OUR COMMONWEALTH:

A PRIMER ON THE KENTUCKY STATE BUDGET

KCEP
KENTUCKY CENTER for ECONOMIC POLICY

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The Kentucky Center for Economic Policy is a nonprofit, 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 on MACED, visit www.maced.org.

WHY THE BUDGET MATTERS

The Budget of the Commonwealth is a financial plan, enacted every two years by Kentucky's General Assembly, that maps out the state's investments in education, health, transportation, public safety, human services and other areas that build a strong state economy. As such, the budget is a statement of Kentucky's priorities: How we invest in Kentuckians of all ages and stations in life reflects our commitment to flourishing communities today and to a brighter economic future tomorrow.

This primer covers the basics of the Budget of the Commonwealth: where money comes from, how it is spent, and the people and processes that determine both. The primer also examines Kentucky's fiscal health: Is there enough money to pay for the public services that make Kentucky a good place to live, work and raise families, that empower homegrown entrepreneurs and attract people to our state? What priorities and values are reflected in the budget decisions lawmakers have made?

Finally, we hope this primer makes the case for why each of us should care about the Budget of the Commonwealth: It is a powerful document, backed by the force of law, that details how our decision makers carry out their charge to invest responsibly and build shared prosperity. By grasping the basics, we can be better citizen advocates for a healthy budget that supports a great state.

Kentucky's seal is a good reminder of our common destiny.

WHERE THE MONEY COMES FROM

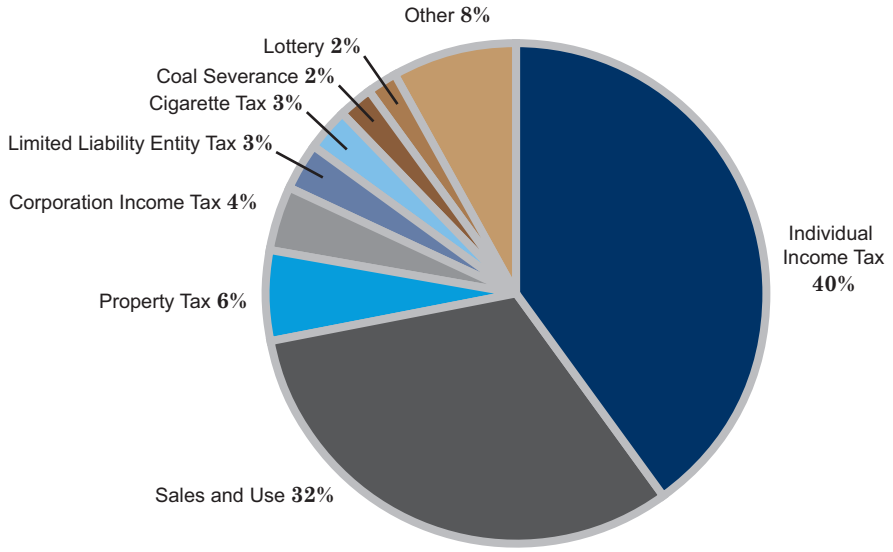
The resources Kentucky has to invest in its people come from a variety of taxes and other revenue sources that are broadly categorized as **General Fund revenue, Road Fund revenue, restricted funds, federal funds and Tobacco Settlement funds**. General Fund revenue and federal funds each account for more than a third of Kentucky's available revenue, restricted funds another fourth, the Road Fund about five percent, and Tobacco Settlement money less than one percent.

CONTRIBUTION OF REVENUE FUNDS TO THE BUDGET OF THE COMMONWEALTH, 2013 (BILLIONS)	
Federal Funds	$10.1
General Fund	$9.6
Restricted Funds	$7.4
Road Fund	$1.5
Tobacco Settlement Funds	$0.1
	Total $28.7

Numbers, which include carry forward balances from previous years, are based on estimates in the enacted 2012-2014 Budget of the Commonwealth.

The **General Fund** is Kentucky's primary pool for revenue generated within the state, largely by taxes. This money is used to carry out numerous responsibilities, including education, human services and health care. **Individual income tax and sales tax are the two largest single sources of state tax revenue** and together comprise nearly three-fourths of General Fund revenue. Other sources, shown in the pie graph below, include property taxes and taxes on cigarettes, coal mining and corporate income.

