Report of the
Task Force on Tax Expenditures

Research Memorandum No.______________

Legislative Research Commission
Frankfort, Kentucky

December 2018

Kentucky Legislative Research Commission

SENATE	HOUSE
Robert Stivers President, LRC Co-Chair	**David W. Osborne** Speaker Pro Tempore
Jimmy Higdon President Pro Tempore	**Jonathan Shell** Majority Floor Leader
Damon Thayer Majority Floor Leader	**Rocky Adkins** Minority Floor Leader
Ray S. Jones II Minority Floor Leader	**David R. Meade** Majority Caucus Chair
Dan "Malano" Seum Majority Caucus Chair	**Dennis Keene** Minority Caucus Chair
Dorsey Ridley Minority Caucus Chair	**Kevin Bratcher** Majority Whip
Mike Wilson Majority Whip	**Wilson Stone** Minority Whip
Dennis Parrett Minority Whip	

The Kentucky Legislative Research Commission is a 16-member committee comprised of the majority and minority leadership of the Kentucky Senate and House of Representatives. Under Chapter 7 of the Kentucky Revised Statutes, the Commission constitutes the administrative office for the Kentucky General Assembly. Its director serves as chief administrative officer of the legislature when it is not in session. The Commission and its staff, by law and by practice, perform numerous fact-finding and service functions for members of the General Assembly. The Commission provides professional, clerical, and other employees required by legislators when the General Assembly is in session and during the interim period between sessions. These employees, in turn, assist committees and individual members in preparing legislation. Other services include conducting studies and investigations, organizing and staffing committee meetings and public hearings, maintaining official legislative records and other reference materials, furnishing information about the legislature to the public, compiling and publishing administrative regulations, administering a legislative intern program, conducting a pre-session orientation conference for legislators, and publishing a daily index of legislative activity during sessions of the General Assembly.

The Commission also is responsible for statute revision; publication and distribution of the Acts and Journals following sessions of the General Assembly; and maintenance of furnishings, equipment, and supplies for the legislature.

The Commission functions as Kentucky's Commission on Interstate Cooperation in carrying out the program of the Council of State Governments as it relates to Kentucky.

Report of the Task Force on Tax Expenditures

Members

Sen. Chris McDaniel, Co-Chair
Rep. Ken Fleming, Co-Chair

Senate	House
Sen. David Givens Sen. Wil Schroder Sen. Dennis Parrett Sen. Morgan McGarvey	Rep. Jason Petrie Rep. Diane St. Onge Rep. James Tipton Rep. Susan Westrom Rep. Jim Wayne

Rep. Steven Rudy (*ex officio*/non-voting)

Project Staff

Jennifer Hays
Cynthia Brown
Katy Jenkins
Amit Shanker
Kevin Branscum
Charlotte Quarles
Chase O'Dell

Research Memorandum No. ________

Legislative Research Commission
Frankfort, Kentucky
lrc.ky.gov

Approved by the Task Force on Tax Expenditures
December _________________

Paid for with state funds. Available in alternative format by request.

Forward

The Task Force on Tax Expenditures was created on April 14, 2018, via a memorandum jointly signed by Senate President Robert Stivers and House Speaker Pro Tempore David Osborne. The authorizing memorandum is included as Appendix A. The Task Force was created for the 2018 legislative interim and authorized to meet once monthly upon agreement of the co-chairs through December 30, 2018.

The Task Force on Tax Expenditures was directed to review, examine, and analyze the state's tax expenditures, as specified by the co-chairs, and to submit a report to the President of the Senate, Speaker of the House, and Interim Joint Committee on Appropriations and Revenue. The report shall contain recommended General Assembly action and be detailed enough to determine the expenditures' validity and sunset provisions. This publication is that report.

The task force members would like to acknowledge the many stakeholders who provided valuable suggestions and comments to the task force as well as the many individuals who provided testimony and expert insight, including representatives from the:

- Office of State Budget Director;
- Department of Revenue;
- Cabinet for Economic Development;
- Tourism, Arts and Heritage Cabinet;
- Kentucky Farm Bureau Federation;
- Kentucky Retail Federation;
- Kentucky Association of Manufacturers;
- Kentucky Center for Economic Policy;
- Pegasus Institute; and
- Legislative Research Commission, Appropriations and Revenue Committee staff.

Legislative Research Commission
Frankfort, Kentucky
December ___________________

Contents

Summary ....

Chapter 1 – Comments from the June 28, 2018, Meeting

- Office of State Budget Director ....
- Department of Revenue ....
- Cabinet for Economic Development ....
- Tourism, Arts and Heritage Cabinet ....

Chapter 2 – Comments from the July 26, 2018, Meeting

- Top 10 Tax Expenditures by Amount ....
  - Sales Tax ....
  - Individual Income Tax ....
  - Property Tax ....
  - Corporation Income Tax ....
- The Bottom 5% of Tax Expenditures ....

Chapter 3 – Comments from the August 30, 2018, Meeting

- Kentucky Farm Bureau Federation ....
- Kentucky Retail Federation ....
- Kentucky Association of Manufacturers ....

Chapter 4 – Comments from the October 25, 2018, Meeting

- Kentucky Center for Economic Policy ....
- Pegasus Institute ....

Chapter 5 – Comments from the December 13, 2018, Meeting

- Comments and Recommendations from the Co-Chairs ....

Appendices

Appendix A – Authorizing Memorandum for the Task Force on Tax Expenditures ....

Appendix B – Tax Expenditures Analysis, Fiscal Years 2018-2020 ....

Appendix C – Listing of Certain Tax Expenditures by Dollar Amount ....

Summary

On November 30, 2017, John Chilton, State Budget Director, completed the *Tax Expenditure Analysis, Fiscal Years 2018-2020*. The publication was delivered to the Governor, Matthew G. Bevin, and each branch of government. Included in the 2017 edition are detailed estimates of General Fund and Road Fund revenue losses attributable to tax expenditures for the then-current fiscal year (fiscal year 2017-2018) and the next two fiscal years, 2018-2019 and 2019-2020.

A grand total of all tax expenditures, excluding tourism credits or subsidies, Tax Increment Financing (TIF) projects, federal tax expenditures, and tax expenditures associated with the sales taxation of services is as follows:

Fiscal Year 2017-2018	**$ 9,370.5 million**
Fiscal Year 2018-2019	**$ 9,691.6 million**
Fiscal Year 2019-2020	**$10,027.6 million**

The purpose of a *Tax Expenditure Analysis* is to quantify and catalog specific tax reductions that have been established by statute. An item is determined to be a tax expenditure if the tax revenue associated with that item is reduced because of a specific statue enacted by the Kentucky General Assembly.

Direct budgetary expenditures (appropriations) are made by distributing funds actually collected by the Commonwealth. Tax expenditures are made by authorizing preferential tax treatment that allows the targeted recipient to retain money that would otherwise be paid in taxes to the Commonwealth.

Direct expenditures are evaluated during each budget cycle and are approved, adjusted, or rejected during the budget process. State tax expenditures, however, are evaluated and approved primarily at the time of adoption and implementation, unless the enabling legislation expires or "sunsets" at a statutorily-defined future date. There is no process to systematically review or periodically re-evaluate tax expenditures in subsequent years, except by the *Tax Expenditure Analysis*.

The mission of the Task Force on Tax Expenditures was to review, examine, and analyze the state's tax expenditures. The co-chairs agreed to proceed with monthly meetings to understand:

- What the tax expenditures are; and
- How the tax expenditures work.

Chapter 1

Office of State Budget Director
The Tax Expenditure Analysis
Fiscal Years 2018-2020
Presented by:
Greg Harkenrider
Dr. Michael Jones

2016 RS HB 303, commonly called the executive branch budget bill, required the Office of State Budget Director to provide, by November 30, 2017, a report of the revenue loss affected by tax expenditures to each branch of government by giving detailed General Fund and Road Fund estimates for the current and next two fiscal years. The executive branch budget bill also required the Department of Revenue to provide assistance and furnish data which is not restricted as confidential data by KRS 131.190. The required report is included as Appendix ________ of this document.

Within the bill, "tax expenditure" is defined to mean:

1. An exemption, exclusion, or deduction from the base of a tax;
2. A credit against the tax;
3. A deferral of a tax; or
4. A preferential tax rate.

The estimates shall include for each tax expenditure:

1. The amount of revenue loss;
2. A citation of the legal authority for the tax expenditure;
3. The year in which it was enacted; and
4. The year in which it became effective.

The first Tax Expenditure Analysis was produced in 1988. 2018 RS HB 200 requires the Office of State Budget Director to provide the next Tax Expenditure Analysis by November 30, 2019.

