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Dr. Hackbart has served as State Budget Director for the Commonwealth of Kentucky during the gubernatorial terms of Governors Brown and Wilkinson. As Budget Director for Gov. Wilkinson, he served on the KERA Task Force and was responsible for initially implementing the financial portion of the KERA of 1990.

OPENING GENERAL SESSION
Monday, October 2, 1995

Dr. Merl M. Hackbart
Special Assistant to the Chancellor
University of Kentucky

THE FUTURE OF STATE FUNDING

My role this morning is to provide you with an overview of the activities of the Kentucky Commission on Tax Policy. Many of you probably have begun to read stories about the activities of the Commission and some of its recommendations. Until the last two or three weeks, the Commission has operated in a very fluid manner—the discussions have been relatively low key, and the process has been educational. There is probably one reason for that—it wasn't until the last two or three weeks that it actually started looking at recommendations. Once you start looking at recommendations and suggestions for change, it seems like everyone pays more attention and the issues become a lot clearer.

The Commission was established in February of this year by Governor Jones. It included representatives from the private sector and from the executive and legislative branches of government. Currently, there are approximately forty-eight members. (Some of the individuals who started with the Commission are no longer able to serve for personal reasons or for moving into other activities.) It is a broad-based Commission—there are individuals from different businesses and different sectors of our economy. I think the members bring a lot of knowledge about their specific areas to the deliberations.

What has been fascinating about the Commission is that the members have had good interchange in terms of what the Commission ought to attempt. The Commission is probably the first comprehensive tax reform effort that has taken place in Kentucky since I have been associated with Kentucky state government and the University of Kentucky since coming here in 1973. Over that time, we have had a lot of changes in the tax code, but those changes have occurred incrementally—they have occurred during special sessions and they have occurred as a result of new initiatives (i.e., the education reform efforts of the 1990 session).

To my knowledge, in the last 20-25 years, there has not been a comprehensive review of the entire tax code of Kentucky. A variety of concerns has evolved. Public leaders and private-sector leaders as well have expressed concern about the evolutionary process. There are a lot of individuals who have talked to the Commission, and members of the Commission themselves have talked about the fact that Kentucky's tax code is a very complex tax structure. It is very difficult for business and industry to be responsible for participating in that process. Individuals have difficulty dealing with the tax forms. We hear a lot of discussion about individual tax forms (the intangible property tax forms, for example). There is also discussion about the fact that we have insufficient revenue in certain situations and, in general, that insufficiency tends to be cyclical.

I have had the privilege of serving as Kentucky's budget director twice, both times during periods of economic recession. The state revenues, of course, tend to follow the cycle—when the economy declines, the state revenues decline and then the general fund declines.

As we look to the future and the action that is taking place in Washington (both in the Senate and in the House), we see a shifting of more responsibility to state governments and to local governments. Often, that rhetoric also is included in discussions about actually reducing the federal government expenditures. I think most state people realize that is suggesting that responsibility for the really hard decisions are being shifted to state and local governments, but that the revenue they will be receiving from the federal government to assist in the costs of the programs will eventually be reduced. We have some historical incidents where sufficiency was a concern. But, as we look to the future, I think we not only have to look at our own values, our own desires, our own feelings about what the government should be doing, but we also have to take into consideration the changes in Washington that will dramatically impact state and local governments. I think that impact has been understated up to this point—we are still not sure what Congress will do but over time, we are going to be seeing that impact.

Another factor about our current tax code is that our revenue sources are very unstable, we have fluctuations that are hard to predict.

The corporate income tax, for example, in 1991, produced $300 million of revenue. In fiscal 1993, it dropped to $250 million. In fiscal 1994, it went back up to $350 million. So, fluctuations are very problematic, at least in the general fund.

There also is concern about the current tax structure in terms of its fairness. Are we being fair to the lower-income taxpayers based upon their ability to pay? Probably the new issue that has arisen, not only in Kentucky but across the country (at least in the last 5-10 years), is the impact of a state tax structure on business. In other words, do we have a tax environment that encourages new investment, that encourages business firms to look to the future, to look to Kentucky as a good place to locate? The issue of competitiveness has emerged as a major issue.

As I mentioned, we have had a lot of changes in the tax code in the last 20 years. In sales tax alone, there are $1.8 billion of exemptions but, at the same time, the sales tax generates $1.6 billion. We, in effect, have more exemptions from one of our principal tax sources than we have revenue. Probably the major reason is that incrementally in different sessions over the last 25 or 30 years, we have tended to exempt different types of activities from the general sales tax. For example, food, medical drugs, and other types of special provisions for other sectors of the economy have occurred incrementally. And, no, we have not looked at the entire picture of the $1.8 billion of exemptions as to whether they all should be there. I suppose at some point, there was a good reason to have those exemptions. I am sure some industrial group or some other sector of the economy was concerned about its particular position relative to competitors, relative to taxpayers in other areas, and the legislators have responded by providing those exemptions. It is a problem that has evolved over a long period of time.

We are focusing on four major issues as we address the challenge of examining the entire tax structure to recommend changes and revisions. First of all, the Commission is focusing on the issue of adequacy—both of the general fund and the road fund. Also, we are reviewing the issue of fairness for taxpayers in various income categories bearing their appropriate burden.

Another major focus is the issue of competitiveness. The state of North Carolina conducted a significant study approximately a year ago on the competitiveness effect of their tax code. It is an issue that a number of states are examining because tax competition has evolved over the last 20 years among the states. Of course, there are obvious impacts anytime you change a tax code, so it seems logical that we ought to look at our current code and determine whether we are competitive. Do we have the type of business tax environment to encourage growth in the future?

Finally, the fourth factor the Commission has focused on is the issue of simplicity. In other words, is our tax code simple, easy to administer, easy for our taxpayers to comply with, if they want to comply with it?

The four principles that have guided the Commission's activity—adequacy, fairness, competitiveness, simplicity—are value-laden terms. Who could not be for an adequate tax revenue structure? Who could not be for a fair tax structure? Who could not be for a competitive structure? And, who could not be for a simple tax structure? But, what do these terms really mean, what are their implications?

Adequacy

Adequacy, as indicated, is essentially sound and relatively simple. But I think the Tax Commission has looked at the issue of adequacy in terms of two considerations. First of all, do the revenue base and individual taxes grow as the economy grows? We assume the ultimate reason to have a public sector in a free-market economy is to provide those kinds of resources and those kinds of activities that the market economy cannot provide. Obviously, the trend is to grow as the economy grows, and we need more roads as the economy grows.

