

MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy
Research Brief

Summary:

Our analysis shows that overall, the Governor's tax modernization plan would have a regressive impact on the state's tax structure, resulting in a net tax hike for low- and middle-income taxpayers and a net tax cut for the very wealthiest Kentuckians.

This KYA report is funded through the Ammie E. Casey Foundation, Open Society Institute, Stoneman Family Foundation, and the generous support of local benefactors. Contents of this report are the sole responsibility of Kentucky Youth Advocates.

KYA is a partner in the Kentucky Economic Justice Alliance (KEJA). Other partners are the Democracy Resource Center, Kentuckians for the Commonwealth, and Appalshop. KEJA works for fair and adequate taxation.



The Distributional Impact of Governor Fletcher's JOBS for Kentucky Tax Modernization Plan

Kentucky Governor Ernie Fletcher recently unveiled his JOBS for Kentucky Tax Modernization Plan. The plan would enact a major "tax shift," reducing the state's reliance on personal income taxes and increasing the role of cigarette taxes for the state's general fund. The plan would also make changes to the state's alcohol, sales, property and corporate taxes.

When fully implemented in fiscal year 2008, the plan as proposed by the administration would leave Kentucky tax collections essentially unchanged overall. Thus, the plan is said to be "revenue neutral."

This analysis estimates the distributional impact of the Governor's proposal, with a specific emphasis on the proposed income and cigarette tax changes. A distributional analysis looks at the percentage of income paid in state taxes by different income groups. Studies by both the Kentucky Legislative Research Commission and the Institute on Taxation and Economic Policy show that Kentucky's overall tax system is regressive. That is, the lowest income fifth pays a larger percentage in state and local taxes than the wealthiest fifth of the state's population.

Our analysis shows that overall, the plan would have a regressive im-

pact on the state's tax structure, resulting in a net tax hike for low- and middle-income taxpayers and a net tax cut for the very wealthiest Kentuckians.

Overview of the Governor's Tax Plan

The Kentucky individual income tax uses a graduated rate structure with tax rates ranging from 2 percent to 6 percent of taxable income, with the top tax rate applying to taxable income over \$8,000. The income tax includes a low-income tax credit designed to eliminate income tax liability for the poorest Kentuckians. Put in place in 1990, the low-income credit reduces to zero state income taxes for individuals with incomes up to \$5,000 and for a family of four up to \$5,570.

The state's cigarette tax is currently the lowest in the country, at 3 cents per pack.

The Governor's proposed changes to Kentucky's income and cigarette taxes include:

- Gradually lowering the top income tax rate, which starts at \$8,000 of taxable income, from 6 percent to 5.45 percent by 2008.
- Expanding the low-income tax

“The largest benefits from this proposal would accrue to the wealthiest Kentuckians.”

credit to eliminate the state income tax liability for more low income Kentuckians.

- Increasing the cigarette excise tax by \$0.31 per pack. In later years, the tax rate would be set by a formula pegged to surrounding states’ taxes and limiting the Kentucky tax to 90 percent of the surrounding states’ average.

Analysis of the Governor’s Tax Plan

The table below shows the distributional impact of the major components of the Fletcher tax modernization plan if fully enacted in calendar year 2006:

- The largest benefits from this proposal would accrue to the wealthiest Kentuckians. The wealthiest one percent of Kentuckians—those earning over \$270,000 in 2006—would realize an average state tax cut of \$2,803.
- Expanding the low income tax credit provides a substantial

income tax cut for the poorest 20 percent of Kentuckians, those with incomes under \$14,000. Taxpayers in the bottom income quintile would see their income taxes go down by 0.5 percent of their income, on average.

- However, for the poorest income group as a whole, the benefits of the income tax cut are completely offset by a regressive cigarette tax increase. When cigarette tax and other tax changes are taken into account, the poorest income quintile would see a net tax increase overall—and the average tax change within this group would be a tax hike of \$31, or 0.4 percent of income. Since the cigarette tax applies only to smokers, the net change for any individual within this group will vary substantially depending on whether they smoke.
- For middle-income taxpayers, the pattern is similar. Income tax cuts are more than offset, in the aggregate, by hikes in cigarette

