



COMMONWEALTH AT RISK:

A PREVIEW OF THE 2018-2020
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, KCEP is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website www.kypolicy.org.

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A PREVIEW OF THE 2018–2020 KENTUCKY STATE BUDGET

With a reluctance to clean up tax breaks to generate new resources, forecasted weak revenue growth, the need to maintain or even increase large pension payments, and many program areas on the brink of crisis, the 2018-2020 budget is shaping up as perhaps the worst in recent memory for the commonwealth.

Unlike other states, Kentucky is not reinvesting in education as our economy recovers from the Great Recession. Some school districts are in financial crisis. College has become increasingly unaffordable. The number of Kentuckians incarcerated continues to grow, and the justice system is strained. Community and family services are spread too thin to provide a reliable safety net for the most vulnerable. Kentucky is not making adequate progress on addressing racial and regional disparities. And we lack the resources needed to update our infrastructure and support economic growth.

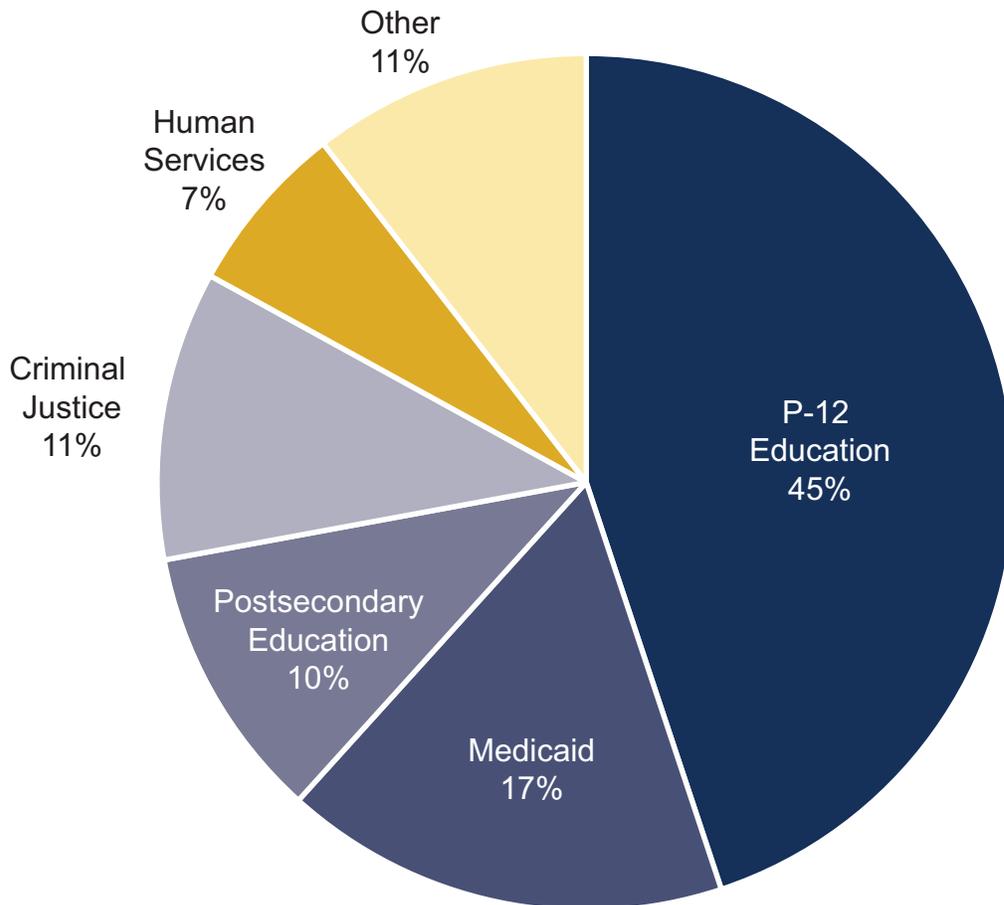
How bad will it get before we decide to fix the revenue problem we have? Permanent or at least very long-term damage could be done. Yet we still have a choice to invest in our commonwealth.

In this report, we discuss budget and revenue needs as the Kentucky General Assembly heads into a session that will decide the state's spending priorities over the next two years. Will legislators choose to continue cutting vital investments that benefit us all, perhaps at levels deeper than ever before? Or will they choose a balanced approach that includes cleaning up the tax code to raise new revenue and set Kentucky on a better course?

PART 1: THE BUDGET

State lawmakers have been making cuts to the General Fund budget for a decade now—and due to a budget shortfall for 2018, the governor recently ordered another round of budget cuts this fiscal year. In addition to the largest areas of state spending—including primary and secondary education—these cuts have harmed many smaller but important services and programs. The chart below illustrates the major ways the state’s General Fund, which totals about \$11 billion, is spent. In this section, we provide an overview of state spending, give examples of the impacts of the cuts, describe costs the state is facing in the next budget and identify some targeted investments that should be made to move Kentucky forward.

2016–2018 How General Fund Monies Are Spent



Source: Office of State Budget Director (OSBD).

UNDERINVESTMENT IN P-12 EDUCATION CONTINUES

Kentucky schools continue to struggle with fewer resources due to funding cuts and freezes in recent years. The state received an “F” in Education Week’s 2017 Quality Counts report for education spending—and a rank of 37th in the nation.¹ Legislators have attempted to protect education funding in some ways—for instance, by keeping the education funding formula, SEEK (Support Education Excellence in Kentucky), from being directly cut (indirect cuts have resulted, however, from the impact of inflation on relatively flat funding). Other important areas within the education budget have suffered large direct cuts and the cumulative impact has been significant and detrimental.

Funding for SEEK has essentially been frozen since 2008—with very small increases in 2015 and 2016.² When inflation and number of students are taken into account, SEEK funding per student is 15.8 percent lower in 2018 than it was in 2008.³ That gives Kentucky the third deepest cut in the nation to its core formula funding for local schools since 2008. Restoring SEEK funding to its inflation-adjusted 2008 per-pupil level would cost more than \$491 million a year.⁴

LEARNING SUPPORT FUNDING HAS FALLEN DRASTICALLY OVER THE DECADE

As illustrated below, non-SEEK components of P-12 education that fall under “Learning and Results Services” in the budget also have been cut significantly since 2008. Increases in these areas in 2015 and 2016 were not enough to get back to 2008 levels in most cases, even before taking inflation into account.

Funding for Primary and Secondary Education Programs Since 2008

| | FY 08 (originally enacted) | FY 18 | Dollar change | Percent Change | Inflation-Adjusted Percent Change |
|--|-------------------------------|---------------|----------------|----------------|-----------------------------------|
| Instructional resources/ textbooks | \$ 21,700,000 | \$ 16,700,000 | \$ (5,000,000) | -23% | -34% |
| Extended school services | \$ 31,859,500 | \$ 25,510,700 | \$ (6,348,800) | -20% | -32% |
| Professional development | \$ 15,034,700 | \$ 11,927,700 | \$ (3,107,000) | -21% | -32% |
| Safe schools | \$ 10,378,300 | \$ 10,378,300 | \$ 0 | 0% | -15% |
| Family Resource and Youth Services Centers (FRYSCs) | \$ 51,850,700 | \$ 52,148,300 | \$ 297,600 | 0.6% | -14% |

Source: KCEP analysis of OSBD data.