The second consideration relative to adequacy is focused on the issue of fluctuations. Is the revenue base one that is stable so that the budget office, the Governor, the legislators, and the general public can expect the public sector to gross in a public fashion so we can plan for future activities and to react with the challenges in a reasonable way? Can we develop a tax structure that eliminates the booms and busts in our revenue flow? Obviously, to the degree that we have a broad-based tax system, can we expect to eliminate some of the fluctuations on the first account? Is the tax base stable relative to growth? Is the revenue growing as our economy grows? I think if we look at some macro-numbers, we probably get a pretty good idea that quite possibly our revenue has grown pretty much in line with our economy. In 1981, for example, the state's total revenue represented six percent of personal income. In 1994, the state's percent of personal income in Kentucky represented seven percent of personal income. The major reason we shifted from the six percent to the seven percent of personal income was because of the major changes that occurred in the 1990 session. The 1990 session essentially focused on providing sufficient and adequate funding for elementary and secondary education and, as a result, taxes for all taxpayers in Kentucky increased in 1990. As far as the growth of the tax is concerned (other than the inaction in the 1990 session), it has probably been adequate if you consider adequate to simply represent a situation in which the state's revenue is growing in proportion to the state's economy.

Fairness

The other characteristic that we looked at is the issue of fairness in terms of the distribution of the tax burden. Of course, the Commission has looked at the two traditional tax principles. First of all, the principle of benefits received. A good example of the benefits received principle in term of fairness is the tax on gasoline. When we drive our automobiles, we are paying the tax and we are getting the benefit of the highway system, so conceptually one way of looking at fairness is based upon the benefits received. Or, the people getting the benefits are paying the bill.

The second principle, which is a little bit counter to the first, is the principle of the ability to pay. Based upon this principle, we look at our tax system in two contexts. First of all, in terms of horizontal equity—everyone with approximately the same income level pays approximately the same tax or bears the same burden of the cost of state government. The second principal of ability to pay is the vertical equity, in which people of different income levels pay proportionately different levels of taxes. We talk about terms such as progressive and regressive and, as I mentioned, the Commission in the last couple of weeks is beginning to focus on specific recommendations and issues like adequacy and fairness. We discuss replacing this tax with that tax or modifying this tax in order to modify that tax, then the "rubber really hits the road" with tax reform and tax discussions.

Competitiveness

Beyond the fairness issue, we have the competitiveness issue. That is an issue that in the 1960s and 1970s we did not talk about very much. But, certainly as a part of the problems with the national economy in the 1970s, we witnessed a period in which state governments across the country were changing the tax policy in response to their willingness or their desire to increase economic growth. So, we have a series of tax changes in terms of rate changes partly to restore the revenue base.

We have a lot of changes in the area of giving tax credits to industries that might locate in a state or region. We have discussed whether Kentucky's tax code is competitive. Certainly in any political campaign, that same discussion appears. The Tax Commission feels that this is a very important issue, and a very difficult and touchy one. To some extent, competitiveness is in the eye of the beholder. The Commission decided to use an outside consultant to help with the basic analysis of whether Kentucky's tax structure is competitive. So, they employed the Barince Group, which is a public accounting firm with a lot of experience dealing with tax issues across the country. They conducted a lot of competitive studies and they were given the challenge of looking at the competitive issue in terms of business and also in terms of households. They selected 18 different industry groups in Kentucky and then compared Kentucky with 14 other states for a very broad-based study. Their findings showed that we were relatively competitive in terms of business taxes. In fact, we ranked quite well compared to the other states in our region. In the business tax area, Kentucky was found to rank 10 out of 15 in terms of the other states in the region based upon the effective rate of return of those businesses after taxes.

The property tax was found to be relatively low—in fact, we were found to be the fourth lowest. Certainly property tax is very important to business and industrial groups, and we rate relatively low in that area. I think we have already been aware of that for sometime.

They did, however, raise some red flags about the tax code as it relates to the private sector. The individual income tax was found to be relatively high compared to other states in our region. They also identified other areas in which we differ. Certainly our sales tax is relatively narrow-based, which is one of the reasons we have a lot of fluctuation compared to other states in that particular source. Of course, the intangible property tax has been discussed for sometime in the state and, certainly, the Commission will take a look at that. In terms of the competitiveness of individuals in a household, we probably have higher taxes as compared to business taxes.

Simplicity

Obviously, there is unanimous agreement that the area of simplicity is critical to the development of a sound tax base. We have even heard a discussion in Washington about trying to simplify the federal tax code. Not that it needs any simplification! I believe our tax code in Kentucky has similar difficulties.

The sales tax is the simplest tax we have, it is a tax that everyone understands. Its impact is clear and it is probably the simplest tax administered. The income tax, by comparison, is complex. We have a slightly different tax base than the federal tax system. There is a lot of talk about piggybacking or adopting portions of the federal tax code so when taxpayers file their federal tax return, their state tax return becomes a very simple process.

In the corporate arena, we have a very difficult challenge in terms of simplicity. Different states have different tax bases. Kentucky has the allocation problem, corporate profits, and it is an area the Tax Commission has focused on in some detail.

The tax in Kentucky that is probably the most difficult to administer is the property tax. Because the assessment process is fundamental to our property tax system, issues about complexity arise.

Summary

To summarize, the Tax Commission was established last February and was given a very broad challenge to review the entire tax code for the first time in decades to get some perspective in terms of fairness, stability, and adequacy. Do we have a tax code so that as the economy grows, state government will be able to provide those services that the people of Kentucky would like it to provide or do we have a tax code that results in a lot of fluctuations and requires decisions that probably should not be made almost necessary?

The issue of fairness is the most difficult issue with which to deal. The old comment about the only fair tax being the tax you don't pay is probably very relevant here. Taxpayers look at fairness in terms of their own perspective. We have had some very fascinating discussions about that issue in the Commission. Also, we are in the process of reviewing recommendations.

There will be a KET program on October 11 that will focus on some of those recommendations, and there will be other discussions held in the public to help people understand about more of the options we could pursue in trying to make our tax code more fair, more equitable, more competitive. People will maintain a philosophy that they are going to honestly and with great integrity comply with the tax code to the degree that there is a feeling that other people are paying fair taxes. Confidence is declining and I believe that is a severe problem for the future.

The Commission has worked very well, very effectively, and, hopefully, good recommendations will result. Whether or not those recommendations will be adopted—one has to be an optimist. But we will certainly find that out in the next few years. I think the work of the Commission will have a long-term impact. The Legislature next January may not opt for any or opt for all of the recommendations, but I think it does provide background.

