Reinvestment or Retrenchment?

A Preview of the 2014-2016 Kentucky State Budget

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Kentucky Center for Economic Policy
January 2014

About Us

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). KCEP is a member of the State Fiscal Analysis Initiative (SFAI), a national network of organizations that work to address state tax and budget issues coordinated by the Center on Budget and Policy Priorities. For more information, please visit KCEP's website at www.kypolicy.org.

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A Preview of the 2014-2016 Kentucky State Budget

State lawmakers face enormous financial challenges when they craft a new two-year state budget starting in January. Over the last six years, Kentucky has deeply cut funding for schools, health care and other vital services while putting off new investments in the state's economic future. But a meager revenue forecast for the next two years will make it impossible to enact a budget that moves Kentucky forward unless the state also addresses the need for additional revenue.

The context Kentucky faces in its next budget includes the following:

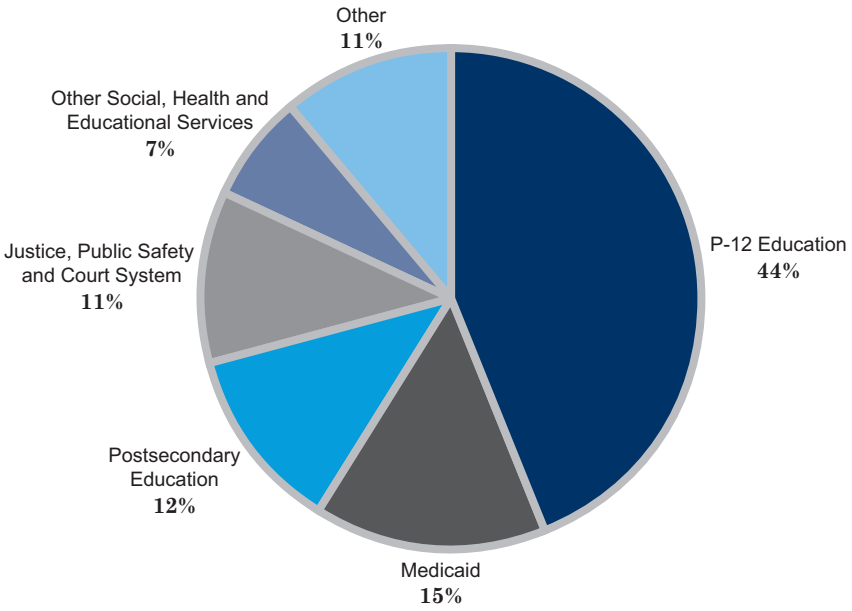
- Thirteen rounds of budget cuts have meant deep, painful reductions in funding for education, health, human services and a variety of other important areas. The results include out-of-date textbooks, shuttered child care centers, rising college tuition and denial of needed services to Kentucky's most vulnerable citizens. It has also meant a failure to make further investments that will pay off in the future in areas like early childhood education, preventive health care, economic development and poverty mitigation.
- The $246 million in new revenue expected in the first year of the next budget will fall far short of meeting Kentucky's growing needs. The cost of replacing one-time funds used to balance the current budget, keeping up with inflation, rolling back harmful budget cuts and paying the state's employee and teacher pension obligations quickly reaches hundreds of millions or even a billion dollars or more.
- Even if economic growth were at full steam, Kentucky's outdated, inadequate tax system would fail to generate enough revenue to keep up with growth in the economy. The small revenue bill lawmakers approved in 2013 to replenish pension funding hasn't appreciably brightened the forecast. Its impact is diminished by expected softening in revenues from corporate, coal severance and cigarette taxes and continued weakness in sales tax growth.

Kentucky faces a big choice in the coming budget debate: reinvestment in our families and our economy or further retrenchment. The decision comes down to revenue. Rollback of harmful budget cuts, fiscally responsible decisions about the state's liabilities and needed new investments cannot happen without more resources. Another budget without reforms to Kentucky's tax system that generate additional revenue will mean further retrenchment for our schools, health care and public services—and further delay in the progress Kentucky desperately needs.

Part 1: The Budget

Since 2008, state lawmakers have made 13 rounds of cuts to the General Fund budget, totaling $1.6 billion.[1] Those cuts have hit the largest areas of state spending—including elementary and secondary education, Medicaid and postsecondary education—as well as many smaller but still important services and programs (see below for graph on how General Fund dollars are spent). In this section, we provide an overview of those cuts, give examples of the impact, describe costs the state is facing in the next budget and identify some of the problems that result from not investing enough in a variety of public services.

2014 State General Fund Spending



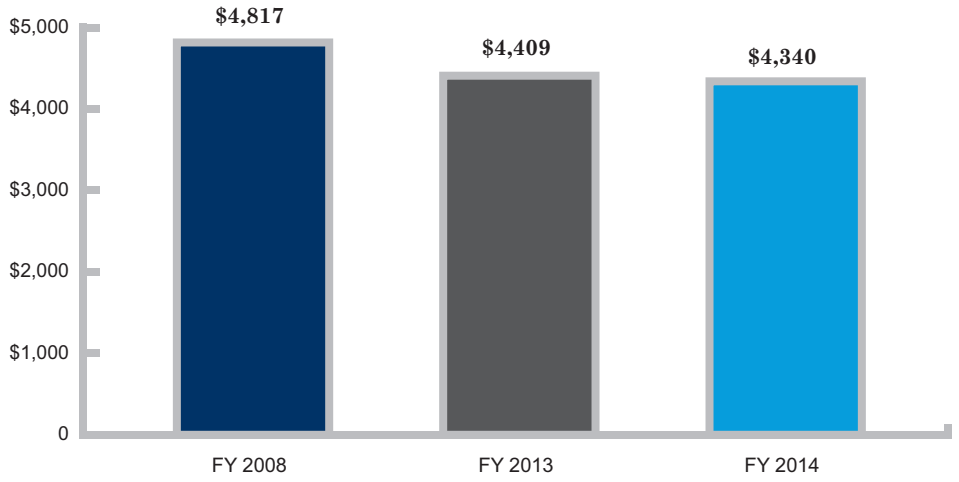
Source: Budget of the Commonwealth 2013-2014

P-12 Education Funding Falls Below 2008 Level

Though many political leaders identify education as a top priority, schools have not been spared from budget cuts. Funding for SEEK—the formula the state uses to allocate dollars to local schools—essentially has been frozen since 2008. After taking into account inflation and enrollment growth over those years, the state has reduced per pupil SEEK funding by 9.9 percent or $477 (see graph next page). That places Kentucky at fourteenth on the list of states that have made the deepest cuts to core school funding since the start of the recession, according to a report by the Center on Budget and Policy Priorities.[2] Kentucky is also one of only fifteen states that have continued to cut elementary and secondary education funding in the current year. Restoring SEEK funding to its inflation-adjusted 2008 per pupil level would cost about $318 million per year.[3]

Lawmakers have made even deeper cuts in other funding for P-12 education. The state has cut all money for textbook purchases the last four years. Between 2008 and 2013, funding for afterschool programs was reduced by 61 percent, professional development by 65 percent, school technology by 21 percent, career and technical

Per Pupil SEEK Spending Has Declined 9.9 Percent Since 2008
(Inflation-Adjusted)



Source: Center on Budget and Policy Priorities

education by 22 percent and school safety by 60 percent (even before accounting for inflation; see table below). Despite all of the evidence of the economic and social benefits of early childhood education, preschool funding was also 5 percent lower in 2013 than it was in 2008.[4] Governor Beshear had included money in his 2013-2014 budget proposal to the legislature for a slight expansion of eligibility for preschool to four year olds in families with incomes up to 160 percent of the federal poverty line—about $31,000 for a family of three—which would have allowed 4,400 more children to attend preschool. But lawmakers rejected that expansion.[5]

Cuts to P-12 Education Programs Since 2008

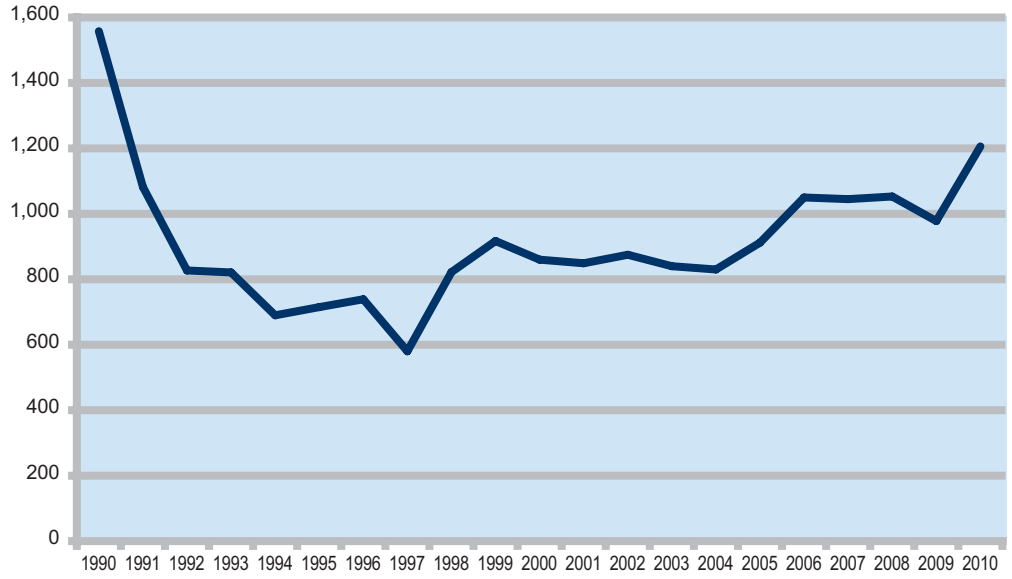
	FY 08 (originally enacted)	FY 13	Dollar Change	Percent Change	Inflation-Adjusted Percent Change
Textbooks	21.7	0	-21.7	-100%	-100%
Extended School Services	31.8	12.3	-19.5	-61%	-65%
Professional Development	15	5.3	-9.7	-65%	-68%
School Technology	39.8	31.5	-8.3	-21%	-28%
Career and Technical Education	30.3	23.7	-6.6	-22%	-29%
Safe Schools	10.4	4.2	-6.2	-60%	-63%
Preschool	75.1	71.3	-3.8	-5%	-13%
Total	224.1	148.3	-75.8	-34%	-40%

