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WWW.KYPOLICY.ORG KCEP | 433 CHESTNUT STREET | BEREA, KENTUCKY 40403 | 859-986-2373

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# Kentucky Faces Serious Challenges with Next Budget

Lawmakers face a grim financial situation when they meet in January to craft a new budget for 2013 and 2014. The state has balanced recent budgets by pushing costs off to future years and by utilizing one-time measures. Deep budget cuts in a range of areas are leaving gaps in critical services. At the same time, the weak economy is resulting in only modest revenue growth. Without additional revenues through reforms of Kentucky's tax system, the state will continue to inadequately fund important areas like education, health and human services.

## 2012 budget has a large structural deficit

The state managed to patch together the budget for 2012 in part by enacting cuts to services. The budgets for most agencies were reduced eight percent from 2010 levels: 4.5 percent cuts made when the budget was enacted; 1.5 percent cuts in 2011 that carry forward to 2012; and additional two percent cuts totaling $29 million that were announced in November.

In addition, the state used a variety of one-time monies to close the budget gap for 2012. Those one-time sources present a problem in formulating the next budget, as new sources must be found or additional budget cuts made in order to close the structural deficit they create. One-time measures used in 2012 include:

- Utilizing a carry-forward balance of $133.1 million that will not be available in 2013.
- Delaying a $72 million payment on the last payroll of 2012 until the first day of 2013.
- Transferring $122.6 million in funds from a variety of other state funds into the General Fund.
- Restructuring debt to avoid $130 million in debt service payments in 2012, a move that pushed principal and interest costs off to future years.
- Adjusting the timing of bond issues to avoid an additional $57.9 million in debt service payments.
- Using $75.5 million in expected tax revenues that are above the previous official revenue estimate.[1]

## New expenditures will come due in 2013

In addition, the state will face new costs in 2013 that were not part of the 2012 budget. Those costs include:

**Additional payroll in 2013**
The delay of the last payroll of 2012 not only creates a structural imbalance of $72 million in the 2012 budget—it also adds an additional cost of $72 million to the 2013 budget. The net impact is $144 million because the state must make two extra payrolls in 2013 compared to 2012.

**Bigger payments to address pension liability**
The state must continue to make growing payments to the pension system to address its large liability, which was created by the legislature's past unwillingness to make required payments and by the huge decline in the financial markets during the last recession. According to analysis that accompanied pension reform legislation passed in 2008, the state must come up with an additional $26.4 million in new General Fund dollars every year to stay on track with the plan established in that bill.[2]

**Figure 1**

## Analysis of General Fund FY 2013

| | | |
|---|---|---|
| **Revenue** | | |
| **Additional revenue** | | |
| Projected growth in revenue | 212,900,000 | |
| *Subtotal* | *212,900,000* | |
| | | |
| **Other potential revenue sources** | | |
| Amount in the Budget Reserve Trust Fund | 121,800,000 | |
| Potential surplus for '12 (after $75.5 million used for '12 + coal severance distributions) | 30,000,000 | |
| *Subtotal* | *151,800,000* | |
| | | |
| **Expenditures** | | |
| **Ways in which FY 12 budget was out of balance** | | |
| Use of carry-forward | 133,113,900 | |
| Not paying last payroll of '12 | 72,000,000 | |
| Fund transfers | 122,659,600 | |
| Debt restructuring | 130,000,000 | |
| Debt service lapse | 57,900,000 | |
| *Subtotal* | *515,673,500* | |
| | | |
| **Additional expenditures state will face in '13** | | |
| 25 payrolls compared to 23 in 2012 | 72,000,000 | |
| Additional pension costs | 26,400,000 | Est. |
| *Subtotal* | *98,400,000* | |
| | | |
| **Other potential costs** | | |
| Unemployment insurance interest '12 (if no employer surcharge enacted & GF used) | 28,200,000 | |
| Unemployment insurance '13 (if no surcharge enacted & GF used) | 28,200,000 | Est. |
| *Subtotal* | *56,400,000* | |
| | | |
| **Growth in cost of current (FY '12) services** | | |
| Low estimate | 300,000,000 | Est. |
| High estimate | 600,000,000 | Est. |
| | | |
| **Difference** | | |
| *Net surplus/(deficit) without growth in cost of services* | *(305,773,500)* | |
| *Net surplus/(deficit) w/ cost of services low estimate* | *(605,773,500)* | |
| *Net surplus/(deficit) w/ cost of services high estimate* | *(905,773,500)* | |