Common Examples of the Various Types of Tax Expenditures

Exemption. The property tax homestead exemption of $37,600 is available on the principal residence of every taxpayer who is 65 years of age or older or is classified as totally disabled. The fair cash value of the parcel is reduced by the exemption and the property tax rate is applied to the remaining value.

Exclusion. Social Security income that is taxed for federal income tax purposes is excluded from the computation of gross income for Kentucky income tax purposes.

Deduction. A net operating loss for a business is allowed to be carried forward by the business to a future taxable year and deducted when net income is realized.

Credit. The limited liability entity tax credit is allowed against the amount of income tax due for the entity. The purpose of this credit is for the entity to pay the higher of the two taxes, income or limited liability entity tax, instead of the total of both taxes.

Deferral. Interest earned on United States savings bonds may be deferred until the bonds are redeemed. The income is taxed when recognized, instead of when realized.

Preferential Tax Rate. For property tax purposes, business inventories are taxed at a lower rate than most other tangible personal property. The preferential tax rate for business inventories is 5 cents for each $100 of value, instead of 45 cents for each $100 of value.

Tax Expenditures versus Budgetary Appropriations

Tax expenditures differ from budgetary appropriations. Tax expenditures are approved by the General Assembly and then become codified until modified by a future General Assembly. They are not reapproved every year. Budgetary appropriations are reviewed every two years when the budgets for the three branches of government are enacted, i.e., the Executive, Judicial, and Legislative bills. Once a tax expenditure becomes codified, future biennial budget balance sheets do not carry the revenue loss. The revenue loss from the tax expenditure is absorbed into the Consensus Forecast Group estimates.

Chart 1.
FY 2017 General Fund Receipts Composition

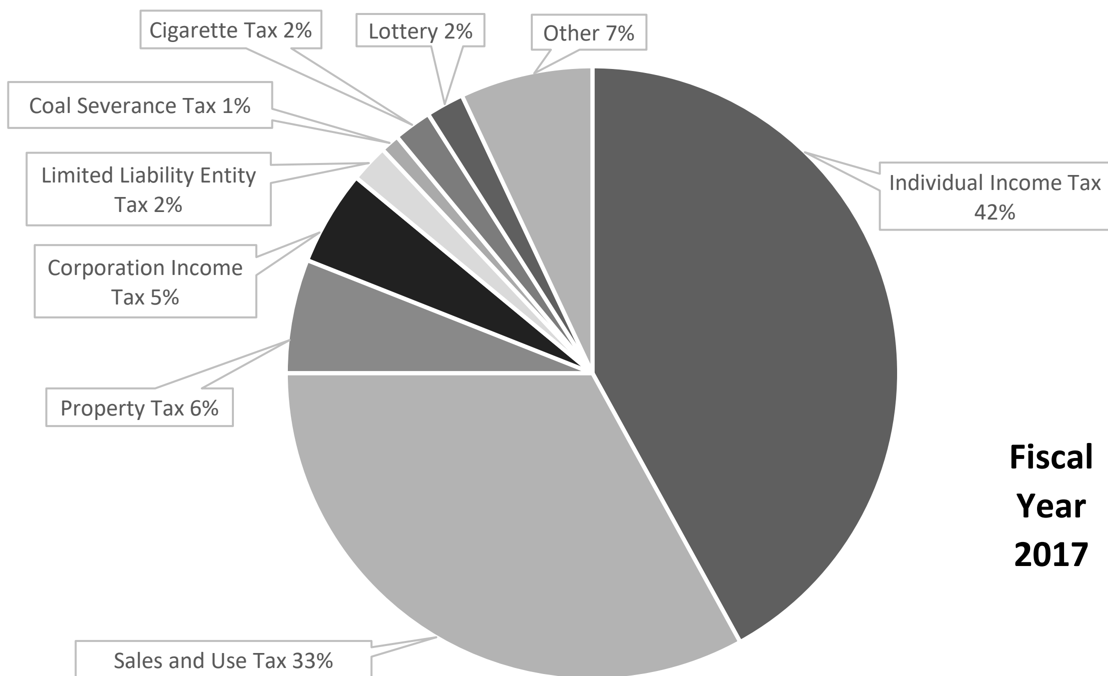
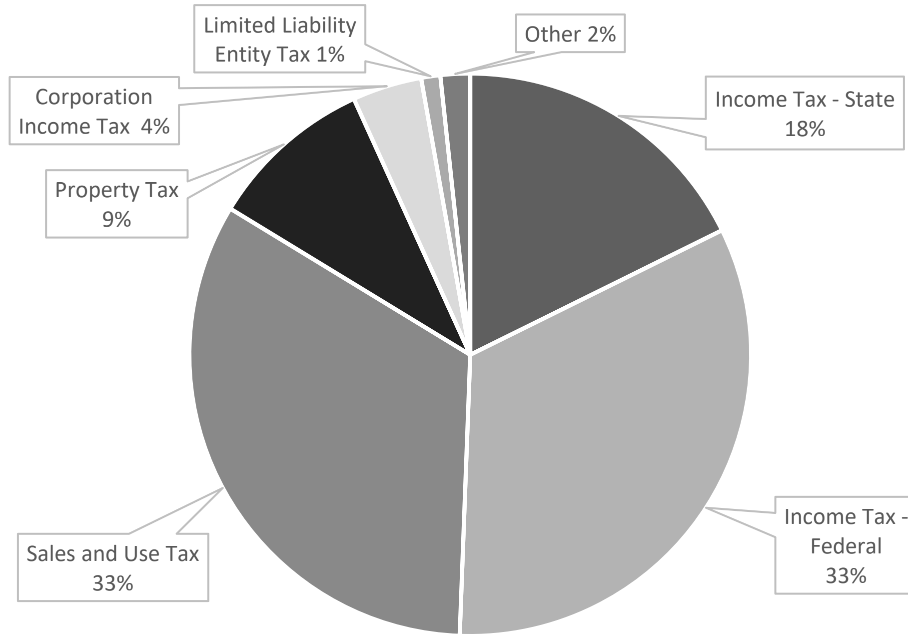


Chart 2.
Tax Expenditures by Tax Type



The following table compares the percentage of receipts by the four major type taxes with that tax's percentage of tax expenditures. These major taxes have relatively equal percentages of receipts and tax expenditures for each tax, with only Individual Income Tax having a slightly higher percentage of tax expenditures.

Table 1.
Comparison of Receipts Percentage and Tax Expenditures Percentage by Major Tax

Type Tax	Receipts Percentage	Tax Expenditures Percentage
Individual Income Tax	42%	51%
Sales and Use Tax	33%	33%
Property Tax	6%	9%
Corporation Income Tax	5%	4%

The Process for Formulating the Tax Expenditure Estimates

Prior to each legislative session in an even-numbered year, the Office of State Budget Director staff estimate each tax expenditure for the current fiscal year and the upcoming two-year biennium. The same staff estimate the Consensus Forecast Group receipts and the Tax Expenditure values.

Growth or decline in a tax expenditure estimate is determined by several factors, including the rate of new applications or utilization of the tax expenditure, the pattern of historical growth or decline, growth or decline in the underlying tax, or programmatic knowledge about the tax expenditure.

The accuracy of the estimates is determined by the quality of the underlying data. There are various data sources with some sources having a higher degree of accuracy than others. The following data sources are ranked from ideal to acceptable:

- Actual tax return data from the Department of Revenue;
- Individual income tax data over multiple years contained with a microsimulation model;
- Cabinet-level tax credit data from those agencies authorizing tax credits;
- Cabinet-level applications approved by those agencies authorizing tax credits;
- Kentucky-specific research performed by staff within the Office of the State Budget Director;
- Federal Statistics of Income related to Kentucky taxpayers;
- Federal tax expenditure data apportioned to Kentucky; and
- Federal Census or other national data apportioned to Kentucky.

In an ideal world, all of the data would come from tax returns filed with the Department of Revenue. In the real world, only a fraction of the data comes from the Department. Generally, the amounts of tax credits claimed and economic incentives approved are tracked very closely. For other tax expenditures, however, not every line item on a tax return is captured and saved by the Department. Therefore, data is not available for those line items. Errors in data can be problematic. A taxpayer may place a number on the wrong line of a tax return. The tax return computation may be completely modified by a taxpayer to eliminate data items but end with the correct tax due result. These data errors are not corrected by the Department because the correct amount of tax was paid. But, the data errors may significantly impact the results of an estimate. Finally, data from the Department comes in piecemeal fashion. There is no one processing system that contains all data for all tax expenditures. Line items from one tax may need to be compared to line items from another tax and those line items may need to separately requested, received, and evaluated.

For some tax expenditures, an estimate of "minimal" or "substantial" may be listed. In these cases, no data is available but sufficient institutional knowledge is used to determine if the estimate should be above or below a standard dollar amount. A minimal estimate is characterized as being $1 million or less. A substantial estimate is characterized as being more than $1 million.