Source: KCEP analysis of Office of the State Budget Director data

Kentucky now ranks 39th in per pupil state and local funding for education.[6] The state's schools have made substantial progress over the past few decades in increasing overall education quality, but lack of funds is a barrier to further progress and threatens to erode the advances that have been made. The underfunding of schools led Education Week to give Kentucky a grade of F in the spending category of its 2013 Quality Counts report.[7]

The trend has made inequities between rich and poor school districts even worse. When school districts have fewer state dollars, they either cut services or depend more heavily on local taxes. Districts with less property wealth and economic growth are at a disadvantage compared to wealthier districts that can generate more revenue per student.[8] The vast differences in funding between districts prompted lawmakers to pass the Kentucky Education Reform Act (KERA) in 1990, which created the SEEK formula to reduce inequity. However, the funding gap between the richest and poorest school districts has been slowly growing since then, as seen in the graph below.[9]

Growing Gap in Per Pupil State and Local Revenues
Between Wealthiest 20 Percent and Poorest 20 Percent of Kentucky School Districts
(Inflation-Adjusted)



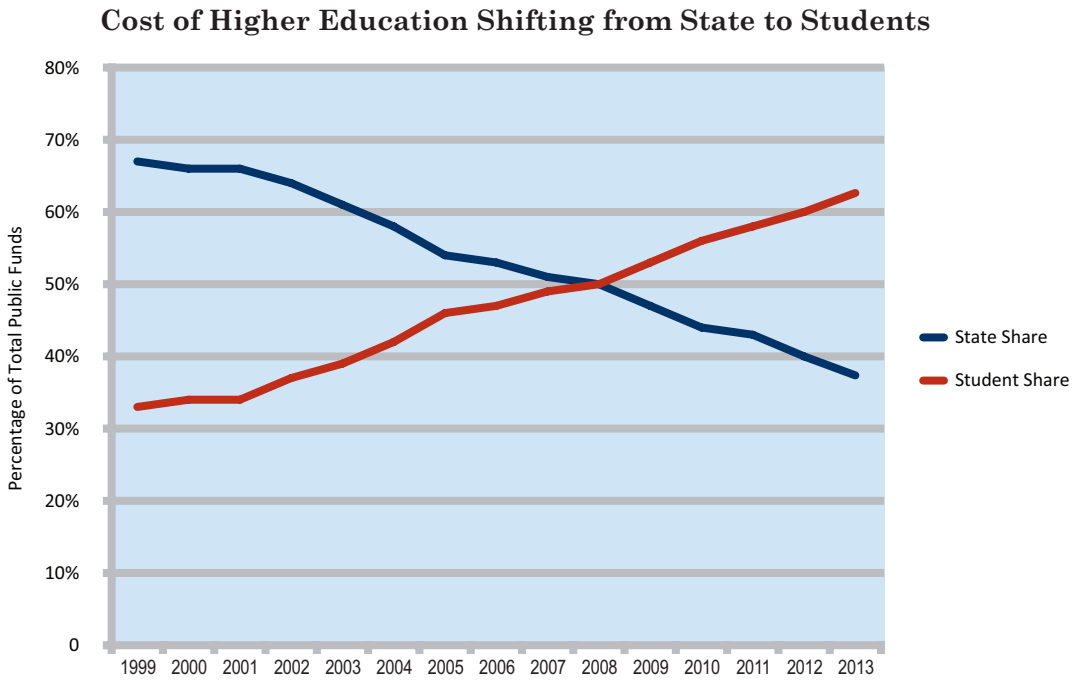
Source: Office of Education Accountability 2011 School Finance Report

The Kentucky Department of Education has requested $152 million in additional money in 2015 and $184 million in 2016. That would provide funds to return SEEK base funding (which is only a portion of total SEEK funding) back to its 2009 level not taking inflation into account; restore funding for textbooks, preschool, professional development, school safety and extended school services to its 2008 levels; and include money for technology, college and career readiness, help for low-achieving districts and facility improvements.

Higher Education Costs Skyrocket for Students, Families

The state's universities and community colleges received nearly 25 percent less in General Fund support in 2013 than they did in 2008, once inflation is taken into account.

One reason higher education has been cut deeply in Kentucky and around the country is that, unlike many other services, universities and community colleges have their own funding source—tuition and fees paid by students. The recent cuts are part of a trend in which most of the cost of public higher education is gradually being shifted from the state to students. As shown in the next graph, the state's share of funding for postsecondary education declined from 67 percent in 1999 to only 37 percent in 2013.[10] Tuition increases at state universities ranged from 184 percent (University of Louisville) to 254 percent (Western Kentucky University) from 2000 to 2013; over the same period, tuition grew 256 percent for community and technical colleges.[11]



Source: Kentucky Council on Postsecondary Education

Cuts have also reduced access to financial aid for students who need it most. Kentucky's financial aid programs are tied to lottery funding, but lottery revenues don't come close to generating enough funds to provide aid to all students who qualify. More than two-thirds of those eligible for the state's need-based financial aid programs cannot access them—the number denied assistance grew from 40,000 students in 2008 to more than 90,000 in 2012.[12] As tuition and fees have skyrocketed, low-income students have had a particularly hard time affording a college education. The state is losing ground in closing the gap between the number of lower-income and minority students who graduate from college compared to their better-off peers.[13]

Health Care and Human Services Cuts Take Toll on Vulnerable Kentuckians

Rapid transition to managed care in the Medicaid program is another way the state has responded to limited revenues. While managed care and other cost-cutting measures will save the state $1.3 billion during the current two-year budget cycle (from all funds—federal funds, General Fund and restricted funds), some patients have endured denial of needed treatment and long commutes to find doctors or hospitals in their plan's network.[14] Health care providers have also faced rejection or delay of payments.[15] A 2012 Urban Institute evaluation called the transition "extremely rapid" and noted that it had set up an "adversarial relationship" between the state, the plans and health care providers.[16]

Kentuckians needing mental health and substance abuse treatment have also been impacted by the managed care transition and harmed by limited state funding. The state's community mental health centers provide treatment and recovery services for people with mental illness, substance abuse challenges, and developmental and intellectual disabilities. These centers rely heavily on General Fund appropriations and Medicaid. However, their General Fund appropriations have not increased in 14 years, and the Medicaid rates paid to community mental health centers are frozen at 1999 levels.[17]

Other areas of health funding have also been reduced. The state has cut $17.7 million from public health departments; funding is now 31 percent below its 2008 level once inflation is taken into account. Many school districts have been forced to scale back their school nurse programs, which some public health departments previously helped operate.[18] In addition, fewer women are receiving prenatal care, fewer children are receiving immunizations, and fewer Kentuckians with diabetes are receiving comprehensive care because of the reduced funding for health departments, according to the governor's office.[19]

The state has also cut the Child Care Assistance Program (CCAP), which provides help with child care costs for low-income working families, and Kinship Care, which provides financial assistance to relatives caring for abused or orphaned children. The cuts have reduced access to care and resulted in job loss. After putting a moratorium on new CCAP enrollments in January (making Kentucky one of only two states that have imposed such a freeze), the state reduced the income eligibility for the program from 150 to 100 percent of the federal poverty line—about $19,000 for a family of three—in July. That gives Kentucky the lowest eligibility threshold in the country.[20] An estimated 2,900 children are denied assistance every month because of the application freeze, while 14,300 a month can't access assistance they would have previously qualified for because of the reduction in income eligibility.[21] 208 child care centers have closed since the freeze and reduction in eligibility took place, resulting in a loss of jobs and access to care for working parents.[22]

Cutbacks in Other Areas Hit a Wide Range of Kentuckians

Numerous other services have been harmed by substantial budget cuts. For instance:

- The state has reduced funding for the Kentucky Arts Council by 39 percent, Kentucky Educational Television (KET) by 36 percent and Libraries and Archives funding by 32 percent, taking account of inflation. KET's workforce has been reduced by 24 percent through attrition and two rounds of terminations, while the number of employees in the Department for Libraries and Archives has declined to 98 from 131.[23]
- The budgets for the Attorney General, State Auditor and Secretary of State have been cut by 31 percent to 35 percent (in inflation-adjusted dollars). These cuts limit the ability of these agencies to protect consumers, keep an eye on spending of public dollars and oversee fair elections.
- Public defenders across the state were handling 488 cases per attorney in 2012 because of budget cuts, "levels that are unethically high and risk public safety," according to the state's Public Advocate.[24]
- Funding for state police has been cut by an inflation-adjusted 26 percent, and the state budget director reports there are fewer state police on the road than in a generation. A shortfall in the state police budget at the end of the year led to the layoff of 20 state troopers.[25]
- Funding for vocational rehabilitation, which helps those with disabilities get work, has been reduced by 23 percent in inflation-adjusted dollars since 2008. Those cuts have resulted in a loss of $11 million in federal matching funds, meaning 8,900 fewer people are being served.[26]
- A lack of environmental enforcement and inspection staff has resulted in delayed or no enforcement of Clean Water Act actions regarding wastewater discharge.[27]
- Public parks have reduced their operating hours and have been unable to perform needed maintenance.[28]
- Local governments have been hit by less state aid for libraries, jails and public transportation.[29]

General Fund Cuts to Selected Agencies from Original 2008 Budget to 2013				
	2008 Enacted	2013 Enacted	Percent Change	Inflation-adjusted percent change
Kentucky Arts Council	4,182,500	2,771,900	-34%	-39%
Kentucky Educational Television	16,816,100	11,861,000	-29%	-36%
Attorney General's Office	14,113,100	10,084,300	-29%	-35%
Secretary of State	2,298,100	1,646,100	-28%	-35%
Libraries and Archives	14,689,300	11,015,900	-25%	-32%
Auditor	5,828,300	4,401,100	-24%	-31%
Public Health	73,823,000	56,085,300	-24%	-31%
Commission on Women	266,200	206,400	-22%	-29%
Commission for Children with Special Health Care Needs	5,917,000	4,674,000	-21%	-28%
Department of Career and Technical Education	29,894,500	23,971,900	-20%	-27%
Division of Air Quality	1,408,600	1,124,700	-20%	-27%
Deaf and Hard of Hearing	933,000	764,200	-18%	-25%
State Police	80,305,900	65,296,000	-19%	-26%
Environmental Protection	26,118,000	20,566,000	-21%	-28%
Vocational Rehabilitation	13,134,400	11,074,800	-16%	-23%
Community and Technical College System	226,331,100	191,455,700	-15%	-23%
Public Universities	881,434,300	746,960,400	-15%	-23%
Kentucky Nature Preserves Commission	1,166,500	979,700	-16%	-23%
Division of Water	11,965,300	10,221,500	-15%	-22%
Commission on Human Rights	1,859,100	1,616,100	-13%	-21%

Source: KCEP analysis of Budgets of the Commonwealth

Public Employees Lose Ground

Kentucky's austere budget has also affected employees' compensation. Social workers, corrections officers and other state workers have not had a raise in four years.[30] The state has also reduced health benefits for employees. In 2008, the state cut pensions for new workers and increased the amount they must contribute to retiree health insurance. Retirement benefits for new workers were cut again in the pension legislation that passed the 2013 legislative session. That law eliminated the defined benefit plan for new state employees and replaced it with a hybrid cash balance plan that exposes employees' retirement funds to greater risk.[31] State retirees also haven't received cost of living adjustments (COLAs) for their pensions the last two years, and the new pension law eliminated automatic COLAs in the future unless the legislature provides funding up-front.

Those cuts are likely to widen the gap in compensation between public and private workers. Public employees in Kentucky receive 12.8 percent less in total yearly compensation than comparable private-sector workers and 9.2 percent less on an hourly basis according to a study commissioned by KCEP. Prior to the recent cuts, public workers' benefits tended to be somewhat better than workers with the same skills in the private sector, but their overall compensation is lower because their wages are substantially worse.[32]

Budget cuts have also led to fewer workers at state agencies. With 33,321 employees, Kentucky now has the smallest state workforce it has had since 1974.[33] That's nearly 10,000 fewer workers than in the early 1990s. Cuts in state and federal funding and difficulty generating local revenues have also led to layoffs and other staff reductions at the local level, from schools to universities to social service agencies.[34]

New Costs Coming Next Budget

In addition to the cost of rolling back some of the harmful budget cuts, Kentucky faces new costs in the next budget that lawmakers will be hard-pressed to cover with expected revenue.

Unfunded Pension Liabilities Pile Up

The state needs to put much more money into public employees' retirement funds to meet its obligations. Kentucky's main retirement plan for state employees in non-hazardous jobs only has enough money to cover 23 percent of its future obligations, in large part because the legislature has failed to make the full annual payment to the fund (including funding for benefit changes and COLAs) for the last eleven years.[35] When the state doesn't make a full payment, it misses out on investment returns it could otherwise be getting for those dollars.[36] Plus, the pension system's low funded ratio means it needs to keep more cash on hand to pay current benefits, depriving it of some investment opportunities and making it harder to achieve its investment return targets.

The new pension law includes a promise to make the full actuarially-required contributions starting in 2015. The state has indicated that doing so will require $100-120 million more in General Fund money starting next year.[37]

Liability has also grown substantially in the Kentucky Teachers' Retirement System because the state stopped making full contributions to the system in 2009. The first missed payment was only $60.5 million. But after six years of not making these payments—and on top of investment losses from the recession—the debt has compounded and the system is only 52 percent funded. To become actuarially sound, the state should make additional contributions of $390 million in 2015 and $400 million in 2016, amounts equal to about 10 percent of total teacher salaries in the state.

Routine Cost Increases Must Be Covered

Costs grow each year even to maintain current levels of services. Inflation in health care costs is a particularly important driver because it has tended to be higher than other forms of inflation and because Medicaid and employee health insurance are substantial state expenditures. For instance, 5 percent inflation in Medicaid would mean $75 million more in costs, while the same level of inflation in teachers' and employees' health insurance would mean $40 million more, according to the state budget director.[38] The state has cut costs in both areas in recent years by the shift to Medicaid managed care and by cuts to state worker health insurance. However, medical cost inflation is driven largely by fundamental aspects of the American health care system that the state does not control and that national health reform is only beginning to address. The growth in national health care costs has slowed in the last few years, but it is uncertain whether that trend is permanent.[39]

The budget must also take account of inflation in other areas, including transportation costs and the cost of materials and equipment. Basic costs for state and local governments have increased 7.1 percent since 2008, according to the U.S. Bureau of Economic Analysis.[40]

Corrections System Remains a Big Budget Challenge

Over the last fifteen years, state spending on the justice system has increased 101 percent while total state spending has gone up only 63 percent.[41] Higher spending is the result of growth in arrests, more jail and prison sentences rather than probation or alternative sanctions, greater incarceration of drug offenders and ex-convicts returning to prison at a rate of 30 percent.[42] House Bill 463, passed during the 2011 General Assembly, reduced prison time for non-violent drug offenders, increased investment in drug treatment and put greater emphasis on programs that have evidence of reducing the number of repeat offenders.

At the time of enactment, HB 463 was projected to save the state $420 million over 10 years. However, the reforms will take time to implement and corrections costs remain higher than they were before the recession. What's more, Kentucky's prison population at the end of 2013 was larger than anticipated, requiring lawmakers to spend an additional $22.4 million on the justice system.[43] HB 463 is a promising approach to reducing state costs and more effectively dealing with crime, but will require new public dollars for investment in drug treatment, job training and other rehabilitation programs.

Debt Service Costs Are Rising

For the years 2009-2012, the state restructured some of its debt in order to cut costs in the current budget. Unlike refinancing—which involves taking advantage of lower interest rates—restructuring is done to push debt forward to future years, and ends up costing the state more in the long run. As a result, appropriation-supported debt service as a share of total revenue was higher in the 2013 and 2014 budget (6.58 percent and 6.52 percent, respectively) than it was in the 2009 and 2010 budget (4.81 percent and 2.97 percent, respectively).[44] According to a state analysis, the additional interest cost for the General Fund as a result of the restructuring will rise to $35.4 million a year in 2015 and 2016 compared to $23 million in 2013 and $26 million in 2014.[45] The 2013-2014 state budget did not include any further debt restructuring during the current biennium.

Weak Economy Increases Budget Pressures

Kentucky's economy is still weak, and the number of working-age adults who are employed remains substantially below where it was before the recession began. That reduces state revenue (as discussed later in this report), and also increases spending because it means more people are eligible for and need certain services. For instance:

- **Medicaid.** Job losses in the recession made more Kentuckians eligible for Medicaid, and the lack of adequate employment and income growth in the recovery has kept enrollment elevated. The state had 100,000 more people enrolled in Medicaid in 2012 than it did in 2008. States received temporary financial help with their Medicaid costs from the federal government, but that expired in 2011.