Sources: KCEP calculations using data from Office of the State Budget Director, Legislative Research Commission

**Unemployment insurance interest costs**
Kentucky has not determined a way to pay interest due on unemployment insurance funds borrowed from the federal government after the state's trust fund ran out of money. The state borrowed money internally to write a $28.2 million check for the first payment in September 2011, and a similar-sized payment is due next year. But Kentucky has not yet identified a permanent source of funds to make those payments. In a KCEP brief, we recommend enacting an employer surcharge like 19 other states rather than taking monies from the already-oversubscribed General Fund. Past cuts in unemployment insurance taxes for employers are a major reason that the state trust fund ran out of money.[3]

**Cost of maintaining existing services**
Maintaining existing services in areas like education and health care requires additional dollars each year because of cost inflation. Unlike 22 other states, Kentucky does not produce an analysis of the cost of providing the current level of services in future years, so exact estimates are not available.[4] However, we know that drivers like health inflation, growth in consumer prices, population growth, and increases in the eligibility and need for services raise costs. In recent years, the state has reduced cost growth in public employee health insurance and hopes that Medicaid cost growth will slow due to the adoption of managed care. Nonetheless, those areas and others continue to be major cost drivers, and it is reasonable to assume that the state needs between $300 million and $600 million more in 2013 to pay for the same level of services provided in 2012.[5]

## Forecasted revenue growth is meager and economic outlook is troubling

On top of additional costs, revenue growth is very modest. The new projections from the Consensus Forecasting Group—the independent body that produces state revenue estimates—indicate that Kentucky will have only $213 million more for 2013 above the official estimate for 2012, an increase of 2.4 percent.[6] Among the expected trends in revenue sources are:

- Modest growth in the individual income tax and sales tax because of the sluggish economy.
- Some leveling of growth in corporate taxes and coal severance taxes after a few years of strong receipts driven by large corporate profits and high coal prices.
- Continued decline in the cigarette tax as consumption falls.
- Weak growth in property taxes because of the fallen housing market.
- Ongoing modest growth in lottery revenues.

The structural problems with Kentucky's tax system exacerbate these revenue challenges. An outdated sales tax that doesn't apply to services means an eroding sales tax base that prevents revenues from keeping pace with economic growth. Loopholes and growing tax breaks enable too many corporations to avoid payment of corporate taxes. And unwillingness to both address tax deductions that tend to benefit higher-income Kentuckians and create a more graduate income tax rate structure limit the response of revenue to income growth.

The decline in fiscal support from the federal government is another important factor in the bleak revenue outlook. The American Recovery and Reinvestment Act provided over $3 billion to help Kentucky balance its budget, create jobs and meet emerging needs during the recession. That money has run out, and Congress is not poised to provide additional support at this time despite the continued budget gaps. Instead, Congress is making cuts to the federal budget as part of the deficit reduction debate. Cuts reduce funds for education, human services, health care and other areas and have a direct impact on the state's ability to provide services.[7] According to one estimate, the automatic cuts that will start next year because of the failure of the Supercommittee to agree to a deficit reduction package will reduce federal funds to Kentucky by $128.9 million in 2013 compared to 2012.[8]

The only bright news in the state's revenue picture is that receipts are slightly above the previous official forecast for 2011 and 2012. Kentucky was able to deposit $122 million into the state's rainy day fund at the end of 2011. Current forecasts are that the state will end 2012 with $136.5 million more than the

previous official forecast, although an estimated $31 million is automatically dedicated to coal severance tax funds and, as mentioned previously, $75.5 million is already being claimed to close the 2012 budget gap, leaving a potential surplus of $30 million.

