July 13, 2021

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THE COMMONWEALTH OF KENTUCKY: AN ECONOMIC HISTORY AND PROSPERITY AGENDA

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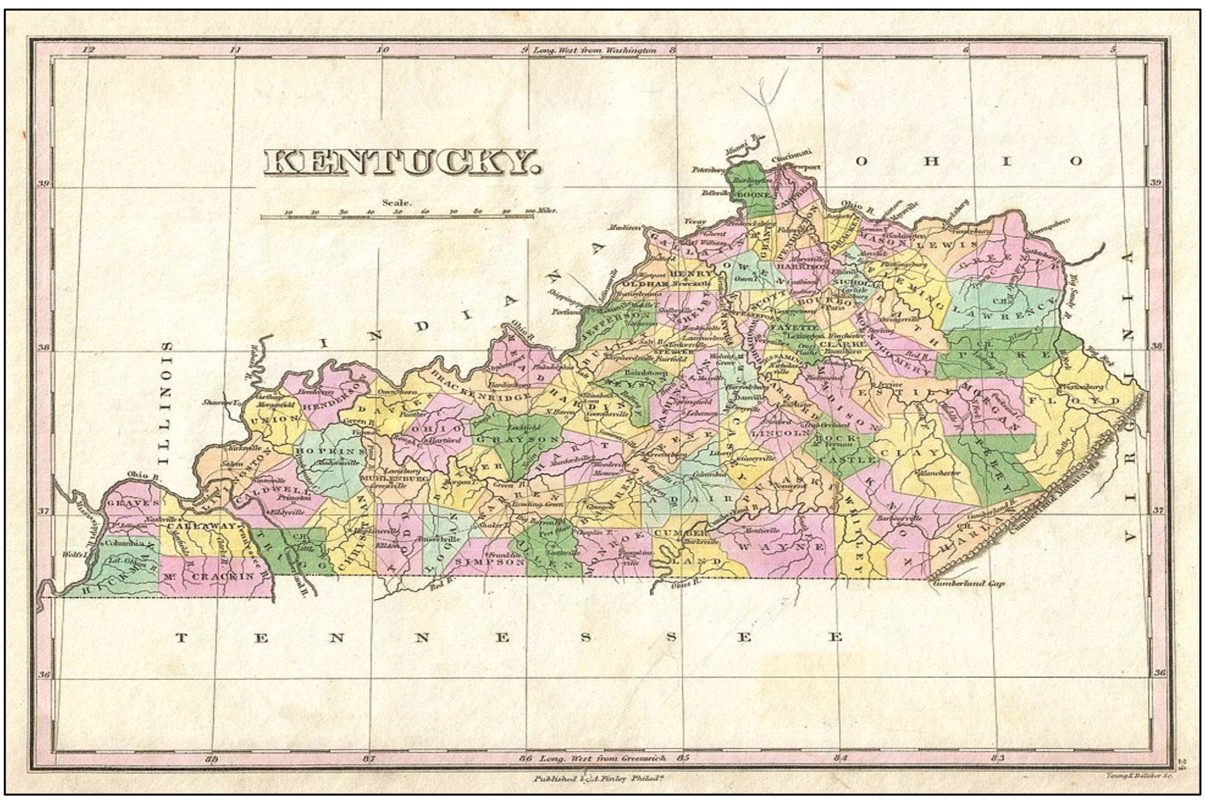
With John B. Burke and Nicholas C. Drinkwater

July 2021



1827 Map of the Commonwealth of Kentucky
Anthony Finley, *A New General Altas,* Philadelphia, 1827.

Kentucky Constitution Section 228

Oath of officers and attorneys.

Members of the General Assembly and all officers, before they enter upon the execution of the duties of their respective offices, and all members of the bar, before they enter upon the practice of their profession, shall take the following oath or affirmation: I do solemnly swear (or affirm, as the case may be) that I will support the Constitution of the United States and the Constitution of this Commonwealth, and be faithful and true to the Commonwealth of Kentucky so long as I continue a citizen thereof, and that I will faithfully execute, to the best of my ability, the office of .... according to law; and I do further solemnly swear (or affirm) that since the adoption of the present Constitution, I, being a citizen of this State, have not fought a duel with deadly weapons within this State nor out of it, nor have I sent or accepted a challenge to fight a duel with deadly weapons, nor have I acted as second in carrying a challenge, nor aided or assisted any person thus offending, so help me God.

Text as Ratified on: August 3, 1891, and revised September 28, 1891.
History: Not yet amended.

The research involved in documenting Kentucky's rich economic history was an enormous task and one I'm quite certain time would have proven to be impossible in the absence of contributions made by several dear friends and proud Kentuckians. Words cannot begin to express my sincere gratitude for the valuable time, counsel, and research materials offered in the course of preparing this work. In this spirit, I wish to thank Bill Samuels, Jr., David A. Jones, Terry Forcht, Joe Craft III, and Mac Brown.

This work also benefited from the expertise of the following individuals: Mark F. Sommer, John Chilton, and Greg Harkenrider. Though each was exceedingly generous in sharing his wealth of research materials, knowledge, and perhaps more importantly, took the time to offer helpful criticisms, it must be stated that the conclusions reached in this report are solely those of its author.

The Commonwealth of Kentucky:
An Economic History and Prosperity Agenda

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1. LETTER TO BILL SAMUELS: THE STATE OF KENTUCKY'S ECONOMY

August 18, 2015

Mr. Bill Samuels
Maker's Mark Distillery, Inc.
6200 Dutchman's Lane, Suite 103
Louisville, KY 40205

Dear Bill,

If there is a single symbol of Kentucky's economic malaise, it is the Cincinnati/Northern Kentucky International Airport. I gave a talk in July, 2015 at the Federal Home Loan Bank conference in Cincinnati, and I flew from Nashville to Cincinnati (i.e. Covington, KY) and back again. All I can say is wow. I felt like Jack Nicholson in The Shining. The Covington airport was creepy empty. Maybe one in six or seven gates had a plane, and in the halls there were no people, but the shops were open...which I found out later being open was a requirement in their original contract even though they had virtually no customers and would love to close their shops. The massive train system wasn't running, either. And I'm hardly alone in my low opinion of the Covington airport: the CEO of Fortune 500 company Veritiv, Mary Laschinger, said, "the airport is not suitable for business travel" shortly before moving the company's headquarters—and 50 high paying jobs—to Atlanta in 2015.[1] According to NPR, the Covington airport ranks among the best in the country, receiving accolades for its "airy and spacious screening area."[2] Apparently, no business is good business to our friends at NPR.

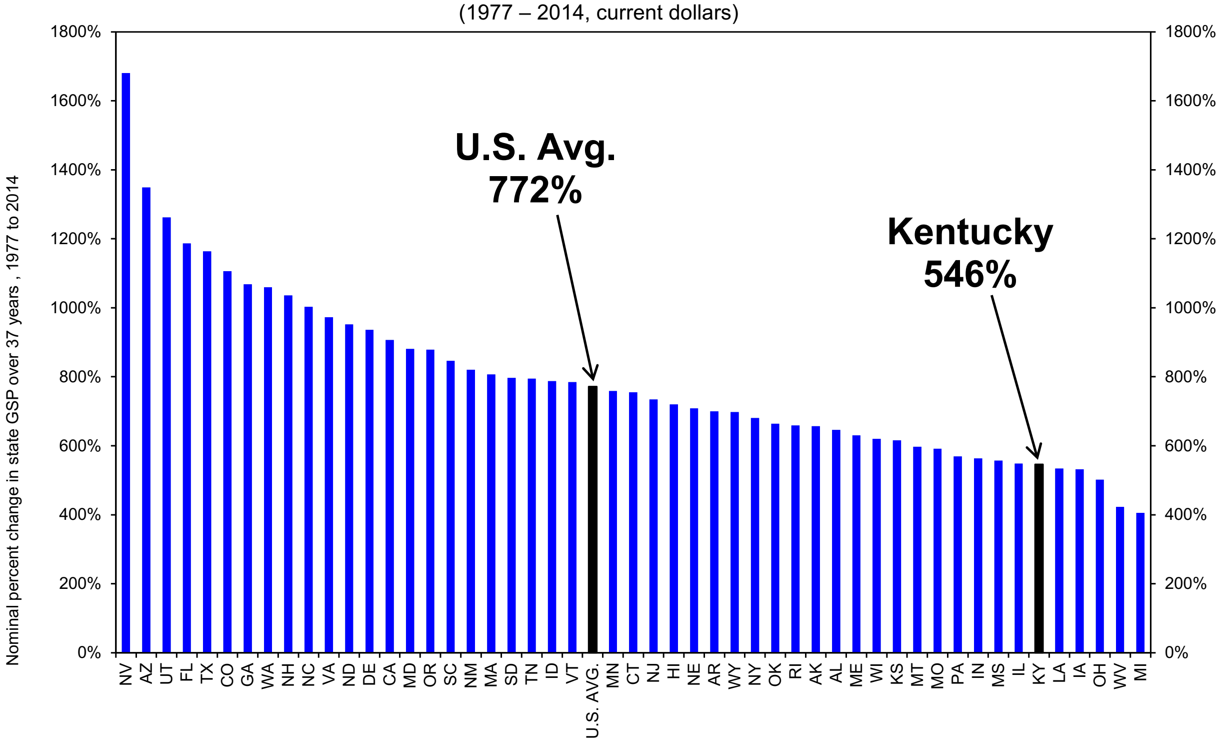
This is a slightly longer version of my response to the editorial you sent me a little while ago on how well Kentucky is doing—what with budget surpluses and robust growth (just kidding).

<u>Background</u>
Kentucky has been in a long secular decline relative to the nation since the mid-1970s and shows no signs of reversal (see Figure 1).

My belief is that Kentucky's economy has been significantly damaged by the fiscal actions of Kentucky's state and local governments. My belief is based not so much on Kentucky-specific data, but on a lifetime of research on government taxation and spending covering: i.) cross-sections of countries, ii.) time series of a number of individual countries, iii.) specific analysis of individual states, and, iv.) a comprehensive time series / cross-section analysis of all 50 states over the past 70 plus years. To be sure, correlation is not causation. To definitively demonstrate causation we need to show: a.) correlation, b.) isolation, and finally, c.) insertion. The insertion requirement is difficult given the world's unwillingness to allow experimentation with actual economies. But nonetheless you have my background vis-à-vis Kentucky.

[1] Fatima Hussein and Jason Williams, "Fortune 500 boss: CVG reason for leaving," *Cincinnati.com*, October 16, 2015. http://www.cincinnati.com/story/money/2015/10/16/fortune-500-boss-cvg-reason-leaving/73605974/
[2] Brian Naylor, "Cincinnati's Airport: Best In The U.S.?" NPC, September 2, 2013. http://www.npr.org/2013/09/02/217267752/cincinnatis-airport-best-in-the-u-s

Figure 1
State Growth[3]
(1977 – 2014, current dollars)



States ranked from highest growth to lowest growth over the 1977 to 2014 period

Policies

There are lots of ways to slice and dice a state's political / economy and performance data. For example, Kentucky has cut its top corporate income tax rate over the past several years from 9.2% (combined 7.0% state and 2.2% local rates, the 10th highest in the nation) to 8.2% (combined 6.0% state and 2.2% local rates, the 15th highest). That's moving in the right direction.

Kentucky has kept the Federal minimum wage and has reasonable workers compensation costs,[4] but is one of 25 states that does not have a right-to-work law. This is becoming more and more important for Kentucky, given that border states Virginia, Tennessee and most recently Indiana have become right-to-work states. Kentucky has always (the past several years at least) had low property taxes, but maintains an eccentric inheritance tax[5] (one of 22 states) and has the highest public debt servicing costs to tax receipts ratio in the nation.

As of FY 2013, Kentucky's combined state and local pension liability was $42.04 billion.[6] At that time, the state's pension system held an estimated $18.57 billion in assets; therefore, $23.47 billion of the liability was unfunded. For FY 2013, Kentucky only contributed 67.1% of a recommended payment of $1.35 billion to its pension system. The

[3] Source: Bureau of Economic Analysis
[4] Dr. Arthur B. Laffer, Jonathan Williams and Stephen Moore, Rich States, Poor States, American Legislative Exchange Council, 2016. https://www.alec.org/publication/rich-states-poor-states/
[5] Kentucky allowed its estate tax to expire on January 1, 2005, but it still levies an inheritance tax. Kentucky's inheritance tax laws are nearly as byzantine as its income tax laws. Under the inheritance tax there are three classes of beneficiaries: Class A, Class B and Class C. Class A beneficiaries include immediate family members who, as of June 30, 1998, are exempt from inheritance taxes. Class B beneficiaries include extended family members who, after an exemption of $1,000, pay a top rate of 16% on inheritances valued at over $200,000. Class C beneficiaries are those who do not fit into Class A or Class B. They receive an exemption of $500 and pay a top rate of 16% on inheritances valued at over $200,000.
http://www.revenue.ky.gov/NR/rdonlyres/3F6FF04D-F7C8-4699-9DA9-FF77C9470835/0/92F101714.pdf
[6] "The Fiscal Health of State Pension Plans," Pew Charitable Trusts, July 31, 2015.
http://www.pewtrusts.org/en/multimedia/data-visualizations/2015/the-fiscal-health-of-state-pension-plans#/statecomparison

state's pension system was ranked 49th out of 50 by Pew Charitable Trusts on the basis of its aggregate funding percentage in 2015.[7]

What strikes me as truly dangerous is that Kentucky has 218 state and local individual and corporate income tax rate jurisdictions.[8] Local income taxes are especially dangerous because a city… say Burkesville… can on its own volition raise its income tax, causing damage and revenue loss to the rest of the state income tax regime while successfully raising revenues on its own account. Independent overlapping income tax regimes create serious conflicts of interest that incentivize the overall state jurisdictions to impose excessively high tax rates. The incentives for good tax policy are misaligned, yet extremely hard to reign in. The ability to levy local personal and corporate income taxes was in my mind the *sine qua non* of Detroit's demise. A handful of other states have problems similar to Kentucky's problem by having a lot of tax jurisdictions: Indiana, Iowa, Kansas, Ohio and Pennsylvania.[9]

<u>Corruption</u>

Perhaps the biggest problem Kentucky currently has is the perception, if not the reality, of state and local government corruption. Just read the following release on the FBI's website re: Kentucky and Kentucky alone:[10]

> "Special Agent in Charge Howard S. Marshall of the FBI's Louisville Division, joined by John E. Kuhn, Jr. United States Attorney for the Western District of Kentucky, and Kerry B. Harvey, United States Attorney for the Eastern District of Kentucky, announced today (July 31st, 2015) a new initiative designed to solicit the public's help in identifying public corruption within our community. The initiative includes the launch of a new, toll-free tip line (844) KYNOPC1 (596-6721), a billboard campaign, and a dedicated e-mail address Kentucky_PC_Complaints@ic.fbi.gov.
>
> "You will also see billboards around the state bearing this number and e-mail address." SAC Marshall noted, "The End Corruption Now campaign seeks to unite the commonwealth in the fight against corruption at every level, from the proverbial dog catcher, to the police officer, to the highest state and federal officials in the commonwealth."
>
> "Kentucky is not only perceived to be *illegally* corrupt but also *legally* corrupt."[11]

<u>The Economy</u>

On a performance level, Kentucky's economic growth as measured by Gross State Product (GSP) from 1977 through 2014 was the sixth slowest (546%) of all 50 states, only besting Louisiana (534%), Iowa (532%), Ohio (501%), West Virginia (422%), and Michigan (406%) (see Figure 1 on page 1). The U.S. average was 772%, and Kentucky's neighbor to the south, Tennessee, was 795%. This is terrifying.

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[7] "The Fiscal Health of State Pension Plans," Pew Charitable Trusts, July 31, 2015.
http://www.pewtrusts.org/en/multimedia/data-visualizations/2015/the-fiscal-health-of-state-pension-plans#/statecomparison

[8] The following source was updated for the year 2014: "Local Income Tax Rates by Jurisdiction, 2011", The Tax Foundation, August 31, 2011.
http://taxfoundation.org/article/local-income-tax-rates-jurisdiction-2011

[9] Several other states have a small number of jurisdictions: Alabama, California, Colorado, Delaware, Maryland, Michigan, Missouri, New Jersey, New York, Oregon and West Virginia. For more information see: "Number of Local Income Tax Jurisdictions by State, 2011", Tax Foundation, August 31, 2011.
http://taxfoundation.org/sites/taxfoundation.org/files/docs/local-incometax-numberof_jurisdictions-bystate--2008-20110831.pdf

[10] "FBI Louisville Seeks the Public's Assistance in Identifying Public Corruption within the Commonwealth of Kentucky", Federal Bureau of Investigation, Press Release, July 31, 2015.
https://www.fbi.gov/louisville/press-releases/2015/fbi-louisville-seeks-the-publics-assistance-in-identifying-public-corruption-within-the-commonwealth-of-kentucky

[11] The 2014 Harvard study on state and local government corruption that prompted the FBI to start the End Corruption Now campaign, ranked Kentucky's corruption problem among the worst of all 50 states. For more details, refer to:
Oguzhan Dincer and Michael Johnston, "Measuring Illegal and Legal Corruption in American States: some Results from the Corruption in America Survey", Harvard University, Edmond J. Safra Center for Ethics, December 1, 2014.
http://ethics.harvard.edu/blog/measuring-illegal-and-legal-corruption-american-states-some-results-safra

Contributing to this poor record of economic growth is the fact that Kentucky's employment-to-population ratio fell from 56.8% in 1977 to 54.8% in 2014, while the U.S. equivalent numbers were 57.9% in 1977 and 59.0% in 2014.[12] As it so happens, not only was Kentucky's employment to population lower than the U.S. average, but it fell during this period while employment to population rose for the country as a whole. To add insult to injury, Kentucky's population grew substantially less than the average of all states. Not only were there less people, but fewer and fewer of them were working overtime.

And to put the cherry on the top of the ice cream sundae, Kentucky's workers have been and still are less productive than the average worker in the country, and they are becoming progressively less productive. Using GSP again as our measure of output, in 1977, the average output of all Kentucky employees was in 27th place with $19,952 per employee compared to the U.S. average of $21,160 per employee. By 2013, Kentucky had fallen to 41st place among all states with $97,025 per employee versus a U.S. average of $115,895.

There is a downward spiral in Kentucky's economy, and its deterioration is accelerating.

As a consequence of Kentucky's downward economic spiral, Kentucky's population is transitioning more and more to dependency on the state for both "jobs" and welfare.

State and Local Government Employment

In 1977, the number of full-time equivalent employees in all of Kentucky's state and local governments was 41.74 per 1,000 population. This put Kentucky, as of 1977, in 49th place (i.e. 2nd lowest per 1,000 population) in the nation, only a smidgeon above Pennsylvania—pretty impressive. The U.S. average of state and local full-time equivalent government employees in 1977 was 48.19.

By 2013, the U.S. average of state and local full-time equivalent employees in government had increased to 50.81 and Kentucky had gone from second lowest in the nation to the 23rd highest at 53.74. This increase from 41.74 to 53.74 in a little over 35 years represents an enormous increase in state and local government employment for Kentucky—the 7th largest increase in the U.S. For at least some of the states with higher growth in state and local government employment, the increase is justified by rapidly rising real income per capita. Such is not the case for Kentucky.

To show the growth in state and local government employment from a slightly different perspective, in 1977 Kentucky spent 5.43% of state GSP on pay for public sector employees. Again, this ranked Kentucky the second lowest in the nation—only bested by Louisiana. The national average was 6.90% and Arizona had the highest ratio of 8.50%.

By 2013, Kentucky had moved way up the ranks to 19th highest total government employee pay as a share of GSP, again at 5.43%. Kentucky's increase in total pay for state and local government employees was the third largest in the nation. This was a period when state and local governments around the nation were cutting way back. Only two states showed any increase and the U.S. average, which in 1977 was 6.9% of GSP, would by 2013 be 5.14% of GSP, for a 36-year decline of over 25% compared to Kentucky's "no change."

To put state and local government employment in the broader context, remember how poorly Kentucky has performed in the aggregate, add to that the fact that the increase in state and local government employment in Kentucky was the 7th largest and *voila,* you can see private employment has been doubly discouraged.

[12] "States and selected areas: Employment status of the civilian noninstitutional population, January 1976 to date, seasonally adjusted", Bureau of Labor Statistics. http://www.bls.gov/lau/ststdsadata.txt

Welfare

To round out the story of Kentucky's transition from workfare to welfare just look at Table 1:

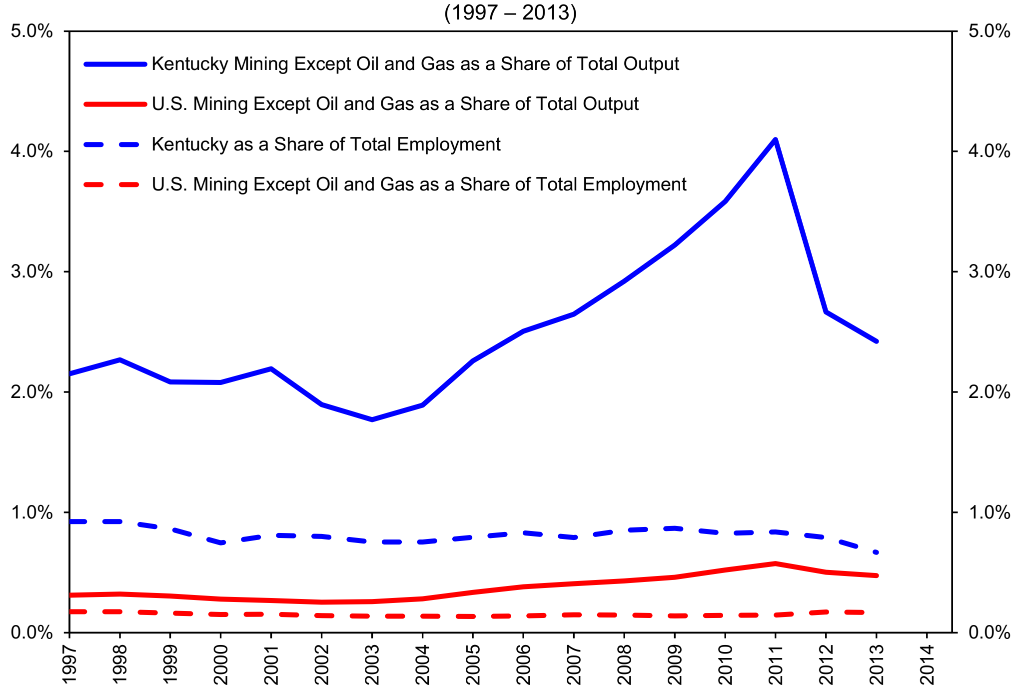
Table 1
Welfare Participation
Kentucky vs. the United States[13,14,15]
(per 10,000 population, 2014)

	Kentucky	United States
Households on Public Assistance	109	107
SSI Recipients	434	265
SSDI Recipients	514	299
Medicaid and CHIP Recipients	2,432	2,193
Foodstamps (SNAP) Recipients	1,876	1,460
WIC Food Supplemental Recipients	276	259
National School Lunch Program Recipients	1,200	954
National Breakfast Program Recipients	632	427

Coal

The coal mining industry is viewed as important to Kentucky's economy, but data suggest its importance may be overstated. The BEA no longer reports specific data for the coal industry, but data for mining excluding oil and gas production provides some insight (see Figure 2).

Figure 2
Mining Except Oil and Gas as a Share of All Industry Output and Employment
Kentucky vs. the United States[16]
(1997 – 2013)



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[13] United States Department of Agriculture, "Data and Statistics", Food and Nutrition Service. http://www.fns.usda.gov/data-and-statistics
[14] "Total Monthly Medicaid and CHIP Enrollment", Henry J. Kaiser Family Foundation. http://kff.org/health-reform/state-indicator/total-monthly-medicaid-and-chip-enrollment/
[15] "SSI Recipients by State and County 2013", Social Security Administration, July 2014. http://www.ssa.gov/policy/docs/statcomps/ssi_sc/2013/index.html, and, "Annual Statistical Report on the Social Security Disability Insurance Program, 2013", Social Security Administration, December 2014. http://www.ssa.gov/policy/docs/statcomps/di_asr/2013/index.html
[16] Source: Bureau of Economic Analysis

In 1997, mining excluding oil and gas was 2.15% of total output in Kentucky, versus 0.31% of total output nationwide that same year. By 2013, mining excluding oil and gas increased to 2.42% of total output in Kentucky, a significant increase since 1997, while nationwide mining excluding oil and gas output would also rise. In terms of employment, mining except oil and gas contributed 20,522 jobs or 0.92% of total employment in Kentucky in 1997 versus 0.17% of total employment nationwide. By 2013, employment in this sector declined 28% to 16,105 total jobs in Kentucky versus a 3% decline nationwide. The decline of Kentucky's coal industry can have widely divergent impacts on the various regions of the state.

Health Care

Growth in employment costs for Kentucky's publicly managed health care and hospital system outpaced the national average between 1993 and 2013 (refer to Table 2). By 2013, Kentucky was employing more public FTE health care and hospital employees per 1,000 population than the national average and devoting a higher share of its GSP to compensation for health care and hospital workers than the national average.

Table 2

Health Care and Hospital Employment
Kentucky vs. the United States[17]

(FTE = Full-Time Equivalent Employees)

	Average Annual Pay per FTE				FTE Employees Per 1,000				Total Annual Pay / Share of GSP		
	1993	2013	1993-2013 Change		1993	2013	1993-2013 Change		1993	2013	1993-2013 Change
Kentucky	$ 23,461	$ 46,446	97.97%		4.00	4.45	11.06%		0.44%	0.50%	12.51%
United States	$ 29,417	$ 55,372	88.23%		5.35	4.41	-17.58%		0.63%	0.46%	-27.75%

Despite the increased health care and hospital expenditures between 1993 and 2013, health outcomes in Kentucky have seen no significant improvement. The United Health Foundation's Annual ranking of state health outcomes ranked Kentucky 46th out of 50 in 1993 and 45th in 2013.[18] The highest score during the period was 39th in 2008. With the Affordable Care Act coming on stream in 2014, hospital costs are expected to surge while quality is expected to go the other way.

Tax Rates, Tax Revenues and Growth

Kentucky put in a personal income tax in 1936 with the highest tax rate of 5% on income over $5,000.[19] In 1950, the top rate was increased to 6% and applied to income over $8,000.[20] In 2006, Kentucky introduced the current rate of 5.8% on income between $8,000 and $75,000 as well as a new top rate of 6% on income over $75,000.[21] The top local rate is currently 2.2%, making the combined state and local top personal income tax rate 8.2%.

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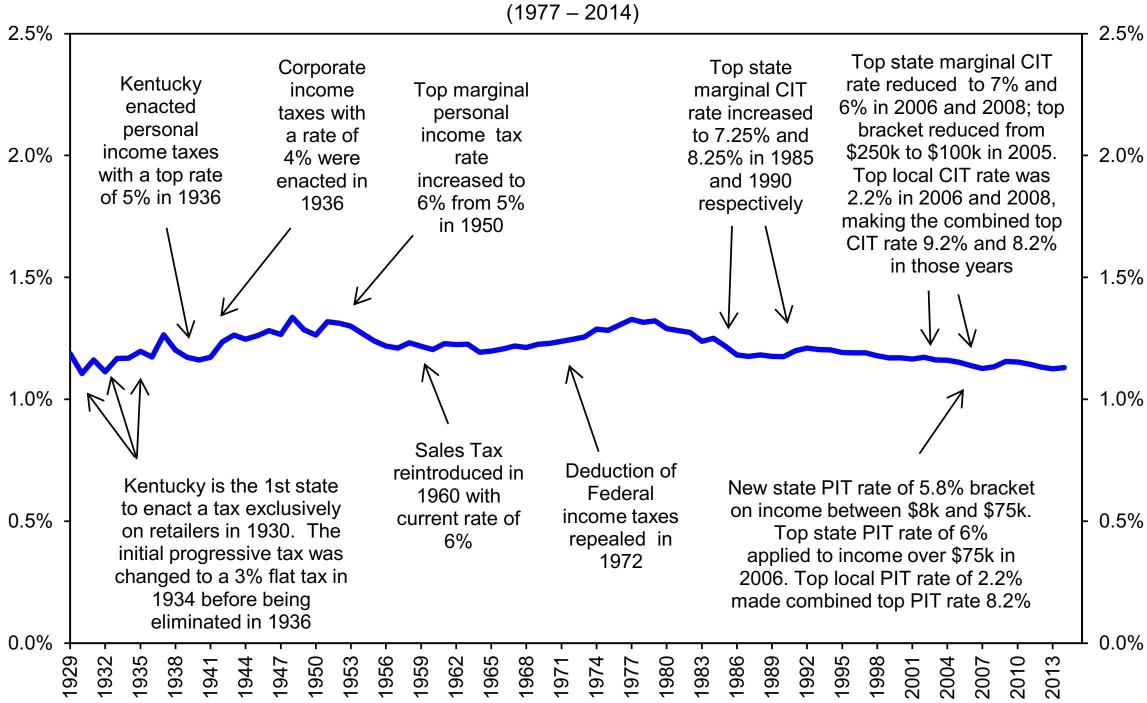
[17] Source: U.S. Census Bureau, State and Local Finances
[18] "America's Health Rankings, State Data, Kentucky", United Health Foundation. http://www.americashealthrankings.org/KY
[19] "Kentucky's Major Sources of Revenue", *The Courier Journal*, 2014. http://archive.courier-journal.com/html/2012/09/kentucky-taxes/
[20] http://www.kywomensnetwork.org/toolkit/TaxStudyExecutiveSummary.pdf
[21] Jared Walczak, "State Individual Income Tax Rates and Brackets for 2015", Tax Foundation, April 15, 2015. http://taxfoundation.org/article/state-individual-income-tax-rates-and-brackets-2015

Figure 3
Personal Income
Kentucky as a Share of the United States[22]
(1977 – 2014)

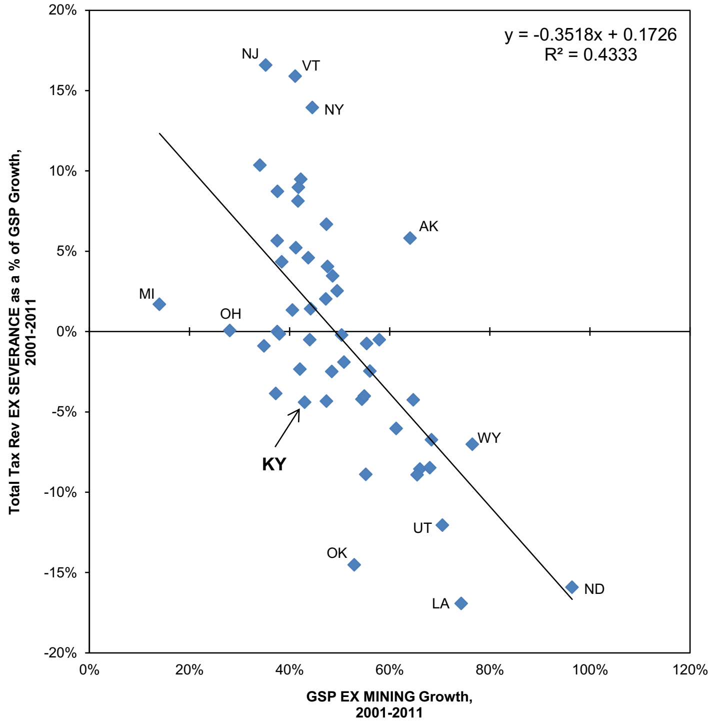


Kentucky's tax on corporate income was also first levied in 1936.[23] The rate was 4% of net income attributable to Kentucky after the deduction of federal income tax. In 1972, the deduction of federal income tax was repealed. Several rate changes have occurred, including increasing the top rate of the graduated scale to 7.25% and 8.25% in 1985 and 1990, respectively. Currently, the top state corporate income tax rate is 6% and is applied to income over $100,000, and the top local corporate income tax rate is 2.2%, making the combined top corporate income tax rate in Kentucky 8.2%.[24]

Kentucky is credited with being the first state to levy a sales tax exclusively on retailers, having adopted a progressive sales tax based on the volume of sales in 1930.[25,26] The initial tax would be replaced with a flat 3% sales tax in 1934, before that tax was eliminated in 1936.[27] Kentucky would reintroduce the sales tax in 1960, at its current rate of 6.0%.[28]

[22] Source: Bureau of Economic Analysis
[23] Commonwealth of Kentucky, "Tax Expenditure Analysis, Fiscal Years 2014-2016", Governor's Office for Economic Analysis, Office of State Budget Director, April 30, 2014.
http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202014-2016.pdf
[24] State Corporate Income Tax Rates, 2000-2014", Tax Foundation, March 22, 2013.
http://taxfoundation.org/article/state-corporate-income-tax-rates
[25] William F. Fox, "History and Economic Impact", University of Tennessee website, March 13, 2002.
http://cber.bus.utk.edu/staff/mnmecon338/foxipt.pdf
[26] "Kentucky Sales Tax Effective July 1", *Chicago Packer*, July 7, 1934.
http://idnc.library.illinois.edu/cgi-bin/illinois?a=d&d=CHP19340707.2.195&e=-------en-20--1--txt-txIN-------#
[27] In addition, the Kentucky's State Legislature failed to annul the existing progressive sales tax on retailers before the flat rate sales tax became law. As such retailers were legally subject to two different sales taxes at the same time. For more info, see:
"Propose to Revise the Kentucky Chain Store Tax", *Chicago Packer*, July 7, 1934. http://idnc.library.illinois.edu/cgi-bin/illinois?a=d&d=CHP19340707.2.195&e=-------en-20--1--txt-txIN-------#
[28] Scott Drenkard, Jared Walczak, "State and Local Sales Tax Rates, Midyear 2015", Tax Foundation, July 9, 2015.
http://taxfoundation.org/article/state-and-local-sales-tax-rates-midyear-2015

Figure 4
Ten-Year Percentage Change in Total Tax Revenues ex Severance Taxes as a Percentage of GSP versus Ten-Year Percentage of GSP versus 10-Year Percentage Change in GSP ex Mining[29]
(2001 – 2011)



Source: U.S. Census Bureau, Bureau of Economic Analysis, Laffer Associates

As a final point, my attention has been drawn to an interesting statistic, which can be compared and contrasted to the underperformance data for Kentucky. This statistic was described in my book the *Wealth of States,* and it removes the effect of hydrocarbons on the performance of all states in the context of state and local taxes. Taxes on hydrocarbons (oil, natural gas and coal) greatly distort tax revenues and gross state products of a few states when prices are high. We find that Kentucky has had the fifth greatest increase in state and local tax revenues per $100 of state GSP in the nation.[30] This number corresponds, roughly mind you, to state and local tax rate increases over the 35 year period. For the country as a whole, state and local governments cut tax rates by 2.5% from 1977 to 2012, while Kentucky raised tax rates by 22%. Relative tax increases have consequences (see Figure 4).

This tax rate increase in Kentucky moves hand in hand with Kentucky's abysmal economic performance and subpar performance in the growth of total state and local tax revenues. There's a curve that relates tax rates to economic performance and subsequently to tax revenues.

Let's hope the best is yet to come.

Your friend,

Arthur B. Laffer

[29] Dr, Arthur B. Laffer, Stephen Moore, Rex A. Sinquefield, and Travis Brown. *An Inquiry into the Nature and Causes of the Wealth of States: How Taxes, Energy, and Worker Freedom Change Everything.* Hoboken: Wiley, 2014.
[30] The reason for said removal is simply because a small handful of states to—to wit North Dakota, Alaska, etc.—have had a huge surge in tax revenues and to a lesser extent GSP due to the hydro-carbon bonanza of recent years. This adjustment is in line with the procedures followed by the Tax Foundation.

2. PRIMUM PRIMORUM: A TAX PROPOSAL FOR PROSPERITY

Sales, Property, and Income Taxes:
Tax Bases with All Tax Expenditures Eliminated and Tax Rates Required to Collect All FY 2016 State and Local Taxes

Ref	Total Tax Revenue to Collect	
1	Total General and Road Fund Revenue and Local Tax Revenue	16,904,640,285

	Broad-based Sales Tax Base Calculation		Broad-based Sales Tax Rate Required to Collect All State and Local Tax Revenue
2	Total State Sales Tax Revenue (General and Road Funds)	5,297,132,581	**8.85%**
3	Total Local Sales Tax Revenue Estimate	577,295,507	
4	Total Sales Tax Expenditures - Goods	3,189,300,000	
5	Total Sales Tax Expenditures - Services	2,392,500,000	
6	Total Expenditures (4 + 5)	5,581,800,000	
7	Total Potential Revenues after 6% state rate (2 + 3 + 6)*	11,456,228,088	
8	**Sales Tax Base**	**190,937,134,802**	

	Broad-based Property Tax Base Calculation		Broad-based Property Rate Required to Collect All State and Local Tax Revenue
9	Total State Property Tax Revenue	558,377,000	**2.55%**
10	Total Local Property Tax Revenue	2,659,484,000	
11	Total State and Local Property Tax Revenue (9 + 10)	3,217,861,000	
12	Total Real Property Tax Expenditures	516,242,000	
13	Total Personal Tangible Property Tax Expenditures	195,010,000	
14	Total Property Revenue w/o Tax Expenditures (11 + 12 + 13)	3,929,113,000	
15	**Property Tax Base (land, residential and commerical/industrial)**	**661,774,528,517**	

	Broad-based Income Tax Base Calculation		Broad-based Income Tax Rate Required to Collect All State and Local Tax Revenue
	Personal Income Tax Base		**4.48%**
16	Total State Personal Income Tax Revenue	4,282,080,975	
17	Total Local Personal Income Tax Revenue	1,337,775,058	
18	Total Personal Income Tax Expenditures	4,951,800,000	
19	Total Potential Personal Income Tax Revenue w/o Tax Expenditures (16 + 17 + 18)	10,571,656,033	
20	Personal Income Tax Base (from BEA)	176,182,641,000	
	Corporate Income Tax Base		
21	Total State Corporate Income Tax Revenue	526,637,870	
22	Total Local Corporate Income Tax Revenue	100,617,854	
23	Total Corporate Income Tax Expenditures	328,098,000	
24	Total Potential Corporate Income Tax Revenue w/o Tax Expenditures (21 + 22 +23)	955,353,724	
25	Corporate Income Tax Base (2016 GSP Estimate)	200,990,926,918	
26	**Total Income Tax Base (20 + 25)**	**377,173,567,918**	

PRIMUM PRIMORUM: A TAX PROPOSAL FOR PROSPERITY

INTRODUCTION

On a state level, there is no general government policy variable mixture that has more impact on a state's economic performance than the structure, the volume, and the character of its tax system. People and businesses respond to incentives and taxes are a prime example of negative incentives. We tax people who smoke to stop people from smoking, we tax speeders to get them to stop speeding. Why then do we tax people who earn income? Why do we tax people who employ other people? Why do we tax businesses that make wonderful products at low cost and have lots of profits? We don't tax these activities to reduce incomes, employment or profits, we tax these activities to raise revenues and to redistribute income. But don't for a minute believe that taxing income, employment and profits won't reduce income, employment and profits. It will. Potential taxpayers do what they can to avoid paying taxes depending, of course, on their abilities to avoid paying taxes, the importance to them of the income and the severity of the taxes.

In other words, people will do what they can to avoid, evade or otherwise not report taxable income. Economics is all about incentives.

I. People and businesses can and do change the location of their taxable income by moving from high tax locations to lower tax locations. The whole recent brouhaha regarding Apple, Ireland and the EU's tax policy is a perfect case in point. A great example of this is also how many Kentuckians are actual legal residents of Tennessee and Florida (zero income tax states with no death tax) or have left Kentucky completely (see Table 1 below).

Table 1
The Top 5 States Where Kentucky Residents Moved Compared to the Top 5 States Where Other State Residents Moved to Kentucky[1,2]
(total between 1992 through 2012, based on Aggregated Adjusted Gross Income)

	State	Households			AAGI (000's $)			AAGI/HHD		
		Sum 1992 - 2012			Sum 1992 - 2012			Sum 1992 - 2012		
		Net Flow into (+) / out of (-) KY	Inflows (into KY)	Outflows (out of KY)	Net Flow into (+) / out of (-) KY	Inflows (into KY)	Outflows (out of KY)	Net Flow into (+) / out of (-) KY	Inflows (into KY)	Outflows (out of KY)
Largest Income Deficit States	Florida	-6,637	68,013	74,650	-1,296,681	2,327,569	3,624,250	-14,327	34,222	48,550
	Tennessee	-15,900	90,682	106,582	-570,064	2,777,833	3,347,897	-779	30,633	31,411
	South Carolina	-1,890	13,584	15,474	-183,710	477,233	660,943	-7,581	35,132	42,713
	North Carolina	-2,250	28,460	30,710	-173,332	1,035,398	1,208,730	-2,979	36,381	39,359
	Georgia	-2,188	33,576	35,764	-120,940	1,254,429	1,375,369	-1,096	37,361	38,457
Largest Income Surplus States	Ohio	26,489	136,749	110,260	1,036,189	4,896,725	3,860,536	795	35,808	35,013
	Illinois	10,531	42,434	31,903	454,224	1,654,672	1,200,448	1,366	38,994	37,628
	Michigan	10,115	29,571	19,456	395,292	1,143,205	747,913	218	38,660	38,441
	New York	4,425	19,676	15,251	250,236	803,782	553,546	4,555	40,851	36,296
	California	5,577	33,751	28,174	215,616	1,345,096	1,129,480	-236	39,854	40,089

II. Potential taxpayers can also change the timing of their incomes by making use of 401ks, IRAs, Keoghs and other tax deferral options in order to reduce their tax liabilities. One just has to look at GE's severance contract with its former CEO Jack Welch to see just how tax driven this world really is.[3]

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[1] Sources: Internal Revenue Service, Statistics of Income. Calculations by Laffer Associates.

[2] The average income of households is calculated by dividing the AAGI by the total number of households migrating into and out of each respective state, and provides insight as to the change in spending power and wealth given the migration of taxpayers around the country. The net flow is found by calculating the difference between the Average Income inflow and outflow and dividing that difference by the average between the inflow and outflow amounts. This method facilitates comparisons of net flows between the different levels of Average Income witnessed across the different states shown in the table.

[3] In order to avoid paying taxes, GE and former CEO Jack Welch settled upon a severance package comprised entirely of benefits paid in kind, providing "continued access to Company facilities and services comparable to those provided to him prior to his retirement." For more

III. Taxpayers can as well change the composition of their income from higher taxed forms of income such as wage income, or income on dividends into lower taxed income categories such as capital gains (especially unrealized capital gains), carried interest, charitable family trusts and other tax advantaged income categories.[4]

Table 2

Top 9 Income Tax States vs. Zero Income Tax States: 10-Year Growth in Net Domestic In-Migration and Net-In Returns as a % Gross Returns (Returns In + Returns Out)[5,6]

(2002 to 2012)

	As of 1/1/2013	*2002 - 2012*	
State	Top Marginal PIT Rate†	Net Domestic In-Migration	Net In IRS tax Returns as a % Gross IRS tax Returns (Returns In + Return Out)
Alaska	0.00%	-1.2%	-0.7%
Florida	0.00%	5.6%	5.7%
Nevada	0.00%	10.3%	11.6%
South Dakota	0.00%	2.1%	1.9%
Texas	0.00%	4.3%	4.5%
Washington	0.00%	3.8%	3.7%
Wyoming	0.00%	5.3%	4.0%
New Hampshire‖	0.00%	0.7%	-0.9%
Tennessee‖	0.00%	4.5%	4.8%
Avg. of 9 Zero Earned Income Tax Rate States*	**0.00%**	**3.9%**	**3.8%**
U.S. Avg.*	**5.70%**	**0.9%**	**0.6%**
Avg. of 9 Highest Earned Income Tax Rate States*	**10.23%**	**-2.2%**	**-1.9%**
Kentucky	8.20%	1.8%	1.6%
Ohio	8.43%	-3.2%	-4.5%
Maryland	8.95%	-2.2%	-1.5%
Vermont	8.95%	-1.0%	-2.7%
New Jersey	9.97%	-5.6%	-5.9%
Oregon	10.61%	4.4%	5.1%
Hawaii	11.00%	-2.0%	0.1%
New York	12.70%	-8.0%	-6.6%
California	13.30%	-3.9%	-2.7%

* Averages are equal-weighted. † Top Marginal PIT Rate is the top marginal rate on personal earned income imposed as of 1/1/2013 using the tax rate of each state's largest city as a proxy for the local tax. The deductibility of federal taxes from state tax liability is included where applicable. New Hampshire and Tennessee tax interest and dividend income—so-called "unearned" income—but not ordinary wage income.

** The U.S. Census Bureau defines Net domestic migration as "The difference between domestic in-migration to an area and domestic out-migration from the same area during a specified time period. Domestic in-migration consist of moves where both the origin and the destination are within the United States (excluding Puerto Rico). The net domestic migration rate expresses net domestic migration during a specified time period as a proportion of an area's population at the midpoint of the time period. Rates are expressed per 1,000 population."

Source: Laffer Associates, U.S. Census Bureau, Internal Revenue Service, Statistics of Income

IV. In addition to all of the above legal ways to reduce tax burdens, people and businesses can simply stop working or, at a minimum, earn less than they could have earned because of taxes.

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information and details, see: Geraldine Fabrikant, "G.E. Expenses For Ex-Chief Cited in Filing," *The New York Times*, September 6, 2002. http://www.nytimes.com/2002/09/06/business/ge-expenses-for-ex-chief-cited-in-filing.html

[4] A prime example can be seen by how Warren Buffett successful, and legally, shelters the vast majority of his true income, which was $12 billion in 2012, from taxation. See: Arthur B. Laffer, "Warren Buffett's Call for Higher Taxes On the Rich," Laffer Associates, January 3, 2012.

[5] Sources: U.S. Census Bureau and Internal Revenue Service, Statistics of Income

In sum, taxpayers can change the location of their income, the timing of their income, the composition of their income and the volume of their income. If this in any way seems exotic or obtuse, it shouldn't. If people who work are taxed and people who don't work are subsidized you shouldn't be surprised to find a lot of people not working.

Simplifying the Tax Code

Potential taxpayers can also—at great personal risk—cheat on their taxes as they are reported from time to time. Tax evasion at all jurisdictional and income levels is a material consideration and is directly a result of the existing tax system and tax codes. The difficulty in assessing the impact of tax evasion is simply that tax evaders deliberately try to hide the income on which they are attempting to evade taxes, and they generally do a pretty damn good job of it. Gunnar Myrdal, the Nobel Laureate in Economics in 1972, summarized Sweden's experience with high marginal income tax rates as the following:

> *The Swedish honesty has been a matter of pride for me and my generation. I now believe that through a system of bad laws we are becoming hucksters. Of all the inadequacies of our income tax laws, the most serious aspect is that it directly invites us to commit tax evasion and tax fraud.*[7]

On a federal level, the IRS estimates that tax evasion accounts for well over 10% of legitimate tax collections and a more recent study estimated 18-19% of taxable income is not properly reported to the IRS.[8] Therefore, on state and local levels, where evasion is much easier, convictions far fewer and penalties far lighter, tax evasion is in likely higher than at the federal level. Kentucky is also considered by many to be one of the most politically corrupt states in the nation. In Kentucky, on a dollar for dollar basis, I would estimate that tax evasion is one of the highest rates in the country in large part because of its tax codes (see section, "A Brief History of Political Corruption in Kentucky"). In the words of Senator Barry Goldwater, "The U.S. income tax created more criminals than any other single act of government."[9]

There is no better solution to tax evasion at the state and local levels of government than a simple, fair, transparent and light tax code combined with competent enforcement efforts. If evasion is made less attractive, there will be less of it. It is also demonstrably true that people tend not to cheat nearly as much when they consider the tax codes fair and honest.

In the prior few pages of this report we have described Kentucky's state and local government finances, but not in the type of detail that lends itself to specific economic analysis (that will be done in a forthcoming section). The secret for success, whether it be in Kentucky or elsewhere, is in the details. In previous sections of this report, we have also described in detail Kentucky's state and local government system of taxation, whether sales taxes, property taxes or income taxes as they are applied to the actual economy of Kentucky. From any reasonable standpoint of fairness, efficiency, simplicity or goal orientation, such as growth in output or employment, Kentucky's tax system is a travesty and counter-productive.

Kentucky's system of taxation does not foster fairness. It is arcane, complex, and definitely not transparent and it is extremely costly to comply with. And lastly, as shown by Kentucky's abysmal economic performance, Kentucky's tax system does not encourage growth in output or employment.

But what does Kentucky's tax system achieve? Kentucky's tax system, along with the arcane layers of state and local government spending, is the perfect environment to encourage fraud, deceit and fiscal corruption. And in this realm, Kentucky ranks number one (see again: "A Brief History of Political Corruption in Kentucky").

When it comes to remedies for economic anemia and government reforms, Kentucky's tax system is the *primum primorum*. Kentucky's culture of corruption thrives on Kentucky's tax system as nothing else, and were Kentucky's tax

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[7] Gunnar Myrdal, "Dags for ett bättre skattesystem (Time for a better tax system)," *Taxes*, p. 500, 1982.
[8] Richard J. Cebula and Edgar L. Feige, "America's Underground Economy: Measuring the Size, Growth and Determinants of Income Tax Evasion," https://ideas.repec.org/p/pra/mprapa/29672.html
[9] From an interview on *Firing Line*, hosted by William F. Buckley on PBS, Nov. 18, 1989. As cited in the following:
Hugh Rawson, Margaret Miner, *The Oxford Dictionary of American Quotations*, Oxford: Oxford UP, 2006. https://books.google.com/books?isbn=0195168232

system to be reformed properly with a single-minded system of tax enforcement, it would be a short order before fiscal corruption would all but disappear.

There are many theorems of economics that apply beautifully to Kentucky's economy and especially to her overall system of taxation. These theorems will be discussed in the ensuing pages. But there are just two principles of taxation, which if meticulously adhered to in tax policy, will allow Kentucky to excel and prosper and allow her citizens to regain the freedom they need to pursue happiness: universality[10] and uniformity (refer to the section on "Kentucky's Inventory Tax: A Prime Example of a Dysfunctional Tax").[11]

When levying taxes, you are striving for harm abatement. Therefore, taxes must be uniform for all economic activities and apply universally to all taxpayers at all levels of income.

The way I've previously liked to express these principles is that all taxes are harmful, and that the goal of tax policy is to collect the requisite revenues to run a limited government in the least harmful fashion. Thus, first of all, the damage done to the economy per dollar of tax collected should be as low as humanly possible and secondly, the total number of dollars collected by government through taxation should be the bare minimum for government to carry out its appointed tasks. An economy cannot be taxed into prosperity and no example illustrates this principle better than the current state of affairs in Kentucky. Kentucky is the poster child for bad tax policy.

In practical terms, the tax principles of universality and uniformity point directly to a tax system with the lowest possible tax rate and the broadest possible tax base. The lowest possible tax rate is needed to provide all taxpayers with the least incentives to evade, avoid or otherwise not report taxable income. And the broadest possible tax base is needed so as to provide the fewest possible places where taxpayers can hide their income in order to avoid paying taxes.

Applying these principles in an ideal world would mandate no tax deductions, no tax exemptions, no tax credits, no tax expenditures, and no tax preferences for anyone at any time irrespective of the level of their income. The tax rates for all forms of income and all levels of income should be the exact same. The only legitimate reason for not paying as much in taxes as the next person is that your income is not as great as is the next person's income. And, in fact, legitimately the amount less you should pay in tax should be directly proportional to the amount less you earn in income.

Maximizing Efficiency of Tax Collections

One other tax principle described earlier allows us to narrow the field of tax options quite a bit further. The principle, quite simply stated, is that the amount tax payers actually pay when considering all costs associated with paying taxes should be as close as possible to the amount of taxes actually collected, net of all collection expenses by government.[12] There is always a slip betwixt the cup and the lip when it comes to taxation in the real world. Neither the private sector nor the government is frictionless or costless when it comes to executing its financial affairs. Therefore, when choosing which low tax rate / broad tax base system of taxation, we must focus on which system economizes most on the total cost, i.e. private plus government collections costs.

As a starting point, there are economic entities in society that through years of experience have developed considerable expertise in collecting, disbursing, and handling financial transactions between the non-government economy and government. These entities, of course, are what we call businesses. Businesses today collect almost all sales taxes, payroll taxes, business income taxes, and a good share of property taxes and personal income taxes (withholding).

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[10] Definition of 'Universality': the principle of taxation that with few exemptions such as property belonging to the government (i.e. public property), places of religious worship and burial, institutions of public charity, learning institutions, shall be subject to property taxation.[10]
See: David L. Sjoquist, "A Brief History of the Property Tax in Georgia," Georgia State University, Andrew Young School of Policy Studies, Fiscal Research Center, No. 182, August 2008. http://cslf.gsu.edu/files/2014/06/brief_history_of_the_property_tax_in_georgia.pdf

[11] The concept of Uniformity: "Uniformity in taxation implies equality in the burden of taxation, which cannot exist without uniformity in the mode of assessment, as well as in the rate of taxation. Further, the uniformity must be coextensive with the territory [i.e. being identical across the entire region] to which it applies. And it must be extended to all property subject to taxation, so that that property may be taxed alike and equally."
See: "Uniformity," *Black's Law Dictionary Online*. http://thelawdictionary.org/uniformity/

[12] For an extensive analysis and an estimate of the costs associated with tax collection, please refer to the following study:
Arthur B. Laffer, Ph.D., Wayne H. Winegarden, Ph.D., and John Childs, "The Economic Burden Caused by Tax Code Complexity," The Laffer Center, July 2011. http://www.laffercenter.com/wp-content/uploads/2011/06/2011-Laffer-TaxCodeComplexity.pdf

Here again we can describe a practical principle as to how to choose the best tax system. The principle is that the greater the share of taxes paid to government by business, even if those taxes were assessed on individuals, e.g. the lesser the share of taxes actually paid by individuals, the more efficient and less costly will be the administration costs of collecting taxes. Businesses are set up specifically to handle financial transactions efficiently and should be relied upon maximally in the process of tax collection.

For government tax collection agencies and departments, the issues are more complex—but in general, the simpler the tax code, the fewer tax sources there are, the less costly will be governments' collection outlays and, therefore, the greater will be governments' tax collection efficiency. For true government efficiency, a lot more needs to be considered beyond just tax code simplicity, but tax code simplicity is a good start. For the private sector, we can in general rely on a system of profit and loss to assure efficiency. This is not the case with government.

As it so happens in Kentucky, the three major sources of tax collection already exist and are highly developed. Kentucky already has a sales tax system, an income and payroll tax system (both individual and business) and a property tax system in place.

Table 1

Kentucky: State and Local Sales, Income, and Property Taxes[13]

($ = 000s)

	2013		
	State & Local	State	Local
Sales Tax	5,667,407	5,110,456	556,951
Individual Income	4,886,064	3,722,964	1,163,100
Corporate Income	770,465	646,875	123,590
Property	3,217,861	558,377	2,659,484

Each separate tax has its own specific features and characteristics, which add to compliance, collection, and payment costs. Therefore, the fewer the tax systems actually used, the less will be the overall deleterious consequences to a well-functioning economy. Likewise, even with a rudimentary structure in place, politicians will from time-to-time see this as an untapped opportunity to raise revenue and suffocate the economy—not a good option to keep open. Thus, a good tax system will eliminate rather than merely reduce, resulting in small taxes so as to avoid political temptation and extra costs.

Going back to the basics of taxation and remembering that all taxes are harmful for the economy and should be avoided, introducing tax expenditures inside a tax system—which are intended as positive incentives—should be avoided. Mixing positive and negative incentives in a single tax system results in a host of unintended consequences.

A far better system to meet the economic objectives of tax expenditures would be the simple single tax rate on the broadest possible base and then write checks to all the women with dependent children. It's simpler, more cost effective, distorts incentives less and, most of all, is transparent and comprehensive. Spending should be saved for activities with positive incentives, while taxation should be the exclusive domain of negative incentives. To confer the same aggregate level of benefits that tax expenditures, such as credits, refundable credits, deductions, exemptions, and preferences, would have conferred on recipients will necessitate some increase in tax revenues in order to increase spending to offset the absence of those tax expenditures. But all in all, the system will function much better.

[13] Source: U.S. Census Bureau, State & Local Finances.

ANALYSIS OF STATE & LOCAL REVENUE

The state of Kentucky during the 2013 fiscal year had a Gross State Product (GSP) of $182.7 billion.[14] This means that the market value of all goods and services produced in Kentucky from July 1, 2012 through June 30, 2013 was estimated to be $182.7 billion. This GSP ranks Kentucky as having the 27th highest output of all U.S. states in 2013.

All state and local government entities in Kentucky combined collected $38.1 billion in revenue in 2013 according to data published by the U.S. Census Bureau. For the purposes of this report, Total Revenue is the sum of four major revenue categories:[15] 1.) Intergovernmental revenue (transfers from federal to state and local governments), 2.) General revenue from own sources (sales, income, property, and other taxes plus fees), 3.) Utility revenue (revenue from the sale of utility commodities and services to the public and other governments),[16] and 4.) Insurance trust revenue (employee contributions to state retirement benefits, interest on investments of retirement systems provided by governments for public employees).[17] See Table 2 below:

Table 2
Kentucky: Four Major Components of Total Revenue[18]
($ = 000s)

	2013		
	State & Local	**State**	**Local**
Total Revenue	**38,093,383**	**28,607,106**	**13,961,273**
Intergovernmental revenue	8,509,786	8,083,482	4,901,300
General revenue from ow n sources	22,212,974	14,843,124	7,369,850
Utility revenue	1,605,856	0	1,605,856
Insurance trust revenue	5,764,767	5,680,500	84,267

Note: State and local revenue are less than state plus local by the amount State transfers and local governments because of consolidations.

Major Components of Government Revenue

1. Intergovernmental Revenue

Intergovernmental transfers are part and parcel of the relationship between the federal government and the states. Federal transfers serve a variety of purposes—they are primarily used to fund federally mandated government programs, such as Medicaid, Aid to Families with Dependent Children (AFDC) and Temporary Assistance to Needy Families (TANF), which, together account for approximately 40% of all federal-state transfers.[19] Federal-state transfers also include cash payments to the needy, aged, blind, and disabled under the Supplemental Security Income (SSI) program[20] and funds for administration of federal-state unemployment compensation systems.[21]

Though the federal government provides little if any direct support for local governments, local governments often receive federal funds that are funneled through state governments. State-local transfers (which, again, may include federal funds) are very important not only for funding school districts (an estimated 53% of all state-local transfers

[14] Bureau of Economic Analysis.
[15] In the strictest sense, there are four main categories that comprise total revenue: general revenue, utility revenue, liquor store revenue and insurance trust revenue. For purposes of clarity, however, we have chosen to split general revenue down into two categories, intergovernmental revenue and general revenue from own sources, resulting in four main categories for total revenue (intergovernmental revenue, general revenue from own sources, utility revenue, and insurance trust revenue). Although the U.S. Census Bureau lists revenues from publicly-owned liquor stores as a distinct major category under Total Revenues, liquor store revenues are excluded from our analysis given that Kentucky's liquor stores are privately run and, thus, there are no sales from publicly-run liquor stores.
[16] U.S. Census Bureau, State Government Finances, "Definitions." https://www.census.gov/govs/state/definitions.html
[17] U.S. Census Bureau, 2013 State & Local Government Finances.
[18] Source: U.S. Census Bureau, 2013 State & Local Government Finances.
[19] David E. Wildasin, "Intergovernmental Transfers to Local Governments," Institute for Federalism & Intergovernmental Relations, IFIR Working Paper Series, Paper No. 2009-11, August, 2009 (Revised). http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2009-11.pdf
[20] For more information on eligibility and benefits, refer to the Social Security Administration website https://www.ssa.gov/ssi/
[21] "Government Finance and Employment Classification Manual," U.S. Census Bureau, November 2000. https://www.census.gov/govs/www/class_ch7_ir.html

account for some 55% of school revenues), but also for public infrastructure, income maintenance, roads and highways, air and sea ports, and sewerage and waste facilities.[22]

Kentucky's budget is highly dependent on federal transfers—much, much more so than is the average state—with federal transfers accounting for 22.3% of Kentucky's state and local government budgets versus an average of 17.1% for all states. In 2013, state and local governments in Kentucky received a total of $8.5 billion in transfers from the federal government (see Table 3), amounting to 22.3% of total revenue collected by Kentucky's state and local governments (9th highest among all 50 states) and 4.7% of Kentucky's GDP (13th highest).[23] As a share of the $27.7 billion in total tax revenue paid to the federal government[24] by Kentuckians in 2013, the state's $8.5 billion in federal transfers ranked 14th highest among the states.[25] That Kentucky receives a higher share of its tax contributions to the federal government back in the form intergovernmental transfers indicates Kentucky is more dependent on federal funds to provide public services.

Table 3

Kentucky: Intergovernmental Transfers[26,27]

($ = 000s)

	2013		
	State & Local	**State**	**Local**
Intergovernmental revenue	**8,509,786**	**8,083,482**	**4,901,300**
From Federal government	8,509,786	8,047,093	462,693
From State government	0	0	4,438,607
From Local governments	0	36,389	0

The state (excluding local governments) received nearly $8.1 billion of the $8.5 billion in federal transfers Kentucky received, and $460 million those federal transfers went directly to local governments (also, it is highly unusual for local governments to receive federal transfers directly). State-local transfers amounted to $4.4 billion, some of which was likely transferred from the federal government to the state. That some transfers went first to the state, and then were redirected by the state to local governments, is the reason why the transfer revenue figures in Table 3 don't always sum left-to-right in Table 2 (see footnote 57 for additional discussion on this issue and walkthrough of how consolidation of revenues reported in Table 2).

[22] David E. Wildasin, "Intergovernmental Transfers to Local Governments," Institute for Federalism & Intergovernmental Relations, IFIR Working Paper Series, Paper No. 2009-11, August, 2009 (Revised). http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2009-11.pdf

[23] The U.S. Census Bureau defines Intergovernmental Transfers as the following: Amounts received from other governments, including grants, shared taxes, and contingent loans and advances for support of particular functions or for general financial support; any significant and identifiable amounts received as reimbursement for performance of governmental services for other governments; and any other form of revenue representing the sharing by other governments in the financing of activities administered by the receiving government. All intergovernmental revenue is reported in the general government sector, even if it is used to support activities in other sectors (such as utilities). Source: U.S. Census Bureau, State Government Finances, Definitions. https://www.census.gov/govs/state/definitions.html

[24] As stated by the IRS, this total figure for federal tax revenue paid by Kentucky includes the following revenue sources: business income taxes, individual income taxes, employment taxes, estate, gift, and trust taxes, unemployment insurance taxes, railroad retirement taxes, and excise taxes; however, excise taxes paid to the U.S. Customs and Border Protection and the Alcohol and Tobacco Tax and Trade Bureau are excluded. For more information, refer to the following:
"2013 Internal Revenue Service Data Book," Internal Revenue Service, Pages 12-14, October 1, 2012 to September 30, 2013.
https://www.irs.gov/pub/irs-soi/13databk.pdf

[25] "2013 Internal Revenue Service Data Book," Internal Revenue Service, October 1, 2012 to September 30, 2013.
https://www.irs.gov/pub/irs-soi/13databk.pdf

[26] Source: U.S. Census Bureau, 2013 State & Local Government Finances

[27] A note on the figures in Table 2: the components of each jurisdictional level sum to the total intergovernmental transfer revenue for that jurisdictional level. With the State as an example, Local government transfers ($36,389) + Federal government transfers ($8,047,093) = total State intergovernmental revenue ($8,083,482). Moving left-right however, across all jurisdictional levels the components only sum 2nd line. This is because some transfers from the Federal government to the State are then transferred to Local governments and thus show up twice in Table 2. Referring to the top-line number, in total, Federal transfers to state and local governments ($8,509,786) are not the sum of Federal transfers to the State ($8,083,482) and Local governments ($4,901,300). This is because the Local governments receive funds from the Federal government via the State ($4,438,607) and the State receives some transfer funds from Local governments ($36,389); these funds are double-counted in the top-line of the table—subtracting them from the jurisdictional levels that both receives and redirects them—eliminates double-counting and allows the top-line to sum left-right ($8,509,786 = $8,083,482 + $4,901,300 - $4,438,607 - $36,389).

2. General Revenue from Own Sources

General revenue from own sources includes the following two revenue sources: taxes, and charges and miscellaneous revenue. In Kentucky, general revenue from own sources amounted to $22.2 billion at the state and local levels (58% of total state and local revenue and 12% of GSP) in 2013 (see Table 4). These collections amounted to $14.8 billion at the state level (52% of total revenue for the state) and $7.4 billion for local governments (53% of total revenue for local governments).

Table 4
Kentucky: General Revenue from Own Sources[28]
($ = 000s)

	2013		
	State & Local	**State**	**Local**
General revenue from own sources	**22,212,974**	**14,843,124**	**7,369,850**
Taxes	15,431,580	10,815,954	4,615,626
Charges and miscellaneous general revenue	6,781,394	4,027,170	2,754,224

A. Taxes: In 2013, taxes constituted the single largest revenue source for both state and local governments in Kentucky, totaling $15.4 billion, or 40% of total revenue and 8.4% of GSP. The U.S. Census disaggregates state and local tax data into the following six major categories[29] ranked in order of their revenue contribution to state and local governments. See Table 5:

Table 5
Kentucky: Tax Revenues[30]
($ = 000s)

	2013		
	State & Local	**State**	**Local**
Taxes	**15,431,580**	**10,815,954**	**4,615,626**
Sales and gross receipts	5,667,407	5,110,456	556,951
Individual income	4,886,064	3,722,964	1,163,100
Corporate income	770,465	646,875	123,590
Property	3,217,861	558,377	2,659,484
Other taxes	673,818	592,522	81,296
Motor vehicle license	215,965	184,760	31,205

a) **Sales and Gross Receipts Taxes:** Kentucky levies a statewide sales and use tax of 6%, and Kentucky's Constitution currently forbids a local sales tax.[31] The sales tax is "imposed on the gross receipts derived from both retail sales of tangible personal property, digital property, and sales of certain services to the final customer in Kentucky."[32] Similarly, Kentucky's use tax is levied "on the purchase price of tangible personal property, digital property purchased for storage, use or other consumption in Kentucky. The use tax is a "back stop" for sales tax and generally applies to property purchased outside the state for storage, use or consumption within the state." Kentucky does not provide revenue data for the use tax portion of total sales tax collections.

b) **Individual Income Taxes:** At the state level, Kentucky currently levies a personal income tax (PIT) with a top rate of 6% on income over $75,000. In 2013, (with the same top PIT rate and structure) Kentucky collected $3.7 billion or 34% of its total tax revenue at the state level (see Table 5).

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[28] Source: U.S. Census Bureau, 2013 State & Local Government Finances
[29] By accessing the U.S. Census Bureau's state and local finance data in its public use format, these tax categories, as well as all other revenue data can be further broken down to reveal more specific tax and revenue sources.
[30] Source: U.S. Census Bureau, 2013 State & Local Government Finances
[31] In 2015, a bill proposing a local option sales tax was passed in Kentucky's House, but was not put to a vote in the Senate. The bill, HB1, proposed a constitutional amendment allowing local governments to add up to 1% on top of the state's 6%. The 1% tax would be temporary and to fund special projects and the tax would have expired once the funding needs of the project had been met. Local governments would not have been able to impose the new tax without a referendum.
[32] "Sales & Use Tax," Kentucky Department of Revenue. http://revenue.ky.gov/Business/Sales-Use-Tax/Pages/default.aspx

Kentucky also levies individual income taxes at the local jurisdictional level. In 2013, local governments in Kentucky received $1.2 billion, or 25% of their total tax revenue, from PIT.

It should be noted that only a minority of states levy taxes on individual income at the county and municipal levels.[33] Though the same data are no longer available for 2013, in 2015 there were 226 income tax districts in Kentucky, some of which tax personal income, while others tax business income.[34,35] These income tax districts included 75 of Kentucky's 120 counties,[36,37,38] 5 school districts,[39,40] and 1 special district in Boone County that levies a tax for mental health services.[41] The remaining 145 income tax districts operate at the municipal level.

All of Kentucky's local tax districts that levy taxes on income do so via the occupational license tax; however, the occupational license tax varies considerably in rate and form among the districts. In some cases, individuals are subject to occupational license taxes in multiple jurisdictions—for example, at both the municipal and county levels.[42] In counties with a population exceeding 30,000, the occupational license tax is capped at 1%.[43,44]

On personal income, Kentucky's occupational license tax is levied via the payroll tax. Payroll taxes are taxes levied on the income of employees. In 2015, 79 tax districts levied payroll taxes on individual income through payroll taxes. They may be paid to the government by the individual, or collected by employers, who then remit the proceeds to the government.

c) **Property taxes:** Kentucky levies taxes on real property and tangible property at the state and local levels. Perhaps most notable is the fact that Kentucky is one of two states—the other is West Virginia—to levy inventory taxes at both the state and local government levels. For an extensive analysis of the structure and economic impact of Kentucky's property tax policies, refer to our section "History of Property Taxes in Kentucky."

d) **Taxes on Corporate Income:** Businesses operating in the state of Kentucky are generally subject to two taxes on business at the state level.[45] Kentucky collected $646.9 million in revenue from taxes on corporate income at the state level and $123.6 million in revenue from taxes on corporate income at the local level in 2013.

- **Corporate Income Taxes (CIT):** Corporations with taxable income derived from operations in Kentucky must pay the state's CIT on the portion of their income derived from activities within the

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[33] As of 2011, only 17 states taxed income at the city and county levels. Joseph Henchman and Jason Sapia, "Local Income Taxes: City- and County-Level Income and Wage Taxes Continue to Wane," The Tax Foundation, August 31, 2011. http://taxfoundation.org/article/local-income-taxes-city-and-county-level-income-and-wage-taxes-continue-wane
[34] "2014 Kentucky Communities Imposing an Occupational Tax," Kentucky Occupational License Association, Compiled by the Kentucky Society of CPAs. http://www.kyola.org/images/stories/food/2014occlist1.pdf
[35] The document cited in the previous footnote was for 2014. The Kentucky Occupational License Association website that hosted the document noted a single tax rate change for 2015. http://www.kyola.org/
[36] *Ibid*.
[37] "What would Kentucky Be Like Without Its Large Number of Counties," Secretary of State, State of Kentucky. http://www.sos.ky.gov/admin/land/resources/articles/Documents/Counties.pdf
[38] Only two states have more counties than Kentucky: Texas (254) and Georgia (159). However, Kentucky is far smaller than each in terms of both land area and population. Source: "County (United States)", https://en.wikipedia.org/wiki/County_%28United_States%29
[39] These include the school districts of Boone County, Fayette County, Marshall County, Scott County, and Warren County.
[40] *Ibid*.
[41] *Ibid*.
[42] With the exception of counties with a population of less than 30,000 people, which may grant credits against the occupational license taxes paid to a county to a city within its confines. Source: "68.199 County that attains population of 30,000 – Credit against occupational license fee – Voluntary credit – New fee or increase in fee," 2013 Kentucky Revised Statutes. KY Rev Stat S 68.199 (2013). http://law.justia.com/codes/kentucky/2013/chapter-68/section-68.199/
[43] "69.197 License fees in counties of 30,000 or more – Exemptions from local fees and taxes – Regulation of ministers," 2013 Kentucky Revised Statutes. KY Rev State S 68.197. http://law.justia.com/codes/kentucky/2013/chapter-68/section-68.197/
[44] For more information on exemptions to the occupational license tax, see the source listed in the previous footnote.
[45] Some businesses, such as banks and insurance companies are subject to additional taxes. For more information, refer to the following: "Just the Facts: Kentucky Business Taxes," December 2015. https://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf

state.[46] The top CIT rate is 6% on net taxable income in excess of $100,001.[47] Of the $646.9 million in taxes on corporate income Kentucky collected at the state level in 2013, $400.8 million, or 62%, was collected from the CIT.[48]

- **Limited Liability Entity Tax (LLET):** Kentucky's LLET tax applies to both C-Corps and Limited Liability Pass-Through Entities (LLPTEs).[49] The LLET is not an alternative to another tax on business, though businesses paying the LLET have a choice between paying the lesser of $0.95/$100 of Kentucky gross receipts or $0.75/$100 of Kentucky gross profits. A minimum LLET tax of $175 is owed by each business subject to the tax. Of the $646.9 million corporate income taxes Kentucky collected at the state level in 2013, Kentucky collected $246.1 million, or 38%, from the LLET.[50]

- **Local Business Taxes:** As mentioned, all of Kentucky's local tax districts that levy taxes on income do so via the occupational license tax. Therefore, Kentucky also levies corporate income taxes at the local level via the occupational license tax. The tax is levied on C corps, S corps, limited partnerships, general partnerships, and even many types of trusts. Most business activity is subject to occupational license taxation, with the state-wide exemption of insurance companies (which are subject to a separate tax on insurance premiums) banks, trust companies, and state or federally chartered savings and loan associations.[51]

  Local taxes on business activities take two forms: Business profits taxes (net or gross) and gross receipts taxes. Business profits taxes are levied on the profits of business activity and allows for normal deduction of business costs.[52] In some jurisdictions, businesses may be subject to the gross receipts tax. Gross receipts taxes are taxes levied on the total revenue of a firm. While similar to sales taxes, gross receipts taxes tax all transactions, including intermediate business-to-business purchases, raw materials and equipment. As a result, the value created in initial stages of production is taxed repeatedly in later stages, what economists call "tax pyramiding." Tax pyramiding discourages investment and productivity, and is harmful to revenue collections in the long run as well.

  In 2013, local governments received $0.1 billion, or less than 1% of their total revenue from local taxes on corporate income (refer back to Table 5).

e) All Other Taxes: Frequently includes the following taxes: estate and gift taxes (refer to our chapter on Kentucky's Inheritance Tax for extensive analysis of the state's policy structure and its harmful economic impacts), documentary and stock transfer taxes, severance taxes, and Not Elsewhere Classified (NEC) taxes, but can include up to eight other taxes depending on the state, though the U.S. Census Bureau provides no further information on the 8 taxes.

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[46] To determine the taxable income for activities within the state, Kentucky, like most states relies upon the Uniform Division of Income for Tax Purpose Act (UDITPA), which relies upon three factors (sales, property and payroll).
Source: "Just the Facts: Kentucky Business Taxes," December 2015. https://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf

[47] *Ibid.*

[48] The U.S. Census does not offer specific tax revenue data or information for Kentucky's CIT or LLET that would allow a reader to confirm what is included in the Census' topline revenue figure of $646.9 million in 2013; however, the topline figure the Census offers for taxes on corporate income ($646.9) is the sum of the two revenue figures Kentucky budget documents report was collected in 2013 for the CIT ($400.8 million) and the LLET ($246.1 million).
Source: "Quarterly Economic & Revenue Report," Commonwealth of Kentucky, Governor's Office for Economic Fourth Quarter, Fiscal Year 2013. http://osbd.ky.gov/Publications/Quarterly%20Economic%20and%20Revenue%20Reports%20%20Fiscal%202/13-4thQrtRevenue.pdf

[49] To determine the taxable income for activities within the state, Kentucky, like most states relies upon the Uniform Division of Income for Tax Purpose Act (UDITPA), which uses relies upon three factors (sales, property and payroll).
Source: "Just the Facts: Kentucky Business Taxes," December 2015. https://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf

[50] Source: "Quarterly Economic & Revenue Report," Commonwealth of Kentucky, Governor's Office for Economic Fourth Quarter, Fiscal Year 2013.
http://osbd.ky.gov/Publications/Quarterly%20Economic%20and%20Revenue%20Reports%20%20Fiscal%202/13-4thQrtRevenue.pdf

[51] For more information on exemptions to the occupational license tax, see the source listed in the previous footnote.