  Many thousands more Kentuckians will be enrolled in Medicaid in the next budget because of the Medicaid expansion included in the Affordable Care Act. However, the federal government will pay for the entire cost of those newly-eligible individuals for the first three years. There will be new state costs for those currently-eligible individuals who are expected to enroll because of the publicity about the expansion. But even with those costs, the expansion is a net benefit to the budget according to a state analysis. Kentucky will benefit from a reduction in the amount of money it pays now to treat the uninsured, changes that allow the state to draw more federal funds for covering some individuals and the additional tax revenue that will come from health care-related job creation resulting from the expansion.[46]

- **Higher Education.** More people go to college for the first time or return to school when employment prospects are limited. The state saw an especially large increase in community college enrollment in 2009 and 2010, and enrollment has declined somewhat since then. But there were still 13,516 more public undergraduate and community college students in 2012 than there were in 2008 (a 7 percent increase), and over 33,000 more than 10 years ago.[47]
- **Social Services.** More people qualify for and need a variety of state-funded services when unemployment remains high. Examples include Meals on Wheels and other programs for seniors, financial aid for higher education, public defenders, job training programs and child care subsidies. People are also more likely to rely on public services like libraries and public schools when they cannot afford private options.

Growing Need for Long-Term Investments

Restoring painful cuts and improving Kentucky's long-term fiscal health should be the top priorities when the legislature considers a new budget beginning in January. But there are other important investments Kentucky is missing out on making because of the austere budget—investments that would improve our quality of life, meet more people's needs and strengthen the economy over the long-term. Here are a few critical areas where more investment is needed:

Advancing Education

Education is a crucial investment for building a strong economy, a high quality of life and a fully-functioning democracy. Better educated workers are more productive and earn more, as documented in a recent report by the non-partisan Economic Policy Institute.[48] Investing in education "builds a strong foundation for economic success and shared prosperity," and can also be good for state budgets because workers with higher incomes contribute more taxes over their lifetimes," the report notes. However, in Kentucky just 26.2 percent of the workforce has at least a bachelor's degree, lower than 42 other states, and the state ranks fifth from the bottom in associate's degree holders.[49]

Education should be strengthened at all levels, including the early years. Every $1 invested by a state in universal preschool results in $3 in higher earnings for its residents, according to one economist who has studied the issue. In the long run, investment in universal preschool creates twice as many jobs for state residents and boosts earnings 15 percent more than investing the same amount of money in business tax subsidies.[50] Far from providing funds for universal preschool, Kentucky doesn't even fund all-day kindergarten statewide and has cut funding for preschool and child care subsidies.

Improving Health

Kentucky consistently ranks among the worst states in health status. The state ranks seventh from the bottom in overall health and has the highest rates of cancer deaths and preventable hospitalizations in the country, according to the United Health Foundation. Kentucky also ranks among the ten worst states in obesity, diabetes and deaths from cardiovascular disease.[51]

The Affordable Care Act (ACA) provides a tremendous opportunity to improve Kentuckians' health because it will expand coverage to many currently-uninsured residents through the Medicaid expansion and the state-based private insurance exchange. It also requires greater emphasis on preventive and primary care. On top of implementing the ACA, the state needs to do more to strengthen its public health and mental health services in order to improve quality of life and strengthen the workforce.

Creating Ladders Out of Poverty

Kentucky also consistently ranks among the poorest states in the country. In the most recent Census, it has the eighth-highest poverty rate and the eighth-lowest median income.[52] To move more people out of poverty, which would strengthen the economy, improve quality of life and bolster the state's finances, Kentucky must provide people the support and access to opportunity they need.

That includes affordable education at all levels aligned to career pathways, as well as a variety of supports—including access to child care, an earned income tax credit, affordable financial services, affordable housing, drug treatment for those who need it and more. Instead, budget cuts mean rungs on the ladder of opportunity are broken or missing, holding back individuals and the state as a whole. The lack of support leads to troubling outcomes like a 30 percent rate of return to state prisons for previous offenders. Kentucky needs to make investments in people that will pay back as more Kentuckians move into the middle class.

Addressing an Aging Population

The share of the Kentucky population over age 65 is expected to rise to 20 percent from 13 percent by 2030.[53] More retirees will mean less tax revenue for the state and greater need for programs that serve the elderly. In particular, low-income seniors will turn to Medicaid to pay for nursing home care. A growing population of seniors will also increase the need for education and training programs for caregivers, the costs associated with an aging prison population, transportation needs, and a variety of other aging and independent living services. Kentucky will need to plan for those costs in the coming years.

Preparing for a Rainy Day

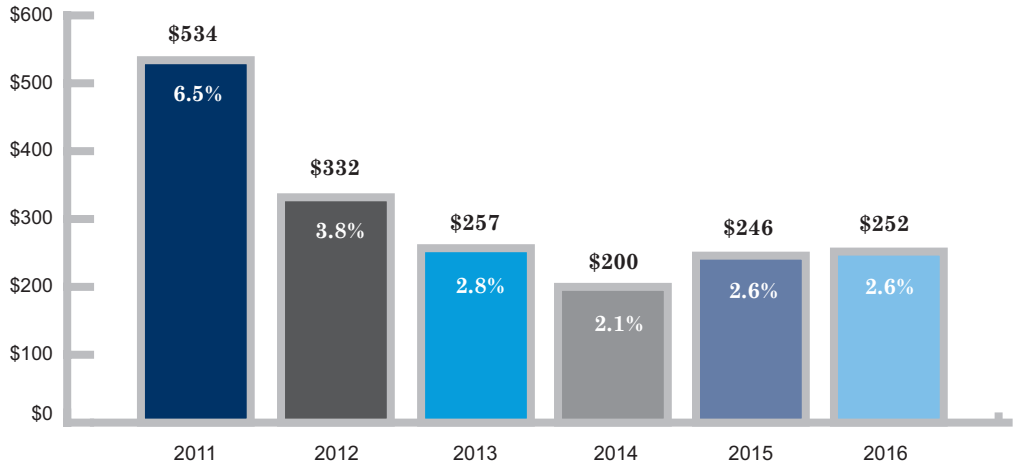
As discussed elsewhere in this report, Kentucky is expected to have only $98.3 million in its rainy day fund at the end of this fiscal year, an amount equal to only about one percent of its budget.[54] That gives the state very little cushion to prepare for the next recession, when revenues will again go down just as the need for services goes up. Experts recommend building rainy day funds up to around 15 percent of the state budget.[55] Kentucky had a rainy day fund equal to only 2.5 percent of the budget going into the last recession, and it was one reason that cuts have been so deep.[56] Kentucky should be generating enough revenue to begin rebuilding its rainy day fund while also meeting other crucial needs.

Part 2: Revenue

The second half of this report examines the revenue side of the 2015-16 state budget. Specifically, it explores the factors contributing to the level of resources Kentucky expects to have available in the coming biennium.

In December, the state's Consensus Forecasting Group (CFG) approved an official revenue estimate showing very modest revenue growth in the General Fund for fiscal years 2014 through 2016 (see the figure below). Kentucky's General Fund is forecast to total $9.55 billion in 2014, which is $200 million or 2.1 percent more than in 2013. Growth is expected to be 2.6 percent in both 2015 and 2016, adding $246 million and $252 million in revenue those two years.

New Dollars Each Year in General Fund Revenue
(Millions)



Source: KCEP analysis of Office of the State Budget Director data, Consensus Forecasting Group Official Estimate

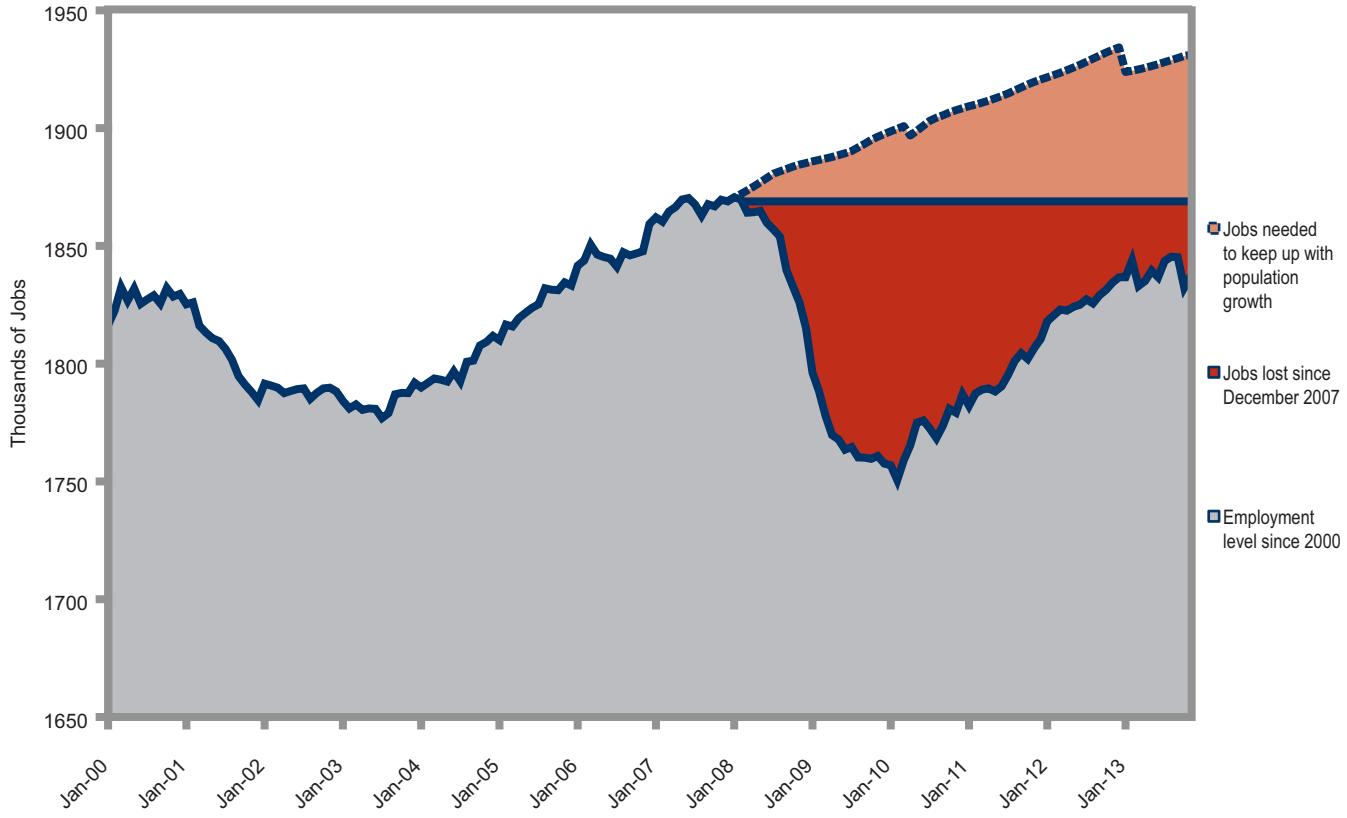
As described below, the weak revenue forecast is a result of the still-sluggish economic recovery; the major flaws and shortcomings in most of Kentucky's major tax sources; continued weakness in sales tax growth; and a lack of growth or even decline in corporate, coal severance and cigarette tax revenues.