## More budget cuts would be on top of previous deep cuts

As Kentucky faces a large gap in crafting the 2013-2014 budget, state leaders should recognize that any new budget cuts would come on top of substantial cuts made over the last few years. The agencies targeted in November for cuts of an additional two percent are the same programs that were targeted for previous reductions; these agencies are listed in the Appendix. Many agencies have been cut more than 20 percent from round after round of cuts (as seen in Figure 2). Including cost drivers in these calculations, like inflation and growth in eligibility, reveals an even more troubling picture. For example, as described in a recent KCEP research brief, inflation-adjusted per student spending on higher education is 23 percent lower in 2012 than in 2008.[9]

**Figure 2**

**Cuts to Selected Agencies 2008-2012**

| | 2008 Enacted | 2012 Revised (with 2% cuts) | Percent Change | Dollar Difference |
|---|---|---|---|---|
| **Attorney General's Office** | 14,113,100 | 10,537,450 | -25% | (3,575,650) |
| **Behavioral Health** | 194,117,600 | 181,941,100 | -6% | (12,176,500) |
| **Board of Elections** | 4,861,900 | 3,891,200 | -20% | (970,700) |
| **Comm. for Children w/ Spec. Health Needs** | 5,917,000 | 4,836,006 | -18% | (1,080,994) |
| **Commission on Human Rights** | 1,859,100 | 1,670,214 | -10% | (188,886) |
| **Commission on Women** | 266,200 | 205,800 | -23% | (60,400) |
| **Department of Community Based Services** | 341,633,700 | 312,749,600 | -8% | (28,884,100) |
| **Dept. of Career and Technical Education** | 29,894,500 | 25,194,918 | -16% | (4,699,582) |
| **Div. of Child Abuse & Domestic Violence Services** | 6,869,700 | 5,229,700 | -24% | (1,640,000) |
| **Division of Conservation** | 2,504,200 | 2,075,542 | -17% | (428,658) |
| **Division of Water** | 11,965,300 | 10,032,750 | -16% | (1,932,550) |
| **K-12 Education (non-SEEK, non-health ins.)** | 403,659,771 | 307,638,758 | -24% | (96,021,013) |
| **Kentucky Arts Council** | 4,182,500 | 2,984,198 | -29% | (1,198,302) |
| **Kentucky Educational Television** | 16,816,100 | 11,863,684 | -29% | (4,952,416) |
| **Kentucky Nature Preserves Commission** | 1,166,500 | 1,010,282 | -13% | (156,218) |
| **Libraries and Archives** | 14,689,300 | 11,076,744 | -25% | (3,612,556) |
| **Pre-School** | 75,127,000 | 71,806,300 | -4% | (3,320,700) |
| **Public Health** | 73,823,000 | 60,086,250 | -19% | (13,736,750) |
| **State Police** | 80,305,900 | 64,195,194 | -20% | (16,110,706) |

Source: KCEP calculation using data from Office of the State Budget Director

The cumulative result of these cuts will be felt more deeply now that the Recovery Act monies have dried up. It would cost well over a billion additional General Fund dollars to provide 2008 level of services in 2012.

Rolling back cuts made over the last few years would be a monumental task, but even that wouldn't address longstanding and widely recognized deficiencies in Kentucky's funding for key programs and

services. Financial aid to help students address rising college tuition is underfunded, and in Kentucky two-thirds of those who qualify for need-based financial aid do not receive any support.[10] The state has limited access to early childhood education and does not pay the costs of full-day kindergarten despite widespread evidence of the economic and child development benefits of early care.[11] The Medicaid program does not cover drug treatment even with Kentucky's huge addiction problem. And funding for a wide range of other programs—from state parks to mental health, child protective services, and the judicial system—has been frozen or underfunded for many years.