Over time when we deal with these issues, at least there is one comprehensive view that acts as a conscience of what might be a good, sound structure for the future for the Commonwealth of Kentucky. If the Commission accomplishes that, it has been a worthwhile experience.

***Glenn B. Mitchell** is Commissioner of the Department of Fiscal Management for the Kentucky Transportation Cabinet. He also serves as acting Executive Director of the Office of Policy and Budget for the Cabinet.*

As the chief financial officer for the Cabinet, he has charge of the accounting, auditing, and toll collection functions. In his budget positions, Mr. Mitchell has been closely involved with the development and execution of the past four transportation biennial budgets, which involve the expenditure of approximately $8 billion in state and federal funds.

OPENING GENERAL SESSION
Monday, October 2, 1995

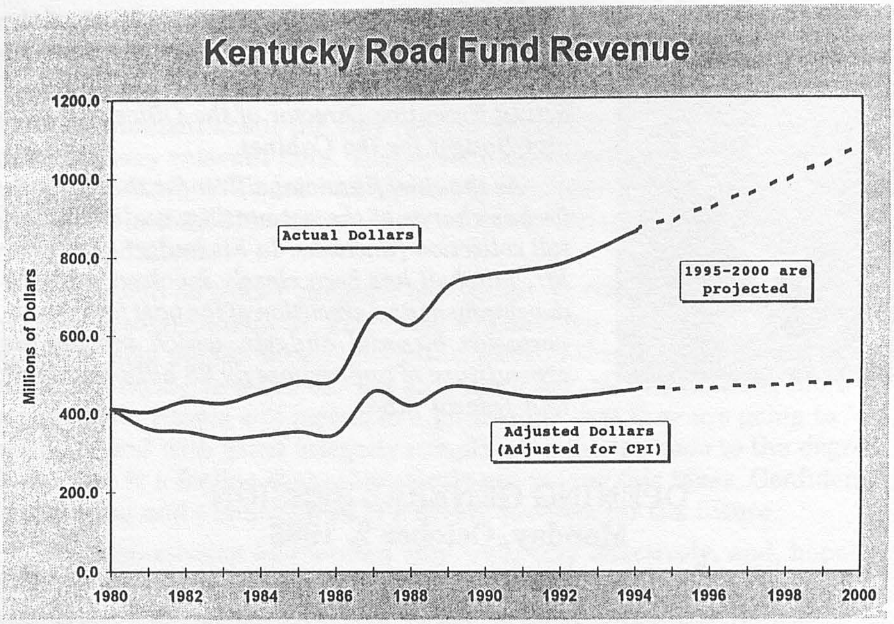
Glenn B. Mitchell
Executive Director, Policy and Budget
Kentucky Transportation Cabinet

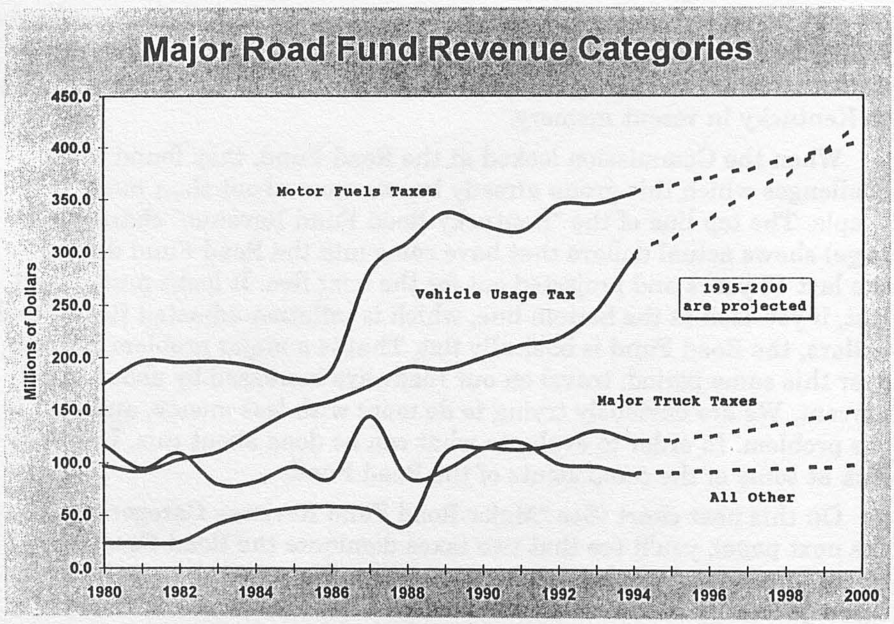
THE FUTURE OF STATE FUNDING

Merl Hackbart gave you a good overview of the Kentucky Commission on Tax Policy and what it is trying to do. As he pointed out, the Commission is conducting the first comprehensive review of all tax policy in Kentucky in recent memory.

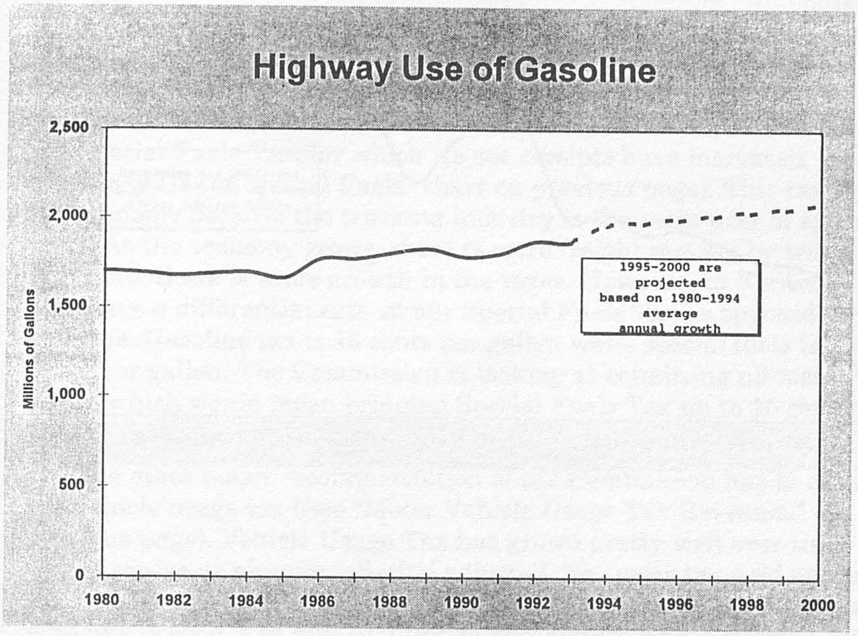
When the Commission looked at the Road Fund, they found some challenges which this group already knows more about than most people. The top line of the "Kentucky Road Fund Revenue" chart (next page) shows actual dollars that have come into the Road Fund during the last 15 years and projected out for the next five. It looks pretty good. But, if you look at the bottom line, which is inflation-adjusted Road Fund dollars, the Road Fund is basically flat. That is a major problem because, over this same period, travel on our roadways increased by about 50-60 percent. We are obviously trying to do more with less money, and that is the problem. In order to evaluate what can be done about this, I want to look at some of the components of the Road Fund.

