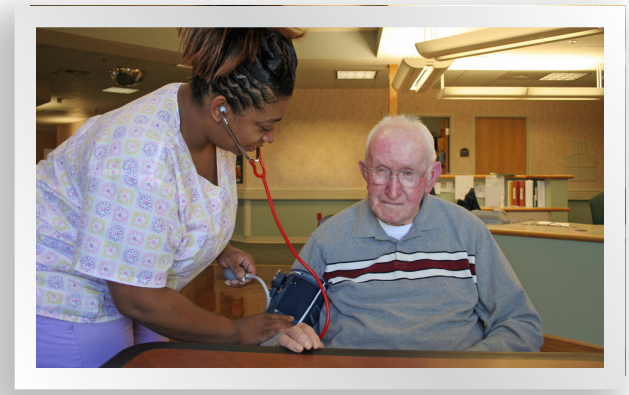

INVESTING IN KENTUCKY'S FUTURE

A PREVIEW OF THE 2016–2018 KENTUCKY STATE BUDGET

KCEP
KENTUCKY CENTER for ECONOMIC POLICY

INVESTING IN KENTUCKY'S FUTURE:
A PREVIEW OF THE 2016-2018 KENTUCKY STATE BUDGET

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Kentucky Center for Economic Policy
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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). For more information, please visit KCEP's website at www.kypolicy.org.

INVESTING IN KENTUCKY'S FUTURE

A PREVIEW OF THE 2016–2018 KENTUCKY STATE BUDGET

It is often said there is no clearer expression of the values of a country, state or community than its budget. It's through the budget that we pool resources together to pay for things we cannot do alone. Kentucky is a Commonwealth, and the health of the budget is a clear measure of our investment in shared prosperity.

As in recent sessions, state lawmakers will face enormous challenges crafting a new two-year budget starting in January. Since 2008, Kentucky has deeply reduced funding for vital services through 15 rounds of budget cuts totaling $1.7 billion. The state has avoided even deeper cuts only by underfunding pension payments owed to employees and teachers, increasing the future cost of those obligations. Now, even as many states are beginning to reinvest in areas they cut through the Great Recession and its aftermath, Kentucky will again face an extremely tight budget.

The $327 million in new revenue expected the first year of the new budget will fall far short of paying even basic costs. The bill for new expenses associated with pensions, Medicaid, corrections and a growing school population alone is over $800 million that year.

And there's a clearly-demonstrated need to go beyond the basics and invest in areas that would move Kentucky forward, including improving schools, increasing college affordability and enhancing the health of our population. We also have an obligation to protect public safety and the lives of Kentucky's most vulnerable, provide a modern infrastructure and operate a fair justice system.

We shouldn't limit our debate over these priorities to the budget itself—which amounts to $10 billion in the General Fund—while leaving another $12 billion in so-called tax expenditures (including exemptions, credits and loopholes) unexamined. That money on the table could fill some portion of Kentucky's investment needs if we took action to clean up and simplify the tax code.

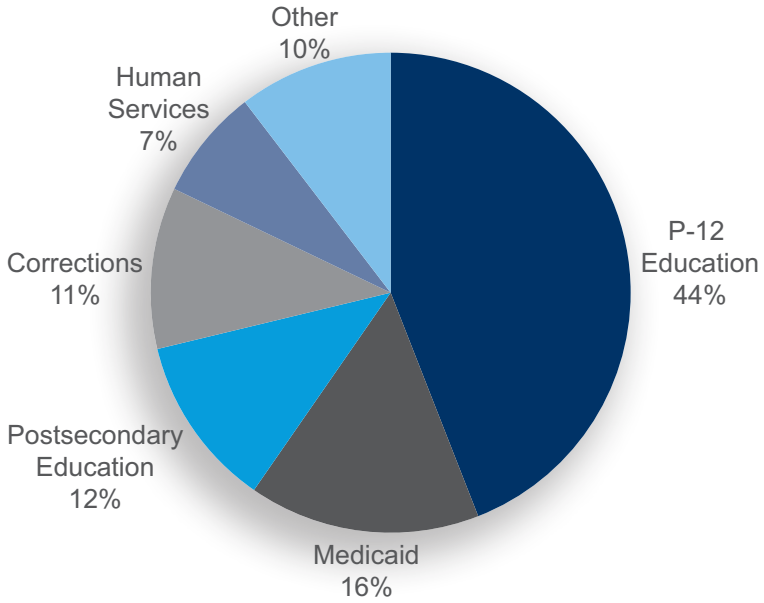
The budget belongs to everyone in the Commonwealth. When more Kentuckians learn about and engage in the budget process, it can better contribute to thriving communities and a stronger state. This report provides an overview of the budget situation the General Assembly will face in 2016.

PART 1: THE BUDGET

Since 2008, state lawmakers have made 15 rounds of cuts to the General Fund budget, totaling $1.7 billion. Those cuts have impacted 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 problems that result from underinvesting in a variety of public services.

2014-2016 How General Fund Monies Are Spent

Total: $20.3 billion over biennium



Source: Budget of the Commonwealth 2014-2016.

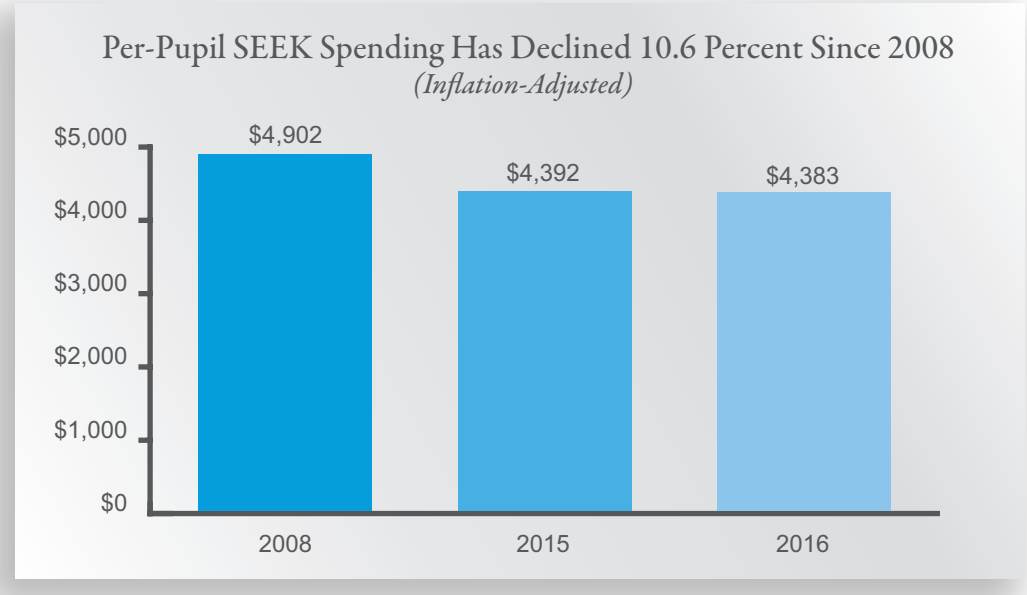
UNDERINVESTMENT IN P-12 EDUCATION CONTINUES

Kentucky's schools are continuing to deal with fewer resources due to the budget cuts of recent years, despite efforts to protect P-12 education in the budget relative to other areas—and even with a small increase in funding in the 2014-2016 budget. The state ranks 10th worst in the country when it comes to K-12 funding cuts since the recession started in 2008—with a decline of 12.1 percent per student in inflation-adjusted terms—according to a report by the Center on Budget and Policy Priorities.[1]

Between 2008 and 2014, funding for SEEK—Kentucky's formula for allocating money to local schools—was essentially frozen. While the 2014-2016 budget included an increase in SEEK funding of $92 million (or 3.2 percent) in 2015 and $37 million (or 1.3 percent) in 2016, these increases just maintain existing funding once inflation is taken into account.[2] A small additional increase in SEEK funding was also implemented in 2015 to cover greater than expected student enrollment. The legislature authorized up to $10 million in appropriations

from end-of-year surpluses or the rainy day fund for SEEK in 2015 because actual school attendance numbers exceeded what was budgeted.[3]

The increases did not begin to roll back previous cuts. In fact, SEEK funding per student in the budget is still 10.6 percent below 2008 levels in 2016 after adjusting for inflation.[4] This makes Kentucky sixth worst in the nation when it comes to cuts in core formula funding for local schools since 2008. The state is also one of a handful that continued to cut education funding this current fiscal year. Restoring SEEK funding to its inflation-adjusted 2008 per-pupil level would cost about $356 million a year.[5]



Source: Center on Budget and Policy Priorities.

Funding did go up for Learning and Results Services—which includes a range of primary and secondary education support programs—in 2015 and 2016, but the increases were not enough to get back to 2008 levels in most cases, even before taking inflation into account. Since 2008, textbooks have been cut 33 percent and after school programs by 30 percent when inflation is included.

Funding for Primary and Secondary Education Programs Since 2008

	FY 08 (originally enacted)	FY 16	Dollar Change	Percent Change	Inflation-Adjusted Percent Change
Instructional Resources/Textbooks	$21.7	$16.7	-$5.0	-23%	-33%
Extended School Services	$31.8	$25.5	-$6.3	-20%	-30%
Professional Development	$15.0	$11.9	-$3.1	-21%	-31%
Safe Schools	$10.4	$10.4	$0	0%	-13%

Millions of dollars. Source: KCEP analysis of Office of the State Budget Director (OSBD) data.

Also, public pre-school received some additional investment in 2016—$18 million more than the previous year (a 25 percent increase) in order to expand eligibility for four-year-olds with household incomes up to 160 percent of

the poverty level; the cut-off was previously 150 percent of that level. Investments in pre-school have been shown to bring high returns in terms of greater educational attainment and earnings, lower crime rates and less social spending later in life.[6] Half of kindergarteners in Kentucky begin the school year not being kindergarten ready.[7]

The 2014-2016 state budget also included a small automatic pay raise for teachers and administrative staff in both 2015 (one percent) and 2016 (two percent). This is the first raise for school employees in several budget cycles.

A 2014 report commissioned by the Council for Better Education (CBE) concluded that in order to reach the high academic achievement goals set out in 2009's Senate Bill 1, the state needs a funding system that better supports schools.[8] The study's evaluation of Kentucky's performance at its current level of funding—compared to national averages, comparison states and leading states—found that the state is performing relatively well considering its low level of funding. But in order to make progress additional investments will be necessary.