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Additional cuts ordered by the governor last week reduced the budget for the Kentucky Department of Education (KDE) by another \$20.5 million this year.⁵ KDE’s preliminary plan for absorbing these additional reductions included more cuts to textbooks and instructional devices, professional development, safe schools, Family Resource and Youth Services Centers (FRYSCs), Appalachian Tutoring and Visually Impaired Preschool Services, among other areas.⁶

With charter school legislation passing in 2016 and the first charter schools expected to open next school year—and no additional funding provided to support these new schools—Kentucky’s education funding problems will likely worsen as a result, as indicated in a recent report by Moody’s.⁷

EARLY CHILDHOOD EDUCATION ONLY PARTIALLY FUNDED

Kentucky offers preschool and Kindergarten programs, but eligibility and access are limited in ways that hinder their effectiveness. Eligibility for preschool without paying tuition is currently restricted to families with incomes below 160 percent of the poverty level. That is an increase from 150 percent prior to 2016. The 2016–2018 budget that passed the General Assembly expanded eligibility further to 200 percent of the poverty level, but this provision was line-item vetoed by the governor. KDE is requesting funding to expand preschool eligibility to 200 percent of the poverty level in 2019 and 2020, which would cost \$78.5 million each year.⁸

While full-day preschool in Kentucky has been shown to be more effective than half-day preschool at preparing children for Kindergarten, just 40 percent of school districts are offering full-day preschool, largely because of funding challenges.⁹ Currently school districts are spending \$4,395 more per child on average than they receive from the preschool funds allocated by the General Assembly.¹⁰ In addition, all but 13 school districts provide transportation for their preschool students, which is not funded by the state.

Likewise, though full-day Kindergarten is more effective in promoting academic success than half-day programs, the state only provides funding for half-day Kindergarten. However, because of the clear academic advantages, almost all school districts offer a full-day program (just six offer half-day and another four offer both full- and half-day), causing significant budgetary strain for many districts.¹¹ In fact, budgetary reasons led three districts to switch from full-day to half-day between 2013 and 2015. KDE is requesting an increase of \$172 million a year or \$344 million over the 2018–2020 biennium to fund full-day Kindergarten across the state.¹²

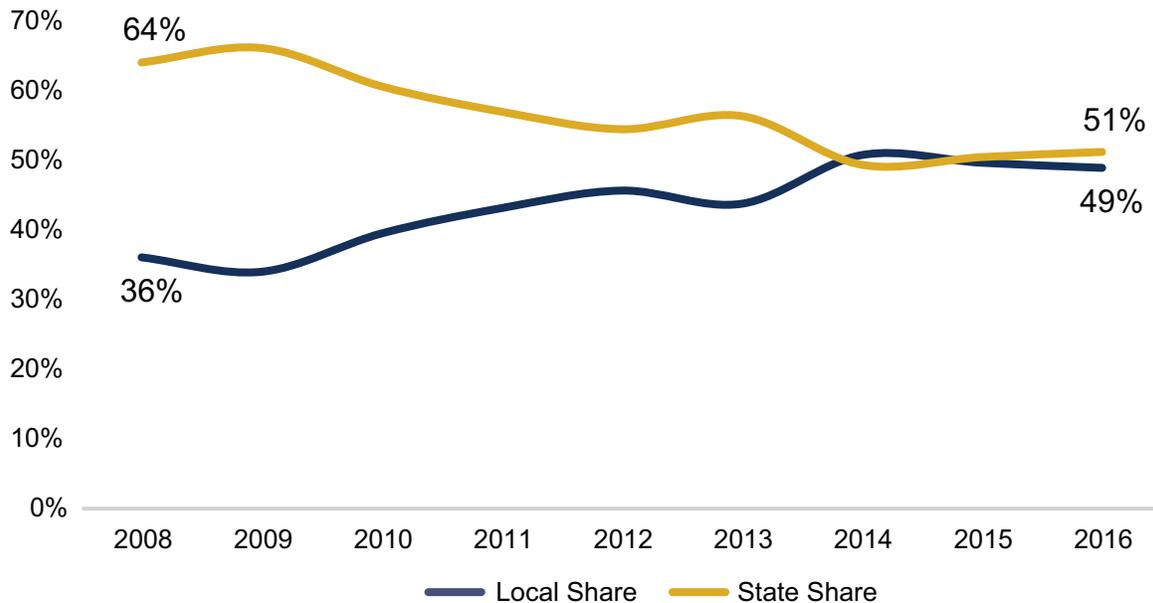
WEAK STATE RESOURCES LEAD TO COST-SHIFT TO LOCAL DISTRICTS

Another concerning example of the growing cost-shift from the state to local districts is the transportation component of the SEEK formula. Kentucky law establishes a formula for determining transportation funding based on the characteristics of each district. Beginning in the late 2000s, the General Assembly elected to only partially fund this provision, resulting in substantially less state funding than the total cost determined under the formula. As illustrated in the graph on the next page, local districts have used their own resources to make up the difference.¹³

In its 2018–2020 budget request, KDE has asked the state to return to fully funding the cost of transportation as determined by the formula, at a cost of an estimated additional \$133 million a year.¹⁴

Another issue that further confounds these funding issues for districts in coal counties is that declining receipts from unmined mineral taxes and tangible personal property taxes—due to the shrinking coal industry and changes to assessments for unmined minerals in the 2016–2017 school year—have diminished their tax base, and therefore reduced their ability to raise revenues.¹⁵ KDE is requesting that the General Assembly provide assistance to these districts, for example by appropriating funds in the 2018–2020 budget to make emergency loans.¹⁶

Local School Districts Pay an Increasing Share of Transportation Costs



Source: KCEP analysis of KDE SEEK Calculations and Annual Financial Revenues and Expenditures.

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LACK OF RESOURCES LIMITS NEEDED ADVANCEMENTS

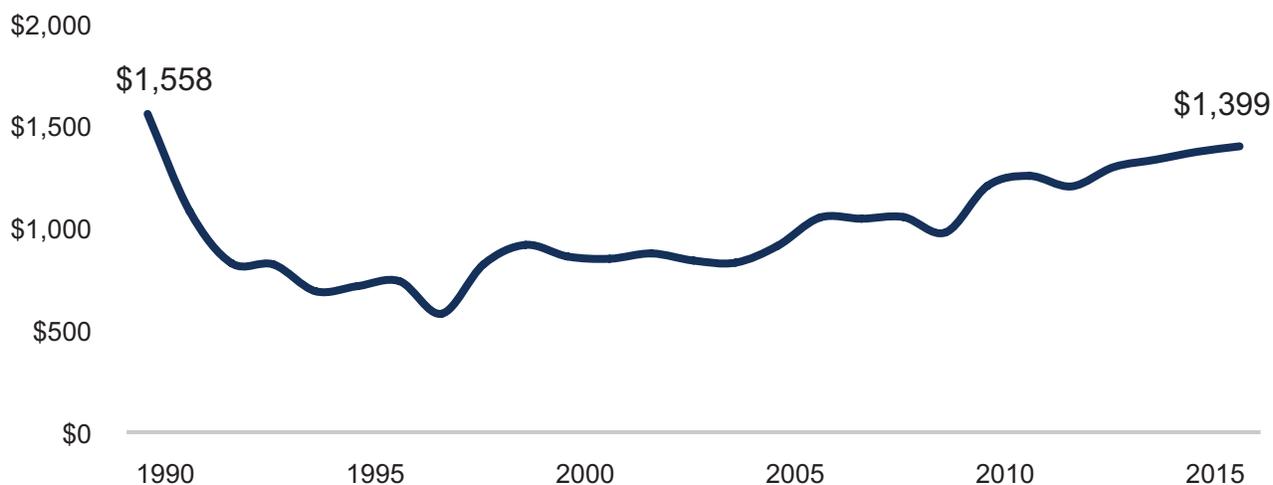
Due to these state funding cuts to education, many Kentucky school districts are having to make difficult budget decisions about reducing or eliminating staff, student supports, courses, and art and music programs. In addition, many are unable to give staff raises or meet facility needs.¹⁷