On this next chart (See "Major Road Fund Revenue Categories" on the next page), you'll see that two taxes dominate the Road Fund—the Motor Fuels Tax and the Vehicle Usage Tax. Together, they make up three-quarters of the revenues to the Road Fund and the Tax Policy Commission looked at those first. They came up with two recommendations concerning fuel taxes. Of course, nothing is final at this point.

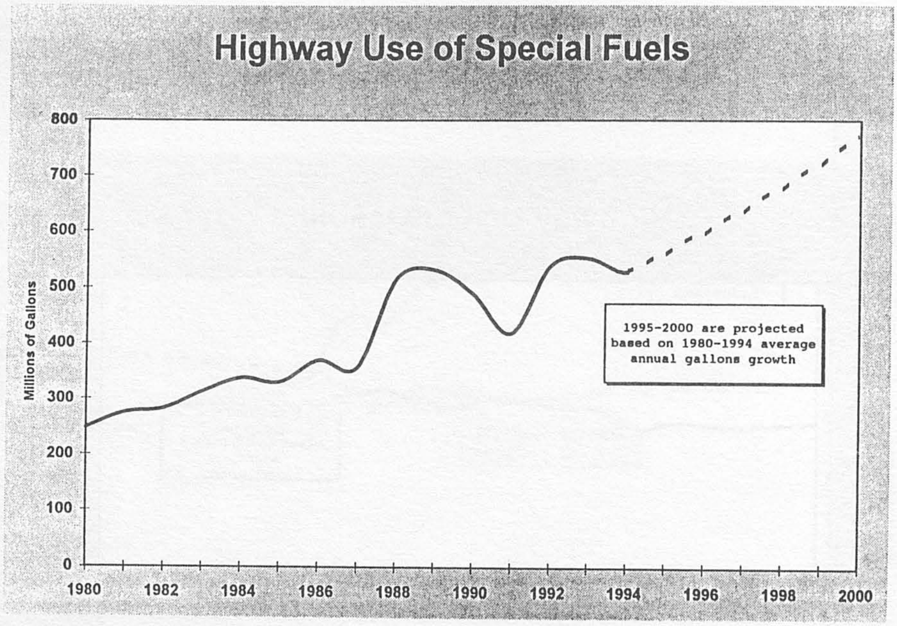

Kentucky Road Fund Revenue
Millions of Dollars
1200.0
1000.0
800.0
600.0
400.0
200.0
0.0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
Actual Dollars
1995-2000 are projected
Adjusted Dollars (Adjusted for CPI)

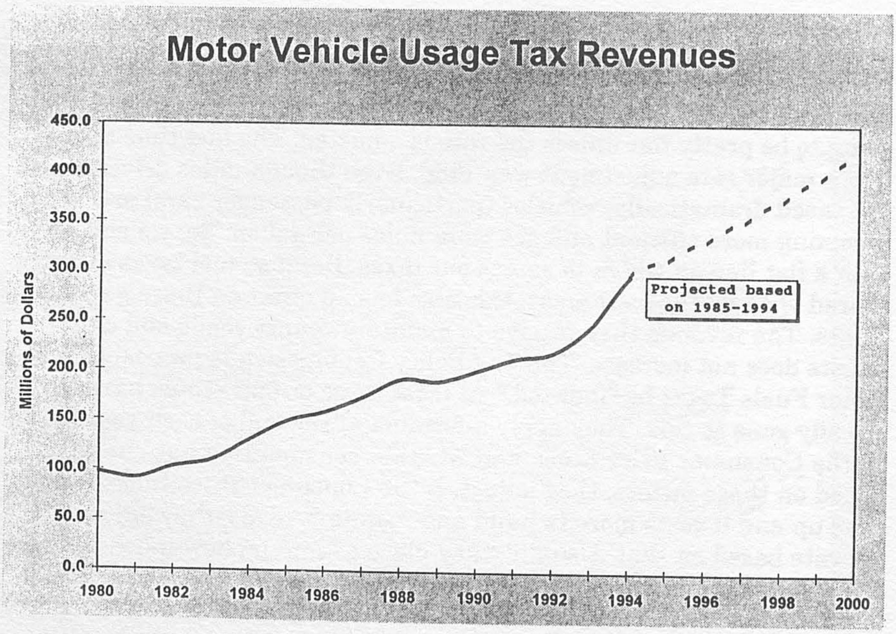

Major Road Fund Revenue Categories
Millions of Dollars
450.0
400.0
350.0
300.0
250.0
200.0
150.0
100.0
50.0
0.0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
Motor Fuels Taxes
Vehicle Usage Tax
1995-2000 are projected
Major Truck Taxes
All Other

The first recommendation deals with the fact that consumption of fuels (in particular, gasoline) has not changed in Kentucky over the last 15 years. That line is almost flat (See "Highway Use of Gasoline" below).



Since gasoline tax is charged on a per-gallon basis, revenues also are going to be pretty flat unless the rate is adjusted. The last time there was a major rate adjustment was 1986. Even though miles driven have increased dramatically, vehicles (particularly passenger cars) are becoming more efficient and get more miles per gallon. So, we end up with a flat line on which to assess our taxes. Because fuel taxes also are shared with local government, this also has an effect on those governments. The revenue they receive to maintain county roads and city streets does not increase. The Tax Policy Commission is proposing that Motor Fuels Taxes be "indexed." At least three or four states have already gone to this. They apply a formula at the end of each year based on the Consumer Price Index and whether consumption has changed. Based on these factors, they adjust. If the Consumer Price Index has gone up and it costs more to build and maintain roads, they adjust the tax rate based on that. Usually, they place a "cap" on how much the tax can increase—a few percent per year. Wisconsin even had one year in which motorists had used a lot more fuel, so they actually decreased their tax from that year to the next. A lot of us involved with the Commission believe this is a good solution to the "flatness" in the Motor Fuels


Highway Use of Special Fuels
Millions of Gallons
800
700
600
500
400
300
200
100
0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
1995-2000 are projected based on 1980-1994 average annual gallons growth


Motor Vehicle Usage Tax Revenues
Millions of Dollars
450.0
400.0
350.0
300.0
250.0
200.0
150.0
100.0
50.0
0.0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
Projected based on 1985-1994

Tax. Plus, it would keep us from having to go back to the Legislature every 5 to 10 years to get a tax increase. That is always politically difficult and the consumer doesn't like it either because he is suddenly hit with an additional dollar in tax each time he fills up his tank. Using the indexing, the consumer might see an increase of only 10 cents per fill-up from one year to the next and that is not likely to be noticed. Hopefully, the only thing he will notice is that the roads are being properly maintained.