Revenue Sources as Shares of the General Fund, 2013
Total: $9.3 Billion



Numbers are based on actual receipts from Fiscal Year 2013.

Why does Kentucky have so many different taxes? Just like a healthy retirement fund consists of diverse investments, we need different kinds of taxes to ensure stable funding of schools, health care, public safety and other priorities as the economy changes. A diversity of taxes also keeps the state from relying too heavily on one source of revenue.

The **Individual Income Tax** is essential to ensuring that Kentucky has enough resources to fund our schools and other priorities. It is the largest single source of revenue and is also the most productive tax over time, accounting for 89 percent of General Fund revenue growth from 2007 through 2013. A progressive income tax with higher rates for higher-income people is especially important, as it taxes people based on their ability to pay.

Income	KY Income Tax Rate
$0-$3,000	2%
$3,001-$4,000	3%
$4,001-$5,000	4%
$5,001-$8,000	5%
$8,001-$75,000	5.8%
$75,001 +	6%

Road Fund: Road Fund revenue is invested in Kentucky's highways and bridges. The motor fuels tax comprises more than half of Road Fund revenue, with the motor vehicle usage tax (a tax on car purchases) contributing about another third.

Federal Funds: The federal government disperses grant funds and other forms of assistance to states for a variety of purposes, such as Title 1 funds for poor schools, the National School Lunch Program, Temporary Assistance to Needy Families, Medicaid, Head Start and more. While some of the funding is based on the number of eligible recipients in Kentucky, other amounts are decided by Congress.

Tobacco Settlement Fund: A legal settlement between major tobacco manufacturers and states, known as the Master Settlement Agreement, set up annual payments from tobacco companies to states for costs associated with tobacco-related illness. Payments to Kentucky have totaled $1.6 billion since 2001.

Restricted Funds: This money is collected by state agencies through fees, tuition and other charges. Although funds are legally designated for particular purposes, the legislature sometimes repurposes them for General Fund use.

Rainy Day Fund: When Kentucky faces a budget deficit, cash reserves in the state's rainy day fund can be used to help limit cuts. By law, a portion of any General Fund surplus at the end of the year goes into the rainy day fund. The state can also appropriate money to the fund in good economic times.

Factors affecting revenue in Kentucky: By determining what the state taxes and the rate at which things are taxed, Kentucky's tax laws directly impact the amount of revenue the state has to do its work. Economic conditions are also a major factor in the amount of revenue Kentucky has available. When the economy is sluggish, for example, low employment and depressed consumer demand can drive down income and sales tax revenue. When the federal government cuts federal funds to states, it means fewer resources for services the state provides.

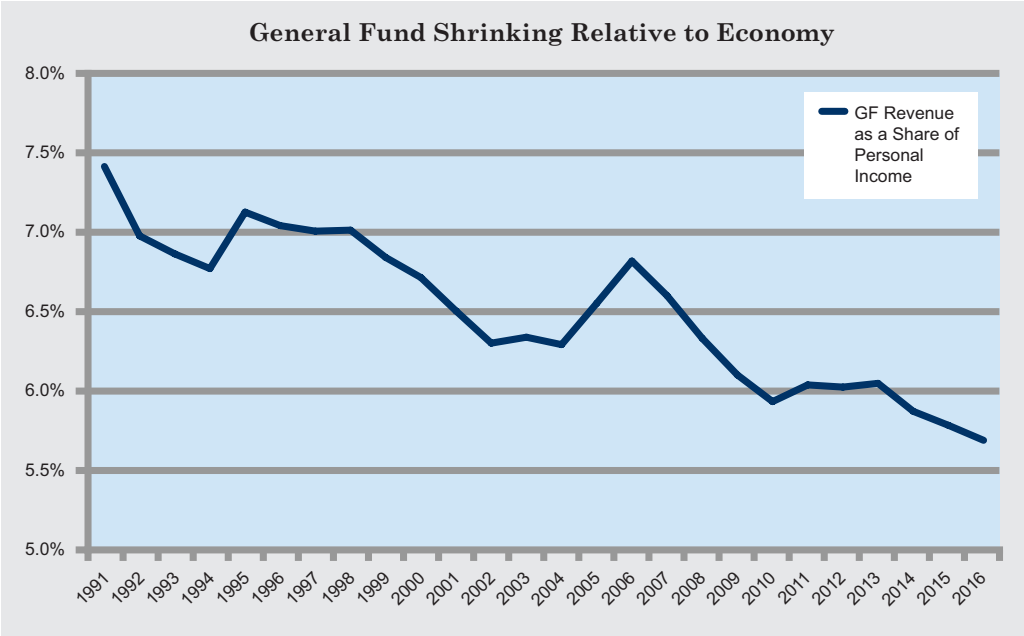
Why Should Revenue Grow With the Economy?
When revenue grows with the economy, the state can continue to provide a certain level and standard of services to Kentuckians. But when revenue declines relative to the economy, the state's ability to sustain quality education, health care, human services and public protection shrinks. That means less money for things that matter to all Kentuckians.