Soft Economy Leads to Weak Revenue Growth

The weak revenue forecast Kentucky faces in the coming biennium is due partly to the sluggishness of the economic recovery. Persistently high unemployment and stagnant wages are holding back Kentucky's largest sources of General Fund revenue, the individual income tax and sales and use tax.

In November 2013, Kentucky still had 29,700 fewer jobs than it had before the recession hit in December 2007. To return to pre-recession employment levels, Kentucky needs to add those jobs plus 62,400 more to account for population growth since then (see next graph). That means Kentucky would need to add 2,000 jobs per month over the next three years to get back to pre-recession unemployment rates—but net job growth in the state has been flat over the last year.[57]

Kentucky Still Has a Significant Jobs Deficit



Source: Economic Policy Institute

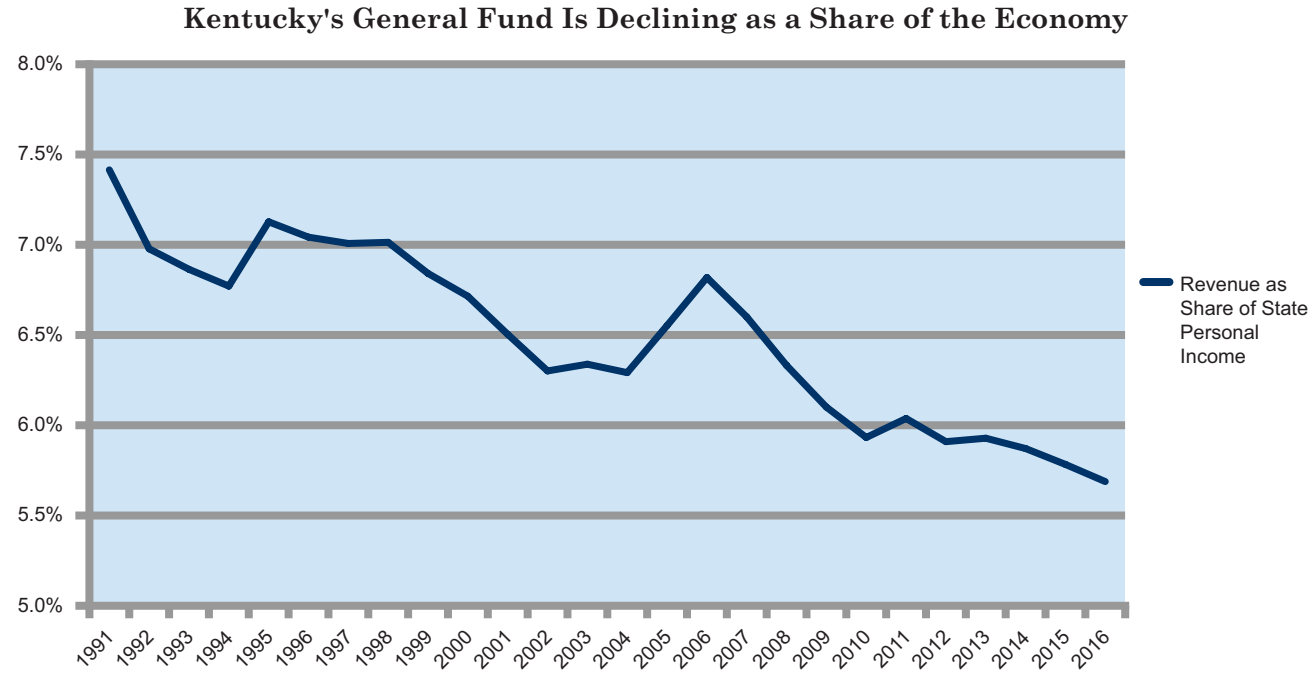
The new jobs being created tend to pay less than those the state has lost, especially for Kentuckians with lower levels of education. Since December 2007, employment in manufacturing is down by 11.5 percent and in construction by 20.1 percent, while jobs in leisure and hospitality have grown by 3.9 percent. [58] Many such service-sector jobs pay so little that employees must rely on public assistance to make ends meet.[59] Education and health jobs are also up 7 percent, but many of these jobs require higher levels of education.

Erosion of wages for low- and middle-income workers began even before the recession. Wages for Kentucky workers at the tenth percentile fell 1.5 percent during 2012 to $7.99 an hour, and have declined 6.5 percent since 2001 taking account of inflation.[60] For workers at the median, inflation-adjusted wages fell 2.8 percent in 2012 and by 7.1 percent since 2001. With so many people looking for work, employees have little bargaining power for better wages. In fact, the share of the state workforce making poverty-level wages grew to nearly one-third by 2012, up from one-fourth in 2001 (see graph next page). [61]

Source: Economic Policy Institute

Major Flaws in Kentucky's Revenue System Hold State Back

The weak economy cannot entirely explain Kentucky's lackluster revenue receipts. Fundamental problems with the state tax system are causing the General Fund to erode as a share of the economy (see figure below). That means even in good times, Kentucky is increasingly less able to generate the revenue it needs. As the cost of providing public services rises with inflation, population growth and other factors, the state's ability to adequately fund education, health and other public services is shrinking. Consultants to the Governor's 2012 Blue Ribbon

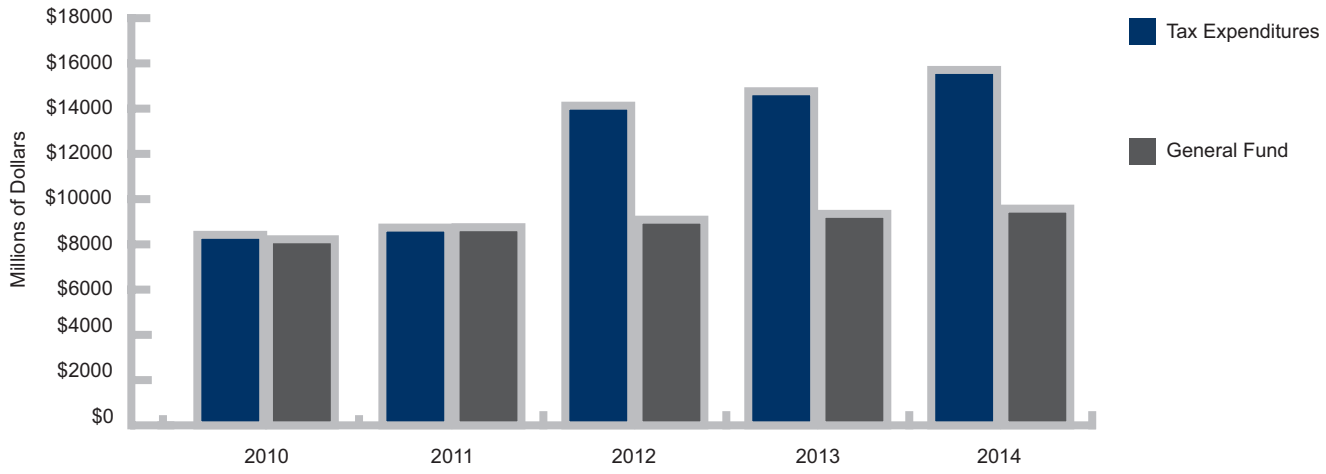


Source: KCEP analysis of data from the Office of the State Budget Director, Bureau of Economic Analysis, Global Insight

Commission on Tax Reform (BRC)—one of 13 studies since 1982 on the need for tax reform in Kentucky—estimated that Kentucky would fall an additional $1 billion short of being able to meet its needs by 2020 if the state's taxes are not modernized.[62]

The problem with the state tax system is twofold: Kentucky's tax laws are not keeping up with the changing economy and the state has too many tax exemptions, deductions, loopholes, credits and limits—often called "tax expenditures" since their effect is akin to spending—that are not evaluated for their costs and benefits to the state. Unlike spending that must be approved each budget session, tax expenditures are part of tax law and only come up for review if they are enacted with an expiration date or if lawmakers choose to address them, both of which rarely happen. In 2014, tax expenditures coming from the General Fund will cost the state $15.7 billion while the General Fund is expected to generate $9.5 billion in revenue (see graph below).[63]

Tax Expenditures are Growing, Draining Revenue from General Fund



Source: Office of the State Budget Director

What follows is a review of the revenue forecast and particular challenges for each of Kentucky's major revenue sources.