The second recommendation that deals with fuel taxes has to do with the Special Fuels Tax, for which we see receipts have increased. (See "Highway Use of Special Fuels" chart on previous page). This tax mirrors the economy because the trucking industry is the main user of special fuels. As the economy grows, there is more freight moving by truck and, therefore, there is some growth in the taxes. However, in Kentucky we now have a differential rate on our Special Fuels Tax as opposed to our gasoline. Gasoline tax is 15 cents per gallon while special fuels is 12 cents per gallon. The Commission is looking at equalizing all motor fuels taxes, which would mean bringing Special Fuels Tax up to 15 cents per gallon, the same as gasoline.

The other major recommendation of the Commission has to do with the vehicle usage tax (See "Motor Vehicle Usage Tax Revenues" on previous page). Vehicle Usage Tax has grown pretty well over time. This tax, of course, is already inflation adjusted. The sales tax paid on cars is responsive both to the economy, since people buy more cars when the economy is good, and also to inflation because car prices increase just as the cost of other items increase. Therefore, the Vehicle Usage Tax has been pretty successful at mirroring the economy. In the last two or three years, there has been a good upturn because car sales have been pretty hot since the economy has been fairly positive. However, the fact that car sales mirror the economy is both a blessing and a curse, because we have found that this category of taxes is by far the most volatile in the Road Fund. In other words, it changes from year to year based on the economy. If the economy is doing well and consumer confidence is up, usually the first thing people do is buy a new car or trade for a newer car. When the economy turns sour, the first thing that consumers delay is trading in their cars. We have had "feast and famine" in this category. This chart doesn't show it well but, you can see some peaks and valleys. This is a "smooth-lined" chart, so we have taken some of the jumps out of it. Believe me, it is very volatile and, generally, when the Road Fund is off and we don't make estimates, it is because this tax hasn't performed up to expectations.

A recommendation that the Commission is looking at will reduce the jumps in the Motor Vehicle Usage tax. Right now, when someone trades in a used car on another used car, he or she pays tax only on the difference in value between them. However, if a consumer trades in a used car on a new car, he or she doesn't get any trade-in credit, they pay the full sales tax on the value of that new car. The Fairness Subcommittee of the

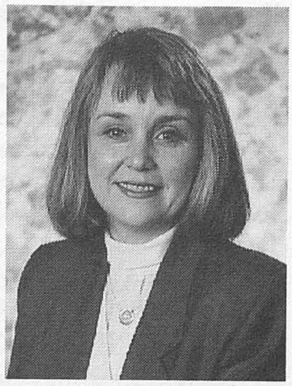
Tax Policy Commission picked this out because it seemed inequitable. The Adequacy Committee pointed to it because it increases the volatility of the Vehicle Usage Tax because the cars that people delay buying when the economy turns a little sour are new cars. They will continue to buy used cars, but we are only taxing a portion of the value of those used cars, whereas we tax a hundred percent, or ninety percent, of the value of the new ones. So, the recommendation of the Adequacy Committee (which the full Committee has not yet addressed) is to equalize the treatment of this trade-in credit. Either take it off for all vehicles or allow it for all vehicles, and do it in a revenue neutral manner so that the same amount keeps coming into the Road Fund. We believe that this amount will simply be coming in more predictably in the future.

Tax reform is certainly not easy. Those on the Commission have recognized this. The easy part is cutting taxes. As our chairman, Bill Lear, has said several times at our meetings, "When you're running downhill, you can really move along but, when you start cutting here and increasing taxes in other places, that's when you really bog down." We found one thing that is important is to learn from the lessons of the past. I would like to close with a story.

This story involves my friends Jack Fish and Merl Hackbart. A lot of you probably don't know this, but Jack and Merl are big game hunters and they occasionally charter a private plane and fly to Canada to hunt moose. On one trip, they had a really successful hunt—bagged two large moose. When the pilot picked them up to take them home, he said, "I can't fly you out of here with all of your gear and those two moose, it's just too heavy." They argued for a few minutes and Jack said, "I don't understand, last year the pilot loaded everything we had, including the two moose we bagged." The pilot replied, "Well, I guess if he could do it, so can I." So, they loaded the plane, headed across the lake, and gently lifted into the air. The next thing you know they are clipping tree tops and the plane crashed right into the side of the mountain. Miraculously, nobody was hurt. Merl stuck his head out of the wreckage and looked around. Jack said, "Where are we?" Merl answered, "Well, we're about a mile further than we got last year."

I hope with the right preparation and the right planning, that tax reform will "fly" in Kentucky this time and we get further than we have in the past. Thank you very much.

Sylvia L. Lovely has served as Executive Director of the Kentucky League of Cities, a statewide service organization for municipalities, since 1990. For three years prior to that, she was KLC's Director of Intergovernmental Services with responsibility for a $170-million bond program.



Ms. Lovely, a native of Frenchburg, graduated from Morehead State University. She received her Juris Doctorate from the University of Kentucky College of Law, and is licensed to practice in Kentucky and Florida. Prior to joining KLC, she served as Director of the Fayette County Bar Association Pro Bono Program, and as an assistant Attorney General.

OPENING GENERAL SESSION
Monday, October 2, 1995

Sylvia L. Lovely
Executive Director
Kentucky League of Cities

THE FUTURE OF STATE FUNDING

I want to talk with you today about local government revenues and about my work as a member of the Tax Commission. I will divide my presentation into three sections. First of all, I want to talk about the revenue challenges faced by local governments—and those challenges are considerable. Secondly, I will talk about my work on the Kentucky Tax Commission and my role within the Commission. Thirdly, I will talk about what the Kentucky League of Cities is doing about these challenges, and what we intend to do and are already doing to continue, extend, and add value to the work of the Commission.

