KAED KENTUCKY ASSOCIATION for ECONOMIC DEVELOPMENT

A commonwealth of opportunity

POSITION STATEMENT
The Governor's Blue Ribbon Commission on Tax Reform

INTRODUCTION

The Kentucky Association for Economic Development (KAED) represents 386 economic development professionals across the Commonwealth. Economic developers are Kentucky's front line and first responders in the competitive global environment of recruiting job creation and capital investment through the attraction of new business development as well as the encouragement of existing business growth. No group outside of our state's business and industry leaders are more attuned to the needs and challenges of Kentucky's business climate, which is directly influenced by a diverse and complex variety of political, economic, cultural, social, geographic, regulatory, infrastructural, educational, and workforce issues. Kentucky's tax structure is but one aspect of these critical issues which impact its business climate.

The members of KAED speak with a united voice through our Board of Directors to address several aspects of needed reforms to Kentucky's tax code. The foundation of our position statement is a basic guiding principle: **Kentucky's tax code must encourage economic growth through job creation and capital investment.**

IS KENTUCKY'S TAX CODE COMPETITIVE?

For economic development professionals, the first and most critical standard of review for tax policy in today's economic development environment must be: **Is it competitive?** Kentucky's state, regional, and local economic developers are challenged by a "dog eat dog" level of competition on a global scale produced by a shrinking number of new business projects being pursued by increasingly aggressive competitor states and communities.

To achieve KAED's objective of economic growth through job creation and capital investment, Kentucky's environment for business development must be competitive. The Commonwealth's tax code is a primary factor considered by companies and site selection consultants in judging whether Kentucky is a favorable location for new business establishment or existing business expansion

KAED adopts the findings and analysis recently published by the Tax Foundation in collaboration with KPMG in *Location Matters: A Comparative Analysis of State Tax Costs on Business* (found at http://taxfoundation.org/article/location-matters). In that report, Kentucky ranked 18th overall for state tax costs on mature operations and seventh overall for newly-established operations. Kentucky's state-specific findings are found on page 102 of this report. These results show that Kentucky's tax structure is not as competitive as desired and is significantly less competitive for several key business sectors.

While Kentucky's tax structure fares better in most sectors with new firms locating in our state, we are creating our own business retention problem by taxing mature firms in a less competitive posture. We consider it an unsustainable paradox and a colossal waste of Kentucky's limited financial resources to successfully induce a new company to locate in our state with favorable tax implications, then to alienate that company with increasingly burdensome tax policies as that Kentucky firm matures. This is nothing less than a "bait and switch" scenario that forces mature firms to consider relocation from Kentucky to another state for more favorable tax policies.

An excerpt of the report's sector rankings for mature and new firms is shown below.

	Mature Firms	**New Firms**
Overall Competitiveness	18	7
Corporate Headquarters	12	6
Research & Development	35	9
Retail	17	6
Call Centers	13	12
Capital-Intensive Manufacturing	24	35
Labor-Intensive Manufacturing	17	11

We anticipate that the comparative analysis of Kentucky's revenue and revenue sources to be provided to the Commission from the University of Kentucky's Center for Business and Economic Research (CBER) will also demonstrate clearly that Kentucky's tax structure does not compare favorably to our competitor states.

TARGETED TAX REFORMS

KAED wishes to provide the Commission with politically realistic and tangible solutions for tax reforms that would be beneficial to Kentucky's economic growth through job creation and capital investment.

To that end, we are hesitant to propose solutions that would require the ponderous procedure of amending the state's constitution. However, we strongly recommend action on the following targeted items.

Inventory Tax: As confirmed in the Tax Foundation/KPMG analysis, Kentucky is one of the last nine (9) states in the Union to retain a state tax on inventory. We recommend its elimination.

Research and Development (R&D) Tax Credit: Also noted in the Tax Foundation/KPMG analysis, Kentucky is one of the few states that do not offer a R&D Tax Credit. We recommend that such as tax credit be established.

Property Tax:

a. *Local Municipal Exemption:* While we understand that any substantive reform regarding the state or local property tax would require an amendment to Section 170 of the Kentucky

Constitution, we do recommend the amendment of Kentucky Revised Statutes (KRS 92.300(1) to:

i. Add an exemption for the value of new construction additions resulting from an expansion;
ii. Add non-manufacturing establishments such as distribution centers, data centers, call centers, back offices, and corporate headquarters—following those now eligible under the Kentucky Business Incentive (KBI) program; and
iii. Extend the period of exemption from the current five (5) years to a period of 10-15 years to conform to incentive recovery periods established by KBI or the Kentucky Reinvestment Act.

