OUR COMMONWEALTH:

A PRIMER ON THE KENTUCKY STATE BUDGET

KCEP
KENTUCKY CENTER for ECONOMIC POLICY

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The Kentucky Center for Economic Policy (KCEP) 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.

WHY THE BUDGET MATTERS

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

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

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

WHERE THE MONEY COMES FROM

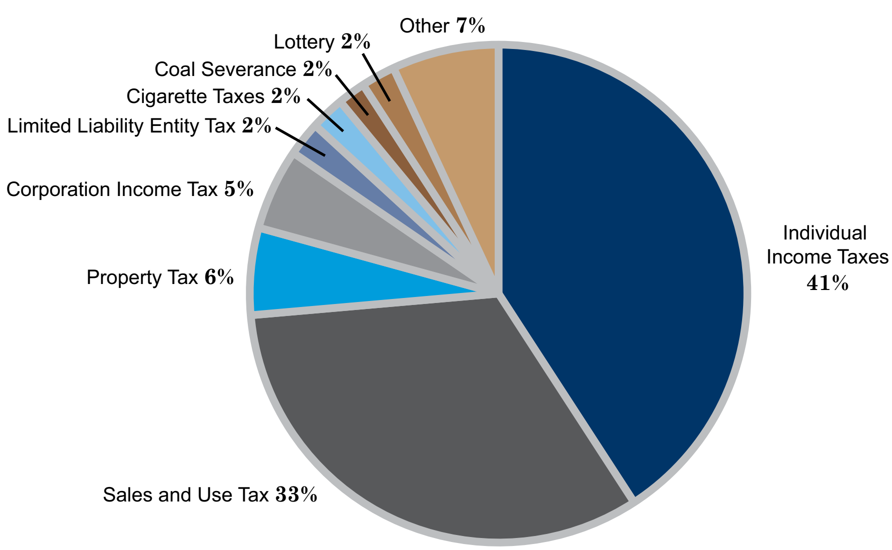
The resources Kentucky has to invest in thriving communities come from a variety of taxes and other revenue sources that are broadly categorized as **General Fund Revenue, Road Fund Revenue, restricted funds, federal funds and Tobacco Settlement Funds**. General Fund revenue and federal funds each account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

CONTRIBUTION OF REVENUE FUNDS TO THE BUDGET OF THE COMMONWEALTH, 2015 (BILLIONS)	
Federal Funds	$10.9
The General Fund	$10.2
Restricted Funds	$7.8
The Road Fund	$1.6
Tobacco Settlement Funds	$0.1
	Total $30.6

Numbers, which include carry forward balances from previous years, are based on estimates in the enacted 2014-2016 Budget of the Commonwealth.

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

Revenue Sources as a Share of the General Fund, 2015
Total: $10 Billion



Numbers are based on actual receipts from Fiscal Year 2015.

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

The **Individual Income Tax** is essential to ensure that Kentucky has enough resources to fund our schools and other priorities. It is the largest single source of revenue and is also the most productive tax over time, growing more than double the rate of the sales tax since 2007. A progressive income tax with higher rates for higher-income people is especially important, as it taxes people based on their ability to pay and reflects growing income inequality in the economy.

ADJUSTED GROSS INCOME	KY INCOME TAX RATE
$0-$3,000	2%
$3,001-$4,000	3%
$4,001-$5,000	4%
$5,001-$8,000	5%
$8,001-$75,000	5.8%
$75,001 +	6%

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

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

Tobacco Settlement Fund: A legal settlement in 1998 between major tobacco manufacturers and states, known as the Master Settlement Agreement, set up payments from tobacco companies to states for costs associated with tobacco-related illness. Payments to Kentucky have totaled $1.8 billion.

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

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

Many factors affect revenue in Kentucky: By determining what the state taxes and the rate at which it is taxed, Kentucky's tax laws directly impact the amount of revenue the state has to do its work. Economic conditions are also a major factor affecting revenue to the extent that tax laws preserve a healthy connection between the state's economy and revenue system. Also, funding decisions by the federal government impact the resources we have to provide services.

