place. The Commission heard expert presentations from:
 - Professors and state university business schools;
 - Kentucky Society of CPAs;
 - Kentucky Department of Revenue;
 - Office of the State Budget Director;
- A meeting was held in each of the six Congressional Districts
- A website was created to take information, thoughts and proposals from the public

Tax Reform Process

- Overall, we heard at the public hearings:
 - Almost 100 requests for the state to raise more revenue, to make the tax code more elastic, to spend more on state programs, or, in a very few cases, to spend less on state services
 - Over a dozen requests or suggestions to simplify the tax code
 - Almost 50 requests to make our tax code more fair
 - Over 50 proposals or requests to make our tax code more competitive for businesses, or to ensure our tax code provides adequate oversight of business tax breaks
- Proposals taken under consideration by the Commission were narrowed to 96. The Commission voted to approve 54 proposals

Commission Recommendations

Individual Income Tax

- Reduce the individual income tax rate structure
- Enact an Earned Income Tax Credit
- Cap itemized deductions
- Amend the pension income exclusion from \$41,110 to \$30,000, and phase out the exclusion for total income over \$30,000
- Implement a tax deduction for 529 savings plan contributions

Commission Recommendations

Corporate Income Tax

- Lower the top corporate tax rate from 6.0 percent to 5.8 percent to mirror the top rate for individual income taxes
- Add back management fees in the calculation of the corporate income tax base
- Implement single factor apportionment, and change the existing cost-of-performance based formula for apportioning sales to incorporate a destination sourcing for services
- Amend the small-business definition for minimum LLET from \$3.0 million to \$1.0 million
- Establish an angel investor tax credit program
- Expand the state's R&D Tax Credit to human capital

Commission Recommendations

Sales and Excise Taxes

- Broaden the sales tax to selected services, following certain principles
- Apply sales and transient room tax to entire hotel accommodation price
- Impose a gross receipts tax of 1 percent on utilities and dedicate additional revenues to SEEK
- Increase the tax rate on cigarettes to \$1.00 and other tobacco products commensurate to the cigarette tax
- Apply sales tax to pre-written computer software made available for access without a download
- Exempt the sales and use tax on certain equine products to promote our signature Industry
- Increase collection of remote location and internet sales

Commission Recommendations

Property Taxes

- Create an income tax credit for the signature bourbon industry
- Exempt inventory from state property tax
- Freeze the state property tax rate at 12 cents per \$100 of value
- Eliminate selected negligible state property tax rates for tangible personal property, with an emphasis on classes of property subject to the “State Rate” only

Other Taxes/Issues

- Impose the Pari-mutuel tax on advance deposit wagers made on live races conducted at Kentucky race tracks
- Provide for a review every five years of all tax incentives and expenditures

Commission Recommendations

Road Fund Taxes

- Raise the floor of the average wholesale price for fuels taxes
- Reduce dealer's compensation on motor fuels tax from 2.25% to 1%
- Implement a trade-in credit for new car purchases

Commission Recommendations

Local Taxation Issues

- Amend the Constitution to allow a local option sales tax.

Simplicity, Compliance and Tax Administration

- 15 recommendations, many by the Department of Revenue, to simplify the state's tax code, make it easier for taxpayers to comply and prevent expensive legal actions by the state or taxpayers.



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