Adjusted for the cost of doing business in each state, Kentucky's per-pupil spending is below the national average, ranking 29th nationally. Also just behind the national average is the state's pupil to classroom teacher ratio. Meanwhile, high achieving states typically spend between 15.9 percent and 96.6 percent more than Kentucky per pupil on their schools. Education Week gave Kentucky a grade of F in the spending category of its 2015 Quality Counts report card.[9]

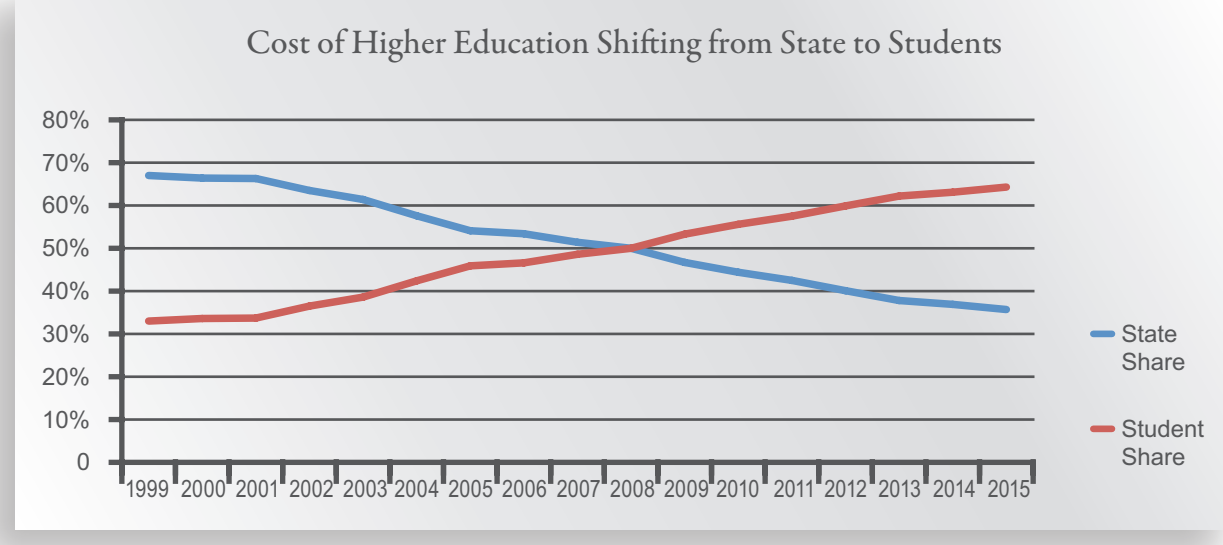
The state budget cuts—alongside federal education cuts—are being felt especially hard in the state's poorer school districts as they are less able to make up for cuts with local property taxes. The same local property tax increase yields more than 10 times more funding per student in the wealthiest Kentucky school districts than in the poorest ones.[10] The underfunding of the state's poorer schools means low-income children, who because of their economic situation already face many barriers in life, also have fewer educational resources. The Kentucky Education Reform Act of 1990 (KERA) created the SEEK formula to reduce such inequities, but the funding gap has been slowly growing since then.[11]

The state will need a projected $63.6 million just to cover costs associated with additional students enrolling in the 2016-2018 budget.[12] The state's Department of Education is requesting an additional $349 million in funding over the biennium, including monies to cover transportation costs that have shifted from the state to school boards and more slots for pre-school.[13]

HIGHER EDUCATION CUTS MAKING COLLEGE UNAFFORDABLE FOR MANY

Compared to before the Great Recession, Kentucky's public universities and colleges are receiving 28 percent less in state funding (28 percent less to public universities and 27 percent less to the community college system) once inflation is taken into account.

The recent cuts are part of a trend where the cost of public higher education is 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 36 percent in 2015. Tuition and fee increases at state universities over that time period ranged from 206 percent (Murray State University) to 286 percent (Western Kentucky University) and 203 percent at community and technical colleges.[14]



Source: Council on Postsecondary Education.

Kentucky ranks 11th worst among states in its cuts to per-student funding for higher education since 2008, according to a report by the Center on Budget and Policy Priorities. While most all states have begun to reinvest in the last couple of years, Kentucky is one of just three states that continued to cut higher education funding between 2014 and 2015.[15]

Such disinvestment may lead to more limited access to higher education and opportunities for economic growth as the state's public universities and community colleges end up raising tuition in order to compensate somewhat for the state budget cuts. Kentucky is among the five states with the highest increase in the average cost of tuition since last year—a 3.9 percent increase or an average of $344 more per student than last year.[16]

Kentucky's community colleges were ranked as having the highest tuition among Southern Regional Education Board states and the 11th highest community college tuition in the nation in 2013.[17] The 2014-2016 budget included allowing the state's community college system to charge fees to students in order to finance construction projects—$4 per credit hour in 2015 and rising to $8 per credit hour in 2016. These fees are on top of escalating tuition.

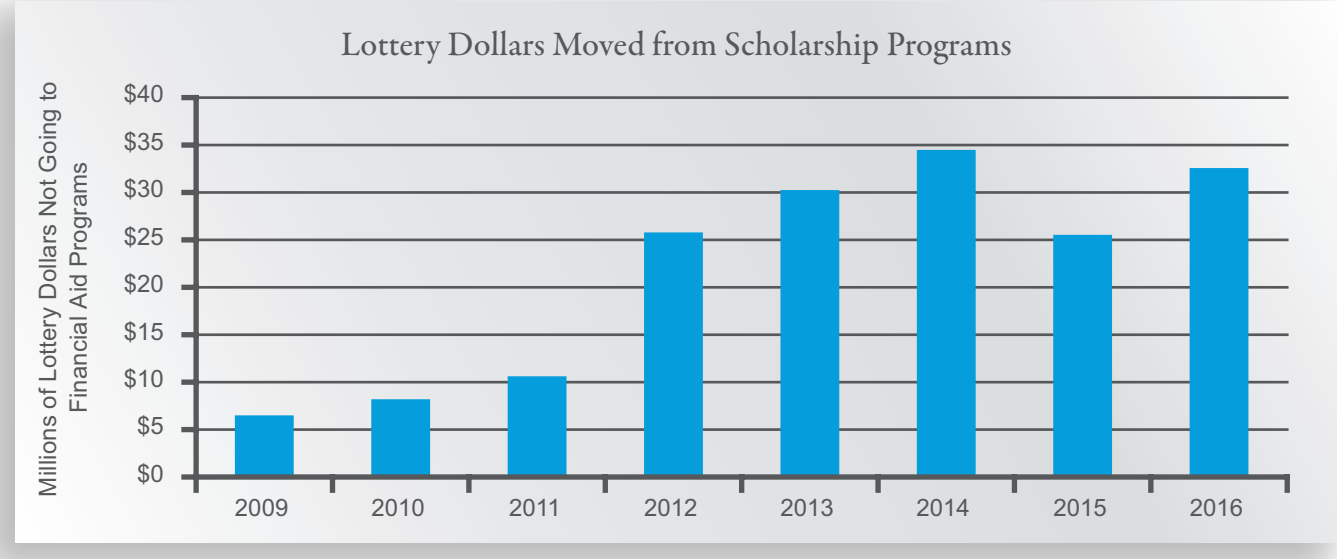
In addition to increased tuition, the state's higher education institutions have had to cut back on staff, defer maintenance issues—some of which are very serious—and are relying more heavily on part-time faculty.[18]

The Council on Postsecondary Education (CPE) has included in its 2016-2018 budget request additional funds to stabilize tuition at the state's community colleges—$1.75 million in 2017 and $3.5 million in 2018 to support lower tuition and fee increases. CPE is also requesting a partial restoration of budget cuts since 2008 in its operating funds request through a performance based funding model; the requested performance funds are $43.4 million in 2017 and $86.7 million in 2018.[19]

Meanwhile, Kentucky's lottery-funded need-based financial aid programs are not fully funded, which means that thousands of students who qualify for aid do not receive it—over 62,000 students in 2015 (for the College Access Program (CAP) and Kentucky Tuition Grant (KTG) combined) or around 56 percent of those who qualify for an award.[20]

Part of the reason is that an increasing amount of lottery money—an estimated $32.6 million in 2016—is being diverted from need-based financial aid programs to fill other holes in the budget. By statute, all but $3 million of

lottery revenue is to go to the state's three main scholarship programs, which include both merit- and need-based aid. But the diversion of monies comes out of the state's need-based scholarship programs. While 55 percent of the lottery money is supposed to go to the need-based programs (CAP and KTG) and 45 percent to the merit-based Kentucky Educational Excellence Scholarship (KEES), in 2016 CAP and KTG received just 40 percent while KEES was fully funded.[21]



Source: KCEP analysis of OSBD and Kentucky Higher Education Assistance Authority (KHEAA) data.

Amidst these college affordability issues, it is not surprising that the state has low rates of low-income students earning degrees and credentials. According to CPE's most recent accountability report, the bachelor's degree graduation rate for low-income Kentuckians was just 36.6 percent, compared to the 48.9 percent for all Kentucky students at four-year institutions.[22] For associate's degrees, the graduation rate for all Kentucky students at the state's two-year-degree-granting colleges—where many of the students are low-income—was just 12.8 percent. Kentucky also has the third highest student loan default rate in the nation and student debt is on the rise.[23]

It is also important to note that Kentucky Adult Education (KYAE), which is part of CPE, was cut by 36 percent between 2008 and 2016 in inflation adjusted terms. Meanwhile, 360,830 working age (18-64) Kentuckians (13.1 percent) did not have a high school diploma or equivalency credential in 2013, ranking the state 37th in the nation on that measure.[24] CPE is requesting an additional $1.2 million in 2017 and $2.4 million in 2018 to support local adult education providers.[25]

MEDICAID EXPANSION A GOOD DEAL FOR KENTUCKY

Low-income Kentuckians are benefitting greatly from the state's move to expand Medicaid eligibility through the Affordable Care Act (ACA) to 138 percent of the federal poverty line. So far more than 425,000 Kentuckians have newly qualified for coverage.[26] The expansion is the major reason Kentucky's rate of uninsured dropped from 14.3 percent in 2013 to 8.5 percent in 2014, the biggest decline in the nation.[27] And many Medicaid participants are utilizing preventive health care services like cancer screenings, which are expected to improve health outcomes and help with Medicaid costs in the future.[28]

The ACA has also improved access to mental health and substance abuse services for low-income Kentuckians and has reduced the necessity of state funding for these services that are now covered by Medicaid. Nearly 15,000 Medicaid members with a substance use disorder have received treatment since January 2014, when these services became a newly covered essential health benefit through the ACA, and 34 percent more of Kentucky's Medicaid participants received behavioral health services in 2014 than in 2013.[29]

Kentucky's expansion of Medicaid eligibility will have its first costs come due in the 2016-2018 budget. For the first three years of the expansion, the federal government pays all costs; then the state begins paying a share, which phases up to 10 percent in 2020 where it remains thereafter. Kentucky will pay five percent of the costs in 2017 and six percent in 2018. The state's portion is projected to be $62.3 million in 2017 and $149 million in 2018.[30]

While these incremental costs of the Medicaid expansion must be included in the 2016-2018 budget, the state is also achieving savings because of increased coverage and as well as from tax revenue due to the jobs created from the injection of federal dollars. Data from the Cabinet for Health and Family Services (CHFS) shows there are savings in the General Fund budget on indigent care, mental health and substance abuse, public health and other areas that are now covered by Medicaid with the federal government picking up most of the costs. There are also individuals covered under traditional Medicaid through special eligibility categories (i.e., through the Breast and Cervical Cancer Screening Treatment Program) where the state was paying 30 percent of the costs that are now eligible for expansion Medicaid where the state pays a smaller share. As shown in the table below, those savings of $265 million over the next two years exceed the $211 million the state will need to put forward for its match.

Savings and Cost of Medicaid Expansion in the State Budget

	FY 17	FY 18	Total
Dept for Behavioral Health, Development & Intellectual Disabilities	-$30.6	-$31.2	
Dept for Public Health	-$11.9	-$12.2	
Dept of Corrections	-$11.5	-$11.7	
Quality Care Charity Trust Fund (QCCT)	-$18.5	-$18.9	
Dept for Community Based Services	-$1.1	-$1.1	
Subtotal	**-$73.6**	**-$75.1**	**-$148.7**
Breast and Cervical Cancer Screening	-$1.9	-$2.0	
Spend Down Recipients	-$37.2	-$37.2	
Ky Transitional Assistance Program /TANF	-$9.5	-$9.2	
Nursing Facility-short term	-$9.5	-$9.7	
Subtotal	**-$58.1**	**-$58.1**	**-$116.2**
Total	**-$131.7**	**-$133.2**	**-$264.9**
State Cost for Medicaid Expansion	$62.3	$149.0	$211.3
Net	**-$69.4**	**$15.8**	**-$53.6**

Millions of dollars. Sources: Cabinet for Health and Family Services; OSBD, "General Fund 2016-2018 Budget Analysis."

A report by Deloitte and the University of Louisville on the state's Medicaid expansion included those areas of savings as well as the benefits from increased tax revenue due to job creation, and estimated that the total

positive net impact of expansion on the budget is $119 million in 2017 and $221 million in 2018.[31] While it's impossible to say exactly how many jobs have been created so far directly because of the expansion, the state had 11,700 more jobs in the health care and social assistance sector in November 2015 than it had in December 2013, before the expansion began.[32]

There has been some discussion that the new administration plans to dismantle Kynect, the state-based private insurance exchange, and shift Kentucky to the federal health insurance exchange. There are significant costs associated with these actions. For instance, it has been estimated that moving to the federal exchange would cost the state $23 million in technology costs alone.[33]

Other state health care spending beyond the Medicaid expansion remains seriously challenged. Kentucky's community mental health centers that provide treatment and recovery services for people struggling with mental illness and substance abuse, as well as those with developmental and intellectual disabilities, have not received a state funding increase since the 1990s; funding has therefore failed to keep up with inflation or the growth in demand for services, which has been especially high with the weak economy.[34] As a result, Kentucky's community mental health centers have been unable to serve all of those who need their services.[35]

According to the National Alliance on Mental Illness's most recent report card, Kentucky was one of six states to receive a grade of "F" for its poor funding of behavioral health services, and the Kaiser Family Foundation ranked Kentucky 45th in per capita mental health services expenditures.[36]

Now that health insurance policies are mandated to cover treatment for mental health and substance abuse disorders, the expanded Medicaid population can receive treatment at community mental health centers covered by Medicaid; this means fewer General Fund dollars are now needed for treating this group. However, even with the expansion, community mental health centers are struggling with higher administrative costs in dealing with the Medicaid Managed Care Organizations (MCOs), reduced revenue and difficulty in meeting the increased need for services.