Research shows adequate school funding makes a real difference in a child's success in school and later in life. One study found that when school spending increased by 10 percent over the 12 years a low-income child was in attendance, that child was less likely to be poor as an adult, more likely to graduate from high school and had more than a seven percent increase in earnings as an adult.¹⁸ Another study found the achievement gap between rich and poor students shrank by around 20 percent in school districts located in states where funding reforms took place to address wealth inequities among districts—while the gap grew in states where there was no funding reform.¹⁹

Kentucky benefitted from such reforms in the past. The 1990 Kentucky Education Reform Act (KERA) established a funding system that provides more state funding to school districts that have less ability to raise revenue locally, equalizing funding among property rich and property poor districts. After the passage of KERA, funding disparities were reduced and national achievement rankings have improved. Unfortunately, due to inadequate state funding and an increasing reliance on local districts—the poorer of which struggle to offset lost state revenue—equity gains made through KERA are being lost.²⁰ (See graph on next page.)

The Funding Gap Between Kentucky's Poorest and Wealthiest School Districts Continues to Grow

Gap between top and bottom school district quintiles in per-pupil, state and local revenue (inflation-adjusted for 1990 Dollars)



Source: Kentucky Office of Education Accountability (1990–2010); KCEP analysis of KDE and Bureau of Labor Statistics data, CPI-U series (2011–2016).

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Inadequate funding and funding inequities also inhibit the state's ability to close demographic achievement gaps. 2017 results from standardized assessments for grades three through eight (KPREP) show a widening achievement gap for African American students.²¹ For students qualifying for Free and Reduced Price Lunch (FRPL), Latino students and English Language Learners, exam results were mixed.²²

NEW INVESTMENTS IN HIGH SCHOOL EDUCATION/TRAINING

There are some areas of the education budget that are receiving greater investment. More funding has been provided to expand high school students' access to dual credit programs, which enable them to earn college credit by enrolling in college-level classes while still in high school.²³ For the 2016–18 biennium, \$15 million was appropriated for a dual credit scholarship that enables any junior or senior to earn dual credit for up to two courses, at no cost to the student. There were 48,176 students participating in dual enrollment at a Kentucky public community college or university in 2017, compared to 32,104 in 2016.²⁴ Additional resources—\$100 million in bond funds budgeted over the biennium—are being invested as part of the Work Ready Skills Initiative to finance buildings and equipment for training programs in several occupational sectors considered to be in high demand; qualifying projects are collaborations among high schools, community colleges and industries.²⁵

HIGHER EDUCATION CUTS MAKE COLLEGE LESS AFFORDABLE

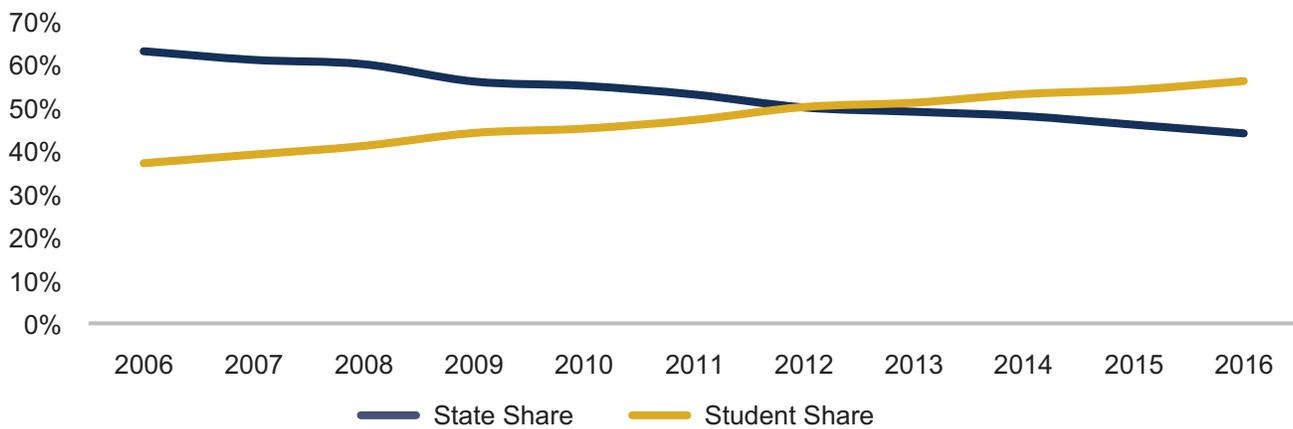
Large cumulative cuts to Kentucky's higher education system are behind the increasing cost of college in Kentucky. Compared to before the Great Recession, Kentucky's public universities and community colleges are

receiving 26 percent less in state funding per student once inflation is taken into account.²⁶ This makes Kentucky 10th worst among states for its cuts to per student funding for higher education since 2008. Most states have begun to reinvest in higher education over the last couple of years, but Kentucky is one of the few that continued to cut higher education funding between 2016 and 2017.

The most recent cuts are part of a decade-long trend in which the cost of public higher education is being shifted from the state to students. As shown in the graph, the state's share of funding for postsecondary education declined from 63 percent in 2006 to only 44 percent in 2016. Tuition and fee increases at state universities over that time period averaged 52 percent when adjusted for inflation, and ranged from 38 percent (Kentucky State University) to 63 percent (University of Louisville) and 33 percent at community and technical colleges.²⁷

Cost of Higher Education Shifting from State to Students

The state and student shares of total postsecondary funds in Kentucky



Source: OSBD and CPE.

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These state cut-driven increases in tuition have vastly outpaced wage growth in recent years, which has made college harder to afford, especially for low-income families. Kentucky continues to have high rates of student loan default, and research shows many community college students face challenges with hunger and homelessness, particularly students of color, former foster youth and student parents.²⁸ Not only does this limit access to higher education opportunities for individuals and families, but it limits opportunities for economic growth in communities across our state. Even community colleges are pricing out students. In 2015, Kentucky's community colleges were ranked as having the highest tuition among Southern Regional Education Board States, with a tuition rate more than \$1,000 above the national average.²⁹ Kentucky has also been ranked as having the 11th highest community college tuition in the nation.³⁰

In addition to increased tuition, the state's higher education institutions report cutting back on staff, deferring routine but potentially serious maintenance issues, and relying more heavily on part-time faculty.³¹ Within the community and technical college system, almost immediately after the cuts in the last budget, over 500 faculty and staff positions were cut, including 170 faculty and staff layoffs. The system's administration cited state funding cuts and enrollment decreases as the primary drivers.³²

These state cuts and higher tuition have likely contributed to the state's lack of progress in addressing its higher education achievement gaps. The most recent analysis shows that in 2014, 35.9 percent of minority students and 36.5 percent of low-income students completed a bachelor's degree within six years, as compared to 49.2 percent of all Kentucky students (more recent data available from individual institutions indicates a lack of further progress since then).³³ Low-income and minority students seeking an associate's degree similarly had low degree completion rates compared to the rest of their cohort. Rising tuition is especially a barrier for low-income students and students of color, and state cuts reduce support services that are critical to helping these students complete their degrees.³⁴ Students who are the first in their family to pursue higher education, who are disproportionately students of color and from lower income families, are hit twice by state funding cuts as support services that help acclimate first generation students to college have been cut to balance university budgets.