ENSURING A HEALTHY, RESPONSIBLE BUDGET

Because Kentucky's budget must be balanced—meaning the state cannot spend more than it takes in—the General Assembly has to pay attention to both the revenue and spending sides of the budget. Here are some important things to consider about Kentucky's ability to meet the needs of its residents through the budget.

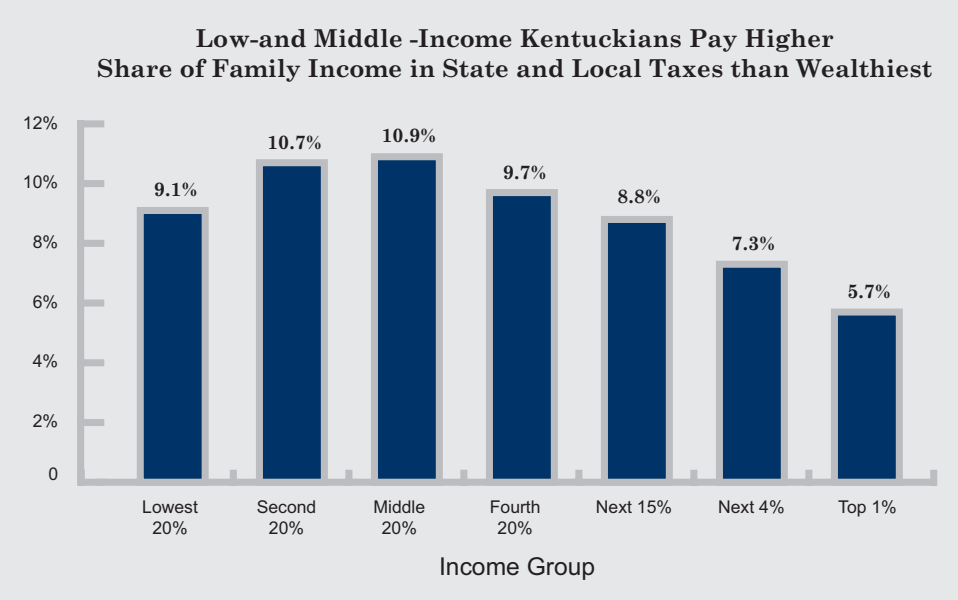
Does the state have enough revenue to invest in the public services that matter to all Kentuckians? Kentucky is not generating enough revenue to meet its needs; funding for public schools is so low that Education Week gave the state a grade of F for spending in its 2013 Quality Counts report. Public service areas ranging from mental health to need-based college aid have been deeply underfunded for many years. Instead of using a balanced approach to shortfalls that includes new revenue, **lawmakers have relied heavily on cuts, reducing the state budget by $1.6 billion in the last six years**.

Is revenue growing with the economy? General Fund revenue is declining as a share of the state's economy. The trend is expected to continue based on economic projections. Without modernizing the state's tax code, Kentucky will not have the revenue it needs to sustain investments in schools, workforce development and other public services, even at current levels that fall far short of meeting the needs of families, individuals and communities.