Alongside the heroin legislation passed in Kentucky's 2015 General Assembly, the state appropriated $10 million in immediate funding for substance abuse treatment and those programs will cost $24 million annually. Among the efforts these funds are being used to support in 2016 are: $2.6 million for grants to community mental health centers to fund additional substance abuse treatment resources on a local level, as well as funding for treatment in local jails and $1 million to the Kentucky Agency for Substance Abuse Policy (KY-ASAP) to supplement traditional programming.[37]

HUMAN SERVICE CUTS CONTINUE TO TAKE A TOLL ON VULNERABLE KENTUCKIANS

CHILD CARE

More than 24,000 Kentuckians rely on Kentucky's Child Care Assistance Program (CCAP), which provides help with child care costs for low-income families.[38] The 2014-2016 budget included a phased-in restoration of cuts that had been made to CCAP in 2013 due to a budget shortfall for the Department for Community Based Services.[39] In 2013, applications were frozen and eligibility dropped to 100 percent of the federal poverty level

(down from 150 percent). Appropriations in the 2014-2016 budget were enough to enable CCAP to reopen the program and return to qualifying those up to 140 percent of the 2011 federal poverty level in 2015 and to go back up to 150 percent of the poverty level in 2016. However, total funding for child care assistance is still 30 percent less than pre-recession levels when adjusted for inflation; this is because federal funding is half of what it was in 2011 and state funding has had to increase to partially make up for these cuts.[40] Even with the restoration of cuts Kentucky has the ninth lowest eligibility cap in the country. Some advocates are calling for lawmakers to increase the eligibility limit for CCAP to 200 percent of the federal poverty level. There are also concerns about the continued low reimbursement rates, which are a challenge for child care centers and their employees.[41]

In 2013, the state's Kinship Care program—which provides a $300 monthly stipend to relatives caring for abused or orphaned children—was also subject to a moratorium on new enrollments. Prior to the moratorium, the program had been growing at about seven percent a year. These cuts, which prevent eligible families from receiving financial support, were not restored in the 2014-2016 state budget.[42]

SOCIAL WORKERS

The state's social workers, who protect the safety of many Kentucky children, face well-publicized challenges. CHFS recently testified that the state's social workers struggle under a growing workload of child abuse and neglect cases, with high staff vacancies and frequent turnover as workers quit.[43] In June the number of children removed from homes because of abuse or neglect reached more than 8,000, which may have been an all-time high for the state. Without more workers to manage cases, children stay in foster care longer.

Turnover rates for social workers in the state's urban areas were especially high in 2014, with nearly half in northern Kentucky and one in five in Louisville leaving the job.[44] CHFS has commissioned an independent study of its workers' caseloads in order to determine adequate staffing levels. While social workers can legally have no more than 25 active cases in Kentucky, national accreditation standards limit the number to 18. Kentucky's Child Fatality and Near Fatality Review Panel, established in 2013, found that high caseloads were a consistent theme in cases of child deaths and serious injuries. At the same time, many individual workers may actually be carrying caseloads closer to 50 or 60 or more if all visits, court appearances, reports and other required documentation are counted.[45]

OTHER HUMAN SERVICE NEEDS

More than 13,000 people are on waiting lists at the Department for Aging and Independent Living for meals, transportation, home-based based services and caregiver services—and some have been waiting as long as five years.[46] The state's needs for these services will continue to grow as Kentucky is one of the fastest aging states.[47]

Meanwhile, the Michelle P Waiver program—which provides services that help Kentuckians with intellectual and developmental disabilities remain close to their homes, families and friends—has a waiting list of around 4,000 people, even though the legislature added 250 slots in 2015 and 250 more in 2016.[48]

In addition, public defenders, who represent Kentuckians who cannot afford to hire an attorney, remain at 2014 funding levels despite the caseload at that funding level being 476 newly assigned cases per attorney each

year; this level is considered to be excessive and even unethical, according to the state's Department of Public Advocacy.[49] In 2015, almost every staff attorney in the state had a caseload that exceeded the maximum national standard.[50]

And caseloads for Kentucky's guardianship program are also high. The program provides a legal relationship between a court-appointed party who assumes the responsibility of guardian and a ward, a person declared legally disabled by the court and who cannot manage his or her own well-being. At the current funding level in 2014, guardians had an average caseload of 73 wards (and some have up to 90); the goal is for guardians to have just 40 wards.[51]

FUNDING CUTS/NEEDS IN OTHER AREAS AFFECT A WIDE RANGE OF KENTUCKIANS

Many other services have been harmed by state budget cuts, including:

- Funding for the Kentucky Arts Council has now been cut by 42 percent, Kentucky Educational Television (KET) by 32 percent and Libraries and Archives by 26 percent, taking inflation into account. Prior to the most recent cuts, KET's workforce had already been reduced by 24 percent, and the number of employees in the Department for Libraries and Archives had declined from 131 to 98.[52] With the additional cuts in the 2014-2016 budget, a reduction of services provided through the Kentucky Department for Libraries and Archives was expected.[53]
- The budgets for the Attorney General, State Auditor and Secretary of State have been cut by 29 percent to 37 percent. These cuts impact the state's ability to protect consumers, oversee fair elections and keep an eye on how public dollars are spent.
- Funding for state police has been cut by an inflation-adjusted 18 percent. In the last budget, Kentucky State Police were cut by 2.5 percent. An additional $1.8 million was also provided to reinstate a program that would allow the agency to hire back 15 retired officers. However, overall coverage is about 125 troopers below what is recommended.[54] In addition, the Kentucky State Police Professional Association recently testified that troopers' pay in Kentucky is lower than in border states when averaged; and pay has been a barrier to the recruitment and retention of troopers. The last substantial pay raise happened in 2006, by executive order, allowing a $3,100 training stipend.[55]
- Budget cuts have contributed to a backlog of untested rape kits in Kentucky's state and local law enforcement offices.[56]
- Kentucky's Association of Children's Advocacy Centers says there's a need for additional funding in order to respond to the current demand for services for victims of child abuse—and to expand to serve a larger number (a projected increase of 3.9 percent per year). Since 2008, there has been a 27 percent increase in child victims of abuse and this alarming figure is expected to increase in coming years.[57]
- Vocational Rehabilitation, which helps Kentuckians with disabilities find work, has had its funding reduced by 22 percent in inflation-adjusted dollars since 2008. These cuts have resulted in the state missing out on federal Office of Vocational Rehabilitation funding—as well as federal Office of the Blind money—because state funding didn't meet the maximum grant match amount.[58]

- Funding reductions to the Energy and Environment Cabinet jeopardize the state's ability to respond to emergencies and also to regulate air, hazardous waste and solid waste infractions that could prevent some crises from developing.[59] Water quality has also suffered due to reduced capacity for environmental enforcement resulting from budget cuts.[60]
- The infrastructure at Kentucky's state parks is deteriorating. They experience power outages, loss of phone and internet service, and outdated and crumbling water and sewer lines. The lack of high speed internet is costing state parks as they lose clientele—for instance, major trade organizations that hold conventions.[61] Personnel has been cut from 1,160 state employees in state parks in 2008 to just 761.[62]

General Fund Cuts to Selected Agencies from Original 2008 Budget to 2016

	2008 Enacted	2016	Percent Change	Inflation-Adjusted Percent Change
Kentucky Arts Council	$4,182,500	$2,796,200	-33%	-42%
Kentucky Educational Television	$16,816,100	$13,245,000	-21%	-32%
Attorney General's Office	$14,113,100	$10,622,700	-25%	-35%
Secretary of State	$2,298,100	$1,662,800	-28%	-37%
Libraries and Archives	$14,689,300	$12,543,400	-15%	-26%
Deaf and Hard of Hearing	$933,000	$883,200	-5%	-18%
Auditor	$5,828,300	$4,775,300	-18%	-29%
Public Health	$73,823,000	$71,111,300	-4%	-16%
Commission on Women	$266,200	$232,000	-13%	-24%
Commission for Children with Special Health Care Needs	$5,917,000	$5,587,200	-6%	-18%
State Police	$80,305,900	$75,788,600	-6%	-18%
Vocational Rehabilitation	$13,134,400	$11,709,100	-11%	-22%
Kentucky Nature Preserves Commission	$1,166,500	$1,086,400	-7%	-19%
Community and Technical College System	$226,331,100	$190,162,300	-16%	-27%
Universities	$881,434,300	$726,042,600	-18%	-28%
Commission on Human Rights	$1,859,100	$1,738,800	-6%	-19%
Environmental Protection	$26,118,000	$21,846,400	-16%	-27%
Energy Development and Independence	$2,341,500	$1,356,600	-42%	-50%

KCEP analysis of Budgets of the Commonwealth.

STATE MUST FACE TEACHER AND PUBLIC EMPLOYEE PENSION FUNDING CRISIS

One of the biggest issues facing the 2016-2018 budget is the state's unfunded pension liabilities for the Kentucky Teachers' Retirement System (KTRS) as well as the Kentucky Employees Retirement System (KERS), which covers state workers.

For years the state has neglected its full KERS and KTRS payments. Shortfalls in KERS payments started as early as 1993 but began in earnest in 2004. Between 2007 and 2014, the state shortchanged KERS by at least $100 million a year. Likewise, the state stopped making full required contributions to KTRS in 2009 and the amount owed has since ballooned as the state skipped payments and fully experienced the investment losses from the recession. As a result, there is a huge funding gap between what KERS and KTRS have promised in benefits and current funding. With the KERS non-hazardous plan, the unfunded liability is at $11 billion and the plan is just 17.7 percent funded in 2015, utilizing a new lower assumed investment return.[63] The unfunded liability for KTRS is $14 billion (and $24 billion according to new accounting rules that must be used because the state is not making fully actuarially required payments).[64] KTRS is estimated to be 54 percent funded (and 42 percent funded according to the new standards).[65]

In the last budget, the state did commit to full actuarial funding for KERS. However, the plan is still at risk because it has limited assets with which to invest to meet its targets and must maintain liquidity in order to pay out benefits. Even with the added dollars the system's funded ratio is expected to decline to 15 percent by 2020 according to an actuarial study produced for the system. The plan has a five to eight percent chance of running out of money.[66]

Action has not yet been taken to begin making full payments to KTRS. A House proposal in the 2015 General Assembly to use bonds to help shore up KTRS and allow the state to phase in to full funding of the system did not pass the Senate. Although the system's funded ratio is better than the KERS non-hazardous plan, the gap in dollars between what the state is now putting in and what it should put in according to the actuary is even larger with KTRS than it was with KERS. A work group was formed in the summer of 2015 to recommend funding solutions for KTRS. While a number of options were considered, the only specific funding recommendation was to allow monies now going to KTRS for debt service on bonds and payments for past cost of living adjustments and other benefits to continue to stay with the system in the future.[67]

Public employees have further been losing ground with the reduction of their retirement benefits. Legislation was passed in 2013 that suspended cost of living adjustments for pensions, eliminated the defined benefit plan for new state employees and replaced it with a hybrid cash balance plan that exposes employees' retirement income to greater risk.

The state has also reduced health benefits for employees by increasing the amount they have to contribute for health insurance. Employees contributed 48 percent more out of pocket for medical expenses in 2014 than in 2008.[68] Meanwhile, the state most recently transferred $63.5 million from the Public Employee Health Trust Fund to the state's rainy day fund. This is on top of a similar $93 million transfer to the General Fund in 2015 and a $50 million transfer in 2009. The money is available because less has been paid out in claims and other expenses than employees and the state have contributed to the fund.