## How Kentucky can move forward

Many of the temporary fixes that balanced the budget in past years have worsened the state's financial situation. New costs for the 2013-2014 budget include expenditures carried over from previous years. Dollars now in the rainy day fund are easily used up to fill the budget gap; the state revenue outlook is very modest; and additional federal support cannot be expected. Even maintaining existing services, which are inadequate, would require additional funds due to cost inflation.

In order to overcome these considerable budget challenges, Kentucky should work toward long-term solutions. Cutting the budget even more takes dollars out of an economy still struggling with high unemployment, and shrinks services that are especially needed at this time. Kentucky's approach to the budget crisis of the last few years has been too narrowly focused on budget cuts to the exclusion of new revenue with the exception of cigarette and alcohol tax increases in 2009. In his inaugural address, Governor Beshear called for tax reform to make a better future possible for Kentuckians. The state should move forward on comprehensive tax reform during this legislative session in order to both address long-standing structural revenue problems and ease this year's budget pressures.

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*The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the Commonwealth. Launched in 2011, the Center is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website at www.kypolicy.org.*

# Appendix:
# State Agencies Subject to Additional Two Percent Budget Reductions

**General Government**
Office of the Governor
Office of State Budget Director
State Planning Fund
Homeland Security
Veterans' Affairs
Governor's Office for Agricultural Policy
Kentucky Infrastructure Authority
Military Affairs
Commission on Human Rights
Commission on Women
Department for Local Government
Area Development Fund
Secretary of State
Attorney General
Treasury
Agriculture
Auditor of Public Accounts
Personnel Board
Accountancy
Architects
Auctioneers
Chiropractic Examiners
Dentistry
Embalmers and Funeral Directors
Licensure for Prof. Engineers and Land Surveyors
Hairdressers and Cosmetologists
Medical Licensure
Nursing
Pharmacy
Physical Therapy
Real Estate Appraisers
Real Estate Commission
Kentucky River Authority
School Facilities Construction Commission

**Health and Family Services Cabinet**
General Admin and Program Support
Children with Special Health Care Needs
Income Support
Public Health
Health Policy
Family Resource Centers & Volunteer Services
Aging and Independent Living Services

**Justice and Public Safety Cabinet**

**Economic Development Cabinet**
Secretary
Business Development
Financial Incentives

**Department of Education**
Executive Policy and Management
Operations and Support Services
Learning and Results Services

**Education & Workforce Development Cabinet**
General Administration and Program Support
Deaf and Hard of Hearing
Kentucky Educational Television
Environmental Education Council
Libraries and Archives-General Operations
Libraries and Archives-Direct Local Aid
Office for the Blind
Employment and Training
Career and Technical Education
Vocational Rehabilitation
Education Professional Standards Board

**Energy and Environment Cabinet**
Office of the Secretary
Environmental Protection
Natural Resources
Energy Development and Independence
Environmental Quality Commission
Ky Nature Preserves Commission
Public Service Commission

**Finance and Administration Cabinet**
General Administration
Controller
Facilities and Support Services
Commonwealth Office of Technology
Revenue
Property Valuation Administrators

**Tourism, Arts, and Heritage Cabinet**
Office of the Secretary
Artisans Center
Travel
Arts Council
Kentucky Historical Society

Justice Administration
Criminal Justice Training
State Police
Corrections Management
Local Jail Support