Limitations of the Tax Expenditure Analysis

Staff from the Office of State Budget Director pointed out several limitations of the estimates within the Tax Expenditure Analysis.

A fiscal note for proposed legislation may differ from the estimate found in the Tax Expenditure Analysis. When a tax expenditure is eliminated or modified by law, several factors can occur that alter behavior. Additionally, effective dates may speed up or delay tax collections. For example, taxpayers may move out of state, consumers may demand less of the good or service, taxpayers may avoid or refuse to comply with the change, or collections may lag as a result of the proposed change.

A fiscal note may never begin with the tax expenditure as the starting point. In most every case, a fiscal note will take into consideration other states' experiences, a deeper appreciation of compliance issues, additional external data sources that would refine the fiscal note estimate, and Kentucky data sources related to industry-specific impacts.

Finally, the Tax Expenditure Analysis does not contain specific information to assist the reader in the application of the estimates. For example:

- There is no data dictionary explaining the source of the data used to produce the estimate;
- A confidence index is not available for each estimate; and
- The publication does not aggregate tax expenditures which may be available across multiple taxes, such as a tax credit available for individual income, corporation income, and limited liability entity taxes.

Department of Revenue
Interaction between the Department of Revenue and Tax Expenditures
Presented by:
Daniel P. Bork, Commissioner

Data Confidentiality Requirements

KRS 131.081, 131.190, and federal data restrictions require the Department of Revenue to keep taxpayer information confidential. Maintaining public trust is vital to the successful administration of our tax system. Public trust is bolstered in several ways:

- Protecting confidentiality;
- Preventing unauthorized disclosures; and
- Protecting the department's information systems.

KRS 131.081 – The Taxpayer Bill of Rights

The Kentucky Taxpayer Bill of Rights states:

> "Taxpayers shall have a right to privacy with regard to the information provided on their Kentucky tax returns and reports, including any attached information or documents." [KRS 131.081(15)]

KRS 131.190 – Confidentiality of Information Received by the Department

Generally, whether presently or formerly having access to information submitted by a taxpayer or a taxpayer representative, every person having that access is prohibited from inspecting or divulging that information without authorization. This statutory prohibition requires all information be safeguarded as confidential unless a specific exception is listed in KRS 131.190.

KRS 131.190 was amended in 2018 RS HB 487 to allow the department to provide the Legislative Research Commission with the following information as an exception to the confidentiality requirement:

- KRS 139.519 for the purposes of the sales and use tax refund on building materials used for disaster recovery;
- KRS 141.436 for purposes of the energy efficiency products credit;
- KRS 141.437 for purposes of the ENERGY STAR home and ENERGY STAR manufactured home credits;
- KRS 148.544 for purposes of the film industry incentives;
- KRS 154.26-095 for purposes of the Kentucky industrial revitalization tax credits and job assessment fees;
- KRS 141.068 for purposes of the Kentucky investment fund;
- KRS 141.396 for purposes of the angel investor tax credit;
- KRS 141.389 for purposes of the distilled spirits credit; and
- KRS 141.408 for purposes of the inventory credit.

Without a specific exception listed in KRS 131.190, the department will only provide statistical data. Statistical data must include summarized data from more than three taxpayers.

Any person who violates the intentional unauthorized inspection provisions of KRS 131.190 shall be fined not more than $500 or imprisoned for not more than six months, or both. Any person who violates the provisions by divulging confidential taxpayer information shall be fined not more than $1,000 or imprisoned for not more than one year, or both. In addition to these penalties, the person may be disqualified and removed from office or employment.

Internal Revenue Service Restrictions

The Department of Revenue is prohibited from sharing any federal tax information received from the Internal Revenue Service. 26 U.S. sec. 6103(a)(3) prohibits an officer or employee of any state from disclosing any federal return or federal return information obtained by that individual in any manner in connection with his or her service as an officer or an employee.

Since federal tax information is commingled within many of the department's systems, sharing statistical information may not be allowed because federal tax information may be included in that information and release must be approved by the Internal Revenue Service.

To access federal tax information, department must:

- Complete FBI finger print and background investigations for each employee with access;
- Train staff on the requirements to protect the federal tax information;
- Restrict areas with two physical barriers;
- Escort all visitors;
- Record all movement of federal tax information data; and
- Follow strict computer security requirements established by the National Institute of Standard and Technology.

According to KRS 131.190(4), access to and inspection of information received from the Internal Revenue Service is for department use only and shall not be made available to any other agency of state government, or any county, city, or other state. Penalties associated with disclosing or misusing federal tax information range from a $1,000 fine and one year in prison to a $5,000 fine and five years in prison.

The use of federal tax information by the department during the calendar year 2017 produced approximately $86 million in compliance dollars.

Protecting Taxpayer Information

The department maintains taxpayer confidentiality by:

- Maintaining physical barriers, including reception areas, locked areas with access through keys or electronic controls, computer passwords, badged employees, and security guards;
- Requiring visitors to sign in and sign out and be escorted at all times;
- Restricting access specifically an on a "need-to-know" basis;

- Monitoring and tracking access to data and restricting computer access based on the job duties of the employee;
- Following a clean desk policy;
- Keeping conversations at a minimum volume;
- Having computer screens facing away from walk ways;
- Requiring all computers to be locked when staff is away from their desk;
- Ensuring electronic transmission of taxpayer information is encrypted;
- Destroying taxpayer data property when no longer needed, including specific steps related to disposal of paper and electronic files;
- Prohibiting overseas access; and
- Prohibiting access to taxpayer records of family members, friends, acquaintances, or co-workers.

Cabinet for Economic Development
Overview of Incentive Programs
Presented by:
John Bevington, Commissioner, Department for Business Development
Jessica Burke, Executive Director, Office of Legal Services
Sarah Butler, Director, Incentive Administrative Division

The Cabinet's Mission

The Kentucky Cabinet for Economic Development is the primary state agency responsible for encouraging job creation, business retention, and new investment in the state. Cabinet employees work with clients, consultants, utilities, the federal government, other state agencies, and local governments to:

- Create jobs;
- Focus on advanced manufacturing;
- Provide a trained workforce;
- Build relationships;
- Engage communities;
- Support existing industry;
- Foster a positive business climate; and
- Attract foreign direct investment.

Their purpose is to lower the cost of doing business within the Commonwealth through the utilization of tax incentives, cash programs, and workforce development programs.

Tax Incentive Programs

All tax incentive programs are performance based. The following information is presented for those tax incentive programs most utilized.

Kentucky Business Investment Program (KBI).
To be eligible for this incentive, the company must be in the business of manufacturing; agribusiness; alternative fuel, gasification, or renewable energy production; a non-retail service or technology industry; or maintain a regional or national headquarters within the Commonwealth.

The incentives include corporation income tax and limited liability entity tax credits and employee wage assessments for up to 10 or 15 years, depending on the location of the project.

The company is required to create at least 10 new, full-time jobs for Kentucky residents, have a minimum investment of $100,000 in eligible costs, and maintain a minimum hourly wage and total hourly compensation through negotiated job and wage targets.

Through June 19, 2018, the Commonwealth provided $3,042 of incentive for each new job reported based on total actual incentives claimed to date and actual jobs reported. Based on actual jobs and wages reported in 2016 by companies approved to claim incentives, the estimated payroll for new, full-time Kentucky resident jobs is approximately $1 billion. This equated to $16.89 for

every $1 of claimed incentives. To date, there have been $172,034,850 in awarded incentives, $150,320,877 in earned incentives, and $59,845,588 in claimed incentives.

Table No. ___
KBI Statistics

		JOBS			WAGES		
Year	Number of Projects	Jobs Reported	Job Target	Percentage Achieved	Average Wage Reported	Wage Target	Percentage Achieved
2010	1	40	51	78%	$11.42	$11.00	104%
2011	5	269	257	105%	$35.00	$28.90	121%
2012	18	1,264	1,154	110%	$25.30	$23.23	109%
2013	58	5,882	5,395	109%	$24.88	$23.35	107%
2014	94	10,019	9,552	105%	$24.87	$22.99	108%
2015	136	14,197	12,720	112%	$25.28	$28.22	113%
2016	177	19,670	17,320	114%	$24.71	$21.65	114%
2017	148	15,495	12,224	127%	$25.52	$21.80	117%

Year	Approval Annual Maximum	Earned Annual Maximum	Incentives Claimed[1]	Utilization Rate
2010-2012[2]	$5,182,833	$4,914,663	$2,104, 094	43%
2013	$15,799,451	$14,088,369	$6,601,085	47%
2014	$27,770,169	$24,112,127	$13,131,631	54%
2015	$46,169,440	$40,372,578	$18,084,965	45%
2016	$39,770,648	$35,232,494	$19,923,814	57%
2017	$37,342,310	$31,600,377	N/A	N/A
Grand Total	**$172,034,850**	**$150,320,877**	**$59,845,588**	**40%**

[1] Data is based on information provided by the Department of Revenue. Total incentives claimed represent the total of income tax credits and wage assessments claimed through December 31, 2017.
[2] Due to taxpayer confidentiality, years 2010 – 2012 were combined.