After several years without raises, state employees did receive tiered raises in the 2014-2016 budget (between one percent for the highest earners and five percent for the lowest earners) in 2015 and a flat one percent raise for all employees in 2016. As noted previously, public school teachers and staff received a one percent raise in 2015 and a two percent raise in 2016.

NEW COSTS IN NEXT BUDGET ARE MOUNTING

On top of the funding needs created by budget cuts, Kentucky faces new costs in the 2016-2018 budget that will be difficult to cover given expected revenue.

UNFUNDED PENSION LIABILITIES

In order to meet its obligations, the state needs to put much more money into its retirement systems to cover its full actuarially required contributions. For KERS this was expected to mean an additional $120 million next biennium—$60 million each year. But now that the pension oversight board has recommended using the new lower rate of return on the KERS contributions in the 2016-2018 budget, this amount will increase.[69] KTRS will need more than a billion dollars more than in the previous budget—$544 million more in 2017 and $512 million more in 2018.[70] These unfunded pension liabilities led Standard and Poor's to downgrade Kentucky's credit rating by one notch. Only two states now have a lower rating; such a downgrade typically increases a state's cost to borrow money.[71]

ROUTINE COST INCREASES

Due to a number of factors, each year it becomes more expensive just to maintain current levels of state services. Inflation in health care costs is a particularly large expense for the state as it tends to be higher than other forms of inflation, and Medicaid and employee health insurance are substantial state expenditures.

After six years of somewhat slower national health spending growth below 5 percent, health costs grew 5.5 percent in 2014 and are expected to grow 5.3 percent in 2015.[72] Spending growth is then projected to average 5.8 percent through 2024, peaking at 6.3 percent in 2020, according to one recent projection.

According to the Office of the State Budget Director, costs for traditional Medicaid (not including the expansion) will grow by $133 million in 2017 and $230 million in 2018. And every one percent increase in employee health insurance costs will mean $14 million more is needed in 2017 and $23 million more in 2018.[73]

In addition to the increase in health care costs, the state budget must take into account inflation in other areas as well—for instance, transportation costs and the cost of materials and equipment. According to the U.S. Bureau of Economic Analysis, basic inflation for state and local governments increased 12 percent between 2008 and 2014.[74]

CORRECTIONS SYSTEM

With one of the nation's fastest growing prison populations, Kentucky's state corrections spending went from $140 million in 1990 to $440 million in 2010—an increase of 214 percent.[75] Kentucky passed the "Public Safety

and Offender Accountability Act" (HB 463) in 2011 in response to the growing recognition that mandatory minimum sentences for drug crimes have cost Kentucky without leading to decreased crime rates. The legislation reduced prison time for non-violent drug offenders, increased offenders' opportunities for drug treatment and emphasized programs that have evidence of reducing the likelihood that an inmate will return to prison. The legislation was initially projected to save the state $420 million over 10 years.

While HB 463 has resulted in some periods of decline in the prison population, the decrease—and savings to the state—have not been as much as had been forecast. A January 2014 estimate was that HB 463 had resulted in a total savings of $34.3 million; however, the state's inmate population has been increasing fairly steadily since mid-2013 and is now back to 2011 levels.[76] These increases do not have to do with growth in crime; Kentucky's crime rate and violent crime rate have been falling and are both below the national average.

Part of the issue is that parole rates unexpectedly went down and therefore inmates are staying in prison longer—although parole rates have recently been increasing.[77] Some in the criminal justice system who disagree with the reform measures exercise their discretion in ways that prevent the reforms from being fully implemented—for instance, judges who are opposed to pretrial release for low- and moderate-risk arrestees and prosecutors who refuse to use deferred prosecution.[78]

A new development is that heroin legislation (SB 192) passed in the 2015 General Assembly imposes more prison time for some drug offenses, potentially bolstering the inmate population and increasing costs to the state.[79]

The state's projected expenses for additional inmates are $9.4 million over the biennium.[80]

DEBT SERVICE COSTS

The state restructured some of its debt between 2009 and 2012, pushing debt forward to future years—and costing more in the long run—in order to reduce immediate budget costs at the time. As a result, appropriation-supported debt service as a share of total revenue has been on the rise recently. It was higher in the 2015 and 2016 budget (6.84 percent and 6.68 percent, respectively) than in the 2013 and 2014 budget (5.94 percent and 6.14 percent, respectively). And it was higher in 2013 and 2014 than in most preceding years. A 2011 state analysis calculated that the additional interest cost for the General Fund as a result of the restructuring would be $35.4 million in 2015 and 2016 compared to $23 million in 2013 and $26 million in 2014.[81]

The 2014-2016 budget did not include any additional debt restructuring, although it did include approximately $1.5 billion in bonded projects compared to $239 million in the 2012-2014 budget. New debt service for school projects obligated by the 2014 General Assembly is projected to be $30.8 million over the two years of the 2016-2018 budget.[82]

ECONOMY SHORT OF FULL RECOVERY MEANS CONTINUED BUDGET PRESSURES

The economy is improving, but Kentucky still faces many economic challenges. Slack in the labor market, uneven growth across Kentucky and persistent poverty, among other factors, limit state revenue (as discussed later in this report) and also increase spending in order to provide services to those who need and are eligible for them.[83]

- **Medicaid Expansion.** With a weak economy, around 425,000 Kentuckians have enrolled in Medicaid through the expansion — many more than originally expected. Though some of those expansion recipients lack jobs, the majority are working but are employed at jobs that do not provide affordable health insurance. A KCEP analysis showed that the biggest industries in Kentucky where workers gained health coverage through the expansion in 2014 were restaurant and food services, construction and temp agencies.[84]
- **Social Services.** With the economy still weak, the need for state-funded services continues to be great. For instance: there are waiting lists for Meals on Wheels and other programs for seniors; tens of thousands of low-income students who qualify for state need-based do not receive it due to lack of funds; and public defender caseloads remain high as the number of newly assigned public defender cases per year has been on the rise even as Kentucky has experienced a drop in crime.

NEED FOR LONG-TERM INVESTMENTS IN KENTUCKY GROWING

With the 2016-2018 budget, the legislature's top priorities should be making necessary pension payments and restoring cuts. However, there are important investments Kentucky misses out on when its tight budget situation requires it to narrowly focus on these issues — investments in education, health and poverty reduction that would help improve quality of life and strengthen the economy in the long term.

ADVANCING EDUCATION

Education is a critical investment for building a strong state economy and creating a high quality of life for Kentuckians. Better educated Kentuckians are more productive, earn more and contribute more taxes over their lifetimes.[85] Only 34.4 percent of adults 25 to 54 in Kentucky have an associate's degree or higher, ranking the state 9th from the bottom on this measure.[86] Just 26 percent of the state's workforce has a bachelor's degree or higher.[87]

Further investment in early childhood education in Kentucky in particular would have a considerable pay-off long term. According to one economist, every $1 investment by a state in universal pre-school results in $3 in higher earnings for the state's residents. Investment in universal pre-school has also been shown to create twice as many jobs for state residents and increase earnings 15 percent more than investing the same amount of money in business tax subsidies.[88] The additional slots for low-income Kentucky four-year-olds to attend pre-school in the 2014-2016 budget were a step in the right direction, as was the gradual restoration of childcare cuts. But further expansion of these and other worthy programs — for instance, funding all-day kindergarten statewide — would be an investment in the state's future.

Expanding the state's career pathways efforts is another area that could yield important results — especially in the health sector.[89] Additional investments in inmate education could also help to improve the state's more than 30 percent rate of recidivism, the rate of return to state prisons for previous offenders.[90]

IMPROVING HEALTH

Kentucky typically ranks at the bottom on most measures of health status, although it may be gaining some ground. According to the United Health Foundation, Kentucky is now 44th in overall health, down from 47th the

previous year.[91] The state ranks worst among states in cancer deaths, 47th in number of poor mental health days and 49th in number of poor physical health days. Kentucky also ranks third worst in drug deaths. However, it did move from 46th in obesity in 2014 to 39th in 2015.

The state's move to expand Medicaid is expected to pay off both in the short term as more low-income Kentuckians can now seek care for medical conditions that are in many cases overdue for treatment as well as receive preventive medical care that is expected to lead to a healthier state in the long run. In 2014, 90,000 Medicaid expansion members received cholesterol screening and 80,000 expansion members had preventive dental care.[92]

In addition to holding onto the gains made through the Medicaid expansion and Kynect, Kentucky needs to do more to strengthen its mental health and substance abuse treatment services. These investments would help to improve quality of life in the state and also strengthen the workforce.

CREATING LADDERS OUT OF POVERTY

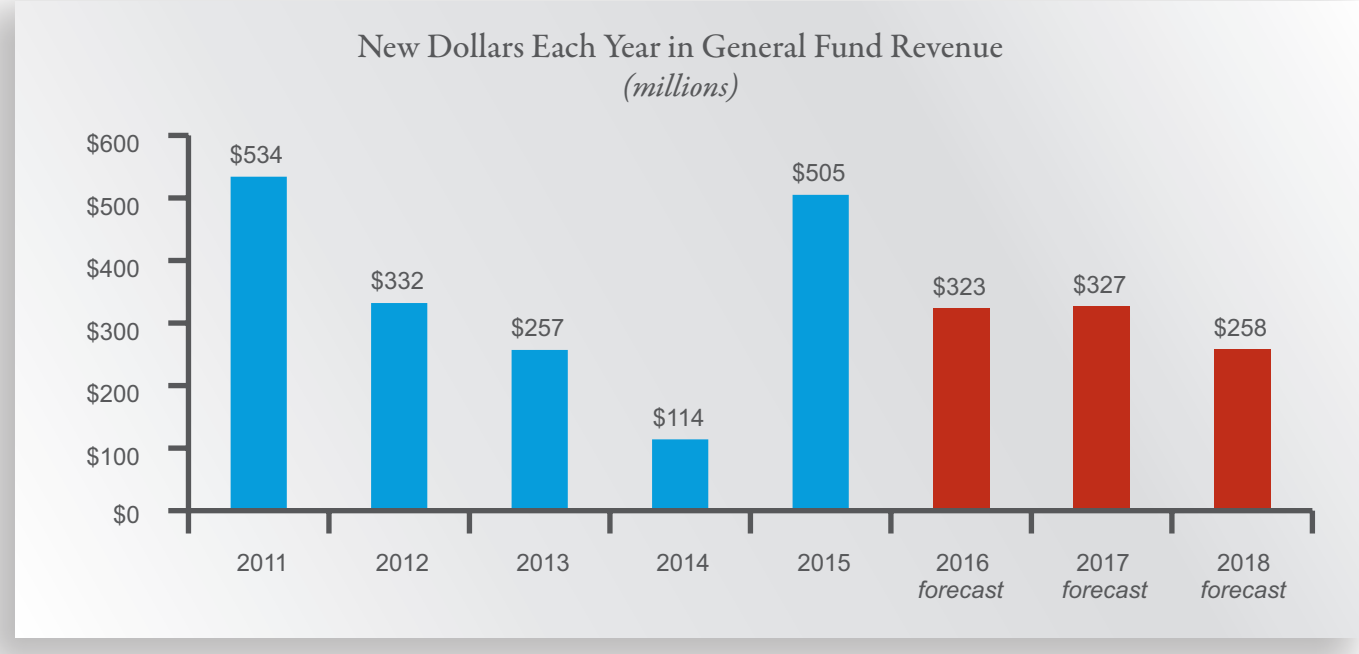
Kentucky is also consistently one of the poorest states in the country. According to the most recent Census data, Kentucky's overall poverty rate of 19.1 percent makes it the 5th highest in the nation, and the state's median income is the 5th lowest.[93]

In order to move more people out of poverty, the state needs to provide more support and access to opportunities. Among the solid strategies for doing this are: increasing access to high quality child care, expanding the state's career pathways efforts, creating a state Earned Income Tax Credit (EITC), providing more affordable financial services like state sponsored public retirement accounts, increasing affordable housing options, and enabling more Kentuckians to access drug treatment. Budget cuts lead to rungs on the ladder of opportunity cracking or breaking off, holding back individuals and the state as a whole. Kentucky should make important investments in its people that will be paid back as more Kentuckians rise above the poverty level and enter the middle class.