[52] For more information, refer to the following:
"Just the Facts: Kentucky Business Taxes," Kentucky Department of Revenue, December 1, 2015. https://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf

f) **Motor Vehicle License Taxes:** According to the U.S. Census, motor vehicle license taxes are

…imposed on owners or operators of motor vehicles, commercial and non-commercial, for the right to use public highways, including charges for title registration and inspection of vehicles. [Motor vehicle licenses taxes] do not include personal property taxes or sales and gross receipts taxes relating to motor carriers based on assessed value of property, gross receipts, or net income, or other taxes on the business of motor transport.[53]

B. <u>Charges and Miscellaneous General Revenue:</u> Charges and miscellaneous general revenue constitute the second major component of general revenue from own sources (the first major component is taxes). For state and local governments in 2013, charges and miscellaneous general revenue generated $6.8 billion, approximately 18% of the total budgets for Kentucky's state and local governments. To wit:

a) **Current Charges:** The current charges portion of charges and miscellaneous general revenue is revenue generated from the sale of products or services by state and local governments (see Table 6).[54]

Table 6
Kentucky: Current Charges[55]
($ = 000s)

	2013		
	State & Local	**State**	**Local**
Current charges	**4,912,671**	**2,881,246**	**2,031,425**
Education	1,497,042	1,383,038	114,004
Hospitals	1,768,576	1,163,425	605,151
Highw ays	7,394	5,079	2,315
Air transportation (airports)	132,906	1,027	131,879
Parking facilities	21,322	0	21,322
Sea and inland port facilities	15,393	0	15,393
Natural resources	51,317	50,039	1,278
Parks and recreation	115,380	61,221	54,159
Housing and community development	31,880	10,032	21,848
Sew erage	556,190	0	556,190
Solid w aste management	136,400	0	136,400
Other charges	578,871	207,385	371,486

b) **Miscellaneous General Revenue:** Includes revenue generated from dividends on investments (excluding insurance trust funds); special assessments; profits on the sale of property and other general revenue, which includes revenue from recovery of losses recorded in a prior fiscal year; premiums on bonds issued; and profits on investments (see Table 7).[56] 'Other general revenue' serves as a "catch-all" for any revenue a state generates from its own sources that is not allocated to other area categories in the Census report of Kentucky's revenue collections.[57]

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[53] Source: U.S. Census Bureau, State Government Finances, Definitions. https://www.census.gov/govs/state/definitions.html
[54] For further documentation on the sources of Charges, refer to the following source:
U.S. Census Bureau, "Federal, State, and Local Governments: Government Finance and Employment Classification Manual, Descriptions of Current Charges Categories," Governments Division, November 16, 2000, revised October 31, 2011. http://www.census.gov/govs/www/class_ch7_current.html
[55] Source: U.S. Census Bureau, 2013 State & Local Government Finances.
[56] *Ibid.*
[57] "2006 Classification Manual: Chapter 4," U.S. Census, 2006. https://www2.census.gov/govs/class06/

Table 7
Kentucky: Miscellaneous General Revenue[58]
($ = 000s)

	2013		
	State & Local	State	Local
Miscellaneous general revenue	**1,868,723**	**1,145,924**	**722,799**
Interest earnings	711,785	259,590	452,195
Special assessments	17,700	0	17,700
Sale of property	27,808	9,704	18,104
Other general revenue	1,111,430	876,630	234,800

3. Utility Revenue

The U.S. Census Bureau defines Utility Revenue as the following:

> *Revenue from sale of utility commodities and services to the public and to other governments. Does not include amounts from sales to the parent government. Also excludes income from utility fund investments and from other non-operating properties (treated as General revenue). Any monies from taxes, special assessments, and intergovernmental revenue are classified as General revenue, not Utility revenue.*[59]

In 2013, Utilities generated $1.6 billion in revenue, all of which went to local governments in Kentucky (see Table 8 below).

Table 8
Kentucky: Utility Revenue[60]
($ = 000s)

	2013		
	State & Local	State	Local
Utility revenue	**1,605,856**	**0**	**1,605,856**
Water supply	699,697	0	699,697
Electric pow er	553,010	0	553,010
Gas supply	330,472	0	330,472
Transit	22,677	0	22,677

4. Insurance Trust Revenue

The U.S. Census Bureau defines Insurance Trust Revenue as the following:

> *Revenue from contributions required of employers and employees for financing social insurance programs operated by the government (see Insurance trust system, below) and earnings on assets held for such systems. Excludes any contributions by a government–either as employer contributions or for general financial support–to a social insurance system it administers. Note that tax proceeds, donations, and any forms of revenue other than those enumerated above are classified as general revenue, even though such amounts may be received specifically for insurance trust purposes.*[61]

[58] Source: U.S. Census Bureau, 2013 State & Local Government Finances.
[59] U.S. Census Bureau, State Government Finances, Definitions. **https://www.census.gov/govs/state/definitions.html#u**
[60] Source: U.S. Census Bureau, 2013 State & Local Government Finances
[61] Source: U.S. Census Bureau, State Government Finances, Definitions. **https://www.census.gov/govs/state/definitions.html#u**

In 2013, state and local governments collected $5.8 billion in revenue from Insurance Trusts, or 15%, of state and local government budgets (see Table 9 below).[62] According to Kentucky, the state lost $400,000 on investments in 2013.[63]

Table 9

Kentucky: Insurance Trust Revenue[64]

($ = 000s)

	2013		
	State & Local	**State**	**Local**
Insurance trust revenue	**5,764,767**	**5,680,500**	**84,267**
Unemployment compensation	1,149,266	1,149,266	0
Employee retirement	4,386,136	4,301,869	84,267
Workers' compensation	229,365	229,365	0
Other insurance trust revenue	0	0	0

[62] For extensive information from the U.S. Census Bureau on Insurance Trust Revenue, refer to the following source: U.S. Census Bureau, "Federal, State, and Local Governments: Government Finance and Employment Classification Manual, Descriptions of Current Charges Categories," Governments Division, November 16, 2000, revised October 31, 2011. http://www.census.gov/govs/www/class_ch7_current.html

[63] Source: "Quarterly Economic & Revenue Report," Commonwealth of Kentucky, Governor's Office for Economic Fourth Quarter, Fiscal Year 2013. http://osbd.ky.gov/Publications/Quarterly%20Economic%20and%20Revenue%20Reports%20%20Fiscal%202/13-4thQrtRevenue.pdf

[64] U.S. Census Bureau, 2013 State & Local Government Finances

REPLACING THE EXISTING TAX STRUCTURE

Kentucky can improve its economic performance by abandoning its complicated and complex tax code in favor of a simple, efficient tax code that is mindful of incentives. An efficient tax code could meet Kentucky's current tax revenue collections in the short term, and in the long term provide even more tax revenues as employment, output, and production are increased.

This section lays out the numerical possibilities for consolidating taxes. Static revenue (i.e. no supply-side effects) assumptions are maintained to ensure that Kentucky's state and local governments can finance public services at current levels, and only the broadest categories of taxes are considered: sales, income, and property (A detailed analysis of FY 2016 sales, property, and income tax expenditures as reported by the state of Kentucky is included in the appendix). This requires the elimination of all sales, property, and income tax expenditures.[65] The numbers and analysis are far from precise although hopefully they are generally in the correct range. The purpose here is to see what could be and how it could replace what is with the intention of invigorating Kentucky's economy and funding public services.

Kentucky's state and local governments will collect an estimated $16.9 billion in tax revenue, approximately 8.4% of GSP, in FY 2016 (see Table 10).[66]

Table 10
Estimated State and Local Tax Collections and Gross State Product
(FY 2016)

Estimated Total State & Local Taxes	Estimated GSP	Total State & Local Tax Collections Share of GSP
$ 16,904,640,285	$ 200,990,926,918	8.4%

Kentucky can meet its current tax revenue collections by levying a single broad-based sales, property, or income tax, or, if it chooses, a combination of two or three of those taxes.

What follows is a high-level view of how sales, property, and income taxes can be designed to meet Kentucky's current tax revenue levels. For each tax, the tax base is estimated; then we estimate the tax rate required to meet all state and local tax revenue.

[65] A comprehensive list of all FY 2016 sales, property, and income tax expenditures is included in the appendix.
[66] A walkthrough of the processes used to estimate local tax collections and gross state product is included in the appendix of this chapter.

Sales Tax

A sales tax would ideally be levied on all goods and services in Kentucky and would include a sales tax base without any credits, deductions, exemptions, or exclusions. We estimate such a broad-based sales tax base in the following way (refer to Table 11 and steps 1-4 listed immediately afterwards):

Table 11
2016 Broad-based Sales Tax Base Calculation[67,68]
(Current Dollars)

Step	2016	Revenue
1	Total State Sales Tax Revenue (General and Road Funds)	5,297,132,581
	Total Local Sales Tax Revenue Estimate	577,295,507
	Total State and Local Sales Tax Revenue	5,874,428,088
2	Total Sales Tax Expenditures - Goods	3,189,300,000
	Total Sales Tax Expenditures - Services	2,392,500,000
	Total Sales Tax Expenditures	5,581,800,000
3	Total Potential Revenues (Actual Revenues + Revenue from Eliminating Tax Expenditures)	11,456,228,088
4	**Sales Tax Base**	**190,937,134,800**

1. We find total state and local sales tax revenue by adding $5.297 billion in sales taxes, as reported by the state, to our estimate of $0.577 billion in local sales taxes[69] to get a total of $5.874 billion in state and local sales taxes.[70]

2. We find the potential sales tax revenue (on a static basis) that could be collected by eliminating all sales tax expenditures on goods and services. Thus, we add the estimates for tax expenditures on goods, $3.189 billion, and tax expenditures services, $2.393 billion, to get a total of $5.582 billion in revenue that could be collected by eliminating all sales tax expenditures.[71]

3. Next, we add the results of step 1, $5.874 billion in estimated state and local sales taxes, and step 2, the $5.582 billion in potential revenue that could be collected on static basis if all sales tax expenditures were eliminated, to find the total potential sales tax revenue: $11.456 billion.

4. Finally, we divide the $11.456 billion in total potential sales tax revenue that could be collected by a broad-based sales tax levied on all goods and services without any credits, deductions, exemptions or exclusions by the current statewide sales tax rate of 6% (see footnote below), which yields **an estimated sales tax base of $190.937 billion.**[72]

With a broad-based sales tax base of $190.937 billion, **Kentucky could meet its total FY 2016 state and local tax collections of $16.905 billion with a sales tax rate of 8.85%** ($16.905 billion in state and local tax revenue / $190.937 billion property tax base = 8.85% sales tax rate).

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[67] Source: "Quarterly Economic and Revenue Report: Fourth Quarter Fiscal Year 2016, Annual Edition," Commonwealth of Kentucky, Office of State Budget Director, 2016.
http://osbd.ky.gov/Publications/Quarterly%20Economic%20and%20Revenue%20Reports%20%20Fiscal%2012/16-4thQrtRevenue.pdf
[68] Source: "Commonwealth of Kentucky: Tax Expenditure Analysis Fiscal years 2016-2018," Office of State Budget Director, Governor's Office for Economic Analysis, November 15, 2015.
http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf
[69] While Kentucky does not current have a local sales tax option, select motor vehicle taxes collected by local governments are categorized as sales taxes.
[70] For a walkthrough of how all local taxes were estimated for 2016, refer to the appendix.
[71] "Commonwealth of Kentucky: Tax Expenditure Analysis Fiscal years 2016-2018," Office of State Budget Director, Governor's Office for Economic Analysis, November 15, 2015.
http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf
[72] Many items associated with sales tax expenditures are subject to rates other than the statewide sales tax rate of 6%. For simplicity's sake, a statewide rate of 6% was assumed to determine the sales tax base. In reality, the effective sales tax rate is lower than 6%, and our calculation based on a 6% sales yields a lower sales tax base than a lower sales tax rate would. Thus, our 6% sales tax rate assumption results in a higher estimated sales tax rate than is actually necessary to collect FY 2016 state and local tax revenue.

Property Tax

The method by which the sales tax base was estimated, i.e., adding current tax revenue and potential revenue from elimination of all sales tax expenditures, was impractical for estimating the property tax base due to the number of different property tax rates levied on different items in Kentucky's property tax base. Instead, determining the property tax base required estimation of the market value of all land, residential, commercial, and industrial property located within the state of Kentucky (see appendix for a guide to the estimation process).[73]

Below are the components and their market value that comprise our estimate of the broad-based property tax base for Kentucky in 2016:

Table 12
2016 Property Tax Base: Estimated Market Value of Components[74]
(Current dollars)

Tax Base	Market Value	
All Homes (including Land)	$	218,385,594,411
All Commerical/Industrial Property	$	443,388,934,106
Total	**$**	**661,774,528,517**

With a property tax base of $661.775 billion, **Kentucky could meet its total FY 2016 state and local tax collections of $16.905 billion with a property tax rate of 2.55%** ($16.905 billion in state and local tax revenue / $661.775 billion property tax base = 2.55% property tax rate).

Income Tax

The broadest possible tax base for a tax on income would include estimates for personal income and income from business value-added (gross state product); both of these data are published by Bureau of Economic Analysis.

Below are estimations of the value of the two components of the income tax base:

Table 13
2016 Income Tax Base: Components and Value[75]
(Current dollars)

Income Tax Base	Value	
Personal Income Tax Base	$	176,182,641,000
Business Value Added (GSP)	$	200,990,926,918
Total	**$**	**377,173,567,918**

With an income tax base of $377.174 billion, **Kentucky could meet its total FY 2016 state and local tax collections of $16.905 billion with a personal income tax rate of 4.48% and a business net sales tax rate also of 4.48%** ($16.905 billion in tax revenue / $377.174 billion income tax base = 4.48% income tax rate).

[73] Sources: Lincoln Institute of Land Policy, the Tax Foundation, Bureau of Economic Analysis with calculations by Laffer Associates https://www.bea.gov/papers/pdf/new-estimates-of-value-of-land-of-the-united-states-larson.pdf
[74] Sources: Lincoln Institute of Land Policy, the Tax Foundation, Bureau of Economic Analysis with calculations by Laffer Associates https://www.bea.gov/papers/pdf/new-estimates-of-value-of-land-of-the-united-states-larson.pdf
[75] Source: Bureau of Economic Analysis (BEA).

Combinations of Sales, Property, and Income Taxes

Given our static assumptions and what we believe to be conservative estimates of the various tax bases, i.e., no supply-side or incentive effects, it is a matter of plain arithmetic to combine these various taxes. Table 14 contains sales, property, and income tax rates required for each tax to contribute 50% of revenue:

Table 14
Sales, Property, and Income Tax Rates with Each Tax Rate Collecting 50% of 2016 State and Local Tax Revenue

Sales Tax	Property Tax	Income Tax
4.43%	1.28%	-
4.43%	-	2.24%
-	1.28%	2.24%

Considerations in using these numbers other than their lack of precision include:

1. Dynamic effects that could be very significant and positive e.g. higher gross state product, less welfare, more in-migration of jobs and production, would all increase state and local tax collections.

2. Major reductions in the inefficiencies of processing and handling of tax revenues—perhaps as high as 1% of gross state product.[76]

3. A major reduction of fraud, abuse and outright criminal activities, again adding to the efficacy of fiscal policy. This effect would be as high as 1% of gross state product.[77]

[76] For more information on the costs associated with tax code complexity, see the following source:
Arthur B. Laffer, Ph.D., "The Economic Burden Caused by Tax Code Complexity," The Laffer Center at the Pacific Research Institute, April 14, 2011. http://www.laffercenter.com/the-economic-burden-caused-by-tax-code-complexity/

[77] *Ibid.*

APPENDIX

1. Walkthrough of Estimation Processes

FY 2016 Gross State Product (GSP) Estimate

The Bureau of Economic Analysis (BEA) releases estimates of Gross State Product (GSP) several times a year. Estimates are released for GSP as measured on both a quarterly and annual basis. Initial estimates are subject to revision at scheduled intervals (oftentimes the revisions are substantially different than the initial release—for more information see footnote below).[78,79,80] At the time this report was written, GSP data for the states had been released through FY 2015; FY 2016 GSP estimates for the states were not yet available, requiring a FY 2016 estimate to be calculated for Kentucky.

The FY 2016 GSP estimate for Kentucky was calculated in the following way:

1. Kentucky's recent growth in economic output as measured by GSP was used to estimate its FY 2016 GSP. The compound annual growth rate (CAGR) in Kentucky's GSP for the five-year period beginning in FY 2010 and ending in FY 2015 was deemed an appropriate period on which the forecast could be based.[81,82,83] CAGR, defined as the "mean annual growth rate over a specified period of time longer than one year," is the preferred way to assess annual averages in investment growth or economic growth. A less attractive, but still frequently used method, that uses simple annual averages can occasionally lead to misleading results (see footnote below for example on "misleading" results).[84,85] Kentucky's CAGR was 3.3% between 2010 and 2015.

2. Kentucky's CAGR of 3.3% was applied to Kentucky's actual 2015 GSP of $194.6 billion to return a FY 2016 GSP estimate of $201 billion (see Table 12 below).

Table 12

Kentucky Gross State Product (GSP): Historical Data and Estimated GSP[86]

(2009 – 2015 = actual; 2016 = estimated)

	Actual GSP							Estimated GSP
		CAGR used to Estimated 2016 GSP						
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Kentucky GSP (000s)	156,113,000	165,787,000	172,255,000	178,210,000	182,696,000	188,518,000	194,643,000	200,990,927

Tax Expenditures: Deviations from a "Normal" Tax Base

Taxes are negative in nature: we tax bad activities to reduce the incentive to engage in them. For instance, we tax speeders to stop speeding, we tax alcohol to stop drinking, and we tax smokers to stop smoking. But at the same time, we also tax many desirable activities, such as work, saving, and investment—the activities from which wealth is born and then grows. And don't for a moment believe that taxes on these good activities won't have the same deleterious

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78 For a schedule of the BEA's major data releases, including GSP estimates, refer to the following:
"2016 News Release Schedule," Bureau of Economic. http://www.bea.gov/newsreleases/2016rd.htm

79 GSP revisions can vary substantially. For our view on GSP revisions, refer to the following:
Arthur B. Laffer, Ph.D. and Kenneth B. Petersen, Ph.D. "GDP Revisions: Chilling Reading," Laffer Associates, August 9, 2016.

80 For additional information on the BEA's GSP revisions, see:
"How accurate and reliable are BEA's early GDP estimates and revisions, and how have the revisions to GDP over time affected the picture of GDP growth?" Bureau of Economic Analysis, http://www.bea.gov/faq/index.cfm?faq_id=1000

81 Kentucky's GSP growth was 6.2% between 2009 and 2010; however, this high growth was excluded from the sample used to estimate FY 2016 GSP for (2) reasons. 1) Kentucky's 6.2% GSP growths is an outlier among state GSP growth and 2.) the state's 6.2% GSP growth may be considered a one-time "slingshot effect" attributed to initial growth as the country rebounded from the Great Recession, which hit its trough in June 2009 according to the National Bureau of Economic Research (NBER).

82 The formula for compound annual growth rate is the following:
CAGR = (Ending Value/Beginning Value) ^ (1/# of Years) - 1

83 Source: Bureau of Economic Analysis.

84 "Compound Annual Growth Rate – CAGR," Investopedia, http://www.investopedia.com/terms/a/aagr.asp

85 To illustrate, let's look at an example of GSP for three periods. In period 1, GSP was $25 billion, $50 billion in the 2nd period, and $25 in the 3rd period. Growth was 100% ($50 billion – $25 billion / $25 billion x 100) between the 1st and 2nd periods and -50% ($25 billion - $50 billion / $50 billion x 100) between the 2nd and 3rd periods. The average growth rate was thus 25% ((100% growth + -50% growth)

86 Source: Bureau of Economic Analysis and Laffer Associates Calculations

affect they have on speeding and drinking. They do. Therefore, in order to provide the least harm to employment, output, and production, and the economy, these wealth-producing activities should be taxed in a manner that abides by the maxim *primum non nocere*, or first, do no harm. This means taxing productive activities in the least damaging way possible, with a low-rate, broad-based tax.

Being negative in nature, a system of taxation should *never* include positive incentives. Positive incentives in the tax code only serve to distort incentives and provide opportunities for tax avoidance (shifting to non-taxed, or lower-taxed activities) or tax evasion (not paying one's legal tax liabilities). In the process, positive incentives leave government tax collections, *ceteris paribus*, lower than they would have been otherwise. Positive tax incentives include tax credits, tax exemptions, and most importantly for our current purposes, tax expenditures, all of which are abundant in Kentucky's current tax code and are contributing to the state's economy as one would expect: by reducing the incentives for wealth production and having a deleterious effects on government tax collections.

A tax expenditure can best be understood as "a departure from the 'normal' tax base that lowers a taxpayer's burden– for example."[87] In no small feat of bureaucratic imagination or creative linguistics, the lowering of the tax burden for a specific category of taxpayer or taxable activity is considered an "expenditure" because the government, by forgoing the opportunity to collect tax revenue, has effectively "spent" those revenues. Who says *creative destruction* is the sole domain of the private sector?

The notion of the tax expenditure can be attributed to Assistant Secretary of the Treasury Stanley Surrey.[88] Developed in the 1960s, the tax expenditure became part of the federal budget in 1974. Under a congressional mandate, tax expenditures were first officially defined as "revenue losses attributable to provisions of the Federal tax laws which allow special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[89]

Revenue Estimates Arising from Changes in the Tax Base

In order to estimate the revenue effects of changes in Kentucky's personal income tax, corporate income tax, sales tax, and property tax policies arising from broadening of each tax base, this report draws extensively upon a tax expenditure report produced by Kentucky's Office of the State Budget Director, entitled "Commonwealth of Kentucky: Tax Expenditure Analysis Fiscal years 2016-2018."[90] Kentucky's tax expenditure report is produced biannually and following the guidelines set out in Kentucky House Bill 235, the report seeks "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 statute or act of the Kentucky General Assembly."[91] The tax expenditure report includes estimates for state-level tax expenditures, with no substantive estimates for local tax expenditures.

The Kentucky Tax Expenditure report, besides being a valuable repository of tax and tax-related data, is also full of valuable economic insights germane to our analysis. The following (3) bullet points are excerpts from the Kentucky Tax Expenditure Report:[92]

1. Tax expenditures are best described as deviations from the "normal" or "appropriate" tax structure.[93] For example, a business income tax is normally levied on net income, after reducing for the customary expenses

[87] As cited in Alan Cole, "Corporate and Individual Tax Expenditures," Tax Foundation, August 3, 2015. http://taxfoundation.org/article/corporate-and-individual-tax-expenditures The definition
[88] Alan Cole, "Corporate and Individual Tax Expenditures," Tax Foundation, August 3, 2015. http://taxfoundation.org/article/corporate-and-individual-tax-expenditures
[89] From Cole, which attributes the following source:
Congressional Budget and Impoundment Control Act of 1974, 2 U.S.C. Section 622(3)
http://legcounsel.house.gov/Comps/93-344.pdf
[90] Source: "Commonwealth of Kentucky: Tax Expenditure Analysis Fiscal years 2016-2018," Office of State Budget Director, Governor's Office for Economic Analysis, November 15, 2015.
http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf
[91] The full text of Kentucky House Bill 235 can be read here at the following link:
http://www.lrc.ky.gov/record/14rs/hb235.htm
[92] *Ibid.*
[93] The "normal" or "appropriate" tax structure or tax base may be considered what constitutes an ideal tax base that was free of any deductions, credits, or exemptions. For more information, see the following:

incurred to produce that income. As a result, most business expenses are not tax expenditures. Similarly, sales tax is usually levied on retail sales of tangible property. Therefore, the failure to tax sales for resale, wholesale sales, or sales of certain services do not create a tax expenditure because these classes of transactions are incongruous with the philosophical underpinnings of the retail sales tax.

2. Unlike direct appropriations, which must be continuously reviewed and approved by the General Assembly to remain in effect, state tax expenditures are usually not included in this review process. As a result, programs funded through tax expenditures receive priority funding over all other programs because they are automatically deducted from the revenue projections used to formulate the biennial budget. Tax expenditures are more formally budgeted at the federal level, as a tax expenditure has the same budgetary costs as a direct appropriation. However, this level of analysis is rarely seen at the state level, given the complexity of the analysis and uncertainty created for the tax-paying community. In all probability, many "tax expenditure" programs would not receive the same priority if they had to compete on equal footing during the biennial appropriation process.

3. The estimates for each tax expenditure contained in this analysis were made independently, with the assumption that all other provisions of the tax laws remained unchanged and that taxpayer behavior remained constant. This was done because the analysis attempts to measure the costs of the expenditures and not what would happen if one or more were repealed. This analysis should not be viewed as an estimate of the impact of repealing one or more tax expenditures because the estimated cost of the expenditure(s) may not necessarily equal the increased revenue resulting from repeal.

In reality, elimination of tax expenditures will change incentives and in turn, tax revenues will be impacted. Assessing the dynamic effects of eliminating many taxes is problematic due to the number and variety and taxes involved. Therefore, we have chosen to assess elimination of tax expenditures with a static, accounting approach.

<u>Estimate of Local Revenue</u>
Replacing Kentucky's current tax regime with a low-rate, broad based flat tax designed to collect the current revenues requires an accurate assessment of revenue collections at both state and local government levels. This process is complicated by a lack of available data, thus necessitating a partial estimate of revenue collections. Here is a guide to the estimation process:

At the state level, Kentucky posts its biennial budget and numerous budget-related documents, such as official revenue estimates, tax expenditure reports, and quarterly economic and revenue reports online, making an assessment of Kentucky's current revenue straightforward. However, an assessment of revenue collections at the local government level, which includes cities, towns, counties, school districts and special districts is far more complicated because the vast majority of Kentucky's local governments do not post their budgets online, nor are they required to submit their budgets to the state. the only publicly-available estimate of local government revenues is produced annually by the U.S. Census Bureau, though due to lags in its reporting schedule, the most recent data the Census Bureau offers is from 2013—not recent enough for our purposes, due to changes in fiscal policy since 2013 that impact current revenue collections (an estimate based solely on these 2013 revenue would reflect the fiscal policies at that time rather than those of today).

Liz Malm, "What's Normal? Defining the Tax Base," Multistate Associates, NCSL Tax Task Force, January 8, 2016. http://www.ncsl.org/documents/task_forces/Defining_The_Normal_Tax_Base_Final.pdf

2. Kentucky: Tax Expenditures by Category

Table 1

Estimate of Gross State Product (GSP) and Enacted General Fund and Combined General Fund and Road Fund Figures[94,95,96]

	FY 2016		
	Gross State Product (GSP)	General Fund	General and Road Funds
Kentucky	$ 200,990,926,918	$ 10,741,686,500	$ 12,194,921,400

Table 2

Tax Expenditures by Category and Expenditures as a Share of GSP, Enacted General Fund, and Combined General Fund and Road Fund[97,98]

	FY 2016 Estimate			
Expenditures	Tax Expenditure	Gross State Product (GSP)	General Fund	General and Road Funds
Corporate Income Tax (CIT)	**$ 328,098,000**	**0.16%**	**3.05%**	**2.69%**
Exemptions	$ 188,000,000	0.09%	1.75%	1.54%
Credits	$ 32,498,000	0.02%	0.30%	0.27%
Deductions	$ 107,600,000	0.05%	1.00%	0.88%
Personal Income Tax (PIT)	**$ 4,951,800,000**	**2.46%**	**46.10%**	**40.61%**
Exclusions	$ 3,697,000,000	1.84%	34.42%	30.32%
Credits	$ 256,500,000	0.13%	2.39%	2.10%
Deductions	$ 998,300,000	0.50%	9.29%	8.19%
Property Tax	**$ 714,252,000**	**0.36%**	**6.65%**	**5.86%**
Real Property	$ 516,242,000	0.26%	4.81%	4.23%
Tangible Property	$ 198,010,000	0.10%	1.84%	1.62%

[94] The FY 2016 GSP figure was estimated by applying the CAGR for the five years between 2010 and 2015 to actual FY 2015 GSP.
[95] Source: Bureau of Economic Analysis
[96] Source: "2016 – 2018 Budget of the Commonwealth: Budget in Brief," Commonwealth of Kentucky, January 26, 2016. http://osbd.ky.gov/Publications/Documents/Budget%20Documents/20162018%20Budget%20of%20the%20Commonwealth/Budget%20in%20Brief%20-%207-7-16.pdf
[97] Source: *Ibid.*
[98] Source: "Tax Expenditure Analysis Fiscal Years 2016 – 2018," Commonwealth of Kentucky. http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf

Corporate Income Tax (CIT) Expenditures by Category

CIT Exemptions: Estimated Revenue Loss, Share of GSP, and Share of General and General and Road Funds

		FY 2016 Estimate						
	CIT Exemption	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Coal Royalties	Minimal (< $1 million)	0.00%	0.00%	0.00%	KRS 141/010(12)(d)	1962	A corporation owning an economic interest in coal land may exclude 50% of any royalties received from such land if it does not deduct certain expenses related to the production of the royalty income, including percentage depletion.
2	Credit Unions	$ 2,500,000	0.00%	0.02%	0.02%	KRS 286.6-115	1984	Credit unions are exempt from corporation income tax. The shares of credit unions shall not be subject to any stock transfer tax either when issued or when transferred from one member to another.
3	Dividend Income	$ 168,000,000	0.08%	1.56%	1.38%	KRS 141.010(12)(b)	1969	Dividend income (domestic and foreign) is excluded from gross income.
4	Homeowners' Associations	$ -	0.00%	0.00%	0.00%	KRS 141.010(14)c	1998	Certain income of qualified homeowners' associations is considered exempt function incomeand is therefore not taxable for income tax purposes.
5	Real Estate Investment Trust (REIT)	$ 17,500,000	0.01%	0.16%	0.14%	KRS 141.010(14)(d)	1998	REIT's are allowed the dividend paid deduction for corporation income tax if the REIT is not a captive real estate investment trust as defined by KRS 141.010(29).
		$ 188,000,000	0.09%	1.75%	1.54%			

CIT Deductions as a Share of GSP and Share of General and General and Road Funds

		FY 2016 Estimate						
	CIT Deduction	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Charitable Contributions	$ 16,000,000	0.01%	0.15%	0.13%	KRS 141.010(13)(d)(6), IRC Sec 170	1954	Charitable donations of up to 10 percent of taxable income are deductible from net income. A carryover of excess contributions is allowed for up to five years.
2	Deductibility of Patronage Dividends	$ 15,000,000	0.01%	0.14%	0.12%	KRS 141.010(12)b, IRC Sec 521	1954	Dividends paid to members of patrons of incorporated cooperatives, such as farmer cooperatives, are deductible.
3	Domestic Production Activities	$ 10,000,000	0.00%	0.09%	0.08%	KRS 141.010(13)(d), IRC Sec. 199	2010	For taxable years beginning on or after January 1, 2010, the domestic production activities deduction allowed under Section 199 of the IRC.
4	Excess of Percentage Over Cost Depletion	$ 3,500,000	0.00%	0.03%	0.03%	KRS 141.010(12)d, IRC sec. 631c	-	The method of computing the depletion deduction is based upon an arbitrary percentage of gross income from production (gross income from the property). The percentage depletion allowance is limited to 100 percent of the taxable income from oil and gas operations computed with respect to each separate operating mineral interest.
5	Leasehold Interest of Property Contributed as Living Quarters for Homeless	$ -	0.00%	0.00%	0.00%	KRS 141.0202	1990	A deduction is allowed for the value of any leasehold inerest of property contributed to a charitable organization if the leased property is to be used by the charitable organization to provide temporary living quarters for a homeless family.
6	Net Operating Loss Deduction	$ 63,100,000	0.03%	0.59%	0.52%	KRS 141.011	1980	In calculating Kentucky taxable income, a corporation may carry forward a net operating loss for twenty years, in order to reduce taxable income in profitable years. The net operating loss carry back deduction is not allowed for losses incurred in tax years beginning on or after January 1, 2005.
		$ 107,600,000	0.05%	1.00%	0.88%			

CIT Credits: Estimated Revenue Loss, Share of GSP, and Share of General and General and Road Funds

		FY 2016 Estimate						
	CIT Credit	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Biodiesel and Renewable Diesel Tax Credit	$ 2,700,000	0.00%	0.03%	0.02%	KRS 141.423	2005	A credit of up to $1 per gallon may be taken for producing or blending biodiesel and renewable diesel fuels. The total amount that may be taken is capped each fiscal year. The amount shown below are equal to the capped total for each year.
2	Clean Coal Incentive Credit	$ 2,100,000	0.00%	0.02%	0.02%	KRS 141.428(1)a	2005	Acredit is available at a rate of $2 per ton of qualifying coal burned by an electricity generation facility investing more than $150 million and certified by the Energy and Environmental Cabinet as using clean coal equipment and technology and buring coal subject to Kentucky's severance tax. The credit shall not be carried forward and must be used on the tax return filed for the period during which the eligible coal was purchased.
3	Coal Conversion Credit	$ 150,000	0.00%	0.00%	0.00%	KRS 141.041	1984	Corporations may claim an income tax credit equal to 4.5 percent of the purchase price, minus transportation costs, of coal consumed or substituted in heating facilities that are currently using a different source of energy.
4	Coal Incentive Credit	$ 3,500,000	0.00%	0.03%	0.03%	KRS 141.0405	2000	A credit is allowed to a) any electric power company subject to tax pursuant to KRS 136.120, b) any entity that operates a coal-fired electric generation plan or c) any entity that is an alternative fuel facility or gasification facility not already approved for incentives pursuant to KRS Chapter 154 Section 27. The credit is equal to $2 per each incentive ton of coal purchased subject to tax pursuant to KRS 143.020 and is used to generate electric power or used as feedstock for an alternative fuel facility or gasification facility. Incentive tons are calculated as current year usage minus the base year, where the base year is that coal purchased in calender year 1999. For entities created after this base year, the base shalll be equal to zero.
5	Consolidation of the Kentucky Economic Development Finance Authority (KEDFA) Economic	$ 2,900,000	0.00%	0.03%	0.02%	KRS 154.32-070	2009	An approved company many be eligible for a credit of up to 100% of the Kentucky income tax.
6	Construction of Research Facilities Credit	$ 550,000	0.00%	0.01%	0.00%	KRS 141.395	2002	Five percent of the qualified costs of construction of research facilities is allowed as a nonrefundable credit against corporation income tax.
7	Employer GED Credit	$ -	0.00%	0.00%	0.00%	KRS 164.0062	2013	An employer who assists an individual to complete coursework leading to his or her high school equivalency diploma (GED) shall receive a state tax credit against the income tax equal to 50 percent of the student's hourly salary for time released by the employer to study for the test, limited to a total of $1,250.
8	Environmental Remediation Tax Credit	$ 37,000	0.00%	0.00%	0.00%	KRS 141.418	2005	A taxpayer who agrees to clean up or develop an existing abandoned brownfield area may qualify for a credit against corporation income taxes in a maximum amount of $150,000.
9	Environmental Stewardship Tax Credit	$ -	0.00%	0.00%	0.00%	KRS 154.48-010(4) KRS 141:020	2010	A credit is available for a taxpayer undertaking an environmental stewardship project with a minimum investment of at least $5 million. The credit covers 100 percent of eligible skills upgrade training costs and up to 25 percent of a project's fixed assets. The Cabinet for Economic Development approves a project producing a new or improved manufactured product that has a lesser or reduced adverse effect on human health or the environment for a taxpayer meeting certain wage requirements.
10	Ethanol and Cellulosic Ethanol Tax Credit	$ 350,000	0.00%	0.00%	0.00%	KRS 141.422-425 KRS 141.423	2007	A producer of ethanol or cellulosic is allowed a credit equal to $1 per gallon, capped at a total of $10 million in credits authorized for each type of product per year for all producers.
11	Film Industry Tax Credit	$ 1,000,000	0.00%	0.01%	0.01%	KRS 141.383 KRS 148.546(3)(b)	2009 and 2014	Approved companies that film or produce a motion picture or entertainment production, commercial, or doumentary may recover up to 30% for a motion picture or entertainment production filmed or produced in whole or in part in any Kentucky county other than in an enhanced incentive county and 35% for an enhanced incentive county. Qualifying expenditures include expenditures made in Kentucky that are directly used in or for a motion picture or entertainment production. There was a cap of $5.0 million for FY11 and $7.5 million for FY12. There has been no cap on film credits since the cap was repealed in FY12.
12	Kentucky Investment Fund Tax Credit	$ 27,000	0.00%	0.00%	0.00%	KRS 154.20-258	2006	An investor making a cash contribution to a qualified investment fund is allowed a credit equal to 40 percent of the contribution against the corporate income tax liability. The credit may be carried forward up to 15 years, but cannot exceed 50 percent of the initial aggregate credit amount approved for the investment fund, which would be proportionally available to investors.
13	(KIDA) Economic Development Credit Kentucky Industrial Development Act	$ 3,500,000	0.00%	0.03%	0.03%	KRS 141.400	1992 Repealed 2009	A 100% credit is allowed against the income of an approved company generated by or arising out of the economic development project. The credit can be carried forward for up to 10 years.
14	(KIRA) Economic Development Credit Kentucky Industrial Revitalization Agreement	$ 500,000	0.00%	0.00%	0.00%	KRS 141.403, KRS 154.26-090	1992 Repealed 2009; effective 2014	A 100% credit of the license tax attributable to the location of the economic revitalization project is allowed against the income of an approved company generated by or arising out of the economic development project. The credit can be carried forward for up to 10 years, but cannot exceed 75% of the approved costs of the project.
15	(KJDA) Economic Development Credit Kentucky Jobs Development Act	$ 1,900,000	0.00%	0.02%	0.02%	KRS 154.24-130	1992, 2009	A 100% credit is allowed against the income of an approved company generated by or arising out of the economic development project. The credit can be carried forward for up to 10 years.
16	(KREDA) Economic Development Credit Kentucky Rural Economic	$ 3,500,000	0.00%	0.03%	0.03%	KRS 154.22-050	1988, Repealed 2009	A 100% credit is allowed against the income of an approved company generated by or arising out of the economic development project. The credit can be carried forward for up to 15 years.
17	Kentucky Small Business Investment Credit	$ 134,000	0.00%	0.00%	0.00%	KRS 141.384	2010, 2014	KRS 141.384 was amended to allow the credit to apply to taxable years beginning after December 31, 2010. A small business may be eligible for a nonrefundable credit of up to 100% of the Kentucky income tax imposed pursuant to KRS.
18	Metropolitan College Program Tax Credit	$ -	0.00%	0.00%	0.00%	KRS 141.381	2009, 2012	Parties to the Metropolitan College Consortium Agreement may qualify for a 50% tax credit for tuition and other educational expenses paid on behalf of a student participating in the Metropolitan college. The credit shall expire on April 15, 2017 unless extended by the General Assembly.
19	Qualified Farming Operation Credit	$ -	0.00%	0.00%	0.00%	KRS 141.414, 141.412	2006	A corporation engaged in farming in Kentucky that provides raw materials for food producing facilities in Kentucky, that purchases new building or equipment, or that incurs training expenses to support its participation in a networking project is entitled to a nonrefundable credit for those charges against the corporation income tax imposed on income arising from its participation in the networking project. The annual credit shall be available for the first (5) years that the farming operation is involved in the networking project not to exceed the income generated by the qualified farm.
20	Railroad Improvement Tax Credit	$ 2,700,000	0.00%	0.03%	0.02%	KRS 141.385	2009	Class II and Class III railroads, as defined by the Federal Surface Transportation Board, may receive credit against costs incurred for railroad maintenance and improvement and for railroad expansion or upgrades to accommodate the transport fosil energy or biomass resource. A 50% credit is allowed.
21	Recycling Credit	$ 6,300,000	0.00%	0.06%	0.05%	KRS 141.390	1991	A credit of 50% of the installed cost of recycling or composting equipment, used exclusively in this state, for post consumer waste is allowed.
22	Skills Training Investment Tax Credit	$ 650,000	0.00%	0.01%	0.01%	KRS 154.12-2086, KRS 141.020, KRS 141.040, KRS 141.0401	1998	A credit of 50% of the approved cost of a company's skills training program is allowed against the corporate income tax liability.
23	Unemployment Tax Credit	Minimal (< $1 million)	0.00%	0.00%	0.00%	KRS 141.065	1982	Corporations hiring persons who have been unemployed for 60 days and who remain employeed for 180 days, are allowed a $100 tax credit for each qualified person.
		$ 32,498,000	0.02%	0.30%	0.27%			

Personal Income Tax (PIT) Expenditures by Category

PIT Expenditures: Estimated Revenue Loss, Share of GSP, and Share of General and General and Road Funds

		FY 2016 Estimate						
	Pit Exclusion	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Active Duty Military Pay Exemption	$ 19,400,000	0.01%	0.18%	0.16%	KRS 141.010(10)(u)	2010	For taxable years beginning on or after January 1, 2010, exclude all non-combat military pay received by active duty members of the Armed Forces of the United States, and members of the National Guard, including compensation for state active duty as described in KRS 38.205. Combat pay is also excluded from Kentucky income taxation by virtue of it being exempt from federal taxation. Please see expenditure No. 2 to see the additional value of the combat pay.
2	Armed Forces Personnel Benefits and Allowances	$ 104,600,000	0.05%	0.97%	0.86%	Internal Revenue Code Sections 112 and 134	Effective 1986 and 1996	The housing and meals provided military personnel, either in cash or in kind, as well as certain amounts of pay related to combat service, are excluded from income subject to tax.
3	Assistance for Adopted Foster Children and Foster Care Payments	$ 4,400,000	0.00%	0.04%	0.04%	Internal Revenue Code Section 131 and 137	1978 and 2002	Taxpayers who adopt eligible children from the public foster care system can receive monthly payments for the children's significant and varied needs and a reimbursement of up to $3,950 for expenses. These payments are excluded from gross income. This federal provision will sunset for some taxpayers for taxable years beginning after December 31, 2009. Additional, gross income does not include amounts recieved by a foster care provider. There is a $10,000 exclusion for adoption of a child with special needs regardless of expenses.
4	Basis of Capital Gains on Gifts	$ 56,400,000	0.03%	0.53%	0.46%	Internal Revenue Code Section 1015	1959	When a gift is made, the donor's basis in the transferred property (the cost that was incurred when the transferred property was first acquired) carries over to the donee. The carryover of the donor's basis allows a continued deferral of unrealized capital gains.
5	Cancellation of Indebtedness	$ -	0.00%	0.00%	0.00%	Internal Revenue Code Section 108	1980	Individuals are not required to report the cancellation of certain indebtedness as current income. If the canceled debt is not reported as current income, the basis of the underlying property must be reduced by the amount canceled. Negative tax expenditures can occur when incoming tax receipts from past deferrals are greater than deferred receipts from new activity.
6	Capital Gains - Eminent Doman	Minimal (< $1 million)	0.00%	0.00%	0.00%	KRS 141.010(10)(u)	2010	Capital gains on property taken by eminent domain are exempt from individual income tax. When incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative despite the fact that in present-value terms, current deferrals have a positive cost to the government.
7	Capital Gain on Property Transferred at Death	$ 506,500,000	0.25%	4.72%	4.15%	Internal Revenue Code Section 1014	1954	No tax is imposed on capital gains resulting from the transfer at death of appreciated property. The appreciation that accrued during the lifetime of the transferor is never taxed as income.
8	Disabled Coal Miners	$ 200,000	0.00%	0.00%	0.00%	Internal Revenue Code Section 104 and 192	2002 and 1992	Although it is income to the recipient, disability paymnts to former coal miners out of the Black Lung Trust Fund are not subject to the income tax.
9	Employee Stock Ownership Plan Provisions (ESOPs)	$ 2,900,000	0.00%	0.03%	0.02%	Internal Revenue Code Section 421	1981, 2004	Employer-paid contributions to ESOPs are deductibe by the employer as part of employee compensation costs. They are not included in the employee's gross income for tax purposes until they are piad out as benefits.
10	Employer Contributions for Medical Insurance and Medical Care	$ 783,500,000	0.39%	7.29%	6.42%	Internal Revenue Code Section 105(b) and 106	2008, 2006	Employer-paid health insurance premiums and other medical expenses (including long-erm care) are deducted as a business expense by employers, but they are not included in employee gross income. The self-employed also may deduct up to 100% of their family health insurance premiums.
11	Employer-Procided Benefits of Premiums on Group Term Life, Accident and Disability Insurance	$ 20,800,000	0.01%	0.19%	0.17%	Internal Revenue Code Section 79(a) and 106	effective 1990 and 2006, respectively	Employer payment of employee group term life insurance premiums for coverage up to $50,000 per employee is excluded from an employee's gross income even though the employer's cost for thebenefit is a deductible business expense. Employer contributions for premiums on accident injury and accidental death insurance are not included in income by the employee and are deductible by the employer.
12	Employer-Provided Child Care Exclusion	$ 7,600,000	0.00%	0.07%	0.06%	Internal Revenue Code Section 129	1981	Up to $5,000 employer-provided child care is excluded from an employee's gross income even though the employer's costs for the child care are a deductible business expense.
13	Employer-Provided Educational Assistance	$ 6,400,000	0.00%	0.06%	0.05%	Internal Revenue Code Section 127	1986	Employer-provided educational assistance is excluded from an employee's gross income.
14	Employer-Provided Meals and Lodging	$ 34,100,000	0.02%	0.32%	0.28%	Internal Revenue Code Section 119	1998	Employer-provided meals and lodging are excluded from an employee's gross income even though the employer's cost for these items are a deductible business expense.
15	Exclusion of GI Bill Benefits	$ 12,900,000	0.01%	0.12%	0.11%	Internal Revenue Code Section 72(n) and 104	2008	GI Bill benefits paid by the Veterans Administration are excluded from gross income.
16	Federal Military Retirement Income Received	$ 126,000,000	0.06%	1.17%	1.03%	KRS 141.021	1995	A total exclusion is allowed from gross income for federal and military retirement income. Except federal retirement annuities and local government retirement annuities accrued or accruing on or after January 1, 1998, federal and military retirement income received shall be subject to the tax imposed by KRS 141.020.
17	Financial Institutions Structured as S Corporations	Minimal (< $1 million)	0.00%	0.00%	0.00%	KRS 141.010(10)(j)(1)(a)	1997	Distributive shares of income from financial institutions structured as S Corporations are excludable from gross income for individual taxpayers.
18	Gain on the Sale of a Personal Residence	$ 143,400,000	0.07%	1.33%	1.18%	Internal Revenue Code Sections 121	2008	A homeowner can exlude from tax up to $500,000 ($250,000 for singles) of the capital.
19	Income Averaging for Farmers	$ 1,100,000	0.00%	0.01%	0.01%	Internal Revenue Code Section 1301	1986	A taxpayer may lower his or her tax liability by averaging, over the prior 3-year period, the taxable income from farming and fishing.
20	Income Earned Abroad by U.S. Citizens	$ 47,700,000	0.02%	0.44%	0.39%	Internal Revenue Code Section 911 and 912	2007 and 1988	U.S. citizens who lived abroad, worked in the private sector, and satisfied a foreign residency requirement may exclude up to $80,000 in foreign earned income from U.S. taxes. In addition, if these taxpayers receive an allowance for foreign housing from their employers, they may also exclude the value of that allowance. Federal civilian employees and Peace Corps members who work outside the continental United States are allowed to exclude from U.S. taxable income allowances they receive to compensate them for the relatively high costs associated with living overseas. The allowances supplement wage income and cover expenses like rent, education, and the cost of travel to and from the United States.
21	Installment Sales	$ 13,400,000	0.01%	0.12%	0.11%	Internal Revenue Code Section 453	2004	The general rule for installment sales is that the income is taxed when each installment is received and not in the year of the sale. The exception to the general rule is that a "dealer" cannot defer the tax on the sale, i.e., they must report the entire sales price on an installment sale regardless of when the income is received. The tax expenditure occurs since the Federal Government permits an irrevocable election, approved by the IRS commissioner, to opt out of the exception, thereby allowing the deferral of income and making the general rule apply to dealer once again. The delay in taxation of future installment is the basis for the tax expenditure. The Kentucky automatically honors the irrevocable election by virtue of our last code update that synchronized the Kentucky states to federal tax code.
22	Interest on Life Insurance Savings	$ 64,300,000	0.03%	0.60%	0.53%	Internal Revenue Code Section 101(a)	2006	Favorable tax treatment is provided for investment income within qualified life insurance and annuity contracts. Investment income earned on qualified life insurance contracts held until death is permanently exempt from income tax. Investment income distributed prior to the death of the insured is tax-deferred, if not tax-exempt. Investment income earned on annuities is treated less favorably than income earned on life insurance contracts, but it benefits from tax deferral without annual contribution or income generally applicable to other tax-favored retirement income plans.
23	Miscellaneous Fringe Benefits	$ 76,700,000	0.04%	0.71%	0.63%	Internal Revenue Code Section 132	2009	Any fringe benefit that qualifies as a no-additional-cost service, qualified employee discount, working conditionfringe, de minimis fringe, qualified transportation fringe, qualified moving expense reimbursement, qalified retirement planning services, or qualified military base realignment and closure fringe is excluded from income.
24	Passive Loss Rules Exception	$ 67,000,000	0.03%	0.62%	0.55%	Internal Revenue Code Section 469	1993	In general, the passive activity loss or the passive activity credits may not offset income from other sources. Losses up to $25,000 attributable to certain rental real estate activity are exempt from this rule.
25	Pension Contributions and Earnings from Employer Plans	$ 560,000,000	0.28%	5.21%	4.59%	KRS 141.010(10)(d)	1983	Employer contributions to pension plans are excluded from an employee's gross income even though the employer can deduct the contributions. In addition, the tax on the investment income earned by the pension plans is deferred until the money is withdrawn.
26	Precinct Workers	$ 100,000	0.00%	0.00%	0.00%	KRS 141.010(10)(1)	1997	Income earned by precinct workers for election training or work at election booths is exempt from income tax.
27	Private Pensions and Individual Retirement Accounts	$ 478,200,000	0.24%	4.45%	3.92%	KRS 141.010(10)(i)(2)	1995	Up to $41,110 in benefits received by both the taxpayer from private pensions, Individual Retirement Accounts (IRAs), and Roth IRAs is exempted from income.
28	Public Assistance Benefits	$ 5,000,000	0.00%	0.05%	0.04%	Internal Revenue Code Section 421	1999	Public assistance or welfare benefits are not taxed. These include Temporary Assistance for Needy Families (TANF) and Supplemental Security Income (SSI).
29	Railroad and Supplemental Railroad Retirement System Benefits	$ 2,400,000	0.00%	0.02%	0.02%	45 USCA Section 231M and KRS 141.010(10)(b)	2010	All Railroad Retirement Board benefits and supplemental railroad retirement benefits are not taxed. In Kentucky all pension or retirement income paid under a written retirement plan is eligible for exclusion.
30	Scholarship and Fellowship Income	$ 24,300,000	0.01%	0.23%	0.20%	Internal Revenue Code Section 117	2001	Scholarships and fellowships are excluded from taxable income to the extent they pay for tuition and course-related expenses of the grantee. Similarly, tuition reductions for employees of educational instituions and their families are not included in taxable income.
31	Social Security Benefits for Retired Workers, Disabled Workers, Dependents and Survivors	$ 314,600,000	0.16%	2.93%	2.58%	Internal Revenue Code Section 86 and KRS 141.010(10)e	1954, 2010	Social Security benefits paid to retired workers and their dependents, to persons who are survivors of deceased workers and to disabled workers and their dependents are not taxed. Kentucky has not adopted IRC Sec. 86 which taxes a portion of these payments if the taxpayer's income is above a certain level.
32	State Employee Pension Benefits and Contributions	$ 74,500,000	0.04%	0.69%	0.61%	KRS 141.0109(10)d	2010	For taxable years beginning on or after January 1, 2010, exclude all non-combat military pay received by active duty members of the Armed Forces of the United States, and members of the National Guard, including compensation for state active duty as descr
33	Veteran's Pension, Death and Disability Compensation	$ 55,800,000	0.03%	0.52%	0.46%	Internal Revenue Code Secti0on 104(a)(4)(5)	2002	All compensation due to pension paymens, death or disability paid by the Veterans Administration is excluded from taxable income.
34	Worker's Compensation Benefits	$ 82,800,000	0.04%	0.77%	0.68%	Internal Revenue Code 104(a)	2002	Workers compensation benefits, paid to disabled employees or their survivors for employment-related injuries or disease, are not taxed.
		$ 3,697,000,000	1.84%	34.42%	30.32%			

PIT Expenditures: Credits as a Share of GSP and General and General and Road Fund

		FY 2016 Estimate						
	Pit Credit	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Child and Dependent Care Credit	$ 9,300,000	0.00%	0.09%	0.08%	KRS 141.067	1990	A credit equal to 20% of the federal child care amount is allowed.
2	Credit for Hiring Unemployed	$ -	0.00%	0.00%	0.00%	KRS 141.065	2009	A credit of $100 is allowed for each qualifiying unemployed person hired.
3	Expanded Low Income Tax Credit	$ 112,400,000	0.06%	1.05%	0.92%	KRS 141.066	2005	Kentucky residents are allowed a low income tax credit based on modified adjusted gross income (MGI) that is equal to federal adjusted gross income plus any interest income from other states' municipal bonds and pension income from a qualifying lump-sum distribution. Single individuals whose MGI and married couples whose combined MGI is at or below federal poverty level for their family size will receive a 100% tax credit. The amounts are indexed for inflation each year. The 2014 federal poverty level for a family of one (1) is $11,670; for a family size of two (2) is $15,730; for a family size of three (3) is $19,790; and for a family size of foue (4) or more (for Kentucky purposes) is $23,850.
4	Historic Preservation Tax Credit	$ 300,000	0.00%	0.00%	0.00%	KRS 171.396(3)(b) and 171.397(1)(b) and (2)(a)	2009	A credit is allowed against individual income tax for a portion of the cost of restoring a qualified residential structure listed on the National Registry of Historic Places. The credit is equal to 30% of the rehabilitation expenses, in the case of owner-occuposed residential property, and 20% of the rehabilitation expenses, in the case of all other property. The total credit available is capped at $3 million for applications received prior to April 30, 2010 ad $5 million for applications received on or after April 30, 2010 with each individual owner-occupied property receiving no mre than $60,000.
5	Job Development Credits	$ 57,400,000	0.03%	0.53%	0.47%	Many statutes (available upon request)	2002, 2006, 2010	Job development credits occur when a compan y is approved for a development project ad that company is allowed to assess a fee on the hired qualified employees. This fee is collected by the employer by keeping part of their normal withholding that would have gone to the state for individual income tax purposes. That employee is then entitled to claim an individual income tax credit equal to the assessment fee. For the first three of these five credits (Kentucky Rural Development Act, Kentucky Jobs Development Act, and Kentucky Industrial Revitalization Act) if the local government in which the project is located has a local occupation license fee which is less than 1%, then the assessment fee is 4% plus the full occupational license fee. The Incentives for Energy Independence Act provides for a flat four percent credit against the assessment fee. The Kentucky Industrial Development Act provides for a flat 3% credit against the assessment fee.
6	Kentucky Angel Investment Act	$ 2,500,000	0.00%	0.02%	0.02%	KRS 154.20-232 and KRS 154.20-36	2014	A credit for certain investments in small business located in the Commonwealth, operating in the fields of knowledge-based, high0tech, and research and development, and showing a potential for rapid growth. The total amout of tax credit to all qualified investors shall be no more than $3 million and for any individual qualified investor shall be no more than $200,000. The total amount of tax credit shall be no more than $40 million in total for all years.
7	Kentucky Energy Efficiency Products Tax Credit	$ 2,600,000	0.00%	0.02%	0.02%	KRS 141.436	2010	The energy efficient products credit remains effective for taxable years beginning after December 31, 2008 and before January 1, 2016. Unused amounts are limited to a one-year carry forward period.
8	Kentucky Small Bueinss Investment Credit	$ 100,000	0.00%	0.00%	0.00%	KRS 141.384	2010	KRS 141.384 was amended to allow the credit to apply to taxable years beginning after December 31, 2010. A small business may be eligible for a nonrefundable credit of up to 100% of the Kentucky income tax imposed pursuant to KRS 41.020 or 141.040 and the limited liability entity tax imposed pursuant to KRS 141.0401. The maximum amount of credits that may be committed in each fiscal year by the Kentucky Economic Development Finance Authority shall be capped at $3 million. The maximum amount of credit for each small business for each year shall not exceed $25,000. Unused credits may be carried forward fpr u to 5 years.
9	Personal and Dependent Tax Credits	$ 53,500,000	0.03%	0.50%	0.44%	KRS 141.020(3)	2013	Tax credits, when applicable, shall be deducted to arrive at the annual tax rate as follows : $10 unmarried individual; $20 married filing joint return; $10 for each dependent; additional $40 for 65 years old or older; $40 if taxpayer is blind; and, an additional $20 for members of the Kentucky National Guard.
10	Postsecondary Education Tuition Credit	$ 17,800,000	0.01%	0.17%	0.15%	KRS 141.069 and Internal Revenue Code Section 25A	2005 and 2009	A credit equal to 25% of the amount of the federal Hope Scholarship and the lifetime learning credit is available. The credit applies only to undergraduate studies, phases out for hiher incomes and applies to most higher education opportunities with Kentucky. Any unused credit may be carried forward for 5 years.
11	Recycling and/or Composting Equipment Credit	$ 600,000	0.00%	0.01%	0.00%	KRS 141.390(2)	2008	A credit is allowed for 50 percent of the installed costs of recycling or composting equipment used exclusively in this state for recycling or composting post-consumer waste. The credit shall be limited to a period of 10 years commencing with the approval of th erecycling credit application. In each taxable year, the amount of credits claimed for all major recycling projects shall be limited to 50 percent of the excess of the total of each tax liability over the baseline tax liability of the taxpayer or $2,500,000 which is less.
		$ 256,500,000	0.13%	2.39%	2.10%			

PIT Expenditures: Deductions as a Share of GSP and Share of General and General and Road Funds

		FY 2016 Estimate						
	Pit Deduction	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Casualty and Theft Losses	$ 1,000,000	0.00%	0.01%	0.01%	Internal Revenue Code Section 165	2008	Any uninsured losses incurred by the taxpayer during the tax year as a result of a casualty or theft are deductible as an itemized deduction.
2	Charitable Contributions	$ 103,800,000	0.05%	0.97%	0.85%	Internal Revenue Code Section 170(b)	2008	The deduction ceiling for most charitable contributions is 50% of Kentucky adjusted gross income (AGI), computed without regard to any net operating loss deduction. If the aggreate amount of contributions exceeds the limitation, it can be carried over 15 succeeding years in order of time. gifts to private nonprofit organizations are limited to 20% of AGI. Some capital gain property is limited to 30% of AGI.
3	Excess of Percentage over Cost Depletion	$ 5,500,000	0.00%	0.05%	0.05%	Internal Revenue Code Section 613	2005	The deduction is the larger of the value of property being expensed by cost or by percentage of depletion.
4	Health Savings Account Deduction	$ 43,000,000	0.02%	0.40%	0.35%	Internal Revenue Code Section 223	2006	Employee contributions to a Health Savings Account are deductible within the same limitations provided for federal purposes.
5	Home Mortgage Interest	$ 162,800,000	0.08%	1.52%	1.33%	Internal Revenue Code Section 163(a)	2009	An itemized deduction is allowed for all interest paid or accrued on owner-occupied homes during thhe taxable year.
6	Individual Retirement Account Contributions	$ 138,800,000	0.07%	1.29%	1.14%	Internal Revenue Code Section 219(a)(b)	2008	Individual taxpayers can take advantage of several different IRAs: deductible IRAs, non-deductible IRAs, and Roth IRAs. The annual contributions limit applies to the total of a taxpayer's deductible, non-deductible, and Roth IRAs contributions. The IRA contribution limit is $5,000 in 2008 and shall be increased by such dollar amount, mmultiplied by the cost of living adjustment thereafter. The tax on investment income earned by 401(k) plans, non-deductible IRAs, and deductible IRAs is deferred until the money is withdrawn.
7	Interest on Educational Loans	$ 13,400,000	0.01%	0.12%	0.11%	Internal Revenue Code Section 221	2005	Up o $2,500 of interest paid on qualified educational loans is deductible.
8	Interest on U.S. Savings Bonds	$ 7,700,000	0.00%	0.07%	0.06%	Interest Revenue Code 149	1959	Taxpayers may defer paying tax on interest earned on U.S. savings bongs until the bonds are deemed.
9	Job Expenses and Other Miscellaneous Deductions	$ 43,400,000	0.02%	0.40%	0.36%	Internal Revenue Code Section 62, Internal Revenue Code 67	2008 and 2000	Unreimbursed employee expenses and various other allowable expenses for individuals are deducted from adjusted gross income to the extent that the total expenses exceed two percent of adjusted gross income. Examples of these miscellaneous deductions are: moving expenses, alimony, Archer MSAs, interest on educational loans, higher education expenses, and health savings accounts.
10	Keogh Plan Contributions	$ 7,800,000	0.00%	0.07%	0.06%	Internal Revenue Code Section 404(a)(8)	1963	A self-employed individual may make deductible contributions to his or her own retirement (Keogh) plan equal to 25% of his or her income, up o an indexed maximum amount of income. Total plans contributions are limited to 24% of a firm's total wages. The tax on the investment income earned by Keogh plans is deferred until withdrawn.
11	Medical Expenses	$ 42,200,000	0.02%	0.39%	0.35%	Internal Revenue Code Section 213	1990	For taxable year beginning after December 31, 2012 and ending before January 1, 2017. Medical and dental expenses in excess of 10% of Kentucky AGI are deductible when itemizing deductions.
12	Net Operating Loss Deduction	$ 56,200,000	0.03%	0.52%	0.46%	KRS 141.010(12))(m)	1980	The Kentucky net operating loss deduction is permitted in computing AGI. Beginning in 2005, taxpayers are no longer alllowed to carry back a net operating loss but may continue to carry forward any net operating loss.
13	Parsonage Allowances	$ 5,900,000	0.00%	0.05%	0.05%	Internal Revenue Code Section 265(6)	2009 and 2002	The value of a minister's housing allowance and the rental value of parsonages are not included in a minister's taxable income.
14	Property Tax on Owner-Occupied Homes	$ 62,400,000	0.03%	0.58%	0.51%	Internal Revenue Code Section 164	2009	State, local, and foreign real property taxes are deductible as itemized deductions.
15	Standard Deduction	$ 149,500,000	0.07%	1.39%	1.23%	KRS 141.081(2)	1946	A taxpayer who does not itemize deduction is permitted a deduction of a predetermined amount referred to as the "standard deduction". The amount of the deduction has been amended several times; under current law it increases based on inflation. For 2014 the standard deduction was $2,400 per taxpayer.
16	State and Local Taxes Other than Home Property Taxes	$ 39,200,000	0.02%	0.36%	0.32%	Internal Revenue Code Section 164(a)	2009	A taxpayer who itemizes may deduct: state, local, foreign, and real property taxes; personal property taxes; income, war profits, and excess profits taxes; the GST tax imposed in income distributions; environmental tax; and qualifid motor vehicle imposed by a windfall property tax and a local occupation tax.
17	U.S. Production Activities	$ 115,700,000	0.06%	1.08%	0.95%	Internal Revenue Code Section 199(a)(2) and House Bill 2	2008 and 2010	This provision was introduced by the American Jobs Creation Act (AJCA) in 2004 and allows for a deduction equal to a portion of taxable income attributable to domestic production. For taxable periods 2005 and 2006 the amount of the deduction is equal to 3% of taxable income attributable to domestic production. for taxable years 2007, 2008 or 2009 the amount of the deduction is 6% and for taxable years beginning after 2009 the amount of the deduction is 9%. For taxable years beginning on or after January 1,, 010, the amount of domestidc production activities deduction is 6% based on HB 2 Special Session 2010.
		$ 998,300,000	0.50%	9.29%	8.19%			

Property Tax Expenditures:
Real Property Expenditures as a Share of GSP and Share General and General and Road Funds

		FY 2016 Estimate						
	Real Property Expenditure	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Agricultural and Horticultural Land Assessment Protection	$ 100,000	0.00%	0.00%	0.00%	KRS 132.450	1999	This land will not lose its agricultural and horticultural assessment if it fails to meet the minimym acreage requirement due to the fact a portion of the land has been acquired for public purposes.
2	Agricultural Value of Real Property	$ 47,200,000	0.02%	0.44%	0.39%	KRS 132.450	1942	A special procedure is provided for assessing real property at its agricultural or horticultural value.
3	Alcohol Production Facilities	$ -	0.00%	0.00%	0.00%	KRS 132.020(1)(1)	1980	Alcohol production facilities are taxed at a reduced rate of 1/10th of a cent per $100 of value. Alcohol production facilities are defined in KRS 247.910 as facilities whose primary purpose is producing ethanol, not alcohol which will be consumed as a beverage. According to the Department of Revenue, this classification has never been utilitzed since its creation in 1980.
4	Environmental Remediation Property	$ 3,000	0.00%	0.00%	0.00%	KRS 132.020(1)c	2005	The owner of all qualifying voluntary environmental remediation property pays tax at the rate of one and one-half cents ($0.015) per $100 of value for this property.
5	Homestead Exemption	$ 15,300,000	0.01%	0.14%	0.13%	Kentucky Constitution Section 172 and KRS 132.810	Constitution effective 1891 and statute effective 2008	A taxpayer 65 years of age or older or totally disabled is allowed an exemption against the assessed value of a single-unit residence. This exemption is now $36,900 which reflects a $900 increase over the 2013-2014 exemption of $36,000.
6	Intrastate Railroad and Railway Companies	$ 22,000	0.00%	0.00%	0.00%	KRS 132.020(1)(0)	1990	Railroads or railway companies operating solely within the Commonwealth are taxed at a reducd rate of 10 cents ($0.10) per $100 on their operating real property.
7	Leasehold Interests in Building Financed with Industrial Revenue Bonds	$ 2,700,000	0.00%	0.03%	0.02%	KRS 132.020(2)c	1978	Leasehold interests privately held in industrial buildings owned and financed by tax-exempt governmental units are taxed at a reduced rate of $0.015 per $100 of value. Note: This is the real estate portion only.
8	Property of Local Governments in Neighboring States	$ 17,000	0.00%	0.00%	0.00%	KRS 132.192	2005	All real property owned by another state or a political subdivision of another state that is used exclusively for public purposes is exempt from taxation if a comparable exempton is provided in the state or political subdivision for property owned by the Commonwealth or its political subdivisions.
9	Real Property owned by Exempt Entities	$ 46,700,000	0.02%	0.43%	0.38%	Kentucky Constitution Section 170	1891	Real property owned and occupied by institutions of religion, institutions of purely public charity, and institutions of education are exempted from taation by the Kentucky Constitution.
10	State Real Property Tax Yearly Revenue Ceiling	$ 404,200,000	0.20%	3.76%	3.31%	KRS 132.020(2)c	1979	Prior to the passage of House Bill 44 in 1979, the real property tax rate was 31.5 cents per $100 of assessed value. The adjusted tax rate for 2014 is 12.2 cents per $100 of assessed value.
		$ 516,242,000	0.26%	4.81%	4.23%			

Property Tax Expenditures:
Tangible Property Tax Expenditures as a Share of GSP and Share General and General and Road Funds

		FY 2016 Estimate						
	Tangible Property Expenditure	Tax Expenditure	Share of GSP	Share of General Fund	Share of General and Road Funds	Statute / Internal Revenue Code	Effective Date	Description
1	Agricultural Products	$ 3,600,000	0.00%	0.03%	0.03%	KRS 132.020(1)e	1950	Agricultural products are taxed at a reduced rate of 1.5 cents per $100.
2	Aircraft	$ 1,700,000	0.00%	0.02%	0.01%	KRS 132.020(1)(p)	1999	Airplaces, not used in the business of transporting persons or property for compensation or hire, are taxed at the reduced state rate of 1.5 cents per $100.
3	Business Inventories	$ 72,000,000	0.04%	0.67%	0.59%	KRS 132.020(1)n	1990	Business inventories are taxed at a reduced rate of 5 cents per $100. This category includes machinery and equipment held in inventory in the regular course of business for sale or lease and originating under a floor plan financing agreement.
4	Carlines	$ 1,000,000	0.00%	0.01%	0.01%	KRS 136.120(1)	1990	Any company, other than a railroad company, which owns, uses, furnishes, leases, rents, or operates to, from, from through, in, or across this state or any part thereof, any kind of railroad car is taxed at a reduced rate. The rate is computed annually. The current rate in effect is 22.67 cents per $100.
5	Federally Documented Vessels	$ 600,000	0.00%	0.01%	0.00%	KRS 132.020(1)q	1999	Documented boats, not used in the business of transporting persons or property for compensation or hire, are taxed at a reduced rate of 1.5 cents per $100.
6	Foreign Trade Zone	$ 20,700,000	0.01%	0.19%	0.17%	KRS 132.020(1)(h)	1982	Property located in an activated foreign trade zone is taxed at a reduced rate of 1/10 of a cent per $100.
7	Historic Vehicles	$ 220,000	0.00%	0.00%	0.00%	KRS 132.020(1)(m)	1984	Historic vehicles are taxed at a reduced rate of 25 cents per $100.
8	In-Transit Goods	$ 19,700,000	0.01%	0.18%	0.16%	KRS 132.097	1999	Goods shipped into Kentucky and placed in a warehouse or distribution center with the purpose of continued shipment outside of Kentucky within six months are exempt from property tax at the state level.
9	Intrastate Railroads and Railway Companies	$ 190,000	0.00%	0.00%	0.00%	KRS 132.020(1)(o)	1990	Railroads or railway companies operating solely within the Commonwealth are taxed at a reduced rate of 10 cents per $100 on their operating tangible property.
10	Interstate Trucks, Tractors, and Buses	$ 4,300,000	0.00%	0.04%	0.04%	KRS 132.760 and KRS 136.188	1990 and 2007	Commercial vehicles that have routes or systems partly within this state and partly within another state or states are taxed at a reduced rate. This rate is computed annually. The rate in effect January 1, 2015 was 22.38 cents per $100.
11	Leasehold Interests	$ 3,900,000	0.00%	0.04%	0.03%	KRS 132.020(1)b	1990	Leasehold interests privately held in industrial buildings owned and financed by tax-exempt governmental units are taxed at a reduced rate of 1.5 cents per $100 of value. Note: This is the tangible personal property only.
12	Machinery Used in Farming and Livestock and Domestic Fowl	$ 5,100,000	0.00%	0.05%	0.04%	KRS 132.020(1)(f)	1917	Machinery used in farming and the value of all livestock and 25 domestic fowl is taxed at a reduced rate of 1/10 of a cent per $100.
13	Manufacturing Machinery; Pollution Control Equipment; and Radio, Television and Telephonic Equipment	$ 65,000,000	0.03%	0.61%	0.53%	KRS 132.020(1)(i)(1)(j)(1)(k)	1977 and 1998	Machinery, regardless of ownership, used in the manufacturing process is taxed at a reduced rate of 15 cents per $100. Pollution control equipment is taxed a reduced rate of 15 cents per $100. Radio, television, and telephonic equipment are taxed at a reduced rate of 15 cents per $100.
14	Motor Vehicles with a Salvage title	Minimal (< $1 million)	0.00%	0.00%	0.00%	KRS 134.810	1999	Motor vehicles with a salvage title and held by an insurance company on January 1 are taxed at a reduced rate of 5 cents per $100 of value. This provision allows salvage vehicles held by an insurance company to be taxed in the same manner as motor vehicle dealers' inventory.
15	Property of Local Governments in Neighboring States	$ -	0.00%	0.00%	0.00%	KRS 132.192	2005	All personal property owned by another state or a political subdivision of another state that is used exclusively for public purposes is exempt from taxation if a comparable exemption is provided in that state or political subdivision for property owned by the Commonwealth or its political subdivisions.
16	Personal Property used in Vending Stands Operated by the Blind	Minimal (< $1 million)	0.00%	0.00%	0.00%	KRS 132.193(1)	1998	Personal property used in vending stands leased and operated by blind persons under the auspices of the Office for the Blind is exempt from taxation.
		$ 198,010,000	0.10%	1.84%	1.62%			

3. KENTUCKY'S INVENTORY TAX: PRIME EXAMPLE OF A DYSFUNCTIONAL PROPERTY TAX[1]

States plus the District of Columbia With (in red) and Without (in white) Inventory Taxes[2,3]

	1966	1976	1996	2006	2016	
State	AK	AK	AL	AL	AL	
	AZ	AL	AZ	AZ	AZ	
	DE	AZ	CA	CA	CA	
	FL	DC	CO	CO	CO	
	MN	DE	CT	CT	CT	
	NJ	FL	DC	DC	DC	
	NY	HI	DE	DE	DE	
	PA	ID	FL	FL	FL	
	AL	MI	HI	HI	HI	
	AR	MN	IA	IA	IA	
	CA	ND	ID	ID	ID	
	CO	NE	IL	IL	IL	
	CT	NH	KS	KS	IN	
	DC	NJ	LA	LA	KS	
	GA	NM	MI	ME	ME	
	HI	NY	MN	MI	MI	
	ID	OR	MO	MN	MN	
	IL	PA	MT	MO	MO	
	IN	UT	NC	MT	MT	
	IA	WY	ND	NC	NC	
	KS	AR	NE	ND	ND	
	KY	CA	NH	NE	NE	
	LA	CO	NJ	NH	NH	
	ME	CT	NM	NJ	NJ	
	MD	GA	NV	NM	NM	
	MA	IA	NY	NV	NV	
	MI	IL	OR	NY	NY	
	MS	IN	PA	OR	OH	
	MO	KS	SD	PA	OR	
	MT	KY	TN	SD	PA	
	NE	LA	UT	TN	RI	
	NV	MA	WA	UT	SC	
	NH	MD	WI	WA	SD	
	NM	ME	WY	WI	TN	
	NC	MO	AK	WY	UT	
	ND	MS	AR	AK	WA	
	OH	MT	GA	AR	WI	
	OK	NC	IN	GA	WY	
	OR	NV	KY	IN	AK	
	RI	OH	MA	KY	AR	
	SC	OK	MD	MA	GA	
	SD	RI	ME	MD	LA	
	TN	SC	MS	MS	MA	
	TX	SD	OH	OH	MD	
	UT	TN	OK	OK	MS	
	VT	TX	RI	RI	OK	
	VA	VA	SC	SC	TX	
	WA	VT	TX	TX	VA	
	WV	WA	VA	VA	VT	
	WI	WI	VT	VT	KY	KY
	WY	WV	WV	WV	WV	WV
Total Red	**43**	**31**	**17**	**16**	**13**	**2**

Local Inventory Taxes

State Inventory Taxes

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[1] I wish to thank Mark F. Sommer of Frost Brown Todd, LLC for sharing his wealth of knowledge on property taxes with us while we conducted research for this chapter.

[2] Over 150 sources were used to prepare this table. Sources included state constitutions, legislative history, academic papers and various policy websites. Sources can be provided upon request.

[3] 'States with inventory taxes' refers to states in in which inventory taxes are collected at any jurisdictional level, whether state or local (county, city, and/or special district, such as school or fire district), or any combination of jurisdictions both state and local. For example, though Alaska has an inventory tax in 6 municipalities and does not collect an inventory tax at the state level, it is still considered to be an inventory tax state in 1996, 2006 and 2016. As another example, Kentucky collects inventory taxes at both state and local levels and is also included.

GLOSSARY

Below are generally accepted legal definitions of some concepts used in this chapter:

Property: "something that is owned by a person, business, etc."[4]

Real Property: "real property refers to land. Land, in its general usage, includes not only the face of the earth but everything of a permanent nature over or under it."[5]

Examples: a house, garage or an auxiliary building. Also, crops and forestry.

Improvements to Real Property: a "permanent addition to or betterment of real property that enhances its capital value and that involves the expenditure of labor or money and is designed to make the property more useful or valuable as distinguished from ordinary repairs."[6]

Examples for a house are: carpeting, awnings, cabinets and shelving (for domestic use only), walk-in coolers and freezers.

Tangible Personal Property: "property, other than real property, that has a physical existence and an intrinsic value."[7]

Examples: machinery used in a production process, household goods, office furniture, computers.

Intangible Personal Property: "personal property in which the existence and value of the property are generally represented by a descriptive document rather than the property itself."[8]

Examples: patents, cash-in-hand, bonds, stocks.

Inventory: "a stock or other property of a kind in hand of a taxpayer which would be included in the inventory at the close of the taxable year amounts to an inventory item. The property held by a taxpayer mainly for sale to customers in the ordinary course of his/her trade or business is included as an inventory item." Essentially, "[inventory] includes property not amounting to a capital asset."[9]

Examples: vehicles held for sale by an automotive dealer, finished goods held by manufacturers awaiting shipment to a distributor, raw materials that serve as inputs for a finished good held by a producer.

Market Value: "the most probable price (in terms of money) which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under normal market conditions.[10]

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[4] "Property," Definition. *Merriam-Webster Online*. http://www.merriam-webster.com/dictionary/property

[5] "Real Property," Definition, Legal Information Institute, Cornell University Law School. https://www.law.cornell.edu/wex/real_property

[6] "Improvement to Real Property," Definition, *U.S. Legal Online.* As defined in Integrity Floorcovering, Inc. v. Broan-Nutone, LLC, 521 F.3d 914, 917-918 (8th Cir. Minn. 2008). http://definitions.uslegal.com/i/improvement-to-real-property/

[7] "Tangible Personal Property," Definition, *U.S. Legal Online*. As defined in 49 CFR 262.3 [Title 49 – Transportation; Subtitle B Other Regulations Relating to Transportation; Chapter II Federal Railroad Administration, Department of Transportation; Part 262 Implementation of Program for Capital Grants for Rail Line Relocation and Improvement Projects]. http://definitions.uslegal.com/t/tangible-personal-property/

[8] "Intangible Personal Property," Definition, *U.S. Legal Online*. As defined in 41 CFR 102-36.40 [Title 41 Public Contracts and Property Management; Subtitle C Federal Property Management Regulations System; Chapter 102 Federal Management Regulation System; Subchapter B Personal Property; Part 102-36 Disposition of Excess Personal Property; Subpart A General Provisions]. http://definitions.uslegal.com/i/intangible-personal-property/

[9] "Inventories," Definition, *U.S. Legal Online*. As defined in 26 USCS § 751 and 26 USCS § 1221(a)(1). http://inventories.uslegal.com/

[10] "Market Value," Definition, International Association of Assessing Officers (IAAO). http://www.iaao.org/

Levy (verb): "the act of assessing a tax on property, sales, or other transactions by a governmental legislative body, such as a board of supervisors or commissioner."[11]

(noun): "An act of levying a tax, fee, or fine: A tax so raised."[12]

Tax Base: "the assessed value of a set of assets which is subject to tax."[13]

Example: the tax base is all taxable income subject to the income tax.