Amidst the long-term trend of cuts to higher education in Kentucky, the state has also instituted a performance funding model that ties some funding for public postsecondary institutions to certain performance metrics. This model could make addressing higher education achievement gaps for low-income, minority, adult and academically underprepared students even more difficult.³⁵ First implemented in the 2018 fiscal year with only five percent of funding distributed through the formula, it is expected that moving forward, all state funding for public colleges and universities will be allocated through this model. As designed, the public universities compete for funds and the community colleges compete among themselves.³⁶ Very little of this model incentivizes colleges and universities to close achievement gaps for low-income and underrepresented minority students.

The Council on Postsecondary Education (CPE) has included in its 2018–2020 budget request an increase of \$160 million across the biennium to provide more money for performance funding and to help cover rising pension contributions at many higher education institutions, which are expected to be significant.³⁷

It is also important to note that Kentucky Adult Education (KYAE), which is part of CPE, has been cut 30 percent over the past 10 years before taking inflation into account. Meanwhile, 12.9 percent of working age (18–64) Kentuckians did not have a high school diploma or equivalency credential in 2015. While that number has steadily declined since 2010, it remains the 11th highest share in the country.³⁸

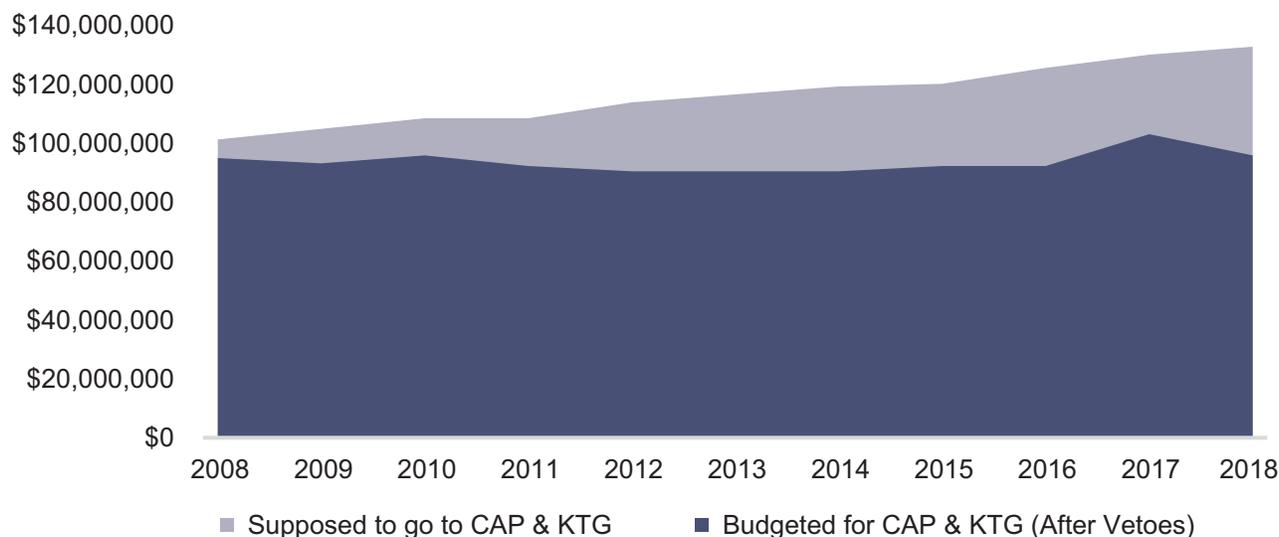
STATE FINANCIAL AID IS UNDERFUNDED

At the same time Kentuckians face steep tuition hikes at our public universities and community colleges, Kentucky's lottery-funded, need-based financial aid programs—already modest—are not fully funded. Thousands of students who qualify for aid are being turned away each year due to lack of funds. By statute, all but \$3 million of lottery revenue is devoted to the state's three main scholarship programs, which include both merit- and need-based aid. But for a decade, a growing amount of those funds have been diverted to the General Fund to pay for other state priorities and make up for lost tax revenue. While 55 percent of the lottery money is supposed to go to the need-based programs—the College Access Program (CAP) and Kentucky Tuition Grant (KTG)—and 45 percent to the merit-based Kentucky Educational Excellence Scholarship (KEES), in 2018 CAP and KTG received just 40 percent while KEES was fully funded.

In the 2016–2018 budget, \$40.3 million in lottery proceeds were diverted from need-based financial aid programs to the dual credit scholarship program and the Work Ready Scholarship program. The General Assembly attempted to replace this funding in a separate, later-enacted appropriations bill, but those appropriations were

Kentucky's Two Need-Based Scholarships Have Been Underfunded for a Decade

Statutorily Required Funding for CAP & KTG vs. Budgeted Funding from 2008–2018



Source: KCEP analysis of data from the OSBD.

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vetoed by the governor. In the end, rather than the \$55 million originally budgeted, funding was increased by just \$14.7 million across the biennium representing just shy of 8,000 additional scholarships.

Distinct from the Work Ready Skills Initiative discussed in the P-12 education section of this report, the Work Ready Scholarship is a new program funded in the 2016–2018 budget. Though originally intended to provide free community college tuition to recent high school graduates, the final version of the scholarship is much more limited. Starting in the fall of 2017, the scholarship covers the equivalent of community college tuition and mandatory fees for short-term certificates or diplomas in five occupational areas—including advanced manufacturing and health care—at Kentucky community colleges, several public universities and two private institutions.³⁹ As a last-dollar program, Pell Grants and other scholarships are applied to a student's tuition and mandatory fee bill first so many low-income students who receive Pell Grants will not benefit from the scholarship.⁴⁰

MEDICAID WORKS AND REQUIRES GROWING INVESTMENT

Medicaid is the second largest single General Fund appropriation in the state budget, behind only P-12 education. It is also among the fastest growing expenditures in the budget, as medical inflation generally grows faster than inflation in the economy at large and as the state pays for its increasing share to fund Medicaid expansion. Keeping up with these costs is important, as investments in health create long-term dividends in our economy and well-being as a state. Recent successes in health care access and outcomes from expanded Medicaid eligibility are a good example of why those investments should be protected.

Low-income Kentuckians are benefitting from the state’s move to expand Medicaid eligibility through the Affordable Care Act (ACA) to 138 percent of the federal poverty line (\$16,670 in annual earnings for an individual). So far, more than 475,000 Kentuckians have newly qualified for coverage.⁴¹ The expansion is the major reason Kentucky’s rate of uninsured dropped from 14.3 percent in 2013 to 5.1 percent in 2016, the biggest decline in the nation.⁴² In total, over 1.4 million Kentuckians have coverage through traditional and expanded Medicaid, which is just under one-third of the population.

Nearly 1 in 3 Kentuckians Are Covered by Medicaid

Share of the population in each county covered by Medicaid



Source: KCEP analysis of Kentucky Cabinet for Health and Family Services Medicaid enrollment data and 2016 Census Population Estimates.