Kentucky Enterprise Initiative Act (KEIA).
To be eligible for this incentive, the company must be in the business of manufacturing; tourism; alternative fuel, gasification, or renewable energy production; a non-retail services or technology industry; or maintain a regional or national headquarters within the Commonwealth.

The incentives are a refund of sales and use tax paid for building fixtures, construction materials, electronic processing equipment, research and development equipment, or flight simulators.

The company is required to have a minimum investment of $500,000 in eligible costs. There is an annual statutory limit of $20 million of incentive allotted for building fixtures and construction materials and an annual statutory limit of $5 million of incentive allotted for electronic processing, research and development equipment, and flight simulators.

Table No. _____
KEIA Results from Inception through May 2018

Number of Approvals	620
Value of Projected Investment	$15,842,308,123
Value of Incentives Approved for Construction Materials and Building Fixtures	$161,114,095
Value of Incentives Approved for R&D and Electronic Processing Equipment	$13,723,019

Kentucky Reinvestment Act (KRA).
To be eligible for this incentive, the company must be in the business of manufacturing or be a related company operating on a permanent basis and needing to reinvest in its existing facility and equipment. The incentives include corporation income tax and limited liability entity tax credits for up to 10 years. The company is required to invest at least $2.5 million in eligible costs and retain at least 85% of the existing full-time employees.

Table No. ___
KRA Results from July 2009 through May 2018

	Preliminary Approval	Final Approval
Number of Approvals	62	43
Value of Projected Investment	$2,230,779,025	$1,907,249,994
Number of Jobs Retained	28,141	23,991
Value of Incentives Approved	$228,950,457	$189,925,457
Value of Incentives Claimed	NA	$20,893,265 [3]

[3] Includes two projects approved prior to 2009 that are not represented in the other amounts or statistics.

Kentucky Small Business Tax Credit (KSBTC).
Job creation is the driver for this tax incentive. A company must create and fill one or more positions over the base employment and invest $5,000 or more in qualifying equipment or technology. The maximum amount of credits that may be committed in each fiscal year is capped at $3 M and the maximum credit for each small business cannot exceed $25,000 for each year.

As of May 31, 2018, $18 M in new investments have been made and 1,706 new jobs have been created, with only $5.7 M in tax credits awarded.

Other tax incentive programs administered by the Cabinet for Economic Development include the Kentucky Industrial Revitalization Act (KIRA), Kentucky Jobs Retention Act (KJRA), and the Tax Increment Financing (TIF) program.

Three programs were allowed to sunset in 2009, but remain in effect as taxpayers claim the remaining incentives. They are the Kentucky Rural Economic Development Act (KREDA), the Kentucky Industrial Development Act (KIDA), and the Kentucky Jobs Development Act (KJDA).

Legislation enacted during the 2018 Regular Session of the General Assembly suspended two programs. They are the Kentucky Investment Fund Act (KIFA) and the Angel Investment Tax Credit program.

Finally, the Cabinet administers two workforce programs through the Bluegrass State Skills Corporation (BSSC). The Skills Training Investment Credit (STIC) and the Grant-in-Aid (GIA) program allow up to 50% of costs to train Kentucky residents who are full-time employees and who are paid at least $12.51 per hour, plus benefits. The STIC is limited to $2.5 M annually and the GIA is limited to $2.3 M annually. The maximum allowed to any one company is $75,000.

The trend for economic development incentives in most states is to allow up-front cash, with claw-back provisions if the investment or job creation is not fully implemented. The Cabinet prefers tax incentives over time. However, a company may wish to have cash in hand to offset the implementation costs of a new project. The end result for either an incentive program or up-front cash is to lower the cost of doing business in Kentucky and encourage economic development.

Tourism, Arts and Heritage Cabinet
Overview of Incentive Programs
Presented by:
Regina Stivers, Deputy Secretary
Jay Hall, Executive Director, Kentucky Office of Film and Development
Craig Potts, Executive Director, Kentucky Heritage Council

This agency administers three incentive programs: (1) The Historic Preservation Tax Credit; (2) Film Industry Incentives; and (3) The Tourism Development Program Act.

Historic Preservation Tax Credit. The purpose of the tax credit is to bring dilapidated buildings back to active occupancy, drive economic development, and create jobs. This credit is a pro-rated 20% incentive with a $5 M annual cap. Eligible properties must be listed on the national Register of Historic Places. All of Kentucky's 120 counties have eligible properties, and rural counties make up approximately 40% of applications each year.

For every dollar invested through this tax credit, the Commonwealth will collect $5.22 in new tax revenues over 20 years. Nearly 30% of the cost of the tax credit is recouped before the credit is taken due to new tax revenues generated during the construction phase of each project. Since 2005, $76 M in Kentucky Historic Tax Credits have leveraged $1.38 B worth of investment. Of this investment, 60% was for labor and 40% was for materials. Both generated taxes. Income tax receipts are increased by job creation. Sales tax receipts are increased by materials purchased. Property tax receipts are increased by returning delinquent properties to the tax rolls.

Presenters pointed out that West Virginia recently called a special session to raise that state's Historic Preservation credit cap to $30 M annually.

Table No. ____
State Historic Credits in Kentucky's Neighborhood

State	Credit %	Program Annual Cap	Project Cap
Kentucky	20%	$5,000,000	$400,000
Illinois	25%	**Uncapped**	**Uncapped**
Indiana	20%	$450,000	$100,000
Missouri	25%	$140,000,000, but no cap for projects with less than $1,100,000 in qualified rehabilitation expenditures	None
North Carolina	20%	**Uncapped**	**Uncapped**
Ohio	25%	$60,000,000	$5,000,000
Virginia	25%	**Uncapped**	**Uncapped**
West Virginia	25%	$30,000,000	$10,000,000

Film Industry Incentives. Production companies of approved film projects are able to receive a tax credit for up to 35% of the production costs. Approved projects must begin production within 2 years and complete production with 4 years of the approval date. The program is current capped at an annual maximum of $100 M of incentives. Eligible productions include television shows, feature films, documentaries, and Broadway productions.

Approximately 10% of the applicants complete production activities and receive incentives. Over the program's nine-year history, $53.1 M has been spent by the industry, $14.6 M in state incentives have been paid, and $4.2 M in additional state and local tax receipts have been generated. On February 1, 2018, the Kentucky Film Office suspended the acceptance of applications for projects.

Table No. ____

Film Industry Incentive Statistics

Year	Number of Jobs	Capital Investment Approved	Incentive Approved	Actual Capital Investment	Actual Incentive
2009	74	$8,100,000	$1,447,598	$6,137,991	$1,227,598
2010	8	911,251	182,250	695,473	140,647
2011	0	5,248,069	1,049,614	0	0
2012	21	1,982,345	426,630	1,729,857	345,971
2013	35	4,894,055	889,134	2,941,191	588,300
2014	0	0	0	0	0
2015	59	35,085,600	9,275,831	4,192,184	1,506,990
2016	390	156,379,745	50,274,950	32,532,027	9,596,415
2017	50	414,490,855	119,220,755	4,192,184	1,276,277
2018	TBD	1,341,440,701	424,221,163	TBD	TBD
Total	**638**	**$1,968,532,621**	**$606,987,925**	**$53,142,971**	**$14,682,199**

Tourism Development Program Incentives. Developers of a new or expanding tourism project are allowed to recover up to 25% of the project's development costs over a ten-year term. Lodging facility projects that are constructed on the property of a state park, federal park, or national forest are eligible to recover up to 50% of development costs over a twenty-year term. An expanding tourism attraction receives an incentive equal to the increased sales tax related specifically to the expansion.

The Department of Revenue annually issues a sales tax refund to any developer of an approved project. Sales tax is generally collected at the attraction on admission tickets, food and gift sales, and lodging costs.

Since 1997, 6,816 jobs have been created in Kentucky through tourism development investments and $1.1 B capital investment has been made. $253 M in incentives have been approved.