b. *Private, Nonprofit Industrial Development Corporations:* As a representative of economic development organizations across the Commonwealth, KAED would be remiss not to mention the Kentucky Supreme Court's recent decision in *Floyd County Property Valuation Administrator v. Prestonsburg Industrial Corporation*, No. 2010-SC-000376-DG (Ky. Apr. 26, 2012). In this case, the Court decided that a private, nonprofit industrial development corporation was not a charitable organization for the purpose of Section 170 of the Kentucky Constitution, which exempts "institutions of purely public charity" from paying ad valorem taxes. Therefore, a private, nonprofit corporate entity historically known in Kentucky as an industrial foundation, industrial corporation, or economic development corporation will be subject to payment of state and local ad valorem taxes on real estate such as industrial or business parks that are developed by them for the public purpose of a community's business recruitment and job creation. We call upon the General Assembly at its next regular session to legislatively designate that the important public purpose served by private, nonprofit industrial development corporations in purchasing and developing land for business attraction, job creation, and capital investment should exempt these entities from ad valorem taxes on their real estate holdings.

Sales Tax:

a. *Technology Equipment:* Kentucky's current sales tax provisions disadvantage our state in consideration by data center, call center, and server farm projects because sales tax must be paid continually on the regular replacement of technology equipment required as a matter of course in those operations. We recommend the elimination of sales tax from purchase of equipment for data centers, call centers, and server farms to conform to the similar rule for manufacturing equipment. As an alternative, we suggest that the Kentucky Enterprise Initiative Act be amended to provide a sales/use tax refund for these expenditures.

b. *Local Option:* While Kentucky prides itself as a "home rule" state, there is very little tax discretion granted by the Kentucky Constitution or deferred by the General Assembly to the Commonwealth's local governments. Perhaps the fiscal burden of business incentives on state government could be reduced if counties and/or cities had the capability to levy a local sales tax, a percentage of which could be designated to local economic development programs and incentives. This has been a successful enterprise in Arkansas, Colorado, and Texas, where local governments and economic development agencies have significant financial resources to negotiate a deal.

TAX INCENTIVES

KAED recognizes that a study of possible tax reforms may trigger a review of Kentucky's tax incentives for business development. Let us be perfectly clear: **We reiterate our strong support for and our membership's daily reliance upon the current array of tax incentive programs administered by the Kentucky Cabinet for Economic Development.** In fact, it was by and through KAED's active legislative advocacy that the Incentives for a New Kentucky (House Bill 3) was passed in the 2009 Special Session. The sorely needed update and enhancement of state incentive programs made possible by House Bill 3 was essential to making Kentucky more competitive for recruiting new business investment and retaining existing business growth in a changing economic landscape.

For Kentucky's economic development community, the current array of state tax incentives is the bare minimum necessary to stay in the game. However, we actually need more creative, flexible, and aggressive financial incentives to win the game.

State tax credits recoverable over a period of years, such as the 10-15 year recovery afforded by the Kentucky Business Incentives (KBI) program or Kentucky Reinvestment Act (KRA), are just not as attractive or meaningful in a world in which companies seek up-front capital to minimize risk and start-up costs to seal the deal. In fact, forecasting 10-15 years into the future for any company in this economic climate and technological era may as well be a talent reserved for Nostradamus.

The winning feature of financial incentives today is **net present value**. Companies base their investment decisions on what is first a sound business case, but that decision is heavily influenced by the estimated impact of initial start-up and operation costs to the company's bottom line. States and communities that can directly reduce that cost impact have the ace up their sleeve.

We offer two possible solutions to address this issue:

Creation of a Deal-Closing Fund: The current trend in successful states is the creation and utilization of "deal-closing" funds such as the Texas Enterprise Fund, a summary of which may be reviewed at http://www.governor.state.tx.us/ecodev/financial_resources/texas_enterprise_fund. The closest program we have in Kentucky is the Economic Development (ED) Bond Fund, from which grants may be made by the Kentucky Economic Development Finance Authority (KEDFA) at the recommendation of Cabinet staff. Those grants are subject to contractual agreements in the same manner of other incentives, and are subject to repayment ("clawbacks") in the event job projections are not met.

However, the ED Bond Fund is insufficiently capitalized for Kentucky to compete with states that strategically use their deal-closing funds. One solution is to significantly increase ED Bond funding through the biennial budget process. However, a better option is to dedicate a percentage of the state corporate income tax or state sales tax to achieve a well-funded and competitive deal-closing fund for Kentucky.

Sale of Tax Credits: Kentucky could allow companies that are finally approved for state corporate tax credits under the state's incentive programs to sell those credits on the market to other companies that can utilize them to offset their state corporate tax liability. This would generate the

up-front capital that companies desire rather than opting to gamble that the credits may be ultimately used 10-15 years down the road. Other states, most recently Alabama, have authorized the sale of tax credits under limited circumstances.

CONCLUSION

Where KAED has identified problems of competitiveness in Kentucky's current tax structure, we have endeavored to provide realistic solutions informed by the practical experience of Kentucky's economic development practitioners in recruiting and retaining businesses. We offer our continued assistance and insight to the Commission as we work together to shape a tax policy for Kentucky that achieves our objective of encouraging economic growth through job creation and capital investment.