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As a result of the expansion, use of a primary care physician, regular care for chronic conditions, and screenings for health problems like diabetes, cancer and hypertension have all substantially increased. This greater use of care has already begun to translate to better health, with preventable hospitalizations dropping for asthma and hypertension, fewer Kentuckians smoking, a lower rate of infant mortality and breast cancer deaths and a growing share of Medicaid expansion-eligible Kentuckians reporting excellent health.⁴³ Given the existence of health disparities by region, socioeconomic status, and race and ethnicity, access to health coverage is all the more important to ensure Kentuckians can get health care when they need it.⁴⁴

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. Between the 1st quarter of 2014 and the last quarter of 2016, Medicaid-covered treatment for a substance use disorder rose over 500 percent, from 2,772 treatments to 16,791.⁴⁵

Overall, Kentucky is starting to get healthier. According to the Commonwealth Fund, Kentucky has jumped from 47th to 39th in state health systems performance, based on multiple metrics.⁴⁶ Kentuckians who became newly

eligible for Medicaid compared to economically similar adults in Texas, which did not expand Medicaid, are getting to the doctor more easily and often, and many are getting healthier as a result.⁴⁷

This new influx of covered patients through Medicaid has resulted in a nearly \$2 billion decrease in uncompensated care at hospitals. This decrease and a broader increase in revenue resulting from the Medicaid expansion have contributed to the health care sector growing by 15,000 jobs in Kentucky since 2013, outpacing the rest of the economy. A thriving health care sector is an economic driver for the rest of the commonwealth as every dollar invested results in \$1.50 to \$2 circulating in the economy at large.⁴⁸ Healthier communities lead to a more productive workforce as well.

Medicaid is largely paid for by the federal government. The share of traditional Medicaid spending—which covers low-income pregnant women, children and elderly, as well as some disabled Kentuckians—paid for by the federal government is known as the Federal Medical Assistance Percentage (FMAP). For traditional Medicaid, this share depends on the economic wellbeing of each state, and ranges from around 50 percent to just under 75 percent. Kentucky’s has been right around 70 percent for several years, but starting next fiscal year Kentucky’s FMAP will be 71.67 percent, which will reduce what Kentucky would otherwise have had to pay for traditional Medicaid by approximately \$28 million in 2019 and \$38 million in 2020.⁴⁹

Distinctly, Medicaid expansion has an enhanced FMAP. For the first three years of the expansion, the federal government paid all costs. Since then the state’s share has been phasing up to 10 percent in 2020 (the calendar year, as opposed to the state’s fiscal year, which begins July 1) where it will remain thereafter. The state projects Medicaid expansion will cost a total of \$3.7 billion in 2019 and \$3.8 billion in 2020; Kentucky’s 6.5 percent responsibility in state fiscal year 2019 would be \$238.5 million, and its 8.5 percent responsibility in state fiscal year 2020 would be \$326.2 million. Year over year, the state will need to pay an additional \$45.6 million in 2019 and 87.7 million in 2020.⁵⁰

THREAT TO HEALTH CARE GAINS FROM THE 1115 MEDICAID WAIVER

The estimates in this section from the Cabinet are based on Kentucky’s existing Medicaid program. The state’s pending 1115 waiver—the governor’s request to the federal government to allow the state to make changes to Medicaid—“saves money” by erecting barriers to getting and keeping Medicaid coverage, especially for newly eligible adults. The waiver’s lower cost and enrollment growth estimates are largely due to 97,000 adults losing Medicaid coverage.

Specifically, the waiver removes benefits like non-emergency medical transportation to doctors’ appointments, retroactive eligibility that covers medical bills three months prior to enrollment, and vision and dental coverage. It also creates two new accounts, a health savings account and an incentives account, for members to manage. Most onerously, it makes enrollment conditional on four new things:

- A 20 hours per week “community engagement requirement” for work, volunteering or both.
- Monthly premiums, which grow over time for enrollees who earn between \$12,080 and \$16,670 annually (for an individual).
- Reporting requirements for relevant changes in employment hours and income.
- An annual redetermination, requiring members to complete the entire eligibility determination process once a year.

Failure to comply with any of these new requirements results in a loss of coverage without the chance to re-enroll for the next six months. The only way to end the “lock out” period early is to take a financial or health literacy class, and if the lock out is for failure to pay premiums, the member must also pay three months of premiums up front.⁵¹

The cost savings from covering fewer people are greatly reduced by the expensive administrative structures necessary to implement the requirements described above. In addition, with approximately 97,000 fewer people covered and fewer benefits for the rest, there will be reduced economic activity in the health care sector and economy as a whole along with harm to the health of Kentuckians who are no longer covered.⁵²

WAITING LISTS FOR SPECIAL POPULATIONS

Through a different kind of waiver program, traditional Medicaid pays for in-home care for individuals with significant health care needs such as intellectual or developmental disabilities and brain injuries. Referred to as 1915c waivers, these programs are vital to keeping disabled Kentuckians in the community rather than in nursing homes or state-run institutions, which are more expensive and less desirable for many people. As of August 2017, there were 23,272 Kentuckians receiving long-term services and support through six such waiver programs, and a waiting list of 8,180 eligible people not receiving waiver coverage due to lack of state resources.

Medicaid Waivers

| Waiver | Description | 2017 Enrollment | Waitlist for Waiver |
|-------------------------------------|---|-----------------|---------------------|
| Acquired Brain Injury (ABI) | Provides intensive services and support to adults with acquired brain injuries working to re-enter community life. Services are provided exclusively in community settings. | 192 | 0 |
| Acquired Brain Injury—LTC (ABI-LTC) | Provides an alternative to institutional care for individuals that have reached a plateau in their rehabilitation level and require maintenance services to avoid institutionalization and to live safely in the community. | 256 | 207 |
| Home and Community Based (HCB) | Provides services and supports to elderly people or children and adults with disabilities to help them remain in or return to their homes. | 8,018 | 0 |
| Model II (MW-II) | Community-based, in-home waiver services for an individual who is dependent on a ventilator 12 hours or greater per day, needs high intensity nursing care services 24 hours per day and would otherwise require care in a hospital-based nursing facility. | 40 | 0 |
| Michele P. (MPW) | Program developed as an alternative to institutional care for individuals with intellectual or developmental disabilities. MPW allows individuals to remain in their homes with services and supports. | 10,115 | 5,728 |
| Supports for Community Living (SCL) | An alternative to institutional care for individuals with intellectual and developmental disabilities. SCL allows individuals to remain in or return to the community in the least restrictive setting. | 4,651 | 2,245 |

Source: CHFS presentation to the Medicaid Oversight and Advisory Committee on Aug. 17, 2017.

The rates for providers of services under these waivers have not increased in years, even though inflation has increased the cost of care. For this reason, the group representing 1915c service providers is requesting a 25 percent increase in state funding, or \$26 million each year, for the sole purpose of bringing funding up to a sustainable level (this additional funding would not alleviate waiting lists). In their budget request testimony, the Kentucky Association of Private Providers stated that this increase would leverage \$87 million in federal funding, bring payments to \$247 per person per day—still well below the cost for institutionalized care at over \$1,500 per person per day—and save the state millions.⁵³ According to AARP, Kentucky ranks last out of all 50 states and Washington D.C. for the quality and availability of long-term services and supports in the community.⁵⁴

HUMAN SERVICES THAT IMPACT VULNERABLE KENTUCKIANS ARE DEEPLY UNDERFUNDED

CHILD CARE ASSISTANCE NEEDS AN UPDATE TO SERVE KENTUCKY'S YOUNGEST

More than 28,000 Kentucky kids benefit from the Child Care Assistance Program (CCAP), which provides help with child care costs for low-income families.⁵⁵ The 2016–2018 budget includes a \$21.2 million increase in funding to raise the eligibility threshold for families from 150 percent of the 2011 poverty line to 160 percent of the current federal poverty level, or \$39,360 for a family of four in 2017. However, total funding for child care assistance is still below pre-recession levels when adjusted for inflation, because federal funding is half of what it was in 2011 and increases in state funding have only partially offset the federal cuts.