PART 2: REVENUE

The second half of this report concerns the revenue the state will collect over the 2016-2018 biennium to meet the budget needs described above, with a focus on factors impacting growth in the General Fund and each of its major revenue sources.

In December, the state's Consensus Forecasting Group (CFG) made official revenue estimates for budget years 2016 through 2018, showing moderate growth in the General Fund: 3.2 percent growth in 2016 and then again in 2017, and 2.4 percent in 2018. Nominally, growth is expected to hover around $320 million in 2016 and 2017, then taper off slightly to $258 million in 2018.[94]



Source: OSBD, June Receipts, Consensus Forecasting Group 2016-2018 Official Revenue Forecast.

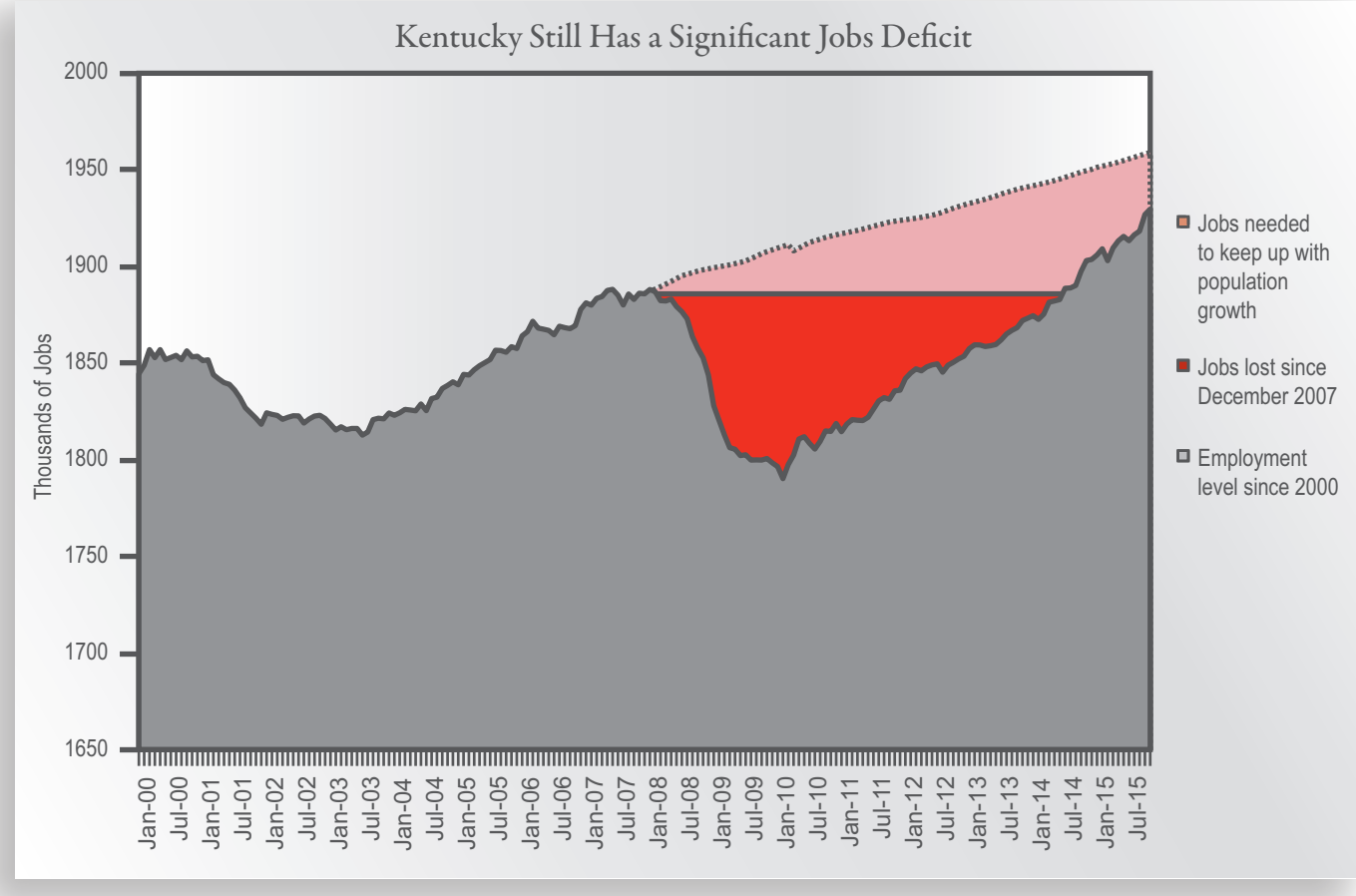
The projections also show that Kentucky will end the current budget year, fiscal year 2016, with an estimated $223 million in revenue above what was previously forecasted. This will be the second year in a row that revenues have exceeded the CFG's projections. Yet despite these extra dollars and moderate year over year growth, a large shortfall exists when the reference point is Kentucky's budget demands.

LOPSIDED, MODERATE ECONOMIC GROWTH STILL HOLDING BACK REVENUE

Kentucky's recovery from the Great Recession has been long and slow. At first glance, Kentucky's labor market—the primary avenue through which most Kentuckians experience economic growth and therefore a main factor in income and sales tax performance—has shown considerable improvement. As of November 2015, Kentucky's unemployment rate was down to 4.9 percent and after 5 straight years of job growth, the 120,000 jobs that were lost in the Great Recession have been replaced and surpassed.[95]

Yet by other measures, there is still significant slack in the labor market. Because the unemployment rate does not count discouraged workers who have stopped looking for jobs, it doesn't reflect the true size of the population who might seek work if it were more widely available. A different indicator, the prime-age employment to population ratio (EPOP), measures the number of Kentuckians with jobs against the state's population of adults, ages 25 to 54. At 70 percent, the state is still 6 percentage points below its pre-recession EPOP and has the 2nd worst ratio in the nation.[96]

Similarly, even though there are 54,700 more jobs today in Kentucky than there were prior to the recession, the state needs an additional 36,500—for a total of 91,200 more jobs than there were in December 2007– to keep up with population growth since then (see graph below). At a growth rate of 2,000 new jobs a month, it would take 3 years to get back to pre-recession employment levels.



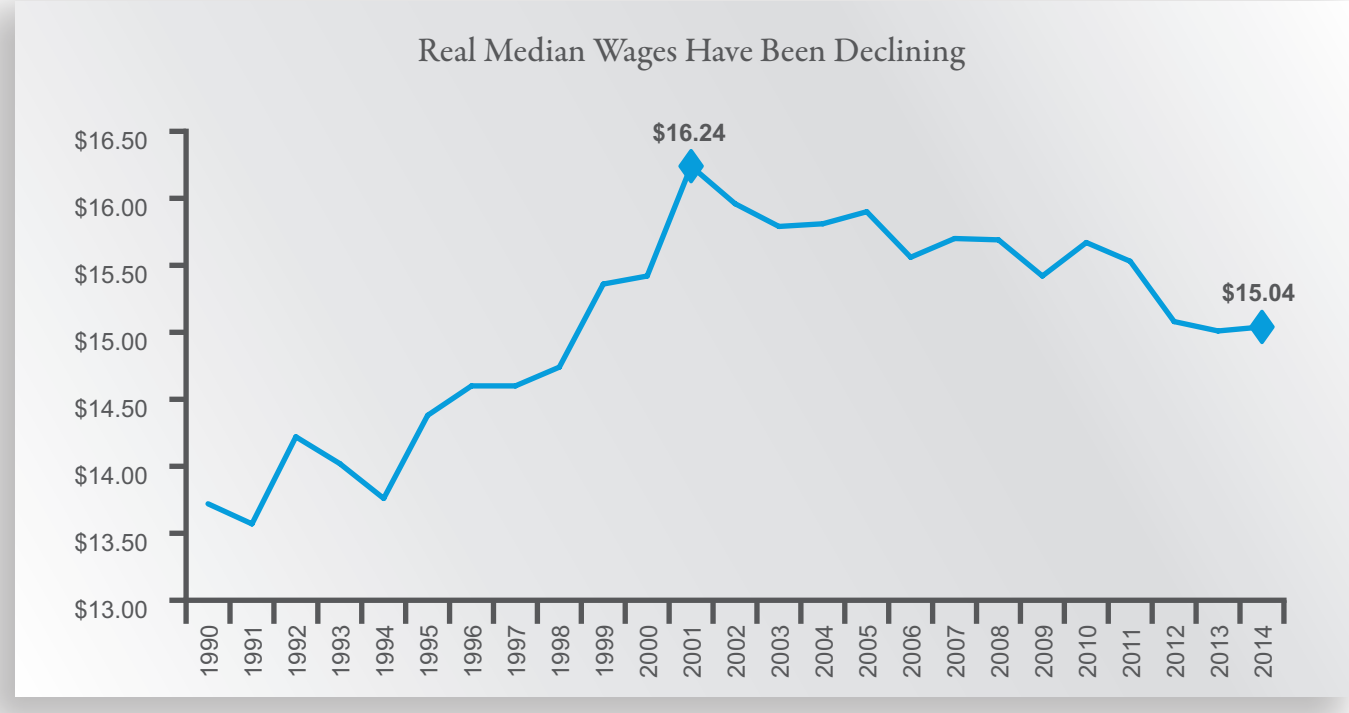
Source Economic Policy Institute (EPI) analysis of Bureau of Labor Statistics (BLS) data.

Another problem for workers is with the quality of jobs replacing those lost in the recession. Growth in the manufacturing sector is stronger in Kentucky than in the nation as a whole. However, neither manufacturing nor construction have fully recovered, with 7,600, or 9 percent, fewer construction jobs and 7,200, or 3 percent, fewer manufacturing jobs in November 2015 than there were in December 2007.[97] And jobs in coal mining have fallen from 18,812 in the 3rd quarter of 2011 to 9,356 by the 3rd quarter of 2015.[98] Historically, these industries paid good wages to workers with lower levels of education, but many of the jobs replacing them do not pay as well.

There were 18,100, or 11 percent, more jobs in the typically low-wage leisure and hospitality sector in November 2015 than there were in December 2007. And as of June of this year, one in five of the net new jobs created over the previous five years was in "employment services"—temp agencies, which staff a variety of businesses including manufacturing firms but typically at lower pay rates and with less job security than traditional employees receive.[99] The "professional and business services" sector which includes temp agencies has seen the largest nominal and relative growth of sectors in Kentucky since the recession—29,500, or 16 percent, more jobs in November 2015 than in December 2007.

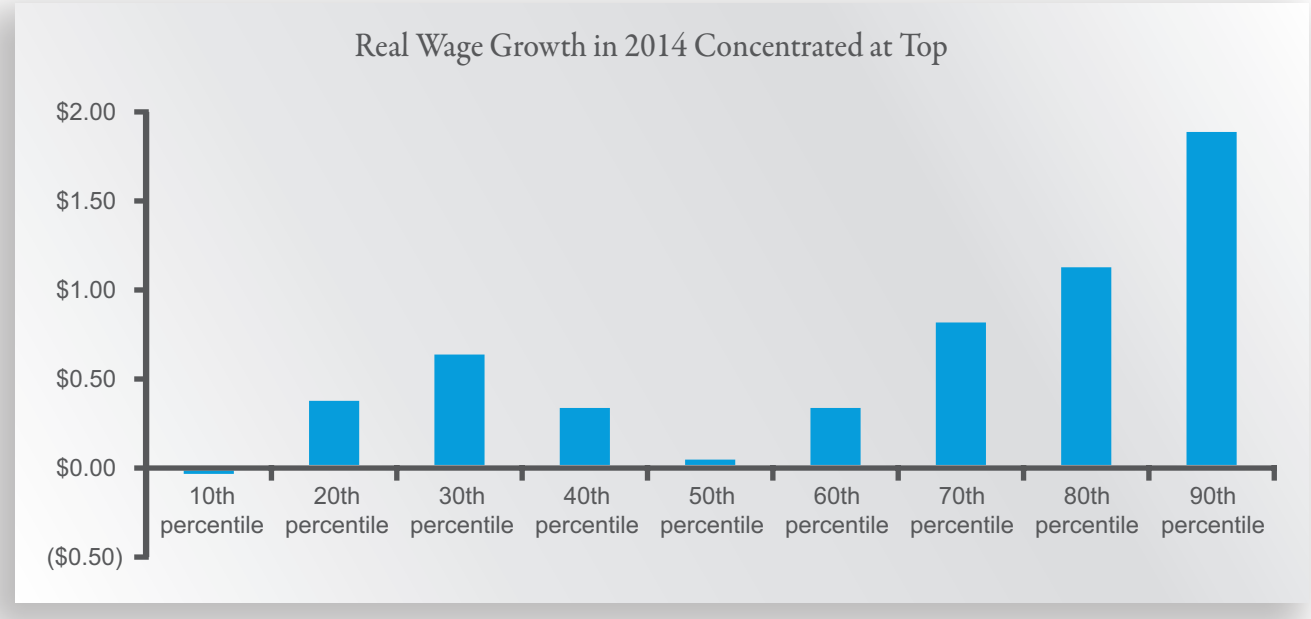
On the bright side, education and health services—a sector with higher average wages than leisure and hospitality—has seen substantial growth with 28,900 more jobs in November than there were in December 2007.[100] Part of the growth in health services is due to the increased demand for health care now that more Kentuckians have health insurance under the ACA.