First of all, let me describe several challenges. The first challenge we face at the local government level is dealing with the public mentality. We are going into the 1996 "slash-and-burn" session and we are really frightened about the mood out there. There is a certain dissatisfaction with government—there are many reasons given but one interesting aspect is the lack of desire or lack of understanding of the relationship between getting services and paying taxes. Although there are many of us who have hope that, in the long run, the right things will be done, I do think there is an awful lot of pressure on our legislators, particularly if we are not right at their door trying to explain to them what is really going on out there.

The second challenge concerns devolution from the federal level to the state and local levels. It all translates into less money and more control. I think all of us like the control aspect, but the less money part is slightly daunting and a little scary. I think we would face this regardless of whether Democrats or Republicans were in office. The deficit is fact and with the very sound movement of balancing the federal budget. The National League of Cities itself has as its major platform the reduction of the deficit. Those of you in transportation know that what we are facing at the federal level is a gloomy picture down the road.

Given the shift from federal to state responsibility is inevitable. We are going to have to face these cuts which are threatening to be very, very serious to mass transit and to all kinds of things that we take for granted. I would also say that none of us have thought much about it, particularly at the state leadership level. North Carolina and a few other states have begun to look at this issue of responsibility shifting from the federal to the state and local levels. I do not know when we are going to start dealing with it in this state but, if you have read the news articles, Kentucky will be highly impacted—more impacted than other states because it receives a larger proportionate share of federal funds.

The second issue that I wanted to address is my role on the Kentucky Tax Commission and its work from my perspective. First of all, I would have to say that it has been a very pleasant surprise, if nothing else. I was with C.D. Noland, the state representative from Irvine, at lunch the other day and he said, "Well, if nothing else comes of this, it has been great, I have really learned a lot." That is wonderful and it shows the power of what this kind of commission can do to educate our legislators. It has far exceeded my expectations, but we are nearing the time when we have to make those difficult decisions and take some of those difficult votes.

The Commission's mission is no less than a rewrite of state tax policy. It does not officially include within its purview the local tax policy. I have, as would be required of me in my role as executive director of KLC, protested: "We must include the study of local government tax policy." The fact is, local government taxation could not have been included and the Governor's timetable of a report in November 1996 met.

It was important, I think, in spite of the fact that local government was not included within the scope of the Commission's work to have some local government representatives. Although, we are a large part of the Commonwealth. With 435 cities, 120 counties, and countless special districts, it was important to involve local government officials in writing state tax policy. In addition, there are others that I have had the opportunity to be exposed to—some of our greatest business leaders. There are also representatives of other interest groups such as the Task Force on Hunger and Kentucky Youth Advocates. All of those groups get together in a room and get into some very, very good debates. In spite of the fact that their mission does not include local tax policy, you can well imagine that the discussions have not been confined to state tax policy. It is impossible to discuss state tax policy without discussing it from the local perspective. Although it is not within that mission, we have been able to make some good points.

I think that some enlightenment, some education, has actually occurred and I, for instance, heard one member, who happens to be a doctor in Ashland and a particularly thoughtful member, remark during one of our meetings, "We need more flexibility at the local level." I was stunned! I thought, in essence, that's my speech. It was really great to hear somebody outside local government make our more cogent remarks. So, there is a key recognition for the need for local study.

I believe we can achieve the goal of reviewing local government taxation. One interesting comment I heard just the other day showed that at least people are beginning to give this some thought. Mer Grayson, a banker in Northern Kentucky, is on the Commission. I was giving my usual speech about how we need to have a study at the local government level and more flexibility, and Mer nearly came out of his chair and said, "Those local governments can get in my pocket any time they want! I don't think they have any problems." So we had to calm Mer down by saying, "That's exactly why we need to be studying this, Mer." So, there is enlightenment and there is a lot of turmoil in peoples' minds about what is happening at the local level.

The interrelationship between state and local levels are reflective of the interrelationships among the attributes of a sound tax system; fairness, competitiveness, adequacy, and simplicity.

What is competitiveness when compared to fairness? What is adequacy to run our government, and simplicity? We want simpler taxes; we want to understand what we are doing. We do not mind sending the check, yet we wish to know what we are paying for. That is next to car taxes as being one of the biggest issues. Let me give you some illustrations as to why you cannot talk about state tax policy without talking about local tax policy. Property taxes, real, personal, intangible, are very interesting because you know most everybody is talking right now about doing away with intangible taxes. Well, that sounds simple. It sounds like it's a wonderful thing to do for competitiveness. It does not encourage wealthy individuals to stay in the state and thus spend their money and invest in this state, but it produces about $20 million at the local level, so it is a very serious thing.

One thing that came out of the Tax Commission's work was the "Competitiveness Study." Surrounding states that were compared to Kentucky's tax structure showed us to be a high income-tax state owing largely in part to the fact that local governments rely so heavily on occupational taxes. What was not said at the same time is that we are a low property-tax state and, unlike many of our sister states and local governments, do not have a local option sales tax available to local government. We have very inflexible revenue sources.

What we on the Commission are evolving around to addressing is what do we do about this great big issue of not being able to really address local government but needing to address it because of some of the important taxes that we are talking about. We are openly discussing it when it comes up and going to push as a Commission for additional studies of the city, county, and special district issues. With the final Commission report, there is an important objective not to worsen the position of local government.

This brings me to a discussion of the study that is being conducted by the Kentucky League of Cities. If we were going to be part of a study of state tax policy, what a better moment in time to be talking about our own situation. Frankly, we saw it as a survival issue with the 1996 session coming up. We must get some good solid educational facts about our local government out to our state leaders or we stand to be hurt very, very badly in, again, what I call the slash-and-burn session.

KLC hired Merl Hackbart and Jim Ramsey to assist with the study and we have been working feverishly trying to meet our own deadlines, which has been a challenge, but it has been exciting. Some of the things that we are looking at are adequacy, fairness, competitiveness, and simplicity at the city tax level. Now again, that is only a small part of the big picture of what we are doing. I believe KACO is beginning to do this as well. I had heard that that association has a committee to look into this and that it also will have to be done at the special district level. At some point, this will all have to be brought together. We do not think that this coming together will happen before the 1996 session, but we do think it will occur.

Currently, cities and counties can levy, for the most part, taxes consisting of the insurance premium tax, occupational tax, and property tax. Kentucky local government has no sales tax authority and others are very limited. We are facing, perhaps, some challenges to some of those revenue sources which really scares us a great deal. Again, local government tax revenue sources are very limited.