Are revenue sources diverse and broad-based? Despite levying a variety of taxes, Kentucky struggles to derive enough revenue from them because of a variety of exemptions, exclusions, credits and other aspects of the tax code that result in lost revenue. For instance, the sales tax does not apply to most services—a growing part of the economy—and income tax loopholes keep some businesses and individuals from contributing their share. These tax breaks are often called tax expenditures because they have the same effect as spending on the state budget (see page 9 for more on tax breaks).

Are Kentuckians taxed their fair share based on ability to pay? Low- and middle-income Kentuckians pay between nine and eleven percent of family income in state and local taxes, but the very wealthiest Kentuckians pay less than six percent. Even though all people and businesses benefit from good schools and safe and healthy communities, not all contribute their share to these investments.



THE BUDGET PROCESS

Who decides what and how Kentucky invests in school textbooks, bridges, public health departments and new police cars? What does that process look like? The big picture looks like this: In even-numbered years, the General Assembly creates a two-year Budget of the Commonwealth. Here's a closer look at the budget process.

KEY PLAYERS

CONSENSUS FORECASTING GROUP	The CFG is a non-partisan group of economists that works with the Office of the State Budget Director (OSBD) and the Legislative Research Commission (LRC) prior to the budget session to develop the official revenue forecast.
OFFICE OF THE STATE BUDGET DIRECTOR	The OSBD provides analysis of policy, economic and budget issues facing the state; it also supports and manages the budget process.
CABINETS, DEPARTMENTS AND OFFICES	State agencies—for example the Cabinet for Health and Family Services, the Department of Education, and the Attorney General—identify budget needs within different areas of government and present budget requests to the Governor, Chief Justice, LRC and the legislature during the budget review process.
GOVERNOR	The Governor, who presents the executive budget proposal, has the authority to veto particular spending items in the budget bill passed by the legislature.
BRANCH HEADS	Kentucky's Governor, Chief Justice and LRC are responsible for budget proposals for the executive, judicial and legislative branches of government, respectively.
THE GENERAL ASSEMBLY	Comprised of 38 Senators and 100 House Representatives, the legislature is given exclusive power by the state constitution to tax and spend, the primary obligation to pass a budget and the power to override the governor's budget vetoes.
LEGISLATIVE RESEARCH COMMISSION	In addition to proposing the legislative branch budget, the LRC provides research, technical and administrative support to the General Assembly in the budget process.
APPROPRIATIONS AND REVENUE COMMITTEES	These committees, including budget review subcommittees, develop House and Senate budget proposals for consideration by the full General Assembly.
CITIZENS	Kentuckians vote legislators into office and pay the taxes that fund a good portion of the budget. Citizen advocates can also influence the budget process by speaking out publicly, lobbying and reaching out to legislators at home.

TIMELINE

1 PREPARING FOR THE BUDGET SESSION

APRIL	State agencies submit six-year plans for improving old structures and building new facilities to the Capital Planning Advisory Board.
JULY	The LRC issues budget instructions and forms to state agencies.
AUGUST	The OSBD and CFG issue a budget planning report with economic projections and preliminary revenue estimates for the General Fund and Road Fund in the coming budget biennium (a two-year period).
SEPTEMBER	The Finance and Administration Cabinet issues budget instructions and forms to the executive, legislative and judicial branches as well as the Transportation Cabinet to create their budget recommendations.
OCTOBER	The OSBD and CFG refine their August forecast and provide a preliminary revenue estimate that is the basis for budget planning. State agencies estimate their own restricted funds and federal funds.
NOVEMBER	The Capital Planning Advisory Board presents its six-year state capital improvement plan to the Governor, Chief Justice and LRC. Agencies submit budget requests to branch officers. Proposals are based on funding needed to continue current levels of service and additional funding for new or expanded services.

2 THE BUDGET PROCESS OF THE GENERAL ASSEMBLY

DAY 1	DAY 10	DAY 15	SIX WEEKS
The legislative session begins on the first Tuesday after the first Monday in January.	By the tenth legislative day, the Governor, Chief Justice and LRC submit their budget proposals to the General Assembly. At this time, the Governor gives the budget address.	By the fifteenth day, the OSBD and CFG present the state's official revenue forecast.	Appropriations and Revenue Committees (including six subcommittees in the House and one full Senate panel) review budget proposals and make alternative proposals. Hearings are conducted in the House over a six-week period. Agencies and, at times, members of the public testify about budget needs. The LRC provides committees with documents comparing agency budget requests with recommendations from the Governor, Chief Justice and LRC.