On the whole, wages are stagnant or declining for many Kentucky workers. At the median and once inflation is accounted for, Kentucky workers were still making $0.66 less per hour in 2014 than they did in 2007 and $1.20 less than in 2001 (see below). In other words, the economic recoveries from the last two recessions have not shown up in the median worker's paycheck. With negative real wage growth between 2007 and 2014 for workers in the bottom 4 deciles and a poverty rate that is still 1.8 percentage points higher than it was in 2007 (19.1 percent in 2014), Kentuckians at the bottom are also still struggling from the recession.[101]



Source: EPI analysis of Current Population Survey (CPS) data.

The story is different, however, for better-off Kentuckians. Last year the real wage rate grew by $1.87 for workers in the 90th percentile—much higher than any other decile (see figure below). In fact, workers in the top decile are the only group for whom wages actually grew between 2007 and 2014. Because wages make up a smaller share of households' total income at the top end of the distribution than they do for middle-income families for whom earnings are the biggest share, lopsidedness in the recovery becomes even clearer when other types of income are examined. Between 2009 and 2012 (the last year for which data are available), Kentuckians in the top 10 percent of the income distribution took home 48 percent of income growth, while the remaining 90 percent of residents shared the other half.[102]

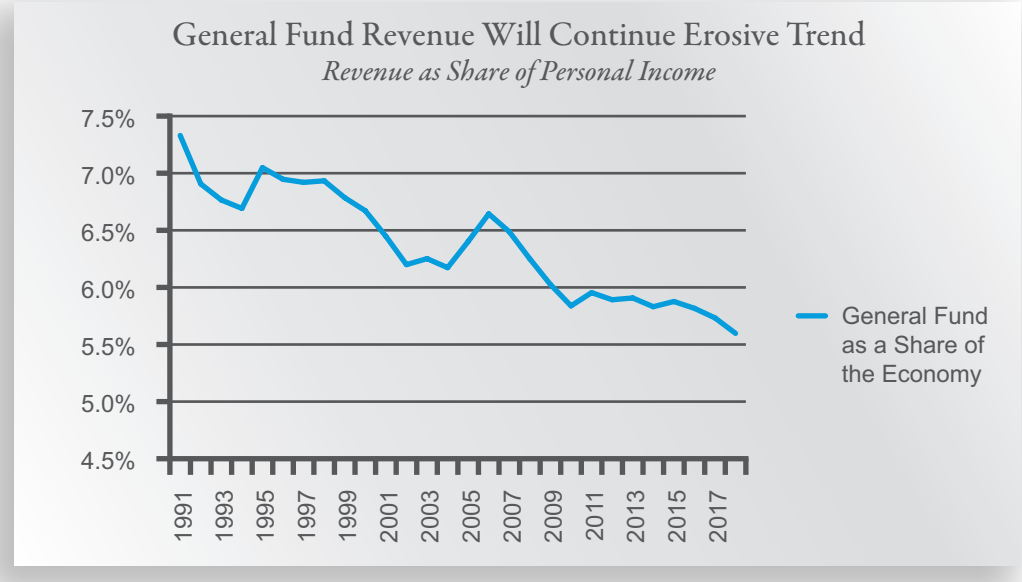


Source: EPI analysis of CPS data.

The corporate sector has also done well in recent years, evidenced by historic stock market highs in 2014 and record corporate profits in 2013. After-tax profits of corporations accounted for 10 percent of national gross domestic product in 2013 and 9.7 percent in 2012, substantially higher than the previous record of 9.1 percent in 1929 when the data was first collected.[103]

DISCONNECT BETWEEN ECONOMY, TAXES LEAVING THE STATE WITH LESS

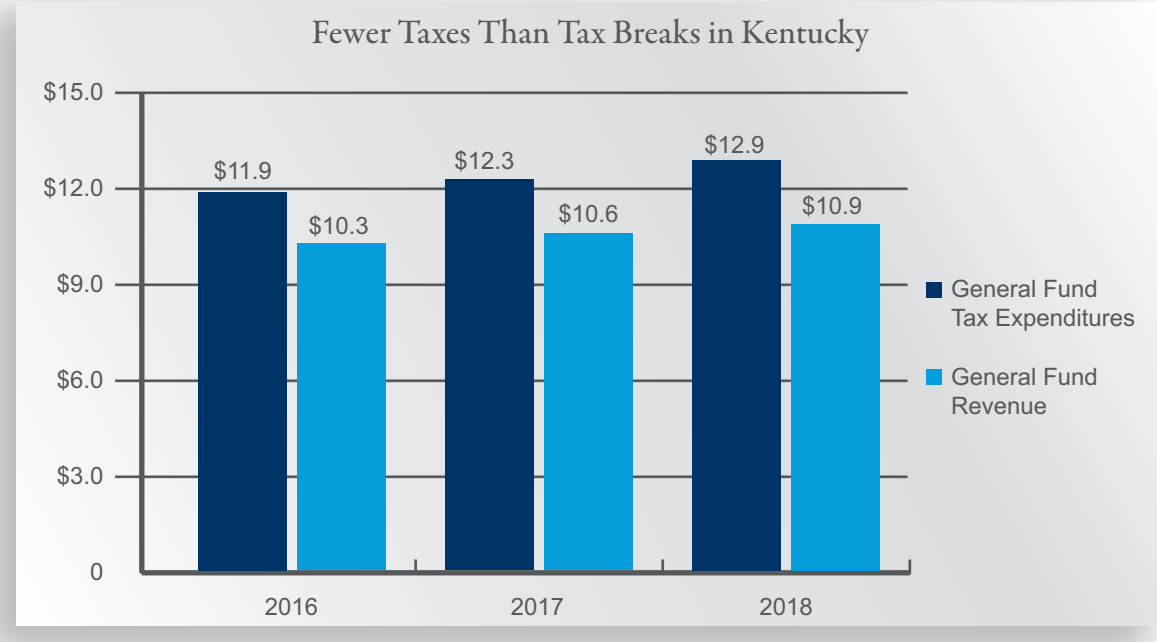
The strength of the economy is a major factor affecting how much revenue is generated in Kentucky. But too many tax breaks in areas where the economy is growing—and for those who are benefiting the most from growth—have weakened the extent to which an improving economy results in revenue for the state. General Fund revenue has been declining relative to the economy for the last few decades (see next page).



Source: KCEP analysis of data from OSBD, CFG, Bureau of Economic Analysis (BEA).

Ideally, revenue would keep pace with economic growth so the state can sustain the level of services it has committed to provide. But between 2015 and 2018, General Fund revenue is expected to continue shrinking as a share of the economy from 5.9 percent to 5.6 percent, representing $583 million in lost revenue. Looking back, if revenue had kept pace with the economy since 1991, Kentucky would have collected an additional $2.4 billion in FY 2015 —1.4 percent of the state's $170 billion economy.[104]

The state quantifies a large portion of these losses in its biennial tax expenditure report, published prior to each budget session.[105] Expenditures—tax exemptions, loopholes, credits and limits—leave tax dollars on the table that would otherwise be available for public services. As the table below shows, Kentucky is losing more to tax breaks each year than it collects in revenue by a growing margin that will reach an estimated $2 billion in 2018.



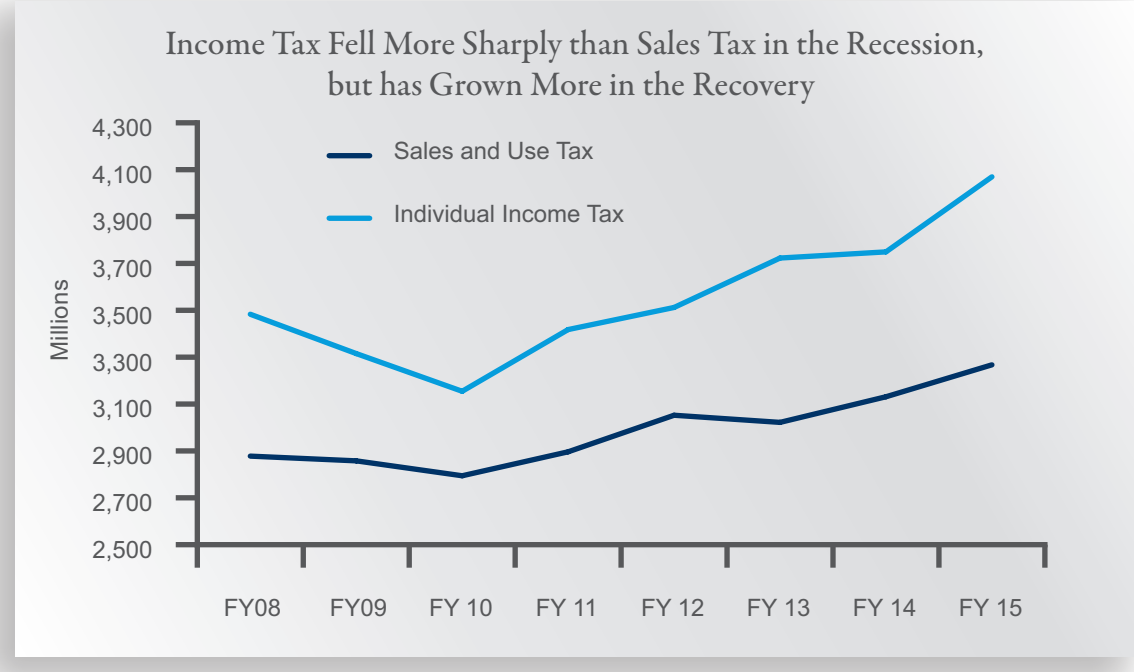
Source: Commonwealth of Kentucky Tax Expenditure Analysis, FY 2016-2018.

The overarching problem with tax expenditures is not that they lack policy purpose, but scrutiny. Unlike budgeted items which compete with other priorities through the appropriations process every two years, tax breaks persist in the tax code, largely unexamined for their cost effectiveness or changing impact on the budget. The following review of Kentucky's major revenue sources and the factors impacting their performance includes particular tax expenditures.

INDIVIDUAL INCOME TAX

The individual income tax (IIT) is Kentucky's single largest, best growing and most progressive source of revenue. It generated $4.1 billion in FY 2015, 8.5 percent more than in 2014, and accounted for 41 percent of the total General Fund in 2015. Job growth and solid stock market performance helped, as did the fact that federal capital gains tax changes prompted the sale of assets in 2013, boosting capital gains taxes that year at the expense of 2014 receipts, therefore lowering the baseline over which 2015 receipts grew.[106]

Income tax growth is stronger than other sources over the long term, as well. Since 2007, the IIT has grown 34 percent compared to 16 percent growth for the sales and use tax, Kentucky's second largest source of revenue. If the income tax had grown by 16 percent over that time, Kentucky would have ended FY 2015 with $541 million less revenue. And while income taxes have been critiqued as volatile by advocates of a heavier reliance on consumption taxes, the nature of that volatility is an asset to the General Fund over time: Even though they tend to fall more precipitously in a recession than sales taxes, they also recover more sharply (see below).[107]



Source: OSBD, June Receipts.