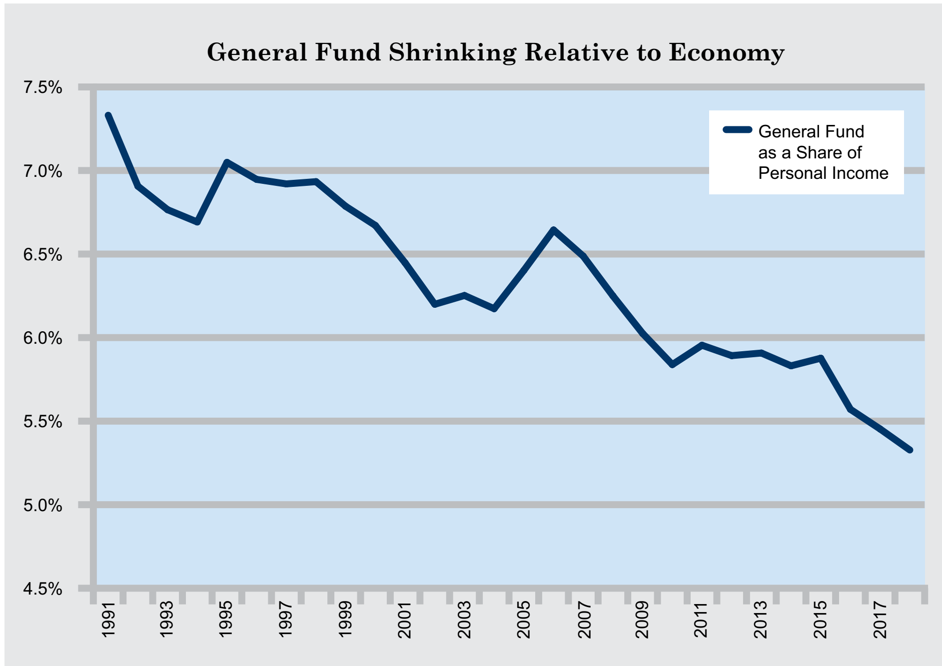
Why Should Revenue Grow With the Economy? When revenue keeps up with economic growth, the state can sustain a certain level and standard of services to Kentuckians. But when revenue declines relative to the economy, the state's ability to maintain quality education, health care, human services and public protection shrinks.

ENSURING A HEALTHY, RESPONSIBLE BUDGET

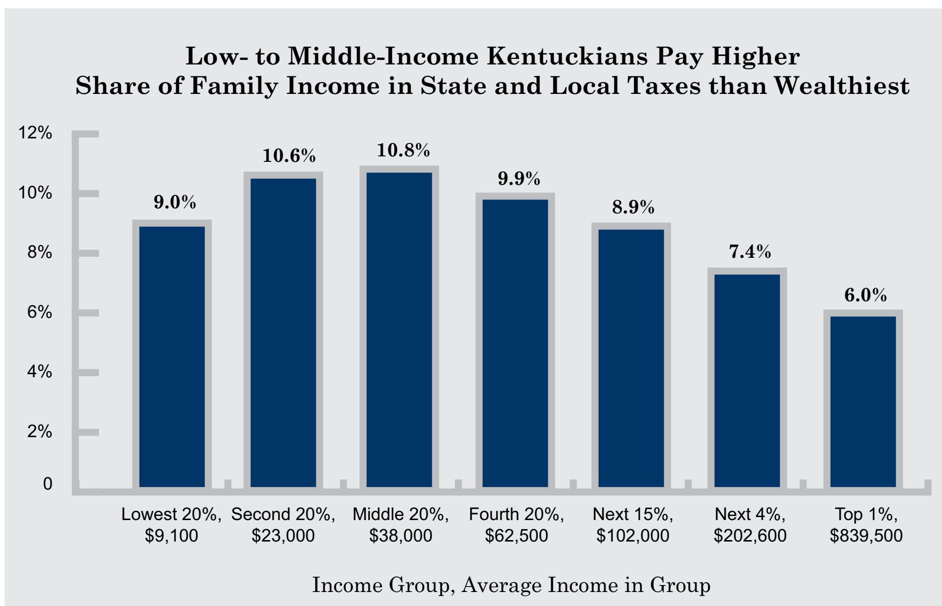
Because Kentucky's budget must be balanced — meaning the state cannot spend more than it takes in — the General Assembly has to steward both the revenue and spending sides of the budget. Here are some important indicators that Kentucky's revenue system needs improvement:

More resources are needed to invest in a stronger Commonwealth: Funding for public schools is still lower than it was prior to the Great Recession once inflation is taken into account; because contributions to teachers' and other public employees' pensions have been insufficient in recent years, those systems are about $30 billion in debt; and public service areas ranging from mental health to need-based college aid have been deeply underfunded for many years.

We have less to invest than in the past: Relative to the state's economy, General Fund revenue is shrinking. Without making some common sense changes to the state's tax code, that trend will continue and Kentucky will have less and less of what it takes to sustain its investments, even at current low levels.



Kentucky loses more to tax breaks than it collects in General Fund revenue: Despite levying a variety of taxes, Kentucky struggles to derive enough revenue from them because too many exemptions, exclusions, credits and other tax breaks result in lost revenue. For instance, individual income tax giveaways and corporate income tax loopholes narrow the tax base and benefit some groups over others. Kentucky needs to clean up these tax breaks (see page 9 for more on these "expenditures").



We rely most heavily on moderate- to middle-income families and the least on the wealthiest: Even though all Kentuckians benefit from good schools and other services that our taxes provide, low- and middle-income Kentuckians pay between 9 percent and 11 percent of family income in state and local taxes, while the top 1 percent pay just 6 percent.

THE BUDGET PROCESS

Who decides what and how Kentucky invests in K-12 students, county roads and bridges, college financial aid and agricultural development? What does that process look like? The big picture looks like this: In even-numbered years, the General Assembly creates a two-year Budget of the Commonwealth. Here's a closer look at the budget process:

KEY PLAYERS

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

TIMELINE

1 PREPARING FOR THE BUDGET SESSION

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

2 THE BUDGET PROCESS OF THE GENERAL ASSEMBLY

DAY 1

The legislative session begins on the first Tuesday after the first Monday in January.

DAY 10

By the tenth legislative day (or the 15th following the election of a new Governor), the Governor, Chief Justice and LRC submit their budget proposals to the General Assembly. At this time, the Governor gives the budget address.

DAY 15

By the fifteenth day, the OSBD and CFG present the state's official revenue forecast.

SIX WEEKS

Appropriations and Revenue Committees (including six subcommittees in the House and one full Senate panel) review budget proposals and make alternative proposals. Hearings are conducted in the House over a six-week period. Agencies and, at times, members of the public testify about budget needs. The LRC provides committees with documents comparing agency budget requests with recommendations from the Governor, Chief Justice and LRC.