Impact of Kentucky Tax Changes Proposed by Gov. Ernie Fletcher

All Kentucky Taxpayers, 2006

2006 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$14,000	\$14,000 – \$25,000	\$25,000 – \$42,000	\$42,000 – \$67,000	\$67,000 – \$124,000	\$124,000 – \$270,000	\$270,000 – Or More
Average Income in Group	\$9,000	\$19,000	\$33,000	\$54,000	\$88,000	\$167,000	\$652,000
State Tax Change as % of Income, All Taxpayers in 2006							
Income Tax Changes	-0.5%	-0.2%	-0.2%	-0.3%	-0.3%	-0.4%	-0.4%
Cigarette Tax to 34 cents	+0.8%	+0.4%	+0.3%	+0.2%	+0.1%	+0.1%	+0.0%
Other Tax Changes	+0.1%	+0.1%	+0.1%	+0.0%	+0.0%	+0.0%	-0.0%
Total	+0.4%	+0.3%	+0.1%	-0.0%	-0.2%	-0.3%	-0.4%
Federal Offset	—	+0.0%	+0.0%	+0.0%	+0.0%	+0.0%	+0.1%
Net state/federal impact of Proposal	+0.4%	+0.3%	+0.1%	-0.0%	-0.1%	-0.3%	-0.3%
Average State Tax Change \$	\$ +31	\$ +59	\$ +48	\$ -20	\$ -151	\$ -494	\$ -2,803
Federal Tax Change, avg \$	\$ —	\$ +0	\$ +1	\$ +8	\$ +43	\$ +35	\$ +621
Net state/federal impact \$	\$ +31	\$ +59	\$ +49	\$ -11	\$ -108	\$ -459	\$ -2,182

SOURCE: Institute on Taxation and Economic Policy, February 2005



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“Instead of adding fairness to the over state and local tax system, the proposed changes increase the regressivity of the tax structure.”

*The Institute on Taxation and Economic Policy is a non-partisan tax research organization in Washington, D.C. The ITEP micro-simulation tax model is similar in methodology and data sources to the elaborate computer models used by the U.S. Treasury and the congressional Joint Committee on Taxation, except that the ITEP model adds state by state estimating capabilities.
 www.ITEPnet.org
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taxes and other taxes.

Detailed Analysis of the Governor’s Income Tax Proposal

Fletcher’s tax proposal exempts some individuals at the lowest income range from state income taxes. The proposal also cuts the top income tax rate over the course of four years from 6 to 5.45 percent.

As the chart below shows, the change in the top income tax rate when fully implemented would essentially cut taxes for all but the lowest income quintile. (The lowest income quintile would be largely exempt from taxes because of the expanded low income credit.)

The expected savings from the income tax rate cut range from \$1 to \$2,857, from lowest to highest income Kentuckians. As a percent of income, the wealthiest five percent save 0.4 percent of their income while the middle group saves only half as much (0.2 percent of their income).

Summary

The proposed tax changes outlined here would reduce income taxes for many Kentuckians—but would shift the burden of funding state services from Kentucky non-smokers and onto smokers. And because cigarette taxes are regressive, falling most heavily on low-income Kentuckians as a share of income, these tax changes would also shift tax liability from wealthier Kentuckians to lower-income taxpayers. Instead of adding fairness to the over state and local tax system, the proposed changes increase the regressivity of the tax structure.

The estimates presented in this brief show the impact of fully implementing each of the Governor’s proposals in calendar year 2006. Since the income tax rate cuts would not be fully implemented, under the Governor’s plan, until 2008, the actual income tax cuts enjoyed by Kentuckians in 2006 would be somewhat smaller than the estimates presented here. The “fully phased in” approach taken in this analysis is used because it gives a better understanding of the long-term impact of the plan.

Impact of Kentucky Income Tax Changes Proposed by Gov. Ernie Fletcher

All Kentucky Taxpayers, 2006

2006 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$14,000	\$14,000 – \$25,000	\$25,000 – \$42,000	\$42,000 – \$67,000	\$67,000 – \$124,000	\$124,000 – \$270,000	\$270,000 – Or More
Average Income in Group	\$9,000	\$19,000	\$33,000	\$53,000	\$88,000	\$167,000	\$652,000
Governor's Plan: Top Rate Reduction to 5.45 percent							
Share of Income	-0.0%	-0.1%	-0.2%	-0.2%	-0.3%	-0.4%	-0.4%
Average Tax Change	-1	-25	-68	-131	-274	-617	-2,857
Governor's Plan: Low Income Credit							
Share of Income	-0.5%	-0.1%	-0.0%	-0.0%	-0.0%	—	—
Average Tax Change	-42	-18	-5	-4	-1	—	—

SOURCE: Institute on Taxation and Economic Policy, February 2005.