Tax Rate: "Tax rate is the rate at which a business or person is taxed on income or the rate of tax on the value of a good, service or asset paid as tax."[14] (Usually measured in percentage terms).

Example: a 6% sales tax has a tax rate of 6%.

Fiscal Year: "the accounting period for which annual financial statements are regularly prepared, generally a period of 12 months."[15] In the case of the government of most states, the fiscal year is usually from July 1st through June 30th.

The concept of Uniformity: "Uniformity in taxation implies equality in the burden of taxation, which cannot exist without uniformity in the mode of assessment, as well as in the rate of taxation. Further, the uniformity must be coextensive with the territory [i.e. being identical across the entire region] to which it applies. And it must be extended to all property subject to taxation, so that that property may be taxed alike and equally."[16]

The concept of Universality: the principle of taxation that with few exemptions such as property belonging to the government (i.e. public property), places of religious worship and burial, institutions of public charity, learning institutions, shall be subject to property taxation.[17]

11 "Levy," Definition, *U.S. Legal Online*. http://definitions.uslegal.com/l/levy/
12 "Levy," Definition, Oxford Dictionaries Online. http://www.oxforddictionaries.com/us/definition/american_english/levy
13 "Tax Base," Definition, *U.S. Legal Online*. http://definitions.uslegal.com/t/tax-base/
14 "Tax Rate," Definition, *U.S. Legal Online*. http://definitions.uslegal.com/t/tax-rate/
15 "Fiscal Year," Definition, *U.S. Legal Online*. http://definitions.uslegal.com/f/fiscal-year/
16 "Uniformity," *Black's Law Dictionary Online*. http://thelawdictionary.org/uniformity/
17 David L. Sjoquist, "A Brief History of the Property Tax in Georgia," Georgia State University, Andrew Young School of Policy Studies, Fiscal Research Center, No. 182, August 2008. http://cslf.gsu.edu/files/2014/06/brief_history_of_the_property_tax_in_georgia.pdf

THE INVENTORY TAX

SUMMARY AND CONCLUSION

Kentucky's inventory tax is a relic of the past. In the last 50 years, the number of states levying an inventory tax has fallen from 42 to 13. Kentucky, along with West Virginia, are the only two states that have both state and local inventory taxes. And five of the seven states that Kentucky shares a border with, Illinois, Indiana, Missouri, Ohio and Tennessee, no longer have inventory taxes. Virginia taxes inventory at the local level. The bottom line is that businesses weary of the inventory tax have plenty of options for more hospitable tax climates and they do not need to move to China—they can just move to a neighboring state.

- Kentucky's inventory tax violates several principles of sound tax policy:

  - **Principle of Taxation #1**: The inventory tax ensures for double taxation by taxing assets (inventories) and then taxing the income from those assets. This is the classic conflict between taxing stocks or flows but <u>not</u> both. Taxing both stocks and flows reduces the incentive to invest in capital.

  - **Principle of Taxation #2**: The inventory tax taxes mobile assets, which is a "no-no" for all taxes because mobile assets can move out of the tax jurisdiction. The inventory tax is easy to avoid or evade (relative to taxes on real property, which is immobile by nature).

  - **Principle of Taxation #3**: The inventory tax levies a high tax rate on a narrow base. A high tax rate on a narrow base enhances the incentive to businesses to evade or avoid paying their tax obligations, or shift from taxable to non-taxable business activities, resulting in a further decline in the tax base.

  - **The Solution**: Kentucky would be well served to pursue tax reform based on pro-growth tax policies that would include removal of the inventory tax and instead focus on a low-rate, uniform, broad-based system of taxation of real property. These reforms would remove temptation by eliminating a corruption primed tax from available avenues of corrupt practices. The key principal for Kentucky is to collect taxes in the least damaging fashion, which means using taxes where the per dollar revenue is associated with the least reduction in output.

- As shown from the front page table, Kentucky is way behind the inventory tax power curve. During the tax cutting boom of the late 1970s and '80s, many states removed inventory from the property tax base to enhance their state's business climate and increase employment, output and production. Kentucky today is one of 13 states that currently allows taxation of inventory and only one of 2 states that tax inventory at both the state and local levels.

- Kentucky received a miniscule 0.10% and 0.11% of total tax revenue from inventory taxes at the state level in fiscal years 2014 and 2015, respectively. By all accounts the damage done is disproportionately large. At the local level, Kentucky received approximately 3.0% of estimated tax revenues from inventory taxes in 2014 and 2015. For such small revenue contributions, the state's inventory tax makes Kentucky's business environment a relatively unwelcome investment destination.

- In addition:

  - Many studies show Kentucky to be one of the most corrupt states—all the more reason for the state to remove a potential source for corruption and pursue tax reform based on pro-growth economic principles that can fund public services while posing the least possible harm to employment, output and production.

    - The costs of assessment and collections for Kentucky's state and local inventory tax are high. The prevalence of court cases involving the inventory tax—most of which resulted in decisions favoring the business—indicates high costs of litigation for taxpayers and some Kentucky businesses.

- California provides an example of the economic benefits of exempting inventory from taxation.

Primer: Taxation in Theory and Practice

1. Stocks vs. Flows

In general, asset value (or what is called stock) taxes should never be mixed with income (or revenue, sometimes called flow) taxes. Income is an amount of money received over a period of time usually one year and is, for example, derived by using assets along with other factors of production such as labor during the same period of time. The use of both asset value taxes and income taxes results in many unintended consequences of double, triple or even higher multiple taxes on the same items.

The value of an asset is that asset's productivity in the production process over its lifetime discounted back to the present. Therefore, if you tax both the value of the asset and the income it derives in the production process you've created a double tax system on that asset. This results in an economy biased against capital formation and will in due course inure to the detriment of one and all in a given tax jurisdiction.

Sales taxes and income taxes are income or flow taxes while capital gains taxes, property taxes, death taxes and inventory taxes are all asset or stock taxes.

2. Optimal Tax Rates

Tax rates should be as low as possible and levied on the broadest possible base, in order to provide the necessary funds for public services while posing the least amount of harm to economic growth.

High tax rates on a narrow tax base produce just the opposite outcome by hindering growth and encouraging businesses to avoid or evade paying taxes or engaging in productive taxable activities—the inventory tax is especially burdensome to businesses in the retail and wholesale sectors. And it leaks like a sieve giving advantage to those who play the tax game. The higher the tax rate and the smaller the tax base the greater the damage per dollar of tax revenue.

Taxing mobile assets such as inventory likewise encourages businesses to move assets outside a tax jurisdiction. By taxing mobile assets, Kentucky's inventory tax also encourages businesses to evade or avoid the inventory tax. As a general rule, the more mobile the assets the more damage the tax will cause per dollar of tax revenue.

The complex manner in which the tax is administered contributes to uncertainty for businesses subject to the inventory tax and further discourages investment in Kentucky. It also encourages corruption, favoritism and deceit.

Kentucky's tax system is replete with internal contradictions, inefficiencies and arbitrary and unnecessary complications as you will soon see.

3. Structure of Excise Taxation

Excise taxes are taxes levied when a purchase is made of a specific good, such as gasoline or real property, and come in two main forms—specific and "ad valorem." A specific excise tax is a tax with a fixed monetary amount per unit (e.g., pack of cigarettes or bottle of wine). "Ad valorem" taxes (Latin for "according to value") are excise taxes levied as a percentage of the market value of property. Historically, property taxes have been ad valorem taxes.

Ad valorem taxes have many advantages over specific excise taxes and some significant disadvantages as well. The fixed percentage of an ad valorem tax as a share of the total market value of property value when prices rise evenly over time maintains government revenue growth, without a need to adjust for the consumer price index (CPI) or income growth in general as with specific excise taxes. However, the administration costs associated with ad valorem taxes are relatively high because the government must regularly assess property values and resolve any assessment disputes with the public, whereas with specific taxes, only the volume of items subject to the tax must be determined. Additionally, property tax revenues are subject to greater fluctuation than excise tax collections, given variance in assessment values and changing market prices of real and personal property based on the performance of the economy. One other advantage of specific excise taxes is that the consequences of business pricing decisions are born 100% by the seller and therefore are not magnified by the tax structure as would be the case with an ad valorem tax.

The Inventory Tax in Kentucky

Kentucky's inventory tax is a holdover from the 19th century, when, like all states, Kentucky taxed real, tangible, and intangible property with a single uniform ad valorem tax rate. Starting in the mid-20th century, states began to exempt some or all forms of inventory from taxation in an effort to increase employment, output and production. In 1966, 43 states and the District of Columbia taxed inventory though many states began to eliminate some forms of inventory from their property tax bases, such as finished goods intended for export to other states, (refer to table on page 1).[1] Over the next decade, 12 states and the District of Columbia eliminated their inventory taxes, leaving inventory subject to taxation in only 31 states.[2] And by the time the tax cutting boom of the late 1970s and '80s had come and gone, the majority of states had ceased taxing most, if not all, forms of inventory. As of January 1st 2016, only 13 states, including Kentucky, levied a tax on inventory.[3] Kentucky is one of two states (the other is West Virginia) in which inventory may be subject to taxation at both state and local (city, county, school districts, and special districts). The remaining 11 states merely authorize inventory taxation at the local level, and some states, such as Vermont, only tax inventory in a handful of cities.

In Kentucky, business inventories, whether they are raw materials, finished goods awaiting shipment held by a manufacturer, or inventories held by retailers, are classified as tangible personal property and subject to ad valorem taxation. Inventory tax rates vary vertically (state versus county) and horizontally (city versus city). To complicate tax compliance for businesses, some types of inventory may be subject to taxes in one tax jurisdiction (for example, at the state level) but exempt from one or a combination of tax jurisdictions (city, county and school districts).[4] The wide array of rates and exemptions at state and local levels make tax compliance for existing businesses troublesome and expensive, and make estimating a potential inventory tax liability for any new businesses considering Kentucky as a home for operations a major endeavor.

At the state level, Kentucky taxes business inventories, including manufacturers raw materials and finished goods, merchants inventory, motor vehicles held for sale and goods held in storage at a rate of 5 cents per $100 of assessed fair market value (localities are allowed to set their own inventory tax rates—assuming the type of inventory is not exempt from their jurisdictions).[5] Inventory also includes "machinery and equipment held in inventory in the regular

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[1] The states that did not have an inventory tax were: Alaska, Arizona, Delaware, Florida, Minnesota, New Jersey, New York, and Rhode Island.
[2] The District of Columbia began to phase out its inventory tax in 1973 and the phase-out was complete in 1975.
Source: "D.C. Tax Facts," Government of the District of Columbia, Office of the Chief Financial Officer, Office of Revenue Analysis, 2014. http://cfo.dc.gov/sites/default/files/dc/sites/ocfo/publication/attachments/14%20TAXFACTS.pdf
[3] Some states, by statute, claim not to tax inventory, yet still levy a tax on inventory in some form. For example: Tennessee, by statute, effectively levies no direct tax on inventory. However, under the state's Franchise Tax, which levies a tax on the net worth of a business, inventory may be indirectly taxed—though there are many instances where inventory can be deducted from the net worth. For more information, see:
Dwayne W. Barrett, Richard A. Johnson and Brett R Carter. "Tennessee Property Tax," Bradley Arant Bolt Cummings, LLP, 2011. http://www.babc.com/files/Uploads/Documents/TN_Property%20Tax_2011_p1.pdf and,
"Tennessee Franchise and Excise Tax Guide," Tennessee Department of Revenue, November 2015. http://tn.gov/assets/entities/revenue/attachments/feguide.pdf
[4] Only 2 states, Kentucky and West Virginia, publish documents that provide cumulative property tax rates for each tax jurisdiction, state, county, city and special district. To determine cumulative property tax rates in the 11 other states with inventory taxes would require looking up the rates individually for each county, city, and special district that levy the tax in each state. There are hundreds of tax jurisdictions that tax inventory in these states.
[5] To see how complicated the inventory tax policy is refer to:
"2015 Property Tax Rates," Commonwealth of Kentucky, Department of Revenue.
http://revenue.ky.gov/NR/rdonlyres/9FBE2D86-8D63-4542-8A09-761C48B60901/0/2015TaxRateBook.pdf, and,
"2015 Property Tax Forms and Instructions," Commonwealth of Kentucky, Department of Revenue.
http://revenue.ky.gov/NR/rdonlyres/02941EE2-ECCD-4E6F-8432-0FB39F11CAB1/0/62A500P2015.pdf

course of business for sale or lease and originating under a floor plan financing arrangement."[6,7] However, not all inventory that falls under these classifications is subject to taxation at the state level. Since January 1, 2002, inventory placed in a warehouse or distribution center that is intended to be shipped out-of-state is exempt from the state inventory tax under the Goods-in-Transit (GIT) exemption.[8] To qualify for the Goods-in-Transit (GIT) exemption, the owner must demonstrate that the personal property will be shipped out of state within the next six (6) months.[9]

The complexity increases considerably at the local level.

Consider Louisville-Jefferson County, with its 105 tax jurisdictions (refer to appendix for full listings of tax rates and jurisdictions). First, all qualifying inventory in Louisville-Jefferson County is subject to state inventory taxation (refer to the previous paragraph). At the county level, motor vehicles held for sale, manufacturers' raw materials are exempt from taxation by statute as they are in all local jurisdictions, but manufacturers finished goods and merchants inventory, are subject to taxation at a rate of 98.2 cents per $100 market value. Two school districts operate in Louisville-Jefferson County and both levy taxes on merchant's inventories (at rates of 98.2 cents and 71 cents per $100 of market value)—so long as the inventories are not considered Goods-In-Transit (GIT), which are exempt from city, county and school district taxation. Of the 21 special districts in Louisville-Jefferson County, 19 tax merchant's inventory and 18 tax inventory Goods-In-Transit (GIT) at varying rates (Note that Goods-In-Transit are exempt from all tax jurisdictions *except* special districts—at least 776 special districts exist with the authority to tax were active in Kentucky in 2012, making Goods-In-Transit (GIT) subject to taxation across much of Kentucky).[10] Considering that revenues from taxes in these special districts are devoted to provision of ambulance services, fire department services, garbage collection and parks services, and assuming businesses operating in Louisville-Jefferson County have access to most or all of these services, those businesses would be subject to inventory taxes in several special tax jurisdictions. Of the 81 city-level districts that tax inventory in Louisville-Jefferson County, four tax merchant's inventory.

At the state level, Kentucky's inventory tax collections contribute very little to total state tax collections (see Table 1).[11] In fiscal year 2014, inventory taxes contributed $11,644,000, or 0.11% of total taxes to the state of Kentucky. In fiscal year 2015, inventory taxes declined in absolute terms and as a share of total tax revenues despite growth in Kentucky's economy. Inventory tax revenues were $11,602,400, or 0.10% of total taxes paid to the state of Kentucky.

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[6] State of Kentucky, "Commonwealth of Kentucky, Tax Expenditure Analysis: Fiscal Years 2016 – 2018," Governor's Office for Economic Analysis and Office of State Budget Director. http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf

[7] According to the National Independent Automobile Dealers Association, "Floor plan financing is a revolving line of credit that allows the borrower to obtain financing for retail goods. These loans are made against a specific piece of collateral (i.e. an auto, RV, manufactured home, etc.). When each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid."
Source: "Dealer Floor Plan Financing: Frequently Asked Questions for Borrowers and Lenders," National Independent Automobile Dealers Association, July 2009. http://www.niada.com/PDFs/Information/SBAFloorPlan/FrequentlyAskedQuestions7-1-09.pdf

[8] Kentucky Revised Statute (KRS) 132.099. "Local taxation of personal property held for shipment out of state – Definitions." http://www.lrc.ky.gov/statutes/statute.aspx?id=40056

[9] Kentucky Revised Statute (KRS) 132.099. "Local taxation of personal property held for shipment out of state – Definitions." http://www.lrc.ky.gov/statutes/statute.aspx?id=40056

[10] Adam H. Edelen, "Ghost Government: A Report on Special Districts in Kentucky," Commonwealth of Kentucky, Auditor of Public Accounts, 2012. http://apps.auditor.ky.gov/public/theregistry/2012GhostGovernmentSpecialDistrictsReport.pdf

[11] Inventory tax data are not included in U.S Census reports or publicly available in reports from the Kentucky Department of Revenue. However, the Governor's Office did provide us with inventory tax data for state and local governments for fiscal years 2014 and 2015.

Table 1

Kentucky: State Inventory Taxes as a Share of State General Revenue Taxes[12,13]

($ in thousands)

	FY 2014		FY 2015	
	Taxes Paid	Share of Total Taxes	Taxes Paid	Share of Total Taxes
Income Taxes	4,209,469	38.81%	4,604,837	40.46%
Sales and Gross Receipts Taxes	5,575,312	51.40%	5,714,300	50.20%
Property Taxes	553,339	5.10%	570,998	5.02%
Inventory Taxes	11,644	0.11%	11,602	0.10%
Other Taxes	508,519	4.69%	492,126	4.32%
Inheritance and Estate Taxes	51,513	0.47%	52,616	0.46%
Total Taxes	**10,846,639**	**100.00%**	**11,382,261**	**100.00%**

The story is similar at the local government level, with inventory tax revenues providing a small share of estimated[14] local government tax revenue (see Table 2 below). In fiscal year 2014, inventory taxes contributed $148,128,960, or an estimated 3.14% of total taxes to local governments in Kentucky. In fiscal year 2015, inventory taxes declined as a share of estimated tax revenues despite growth in Kentucky's economy, totaling $148,503,307 or 3.0% of estimated taxes paid to local governments in Kentucky.

Table 2

Kentucky: Local Inventory Taxes as a Share of Estimated Local General Revenue Taxes[15,16,17,18,19]

($ in thousands)

	FY 2014		FY 2015	
	Taxes Paid	Share of Estimated Total Taxes	Taxes Paid	Share of Estimated Total Taxes
Income Taxes	1,292,270	27.35%	1,356,084	27.35%
Sales and Gross Receipts Taxes[22]	597,845	12.65%	627,367	12.65%
Property Taxes	2,721,303	57.60%	2,855,685	57.60%
Inventory Taxes	148,129	3.14%	148,503	3.00%
Other Taxes	112,768	2.39%	118,336	2.39%
Total Taxes	**4,724,185**	**100.00%**	**4,957,472**	**100.00%**

For such little benefit in terms of state and local tax revenue, Kentucky's inventory tax is making the state an unattractive destination for business. In recent years, there have been several well publicized incidences of the inventory tax impacting a businesses' decision to locate in Kentucky:

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[12] Source: Page 208, State of Kentucky, "Comprehensive annual Financial Report for the fiscal Year Ended June 30, 2014," Finance and Administration Cabinet.. http://finance.ky.gov/Office%20of%20the%20Controller/2015CAFR.pdf

[13] Source: Page 242, State of Kentucky, "Comprehensive annual Financial Report for the fiscal Year Ended June 30, 2015," Finance and Administration Cabinet. http://finance.ky.gov/Office%20of%20the%20Controller/2015CAFR.pdf

[14] State and local tax data are not yet available from the U.S. Census for 2014 and 2015, and Kentucky does not publish total local tax collections on an annual basis. Therefore, estimation of total local tax revenues and the distribution of tax revenue by tax source e.g., income or sales taxes, was required for 2014 and 2015. To estimate total local tax revenue for 2014 and 2015, first we determined the average local-to-state ratio observed in the U.S. Census data over the past four years. In Kentucky, local government tax revenue was consistently around 43% of state general tax revenue. The 43% local-to-state total tax revenue data ratio was then applied to the 2014 and 2015 state general tax revenue totals to determine the local general tax revenue estimate for those two years. The inventory tax data was divided by the total tax revenue estimates to determine the shares for 2014 and 2015, respectively. The distribution of taxes by tax source for 2014 and 2015 was taken from the average distribution for 2010-2013 from U.S. Census data.

[15] Source: U.S. State and Local Finances. http://www.census.gov/govs/local/

[16] Source: Kentucky Governor's Office.

[17] Source: Page 208, State of Kentucky, "Comprehensive annual Financial Report for the fiscal Year Ended June 30, 2014," Finance and Administration Cabinet.. http://finance.ky.gov/Office%20of%20the%20Controller/2015CAFR.pdf

[18] Source: Page 242, State of Kentucky, "Comprehensive annual Financial Report for the fiscal Year Ended June 30, 2015," Finance and Administration Cabinet. http://finance.ky.gov/Office%20of%20the%20Controller/2015CAFR.pdf

[19] Kentucky does not have a general sales tax that contributes to local tax revenue. The "Sales and Gross Receipts Taxes" reported by the U.S. Census that was used to calculate the estimate in Table 2 reflects Kentucky's local gross receipts tax on utilities (telephone, water, gas and electric and cable). Over 100 counties in Kentucky levy this 3% tax to fund schools.

Source: "Just the Facts: Kentucky Business Taxes," Kentucky Cabinet for Economic Development. http://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf

- **Gap, Inc.**: In 2000, Gap, Inc. ("Gap") was in a dispute with the Kentucky Department of Revenue over how the retailer's inventory held at a distribution center in Northern Kentucky should be taxed.[20] Gap claimed the inventory qualified as goods-in-transit and was therefore exempt from all state and local inventory property taxation under Kentucky's Goods-in-Transit (GIT) exemption. The Department of Revenue disagreed, claiming the goods were "Merchants Inventory" subject to a tax rate of 45 cents per $100 of value. The Department of Revenue claimed that The Gap was delinquent on taxes in the total amount of $1.5 million dating back to 1992. The Kentucky Board of Tax Appeals ruled in favor of the Department of Revenue on the basis that the goods did not qualify as goods-in-transit, since they were being stored by Gap and merely waiting to be delivered to its own retail locations as opposed to awaiting shipment from one business to a third party business.

  However, the Kentucky Board of Tax Appeals suggested the delinquent tax penalties should be "abated due to reasonable cause" on the basis the language of the goods-in-transit statute was unclear.[21] In 2013, Gap announced it would be closing two distribution centers in Northern Kentucky, impacting about 350 workers.[22] Gap had no plans to close any other distribution centers at the time.[23] The company's National Recovery Center, which manages store returns, its Dolwick Logistics Business Center, which manages logistics and IT for North America, remain open in Hebron, Kentucky.

- **Chegg, Inc.**: California-based textbook company Chegg, Inc. ("Chegg") has been embroiled in a lawsuit for several years in first the Bullitt Circuit Court and then the Franklin Circuit Court over whether the company's inventory stored at its Shepherdsville Kentucky warehouse was exempt from state and most local property taxation. Chegg believes it is exempt from the inventory tax since its inventory is shipped to customers within six months, and therefore qualified for exemption. The Department of Revenue, however, did not agree on the basis that Chegg rents rather than sells most of its semester-driven college textbooks, which are ultimately returned to its Sheperdsville, Kentucky facility and claimed Chegg owed the state $956,228.84 inventory taxes.[24,25] The Franklin Circuit Court agreed with Chegg, though the State appealed the Court's decision.[26] On March 4th, 2016, the Court of Appeals affirmed the ruling of the Franklin Circuit Court that Chegg was not in violation of Kentucky property tax law and that no tax was due.[27] The Department of Revenue appealed to the Supreme Court, but the Court declined to hear the case.[28]

  Prior to the final ruling, in 2015, Chegg announced it would be closing its Shepherdsville facility and leaving Kentucky, citing the State's position on the inventory tax was "contrary to business" and that the legal fees incurred fighting for exemption have largely been "a waste."[29] Closure of the Shepherdsville facility impacts 35 full-time, year- round employees, and up to 1,000 seasonal full-

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[20] "The Gap, Inc. and Banana Republic, Inc. Appellants v. Revenue Cabinet, Commonwealth of Kentucky, Appellee." Thomson-Reuters, Tax and Accounting, 2015.
[21] *Ibid.*
[22] Lisa Benson, "Gap to close distribution centers in Hebron, cut jobs," *Cincinnati Business Courier*, January 16, 2013. http://www.bizjournals.com/cincinnati/news/2013/01/16/gap-to-close-distribution-centers-in.html
[23] *Ibid.*
[24] "Kentucky Board of Appeals Holds that Leased Goods Do Not Qualify for Warehouse Property Tax Exemption," *SALT Law Letter*, Bingham Greenebaum Doll, LLP, February 10, 2014. https://www.bgdlegal.com/news/2014/02/10/salt-law-letter/kentucky-board-of-tax-appeals-holds-that-leased-goods-do-not-qualify-for-warehouse-property-tax-exemption/
[25] "Tax Update for Companies Doing Business in Kentucky & Indiana," 24th Annual Ohio Tax Conference, January 27, 2015. https://www.mecseminars.com/sites/default/files/presentation-files/Workshop%20N%20-%20Tax%20Update%20for%20Companies%20Doing%20Business%20in%20Kentucky%20and%20Indiana.pdf
[26] *Ibid.*
[27] *Department of Revenue, Finance and Administration, Commonwealth of Kentucky v. Chegg, Inc*. Appeal from Franklin Circuit Court Honorable Thomas D. Wingate, Judge, Action No. 14-CI-00170. March 4, 2016.
[28] Chegg, Inc. v. Finance and Administration Cabinet, Dep't of Revenue et. al., 2014-CA-001922-MR (Ky. App. Mar 4, 2016), Motion for Discretionary Review Denied, No. 2016-SC-000164-D (Ky.), ff'd No. 14-CI-170 (Frank. Cir. Ct., Div. II, Oct. 29, 2014), rev'g File No. K12-R-28 (KBTA), Order No. K-24470 (Jan. 13, 2014).
[29] *Ibid.*

and part-time employees.[30] Chegg announced that it will be outsourcing its logistics and warehousing to Ingram Content Group, Inc. based in Tennessee, which has no inventory tax.[31]

Here are several more recent cases involving inventory taxes:

- **Pinkerton Tobacco Company, LP.**: Pinkerton Tobacco Company, LP ("Pinkerton") manufactures tobacco products in Kentucky and then stores the products on-site until they are sold.[32] At issue was whether Pinkerton was entitled to the Goods-in-Transit (GIT) exemption from state inventory taxes, since Pinkerton, the company that owned the inventory at the time of assessment, transferred it to another subsidiary of its parent company, Swedish Match North America (SMNA). Swedish Match North America (SMNA) was responsible for the final sale to customers, but never took possession of the goods in question.

  The Kentucky Department of Revenue submitted inventory tax assessments to Pinkerton for 2003 and 2004. Pinkerton claimed that 93% of its products were ultimately shipped out-of-state, a claim that was not disputed by the Kentucky Department of Revenue. However, the Kentucky Department of Revenue argued that as a result of making "intercompany sales" to Swedish Match North America (SMNA), and due to Pinkerton not being responsible for shipping to consumers, Pinkerton could not prove that the inventory would be shipped out-of-state within the required six month period of the Goods-in-Transit (GIT) exemption and was responsible for paying state inventory taxes.[33]

  In 2014, the Franklin Circuit Court affirmed the Kentucky Board of Tax Appeal's 2013 ruling that the Pinkerton qualified for Kentucky's Good-in-Transit (GIT) exemption.[34] The Court reached the decision on the basis that intercompany sales did not prevent Pinkerton from demonstrating that its products were shipped out-of-state within a six month period.[35] Furthermore, the Franklin Circuit Court determined there was nothing in the language of the Goods-in-Transit (GIT) exemption that required the owner of the goods to also be the shipper of the goods; ownership of inventory at the time of assessment and out-of-state shipment within a six month period were all that were required to qualify for the exemption.[36] In addition, the Court ordered the original tax assessments be voided and instructed the Kentucky Department of Revenue to issue Pinkerton a refund for inventory taxes paid.[37]

- **Wilson Equipment Company, LLC.:** For tax years 2004-2011, the Wilson Equipment Company ("Wilson") listed its inventory, new and used farm machinery and equipment, that was held under a floor plan financing agreement[38] was exempt from local inventory taxes and only subject to state inventory taxes in accordance with Kentucky Revised Statute (KRS) 132.200(16).[39,40] Kentucky Revised Statute (KRS) states "new farm machinery and other equipment held in the retailer's

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[30] Marty Finley, "Textbook rental company to close Shepherdsville facility," *Louisville Business First*, February 24, 2015. http://www.bizjournals.com/louisville/news/2015/02/24/textbook-rental-company-to-close-shepherdsville.html
[31] *Ibid.*
[32] "Tax in the Bluegrass – 2013-2014 Federal and Kentucky Tax Update and Developments," Kentucky Bar Association, Annual Convention, 2014. https://c.ymcdn.com/sites/www.kybar.org/resource/resmgr/2014_Convention_Images/36_ac2014.pdf
[33] *Ibid.*
[34] Jennifer S. Smart, "Tobacco company entitled to exemption for inventory-in-transit," Stoll Keenon Ogden, PLLC, April 29, 2013. http://www.lexology.com/library/detail.aspx?g=5611acb9-5188-4d67-bc42-933c260be6c8
[35] Jennifer S. Smart, "Tobacco company's exemption for inventory-in-transit upheld," Stoll Keenon Ogden, PLLC, March 3, 2014. http://www.lexology.com/library/detail.aspx?g=0811f73b-2bab-4cb5-a67a-337d2abac573
[36] *Ibid.*
[37] *Ibid.*
[38] According to the National Independent Automobile Dealers Association, "Floor plan financing is a revolving line of credit that allows the borrower to obtain financing for retail goods. These loans are made against a specific piece of collateral (i.e. an auto, RV, manufactured home, etc.). When each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid."
Source: "Dealer Floor Plan Financing: Frequently Asked Questions for Borrowers and Lenders," National Independent Automobile Dealers Association, July 2009. http://www.niada.com/PDFs/Information/SBAFloorPlan/FrequentlyAskedQuestions7-1-09.pdf
[39] Kentucky Revised Statute (KRS) 132.200(16). "Property subject to state tax only." http://www.lrc.ky.gov/Statutes/statute.aspx?id=43463
[40] Jennifer Smart, "Is machinery held in inventory under a floor-plan financing arrangement exempt from local tangible property tax?" Stoll Keenon Ogden, PLLC, Newsroom Publication.
http://www.skofirm.com/newsroom/publications/machinery-held-inventory-under-a-floor-plan-financing-arrangement-exempt-local-tangible-personal-property-tax

inventory for sale under a floor plan financing agreement by a retailer" is exempt from local taxation. When Wilson was audited for tax years 2004 through 2011, the Kentucky Department of Revenue claimed Wilson was responsible for property taxes on some of its inventory that, in the Department's view, was not covered by Kentucky Revised State (KRS) 132.200(16). The Department's interpretation was that only "new machinery" was exempt from local taxation, and that the "other equipment" listed in Kentucky Revised State (KRS) 132.200(16) must also be "new equipment" instead of "used equipment" which Wilson sold and listed on exempt on its taxes forms during the tax years of the audit. The Kentucky Board of Tax Appeals sided with Wilson's interpretation, though the Kentucky Department of Revenue appealed.[41] A decision was pending as of March 2016.

And the beat goes on:

- **Dayton Power & Light Co.**: Dayton Power & Light Co. ("Dayton") owned a 31% interest in a public service company that provided electricity in Boone Kentucky.[42] The case was concerned with whether the franchise value of a public service company i.e. the earning value ascribed to its capital, should be taxed as a separate and distinct class of property subject to full state and local rates, or allocated across all the classifications of the utility's property (including inventory) and subject to applicable state and local rates for each category. The allocation method was utilized by Dayton for tax years 1999-2003, which, significantly lowered the tax rate on Dayton's franchise and exempted Dayton from local property taxes. Dayton's use of the allocation method and its exemption from local property taxes were approved by the Kentucky Department of Revenue. However, in 2006, the Department determined that franchise should be taxed separately. The Kentucky Court of Appeals agreed, deciding the franchise value was subject to a "catch all" tax at full state and local rates.[43] The decision marked a reversal of opinion by the Kentucky Court of Appeals as prior to 2006, the court had approved the allocation method for use by public service companies and assessment by the Kentucky Department of Revenue. The Kentucky Court of Appeals stated the interpretation prior to 2006 was incorrect and that the new valuation method was statutorily correct.[44] In accordance with the ruling by Court of Appeals, Dayton was responsible for submitting tax payments totaling the amount that would have been due under the "catch all" method for tax years 1999-2003.[45]

How's this for quixotic, uncertain and deleterious treatment of an upstanding service provider and job creator?

Unfortunately, the businesses involved in these long inventory tax disputes were, under normal legal circumstances in Kentucky, responsible for their own attorney fees. While Kentucky law does allow the prevailing party to recover costs incurred in the course of litigation with the state, the decision reached in *Bault's Langley Auto Center v. Revenue Cabinet* was the following:

> there was no statute authorizing an award of attorney fees to a prevailing party in an administrative hearing [e.g., a hearing with the Kentucky Department of Revenue] governed by KRS Chapter 13B and that the rules allowing for attorney fees in Kentucky civil actions did not apply to administrative hearings.[46]

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[41] Timothy Eifler, Erica Horn, Stephen Sherman and Jennifer Smart, "COST SPRING 2015: Kentucky State and Local Tax Developments," Stoll Keenon Ogden, PLLC.
http://www.skofirm.com/newsroom/publications/spring-2015-kentucky-state-and-local-tax-developments

[42] Erica L. Horn and Stephen S. Sherman, "Kentucky Court Holds Utility Franchise Subject to Highest State & Local Property Tax Rates," Stoll Keenon Ogden, PLLC.
http://www.skofirm.com/sites/default/files/publications/kentucky-court-holds-utility-franchise-subject-highest-state-local-property-tax-rates-4511.pdf

[43] Jennifer S. Smart, Esq., "Kentucky Court Upholds Separate Taxation of Public Utility's Franchise at Full State and Local Property Tax Rates," *Counsels Corner*, Stoll Keenon Ogden, PLLC, March 2013.
http://www.skofirm.com/sites/default/files/publications/kentucky-court-upholds-separate-taxation-public-utilitys-franchise-full-state-and-local-property-tax-rates-4654.pdf

[44] "Dayton Power and Light Company v Department of Revenue, Finance and Administration Cabinet," Commonwealth of Kentucky Case No. 2011-CA-001438-MR (KY Ct. App., Nov. 2, 2012).
http://judicialview.com/State-Cases/kentucky/Taxation/Dayton-Power-and-Light-Company-v-Department-of-Revenue-Finance-and-Administration-Cabinet-Commonwealth-of-Kentucky/42/566652

[45] *Ibid.*

[46] "Stephen P. Kranz, Diann L. Smith, and Eric Carstens, "Who Pays Your Lawyer? A Scorecard of SALT Attorney Fee Provisions," *Tax Analysts*, August 5, 2015. Reprinted from *State Tax Today*, July 23, 2014.

Economic Considerations When Removing the Inventory Tax

There are theoretical reasons for removing inventory from the tax base, aside from the complicated manner in which Kentucky levies its inventory tax i.e. at different rates and across several jurisdictions of government. To be sure, elimination of the inventory tax will have revenue implications for state and local governments, though the long run effects are positive for economic growth.

As stated in the *Handbook on Taxation*, "in spite of the sizable revenue loss, it is in the economic interest of a state to consider dropping commercial and industrial inventory from the tax base…Commercial and industrial inventories are by their nature very mobile.[47] The economic literature, though not unanimous, leans strongly towards the idea that tax rates influence migration of both individuals and businesses, what economists refer to as the Tiebout Hypothesis.[48] The Tiebout Hypothesis rings especially true with regards to inventory. The mobile nature of inventory makes the inventory tax easy to avoid by temporarily moving goods subject to the tax out of a taxable jurisdiction or avoiding inventory taxes altogether by relocating to tax jurisdictions with no inventory taxes. These are not the types of considerations you want your state's top employers to focus on in lieu of producing high quality products at competitive prices.

A state that places a tax on mobile assets such as inventory will almost always be at a competitive disadvantage when compared to surrounding states [that don't tax inventory]. This is especially true for Kentucky, which shares a border with seven states, five of whom (Illinois, Indiana, Missouri, Ohio and Tennessee) do not have inventory taxes. Keeping the tax provides a strong incentive for firms that maintain a high level of inventory to expand to other states in which inventory is not taxed and for new firms to select other states when considering locations.

Additionally, the removal of inventory from the property tax base would make tangible personal property tax revenues more stable, though to be sure fluctuations in the market value of the tax value necessarily lead to a tax base less stable than items subject to specific excise taxes, such as cigarettes and alcohol. A large portion of the tax, including the inventory tax portion is influenced by price, and its removal would make the remaining tax base, valued on historical cost, inelastic.

However, the removal of inventory from the property tax base is unlikely to reduce the need for public services or goods and therefore, keeping in mind the principles of sound tax policy, all remaining taxable property should be taxed at a uniform rate and on a broad basis. This proposal may shift the tax from certain commercial and industrial taxpayers to other commercial and industrial taxpayers or to other sectors. Sectors gaining the most from this change statically would be those sectors with large inventories relative to value-added including the retail sector, the wholesale sector, and the manufacturing sector. [We note here: the dynamic effects resulting from exemption of inventory depend on the market's supply-side response. We contend that the benefits to employment, output and production—and in the long term, the revenue collections—are very likely to outweigh the current revenue benefits, which are small—refer back to Tables 1 and 2 on page 49].

Case Studies in the Removal of Inventory Taxes: California and Other States

In 1968, California governor Ronald Reagan created a property tax exemption for businesses that exempted 15% of inventories.[49] Four years later, Gov. Reagan increased the business inventory tax exemption to 50% of inventories. "This tax reduction was quickly made irrelevant by rising property values," and rising property tax liabilities.[50] By 1979,

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http://www.taxanalysts.com/www/features.nsf/Articles/0A36D84DAA1E272485257D2B006A9073

[47] *Handbook on Taxation*, edited by W. Bartley Hildreth and James A. Richardson. CRC Press, January 1999. https://books.google.com/books?hl=en&lr=&id=1CkRqHX0caYC&oi=fnd&pg=PA119&dq=kentucky+inventory+tax+history&ots=lQCIrEF4F2&sig=nTmo6uSzUIR90S-%20A1IKGhpSuYWQ#v=snippet&q=inventory&f=false

[48] The Tiebout Hypothesis was developed in a 1956 paper by economist Charles M. Tiebout. Source: Charles. M. Tiebout, "A Pure Theory of Local Expenditures," The Journal of Political Economy, Vol. 64., No. 5, (Oct., 1956), pp. 416-424. http://www.unc.edu/~fbaum/teaching/PLSC541_Fall08/tiebout_1956.pdf

[49] "An Historical Analysis of Tax and Fiscal Propositions in California, 1978-2004," Working Partnerships USA, May 2006. http://www.wpusa.org/Focus-Areas/gov_TFP%20report%20guts.pdf

[50] *Ibid.*

most business inventories were exempt from local property taxes by statute.[51] The state was required to reimburse local governments for lost revenue.

In June of 1980, Orange County businessman and tax activist Howard Jarvis and co-authors economist Dr. Arthur B. Laffer and Democratic State Senator Bob Wilson introduced Proposition 9, which sought to amend California's constitution to exempt business inventories from taxation. Though not required to by law according to the Legislative Counsel, Proposition 9 would continue to reimburse local governments for revenue due to the elimination of the inventory tax.[52] Proposition 9 was defeated at the polls, with 54% of the voters opposing it statewide.[53] However, Gov. Jerry Brown was able to fully abolish the inventory tax by statute one month later in July of 1980. According to California Statute 1980, Ch. 411, "for the 1980–81 fiscal year and fiscal years thereafter, business inventories are exempt from taxation and the assessor shall not assess business inventories."[54]

- The removal of inventory from the property tax base had the following impact in San Joaquin County:
    - Prior to full exemption of inventory, in 1979-80 assessment rolls[55] were $1.79 billion, which included $111 million in non-exempt inventory values.[56]
    - In 1980-81, the first full year of exemption for inventory values, assessment rolls were $1.83 billion, representing an increase of 1.9%.[57] The San Joaquin County Assessor anticipated property tax revenue to grow between 12 and 15% between 1979-80 and 1980-1981 despite full inventory exemption in 1980-81.[58]
    - At the time the exemption was passed, total reimbursements for revenue lost due to elimination of the inventory tax were an estimated $459 million for tax year 1980-81.[59]

Several states have exempted inventory from taxation by amending their state Constitutions. Below are three examples:

- **Utah:** Utah eliminated its inventory tax in a two-step process. First, in 1964, the Constitution was amended to exempt inventory held for out of state sale (the "Freeport exemption"). In 1968, another Constitutional amendment, Proposition No. 3, proposed exempting inventory held for sale in Utah. Prior to voting on Proposition No. 3, an editorial argued the inventory tax should be completely eliminated because it was hard to administer, it was unfair given inventory destined for sale outside Utah was exempt and also because the tax was more punitive during slow economic times when business income growth slowed but inventories, subject to taxation, continued to expand.[60] Proposition No. 3 passed overwhelming, with 71.8% of votes in favor of the measure.[61]

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[51] "Taxation. Income. California Proposition 9," University of California, Hastings College of the Law, Scholarship Repository. http://repository.uchastings.edu/cgi/viewcontent.cgi?article=1882&context=ca_ballot_props

[52] *Ibid*.

[53] Rob Kling, Spencer C. Olin Jr., and Mark Poster, "Postsuburban California: The Transformation of Orange County since World War II," University of California Press: 1995. https://books.google.com/books?id=XC_QGlNr6UEC&dq=Postsuburban+California:+The+Transformation+of+Orange+County+since+World+War+II&source=gbs_navlinks_s

[54] State of California, "Revenue and Taxation Code, Property Taxation, Part 2. Assessment," California State Board of Equalization. https://www.boe.ca.gov/lawguides/property/archive/2011/rt/219.html

[55] An "assessment roll is a record of taxable persons and property in a taxing jurisdiction. Such rolls are prepared by tax assessors. An assessment roll of a town, for example, includes each individual tract of land within its taxing jurisdiction and shows the assessed value of each. It is also termed as assessment list."
Source: "Assessment Roll Law & Legal Definition," *USLegal.com*. http://definitions.uslegal.com/a/assessment-roll/
http://definitions.uslegal.com/a/assessment-roll/

[56] "Tax assessment gains despite inventory roll loss," *Lodi-News Sentinel*, July 5, 1980. https://news.google.com/newspapers?nid=2245&dat=19800705&id=yWkzAAAAIBAJ&sjid=ODIHAAAAIBAJ&pg=7026,421846&hl=en

[57] *Ibid.*

[58] *Ibid.*

[59] *Ibid.*

[60] "Proposition No. 3, Vote Yes to Repeal the Inventory Tax," *The Deseret News*, September 24, 1968. https://news.google.com/newspapers?nid=336&dat=19680924&id=McROAAAAIBAJ&sjid=YUkDAAAAIBAJ&pg=6649,5146668&hl=en

[61] "Utah Proposition No. 3: Inventory Tax Repeal (1968)," Ballotpedia. https://ballotpedia.org/Utah_Proposition_No._3:_Inventory_Tax_Repeal_%281968%29

- **Illinois:** Illinois' path to inventory exemption was more complicated. In 1970, 74.7% of voters approved a new Constitution in Illinois, referred to as the "Constitution of 1970."[62] The Constitution of 1970 set out a plan to abolish local personal property taxes on business, including inventory, by 1979 and replace them with state level taxes on those same businesses. The proceeds of the replacement taxes would be held in a fund called the Personal Property Replacement Tax Fund before being distributed to local tax districts. The Constitution of 1970 did not stipulate what form of taxes would replace the personal property tax on business; however, the state did promise to replace revenue lost by local governments after 1979 based on the share of personal property taxes received by local tax districts in 1977 (1976 for Cook County, where Chicago is located). The amount received by each local tax district is called its "allocation factor."[63]

  Replacement of revenues lost by the exemption of personal property taxes on businesses by the state continues today.[64] For 2015, the State of Illinois replaced lost personal property taxes to local tax districts with the following taxes: a 2.5% tax on corporate income, a 1.5% tax on the income of partnerships, trusts and S corporations, and a 0.8% tax on the invested capital of public utilities.[65] Cook County (where Chicago is located) currently receives 51.65% of all proceeds from the replacement taxes and the remaining portion, 48.35%, is divided among the rest of the counties as follows: if tax District A received 5% of all tax revenue collected by all tax districts from personal property taxes on businesses in 1977, District A would receive 5% of the proceeds from the replacement taxes collected by all districts (excluding Cook County) in 2015. Tax districts created after 1977 receive no allocation factor since they did not experience a loss in revenue from the exemption of personal property taxes on businesses. Allocation factors can change if there are significant changes in the distribution of personal property taxes collected in the base year (1976 or 1977) in the event a tax refund for the base year is issued or if shifts in the distributions of collections for the base year are discovered.

  In some cases, the state directs how funds from the personal property replacement taxes must be used by localities.[66] For example, if a local tax district used property taxes for "debt service" in 1976 or 1977, it must use a comparable share of the replacement tax money it receives from the state for debt service. The same is true for pension or retirement commitments, and in some cases, libraries in local tax districts. Once these commitments have been met by local tax districts, the local tax district can use the remaining funds received from the replacement tax for the same purpose as the funds the local tax districts collects from real estate taxes.

- **Missouri:** Missouri exempted inventories from taxation with the passage of the Missouri Property Tax Assessment and Exemption Amendment, referred to as Amendment 7, on August 3, 1982.[67] The measure was a legislatively-referred constitutional amendment that was first approved in both chambers of the Missouri General Assembly, which paved the way for it to be put to a public vote.[68] The measure, which also exempt homesteads from taxation, received overwhelming support from the public, receiving support from 63.9% of voters.[69]

[62] Frank Kopecky and Mary Sherman Harris, "Understanding the Illinois Constitution: 2001 Edition," Illinois Bar Foundation, 1986, revised and reprinted by the Illinois LEARN Program, 2000. https://www.isba.org/sites/default/files/teachers/publications/constbook.pdf
[63] "Personal Property Replacement Tax," Illinois Department of Revenue, Local Government, 2016. http://www.revenue.state.il.us/localgovernment/overview/howdisbursed/replacement.htm
[64] "The Illinois Property Tax System: A general guide to the local property tax cycle," Illinois Department of Revenue, Property Tax Division. http://www.revenue.state.il.us/publications/localgovernment/ptax1004.pdf
[65] *Ibid.*
[66] *Ibid.*
[67] "Missouri Property Tax Assessment and Exemption, Amendment 7 (August 1982)," Ballotpedia. https://ballotpedia.org/Missouri_Property_Tax_Assessment_and_Exemption,_Amendment_7_%28August_1982%29
[68] "Amending state constitutions," Ballotpedia. https://ballotpedia.org/Amending_state_constitutions#Missouri
[69] "Missouri Property Tax Assessment and Exemption, Amendment 7 (August 1982)," Ballotpedia. https://ballotpedia.org/Missouri_Property_Tax_Assessment_and_Exemption,_Amendment_7_%28August_1982%29

Several states have exempted inventory from taxation by revision of existing statutes:

- **Alabama:** eliminated its inventory tax by statute in 1975.[70] Three years later, Alabama's Constitution was amended to permanently exclude business inventory from taxation.[71]

- **Rhode Island:** Rhode Island eliminated its local-only inventory tax by statute over a ten-year period beginning in the fiscal year 2000.[72] Starting in 2000 the inventory tax rate, set by local officials in fiscal year 1999, was reduced by 10 equal percent tax rate reductions every year, until being fully phased out in fiscal year 2009. The state did not provide a carryover to local governments for revenues lost due to elimination of the inventory tax.

[70] "Property Tax Incentives," Alabama Department of Revenue. http://revenue.alabama.gov/taxincentives/proptaxincentives.cfm and Section 40-9-1(23), Code of Alabama 1975, http://revenue.alabama.gov/advalorem/exemptions/40-9-1.pdf

[71] Alabama Constitution of 1901. Amendment 373. http://alisondb.legislature.state.al.us/alison/codeofalabama/constitution/1901/CA-888542.htm

[72] "2005 Rhode Island Code – Section 44-3-29.1 – Wholesale and retail inventory tax phase out," Justia U.S. Law Online, http://law.justia.com/codes/rhode-island/2005/title44/44-3-29.1.html

APPENDIX

1. Jefferson County: Select Property Tax Rates for 2015[89]

Tax District Type	Tax District	Real Estate	Tangible Personal Property	Merchant's Inventory	Inventory-In-Transit
County	Louisville-Jefferson County	12.54	16.00	0.00	0.00
School	General Anchorage Independent	98.20	98.20	98.20	0.00
School	General Jefferson County	71.00	71.00	71.00	0.00
Special	Anchorage Ambulance District	8.50	8.5	8.50	8.50
Special	Anchorage Fire District	10.00	10.00	10.00	10.00
Special	Buechel Fire District	10.00	10.00	10.00	10.00
Special	Camp Taylor Fire District	10.00	10.00	10.00	10.00
Special	Eastwood Fire District	10.00	10.00	10.00	10.00
Special	Fairdale Fire District	10.00	10.00	10.00	10.00
Special	Fern Creek Fire District	10.00	10.00	10.00	10.00
Special	Harrods Creek Fire District	10.00	10.00	10.00	10.00
Special	Highview Fire District	10.00	10.00	10.00	10.00
Special	Jeffersontown Fire District	10.00	10.00	10.00	10.00
Special	Lake Dreamland Fire District	10.00	10.00	10.00	10.00
Special	Louisville Downtown Management District	7.45	0.00	0.00	0.00
Special	Lyndon Fire District	10.00	10.00	10.00	10.00
Special	Lynnview Garbage Fund	10.00	10.00	10.00	0.00
Special	McMahan Fire District #14	10.00	10.00	10.00	10.00
Special	Middletown Fire District	10.00	10.00	10.00	10.00
Special	Pleasure Ridge Park Fire District	10.00	10.00	10.00	10.00
Special	Okolona Fire District	10.00	10.00	10.00	10.00
Special	St. Matthews Fire District	10.00	10.00	10.00	10.00
Special	Urban Services District Louisville	35.38	56.60	0.00	0.00
Special	Worthington Fire District	10.00	10.00	10.00	10.00
City	Anchorage	41.60	41.60	41.60	0.00
City	Audobon Park	27.00	0.00	0.00	0.00
City	Bancroft	37.40	0.00	0.00	0.00
City	Barbourmeade	20.90	0.00	0.00	0.00
City	Beechwood Village	13.00	0.00	0.00	0.00
City	Bellemeade	7.50	0.00	0.00	0.00
City	Bellewood	19.00	0.00	0.00	0.00
City	Blue Ridge Manor	20.00	0.00	0.00	0.00
City	Briarwood	29.00	0.00	0.00	0.00
City	Broeck Pointe	21.50	0.00	0.00	0.00
City	Brownsboro Farm	26.60	0.00	0.00	0.00
City	Brownsboro Village	19.63	0.00	0.00	0.00
City	Cambridge	20.50	0.00	0.00	0.00
City	Coldstream	13.00	0.00	0.00	0.00
City	Creekside	22.00	0.00	0.00	0.00
City	Crossgate	22.50	0.00	0.00	0.00
City	Douglass Hills	13.90	0.00	0.00	0.00
City	Druid Hills	10.10	0.00	0.00	0.00
City	Fincastle	20.00	0.00	0.00	0.00
City	Forest Hills	15.00	0.00	0.00	0.00
City	Glenview	13.00	0.00	0.00	0.00
City	Glenview Hills	11.00	0.00	0.00	0.00
City	Glenview Manor	18.00	0.00	0.00	0.00
City	Goose Creek	17.00	0.00	0.00	0.00
City	Graymoor-Devondale	20.00	0.00	0.00	0.00
City	Green Spring	18.70	0.00	0.00	0.00
City	Heritage Creek	20.30	0.00	0.00	0.00
City	Hickory Hill	24.70	0.00	0.00	0.00
City	Hills and Dales	20.70	0.00	0.00	0.00
City	Hollow Creek	34.00	0.00	0.00	0.00
City	Houston Acres	20.60	0.00	0.00	0.00
City	Hurstbourne	18.50	0.00	0.00	0.00
City	Hurstbourne Acres	14.00	0.00	0.00	0.00
City	Indian Hillls	20.00	0.00	0.00	0.00
City	Jeffersontown	14.78	0.00	0.00	0.00
City	Kingsley	33.00	0.00	0.00	0.00
City	Langdon Place	28.00	0.00	0.00	0.00
City	Lincolnshire	22.00	0.00	0.00	0.00
City	Lyndon	13.00	0.00	0.00	0.00
City	Lynnview	29.70	11.90	11.90	0.00
City	Manor Creek	30.00	0.00	0.00	0.00
City	Maryhill Estates	15.00	0.00	0.00	0.00
City	Meadow Vale	14.00	0.00	0.00	0.00
City	Meadowbrook Farm	7.40	0.00	0.00	0.00
City	Meadowview Estates	13.10	0.00	0.00	0.00
City	Middletown	13.50	0.00	0.00	0.00
City	Mockingbird Valley	15.25	0.00	0.00	0.00
City	Moorland	24.00	0.00	0.00	0.00
City	Murray Hill	20.60	0.00	0.00	0.00
City	Norbourne Estates	16.20	0.00	0.00	0.00
City	Northfield	19.00	0.00	0.00	0.00
City	Norwood	19.50	0.00	0.00	0.00
City	Old Brownsboro Place	34.70	0.00	0.00	0.00
City	Parkway Village	16.30	0.00	0.00	0.00
City	Plantation	30.00	0.00	0.00	0.00
City	Poplar Hills	15.00	0.00	0.00	0.00
City	Prospect	21.25	0.00	0.00	0.00
City	Richlawn	15.00	0.00	0.00	0.00
City	Riverwood	11.41	0.00	0.00	0.00
City	Rolling Fields	9.60	0.00	0.00	0.00
City	Rolling Hills	19.30	0.00	0.00	0.00
City	Saint Matthews	20.00	0.00	0.00	0.00
City	Saint Regis Park	13.80	0.00	0.00	0.00
City	Seneca Gardens	21.31	0.00	0.00	0.00
City	Shively	33.90	36.30	36.30	0.00
City	Spring Mill	20.00	0.00	0.00	0.00
City	Spring Valley	17.78	0.00	0.00	0.00
City	Strathmoor Manor	32.00	0.00	0.00	0.00
City	Strathmoor Village	25.00	0.00	0.00	0.00
City	Sycamore	0.00	0.00	0.00	0.00
City	Ten Broeck	10.32	0.00	0.00	0.00
City	Thornhill	12.00	0.00	0.00	0.00
City	Watterson Park	9.50	0.00	0.00	0.00
City	Wellington	19.67	6.50	6.50	0.00
City	West Buechel	20.00	0.00	0.00	0.00
City	Westwood	16.40	0.00	0.00	0.00
City	Wildwood	16.10	0.00	0.00	0.00
City	Windy Hills	17.00	0.00	0.00	0.00
City	Woodland Hills	13.24	0.00	0.00	0.00
City	Woodlawn Park	17.20	0.00	0.00	0.00
City	Worthington Hills	23.00	0.00	0.00	0.00

[89] "Commonwealth of Kentucky Property Tax Rates 2015," Department of Revenue, Office of Property Valuation. http://revenue.ky.gov/Documents/2015TaxRateBook.pdf

THE PROPERTY TAX

History of Property Taxation in the United States

The typical property tax base in the majority of states now includes real property, improvements to real property, and limited tangible and intangible personal property. Because of the extent of limitations, the property tax today cannot be considered as broad-based a tax as it was in many states throughout the early history of the United States. The gradual narrowing of the property tax base since Colonial times can be attributed to two primary factors: first, the desire among states to increase productivity as the economy shifts from agricultural to industrial and then to a service economy, and second, widespread concern among tax experts about the ability of tax professionals to effectively collect tax revenues from the personal property tax base.[1] Since Colonial times, ~~r~~eliance on property taxes as a source of revenue has ebbed and flowed as political power shifted between state, local and national levels of government.

The decentralized nature of political power in the United States following the Revolutionary War contributed to the rise of state governments as the most active form of government between 1790 and the early 1840s.[2] Prior to the 1840s, the dominant means by which states funded government services was with "asset income," i.e. the revenue from infrastructure investments, a realization of the Cameralist ideal, wherein states were largely funded with income from state-owned assets rather than direct taxation. States took the lead with infrastructure investment, investing heavily in basic transportation and financial infrastructure as part of a strategy to meet many public policy objectives while boosting the American economy. Such a role was largely denied to the national government in the wake of Jacksonian democracy, which, with its strict construction interpretation of the Constitution set out a limited economic role for the national government. Typically, states made investments through experimentation with public/private corporations. Through corporations, states invested in banks, canals, roads and railways, which yielded substantial dividends, fees and indirect taxes.

State and local governments also relied on the property tax as a means for generating revenue in the first few decades following the Revolutionary War. But for three brief instances to finance war expenditures during preparations for war with France in 1798, the War of 1812 and the Civil War, the federal government has not taxed property (see footnote below for details).[3] The property tax was typically a broad-based tax on wealth applied to real property, i.e., real estate, and to household and business property as well.[4] The West and South regions were much slower than the Atlantic Seaboard to see economic development and asset income resulting from infrastructure investment and were more reliant on property taxes than user fees and taxes generated from canals, railroads and the financial sector as a result.

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[1] As quoted in Joan Youngman "Introduction to Legal Issues in Property Valuation and Taxation," *Assessment Journal*, March/April 1994. https://www.lincolninst.edu/subcenters/property-valuation-and-taxation-library/dl/youngman_2.pdf

[2] John Joseph Wallis, "American Government Finance in the Long Run: 1790 to 1990," *The Journal of Economic Perspectives*, Vol 14, No. 1 (Winter 2000), pp. 61-82. http://www.piketty.pse.ens.fr/files/Wallis00.pdf

[3] The first instance of the federal government taxing property was in 1798 as the United States prepared for war with France. To pay for a larger navy, the Federalist Congress approved a direct tax on land, slaves, and real estate. The property tax was paid to the federal government, but assessed and collected by local officials. By 1802, all three taxes were abolished, as part of President Jefferson's effort to end all internal taxes, including the whiskey excise tax and the land tax. The second Federal property tax was enacted to finance the War of 1812. The war had substantially reduced international trade and reduced customs revenue. The property tax was once again administered at the local level to save the costs of creating a new and extensive bureaucracy. The tax was automatically repealed when armistice took effect. The third Federal property tax occurred during the Civil War. In 1861, the rising deficit led the Federal government to enact income taxes and a property tax. The property tax was a direct tax on all land within a state levied in proportion to the state's population. The property tax was allowed to expire when the War ended.
Source: David Brunori, Richard Green, Michael Bell, Chanyung Choi and Bing Yuan, "The Property Tax: Its Role and Significance in Funding State and Local Government Services," George Washington Institute of Public Policy (GWIPP), Working Paper Series Paper Number 27, The George Washington University, March 2006. http://gwipp.gwu.edu/files/downloads/Working_Paper_027_PropertyTax.pdf

[4] *Handbook on Taxation*, edited by W. Bartley Hidreth and James A. Richardson. CRC Press, January 1999.
https://books.google.com/books?hl=en&lr=&id=1CkRqHX0caYC&oi=fnd&pg=PA119&dq=kentucky+inventory+tax+history&ots=lQCIrEF4F2&sig=nTmo6uSzUIR90S-%20A1lKGhpSuYWQ#v=snippet&q=inventory&f=false

By the second half of the 1830s, property taxes averaged 2% of state revenues among states in the Atlantic Seaboard, and averaged 34% of state revenue in states located in the West and South (see Table 1).[5] The revenues from asset income allowed many states to lower property taxes. By 1835, Maryland, New York, Rhode Island, Massachusetts, Pennsylvania, South Carolina, Georgia and Alabama were able to eliminate property taxes altogether.

Table 1
Property Tax Revenues as a Share of All State Government Revenues: Select States[6]

	1835-1841	1842-1848	1902
Atlantic Seaboard			
DE, MA, MD, NY, NC, PA, RI, SC	2%	17%	55%
West and South			
AR, IL, IN, KY, MS, OH	34%	45%	70%
All States	16%	30%	57%

By 1836, state spending on infrastructure projects accelerated and reached unsustainable levels and by the late 1830s state debt reached roughly eight times the combined debts of the national and local governments.[7,8] The public/private nature of the investment projects, funded by tax dollars, led the partnerships to take on more and increasingly risky projects than they would have tended to otherwise if funded through purely private capital—a clear case of the "tragedy of the commons."[9] A severe economic depression began in 1839, referred to as the Crisis of 1839.[10] By 1841, it was clear that the enormous state debt, which had ballooned to $200 million—half of which was held overseas in Britain largely in "canal bonds"—would remain unpaid.[11] The following year, 1842, eight states and the Territory of Florida defaulted on debts largely incurred to fund infrastructure investments. Many of the expensive infrastructure projects undertaken by state governments in the run-up to the Crisis of 1839 were transferred to private ownership. As a result, the newly-private infrastructure property was subject to property taxation, adding considerably to the property tax base.[12]

In the wake of the Crisis of 1839, many states adopted new constitutions, or passed constitutional amendments or revisions intended to prevent future financial crises and set new guidelines for how governments should be funded. Strict limitations on state borrowing and investments in public/private partnerships were enacted, and in some cases public/private partnerships were explicitly forbidden. New or amended state constitutions mandated property tax collections and set guidelines for how they were to be collected.[13]

In the 19th century, all states adopted "uniformity" provisions in an attempt to ensure "that each person bear a proportional share of the cost of government…Uniformity with respect to real property taxation generally means that property is taxed by the ad valorem method at the same effective rate…Uniformity is defined territorially; that is,

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[5] *Ibid.*
[6] Source: Sylla and Wallis (1998) as cited in: John Joseph Wallis, "American Government Finance in the Long Run: 1790 to 1990," *The Journal of Economic Perspectives*, Vol 14, No. 1 (Winter 2000), pp. 61-82. http://www.piketty.pse.ens.fr/files/Wallis00.pdf
[7] John Joseph Wallis, "What Caused the Crisis of 1839?" National Bureau of Economic Research, Working Paper Series on Historical Factors in Long Run Growth, Historical Paper 133, April 2001. http://www.nber.org/papers/h0133.pdf
[8] *Ibid.*
[9] "The tragedy of the commons is an economic problem in which every individual tries to reap the greatest benefit from a given resource. As the demand for the resource overwhelms the supply, every individual who consumes an additional unit directly harms others who can no longer enjoy the benefits. Generally, the resource of interest is easily available to all individuals. The tragedy of the commons occurs when individuals neglect the well-being of society (or the group) in the pursuit of personal gain. For example, if neighboring farmers increase the number of their own sheep living on a common block of land, eventually the land will become depleted and not be able to support the sheep, which is detrimental to all."
Source: "Tragedy of the Commons," Definition, *Investopedia Online*. http://www.investopedia.com/terms/t/tragedy-of-the-commons.asp
[10] *Ibid.*
[11] Namsuk Kim and John Joseph Wallis, "The market for American state government bonds in Britain and the United States, 1830-43," *Economic History Review*, LVIII, 4 (2005), pp. 736-764. http://econweb.umd.edu/~wallis/Papers/bond_final_ehr_320.pdf
[12] Mabel Newcomer, "The Growth of Property Tax Exemptions," *National Tax Journal*, Vol. 6, No. 2 (June 1953), pp. 116-128. http://www.jstor.org/stable/41790601?seq=1#page_scan_tab_contents
[13] *Ibid.*

uniformity is required within the particular taxing jurisdiction."[14] The majority of state constitutions would also include "universality" provisions, requiring that all property be subject to taxation (see table 2). Though many state constitutions enumerated exemptions, legislative exemption of certain classes or specific types of property, was prohibited by universality absent a constitutional amendment or revision.[15]

By 1842-1848, the reversion to property taxes as an important source of public funding was clear: property taxes in states in the Atlantic Seaboard were 17% of all state revenues, while in the West and South, they were 45% (refer back to Table 1). By the late 1840s, local governments assumed many of the responsibilities held by states prior to the Crisis of 1839, in the process local governments became the most active level of government in the United States. Like states, local governments turned to property taxes as the primary source of revenue.

[14] *Handbook on Taxation*, edited by W. Bartley Hidreth and James A. Richardson. CRC Press, January 1999. https://books.google.com/books?hl=en&lr=&id=1CkRqHX0caYC&oi=fnd&pg=PA119&dq=kentucky+inventory+tax+history&ots=lQCIrEF4F2&sig=nTmo6uSzUIR90S-%20A1IKGhpSuYWQ#v=snippet&q=inventory&f=false

[15] *Ibid.*

Table 2

19th Century Adoption of Uniformity and Universality Provisions by State[16,17,18]

	Year	Universality Provision
Illinois	1818	Yes
Missouri	1820	No
Tennessee[16]	1834	Yes
Arkansas	1836	No
Florida	1838	No
Louisiana[16]	1845	No
Texas	1845	Yes
Wisconsin	1848	No
California	1849	Yes
Michigan[16]	1850	No
Virginia[16]	1850	Yes
Indiana	1851	Yes
Ohio[16]	1851	Yes
Minnesota	1857	Yes
Kansas	1859	No
Oregon	1859	Yes
West Virginia	1863	Yes
Nevada	1864	Yes
South Carolina[16]	1865	Yes
Georgia[16]	1868	No
North Carolina[16]	1868	Yes
Mississippi[16]	1869	Yes
Maine[16]	1875	No
Nebraska[16]	1875	No
New Jersey[16]	1875	No
Montana	1889	Yes
North Dakota	1889	Yes
South Dakota	1889	Yes
Washington	1889	Yes
Idaho	1890	Yes
Wyoming	1890	No
Kentucky[16]	1891	Yes
Utah	1896	Yes

[16] Indicates change by constitutional amendment or revision. A constitutional revision may be understood as a "comprehensive change to the basic plan for government," while a constitutional amendment is much "more narrow in scope and purpose and affects fewer constitutional provisions." Source for definitions: Katherine M. Mauk, "Approaches to Altering State Constitutions," Public Law Research Institute, Hastings College of the Law, 1994. http://gov.uchastings.edu/public-law/docs/plri/statecon.pdf

[17] The year list for each state in the table represents the 1st appearance of uniformity provisions in the constitution of that state.

[18] Source: Glenn W, Fisher, "History of Property Taxes in the United States," Economic History Association Online, edited by Robert Whaples, September 30, 2002. https://eh.net/encyclopedia/history-of-property-taxes-in-the-united-states/

Table 3

Property Taxes as a Share of Total Taxes: State and Local Governments[19]

(1902 – 2012)

Year	State Government	Local Government
1902	52.6	88.6
1913	46.5	91.1
1922	36.7	96.0
1932	17.4	97.3
1942	6.8	92.4
1952	3.8	97.5
1962	3.1	87.7
1972	2.1	83.7
1982	1.9	76.1
1992	2.2	75.6
2002	1.8	72.9
2012	1.2	73.6

Reliance on property taxes fell dramatically since the end of World War II. By 2002, property taxes were 1.8% and 73.6% of state government and local government tax revenues, respectively. The decline of the reliance among states on property taxes as a source of revenue since the early 1900s coincided with the transition away from the broad-based general property taxes of Colonial times towards a property tax system with classifications and exemptions for a number of different kinds of property. Many states abolished "equal and uniform" property taxation clauses in their constitutions, and subsequently classified all property into one of three categories: real property, tangible personal property and intangible personal property.[20] Within all three categories of property, an increasing number of exemptions, exclusions and differentiations for types of property were granted in the second half of the 19th century, a trend that has continued throughout the 20th century and up until today.

1. Real Property

Unlike tangible property (machinery, household goods, office furniture) and intangible personal property (patents, cash-in-hand, stocks), real property (land, housing, permanent structures) has remained a significant component of the property tax base. State and local governments have relied on taxation of real property due to the merits of property taxes vis-à-vis other taxes. First, the market value of real property is typically easier to assess than the market value of tangible personal property (the same cannot be said for intangible personal property, which is usually denominated in dollar terms). Second, real property, being immobile has a clear situs (location for taxation), thus limiting the possibility of tax avoidance. Third, property taxes are most often local taxes that fund local improvements and services; because the taxpayer is more likely to capture the benefits of paying property taxes, the rate of compliance for real property taxes is high. Fourth, the base for the real property tax is broad, which itself has several advantages. A broad base allows a low rate to be levied that can yield substantial revenue.[21] Fifth, the potential for property tax competition—when two or more levels of government collect the same tax and compete for revenues from the same base (this again is an example the "tragedy of the commons," when overtaxing from many sources destroys the value of the taxed asset)—with the Federal government is low, since the Federal government does not collect property taxes (though competition can and does exist when both a state and locality collect property taxes). Sixth, compliance costs for

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[19] Source: U.S. Bureau of the Census (1995*). Historical Statistics of State and Local Finances*, 1902-1953, U.S. Government Printing Office, Washington, D.C.; U.S. Bureau of the Census, *Government Finances for 1992, 2002 and 2012*, U.S. Government Printing Office, Washington, D.C. http://www.census.gov/en.html

[20] *Ibid*

[21] Roy Bahl and Jorge Martinez-Vazquez, "The Property Tax in Developing Countries: Current Practices and Prospects," Lincoln Institute of Land Policy Working Paper, 2007. https://www.researchgate.net/profile/Jorge_Martinez-Vazquez/publication/228652506_The_property_tax_in_developing_countries_Current_practice_and_prospects/links/0912f5098cd8d85fa4000000.pdf

taxpayers tend to be low relative to compliance costs for other taxes since property taxes are assessed by local authorities.[22] Costs can rise substantially, however, in the event of an appeals process. Seventh, by taxing stocks (property) instead of flows (income), the property tax poses less harm to the incentive to engage in productive activities.

Despite the relative benefits of taxing real property, there remains a common problem with real property taxation: exemptions for certain real property have become commonplace among states. There are also exemptions for government facilities, limited industrial facilities, for low-income housing and for qualifying disabled individuals. There is also the 'homestead exemption," a law that provides "shelter for a surviving spouse while preventing the forced sale of a home to meet creditor obligations and property taxes."[23]

2. Intangible Personal Property

The single greatest contributing factor in the decline of the property tax base since the Civil War can be attributed to the exemption of intangible personal property by many states.

Taxation of intangible personal property declined due in large part to two factors. The first reason was the inherent difficulty of identifying and collecting taxes on intangibles, a problem that was identified decades earlier in the post-Civil War era, when intangible wealth supplanted tangible wealth as the dominant form of personal wealth in the United States.[24] A tax on intangibles such as corporate securities and bank accounts proved to be difficult for local governments to administer, as those items could be concealed or moved outside the tax jurisdiction. As economist Edwin Seligman noted in his study of state tax reports issued between 1872 and 1897, "every annual report of the state comptrollers and assessors complains bitterly that the assessment of personal is nothing but an incentive to perjury."[25]

The decline of taxation of intangible personal property was also due to "the recognition of the presence of double taxation of property, which made the inclusion of such property in the property tax base of questionable equity."[26] Double taxation could arise when the property tax is levied on the intangible property which is associated with tangible property which is also taxed. For example, double taxation would occur in the event a property tax is levied on the full value of real estate as well as on the mortgage on the same real estate held by a financial institution.[27]

The decline among the states levying intangible personal property taxes over the past 100 years cannot be considered anything but precipitous (see Figure 1). At the start of the 20th century, all but 3 states levied taxes on intangible personal property.[28] By 1953, 40 states and the District of Columbia gave intangible personal property preferential tax status such as reduced tax rates or full exemption. Over 50 years later, Kentucky exempted nearly all intangible personal property as of January 1, 2006 (for a thorough discussion of legal decision that resulted in Kentucky's exemption of intangibles from the property tax base, see page forthcoming "Intangible Personal Property" in "Property Taxation in Kentucky" section). Currently, 8 states tax intangible personal property in some form.[29]

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[22] Source: *Ibid*

[23] "Homestead protection is extended to every person in the U.S or to any natural person regardless of marital status or lack of dependents. It is an automatic benefit in most of U.S. states and one can a file a claim where it is not automatic. Most homestead exemptions use a monetary value to determine property tax protection by implementing a progressive-style tax to home value in order to assure that homes with lower assessed value benefit the most from the exemption."
Source: "Homestead Exemption," Definition. *U.S. Legal Online*. http://definitions.uslegal.com/h/homestead-exemption/

[24] As quoted in Joan Youngman "Introduction to Legal Issues in Property Valuation and Taxation," *Assessment Journal*, March/April 1994. https://www.lincolninst.edu/subcenters/property-valuation-and-taxation-library/dl/youngman_2.pdf

[25] *Ibid*

[26] *Ibid*

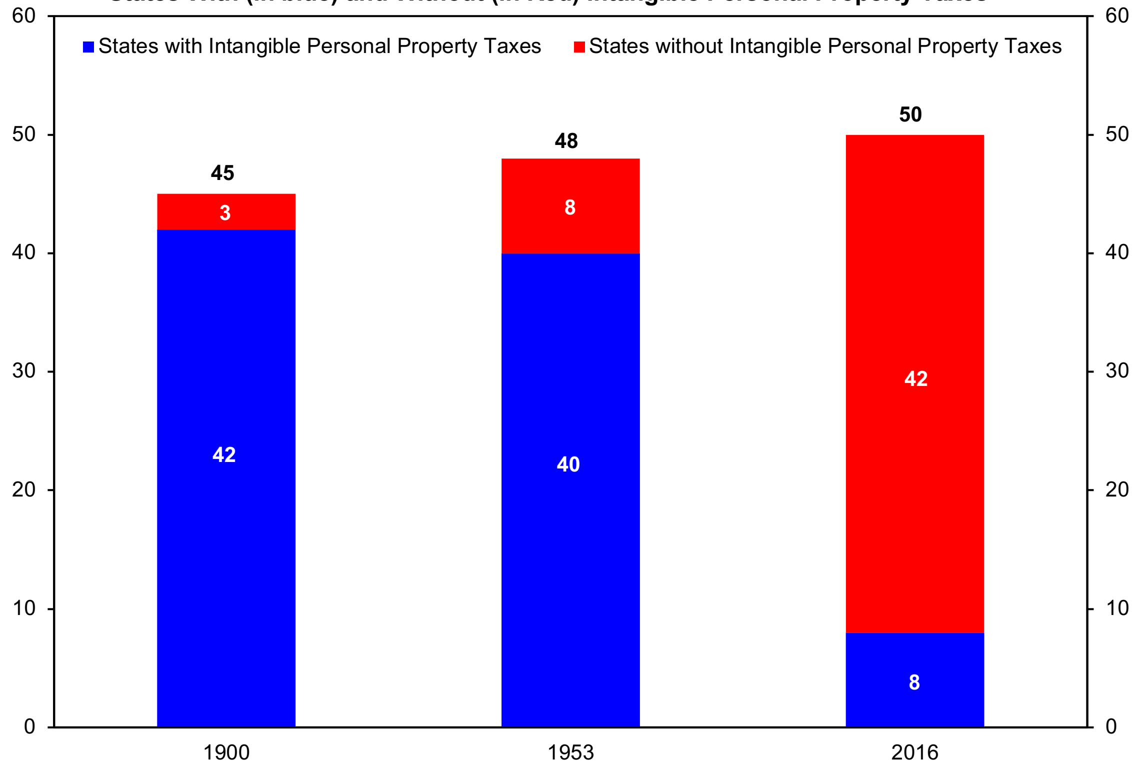
[27] "Taxation in the Same State of Real Property and Debt Secured by Mortgage or Other Lien Thereon as Double Taxation," *American Law Reports*, 742 (1939), and,
Joan Youngman "Introduction to Legal Issues in Property Valuation and Taxation," *Assessment Journal*, March/April 1994. https://www.lincolninst.edu/subcenters/property-valuation-and-taxation-library/dl/youngman_2.pdf

[28] *Ibid*

[29] Those states are: Alabama, Iowa, Louisiana, Mississippi, North Carolina, South Dakota, Tennessee and Texas.
Source: Jared Walczak, Scott Drenkard, and Joseph Henchman, "2016 State Business Tax Climate Index," Tax Foundation, November 17, 2005. http://taxfoundation.org/article/2016-state-business-tax-climate-index

Figure 1

States With (in blue) and Without (in Red) Intangible Personal Property Taxes[30,31]



The increase in the value of intangible personal property relative to the real and tangible components of the property tax base over the last 150 years and the large-scale removal of intangibles from the property tax base in the 20th century has resulted in a substantial decline in the property tax base.