Unlike a lot of other states, there is no major tax or tax group reserved for local governments in Kentucky. We also found in our study that there is a mismatch between taxpayers—who pays and who receives—and, to a degree, there is a fairness issue when that gets too unbalanced. What we also have found is that, like state government, local government is not being permitted to take advantage of our changing times. We are moving more towards a "consumption" economy. Perhaps that would dictate that sales tax should be something that we should all look at, we are not sure.

Ron Crouch (state demographer from the University of Louisville) talks about the "graying" of our society which will impact on local government taxation. We have a reliance on property taxes, which is going down, but we also provide homestead exemptions for the elderly. With all of that, services for the elderly are usually higher level than other folks. And yet, our tax base is not keeping up with the graying of the population and probably the eroding of real property and occupational tax bases. You can see the reliance on occupational taxes—the elderly do not work so those numbers increase. In fact, Ron Crouch talks about an inverted triangle where there are going to be very few people working at the bottom to support the larger group at the top.

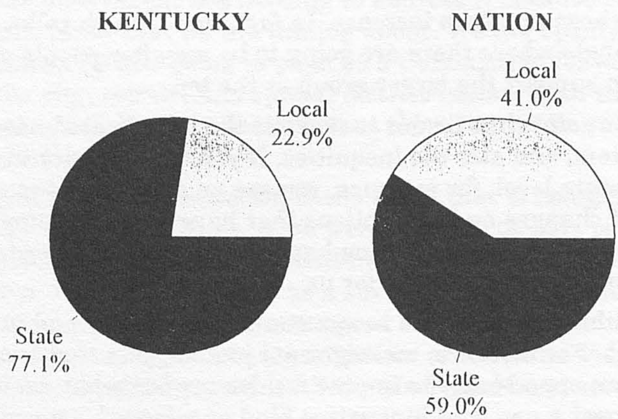
The other point that I want to make is the complicated nature of the local tax system, and also the inequities. If you look at sales tax exemptions at the state level, for instance, you see no apparent reason for the patchwork of changes and exemptions that have been implemented over time. We have seen the same thing happen at the local government level and it presents a real challenge for us.

Another thing you will see in our study is some new and innovative types of ideas. For instance, we might not just suggest that local governments have an opportunity to impose a sales tax but what we may do is perhaps suggest a new and innovative kind of sales tax. One of our biggest issues (and it inevitably comes up from business leaders) is how can you possibly all do your business and maintain survival with 435 cities and 120 counties. We think that is an important issue to consider. Perhaps there would be some sort of overlay taxing authority that could be shared among local governments. We happen to think that Kentucky is a state of small communities; it tends to see its identity as that. In fact, that is one of our greatest selling points across the nation—that is why people like Kentucky. Our crime rates are relatively low. These are important things to preserve and yet we may have to be innovative in our approach to try to answer questions about how to fund local government in the future. Incidentally, one of the biggest issues that we face while doing this study is that there is not very adequate data about local governments in the state of Kentucky. It is a pretty amazing thing. In some of our sister states, there is very solid data available about local government, but there is not in Kentucky. With much of the data that we have, it is impossible to sort out cities, counties, and special districts. We need to know what we are studying before we can study it.

This chart (see top of next page) shows you an interesting fact about Kentucky compared to the nation. The tax revenue paid in Kentucky is so much less than the national tax burden. This is the amount of local taxes as compared to state taxes. That presents almost more questions than answers. We are not sure if Kentucky is a heavily centralized service state where services are centralized at state government. We are not sure what that means. Are local governments providing services but not getting enough money to do them? We think it is very interesting and presents some interesting opportunities for study.

I mentioned Kentucky's local government tax from cities, which is not all that different from counties. The main place where we make our

Distribution of Total State and Local Tax Revenue (1992)



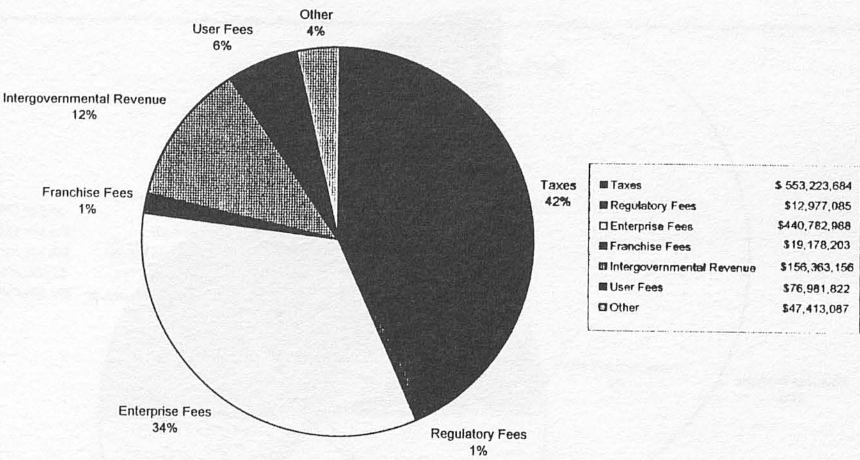
Source: Significant Features of Fiscal Federalism, Advisory Commission on Intergovernmental Relations (December, 1994)

money is in license fees, personal property, real property, and ad valorem taxes, which is real property. It is very, very limited. I served on a tax structure committee that Mayor Pam Miller put together when she was trying to raise occupational taxes to pay for a federal mandate on landfills. I remember sitting down with this group of very highly educated citizens and the first thing somebody said was, "Why don't we put on a sales tax, that's a lot better tax than an occupational tax." We had to inform that person that it is not constitutional in Kentucky.

This is where cities—keep in mind, this is not all that different from counties—(this is averaged) get most of their tax revenues (see next page). Intergovernmental revenue is an interesting one to watch and is likely to go down as we get less money from the federal government. Enterprise fees, of course, water, sewer, those sorts of things.

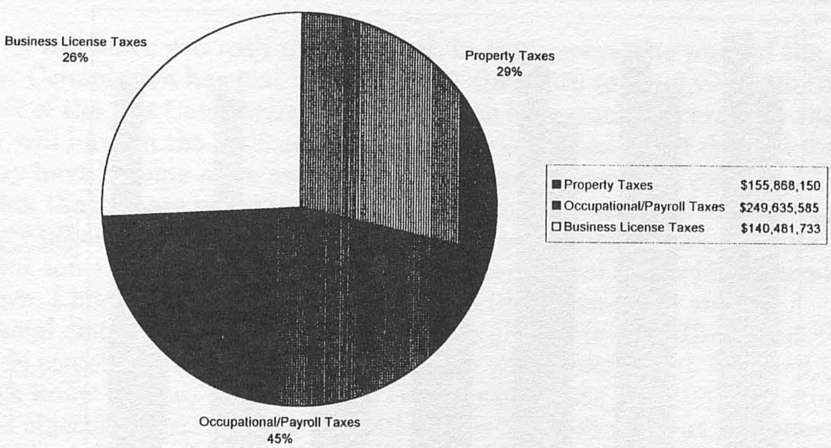
The next chart (see next page) deals with city tax revenues. You can see one interesting phenomenon—business license taxes, which includes the insurance premium tax and occupational payroll taxes, are very large and growing. In fact, property taxes have decreased over time due to the effects of House Bill 44 and they will continue to decrease as an issue and probably decrease with the graying of our population. You will see even higher taxes in that other category if these are the only kind of sources that we have available to us. Business license taxes are a major source of revenue. Insurance premium taxes are the major portion of that.