Chapter 2

Discussion of the Top 10 Tax Expenditures and
A Review of the Bottom 5% Tax Expenditures

Presented by:
John E. Chilton, State Budget Director
Daniel P. Bork, Commissioner, Department of Revenue
Greg Harkenrider, Deputy Executive Director, Office of State Budget Director
Jennifer Hays, Committee Staff Administrator, Legislative Research Commission

Top 10 Tax Expenditures by Amount

Appendix ________ contains the listing of certain tax expenditures, by dollar amount, from largest to smallest that was presented at the July 26, 2018, meeting of the Task Force. Six of the top 10 tax expenditures are for sales and use tax. They are:

- Prescription drugs, prosthetic devices, and physical aids;
- Food and food ingredients;
- Charitable, religious, and educational organizations;
- Residential utilities;
- State, cities, counties, and special taxing districts; and
- Various agricultural items, including livestock, feed, seeds and fertilizers.

The remaining four tax expenditures from the list are:

- The standard deduction (individual income tax);
- Social security benefits (individual income tax);
- The annual tax rate ceiling (real property tax); and
- The exclusion of dividend income (corporation income tax).

Any elimination of a tax expenditure should involve a holistic approach that is part of comprehensive tax reform. Regressivity is a consequence of eliminating many of those tax expenditures listed in the top 10. Therefore, an overall tax strategy, rather than individual expenditures, should be considered by Task Force members. For example, if the strategy is to tax all final consumption, then expanding the standard deduction might be preferable to eliminating that expenditure. For a second 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 the smallest expenditures. Every tax expenditure has a constituent that will lobby to keep that expenditure.

Economists seek to minimize market distortions. As a principle of optimal taxation, policy makers should consider the impacts of taxation on the market. In general, especially for the sales and use tax, the market distortion is directly proportional to the elasticity of demand for the taxed commodity. For example, pharmaceuticals are necessities. Necessity consumption is not as sensitive to price, and the quantity consumed will not change greatly with a change in price. Therefore, smaller market distortion and optimal taxation will occur. Market distortions within the Kentucky market are also sensitive to border effects. Fifty-two percent of Kentuckians live in

a border county. For example, pharmaceutical purchases may leave the state if Kentucky imposes a tax. None of our border states tax pharmaceuticals with prescriptions.

Sales and Use Tax

Prescription Drugs, Prosthetic Devices, and Physical Aids. KRS 139.472 exempts from sales and use tax prescription drugs, prosthetic devices, and physical aids. This exemption includes:

- Prescription drugs;
- Over-the-counter drugs dispensed with a prescription;
- Medical oxygen and oxygen delivery equipment;
- Insulin and diabetic supplies;
- Colostomy, ostomy, or ileostomy supplies;
- Prosthetic devices;
- Mobility enhancing equipment dispensed with a prescription; and
- Durable medical equipment dispensed with a prescription.

The elimination of this tax expenditure would have a positive effect on General Fund revenues since it is one of the largest tax expenditures. The additional General Fund dollars may be used to reduce other tax rates or fortify other budgetary needs. The elimination would make the sales and use tax more regressive. An unequal treatment between individuals receiving federally subsidized benefits and individuals not receiving those benefits may occur if the Commonwealth is not allowed to assess sales tax on federally subsidized benefits. Proponents of the elimination should expect fierce opposition from insurance companies, pharmaceutical companies, healthcare providers, and other advocacy groups.

Food and Food Ingredients. KRS 139.485 exempts food and food ingredients from sales and use tax. This Streamlined Sales Tax defined term does not include alcoholic beverages, prepared food, tobacco, candy, dietary supplements, or soft drinks. The six exceptions are taxable items for sales and use tax purposes. The elimination of this tax expenditure would be easy to implement and administer. There would be relatively small market distortions from this change. Negative impacts include the regressive implications of the sales tax, which may cause substitution with prepared foods. Additionally, border transactions may be impacted and legislators may expect opposition from a variety of groups.

Table No. _____

Taxation of Food by Kentucky's Border States

State	Tax Rate
Kentucky	No tax
Ohio	No tax
Indiana	No Tax
Illinois	1%
Missouri	1.225%
Virginia	1.5% State + 1% Local
West Virginia	5%
Tennessee	5.5%

Charitable, Religious, and Educational Organizations. The sales and use tax does not apply to certain sales made **to** a charitable, religious, or educational organization which qualifies for exemption from income taxation under Section 501(c)(3) of the Internal Revenue Code. Sales made **by** these organizations are subject to sales and use tax, if the item the organization sells is subject to the tax. If the item is subject to tax, the organization is required to collect the tax from their customer and remit the tax to the Commonwealth.

If this tax expenditure were to be eliminated, the positive effects include a fairly small market distortion may occur and administration by the Department of Revenue would be easily implemented. The negative effects include a possible discouragement to the formation and operation of these organizations, a possible increase in the cost of education, and a possible curtailing to the supply of many public goods generated by these entities.

Residential Utilities. 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 exempt under KRS 139.470(8). The utility must classify the location as residential as provided by the Public Service Commission or the Tennessee Valley Authority, as applicable.

Kentucky is considered a low-tax state for residential utilities, since at least 32 other states tax utilities either through a sales tax on the consumer or a gross receipts tax on the utility provider. The elimination of this tax expenditure would level the playing field with commercial utilities, which are currently taxable. Minimal market distortions are expected due to consumption remaining stable. Negative impacts include, once again, the regressive nature on low-income households and an added increase in utility bills in areas where utility costs are already being increased.

State, Cities, Counties, and Special Taxing Districts. Sales to any cabinet, department, bureau, commission, board, or other statutory or constitutional agency of the state, a county, a city, or any special taxing district are exempt from sales and use tax under KRS 139.470(7). The exemption applies only to purchases for use solely in the government function. One must consider the budgetary impact of increased costs to local government if this tax expenditure is eliminated. However, the elimination would bring parity with businesses that provide similar services.

Various Agricultural Items, including Livestock, Feed, Seeds and Fertilizers. These items must generally be a product of food for human consumption, used for breeding or dairy purposes, and sold by or to a person regularly engaged in the business of farming. If it qualifies, the sale is exempt under KRS 139.480. Over time, the agricultural exemption for sales and use tax purposes has been expanded to include more animals, including ratites, llamas, alpacas, buffalo, aquatic organisms, and cervids. Some items in this category are inputs into the production process of a final good. Sound tax policy would avoid taxing intermediate inputs into the production process when the final product is taxed. However, when considering food for human consumption, the final good is not taxed in Kentucky. The elimination of this tax expenditure may adversely affect the farm community and also disproportionately affect rural areas versus urban areas of the state.

Individual Income Tax

Standard Deduction. At the election of the individual, itemized deductions or the standard deduction may be claimed on the income tax return according to KRS 141.081. 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 amounts. Negative impact of eliminating the standard deduction includes the regressive nature when applied to low-income taxpayers and the extra tax burden on filers who may not have deductions allowed under an itemized deduction scenario. When researching the most recent income tax database, approximately 54% of resident returns and approximately 79% of nonresident returns filed use the standard deduction.

Social Security Benefits. Any portion of Social Security benefits taxed at the federal level are exempt for Kentucky income tax purposes according to KRS 141.019(1)(e). For federal income tax purposes, Social Security benefits may be exempt if combined income is below $32,000, up to 50% taxable if combined income is between $32,000 and $44,000, and up to 85% taxable if combined income is more than $44,000. Since the taxation of this income is means tested at the federal level by providing graduated levels of taxation, eliminating the state exemption on Social Security benefits would not be regressive. Some proponents may argue that all retirement income should be taxed in a similar manner. However, only 13 states tax Social Security benefits.

Property Tax

Limited Property Tax Rate Increases. The state tax rate on real property is reduced to compensate for any increase in the aggregated assessed value of real property to the extent that the increase exceeds the preceding year's assessment by more than 4%. Excluded from this calculation are the following:

- 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).

The statutory tax rate for real property is thirty-one and one-half cents ($0.315) for each $100 of assessed value. However, because of the limits described above as enacted by 1979 SS HB 44, the current state rate is twelve and two-tenths cents ($0.122) on each $100 of assessed value. If the provisions of HB 44 are merely removed, the rate would return to the statutory rate of $0.315. Therefore, it is not practical or feasible to merely eliminate this tax expenditure. A more reasonable approach may be to freeze the real property tax rate at a specific level.

One other consideration is the fact that HB 44 limits the amount of property tax receipts even in years when assessment values are not exceeding the 4% threshold because there is no statutory provision that allows the rate to be increased during those years. Since the 2008 recession, assessment values have been much lower than the 4% limit and the property tax rate has stabilized at twelve and two-tenths cents ($0.122) for each year. The following table indicates the percentage increase of assessment values for each year since 2008.