3. <u>Tangible Personal Property</u>

The exemption of tangible personal property from the property tax base increased throughout the 20th century as states sought to increase productivity. The trend continues today (see Figure 2). In 1953, three states, Pennsylvania, New York and Delaware fully exempted tangible personal property, while many other states had exemptions for specific forms of tangible personal property, such as household items, business inventories, and machinery used in agriculture and industry. By 2012, seven states entirely exempted tangible personal property from taxation (Delaware, Hawaii, Iowa, Illinois, New York, Ohio and Pennsylvania), and four states had eliminated most taxes on tangible personal property (Minnesota, New Jersey, North Dakota and South Dakota).[32]

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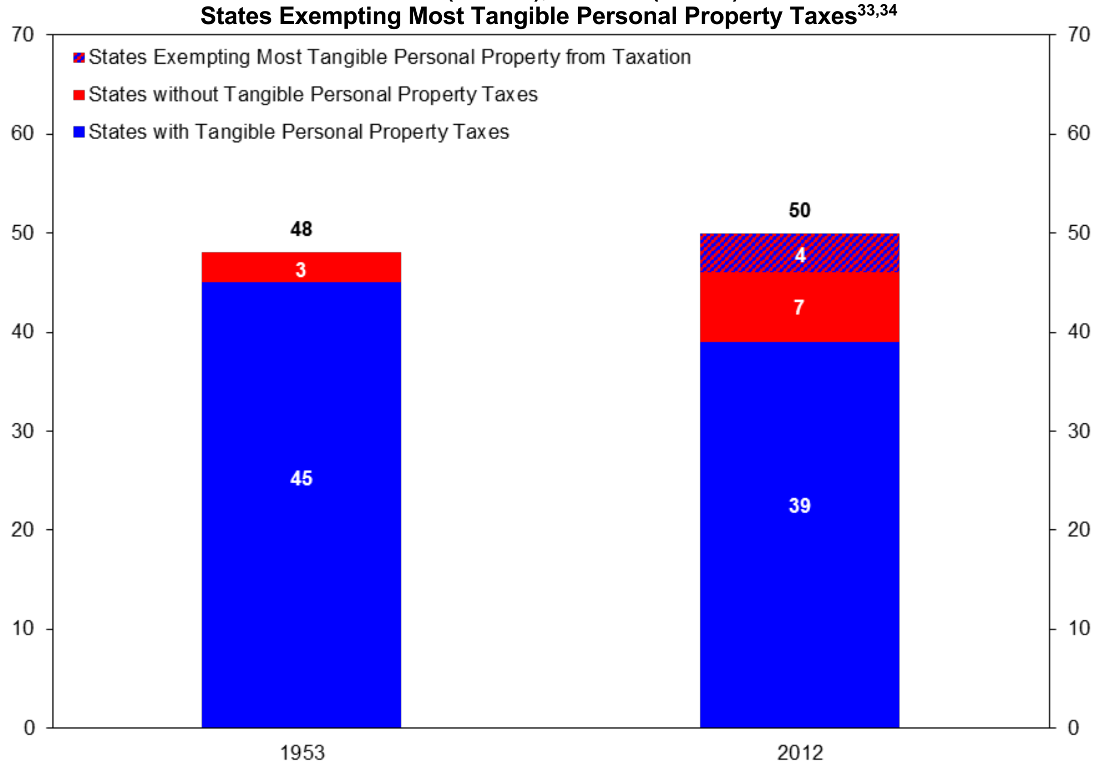
[30] Sources: Refer to paragraph text associated with Figure 1.

[31] In 1900, there were 45 states in the United States. In 1907, Oklahoma became the 46th state. New Mexico and Arizona became the 47th and 48th states, respectively in 1912, and Alaska and Hawaii entered the Union in 1959.

[32] Joyce Errecart, Ed Gerrish and Scott Drenkard, "States Moving Away From Taxes on Tangible Personal Property," Tax Foundation, October 4, 2012. http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property

Figure 2
States With (in Blue), Without (in Red) and States Exempting Most Tangible Personal Property Taxes[33,34]



Property Taxation in Kentucky

Kentucky has levied a tax on property since becoming a state on June 1, 1792.[35] Originally, each item of property was subject to a set levy or tax, which is called a specific fixed tax. In 1814, the method for levying property taxes was changed to the *ad valorem* method, which taxes property based on its fair market value.[36] The "ad valorem" property tax is the method by which property taxes are currently levied in Kentucky.

As was the case for property taxes in most states during the late 18th and 19th centuries, Kentucky's property tax was a broad-based general property tax. In 1914, Kentucky's statutory general property tax rate was $0.55 per $100 of assessed value, considered high for the time, though the effective rate was estimated to be half that amount as assessments were typically estimated to be half of the actual market value (the current process used to determine property tax liabilities for each property classification system will be discussed in each classification).[37]

Kentucky courts "have consistently construed the meaning of 'property' in the broadest form possible:"[38]

> "'Property' as used in the revenue statute means everything of value that a person owns that is or may be the subject of sale or exchange or that when offered for sale will bring some price... The term (property) is therefore said to include everything which is the subject of ownership, corporeal or incorporeal ["property that can be seen and handled such as real estate or personal property

[33] For sources, refer to paragraph associated with Figure 2.
[34] Alaska and Hawaii did not enter the Union until 1959.
[35] State of Kentucky, "Commonwealth of Kentucky, Tax Expenditure Analysis: Fiscal Years 2016 – 2018," Governor's Office for Economic Analysis and Office of State Budget Director. http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf
[36] *Ibid.*
[37] Anna Youngman, "The Revenue System in Kentucky: A Study in Finance," The Quarterly Journal of Economics, Vol. 32, Nol. 1 (Nov., 1917), pp. 142-205, Oxford UP. http://www.jstor.org/stable/pdf/1885082.pdf?acceptTC=true
[38] Mark F. Sommer and Mark A Loyd, *ABA Property Tax Deskbook.* https://www.bgdlegal.com/clientuploads/Kentucky%20Property%20Tax%20chapter.pdf

having a tangible form and structure, like a building, equipment or vehicle" is corporeal[39]] tangible or intangible [property "capable of being touched: able to be perceived as materially existent esp. by the sense of touch: palpable, tactile" is corporeal[40]], visible or invisible ['visible' refers to property which can be seen, and 'invisible' refers to assets that cannot be seen, such as trademarks or copyrights[41]], real or personal, chosen in action ["the bundle of personal rights over property which can only be claimed or enforced by action, and not by taking physical possession, for example, a cash balance at a bank or money due on a bond"[42]] as well as in possession, everything which has an exchangeable value, or which goes to make up one's wealth or estate."[43]

In Kentucky, for tax purposes property falls under two broad categories: **real property**, which the state defines as "all lands within the state and improvements thereon." **Personal property**, which the state defines as "every species and character of property, tangible and intangible, other than real property."[44] In Kentucky**, personal property** falls under two categories: **intangible personal property** and **tangible personal property**.

1. Real Property Taxation in Kentucky

Kentucky's Constitution requires that real property be taxed annually by all taxing authorities that levy the real property tax.[45] Like most states, Kentucky's real property tax law allows numerous exemptions. These exemptions include the Homestead Exemption, which exempts the primary long-term personal residence of a homeowner who is 65 years or older and property owned by disabled citizens that meet certain qualifications. Several other kinds of real property are exempt: public property for public use, not-for-profit cemeteries, property owned by religious and not-for-profit education institutions.[46,47]

A constitutional amendment would be required to change the real property tax laws in Kentucky. Amending the constitution requires first, approval of 60% of each chamber of the Kentucky Legislature to put the measure on a ballot during the next general election, and second, approval of the measure by a simple majority of voters.[48]

During the 1970s, inflation was causing both property values and the property tax levy to increase substantially.[49] To provide tax relief, House Bill (HB) 44 was passed during an Extraordinary Session of Kentucky's General Assembly in the absence of Governor Julian Carroll in 1979, one year after California's Proposition 13. H.B. 44 limited growth of the total local tax revenues collected by local governments on real property to 4% per year.[50,51]

Kentucky's real property assessment process is complicated.

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[39] "Corporeal Property Law & Legal Definition," *USLegal.com*. http://definitions.uslegal.com/c/corporeal-property/

[40] "Tangible Property," Definition, U.S. Legal Online. http://definitions.uslegal.com/t/tangible-property/

[41] Here is a definition of 'invisible assets': "An item of value that is intangible and that cannot be seen, such as brand recognition and intellectual property including trademarks, copyrights or patents. Invisible assets are non-material assets that are shown in a company's balance sheet, and include research and development costs, concessions, patents, licenses, trademarks and goodwill. Also called intangible assets." Source: "Invisible Assets," Definition, Investopedia. http://www.investopedia.com/terms/i/invisible-asset.asp

[42] "Chose in Action," *Practical Law: A Thomson Reuters Legal Solution*. http://us.practicallaw.com/2-107-5828

[43] *Ibid.*

[44] *Ibid.*

[45] Kentucky Constitution, Section 170, "Property Exemption from taxation – Cities may exempt factories for five years." http://www.lrc.ky.gov/legresou/constitu/170.htm

[46] *Ibid.*

[47] For more information, refer to source in previous footnote.

[48] Kentucky Constitution, Section 256. "Amendments to Constitution – How proposed and voted upon." http://www.lrc.state.ky.us/legresou/constitu/256.htm

[49] *Ibid.*

[50] "Local Mandate Fiscal Impact Estimate," Kentucky Legislative Research Commission, 2013 Regular Session. www.lrc.ky.gov/record/13rs/HB317/LM.doc

[51] House Bill 44 was passed during an extraordinary session of Kentucky's General Assembly called by Lt. Gov. Thelma Stovall while Gov. Julian Carol was out of state. Lt. Gov. Stovall, inspired by California's tax revolt, at the time stated "Everybody was talking about it [enacting tax relief legislation] but nobody was doing anything," and utilized her power as acting Governor while Governor Carol was out of state, in accordance with Kentucky's Constitution. While serving as Secretary of State, Stovall assumed the role as acting Governor while the Governor and Lt. Governor were out of state, and pardoned a man serving a life sentence for stealing $28.
Source: Bill Billiter, "Thelma Stovall's tax revolt is bringing in the votes," *The Spokesman-Review*, February 4, 1979, reprinted from *The Los Angeles Times*.
https://news.google.com/newspapers?nid=1314&dat=19790204&id=4z1OAAAAIBAJ&sjid=B-4DAAAAIBAJ&pg=7253,1920247&hl=en and "Nation," *Time Magazine*, February 12, 1979. http://content.time.com/time/magazine/article/0,9171,920090,00.html

Real property is assessed by a local Property Valuation Administrator (PVA) at 100% of its market value as of January 1 by the end of the 1st quarter.[52,53] Here is description of the assessment process: First, the Property Valuation Administrator (PVA) determines the "compensating rate," a rate that, when applied to the current year total assessment of all real property in a taxing district, excluding new property and personal property, real property that qualifies for the Homestead Exemption, and the difference between the market value of agricultural and horticultural value of agricultural or horticultural land, generates the same amount of total revenue from the previous year. The Property Valuation Administrator (PVA) then applies the compensating rate to the entire assessment role for the current year (including new property). If applying the compensating rate to the total assessment role for the current year generates less real property revenue than the previous year, then the compensating rate *must* be adjusted upward, in accordance with Kentucky law.[54] The requirement that the compensating rate be increased to ensure that current year revenues from real property exceed revenues from real property in the previous year resulted from a change in tax law that sought to offset revenues losses from the decline in the personal tangible property tax base.[55]

In the event total revenue collections from real property exceed the maximum 4% year over year growth mandated by House Bill (HB) 44, existing law under Kentucky Revised State (KRS) 132.017 provides provisions for voters to recall the portion of the real property tax collection that is in excess of the mandated 4% maximum growth in total revenue from real property tax collections.[56,57]

House Bill (HB) 44 is a "revenue cap" that limits total real property tax revenue growth in any taxing jurisdiction; however, by law, Kentucky also limits property tax *rates* in most tax jurisdictions. The Kentucky Constitution limits property tax rates in counties (50 cents per $100 of assessed value), municipalities (75 cents to $1.50 per $100 of assessed value depending on population size), and special tax districts (50 cents per $100 of assessed value).[58] By statute, the property tax rate in school districts to $1.50 per $100 of assessed value.[59] With voter approval, the Kentucky Constitution allows counties to exceed the limit, with voter approval, an extra property tax of 20 cents per $100 of value per year to fund public roads.[60] Cities and counties may also levy, again with voter approval, a special property tax in addition to the statutory limit.[61]

While total real property tax revenue is restricted to revenue year over year growth of 4%, and property tax rates are restricted, property *tax rates* may fluctuate considerably, whether as a result of a housing downturn or underassessment by Property Valuation Administrators. For example, real property tax rates in Bellevue, Kentucky--which has always taken the maximum 4% revenue increase allowed by House Bill (HB) 44—have increased more than 4 percent on 3 occasions since 2001, all during years in which assessment roles declined in value year over year (see Table 4).

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52 "Local Mandate Fiscal Impact Estimate," Kentucky Legislative Research Commission, 2013 Regular Session. www.lrc.ky.gov/record/13rs/HB317/LM.doc

53 KRS 132.010. "Definitions for Chapter." http://www.lrc.ky.gov/statutes/statute.aspx?id=42716

54 KRS 132.010(6). "Definitions for Chapter." http://www.lrc.ky.gov/statutes/statute.aspx?id=42716

55 *Ibid.*

56 KRS 132.017. "Recall petition – Requirements and procedures – Reconsideration – Election – Second billing." http://www.lrc.ky.gov/statutes/statute.aspx?id=28200

57 *Ibid.*

58 Kentucky Constitution, Section 157, "Maximum tax rate for cities, counties, and taxing districts." http://www.lrc.state.ky.us/legresou/constitu/157.htm

59 KRS 160.475. "Ad valorem tax levy for school purposes – Maximum rates – Subdistrict taxes abolished." http://www.lrc.ky.gov/statutes/statute.aspx?id=3744

60 Kentucky Constitution, Section 157A, "Credit of Commonwealth may be loaned or given to county for roads – County may vote to incur indebtedness and levy tax for roads." http://www.lrc.state.ky.us/legresou/constitu/157a.htm

61 *Ibid.*

Table 4
Real Property Tax Rates and Assessed Value: City of Bellevue, Kentucky[62]
(2001–2014)

Year	Tax Rate (cents per $100)	YoY Tax Rate Change	Assessed Value (actual)	YoY Assessment Value Change
2001	2.75	-	$ 176,329,700	-
2002	2.78	1.1%	$ 180,967,500	2.6%
2003	3.07	10.4%	$ 174,674,800	-3.5%
2004	2.68	-12.7%	$ 208,254,600	19.2%
2005	2.56	-4.5%	$ 228,084,000	9.5%
2006	2.55	-0.4%	$ 239,224,600	4.9%
2007	2.60	2.0%	$ 282,995,200	18.3%
2008	2.32	-10.8%	$ 334,407,300	18.2%
2009	2.45	5.6%	$ 334,329,500	0.0%
2010	2.53	3.3%	$ 345,310,500	3.3%
2011	2.63	4.0%	$ 353,434,000	2.4%
2012	2.73	3.8%	$ 355,223,000	0.5%
2013	2.90	6.2%	$ 353,049,800	-0.6%
2014	3.06	5.5%	$ 350,629,700	-0.7%

There is evidence suggesting that underassessment of the value of real property is commonplace in Kentucky.[63] In 1914, one academic study estimated Kentucky's property assessments were approximately half of market value.[64] A recent econometric analysis suggested that throughout Kentucky residential property was assessed at 75% of its market value. Rural properties were under-assessed, with only 69% of market value being captured by Property Valuation Administrators on average, while urban properties were assessed at 79% of their market value on average. The author of that study hypothesized under-assessment could be attributed to the lack of training among Property Valuation Administrators in Kentucky, especially in rural areas.[65]

Kentucky's assessment process is complicated, but House Bill (HB) 44 has successfully reduced state-level real property tax rates since its passage in 1978. In 1977, the state real property tax rate was 31.5 cents per $100 of assessed value. By 2015, the state real property tax rate had fallen to 12.2 cents per $100 of assessed value.[66] In 2015, Kentucky's mean effective property tax rate of 0.85% on owner-occupied housing was the 13th lowest in the country according to the Tax Foundation.[67] In 2014, real property tax rates on homes, apartments, and commercial property in Louisville, Kentucky, the 30th most populous city in the country in 2014, were consistently below the national average but also consistently in the top 50 highest cities in the country.[68,69]

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[62] Source: "Historic Perspective," Bellevue, News and Events, September 8, 2015. http://bellevueky.org/explaining-property-tax-increase/
[63] Brian Smith, "Do Property Assessors in Kentucky Value Residential Property at Fair Market Value," University of Kentucky, Martin School of Public Policy and Administration, April 2007. http://www.martin.uky.edu/centers_research/Capstones_2007/Smith.pdf
[64] Anna Youngman, "The Revenue System in Kentucky: A Study in Finance," The Quarterly Journal of Economics, Vol. 32, Nol. 1 (Nov., 1917), pp. 142-205, Oxford UP. http://www.jstor.org/stable/pdf/1885082.pdf?acceptTC=true
[65] *Ibid.*
[66] State of Kentucky, "Commonwealth of Kentucky, Tax Expenditure Analysis: Fiscal Years 2016 – 2018," Governor's Office for Economic Analysis and Office of State Budget Director. http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf
[67] Jared Walczak, "How High Are Property Taxes in Your State?" Tax Foundation, August 13, 2015. http://taxfoundation.org/blog/how-high-are-property-taxes-your-state
[68] U.S. Census Bureau
[69] "50-State Property Tax Comparison Study," Lincoln Institute, Minnesota Center for Fiscal Excellence, April 2015. https://www.lincolninst.edu/pubs/dl/3550_2891_Pay_2014_PT_Report.pdf

2. Intangible Personal Property Taxation in Kentucky

Kentucky defines intangible personal property as "stocks, mutual funds, money market funds, bonds, loans, notes, mortgages" and other financial instruments.[70,71] Prior to January 1, 2006, all residents of Kentucky were required to pay taxes on intangible personal property. Some out-of-state intangible personal property was subject to taxation, such as out-of-state corporate and municipal bonds, accounts receivable held by Kentucky taxpayers (both individual and corporate) and trusts whose current beneficiaries resided in Kentucky, while some out-of-state intangible personal property, such as United States government bonds was exempt from intangible personal property taxation.[72] Some in-state intangible personal property was subject to taxation, such as bonds issued by Kentucky-based corporations, churches, while some in-state intangible personal property was exempt from taxation, such as state, municipal and school bonds issued in or by the state of Kentucky.[73]

The removal of intangibles from the property tax in Kentucky resulted from a decision in the Kentucky Supreme Court. In 1997, *St. Ledger v. Commonwealth of Kentucky, Revenue Cabinet*, the Supreme Court of Kentucky ruled two of Kentucky's intangible property taxes, the Bank Deposits Tax and Corporate Shares taxes unconstitutional on the basis they violated the Interstate Commerce Clause and Kentucky's constitution provision for tax exemption, respectively.[74] Kentucky levied its Bank Deposit Tax at a higher rate on deposits held out-of-state than on deposits held in accounts located in Kentucky, a violation of the Interstate Commerce Clause. The basis for this ruling had precedence in a similar case in North Carolina, *Fulton Corp. v. Faulkner*.

The second tax on intangible personal property under scrutiny in *St. Ledger* was the Corporate Share Tax.[75] Kentucky levied a property tax on corporate stock owned by Kentucky residents at a rate of $0.25 per $100 of market value. The Court deemed the Corporate Share Tax double-taxed Kentucky residents. Under Kentucky's Exemption Statute, a tax exemption for the shareholders of stock in corporations that paid taxes in Kentucky on at least 75% of their total property. While all property was subject to taxation in the Kentucky Constitution at the time and the General Assembly could not exempt certain classes under Section 170 of the Constitution, had the Exemption Statute been struck down under existing law, the profits of corporations and the shares of those corporations held by citizens of Kentucky would have been taxed—a clear case of double taxation, which the Kentucky Supreme Court and the General Legislature deemed was not in the spirit of Kentucky law. The Court noted that "While the Constitution requires that all property shall be taxed (Constitution, Section 171) and the General Assembly is prohibited from exempting any property by section 170 of the Constitution, it is not required that every phase of property shall be taxed. Nor is it. Nor has it ever been." Additionally, the Court ruled that such an instance of double taxation would have been an additional violation of the Interstate Commerce Clause.[76]

The Supreme Court of Kentucky ruled that, since both taxes were deemed unconstitutional, "some type of refund [to taxpayers who paid the relevant taxes] under these circumstances as a matter of state law, independent of due process requirements.[77] As a result of *St. Ledger*, 100,000 taxpayers received intangible property tax refunds that totaled $143 million in tax and $40 million in interest from the Kentucky Department of Revenue.[78]

In 1998, the Kentucky Constitution was amended to allow the General Assembly to exempt any other class of personal property from any and all property taxation.[79,80] Effective January 1, 2006, Kentucky no longer taxed most intangible

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[70] Source: *Ibid.*

[71] For a complete list of what Kentucky defines as intangible personal property, see Sommer and Loyd.

[72] "Instructions: Intangible Personal Property Tax Return (Revenue Form 62A376)," Kentucky Department of Revenue. http://revenue.ky.gov/nr/rdonlyres/320e1e77-4901-428d-b6bd-1366ec68b83e/0/62a376i.pdf

[73] *Ibid.*

[74] "St Ledger v. Commonwealth Revenue Cabinet," Find Law Online, Supreme Court of Kentucky, Decided: January 30, 1997. http://caselaw.findlaw.com/ky-supreme-court/1323265.html#sthash.MwgMUQ0R.dpuf

[75] *Ibid*

[76] *Ibid.*

[77] "St Ledger v. Commonwealth Revenue Cabinet," Find Law Online, Supreme Court of Kentucky, Decided: January 30, 1997. http://caselaw.findlaw.com/ky-supreme-court/1323265.html#sthash.MwgMUQ0R.dpuf

[78] "Settlement Reached in Intangible Tax Refund Case," Kentucky Department of Law, 1997. http://governors.e-archives.ky.gov/_govpatton/search/pressreleases/1997/taxrefnd.htm

[79] "Kentucky Property Tax Exemptions, Amendment 2 (1998)," Ballotpedia. https://ballotpedia.org/Kentucky_Property_Tax_Exemptions,_Amendment_2_%281998%29

[80] Amendment 2 also permitted the General Assembly to exempt motor vehicles from property taxation. The homestead property tax exemption was also extended to persons who are considered disabled by the standards of any public or private retirement program.
Source: *Ibid.*

personal property, though financial institutions are still subject to some taxes.[81,82] The exemption of intangible property from the property tax base has substantially limited the potential for double taxation of property in the state of Kentucky.

3. Tangible Personal Property Taxation in Kentucky

Kentucky defines tangible personal property as "moveable property that has not become affixed to real property that may be seen, felt or touched" such as vehicles or office furniture.[83] Only tangible personal property located in the state of Kentucky is subject to tangible personal property taxation.[84]

By statute, "a written law by a legislative body," Kentucky allows tangible personal property to be taxed or to be exempt from taxation in the following six jurisdictions: state, county, city, school district, fire district and special district.[85,86,87] In 1998, section 172 of the Kentucky Constitution was amended to grant the General Assembly the power to exempt any class of personal property.[88] To revise a statute in Kentucky requires a bill to be passed by at least two-fifths of the members of the chamber (40 of 100 House members and 16 of 38 members of the Senate).[89]

All tangible personal property may be classified on the basis of whether it is (a) exempt from tangible personal property taxation and (b) if subject to tangible personal property taxation, at what rate and by which level tax jurisdiction.[90] Complete information of tangible personal property tax rates on all items subject to tangible personal property taxes at the state and local level in Kentucky can be found in the appendix (see page 73).

a. **Full Tangible Personal Property Exemption at State and Local Levels:** Under Section 170 of the Kentucky Constitution the following tangible personal property is a sample of the property exempt from taxation: all tangible personal property owned by the government and religious institutions, entirely charitable institutions, non-profit educational institutions, public libraries, and crops grown in the year of assessment and held by the grower.[91] The Constitution also grants cities the authority to exempt factories and related tangible personal property from property taxation for five years. Personal household goods are exempt~~ion~~ by the Constitution as well. By statute, 25 domestic fowl for each family are also exempt from property taxation.[92]

b. **Tangible Personal Property Taxed at the State Level Only:** Kentucky Revised Statute 132.200 sets forth the items that are subject to the tangible personal property tax only at the state level. Such items include farm implements and machinery, raw materials and work in progress, a variety of vehicles used in commerce, and equipment used in a wide variety of productive capacities.[93] With the exception of business inventory held for export that is located in a foreign trade zone (FTZ) tangible personal property is also subject to taxation at the state level only.[94] Foreign trade zones are "secure areas under U.S. Customs and Border Protection supervision" that are "the United States'

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81 In 2016, only eight states levied taxes on intangible personal property in some manner. Those states were: Alabama, Iowa, Louisiana, Mississippi, North Carolina, South Dakota, Tennessee and Texas.
Source: Jared Walczak, Scott Drenkard, and Joseph Henchman, "2016 State Business Tax Climate Index," Tax Foundation, November 17, 2005. http://taxfoundation.org/article/2016-state-business-tax-climate-index

82 For example, banks are still taxed at the state & local level s on demand and time deposits they hold.

83 Mark F. Sommer and Mark A Loyd, *ABA Property Tax Deskbook.* https://www.bgdlegal.com/clientuploads/Kentucky%20Property%20Tax%20chapter.pdf

84 "2015 Personal Property Tax Forms and Instructions," Kentucky Department of Revenue, Office of Property Valuation. http://revenue.ky.gov/NR/rdonlyres/02941EE2-ECCD-4E6F-8432-0FB39F11CAB1/0/62A500P2015revised72915.pdf

85 State of Kentucky, "Commonwealth of Kentucky, Tax Expenditure Analysis: Fiscal Years 2016 – 2018," Governor's Office for Economic Analysis and Office of State Budget Director. http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf

86 Definition of "statute," Oxford Dictionary, American English. http://www.oxforddictionaries.com/us/definition/american_english/statute

87 Save for several constitutionally-mandated tangible personal property exemptions as described in the subsection below, "Tangible Personal Property Taxed at Full State and Local Rates."

88 Mark F. Sommer and Mark A Loyd, *ABA Property Tax Deskbook.* https://www.bgdlegal.com/clientuploads/Kentucky%20Property%20Tax%20chapter.pdf

89 "How a Bill Becomes a Law," Kentucky Legislature. http://www.lrc.ky.gov/legproc/how_law.htm

90 *Ibid.*

91 For a complete list of exemptions listed in the Kentucky Constitution, see the following source:
http://www.lrc.ky.gov/legresou/constitu/170.htm

92 KRS 132.190 (1). "Property subject to taxation – Situs." http://www.lrc.ky.gov/statutes/statute.aspx?id=28233

93 KRS 132.200. "Property subject to state tax only." http://www.lrc.ky.gov/Statutes/statute.aspx?id=42718

94 "FactSheet: U.S. Foreign Trade Zones—Kentucky Tax Advantages," Cabinet for Economic Development. https://www.thinkkentucky.com/kyedc/pdfs/usftznky.pdf

version of what are known internationally as free-trade zones." Tangible personal property of qualifying pollution control facilities is subject to taxation at the state level only.[95]

c. **Tangible Personal Property Taxed at Full State and Local Rates:** most items not listed in Kentucky Revised Statute (KRS) 132.200 fall under this situs, including motor vehicles, (except certain motor vehicles exempt from local tangible personal property taxation) commercial aircraft, non-Kentucky registered watercraft (commercial and non-commerical); federally documented vessels for hire; retail and wholesale inventory and manufacturer's finished inventories, computer equipment, collectibles, business furniture and fixtures, professional trade tools and equipment, research libraries; signs and billboards, radio and television towers, drilling, mining and construction equipment, precious metals and mobile homes.[96]

d. **Tangible Personal Property Taxed at Full State but Only at a Limited Local Rate:** refers to tangible personal property which is subject to tangible personal property taxation at the state level and a limited tangible personal property tax at the city and county levels under Kentucky Revised Statute (KRS) 132.200(6). Items subject to this classification are all unmanufactured agricultural products, such as tobacco and other farm products that are not in the possession of a manufacturer, grower, or grower's agent at the time of assessment.[97]

Goods-in-Transit: Since 2000 Kentucky has exempted personal property "held in a warehouse or distribution center for the subsequent shipment to an out-of-state destination" from state property taxes.[98] This is referred to as the Goods-in-Transit exemption. To qualify for the Goods-in-Transit exemption the owner must demonstrate that the personal property will be shipped out of state within the next (6) months. The Goods-in-Transit exemption was extended to cities, counties, charter counties, urban-counties, and school districts beginning in 2002.[99] However, fire districts and other special districts are not required to exempt property under the Goods-in-Transit exemption. In 2012, there were an estimated 27 special districts with the authority to levy ad valorem taxes.[100]

In 1982, Kentucky's General Assembly enacted legislation that allowed local jurisdictions to increase the property tax rate on tangible personal property up to the point where the rate of increase in tangible property tax revenues collected could not exceed the rate of increase in real property revenues, with a maximum of a 4% increase.[101]

Kentucky taxes tangible personal property at varying rates depending on the type of property (see appendix for full 2015 rates on property in all taxing jurisdictions). For example, raw materials are taxed at a state rate of $0.05 per $100 valuation and are exempt from local taxation.[102] Manufacturing machinery is taxed at a rate of $0.15 per $100 valuation at the state level and is exempt from taxation at the local level.[103] Business furniture and computer equipment is taxed at a rate of $0.45 per $100 value at the state level and is not exempt from local tangible property tax taxation. According to Kentucky's Cabinet for Economic Development, aggregate local tax rates for tangible property taxes vary, "averaging $0.45 per $100 of assessed market value among the 120 counties [the total number of counties in Kentucky]

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[95] For additional information on tangible personal property subject to property taxation at the state level only, refer to:
Source: "2016 Personal Property Tax Forms and Instructions," Commonwealth of Kentucky, Department of Revenue. https://boonepva.ky.gov/2016%20tangible%20tax%20form.pdf

[96] Mark F. Sommer and Mark A Loyd, *ABA Property Tax Deskbook.* https://www.bgdlegal.com/clientuploads/Kentucky%20Property%20Tax%20chapter.pdf

[97] "2015 Personal Property Tax Forms and Instructions," Commonwealth of Kentucky, Department of Revenue. http://revenue.ky.gov/NR/rdonlyres/02941EE2-ECCD-4E6F-8432-0FB39F11CAB1/0/62A500P2015.pdf

[98] KRS 132.097 "Exemption from state ad valorem tax of personal property held for shipment out of state." http://www.lrc.ky.gov/statutes/statute.aspx?id=28221

[99] KRS 132.099 "Local taxation of personal property for shipment out of state." http://www.lrc.ky.gov/statutes/statute.aspx?id=40056

[100] Adam H. Edelen, "Ghost Government – A Report on Special Districts in Kentucky," Kentucky State Auditor of Public Accounts, November 14, 2012. http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2012GhostGvoernmentSpecialDistrictsreport.pdf

[101] State of Kentucky, "Commonwealth of Kentucky, Tax Expenditure Analysis: Fiscal Years 2016 – 2018," Governor's Office for Economic Analysis and Office of State Budget Director. http://osbd.ky.gov/Publications/Documents/Special%20Reports/Tax%20Expenditure%20Analysis%20Fiscal%20Years%202016-2018.pdf

[102] "FactSheet: Kentucky Business Taxes," Cabinet for Economic Development, December 2015. https://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf

[103] *Ibid.*

and $0.2863 per $100 of value in the 299 cities that levy the tax."[104] According to the Kentucky Department of Revenue, the weighted average state and local tangible property tax rate is $0.64 cents per $100 of assessed market value.[105]

4. Revenue Implications of Kentucky's Property Tax

As a share of total tax revenues, revenues from property taxes have declined since 1793, when property tax revenues were over 86% of state revenue.[106] In FY2015, total property tax collections of $563.4 million accounted for 6% of state revenue.[107]

In Kentucky, state property tax revenues increased from 3.3% of state tax revenue in 1972 to 5.0% of state tax revenue in 2012 (see Table 5). Among all states, state property taxes as a share of total state tax revenue decreased from 2.1% in 1972 to 1.6% in 2012. As a share of GSP, Kentucky's state property taxes were 0.2% of GSP in 1972 and 0.3% of GSP in 2012. Among all states, property taxes were 0.1% of GSP in 1972 and 2012.

Table 5

Kentucky and the United States:
State Property Taxes as a Share of State Taxes and Gross State Product[108,109]
(dollars = thousands, 1972 and 2012)

	1972				2012			
	Total State Taxes	State Property Taxes	State Property Taxes % of Total State Taxes	State Property Taxes % of GSP	Total State Taxes	State Property Taxes	State Property Taxes % of Total State Taxes	State Property Taxes % of GSP
Kentucky	860,927	28,477	3.3%	0.2%	10,505,794	529,567	5.0%	0.3%
United States	59,870,369	1,257,173	2.1%	0.1%	797,953,030	13,110,672	1.6%	0.1%

As a share of local taxes, local property tax revenues in Kentucky decreased from 70.7% of state tax revenue in 1972 to 57.5% of state tax revenue in 2012 (see Table 6). Among all states, local property taxes as a share of total state tax revenue decreased from 83.7% in 1972 to 73.6% in 2012. As a share of GSP, local property taxes were 1.3% of GSP in 1972 and 1.5% of GSP in 2012. Among all states, property taxes were 3.3% of GSP in 1972 and 2.7% of GSP in 2012.

Table 6

Kentucky and the United States:
Local Property Taxes as a Share of Local Taxes and Gross State Product[110,111]
(dollars = thousands, 1972 and 2012)

	1972				2012			
	Total Local Taxes	Local Property Taxes	Local Property Taxes % of Total Local Taxes	Local Property Taxes % of GSP	Total Local Taxes	Local Property Taxes	Local Property Taxes % of Total Local Taxes	Local Property Taxes % of GSP
Kentucky	305,219	215,921	70.7%	1.3%	4,524,196	2,600,687	57.5%	1.5%
United States	49,733,769	41,620,016	83.7%	3.3%	589,963,273	434,009,448	73.6%	2.7%

104 "FactSheet: Kentucky Business Taxes," Cabinet for Economic Development, December 2015. https://www.thinkkentucky.com/kyedc/pdfs/KYBusinessTaxes.pdf
105 Source: "2015 Property Tax Handbook," Kentucky Department of Revenue, 2015.
106 Source: *Ibid*.
107 Source: *Ibid*.
108 Source: U.S. Census Bureau, State & Local Finances.
109 Source: Bureau of Economic Analysis.
110 Source: U.S. Census Bureau, State & Local Finances.
111 Source: Bureau of Economic Analysis.

C. APPENDIX

1. State of Kentucky: 2015 Personal Property Tax Forms and Instructions

COMMONWEALTH OF KENTUCKY
DEPARTMENT OF REVENUE
OFFICE OF PROPERTY VALUATION
DIVISION OF STATE VALUATION
FOURTH FLOOR, STATION 32
501 HIGH STREET
FRANKFORT, KENTUCKY 40601-2103

62A500 (P) (11-14)

2015
PERSONAL PROPERTY TAX FORMS
AND
INSTRUCTIONS

* * * * * * * * * * * * * * *

This packet contains forms and instructions for filing your 2015 tangible personal property tax return.

Please:

- File with the Property Valuation Administrator of the county of taxable situs (see pages 9 and 10) or Department of Revenue by May 15, 2015. All returns postmarked ***after*** May 15, 2015, will be assessed for the tax plus applicable penalties and interest by the Department of Revenue.
- **THERE IS NO FILING EXTENSION PROVISION FOR TANGIBLE PERSONAL PROPERTY TAX RETURNS.**
- Tangible personal property tax returns filed after May 15, 2015, will not be allowed a discount.
- **Enter your Social Security or Federal Employer Identification Number** on all returns, schedules, attachments and correspondence.
- **Staple all pages of each return together.**
- **Sign all returns and list appropriate telephone numbers and an email address (if applicable).**
- **DO NOT FILE** personal property tax returns with the income tax return.
- **DO NOT SEND PAYMENT WITH THE RETURN.** Timely filed tangible returns will be billed no earlier than September 15 and are payable to the county sheriff. Returns filed after the due date are billed by the Division of State Valuation.

Should you have any questions regarding the tangible personal property tax returns, please do not hesitate to contact the Division of State Valuation at (502) 564-2557. Go to **www.revenue.ky.gov** to download forms.

Kentucky
UNBRIDLED SPIRIT

What's New

Housebill 301 amends KRS 132.200 as follows:

Effective January 1, 2015, recreational vehicles, as defined by KRS 132.010, held for sale in a retailer's inventory are subject to a state rate only.

List these on Line 34 of this Form (62A500).

Kentucky Department of Revenue Mission Statement

As part of the Finance and Administration Cabinet, the mission of the Kentucky Department of Revenue is to administer tax laws, collect revenue, and provide services in a fair, courteous, and efficient manner for the benefit of the Commonwealth and its citizens.

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The Kentucky Department of Revenue does not discriminate on the basis of race, color, national origin, sex, age, religion, disability, sexual orientation, gender identity, veteran status, genetic information or ancestry in employment or the provision of services.

INSTRUCTIONS

TANGIBLE PROPERTY TAX RETURNS
(REVENUE FORMS 62A500, 62A500-A, 62A500-C, 62A500-L , 62A500-S1, 62A500-W and 62A500–MI)

Definitions and General Instructions

The tangible personal property tax return includes instructions to assist taxpayers in preparing Revenue Forms 62A500, 62A500-A, 62A500-C, 62A500-L, 62A500-S1, 62A500-W and 62A500-MI. These instructions do not supersede the Kentucky Constitution or applicable Kentucky Revised Statutes.

Taxpayer—All individuals and business entities who own, lease or have a beneficial interest in taxable tangible property located within Kentucky on January 1 **must** file a tangible property tax return. All tangible property is taxable, except the following:

- personal household goods used in the home;
- crops grown in the year which the assessment is made and in the hands of the producer;
- tangible personal property owned by institutions exempted under Section 170 of the Kentucky Constitution.

The tangible return and instructions do not apply to real property, registered motor vehicles, apportioned vehicles or the following classes of property which should be reported to the Public Service Branch:

Commercial aircraft.
Commercial watercraft.
Distilled spirits held in bonded warehouses.
Public Service Companies taxed under the provisions of KRS 136.120.
Communications Service Providers.
Multi-Channel Video Programming Service Providers.

Report Commercial Aircraft on Form 61A206.

Report Commercial Watercraft on Form 61A207.

Report Distilled Spirits in bonded warehouses on the Annual Report of Distilled Spirits in Bonded Warehouses, Form 61A508.

Report Public Service Companies on the Public Service Tax Return, Form 61A200.

Report Communications Service Providers and Multi-Channel Video Programming Service Providers on Form 61A500.

Communications Service Providers and Multi-Channel Video Programming Service Providers are required to report property taxed under KRS 132 on Form 61A500. This includes:

- All telephone companies (including paging services)
- All cable television companies
- All Direct Broadcast Satellite (DBS) companies
- Wireless cable Direct Broadcast Companies
- Voice Over Internet Protocol (VOIP)
- Internet Protocol Television Service (IPTV)

Assessment Date—The assessment date for all tangible personal property is January 1.

Situs of Tangible Property—The taxable situs of tangible personal property in Kentucky is in the county where the property is physically located on January 1.

Filing Requirements—To properly report, note the following:

- Kentucky does not allow consolidated and joint returns.
- File a tangible property tax return for **each property location** within Kentucky.
- The return **must include** the property location by street address and county. A post office box is not acceptable as the property address.
- File the return between January 1 and May 15. If May 15 falls on a weekend, the return is due the first business day following May 15. Use the appropriate year form for the assessment date.
- **Do not enclose the tangible return with the income tax return.**
- File the return with the Property Valuation Administrator (PVA) in the county of taxable situs or with the Division of State Valuation. See pages 9 and 10 for a complete listing of mailing addresses.
- **THERE IS NO FILING EXTENSION FOR THIS RETURN.**

Payment of Taxes— Do Not Send Payments With Your Return. The sheriff in each county mails the tax bills no earlier than September 15. Returns filed after the due date are billed by the Division of State Valuation.

Classification of Property—Real property includes all lands within this state and improvements thereon. Tangible personal property is every physical item subject to ownership, except real and intangible property.

Lessors and Lessees of Tangible Personal Property—Leased property must be listed by the owner on Revenue Form 62A500, regardless of the lease agreement's terms regarding tax liability. ***Classify leased assets based upon their economic life.*** If the lessee is obligated to purchase the property (i.e., capital lease), he is deemed the owner and is required to list such property. If the lease terms do not obligate the lessee to purchase the property (i.e., operating lease), the lessor is deemed to be the owner and is required to list such property. The tax return must contain the name of the lessee and location of property. The lessee must file Revenue Form 62A500–L.

Property leased to Communications Service Providers and Multi-Channel Video Programming Service Providers under an operating lease must be reported on Form 62A500 by the lessor.

Tangible property leased to local governmental jurisdictions is exempt from state and local tax under the Governmental Leasing Act. Tangible property leased to any other tax–exempt entity must be reported by the lessor. Tangible property leased from tax–exempt entities by nonexempt lessees must be reported by the lessee.

Depreciable Assets—List depreciable assets on the appropriate schedule(s) at original cost. Apply appropriate factor(s) to obtain reported value. Do not use book depreciation for computing the fair cash value of depreciable assets. For tangible property tax purposes, assets are never fully depreciated and must be reported. Noncommercial aircraft and federally documented watercraft (boats) should be categorized and listed on the appropriate forms. However, they are not depreciable pursuant to Schedule A or B factors. See line-by-line instructions for details.

Manufacturing Machinery—List machinery actually engaged in the manufacturing process, whether owned or leased, on Revenue Form 62A500, Schedule B. Manufacturing begins at the point the raw material enters a process and is acted upon to change its size, shape or composition and ends when the product is in saleable condition. **All activities preceding the introduction of the raw material into the manufacturing process and following the point at which the finished product is packaged or ready for sale are not manufacturing activities. Examples include engineering, maintenance, inspection, and quality control conducted independent from the manufacturing process.**

Inventories—List inventories at fair cash value using full absorption first-in-first-out (FIFO) costing. Such costs include freight, labor, taxes and duties. LIFO deductions are not allowable. See line 31 instructions for details. The owner of consigned manufacturing or merchandising inventory must list the property. Kentucky merchants must list merchandise consigned by a nonresident on the Consignee Tangible Personal Property Tax Return, Revenue Form 62A500-C. For consignee reporting requirements, see the instructions for Revenue Form 62A500-C.

Automobile dealers must report **all** vehicles whether new, used, dealer assigned, titled, untitled, registered, or unregistered held for sale as motor vehicle inventory. Vehicles titled to dealers for their personal use are the only exception. List these vehicles on Form 62A500, Schedule C. All new vehicles are valued at the dealer's cost and used vehicles are valued at the NADA clean trade-in value. Include a list of motor vehicles with the 62A500-S1 return. The list must include make, model, year, Kentucky license plate number, if applicable, and vehicle identification number (VIN).

Farming Equipment and Livestock—Farm implements, farm machinery and livestock owned by, or leased to, a person actually engaged in farming should be reported on Form 62A500. See line 50 instructions for details.

Foreign Trade Zones—Tangible property located within an **activated** foreign trade zone, as designated under Title 19 U.S.C. Sec. 81, is subject to a state rate only. The business must file a tangible return to claim Foreign Trade Zone status. Attach a copy of the foreign trade zone certificate.

Pollution Control Facility—Tangible property of a qualifying pollution control facility is subject to a state rate only. A taxpayer must have an approved pollution control exemption certificate issued by the Kentucky Department of Revenue, Division of Sales and Use Tax, using Form 51A149. This must be approved by the January 1st assessment date. List qualifying property on Form 62A500, Schedule B.

Industrial Revenue Bonds—Tangible personal property owned and financed by a tax-exempt governmental unit or tax-exempt statutory authority, as defined under KRS 103.200, is subject to a state rate only. This includes all privately owned leasehold interests in industrial buildings owned and financed by a tax-exempt governmental unit or tax-exempt statutory authority. Report property value on Form 62A500, line 39. See line-by-line instructions for details.

Rebuilds or Capitalized Repairs—Cost figures for rebuilt equipment must be segregated according to "original" and "rebuild" costs and listed under two economic life classes on the tangible personal property tax return. The original cost of all assets is included in the year of acquisition in the appropriate class life. Any rebuild(s) capitalized for book or tax purposes are to be entered in the appropriate class life for the expected life of the rebuild. If a second rebuild occurs, the second rebuild is again included in age 1 of the appropriate class for the expected life of that rebuild. The first rebuild is then deleted from the original cost column and dropped from the valuation process.

Exceptions to the Fair Cash Value Computation

Taxable property inoperable and held for disposal as of the assessment date may be valued separately. List this property on Schedule C and include an affidavit explaining the circumstances and the basis for valuation. Such property is valued as follows:

- if component parts have been removed and the remainder is useless to the business, report the actual scrap or salvage value; or
- if a visual inspection confirms that useful life has not ended, the true value is the greater of its depreciated book value or the actual salvage value; or
- property sold on or before the due date of the return through a proven arm's length transaction, is reported at the selling price.

Temporary idleness is not sufficient cause for separate valuation. This includes idleness attributed to seasonal operation or from repair or overhaul of equipment. Idled equipment no longer actually engaged in manufacturing is deemed to be Schedule A property and subject to full local rates.

Listing and Valuing Tangible Personal Property

List depreciable property on Form 62A500, Schedule A or B, based on its economic life. To assist taxpayers in determining proper economic life classification a partial listing of North American Industrial Classification System (NAICS) codes is included. Property descriptions frequently used in these specific industries are listed under each code. Most businesses have property falling into more than one economic life classification. **Use the chart as a general guide.**

An asset listing of each item of property must be available to the Department of Revenue upon request. The asset listing should include original cost, make, model, serial number and/or other identification numbers.

Fair Cash Value Computation

The fair cash value computation begins with cost. Cost must include inbound freight, mill-wrighting, overhead, investment tax credits, assembly and installation labor, material and expenses, and sales and use taxes. Premium pay and payroll taxes are included in labor costs. Costs are not reduced by trade-in allowances. Capitalize costs of major overhauls in the year in which they occur.

Cost should be net of additions, disposals and transfers occurring during the year. Multiply aggregate cost by the applicable conversion factor to determine reported value. The column totals represent the total original cost and total reported value of each class of property. Original cost totals must generally reconcile with the book cost. **NOTE: Property written off the records, but still physically on hand, must be included in the computation.**

GENERAL INFORMATION
Revenue Form 62A500

Alternative Reporting Requirement

Tangible property should be reported using the composite factors, methods, and guidelines provided with Form 62A500.

If a taxpayer believes the composite factors in the return have overvalued or undervalued the property, the taxpayer may petition the Department of Revenue to accept an alternative reporting method. The taxpayer must file the return and affidavit of alternative valuation with the **Division of State Valuation, not the local PVA.** The affidavit must include a proposed alternative valuation method, justification of the method chosen, detailed documentation, including, but not limited to: independent appraisals, actual production, and sales and usage reports, that support the proposed method. **Accepting the alternative valuation method as filed in order to expedite the processing of the return, does not affect the department's right to eventually audit the return and the method used.**

For valuation information or assistance in filing this return, contact the PVA in your county (see the addresses and telephone numbers in these instructions) or the Division of State Valuation at (502) 564-2557. Go to **www.revenue.ky.gov** to download forms.

General Information—The following information is required to accurately process the return.

- Social Security number or Federal Employer Identification Number;
- NAICS code that most closely identifies your business activity;
- type of business activity;
- tangible personal property listings in other Kentucky counties (check appropriate box);
- name and address of business;
- **property location (street address);**
- county where the property is physically located;
- organization type (check appropriate box); and
- taxpayer signature, email, and telephone number and the preparer's (other than taxpayer) name and contact information at the bottom of Form 62A500, Schedule C.

Failure to properly complete the general information section may result in omitted property notices, subject to penalties and interest.

Instructions for Lines 11–16 and 21–26 (Depreciable Assets)

Schedule A property includes, but is not limited to:

- business furniture and fixtures;
- professional trade tools and equipment;
- signs and billboards;
- drilling, mining and construction equipment;
- computers and related pheripheral equipment; and
- telephone, cable and cellular towers.

Schedule B property includes:

- qualifying commercial radio and television equipment;
- qualified pollution control facilities; and
- manufacturing machinery and computer equipment controlling the machinery; and
- radio and television towers.

Schedules A and B list six economic life classes. **Property is classified by the expected economic life, not the depreciable life used for accelerated income tax purposes.**

The age of property, whether purchased new or used, is determined as follows: property purchased in the year prior to the assessment date is age 1; purchases made 2 years prior are age 2; etc. Assets listed into Classes I, II and III, whose ages exceed the maximum age for each class (13 years), should be aggregated on "Age 13+" of the original cost column. Assets listed into Classes IV and V whose ages exceed the maximum age for each class (27 years) should be aggregated on "Age 27+" of the original cost column. As long as an asset is in use, it is valued using the appropriate factor as determined by its class and age. For Class VI assets whose age is greater than 27 years contact the State Valuation Branch for the appropriate factor.

Multiply the original cost by the conversion factor to arrive at the reported value. Add original costs for each class to determine the total original cost by class. Add reported values for each class to determine the total reported value by class. The column totals for original cost and reported value for each class of property are listed in the space provided for Schedule A and B property on Form 62A500, page 1. The grand total of original cost and reported value for all classes of property are summarized on lines 17 and 27.

All fully depreciated assets must continue to be reported, as long as they are on hand, in the manner described above.

Line-by-Line Instructions

The following describes the various property categories. Report these values on Form 62A500, page 1.

31 *Merchants Inventory*—Merchants inventory represents goods held for sale or machinery and equipment that originated under a floor plan financing agreement. It may include retail goods, wholesale goods, consigned goods and goods held by a distributor. *Attach a separate schedule for machinery and equipment reported as inventory.*

Used Boats Held for Sale by a Licensed Boat Dealer—(A separate schedule, Form 62A500-MI, is included with this instruction package.)

32 *Manufacturers Finished Goods*—Manufacturers finished goods represent products that have been manufactured and are ready for sale or shipment.

33 *Manufacturers Raw Materials*—This group includes raw materials actually on hand at the plant for the purpose of introduction to the manufacturing process. It does not include unmanufactured agricultural products. ***List raw materials not on hand at the plant on line 35.***

Manufacturers Goods in Process—Manufacturers goods in process include inventory that has been acted upon in some manner, but has not completed the manufacturing process.

34 *Motor Vehicles Held for Sale (Dealers Only)*—Motor vehicles held for sale shall be subject to property tax as goods held for sale in the regular course of business and are subject to a state rate only, valued at dealer's cost, if new and NADA clean trade-in value, if used. *(A separate schedule, Form 62A500-S1, is included with this instruction package.)*

Rental Vehicles of a Motor Vehicle Dealer are ***not*** *considered as Inventory*—Nonregisted motor vehicles used in the operation of the motor vehicle dealership such as loaner/rental vehicles used in the service department for customers to drive while services are being rendered on their motor vehicle. These motor vehicles should be registered with the county clerk and property tax paid at that time. Nonregistered rental/loaner motor vehicles should be listed on Schedule A, Class III.

Service department motor vehicles of a motor vehicle dealer along with personal use vehicles are ***not*** *considered as Inventory*—**Nonregistered** pick up motor vehicles, wreckers, towing vehicles, etc. used in the service department of a motor vehicle dealer. These motor vehicles should be registered with the county clerk and property tax paid at that time. Nonregistered service department motor vehicles should be listed on Schedule A, Class III.

Salvage Titled Vehicles (Insurance Companies Only)—Salvage titled motor vehicles held by an insurance company are subject to tax as goods held for sale in the regular course of business and are reported on line 34.

New Farm Machinery Held Under a Floor Plan—New farm machinery and other equipment held in the retailer's inventory for sale under a floor plan financing arrangement by a retailer, are subject to a state rate only.

New Boats and Marine Inventory (Dealers Only)—New boats and new marine inventory held for retail sale under a floor plan financing arrangement by a dealer registered under KRS 235.220 are subject to a state rate only.

Nonferrous Metal located in a commodity warehouse and held on warrant is subject to a state rate only.

Biotechnology Products held in a warehouse for distribution by the manufacturer or affiliate are subject to a state rate only.

Recreational Vehicles, as defined by KRS 132.010, held for sale in a retailer's inventory are subject to a state rate only.

35 *Goods Stored in Warehouse/Distribution Center*—Report personal property placed in a warehouse or distribution center for shipment to a Kentucky destination or held longer than six months on line 35.

36 *Goods Stored in Warehouse/Distribution Center—in Transit*—Personal property placed in a warehouse or distribution center for purposes of further shipment to an out-of-state destination shall be reported on line 36. The owner of the property must demonstrate that the personal property will be shipped out of state within the next six months. Property shipped to in-state destinations or held longer than six months is reported on line 35.

This property classification is exempted from state, county, school and city tax and may be subject to special district taxation.

37 *Unmanufactured Tobacco Products not at Manufacturers Plant nor in the Hands of the Grower or His Agent*—Tobacco grown in the year of assessment is exempt from taxation in that year. Such products still on hand as of January 1 of the following year would be taxable. This property is subject to a state property tax rate and a county/city tax rate.

38 *Other Unmanufactured Agricultural Products not at Manufacturers Plant nor in the Hands of the Grower or His Agent*—Any unmanufactured agricultural products, other than tobacco not in the hands of the manufacturer, grower or the grower's agent, are subject to a state tax rate and a county/city tax rate.

39 *Unmanufactured Agricultural Products at Manufacturers Plant or in the Hands of the Grower or His Agent*—Any unmanufactured agricultural products actually in the hands of the manufacturer, grower or the grower's agent are subject to a state tax rate only.

Industrial Revenue Bond Property—Tangible personal property purchased with an industrial revenue bond (IRB) is subject to taxation at a state rate only. **This rate shall not apply to the portion of value of the leasehold interest created through any private financing**. Upon expiration of the bond, property is fully reportable on Schedules A and B at the appropriate age. The information necessary for calculation of taxable value of IRB property includes the following:

- the amount of the bond,
- the real property assessment,
- the personal property assessment,
- the life of the bond, and
- recipient of the property upon full amortization of the bond.

The valuation of industrial revenue bond personal property contemplates ownership upon full amortization of the bond issue. If the property converts to the private entity upon full amortization, the property is assessed higher as the bond ages and as the private enterprise assumes a greater leasehold interest.

The following example provides the basics of IRB property valuation:

Total industrial revenue bond value	—	$11,000,000
Real property valuation	—	$1,000,000
Life of the bond issue	—	20 Years

The private entity receives the IRB property upon amortization of the issuance.

Total industrial revenue bond	$11,000,000
Less: Real property valuation	($ 1,000,000)
Tangible personal property cost	$10,000,000

All machinery purchased under the IRB must first be segregated and calculated as described for lines 11–16 and 21–26.

Step 1: $10,000,000 X Economic Life Factor = Reported Value

Step 2: Reported Value X Actual Property Age/20 (e.g., life of the IRB)

Step 3: Carry Step 2 result to Form 62A500, line 39.

Conversely, if the tax-exempt statutory authority ultimately receives the property, the assessed valuation for taxation purposes begins at 100 percent and is fully amortized over the life of the bond.

Contact the Division of State Valuation at (502) 564-2557 with questions or for additional information and instruction.

Qualifying Voluntary Environmental Remediation Property—Provided the property owner has corrected the effect of all known releases of hazardous substances, pollutants, contaminants, petroleum, or petroleum products located on the property consistent with a corrective action plan approved by the Energy and Environment Cabinet pursuant to KRS 224.01-400, 224.01-405, or 224.60-135, and provided the cleanup was not financed through a public grant or the petroleum storage tank environmental assurance fund, the property may be reported on Line 39. This rate shall apply for a period of three (3) years following the Energy and Environment Cabinet's issuance of a No Further Action Letter or its equivalent, after which the regular tax rate shall apply.

50 *Livestock and Farm Equipment*—List the fair cash value of all owned or leased farm equipment and livestock. The Miscellaneous Worksheet can be used for depreciation purposes.

60 *Other Tangible Personal Property*—List the totals from Schedule C on Form 62A500, line 60.

Schedule C property includes:

- aircraft for hire (not reported on Form 61A200);
- non-Kentucky registered watercraft (not reported on Form 61A207);
- U.S. Coast Guard documented watercraft used for commercial purposes (not reported on Form 61A207);
- **materials, supplies and spare parts;**
- investment properties such as coin, stamp, art or other collections;
- research libraries; and
- precious metals.

List aircraft for hire on the appropriate line on Schedule C at fair market value.

Materials, supplies and spare parts, normally expensed, must be segregated and valued separately. Any supplies included in inventory should be removed from the inventory value and reported on Schedule C. In all cases, list such property at original cost.

Supply items are valued at original cost in the amount on hand at year-end. Returnable containers, such as barrels, bottles, carboys, coops, cylinders, drums, reels, etc., are valued separately at original cost. In absence of year end totals, use the yearly expense accounts total divided by 12.

List the fair market value of all coin collections, stamp collections, art works, other collectibles and research libraries. List the number of ounces of all gold, silver, platinum and other precious metals. If the market value of a precious metal is known, list the value per ounce as of the preceding December 31 in the Value Per Ounce column. Multiply the number of ounces by the value per ounce to determine the total fair market value.

70 *Activated Foreign Trade Zone*—Tangible personal property located within an activated foreign trade zone as designated under Title 19 U.S.C. Section 81 is subject to taxation at a state rate only. Complete Form 62A500 using the composite conversion factors for depreciable assets.

81 *Construction Work in Progress (Manufacturing Machinery)*—Machinery and equipment that eventually becomes part of the manufacturing process is classified as manufacturing machinery during the construction period. Report such property at original cost.

82 *Construction Work in Progress (Other Tangible Property)*—During the construction period, list all tangible property that does not become part of the manufacturing process on line 82. **NOTE:** Tangible property includes contractor's building components.

90 *Recycling Machinery and Equipment*—List machinery or equipment, not used in a manufacturing process, owned by a business, industry or organization in order to collect, source separate, compress, bale, shred or otherwise handle waste materials if the machinery or equipment is primarily used for recycling purposes (KRS 132.200(15)). *Examples:* balers, briquetters, compactors, containers, conveyors, conveyor systems, cranes with grapple hooks, crushers, densifyers, exhaust fans, fluffers, granulators, lift-gates, magnetic separators, material recovery facility equipment, pallet jacks, perforators, pumps with oil, scales, screeners, shears, shredders, two-wheel carts and vacuum systems. Use the trending factors in the Miscellaneous Worksheet to age the equipment.

Revenue Form 62A500-A

Noncommercial Aircraft — List the serial number, federal registration number, make, year, model, size, power and value of all aircraft owned on January 1. Attach a separate sheet if necessary. Include additional information regarding avionics equipment, engine hours, condition and other documentation that may influence the aircraft value in the space provided. Do not list aircraft assessed as public service company property. **List aircraft used in the business of transporting persons or property for compensation or hire and not assessed as a public utility on Revenue Form 62A500, Schedule C. Taxation is based on the situs of the aircraft, on January 1st or the majority of the year, regardless of the owner's residency.**

Revenue Form 62A500-C

If on January 1 you have in your possession any consigned inventory that is held and not owned by you, you are required to complete this form and report the kind, nature, owner and value of all such inventory. If you are assuming the responsibility for the property taxes on the consigned inventory, you must report the value of such inventory on the tangible personal property tax return appropriate for your business activity. Consigned inventory must be valued using full absorption first-in-first-out (FIFO) costing. LIFO deductions are not allowable. A separate return is required for each location at which consigned goods are located. File the return as an attachment to Revenue Form 62A500.

Revenue Form 62A500-L

All persons and business entities who lease tangible personal property from others (e.g., lessees) are required to file the Lessee Tangible Personal Property Tax Return, Revenue Form 62A500-L. A separate return for each property location is required. File the return as an attachment to Revenue Form 62A500.

Provide all information requested. List the name and address of the lessor and the related equipment information, including the type of equipment, year of manufacture, model, selling price new, gross annual rent, date of the lease, length of the lease and purchase price at the end of the lease. Attach a separate schedule if necessary.

Revenue Form 62A500-W

Documented Watercraft — Boats registered with the United States Coast Guard, sitused in Kentucky, are subject to personal property taxes. These must be listed on the Tangible Personal Property Tax Return (Documented Watercraft), Revenue Form 62A500-W, and filed with the State Valuation Branch or PVA in the county where the boat is sitused. **Taxation is based on the situs of the boat, on January 1st or the majority of the year, regardless of the owner's residency.**

Do not list any commercial watercraft on this return. Commercial watercraft includes federally documented watercraft used in transporting people and/or property for compensation or hire. The documented watercraft classification does not include short-term leases or rentals of recreational watercraft. Documented watercraft used for hire or rented should be reported on Schedule C or with the Public Service Section.

Amended Return Requirement

Taxpayers who discover an error was made on their personal property tax returns can file an amended return along with explanation of why the return is being amended and documentation to support the amended return. Form 62A500 needs to be completed with" AMENDED" written at the top of the form.

Amended returns resulting in a possible refund should be filed within 2 years from the date of payment in accordance with KRS 134.590 and should be accompanied by a refund application (Revenue Form 62A366R). Applications can be obtained by contacting the local Property Valuation Administrator or the Office of Property Valuation, Division of State Valuation.

KRS 134.590 (2) No state government agency shall authorize a refund unless each taxpayer individually applies for a refund within two (2) years from the date the taxpayer paid the tax. Each claim or application for a refund shall be in writing and state the specific grounds upon which it is based.

Property Classification Guidelines

Property is classified by the expected economic life, not the depreciable life used for accelerated income tax purposes. To assist taxpayers in determining proper economic life classification, a partial listing of the North American Industry Classification System (NAICS) codes follows. Property descriptions frequently used in these specific industries are listed under each code. Most businesses have property falling into more than one economic life classification.

GENERAL BUSINESS ACTIVITIES	CLASS
General business purpose integrated computer systems and related peripheral equipment, such as computers, micro-processors, terminals, servers, printers, data entry equipment and pre-written software.	I
General administrative activities involving data handling equipment such as typewriters, calculators, adding and accounting machines, copiers and duplicating equipment, and fax machines.	II
General administrative activities involving the use of desks, file cabinets, communications equipment, security systems, and other office furniture, fixtures and equipment.	III
Only dozers, tractors, off-road trucks and loaders used in mining and construction.	IV

NOTE: There is no single class for computers and related hardware used to control manufacturing processes.

NAICS Code	Business Description	Class
	AGRICULTURE, FORESTRY FISHING AND HUNTING	
	• Logging equipment	III
	• Office furniture and equipment, fork lifts	III
	• Harvesting equipment	III
	• Grain bins	III
111000	Crop production (including greenhouse and floriculture)	
112900	Animal production (including breeding of cats and dogs)	
113000	Forestry and logging (including forest nurseries and timber tracts)	
114110	Fishing	
114210	Hunting and trapping	
	MINING	
	• Belting, continuous miner and roof driller	I
	• Batteries, rockdusters, scoops and shuttle cars	I
	• Below ground belt structure	I
	• Office furniture and equipment, fork lifts	III
	• Supply cars, underground locomotives, mine fans	III
	• Electrical substations, personnel carriers	III
	• Dozers, tractors, loaders, dump trucks, and highwall miners used in the mining business	IV
	• Above ground belt structure	V
	• Coal/mineral processing equipment (used to wash, size and crush)	VI
	• Above-ground locomotives	VI
211110	Oil and gas extraction	
212110	Coal mining	
212200	Metal ore mining	
212300	Nonmetallic mineral mining and quarrying	
	CONSTRUCTION	
	• Office furniture and equipment, fork lifts	III
	• Barricades and warning signs	III
	• Backhoe, unlicensed trailer and wagon	III
	• Trenchers, boring machines, ditch diggers	III
	• Dozers, tractors, off-road trucks and loaders	IV
	• Pulverizers and mixers	V
	• Cranes and mobile offices	V
233110	Land subdivision and land development	
233200	Residential building construction	
233300	Nonresidential building construction	
234100	Highway, street, bridge and tunnel construction	
235110	Plumbing, heating and air-conditioning contractors	
235210	Painting and wall covering contractors	
235310	Electric contractors	
235400	Masonry, drywall, insulation and tile contractors	
235500	Carpentry and floor contractors	
235610	Roofing, siding and sheet metal contractors	
235710	Concrete contractors	
235810	Water well drilling contractors	

NAICS Code	Business Description	Class
	MANUFACTURING	
	• Special tools (including jigs, molds, die cavities)	I
	• Laser cutters	II
	• Production Fork lifts	III
	• Small drill presses and small hydraulic presses	III
	• Heavy equipment (presses, casting machines)	VI
	• Above-ground tanks < = 30,000 gallons	VI
	Food Manufacturing	
	• Juice extractors, peelers and corers, cutters	III
	• Potato chip fryers, slicers and related equipment	III
	• Palletizer, carts, flaking trays	V
	• Dryer, steel bins, extruder, centrifuge MDL, blender	V
	• Cranes	V
311110	Animal food manufacturing	
311200	Grain and oilseed milling	
311300	Sugar and confectionery product mfg.	
311400	Fruit and vegetable preserving and specialty food	
311500	Dairy product mfg.	
311610	Animal slaughtering and processing	
311710	Seafood product preparation and packaging	
311800	Bakeries and tortilla mfg.	
311900	Other food mfg. (including coffee, tea, flavoring and seasonings)	
	Beverage and Tobacco Manufacturing	
	• Casing, control and measuring instruments	III
	• Brewing, blend and dispersion equipment	III
	• Drying and flavor machines	V
	• Fermentation, sterilization equipment and system	VI
312100	Beverages (including breweries, wineries and distilleries)	
312200	Tobacco mfg.	
	Apparel, Textile Mills and Textile Product Mills	
	• Cleaning and micro dust extracting machines	III
	• Laser cutter, microprocessor control equipment	III
	• Boarding, dryers, knitting machines	III
	• Textile mill equipment, except knitwear	V
	• Carding, combing and roving machinery	V
	• Sewing machine, cutter, spreader, tacker	V
313000	Textile mills	
314000	Textile product mills	
315100	Apparel knitting mills	
315210	Cut and sew apparel contractors	
315990	Apparel accessories and other apparel mfg.	
	Leather and Allied Product Manufacturing	
	• Storage racks and maintenance equipment	V
	• Sewing machine, cutter, spreader, tacker	V
	• Assets used in tanning and currying	V
316110	Leather and hide tanning and finishing	
316210	Footwear mfg. (including leather, rubber and plastics)	
316990	Other leather and allied product mfg.	
	Wood Products Manufacturing	
	• Saw-mill equipment	III
	• Sanders, clamps and dust collectors	III
	• Chippers, grinders and lathes	V
	• Cutting, drying and wood presses	V
321110	Sawmills and wood preservation	
321210	Veneer, plywood and engineered wood product mfg.	
321900	Other wood product mfg.	
	Paper, Printing and Related Support Activities	
	• Bailer, shredder, selectronic imaging	III
	• Collating, folding, labeling machines	III
	• Feeders, binders and trimmer	V
	• Non-automated presses	V
	• Presses and assets used in pulps mfg.	VI
322100	Pulp, paper and paperboard mills	
322200	Converted paper product mfg.	
323100	Printing and related support activities	

NAICS Code	Business Description	Class
	Petroleum and Coal Products Manufacturing	
	• Fork lifts, scissor lifts and aerial lifts	III
	• Trenchers, boring machines, ditch diggers	III
324110	Petroleum refineries (including integrated)	
324120	Asphalt paving, roofing and saturated materials mfg.	
324190	Other petroleum and coal products mfg.	
	Chemical Manufacturing	
	• Gas chromatograph, spectrometer, GLC, HPLC	III
	• Injection and lost-core molding machine	III
	• Dryer, belt, kiln, mills	V
	• Mixing and blending equipment	V
325100	Basic chemical mfg.	
325200	Resin, synthetic rubber and artificial and synthetic fibers	
325300	Pesticide, fertilizer and other agricultural chemical mfg.	
325410	Pharmaceutical and medicine mfg.	
325500	Paint coating and adhesive mfg.	
325600	Soap, cleaning compound and toilet preparation mfg.	
325900	Other chemical product mfg.	
	Plastics and Rubber Products Manufacturing	
	• Mandrels, lasts, pallets, patterns, rings and insert plates	I
	• Injection molding machine	III
	• Packers, sealers, labelers and label dispensers	III
	• Storage racks and maintenance equipment	V
	• Extruders, kneaders, mixing mills, dryers	V
	• Baling presses and separators	V
326100	Plastics product mfg.	
326200	Rubber product mfg.	
	Nonmetallic Mineral Product Manufacturing	
	• Fork lifts, scissor lifts and aerial lifts	III
	• Stone grinders and polishers	V
	• Gang saws, block cutter and diamond wire machines	V
	• Production of flat, blown, or pressed products	VI
	• All other equipment used in glass and lime mfg.	VI
327100	Clay product and refractory mfg.	
327210	Glass and glass product mfg.	
327300	Cement and concrete product mfg.	
327400	Lime and gypsum product mfg.	
327900	Other nonmetallic mineral product mfg.	
	Primary Metal Manufacturing	
	• Assets used in the smelting and refining	VI
	• Rolls, mandrels, refractories	VI
	• Strand-slab caster, mill, temper rolling	VI
331110	Iron and steel mills and ferroalloy mfg.	
331310	Alumna and aluminum production and processing	
331500	Foundries	
	Fabricated Metal Products Manufacturing	
	• Welders and torches	III
	• Storage racks and powder booths	V
	• Holding furnace, wire baskets	V
	• Grinders, lathes, saws, shears and cutters	V
	• Bar feeders, bending and lapping machines	V
	• Extruders and stamping machines	VI
	• Presses, casting machines	VI
332000	Fabricate metal product mfg.	
332110	Forging and stamping	
332510	Hardware mfg.	
332700	Machine shops; screw, nut and bolt mfg.	
332810	Coating, engraving, heat treating and allied activities	
332900	Other fabricated metal product mfg.	