3 AFTER THE BUDGET IS PASSED

Every three months, the OSBD compares the official revenue forecast on which the budget was based to actual and projected receipts for the General and Road Funds. The findings allow agencies to plan for budget reductions if revenue is lower than expected.

State law provides for some revisions that can be made to the budget after it is passed. Interim budget reductions, requests to spend surplus federal or restricted funds, natural disaster spending and other budget adjustments during the fiscal year are reviewed by the Interim Joint Committee on Appropriations and Revenue.

The House Appropriations and Revenue Committee amends and passes a budget which is then brought before the full House for a majority vote (51 representatives must vote for the bill for it to pass).

The House-passed bill moves to the Senate, where substitutes or amendments are made before the Senate's version of the budget is passed.

Differences between the House and Senate budget bills are worked out in conference committee. With a majority vote in both chambers, the legislature passes the new budget bill.

At this point, the Governor has three options: to sign the bill into law, let it become law without signing or veto aspects of the bill. The legislature can override vetoes with a majority vote in both chambers.

The budget bill becomes law and is effective for the biennium.

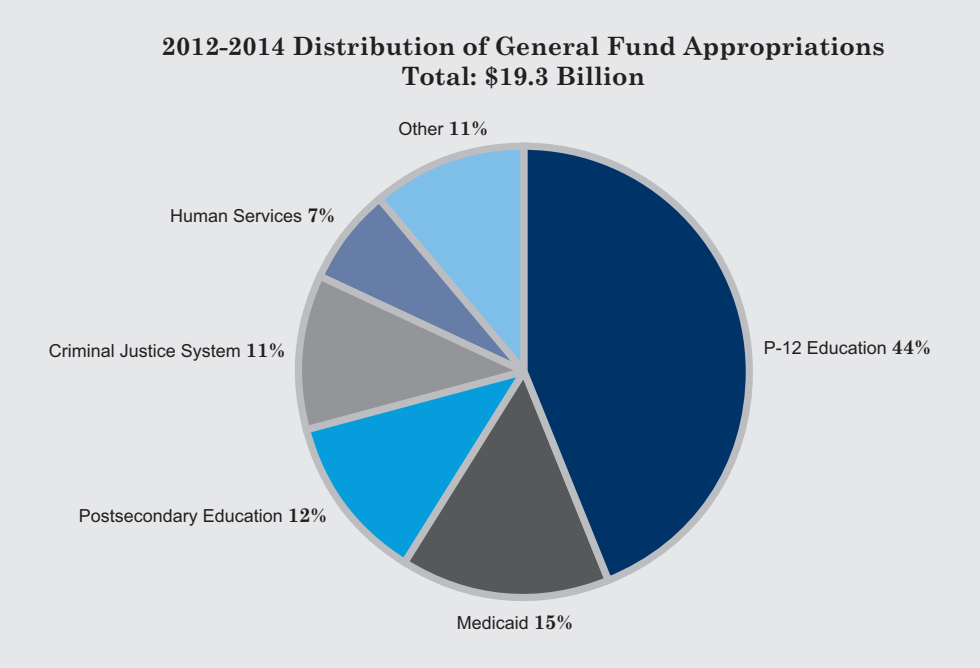
After the session, the LRC produces a conclusive budget memorandum that details the last steps of the budget process and explains the differences between final appropriations and budget recommendations made by the Governor, Chief Justice and LRC.

