Kentucky Governor Matt Bevin announced that he will wait until after August 15th to call a special session of the Kentucky Legislature to consider tax reform. The governor stated that he does not have a fixed position on what that reform must entail. In that light, it would be helpful to compare Kentucky’s current tax structure to other states.

According to 2014 tax data collected at the state level, Kentucky is the 6th most dependent state on income tax revenue as a percentage of state tax collections. It only trails Oregon, Maryland, Massachusetts, California, and New York in its dependence upon income taxes. While Kentucky’s top tax bracket is the nineteenth highest in the country, its overstated importance to the state budget has a lot to do with Kentucky’s lower than average state sales and property tax collections. A reduction in the state income tax rate to 5.75% would place Kentucky’s rate at the US average.

Income Tax Sales Tax Property Tax Increase in Real Per Employment to

(Top Bracket) (State and (State and Capita GDP Population Ratio

Local) Local) Compounded Annual (aged 25-54)

Rate (1997-2015)

US 5.75% 6.89% .87% 1.1% 77.9%

IL 3.75% 8.64% 1.73% .9% 79.5%

IN 3.23% 7.00% .85% 1.1% 80.4%

KY 6.0% 6.00% .72% .5% 73.6%

MO 6.0% 7.89% .91% .5% 81.3%

OH 4.997% 7.14% 1.36% 1.0% 78.5%

TN 0%\* 9.46 .68 .8 75.0%

VA 5.75 5.63 .74 1.0 80.4%

WV 6.5% 6.59 .49 1.1 69.7%

\*5% on capital gains and dividends

Conversely, Kentucky holds the 13th lowest combined state and local sales tax rate and the 14th lowest combined state and local property tax rates. An increase in the state sales tax from 6% to 6.89% and an increase in state property taxes from .72% to .87% would bring Kentucky in line with US averages.

Regionally, of Kentucky’s seven neighbors, only West Virginia has a higher top income tax bracket than Kentucky. Only Virginia has a lower sales tax. Tennessee and West Virginia are the only two Kentucky neighbors with lower property tax rates. At first glance, Governor Bevin’s desire to reduce the state’s reliance on income tax revenue is consistent with bringing Kentucky in line both with US averages and Kentucky’s neighboring states.

State averages, however, gloss over some key challenges for Kentucky. Kentucky is drowning in public pension debt Left unaddressed, unfunded pension liabilities will accelerate the pace at which they will continue to rob money from other state priorities such as education and infrastructure. Recognizing this, Governor Bevin has stated that the tax reform needs to raise new revenue to help solve the pension crisis. Republican lawmakers may rightfully balk at tax increases unless they are accompanied by meaningful pension reform. Past pension promises must be kept, but future promises should only be made in line with future revenues.

Complicating the tax reform picture is that in 2016, among prime working age adults (aged 25-54), Kentucky had the fifth lowest employment to population ratio of any state in the country at 73.6%. Only Alabama, Mississippi, New Mexico, and West Virginia had a lower percentage of working aged adults hold a job. It is difficult to collect tax revenue from people who don’t work. In fact, low employment rates are a drain on state resources. A key element of tax reform should be to encourage Kentuckians to work.

Rather than just lower Kentucky’s top income tax rate to 5.75%, it would be better to simplify the state income tax code down to two rates: a 5% rate on income up to $75,000 and a 5.75% rate on income over $75,000. This would lower the penalty to work for middle class Kentuckians while preserving a progressive state income tax.

Kentucky could increase their state sales tax to 7% while also legalizing local option sales taxes – something that the Kentucky League of Cities has been pushing for years. Raising property taxes faces additional constitutional constraints, but should be on the table if the state is truly engaging in comprehensive tax reform. Property tax revenues are not as volatile as income or sales tax revenues.

Real reform requires tough choices, but real reform is needed. Kentucky’s state finances are not currently on a sustainable path. Kentucky needs to grow its economy, get its adults back to work, invest in tomorrow’s workers and infrastructure, and reform its outdated public pensions. Hopefully the legislature can pull that all off between August 15th and Octoberfest so that we can properly celebrate their accomplishment.