3 AFTER THE BUDGET IS PASSED

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

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

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

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

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

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

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

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

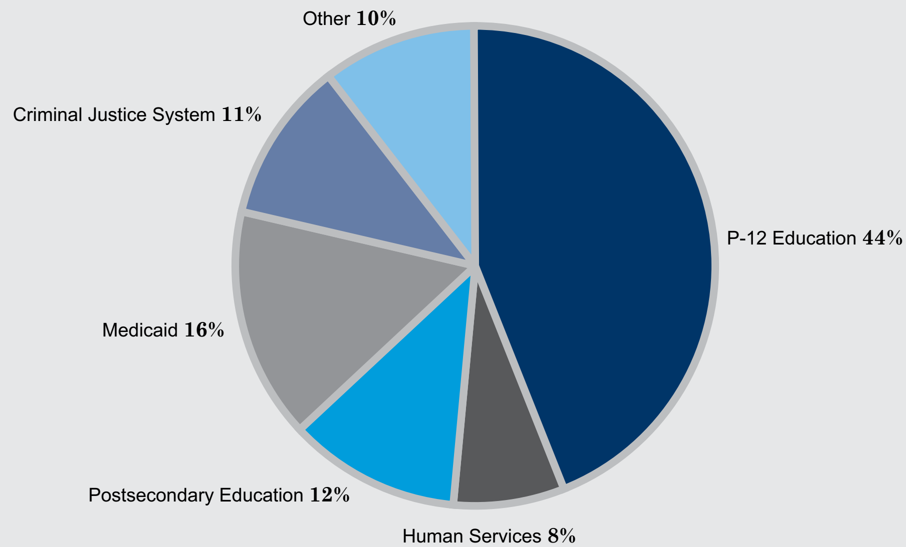
WHERE THE MONEY GOES

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

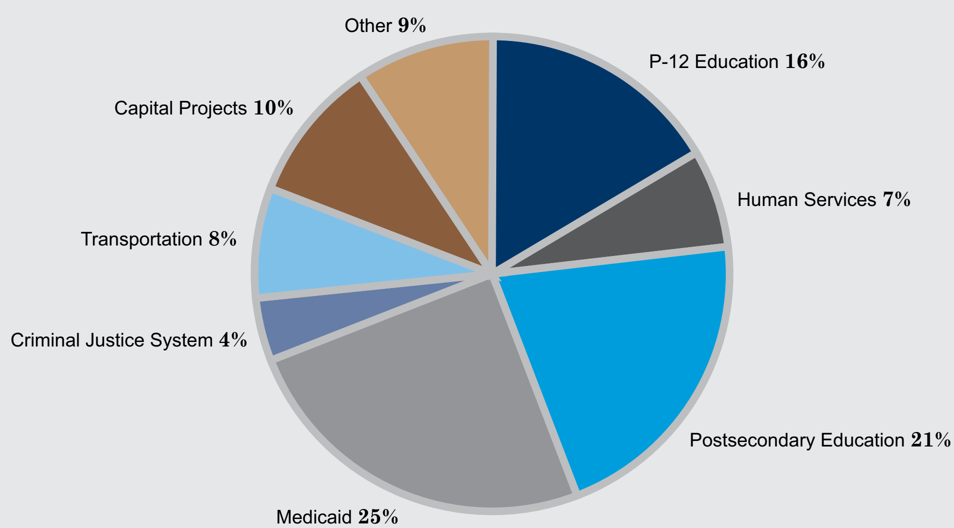
Since the General Fund is Kentucky's main revenue pool, General Fund appropriations are a good place to examine how the state prioritizes those dollars. Taken together, **spending on P-12 education and post-secondary education comprises more than half of General Fund spending**.