NAICS Code	Business Description	Class
	Machinery Manufacturing	
	• Forklifts	III
	• Storage racks and powder booths, conveyors	V
	• Presses, casting machines	VI
333000	Machinery mfg.	
333100	Agriculture and construction machinery mfg.	
333200	Industrial machinery mfg.	
333310	Commercial and service industry machinery	
333410	Air-conditioning, refrigeration equipment mfg.	
333610	Engine, turbine and power transmission equipment	
333900	Other general purpose machinery mfg.	
	Computer and Electronic Product Manufacturing	
	• Forklifts	III
	• Drilling, grinding and tapping machines	V
	• Storage racks and powder booths, conveyors	V
334110	Computer and peripheral equipment mfg.	
334200	Communications equipment mfg.	
334310	Audio and video equipment mfg.	
334410	Semiconductor and other electronic component mfg.	
334500	Electromedical and control instruments mfg.	
334610	Magnetic and optical media mfg.	
	Electrical Equipment and Appliance Manufacturing	
	• Coil and material handling equipment	III
	• Drilling, grinding and tapping machines	V
	• Gear cutting, forming and finishing machines	V
	• Power presses, press brakes and shears	V
335000	Electrical equipment mfg.	
335200	Household appliance mfg.	
335900	Other electrical equipment and component mfg.	
	Transportation Equipment Manufacturing	
	• Forklifts	III
	• Paint booths, conveyors	V
	• Presses, over-head crane	VI
336100	Motor vehicle mfg.	
336210	Motor vehicle body and trailer mfg.	
336300	Motor vehicle parts mfg.	
336410	Aerospace product and parts mfg.	
336510	Railroad rolling stock mfg.	
336610	Ship and boat building	
336990	Other transportation equipment mfg.	
	Furniture and Related Product Manufacturing	
	• Saw-mill equipment	III
	• Sanders, clamps and dust collectors	III
	• Chippers and grinders, lathes	V
	• Cutting and wood presses	V
337000	Furniture and related product mfg.	
	Miscellaneous Manufacturing	
	• Laser cutters	II
	• Office furniture and equipment, fork lifts	III
	• Welders and torches	III
	• Storage racks and maintenance equipment	V
	• Heavy equipment	VI
	• Presses and casting machines	VI
339110	Medical equipment and supplies mfg.	
	WHOLESALE AND RETAIL TRADE	
	• Cash registers, fork lifts	III
	• Photography and developing equipment	III
	• Retail shelving	III
	• Small freezers	III
	• Office furniture and equipment	III
	• Racks and maintenance equipment	V
	• Walk in coolers	V
	• Above ground tanks < = 30,000 gallons	VI
421000	Durable Goods	
422000	Non-durable Goods	
441000	Motor vehicle and parts dealer	
442000	Furniture and home furnishing stores	
443000	Electronic and appliance stores	
444200	Building material and other supplies	
445000	Food and beverage stores	
446000	Health and personal care stores	
447100	Gasoline stations	
448000	Clothing and accessories stores	
451000	Sporting goods, hobby, book and music stores	
454000	General merchandise stores	

NAICS Code	Business Description	Class

TRANSPORTATION AND WAREHOUSING

NAICS Code	Business Description	Class
	• Fork lifts, packaging equipment	III
	• Drum lifts, pallet turners, steel shelving, shrink wrap, conveyors	V
481000	Air transportation	
484200	Specialized freight trucking	
493100	Warehouse and storage	

INFORMATION SERVICES

NAICS Code	Business Description	Class
	• Modulator, mutiplexer, oscilliscope	II
	• Studio camera, VTR, earth satellite	III
	• Audio mixer, analyzer, decoder, teleprompter	III
	• Transmitter, antenna	III
	• Tower	VI
	• Fiber optic and coaxial cable	VI
511000	Publishing industries	
512100	Motion picture and video industries	
512200	Sound recording industries	
513000	Broadcasting and telecommunications	
514100	Information services	
514210	Data processing services	

FINANCE AND INSURANCE

NAICS Code	Business Description	Class
	• Office furniture and equipment	III
522000	Credit intermediation and related activities	
524000	Insurance agents, brokers and related activities	

RENTAL AND LEASING

NAICS Code	Business Description	Class
	• Electronics, video tapes, DVDs and formal wear	I
	• Consigned display fixtures	II
	• Household appliances on lease	II
	• Coin operated machines	II
	• Other leased assets (see page 1)	
532210	Electronics and appliance rental	
532220	Formal wear and costume rental	
532230	Video tape and Disc rental	
532310	General rental centers	
532400	Equipment rental and leasing *(use appropriate classification from applicable industries)*	

PROFESSIONAL, SCIENTIFIC AND TECHNICAL SERVICES

NAICS Code	Business Description	Class
	• Chromatographs and spectrometers	III
	• Packed columns and capillary columns	III
	• Film processor, enlarger, print washer, film dryer	III
541100	Legal services	
541211	Office of certified public accountant	
541310	Architectural and engineering services	
541380	Testing laboratories	
541400	Specialized design services	
541510	Computer systems design services	
541800	Advertising and related services	
541920	Photographic services	
541940	Veterinary services	

ADMIN AND SUPPORT AND WASTE MANAGEMENT SERVICES

NAICS Code	Business Description	Class
	• Waste and trash containers	III
	• Compactors and recycling equipment	V
561300	Employment services	
561430	Business service centers (includes copy shops)	
561440	Collection agencies	
561500	Travel arrangement and reservation services	
561710	Exterminating and pest control services	
562000	Waste management and remediation services	

HEALTH CARE AND SOCIAL SERVICES

NAICS Code	Business Description	Class
	• Magnetic Resonance Imaging (MRI)	I
	• Other high technology medical equipment	II
	• Electro-cardiograph, X-ray and fluoroscope, dental units	III
	• Dental lathes, trimmers and instruments	III
	• Sterilizers and X-ray developers	III
621100	Office of physicians	
621210	Office of dentists	
621300	Offices of other health care practitioners	
621400	Outpatient care centers	
621510	Medical and diagnostic laboratories	
622000	Hospitals	
624000	Social assistance services	

ART, ENTERTAINMENT AND RECREATION

NAICS Code	Business Description	Class
	• Billiard table, automatic pinsetters, time recorder and scorekeeper	III
	• Amusements, rides, booths and other attraction equipment	V
711100	Performing arts companies	
711510	Independent artists, writers and performers	
712100	Museums, historical sites and similar institutions	
713100	Amusement parks and arcades	

ACCOMMODATION AND FOOD SERVICES

NAICS Code	Business Description	Class
	• Glassware, silverware and slicer	III
	• Laundry washer and dryers	III
	• Beverage dispensers and coffee makers	III
	• Small freezers, fryers, grills and microwaves	III
	• Beds and linens	III
	• Small freezers	III
	• Ovens	V
	• Safes	V
	• Walk in coolers	V
721110	Travel accommodation	
721210	RV parks and recreational camps	
721310	Rooming and boarding houses	
722110	Full-service restaurants	
722300	Special food services (contractors and caterers)	
722410	Drinking places (alcoholic beverages)	

OTHER SERVICES

NAICS Code	Business Description	Class
	• Dry cleaning machine, laundry machine, presser	III
	• Film processor, enlarger, print washer, film dryer	III
	• Body lifter, refrigerator, mausoleum lift, embalming table	III
	• Steel chair, dryer, hand tool set	III
	• Tanning beds and booths	III
	• Automotive, diagnostic and machining equipment	III
	• Hoists, disk lathes	V

Repair and Maintenance

NAICS Code	Business Description	Class
811110	Automotive mechanical and electrical repair	
811120	Automotive body, paint and glass repair	
811310	Commercial and industrial equipment repair	
811410	Appliance repair and maintenance	
811420	Reupholstery and furniture repair	
811430	Footwear and leather goods repair	

Personal and Laundry Services

NAICS Code	Business Description	Class
812111	Barber shops	
812112	Beauty salons	
812113	Nail salons	
812210	Funeral homes and funeral services	
812220	Cemeteries and crematories	
812310	Coin-operated laundries and dry-cleaners	
812320	Dry-cleaning and laundry services	
812330	Linen and uniform supply	
812910	Pet care (except veterinary) services	
812920	Photo-finishing	
812930	Parking lots and garages	

COUNTY PVA PHONE NUMBERS AND ADDRESSES

County Code	County	Phone Number	Address	City	ZIP Code
001	Adair	(270) 384-3673	424 Public Square, Courthouse, Suite 2	Columbia	42728
002	Allen	(270) 237-3711	P.O. Box 397	Scottsville	42164
003	Anderson	(502) 839-4061	101 Ollie Bowen Court	Lawrenceburg	40342
004	Ballard	(270) 335-3400	P.O. Box 267	Wickliffe	42087
005	Barren	(270) 651-2026	P.O. Box 1836	Glasgow	42142
006	Bath	(606) 674-6382	P.O. Box 688	Owingsville	40360
007	Bell	(606) 337-2720	P.O. Box 255	Pineville	40977
008	Boone	(859) 334-2181	P.O. Box 388	Burlington	41005
009	Bourbon	(859) 987-2152	Courthouse, Room 15, 301 Main Street	Paris	40361
010	Boyd	(606) 739-5173	P.O. Box 434	Catlettsburg	41129
011	Boyle	(859) 238-1104	Courthouse, 321 West Main Street	Danville	40422
012	Bracken	(606) 735-2228	P.O. Box 310	Brooksville	41004
013	Breathitt	(606) 666-7973	1137 Main Street, Courthouse, Suite 302	Jackson	41339
014	Breckinridge	(270) 756-5154	P.O. Box 516	Hardinsburg	40143
015	Bullitt	(502) 543-7480	P.O. Box 681	Shepherdsville	40165
016	Butler	(270) 526-3455	P.O. Box 538	Morgantown	42261
017	Caldwell	(270) 365-7227	100 East Market Street, Courthouse, Room 28	Princeton	42445
018	Calloway	(270) 753-3482	P.O. Box 547	Murray	42071
019	Campbell	(859) 292-3871	1098 Monmouth Street, Room 329	Newport	41071
020	Carlisle	(270) 628-5498	P.O. Box 206	Bardwell	42023
021	Carroll	(502) 732-5448	Courthouse, 440 Main Street	Carrollton	41008
022	Carter	(606) 474-5663	Courthouse, Room 214, 300 W. Main St.	Grayson	41143
023	Casey	(606) 787-7621	P.O. Box 38	Liberty	42539
024	Christian	(270) 887-4115	P.O. Box 96	Hopkinsville	42241
025	Clark	(859) 745-0250	Courthouse, 34 South Main Street	Winchester	40391
026	Clay	(606) 598-3832	102 Richmond Road, Suite 200	Manchester	40962
027	Clinton	(606) 387-5938	100 Cross St., Courthouse, Room 217	Albany	42602
028	Crittenden	(270) 965-4598	Courthouse, 107 South Main Street, Suite 108	Marion	42064
029	Cumberland	(270) 864-5161	P.O. Box 431	Burkesville	42717
030	Daviess	(270) 685-8474	Courthouse, Room 102, 212 St. Ann Street	Owensboro	42303
031	Edmonson	(270) 597-2381	P.O. Box 37	Brownsville	42210-0037
032	Elliott	(606) 738-5090	P.O. Box 690	Sandy Hook	41171
033	Estill	(606) 723-4569	Courthouse, 130 Main Street	Irvine	40336
034	Fayette	(859) 246-2722	101 E. Vine Street, Suite 600, Phoenix Bldg.	Lexington	40507
035	Fleming	(606) 845-1401	100 Court Square, Room B110	Flemingsburg	41041
036	Floyd	(606) 886-9622	149 South Central Avenue, Room 5	Prestonsburg	41653
037	Franklin	(502) 875-8780	313 West Main Street, Courthouse Annex, Room 209	Frankfort	40601
038	Fulton	(270) 236-2548	2216 Myron Cory Drive, Suite 2	Hickman	42050
039	Gallatin	(859) 567-5621	P.O. Box 470	Warsaw	41095
040	Garrard	(859) 792-3291	Courthouse, 7 Public Square, Suite 2	Lancaster	40444
041	Grant	(859) 824-6511	Courthouse, 101 North Main Street, Room 2	Williamstown	41097
042	Graves	(270) 247-3301	101 East South Street, Courthouse Annex, Suite 5	Mayfield	42066
043	Grayson	(270) 259-4838	10 Public Square	Leitchfield	42754
044	Green	(270) 932-7518	103 South First Street	Greensburg	42743
045	Greenup	(606) 473-9984	Courthouse, Room 209, 301 Main Street, Box 4	Greenup	41144
046	Hancock	(270) 927-6846	P.O. Box 523	Hawesville	42348
047	Hardin	(270) 765-2129	P.O. Box 70	Elizabethtown	42702
048	Harlan	(606) 573-1990	P.O. Box 209	Harlan	40831
049	Harrison	(859) 234-7133	111 South Main Street, Suite 101	Cynthiana	41031
050	Hart	(270) 524-2321	P.O. Box 566	Munfordville	42765
051	Henderson	(270) 827-6024	P.O. Box 2003	Henderson	42419-2003
052	Henry	(502) 845-5740	P.O. Box 11	New Castle	40050
053	Hickman	(270) 653-5521	110 East Clay, Courthouse, Suite F	Clinton	42031
054	Hopkins	(270) 821-3092	25 East Center Street	Madisonville	42431-2077
055	Jackson	(606) 287-7634	P.O. Box 249	McKee	40447
056	Jefferson	(502) 574-6380	Glassworks Building, 815 W. Market Street	Louisville	40202-2654
057	Jessamine	(859) 885-4931	P.O. Box 530	Nicholasville	40340
058	Johnson	(606) 789-2564	Court Street, Courthouse, Suite 229	Paintsville	41240
059	Kenton	(859) 392-1750	303 Court Street, Room 210	Covington	41011
060	Knott	(606) 785-5569	P.O. Box 1021	Hindman	41822
061	Knox	(606) 546-4113	P.O. Box 1509	Barbourville	40906
062	Larue	(270) 358-4202	209 West High St., Courthouse, Ste. 1	Hodgenville	42748
063	Laurel	(606) 864-2889	Courthouse, Room 127, 101 South Main Street	London	40741

COUNTY PVA PHONE NUMBERS AND ADDRESSES
Continued

County Code	County	Phone Number	Address	City	ZIP Code
064	Lawrence	(606) 638-4743	Courthouse, 122 South Main Cross Street	Louisa	41230
065	Lee	(606) 464-4105	P.O. Box 1008	Beattyville	41311
066	Leslie	(606) 672-2456	P.O. Box 1891	Hyden	41749
067	Letcher	(606) 633-2182	156 Main Street, Suite 105	Whitesburg	41858
068	Lewis	(606) 796-2622	112 Second Street, Suite 101	Vanceburg	41179
069	Lincoln	(606) 365-4550	201 East Main Street, Suite 2	Stanford	40484
070	Livingston	(270) 928-2524	P.O. Box 77	Smithland	42081
071	Logan	(270) 726-8334	P.O. Box 307	Russellville	42276
072	Lyon	(270) 388-7271	P.O. Box 148	Eddyville	42038
073	McCracken	(270) 444-4712	Courthouse Annex, 621 Washington Street	Paducah	42003
074	McCreary	(606) 376-2514	P.O. Box 609	Whitley City	42653
075	McLean	(270) 273-3291	P.O. Box 246	Calhoun	42327
076	Madison	(859) 623-5410	135 W. Irvine Street, Suite 103	Richmond	40475-1436
077	Magoffin	(606) 349-6198	P.O. Box 107	Salyersville	41465
078	Marion	(270) 692-3401	223 N. Spalding Avenue, Suite 202	Lebanon	40033
079	Marshall	(270) 527-4728	1101 Main Street	Benton	42025
080	Martin	(606) 298-2807	P.O. Box 341	Inez	41224
081	Mason	(606) 564-3700	220 1/2 Sutton Street	Maysville	41056
082	Meade	(270) 422-2178	516 Hillcrest Drive, Suite 3	Brandenburg	40108
083	Menifee	(606) 768-3514	P.O. Box 36	Frenchburg	40322
084	Mercer	(859) 734-6330	P.O. Box 244	Harrodsburg	40330
085	Metcalfe	(270) 432-3162	P.O. Box 939	Edmonton	42129
086	Monroe	(270) 487-6401	200 North Main Street, Suite A	Tompkinsville	42167-1548
087	Montgomery	(859) 498-8710	44 W. Main Street, Courthouse Annex, Suite E	Mt. Sterling	40353
088	Morgan	(606) 743-3349	P.O. Box 57	West Liberty	41472
089	Muhlenberg	(270) 338-4664	P.O. Box 546	Greenville	42345
090	Nelson	(502) 348-1810	113 East Stephen Foster Avenue	Bardstown	40004
091	Nicholas	(859) 289-3735	P.O. Box 2	Carlisle	40311
092	Ohio	(270) 298-4433	P.O. Box 187	Hartford	42347
093	Oldham	(502) 222-9320	110 West Jefferson Street	LaGrange	40031
094	Owen	(502) 484-5172	Courthouse, 100 North Thomas Street, Room 6	Owenton	40359
095	Owsley	(606) 593-6265	P.O. Box 337	Booneville	41314
096	Pendleton	(859) 654-6055	233 Main Street, Courthouse Room 2	Falmouth	41040
097	Perry	(606) 436-4914	481 Main Street, Ste. 210	Hazard	41701
098	Pike	(606) 432-6201	146 Main Street, Suite 303	Pikeville	41501
099	Powell	(606) 663-4184	P.O. Box 277	Stanton	40380
100	Pulaski	(606) 679-1812	P.O. Box 110	Somerset	42502
101	Robertson	(606) 724-5213	P.O. Box 216	Mt. Olivet	41064
102	Rockcastle	(606) 256-4194	P.O. Box 977	Mt. Vernon	40456
103	Rowan	(606) 784-5512	Courthouse, 600 W. Main Street	Morehead	40351
104	Russell	(270) 343-4395	410 Monument Square, Suite 106	Jamestown	42629
105	Scott	(502) 863-7885	101 East Main Street, Courthouse, Suite 206	Georgetown	40324
106	Shelby	(502) 633-4403	501 Washington Street	Shelbyville	40065
107	Simpson	(270) 586-4261	P.O. Box 424	Franklin	42135
108	Spencer	(502) 477-3207	P.O. Box 425	Taylorsville	40071
109	Taylor	(270) 465-5811	Courthouse, 203 North Court Street	Campbellsville	42718
110	Todd	(270) 265-9966	P.O. Box 593	Elkton	42220
111	Trigg	(270) 522-3271	P.O. Box 1776	Cadiz	42211
112	Trimble	(502) 255-3592	P.O. Box 131	Bedford	40006
113	Union	(270) 389-1933	P.O. Box 177	Morganfield	42437
114	Warren	(270) 843-3268	P.O. Box 1269	Bowling Green	42102-1269
115	Washington	(859) 336-5420	120 East Main Street, Courthouse	Springfield	40069
116	Wayne	(606) 348-6621	55 North Main Street, Courthouse, Suite 107	Monticello	42633
117	Webster	(270) 639-7016	P.O. Box 88	Dixon	42409
118	Whitley	(606) 549-6008	P.O. Box 462	Williamsburg	40769
119	Wolfe	(606) 668-6923	P.O. Box 155	Campton	41301
120	Woodford	(859) 873-4101	Courthouse, Room 108, 103 Main Street	Versailles	40383

DIVISION OF STATE VALUATION, (502) 564-2557
Go to **www.revenue.ky.gov** to download forms.

62A500 (11-14)

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

See pages 9 and 10 for a complete list of mailing addresses.

2015
TANGIBLE PERSONAL PROPERTY TAX RETURN

Property Assessed January 1, 2015

File this return with the PVA in the county of taxable situs or the Office of Property Valuation.

There is no filing extension for this return.

FOR OFFICIAL USE ONLY

County Code / Locator Number

T _ _ _ / _ _ _ _ _ _

Due Date:
Friday
May 15, 2015

15

MAY 2015						
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31						

Social Security No. or Federal ID No.	Name of Business	
2nd SSN if joint return	Name of Taxpayer(s)	Telephone Number ( )
NAICS CODE	Mailing Address	
Type of Business	City or Town State ZIP Code	
Check if applicable Yes	Property Location (Number and Street or Rural Route, City)(Must List)	
Tangible personal property in other KY counties? ☐	Property is Located in County	**For Official Use Only**
Alternative method of valuation? ☐		District Code ____ ____
Final Return? ☐		Type Return ____ ____

Organization	Type
☐ Individual	1
☐ Joint (Co-Owners)	2
☐ Partnership/LLP	3
☐ Domestic Corp./ LLC	4
☐ Foreign Corp./ LLC	5
☐ Fiduciary—Bank	6
☐ Fiduciary—Other	7

NOTE: Taxpayers who have property in more than one location must complete a separate form for each location.

	FROM SCHEDULE A					**FROM SCHEDULE B**			
	Class	Original Cost	Reported Value	**For Official Use Only**		Class	Original Cost	Reported Value	**For Official Use Only**
11	I				21	I			
12	II				22	II			
13	III				23	III			
14	IV				24	IV			
15	V				25	V			
16	VI				26	VI			
17	**Total**				27	**Total**			

	See pages 3 through 5 for instructions.	Taxpayer's Valuation	**For Official Use Only**
31	Merchants Inventory		
32	Manufacturers Finished Goods		
33	Manufacturers Raw Materials/Goods in Process		
34	Motor Vehicles Held for Sale (dealers only) New Farm Machinery Held Under a Floor Plan New Boats and Marine Equipment Held Under a Floor Plan Salvage Titled Vehicles (insurance companies only) Recreational Vehicles Held in a Retailer's Inventory Biotechnology Products Held in a Warehouse (manufacturers and affiliates only) Nonferrous Metal Located in a Commodity Warehouse and Held on Warrant		
35	Goods Stored in Warehouse/Distribution Center (see instructions)		
36	Goods—In Transit (see instructions)		
37	Unmanufactured Tobacco Products not at Manufacturers Plant or in Hands of Grower or His Agent		
38	Other Unmanufactured Agricultural Products not at Manufacturers Plant or in Hands of Grower or His Agent		
39	Unmanufactured Agricultural Products at Manufacturers Plant or in Hands of Grower or His Agent/Industrial Revenue Bond Property Qualifying Voluntary Environmental Remediation Property		
50	Livestock and Farm Machinery/Fluidized Bed Energy Facilities		
60	Other Tangible Property (from Schedule C) (page 2)		
70	Activated Foreign Trade Zone		
81	Construction Work in Progress (manufacturing machinery)		
82	Construction Work in Progress (other tangible property)		
90	Recycling Machinery and Equipment		

SCHEDULE C

Other Tangible Personalty Not Listed Elsewhere				
	Description		Taxpayer's Value	For Official Use Only
Materials and Supplies				
Coin Collections				
Stamp Collections				
Art Works				
Other Collectibles				
Research Libraries				
Other Tangible Property				
Aircraft for Hire				
Documented Watercraft (commercial purposes)				
Precious Metals	Number of Ounces	Value Per Ounce December 31		
Gold				
Platinum				
Silver				
Other				
Total (enter this figure on Line Item 60)				

Comments	
Additional comments and/or information regarding alternative values may be provided by classification below:	
Classification Type	**Comments/Information**

I declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) is a correct and complete return; and that all my taxable property has been listed.

Signature of Taxpayer | Date | Name of Preparer Other Than Taxpayer | Date

☎ Telephone Number | Email Address of Taxpayer | Telephone Number | Email Address of Preparer Other Than Taxpayer

SCHEDULE A

2015 Tangible Personal Property Subject to Full State and Local Rates

Factors change every year. Please use correct year factors.

	CLASS I Under 6.5 Year Economic Life				CLASS II 6.5-8.9 Year Economic Life				CLASS III 9-10.9 Year Economic Life		
Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value
1		.860		1		.917		1		.936	
2		.711		2		.747		2		.798	
3		.562		3		.611		3		.682	
4		.419		4		.509		4		.595	
5		.271		5		.429		5		.524	
6		.200		6		.348		6		.445	
7		.200		7		.289		7		.387	
8		.200		8		.243		8		.340	
9		.200		9		.209		9		.306	
10		.200		10		.200		10		.270	
11		.200		11		.200		11		.248	
12		.200		12		.200		12		.219	
13		.200		13		.200		13		.200	
13+		.200		13+		.200		13+		.200	
Total											

	CLASS IV 11–13.4 Year Economic Life				CLASS V 13.5–17.4 Year Economic Life				CLASS VI Over 17.5 Year Economic Life		
Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value
1		.873		1		.974		1		.974	
2		.657		2		.904		2		.904	
3		.495		3		.841		3		.841	
4		.407		4		.798		4		.798	
5		.379		5		.765		5		.765	
6		.341		6		.707		6		.707	
7		.314		7		.639		7		.668	
8		.292		8		.585		8		.639	
9		.278		9		.548		9		.626	
10		.260		10		.504		10		.602	
11		.253		11		.482		11		.601	
12		.237		12		.443		12		.578	
13		.217		13		.399		13		.544	
14		.200		14		.356		14		.507	
15		.200		15		.316		15		.470	
16		.200		16		.286		16		.445	
17		.200		17		.254		17		.413	
18		.200		18		.227		18		.385	
19		.200		19		.204		19		.362	
20		.200		20		.200		20		.340	
21		.200		21		.200		21		.326	
22		.200		22		.200		22		.310	
23		.200		23		.200		23		.292	
24		.200		24		.200		24		.274	
25		.200		25		.200		25		.258	
26		.200		26		.200		26		.245	
27		.200		27		.200		27		.239	
27+		.200		27+		.200		27+		.230	
Total											

SCHEDULE B (Manufacturing Assets)

2015 Tangible Personal Property Subject to State Rate

Factors change every year. Please use correct year factors.

	CLASS I Under 6.5 Year Economic Life				CLASS II 6.5-8.9 Year Economic Life				CLASS III 9-10.9 Year Economic Life		
Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value
1		.860		1		.917		1		.936	
2		.711		2		.747		2		.798	
3		.562		3		.611		3		.682	
4		.419		4		.509		4		.595	
5		.271		5		.429		5		.524	
6		.200		6		.348		6		.445	
7		.200		7		.289		7		.387	
8		.200		8		.243		8		.340	
9		.200		9		.209		9		.306	
10		.200		10		.200		10		.270	
11		.200		11		.200		11		.248	
12		.200		12		.200		12		.219	
13		.200		13		.200		13		.200	
13+		.200		13+		.200		13+		.200	
Total											

	CLASS IV 11–13.4 Year Economic Life				CLASS V 13.5–17.4 Year Economic Life				CLASS VI Over 17.5 Year Economic Life		
Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value
1		.873		1		.974		1		.974	
2		.657		2		.904		2		.904	
3		.495		3		.841		3		.841	
4		.407		4		.798		4		.798	
5		.379		5		.765		5		.765	
6		.341		6		.707		6		.707	
7		.314		7		.639		7		.668	
8		.292		8		.585		8		.639	
9		.278		9		.548		9		.626	
10		.260		10		.504		10		.602	
11		.253		11		.482		11		.601	
12		.237		12		.443		12		.578	
13		.217		13		.399		13		.544	
14		.200		14		.356		14		.507	
15		.200		15		.316		15		.470	
16		.200		16		.286		16		.445	
17		.200		17		.254		17		.413	
18		.200		18		.227		18		.385	
19		.200		19		.204		19		.362	
20		.200		20		.200		20		.340	
21		.200		21		.200		21		.326	
22		.200		22		.200		22		.310	
23		.200		23		.200		23		.292	
24		.200		24		.200		24		.274	
25		.200		25		.200		25		.258	
26		.200		26		.200		26		.245	
27		.200		27		.200		27		.239	
27+		.200		27+		.200		27+		.230	
Total											

2015 MISCELLANEOUS WORKSHEET

Please check the appropriate box:

[ ] Industial Revenue Bond (IRB)   [ ] Recycling Machinery & Equipment   [ ] Livestock & Farm Machinery (from Line 50)

Factors change every year. Please use correct year factors.

	CLASS I Under 6.5 Year Economic Life				CLASS II 6.5-8.9 Year Economic Life				CLASS III 9-10.9 Year Economic Life		
Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value
1		.860		1		.917		1		.936	
2		.711		2		.747		2		.798	
3		.562		3		.611		3		.682	
4		.419		4		.509		4		.595	
5		.271		5		.429		5		.524	
6		.200		6		.348		6		.445	
7		.200		7		.289		7		.387	
8		.200		8		.243		8		.340	
9		.200		9		.209		9		.306	
10		.200		10		.200		10		.270	
11		.200		11		.200		11		.248	
12		.200		12		.200		12		.219	
13		.200		13		.200		13		.200	
13+		.200		13+		.200		13+		.200	
Total											

	CLASS IV 11–13.4 Year Economic Life				CLASS V 13.5–17.4 Year Economic Life				CLASS VI Over 17.5 Year Economic Life		
Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value	Age	Original Cost	Factor	Reported Value
1		.873		1		.974		1		.974	
2		.657		2		.904		2		.904	
3		.495		3		.841		3		.841	
4		.407		4		.798		4		.798	
5		.379		5		.765		5		.765	
6		.341		6		.707		6		.707	
7		.314		7		.639		7		.668	
8		.292		8		.585		8		.639	
9		.278		9		.548		9		.626	
10		.260		10		.504		10		.602	
11		.253		11		.482		11		.601	
12		.237		12		.443		12		.578	
13		.217		13		.399		13		.544	
14		.200		14		.356		14		.507	
15		.200		15		.316		15		.470	
16		.200		16		.286		16		.445	
17		.200		17		.254		17		.413	
18		.200		18		.227		18		.385	
19		.200		19		.204		19		.362	
20		.200		20		.200		20		.340	
21		.200		21		.200		21		.326	
22		.200		22		.200		22		.310	
23		.200		23		.200		23		.292	
24		.200		24		.200		24		.274	
25		.200		25		.200		25		.258	
26		.200		26		.200		26		.245	
27		.200		27		.200		27		.239	
27+		.200		27+		.200		27+		.230	
Total											

62A500-A (11-14)

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

See pages 9 and 10 for a complete list of mailing addresses.

2015
TANGIBLE PERSONAL PROPERTY TAX RETURN

Property Assessed January 1, 2015

(Aircraft Assessments Only)

FOR OFFICIAL USE ONLY
County Code / Locator Number
T ___ ___ ___ / ___ ___ ___ ___ ___

Due Date: Friday May 15, 2015

MAY 2015						
S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

15

Social Security No. or Federal ID No.	Name of Business	**Organization** / **Type**
2nd SSN if joint return	Name of Taxpayer(s) / Telephone Number ( )	☐ Individual 1
NAICS CODE	Mailing Address	☐ Joint (Co-Owners) 2
Type of Business	City or Town / State / ZIP Code	☐ Partnership/LLP 3
Check if applicable **Yes**	Property Location (Airport Name and Street Address)(Must List)	☐ Domestic Corp./LLC 4
Tangible personal property in other KY counties? ☐	Property is Located in ____ County / **For Official Use Only** District Code ___ ___	☐ Foreign Corp./LLC 5
Final Return? ☐	Type Return ___ ___	☐ Fiduciary—Bank 6
		☐ Fiduciary—Other 7

NOTE: List the serial number, federal registration number, make, model, size, power and value of all aircraft owned on January 1. Attach a separate sheet if necessary. Do not list aircraft assessed as public service company property. Include additional information regarding avionic equipment, condition, engine hours and other documentation that may influence the aircraft value. All aircraft owner information submitted on the return is to be listed as it appears on the Federal Aviation Administration registration. The completed return is to be submitted to the property valuation administrator in the county of taxable situs or the Office of Property Valuation on or before May 15, 2015, regardless of the owner's residency. There is no extension for the filing of tangible personal property tax returns. **DO NOT LIST AIRCRAFT FOR HIRE ON THIS RETURN.**

Line No.	Federal Registration Number and Serial Number	Description (Year, Make, Model, Size, Power)	Taxpayer's Value	Statement of General Condition	**For Official Use Only**
40					
40					
40					
40					
40					

I declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) is a correct and complete return; and that all my taxable property has been listed.

Signature of Taxpayer	Date	Name of Preparer Other Than Taxpayer	Date
☎ Telephone Number	Email Address of Taxpayer	Telephone Number	Email Address of Preparer Other Than Taxpayer

62A500-W (11-14)

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

See pages 9 and 10 for a complete list of mailing addresses.

2015 TANGIBLE PERSONAL PROPERTY TAX RETURN

Property Assessed January 1, 2015

(Documented Watercraft)

FOR OFFICIAL USE ONLY

County Code / Locator Number

T __ __ __ / __ __ __ __ __

Due Date: Friday May 15, 2015

MAY 2015

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	**15**	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

15

Social Security No. or Federal ID No.	Name of Business		Organization / Type
2nd SSN if joint return	Name of Taxpayer(s)	Telephone Number ( )	☐ Individual 1
NAICS CODE	Mailing Address		☐ Joint (Co-Owners) 2
Type of Business	City or Town / State / ZIP Code		☐ Partnership/LLP 3
Check if applicable. Yes	Property Location (Marina Name and Street Address)(Must List)		☐ Domestic Corp./ LLC 4
Tangible personal property in other KY counties? ☐	Property is Located in ___ County	**For Official Use Only** District Code __ __	☐ Foreign Corp./ LLC 5
Final Return? ☐		Type Return __ __	☐ Fiduciary—Bank 6
			☐ Fiduciary—Other 7

NOTE: Owners of documented watercraft not used in the business of transporting people and/or property for compensation or hire based in Kentucky on January 1 are to complete and submit this return on or before May 15, 2015, regardless of the owner's residency. File the return with the property valuation administrator in the county of taxable situs or the Office of Property Valuation. There is no extension for the filing of tangible personal property tax returns. Taxpayers who have property in more than one location must complete a separate form for each location. Documented watercraft used for hire or rented, should be reported on Schedule C or with the Public Service Section. **DO NOT LIST DOMESTIC COMMERCIAL WATERCRAFT ON THIS RETURN. If your boat has been sold, please forward a copy of the bill of sale to the Office of Property Valuation.**

Line No.	Coast Guard Number	Vessel Name	Description (Year, Make, Model, Length, Beam, Motor Horse Power)	Taxpayer's Value	Statement of General Condition	**For Official Use Only**
41						
41						
41						
41						
41						

I declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) is a correct and complete return; and that all my taxable property has been listed.

Signature of Taxpayer	Date	Name of Preparer Other Than Taxpayer	Date
☎ Telephone Number	Email Address of Taxpayer	Telephone Number	Email Address of Preparer Other Than Taxpayer

62A500-L (11-14)

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

See pages 9 and 10 for a complete list of mailing addresses.

LESSEE TANGIBLE PERSONAL PROPERTY TAX RETURN

(For Informational Purposes Only)

Property Assessed January 1, 2015

FOR OFFICIAL USE ONLY
County Code / Locator Number
T ___ ___ ___ / ___ ___ ___ ___ ___

Due Date: Friday May 15, 2015

MAY 2015

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

15

Social Security No. or Federal ID No.	Name of Business	
	Name of Lessee	Telephone Number ( )
2nd SSN if joint return	Mailing Address	
	City or Town / State / ZIP Code	
Property is located in ______ County	Property Location (Number and Street or Rural Route, City)(Must List)	

Any person or business entity leasing tangible personal property from others on January 1 is required to file this return on or before May 15, 2015. **DO NOT** complete this form if you have included the leased property on your Form 62A500. Attach additional schedules if necessary.
Note: *Lessees who have property in more than one location must complete a separate form for each location.*

Lessor Information	Leased Equipment Information
Name ______	Type of Equipment ______
Mailing Address ______	Year ______ Model ______
City, State ZIP Code ______	Selling Price New $______ Annual Rent $______
	Date of Lease ______ Length of Lease ______
For Official Use Only	Buy-out Price at the end of Lease $ ______
Name ______	Type of Equipment ______
Mailing Address ______	Year ______ Model ______
City, State ZIP Code ______	Selling Price New $______ Annual Rent $______
	Date of Lease ______ Length of Lease ______
For Official Use Only	Buy-out Price at the end of Lease $ ______
Name ______	Type of Equipment ______
Mailing Address ______	Year ______ Model ______
City, State ZIP Code ______	Selling Price New $______ Annual Rent $______
	Date of Lease ______ Length of Lease ______
For Official Use Only	Buy-out Price at the end of Lease $ ______

I declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) is a correct and complete return; and that all property not owned by me but in my possession has been listed.

Signature of Lessee	Date	Name of Preparer Other Than Lessee	Date
Telephone Number	Email Address of Lessee	Telephone Number	Email Address of Preparer Other Than Lessee

62A500-C (11-14)

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

See pages 9 and 10 for a complete list of mailing addresses.

CONSIGNEE TANGIBLE PERSONAL PROPERTY TAX RETURN

(For Informational Purposes Only)

Property Assessed January 1, 2015

FOR OFFICIAL USE ONLY

County Code / Locator Number

T _ _ _ / _ _ _ _ _ _

Due Date:
Friday
May 15, 2015

15

MAY 2015						
S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	**15**	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

Social Security No. or Federal ID No.	Name of Business	
	Name of Consignee	Telephone Number ( )
2nd SSN if joint return	Mailing Address	
Property is located in	City or Town State ZIP Code	
_______________ County	Property Location (Number and Street or Rural Route, City)(Must List)	

If, on January 1, you have in your possession any consigned inventory or other items not owned by you, and have not been reported on Form 62A500, complete this return. File this return on or before May 15, 2015. Attach additional schedules if necessary.
Note: *Consignees who have property in more than one location must complete a separate form for each location.*

Consignor Information	Consigned Inventory Information	
	Type	Value
Name of Consignor ______	Merchants Inventory	
Mailing Address ______	Finished Goods	
	Raw Materials/Good in Process	
City, State ZIP Code ______	Other	
Name of Consignor ______	Merchants Inventory	
Mailing Address ______	Finished Goods	
	Raw Materials/Good in Process	
City, State ZIP Code ______	Other	

I declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) is a correct and complete return; and that all property not owned by me but in my possession has been listed.

Signature of Consignee	Date	Name of Preparer Other Than Consignee	Date
☎ Telephone Number	Email Address of Consignee	Telephone Number	Email Address of Preparer Other Than Consignee

62A500-S1 (11-14)

Page No. ______

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

AUTOMOBILE DEALER'S INVENTORY LISTING FOR LINE 34 TANGIBLE PERSONAL PROPERTY TAX RETURN

Property Assessed January 1, 2015

Kentucky UNBRIDLED SPIRIT

Social Security No. or Federal ID No.	Name of Business	
	Name of Dealer	Telephone Number ( )
2nd **SSN** if joint return	Mailing Address	
	City or Town State ZIP Code	
Property is located in ____________________ County	Property Location (Number and Street or Rural Route, City)(Must List)	

Year	Make	Model	License Plate Number (If Applicable)	Vehicle Identification Number	NADA Clean Trade-in Value
Total From This Page ➤					

62A500-M1 (11-14)

Commonwealth of Kentucky
DEPARTMENT OF REVENUE
Office of Property Valuation
Division of State Valuation
Fourth Floor, Station 32
501 High Street
Frankfort, KY 40601-2103

Page No. ______

BOAT DEALER'S USED INVENTORY LISTING FOR LINE 31 TANGIBLE PERSONAL PROPERTY TAX RETURN

Property Assessed January 1, 2015

Kentucky

Social Security No. or Federal ID No.	Name of Business	
	Name of Dealer	Telephone Number ( )
2nd SSN if joint return	Mailing Address	
	City or Town State ZIP Code	
Property is located in ____________________ County	Property Location (Number and Street or Rural Route, City)(Must List)	

Used boats held for sale by a licensed boat dealer should be reported on Line 31 of the 62A500 and listed below.

Year	Make	Model	License Number (If Applicable)	Hull Number	NADA Trade-in Value
				Total From This Page ➤	

4. KENTUCKY'S PENSION CRISIS: A PATH FORWARD[1]

I sort of had the impression that the cupboard was going to be bare. I just didn't know the cupboard was going to be gone too.

- Gov. Steve Beshear on Kentucky's growing pension debt, January 14, 2008[2]

INTRODUCTION

Kentucky's pension system for employees of its state and local governments is distinguished from all other state pension systems by the dramatic extent to which it is underfunded i.e., the degree to which the assets in Kentucky's pension system are not expected to be able to meet the future payments promised to state and local government employees upon retirement.

Such was not always the case. Only 15 years ago, Kentucky's pension system was in excellent health. In 2003, Kentucky's pension debt was $2.8 billion.[3] But after failing to meet annual funding commitments and poor investment performance for over a decade, Kentucky's pension debt reached $31.4 billion—nearly 17% of the state's $188.5 billion gross state product—in 2014.[4,5] By January, the debt had swollen to $32.6 billion. One of the state's largest funds, the Kentucky Teacher's Retirement System (KTRS), had to sell $650 million in assets to be able to make payments to beneficiaries in 2016.[6]

Kentucky's growing pension debt is not just threatening the pensions of beneficiaries, it is starting to boil over and negatively impact the state's economy as a whole. In November 2015, Standard & Poor's Ratings Services cited Kentucky's pension debt as the main reason for downgrading the state's credit rating to "A+" from "AA-."[7] In January 2017, Kentucky's credit outlook was reduced to negative by Standard & Poor's due to the pension debt.[8] Lower credit ratings mean higher borrowing costs—another expenditure Kentucky cannot afford.

Yet, there are reasons for optimism. Under Governor Matt Bevin, Kentucky will meet the full annual recommended contribution (ARC)[9] to the state's pension system after neglecting to do so—often to the tune of several $100 million per year—since 2008.[10] Kentucky's 2017-2018 budget will pour $1.28 billion into state pension systems and will also set aside $125 million to help fund future pension costs, though Gov. Bevin initially requested a set aside of $500 million that, unfortunately, was not included in the final budget.[11]

In addition to making substantial funding contributions to the pension system, Gov. Bevin also signed legislation to improve transparency for records reporting for the pension program, and has repeatedly stated his intention to transition

[1] We wish to thank David A. Jones for sharing his wealth of knowledge and invaluable research materials on state pension systems with us throughout the course of writing this paper.

[2] Hiram Lee, "Kentucky faces budgetary crises, shortfall in state pension funds," World Socialist Web Site, January 17, 2008. https://www.wsws.org/en/articles/2008/01/kent-j17.html

[3] "Issue Brief: The State Pension Funding: 2014, New accounting rules help provide a clearer picture," Pew Charitable Trusts, August 24, 2016. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/08/the-state-pension-funding-gap-2014

[4] *Ibid.*

[5] Bureau of Economic Analysis. http://www.bea.gov/

[6] John Cheves, "Kentucky's public pension outlook weakens; debt grows to $32.6 billion," *Lexington Herald-Leader*, November 28, 2016. http://www.kentucky.com/news/politics-government/article117549488.html

[7] Tom Loftus, "Pension debt lowers Kentucky credit rating," *Louisville Courier-Journal*, September 4, 2015. http://www.courier-journal.com/story/news/politics/2015/09/03/kentucky-credit-rating-downgraded/71668062/

[8] John Cheves, "Kentucky's credit outlook reduced to 'negative' by growing pension debt," *Lexington Herald-Leader*, January 13, 2017. http://www.kentucky.com/news/politics-government/article126347124.html

[9] The acronym ARC may stand for two terms, "actuarially required contribution" and "annual recommended contribution." Though we take the two terms to mean essentially the same thing—the amount that must be contributed to a state's pension system to maintain its long-term integrity, this paper will use the second meaning attributed to ARC.

[10] Meaghan Kilroy, "Kentucky governor signs bill funneling an additional $1.28 billion into pension funds," *Pensions & Investments*, April 29, 2016. http://www.pionline.com/article/20160429/ONLINE/160429846/kentucky-governor-signs-bill-funneling-an-additional-128-billion-into-pension-funds

[11] Meaghan Kilroy, "Kentucky governor signs bill funneling an additional $1.28 billion into pension funds," *Pensions & Investments*, April 29, 2016. http://www.pionline.com/article/20160429/ONLINE/160429846/kentucky-governor-signs-bill-funneling-an-additional-128-billion-into-pension-funds

Kentucky's pension system to a defined contribution plan, the most common retirement plan used in the private sector (see appendix for a list of recent pension-related legislation information).[12,13]

Despite these significant reforms, much more must be done to preserve the financial integrity of both Kentucky's pension system and the state's economy. To that purpose, this paper will outline the details of the current pension program, assess its current status, and explain the causes of Kentucky's pension crisis before describing three radical solutions that could be undertaken to ensure the health of Kentucky's pension system well into the future:

1. **Taxing Pension Benefits:** Kentucky is one of 11 states that exempts most or all pension income (public and private) from state income taxation. By taxing both public and private pensions as normal income, Kentucky could generate many hundreds of millions of dollars per year, depending upon the tax rate and exemptions, which could be used to ensure the health of the state's pension system (see page 11 for revenue estimate).

2. **Pro-rating Monthly Benefits:** Rather than determining an employee's monthly pension income at retirement based on the three- or five-highest years of an employee's salary, benefits could be pro-rated based on the employee's salary earned throughout his or her career.

3. **Transitioning to Defined Contributions:** By transitioning Kentucky from its current hybrid cash balance system to a defined contribution system, Kentucky can relieve pressure on the pension system going forward and, in the process, incentivize public employees to improve productivity to boost their compensation and provide for their retirement.[14]

Considerable legal barriers may present themselves in the course of trying to enact radical pension reform. In anticipation of such legal barriers, this work offers a relevant case history and plausible legal rationale for bringing about significant changes to Kentucky's pension system.

KENTUCKY'S PENSION SYSTEM: BY THE NUMBERS

The U.S. Census publishes data for revenues, expenditures, financial assets, and membership for the 299 state-administered and 6,000 locally-administered defined benefit public pension systems in the United States.[15] We will provide an overview of the FY 2015 data for the 34 public state and local government pension systems active in Kentucky:[16]

- **Total Contributions:** For 2015, contributions into Kentucky's public pension systems amounted to $1.96 billion (see Table 1).[17] Of these total contributions, $0.60 billion were employee contributions and $1.36 billion were government contributions.

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[12] John Cheves, "Which bills survived legislature's final hours, and which didn't," *Lexington Herald-Leader*, April 18, 2016. http://www.kentucky.com/news/politics-government/article72482402.html

[13] *Ibid.*

[14] For more information on defined benefit (DB), defined contribution (DC), and hybrid pension plans, see the appendix.

[15] U.S. Census Bureau, State and Locally-Administered Defined Benefit Pension Systems, 2015 Annual Survey of Public Pensions. https://www.census.gov/govs/retire/

[16] A guide to the methodology used in the 2015 report can be found at the following source: "2015 Census of Governments: Finance—Survey of Public Pensions: State- and Locally-Administered Defined Benefit Data," U.S Census Bureau, https://www2.census.gov/govs/retire/2015%20survey%20methodology.pdf

[17] The U.S. Census defines pension contributions as: "Amounts paid into a pension fund by the parent government or employees pursuant to terms of the fund, state law, actuarial calculation, or other basis for determination. Excludes any amounts received for transmittal to the Federal Social Security System, amounts received from the liquidation of investments, and any other receipts for social insurance programs not part of the pension funds." Source: https://www.census.gov/govs/retire/definitions.html

Table 1
Kentucky: Public Pension Contributions by Source[18]
(2015)

Government Contributions	1,357,133,000
State Government Contributions	1,068,606,000
Local Government Contributions	288,527,000
Employee Contributions	600,283,000
Total Contributions	1,957,416,000

- **Total Payments:** In 2015, total state and local payments in Kentucky amounted to $3.87 billion. The category of total payments includes the following items: benefits (payment of pension benefits, $3.67 billion), withdrawals (return on contributions paid out to employees,[1] $0.05 billion), and other payments (not defined by the Census Bureau, $0.15 billion). For every $1 of the $1.96 billion in contributions paid into Kentucky's public pension systems (refer back to Table 1), state and local public pension systems paid out $1.98 dollars.

- **Membership:** In 2015, Kentucky's public pension systems had total membership of 365,261, of which 218,259 were active members (employees making payments to pension plans[19]) and 147,002 members were inactive (former employees or others on extended leave who have retained retirement credits[20]). $3.67 billion in total public pension benefits were paid out to 149,989 beneficiaries (retirees receiving lump-sum or periodic benefits, depending on the provisions in the plan[21]), an average of $24,444 in pension benefits per recipient in 2015.

50-State Public Pension Fund Performance Rankings

Pew Charitable Trusts releases an annual report ranking public sector retirement systems among the 50 states. The Pew report includes the following data for state-managed pension systems (as opposed to locally-managed systems) in each state: the size of the assets and liabilities of the pension fund, the rate of return on the fund's investments, membership size, and the amount of annual recommended and actual contributions. By looking at long-term trends in these data and comparing them across the 50 states, accurate assessments of the health of the state pension funds can be made.

For 2014, Pew found that, overall, state pension funds benefited from "strong investment performance, with public plans averaging 17% rates of return." Such strong investment performance allowed the nation's retirement system to lower their total liabilities by $35 billion.[22]

New accounting guidelines for all 50 states also took effect in 2014 that aimed to offer the public a more accurate picture of their state's public pension system, especially for states with large unfunded liabilities, such as Kentucky. Under the new guidelines, plans with low funding ratios must now report pension assets and liabilities using more conservative return assumptions. When these new guidelines were used to restate 2013 pension data, the result yielded $72 billion in increased reported pension liabilities and debt. Plans in Illinois and New Jersey, along with the Kentucky Teachers' Retirement System—one of the state's largest pension funds—and the Texas Employees Retirement System, account for over 90% of this amount.[5] Despite this mandate, many states continue to report pension fund data using the prior method to the public; however, Pew reports reflect the data using the new requirements.

[18] Source: U.S. Census Bureau, State and Locally-Administered Defined Benefit Pension Systems, 2015 Annual Survey of Public Pensions. https://www.census.gov/govs/retire/
[19] The U.S. Census Bureau defines active members as "employees making payments to contributory pension plans, as well as other employees on whose behalf contributions are made by the sponsoring government (noncontributory retirement systems). https://www.census.gov/govs/retire/definitions.html
[20] *Ibid.*
[21] *Ibid.*
[22] "Issue Brief: The State Pension Funding: 2014, New accounting rules help provide a clearer picture," Pew Charitable Trusts, August 24, 2016. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/08/the-state-pension-funding-gap-2014

In 2014, the funding ratio, i.e., the asset-to-liability ratio, for the pension systems of all 50 states was 74.8% (refer to Table 2 on page 5). While an improvement from the 71.8% funding ratio in 2013, the 2014 funding ratio is still considerably lower than the 2003 funding ratio across all 50 states: 88.5%.[23] For context, 80% is frequently considered a "healthy" funded ratio, though that benchmark as a symbol of the health of a public pension system is debated.[24] The funding ratios among the states vary considerably according to Pew:

In 2014, among the 50 states, three states surpassed 100% funding ratios:

- South Dakota (107.3% funded, Ranked 1st among the states)
- Oregon (103.6%, 2nd)
- Wisconsin (102.7%, 3rd)

And four states were within striking distance (5 percentage points) of 100% funding:

- North Carolina (99.3%, 4th)
- Tennessee (98.8%, 5th)
- New York (98.1%, 6th)
- Idaho (95.2%, 7th)

At the other end of the spectrum, the three poorest performing states had pensions systems that weren't even 50% funded in 2014:

- New Jersey (42.5%, 48th)
- Illinois (41.3%), 49th)
- **Kentucky (41%, 50th)**

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[23] *Ibid.*

[24] For discussions of the 80% threshold, see the following:
Keith Brainard and Paul Zorn, "The 80-percent threshold: Its source as a healthy or minimum funding level for public pension plans," National Association of State Retirement Administrators, January 2012.
http://www.nasra.org/files/Topical%20Reports/Funding%20Policies/80_percent_funding_threshold.pdf,
"The 80% Pension Funding Myth," American Academy of Actuaries, April 2014. http://www.actuary.org/files/Pension%20Funding.pdf and,
Robert M. Costrell, "The Steady-State Math of the '80 Percent Standard' for Funding and the Policy of High Assumed Returns, Association for Education, Finance, and Policy, March 18, 2016.
https://aefpweb.org/sites/default/files/webform/41/Costrell,%20%2080%20percent%20standard%20and%20High%20Assumed%20Returns,%20AEFP%20conference%20paper.pdf

Table 2
2014 Public Sector Retirement Systems
Among the States: Select Data and Rankings[25]
($ = thousands)

State	Liability (Total Pension Liability)	Assets (Plan Fiduciary Net Postion)	Pension Debt (Net Pension Liability)	Funded Ratio	Change in Percent Funded (vs. previous year)	Funding Rank
South Dakota	9,887,095	10,607,554	(720,459)	107.3%	7.4%	1
Oregon	63,134,800	65,401,500	(2,266,700)	103.6%	7.7%	2
Wisconsin	89,691,173	92,147,447	(2,456,274)	102.7%	2.8%	3
North Carolina	90,335,215	89,659,220	675,995	99.3%	3.3%	4
Tennessee	43,407,305	42,905,157	502,148	98.8%	5.2%	5
New York	193,065,921	189,412,416	3,653,505	98.1%	9.4%	6
Idaho	14,976,003	14,261,351	714,652	95.2%	9.7%	7
Nebraska	12,516,428	11,642,713	873,716	93.0%	13.1%	8
Delaware	9,925,413	9,169,696	755,717	92.4%	4.2%	9
Florida	165,559,392	150,107,677	15,451,715	90.7%	9.8%	10
Washington	80,803,545	72,762,758	8,040,787	90.0%	1.8%	11
Utah	30,025,458	26,569,124	3,456,334	88.5%	8.3%	12
Iowa	32,704,232	28,586,719	4,117,513	87.4%	6.7%	13
Maine	14,991,882	12,861,703	2,130,180	85.8%	6.2%	14
Arkansas	28,496,827	24,370,062	4,126,765	85.5%	11.0%	15
Missouri	61,888,322	52,786,510	9,101,811	85.3%	8.7%	16
Georgia	98,971,364	82,472,943	16,498,421	83.3%	3.9%	17
Minnesota	72,803,264	59,587,598	13,215,666	81.8%	7.2%	18
Oklahoma	35,114,883	28,512,994	6,601,889	81.2%	14.7%	19
Ohio	186,228,703	149,540,458	36,688,245	80.3%	6.3%	20
Wyoming	9,682,721	7,688,940	1,993,781	79.4%	0.7%	21
Texas	201,046,036	159,155,968	41,890,068	79.2%	-1.3%	22
West Virginia	17,150,259	13,330,090	3,820,169	77.7%	10.7%	23
Nevada	44,111,222	33,672,067	10,439,155	76.3%	7.0%	24
California	646,418,986	493,436,931	152,982,055	76.3%	4.1%	25
Montana	12,990,247	9,869,365	3,120,882	76.0%	2.7%	26
Virginia	85,870,937	64,520,891	21,350,046	75.1%	9.6%	27
US Total	**3,701,820,064**	**2,768,267,665**	**933,552,398**	**74.8%**	**3.0%**	**-**
Vermont	5,216,342	3,897,136	1,319,206	74.7%	5.5%	28
New Mexico	35,025,728	25,959,117	9,066,609	74.1%	7.4%	29
North Dakota	6,197,831	4,535,923	1,661,908	73.2%	12.2%	30
Maryland	63,928,070	45,551,291	18,376,779	71.3%	5.9%	31
Alabama	47,283,806	33,331,904	13,951,902	70.5%	4.6%	32
Indiana	44,230,185	30,622,956	13,607,229	69.2%	4.5%	33
Massachusetts	77,981,914	52,563,327	25,418,588	67.4%	6.0%	34
Mississippi	37,481,350	25,219,604	12,261,746	67.3%	9.7%	35
Michigan	84,565,036	56,424,415	28,140,621	66.7%	6.8%	36
Kansas	24,827,591	16,535,797	8,291,794	66.6%	6.7%	37
New Hampshire	11,227,612	7,437,551	3,790,061	66.2%	9.5%	38
Louisiana	49,273,473	32,002,341	17,271,133	64.9%	6.9%	39
Arizona	64,345,745	41,440,778	22,904,967	64.4%	-7.3%	40
Colorado	68,848,418	44,229,312	24,619,106	64.2%	2.8%	41
Hawaii	22,220,098	14,203,015	8,017,082	63.9%	3.9%	42
South Carolina	49,255,784	29,927,711	19,328,073	60.8%	-2.5%	43
Rhode Island	10,802,545	6,562,351	4,240,194	60.7%	2.3%	44
Alaska	19,402,488	11,679,592	7,722,897	60.2%	7.8%	45
Pennsylvania	134,755,832	80,318,115	54,437,717	59.6%	-2.7%	46
Connecticut	53,187,915	26,881,236	26,306,679	50.5%	2.1%	47
New Jersey	196,607,997	83,482,447	113,125,550	42.5%	-20.3%	48
Illinois	190,178,814	78,630,074	111,548,740	41.3%	2.1%	49
Kentucky	**53,177,855**	**21,791,819**	**31,386,036**	**41.0%**	**-3.2%**	**50**

[25] "Issue Brief: The State Pension Funding: 2014, New accounting rules help provide a clearer picture," Pew Charitable trusts, August 24, 2016. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/08/the-state-pension-funding-gap-2014

How Kentucky's Pension System Became the Worst Funded Among the States

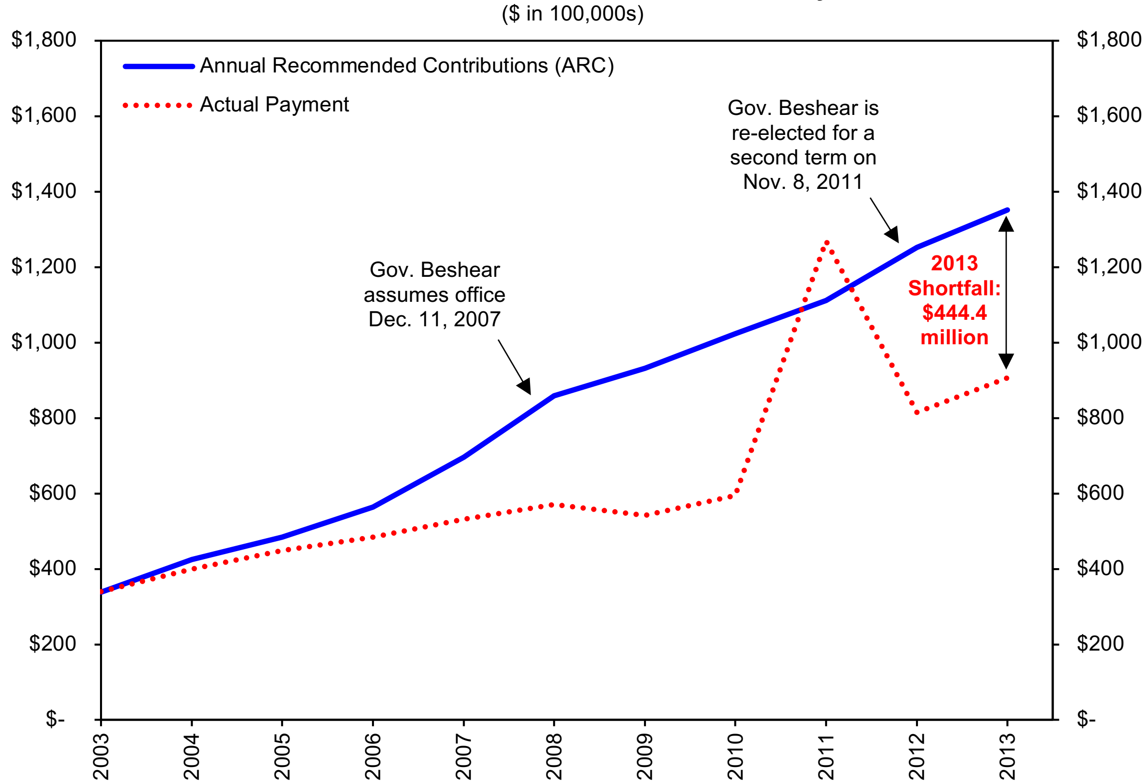
Two factors contributed to the current state of Kentucky's public pension system:

1. **Failure to meet annual recommended contributions (ARCs):** A comprehensive account of all of the attempts by different administrations, committees, panels, and lawsuits brought against state and local governments attempting to understand or solve Kentucky's pension problem could fill hundreds of pages, but the singular cause of the pension crisis is this: Kentucky has, for over a decade, rarely chosen to pay its annual pension bills.

In 1994, the Kentucky Retirement System board sued then-Governor Brereton Jones (D) and the General Assembly "in an attempt to enforce the state's ARC requirement as set in statute. The Court found that the state's actions in declining to fund the ARC did not constitute an unlawful impairment of the Kentucky Employment Retirement System members' inviolable contract rights. This ruling has not been challenged"[26]

The state has therefore continued to allow its pension funds to deteriorate. In 2003, the Kentucky pension system met its ARC, but did not meet it again until 2011—the only year that then-Governor Steve Beshear would meet the state's full ARC during his two terms (eight years) in office. During the remainder of Gov. Beshear's time in office, the state resumed its prior trend, neglecting meet its ARC in 2012 ($438 million shortfall), 2013 ($444 million), 2014 ($220 million), and 2015 ($356 million shortfall in the Kentucky Teachers' Retirement System alone).[27]

Figure 1
2003-2013: Kentucky Retirement Systems
Annual Recommended Contributions and Actual Payments[28]
($ in 100,000s)



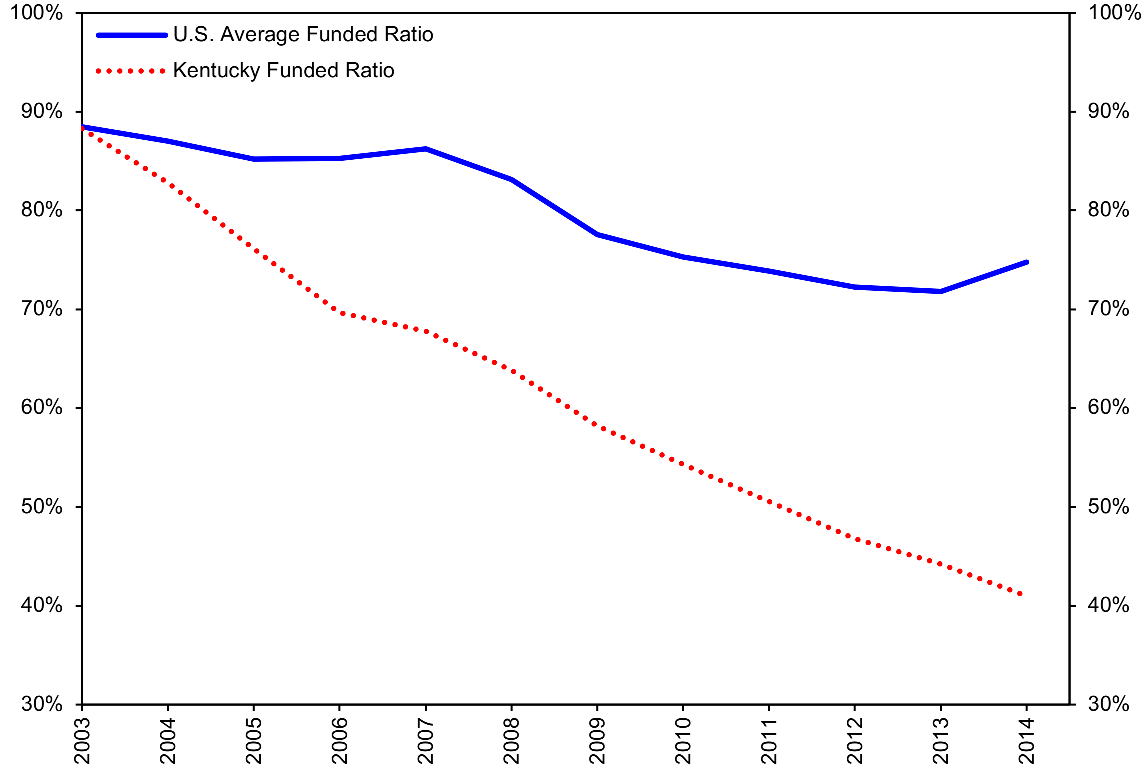
[26] Keith Brainard and Alex Brown, "Spotlight On: The Annual Required Contribution Experience of State retirement Plans, FY 01 to FY 13," National Associations of State Retirement Administrators, March 2015. http://www.nasra.org/files/JointPublications/NASRA_ARC_Spotlight.pdf

[27] Darrell Preston, "Worst-Funded U.S. Pension Shows Kentucky's Neglect: Muni Credit," *Bloomberg*, January 8, 2015. https://www.bloomberg.com/news/articles/2015-01-09/worst-funded-u-s-pension-shows-kentucky-s-neglect-muni-credit

[28] Source: "Issue Brief: The State Pension Funding: 2014, New accounting rules help provide a clearer picture," Pew Charitable trusts, August 24, 2016. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/08/the-state-pension-funding-gap-2014

Kentucky's decision to neglect making the full annual required contributions (ARCs) in all but a single year between 2003 and 2013 lowered the funding ratio i.e., the assets to liabilities ratio, of the state's pension system considerably over that period (see Figure 2). In 2003, Kentucky's pension system was 88.3% funded and the U.S. average was 88.5%. By 2014, however, Kentucky's pension systems was 41.0% funded and the U.S. average funding ratio was 74.8%.

Figure 2
2003-2014 Funding Ratios:
U.S. Average and Kentucky[29]



2. **Poor Investment Performance:** The poor performance of Kentucky's pension investments in the last 15 years was also a major contributor to the state's pension crisis.

Total cash holdings and investment holdings in Kentucky's pension system at the end of the period for 2015 amounted to $29.94 billion, all inclusive. Kentucky's investments returned -0.02%, while the S&P 500 returned 1.38% in 2015 (see Table 3). The difference in returns between Kentucky's investments and the S&P 500 over the last five- and 10-year periods was even greater than the difference in 2015 (see Table 3).[30]

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[29] Source: "Issue Brief: The State Pension Funding: 2014, New accounting rules help provide a clearer picture," Pew Charitable Trusts, August 24, 2016. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/08/the-state-pension-funding-gap-2014

[30] In 2015, such poor investment performance did not prevent the Kentucky Retirement System's board of trustees from rehiring its Executive Director Bill Thielen, who had held the position since 2011, or from increasing his salary from $171,192 to $215,000—a 25% raise. Source: James McNair, "Big Raise for State Pension Boss Prompts Ire of Retirees, Legislators," Kentucky Center for Investigative Reporting, October 26, 2015. http://kycir.org/2015/10/26/big-raise-for-state-pension-boss-prompts-ire-of-retirees-senator/

Table 3
Kentucky: Average Annual Rates of Return of State and Local Public Pension Holdings vs. the S&P 500[31,32,33]

	4Q-15	1 Yr	5 Yr	10 Yr
Kentucky Retirement Systems Total Fund	1.94%	-0.02%	5.84%	5.17%
S&P 500 (Cap Wtd)	7.04%	1.38%	12.57%	7.31%
Difference	-5.10%	-1.40%	-6.73%	-2.14%

And yet, despite this below-market return history, Kentucky still assumes an average rate of return of 6.75% for two of the state's largest pension systems, the KERS non-hazardous and the SPRS state-police systems, and a 7.5% rate of return assumption—nearly 2.5 percentage higher than the average over the last decade—for the other KERS funds.[34,35]

A 10-year difference of 2.14% in annual returns may seem negligible to some; however, that could not be further from the truth. Table 4 depicts the difference in $10,000 when invested in the Kentucky pension system at 5.17% annual returns compared to the S&P 500 at 7.31% annual returns. After 10 years, the S&P 500 returned an extra $3,694, or 22.3%, relative to the Kentucky pension system.

Table 4
Difference in Returns with Initial Investment of $10,000 based on 10-Year Performance: Kentucky Pension Investments vs. the S&P 500 (Cap Wtd)[36]

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Kentucky	$10,517	$11,061	$11,633	$12,234	$12,866	$13,532	$14,231	$14,967	$15,741	$16,555
S&P 500 (Cap Wtd)	$10,731	$11,515	$12,357	$13,261	$14,230	$15,270	$16,386	$17,584	$18,870	$20,249
Difference	-$214	-$455	-$725	-$1,027	-$1,363	-$1,738	-$2,155	-$2,617	-$3,129	-$3,694

To add insult to injury, for the period ending in 2012, the 5-year rate of return on Kentucky's pension holdings was tied for 3rd lowest among all 50 states (with Indiana) at 0.2%.[37] In 2012, the fees Kentucky paid for managing its investments were among the lowest among all 50 states.[38,39] However, skepticism of Kentucky's relatively low investment fees is warranted. A 2015 report by CEM Benchmarking (a global benchmarking firm) found that Kentucky's state-managed annual investment expenses were more than 100% higher than reported by Kentucky Retirement Systems in 2014 ($62.4 million reported vs. $126.6 million reported by CEM Benchmarking).[40]

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[31] Source: "Kentucky Retirement Systems: Investment Performance Analysis," RV Kuhns & Associates, Inc., Period ended June 30, 2016. https://kyret.ky.gov/Investments%20Analysis/2016-06-30-quarterly-analysis.pdf
[32] "Cap Wtd" refers to capitalized weighted index, which is defined as "a type of market index with individual components that are weighted according to their total market capitalization. The larger components carry higher percentage weightings, while the smaller components in the index have lower weights. The type of index is also known as a market value-weighted index."
For more information refer to the following:
"Capitalization-Weighted Index," Investopedia. http://www.investopedia.com/terms/c/capitalizationweightedindex.asp
[33] As stated in RV Kuhn's report, the returns for investments held by the Kentucky Retirement System were net of performance and management fees.
[34] "KRS board approves change to rate of return on pension systems," State Journal, December 3, 2015.
http://www.state-journal.com/2015/12/03/krs-board-approves-change-to-rate-of-return-on-pension-systems/
[35] Jaqueline Pitts, "KRS Board votes to lower assumed rate of return as system continues to fall short," Kentucky Chamber of Commerce, December 3, 2015.
https://kychamberbottomline.com/2015/12/03/krs-board-votes-to-lower-assumed-rate-of-return-as-system-continues-to-fall-short/
[36] Source: *Ibid*., calculations by Laffer Associates.
[37] *Ibid.*
[38] Jeff Hooke and John J. Walters, "Wall Street Fees, Investment Returns, Maryland and 49 Other State Pension Funds," Maryland Policy Report, Maryland Public Policy Report, July 1, 2013.
http://www.mdpolicy.org/research/detail/wall-street-fees-investment-returns-maryland-and-49-other-state-pension-funds
[39] For a breakdown of all of the investments held by the Kentucky Retirement System and the returns on those investments between July 1, 2015 and June 30, 2016, refer to the appendix.
[40] "Investment Cost Effectiveness Analysis (for the 5 years ending December 31, 2014): Kentucky Retirement Systems," CEM Benchmarking, Inc., 2015. https://www.documentcloud.org/documents/2423226-kentucky-retirement-systems-consultants-report.html

Kentucky's Pension System: The Devil's in the Details

Kentucky has made modest attempts to reform its pension systems for years, but the most significant changes were in 2008 and 2013.

Below are guidelines for the Kentucky Retirement Systems pension enacted in 2008[41]:

- Employee contributions increased to 6% from 5%.
- Benefit factor[42] range of 1.1%-1.75% for up to 30 years.
- Time to full retirement follows the Rule of 87: age (minimum 57 years old) + service = 87. Therefore, 30 years of service are required to qualify for full retirement.
- Final compensation calculation: average of salaries for 5 highest years (instead of 3 highest years).
- Health Insurance: must meet Rule of 87 requirements; benefits receive annual adjustment of 1.5%.
- Cost of Living Adjustments: annual adjustment of 1.5%.

In 2013, several key changes to Kentucky's pension system were signed into law:

- A commitment to meeting the full obligation to the pension system, and devoting $100 million extra per year to annual contributions to the program.
- A limit on Cost of Living Adjustments—an assessment of the cost of annual increases of 1.5% are presented yearly to the Legislature for approval and must be fully funded.
- A new hybrid cash balance retirement plan (details below) that receives contributions from the employer and employee with a guaranteed return of 4%, and a lifetime payout based on the balance at retirement. Prior to the introduction of the hybrid plan, employees were enrolled in a defined benefit plan.

Kentucky's Current Pension System—a Hybrid Cash Balance Plan:

- Employees hired after January 1, 2014 are enrolled in the plan. Contributions are made by the employer and the employee. Employees who were promised defined benefit plans prior to the introduction of the hybrid plan keep their defined benefit plans.
- The most important thing to understand about Kentucky's cash balance plan is this: **"that it was designed to cost the same as the old plan but to be more flexible if things did not go as expected."**[43] Several actuarial studies showed the cost to the state of the cash balance system would be at par with the previous defined benefit system, but the returns in the new system would be more predictable and constant."[44]
- The retirement plan manages the investments in the hybrid plan and guarantees the employee an annual return of at least 4%. If long-term returns exceed the guaranteed 4%, then the extra returns will be shared between employees and a rainy day fund within the pension plan to cover years when returns fall below the guarantee. And when a worker is ready to retire, the money in his or her account is converted to lifetime income in the form of an annuity.
- Like a defined contribution plan, the funds in the employee's cash balance account are portable.

While the changes made to the pension system in 2013 were significant, they did not address the existing pension liability that ballooned over the prior 15 years.

Kentucky has three potential options for reducing its existing pension debt and restoring the health of its pension system going forward: 1.) levying an income tax on pension benefits, 2.) pro-rating monthly benefits upon retirement, and/or 3.) transition to a full defined contribution system.

[41] "Kentucky's Successful Public Pension Reform," Pew Charitable Trusts, Public Sector Retirement Systems, September 27, 2013. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2013/09/27/kentuckys-successful-public-pension-reform

[42] The benefit factor is "a percentage based upon the retirement plan, the type of service, and the timing of the member's service," which is multiplied by the amount of an employee's final compensation and number of years of service credit to determine the annual benefit at retirement.
Source: "Overview of the Kentucky Retirement Systems, Administration & Benefits," Kentucky Association of Counties. http://www.kaco.org/media/13331/OVERVIEW%20OF%20KRS%20(final)PublicPensTF%20June2012.pdf

[43] *Ibid.*

[44] *Ibid.*

POTENTIAL SOLUTIONS

Solution #1: Taxing Pension Benefits

While federal income tax liabilities are in place for pension income,[45] all retirement benefits attributable to employment (both public and private) on or prior to December 31, 1997 are exempt from Kentucky's income tax. The share of retirement benefits attributable to employment on or after January 1, 1998 is subject to Kentucky's income tax; however 100% of pension income up to $41,110 is excluded from Kentucky's income tax.[46] With the average beneficiary in Kentucky receiving $24,440 in annual benefits, Kentucky is essentially excluding pension benefits from the state's income tax.

According to the National Conference of State Legislatures (NCSL), 10 states—Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, New York and Pennsylvania—exclude all federal, state and local pension income from taxation; however, some of these 10 states restrict the state and local exemption to pensions from within the state.[47] Among these 10 states, only Kansas taxes any Social Security income; since 2008, Kansas has allowed persons with Adjusted Gross Income (AGI) of less than $75,000 to exclude Social Security income from state taxation. Given the average pension beneficiary received $24,440 in annual benefits in 2015, and $41,110 in public pension benefits are excluded from Kentucky's state personal income tax, Kentucky can be considered the 11th state that excludes most or all pension benefits from state income taxation.

To be sure, the 11 states excluding pension benefits from income taxation differ in their policies. For example, Kansas and Massachusetts do not exclude any private sector retirement income, while the others typically allow a fairly broad exclusion of private sector pension. But the trend is clear: with the single exception of New York,[48] the pension systems of all 11 states rank among the worst in the country in terms of their investment asset-to-pension liability ratio, or funded ratio, with no state being ranked higher than 32 out of 50 in 2014. Note also that most states in Table 5 declined substantially between 2003 and 2014 (see Table 5). In 2003, the average ranking of the states in Table 5 was 31—by 2014 the average was 37.

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[45] Monthly benefits from Kentucky's three major public pension systems, Kentucky Employees Retirement System (KERS), the County Employees Retirement System (CERS), and the State Police Retirement System (SPRS) are subject to federal income tax. Beneficiaries whose contributions to the pension system were made with after-tax dollars[45] are entitled to receive monthly benefits, a portion of which is tax-free. The tax-free share of the monthly pension benefit is referred to as "the monthly exclusion." The monthly exclusion is a specific dollar amount that does not change, and does not change if the beneficiary's retirement benefits increase. The monthly exclusion continues "until there are no remaining payments on the account or until the total of all monthly exclusions on the account equals the member's taxed contributions."

[46] "Kentucky 2015 Kentucky Individual Income Tax Forms," Kentucky Department of Revenue. http://revenue.ky.gov/Forms/2015_740PFINAL.pdf

[47] "State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2014," National Conference of State Legislatures, April 3, 2015. http://www.ncsl.org/documents/fiscal/StateTaxOnPensions2015update.pdf

[48] New York's pension system, the 3rd largest in the country, has consistently ranked among the best public pension systems in the nation as measured by its funding ratio over the last 15 years for several reasons. First, New York mandates that annual recommended contributions are met every single year. Second, managers of the investments in the pension system have consistently lowered assumed rate of returns on investments. In 2010, the return assumption was lowered to 7.5% from 7.75%, and then in 2015 the rate was lowered to 7.0%. Reducing the assumed rate of return has helped the state's pension managers maintain a clearer picture of the actual pension debt. By not wishing the debt away with unrealistic rate assumptions, the state has had more incentive to meet annual recommended contributions to the pension system. Source: Ezequiel Minaya, "New York Lowers Return Assumption for State Retirement System," *The Wall Street Journal*, September 4, 2015. http://www.wsj.com/articles/new-york-lowers-return-assumption-for-state-retirement-system-1441383501

Table 5

Pew Unfunded Liability Rankings among States that Exclude Most or All of Public Pension Benefits from State Income Tax[49]

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Alabama	20	19	23	25	32	32	28	32	32	26	30	32
Haw aii	37	39	41	45	45	42	40	41	42	41	40	42
Illinois	49	46	47	47	47	50	50	50	50	50	50	49
Kansas	39	42	40	41	40	49	41	40	43	44	42	37
Kentucky	**28**	**30**	**33**	**40**	**44**	**43**	**47**	**47**	**49**	**49**	**49**	**50**
Louisiana	45	45	43	43	41	41	44	45	47	46	44	39
Massachusetts	41	38	38	34	33	45	34	28	35	40	38	34
Michigan	29	28	30	20	20	20	21	27	36	38	41	36
Mississippi	36	37	39	38	38	36	35	38	40	43	45	35
New York	8	4	4	2	2	1	1	5	7	8	6	6
Pennsylvania	6	13	21	21	18	17	17	20	28	33	36	46
Avg. Ranking	**31**	**31**	**33**	**32**	**33**	**34**	**33**	**34**	**37**	**38**	**38**	**37**

To clarify our view on the data presented in Table 5, we are not suggesting that exclusion of public benefits from income taxation dictates that a state's public pension system will perform poorly. New York has shown it is possible to exclude pension income from taxation and maintain a solvent system, but the experience in other states has shown doing so is improbable.

That pension income is excluded from taxation is indicative of a larger problem in the tax code: preferential tax treatment of certain groups at the expense of other groups and the public. Such preferential tax treatment to some groups does not lower the demand for services—in this case, the services being future pension benefits that must eventually be paid. By narrowing the tax base, i.e. the size of the group that must fund the future pension benefits, meeting the obligation becomes a heavier burden for those remaining who must bear it. By expanding the tax base and levying income taxes on all pension income—both public and private—Kentucky and other states can substantially improve the health of their pension systems.

Taxing pension benefits would require changing Kentucky's statutes that currently prevent the reduction of any pension benefits;[50] nevertheless, doing so would contribute considerable funds to the pension system, and restore the health of the system—as long as the spending side of the equation is kept in check.

In 2015, total state and local pension payments to beneficiaries in Kentucky amounted to \$3.87 billion. The category of total payments includes the following items: benefits (payment of pension benefits, \$3.67 billion), withdrawals (return on contributions paid out to employees,[51] \$0.05 billion), and other payments (not defined by the Census Bureau, \$0.15 billion).

[49] Sources: NCSL and Pew Research
[50] See appendix for more information.
[51] The U.S. Census defines withdrawals as "Amounts paid to employees or former employees or their survivors, representing return of contributions made by employees during the period of their employment, and any interest on such amounts. Also includes any transfers of investment holdings or reimbursements for benefits paid where another pension fund assumes responsibility for direct benefit payment to retirees."
Source: "Annual Survey of Public Pensions: State & Local Data, Definitions," U.S. Census. https://www.census.gov/govs/retire/definitions.html

A flat tax on the $3.67 billion in pension benefits issued in 2015 would produce the following revenue at various tax rates:

Table 6
Estimated Revenue Generated by Levying a Flat Tax on Pension Benefits for 2015[52]
($ = actual)

Flat Tax Rate	Revenue Generated
1%	36,700,000
2%	73,400,000
3%	110,100,000
4%	146,800,000
5%	183,500,000
6%	220,200,000
7%	256,900,000

Solution #2: Pro-rating Monthly Retirement Benefits

Under current rules, qualifying public employees receive pension benefits based on the average of their five highest salaries from the duration of their tenure. Determining an employee's pension on the five highest salaries creates an incentive for employees to boost compensation. This is often done in the years approaching retirement and is a practice referred to as "pension spiking." Kentucky has laws intended to prevent pension spiking[53] and they are actually enforced: local governments were fined the difference between what the employee was entitled to and what the employee received, to the amount of $570,000 in 2015.[54]

Reducing the prevalence of pension-spiking is a worthwhile effort; however, a more effective approach to eliminating pension-spiking would be to change the economic incentives that determine pension benefits. Pro-rating monthly pension benefits based on each year of compensation would eliminate pension-spiking and manage costs. The logic behind pro-rating benefits is also appealing. Drawing upon an example by Buck:[55]

If an employee accrues a particular level of pension benefits during years one through fifteen of employment, and then accrues a higher level of pension benefits during sixteen through thirty, it would seem odd to be able to claim a legal right to receive only the higher level of pension benefits for the *entirety* of the employee's retirement years.

Solution #3: Transitioning to a Defined Contribution System

From an economic perspective, the most significant benefit of a defined contribution (DC) system relative to other retirement plans stems from the incentive structure.[56,57] DC plans put employees in charge of funding their own retirement, which causes employees to think "on the margin," i.e. to make decisions about work, and leisure—and thus income and productivity as well—in light of the trade-offs between each activity.

Under a DC plan, employees regularly contribute a share their income to a retirement account, which is often matched in whole or in part by the employers. To increase the funds available at the time of their retirement, employees must

52 "State and Locally-Administered Defined Benefit Pension Systems, 2015 Annual Survey of Public Pensions." U.S. Census Bureau. https://www.census.gov/govs/retire/
53 For a guide to Kentucky's anti-spiking laws, refer to the following source:
"Pension Spiking," Kentucky Retirement Systems, Division of Employer Reporting, Compliance, and Education. https://kyret.ky.gov/Employer%20Reporting%20Resources/Pension%20Spiking%20Overview.pdf
54 An estimated 10% of the 3,500 of the employees who retired in 2014 were found to be in violation of Kentucky's anti-spiking laws. For more information, see the following:
Amanda Van Benschoten, "Taxpayers on the hook for pension spiking," Cininnati.com, March 27, 2015. http://www.cincinnati.com/story/news/local/northern-ky/2015/03/27/kentucky-pension-spiking/70559760/
55 Stuart Buck, "Legal Obstacles to State Pension Reform," 2011. SSRN 1917563, 2011.
http://www.aefpweb.org/sites/default/files/webform/Stuart_Buck,_Legal_Obstacles_to_Pension_Reform.pdf
56 For an overview of various retirement plans and the states in which they are offered, refer to the appendix.
57 A primer on the characteristics of different pension plans in included in the appendix.

do one or more of the following: 1.) increase the share of their income contributed to the retirement account, 2.) increase their income, which increases the amount of the contribution to retirement, holding the contribution rate constant, and/or 3.) improve investment returns by becoming educated about investment choices. All three of these choices incentivize employees to take an active role in funding their retirement by improving work performance and output, and thus increasing income and the funds available to them at the time of their retirement.

In terms of aligning incentives for each and every employee, it's critical to realize that each additional dollar added to any one employee's plan will increase the discounted future benefits by exactly $1 for that specific employee. A DC plan removes all distortions resulting from any disassociation between effort and reward. No other system has this feature, which is of the essence to economics.

In addition to the incentive effects under a DC plan, there are many secondary benefits of a DC plan relative to most other plan offerings.

1. **Control:** Given the poor performance of the Kentucky Retirement System in managing the pension system, many Kentuckians would have preferred to have greater control over their retirement planning. Adopting a DC system, such as a 401(k), would grant such autonomy to retirees.

2. **Healthy Turnover:** Requiring employees to serve long tenures in order to qualify for pension benefits is not attractive to all potential workers. Younger workers who don't want to work for the government for decades will prefer the portability of DC plans. And with vesting schedules, younger workers are still incentivized to work in government positions for longer tenures, ensuring worker retention.

3. **Greater Benefits over Shorter Time Periods:** Shorter tenure employees leave service with greater benefits under a DC arrangement than in a defined benefit (DB) system.[58]

4. **Cost Variability:** With a DC system, the employer assumes none of the risk that investment returns will adequately fund retirement, although the employer still pays only through contemporaneous contributions. This allows for greater planning on the part of the employer and requires more responsibility on the part of employees to plan their retirement.