Table No. ____
Percentage Increase of Property Tax Assessment Values

Assessment Year	Increase of Assessment Values
2009	3.11%
2010	0.57%
2011	1.05%
2012	1.02%
2013	0.95%
2014	1.54%
2015	3.01%
2016	2.97%
2017	3.01%

Corporation Income Tax

Dividend Income. KRS 141.039 exempts all dividend income received after December 31, 1969. The tax expenditure was enacted to avoid the double taxation of corporate dividends (income taxed once as profits and then again as dividend income in the hands of the stockholder). The elimination of this tax expenditures would make Kentucky less competitive in terms of our business climate because this exemption also creates parity between single corporations, which usually don't pay dividends, and large conglomerations of corporations.

The Bottom 5% of Tax Expenditures

There are 161 tax expenditures listed, each with a cost of less than $1 M.

- 45 with a zero impact;
- 29 with a minimal impact;
- 33 costing less than $100,000 annually;
- 17 costing between $100,000 and $200,000;
- 13 costing between $200,000 and $500,000; and
- 24 costing between $500,000 and $1 M.

Another 64 tax expenditures round out the bottom 5% of all tax expenditures, each ranging in cost from $1 M to $11.9 M annually. These 224 tax expenditures, making up the bottom 5% include all taxes imposed by the Commonwealth and are comprised of all the various types of tax expenditures, i.e., exemptions, exclusions, deductions, credits, deferrals, and preferential rates.

The gap between the top 10 and the bottom 5% of tax expenditures contains 42 tax expenditures, each ranging in cost between $12.2 M and $120.8 M annually.

Chapter 3

A Discussion with Industry Representatives
Presented by:
Mark Haney, President, Kentucky Farm Bureau Federation
Eddie Melton, 1st Vice President, Kentucky Farm Bureau Federation
Jeff Harper, Director, Public Affairs Division, Kentucky Farm Bureau Federation
Alyson Roby, Medica Pharmacy, Bardstown, Kentucky
Shannon Stiglitz, Kentucky Retail Federation
Lee Lingo, Executive Director, Kentucky Association of Manufacturers
Mike Helton, Director of Advocacy, Kentucky Association of Manufacturers

Kentucky Farm Bureau Federation

This year has generated a record production in crops across the Commonwealth. That, in turn, will mean lower prices for those products. Kentucky is in a global trading economy, trading in commodities all over the world. That fact brings competition, with even more demand in certain areas for Kentucky commodities. Every little piece that goes into the economy, becomes very important at the farm level. But, a tax at any level for those commodities means a slimmer slice for the farmer and our communities.

Sales tax exemptions for production agriculture are extremely important. All surrounding states have exemptions for agriculture and the inputs for agriculture. Taxation by Kentucky could create an environment where our state is not competitive with the surrounding states, especially if the farmer lives close to a border. The expansion of taxation may include everything from buying farm equipment to buying seeds and fertilizer. This expansion of taxation would disrupt the entire agriculture industry.

Farmers purchase their inputs basically at the retail level but they sell products at wholesale. Margins become very important when you get caught in that squeeze. Farmers don't have the ability to pass along increases for input costs that manufacturers or retailers would be able to do. Application of a sales tax to a farmers' purchases would mean a direct hit of 6% to the farmer's bottom line. Elimination of the current tax expenditures would be disruptive to our farmers.

Farm Bureau takes great pride in being a service organization into the communities all across our state, not just county seats or larger towns. Farm Bureau members are in every community to make a difference, to serve the community, and make life better. Every community has a farm supply store that serves that area. There is a social aspect for the local store because that is where we get our news about what's going on in Washington, D.C. and what's going on right here in the Capitol. We sometimes drink coffee there. The social aspect is good; but it is not the most important aspect of having that business in that community. If the local store could no longer serve us in the community because they could no longer supply items that are exempt today, a big void would be created in those communities. Can you imagine the look you would receive if you walked into Wal-Mart and asked for three rolls of barbed wire and ten pounds of steeples? Our local stores provide these items on a daily basis. Elimination of the current tax expenditures may eliminate these stores, which would be disruptive to our communities.

It is crucial that the agricultural exemptions be maintained. The Farm Bureau Federation wants farmers that are utilizing the exemptions for a valid farming purpose. We pledge to work with the committee to make sure that the right incentives are available for the right people.

Kentucky Retail Association

Prescription Medicine. Kentucky currently exempts from the sales and use tax all prescription drugs and over-the-counter medications dispensed with a prescription. The only state currently applying a sales and use tax these prescribed drugs is Illinois. That state taxes drugs at a lower rate of 1%.[4]

In Louisiana, the state is prohibited from levying a sales tax on prescription drugs, but local governments may impose a local tax. The retailer is responsible for collecting and remitting the sales tax, but the insurer is responsible for reimbursing the pharmacy.[5]

According to Bill Fox,[6] Many states formed their tax structure with a concept of fairness and viewed taxing medications as a regressive or unfair tax. Cancer patients, those in end-of-life care, and others with complex, chronic health conditions would bare the majority of this burden, potentially causing many to forego treatment. If a single state begins to tax a good that other states are not taxing, a loss of economic activity through cross-border sales may occur. Finally, an unleveled playing field may occur because the federal government does not pay tax on any programs connected to federal dollars, including Medicaid, Medicare, and the Children's Health Insurance Program (CHIP). The following 2017 chart indicates that 55% of all prescriptions are paid by the federal government.

Table No. ____
2017 Kentucky Prescription Drugs by Payer[7]

Payer	Number of Prescriptions	Percentage
Commercial Insurance	**34,460,562**	**39%**
Medicare	**24,971,368**	**28%**
Medicaid	**23,604,770**	**27%**
Cash	**5,505,471**	**6%**
TOTAL	**88,550,171**	**100%**

---

[4] Source: Federation of Tax Administrators—January 2018 (https://www.taxadmin.org/assets/docs/Research/Rates/sales.pdf)
[5] Louisiana Laws Title 47 Revenue and taxation: RS 47:337.11.1
[6] Fox, William F. "History and Economic Impact," 13 March 2002.
[7] Kaiser Family Foundation. www.kff.org/statedata/ Information does not include federal employees.

Medical Equipment. According to SalesTaxSupport.com, 22 states and the District of Columbia structure their sales tax exemption on medical equipment and supplies in the same manner as Kentucky. Of Kentucky's surrounding states, only Illinois requires sales taxes at a rate of 1% to be paid on medical equipment and supplies.

Cost of Collection. Currently retailers in Kentucky are not reimbursed adequately for being the state's tax collector. Retailers are only allowed a maximum of $50 for each return timely filed. A national cost of collection study estimates that the cost of collecting and remitting the sales tax is approximately 3% of the retailers' gross receipts.[8]

Balanced Health Kentucky Initiative. A new nonprofit organization called Balanced Health Kentucky has taken up the charge of educating legislators on provider taxes. According to this group, the potential exists to provide additional revenue to fund an expected $200-$300 million shortfall in Medicaid. This additional funding could save the Medicaid expansion population. This coalition of hospitals has developed a tool to evaluate the outcome of applying a provider tax to 18 other areas of healthcare that the federal government allows to be taxed for Medicaid-matching funds. One of those 18 taxable areas is outpatient prescription drugs. More information is needed before proceeding with the Balance Health Kentucky proposal or expanding the sales and use tax base to include prescription drugs.

Kentucky Association of Manufacturers (KAM)

KAM General Tax Principles. KAM supports:

- A tax code that is competitive and consistent with surrounding and competitor states;
- The Commonwealth moving to a more consumption-based system and moving away from an income-based system;
- Maintaining the sales and use tax exemptions for anything used in the manufacturing process; and
- Providing sufficient funding to support an education system to produce work-ready employees.

Sales and Use Tax Rates, Exemption, and Expenditures. According to the KAM presentation, Kentucky has the second lowest sales tax rate among our competitor states and the 38th lowest in the country. Thirty-eight states collect some sort of local sales tax. If Kentucky were to move to a local sales tax, any local expenditures or exclusions granted should be consistent with the state exemptions or exclusions. Expenditures and exemptions should be understandable and applied consistently across the Commonwealth.

The sales tax base expansion from the 2018 Regular Session of the General Assembly included services that did not dramatically impact manufacturers. However, the legislation eliminated a tool manufacturers had used to reduce their tax on energy. An energy tolling company was created to take ownership of inventory, thereby reducing the cost of production and reducing the energy costs. Many states use a lower sales tax rate on energy or exempt energy from the tax completely:

---

[8] PriceWaterhouseCoopers, "Retail Sales Tax compliance Costs: A National Estimate," https://netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf.

- Ohio taxes energy at 2% or 3%, depending on a formula;
- Tennessee taxes energy at 1.5%; and
- Indiana and Georgia do not apply sales tax to energy or energy-producing fuels.