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

2014-2016 Distribution of General Fund Appropriations
Total: $20.3 Billion



2014-2016 Distribution of All Funds Appropriations
Total: $66 Billion



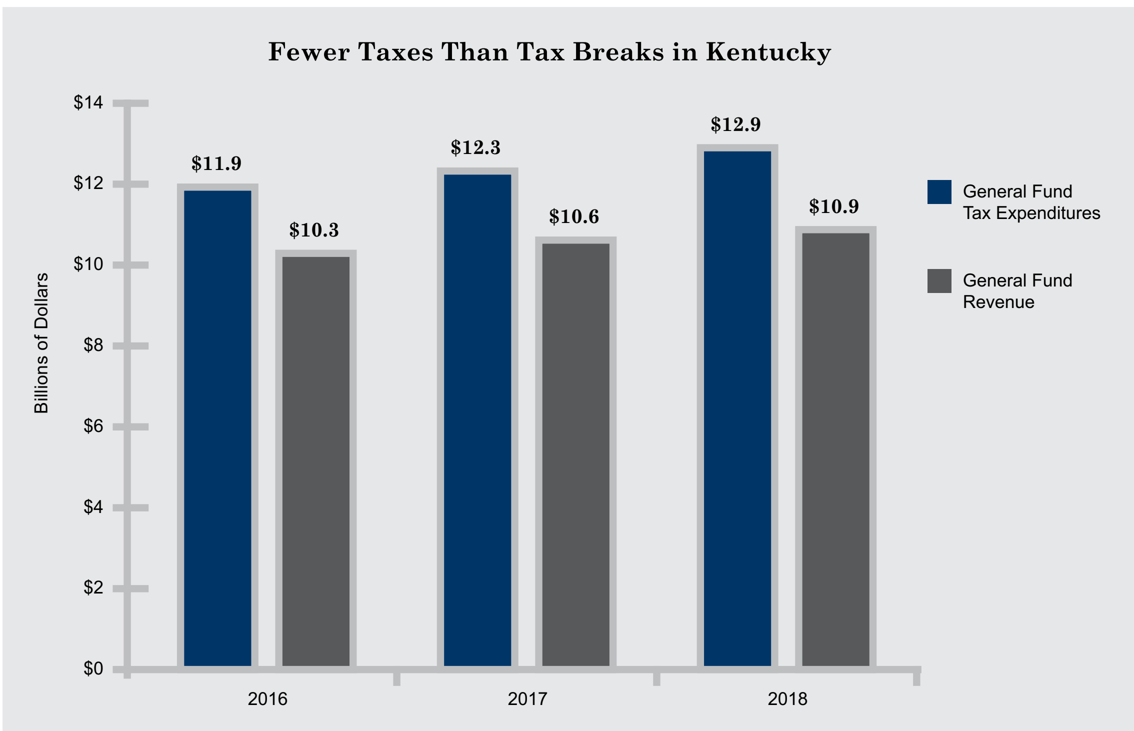
Taking the General Fund, Road Fund, federal, restricted and Tobacco Settlement Funds together, spending on education and health still comprises more than half of the state budget, with capital improvements, transportation, human services, criminal justice and other services comprising the rest.

Of the resources Kentucky invested in P-12 education in 2015, **60 percent went to the state's core spending on students** (Support Education Excellence in Kentucky); 32 percent to improving learning and performance through programs such as preschool, extended school services and teacher professional development; and 8 percent to administrative, technological and other support services for schools.

DIVERTED RESOURCES

More than 250 tax expenditures — deductions, exemptions, credits and other tax giveaways — will drain $11.9 billion from the General Fund in 2016 — $1.6 billion more than will be collected. Unlike budgeted items which go through the appropriations process and are subject to cuts, tax breaks are written into the tax code and do not undergo routine evaluation by lawmakers for their costs and benefits to the state.

Special interests would like Kentuckians to believe that certain tax breaks attract business and individuals to our state and create jobs. But because state taxes are a very small portion of business costs and a negligible consideration in determining where to locate, tax breaks pay for decisions businesses and people make based on other factors. The revenue they drain from the budget leaves fewer resources to invest in the things that really matter to all of us — a competitive workforce, good roads, state-of-the-art technology, strong public safety and court systems and healthy, beautiful communities. Scrutinizing and cleaning up these tax breaks would give us more revenue to invest in our shared interests.



SHRINKING INVESTMENTS

Kentucky has made great strides over the last century thanks to investments through the state budget that have built a better Kentucky, one school, road and healthy community at a time. But in recent years, the state has lost ground and faces losing more. As revenue shrinks in proportion to Kentucky's economy, we are less able to educate the state's current and future workforce and invest in the public goods and services that make Kentucky a good place to live and do business. The resulting budget cuts – 15 rounds since 2008 – are harmful to individuals and the state's economy as a whole.

A BALANCED APPROACH TO THE BUDGET

A budget that supports a prosperous future for all Kentuckians invests more and cuts less. It reflects the shared responsibility and collective benefit of robustly funding the things that make us strong together like good schools and colleges, up-to-date infrastructure and healthy communities. We owe it to ourselves and the next generation of Kentuckians to reign in costly tax breaks, restore revenue and bring true balance to our budget.

Photo by Shawn Poynter/Rural Archive.

FURTHER READING

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

Budget of the Commonwealth: This link takes you to the State Budget Director's webpage where you can download budget documents, including the full biennial budget of the Commonwealth.

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

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

"Investing in Kentucky's Future: A Preview of the 2016-2018 Kentucky State Budget," Kentucky Center for Economic Policy.

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