5. **Lower Administrative Costs:** Actuarial services are not required to the extent necessary for DB plans; however, provision of participant investment education and the cost of administering many individual funds can make DC plans more expensive than DB plans. Typically, however, DC plans are less expensive to administer, with smaller employers reaping the most savings.[59]

6. **Access:** Unlike DB or most hybrid plans, employees can access DC funds pre-retirement.

7. **End of Life Planning:** In a DC plan, account balances may be inherited by heirs other than a spouse upon the beneficiary's death.

[58] "An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans" by David Rajnes, Employee Benefit Research Institute, September, 2001. http://cucfa.org/news/pension_table.html
[59] "An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans" by David Rajnes, Employee Benefit Research Institute, September, 2001. http://cucfa.org/news/pension_table.html

Legal Barriers to Pension Reform

At one end of the spectrum are states like Kentucky, Louisiana, Maine, Missouri, and Ohio, which do not recognize a pension contract until retirement or upon qualification for retirement (in Kentucky, eligibility is at the time of retirement)…[60,61] *As such, "legislation adversely affecting [the benefits of] non-retired workers (and some existing workers who meet the prescribed age and services requirements for retirement eligibility) will be upheld under a contract challenge."*[62]

- "Reforming Public Pensions," *Yale Law & Policy Review*, 2014

If Kentucky is to begin levying a tax on income from public pensions in an effort to lower its existing pension liability, it must first clear a few substantial legal hurdles, both statutory and constitutional.

According to Buck, there are three common legal arguments offered in opposition to pension reform.[63] The first legal argument is that pension reform is precluded by the Contracts Clause of the U.S. Constitution, or its equivalent in a state Constitution. The Contracts Clause stipulates that a government may not pass a law that would enable it to neglect contractual agreements, and any attempt to reduce current or future pension benefits is thus unconstitutional. The second legal argument offered against pension reform is that reducing pension benefits is "taking away" the property of current or future beneficiaries, and is thus a violation of the Takings Clauses of federal and state Constitutions. The third argument typically offered in opposition to pension reform is that pension reform is a violation of Substantive Due Process protections afforded by the 5th and 14th Amendments of the U.S Constitution.

The following sections will outline relevant federal laws, as well as Kentucky legislation, both statutory and constitutional, that may stand in the way of pension reform, as well as examples of how states have previously navigated similar laws in successful pension reform efforts.[64]

1. The Contracts Clause

The most important question that must be asked in determining whether pension reform is possible is, "Does a contract protecting pension benefits exist in Kentucky?"

Section 1 of Kentucky Revised Statute (KRS) 61.692 states that pension benefits "constitute an inviolable contract of the Commonwealth," and are "not subject to reduction or impairment by alteration, amendment, or repeal" (full text below).[65] There are, however, important limitations to Kentucky's statute:

a. Statutes, including KRS 61.692, can be amended or eliminated. In Kentucky, this would require approval by two-fifths of the House and Senate; in the case of a bill involving an appropriation of funds or emergency clause, a simple majority of the House and Senate would be required to amend or eliminate an existing bill.[66]

[60] T. Leigh Anenson, Alex Slabaugh, Karen Eilers Lahey, "Reforming Public Pensions," *Yale Law & Policy Review*, Volume 33: Issue 1, 2014. http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1674&context=ylpr

[61] Alicia H. Munnell and Laura Quinby, "Legal Constraints on Changes in State and Local Pensions," Center for Retirement Research, Boston College, Num. 25, August 2012. http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf

[62] T. Leigh Anenson, Alex Slabaugh, Karen Eilers Lahey, "Reforming Public Pensions," *Yale Law & Policy Review*, Volume 33: Issue 1, 2014. http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1674&context=ylpr

[63] Stuart Buck, "Legal Obstacles to State Pension Reform," 2011. SSRN 1917563, 2011. http://www.aefpweb.org/sites/default/files/webform/Stuart_Buck,_Legal_Obstacles_to_Pension_Reform.pdf

[64] The legal arguments offered in favor of pension reform are drawn from insights contained in two works: Buck (2011) and Anenson, Slabaugh, and Lahey (2014); however, the conclusion that Kentucky can and should pursue pension reform is entirely our own.

[65] The full text of Section 1 outlines: "For members who begin participating in the Kentucky Employees Retirement System prior to January 1, 2014, it is hereby declared that in consideration of the contributions by the members and in further consideration of benefits received by the state from the member's employment, KRS 61.510 to 61.705 shall, except as provided in KRS 6.696 effective September 16, 1993, constitute an inviolable contract of the Commonwealth, and the benefits provided therein shall, except as provided in KRS 6.696, not be subject to reduction or impairment by alteration, amendment, or repeal."

[66] To become law in Kentucky, a bill "must be approved by at least two-fifths of the members of the chamber (40 representatives or 16 senators) and a majority of the members present and voting." However, a higher approval threshold exists "if the bill contains an appropriation of funds or an emergency clause, [meaning] it must be approved by a majority of the members elected to each house (51 representatives and 20 senators)."
Source: "How A Bill Becomes a Law," Kentucky Legislative Research Council. http://www.lrc.ky.gov/legproc/how_law.htm

b. Courts have stated that pension obligations are not considered a contract in several states, including Maine and Connecticut. Buck explains the rationale for such decisions:

> *…the premise, long acknowledged in federal constitutional cases, is that a statutory enactment is generally presumed not to create 'contract or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise... Policies, unlike contracts, are inherently subject to revision and repeal, and to construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body.*[67,68]

While Kentucky's Constitution does not contain any language indicating that pensions are considered a contract between the state and qualified government workers, it does contain an *ex post facto* or "after the fact" provision. In the context of contract law, the *ex post facto* provision is intended to prevent Kentucky from altering an existing contract; however, protection afforded by the existence of an *ex post facto* provision is diminished by the weak protection of contracts under Kentucky's statutory law.

These legal arguments assume that a pension contract does not actually exist in Kentucky, or if it does, it can be successfully challenged, which would pave the way for the existing pension liabilities to be reduced. However, if the court determined that a pension contract does indeed exist in Kentucky, the decision would not necessarily eliminate the potential for pension reform. In this instance, the question that then must be asked is, "When does the contract take effect, i.e., when is protection of pension benefits enforced by law?"

States take a wide variety of positions on what point in time pension benefits are considered a contract. Offering the most protection to current beneficiaries, states like California, Illinois, and Massachusetts, among others, find that a pension contract is in place when employment begins.[69] Under the "first day" rule, as it is known, accruals to one's pension benefits are granted substantial protection, with the possibility of reductions considered highly improbable. The inflexibility of systems under the first day rule in times of economic malaise is leading many courts to loosen restrictions on amending state pension contracts.[70]

At the other end of the spectrum are states like Kentucky, Louisiana, Maine, Missouri, and Ohio, which do not recognize a pension contract until retirement or upon qualification for retirement (in Kentucky, eligibility is at the time of retirement).[71,72] As such, "legislation adversely affecting [the benefits of] non-retired workers (and some existing workers who meet the prescribed age and services requirements for retirement eligibility) will be upheld under a contract challenge."[73]

However, even in the event that pension benefits are considered a contractual right that prevents any reduction in the existing pension liability, legislation to reduce the existing pension liability may ultimately not be deemed unconstitutional. In this instance, the court must consider whether the action by the State has a legitimate public purpose, "such as the remedying of a broad and general social and economic problem."[74] By doing so, the State is "exercising its police power, rather than providing a benefit to special interests. "Courts defer to a lesser degree when the State is a party to the contract because the State's self-interest is at stake."[75]

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[67] Stuart Buck, "Legal Obstacles to State Pension Reform," 2011. SSRN 1917563, 2011.
http://www.aefpweb.org/sites/default/files/webform/Stuart_Buck,_Legal_Obstacles_to_Pension_Reform.pdf
[68] As cited in Buck (2011):
National R.R. Passenger Corp. v. Atchison, Topeka & Sante Fe Ry, 470 U.S. 451, 456-66 (1985) (quotations omitted); see also Koster v. City of Davenport, 183 F.3d 762, 766-67 (8th Cir. 1999) (finding no contractual right to an Iowa pension plan).
[69] T. Leigh Anenson, Alex Slabaugh, Karen Eilers Lahey, "Reforming Public Pensions," *Yale Law & Policy Review*, Volume 33: Issue 1, 2014. http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1674&context=ylpr
[70] For example, Colorado recently determined pension benefits fell under two categories, "core benefits" and "other provisions." Colorado then removed Cost of Living Adjustment (COLA) benefits from core benefits, so annual increases could be at the discretion of the State rather than occurring automatically at an unchanged rate as they had prior to the decision by the Colorado Supreme Court.
Source: *Ibid.*
[71] T. Leigh Anenson, Alex Slabaugh, Karen Eilers Lahey, "Reforming Public Pensions," *Yale Law & Policy Review*, Volume 33: Issue 1, 2014. http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1674&context=ylpr
[72] Alicia H. Munnell and Laura Quinby, "Legal Constraints on Changes in State and Local Pensions," Center for Retirement Research, Boston College, Num. 25, August 2012. http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf
[73] T. Leigh Anenson, Alex Slabaugh, Karen Eilers Lahey, "Reforming Public Pensions," *Yale Law & Policy Review*, Volume 33: Issue 1, 2014. http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1674&context=ylpr
[74] As cited in Buck (2011):
Energy Reserves Group, Inc. v. Kan. Power & Light Co., 459 U.S. 400, 411 (1983).
[75] United States Trust, 431 U.S. at 25-26; Energy Reserves Group, 452 U.S. at 412 n.14.

2. The Takings Clause

The purpose of the Takings Clause in both federal and state constitutions is to prevent seizure of an individual's property without reasonable compensation. With regards to pensions, the Takings Clause would limit the ability for a government to reduce promised benefits. The process for determining whether a contract exists is the same under the Takings Clause as it is under the Contracts Clause; due to the similarity, simultaneously using both arguments adds no additional value.[76]

3. Substantive Due Process

Substantive Due Process is a legal principle enshrined in the 5th and 14th Amendments of the U.S. Constitution intended to prevent states from denying "life, liberty, or property without due process of law."[77,78] According to Buck, that pension reform violates substantive due process is "almost certainly not going to be a winning claim," and a legislature's "action [i.e., pension reform] will be upheld if there is any conceivable rational basis for the action." Buck also found that, "Very few laws [of economic interest] are ever struck down when a rational basis test is the standard…And even if a pension constitutes a property right for constitutional purposes, the very fact that the legitimate legislative process is followed would likely be enough to satisfy substantive due process (even if that action separately violated the Contracts and/or Takings Clauses)."[79]

Successfully navigating these legal barriers would allow Kentucky to begin taxing public pensions and switch from its current hybrid cash balance system to a defined contribution system.

[76] Stuart Buck, "Legal Obstacles to State Pension Reform," 2011. SSRN 1917563, 2011. http://www.aefpweb.org/sites/default/files/webform/Stuart_Buck,_Legal_Obstacles_to_Pension_Reform.pdf
[77] U.S. Constitution, Amendment. V. https://www.whitehouse.gov/1600/constitution
[78] U.S. Constitution, Amendment. XIV. https://www.whitehouse.gov/1600/constitution
[79] *Ibid.*

APPENDIX

How Pensions Work: A Primer

Public pensions offered by state and local governments may take on several different forms. Below is a brief description of the most common plan forms, including the one offered in Kentucky since 2014, the Hybrid Cash Balance plan:

1. **Defined Benefit (DB)** plans: The traditional pension plan in which employees receive set, guaranteed monthly payments after retiring until death or the death of their spouse (whichever occurs later). DB plans may also include cost-of-living adjustments. The amount of the monthly benefit is based upon the employee's wages and tenure.[80] In 2013, 86% of state and local employees eligible for public retirement plans were enrolled defined benefit plans.[81]

2. **Defined Contribution (DC)** plans: Under DC plans, employers make contributions to an employee's account during employment with no guaranteed monthly benefit upon retirement. The ultimate benefit is based solely upon the contributions to, and investment earnings of, the plan. The benefit ceases when the account balance is depleted, regardless of the retiree's age or circumstances. Examples of such plans are 457(b),[82] 401(k), and 403(b) plans.[83,84] DC plans are the preferred retirement plan in the private sector. In 2015, only 3 states—Alaska, Michigan, and Oklahoma—had mandatory DC plans for some or all state employees.[85]

3. **Hybrid** plans: combine features of defined benefit and defined contribution plans, and come in two forms:

    a. **Two-tier DB-DC** plans: combine small DB pensions with DC plans, with the DB component typically funded by the employer and the DC component funded by the employee, the latter being required to ensure adequate funds for the retirement of the employee. Nine states had mandatory two-tier plans for eligible state and local government employees in 2015.[86]

    b. **Cash Balance (CB)** plans: employer-provided plans with automatic participation in which employers and employees make contributions.[87] Investments in cash balance funds are professionally managed and guaranteed an annual return. If long-term returns exceed the guaranteed rate of return, the excess funds are shared between employees and a rainy day fund within the pension plan to cover years when returns fall below the guarantee. When a worker is ready to retire, the money in his or her account is converted to lifetime income in the form of an annuity. Very few state and local governments offer cash balance plans.[88] Since 2014, Kentucky has enrolled new employees in CB plans.

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80 "Defined Benefit Plans (DB) vs. Defined Contribution Plans (DC)," Utah Education Association. http://www.myuea.org/

81 Jason Richwine, "Backgrounder #2765: Nine Fallacies Used to Defend Public-Sector Pensions," Heritage Foundation, February 5, 2013. http://thf_media.s3.amazonaws.com/2013/pdf/bg2765.pdf

82 A 457(b) plan is a form of defined contribution plan. 457 plans are available to some state and local government employees across the U.S. and to some employees in the non-profit sector. Operating much like a 401(k) plan, 457(b) plans allow employees to divert a portion of their salary into the plan before taxes are taken out, and taxes are levied when funds are withdrawn from the account.
Source: "IRC 457(b) Deferred Compensation Plans," Internal Revenue Service.
https://www.irs.gov/retirement-plans/irc-457b-deferred-compensation-plans

83 A 403(b) is an annuity plan for certain employees of public schools, tax-exempt organizations, and certain members of the clergy. Contributions to 403(b) plan accounts are only made by employers and are typically taxed as income when withdrawn. For more information refer to the following:
Source: "403(b) Plan Basics," Internal Revenue Service. https://www.irs.gov/publications/p571/ch01.html

84 *Ibid.*

85 Monique Morrissey, "Will Switching Government Workers to Account-Type Plans Save Taxpayers Money?" Economic Policy Institute, March 5, 2015. http://www.epi.org/publication/will-switching-government-workers-to-account-type-plans-save-taxpayers-money/

86 In 2015, the nine states with two-tier db-dc plans were California, Georgia, Indiana, Michigan, Oregon, Rhode Island, Tennessee, Utah, and Virginia.
Monique Morrissey, "Will Switching Government Workers to Account-Type Plans Save Taxpayers Money?" Economic Policy Institute, March 5, 2015. http://www.epi.org/publication/will-switching-government-workers-to-account-type-plans-save-taxpayers-money/

87 However, the amount in the Cash Balance account is hypothetical and exists for the planning purposes of the employee; the actual payout the employee receives is an annuity or less frequently, a lump-sum payment.

88 Some state and local governments in California, Kansas, Nebraska, and Texas also offer cash balance plans.

Recent Pension Legislation
To date, there have been approximately 50 bills in Kentucky's House and Senate related to public pensions in the 2016 session. The following are the most important bills:

- **House Bill (HB) 47:** Signed into law by Gov. Bevin on March 20, 2015, HB 47 made significant changes to Kentucky's Public Pension Oversight Board, which assists the General Assembly with the review, study, and oversight of the administration, benefits, investments, laws, and regulations related to the Kentucky Retirement System. The most significant change resulting from HB 47 was including the Legislators' Retirement Plan, the Judicial Retirement Plan, and the Kentucky Teachers' Retirement System to the Public Pension Oversight Board's review responsibilities.[89,90]

- **House Bill (HB) 62:** Enacted in the 2015 Regular Session of the Kentucky General Assembly, HB 62 created a statute allowing "certain employers"[91] in the Kentucky Employees Retirement System (KERS) and the County Employees Retirement System (CERS) to voluntarily cease participation in the system and that any agency may be required to involuntarily cease participation in KERS or CERS in the event the board of trustees has determined the employer has not met its legal obligations to Kentucky's pension system.

[89] Kentucky Legislature, Kentucky House Bill (HB). http://www.lrc.ky.gov/record/15rs/HB47.htm
[90] The other changes resulting from HB 47 were the following: Providing that members of the Public Pension Oversight Board appointed by the Speaker of the House of Representatives, the President of the Senate, and the Governor with expertise in pensions or investments shall serve a term of four years; ending the prohibition on members and retired members from serving in these appointed positions; modifying the annual report due date for the Public Pension Oversight Board from December 1 to December 31 of each year.
[91] This list of employers includes the following:
Commonwealth's attorney offices, county attorney offices, local and district health departments governed by KRS Chapter 212, master commissioners, property valuation administration offices, select executive branch agencies, state-administered retirement systems, employers in the legislative or judicial branches, most state-supported universities and community college systems. For more information refer to the following:
Kentucky House Bill (HB) 62. https://legiscan.com/KY/bill/HB62/2015

Kentucky Retirement Systems – Pension Plan, Asset Allocation & Performance

Kentucky Retirement Systems - Pension Plan
Asset Allocation & Performance

As of December 31, 2015

Asset Allocation & Performance

	Allocation		Performance (%)
	Market Value ($)	%	FYTD
Total Fund	**10,829,046,079**	**100.00**	**-2.95**
U.S. Equity Composite	**2,430,922,574**	**22.45**	**-2.66**
River Road Asset Management (SA)	28,929,675	0.27	-1.87
Westwood Management (SA)	93,207,389	0.86	-5.71
Westfield Capital (SA)	112,538,671	1.04	-3.76
Internal S&P 500 Index (SA)	1,368,466,571	12.64	0.17
INVESCO Struct'd Core Equity (SA)	193,431,047	1.79	-3.49
Internal US Mid Cap (SA)	213,962,065	1.98	-6.25
Sasco Capital Inc. (SA)	39,597,813	0.37	-11.15
Systematic Financial Management (SA)	183,807,685	1.70	-6.27
NT Structured Small Cap (SA)	196,946,679	1.82	-7.80
Pension Transition	14,979	0.00	N/A
Non-U.S. Equity Composite	**2,247,619,955**	**20.76**	**-7.72**
Lazard Int'l Strategic Equity (SA)	283,229,566	2.62	-7.05
LSV Int'l Concentrated Value Equity (SA)	264,278,659	2.44	-10.29
The Boston Co. Non-US Value (SA)	1,468,651	0.01	N/A
BTC ACWI Ex US Fund (CF)	949,814,774	8.77	-9.23
American Century Non-US Growth Equity (SA)	351,691,274	3.25	-3.99
Franklin Templeton Non-US Equity (SA)	232,540,589	2.15	-4.61
NT Int'l Sm Cap Eq Index (SA)	159,784,536	1.48	-5.19
Non-US Transition Account	1,900,604	0.02	N/A
Emerging Mkts Equity Composite	**158,551,072**	**1.46**	**-15.07**
BTC Emg Mkts Equity (CF)	86,587,692	0.80	-17.42
Aberdeen Emg Mkts Equity (CF)	-268,960	0.00	N/A
Wellington Emg Mkts Equity (CF)	72,232,340	0.67	-14.99
Fixed Income Composite	**1,999,113,979**	**18.46**	**-0.36**
NISA Core Agg Fixed Income (SA)	994,747,249	9.19	0.93
Cerberus KRS Levered Loan Opps, L.P.	74,573,282	0.69	3.94
Columbia HY Fixed Income (SA)	142,172,835	1.31	-3.09
Loomis Sayles HY Fixed Income (SA)	95,630,607	0.88	-9.64
Shenkman Capital (SA)	102,496,974	0.95	-4.07
Waterfall (SA)	127,505,107	1.18	0.32
Manulife Asset Mgmt (SA)	457,494,414	4.22	0.15
Stone Harbor (SA)	4,161,847	0.04	N/A
Real Return Composite	**893,857,977**	**8.25**	**-6.77**
Internal TIPS (SA)	179,906,425	1.66	-1.21
Nuveen Real Asset Income (SA)	201,300,435	1.86	-2.67
PIMCO:All Asset;Inst (PAAIX)	293,145,798	2.71	-10.32
Tenaska Power Fund II (CF)	9,992,063	0.09	7.12
Tortoise Capital (CF)	67,459,665	0.62	-22.87
Amerra Ag Fund II (CF)	34,494,098	0.32	9.92
Amerra-AGRI Holding (CF)	14,502,289	0.13	N/A
BTG Pactual Brazil Timberland Fund I, L.P.	6,353,067	0.06	-7.45
Magnetar MTP Energy Fund, L.P.	68,024,815	0.63	-17.35
Magnetar MTP EOF II, L.P.	8,348,384	0.08	N/A
Oberland Capital Healthcare, L.P.	2,468,554	0.02	1.62
Taurus Mining Finance Fund	7,842,385	0.07	1.70
Real Estate Composite	**583,034,788**	**5.38**	**4.12**
FHA Mortgages (SA)	1,246,933	0.01	3.34
H/2 Credit Partners (CF)	99,726,052	0.92	-2.36
H/2 Core Real Estate Debt Fund, L.P.	20,620,938	0.19	1.44
Harrison Street Core (CF)	106,211,434	0.98	5.81
Mesa West Core Lending, L.P.	57,239,034	0.53	3.91
Prima Mortgage Invest Trust, LLC	26,822,964	0.25	-1.28
Prologis Targeted U.S. Logistics Fund (CF)	54,644,010	0.50	6.42
Stockbridge SmtMkts, L.P.	75,629,490	0.70	6.44
DivcoWest Fund IV, L.P.	18,013,410	0.17	19.25
Greenfield Acquisition Partners VI, L.P.	28,197,139	0.26	10.77
Greenfield Acquisition Partners VII, L.P.	17,172,943	0.16	9.95
Lubert Adler Real Estate Fund VII, L.P.	13,107,139	0.12	-0.83
Rubenstein Properties Fund II, L.P.	8,600,924	0.08	3.20
Walton Street Real Estate Fund VI, L.P.	21,742,239	0.20	6.21
Walton Street Real Estate Fund VII, L.P.	34,060,138	0.31	10.00
Absolute Return Composite	**1,196,297,827**	**11.05**	**-2.87**
BAAM (SA)	346,998,867	3.20	1.80
PAAMCO (SA)	307,217,778	2.84	-5.90
Prisma Capital Partners (SA)	334,540,383	3.09	-3.92
Tourbillon Global Master Fund, Ltd	30,210,560	0.28	N/A
Davidson-Kemper, L.P.	30,000,000	0.28	N/A
Glenview Capital (CF)	14,494,253	0.13	N/A
HBK II (CF)	15,509,242	0.14	-3.50
Jana Partners (CF)	14,009,065	0.13	-8.83
Knighthead Capital (CF)	14,220,059	0.13	-7.46
LibreMax Capital (CF)	15,439,243	0.14	-2.17
Luxor Capital (CF)	11,770,870	0.11	-15.53
Pine River (CF)	15,069,394	0.14	-6.72
QMS Diversified Global Macro (CF)	15,116,522	0.14	N/A
Scopia PX, LLC	15,803,859	0.15	-1.05
Coatue Qualified Partners, L.P.	15,877,710	0.15	5.85
Private Equity Composite	**1,107,635,087**	**10.23**	**3.69**
Cash Equivalent Composite	**204,933,806**	**1.89**	**0.10**
Cash Equivalents (SA)	204,933,806	1.89	0.10
Other Composite	**7,079,015**	**0.07**	**N/A**

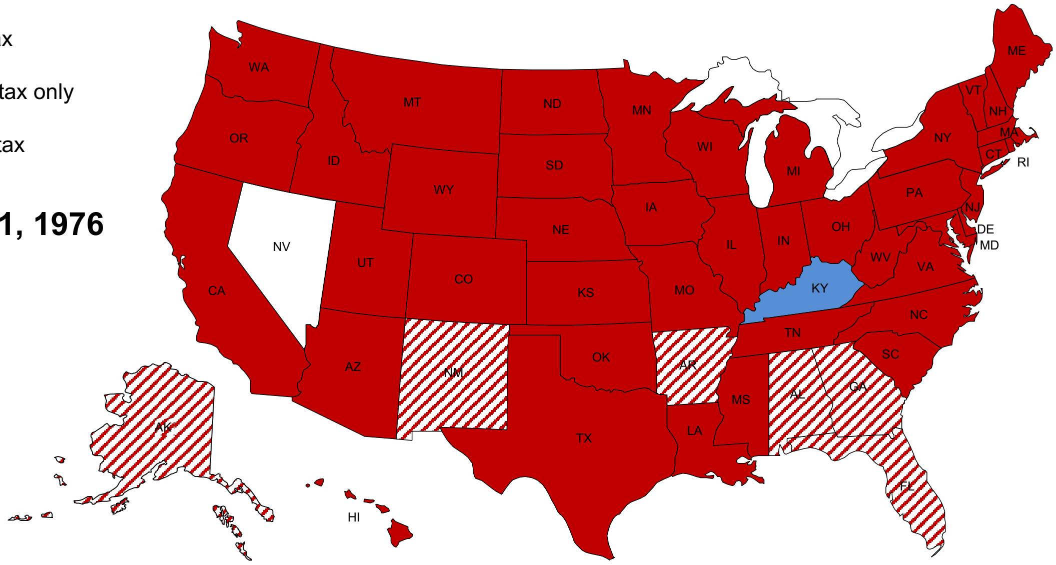
Performance shown is net of fees. Fiscal year ends June 30th. Allocations shown may not sum up to 100% exactly due to rounding. Other Composite consists of Perimeter Park (SA) and BNY fee accruals. Real Estate and Private Equity valuations shown are as of the most recent date available. Negative market value shown for Aberdeen Emg Mkts Equity (CF) reflects fee accruals following account liquidation.

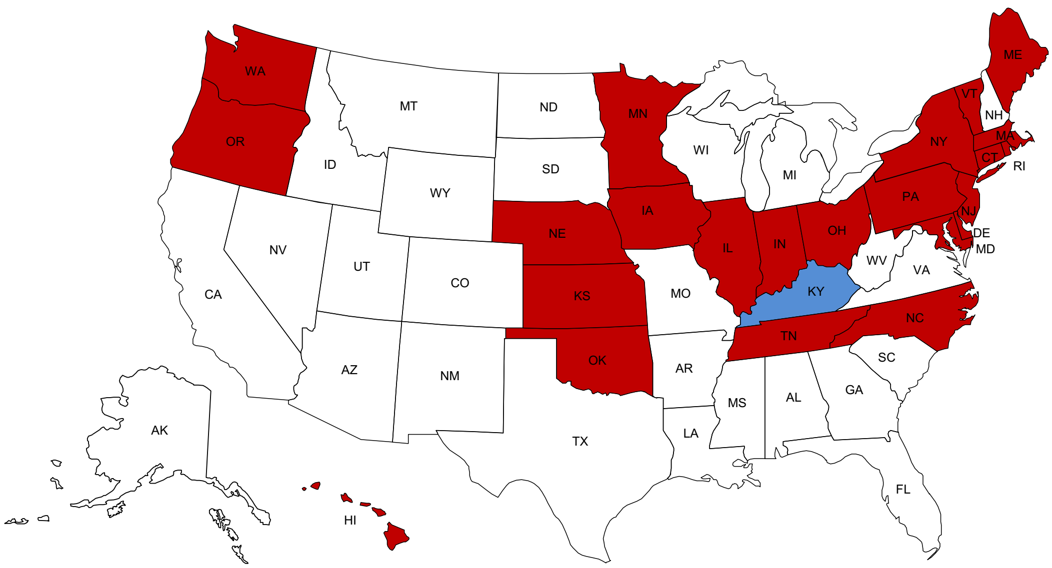
RVK

KENTUCKY'S INHERITANCE TAX

- State with a death tax
- State with "Pick-up" tax only
- State with no death tax

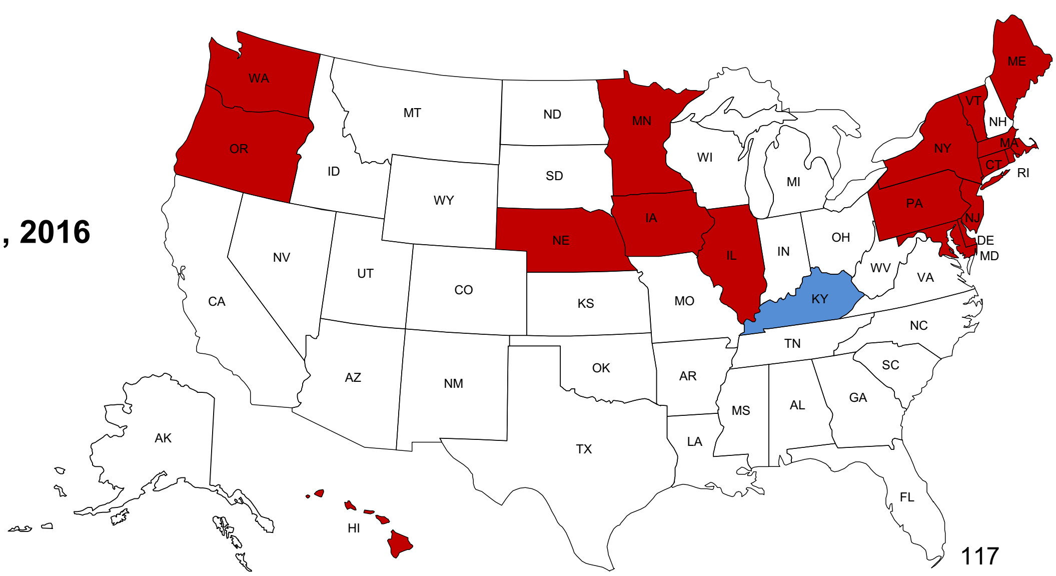
January 1, 1976





January 1, 2006

January 1, 2016



5. KENTUCKY'S INHERITANCE TAX[1]

A Burkesville, Kentucky Landmark ca. 2015

I. SUMMARY AND CONCLUSION[1]

It used to be that the sole purpose of the tax code was to raise the necessary funds to run government. But in today's world the tax mandate has many more facets including income redistribution, rewarding favored industries, and punishing unfavored behavior. And even with the greatly expanded tax mandate, finding an appropriate tax code would be relatively straightforward if only people would stop changing what they do when the tax code changes. The tax code is a lot like the rules of the game of dodgeball. Dodgeball would be so easy if only the players wouldn't duck when the ball is thrown. But they do. As with the rules for dodgeball, people also change what they do when the tax code changes. And, like the ball throwers in dodgeball, the taxer's intentions are more often than not thwarted.

High tax rates imposed on a narrow tax base are the worst aspects of any tax code. High tax rates on narrow bases produce disproportionately large distortions, which seriously damage the economy and yet yield little direct tax revenue. High tax rates are direct incentives for people to evade, avoid or otherwise not report taxable income. A narrow tax base, in turn, allows those same people plenty of tax free alternatives where they can safeguard their income. High tax rates with a narrow tax base are a toxic combination. The damage they cause to the economy always reduces other tax revenues, usually more than the pitiful revenues they raise.

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[1] Sources for front page graphic:

1976 map: Laffer Associates analysis of data from: *Significant Features of Fiscal Federalism, 1976-77 Edition, Volume II Revenue and Debt*, Advisory Commission on Intergovernmental Relations, Table 119, p. 231, March 1977.
http://www.library.unt.edu/gpo/acir/SFFF/SFFF-1976-1977-V2.pdf

2006 map: Laffer Associates; McGuireWoods State Death Tax Chart,
https://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf ; Norton Francis, "Back from the Dead: State Estate Taxes After the Fiscal Cliff," Tax Policy Center, November 14, 2012.
http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412694-Back-from-the-Dead-State-Estate-Taxes-After-the-Fiscal-Cliff.PDF

2016 map: Laffer Associates and McGuireWoods State Death Tax Chart,
https://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf

Kentucky's estate tax is the poster boy for bad tax policy.[2] Kentucky is currently one of only 19 states with an estate tax.[3] Kentucky has the single lowest exemptions for its estate tax and has the third highest estate tax rate. And, what has Kentucky gained from its estate tax? In 2013, the most recent year for which data are available, Kentucky collected a mere 0.38% of its tax revenue from its estate tax according to the U.S. Census Bureau.[4]

To understand the impact estate taxes have had on Kentucky's economy, we use federal estate tax data provided by the IRS. The federal estate tax requires all Americans to file estate taxes regardless of whether the estate tax filers reside in states that levy state estate taxes or not. Therefore, we have a huge repository of estate tax data on the number and size of all qualifying estates, filed by those who reside in states that do and do not levy estate taxes.

In 2014, Kentucky with its high state estate tax, had 1.4 federal estates filed per 100,000 population while Florida—which doesn't levy an estate tax—had 7.17 federal estates filed per 100,000 population—over five times more filings per 100,000 population than Kentucky.[5] The fact that Florida has so many more estate tax filings than Kentucky tells us that wealthy people prefer to both live and die in Florida. This preference among wealthy people is also supported by the fact that the average size of Florida's federal estate was $19,110,643, far larger than Kentucky's average federal estate of $10,387,337 in 2014.[6]

Just to add insult to injury, the average taxable estate in Kentucky is also consistently smaller than the U.S. average. In 2014, the average size of a federal estate filed in Kentucky was almost 27% smaller than the U.S. average, or $3,821,188 less.[7] And Kentucky's 1.4 federal estate tax filings per 100,000 population were almost 63% less than the U.S. average of 3.74 federal estates filed per 100,000 population in 2014. People really do leave Kentucky because of Kentucky's estate tax—and they leave in droves. And these people are the richest, most productive, biggest employers, and biggest consumers—losing them has caused considerable harm to Kentucky's economy.

The cost Kentucky has paid for its estate tax in lost output and jobs is staggering. Had Kentucky eliminated its estate tax 10 years ago and grown at the rate of its non-estate tax peers, Kentucky's gross state product (GSP) would have been almost 10% larger in 2014 and there would have been 125 thousand more jobs in the state. More jobs and more output would have benefited state and local government revenues by about one billion dollars.

The economic damage created by Kentucky's estate tax can also be estimated by examining the extent to which Kentucky's asset base has been reduced. It is important to note upfront that because estates reported to the IRS have declined over time due to changes in federal reporting requirements, and the total value of estates is less than the total value of assets lost, the economic damages calculated based on the lost estates significantly understate the true economic damage. Yet, the economic costs are still staggering. Kentucky's estate tax has lowered the state's asset base by at least $13½ billion to $37 billion, reducing the size of Kentucky's economy, as measured by gross state product, by between $4.6 billion to $12.8 billion.

Potential estate tax payers expend effort and money to avoid the death tax. Many leave the state in anticipation of Kentucky's death tax, taking with them jobs, spending, investments, and entrepreneurial skills. And because of the uncertainty of death, these people leave many years before they die. Once gone, they are loath to come back. Potential immigrants to Kentucky are also put off by Kentucky's extreme estate tax. The last thing Kentucky should want is to drive away the state's richest citizens. Davy Crockett said it best 180 years ago, "the state of Kentucky can go to hell, I'm going to Texas."[8]

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[2] The applicable Kentucky provisions label Kentucky's estate tax an "inheritance tax", but for purposes of this paper, we will refer to the tax as an "estate tax." The statutory Kentucky estate tax was based on the former federal state tax credit but is no longer in effect.

[3] Currently, 19 states have inheritance/estate taxes. However, Indiana, North Carolina, and Ohio all repealed their inheritance/estate taxes effective January 1, 2013. However, because all three states levied inheritance/estate taxes for the majority of the past decade, and the levying of inheritance/estate taxes impacts a state's economic performance, all three states are considered inheritance/estate tax states for the purpose of this study. Thus, a total of 22 states are considered to have inheritance/estate taxes for the purposes of this study. Tennessee's estate tax will be fully repealed as of January 1, 2016, bringing the total number of states with inheritance/estate taxes to 18. Connecticut is the only state to levy a gift tax.

[4] Source: U.S. Census Bureau. State Government Tax Collections. http://www.census.gov/govs/statetax/

[5] Source: IRS, Statistics of Income, https://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-2

[6] Source: *Ibid*.

[7] Source: IRS, Statistics of Income, https://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-2

[8] The original quote can be found in: James, Atkins Shackford, *David Crockett: The Man and the Legend*. 1994.

Kentucky's estate tax discriminates against a very small group of citizens whose productivity greatly exceeds the state's average. These people are job creators, taxpayers, arts supporters, and capital formers. These people allow future generations to advance far beyond the accomplishments of their own generation. And yet, as a reward for doing all this good they are then faced with Kentucky's punitive estate tax. The estate tax is the single most unjust tax ever and it collects virtually no revenue.

II. KENTUCKY'S ESTATE TAX IN CONTEXT

Economics is all about incentives. When a state's economic policies establish pro-growth economic incentives, strong economic growth follows. The reverse is true as well. Bad economics is an equal opportunity destroyer as shown by Kentucky's long history of underachievement.

In addition to Kentucky's estate tax, Kentucky levies a personal income tax with a top marginal rate of 8.45% (combined state rate of 6% & top local rate of 2.45%)[9]. Kentucky is not a right-to-work state.[10] Kentucky's corporate income tax has a top rate of 8.45% (combined state rate of 6% and top local rate of 2.45%). Kentucky also has an inventory tax and a high minimum wage. However, Kentucky's sales tax rate of 6% and its property tax rates are relatively low.[11]

One of Kentucky's many Achilles' heels is the state's estate tax. Kentucky is one of a minority of 19 states that currently levy some type of separate estate or inheritance tax on top of the federal estate tax. To make matters even worse, the current top inheritance tax rate in Kentucky is 16%, one of the highest top estate tax rates among all states, on the value of an inheritance exceeding $200,000.[12,13] Adding insult to injury, in Kentucky, a gift received within (3) years of the death of the giver is considered to be given in contemplation of death and is subject to the estate tax "unless proof is furnished to the contrary."[14]

Once faced by such an unjust and punitive tax, wealthy people turn their backs on Kentucky.

III. THE THEORY OF INCENTIVES

Incentives can be either positive or negative. They are alternatively described as carrots and sticks or pleasure and pain. Whatever their form, people seek positive and avoid negative incentives. If a dog is scolded, for example, the animal's whereabouts will not be known, but the dog is certain not to be where the scolding took place. If, however, a dog is fed, we know exactly where the dog will be.

The principle is simple enough: If an activity should be shunned, a negative incentive is appropriate. Positive incentives come into play in order to make activities attractive. When the dog is fed you can be fairly certain that the dog will be where the food is at feeding time. Positive incentives tell you what to do while negative incentives tell you what not to do.

In the realm of political economics, taxes are negative incentives and government subsidies are positive incentives. People attempt to avoid taxed activities—the higher the tax rate, the greater their attempt to avoid. As with all negative

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[9] Many cities and counties in Kentucky tax personal and business income with the Occupational License Tax.

[10] For more information on Kentucky's local taxes on personal and business income, refer to the following source: 2014 Kentucky Communities Imposing an Occupational Tax," Kentucky Occupational License Association, Compiled by the Kentucky Society of CPAs. http://www.kyola.org/images/stories/food/2014occlist1.pdf

[11] "How High Are Property Taxes in Your State," Tax Foundation, August 13, 2015. http://taxfoundation.org/blog/how-high-are-property-taxes-your-state

[12] "A Guide to Kentucky Inheritance and Estate Taxes: General Information," Kentucky Department of Revenue, July 2014. http://revenue.ky.gov/NR/rdonlyres/3F6FF04D-F7C8-4699-9DA9-FF77C9470835/0/92F101714.pdf

[13] In Kentucky, beneficiaries of an inheritance fall under one of the 3 following categories: Class A (surviving spouse, parent, child, grandchild, brother, sister, half-brother, and half-sister), Class B (niece, nephew, half-niece, half-nephew, daughter-in-law, son-in-law, aunt, uncle, and great grandchild) and Class C (all persons not included in Class A and Class B). Class A beneficiaries are not subject to inheritance taxes. Class B beneficiaries receive a $500 exemption and are subject to a top rate of 16% on the value of an inheritance exceeding $200,000. Class C beneficiaries receive a $1,000 exemption and are subject to a top rate of 16% on the value of an inheritance exceeding $200,000.
Source: A Guide to Kentucky Inheritance and Estate Taxes: General Information," Kentucky Department of Revenue, July 2014. http://revenue.ky.gov/NR/rdonlyres/3F6FF04D-F7C8-4699-9DA9-FF77C9470835/0/92F101714.pdf

[14] *Ibid.*

incentives, no one can be sure how the avoidance will be carried out. It's like a hot stove. You don't know where people's hands will be, but they won't be on the hot stove.

Many tax policies do illustrate a correct understanding of the theory of incentives. For example, government taxes cigarettes to stop people from smoking, not to get them to smoke. Government also fines speeders so they won't speed, not to encourage them to drive faster. And, while a sparkle-headed idea, government pays farmers not to grow food to raise food prices, not lower them. On a personal level, people try to shift income from higher-taxed categories to lower-taxed categories. They purchase tax shelters, move to a lower tax region, and in some cases, they may even choose to earn less income or literally evade the tax at considerable personal risk.

Because tax revenues are necessary to sustain government spending, one canon of taxation has always been to have the largest possible tax base coupled with the lowest possible tax rate. By so doing, people are provided the least opportunity to avoid paying taxes and the lowest incentive to do so. Kentucky's estate tax couldn't be more diametrically opposed to the concept of a broad-based low-rate tax.

Badly designed taxes are detrimental to labor and capital, poor and rich, men and women, and old and young. They are equal opportunity tormentors. High taxes on estates mobilize people to "vote with their feet" and leave the state. Without either the tax revenues or the productivity of the people who fled the state, low wage workers suffer the tax burden. Laffer Associates has produced decades of research demonstrating the enormous effects bad taxes have on states.

Competition among the many states is, in large part, played out by the behavior of mobile factors of production which can "vote with their feet" and relocate to political jurisdictions pursuing more favorable economic policies. Changes in tax rates are easily measured and have a great impact on the supplies of mobile factors of production. And there is probably no factor of production more mobile than wealthy highly productive people. They can live almost anywhere whether they are doctors, lawyers, venture capitalists, entrepreneurs, business professionals, athletes or performing artists. These are the people a state needs to attract, not expel.

It is usually difficult to accurately predict the dynamic effects of supply-side policy changes, but in the case of the elimination of Kentucky's estate tax the evidence is so overwhelming as to make the predictions easy. The issue is not whether the elimination of Kentucky's estate tax will boost Kentucky's growth and increase total tax revenues—it will—but by how much will growth accelerate and will tax revenues rise.

The basic idea behind the relationship between tax rates and tax revenues is that changes in tax rates have two effects on revenues: the arithmetic effect and the economic effect.

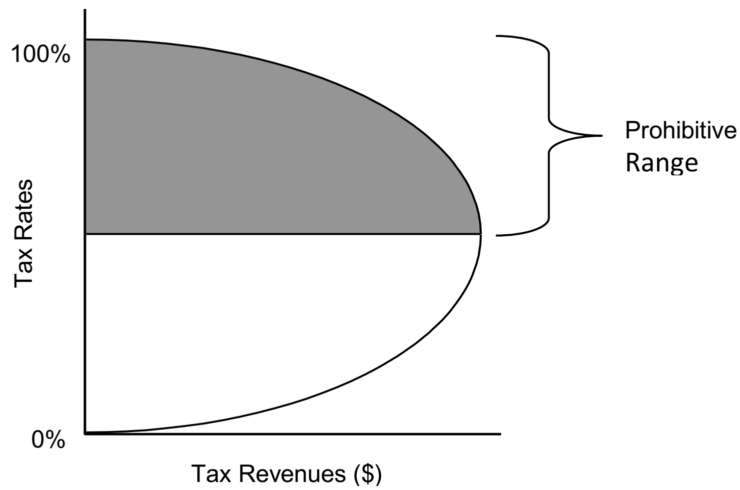
- ***The arithmetic effect*** is simply that if tax rates are lowered, tax revenues per dollar of tax base will be lowered by the amount of the decrease in the rate. And, the reverse is true for an increase in tax rates.

- ***The economic effect*** recognizes the positive impact that lower tax rates have on work, output, and employment and thereby the tax base by providing incentives to increase these activities. Raising tax rates has the opposite economic effect by penalizing participation in the taxed activities.

The arithmetic effect always works in the opposite direction from the economic effect. Therefore, when the economic and the arithmetic effects of tax rate changes are combined, the consequences of the change in tax rates on total tax revenues are no longer quite so obvious.

Figure 1 is a graphic illustration of this concept as illustrated by the Laffer Curve. At a tax rate of 0% the government would collect no tax revenues, no matter how large the tax base. Likewise, at a tax rate of 100%, the government would also collect no tax revenues because no one would be willing to work for an after-tax wage of zero—there would be no tax base. Between these two extremes there are two tax rates that will collect the same amount of revenue: A high tax rate on a small tax base and a low tax rate on a large tax base.

Figure 1
The Laffer Curve



The Laffer Curve itself doesn't say whether a tax cut will raise or lower revenues. Revenue responses to a tax rate change will depend upon the tax system in place, the time period being considered, the ease of moving into untaxed activities, the level of tax rates already in place, the prevalence of legal and accounting-driven tax loopholes, and the proclivities of the productive factors. If the existing tax rate is too high—in the "prohibitive range" shown above—then a tax-rate cut would result in increased output, employment and production as well as tax revenues. The economic effect of the tax cut on total tax revenues would outweigh the arithmetic effect of the tax cut.

And such is the case today for Kentucky's estate tax. The time period is long—literally an individual's lifetime, wealthy productive people can move easily into no estate tax states, the level of the estate tax rate is high, making avoidance highly attractive, accountants and lawyers who specialize in helping the wealthy get around Kentucky's estate tax are everywhere and eager to help and lastly wealthy productive people thrive on avoiding paying taxes. It's a no brainer!

If push comes to shove and taxes are still far too punitive, the wealthy leave. They take their wealth, and frequently their businesses with them in the process. Kentucky is no exception. In the last few years, several major employers have left Kentucky. Fruit of the Loom, which once provided 11,000 manufacturing jobs in Kentucky and was the state's 2nd largest employer, closed its last manufacturing facility in the state in 2014.[15] That same year, Toyota announced it would be moving its manufacturing and engineering headquarters, along with 1,600 jobs employed there from Erlanger, Kentucky to Texas in 2017.[16] And Omnicare, a Fortune 400 company, moved its headquarters, along with 500 jobs, from Covington, Kentucky to Cincinnati, Ohio.[17] Kentucky's tax and forced-union policies were the reason Florida Governor Rick Scott actively sought to bring businesses from Kentucky to his home state. And he was successful, bringing 40 engineering jobs with an average salary of $66,000 from Kentucky to Miami and Fort Lauderdale.[18] As CEO of Columbia/HCA, Governor Scott also moved the company's headquarters from Kentucky to Tennessee in 1995.[19]

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15 "Fruit of the Loom to close Jamestown plant, lay off all 600 workers," *Lexington Herald-Leader*, April 3, 2014. http://www.kentucky.com/news/business/article44481288.html
16 "Toyota Leaving Erlanger, Taking 1,600 Jobs to Texas," *The River City News*, April 28, 2014. http://www.rcnky.com/articles/2014/04/28/toyota-leaving-erlanger-taking-1600-jobs-texas
17 David Holthaus, "Omnicare leaving Covington, moving to Cincinnati," Cincinnati.com, September 19, 2011. http://www.cincinnati.com/article/20110919/BIZ01/309190041/Omnicare-moving-to-Cincinnati?source=nletter-nletter-breakingnews
18 Steve Bousquet, "Gov. Rick Scott announces 40 new jobs from Kentucky or is it Ohio?" Tampa Bay Times, September 22, 2015. http://www.tampabay.com/news/politics/legislature/gov-rick-scott-announces-40-new-jobs-from-kentucky-8212-or-is-it-ohio/2246659
19 Joseph Gerth, "Florida governor seeks to poach Kentucky jobs," Courier-Journal, September 1, 2015. http://www.courier-journal.com/story/news/politics/2015/09/01/florida-governor-poach-kentucky-companies/71528804/

If there is a single symbol of Kentucky's economic malaise, it is the Cincinnati/Northern Kentucky International Airport. I gave a talk in July, 2015 at the Federal Home Loan Bank conference in Cincinnati, and I flew from Nashville to Cincinnati (i.e. Covington, KY) and back again. All I can say is wow. I felt like Jack Nicholson in *The Shining.* The Covington airport was creepy empty. Maybe one in six or seven gates had a plane, and in the halls there were no people, but the shops were open…which I found out later being open was a requirement in their original contract even though they had virtually no customers and would love to close their shops. The massive train system wasn't running, either. And I'm hardly alone in my low opinion of the Covington airport: the CEO of Fortune 500 company Veritiv, Mary Laschinger, said, "the airport is not suitable for business travel" shortly before moving the company's headquarters—and 50 high paying jobs—to Atlanta in 2015.[20] According to NPR, the Covington airport ranks among the best in the country, receiving accolades for its "airy and spacious screening area."[21] Apparently, no business is good business to our friends at NPR.

Just a cursory glance at Kentucky makes it perfectly clear that elimination of the estate tax will spur Kentucky's prosperity and add tax revenues into state and local governments.

IV. THE ESTATE TAX'S IMPACT ON KENTUCKY'S PERFORMANCE

With the Laffer Curve as a backdrop, the harmful effects of Kentucky's anti-growth policies, including its estate tax, are very apparent.

Between 2004 and 2014 Kentucky's economy performed poorly across a variety of metrics (see Table 1 below):

- **Gross state product (GSP) growth:** Between 2004 and 2014, Kentucky's 38% growth lagged behind the average of 47½% GSP growth among the 28 states[22] that don't levy estate taxes, and also lagged behind the U.S. average GSP growth of 43%.
- **Population growth**: Between 2004 and 2014, Kentucky's 6.45% growth lagged behind the average of 10.85% population growth among the 28 states that don't levy estate taxes, and also lagged behind the U.S. average population growth of 8.84%.
- **State & local tax revenue growth**: Between 2002 and 2013, Kentucky's 43% growth was well below the average of 71% state & local tax revenue growth among the 28 states that don't levy estate taxes, and also well below the U.S. average of 66½%.
- Between 2004 and 2014, Kentucky's **growth in personal income** and **total non-farm payroll employment growth** all lagged considerably behind the average among the 28 states that don't levy estate taxes, and tended to lag behind the U.S. average as well.
- Between 2004 and 2014, Kentucky's economy benefited from high oil and coal prices. However, with lower oil prices for the foreseeable future and the declining use of coal as an energy source, Kentucky will not be able to depend on these natural resources to boost its economic performance.

[20] Fatima Hussein and Jason Williams, "Fortune 500 boss: CVG reason for leaving," *Cincinnati.com*, October 16, 2015. http://www.cincinnati.com/story/money/2015/10/16/fortune-500-boss-cvg-reason-leaving/73605974/
[21] Brian Naylor, "Cincinnati's Airport: Best In The U.S.?" NPC, September 2, 2013. http://www.npr.org/2013/09/02/217267752/cincinnatis-airport-best-in-the-u-s
[22] Remember, currently 19 states have inheritance/estate taxes. However, Indiana, North Carolina, and Ohio all repealed their inheritance/estate taxes effective January 1, 2013. However, because all three states levied inheritance/estate taxes for the majority of the past decade, and the levying of inheritance/estate taxes impacts a state's economic performance, all three states are considered inheritance/estate tax states for the purpose of this study. Thus, a total of 22 states are considered to have inheritance/estate taxes for the purposes of this study.

Table 1

10-Year Growth among Five Economic Metrics in Kentucky and Among States w/ and w/o Estate Taxes, and the U.S. Average[23,24]

(2004 – 2014) *

		10-Year Growth				
State	**Estate or Inheritance Tax? Yes=1**	**Gross State Product Growth**	**Population Growth**	**Personal Income Growth**	**Total Nonfarm Payroll Employment Growth**	**State & Local Tax Revenue Growth**
Avg. of 28 States without Death Taxes[24]	0.00	47.49%	10.85%	52.60%	6.56%	71.16%
50-State Avg.[24]	0.42	42.83%	8.84%	48.01%	5.21%	66.50%
Kentucky	**1.00**	**38.09%**	**6.45%**	**41.94%**	**0.93%**	**43.14%**
Avg. of 22 States with Death Taxes[24]	1.00	36.91%	6.29%	42.16%	3.50%	60.57%

* Due to a lag in data availability, the most recent year for which comprehensive state & local tax data are available is 2013. Also, the U.S. Census Bureau does not report local tax data for 2003. Therefore state & local tax revenue growth is measured over an 11-year period between 2002 and 2013.

Among the 9 states that don't levy a personal income tax (PIT), the presence of an estate tax in a state adversely impacts the state's economic performance (see Table 2). In nearly every metric in Table 2, zero PIT states without an estate tax outperformed those with an estate tax by considerable margins. Both zero PIT groups outperformed Kentucky considerably in every metric, showing the significant growth benefits in states that chose not to levy a PIT and the benefits and costs of levying an estate tax.

Table 2

10-Year Growth among Five Economic Metrics in Kentucky and Among No Personal Income Tax States w/ and w/o Estate Taxes[25,26]

(2004 – 2014)*

		10-Year Growth				
State	**Estate or Inheritance Tax? Yes=1**	**Gross State Product Growth**	**Population Growth**	**Personal Income Growth**	**Total Nonfarm Payroll Employment Growth**	**State & Local Tax Revenue Growth**
Avg. of 7 no PIT States without Death Taxes[26]	0.00	52.38%	13.67%	56.30%	10.82%	88.36%
Kentucky	**1.00**	**38.09%**	**6.45%**	**41.94%**	**0.93%**	**43.14%**
Avg. of 2 no PIT States with Death Taxes[26]	1.00	45.20%	12.55%	49.54%	6.14%	56.66%

* Due to a lag in data availability, the most recent year for which comprehensive state & local tax data are available is 2013. Also, the U.S. Census Bureau does not report local tax data for 2003. Therefore state & local tax revenue growth is measured over an 11-year period between 2002 and 2013.

State taxes do not redistribute income from rich to poor, instead they redistribute people from high tax states to low tax states.

Estate taxes are levied on a narrow tax base that represents a very small subset of a state's population. This population is highly mobile. As a consequence, the people subject to Kentucky's estate tax have the ability to change the location of their income to avoid the estate tax. And, the evidence couldn't be clearer.

All of these features make estate taxes the exact opposite of what an optimal tax base should be. Consequently, the expected economic outcome is a redistribution of people away from the states that levy estate taxes toward states that

23 Sources: Bureau of Economic Analysis, Tax Foundation, Bureau of Labor Statistics and U.S. Census Bureau.
24 All averages are equal-weighted.
25 Sources: Bureau of Economic Analysis, Tax Foundation, Bureau of Labor Statistics and U.S. Census Bureau.
26 All averages are equal-weighted.

do not. The incentive to move is strongest, obviously, for those people who must pay the estate taxes. These are the successful entrepreneurs, and when they move, Kentucky loses not only their income, but the income and jobs their businesses create. Kentucky loses the houses they would have purchased. Kentucky loses the purchases they would have made and Kentucky loses a group of wonderful loyal Kentuckians who have been singled out as only being worth the money they pay in taxes when they die.

While Kentucky attracts people to the state from high income, high tax burden states (see the bottom half of Table 3). Kentucky's estate tax encourages some of Kentucky's most productive citizens to leave the state. Over the 1992 through 2012 period, Kentucky had an income migration deficit with 17 states and the District of Columbia—an income migration deficit being defined as the aggregate income of the people leaving Kentucky and going to another state as greater than the aggregate income of the people coming from that other state to Kentucky. Of those 17 states, only 3 and the District of Columbia currently levy estate taxes.

The top 5 states with which Kentucky had an income deficit between 1992 and 2012—none of which currently levy an estate tax aside from Tennessee, which has already repealed its estate tax for 2016—are shown in the top half of Table 3. Florida is the largest net receiver of population and income from Kentucky, which makes sense because Florida has no income tax, no estate tax and is a right-to-work state and as a result is booming relative to Kentucky.

Florida, like all other zero income tax states except Tennessee and Washington, does not impose a state estate tax. And as a result, the people Kentucky is losing to Florida tend to be much higher income people (especially people who are subject to the estate tax), while the people coming to Kentucky from Florida tend to have relatively lower incomes (refer to the top half of Table 3). In fact, the average income of households leaving Kentucky exceeded that of households entering Kentucky between 1992 and 2012 among all of the top 5 states with which Kentucky had an income deficit.

Table 3

The Top 5 States Where Kentucky Residents Moved Compared to the Top 5 States Where Other State Residents Moved to Kentucky[27]

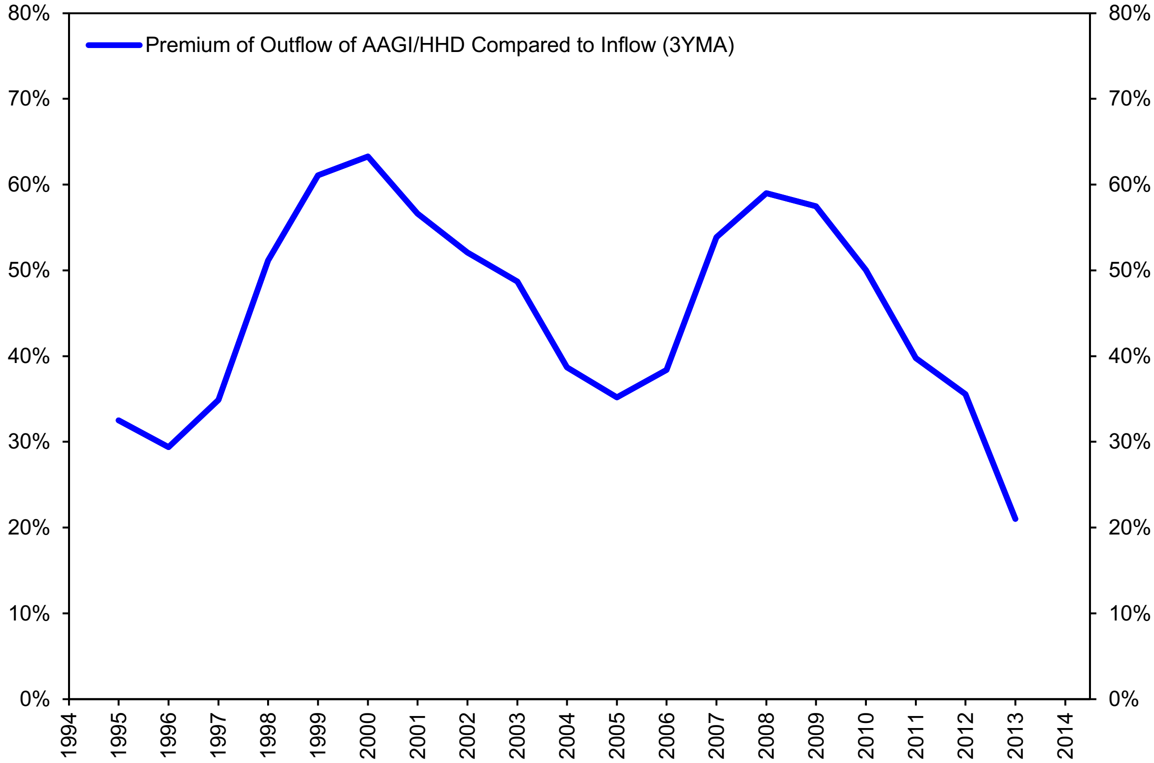
(total between 1992 through 2012, based on Aggregate Adjusted Gross Income)

	State	Households			AAGI (000's $)			AAGI/HHD		
		Sum 1992 - 2012			Sum 1992 - 2012			Sum 1992 - 2012		
		Net Flow into (+) / out of (-) KY	Inflows (into KY)	Outflows (out of KY)	Net Flow into (+) / out of (-) KY	Inflows (into KY)	Outflows (out of KY)	Net Flow into (+) / out of (-) KY	Inflows (into KY)	Outflows (out of KY)
Largest Income Deficit States	Florida	-6,637	68,013	74,650	-1,296,681	2,327,569	3,624,250	-14,327	34,222	48,550
	Tennessee	-15,900	90,682	106,582	-570,064	2,777,833	3,347,897	-779	30,633	31,411
	South Carolina	-1,890	13,584	15,474	-183,710	477,233	660,943	-7,581	35,132	42,713
	North Carolina	-2,250	28,460	30,710	-173,332	1,035,398	1,208,730	-2,979	36,381	39,359
	Georgia	-2,188	33,576	35,764	-120,940	1,254,429	1,375,369	-1,096	37,361	38,457
Largest Income Surplus States	Ohio	26,489	136,749	110,260	1,036,189	4,896,725	3,860,536	795	35,808	35,013
	Illinois	10,531	42,434	31,903	454,224	1,654,672	1,200,448	1,366	38,994	37,628
	Michigan	10,115	29,571	19,456	395,292	1,143,205	747,913	218	38,660	38,441
	New York	4,425	19,676	15,251	250,236	803,782	553,546	4,555	40,851	36,296
	California	5,577	33,751	28,174	215,616	1,345,096	1,129,480	-236	39,854	40,089

Figure 2 illustrates the 3-year average income premium of those Kentuckians migrating to Florida compared to the Floridians migrating to Kentucky. Note that in every single year between 1994 and 2012, the incomes of those leaving Kentucky for Florida exceeded those entering Kentucky from Florida by at least 20% and a maximum of over 60%. This migration of income between Kentucky and Florida will increase incomes of those in Florida relative to Kentucky. By 2014, Florida's personal income per capita of $42,737 was 12.5% higher than Kentucky's personal income per capita of $37,396.

[27] Source: IRS, Statistics of Income, https://www.irs.gov/uac/SOI-Tax-Stats-Migration-Data-2012-2013

Figure 2
Average Income Premium of Kentuckians Migrating to Florida Compared to Floridians Migrating to Kentucky[28,29]
(1994-95 through 2012-13, 3 Year Moving Average)



But the Florida/Kentucky story goes way beyond migration and income data.

To understand the impact estate taxes have on the size and number of estates we examine federal estate tax data provided by the IRS. Federal estate tax data are useful for analysis because all qualifying estates must file estate tax returns with the federal government, regardless of whether or not estate tax filers reside in states that levy estate taxes. Therefore, the number and size of all qualifying estates, filed by those who reside in states that do and do not levy estate taxes, can be subject to analysis.

Using the IRS estate tax data the 30,000 foot picture is brought up close and personal. IRS data on federal estate taxes paid confirm that Kentucky's asset base is suffering. As part of its collection of tax data, the IRS tracks, by state, the number of estates subject to the federal estate tax as well as the aggregate value of all of the estates.

Using IRS data from 1997 through 2014, we focus on two sets of data; first, the average size of estates in Florida and in Kentucky, second, the share of the population filing estates in Florida and Kentucky. And using these data, you can see the type of damage Kentucky's estate tax has wreaked on the state of Kentucky.

[28] Source: IRS, Statistics of Income, https://www.irs.gov/uac/SOI-Tax-Stats-Statistics-of-Income
[29] *This chart displays the relationship between the average incomes of people leaving KY for FL and people leaving FL for KY. For example, a hypothetical value of 33% in 1995 would mean that, on average, the incomes of people leaving KY for FL were 33% higher than those of people leaving FL for KY in 1995.

Due to changes in the federal estate tax law, the federal estate tax data vary over time, but are at all times the same for each and every state. The number of estates reported declines significantly for certain tax years due to changes in the dollar exemption level. The federal estate tax exemption level was $600 thousand in 1997 and rose progressively to $5 million in 2011.[30] There was also a temporary elimination of the estate tax completely in 2010. The applicable tax rate on federal estates also changed over this entire period from 55% in 1997 to 0% in 2010 and then back up to 35% in 2011.[31] For 2015, the federal estate tax exemption is $5.42 million (up from $5.34 million in 2014) and the top federal estate tax rate is 40%.[32] These legislative changes alter the number of estates filed, the total aggregate value of estates filed and the average value of estates filed.

In 1997, the average size of an estate in Kentucky was $1,810,202 and in Florida it was $1,922,097. Florida's average estate was 5.8% higher than Kentucky's. In 2014, Florida's average estate was $19,110,643 and in Kentucky it was $10,387,188. In 2014, Florida's average estate was a full 84% larger than Kentucky's (Figure 3).[33] The wealthiest most productive people in anticipation of an estate tax event move to Florida and leave Kentucky.

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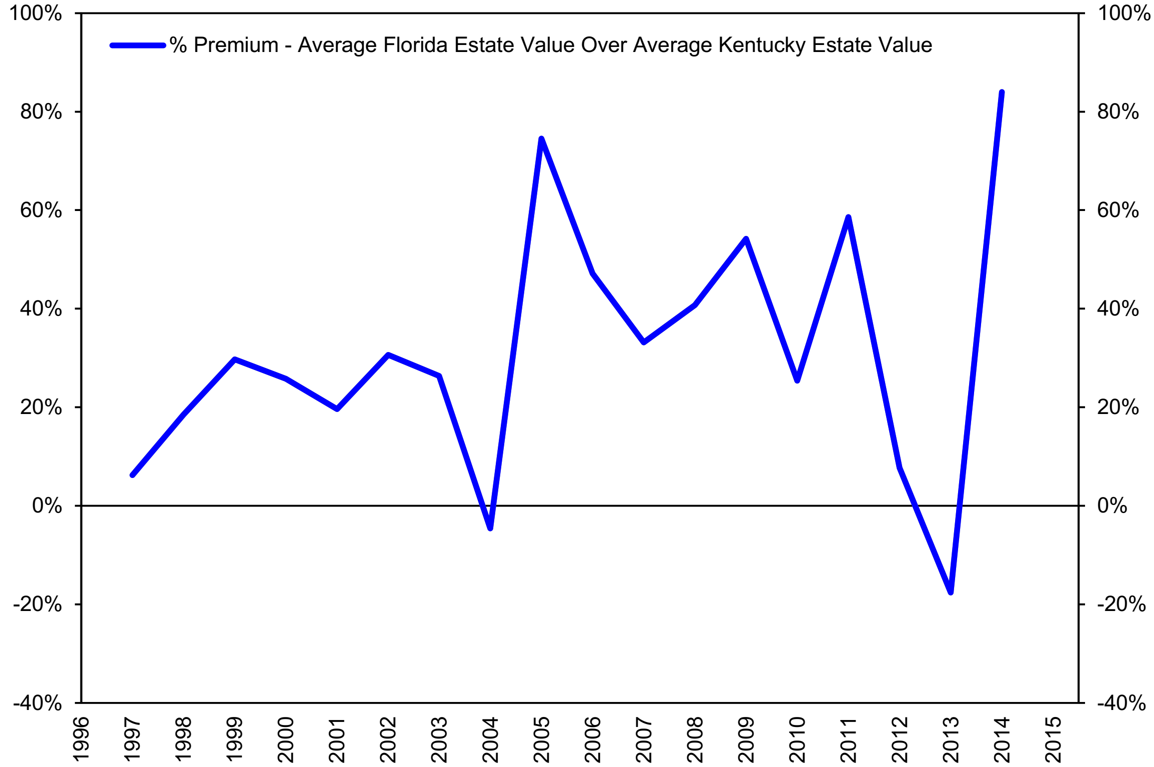
[30] Sources: Barry W. John and Jacob M Mikow, "Federal Estate Tax Returns, 1995-1997," IRS. https://www.irs.gov/pub/irs-soi/97esart.pdf, and "What's New - Estate and Gift Tax," IRS, December 2, 2015. https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Whats-New-Estate-and-Gift-Tax

[31] *Ibid.*

[32] *Ibid.*

[33] Kentucky's average estate values exceeded Florida's average estate value by nearly 5% in 2004 and 20% in 2013. This was caused by the death of a single or small number of extraordinarily wealthy individuals in Kentucky in 2004 and 2013, whose highly valuable estates significantly raised the average estate value in Kentucky. This effect was even more pronounced in Kentucky due to the state's low number of estate tax filings. The total value of Kentucky's estates was $1.4 billion in 2004 and $1.5 billion in 2013—the average total estate value in Kentucky of $1.4 billion between 1997 and 2014. However, Kentucky only had 404 estates filed in 2004 and 76 in 2013, far fewer than Kentucky's 490 average annual filings between 1997 and 2014. The state's low number of filings means the total and average estate values can vary considerably, just as they did in 2004 and 2013. However, aside from these data points, the trend in Figure 3 is abundantly clear: the average value of estates in Florida is far higher than in Kentucky.

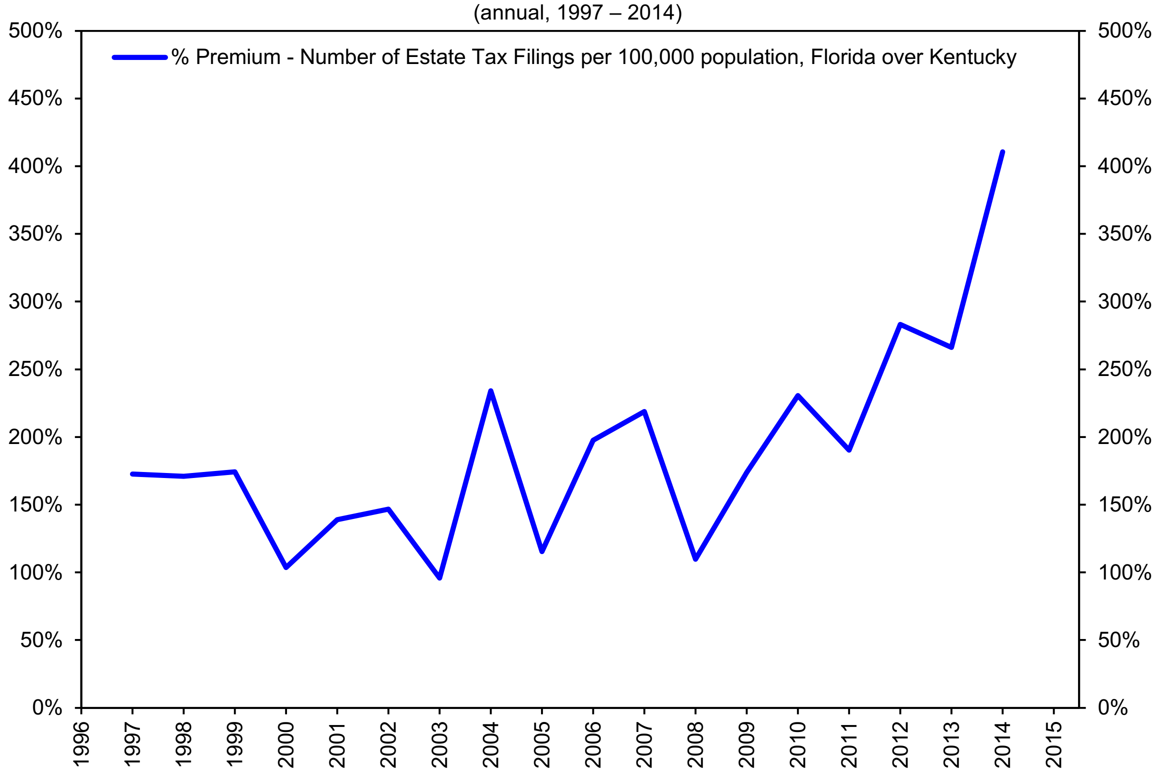
Figure 3
Size of Average Federal Estate: % Premium of Florida over Kentucky[34,35]
(annual, 1997 – 2014)



The second IRS data series is the number of estates filed in a state as a share of the total state population. This comparison only drives the nail in deeper (Figure 4). In 1997, in Kentucky there were on average 20.9 estates filed for every 100,000 people. In that same year in Florida, there were 57 estates filed per 100,000 people. By 2014, the Kentucky estate filing rate dropped to 1.4 estates filed per 100,000 of population (federal tax laws had changed on filing requirements) and in Florida there were 7.2 estates filed per 100,000 of population—well more than five times the Kentucky rate.

[34] Source: IRS, Statistics of Income, https://www.irs.gov/uac/SOI-Tax-Stats-Migration-Data-2012-2013
[35] Average $ Value of Estates Filed = Total $ Value of Estates Filed / # of Estates Filed
The above data are based on federal estate tax data reported to the IRS. Due to changes in the federal estate tax law, the federal estate tax data vary over time. The number of estates reported declines significantly for certain tax years due to changes in the dollar exemption level. The federal estate tax exemption level was $600 thousand in 1997, rose in $25,000 increments to $650 thousand by 2000, increased to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, $3.5 million in 2009, $5 million in 2010 (there was also a temporary elimination of the estate tax completely in 2010 for states that chose this option) and 2011, $5.12 million in 2012. $5.25 million in 2013, $5.34 million in 2014, $5.43 million in 2015 and $5.45 million for 2016. The applicable tax rate on federal estates also declined over this entire period from 55% in 1997 to 0% in 2010 (if that option is chosen), then back up to 35% in 2011 and up to 40% in 2013. These legislative changes alter the number of estates filed, the total aggregate value of estates filed, and the average value of estates filed. This discontinuity was strongest in 2010 when the estate tax was temporarily eliminated.

Figure 4
Number of Federal Estate Tax Returns Filed per 100,000 People:
% Premium of Florida over Kentucky[36,37]
(annual, 1997 – 2014)



To reiterate, not only was the average federal estate size much larger in Florida than it was in Kentucky, but also the number of people filing in Florida was much larger as a share of the population than in Kentucky.

The shocking observation is that these differences are increasing sharply. In the two previous charts, Figures 3 and 4, we have the average size of Florida and Kentucky's estates and the number of filers per 100,000 of population in each state from 1997 through 2014. In both regards, the evidence from estate tax filing shows because Florida is a much more hospitable state for wealthy people to die, Florida is also clearly a much more hospitable environment for wealthy people to live than is Kentucky.

[36] Sources: Bureau of Economic Analysis, and IRS, Statistics of Income, https://www.irs.gov/uac/SOI-Tax-Stats-Migration-Data-2012-2013
[37] The above data are based on federal estate tax data reported to the IRS. Due to changes in the federal estate tax law, the federal estate tax data vary over time. The number of estates reported declines significantly for certain tax years due to changes in the dollar exemption level. The federal estate tax exemption level was $600 thousand in 1997, rose in $25,000 increments to $650 thousand by 2000, increased to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, $3.5 million in 2009, $5 million in 2010 (there was also a temporary elimination of the estate tax completely in 2010 for states that chose this option) and 2011, $5.12 million in 2012. $5.25 million in 2013, $5.34 million in 2014, $5.43 million in 2015 and $5.45 million for 2016. The applicable tax rate on federal estates also declined over this entire period from 55% in 1997 to 0% in 2010 (if that option is chosen), then back up to 35% in 2011 and up to 40% in 2013. These legislative changes alter the number of estates filed, the total aggregate value of estates filed, and the average value of estates filed. This discontinuity was strongest in 2010 when the estate tax was temporarily eliminated.

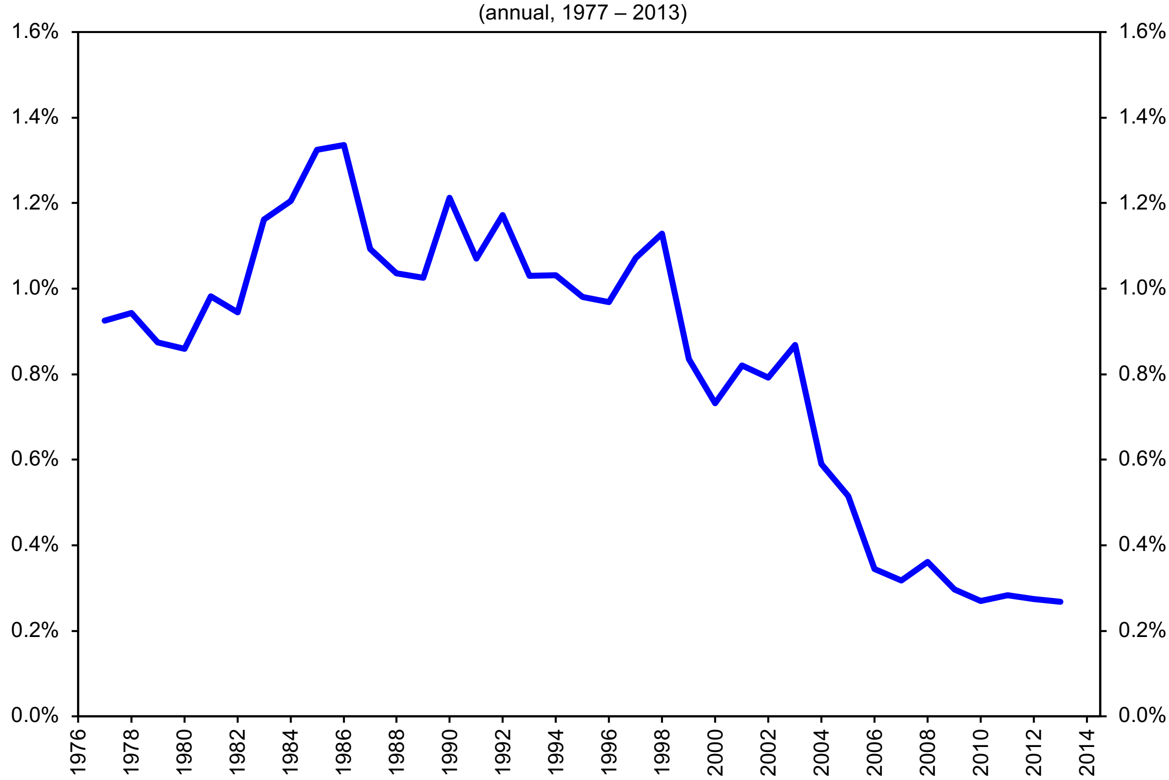
V. KENTUCKY'S ESTATE TAX RAISES VERY LITTLE REVENUE

The evidence presented in Table 1 and Table 2 shows that Kentucky pays a high price for imposing an estate tax in terms of the loss of both high income earners and wealthy people. As high income earners leave a state, they tend to take economic growth and tax revenues with them. Even from a static accounting perspective, Kentucky's estate tax contributes very little to overall state and local tax revenues (see Figure 5). Kentucky's estate tax accounted for less than 0.27% of 2013 total state and local tax revenues[38] and has been declining for decades.