**Labor Cabinet**
Workplace Standards
General Administration and Program Support

**Personnel Cabinet**
State Group Health Insurance Fund

**Postsecondary Education**
Council on Postsecondary Education

Fish and Wildlife Resources
Ky Center for the Arts
Kentucky Heritage Council

**Transportation Cabinet**
General Administration and Support
Aviation
Public Transportation
Vehicle Regulation

**Public Protection Cabinet**
Office of the Secretary
Boxing and Wrestling Authority
Alcoholic Beverage Control
Charitable Gaming
Housing, Buildings and Construction
Board of Claims/Crime Victims' Compensation
Financial Institutions
Insurance
Board of Tax Appeals
Horse Racing Commission

Source: Office of the State Budget Director

[1] 2010-2012 Budget of the Commonwealth General Fund Summary as Revised by the 2011 Special Session, http://www.osbd.ky.gov/NR/rdonlyres/C15D23D5-F86E-475B-A6A5-A9595AEE6C5D/0/GeneralFundrevisedbalancesheetfrom2011SpecialSession.pdf.; Mary Lassiter, "FY 11 Year-End Financial Report," Presentation to the Interim Joint Committee on Appropriations and Revenue, July 28, 2011, http://www.osbd.ky.gov/NR/rdonlyres/C5550F60-B314-43B2-9A1D-EBD57A3B9CB2/0/ARFY11YearEndPresentation110728.pdf.; Kristi Culpepper, "Kentucky's Bonded Indebtedness," Memorandum to the Interim Joint Committee on Appropriations and Revenue, September 22, 2011; Mary Lassiter, "FY 12 Budget Balancing Measures," Presentation to the Interim Joint Committee on Appropriations and Revenue, November 29, 2011, http://www.osbd.ky.gov/NR/rdonlyres/12E2E5EA-1B65-46C2-960B-31053B5726DF/0/111129PresentationtoAR.pdf.

[2] HB 1 08 SS, http://www.lrc.ky.gov/record/08ss/HB1.htm.

[3] Kentucky Center for Economic Policy, "Unemployment Interest Payments are Employer Responsibility," January 11, 2012, http://kypolicy.org/kentucky-re-enact-surcharge-pay-unemployment-interest/.

[4] Elizabeth McNichol and Dylan Grundman, "The Current Services Baseline: A Tool for Understanding Budget Choices," Center on Budget and Policy Priorities, October 21, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3602.

[5] Maintaining recent slower growth rates in employee health care costs would mean finding $121 million in new money in 2013, while keeping cost growth in Medicaid to five percent would mean locating $69 million in new funds. Maintaining funding for the rest of General Fund-financed services at a growth rate of four percent (inflation plus population growth) would mean identifying approximately another $250 million, for a total of $440 million. $300-$600 million represents an overall growth range of three to seven percent.

[6] Projection for 2013 is $212.9 million above the revised official estimate for 2012, as indicated in Figure 1. Materials from the Consensus Forecasting Group meeting, December 21, 2011.

[7] See Kentucky Center for Economic Policy, "What Will the Debt Ceiling Cuts Mean for Kentucky?," August 2, 2011, http://kypolicy.org/will-debt-ceiling-cuts-mean-kentucky/.

[8] Federal Funds Information for States, "State-by-State Analysis of BCA Sequester," Special Analysis 11-06, December 2, 2011.

[9] Kentucky Center for Economic Policy, "State Has Cut Education Funding Substantially from Pre-Recession Levels," October 11, 2011, http://kypolicy.org/state-cut-education-funding-substantially-pre-recession-levels/.

[10] See Jason Bailey and Melissa Fry Konty, "The College Affordability Crunch in Kentucky," Kentucky Center for Economic Policy, November 2, 2011, http://kypolicy.org/college-affordability-crunch-kentucky/.

[11] The Governor's Task Force on Transforming Education in Kentucky recommended providing state funding for full-day kindergarten and providing pre-school for three and four year-olds with family income up to 200 percent of the poverty level. The cost for those two items is estimated at $212 million annually. "Breaking New Ground: Final Report of the Governor's Task Force on Transforming Education in Kentucky," February 2011, http://kytech.ky.gov/TEK_final_report_draft.pdf.