All current expenditures applicable to manufacturers are important and should be retained. Additionally, legislators should consider exempting all direct inputs to a finished good, including exempting repair and replacement parts used in the manufacturing process.

Chapter 4

A Discussion about Kentucky's Economic Policy

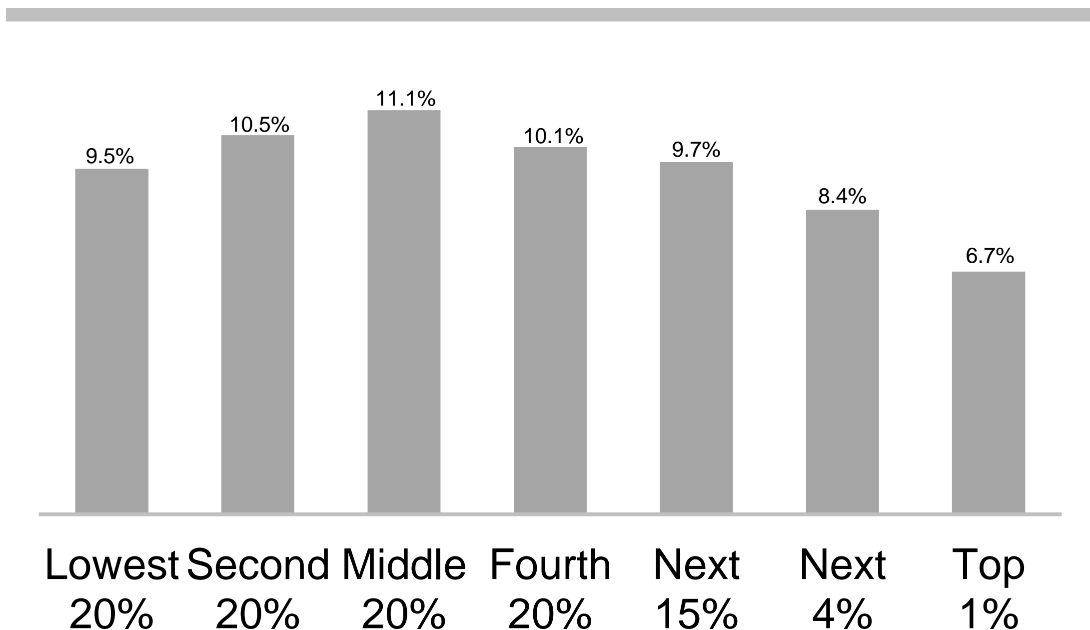
Presented by:
Jason Bailey, Executive Director, Kentucky Center for Economic Policy
Pam Thomas, Senior Fellow, Kentucky Center for Economic Policy
Jordan Harris, Executive Director, Pegasus Institute

Kentucky Center for Economic Policy

Many people in the Commonwealth have a misconception of the impact that tax expenditures have on economic growth. Research says that the effect of state and local taxes on behavior is small and often overstated. All business taxes are just 1.8% of total costs. Interstate migration of people is low and is rarely driven by taxes. The term "competitiveness" when it comes to taxes relates primarily to the ability of the state to invest in education, infrastructure, and other public services.

High-income Kentuckians pay the smallest share of their income in taxes.

Chart No. ______
State and Local Taxes as a Share of Family Income



Sales taxes are regressive and income taxes are slightly progressive in Kentucky.

Chart No. _____
Sales and Excise Taxes and Income Taxes as a Share of Family Income

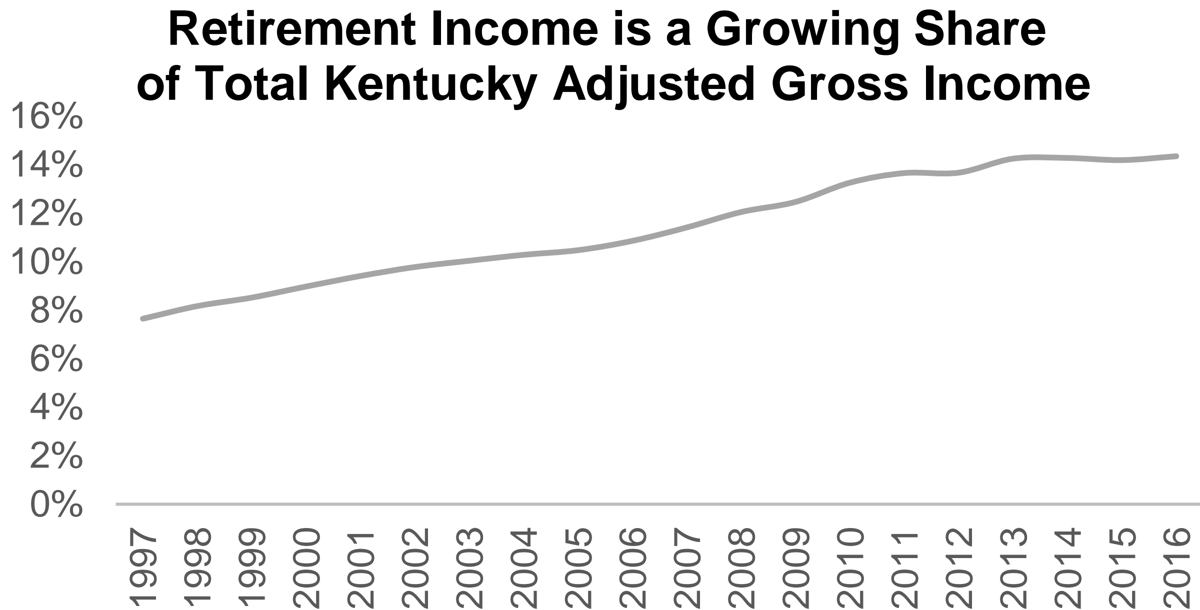
Source: Institute on Taxation and Economic Policy.

Tax expenditures have a higher status than appropriations in the planning and budgeting process. Tax expenditures come "off the top" before the first dollar is appropriated. Budgeted appropriations are for two years, but tax expenditures are usually in perpetuity and are rarely revisited or evaluated. Proponents can increase spending through tax expenditures while labeling them as a tax cut. A recommended approach for tax expenditures includes allowing only those tax expenditures that have been shown through rigorous analysis to be cost-effective and a better use of public dollars than the on-budget programs they displace or only those needed to enhance the equity of the tax system.

The earned income tax credit is an example of a tax expenditure backed by evidence. Research has proven that the infusion of dollars into low-income households creates lasting improvements in the lives of children by lifting those children out of poverty to allow healthier babies, better educational outcomes, and increased earnings for their lifetime.

Personal income tax expenditures should be limited by phasing out the retirement income exclusion entirely for higher income people and capping itemized deductions at 2.5 times the standard deduction.

Chart No. _________
Retirement Income as a Share of Kentucky Adjusted Gross Income



Source: IRS Statistics of Income.

Business tax breaks should also be trimmed. For instance:

- The film tax credit, tax increment financing incentives, and angel investor tax credits should be eliminated;
- Higher wage and job creation standards should be implemented for some business incentives;
- Programs that are not producing a positive return on the Commonwealth's investment should be sunset;
- End many of the sales tax exemptions related to business and impose tax on more services;
- Return to the three-factor apportionment formula for corporations; and
- Reduce the small business provisions for the limited liability entity tax to a range lower than the current range of $3 M to $6 M.

Ending other tax expenditures could include:

- Freezing the state property tax rate so that the rate does not continue to fall over time;
- Applying hospital provider tax to current revenues, not 2006 revenues; and
- Taxing the advanced deposit wagering and instant racing tax at the same tax rate as live racing.

Pegasus Institute

To avoid duplication of the prior discussion and to frame the thought process for this committee to approach the task at hand, there is a need for a 40,000 foot view to decide how to go through the 600 or so tax expenditures listed by the Commonwealth. To proceed, a discussion of the state of Kentucky's economy is necessary.

The State of Kentucky's Economy

There is at least a minor disagreement about how impactful the tax code is on Kentucky's economy overall. The tax code should be rated as one of the foundational or primary issues with our state's economic growth problem. For a state like Kentucky, a state that is land locked, which doesn't have oceans, doesn't have mountains, and doesn't have those things that help us compete or attract talent, fixing the tax code carries a particular weight. The tax code is one of the only levers the state can use to boost itself or make itself more attractive. Arguably, the tax code is more important for a state like ours than for Massachusetts, Florida, California, or even Colorado.

Since 1977, according to the Bureau of Economic Analysis data, Kentucky's economic growth is 30% below the national average. That is not 30% below the state that is number one. That is 30% below the national average. Kentucky ranks 44th in the United States during that time period. In the last 10 years, things don't look that much better for us. Between 2006 and 2016, Kentucky's per capita GDP growth was about 0.3%. By nearly every metric you can use to look at the state of our economy and economic growth over the last 40 years, we have one of the worst economies in the United States.