There are also concerns about CCAP's continued low reimbursement rates. In early 2016, the state increased the rate to providers by five percent, which is about one dollar per child per day, the first increase since 2006. However, reimbursement rates remain very low compared to current full market rates and the real cost of care. As a result, and along with other factors, fewer child care centers are accepting CCAP assistance, making it harder for low-income families to find affordable child care so parents can go back to work, increase work hours or go back to school.

With regard to the quality of child care, Kentucky received a \$44.3 million multi-year grant in 2014 through the U.S. Department of Education called the Race To the Top—Early Learning Challenge. That funding was used to pay for STARS For Kids Now, a program to measure and enhance child care quality; the grant will expire in 2018. STARS For Kids Now has helped many child care centers train and certify their staff and purchase materials to improve the quality of their centers. STARS has also created a ranking system to identify the level of quality being offered that will remain in use after the funding runs out.⁵⁶

KENTUCKY'S SOCIAL WORKERS ARE STILL IN CRISIS

Social workers from the state's Department for Community Based Services (DCBS), who serve on the frontline of the state's child protection program, continue to face well-publicized challenges. The Legislative Research Commission (LRC) recently reported that DCBS social workers struggle with an average workload of 32 cases, which is more than double the national accreditation standards of 15.⁵⁷ Although the most recent biennial budget included an extra \$3.3 million to give long-needed pay raises to social workers in an attempt to reduce high staff turnover, salaries are still too low and the caseloads remain unsustainable.

This unmanageable workload and a low starting salary is why state social workers had a turnover rate of 24 percent in the past year. Across the commonwealth, 8,500 children are in the child protection system because of neglect or abuse, an all-time high and a 25 percent increase since just 2011 —further evidence of the incredible strain on social workers. In order to bring caseloads to the Cabinet’s target of 18 per worker, LRC estimates that DCBS would need to hire an additional 420 workers at a cost of approximately \$28 million.⁵⁸

Children removed from their parents or legal guardians because of unsafe conditions are placed in either kinship, fictive or foster care. Foster parents, who are trained and regulated through the state or private agencies prior to placement, receive an average of \$750 a month per child to help with the care of the child. Alternatively, kinship (relatives such as grandparents) or fictive (adults that the child is familiar with, but has no relation to) custodians—who temporarily care for children while the courts determine the best long-term placement for children—currently receive no financial assistance. The Cabinet estimates that treating these placements similarly will require an additional \$3 million to \$4 million annually.

A third funding need to ensure Kentucky’s at-risk children have the ability to not just survive, but to thrive, is Kinship Care. The program, whose enrollment was frozen in 2013 because of funding cuts, currently serves around 5,800 children. Kinship Care provides \$300 per month per child to caregivers, the majority of whom are grandparents, who have been granted permanent custody of children. The payments help children remain with loved ones who they are familiar with, and helps the state to find permanent homes for children whose parents cannot provide for them. Without kinship caregivers, the state would have an even deeper foster home crisis. The Cabinet for Health and Family Services plans to ask for the funds needed to unfreeze Kinship Care enrollment—an estimated \$17 million a year.⁵⁹

OTHER HUMAN SERVICE NEEDS GOING UNMET

Kentucky’s Department for Behavioral Health, Intellectual and Developmental Disabilities provides a wide range of services for addiction treatment, community living for dependent adults, long-term institutional care for those with severe needs and outpatient mental health services. This division has not received a meaningful state funding increase since the 1990s. Funding has therefore failed to keep up with inflation and the growth in demand for services. Among states, Kentucky has the fifth lowest state mental health expenditures per capita, despite ranking poorly in mental health and with among the highest rates of opioid overdose deaths in the country.⁶⁰

In addition to the services provided by Medicaid, Kentucky also cares for the aged and disabled through the Department for Aging and Independent Living (DAIL). DAIL administers both federally and state-funded programs that help keep dependent adults out of institutionalized care. An example is State Guardianship, which helps keep 4,400 disabled adults in the community and has grown 43 percent over the last 10 years. Caseloads for this program are supposed to be 20 per state worker, but average 71. Though more people need these services as Kentucky’s population ages, the department has seen no meaningful increase in funding for years.⁶¹ As a result, many eligible people are not receiving services: There are 2,000 Kentuckians on the waiting list for home care services that include assistance with housekeeping and personal care, and 2,225 on the “Meals on Wheels” waiting list.⁶² Other state-funded programs administered by DAIL include Hart Supported-Living, the Traumatic Brain Injury Behavioral Program, and certification authority for assisted living and adult day care settings.

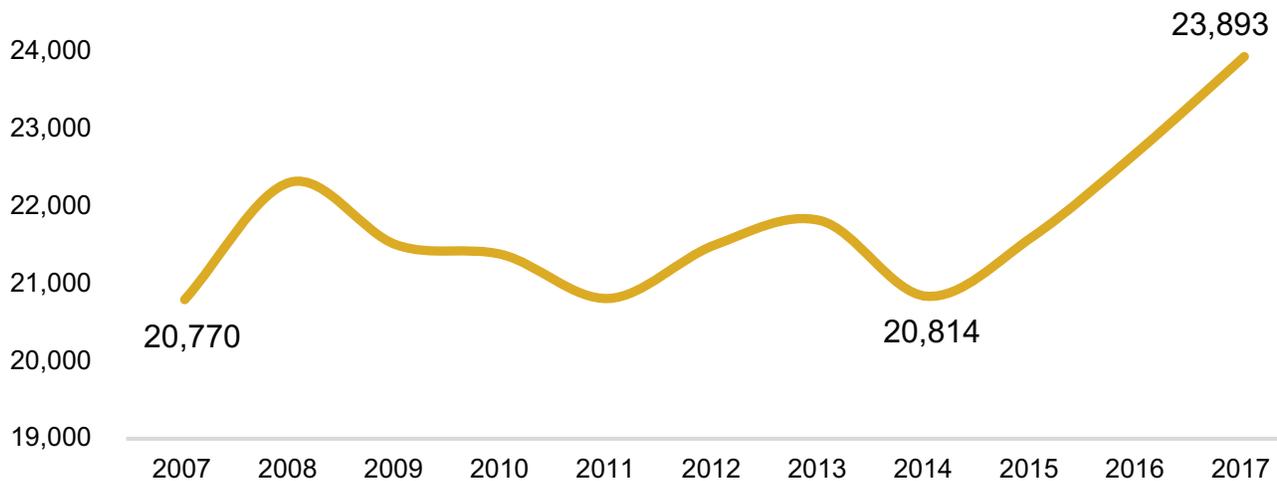
KENTUCKY'S CRIMINAL JUSTICE COSTS RISE AS INMATE POPULATION CONTINUES TO GROW

Despite criminal justice reform legislation passed in 2011, Kentucky's inmate population has continued to grow—putting pressure on the state's local jails and the state budget.