IIT revenue is expected to grow 4 percent in 2016, 4.2 percent in 2017 and 4 percent in 2018. The entire General Fund is expected to grow just 3.2 percent, 3.2 percent and 2.4 percent, respectively. Nominally, the IIT is forecast to grow to $4.2 billion in 2016, $4.4 billion in 2017 and $4.6 billion in 2018.

Despite its magnitude, the IIT is diminished by a number of tax expenditures that are expected to total $5.1 billion in 2016, some of which are listed in the table below.

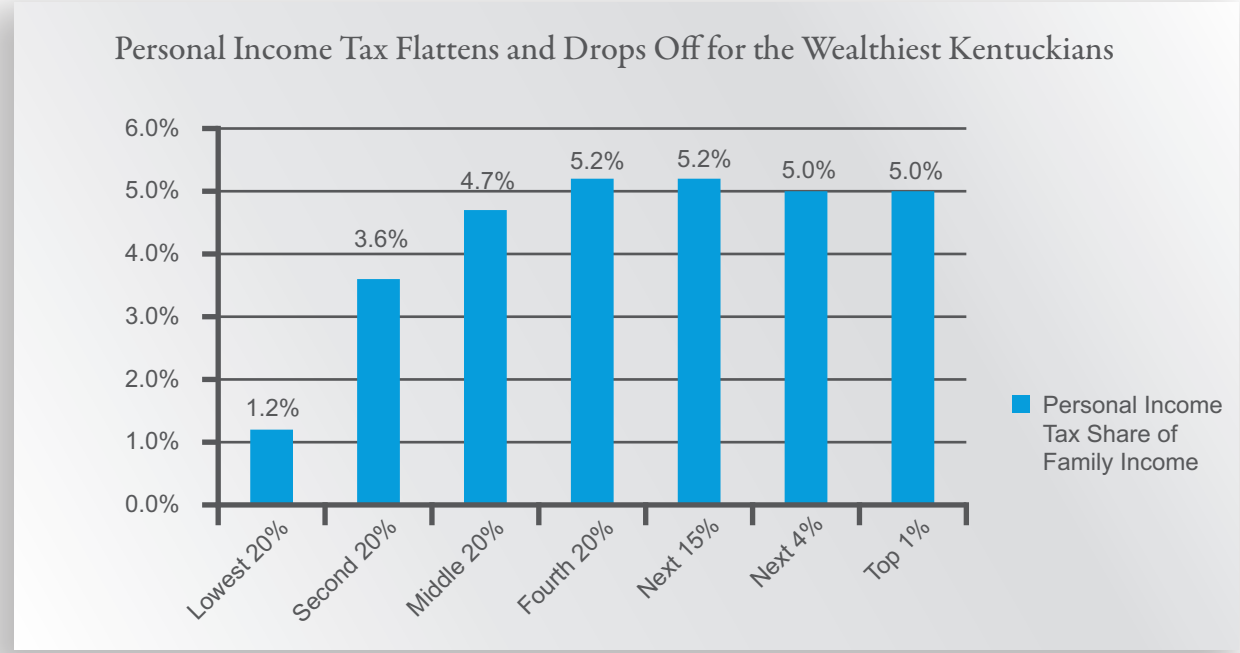
Selected Individual Income Tax Expenditures, FY 2016 ($ millions)	
Capital Gain on Property Transferred at Death	$507
Capital Gain on Gifts	$56
Charitable Contributions	$104
Gain on the Sale of a Personal Residence	$143
Home Mortgage Interest	$163
Individual Retirement Account Contributions	$139
Private Pensions and Individual Retirement Accounts	$478
Property Tax on Owner-Occupied Homes	$62
Other Local and State Taxes	$39
Postsecondary Education Tuition Tax Credit	$18

Source: Tax Expenditure Analysis FY 2016-2018.

Many states have decided to limit a big category of personal income tax expenditures—itemized deductions—due to their costliness and tendency to give tax relief to the wealthy. For example, at a $163 million price tag in 2016, the home mortgage interest deduction benefits homeowners over renters, and by allowing the deduction on up to two homes and bigger deductions for more expensive homes, gives the most benefit to wealthy homeowners.[108]

Similarly, at the current $41,110 rate of Kentucky's pension exclusion (costing the state $478 million in 2016), a married household where both partners receive the full exclusion and the average social security income (untaxed in Kentucky) would have $110,000 in untaxed annual income. This is far more generous than what the majority of Kentucky's neighbors allow. With the share of the state's population over age 65 expected to grow to 20 percent by 2030 from 13 percent today, the exclusion will drain increasingly more revenue from the General Fund—$507 million by 2018. IRS data confirms that the problem is growing: Between 2007 and 2012 (the most recent year for which data is available), retirement income from pension and individual retirement account (IRA) distributions in Kentucky grew 24 percent compared to just 7 percent for wage and salary income.[109]

Due to these growing tax expenditures, the IIT is eroding as a share of Kentucky's economy and will continue to do so. Down to a projected 2.4 percent of personal income in 2018 from 2.9 percent in 1991 after KERA was passed, the 0.5 percent difference amounts to $972 million in lost revenue.[110] A corresponding explanation is while income has been growing primarily for those at the top, personal income taxes as a share of family income flatten out at the upper end of the income distribution and fall off for the wealthiest five percent of Kentuckians (see next page).[111]



Source: Institute on Taxation and Economic Policy (ITEP).

Note: State income and local occupational taxes are included.

SALES TAX

The sales and use tax is Kentucky's second largest source of revenue. At $3.3 billion in FY 2015, it comprised 33 percent of total General Fund revenue. The CFG forecast estimates the sales tax will grow by 4.7 percent to $3.4 billion in 2016, 3.5 percent to $3.5 billion in 2017, and 2.8 percent to $3.6 billion in 2018.

As the previous figure shows, the sales tax did not fall as sharply as the income tax in the Great Recession, but it has had a more sluggish ascent since then. In fact, in three of the last six budget years, sales tax revenue fell. One explanation for its weak performance relative to the income tax is that households at the top have seen a greater share of the economic gains in the recovery, and higher-income households are more likely to save rather than spend additional income. Many less well-off households, which typically spend all of their income out of necessity, have not seen wages grow.

Since 2007, sales tax revenue has grown 16 percent, but the tax has continued its long-term erosion relative to the economy. In the late 1990s, when wages were steadily growing for Kentucky families at the median, the sales tax hovered at around 2.3 percent of the state's economy. Since then, it has fallen to just over 1.9 percent and is forecast to continue eroding through the biennium.

A primary explanation for the broken link between the sales tax and Kentucky's economy is that as consumption shifts toward more spending on services and less on goods, the exclusion of most services from the sales tax base means a decreasing share of consumer spending is taxed. Of the 168 services in at least one other state's tax base, Kentucky taxes only 28, ranking it among states that tax the fewest services.[112] The tax expenditure report estimates that excluding services will cost Kentucky $2.4 billion in 2016, growing to $2.8 billion in 2018.[113]

Another problem is that the state is losing an estimated $224 million a year in untaxed internet purchases—a figure that will likely grow as more purchases are made online. Kentucky is in cooperation with other states

under the Streamlined Sales and Use Tax Agreement (SSUTA) to regulate the taxation of these purchases, but Congress has yet to act to bring internet retailers into compliance.[114]

Other sales tax expenditures include exclusions for food items, prescription drugs and devices, and residential utilities from the sales tax base—policies that make the sales tax somewhat less regressive (the share of family income that families in the bottom 5th of the income distribution pay in sales and excise taxes is 5.5 percent, while it is just 0.8 percent for the top 1 percent).

CORPORATE INCOME TAXES

Kentucky's corporate income tax generated $528 million in 2015, or 5.2 percent, of the General Fund. Receipts have grown by more than 10 percent in 4 of the past 5 fiscal years as corporate profits have been at record highs, with 11.2 percent growth in 2015. This strong performance stands in contrast to the forecast made prior to the 2014 budget session of the General Assembly, which predicted the tax would level off and then decline as businesses started to reinvest profits in hiring, boosting wages and technological improvements. The forecast for the coming biennium predicts more modest growth followed by a decline: 0.7 percent growth in 2016, 9 percent in 2017 and a 4.5 percent drop in 2018.

Despite strong growth in recent years, corporate income tax receipts are reduced by loopholes allowing (generally large) firms to avoid taxation through various strategies. For example, Kentucky is leaving at least $50 million annually on the table by not requiring "combined reporting" on corporate income taxes, as is the law in more than half of corporate income taxing states.[115] Combined reporting prevents corporations from shifting profits to low- or no-tax states and foreign nations by requiring them to include profits from all related subsidiaries on their tax returns.[116]

A number of tax expenditures known as economic development subsidies also diminish the corporate income tax base. With the stated purpose of attracting businesses to Kentucky and encouraging firms to hire more employees, tax break programs continue to expand in Kentucky even though their cost-effectiveness has been brought into question.[117] For example, in each of the previous two sessions, lawmakers have expanded Kentucky's film tax credit program—a type of subsidy that the experience of other states shows can cost more than it returns.[118] After last year's actions, the program has an estimated annual price tag of $1 million, but could "have a significant and serious detrimental fiscal impact" if it is successful in luring films to Kentucky.[119]

Kentucky's limited liability entity tax (LLET) for businesses not organized as corporations contributed $224 million to the General Fund in 2015 or 2.2 percent of total revenue. In contrast to corporate income taxes, the LLET has declined two of the last four budget years. It is forecast to remain stagnant over the biennium, hovering around $220 million.

COAL SEVERANCE TAX

Since 2012, coal severance taxes have fallen by 39.6 percent, from $298 million to $180 million in 2015. The decline is the result of a variety of factors including low natural gas prices, less easily mined coal in eastern Kentucky and new environmental regulations for coal-fired power plants.[120] The forecast for the biennium is bleak: declines in all 3 years at 23.2 percent in 2016, 12.8 percent in 2017 and 10.9 percent in 2018. The coal severance tax is expected to generate $108 million in 2018, just 36 percent of 2012 receipts.

PROPERTY TAXES

Property tax growth has been weak in recent years and the forecast for the coming biennium is a little better: 1.7 percent growth in 2016, 2.1 percent in 2017 and 2.3 percent in 2018. Real property taxes, the single largest source of property taxes at just under half of total property tax receipts, have been especially weak with just 0.1 percent growth in 2014 and 0.4 percent growth in 2015.

Little growth in housing prices since they peaked before the housing crisis is a big driver of lackluster real property receipts. As a result of poor growth, Kentucky's real property tax rate has held steady since 2008 at 12.2 cents per $100 in assessed value—an unprecedented period of stability in the tax rate since HB 44 was passed in 1979. That law caps year over year real property revenue growth at four percent. Since HB 44 went into effect, the real property tax rate has been driven down from 31.5 cents to 12.2 cents. The state would collect $404 million more in 2016 if property taxes had been allowed to grow with property values since 1979.

CIGARETTE TAX

Cigarette tax revenues increased substantially in 2006 and 2010 after cigarette tax increases in each of the preceding years. Yet besides raising revenue, excise taxes also work to push down consumption. As a result of the price increase, and combined with other anti-smoking efforts and attitudes, cigarette consumption and revenue are declining. Since 2010, cigarette tax revenue has fallen each year and the CFG predicts it will shrink slightly from $226 to $221 million over the biennium. Besides the extra dollars in consumers' pockets due to low gas prices and waning competition from e-cigarettes, another factor which may offset declining pack sales to some degree in Kentucky is the $1.00 per pack tax increase in Illinois and 35 cent increase in Ohio.[121]

LOTTERY REVENUE

Revenue from Kentucky's lottery grew just one percent in 2015, less than was projected in the 2014-2016 forecast. Two explanations are "jackpot fatigue"—the need for larger and larger jackpots to entice players—and underperformance from online games.[122] However, slightly stronger growth is expected going forward, partly as a result of new developments for Powerball, Keno and I-Lottery: 4.7 percent in 2016, 1.7 percent in 2017 and 2.1 percent in 2018, with an expected $241 million in receipts in 2018.