Individual Income Tax: The Cornerstone of Revenue Growth

The individual income tax is the state's largest single revenue source, generating $3.7 billion in 2013, or 39.8 percent of the state's General Fund revenue. Despite the stagnant wages of low- to middle-income workers in Kentucky, the individual income tax was responsible for 82 percent of net General Fund growth in 2013 and contributed 89 percent of net growth between 2007 and 2013. Because income tax rates typically rise along with a person's income—and because the incomes of the wealthy tend to rise faster in a recovery than do those of low- and middle-income households—the income tax tends to rebound better early in economic recoveries than the sales tax.[64]

The CFG's forecast predicts that the individual income tax will generate 65 percent of total net General Fund revenue growth over the next two years, with growth of 4.3 percent in 2015 and 4.0 percent in 2015—compared to 2.6 percent growth each year for the General Fund as a whole. Continued strong growth in investment income plays a role as do the small adjustments made as part of the revenue bill to fund pensions passed in the 2013 General Assembly.

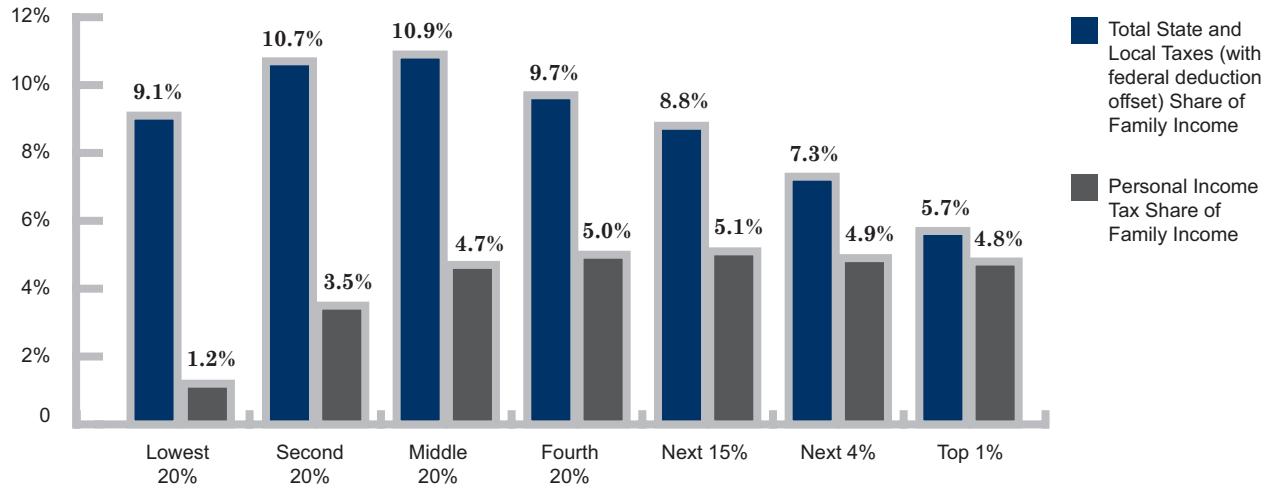
Even though the individual income tax is Kentucky's strongest revenue source, individual income tax breaks—which totaled $8.7 billion in 2013—reduce revenue growth and the tax's fairness. The table below shows the cost of a handful of these tax expenditures, some of which are designed to achieve important policy goals. However, Kentucky has done very little to scrutinize these tax breaks to determine if they are worth the lost revenue. Some of the most expensive deductions disproportionately benefit households on the upper end of the income scale and leave many low-income households out, such as the deduction for home mortgage interest. The governor's Blue Ribbon Commission recommended limiting itemized deductions to $17,500 a year (adjusting afterward for inflation), which would generate an additional $350 million a year and make the income tax more progressive.

Selected Individual Income Tax Expenditures, FY 2013 ($ millions)	
Capital Gain on Property Transferred at Death	$728
Capital Gain on Gifts	$29
Charitable Contributions	$83
Child and Dependent Care Credit	$8
Employer Contributions for Medical Insurance and Care	$2,162
Home Mortgage Interest	$1,219
Individual Retirement Account Contributions	$6
Private Pensions and Individual Retirement Accounts	$937
Scholarship and Fellowship Income	$36
Standard Deduction	$120

Source: Commonwealth of Kentucky 2012-14 Tax Expenditure Analysis

The state's exclusion of the first $41,110 of non-Social Security retirement income from the income tax is a large tax expenditure with a cost that's expected to grow as baby boomers age. The Blue Ribbon Commission recommended that the exclusion be gradually phased out, starting with total income above $30,000. The state could also increase income tax revenue and fairness by adjusting income tax brackets and rates to reflect growing income inequality between the top-earning families and the rest. Taking exclusions and deductions into account, the middle 20 percent of Kentucky families, with incomes between $29,000 and $47,000, and the top one percent, with incomes of more than $309,000, currently pay about the same share of their incomes in income taxes (see graph below).[65]

Kentucky Taxes as a Share of Family Income



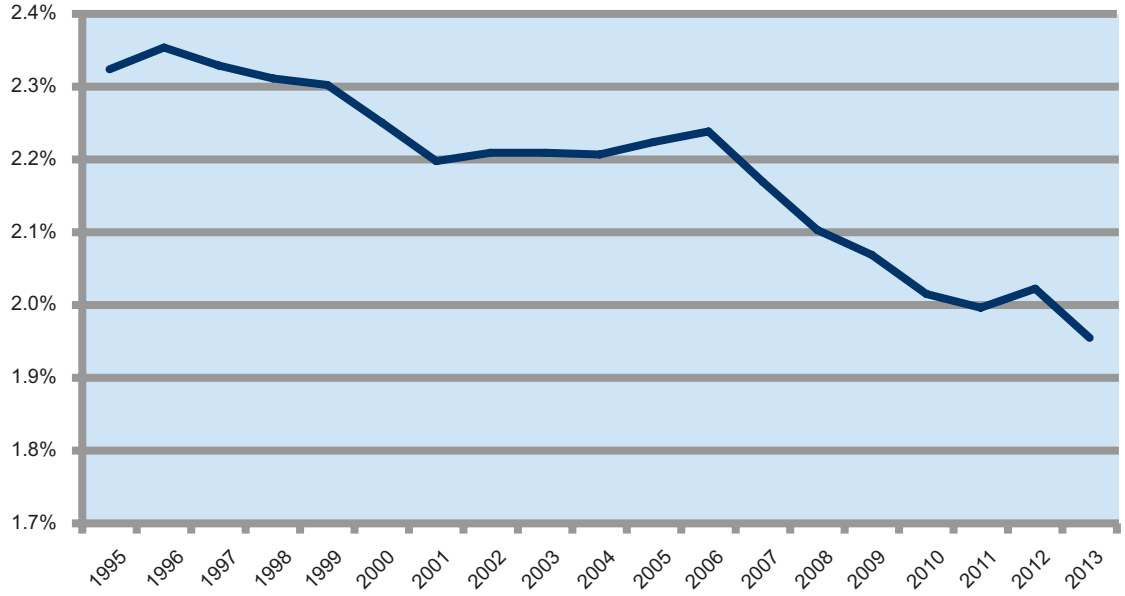
Source: Institute on Taxation and Economic Policy

Sales Tax Eroded by Sluggish Economy, Shift to Services

Kentucky's second-largest source of revenue is the sales tax, which generated $3 billion in General Fund revenue in 2013. With less money in Kentuckians' pockets to purchase durable goods, school supplies and Christmas gifts, sales tax receipts actually declined by one percent in 2013. State sales tax revenue also fell in 2009 and 2010. The CFG's forecast predicts sales tax growth over the next two years but at slower rates than the individual income tax: 1.6 percent in 2015 and 2.1 percent in 2016.

The sluggish economy is not the only reason sales tax growth is expected to be slow. Kentucky's sales tax is declining as a share of the economy because the state does little to tax services, even as services make up a growing share of the economy (see graph below). Of the 168 services taxed by at least one other state, Kentucky taxes only 28, ranking it among the states with the fewest services in the tax base.[66] As a result the state lost $1.8 billion in sales tax receipts in 2013, the Office of the State Budget Director estimates.[67]

Sales and Use Tax Declining as Share of Economy



Source: KCEP analysis of Office of the State Budget Director, Bureau of Economic Analysis data

Kentucky also loses sales tax revenue through untaxed internet purchases—about $224 million a year according to a University of Tennessee study.[68] The state has done its part by adopting a set of sales tax rules and definitions shared by other states called the Streamlined Sales and Use Tax Agreement (SSUTA). But Congress has failed to pass the Marketplace Fairness Act which would make internet retailers responsible for collecting sales taxes owed to states.

