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Taxation Causes Kentucky to Lag Tennessee in Growth

Stephen E. Lile
Western Kentucky University

Taxes and KY's Lagging Growth: Is There a Connection?

Stephen E. Lile*

Preliminary 2006 estimates place KY 46^th among the states in per capita income. More troubling than Kentucky's rank relative to California or Connecticut, however, is just how much ground KY has lost in recent decades to neighboring TN.

KY's lagging performance relative to TN's "jumps out" when KY population and economic figures are expressed as a percent of TN values. For example, in 1966 KY aggregate personal income was 86 percent of TN's but is now only 64 percent. KY's per capita income was 98 percent of TN's and is now 92 percent. KY's population was 82 percent of TN's but is now 70 percent.

Over three times as many people moved to TN as moved to KY between 2000 and 2005. Most of the 19 KY counties along the KY-TN border lost population to TN. The three largest population outflows were between Christian and Montgomery, TN (1,458), Allen and Macon, TN (206), and Calloway and Henry, TN (164).

What accounts for this? KY and TN are similar in terms of history, geography, climate, educational attainment, interstate highways, and in many other respects. We must look elsewhere for an explanation.

The major differences lie in labor law and taxation. TN is a right-to-work state; KY is not. TN has no "broad-based" income tax; KY depends heavily on the individual income tax and KY cities rely heavily on the occupational license tax.

In per capita tax, KY looks like a low tax state but, as Don Soule and I showed in a 1974 */Courier Journal/* piece, comparing states in this way is misleading. Our conclusion-- that states which appear as low-tax in terms of taxes per capita can, in fact, have above average family tax burdens--was reported in */The Wall Street Journal/* and elsewhere.

The following examples compare major 2007 taxes for a hypothetical family based on certain assumptions. Only the "big-three" taxes-- property, income, and sales—are shown. Exhibit 1 shows taxes for a couple with $200,000 income ($180,000 wage/salary income and $20,000 dividends and interest), a $300,000 house, and itemized deductions of $20,000.

Exhibit 1

$200,000 Couple

Property Income Tax _Sales _ Total

State Local State Local

Louisville $3,000 $10,423 $3,960 $1,251 $ -- $18,634

Nashville 3,483 1,050 --- 1,849 594 6,976

The Louisville couple pays about $11,600 more in taxes. A portion of the higher KY tax would be offset by lower federal income tax, assuming the couple itemizes deductions.

Exhibit 2 shows taxes for a middle income couple with a house valued at $100,000 and itemized deductions of $6,500. Taxes in Louisville are roughly twice the level in Nashville. Because a family with this income level is not likely to itemize, the higher KY tax burden is not reduced by lower federal income tax.

Exhibit 2

($50,000 Couple)

Property _Income Tax_ _Sales Tax_ Total

State Local State Local

Louisville $1,000 $2,296 $1,100 $633 $ --- $5,029

Nashville $1,161 --- --- 998 321 2,480

Business taxes are omitted, but families bear about the same amount of business taxes, regardless of where they live, because most of what they buy is produced out-of-state. Some other minor taxes are omitted, but no one can plausibly argue that the higher KY taxes shown here are offset by higher TN excise taxes on gasoline, cigarettes, or by any other tax levied in TN.

A recent story in Hopkinsville's */Kentucky New Era/* reports that "When soldiers are sent to Fort Campbell and briefed on the communities surrounding the military post, more than eight of 10 choose to turn right and live in Tennessee where there is no state or Clarksville city income tax." Lower taxes may not be the only reason, but taxes are likely a factor.

Kentucky is a poor state with a relatively low economic base and for these reasons policy makers face difficult choices. They can continue to emphasize income taxes out of equity concerns. But, this will result in more of the same: lagging economic growth. Or policy makers can follow TN's example by lowering personal taxes, the most visible of which is the personal income tax, and by increasing less visible consumption taxes and businesses taxes in an effort to spur economic activity and make KY more attractive to middle and high income people. Consumption and businesses taxes are also more likely to be exported to nonresidents. Tax exemptions are unwise (e.g. pensions or military pay) because they narrow the tax base and require higher marginal tax rates, the rates most likely to affect work-related decisions.

The tax comparisons presented here are suggestive. In a comprehensive statistical study matching similar states (such as KY and TN) and taking into account a variety of influences on growth, including education and physical capital, WKU colleagues and I find that nearly half of the 10 percent growth advantage for TN from 1997 to 2006 can be attributed to KY's higher tax burden, with labor law also contributing. Until tax policy and labor law change, KY's economy will likely continue to lag TN's and the majority of soldiers at Fort Campbell will make "right turns".

*The author is Professor of Economics at Western Kentucky University and is a past president of the Kentucky Economic Association.