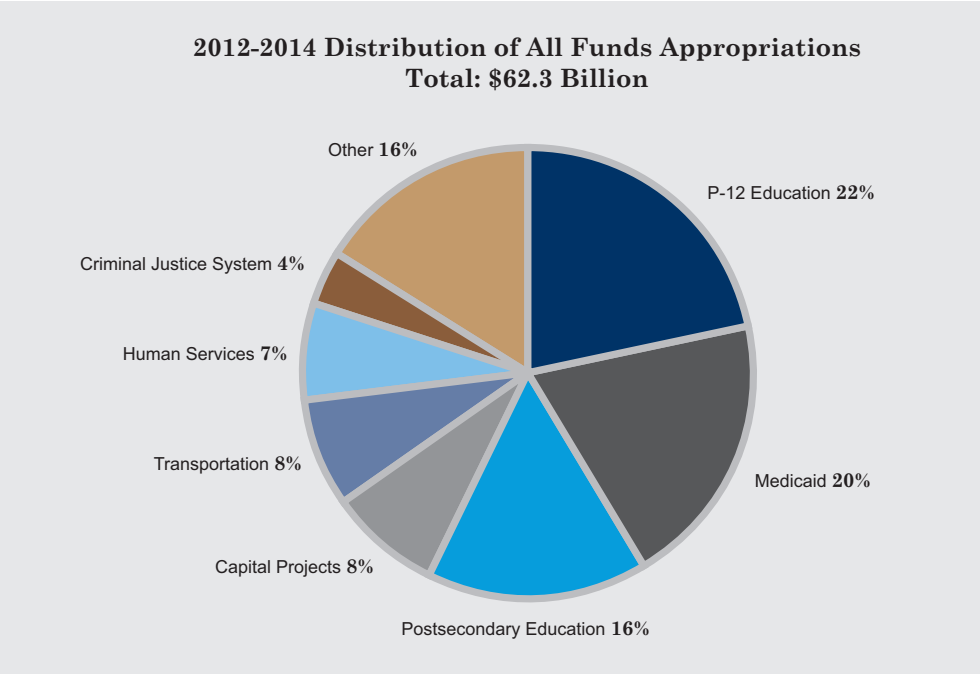
WHERE THE MONEY GOES

Once revenue is collected and appropriated, billions of tax dollars and other revenues are put right back into the state's economy.

Since the General Fund is Kentucky's main revenue pool, General Fund appropriations are a good place to examine how the state spends Kentucky tax dollars. Taken together, **spending on P-12 education and post-secondary education comprises more than half of General Fund spending**.

The remaining funds are split between Medicaid; criminal justice, which includes juvenile justice, the state police and corrections; human services programs like women's health, aging and independent living and child care support; and other programs such as tourism promotion, workforce development, and energy and the environment. Agricultural development, educational television (KET), libraries and parks are just a few more of the public services that make Kentucky a great place to live.





Taking the General Fund, Road Fund, Federal, Restricted and Tobacco Settlement Funds together, spending on education and health still comprises more than half of the state budget, with capital improvements, transportation, human services, criminal justice and other services comprising the rest.

Of the total resources invested in the largest category of spending, P-12 education, **63 percent went to the state's core funding for students** (Support Education Excellence in Kentucky); 30 percent to improving learning and performance through programs such as extended school services, teacher professional development and preschool; and seven percent to administrative, technological and other support services for schools.

DIVERTED RESOURCES

More than 250 tax expenditures —deductions, exemptions, credits and other tax giveaways—drained about $14.8 billion from the General Fund in 2013. Unlike budgeted items which go through the appropriations process and are subject to cuts, tax breaks are written into the tax code and do not undergo routine evaluation by lawmakers for their costs and benefits to the state.