2011's House Bill 463, or the "Public Safety and Offender Accountability Act," has resulted in fewer inmates than would otherwise be the case. The law has meant some savings to the state and better access to substance abuse treatment and programs that help reduce the likelihood incarcerated individuals will return to jail or prison after release, known as recidivism.⁶³ However, for a number of reasons, the favorable impact on the inmate population and state budget were much less than projected. This result is in part because of lower than expected parole rates, and because some judges and prosecutors who disagree with the reform measures have exercised their discretion in ways that prevent the reforms from being fully implemented—such as opposing pretrial release for low- and moderate-risk arrestees and refusing to use deferred prosecution.⁶⁴

Though inmate populations declined for a brief period after the passage of HB 463, Kentucky's inmate population was at an all-time high at the end of September 2017 with 24,679 inmates.⁶⁵ The number of female inmates has been rising particularly rapidly, jumping 27 percent over the last five years.⁶⁶

Kentucky's Inmate Population



Source: Kentucky Department of Corrections.

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As the state's inmate population continues to grow, local jails are becoming increasingly overcrowded. Inmates in overcrowded jails face substandard living conditions and lack access to many of the programs available in prisons that can help reduce the chances of recidivism. In fact, recidivism rates are higher for Kentucky inmates housed in county jails rather than state prisons. According to a 2016 LRC report, for inmates convicted of a Class C felony (Class D is the lowest level), the share of inmates who returned to lock-up within three years is 43.6 percent for those in county jails, compared to 40.2 percent for those in a minimum security prison and 41.4

percent for those in a medium security prison.⁶⁷ As described in the report, of the 76 county jails that house state inmates all but seven were at 120 percent or greater of capacity, including six that were at more than 160 percent of capacity. The state is opening a private prison to alleviate some of the overcrowding; however, there are many concerns about doing so, including abuse and other safety issues that caused the state to previously end the use of private prisons.⁶⁸

As a result of the inmate population growth, state corrections costs have continued to rise at an alarming rate. In 2017, corrections costs were \$43 million more than projected for that year alone. Over the last six years, the total amount of Necessary Government Expense (NGE) for corrections-related expenditures above the budgeted amount was \$139.8 million.⁶⁹ The corrections NGE for 2018 is expected to be even larger than in 2017.⁷⁰

An offshoot of Kentucky's Criminal Justice Policy Assessment Council (CJPAC) (discussed below), the Justice Reinvestment Work Group recently heard testimony that without criminal justice reforms, Kentucky's inmate population is expected to grow by 19 percent over the next decade at a cost of more than \$600 million.⁷¹ Were that to happen, Kentucky would not only need to re-open two more private prisons but would also need to build a new state prison.

INADEQUATE STATE CORRECTIONS RESOURCES SQUEEZING LOCAL FISCAL HEALTH

These trends have resulted in unmanageable local costs as well, particularly with so many state inmates being housed in local jails. Kentucky ranked second worst in the nation for the high share of state and federal inmates in local facilities as of 2014.⁷² In fact, close to half of state inmates are housed in county jails. County jail costs are reportedly one of the most significant drains on county tax dollars, with the cost of county jail operations in some cases exceeding the cost of all other county operations combined. Judge Executive Tommy Turner has testified that in LaRue County 60 percent of the total real property tax dollars collected are used to operate the jail.⁷³

CONTINUED CRIMINAL JUSTICE REFORM EFFORTS AREN'T ALWAYS FORWARD-MOVING

While the Kentucky General Assembly has taken some important steps toward criminal justice reform, it has also taken some steps backward, and additional reforms are greatly needed.

The 2016 General Assembly passed legislation that enables some with felony convictions to have their criminal records expunged. This legislation provides second chances for many formerly involved in the criminal justice system and is expected to open up more employment opportunities for these individuals, which will contribute to lower rates of recidivism. Between July 2016 and September 2017, 1,262 expungements were granted.⁷⁴

With a growing recognition of the need for additional reforms, Governor Bevin created the CJPAC in June 2016. That group included lawmakers, judges, prosecutors, police, clergy and business leaders and was charged with studying the state's criminal code and suggesting improvements to the 2017 General Assembly. The CJPAC explored a number of promising reforms—including expanding drug courts, reclassifying some non-violent Class D felonies (the lowest level) as “gross misdemeanors,” and raising the felony theft threshold, among others.

Although it considered much more sweeping reforms, the package the CJPAC proposed, eventually enacted as Senate Bill 120 in 2017, was much more narrowly focused on reentry and is not expected to have a significant impact on the inmate population in the near future. SB 120 takes some first steps toward promoting successful reentry into the community after incarceration, including: reforms that make it possible for workers with records to receive occupational licenses in some cases; provisions that prevent inmates owing large fines or court costs to be incarcerated if they truly can't afford to pay; the authorization of day reporting programs and reentry centers; and more work opportunities for inmates while incarcerated.⁷⁵

Unfortunately, the 2017 General Assembly took a big step backwards with the passage of House Bill 333 which increases criminal penalties for low-level heroin trafficking. Specifically, it erases distinctions that prevent addicts caught selling or even sharing small amounts of heroin to support their own habit from receiving harsh penalties for heroin trafficking. The legislation is expected to significantly increase corrections costs, with some estimates predicting upwards of \$30 million annually.⁷⁶ Incarceration is a poor solution to addiction and adds to the state's growing inmate population.⁷⁷

The Justice Reinvestment Work Group has developed recommendations for the 2018 session and is receiving technical assistance from the Crime and Justice Institute (CJI) at Community Resources for Justice—an organization that has had success helping Louisiana and Alaska identify meaningful and cost-saving criminal justice reforms. Included in the Justice Reinvestment Work Group's recommendations for the 2018 General Assembly are to reclassify low-level drug possession as a misdemeanor, increase the felony theft threshold from \$500 (roughly the cost of a cell phone) to \$2,000, increase the felony threshold for flagrant nonsupport (failure to pay child support) from \$1,000 to \$10,000, make parole automatic for inmates with certain charges and limit the use of money bail.⁷⁸ As a package, the recommendations would reduce growth in Kentucky's prison population by almost 3,500 beds, averting 79 percent of projected growth in the next 10 years and saving nearly \$340 million in corrections costs through 2027.

Additional reforms with a focus on racial disparities in our criminal justice system are badly needed. African Americans are overrepresented in Kentucky's inmate population. Despite being just eight percent of Kentucky's adult population, African Americans make up 14 percent of all arrests in the state, 16 percent of arrests for serious crimes, 22 percent of the inmate population and 30 percent of the confined juvenile population.⁷⁹ Rather than one racial group simply being more likely than another to commit crimes, the causes of the racial disparities in the criminal justice system are much more complex. Research on the topic points in part to policies and practices such as those related to the "war on drugs," as well as implicit bias and stereotypes in decision-making, which have a disparate impact on African Americans.⁸⁰ Whites, for instance, have a greater tendency to face the lesser charge of heroin possession as opposed to trafficking compared to African Americans, according to data from Kentucky's Department of Public Advocacy (DPA).⁸¹

Kentucky kids' futures are also at stake. If fewer parents are incarcerated or have shorter sentences, their children could see improvements in education, better health and more economic opportunities.⁸² In 2016, Kentucky had the second largest share of children with a parent who has been incarcerated in the nation.⁸³

BUDGET CUTS ALSO STRAIN JUSTICE SYSTEM

Correctional officers received much-needed pay raises in the 2016–2018 budget, and prosecutors, public defenders and the judicial branch were spared cuts. However, most areas of the justice system continue to operate under severely depleted budgets, jeopardizing public safety, access to legal representation for low-income Kentuckians and the continuation of successful programs that save the state money in the long run.