Even in static dollar terms, eliminating Kentucky's estate tax comes with a very small direct revenue loss. According to the U.S. Census Bureau, Kentucky's estate tax raised only $41 million in fiscal year 2013.[39] This is a far cry from the average annual estate tax collections of $80 million during the 1990s.[40] But, from what we know, it was the high estate tax in the 1990s the created Kentucky's poverty and low tax revenues today.

However, the world is not static. As the previous evidence illustrates, eliminating Kentucky's estate tax will increase the rate of economic growth in Kentucky. And as time passes, the elimination of Kentucky's estate tax will have an even greater positive impact on Kentucky's economy. Stronger economic growth benefits everyone including the government through higher tax revenues, less poverty and less welfare and will more than offset the small static revenue loss to the state and provides lots of extra revenues to the local governments.

Figure 5
Kentucky's Estate Tax as a Percentage of Total State and Local Tax Revenues[41]
(annual, 1977 – 2013)

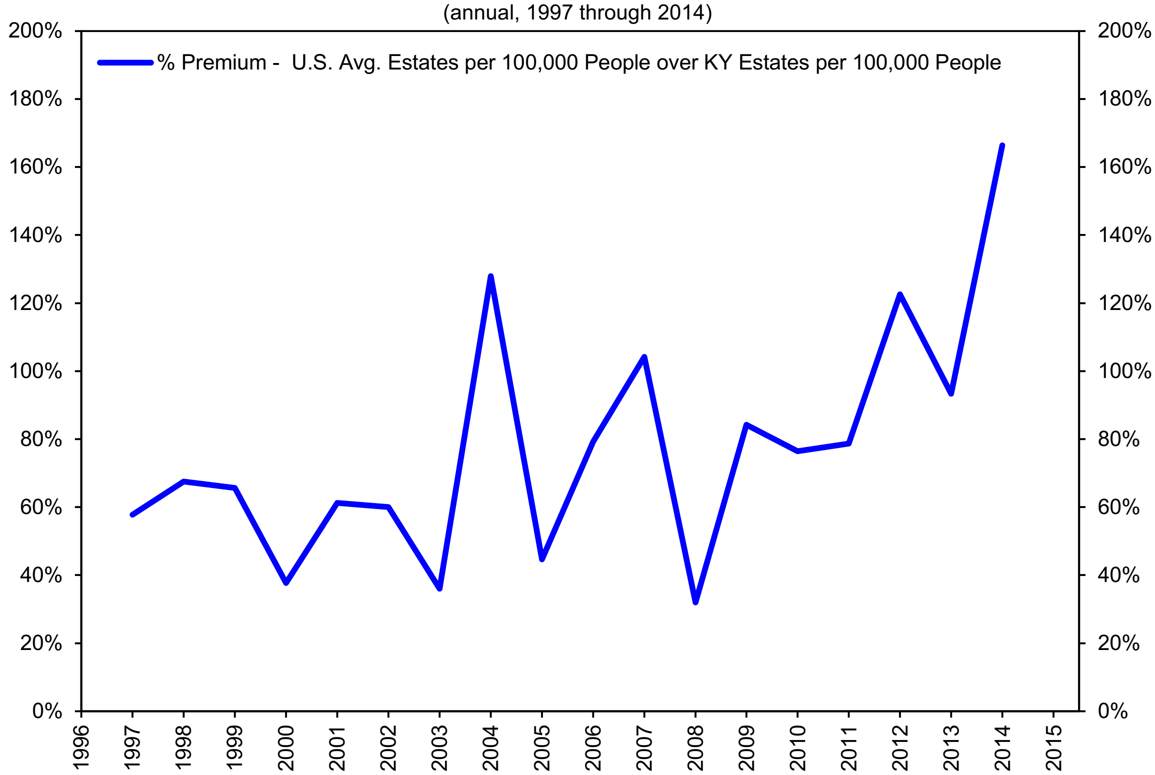


[38] 2012 is the most recent year for which detailed state and local finance data are available from the U.S. Census Bureau.
[39] Source: *Ibid.*
[40] Source: *Ibid.*
[41] Source: U.S. Census Bureau. State Government Tax Collections. http://www.census.gov/govs/statetax/

VI. THE ESTATE TAX'S IMPACT ON THE SIZE AND PREVALENCE OF KENTUCKY'S ESTATE TAX FILINGS

Figures 6 through 9 illustrate Kentucky's underperformance and its consequences. Figure 6 illustrates the % premium of the number of estates per 100,000 of population in the U.S. relative to the number of estates per 100,000 population in Kentucky.

Figure 6
Number of Federal Estate Tax Returns per 100,000 People: % Premium of U.S. over Kentucky[42,43]
(annual, 1997 through 2014)



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[42] Source: IRS, Statistics of Income – Estate Tax Statistics Filing Year, Table 2. https://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics-Filing-Year-Table-2

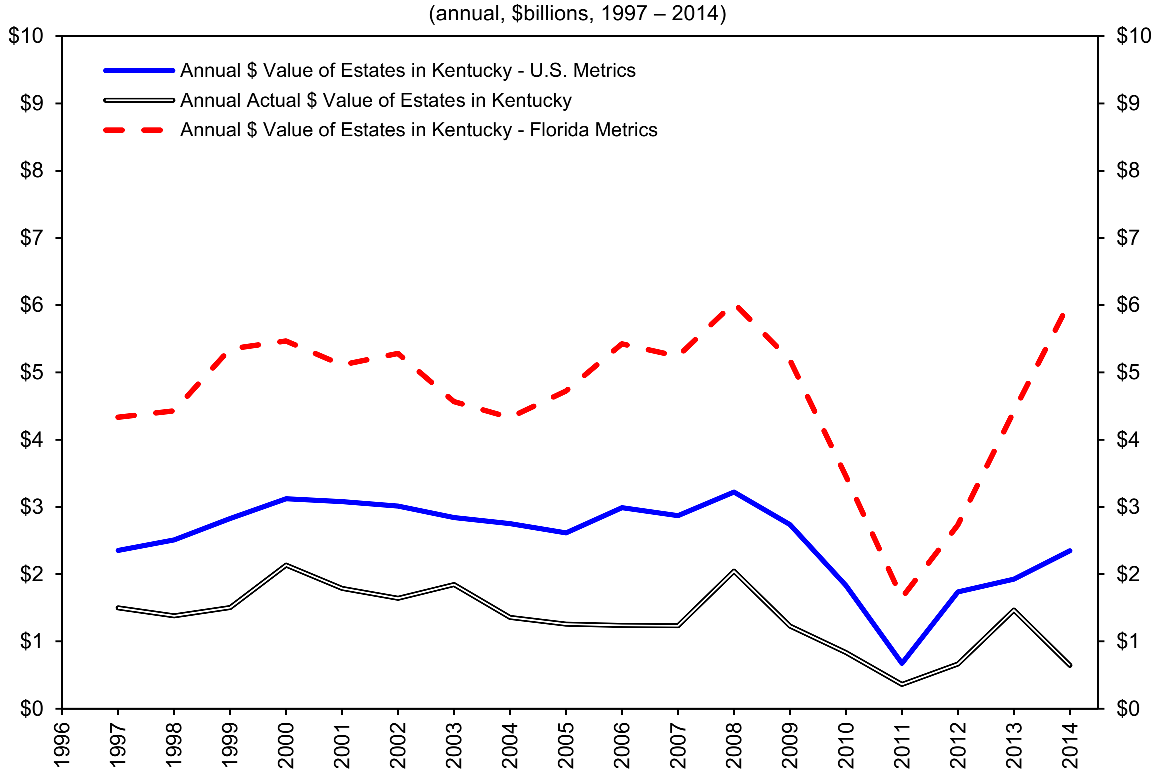
[43] The above data are based on federal estate tax data reported to the IRS. Due to changes in the federal estate tax law, the federal estate tax data vary over time. The number of estates reported declines significantly for certain tax years due to changes in the dollar exemption level. The federal estate tax exemption level was $600 thousand in 1997, rose in $25,000 increments to $650 thousand by 2000, increased to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, $3.5 million in 2009, $5 million in 2010 (there was also a temporary elimination of the estate tax completely in 2010 for states that chose this option) and 2011, $5.12 million in 2012. $5.25 million in 2013, $5.34 million in 2014, $5.43 million in 2015 and $5.45 million for 2016. The applicable tax rate on federal estates also declined over this entire period from 55% in 1997 to 0% in 2010 (if that option is chosen), then back up to 35% in 2011 and up to 40% in 2013. These legislative changes alter the number of estates filed, the total aggregate value of estates filed, and the average value of estates filed. This discontinuity was strongest in 2010 when the estate tax was temporarily eliminated.

Figure 7 compares the total dollar value of all estates in Kentucky to the dollar value of all estates in Kentucky under two different scenarios: (1) if U.S. metrics existed in Kentucky and, (2) the dollar value of all estates in Kentucky if Florida metrics existed in Kentucky.

Figure 7

Total Dollar Value of all Estates in Kentucky
The Dollar Value of all Estates in Kentucky if U.S. Metrics Existed in Kentucky and
The Dollar Value of all Estates in in Kentucky if Florida Metrics existed in Kentucky[44,45]

(annual, $billions, 1997 – 2014)

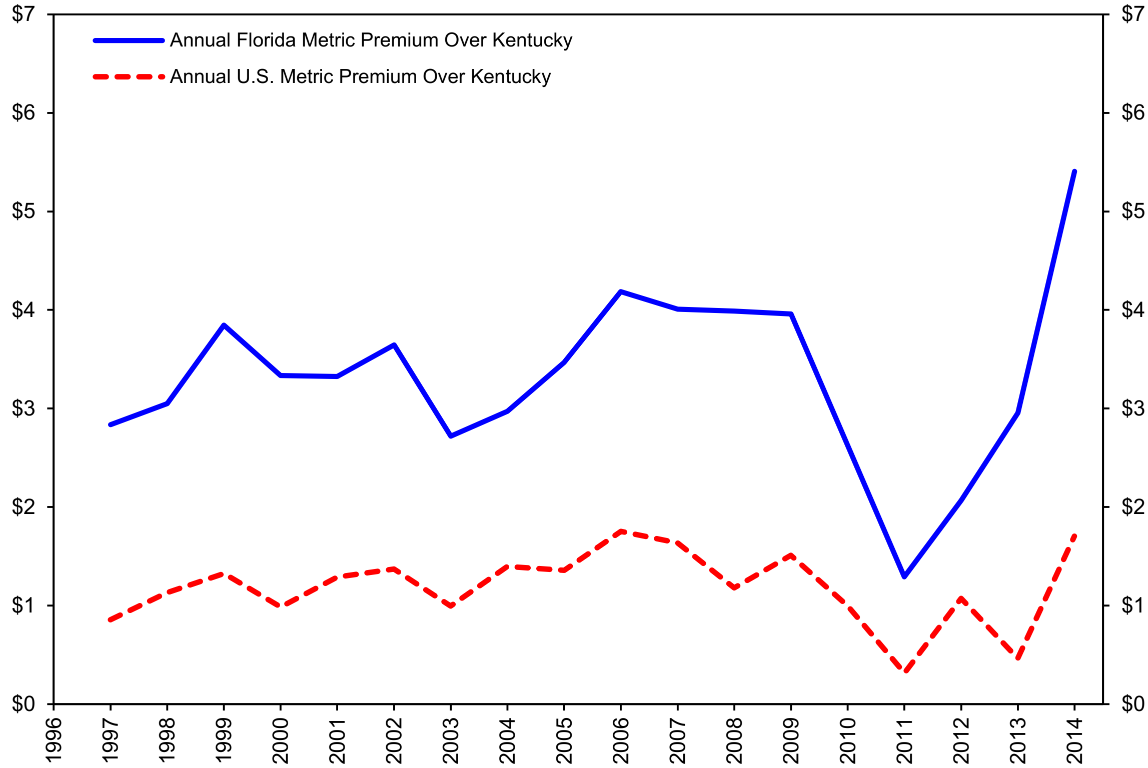


44 Sources: IRS, Statistics of Income and U.S. Census Bureau.

45 The above data are based on federal estate tax data reported to the IRS. Due to changes in the federal estate tax law, the federal estate tax data vary over time. The number of estates reported declines significantly for certain tax years due to changes in the dollar exemption level. The federal estate tax exemption level was $600 thousand in 1997, rose in $25,000 increments to $650 thousand by 2000, increased to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, $3.5 million in 2009, and $5 million in 2011. There is also a temporary elimination of the estate tax completely in 2010 for those estates that chose this option. The applicable tax rate on federal estates also declined over this entire period from 55% in 1997 to 0% in 2010 (if that option is chosen) and then back up to 35% in 2011. These legislative changes alter the number of estates filed, the total aggregate value of estates filed, and the average value of estates filed. These discontinuities are strongest in 2010 when the estate tax was temporarily eliminated.

Figure 8 presents the *additional* value of the estates in Kentucky had the U.S. metrics or the Florida metrics existed in Kentucky in 1997 through 2014.

Figure 8
Potential Increase in the Dollar Value of all Estates in Kentucky
If U.S. Metrics Existed in Kentucky and
If Florida Metrics existed in Kentucky
(annual, $billions, 1997 – 2014)



These charts illustrate a striking deficiency in Kentucky. Taking the last ten years at face value, 2005 through 2014, Kentucky would have had $13½ billion more value of estates using U.S. metrics and $37 billion more value of estates using Florida metrics. These numbers arguably understate the lost capital by a significant amount because Kentucky's population would have also been larger due to stronger economic growth and because these numbers only look at taxable estates, not total estates (which are larger due to gifts, deductions, etc.). Surely some of the people who left Kentucky weren't all that wealthy for taxable estate purposes, but they were still wealthier than they would have been had they stayed in Kentucky. And also once a wealthy family leaves, its descendants stay away as well. In other words, a ten year accumulation probably grossly understates the time of the total effect. But here you have it.

Clearly, Kentucky's economy has lost enormous amounts of accumulated wealth and the reason is Kentucky's estate taxes. This wealth would have created many more Kentucky jobs, alleviated some of Kentucky's poverty and, yes, significantly increased Kentucky's state and local tax revenues.

VII. THE DYNAMIC BENEFITS FROM ELIMINATING KENTUCKY'S ESTATE TAX

No matter which way you look at it, the potential dynamic benefits for Kentucky are significant. All residents of Kentucky are paying an extremely high cost for the state's estate tax, whether they are subject to the estate tax or not. And, it is not just the current residents of Kentucky who are impacted. The estate tax also discourages people from migrating into Kentucky because if they did, they would be subject to the state's estate tax. Kentucky loses the income, spending, jobs, and wealth that these people could be bringing, but are not, because of the estate tax.

Eliminating the estate tax will raise the total amount of investment and economic activity in Kentucky. Greater economic activity will lead to higher consumption, a stronger housing market, and a larger total amount of dividends and interest income reported in the state. Government revenues will benefit in turn because the stronger economic activity creates more *taxable events*. The types of government tax revenues Kentucky could be generating by eliminating the estate tax include:

- Higher revenues from dividends and interest income;
- Higher consumption in the state, therefore higher state sales tax revenues, excise tax revenues, and local sales tax revenues;
- Higher property values, therefore higher local property tax revenues; and,
- Higher employment therefore higher payroll tax revenues.

Greater economic activity will also lead to greater employment in Kentucky. More people will have the pride of working and supporting their own families and, of course, the state economy will benefit from the value their employment creates. Kentucky's budget will also benefit because welfare and unemployment compensation expenditures will be lower as well.

More importantly, these revenues are generated by expanding the economic pie in Kentucky—not by encouraging some of the "pie" to move to another state—a clear win-win policy reform. Kentuckians win by having a stronger economy. Those Kentuckians who would have been subject to the estate tax benefit by not being encouraged to leave their home in order to preserve their income for the children and grandchildren. And, the state wins due to the more vibrant economy that generates a stronger and more stable revenue source to fund important government expenditures.

The evidence presented above can be leveraged to gain a sense of the potential dynamic benefits Kentucky could gain if the state eliminated its estate tax. There are many ways to apply this evidence. We take two perspectives: a wealth or asset perspective and a comparative economic performance perspective.

Wealth is a key economic input. Without wealth there is no capital accumulation. Without capital accumulation, there is no technological progress. Both capital and technology are key inputs for generating economic growth in Kentucky. A 2001 study by Jorgenson and Yip found that capital and technological progress account for nearly 2 percentage points of the annual growth in the U.S. between 1960 and 1995.[46] Because the estate tax is causing wealth to accumulate at a lesser rate than it should, Kentucky's economic growth potential is less than it should be. And, it is not just production that a paucity of wealth impacts. Wealthier societies consume more as well—an effect economists call "the wealth effect." A 2010 study estimated this wealth effect to be around 9-cents per $1 of wealth in the long-term.[47]

In Kentucky, the actual value of the wealth lost is greater than the value of the lost estates—people adjust their estates in response to both federal and state tax policy to minimize the ultimate tax burden. Nevertheless, if we use the size of the lost estates between 2005 and 2014 as a guide, the total wealth of Kentucky is around $13½ billion to $37 billion smaller than it would have been over this entire period. This is wealth that could have been put to use in Kentucky investing in Kentucky businesses each and every year between 2005 and 2014. Instead, these assets have either

[46] Source: Jorgenson, Dale, and Eric Yip (2001). "Whatever Happened to Productivity Growth?" In E.R. Dean, M.J.Harper, and C Hulten, eds., *New Developments in Productivity Analysis,* 205-246. Chicago: University of Chicago Press. http://www.nber.org/chapters/c10133.pdf

[47] Source: Carroll, Christopher D., Misuzu Otsuka, and Jiri Slacalek (2011) "How Large Are Housing and Financial Wealth Effects? A New Approach" *ECB Journal of Money, Credit, and Banking*, Vol. 43, No. 1 (February), pp 55–79. https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1283.pdf?6e10be566cd9ef3751ba33bed5052098

migrated away from Kentucky or never came to Kentucky in the first place and have been subsequently put to work in other states.

Estates are built up over time. Those states that attract people with sizable estates receive the benefits for many years. And, those states—like Kentucky—that encourage people with sizable estates to leave pay the price for many years. This logic implies that the $13½ billion to $37 billion in lost assets impacted Kentucky not just in the year they were reported to the IRS. The assets would have existed in Kentucky for many years prior to when it was reported to the IRS. To account for this fact, our estimate examines the 10-years of potential estates that should have been reported to the IRS but was not, relative to the value of the assets in Kentucky at the beginning of the 10 year period. It is also important to note upfront that because estates reported to the IRS have declined over time, and the total value of estates is less than the total value of assets lost, the actual economic damages calculated significantly understate the true economic damage. Yet, the economic costs are still staggering.

According to the Federal Reserve Board of Governors, the total assets of the U.S. back in 2000 were around $50.1 trillion.[48] Based on Kentucky's share of the U.S. economy, this would equate to a total asset base in Kentucky somewhere in the neighborhood of $546 billion. The loss to Kentucky's asset base due to the estate tax was $13½ billion to $37 billion. A higher asset base directly translates into greater economic growth. Greater economic growth around the same range as the increase in Kentucky's asset base implies that Kentucky's economy, as measured by gross state product, could have been $4.6 billion to $12.8 billion larger than it currently is without the state estate tax.

A larger economy would have led to more jobs in the economy and higher tax revenues for the state. Had Kentucky eliminated its estate tax 10 years ago and grown at the rate of its non-estate tax peers, Kentucky's GSP would have been almost 10% larger in 2014 and there would have been 125 thousand more jobs in the state. More jobs and more output would have benefited state and local government revenues by about one billion dollars in 2014.

Instead of estimating the benefits by looking at the change in Kentucky's asset base, the data presented above illustrates that the annual rate of economic growth in Kentucky is not what it should be. To be sure, Kentucky does have several other policies adversely impacting its growth rate: its earned income taxes, high overall tax burden and forced-unionism aren't doing Kentucky any favors. All three of these features are associated with a significant negative growth premium for these states.

Removing Kentucky's estate tax eliminates the most important policy obstacle that is harming Kentucky's growth potential. With this obstacle removed, there is no reason to believe that Kentucky's rate of economic growth would not resemble the average rate of economic growth for the states without estate taxes (refer back to Table 1). Had Kentucky's economic performance matched the performance of the pro-growth tax states between 2004 and 2014, then by 2014 Kentucky's economy would have been significantly larger.

VIII. FINAL WORD

In our country today, you can pay your taxes fair and square and then take your after tax proceeds to Las Vegas and you can carouse, gamble, drink and smoke and as far as our governments are concerned "go for it"—it's your money. But if you decide to take that same money, you rich vampire squid capitalist, and leave it to others after your death, you'll have to pay 40% in federal death taxes and an additional 16% in Kentucky death taxes.

What's wrong with this picture?

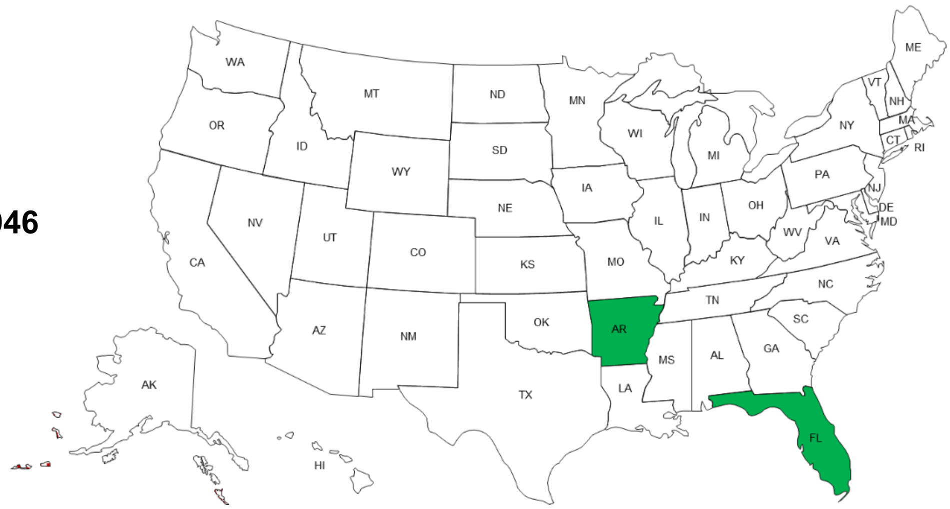
[48] Federal Reserve Board of Governors. Flow of Funds Accounts of the United States. B.100 Balance Sheet of Households and Nonprofit Organizations. 16 September, 2011. http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf

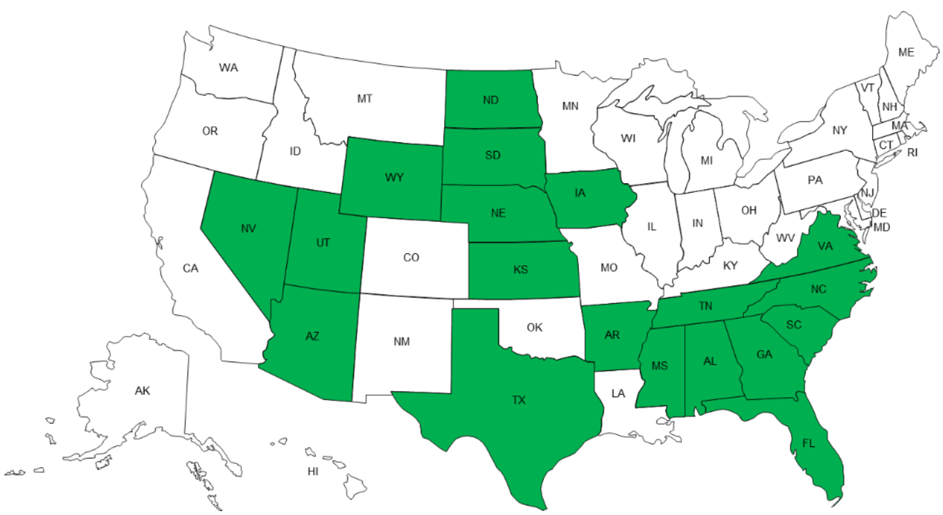
6. RIGHT-TO-WORK

Right to Work state

Non Right to Work state
(Forced Union state)

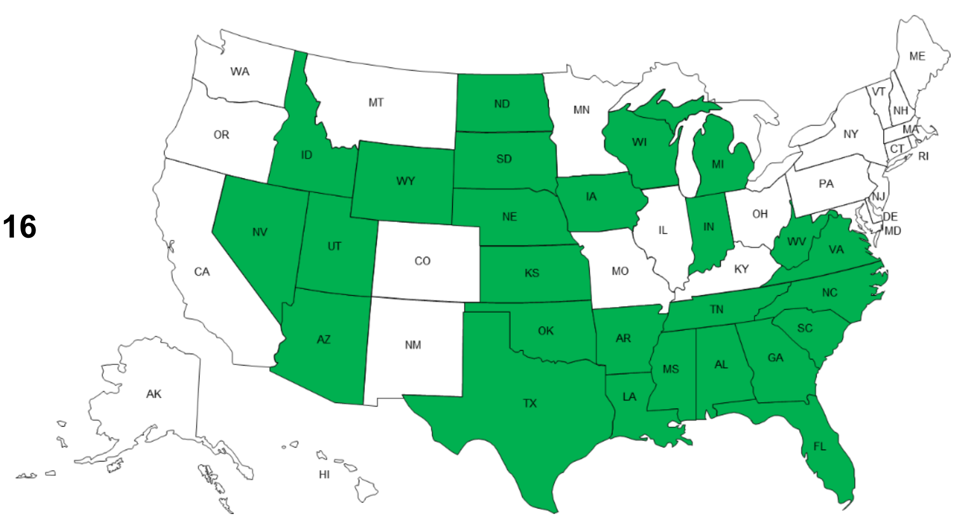
July 1946





July 1966

July 2016



RIGHT-TO-WORK

Introduction

As defined by the National Right to Work Legal Defense Foundation, a right-to-work (RTW) law "guarantees that no person can be compelled, as a condition of employment, to join or not to join, nor to pay dues to a labor union."[1] Allowed by Section 14(b) of the National Labor Relations Act as amended by the Taft-Hartley Act, states are able to pass laws, known as right-to-work laws, which prohibit unions from forcing workers to be union members as a condition of employment.[2] But in the absence of the passage of any right-to-work law, forced-unionism prevails. To understand why right-to-work policies have important implications for unionization and economic growth, a little background is helpful.

The Local Right-to-Work Effort in Kentucky

In Kentucky, unsuccessful attempts to pass right-to-work in the State Legislature have become a tradition. In every legislative session in recent memory, the Republican-led Kentucky State Senate has introduced and passed a right-to-work bill. And in every one of those sessions, the Democrat-led Kentucky House has voted it down. And even if the Kentucky House would have passed right-to-work the Democratic governors would have vetoed the legislation. Right-to-work, let alone the "prevailing wage" provision have been a no-go until now.

The right-to-work effort in Kentucky proved to be no different in the State Legislature during its 2014-2015 session. The Republican majority in the Kentucky State Senate passed right-to work by a vote of 24-12. Upholding tradition, the bill was defeated in the Democrat-led House, this time without even making it out of Committee to be put to the floor for a vote.[3]

Undaunted by yet another defeat in the State Legislature, advocates of right-to-work in Kentucky adopted a new strategy. Desperate to attract out of state investment and create much-needed jobs in Kentucky, some ambitious county governments, backed by representatives from numerous Chamber of Commerce chapters and businesses got creative: if the State Legislature wasn't going to pass right-to-work, local governments would—and they did. By the end of January 2015, Fulton, Hardin, Simpson, Todd and Warren counties—the first four of which share a border with right-to-work states—had adopted local right-to-work ordinances.[4] By the summer of 2015, 11 counties representing over 800,000 Kentuckians had adopted right-to-work and another nine counties were taking initial steps to implement right-to-work.[5] Right-to-work was clearly on the rise in Kentucky.

The legal rationale for Kentucky's local right-to-work push was two-fold:

1. An interpretation by advocates in local governments and the Chamber of Commerce of the National Labor Relations Act (NLRA) in which local governments were not pre-empted in their decision to enact right-to-work.[6] Citing section 14(b) of the NLRA, advocates of local right-to-work claimed that the section's usage of "States and Territories" included not just the state-level government but all political subdivisions within

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[1] More information about right-to-work laws can be found at the following web address: http://www.nrtw.org/b/rtw_faq.htm

[2] The actual text of NLRA Section 15 (b) reads as follows:

> *(b) [Agreements requiring union membership in violation of State law] Nothing in this Act [subchapter] shall be construed as authorizing the execution or application of agreements requiring membership in a labor organization as a condition of employment in any State or Territory in which such execution or application is prohibited by State or Territorial law.*

Source: "National Labor Relations Act," National Labor Relations Board, Accessed August 11, 2015. https://www.nlrb.gov/resources/national-labor-relations-act

[3] "Right-To-Work and Repeal of Prevailing Wage Defeated in Kentucky," Ohio Kentucky ADC website, February 17, 2015. http://oh-kyadc.com/right-to-work-and-repeal-of-prevailing-wage-defeated-in-kentucky/

[4] "Several Kentucky counties passing or considering right to work laws", *Lexington-Herald Leader*, January 17, 2015. http://www.kentucky.com/news/local/counties/scott-county/article44547798.html

[5] *Ibid.*

[6] The full text of the National Labor Relations Act can be found at the following link: Source: National Labor Relations Act, National Labor Relations Board, https://www.nlrb.gov/resources/national-labor-relations-act

a state, i.e. county and city governments, as well.[7] In such an interpretation of 14(b), in the event a state had not adopted right-to-work, county, city, and other jurisdictions falling under the definition of "Territories" were not pre-empted in passing right-to-work legislation by existing federal law, and were free to do so unless expressly forbidden by state law.[8] Since Kentucky had not expressly forbidden local governments to enact right-to-work laws, local governments were free to do so on their own under this interpretation.

2. In 1978, Kentucky passed "home rule" legislation that granted cities broad authority to pass laws related to economic development not expressly prohibited by the State.[9] Right-to-work, perhaps more than any single policy, has the potential to boost economic development, and therefore seemed perfectly justified by Kentucky's home rule law.

Unions, however, were quick to respond to the rise of local right-to-work in Kentucky. Together, nine unions filed suit against Hardin County in the Western District of Kentucky's Louisville Division—one of the most liberal parts of the state. The unions claimed that Congress' intention with the NLRA "was not to authorize every county, city, town and village to adopt their own conflicting policies regarding union security"; they also claimed that precedence was in their favor, citing a decision in similar local right-to-work case in Kentucky dating back to 1965, *Kentucky State AFL-CIO v. Puckett*. In *Kentucky State AFL-CIO v. Puckett*, the Kentucky Court of Appeals struck down local right-to-work ordinances on the basis that city-level right-to-work laws "were a departure from the spirit and purpose of the NLRA." However, *Kentucky State AFL-CIO v. Puckett* pre-dated Kentucky's 1978 home rule legislation that granted broad authority to local governments to pass legislation intended to boost economic development.[10]

Unfortunately for the citizens of Kentucky, in February 2016 U.S. District Judge David J. Hale granted a summary judgment request by unions and in the process, struck down local right-to-work ordinances in Kentucky.[11] Judge Hale's ruling relied on an interpretation of 14(b) in which the reference to "States or Territories" did not authorize local governments to enact their own right-to-work laws, and that therefore, local governments were in fact pre-empted by state laws regarding right-to-work. In short, if a state such as Kentucky had neglected to pass right-to-work, forced unionism was the law of the land statewide.

Hardin County announced it would appeal the decision with the Sixth Circuit Court of Appeals.[12]

The History of Right-to-Work

The growth of large formal union power can be traced back to the National Labor Relations Act of 1935 (NLRA), often referred to as the Wagner Act after famously pro-union New York Senator Robert F. Wagner. Under the Wagner Act, employees had the right to self-organize and bargain with employers collectively and, as employees, were granted legal immunity from employer interference or retribution in their labor practices. This Depression-era Act was, by almost all accounts, an extremely heavy-handed piece of legislation that certainly contributed to the depth and breadth of the economic downturn that had swept the nation. Under the NLRA, union power reached new highs. Within ten years, union membership as a share of the total labor force rocketed from 10% to 34%, nearly all of it in the private sector.[13]

No matter what your feelings are toward unions, union labor contracts do raise the costs of doing business—through higher wages, increased health benefits, more vacation time, higher safety costs, more generous pension/retirement

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[7] Lawrence E. Dube, "Kentucky County Defends Right-to-Work Law in 6th Cir.," *Bloomberg BNA*, June 15, 2015. http://www.bna.com/kentucky-county-defends-n57982074253/

[8] Pamela A. Rolfs, "The Validity of Local Right-to-Work Ordinances under Federal and Mississippi Law", Missouri Law Review, Fall 1991, Volume 56, Issue 4. http://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=3060&context=mlr

[9] Honorable Jon D. Russell, Aaron Bostrom, "Federalism, Dillon Rule, and Home Rule," White Paper, American City County Exchange (ACCE), January 2016.
https://www.alec.org/app/uploads/2016/01/2016-ACCE-White-Paper-Dillon-House-Rule-Final.pdf

[10] Kentucky State AFL-CIO v. Puckett, 391 S.W.2d at 360 (Ky. 1965).

[11] Vin Gurrieri, "Unions Win Challenge to Ky. County's Right-To-Work Law," Law 360.com, February 4, 2016. http://www.law360.com/articles/755179/unions-win-challenge-to-ky-county-s-right-to-work-law

[12] Lawrence E. Dube, "Kentucky County Defends Right-to-Work Law in 6th Cir.," *Bloomberg BNA*, June 15, 2015. http://www.bna.com/kentucky-county-defends-n57982074253/

[13] Data sourced from chart in: Colin Gordon, Ross Eisenbrey, "As unions decline, inequality rises," Economic Policy Institute, June 6, 2012. http://www.epi.org/publication/unions-decline-inequality-rises/

costs, etc.—and thus make labor-intensive businesses less attractive to start up and operate. Unions also could and often did call strikes when their members were not satisfied with their end of the deal. The logic therefore seems elementary my dear Watson that policies benefitting unionization will also retard the establishment and operation of businesses, leading to lower economic growth than would otherwise be achievable with less generous policies toward unions.

For some reason, the idea that labor and capital are complementary, not antagonistic, is anathema to political analysts and "experts" of every stripe. Profits and wages are not a zero sum game where if one increases, the other has to fall. In general, when profits are high, wages are also high and vice versa. Labor and capital do benefit from the same policies and are hurt by the same policies. Labor and capital should be allies, not combatants, because they share the same consequences from public policies, contrary to virtually all politically received doctrine. Growth is the answer, not more government.

There is room, within a narrow range, for either labor or capital to "win"—through higher wages or higher profits—at the expense of the other. The practical problem is that unions always push past the narrow acceptable range and into the areas where labor "wins" so much over capital that total productivity, capital and labor all fall. Just remember, capital without labor and labor without capital are two situations that no business or worker wants to find itself in! Today's unions, in general, function less as advocates for all labor and more as defenders of highly-paid tenured labor against the youngest, least-skilled and least advantaged new entrants to the labor market. And that is not the function of a union; that is the function of a cartel.

Twelve years after its passage, the deleterious effects of the Wagner Act became clear, and Congress passed the Taft-Hartley Act of 1947, which added checks and balances to the Wagner Act while slightly curbing the broad range of powers afforded unions.

Within the framework of labor laws, a number of types of union labor arrangements exist under which a business, or "shop," can operate. According to the U.S. Department of Labor:[14]

> *OPEN SHOP: A business that employs workers without regard to union membership. In the 1920s the "open shop" employed an ill‐disguised attempt to get ride* [sic] *of bona fide unions. States with "Right to Work" laws have decreed the open shop.*
>
> *AGENCY SHOP: A union security clause whereby all members of a bargaining unit must pay a service fee, the equivalent of dues, whether or not they are union members.*
>
> *UNION SHOP: A shop where every member of the bargaining unit must become a member of the union after a specified amount of time.*
>
> *MODIFIED UNION SHOP: A provision in the union contract requiring all new employees to join the union and requiring all workers already in the union to remain as union members.*
>
> *CLOSED SHOP: The hiring and employment of union members only. Illegal under the Taft‐Hartley Act.*

An interesting feature of the Taft-Hartley Act is that the most restrictive labor arrangement a company can operate under—the "closed shop," where hiring and employment are open only to union members—was outlawed. Even with the outlawing of the "closed shop," there still exists a number of labor arrangements which make it difficult for non-union workers to remain unaffiliated with labor unions. The most important feature of the Taft-Hartley Act for our purposes, however, is the fact that Taft-Hartley guaranteed states the ability to pass right-to-work laws. Specifically, the Taft-Hartley Act amended the NLRA by adding Section 14(b), which officially recognized the power of states to enact right-to-work laws by allowing states to prohibit "union shop" and "agency shop" labor arrangements (see Footnote 2). Consequently, many of the states didn't wait long after the passage of the Taft-Hartley Act to enact right-to-work laws (Figure 1).

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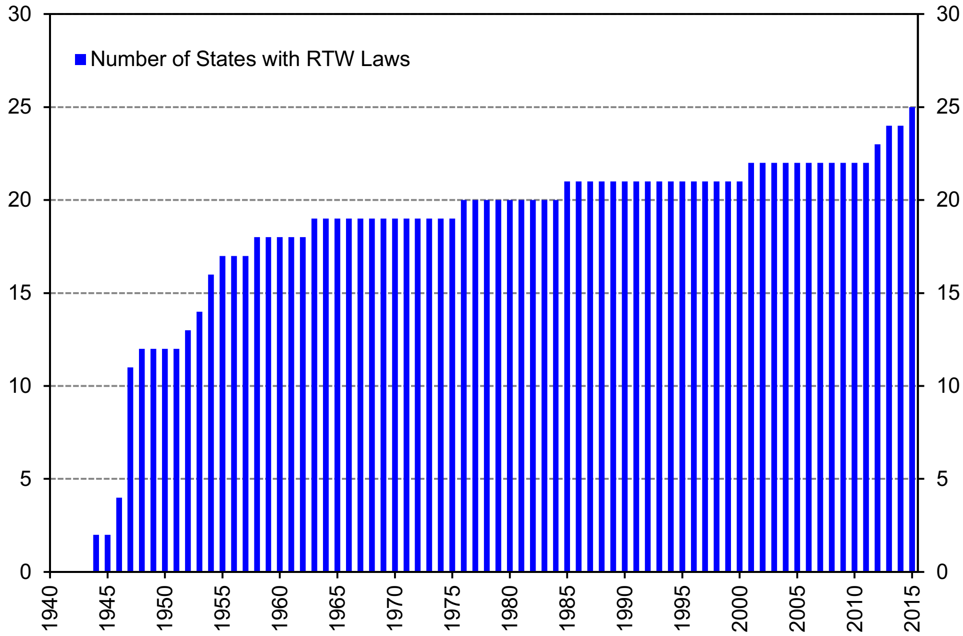
[14] Glossary, United States Department of Labor, accessed July 24, 2015. http://www.dol.gov/dol/aboutdol/history/glossary.htm

Figure 1
Number of States with Right-to-Work Laws



Source: National Right To Work Committee

If you look carefully at Figure 1, you'll notice that four states didn't wait for Taft-Hartley's permission to pass right-to-work laws. These four states—Arizona (1946), Arkansas (1944), Florida (1944) and Nebraska (1946)—all passed constitutional amendments that had the language of future right-to-work laws.[15] These four states took it upon themselves to proactively legislate right-to-work constitutional amendments within their own states, leaving the burden on unions to challenge these constitutional amendments in the courts. Before the unions could gain much traction in getting courts to strike down the right-to-work amendments, Taft-Hartley had been passed, thus cementing the ability for states to enact right-to-work laws.[16]

An interesting feature of our nation's labor laws relates to railroad and airline workers. Because these sorts of jobs result in employees potentially working in multiple states in a single day, unions successfully argued that these workers should be treated differently than other types of workers when it comes to labor laws. As a result, the federal Railway Labor Act governs railroad and airline workers' employment contracts. These workers are completely exempt from right-to-work laws no matter where they live and, in fact, aren't subject to the NLRA at all.

The Effects of Declining Union Power

By 1948, 12 states had right-to-work laws on their books, and, by 1958, the number of right-to-work states rose to 18.[17] It is interesting to note that none of the states enacting right-to-work laws at the time were heavily industrialized states in the northeastern U.S. (refer back to maps on page 96). In fact, not one northeastern state is right-to-work to this day, and only in the past five years has any "rust belt" state passed a right-to-work law (Indiana effective 2012, Michigan effective 2013 and Wisconsin effective 2015). West Virginia became the 26th state to pass right-to-work in 2015. The law was to take effect on July 30th, 2016; however, at the time of this writing, right-to-work's implementation has been stayed pending the outcome of a legal challenge by the local AFL-CIO and 10 labor unions in the state.[18]

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15 "State Right To Work Timeline," National Right To Work Committee, accessed July 28, 2015. https://nrtwc.org/facts-issues/state-right-to-work-timeline-2/

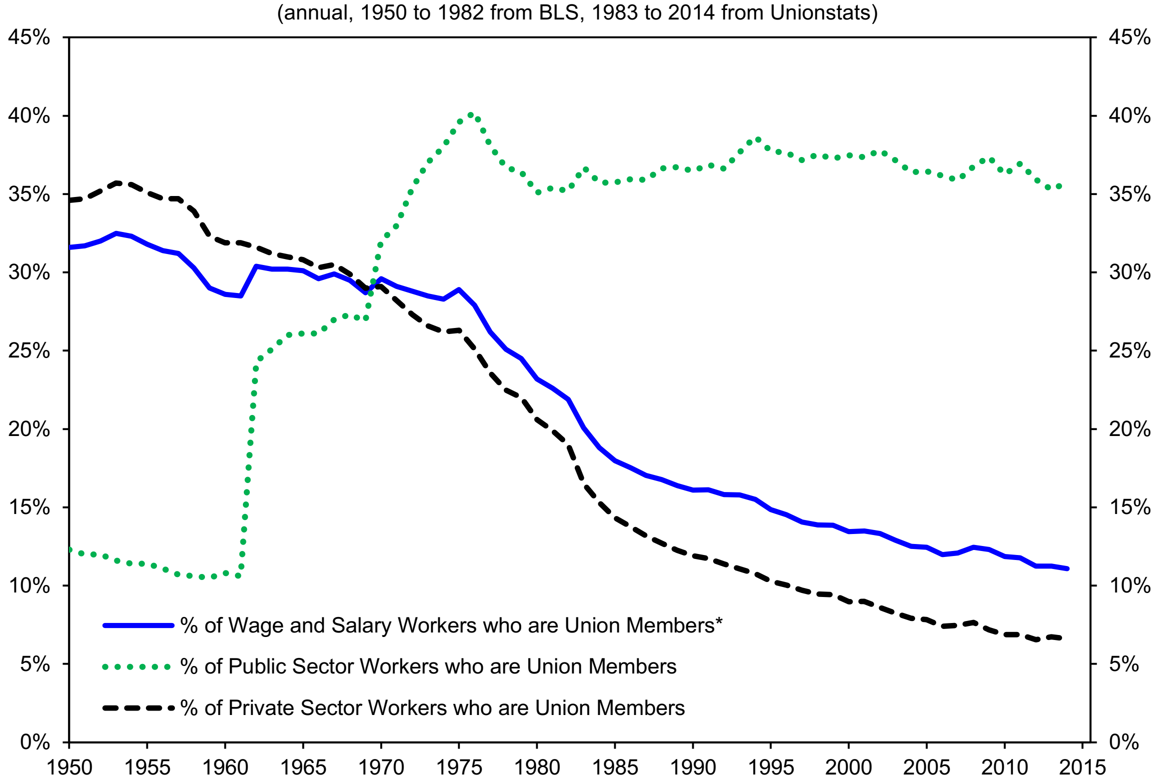
16 William F. Swindler, "Right to Work, a Decade of Development," *Faculty Publications of William & Mary Law School*, Paper 1590, pp. 296-300, 1957. http://scholarship.law.wm.edu/facpubs/1590

17 "State Right To Work Timeline," National Right To Work Committee, accessed July 28, 2015. https://nrtwc.org/facts-issues/state-right-to-work-timeline-2/

18 Phil Kabler, "Labor unions ask for summary judgement in WV right-to-work case," Charleston Gazette-Mail, October 5, 2016. http://www.wvgazettemail.com/news-business/20161005/labor-unions-ask-for-summary-judgment-in-wv-right-to-work-case

The latter half of the 20th century saw steady declines in private sector unionization, which is partially coincident to the increase in right-to-work laws. Even more interesting is the dramatic increase in public sector union membership over that same time period. The most dramatic jump in public sector union membership took place in 1962 when President Kennedy recognized the right of federal employees to bargain collectively (see Figure 2).

Figure 2
Union Membership
(annual, 1950 to 1982 from BLS, 1983 to 2014 from Unionstats)



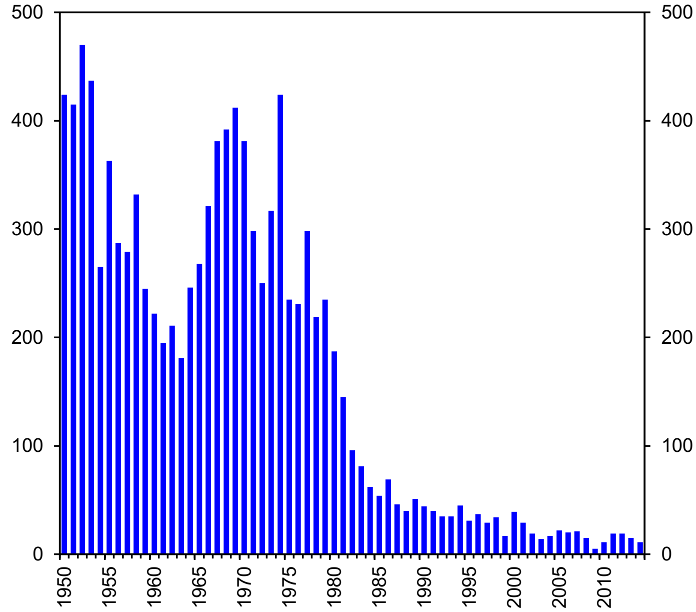
*According to Bureau of Labor Statistics Current Population Survey methodology, "Wage and salary workers receive wages, salary, commissions, tips, or pay in kind from a private employer or from a government unit." This designation does not include unincorporated self-employed workers or unpaid workers. Source: "Employment and Earnings: Household Data," Bureau of Labor Statistics, accessed August 12, 2015, p. 183. http://www.bls.gov/cps/eetech_methods.pdf

Source: Bureau of Labor Statistics, Unionstats.com

In addition to the surge in public sector union membership post 1961, another shocking feature of union membership is illustrated by Figure 2—the decline in private-sector union membership over the whole time period. As more and more workers were legally able to be hired and continue employment without the condition of union membership, more and more workers chose not to join unions. With right-to-work laws in place, unions were no longer allowed to extract dues from workers—against their will—who were not union members working in a shop alongside union members.

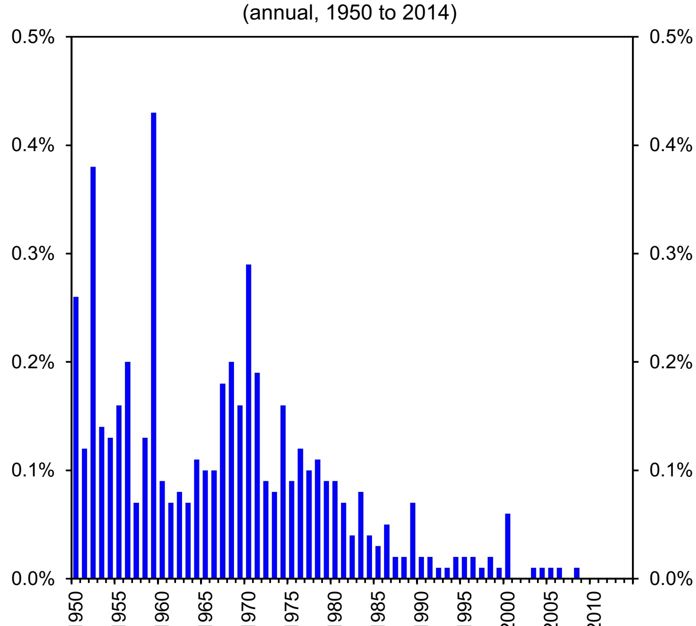
In lockstep with the decreases in union membership came fewer strikes (Figure 3) and less U.S. output lost due to strikes (Figure 4).

Figure 3
Number of Major Work Stoppages Involving more than 1,000 Workers
(annual, 1950 to 2014)



Source: Bureau of Labor Statistics

Figure 4
Percent of Total Working Time Lost Due to Work Stoppages
(annual, 1950 to 2014)



Source: Bureau of Labor Statistics

It is very clear that right-to-work laws had and continue to have a significant impact on whether states have high rates of unionization or not. Just look at Table 1, which ranks the fifty states from highest to lowest rates of private-sector union membership and those states' average annual pay per state & local government full-time equivalent employee (FTEE), with right-to-work states highlighted in green.

Table 1

Right-to-Work Status, Union Share of Private-Sector Employment and Avg. Pay per State & Local FTEE

(right-to-work states are shaded green, right-to-work status as of 1/1/2012, % union membership data are 2013)

		Rank	
State	Right-to-Work?	Share of Private Sector Workers with Union Membership	Avg. Annual Salary per Gov't Employee
New York	No	15.1%	$66,142
Hawaii	No	13.6%	$52,258
Washington	No	11.7%	$63,029
Nevada	Yes	11.0%	$61,188
Michigan	No	11.0%	$55,331
Alaska	No	10.6%	$61,951
Illinois	No	10.0%	$59,445
West Virginia	No	9.8%	$40,568
Kentucky	No	9.2%	$42,213
California	No	8.9%	$70,319
Rhode Island	No	8.9%	$63,128
New Jersey	No	8.7%	$66,947
Minnesota	No	8.4%	$55,675
Wisconsin	No	8.2%	$52,340
Pennsylvania	No	7.8%	$54,155
Ohio	No	7.6%	$50,272
Alabama	Yes	7.5%	$43,138
Indiana	No	7.5%	$44,819
Missouri	No	7.3%	$42,018
Oregon	No	7.0%	$54,839
Connecticut	No	6.8%	$65,436
Massachusetts	No	6.8%	$60,477
Montana	No	6.4%	$45,280
Iowa	Yes	6.4%	$52,339
Delaware	No	5.2%	$52,598
Maryland	No	5.2%	$59,364
Colorado	No	5.0%	$52,758
Kansas	Yes	5.0%	$43,737
Maine	No	4.9%	$44,366
Wyoming	Yes	4.4%	$49,444
Vermont	No	4.2%	$49,276
Nebraska	Yes	4.2%	$47,265
Oklahoma	Yes	4.0%	$41,111
Georgia	Yes	3.8%	$41,932
North Dakota	Yes	3.6%	$45,865
Tennessee	Yes	3.4%	$42,958
New Hampshire	No	3.4%	$48,861
Mississippi	Yes	3.3%	$38,858
Virginia	Yes	3.1%	$49,287
Arizona	Yes	2.9%	$48,927
Louisiana	Yes	2.8%	$43,667
South Dakota	Yes	2.7%	$41,008
Texas	Yes	2.6%	$46,374
South Carolina	Yes	2.5%	$43,559
New Mexico	No	2.3%	$45,441
Idaho	Yes	2.3%	$42,505
Utah	Yes	2.3%	$46,839
Florida	Yes	2.3%	$46,743
Arkansas	Yes	2.1%	$41,024
North Carolina	Yes	1.6%	$45,577

Source: Laffer Associates, UnionStats.com, U.S. Census Bureau

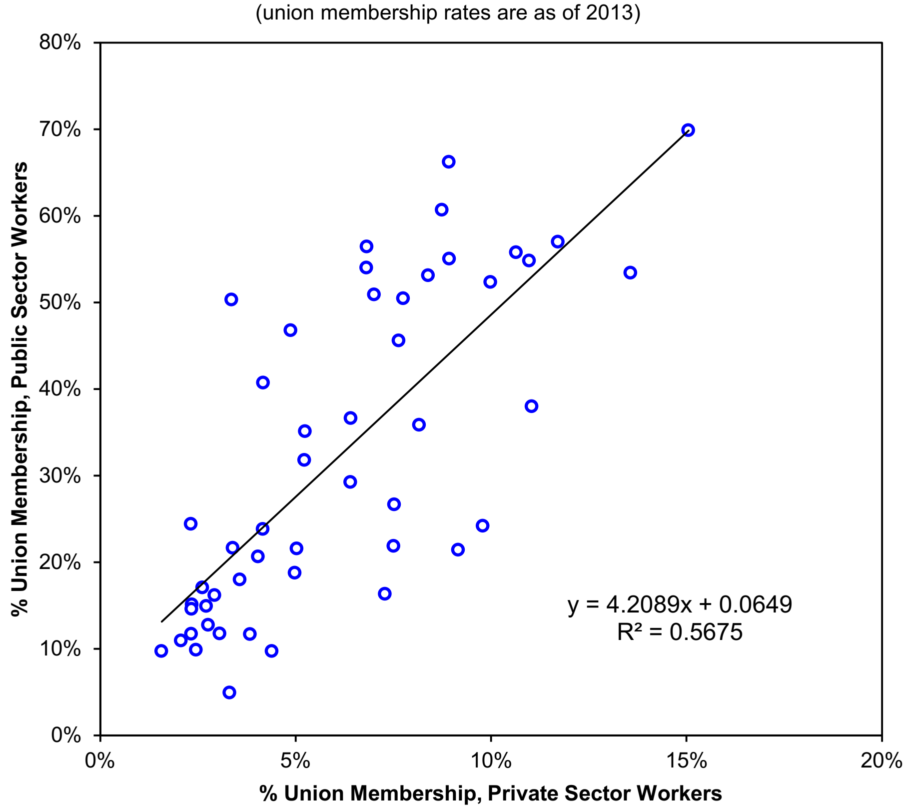
Table 1 is fascinating because the takeaway is just so clear: the bottom half of the chart is nearly solid green (i.e. right-to-work) and the top half is nearly solid white (i.e. forced-union). While there are a few exceptions to this overall pattern, the preponderance of evidence is that right-to-work laws reduce union membership rates in the private sector.

And in turn, private-sector union membership rates are also closely related to public-sector union membership rates. Take a look at Figure 5, which is a scattergram showing the relationship between the public versus private sector unionization rates for the 50 states. The chain of logic leads from right-to-work laws to private sector union membership and then on to public sector unionization. In fact, judging by the statistical relationship, seemingly small differences in private sector union membership are associated with much larger differences (in the same direction) in public sector union membership (note the difference in scales in Figure 5 such that an increase/decrease in private sector union membership rates is associated with a much larger increase/decrease in public sector union membership rates).

Figure 5

Share of Employed who are Union Members in the 50 States: Public Sector vs. Private Sector

(union membership rates are as of 2013)

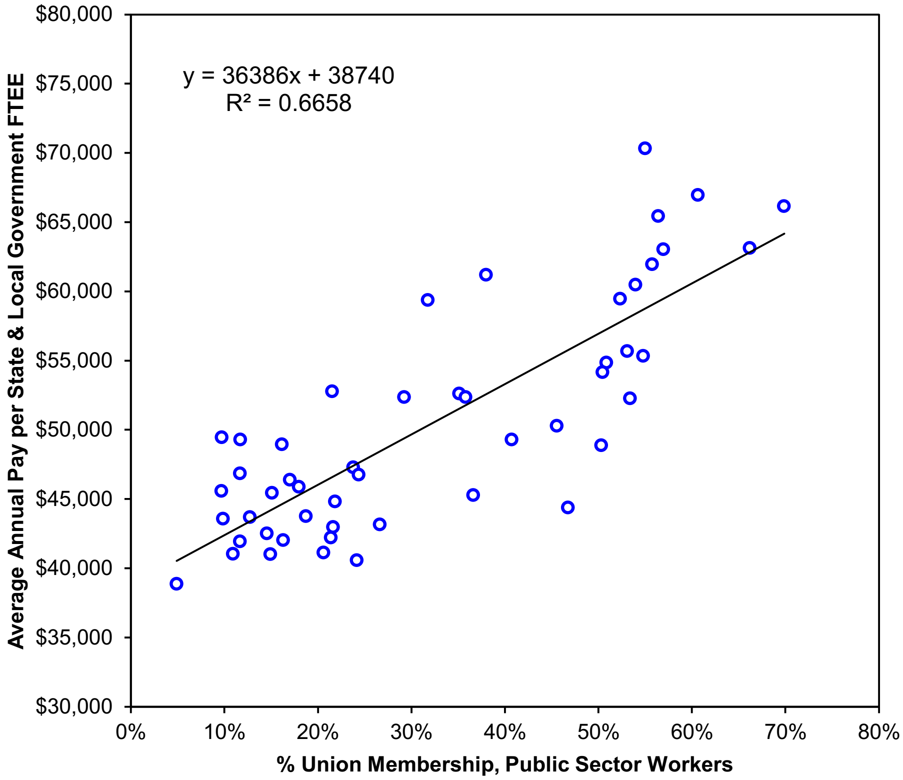


Source: UnionStats.com

From Figure 5 it is very clear that public-sector union membership rates are closely tied to rates of union membership in the private sector. The curious thing about this fact is that right-to-work laws in the vast majority of cases apply only to the private sector.

Why then is the close relationship between public and private-sector union membership rates so important? The answer is simple: because public sector union membership is very costly to state and local governments, taxpayers and thus to state and local prosperity. Take a look at Figure 6, which shows what a dramatic effect public sector union membership rates have on average annual pay per full-time equivalent state & local government employee.

Figure 6
50 States: Average Annual Pay per State & Local Government FTEE vs. Share of Public Employees with Union Membership
(pay data are as of FY 2013, union membership rates are as of 2013)

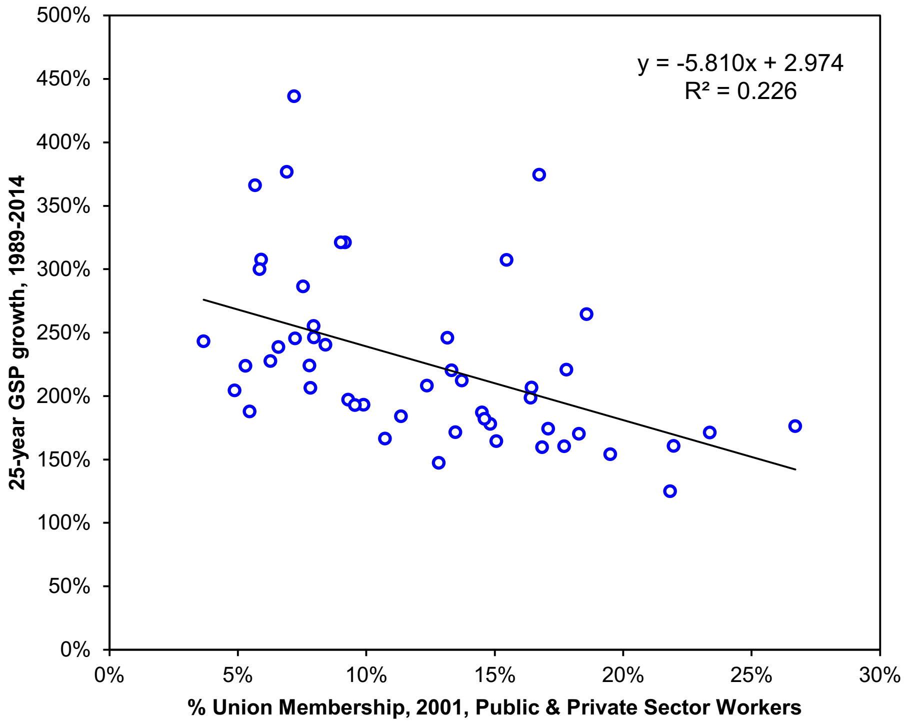


Source: U.S. Census Bureau, UnionStats.com

Thus far we have established that A.) right-to-work laws reduce the share of private sector workers who are union members (Table 1), B.) low rates of union membership in the private sector are closely related to low rates of union membership in the public sector (Figure 6) and C.) that higher rates of public sector union membership are closely related to higher average pay for public sector employees (Figure 6).

Now for the $64,000 question: how do union membership rates impact state growth? Figure 7 shows the rate of union membership on its x-axis and gross state product (GSP) growth over the past quarter century on its y-axis.

Figure 7
50 States: 25-Year GSP Growth vs. Share of Workers with Union Membership
(GSP growth is 1989 to 2014, union membership rates are for public and private sector workers as of 2001)



Source: Bureau of Economic Analysis, UnionStats.com

Case closed.

Unions and the Migration of Businesses, People and Capital

As private-sector union power continues to shrink, unions are desperately trying to find ways to keep jobs and factories in non-right-to-work (herein referred to as "forced-union") states and out of right-to-work states. A recent and highly publicized example of this fight took place between forced-union Washington State and right-to-work South Carolina over the assembly site for Boeing's 787 "Dreamliner" aircraft. Here is a summary straight from the National Labor Relations Board's (NLRB)[1] website of what the union was angered by:[2]

> *On March 26, 2010, the International Association of Machinists and Aerospace Workers, District Lodge 751, filed a charge with the NLRB alleging that the Boeing Company had engaged in multiple unfair labor practices related to its decision to place a second production line for the 787 Dreamliner airplane in a non-union facility.*
>
> *Specifically, the union charged that the decision to transfer the line was made to retaliate against union employees for participating in past strikes and to chill future strike activity, which is protected under the National Labor Relations Act.*
>
> *The union also charged that the company violated the National Labor Relations Act by failing to negotiate over the decision to transfer the production line. The Machinists' union has represented Boeing Company employees in the Puget Sound area of Washington, where the planes are assembled, since 1936, and in Portland, Oregon, where some airplane parts are made, since 1975.*

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[1] "The National Labor Relations Board is an independent federal agency vested with the power to safeguard employees' rights to organize and to determine whether to have unions as their bargaining representative. The agency also acts to prevent and remedy unfair labor practices committed by private sector employers and unions." Source: https://www.nlrb.gov/what-we-do

[2] "Boeing Complaint Background," National Labor Relations Board, accessed July 30, 2015. https://www.nlrb.gov/news-outreach/fact-sheets/fact-sheet-archives/boeing-complaint-fact-sheet/boeing-complaint

The Obama Administration's National Labor Relations Board filed a complaint against Boeing on April 20th, 2011 at the union's request. The NLRB did not file the complaint until after Boeing had nearly completed the construction necessary for the $750 million Dreamliner facility in South Carolina and had already hired 1,000 workers for that location. A Boeing executive quoted in *The New York Times* said the "overriding factor [for the move to South Carolina] was that we cannot afford to have a work stoppage, you know, every three years."[3,4]

The NLRB complaint says one thing loud and clear: unions realize that forced-union states are less competitive than right-to-work states in a wide range of ways, and the only way to stop this exodus of production, capital and employment out of forced-union states is through government regulation.

But, the NLRB needs to tread lightly in cases involving decisions benefitting one state over another. The United States was built on a clear understanding of the benefits of the free flow of goods, services and people among the states, of Ricardo's "gains from trade" and Adam Smith's notion of specialization that leads to "comparative advantage." The ideal of total and complete free trade was written into our very foundation papers. The Commerce Clause of the U.S. Constitution has been interpreted to prohibit excessive impediments to the free trade of goods, services and even labor amongst the states of the United States. And under the Privileges and Immunities Clause, people are entitled to migrate and resettle into any state without limitation; they need only abide by the laws and regulations of their new home, just as long-time residents do.[5]

In the end, the NLRB dropped its charges against Boeing, but not until it had faced a political firestorm that illuminated a contentious debate going on every day in America.

An astonishing way of looking at the trend of states passing right-to-work laws and people choosing to live in those states is by looking at congressional seat apportionment between right-to-work states and forced union states over time (Figure 8).

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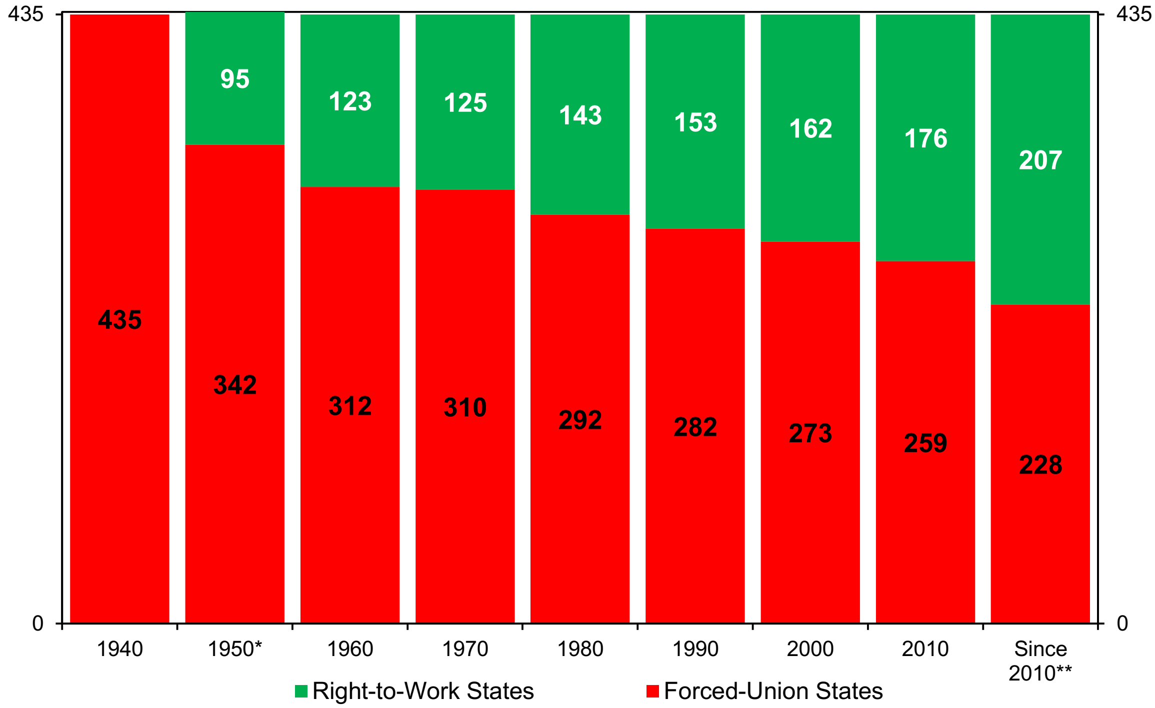
[3] Steven Greenhouse, "Labor Board Tells Boeing New Factory Breaks Law," *The New York Times*, April 21, 2011. http://www.nytimes.com/2011/04/21/business/21boeing.html?_r=0

[4] Steven Greenhouse, "Labor Board Drops Case Against Boeing After Union Reaches Accord," *The New York Times*, December 9, 2011. http://www.nytimes.com/2011/12/10/business/labor-board-drops-case-against-boeing.html

[5] Thanks to Professor James Blumstein, University Professor of Constitutional Law and Health Law at Vanderbilt University, for his review and suggestions concerning the Commerce Clause and Privileges and Immunities Clause of the Constitution.

Figure 8
Congressional Seat Apportionment: Right-to-Work vs. Forced-Union States
(end-of-decade snapshots since the last reapportionment ten years prior)



* During reapportionment for 1950, two extra seats were added (bringing the total to 437) because Alaska and Hawaii had just become states. During the 1960 reapportionment, these two seats were removed, and the total was restored to 435.

** The "Since 2010" data show the change in seats based on Indiana, Michigan and Wisconsin passing RTW since 2010. This number will change before 2020 reapportionment if any state passes or repeals its RTW law.

Source: U.S. Census Bureau, National Right To Work Committee

Every ten years a Census is taken of the U.S., and the 435 U.S. Congressional seats are reallocated to the states based on state population. Figure 8 shows how dramatically the balance of power in Congressional seats has changed over time in favor of right-to-work states.

A change between, say, 1980 and 1990 in Figure 8 above can be broken down into two components. First, there are Congressional seats acquired by right-to-work states from new states passing right-to-work laws. This means that part of the net +10 seats for right-to-work states shown from 1980 to 1990 is attributable to the fact that Idaho (with two congressional seats) passed a right-to-work law in 1985, thus adding +2 seats to the right-to-work seat count. The other effect at play in Figure 9 is the change in population between right-to-work states and forced-union states precipitating decadal redistricting among the states, which summed to a net +8 seats for right-to-work states and net -8 for forced-union states. Who would have guessed that America's population is migrating from forced union to right-to-work states?

<u>Public Sector Unions—Still Going Strong?</u>

Over the past 40 years, public sector union membership has remained in the 35-40% range (Figure 2). But how have public sector workers kept such high rates of union membership while more and more states pass right-to-work laws? Generally speaking, in the private sector, unions push hard in negotiations, but they know in the back of their minds that if they push too hard, their employer will go out of business, leaving them without a job. No such limits exist in the public sector, as the politicians who negotiate and set employment contracts with public sector employees don't face the consequences of making costly deals with unions—politicians are negotiating with someone else's money, after all. Furthermore, politicians are heavily incentivized to negotiate contracts that are favorable to the public sector employees because, being politicians, they correctly see these employees as people who vote their interests.

Compensation packages negotiated by public-sector unions for government employees have, in thousands of cases, become the stuff of legend. One of the most famously "generous" (to the recipients, not the taxpayers) pension arrangements is California's "3% at 50" defined benefit plan available to many public safety officials. This pension plan is available to public safety officials who retire at the age of 50 and pays, for life, 3% of their final year's salary multiplied by their number of years of service. In other words, a police officer who retires at the age of 50 after 30 years of service will receive 90% of his final year's salary as a pension for life. Not only would this 90% payout be generous in any locale, but it is especially generous in California, where, on average as of 2013, police officer pay was $97,500, police captain pay was $166,500, firefighter pay was $125,100 and fire captain pay was $153,600.[6] For example, the city of Vallejo, California, only two years after its three-year-long bankruptcy that ended in 2011, paid its police officers, on average, $147,666 per year and police captains an average of $232,385 per year.[7]

Given that the size of an employee's pension is often determined by the salary earned in the final year of employment, a practice known as "pension spiking" is sometimes utilized which involves increasing one's salary as much as possible in the final year of employment in order to lock in high pension payments going forward. Common methods used are the cashing-out of unused vacation or sick days and promotions with raises in an employee's final year. Catherine Saillant, Maloy Moore and Doug Smith reported in the *Los Angeles Times*:

> *Approaching retirement, Ventura County Chief Executive Marty Robinson was earning $228,000 a year.*
>
> *To boost her pension, which would be based on her final salary, Robinson cashed out nearly $34,000 in unused vacation pay, an $11,000 bonus for having earned a graduate degree and more than $24,000 in extra pension benefits the county owed her.*
>
> *By the time she walked out the door last year, her pension was calculated at $272,000 a year — for life.*[8]

A majority of states today, and for the past half century, allow collective bargaining for government employees. But before the middle of the 20th century, public sector strikes, especially when public safety officials such as police and firefighters were the ones striking, were not tolerated by citizens or politicians. According to Hillsdale College Professor Paul Moreno:

> *When the Boston police unionized and went on strike in 1919, the ensuing chaos—rioting and looting—crippled the public-union idea. Massachusetts Gov. Calvin Coolidge became a national hero by breaking the strike, issuing the dictum: "There is no right to strike against the public safety by anybody, anywhere, any time." President Woodrow Wilson called the strike "an intolerable crime against civilization."*
>
> *President Franklin D. Roosevelt also rejected government unionism. He told the head of the Federation of Federal Employees in 1937 that collective bargaining "cannot be transplanted into the public service. The very nature and purposes of government make it impossible for administrative officials to represent fully or to bind the employer" because "the employer is the whole people, who speak by means of laws."*[9]

It didn't take long for sentiment to change, however, with Wisconsin becoming the first state to allow public sector collective bargaining at the state level 1959.[10] President Kennedy allowed collective bargaining—although not the right

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[6] Philip Reese, "See what California cities pay police, firefighters," *The Sacramento Bee*, March 3, 2011, updated February 2015 with 2013 data, accessed September 25, 2015. http://www.sacbee.com/site-services/databases/article2573210.html
[7] *Ibid.*
[8] Catherine Saillant, Maloy Moore and Doug Smith, "Salary 'spiking' drains public pension funds, analysis finds," *Los Angeles Times*, March 3, 2014. http://articles.latimes.com/2014/mar/03/local/la-me-county-pensions-20120303
[9] Paul Moreno, "How Public Unions Became So Powerful," *The Wall Street Journal*, September 11, 2012. http://www.wsj.com/articles/SB10000872396390444017504577645550224040874
[10] James Sherk, "How Collective Bargaining Affects Government Compensation and Total Spending," Testimony before Committee on Government Affairs, Nevada Assembly, *Heritage Foundation*, April 7, 2015. http://www.heritage.org/research/testimony/2015/how-collective-bargaining-affects-government-compensation-and-total-spending

to strike—for employees at the federal level by issuing Executive Order 10988 on January 17, 1962.[11] Over the next fourteen years, public sector union membership rates went from 10.6% of public employees in 1961 to 40.2% of public employees by 1976 (Figure 3). According to Manhattan Institute fellow Daniel DiSalvo, no state permitted public sector collective bargaining before the late 1950s, only 3 states allowed it in 1959, but by 1980 there were 33 states with laws permitting public sector collective bargaining.[12]

But, after decades of high and stable rates of unionization amongst public sector workers, it seems that public sector unionization may be starting to fade. In July 2015, the Michigan Supreme Court ruled that Michigan's right-to-work law applies not only to private sector workers, but also to public employees. The irony of the situation is that the original suit precipitating this ruling was brought by the United Auto Workers (UAW) in 2012, who claimed that the right-to-work law didn't apply to 17,000 of their members whose contracts were negotiated by the Michigan Civil Service Commission.[13,14] What the UAW and other unions certainly didn't expect was for the Michigan Supreme Court to rule that right-to-work applied to all state workers. Oops!

This new blow to public sector union power follows in the footsteps of the reforms known as Act 10 enacted by Wisconsin Governor Scott Walker in 2011. Governor Walker's reforms, in-essence, enacted a public sector right-to-work law by sharply limiting collective bargaining rights for public sector workers and removing automatic payroll deduction of union dues from state employee paychecks.[15] For Governor Walker, signing a formal right-to-work law in 2015 was just icing on the cake.

The Campaign Finance Impact of Declining Union Power

Unions have long been viewed as piggybanks for political campaigns, mostly Democratic of late, and for good reason. According to data from the Center for Responsive Politics, of the top 15 organizations—that's companies, unions, super PACs, and others—who have donated money to political causes from 1989 to present, 8 of those 15 are unions.[16] These 8 unions—which are the Service Employees International Union (SEIU), American Federation of State, County and Municipal Employees (AFSCME), National Education Association (NEA), American Federation of Teachers (AFT), Carpenter & Joiners Union, International Brotherhood of Electrical Workers, United Food & Commercial Workers Union and the Laborers Union—accounted for an incredible $731 million dollars, or 57%, of the total $1.27 billion of contributions made by the top 15 organizations donating to political causes. And, of the $731 million donated by those eight unions, $709 million, or 97.1%, of the money went to candidates and causes designated by the Center for Responsive Politics as "Democrats & Liberals."[17]

Another thing to keep in mind is that, because of the way campaign contributions are reported per federal law, the Center for Responsive Politics groups contributions from organizations, their PACs, their own treasuries and their employees when reporting the total amount of contributions from an individual organization. For instance, Goldman Sachs, which appears on the top 15 contributors list, is likely only able to have a contribution number large enough to appear on the list because its employees' personal donations are also counted. Unions, on the other hand, may have many members, but do not generally have enormous amounts of employees. Accordingly, the union contributions

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[11] "50th Anniversary: Executive Order 10988," Federal Labor Relations Authority, accessed August 13, 2015. https://www.flra.gov/50th_Anniversary_EO10988

[12] Daniel DiSalvo, "Storm Clouds Ahead: Why Conflict with Public Unions Will Continue," *Manhattan Institute for Policy Research*, Issue Brief No. 13, November 2011, p. 2. http://www.manhattan-institute.org/pdf/ib_13.pdf

[13] "Michigan Union Boomerang," *The Wall Street Journal*, July 29, 2015. http://www.wsj.com/articles/michigan-union-boomerang-1438212048

[14] While unions like the UAW and Teamsters originally represented private sector auto workers and truckers, respectively, these traditionally private sector unions, facing drastically declining membership over the years, have begun to represent public sector workers as well. For more on this, see: Mallory Factor and Elizabeth Factor, *Shadowbosses*, New York, Center Street, 2012.