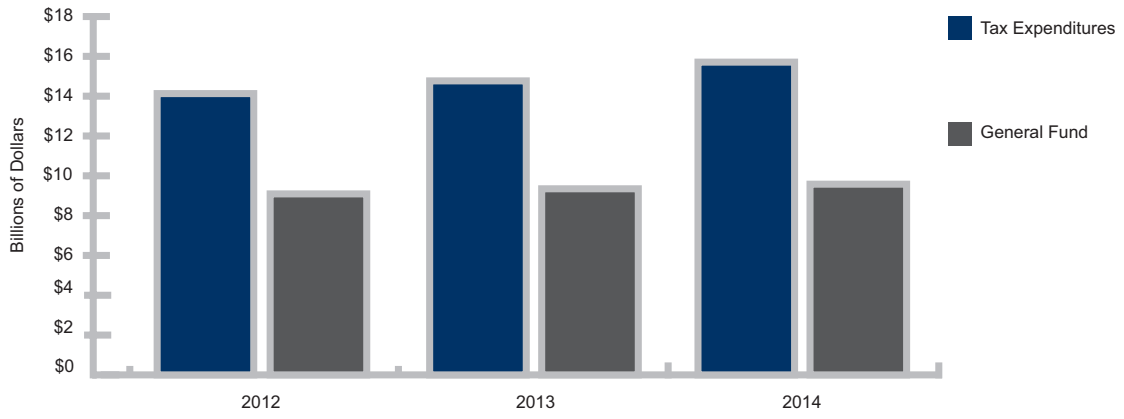
Special interest groups would like Kentuckians to buy into the idea that tax breaks attract business and individuals to our state and create jobs. But because state taxes are a very small portion of business costs and a negligible consideration in determining where to locate, tax breaks pay for decisions businesses and people probably would have made anyway. The revenue they drain from the budget leaves fewer resources to invest in the things that really matter to businesses—an educated workforce, good roads, state-of-the-art technology, strong public safety and court systems, and healthy communities. As the state whittles down spending on public health nurses, student financial aid and teacher training, tax breaks—many of which primarily benefit people at the top of the income scale—go unchecked.

A 2013 shortfall in funding for the Department of Community Based Services led to **child care subsidy cuts** for thousands of working poor families in Kentucky. Parents who no longer receive child care assistance are forced to choose between keeping their jobs and leaving their children in lower-quality care settings, while child care centers are struggling from decreased enrollment. Since the cuts, hundreds of centers have shut their doors. The harm to Kentucky will compound in the long run as children receive lower-quality care at a crucial developmental stage and as childcare options shrink for communities overall.

SHRINKING INVESTMENTS

Kentucky has made great strides over the last century thanks to investments through the state budget that have built a better Kentucky, one school, road and healthy community at a time. But in recent years, the state has lost ground and faces losing more. As revenue shrinks in proportion to Kentucky's economy, the government is less able to educate the state's current and future workforce, keep its people healthy and invest in the public goods and services that make Kentucky a good place to live and do business. The resulting budget cuts are harmful to individuals and the state's economy as a whole.

Tax Expenditures are Growing, Draining Revenue from the General Fund



A BALANCED APPROACH TO THE BUDGET

A budget that meets Kentucky's needs for good schools, quality health care and safe communities requires adequate resources. State lawmakers have relied too heavily in recent years on spending cuts in an attempt to make ends meet, sacrificing those key services and harming Kentucky's people and its economy, both today and in the long-term. We owe it to the next generation of Kentuckians to figure out how to invest in these areas. Kentucky needs tax reform that eliminates costly, ineffective tax breaks, brings our tax code into the 21st Century economy and equips the state with the resources it needs to do its important work.

Photo by Shawn Poynter/Rural Archive.

FURTHER READING

Visit www.kypolicy.org to download "Our Commonwealth: A Primer on the Kentucky State Budget," where you can access links to the following resources.

Budget of the Commonwealth: On the State Budget Director's webpage, you can download budget documents, including the full biennial Budget of the Commonwealth.

Tax Expenditure Report: Kentucky's biennial tax expenditure report allows you to see what tax breaks exist, and how much they cost the state.

Legislative Research Commission: The LRC webpage provides information on current legislative activity, profiles of state senators and representatives and basic information about the General Assembly. It also contains a full version of Kentucky laws.

The Center on Budget and Policy Priorities: CBPP is a national think tank that works on federal and state level policies and programs that affect low- and moderate-income families and individuals.

"Reinvestment or Retrenchment? A Preview of the 2014-2016 Kentucky State Budget," Kentucky Center for Economic Policy.

"What Tax Reform Should Include," Kentucky Center for Economic Policy.

"Reforms Needed to Bring Greater Scrutiny to 'Tax Expenditures'," Kentucky Center for Economic Policy.

"Who Pays," Institute on Taxation and Economic Policy.

"The ITEP Guide to Fair State and Local Taxes," Institute on Taxation and Economic Policy.