Corporate Income Taxes Expected to Level Off, Then Decline

The state's corporate income tax has had strong growth in recent years, in part because of high corporate profits. In 2011, corporate income taxes grew by 26.4 percent, in 2012 by 24.5 percent and in 2013 by 7 percent. Nationally, corporate profits have grown to record highs—even as consumer demand has been depressed—due to a combination of cost-cutting, slow wage growth, access to global markets and limited spending by businesses

on technology and other investments.[69] The CFG projects corporate taxes to grow by 14.9 percent in 2014 before leveling off in 2015 (0.6 percent growth) and beginning to decline in 2016 (-6.3 percent growth).

Revenue from the state's limited liability entity tax—a corporate tax designed for businesses not organized as corporations—is expected to remain relatively flat. In the CFG forecast, limited liability entity tax revenue in 2016 will be only 2.8 percent more than it was in 2013.

Despite arguments that Kentucky should lower its corporate income taxes to lure businesses from other states, Kentucky's business taxes are already comparatively low.[70] Existing loopholes, tax incentives, and other strategies to reduce business tax liability have drained revenue from the General Fund.

For example, unlike a majority of states with corporate income taxes, Kentucky does not require "combined reporting" which treats corporations that operate in numerous states as single entities so they cannot shift tax liability to states with lower or no corporate taxes. Because Kentucky does not practice combined reporting, it is losing between $27 million and $54 million each year, the Legislative Research Commission estimates.[71]

Kentucky also loses a growing amount of money through a variety of economic development subsidies that get little scrutiny and evaluation of whether they are effective. For example, the state lost $66.8 million in revenue in 2013 from "job assessment fees" that give employers the individual income taxes owed to the state by employees. A 2012 study commissioned by the legislature questioned the cost-effectiveness of the state's business incentive programs.[72]

Coal Severance Tax Hit by Declining Production

The coal severance tax paid by mining companies generated $298 million for the General Fund in 2012, but declined by 22.7 percent to $231 million in 2013. As a share of the General Fund, that revenue accounted for just 3.3 percent in 2012 and 2.5 percent in 2013. Until the recent decline, coal severance tax dollars were growing, in large part due to increasing production in western Kentucky and the rising price of eastern Kentucky coal.[73]

But declining eastern Kentucky reserves, the resulting higher costs of mining harder-to-reach coal seams, competition from cheaper natural gas and environmental regulations are all contributing to the decline in eastern Kentucky coal production and thus severance tax revenue. The CFG forecast estimates that coal severance tax receipts will decline by 13 percent in 2014, grow 2 percent in 2015 and fall again in 2016 by 1.5 percent.

Property Taxes Stagnate Because of Weak Housing Market

The forecast for modest property tax revenue growth in the coming biennium—2.2 percent in 2015, and 2.8 percent in 2016—is partially attributable to little expected growth in housing prices. Furthermore, property taxes have been steadily declining as a share of Kentucky's economy since the state enacted a law in 1979 limiting annual property tax revenue growth to 4 percent and causing the property tax rate to decline from 31.5 cents per $100 valuation of property in 1978 to 12.2 cents in 2013. Since 2008, the rate has flattened at 12.2 cents due to stagnant property values. If Kentucky simply had allowed property tax revenue to grow with property values since 1979, the state would have collected $492 million more in revenue in 2013, according to official state estimates.[74]

Cigarette Tax Revenue Drops as Smoking Decreases

After cigarette tax increases in 2005 and 2009, revenue grew substantially. Higher state and federal cigarette taxes and other factors driving down tobacco consumption, however, are contributing to shrinking revenues over

time. Cigarette tax receipts have declined in each of the past three years and are expected to do so through 2016, with revenue dropping to $219 million that year compared to $239 million in 2013.

Lottery Revenue Boosted by Keno

Revenue from the lottery has grown more slowly over time than other state revenue sources. From 1995 to 2013, the General Fund grew by 81 percent while lottery revenues grew by 58 percent. In 2013, lottery revenue totaled $215 million. It is expected to grow by 4.0 percent to $224 million in 2014; by 5.8 percent to $237 million in 2015; and by 5.3 percent to $249.5 million in 2016.

Some of that revenue growth is from Keno, which the lottery began offering in November 2013. Keno is expected to generate $14.5 million in new revenue for the state in the next full fiscal year. That figure is forecast to grow to $29.8 million by 2019.[75]

Tobacco Settlement Funds Facing Hit

Funds from a legal settlement between tobacco companies and the states technically are not part of the state's General Fund, but represent another declining source of revenue.[76] Kentucky has received $1.59 billion in total payments from the Master Settlement Agreement (MSA) since 2001. But annual payments have been declining for a complex set of reasons, particularly lower cigarette sales and a loss of market share among tobacco companies participating in the agreement.[77]

Most recently, an arbitration panel ruled in September that Kentucky was among the states that have not done enough to ensure that tobacco companies that don't participate in the master agreement make escrow payments that keep them from having a significant advantage in the marketplace. Though this decision is being appealed, the state is expecting to collect only $45.4 million in tobacco settlement payments in 2014 compared to $90.8 million assumed in the budget. That likely will mean a cut to the agriculture, early childhood development and health (including smoking cessation) programs funded by the tobacco settlement in the current year.[78] Also, the state faces another potential reduction in tobacco settlement funds in 2016 because of this issue.

Pension Revenue Package Helps but Is Included in Forecast

The pension revenue bill that was passed in 2013 will raise an estimated $65.7 million in 2015 and $69.9 million in 2016 by reducing a state personal income tax credit, closing various loopholes and limiting the compensation businesses receive for remitting sales taxes to the state, among other changes.[79] Another $30 million often attributed to the pension revenue bill comes from a federal tax law change that impacts how itemized deductions are calculated for Kentucky income taxes. However, new dollars from the pension revenue bill are accounted for in the weak revenue forecast. As mentioned elsewhere in this report, its impact is more than offset by slower growth or declines in other revenue sources.

Other Tax Revenue Expected to be Lackluster

Growth in the coming biennium is expected to be weak for "other revenue," a category for miscellaneous sources including wholesale beer taxes, insurance premium taxes and bank franchise taxes. Other revenue accounted for 7.6 percent of total General Fund revenue in 2013. After 8.5 percent growth in 2013, these receipts are expected to grow by just 0.8 percent in 2014, by 0.6 percent in 2015 and by 2 percent in 2016.

Other Resources for the Budget Likely to Be Scarce

The state has typically been able to identify or generate resources beyond expected tax revenues to help balance the state budget. But the availability of comparable extra resources for the 2014-2016 budget is doubtful.

Tax Amnesty

To generate additional revenue in the last budget, the state offered tax amnesty or forgiveness of penalties and interest for individuals and businesses that have been delinquent in paying taxes. The amnesty generated $58.4 million for the state budget in fiscal year 2013, $1.1 million of which went to the Road Fund.[80] Since tax amnesty was done so recently (the state also offered amnesty in 2000), it is not an option to generate new revenues in the next budget.

One-Time Funds

The 2013-2014 state budget was balanced with the help of a variety of one-time funding measures, which the new state budget will have to replace. It has been common practice in Kentucky in recent years for the legislature to transfer resources intended for other purposes into the General Fund and dip into savings in order to balance the budget.

The 2014 budget included $157.5 million in one-time funding from three sources:

- $52.1 million in a small balance left over after the 2013 budget;
- $49 million from the state's rainy day fund;
- $56.3 million in extraordinary fund transfers (greater than $40 million) from other pots of money in state government.[81] This money comes from a wide variety of revenue sources, with the largest including insurance company fees and fees intended to clean up underground petroleum storage tanks.

One-time funding in the 2014 budget was somewhat smaller than it was in 2012. It represented 1.6 percent of the 2014 General Fund revenue and 4.6 percent of 2012 revenue.

This type of funding is not likely to provide substantial resources in the next budget for several reasons.

The $52.1 million carry-forward used in the 2014 budget is not available next year, as the budgeted carry-forward from 2014 to 2015 is $0. The official revenue forecast does predict revenues for 2014 will be $24 million more than originally expected; however, excess revenues result in money deposited into the rainy day fund only if money is left over after paying for all necessary governmental expenses like natural disasters or unexpected costs in certain areas.

As for the rainy day fund, its $98.3 million balance equals only one percent of the budget—far less than needed to prepare for the next recession. It will be difficult to justify using additional rainy day funds to balance the next budget given the need to begin rebuilding the fund.

Road Fund Faces Declining Fortunes

Kentucky collected $1.49 billion in its Road Fund in 2013, 56 percent of which came from the tax on motor fuels, 29 percent from the motor vehicle usage tax, 7 percent from vehicle licenses and the rest from other sources. The Road Fund is expected to grow by 6 percent in 2014 to $1.58 billion, but to decline in 2015 to $1.55 billion and remain basically flat in 2016. Both the fuel tax and usage tax are expected to decrease in 2015. In 2016, fuel tax receipts are expected to continue falling, but the usage tax will grow slightly.

Kentucky's reliance on the motor fuels tax is not sustainable. As fuel efficiency standards increase, total taxable gallons of gasoline will continue their long-term decline. Increases in the price of wholesale gasoline—to which Kentucky's gas tax is tied—have offset the losses in recent years. But the gas tax is also subject to price decreases, and the floor Kentucky set in 2009 is too low to protect the Road Fund from significant losses. The pension reform package passed in 2013 harmed the Road Fund by allowing a trade-in credit for the value of a used car when purchasing a new car, resulting in a loss of $34 million or about 2 percent of Road Fund revenue.