[15] Monica Davey, "Wisconsin Senate Limits Bargaining by Public Workers," *The New York Times*, March 9, 2011. http://www.nytimes.com/2011/03/10/us/10wisconsin.html?pagewanted=all

[16] "Totals on this page reflect donations from employees of the organization, its PAC and in some cases its own treasury. These totals include all campaign contributions to federal candidates, parties, political action committees (including super PACs), federal 527 organizations, and Carey committees. The totals do not include contributions to 501(c) organizations, whose political spending has increased markedly in recent cycles. Unlike other political organizations, they are not required to disclose the corporate and individual donors that make their spending possible."
The 7 non-union organizations on the top 15 contributor list include Democratic campaign bundler ActBlue, investor and environmental activist Tom Steyer's Fahr LLC, Las Vegas Sands casino, the National Association of Realtors, AT&T, Perry Homes and Goldman Sachs.
Source: Center for Responsive Politics, https://www.opensecrets.org/orgs/list.php

[17] Source: Author's analysis of Center for Responsive Politics data which are available here: https://www.opensecrets.org/orgs/list.php

reported are almost entirely made up of direct union contributions. If the Center for Responsive Politics excluded donations by an organization's employees from its top 15 contributors list, it's possible, if not likely, that virtually every spot on the list would be filled by a union.

Even more astounding than the number of large political contributors who are unions is the size of the donations. According to The National Institute for Labor Relations Research, unions spent $1.4 billion, $1.7 billion and $1.7 billion in the 2010, 2012 and 2014 election cycles, respectively.[18] That's serious money.

In California, a state plagued by chronically poor student test scores, yet also a state where teacher salaries are always in the top five highest in the nation, the teachers union has near legendary power. The California Teachers Association (CTA) was founded in 1863, currently has about 325,000 members and represents all teachers in public schools K-12. The California Faculty Association and the California Community College Association are also affiliated with the CTA.

To put the magnitude of the CTA's spending into perspective, the CTA spent about $212 million on state political campaigns in the ten-year period from January 1, 2000 through December 31, 2009. This is more than any other union, business, organization, or individual spent in California—nearly double that of the California State Council of Service Employees, which came in 2nd at $107 million over that same period.[19]

In 1988, the CTA was able to get a California constitutional amendment passed, Proposition 98, which forced the state to spend enormous amounts of the general fund budget on education, and these spending requirements could only be suspended by a 2/3rds majority of the legislature, which has also been strongly supported by the California Teachers Association. The CTA also has sponsored 170 strikes between 1975 and 2012. It's no wonder California students are perennially ranked in the bottom five of the fifty states in educational performance (Table 2).

Table 2
California Ranking in 50-State Ranking of NAEP Test Scores
(50-state ranking based on 4th & 8th grade math & reading scores for years 2003, 2005, 2007, 2009, 2011 and 2013)

2003	2005	2007	2009	2011	2013
46	46	48	47	47	46

Source: U.S. Department of Education National Assessment of Educational Progress

The California story, while an extreme example of public union abuse and exploitation, is a harsh reality of what strong public sector union power can lead to—citizens paying more in the way of taxes and receiving fewer public services in return.[20] As more and more states enact right-to-work laws, as well as pass legislation banning practices such as automatic payroll deduction of union dues, as Wisconsin Act 10 did, the money available to unions for political purposes will start to dry up. Democracy will surely follow.

The Economic Performance Consequences of Right-to-Work

The differences in performance outcomes between states that have right-to-work laws and forced-union states are dramatic.

In the chapter "Why Growth Rates Differ: An Econometric Analysis of the Data," in our first *Wealth of States*, we examined the effects of right-to-work laws on the cross-section time series decadal growth in a state's gross state

[18] 2010 data: "Big Labor Spent $1.4 Billion for Politics," The National Institute for Labor Relations Research. http://www.nilrr.org/files/Big%20Labor%20Political%20Spending%20in%20the%202010%20Election%20Cycle.pdf
2012 data: "Big Labor Spent $1.7 Billion for Politics," The National Institute for Labor Relations Research. http://www.nilrr.org/files/2013_nilrr_political_spending_fact_sheet.pdf
2014 data: "Big Labor Union Bosses Dig Deep," The National Institute for Labor Relations Research. http://www.nilrr.org/wp-content/uploads/2015/04/Big-Labor-Reaches-Into-Union-Treasuries-for-Politics-Fact-Sheet.pdf
[19] "Big Money Talks: California's Billion Dollar Club," California Fair Political Practices Commission, March 2010. http://www.fppc.ca.gov/reports/Report31110.pdf
[20] For a comprehensive assessment of the input costs and resulting public service outcomes in Texas versus California, see: Chapter 7 "Fiscal Parasitic Leakages: Texas versus California" in Arthur B. Laffer, Stephen Moore, Rex A. Sinquefield and Travis H. Brown, *An Inquiry into the Nature and Causes of the Wealth of States*, Hoboken, John Wiley & Sons, 2014.

product.[21] Using regression analysis, we found that being a right-to-work state appears to impart a 15 percentage point growth advantage over a decade to any state that has a right-to-work law, which is both huge and reasonable. And the variable, "RTW," is both statistically and economically extremely important as shown by its *t*-statistic and its R^2 value, as well as by the number of people impacted.[22]

A simple way to examine the effects of right-to-work status on state economic performance is to compare the average performance of right-to-work states versus forced-union states over the past decade (Table 3). Because we are examining a ten-year period ending in 2014, we haven't included the three most recent additions to the right-to-work camp because the period for which these states have been right-to-work has been such a small part of the ten-year window ending in 2014.

Table 3
Economic Performance: 22 Right-to-Work States vs. 28 Forced-Union States
(performance metrics are 10-year % change from 2004-2014 unless otherwise indicated)

	1/1/2012	*2004-2014*	*2005-2014*	*2004-2014*	*2004-2014*	*2004-2014*	*2002-2012*
State	RTW? Yes=1**	Population	Net Domestic In-Migration†	Nonfarm Payroll Employment	Personal Income	Gross State Product	State & Local Tax Revenue‡
Avg. of 22 Right-to-Work States*	1.00	12.40%	3.06%	9.06%	54.74%	50.65%	65.64%
50-State Avg.*	0.44	8.84%	0.71%	6.14%	48.42%	43.59%	63.00%
Avg. of 28 Forced-Union States*	0.00	6.04%	-1.14%	3.86%	43.46%	38.04%	60.93%

* Equal-weighted averages
** RTW status is as of 1/1/2012. Since that date, Indiana, Michigan and Wisconsin have passed RTW laws. We have decided not to include these three states as RTW states because they have only been RTW for a very brief portion of the analysis period.
† Net domestic migration is calculated as the ten-year (2005-2014) sum of net domestic in-migrants divided by the mid-year (2010) population.
‡ 2002-2012 due to Census Bureau data release lag.

Source: Laffer Associates, U.S. Census Bureau, Bureau of Labor Statistics, Bureau of Economic Analysis

As measured in terms of population growth over the past decade, the 22 RTW states beat the 28 forced-union states 12.4% to 6.0%, or by a population growth differential of 6.4 percentage points. In net domestic in-migration, the right-to-work states *gained* over the course of a decade an average of 3.1% of their populations from net domestic migration, while the forced-union states *lost* an average of 1.1% of their populations due to net domestic migration, which resulted in a decadal growth differential of 4.2 percentage points. And what does this mean? For one thing, it means that political power in the U.S. is shifting towards right-to-work states, as demonstrated earlier in Figure 9.

In nonfarm payroll employment growth, RTW states grew 9.1% over the decade compared to employment growth in forced-union states of 3.9%, for an employment growth differential of 5.2 percentage points. In personal income growth, RTW states grew 54.7% compared to forced-union state personal income growth of 43.5%, for a personal income growth differential of 11.3 percentage points. In gross state product, the RTW states once again beat the forced-union states—50.6% to 38.0%—by a decadal growth differential of 12.6 percentage points, which should be no surprise given how much friendlier right-to-work states are to entrepreneurs and business operators. These results are a shorter-term view of the data presented earlier in Figure 8.

Right-to-work states even beat forced-union states by 4.7 percentage points in tax revenue growth over the last decade (65.6% to 60.9%). It's safe to say that right-to-work states beat forced-union states in every single major economic performance variable. These drastically different performance outcomes, when compounded over time, explain just how the "rust belt" got its name.

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[21] Arthur B. Laffer, Stephen Moore, Rex A. Sinquefield and Travis H. Brown, *An Inquiry into the Nature and Causes of the Wealth of States*, p. 133-192, Hoboken, John Wiley & Sons, 2014.
[22] *Ibid.*

Conclusion

Over the entire 50+ year period from 1960 through 2011, only four states passed right-to-work laws. Yet three states have passed right-to-work laws in just the last four years.[23] It seems that right-to-work laws are once again *de rigueur*, and, as demonstrated in this paper, that's a net positive for economic growth and public service outcomes in states with such laws. At the current rate of increase in the number of states with right-to-work laws and the increase in population and economic growth in those states, it looks like the majority of Congressional seats will exist in right-to-work states by the next redistricting in 2020. As fewer and fewer forced-union states remain, and those states witness continued out-migration of people, businesses, employment and capital, their hands will be all but forced to enact right-to-work laws of their own.

[23] The three states are Indiana effective 2012, Michigan effective 2013, and Wisconsin effective 2015.

7. THE BENEFITS OF SCHOOL CHOICE

Introduction

School choice liberates students and parents from poor performing schools in the public education system, empowering them with the ability to choose to attend the schools they prefer, whether public or private. State-level experiments with school choice have taken place for decades; the results stemming from these experiments reveal that the competitive incentives introduced by school choice tend to produce significant, lasting improvements in educational outcomes and contribute to economic growth in the areas in which it is implemented.

Evidence suggests school choice tends to produce the following results:

a) **Improved educational achievement:** as measured by concrete test scores, including standardized national, and even international, achievement tests. Improved test scores are not just among students who use school choice to switch to private schools, but also among students who choose to stay in public schools. School choice could help close the educational achievement gaps between races, between students from lower income and higher income families, and between the U.S. and higher achieving countries in education performance, such as China, Japan, Singapore, and Finland.[1]

b) **Higher Graduation Rates:** experiments in several large school districts indicate that school choice boosts graduation rates and reduces dropout rates among students attending both private schools and public schools.

c) **Higher Wages and Lifetime Earnings:** school choice improves the economic prospects of students by increasing "human capital," the accumulated knowledge and experience that boots productivity in the workplace. Increased human capital translates into higher lifetime wages and incomes. Evidence suggests these impacts are felt in private and public schools when school choice is implemented.

d) **Crime Reduction:** education is a powerful tool to improve the economic opportunities for our nation's youth. School choice, through the improved educational opportunities it provides, can help integrate young men and women into the workforce and dramatically reduce crime in the process.

e) **Economic Development:** school choice can be a potent way to facilitate economic development. Quality schools boost in-migration from underperforming school districts and, in the process, exert upward pressure on residential and commercial property values and stimulate business activity. The public sector benefits as well, with increased employment, output, and production positively impacting the tax collections of state and local governments.

f) **Economic Growth Potential:** were school choice adopted on a broader basis at the state or national levels, the resulting benefits of increased labor market productivity, higher wages and lifetime earnings, residential and commercial development, and improved efficiency in raising tax revenues to fund public services would reach beyond the regional level and substantially improve state and national economic performance.

How School Choice and the Voucher System Work

School choice can be implemented through vouchers or tax credits, which parents and students use to help pay the costs of attending the school of their choice. The voucher or tax credit constitutes a partial rebate of the taxes parents of students attending private schools pay towards public schools. The partial rebate, perhaps 60% of total taxes that would be paid per student attending the public schools, ensures that parents participating in school choice continue to contribute substantial tax revenue towards the public education system to educate children other than their own.

[1] "Asian countries top OECD's latest PISA survey on state of global education," OECD, March 12, 2013. http://www.oecd.org/newsroom/Asian-countries-top-OECD-s-latest-PISA-survey-on-state-of-global-education.htm

The rebate given to parents participating in school choice represents a net fiscal gain resulting from the school choice program for the financing of the public schools. Each parent who uses the voucher or the credit to choose a private school gets back 60% of the per-student cost of a child attending public school—that means public schools gain 40% of the cost of a child attending public school without having to provide any services for each child who chooses to attend a private school.[2] Generally, state-level funding for public schools reflects a payment per student attending the public schools, with other funding coming from the local government. If students choose private schools where there is no school choice program, the public school loses the per-student funding for each student. However, with a school choice program that rebates 60% of the costs of attending public schools to the parents choosing private schools, the public schools are left with 40% of the costs of attending the public school—but they bear none of the costs because the students have chosen to attend private schools. In the event attendance within a public school falls precipitously, the school does risk losing funding—hence, school choice does incentivize public schools to improve performance and retain students.

The Benefits of Competition: In Theory and Practice

a) Competition and School Choice

The immediate effect of implementing school choice is that it introduces competition into the public school system. Parents and students, acting as consumers in a marketplace for education, can choose their school from the available options, with schools competing against each other to be chosen by students and their families. Public school officials and teachers must then solicit and serve the needs and preferences of parents and students regarding what will be taught and how it will be taught to entice parents to choose their school, shifting power from bureaucracies and bureaucrats toward parents and students in the process.

Under school choice, as students exercise the option to leave public schools for private schools, state and local government spending on education can be reduced. School choice options are usually structured to share some of the spending savings with the public schools, leaving more funding with the public schools for each student that chooses a private school, increasing per capita spending for each public school student that remains. The vouchers or tax credits received by families exercising school choice effectively reduce taxes as well, with a net improvement for the state or local government budget for each student that exercises choice.

With a look towards the future, school choice opens up the education system to substantial innovation. Teaching methods have stagnated under the current system, with the typical classroom reflecting the following: a professor lecturing to students in rows of desks in classrooms on campuses, as was done in similar settings hundreds of years ago. With school choice, innovators can experiment with new teaching methods and tools and expand the use of digital technologies, enabling leading experts in each subject matter or field to produce mass instructional communications that can be stored on the internet and accessed individually, empowering students to advance at their own pace.

b) Evidence School Choice Improves Student Performance across the Board

Academic studies examining school choice consistently show that students who are empowered to choose schools gain in educational achievement as measured by standardized test scores and other critical measures. Here is a summary of numerous studies examining school choice's impact on student achievement:

- Forster (2013) found that "[t]welve empirical studies have examined academic outcomes for school choice participants using random assignment, the 'gold standard' of social science. Of these, 11 [studies] find that choice improves student outcomes, six find that all students benefit and five find that some benefit and some are not affected. One study finds no visible impact. No empirical study has found a negative impact."[3]

[2] Friedman explains why this ends up increasing funds for the public schools: "When a student leaves a public school using a choice program, the school loses all the costs associated with educating that student but not the funding….almost all federal and local education spending does not vary with enrollment, so those funds stay when students leave. This means public schools are left with more money to serve the students who remain."

[3] Greg Forster, "A Win-Win Solution, The Empirical Evidence on School Choice," The Friedman Institute on Educational Choice, April 2013 (Third Edition), p. 1. http://www.edchoice.org/wp-content/uploads/2015/07/2013-4-A-Win-Win-Solution-WEB.pdf

- Howell et al. (2000) studied school choice programs in New York City, Washington, D.C. and Dayton, Ohio. Contrary to the oft-held idea among its detractors that school choice only benefits "the best students from the public schools, draining talent and resources from the public system,"[4] Howell et al. found that "[i]n the three cities taken together, the average, overall test-score performance of African-American students who switched from public to private schools was, after one year, 3.3 NPR (national percentile ranking) points higher and, after two years, 6.3 NPR points higher than the performance of the control group remaining in public schools."[5] Howell et al. put their results in context:

  > The school voucher intervention, after two years, erases, on average, about one-third of the difference [between test scores among black and white students]. *If the trend line observed over the first two years continues in subsequent years, the black-white test gap could be eliminated in subsequent years of education for black students who use a voucher to switch from public to private school.*[6] (emphasis added)

- Hoxby (2001) found that in Milwaukee public schools in which at least 66% of students were eligible for vouchers, the students increased achievement test scores more than those in Milwaukee public schools not impacted by school choice by 3.4 percentile points in math, 2.9 points in language, 5.4 points in science and 2.7 points in social studies.[7]

- Greene (2001) found that when school districts in Florida guaranteed students a voucher to help finance a switch to a public or private school if their current public school was failing, "the test score gains of schools facing the imminent prospect of vouchers were more than twice as large as the gains realized by the other schools. When public schools had to compete to retain their students under a choice system, they made substantial progress [in improving test scores]."[8]

- Teske et al. (2001) found results similar to Greene (2001) when the former examined New York City's 2nd school district, which implemented school choice in the 1990s. Test scores improved among both those who exercised choice to move among public schools and those that didn't. Teske et al. summarize: "[w]hile not all studies conclude that choice enhances performance, it is significant to note that the best ones do, and that the authors did not find any study that documents significantly lower performance in choice schools, controlling for students' background."

- Greene and Foster (2002) found that after four years of school choice, a Milwaukee public school with all of its students eligible for vouchers improved its achievement test scores by 15 percentile points more than a public school with only half of its students eligible for vouchers.[9]

- Greene and Winters (2004) found that schools subject to school choice competition in Florida achieved substantially higher math scores than public schools not subject to competition.[10]

- Schneider et al. (2000) studied the effects of competition among public schools through an intradistrict choice reform in District 4 in East Harlem in 1976.[11] They found evidence of higher test scores, especially in reading, due to school choice, which continued 25 years after choice was implemented.

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[4] Jay P. Greene, "The Surprising Consensus on School Choice," *supra*, p. 26.
[5] William G. Howell, Patrick J. Wolf, Paul E. Peterson and David E. Campbell, "Test-Score Effects of School Vouchers in Dayton, Ohio, New York City and Washington, D.C.: Evidence from Randomized Field Trials," The Program on Education Policy and Governance (PEPG), Department of Government, Harvard University, August, 2000, p. 2. https://www.hks.harvard.edu/pepg/PDF/Papers/dnw00x.pdf
[6] *Ibid.*
[7] Caroline Hoxby, "Rising Tide," *Education Next*, Winter, 2001. http://educationnext.org/files/ednext20014_68.pdf
[8] Jay P. Greene, "The Surprising Consensus on School Choice," *supra*, p. 28, 2001.
[9] Jay P. Greene and Greg Forster, "Rising to the Challenge: The Effect of School Choice on Public Schools in Milwaukee and San Antonio," Manhattan Institute, October, 2002. http://www.manhattan-institute.org/pdf/cb_27.pdf
[10] Jay P. Greene and Marcus A. Winters, "Competition Passes the Test," *Education Next* (Summer 2004) 66-71. http://educationnext.org/competition-passes-the-test/
[11] Schneider, M., Teske, P., & Marshall, M. (2000), Choosing Schools: Consumer Choice and the Quality of American Schools. Princeton: Princeton University Press.

- Hanushek and Rivkin (2002) found that public schools subject to greater competition exhibit increased teacher quality and other indicators of increased school quality.[12] Similar beneficial effects of competition on public schools were found by Belfield and Levin (2002), West and Peterson (2006), and Chakrabarti (2004).

c) School Choice: Beneficial to Educators, Too

High-performing teachers benefit from the competitive incentives inherent under a school choice program. Schools seeking to attract students would have incentive to increase salaries and provide better working conditions in order to attract and retain the best teachers.

Allowing talented teachers to focus on their particular specialization would serve as a prime way with which schools would market themselves to potential students. Some teachers would be drawn to and more skilled at serving disadvantaged students, while other teachers would do better to focus on gifted students. Teachers could choose schools best matched with their subject matter expertise and the teaching methodologies and philosophy of their preference. The result would be much better matching of teachers, students and parents, resulting in teachers being more productive and higher incomes than under the current system.

Under school choice, resources would be drawn from bureaucracy and overhead in service of improving circumstances for teachers. By reducing costs associated with bureaucracy and focusing on student outcomes, Bast et al. (2011) estimate that universal school choice would result in average pay raises of $12,000 a year or more for Houston teachers.[13] They write: "[s]chools in a competitive environment cannot afford to waste money on bureaucracy and other things that don't make their way to classrooms. Administrators have a strong incentive to cut spending on bureaucracy and consultants in order to compete for students and the best teachers."[14]

Better working conditions would include improved school discipline and security, increased ability for teachers to choose textbooks and teaching materials, and greater individual teacher control over teaching methods and strategies.[15] Hardly trivial, these are the reasons why "private school teachers consistently report higher levels of satisfaction [relative to their peers in the public education system] with their working conditions."[16]

d) Rising Graduation Rates, Higher Lifetime Earnings

School choice reform would be most beneficial to the most the disadvantaged, the poor, and minorities who are being left behind the worst by the current education system. It is precisely these most disadvantaged students that the status quo is failing the most. These disadvantaged students are falling farther and farther behind their grade level norms, until they drop out altogether at catastrophically high rates. Nationally, more than 7,000 students drop out every school day.[17] That adds up to approximately 1.3 million students dropping out each year.

Several studies indicate that school choice is a powerful tool for increasing high school graduation rates:

- Hill (1995) found that the privately funded Student-Sponsor Partnership program in New York City increased the high school graduation rate to 70%, compared to 39% across the New York City public schools. Hill also found that 90% of those school choice graduates attended college, and those school choice graduates earned higher SAT scores than the control group.[18]

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[12] Hanushek, E.A. and S.G. Rivkin, "Does Public School Competition Affect Teacher Quality," in C.M. Hoxby (ed.) *The Economics of School Choice* (Chicago: University of Chicago Press, 2002).
[13] Joseph L. Bast, Herbert J. Walberg and Bruno Behrend, "How Teachers in Texas Would Benefit from Expanding School Choice," Heartland Institute Policy Brief, April, 2011, p. 5. https://www.heartland.org/_template-assets/documents/publications/29976.pdf
[14] *Ibid.*, p. 9.
[15] *Ibid.*, pp. 6-8.
[16] *Ibid.,* p. 7; See also Greg Forster and Christine D'Andrea, "Free to Teach: What America's Teachers Say About Teaching in Public and Private Schools," The Friedman Foundation for Educational Choice, 2009; U.S. Department of Education, National Center for Education Statistics, "Schools and Staffing Survey (SASS)," http://nces.ed.gov/surveys/sass/.
[17] Alliance for Excellent Education, "The Economic Benefits from Halving the Dropout Rate, A Boom to Businesses in the Nation's Largest Metropolitan Areas," January, 2010, p. 1. http://www.ncacinc.com/sites/default/files/media/research/EconBeneCityCardBooklet011210.pdf
[18] Hill, P. (1995). Private Vouchers in New York City: The Student-Sponsor Partnership Program. In T. Moe (Ed.), Private Vouchers (pp. 113-135). Stanford: Hoover Institution Press.

- Merrifield and Gray (2013) found that from 1998 to 2004, school dropout rates in the Edgewood Independent School District in San Antonio, Texas, declined sharply as graduation rates rocketed up in choice schools. The resulting competition effects caused an echo in the public schools, where dropout rates declined and graduation rates rose as well.[19]

- Warren (2011) estimated that low income school choice students in Milwaukee were "about 18% more likely to graduate from high school than students from across the entire economic spectrum in the Milwaukee public schools."[20]

Increasing high school graduation rates is not just a worthwhile goal for the sake of educating the population, higher levels of basic education also tend to result in higher average wages and lifetime earnings. Higher student achievement builds what economists call "human capital," the educated skills that contribute to improved economic performance and increased productivity and output. Several studies connect the impact of school choice on earnings.

A 2010 study by the Alliance for Excellent Education took the analysis nationally for each of the nation's 50 largest cities and the 45 metropolitan areas that surround them, separately and combined.[21] That study found that reducing the estimated 6,500 students that dropped out of school in the Milwaukee metropolitan area in 2008 by 50% would result in an additional $41 million in earnings from these graduates on average each year throughout their careers.[22] That would result in an additional $7 million in state and local taxes paid each year.[23] The additional graduates would spend an added $28 million each year and invest a further $10 million each year.[24] That increased spending and investment would support 300 new jobs and increase regional GDP by $51 million annually, by the midpoint of their careers.[25] By that point, these new graduates would purchase homes valued by $100 million more than otherwise and spend an additional $3 million on vehicle purchases every year.[26]

Shapiro and Hassett (2013) provide further evidence on the potential lifetime earnings growth from improving graduation rates through school choice reform.[27] Using Census Bureau data to estimate wage effects of school choice, they found:

- A high school dropout working full time until age 64 can expect lifetime earnings of $564,000.[28]

- A high school graduate working full time until age 64 can expect lifetime earnings of $782,000, or $218,000 more than a high school dropout.[29]

- A high school graduate attending college to get an Associate's degree who then works full time until age 64 can expect lifetime earnings of $931,000, another $149,000 more than the high school graduate, and $367,000 more than the high school dropout.[30]

- A student that completes college earning a bachelor's degree and works full time until age 64 can expect lifetime earnings of $1,275,000, about half a million ($493,000) more than the high school graduate and almost three quarters of a million ($711,000) more than the high school dropout.[31]

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[19] Merrifield, John D. and Nathan L. Gray, "School Choice and Development: Evidence from the Edgewood Experiment," *Cato Journal*, Vol. 33, No. 1 (Winter 2013), p.134. http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/1/cj33n1-7.pdf
[20] Warren, John Robert, "Graduation Rates and Public Choice Students in Milwaukee, 2003-2009," School Choice Wisconsin, January, 2011, p. 1. http://www.schoolchoicewi.org/files/1613/6018/6466/2011-Grad-Study-FINAL3.pdf
[21] Alliance for Excellent Education, "The Economic Benefits from Halving the Dropout Rate, A Boom to Businesses in the Nation's Largest Metropolitan Areas," January, 2010, p. 3. http://www.ncacinc.com/sites/default/files/media/research/EconBeneCityCardBooklet011210.pdf
[22] *Ibid.* p.29.
[23] *Ibid.*
[24] *Ibid.*
[25] *Ibid.*
[26] *Ibid.*
[27] Robert J. Shapiro and Kevin A. Hassett, The Economic Benefits of New York City's Public School Reforms, 2002-2013, December, 2013, p. 3. http://www.sonecon.com/docs/studies/Report_on_Economic_Benefits_of_NYC_Educational_Reforms-Shapiro-Hassett-Final-December2013.pdf
[28] *Ibid.*, p. 14.
[29] *Ibid.*
[30] *Ibid.*
[31] *Ibid.*

Shaprio and Hassett's findings indicate that each of the estimated additional 768,820 high school graduates each year from national implementation of school choice would earn an additional $10,000 each year on average. That adds up to an additional $7.688 billion in increased wages and incomes for U.S. workers every year.[32]

e) Crime Reduction

Crime is a drag on economic growth. It is effectively another tax on savings, investment, productivity and property. With crime reduction resulting, new savings and investment would flow into the now underdeveloped and declining areas of crime-afflicted cities, which most investors and entrepreneurs have essentially given up on. New stores and restaurants would open up without fear of vandalism, theft or burglary. Customers could flock to those stores and restaurants without fear of criminal assault on their persons or property. Housing values would rise, stimulating new housing development, particularly on vacant lots, or to replace abandoned or underutilized properties, stimulating associated commercial development.

There is a substantial amount of evidence to support the idea that at a very basic level education reduces crime.[33] For example, Lochner and Moretti (2004) find a one-year increase in average education levels in a state reduces state-level arrest rates by 11% or more.[34] Merlo and Wolpin (2009) estimate that "on average, attending school at 16 reduce the probability of a black male ever committing a crime over ages 19-22 by 42% and the probability of an arrest over those ages by 23%."[35]

Beyond basic educational attainment, there is a growing body of work offering evidence that improving the quality of schools through school choice reduces criminal activity.

Cullen, Jacob and Levitt (2006) found that students "who win lotteries to high-achieving schools are statistically significantly less likely to report that they were subject to disciplinary action at school."[36] In addition, "[s]elf-reported arrest rates are reduced by nearly 60% among students who win lotteries to high-achieving schools relative to students who lose such lotteries (3.8% versus 8.9%). The pattern of self-reported arrest rates is corroborated by administrative data on incarceration rates for students in our sample."

Deming (2011) finds schools choice, by reducing school dropout rates and increasing graduation rates, reduces crime in the long run.[37] At the most basic level, this argument is compelling: "criminal offenders often have low levels of education: only 35% of inmates in U.S. correctional facilities have earned a high school diploma, compared to 82% of the general population." Deming found that winning a lottery for admission to a preferred school at the high school level for high school students in the high risk group (test scores on average one standard deviation below the state average, overwhelmingly male, disproportionately African American, absent and suspended many more days than the average student) reduces felony arrests among these students by about 50%, reduces the average social cost of their crimes by more than 43%, and results in the crimes that are still committed with sentences 40% less than among lottery losers. Among high-risk middle school students, winning a school choice lottery reduces the average social cost of the crimes committed by middle school students by 58% and reduces the sentences for crimes committed by middle school students by 64%.

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[32] Robert J. Shapiro and Kevin A. Hassett, The Economic Benefits of New York City's Public School Reforms, 2002-2013, December, 2013, p. 3. http://www.sonecon.com/docs/studies/Report_on_Economic_Benefits_of_NYC_Educational_Reforms-Shapiro-Hassett-Final-December2013.pdf

[33] For a concise review of the literature assessing the impact of education on crime, refer to the following:
Randi Hjalmarsson and Lance Lochner, "The Impact of Education on Crime: International Evidence," CESifo DICE Report, February 2, 2012. http://www.economics.handels.gu.se/digitalAssets/1439/1439011_49-55_research_lochner.pdf

[34] *Ibid.*

[35] *Ibid.*

[36] Julie Berry Cullen, Brian A. Jacob and Steven Levitt, "The Effect of School Choice on Participants: Evidence from Randomized Lotteries," Econometrica, Vol. 74, No. 5, September, 2006. http://pricetheory.uchicago.edu/levitt/Papers/schoolchoicelottery.pdf

[37] David J. Deming, "Does School Choice Reduce Crime? Evidence from North Carolina," adapted from a study published in the November, 2011 *Quarterly Journal of Economics*. Republished here: http://educationnext.org/does-school-choice-reduce-crime/

School Choice as a Means for Economic Development and Growth

a) Economics of Reduced Government Spending

To the extent that school choice programs may reduce government expenditures on education (i.e. if the program provides a voucher or tax credit of less than the average cost of educating a student in public school), the program has the potential to exert positive supply-side effects throughout the area in which it is implemented. Reductions in government spending tend to increase incentives to work, produce and invest, and economic growth is usually not too far behind.

The Tax Foundation calculates tax burdens faced by citizens at the state and local level for all 50 states and the District of Columbia. Table 1 compares growth in economic metrics among the nine states with the lowest tax burdens and the nine states with the highest tax burdens over the last decade. The nine states with the lowest state and local tax burdens have, on average, tax burdens that are 3.9 percentage points lower than the nine states with the highest state and local tax burdens. To measure performance outcomes in states, we looked at growth in various metrics over 10-year periods. The 10-year performance advantage that the average low tax burden states enjoy over the average high tax burden states is stunning: 2.8 percentage points in gross state product growth, 7.3 percentage points in population growth, 12.1 percentage points in personal income growth, 5.4 percentage points in nonfarm payroll employment growth, and 11.1 percentage points in state & local tax revenue growth.

To provide a rough estimate of the budgetary impacts of a school choice program that amounts to a large cut in state tax burden, we relate the change in tax burden to the GSP performance associated with such a change as shown in Table 1. A one percentage point lower tax burden is associated with 5.4% faster GSP growth over a decade, as incentives to work, produce, and invest are higher due to lower rates of taxation.

Table 1

Nine States with the Lowest Tax Burden vs. Nine States with the Highest Tax Burden[38]

(tax burden as of 2012, performance metrics are 2005-2015 unless otherwise noted)

		10-Year Growth				*9-Yr. Growth*
State	**Tax Burden****	**Gross State Product**	**Population**	**Personal Income**	**Nonfarm Payroll Employment**	**State & Local Tax Revenue*****
Alaska	6.5%	31.1%	10.7%	59.9%	9.9%	186.7%
South Dakota	7.1%	47.9%	10.7%	56.9%	9.8%	47.1%
Wyoming	7.1%	39.2%	14.0%	67.2%	10.1%	50.5%
Tennessee	7.3%	37.4%	10.2%	47.5%	5.4%	34.1%
Louisiana	7.6%	21.4%	2.1%	49.0%	5.2%	34.5%
Texas	7.6%	58.7%	20.6%	72.6%	21.6%	58.2%
New Hampshire	7.9%	29.3%	2.5%	40.0%	3.2%	36.9%
Nevada	8.1%	21.0%	18.9%	28.9%	2.8%	35.7%
South Carolina	8.4%	37.3%	14.7%	51.7%	7.6%	36.4%
Avg. of 9 Lowest Tax Burden States*	**7.5%**	**35.9%**	**11.6%**	**52.6%**	**8.4%**	**57.8%**
50-State Avg.*	**9.5%**	**37.2%**	**8.5%**	**46.8%**	**5.9%**	**48.8%**
Avg. of 9 Highest Tax Burden States*	**11.4%**	**33.1%**	**4.2%**	**40.6%**	**3.0%**	**46.7%**
Minnesota	10.8%	36.1%	7.2%	44.4%	4.9%	54.8%
Rhode Island	10.8%	26.1%	-1.1%	34.0%	-1.3%	28.6%
California	10.9%	39.6%	9.3%	48.6%	6.7%	52.7%
Maryland	10.9%	37.4%	7.4%	38.8%	4.1%	46.1%
Illinois	11.0%	31.6%	2.0%	36.2%	1.7%	53.0%
Wisconsin	11.0%	34.7%	4.1%	39.8%	1.9%	35.0%
New Jersey	12.2%	27.7%	3.5%	36.9%	-0.4%	42.1%
Connecticut	12.6%	24.2%	2.4%	40.1%	0.7%	51.7%
New York	12.7%	40.7%	3.5%	46.4%	8.6%	56.3%

* Averages are equal-weighted.

** Tax burden is calculated as a share of Personal Income by the Tax Foundation and is current for 2012, the most year for which the metric has been calculated. Tax burden is based on data from the Census Bureau's State & Local Government Finances dataset, but makes several modifications to account for taxes paid to other states.

*** State & Local Tax Revenue is the 10-year growth in state and local tax revenue from the Census Bureau's State & Local Government Finances survey. Due to data release lag, these data are from 2004-2013.

b) <u>Property Values and Economic Development</u>

By implementing school choice and reducing tax burdens, state and local governments can revitalize poor-performing schools and foster economic development. The deterioration of metropolitan public schools was a major contributing factor to the migration of the middle class from metropolitan neighborhoods to suburban developments. As the middle class moved *en masse* to the suburbs, employment, output, and production moved with it, severely draining important sources of tax revenue for public services in many metropolitan areas. By improving schools in these once-great areas, school choice serves a promising avenue for urban redevelopment and revival.

[38] Sources: Data provided by the Tax Foundation, Bureau of Economic Analysis, Bureau of Labor Statistics and the U.S Census Bureau, with calculations by Laffer Associates.

Universal school choice policies would encourage families to relocate so that their children could benefit from better schools, public and private, stimulating growth in housing prices and new residential development. Evidence suggests that even a small 1 percentage point increase in the graduation rate in a zip code can boost home prices by 0.54%.[39] That, in turn, would result in growing consumer demand for products and services, promoting business expansion and creation.

Relocating families would also increase the supply of and specialization within the labor market in school choice areas. The new population, development, and workers would mean new tax revenues that could lead to pro-growth tax cuts, further promoting economic development and growth. Those new revenues can also be a source of funding for public services, including education.

i. Case Study: The Edgewood Independent School District

The ability of broad-based school choice to facilitate economic development is evidenced by the experience of school choice in the Edgewood Independent School District in San Antonio, Texas. Merrifield and Gray (2013) found that during the 10-year period in which school choice was adopted by the Edgewood Independent School District, the local economy grew far faster than in the control group used in the study.[40] Below are highlights of the Merrifield and Gray study pertaining to economic development in the Edgewood Independent School District:

- Overall, property values rose by 86.4%, substantially higher than in the control districts between 1998 and 2008.[41]

- The number of single-family dwelling units grew by 2.1% from 1998 to 2001, 4.9% from 1998 to 2005, and 7.4% from 1998 to 2008.[42] The market value for single family homes grew 28.1% from 1998 to 2001, 58.8% from 1998 to 2005, and 95.4% from 1998 to 2008, which was higher than in all the control districts.[43]

- The number of multifamily residential properties grew by 1.5% from 1998 to 2001, 17.1% from 1998 to 2005, and 25.1% from 1998 to 2008.[44] The market value of multifamily residential properties skyrocketed by 209.1% from 1998 to 2008, which was higher than in any of the control districts.[45]

- The market value for mobile homes grew 65.9% from 2000 to 2001 and 96.3% from 2001 to 2002.[46] Growth in the number of mobile homes and in mobile home prices topped all the control districts.[47]

- Market values leveled off after the Edgewood school choice program, financed by private donations that ran out after 10 years, leveled off and then was phased out.

These trends were followed by substantial new business formation in the Edgewood Independent School District, with a lag of about two years:

- The number of commercial properties jumped by 33.2% from 1998 to 2005, and their market value spurred faster than in all the control districts.[48]

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[39] Robert J. Shapiro and Kevin A. Hassett, “The Economic Benefits of New York City’s Public School Reforms, 2002-2013,” December, 2013. http://www.sonecon.com/docs/studies/Report_on_Economic_Benefits_of_NYC_Educational_Reforms-Shapiro-Hassett-Final-December2013.pdf
[40] Merrifield, John D. and Nathan L. Gray, “School Choice and Development: Evidence from the Edgewood Experiment,” *Cato Journal*, Vol. 33, No. 1 (Winter 2013), p.134. http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/1/cj33n1-7.pdf
[41] *Ibid.*
[42] *Ibid.*
[43] *Ibid.* , pp. 136-137.
[44] *Ibid.*, p. 137.
[45] *Ibid.*
[46] *Ibid.*
[47] *Ibid.*
[48] *Ibid.*

- The market value of industrial properties boomed by 227% before the phase-out of school choice began.[49]

Economic development produced property tax revenue growth in Edgewood.[50] Edgewood's increase in graduation rates and declining numbers of dropouts, which are very costly to state and local governments in lost revenues and increased spending for social programs and law enforcement, and job growth boosted tax collections. Merrifield and Gray concluded:

> Regions adopting school choice programs realize immediate economic growth….Identification and measurement of quickly and cheaply realized local economic development effects that could improve the political feasibility of large, low-restriction parental choice programs, and accelerate their spread to additional places, are the most noteworthy effects of the [Edgewood school choice] assessment. A large segment of the population wants private school choice…badly enough to relocate. Increased business activity follows. A political jurisdiction interested in stimulating economic development while also improving their school system (both public and private) need look no further than [school choice] programs. Such programs would not require new taxes.[51]

c) Higher Economic Growth and GDP

Several studies estimate how improvement in educational outcomes in the U.S. might impact gross domestic product.

- Hanushek (2010) calculates that a system-wide improvement in standardized test scores of 0.25 standard deviations indicates a present value gain in future U.S. GDP of $44 trillion.[52] A system-wide improvement of 0.58 standardized deviations, which would rank the U.S. equivalent to the world's leaders in education, indicates a present value gain in future U.S. GDP of $112 trillion.[53] Hanushek estimates these potential gains in GDP would be equivalent to a long term increase in the annual U.S. economic growth rate of 1 percentage point. To demonstrate the significance of this consider the following:
    - At a long term rate of real economic growth of 2%, which has more closely represented recent years, GDP would double every 40 years.
    - At a long-term real economic growth rate of 3%, which is close to the higher growth rate of the U.S. over most of the post-World War II era, GDP would more than triple every 40 years.
    - At a long-term real economic growth rate of 4%, GDP would multiply by nearly 5 times over 40 years. That would multiply again over the following 40 years by another 5 times, leaving GDP 25 times higher after 80 years than it was at the outset. (During the periods when the U.S. followed the most pro-growth policies, the American economy did grow by 4% a year.

.A 2009 study from the consulting firm McKinsey and Co. estimate the economic growth that could be achieved by improving the education system in the U.S. McKinsey reports "If the United States had in recent years closed the gap between its educational achievement levels and those of better performing nations such as Finland and Korea, GDP in 2008 could have been $1.3 trillion to $2.3 trillion higher. This represents 9 to 16% of GDP."[54] The report estimated the following impacts of improving educational outcomes for minorities on the overall U.S. economy:

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[49] Merrifield, John D. and Nathan L. Gray, "School Choice and Development: Evidence from the Edgewood Experiment," *Cato Journal*, Vol. 33, No. 1 (Winter 2013), p.134. http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/1/cj33n1-7.pdf

[50] Merrifield, John D. and Nathan L. Gray, "School Choice and Development: Evidence from the Edgewood Experiment," *Cato Journal*, Vol. 33, No. 1 (Winter 2013), p.134. http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/1/cj33n1-7.pdf

[51] *Ibid.*, p. 140.

[52] Eric A. Hanushek, "The Economic Value of Higher Teacher Quality," National Center for Analysis of Longitudinal Data in Education Research, Working Paper No. 56, December, 2010, p. 21. http://hanushek.stanford.edu/sites/default/files/publications/Hanushek%202011%20EER%2030(3).pdf

[53] *Ibid.*

[54] "The Economic Impact of the Achievement Gap in America's School," McKinsey and Company, April 2009. http://mckinseyonsociety.com/downloads/reports/Education/achievement_gap_report.pdf

- Had the performance gap between black and Latino students and white students been closed [relative to Finland and Korea], GDP would have been between $310 billion and $525 billion higher, or 2 to 4% of GDP, for 2008."[55]

- Had the performance gap between low-income students and their peers been similarly closed, GDP in 2008 would have been $400 billion to $670 billion higher, or 3 to 5% of GDP."[56]

- Had the performance gap between America's low performing states and the rest had been similarly narrowed, GDP in 2008 would have been $425 billion to $700 billion higher, or another 3 to 5% of GDP."[57]

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[55] "The Economic Impact of the Achievement Gap in America's School," McKinsey and Company, April 2009. http://mckinseyonsociety.com/downloads/reports/Education/achievement_gap_report.pdf
[56] *Ibid.*
[57] *Ibid.*

8. A BRIEF HISTORY OF POLITICAL CORRUPTION IN KENTUCKY

F.B.I. anti-corruption billboard in Kentucky[1]

Our ancestors settled the country
when it was wild and dense,
then politicians took it over
and it's been unsettled since

- Unknown, qtd. in A New History of Kentucky[2]

Kentucky's battle with public corruption put the Commonwealth back in the national spotlight following a string of high profile corruption cases in recent years. In 2016 alone, a Federal grand jury subpoenaed the financial records of Kentucky Secretary of State Alison Lundergan Grimes' and those of her father Jerry Lundergan, related to her 2014 and 2015 campaigns. A few months later, Jesse Benton, a former campaign manager for Kentucky Senators Rand Paul and Mitch McConnell was convicted on felony political corruption charges stemming from his role in hiding financial contributions to former Congressman Ron Paul during his 2012 presidential bid.[3] And perhaps no story garnered more attention than that of Tim Longmeyer, a longtime Democrat was sentenced to 70 months in federal prison for accepting illegal kickbacks in exchange for helping a contractor secure lucrative consulting work.[4]

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[1] "FBI Louisville seeks public assistance in identifying public corruption," *WLKY Online*, July 31, 2015. http://www.wlky.com/news/fbi-louisville-seeks-public-assistance-in-identifying-public-corruption/34475530

[2] Lowell H. Harrison and James C. Klotter, *A New History of Kentucky*. Lexington: University of Kentucky Press, 1997. https://books.google.com/books?id=uYXj7L8-njUC&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false

[3] John Cheves, "Convicted political operative remains busy in Kentucky's U.S. Senate race," *Lexington Herald-Leader*, October 26, 2016. http://www.kentucky.com/news/politics-government/article110554857.html

[4] Bill Estep, "Democratic Party insider sentenced to 70 months in prison for role in kickback scheme," *Lexington Herald-Leader*, September 29, 2016. http://www.kentucky.com/news/politics-government/article104939206.html

The focus on Kentucky's corruption problem intensified after a 2014 Harvard study ranked Kentucky's public corruption as the worst in the country was released and received national attention.[5] Soon after, the Federal Bureau of Investigation launched the "End Corruption Now" campaign in Kentucky the following year, complete with billboards across the state and a toll-free tip hotline encouraging citizens to share their knowledge of any political misdeeds.[6]

To the credit of the Kentucky Legislature, lawmakers in the state are making a push towards ethics reform.[7] And so they should: time and time again research has shown Kentucky to be one of the most corrupt states in the nation. And evidence suggests that public corruption has caused long-term economic harm to Kentucky, which the state can simply not afford.

Corruption: A Literature Review

Several studies have assessed public corruption at the state level as well as the effects of public corruption on the economy.

The 2014 Harvard study that led to the "End Corruption Now" campaign assessed the perception of state corruption among nearly 300 reporters who cover state politics.[8] The study assessed illegal corruption, defined as "private gains in the form of cash or gifts by a government official, in exchange for providing specific benefits to private individuals or groups" as well as legal corruption, which it defined as "political gains in the form of campaign contributions or endorsements by a government official, in exchange for providing specific benefits to private individuals or groups, be it by explicit or implicit understanding." Legal corruption, the study claimed, was far more common than illegal corruption among all states.

Using these definitions of corruption, states were assessed at three levels of government, executive, legislative, and judicial.[9] With regards to both illegal and legal corruption, Kentucky received among the lowest scores for its executive and judicial branches, with corruption deemed to be between 'moderately common' and 'common.' Kentucky's scores for its judicial branch fared better, reflecting the national trend. Due to its perception of being illegally and legally corrupt, Kentucky was considered to be the most corrupt state in the country.

In another study, Simpson et al. (2012) examined the number of federal corruption prosecutions at the state level between 1976 and 2010.[10,11] Kentucky's 1.33 convictions per 10,000 population tied for 10th highest among all states along with Tennessee. In terms of absolute convictions, Kentucky's 577 convictions were 15th highest—a very high ranking given the relatively small population of the state.

Most enlightening is the study by Liu and Mikesell (2014) that examined the effects of public corruption on the size and allocation of U.S. state spending.[12] Their study found that during the 1997-2008 period, the 10 most corrupt states (Kentucky was ranked 10th) could have reduced their total annual public expenditure by an average of $1,308 per capita—5.2% of the mean per capita state expenditure—if corruption levels in those 10 states had been average.

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[5] Oguzhan Dincer and Michael Johnston, "Measuring Illegal and Legal Corruption in American States: Some Results from the Corruption in America Survey," Harvard University, Edmond J. Safra Center for Ethics, December 1, 2014. http://ethics.harvard.edu/blog/measuring-illegal-and-legal-corruption-american-states-some-results-safra

[6] "FBI Louisville Seeks the Public's Assistance in Identifying Public Corruption within the Commonwealth of Kentucky," Federal Bureau of Investigation, July 31, 2015. https://www.fbi.gov/louisville/press-releases/2015/fbi-louisville-seeks-the-publics-assistance-in-identifying-public-corruption-within-the-commonwealth-of-kentucky

[7] Davis O'Brien, "Preet Bharara, in Kentucky, Rails Against Corruption," *The Wall Street Journal*, January 6, 2016. http://www.wsj.com/articles/preet-bharara-goes-to-kentucky-to-speak-about-corruption-1452055126

[8] *Ibid.*

[9] *Ibid.*

[10] Dick Simpson et. al., "Chicago and Illinois, Leading the Pack in Corruption," University of Illinois at Chicago, Anti-Corruption Report Number 5, April 18, 2012. https://web.archive.org/web/20140402153827/http://www.uic.edu/depts/pols/ChicagoPolitics/leadingthepack.pdf

[11] The Harvard study noted such a method does have flaws (for example, the severity of crimes are not accounted for, and the number of federal convictions is related to prosecutorial resources in a state). These criticisms have some merit; however, measuring federal prosecution convictions provides a useful alternative method for assessment of state of corruption.

[12] Cheol Liu and John L. Mikesell, "The Impact of Public Officials' Corruption on the Size and Allocation of U.S. State Spending," *Public Administration Review*, Fall 2014. http://faculty.cbpp.uaa.alaska.edu/afgjp/PADM601%20Fall%202014/Corruption%20and%20state%20spending.pdf

Liu and Mikesell found that corruption diverts investment away from social sectors—education and health care—and towards "bribe generating" spending on items that directly benefit public officials, such as capital, construction, highways, borrowing.[13] Corruption also increases total salaries and wages for public officials.

A Brief History of Corruption in Kentucky

Kentucky's battle with public corruption goes back a long, long way.

During the Civil War Kentucky's second State Auditor of Public Accounts, Thomas S. Page, enjoyed a position that granted him the authority to supervise the collection of general revenue from every local tax jurisdiction in the state and the disbursement of funds to the Treasury.[14] His successor found that Page had unlawfully been directing Sheriffs to deliver their collections to him, or if preferred, to save Page the trip and deposit the funds in his personal accounts. Page managed to embezzle public funds in this way over a period that spanned three decades. Laws at the time prevented Page from being criminally prosecuted, and his civil prosecution "was never publicized beyond government documents and proceedings."

Such was the norm in Kentucky during the latter part of the 19th century due to a political system that was quick to grant privileges to favored businesses and encouraged party members to hide malfeasance.[15]

A hundred years later, Kentucky's corruption problem became an open secret in the state's capital, Frankfort. In 1951, a losing candidate for governor attacked the widespread practice of corruption in the legislature, declaring the city was "our Ninevah on the Kentucky River."

Common practice at the time when a bill resulted from unsavory business dealings or monetary exchange was to label the bill a turkey bill, and, as the vote was taken members would yell out, "Gobble, Gobble, Gobble!" In 1972, a live turkey was even released on the House floor, with the name of a bill on a sign on its neck.

Fast forward to the 1990s: "Bless your heart," Kentucky House Speaker Donald Blandford (D-Philpot) said on video as he accepted $500 from a lobbyist in exchange for agreeing to kill a bill that would have limited certain types of betting at horse tracks (a full transcript of the interaction between Blandford and lobbyist William McBee can be found at the link below).[16] Not long after, the FBI launched Operation BOPTROT, an investigation into corruption among the Kentucky General Assembly, the Commonwealth's legislature that led to over a dozen convictions between 1992 and 1995.[17,18] Among those convicted were House Speaker Blandford (D-Philpot) for extortion, racketeering, and lying, the Senate Minority Leader John Rogers (D-15th District), thirteen legislators (nearly 10% had been indicted) and the state "dean" of lobbyists, all found guilty of a variety of crimes.[19] *The Economist* called BOPTROT "one of the worst political scandals in Kentucky's history."[20]

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[13] Cheol Liu and John L. Mikesell, "The Impact of Public Officials' Corruption on the Size and Allocation of U.S. State Spending," *Public Administration Review*, Fall 2014. http://faculty.cbpp.uaa.alaska.edu/afgjp/PADM601%20Fall%202014/Corruption%20and%20state%20spending.pdf

[14] Glen Taul and Dennis Fielding, "Politics and Corruption in Antebellum Kentucky: The Thomas S. Page, 1852-1860," *The Register of the Kentucky Historical Society*, Vol. 89, no. 3 (Summer 19910, pp. 239-265. http://www.jstor.org/stable/23381764?seq=1#page_scan_tab_contents

[15] *Ibid*.

[16] "United States of America, Plaintiff-appellee, v. Donald J. Blandford, Defendant-appellant, 33 F.3d 685 (6th Cir. 1994)," *Justia U.S. Law Online*, U.S. Court of Appeals for the Sixth Circuit - 33 F.3d 685 (6th Cir. 1994), Argued April 28, 1994. Decided Sept. 7, 1994. http://law.justia.com/cases/federal/appellate-courts/F3/33/685/513531/#fn4_ref

[17] B. Drummond Ayres, Jr., "With Leaders Leaving Office for Jail, Kentucky Works to Refurbish Image," *The New York Times*, September 19, 1993. http://www.nytimes.com/1993/09/19/us/with-leaders-leaving-office-for-jail-kentucky-works-to-refurbish-image.html

[18] Despite receiving pay of only $50,000 annually from the state in the four years prior to his conviction, Blandford had a net worth of $500,000 at the time of his conviction. He would eventually be sentenced to 64 months in federal prison and fined $108,000.
Source: "Blandford gets 64-month sentence," *Kentucky New Era*, July 22, 1993.
https://news.google.com/newspapers?nid=266&dat=19930722&id=-9orAAAAIBAJ&sjid=YWQFAAAAIBAJ&pg=1512,1904792&hl=en

[19] "The Lobbying Lawyer," Kentucky Bar Association, 2015 Annual Convention.
http://c.ymcdn.com/sites/www.kybar.org/resource/resmgr/2015_Convention/Lobbying_Lawyer.pdf

[20] *Ibid.*

Ethics Reform in the Wake of BOPTROT

In the wake of BOPTROT, Kentucky enacted numerous policies aimed at reducing the corruption problem. This effort, however, did not achieve the success originally hoped for. Understanding the limitations of the ethics reform push in the wake of BOPTROT can shed light on how the state might better approach ethics reform today.

Here's how the policy formation process worked: the basic policy guidelines were mandated by the state, and the county and municipal governments—which the guidelines were intended to police—were granted the power to form, in detail, the ethics laws by which they would be held accountable.[21] Naturally, this lead the county and municipal governments to write laws that were not only lax in preventing violations, but oftentimes insured that corruption was *legalized*.[22]

Here are some examples in each of the four categories state officials sought to address and the manner in they were undermined by localities:

1. **Standards of Conduct**: The state mandate requiring localities to write local ethics laws simply stated that standards of conduct must be addressed.[23] As a result, local ethics laws lacked continuity and strength. For example, 80% of the counties and 28% of the cities wrote standards of conduct sections that explicitly applied to elected officials only, thus exempting appointed officials and employees from the new ethics laws. In Anderson County, the new law explicitly stated that it was legal to accept any gift or even a job offer from those doing business with the county.[24]

2. **Financial Disclosure:** The state mandate required each local code of ethics to list requirements for financial disclosure. The State Auditor's Office concluded 119 examples in counties and 247 examples in municipalities failed to adequately address basic financial disclosure guidelines.[25] Some localities wrote laws that were technically in compliance, though the laws lacked integrity. For example, in West Liberty, the disclosure rule only required local officials to report income in excess of $250,000. According to West Liberty's mayor pro tem, "the state said you have to give them a number so that's what we gave them." [26]

3. **Nepotism:** As with the other sections, the state mandate required localities to include a section on the employment of family members of officials or employees of the local government. According to the State Auditor, only 55% of the municipalities in Kentucky prohibited nepotism in their laws. Some of the new laws expressly permitted the hiring of family members, with one stating "no more than one of two family members can be hired." As one official commented, "If you need somebody you can trust real well, there's nothing better than a relative."[27]

4. **Enforcement of the Code**: The state mandated that each local government was to designate a person or group to enforce ethics codes. The responsibilities of enforcement included overseeing financial disclosure statements, handling ethics complaints, investing violations, and imposing penalties. The State Auditor's Office found 76 examples in counties and 109 examples in municipalities in which ethics codes did not contain all required provisions.[28] Many localities wrote provisions for ethics review boards, but never actually created one. In other localities, the board never met or only met "as needed."[29]

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[21] Richard C. Fording, Penny M. Miller, and Dana J. Patton, "Reform or Resistance? Local Government Responses to State-Mandated Ethics Reform in Kentucky," *The Journal of Federalism*, April 2003. http://www.bama.ua.edu/~rcfording/FMP_Pub2003.pdf
[22] *Ibid.*
[23] *Ibid.*
[24] *Ibid.*
[25] *Ibid.*
[26] *Ibid.*
[27] *Ibid.*
[28] *Ibid.*
[29] *Ibid.*

Public Corruption in Kentucky: The Last Decade

It's been going on ever since I was a young boy. As soon as you become the age to vote, you have people hounding you to buy your vote. I don't think it will stop. They [the authorities] might slow it down some, and I hope they do, [but vote-buying is] where the money's at.

- 54-year old voter Richard Moore, commenting on vote-buying in Kentucky, 2012[30]

Here are some notable public corruption cases in Kentucky in the last decade starting with the most recent cases:

- In September 2016, Timothy Longmeyer, a Kentucky Democratic Insider and former personal secretary to Governor Steve Beshear was sentenced to 70 months and pay $203,500 in restitution for his role in arranging state contracts for a private contractor.[31] Longmeyer has pleaded guilty to accepting more the $200,000 in exchange for offering lucrative state contracts to businesses. Prosecutors claim Longmeyer accepted bribes from a contractor in 2014 and 2015 that included $197,500 in cash and $6,000 in illegal campaign donations. Investigators have yet to reveal the recipients of the $6,000 in political donations, though Longmeyer did donate to the 2015 campaigns of Attorney General Andy Beshear, Secretary of State Alison Grimes, then-state Auditor Adam Edelen and gubernatorial candidate Jack Conway.

  In exchange for the bribes, Longmeyer arranged a $2 million contract for a Kentucky-based firm, MC Squared Consulting, whose owner, Sam McIntosh was a former staffer for the Kentucky Democratic Party. MC Squared provided focus groups and telemarketing surveys for several companies that provide health insurance to state workers through the Kentucky Employee's Health Plan.

- In May 2016, Jesse Benton, a one-time aide to former Republican Congressman Ron Paul was convicted on felony charges of falsifying campaign records stemming from a 2012 attempt to receive an endorsement in exchange for cash.[32] According to prosecutors, Benton funneled $73,000 to former Iowa State Senator Kent Sorenson via a limited liability company with ties to Sorenson, shortly before the State Senator switched his endorsement from Rep. Michelle Bachman to Rep. Ron Paul ahead of the 2012 Iowa primary. Prosecutors argued Benton used the scheme so that publicly-available campaign expenditure records filed with the Federal Election Commission would not reveal easily traceable payments to Sorenson. Benton, who also served as campaign manager for the Senate campaigns of Senator Rand Paul and Senator Mitch McConnell avoided jail time, but was sentenced to two years of probation and ordered to pay a fine of $10,000.[33]

- In April 2016, federal charges were brought upon retired judge David Daugherty, attorney Eric Conn (see photo below), and psychologist Alfred Adkins for their involvement in an effort to fraudulently obtain over $600 million in federal disability payments for thousands of claimants.[34,35] The indictment claimed that between 2004 and 2012, Conn, Daugherty, and Adkins defrauded the government by submitting erroneous and fraudulent documents to the Social Security Administration (SSA) in order to obtain both retroactive and future disability payments as well as Medicare and Medicaid benefits to claimants and pay attorney fees to Conn, who is reported to have collected up to $. The scheme worked like this: Conn's law firm helped individuals fill

[30] Eric Shawn, "Drug money funds voter fraud in Kentucky," *FoxNews.com*, July 25, 2012. http://www.foxnews.com/politics/2012/07/25/drug-money-funds-voter-fraud-in-kentucky.html

[31] Bill Estep, "Democratic Party insider sentenced to 70 months in prison for role in kickback scheme," *Lexington Herald Leader*, September 29, 2016. http://www.kentucky.com/news/politics-government/article104939206.html

[32] Tal Kopan, "Former Ron Paul aide, Trump super PAC chief convicted in campaign finance trial," *CNN*, May 5, 2016. http://www.cnn.com/2016/05/05/politics/jesse-benton-rand-ron-paul-aide-convicted-trump-super-pac/

[33] Grant Rodgers, "Ron Paul aides avoid jail time in endorsement scheme," *Des Moines Register*, September 20, 2016. http://www.desmoinesregister.com/story/news/crime-and-courts/2016/09/20/jesse-benton-john-tate-sentencing-ron-paul-kent-sorenson-michele-bachmann/90742638/

[34] "Retired Judge, Attorney and Psychologist Indicted in $600 Million Social Security Fraud Scheme," U.S. Department of Justice, Office of Public Affairs, April 5, 2016. https://www.justice.gov/opa/pr/retired-judge-attorney-and-psychologist-indicted-600-million-social-security-fraud-scheme

[35] Miranda Combs and Victor Puente, "FBI: Conn case example of pervasive corruption in Kentucky," WKYT, April 8, 2016. http://www.wkyt.com/content/news/FBI-375086241.html

out disability applications containing medical evaluations conducted by Adkins under the pretext that the claimants would be deemed disabled and medically qualified to receive benefits. According to the Department of Justice, Conn and Adkins "routinely prepared and signed evaluation reports indicating that claimants had limitations considered disabling by the SSA, irrespective of claimants' actual physical or mental conditions, according to the indictment."[36] Once the applications were completed, Conn filed them with the SSA's Huntington Hearing Office, regardless of the claimants' residence, to ensure the applications would be reviewed by then-judge Daugherty, who would then approve them.

According to the indictment documents, once law enforcement began to investigate Conn's practice, he threatened individuals he believed were providing information to authorities. In addition, Conn allegedly destroyed evidence related to the investigation, including documents, computers, and other electronic hardware and property located at his law firm.[37] The case is still ongoing.

A billboard advertising the services of disability attorney Eric C. Conn in Kentucky. That Conn was "Kentucky's one & only board certified Social Security Disability Specialist" did not prevent him from participating in a scheme that defrauded the Social Security Administration and in turn the U.S. taxpayer of $600 million.[38]

- In February 2016, a federal grand jury in Lexington subpoenaed financial records of Kentucky Secretary of State Alison Lundergan Grimes and her father, Jerry Lundergan, related to her political campaigns of 2014 and 2015.[39] The requests related to Jerry Lundergan extend to two of his companies. In 2014, Jerry Lundergan used his companies to support his daughter's unsuccessful bid for a Senate seat, providing her campaign with more than $60,000 in services.[40] In 1989, the elder Lundergan was forced to give up his seat as a state representative, after being convicted of violating state law by using his status as a legislator to

[36] *Ibid.*
[37] *Ibid.*
[38] Coleman Larkin, "The Hip-Hop Legacy of Eric C. Conn," Kentucky for Kentucky, April 6, 2016. http://www.kyforky.com/the-hip-%C2%ADhop-legacy-of-eric-c-conn/
[39] Tom Loftus and Joseph Gerth, "Grand jury subpoenas Grimes' campaign records," *Courier-Journal*, February 1, 2016. http://www.courier-journal.com/story/news/politics/elections/kentucky/2016/02/01/grand-jury-subpoenas-grimes-campaign-records/79651082/
[40] *Ibid.*

secure a contract worth $154,000 for a catering company owned by his family.[41] The conviction was overturned in 1993.[42]

- In June 2015, former state Rep. Keith Hall (D-Phelps) was convicted of bribing a state coal mine inspector to win favorable treatment for mines owned by Hall in Pike County.[43] While serving as vice chairman of the House Natural Resources and Environment Committee, Rep. Hall "paid or otherwise arranged for mine inspector Kelly Shortridge of the Kentucky Division of Mine Reclamation and Enforcement to receive $46,000 while Hall still served in the state House. In exchange, the court argued Shortridge ignored or delayed citing violations and allowed Hall to expand mining operations beyond his permitted area. Hall and Shortridge are currently awaiting sentencing, with the former facing up to 10 years in prison and $250,000 in fines. Hall was previously forced to resign from the Pike County School Board in 1999 after allegedly attempting to influence the awarding of school district jobs.

- In March 2015, the U.S. House Ethics Committee announced that it was investigating Rep. Ed Whitfield (R-1st District, Hopkinsville, Paducah, Henderson and Fort Campbell) for ethics violations.[44] The investigation stems from allegations that Rep. Whitfield improperly used his role as a public servant to help his wife lobby Congress on behalf of her employer, the Humane Society.[45] The investigation was still pending at the start of 2016. Rep. Whitfield announced he will be retiring from his seat, and will not seek re-election in 2016.[46]

- In January 2015, Morgan County Judge-Executive Tim Conley was sentenced to seven years and three months in federal prison for accepting $130,000 in bribes from a contractor bidding on bridge projects in rural Eastern Kentucky.[47] Conley was ordered to serve at least 85% of his sentence, and was ordered to pay $130,000 in restitution--$104,000 to the state and $26,000 to Morgan County.

- In 2013, the former mayor of Martin, Kentucky, her daughter, and two city officials were indicted on charges of conspiracy, fraud, theft of disability payments and aggravated identity theft. Between 2006 and 2013, the four individuals allegedly engaged in a scheme to defraud the Social Security Administration (SSA) and to misapply federal funds.[48,49]

- In 2013, Kentucky Agriculture Commissioner and former University of Kentucky basketball star Richie Farmer was charged with violating 42 counts of state ethics laws, the most violations issued against a public servant by the Executive Branch Ethics Commission.[50] The previous high for charges on ethics violations was 16. While Agriculture Commissioner, Farmer accepted excessive gifts, pre-selected friends and relatives for public positions without engaging in a competitive hiring process, purchased items such as laptops and appliances with state funds for home use and used state funds and personnel to build a basketball court on his personal

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[41] "Former Kentucky Democratic Party Chairman Convicted, Resigns," *Associated Press News Archive*, December 12, 1989. http://www.apnewsarchive.com/1989/Former-Kentucky-Democratic-Party-Chairman-Convicted-Resigns/id-5c58592e24b7534ee636404b46d9ec93
[42] Karla Ward, "Grand jury subpoenas records from Alison Lundergan Grimes' campaigns," *McClatchy DC*, February 2, 2016. http://www.mcclatchydc.com/news/politics-government/article57907998.html
[43] "Jury convicts former Kentucky state Rep. Keith Hall of bribing mine inspector," *Lexington Herald-Leader*, June 26, 2015. http://www.kentucky.com/news/politics-government/article44607147.html
[44] Cristina Marcos, "Ethics opens probe into Rep. Whitfield," *The Hill Online*, March 27, 2015. http://thehill.com/blogs/floor-action/house/237207-ethics-panel-opens-probe-into-rep-whitfield
[45] *Ibid.*
[46] Cristina Marcos, "Rep. Whitfield to retire amid ethics probe," *The Hill Online*, September 29, 2015. http://thehill.com/blogs/ballot-box/house-races/255315-rep-whitfield-to-retire
[47] Bill Estep, "Former Morgan County judge-executive sentenced to more than 7 years in prison," *Lexington Herald-Leader*, January 27, 2015. http://www.kentucky.com/news/politics-government/article44549799.html
[48] "Four Former City Officials in Martin Incited on Fraud Charges," Federal Bureau of Investigation, Eastern District of Kentucky, October 24, 2013. https://www.fbi.gov/louisville/press-releases/2013/four-former-city-officials-in-martin-indicted-on-fraud-charges
[49] Bill Estep, "Martin, Ky., mayor convicted in disability-fraud case," *Lexington Herald-Leader*, March 2014. http://www.kentucky.com/news/local/crime/article44473722.html
[50] Jack Brammer, "Richie Farmer charged with 42 counts of violating Kentucky ethics laws," *Lexington Herald-Leader*, March 18, 2013. http://www.kentucky.com/news/politics-government/article44411700.html

property.[51] Farmer was sentenced to 27 months in federal prison and was ordered to pay total fines and restitution of $120,500, approximately a quarter of the $450,000 he was accused of misappropriating.[52] He was released to a halfway house in December 2015, and is set for official release on March 9, 2016.[53]

- In 2011, eight County officials, including the circuit court judge, the county clerk, the school superintendent and election officers were arrested after they were indicted on federal charges accusing them of engaging in criminal acts to rig elections in 2002, 2004 and 2006.[54,55] "After a seven-week trial, jurors deliberated about nine hours before convicting the defendants on all the charges they faced, which included vote-buying, mail fraud, extortion, racketeering and money laundering." Former Court Judge Cletus Maricle, 67, was sentenced to more than 26 years behind bars. Several convicted major drug dealers testified during the trial about just how easy it was to spread many thousands of dollars around to buy votes."[56] "The Sixth Circuit vacated their convictions in July 2013 and remanded their cases for new trials after finding that the lower court unfairly allowed evidence in the trials regarding certain defendants' involvement in illicit drug deals."[57] "But Maricle in November negotiated a guilty plea to the racketeering charge, admitting that he and his associates accessed the Clay County Board of Elections in order to corruptly influence the outcome of elections, according to the instant opinion. Maricle also confessed to providing cash to bribe voters with the understanding that his associates would ensure that the bribed voters cast their ballots as directed. As part of Maracle's negotiated plea deal, he was sentenced to time served, plus supervised release for two years, including six months of home incarceration, 200 hours of community service, and no participation in the political process, according to the opinion."

- In 2010, the U.S. Attorney's Office brought federal charges against two Elliott County officials for illegally tring to sway the outcome of elections in 2010.[58] County Judge Executive Flemen D. "David" Blair and Deputy County Judge Executive Barry F. Blair, were indicted for theft or bribery for using and distributing state property to help secure votes in the election. Ultimately, the elder Blair avoided serving any time in jail, but was sentenced to three years' probation and ordered to pay $2,500 in fines and restitution in the amount of $5,000 to Elliott County.[59] The younger Blair was sentenced to two years' probation for vote-buying.[60]

- In 2007, former Manchester mayor Daugh K. White was arrested by federal authorities on charges of racketeering.[61] While mayor, White obtained nearly $100,000 from companies bidding on contracts with the City of Manchester. He was sentenced to 84 months in prison.

- In 2006, Kentucky Gov. Ernie Fletcher—the 1st GOP governor in more than 3 decades—was indicted on misdemeanor charges that he directed a scheme to illegally award state jobs to political supporters, the latest

[51] Tom Loftus, "Ex-Kentucky star Richie Farmer sentenced to 27 months in prison," *USA Today,* January 14, 2014. http://www.usatoday.com/story/sports/ncaab/2014/01/14/richie-farmer-kentucky-basketball-sentenced-more-than-two-years-in-prison/4478635/
[52] Roger Alford, "Former UK star Richie Farmer reaches prison plea deal," *New-Orleans Times-Picayune*, September 5, 2013. http://www.nola.com/lsu/index.ssf/2013/09/former_uk_star_richie_farmer_r.html
[53] "Richie Farmer Released to Lexington Halfway House," *Lex18.com*, December 18, 2015. http://www.lex18.com/story/30783251/richie-farmer-to-be-released-from-prison-today
[54] "KY Election Officials Arrested, Charged With 'Changing Votes at E-Voting Machines," *Huffington Post*, April 23, 2009. http://www.huffingtonpost.com/brad-friedman/ky-election-officials-arr_b_177468.html
[55] "Jury convicts all 8 defendants in Clay vote-buying case," *Lexington Herald-Leader*, March 26, 2010. http://www.kentucky.com/news/state/kentucky/article44027145.html
[56] Eric Shawn, "Drug money funds voter fraud in Kentucky," *FoxNews.com*, July 25, 2012. http://www.foxnews.com/politics/2012/07/25/drug-money-funds-voter-fraud-in-kentucky.html
[57] Linda Chiem, "Ky. Judge Permanently Disbarred For Vote-Buying Scheme," Law360.com. http://www.law360.com/articles/579812/ky-judge-permanently-disbarred-for-vote-buying-scheme
[58] "Two Elliott County Officials Indicted for Misappropriating Property in 2010 Election," Federal Bureau of Investigation, U.S. Attorney's Office, Eastern District of Kentucky, October 13, 2010. https://www.fbi.gov/louisville/press-releases/2010/lo101310.htm
[59] Kenneth Hart, "No Prison time for Blair," *The Daily Independent*, November 15, 2011. http://www.dailyindependent.com/news/local_news/no-prison-time-for-blair/article_24b9751f-e380-5689-ae9d-a684bf800853.html
[60] Kenneth Hart, "Ex-Elliott official receives probation," *The Daily Independent*, November 30, 2011. http://www.dailyindependent.com/news/local_news/ex-elliott-official-receives-probation/article_2c347898-4aff-56b0-b6f3-5333a160e3d6.html
[61] "Former Manchester mayor pleads guilty to conspiracy," *The Sentinel Echo*, August 15, 2007. http://www.sentinel-echo.com/news/local_news/former-manchester-mayor-pleads-guilty-to-conspiracy/article_bc00c023-5cf7-5520-b3d5-d87decd9302d.html

twist in a year-long probe into hiring practices in his administration."[62] Gov. Fletcher had initially dismissed the idea that a criminal inquiry was necessary and issued a blanket pardon to all nine of his current and former aides charged in the scandal on the eve of his appearance before a grand jury.[63] Ultimately, the governor signed a statement admitting to wrongdoing, but the charges were dropped under an agreement with Kentucky's Attorney General Greg D. Stumbo.[64]

Kentucky's problem with public corruption extends far beyond a handful of anecdotes involving individual public figures. In 2009, a state audit of the Kentucky League of Cities (KLC), a tax-payer funded "non-stock, nonprofit membership association serving more than 380 Kentucky cities as well as municipal agencies"[65] revealed extreme ethics violations. Here are some of the findings of the audit:[66,67]

Executive salaries skyrocketed between 2002 and 2009. For example:

- Sylvia Lovely, the executive director of KLC, got a boost in her salary from $170,248 in 2002 to $331,186 in 2009. During the same period, the deputy executive director's salary jumped from $141,753 to $255,258 and the chief insurance services officer's salary jumped from $123,909 to $238,867. In all, 19 positions at KLC have salaries exceeding $100,000 per year.

Aside from generous salaries, KLC staff received some valuable retirement perks:

- KLC staff were entitled to retirement bonuses in the form of forgivable loans as an incentive to "remain with KLC and to reward past loyalty and dedication." $400,000 in loans were administered as part of the program and not surprisingly, the bonuses were never paid back.

- The projected monthly pension benefit for Sylvia Lovely if she retires at 65 would be $17,725 for life. At 65, deputy executive director Neil Hackworth will get $16,357 per month for a lifetime.

There were also numerous conflicts of interests in many KLC deals:

- $1.4 million spent on legal services at the law firm where Lovely's husband is a partner.

- $28,600 spent at Azur Restaurant, partially owned by Lovely's husband.

- $14,413 in payments made to Hamilton's wife for decorating services. She was paid an additional $1,000 to travel to NYC for the selection of artwork.

- Several family members of Hamilton's either currently work or previously worked for KLC vendors.

- A current KLC executive board member, who is also the chair for KLC's Insurance Services, serves as an independent insurance agent for the insurance products sold by KLC.

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62 "Kentucky governor indicted over hiring practices," *CNN.com*, May 12, 2006. http://www.cnn.com/2006/LAW/05/12/governor.indicted/

63 "Kentucky Governor Pardons Aides Facings Charges," *The New York Times*, August 30, 2005. http://www.nytimes.com/2005/08/30/us/kentucky-governor-pardons-aides-facing-charges.html

64 "Kentucky Governor Signs Agreement Citing Wrongdoing in a Hiring Scandal," *The New York Times*, August 25, 2006. http://www.nytimes.com/2006/08/25/us/25kentucky.html?_r=0

65 "About," Kentucky League of Cities. http://www.klc.org/news/1758/About_KLC

66 "Long-Awaited Kentucky League of Cities Audit," Page One blog, December 17, 2009. http://pageonekentucky.com/2009/12/17/long-awaited-kentucky-league-of-cities-audit/

67 Crit Luallen, "Examination of Certain Financial Transactions, Policies, and Procedures of the Kentucky League of Cities, Inc.," Auditor of Public Accounts, Commonwealth of Kentucky, 2009. http://www.kentucky.com/latest-news/article40963041.ece/BINARY/Read%20the%20auditor's%20full%20report%20%20%285MB%29

The audit revealed some spending practices were questionable at best:[68]

- $74,463 was spent on credit cards from July 1, 2006 to June 30, 2009 without any supporting documentation. $212,871 was deemed questionable. $53,503 in reimbursements to KLC employees had little documentation and another $13,320 in reimbursements had no documentation. Not surprisingly, the audit found that "KLC had no credit card policy control over one million dollars that was charged on cards issued to employees."

- $430,000 was spent on out-of-state travel, and another $56,000 on meals at local restaurants. $50,000 was spent on event tickets (football, basketball and horse racing).

- $4,200 on a Colorado storytelling workshop; $1,570 at Liquor Barn in one trip; $3,300 for 500 copies of "The Little Red Book of Everyday Heroes" written by none other than Sylvia "Britney" Lovely; $28,000+ at Azur, nearly $5,000 on just two retirement parties.

- During a two-year period KLC spent over $300,000 on vehicles, including $64,000 for Lovely's vehicle. Income related to the personal use of those vehicles was not correctly reported by staff members.

- In excess of $7 million was spent over eight years on the New Cities Foundation, which was formed in 2002 to "research, study, educate and innovate communities about civic engagement." The audit found no quantifiable results associated with the New Cities Foundation.

[68] Crit Luallen, "Examination of Certain Financial Transactions, Policies, and Procedures of the Kentucky League of Cities, Inc.," Auditor of Public Accounts, Commonwealth of Kentucky, 2009.
http://www.kentucky.com/latest-news/article40963041.ece/BINARY/Read%20the%20auditor's%20full%20report%20%285MB%29