Unfortunately, we can't just point to it as being a regional problem. Our neighbor to the south, Tennessee, has grown at 102.5% of the national average since 1977, ranking 21st in that time period. In the last decade, Tennessee's per capita GDP growth has increased by 2.58%, obviously significantly higher than Kentucky's 0.3%. That amounts to about $1,090 per capita in the state of Tennessee. Indiana's per capita GDP growth over that same period is even faster. It is 4.7% between 2006 and 2016. Indiana has done a lot to take advantage of our economic mistakes and of course, the ones by Illinois which are even greater. That represents about $2,000 of additional income per capita. Indiana is ranked 24th in the country during that 40-year period.

The broader impact of that problem is demonstrated by state-wide household income and by labor force participation. These are two of the metrics that are most alarming. Kentucky's average household income is 18% below the national average. That equals about $9,000 per year for each household in Kentucky less than the national average. The Commonwealth ranks 45th in the United States. Interconnected with that is our labor force participation rate. As of August of this year, our labor force participation rate is below 60%, about 59.8%. This ranks 44th in the United States, which is a position lower than it was at this time last year. We have dropped from 43rd to 44th.

The national economy is in a period of great strength. Some are labeling the national economy as being a "too good to be true" economy. So, the question for this committee is what that means for Kentucky. There is no doubt that Kentucky has benefited in many ways from the robust national economy. Earlier this year we hit the lowest unemployment rate in the history of Bureau of Labor

Statistics data for the state of Kentucky. Right now, as we speak, there are more Kentuckians employed than at any point in our state's history.

Let's look at the five Metropolitan Statistical Areas (MSAs) centered in Kentucky. They are Bowling Green, Elizabethtown Lexington, Louisville, and Owensboro. In four of those five MSAs, the labor force is larger today than it was prior to the recession. In the Lexington area it has grown by more than 15% in that time period. In every MSA there are fewer people unemployed today than prior to the recession. The Bowling Green MSA leads the way in that statistic with nearly 66% fewer people unemployed than prior to the recession. On average in the five MSAs centered in Kentucky, there are 42.6% fewer people unemployed than before the recession.

Obviously, those things are a remarkable step in the right direction. There are many metrics that you can look at for Kentucky's economy and say that it's in a good place. But the more important question is how Kentucky compares to regional and national statistics.

Are we fully taking advantage of the robust national economy? Are we fully taking advantage of this period of growth? Or, are we simply benefiting on the coattails of national growth? There are numerous metrics that should give us pause. Paychecks in Kentucky since the recession ended have grown 12% slower overall than the national average. Many parts of our state, especially east of I-75, have seen labor markets shrink significantly since the 2009 recession. Although many of the MSAs and many urban areas have seen growth, the rural areas have not recovered in the same way. This is not a problem that is unique to Kentucky, but it is a problem that is significantly impacting Kentucky. Additionally, our per capita income in Kentucky is 47th in the United States, which also represents a step backwards over the course of the last few decades. We were 43rd.

The question becomes, "How do we fix it?" The two discussions at this meeting may be coming getting to the same result, but coming at it from two different directions. If we are going to eliminate these tax expenditures, what is the purpose for the elimination? There are two basic theories about economic growth. The first is a consumption-based theory, which proposes that economic growth emerges from more consumption, therefore the economic system should be freed up on the demand side. A separate theory is a production based theory, which is the superior of the two theories but also the more necessary of the two for Kentucky's economy. That theory believes that economic growth will be achieved by liberating the production side of the economy, so that businesses can grow and prosper, and they ultimately shape our economy.

Indicators like the labor force participation rate discussed above shows that the problem in Kentucky is on the production side. We have overly burdened our production side in many ways and that businesses need the burden of taxation shifted so that they are allowed to grow and, in turn, grow the economy on a macro scale.

It is critical to note that our current economic condition were all created with the burdensome, broken tax code that this committee is considering. Some of the changes made in 2018 are obviously not part of the equation when we consider our economy or the national growth period. So when considering whether X loophole is beneficial or Y loophole is harmful, remember that all of these loopholes have been contributors, in one way or another, to creating one of the worst

economies in the United States. This is the first point to remember as you evaluate the various tax expenditures that we have in Kentucky.

The 2018 reform bill was the first step, in what will become a long process, of evaluating and moving our state tax code to a system that is overall better for the citizens of the state and overall for better economic growth. It was a positive step in the right direction in so many ways. But doing so in solving the macro problems that our state faces. Every entity that benefits from our Swiss cheese structure has some sort of justification for why their loophole is in there in the first place. This committee should hear them out, to come before you and explain what that justification is. But ultimately, the role of the state is to evaluate these things from a macro standpoint which puts the entire citizenry in mind.

Adam Smith, who basically invented the field of economics, had four maxims by which he said that all taxes must be gauged. Taxes should be:

- Efficient;
- Certain;
- Convenient; and
- Fair.

Those four maxims are as good as any you can find and are worthwhile for you to consider as you evaluate these tax expenditures.

Steps taken in 2018 where goods steps to take, of broadening the base and lowering the rate. The future should be that this book of tax expenditures could be eliminated or reduced to a simple list because they are so inconsequential. But all of that is done under a motivation to lower the rate and broaden the base. There is basic economic consensus that lowering the rate and broadening the base is the easiest and most important way that a state ensures that it stays out of the way of its economy.

It is important to understand that taxation is economically burdensome. There is no way to put together a tax structure that in some way burdens the economy. The role of any governmental entity should be staying out of the way individuals or businesses. That is done primarily through lowering the rate and broadening the base. So, not only consider the four maxims of Adam Smith for determining what makes good taxation, but as you consider which expenditures that should be gone, you do so with the intention of lowering the rate and broadening the base and creating a system that is more competitive with our neighbors.

Chapter 5

Recommendations

Recommendation #1

The General Assembly should enact legislation which would sunset all tax expenditures on June 30, 2020, except for the Top 10 tax expenditures by dollar value as discussed during the July 26, 2018, meeting of the Task Force on Tax Expenditures.

Recommendation #2

The General Assembly should establish a Tax Expenditures Oversight Board. The Board will have the responsibility to review each of the tax expenditures which were sunset by Recommendation #1 prior to the sunset date. Legislation should include the requirement that sufficient data from the appropriate Executive Branch agency be submitted to the Tax Expenditures Oversight Board for evaluation purposes.

Recommendation #3

The Office of State Budget Director should be commended for the difficult task of estimating tax expenditures in the Tax Expenditure Analysis, but the report fails to adequately describe the reasoning, intent, and effectiveness of these expenditures. The Tax Expenditure Analysis does not contain specific information to assist the reader in the application of the estimates. For example:

- There is no data dictionary explaining the source of the data used to produce the estimate;
- A confidence index is not available for each estimate; and
- The publication does not aggregate tax expenditures which may be available across multiple taxes, such as a tax credit available for individual income, corporation income, and limited liability entity taxes.

The General Assembly has two options:

1. Maintain the current process of inserting the requirement of the report in the budget bill, but expand the language as noted above; or
2. Draft legislation to codify the report requirements with a provision in the legislation that allows the budget bill to add additional requirements, if appropriate.

Finally, legislation should be drafted to require a fiscal note for every new tax expenditure introduced.

Recommendation #4

It is recognized that confidentially should be upheld for the protection of all taxpayers; however, the Department of Revenue must be required through legislation to establish a process of collecting information under a unified system and not the current piecemeal approach.

Generally, the amount of tax credits claimed and economic incentives approved are tracked very closely. For other tax expenditures, however, not every line item on a tax return is captured and saved by the Department. Therefore, data is not available for those line items.

Errors in data can be problematic. A taxpayer may place a number on the wrong line of a tax return. The tax return computation may be completely modified by a taxpayer to eliminate data items but end with the correct tax due result. These data errors are not corrected by the Department because the correct amount of tax was paid. But, the data errors may significantly impact the results of an estimate.

Finally, data from the Department comes in piecemeal fashion. There is no one processing system that contains all data for all tax expenditures. Line items from one tax may need to be compared to line items from another tax and those line items may need to separately requested, received, and evaluated.

Recommendation # 5

The General Assembly should codify the requirement that each budget bill contains a summary reference of the tax expenditure analysis. This will put into focus the magnitude of the tax expenditures impact on the state's financial stability. For example, a clear detailed description of the total potential tax receipts should be outlined, followed by the total of tax expenditures, leaving the State's working general receipts.

Recommendation # 6

All new proposed tax expenditures should have an initial sunset clause of five years, including a purpose statement and detailed reporting requirements during that five-year period for evaluation by the Tax Expenditure Oversight Board prior to the sunset date.