Federal Funding Cuts Will Squeeze State Budget

Along with the slow economy and Kentucky's inadequate revenue system, federal budget cuts will reduce resources in the state budget. Federal funding in the state's 2013 budget was $10.1 billion, down from $10.8 billion in 2012 and $11.3 billion in 2010 when American Recovery and Reinvestment Act dollars were at their height.[82]

Federal dollars flow through a variety of programs that bring resources to the state and local levels. Mandatory programs, such as the national school lunch and breakfast programs, Medicaid and the Children's Health Insurance Program (CHIP) are funded based on the number of Kentuckians that meet eligibility requirements. Discretionary programs, on the other hand, such as Title 1 grants for poor school districts, Low Income Home Energy Assistance, Highway Planning and Construction, and Section 8 housing vouchers are funded though the annual appropriations process and are subject to cuts.

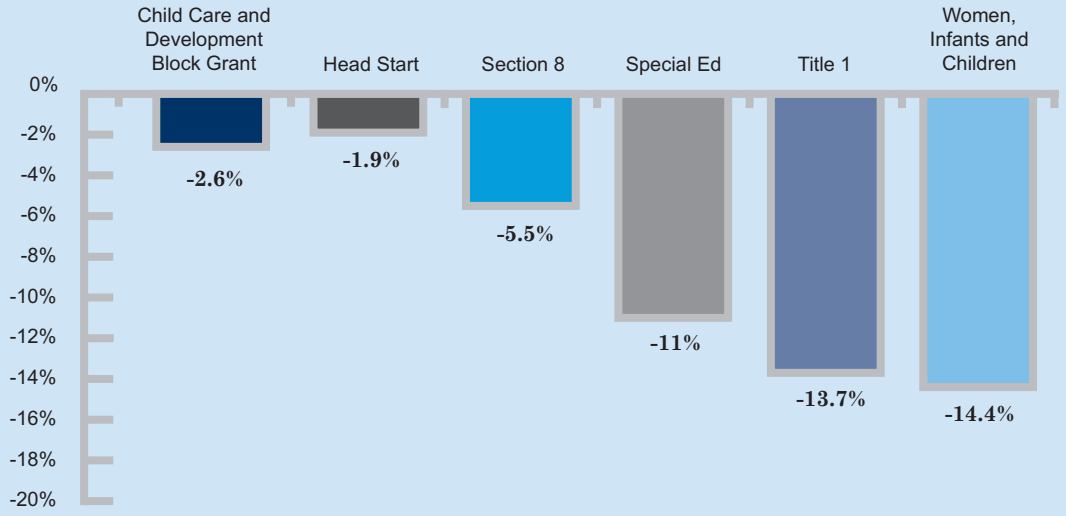
The Budget Control Act of 2011 (BCA) has decreased funding to states in two major ways: it capped discretionary spending through 2021 for a total cut of $1 trillion; and in March 2013, it cut an additional $1.2 trillion through 2021 through the across-the-board cuts known as sequestration. The modest Murray-Ryan budget agreement that passed in December 2013 somewhat mitigates sequester cuts in 2014 and 2015. In 2014, the sequester cuts for non-defense discretionary (NDD) programs (the category that includes grants to states) are reduced by 61 percent. In 2015, sequester cuts to NDD programs are reduced by 25 percent. The impact on individual discretionary programs will not be known until a bill is written after Congress reconvenes in January.

Even with partial sequester relief under the deal—which extends little relief in 2015 and none in 2016, the years that correspond most closely to the years covered by Kentucky's next budget cycle—federal funding in Kentucky will be far below 2010 levels and what Kentucky needs. Nationally, funding for NDD programs in 2014 will be 14.9 percent below 2010 funding levels once inflation is taking into account, and 2015 NDD funding will be 17 percent below those levels.[83]

continued on next page

Although assessing the total impact of the BCA and the recent budget agreement on federal funding to Kentucky is outside the scope of this report, the figure below shows the inflation-adjusted change in funding for select discretionary grants between 2010 and 2013, with an approximation for the effect of sequestration in 2013. Kentucky faced the 8th largest cut in federal grant funding in 2013, the non-partisan Economic Policy Institute estimated.[84]

Federal Grant Funding to Kentucky Has Declined:
Percent Change in Inflation-adjusted Funding for Select Grants between 2010 and 2013



Source: KCEP analysis of data from the Budget of the United States Government & Federal Funds Information for States[85]

One significant countertrend is the new federal dollars coming into the state as a result of Governor Beshear's decision to expand Medicaid. Under the Affordable Care Act, the federal government will pay for 100 percent of new costs over the next three years and will reduce that funding to 90 percent thereafter. But that money will only pay for the expansion and doesn't provide additional resources to help with Kentucky's other budget needs.

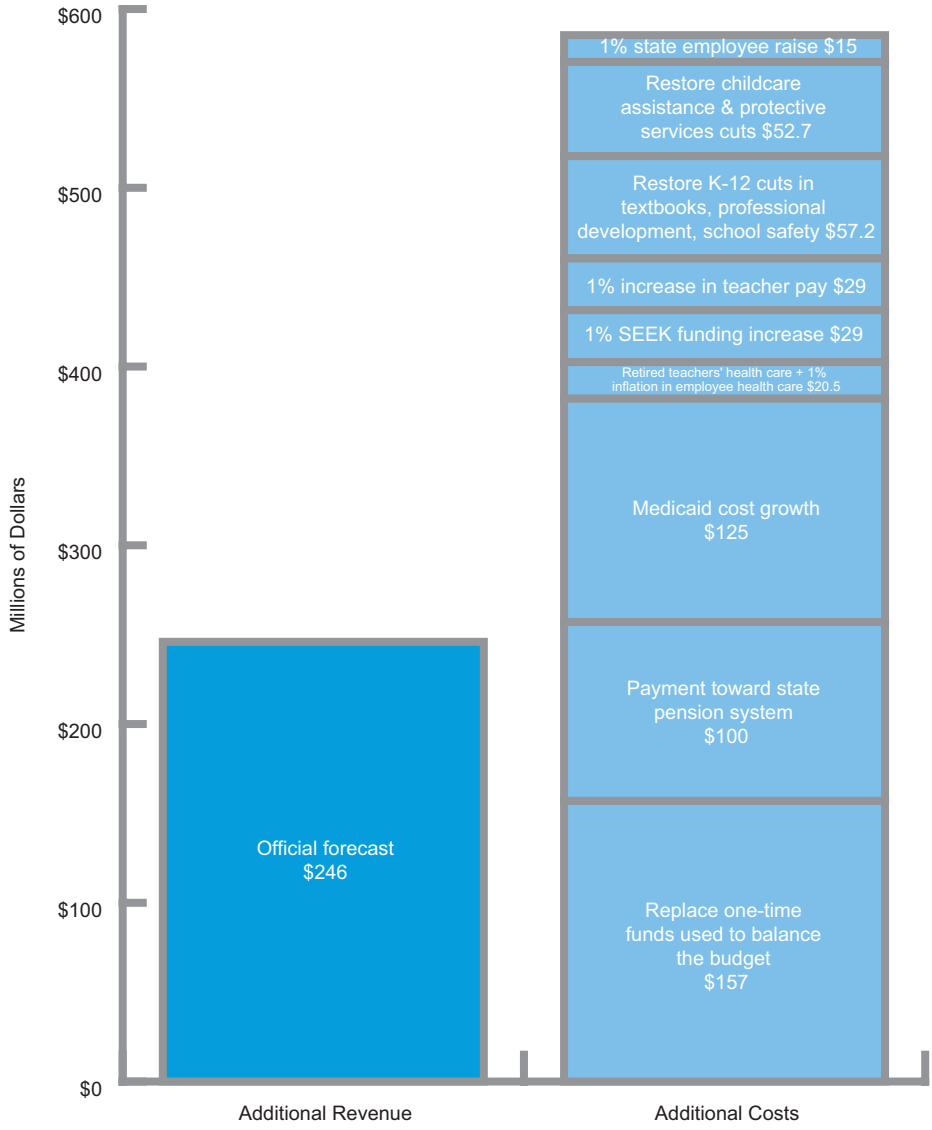
Conclusion

Kentucky will enter its next budget debate facing enormous challenges. A weak revenue forecast caused by the sluggish economy and an inadequate state tax system means limited new dollars. At the same time, the needs in the state budget are many. Kentucky is feeling the effects of harmful budget cuts in education, human services, health care and other areas. The state needs to begin more responsibly paying down its debts. And Kentucky is missing the opportunity to make new investments that could grow our economy and strengthen our quality of life.

As shown in the graph below, the $246 million in expected new General Fund revenue in next year's budget is not even enough to cover the cost of replacing one-time funds used to balance the current budget and make the full payment of the state employees' retirement system. (The graph includes only a sampling of the costs and budget needs included in this report.)

The choice between reinvestment and retrenchment that lawmakers will face in the coming legislative session has big implications for Kentuckians' well-being today and the strength of the Commonwealth far into the future.

New Revenue Wouldn't Even Cover Basic Costs



Source: Office of the State Budget Director

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