City Revenues—All Sources FY 1994



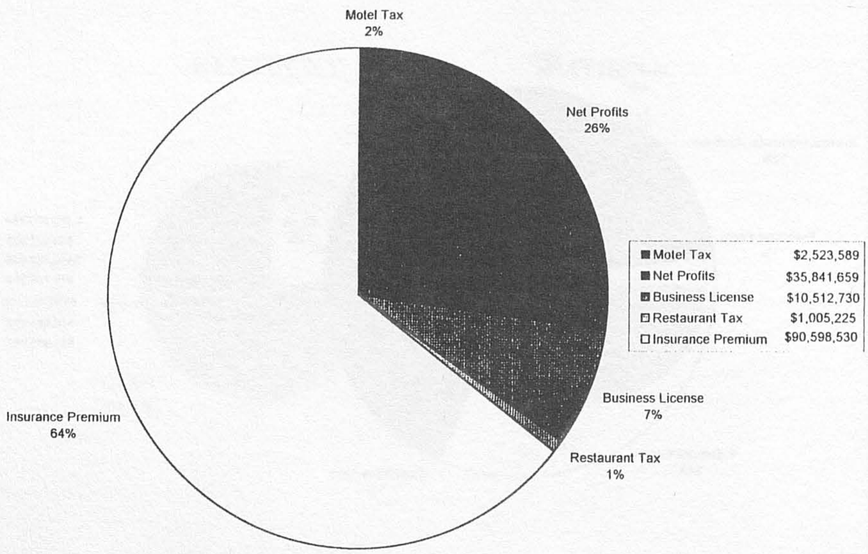
Source: Department of Local Government

City Tax Revenues FY 1994



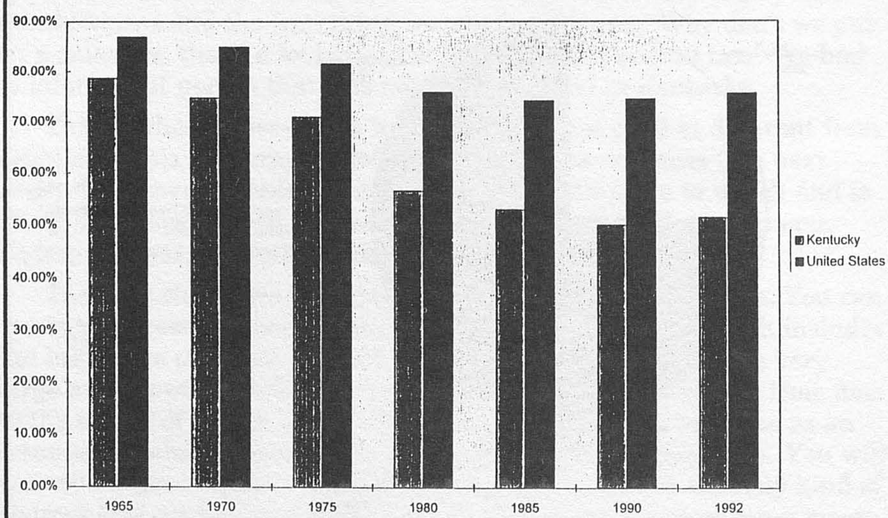
Source: Department of Local Government

Business License Taxes
FY 1994



Source: Department of Local Government

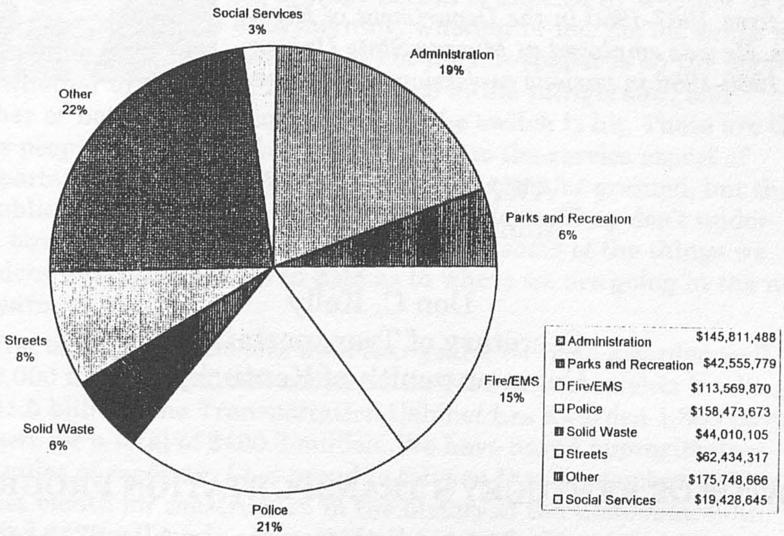
Local Property Taxes as a Percentage of Total Local Tax Revenues------1965-1992



Source: U.S. Advisory Commission on Intergovernmental Relations

Finally, let me just show you city expenditures—police, fire, and administration. We think that the number for street and solid waste is a little high, but those are the kinds of things cities pay for in order to make government operate.

City Expenditures
FY 1994



Source: Department of Local Government

I will leave you with the idea that, in many ways, the work of the Tax Commission has just begun. I think there are varying views on the part of the Tax Commission members as to how much success they think we will have in the 1996 session, but I feel very good about the fact that they have become more aware of the local government tax picture. I think that we are going to have to become more aware of it as it increasingly becomes a player, and work with the state government to implement some of what is happening at the federal level and being handed down. I hope that we can work together with our counties and our special districts to present an informative picture to our citizens and try to do something about this dissatisfaction with government. You and I both know that we often hear the citizen who comes to a public meeting and objects to a certain tax but will appear the next night at a public meeting and ask that funding not be cut to the local senior citizen center or that the potholes be fixed better or whatever. We need to do something about closing that gap in education.

Thank you very much.