TOBACCO SETTLEMENT FUNDS

As a result of the Master Settlement Agreement (MSA) between tobacco companies and states in 1998, companies make payments to states for costs associated with treating tobacco-related illness. While not a source of General Fund revenue, these payments fund priorities in the budget: half to agricultural development and half to early childhood development and health care improvement programs. Kentucky has received a total of $1.8 billion in payments.[123]

A more recent settlement with tobacco companies participating in the MSA over Kentucky's enforcement of non-participating manufacturers (NPMs) in June 2014 meant Kentucky received $69 million more in 2014 than was originally enacted.[124] The 2015 budget amendment bill, HB 510, allocated funds to fill the anticipated 2015 MSA shortfall, restored cuts to MSA programs in the 2016 budget and put the remainder of unanticipated funds in reserve for future action by the General Assembly.[125]

MSA payments are expected to be $88 million in 2016, $87 million in 2017 and $93 million in 2018. The average annual payment over the first 10 years from 2004 to 2013 was $107 million. While the settlement over NPMs will smooth out future payments, declining consumption means tobacco settlement monies will be a shrinking share of Kentucky's total revenue over time.

OTHER TAX REVENUE

Growth in the coming biennium is expected to be weak for "other revenue," a category for miscellaneous sources including the insurance premium tax, bank franchise tax and wholesale beer tax. At $682 million in 2015, other revenue accounted for 6.9 percent of total General Fund revenue. It is expected to grow 3.4 percent in 2016, fall 2.3 percent in 2017, and grow again by 1 percent in 2018.

Inheritance taxes, also classified as "other" tax revenue, contributed $51 million to the General Fund in 2015. Since federal tax changes in the early 2000s eliminated Kentucky's estate tax, taxes on inherited wealth in Kentucky have dropped 39 percent.[126]

OTHER RESOURCES

RAINY DAY FUND

As a result of the $165 million revenue surplus with which Kentucky ended FY 2015, the state deposited $83 million into the Budget Reserve Trust Fund, often called the rainy day fund.[127] Along with an increase of $64 million legislated by the 2015 General Assembly, the total fund balance heading into budget year 2016 was $209 million. As a percentage of the General Fund, which experts agree should be around 10 percent to help with the next recession, Kentucky's rainy day funds are just 2.1 percent. In 2008, before the Great Recession drained the rainy day fund and left its balance near zero for three consecutive years (2009-2011), the fund was just 2.5 percent of the General Fund.

As mentioned previously, the state is currently on track to collect $223 million more in FY 2016 than was originally forecast. Once the surplus is adjusted to reflect expenditures and any necessary government expenses (NGE), the remainder will be deposited into the rainy day fund unless appropriated by the upcoming General Assembly.

FUND TRANSFERS

In order to balance the 2015-2016 budget, the legislature transferred a total of $305 million across funds through both the 2014 budget bill and the 2015 appropriations bill amending the budget. Fund transfers are a common practice in recent years, with the average amount of transfers in the last 8 biennia at $340 million.[128] Transfers in 2015 and 2016 included the following:[129]

- $93 million from the Public Employees Health Trust Fund, dollars that have accrued in that account because, as previously mentioned, employees have paid in more, on balance, than has been paid out in claims and other expenses (another $64 million was transferred from the health fund to the rainy day fund in the 2015 session);
- $45 million from Department of Insurance fees;
- $23 million from the firefighter training funds;
- $22 million from criminal justice training funds;
- $18 million from the Petroleum Underground Storage Tank Fund, revenue that comes from fees meant to help clean up underground petroleum storage tanks;
- $8 million from the Heritage Land Conservation Fund.

The 2016 budget was also dependent on an $82 million carry forward from the prior year that was budgeted to be spent during the year, a hole that will have to be filled in the new budget.

ROAD FUND

Despite important action by state lawmakers in the 2015 session of the General Assembly to lift the floor of the gas tax and smooth the rate-setting process, the Road Fund will feel the effects of recent drops in the price of gasoline over the coming biennium.

The gas tax — which typically generates more than half of Road Fund revenue — totaled $850 million in 2015, $36 million less than in FY 2014 and $20 million less than was budgeted. As a share of Road Fund revenue, the gas tax dropped 1 percentage point to 56 percent in 2015. Because lawmakers did not act sooner to freeze the floor, the gas tax is projected to fall to 51 percent of the Road Fund by 2018. Compared to gas tax receipts in 2014, forecasters predict a 15 percent or $136 million decline by FY 2018.

Other major sources of Road Fund revenue are the motor vehicle usage tax and motor vehicle license tax, which generated $433 million and $108 million in 2015, respectively. Over the course of the biennium, the usage tax is forecast to grow by $53 million, or 12 percent, and the license tax is forecast to fall by $2 million. One factor holding back the usage tax is that even though new car and truck purchases have gone up, the trade-in credit passed in 2013 lowers receipts.[130]

The total Road Fund revenue estimate for FY 2018 is 5 percent, or $82 million, smaller than actual receipts in 2014. The Road Fund will take the hardest hit in FY 2016 (-5 percent) when the full effect of the fallen gas tax affects a entire year of receipts, and then remain basically flat with 0.8 percent growth in 2017 and 1.5 percent in 2018.

Kentucky is not alone in its gas tax challenges. Many other states and the federal government have tax rates that are too low, and lawmakers have not enacted rate-adjustment processes that reflect the growing costs of building and maintaining sound and up-to-date roads and bridges.[131] Another issue is that as fuel efficiency standards increase and consumers purchase more fuel-efficient vehicles, gasoline consumption will fall and revenue with it.

FEDERAL FUNDING

Revenue challenges in Kentucky will be exacerbated in the coming biennium by cuts in federal funding, but not as severely as was originally slated under sequestration. The Bipartisan Budget Act of 2015 eases 90 percent or $33 billion of sequestration cuts to non-defense discretionary (NDD) programs in 2016 and 60 percent or $23 billion in 2017.[132] This relief is more than was offered under the 2013 Murray-Ryan budget agreement, which gave 61 percent and 25 percent relief in 2014 and 2015, respectively.

The deal is also significant in that it avoids a default on the nation's debt by lifting the ceiling until March of 2017; diminishes the likelihood of a federal government shutdown; and avoids safety nets cuts to pay for the relief.[133] A big part of the savings come from extending the sequester to 2025, including a two percent cut to Medicare provider reimbursement rates. The deal also tightens tax compliance and repeals a requirement under the ACA that employers with 200 or more employees begin automatically enrolling new hires in health insurance plans.

Despite the overall positive direction of the budget deal, federal funding for NDD programs in 2016 will still be 12 percent less, once inflation is taken into account, than it was in 2010 at the height of the American Recovery and Reinvestment Act.[134] As a share of the economy, NDD funding is lower than it has been going back to 1962 when data was first collected. At the state level, inflation-adjusted federal funding to Kentucky in 2015 was 13 percent lower than in 2010 at the height of stimulus dollars.[135]

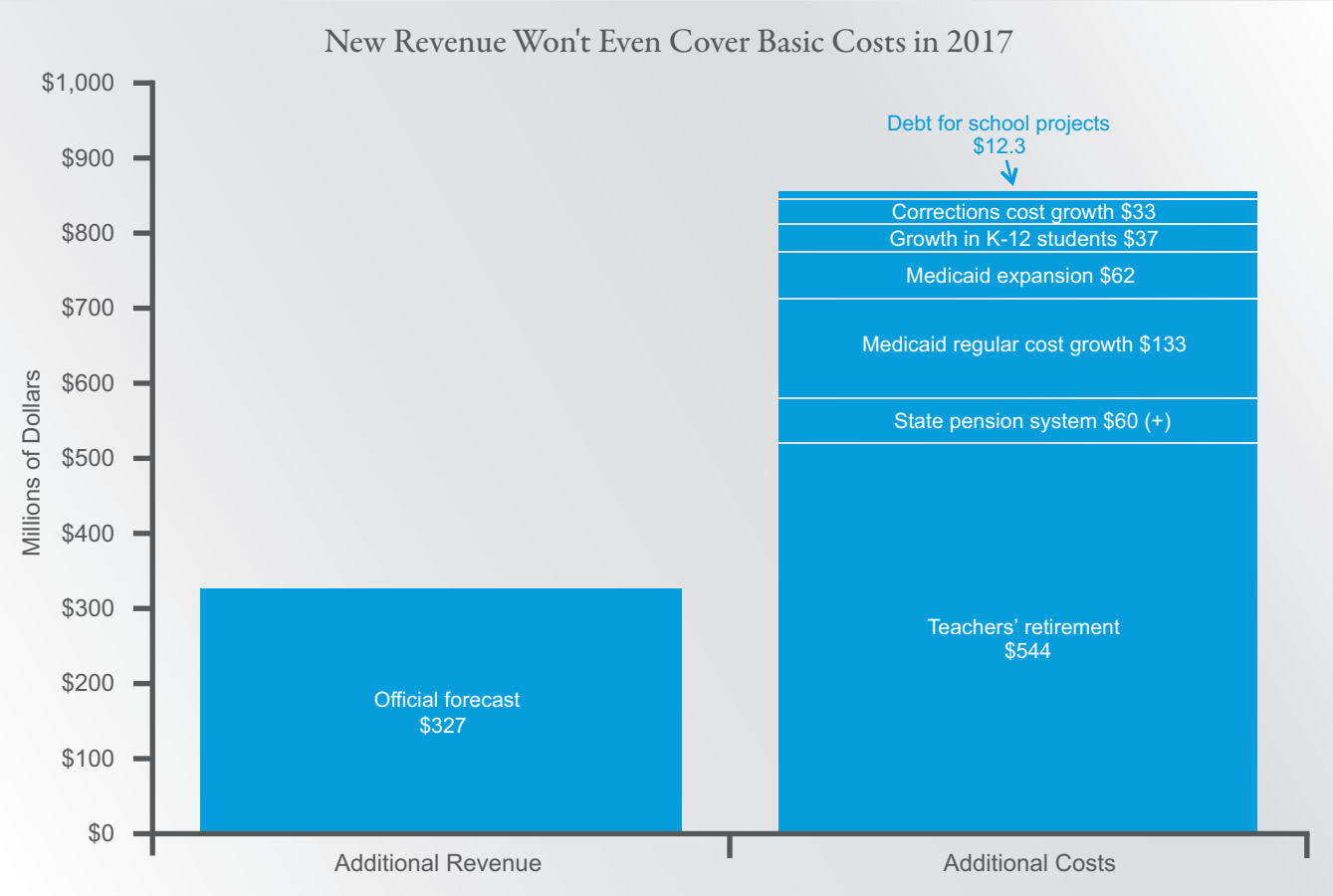
Kentucky's share of federal dollars flows through a variety of programs at the state and local level. Mandatory "entitlement" programs, such as the national school lunch and breakfast programs, Medicaid and the Children's Health Insurance Program (CHIP) are funded based on the number of Kentuckians meeting eligibility requirements. Discretionary programs, on the other hand, such as Title I grants for poor school districts, Low Income Home Energy Assistance, Highway Planning and Construction, and Section 8 Housing Choice Vouchers are funded though the annual appropriations process and are subject to cuts. Compared to the discretionary funding Kentucky received in 2010, and once inflation is taken into account, in 2015 WIC (women, infants, children) and Title I funds were each down 15 percent, and Special Education funding was down 10 percent.[136]

CONCLUSION

The state budget is a powerful tool for improving the quality of life for all Kentuckians. But a large gap persists between the resources we bring in and the expenses we face, even to simply maintain current services and responsibly pay down our debts, much less expand investments in areas we know work.

As shown in the graph below, the $327 million in new General Fund revenue expected in the first year of the new budget is not enough to cover added pension costs alone. The expenses bar on the right totals $858 million, but is missing any money to roll back budget and service cuts made the last few years, provide raises for teachers and state employees and pay for the growth in employee health insurance costs. While the state will have some money in the rainy day fund and from an expected surplus this fiscal year, that money is also the only cushion we have for future recessions. And continued use of fund transfers to balance the budget takes those resources away from their intended uses.

Lawmakers' choices in the next budget will have big implications for Kentuckians today and our Commonwealth far into the future.



Source: OSBD, KTRS.

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