STATE POLICE

The 2016–2018 budget included much-needed pay raises for state troopers, but budgets are still strained. The state needs 1,100 troopers to provide optimal policing services, Kentucky State Police (KSP) reports, yet only 890 troopers are provided for in the budget (and just 853 are currently in the sworn complement).⁸⁴ In addition, in 2016 the state police requested, but were denied funds to buy 200 new police cruisers to begin replacing its aging and high-mileage fleet. At this point, KSP needs 260 new cars within 12 to 18 months, and 180 new cars every year thereafter to retire the aging fleet which includes some cars with over 200,000 miles.⁸⁵

CORRECTIONS

There are severe staffing shortages in adult corrections due to low salaries and poor working conditions. One prison has a vacancy rate for corrections officers of 54 percent.⁸⁶ As a result, corrections officers at particularly understaffed institutions are required to work 12-hour days, five days a week—with probation and parole officers covering weekend shifts. These practices actually end up being costly for the Department of Corrections due to the need to cover overtime pay, travel and lodging.

JUDICIAL BRANCH

Since 2008, Kentucky's judicial branch has eliminated 329 positions through attrition and layoffs, maintained a modified hiring freeze since 2012 and reduced operating costs by almost \$2 million.⁸⁷ The judicial branch is still operating with a structural imbalance, with the total General Fund appropriation for 2017 \$8.3 million less than needed.

DEPARTMENT OF PUBLIC ADVOCACY

The DPA is also in need of much greater investment to reduce workloads and increase salaries of public defender staff.⁸⁸ In 2016, the average number of new cases assigned per DPA trial attorney was 460, an increase of 2.9 percent from the previous year—a level that is 55 percent above national standards.⁸⁹ Caseloads are as high as 178 percent of the national standard (in Somerset), 179 percent (in Bell County) and 186 percent (in Louisville). The DPA has previously noted such caseloads are not only excessive, but unethical.⁹⁰ Their budget request for 2018–2020 includes an additional 51 public defenders to reduce average caseloads below 400, the cost of which is \$4.6 million a year.⁹¹

UNIFIED PROSECUTORIAL SYSTEM

Similarly, recent testimony from prosecutors across the state revealed how strained services already are due to past budget cuts of 29 percent since 2008 (after adjusting for inflation).⁹² Complying with these additional cuts could lead to layoffs, forced closures for a period of time, or delays in court proceedings and in fee collections

that contribute to the General Fund. A budget reduction of this size would also threaten the rocket docket programs, which expedite cases for low-level offenses resulting in savings to local jails. According to testimony by the Commonwealth's Attorneys there are 37 heroin rocket docket programs designed to reduce jail populations and provide treatment alternatives. Lack of staff to administer these programs would immediately reduce associated savings.

ALTERNATIVES TO INCARCERATION

Other state alternatives to incarceration that pay off in the long run are limited by tight budgets. The DPA's Alternative Sentencing Worker (ASW) program, which offers options to individuals who suffer from substance abuse and/or mental health disorders, has a \$5.66 return for every \$1 invested, according to the DPA.⁹³ In 2017, the program led to a savings of more than \$13 million as a result of reducing jail and prison costs.⁹⁴ The DPA is requesting in its budget 11 additional Alternative Sentencing Workers (the cost of which is approximately \$800,000 for the biennium) to reduce caseloads in five large offices that currently have only one ASW—and also to assist with a new program to develop alternative sentencing plans for parolees or probationers facing revocation due to technical violations (such as missing meetings with probation/parole officers or not successfully completing substance abuse treatment).

Drug court is another important alternative to incarceration for those involved in the criminal justice system for reasons related to addiction. For every \$1 spent on drug court through the Administrative Office of the Courts (AOC), the state saves an average of \$4.14.⁹⁵ The recidivism rate for those who complete drug court in Kentucky is just 20 percent versus 57 percent for those on probation convicted of similar offenses two years after the probationary period. Since the program's inception in 1996, graduates from drug court have saved the state more than \$119 million in prison costs. However, additional investments are needed. There are currently seven Kentucky counties that do not have an AOC drug court program (although in four of these counties it is because there are no judges willing to serve in this capacity). Family drug courts were closed in 2010 due to state budget cuts, and volunteers are now raising the money needed to restart a family drug court program in Jefferson County.⁹⁶ The state also had to phase out its juvenile drug court in 2011 due to budget cuts.⁹⁷

Meanwhile, budget cuts have already led to the outsourcing of probation and parole in some cases to private companies that have little accountability to the state. These companies charge varying fees, and no data exists on how recidivism rates compare between the private companies and state probation and parole.⁹⁸

GAINS IN JUVENILE JUSTICE COULD BE AT RISK

While criminal justice reform for the state's adult population has a long way to go, Kentucky has made impressive gains with its juvenile justice reforms. Senate Bill 200, passed in 2014, has been successful in shifting the focus from incarceration to more effective interventions. As a result, the Department of Juvenile Justice (DJJ) has seen a 73 percent reduction in youth detention center placements for low-level offenders.⁹⁹ Since 2014, four DJJ facilities have been closed and the savings (approximately \$1 million so far) from these closures are being reinvested in juvenile justice programming.

An area that needs improvement, however, is the disproportionate share of minority youth who come into contact with the juvenile justice system. While there has been a 42 percent decline in DJJ commitments for white youth since 2015, the decline has been just 19 percent for African American youth.¹⁰⁰ Additional investments in data

collection systems are needed in order to identify where and how these disparities are occurring. Senate Bill 20 introduced in the 2017 General Assembly proposed such data collection measures, but did not pass.¹⁰¹

In 2017, the General Assembly authorized a much-needed 20 percent raise for new youth workers in the juvenile justice system, with commensurate salary increases for 420 existing employees (an investment of about \$2 million a year). Before the raises, salaries ranged from \$23,000 to \$31,000 a year.¹⁰² As a result of low pay and challenging job conditions, turnover in recent years has been incredibly high, with the department hiring 151 people and losing 180 in 2016. Yet even with raises, pay received by juvenile justice workers is still quite low and turnover high—causing DJJ to struggle to maintain the momentum of SB 200. There are also concerns the department will not be able to comply with new federal changes in the ratio of staff per youth (going from 1 to 12 to 1 to 8) that would cost DJJ an additional \$4 million. Failure to comply could put federal funding from the Department of Justice at risk.¹⁰³

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

There have been some important additional investments made in recent years in other parts of the state budget—for instance, in state parks and workforce bonds, as well as to address the problem of a backlog of untested rape kits. However, the cumulative cuts since 2008 have created serious fiscal strain in areas that impact Kentuckians across the state—even before the Governor’s recent additional cuts for 2018. Among the other services that have been harmed by state budget cuts:

- The budgets for the State Auditor, Attorney General and Secretary of State have been cut by 29 percent to 35 percent. These cuts impact the state’s ability to protect consumers, oversee fair elections and monitor how public dollars are spent.
- Funding reductions to the Energy and Environment Cabinet jeopardize the state’s ability to respond to emergencies, monitor and identify air, hazardous waste and solid waste infractions, and prevent crises from developing. Water quality has already suffered due to reduced capacity for environmental enforcement resulting from budget cuts.¹⁰⁴ A recent report found that in 2015 Kentucky had the largest share in the nation of its population getting water from utilities with at least one federal safety regulation violation (53 percent).¹⁰⁵
- Despite the additional funds to address the backlog of untested rape kits, salaries for KSP Laboratory technicians are so low—approximately \$33,000 a year—that positions are hard to fill and turnover is high. This disrupts the ability to meet state goals regarding processing DNA evidence.¹⁰⁶

General Fund Cuts to Selected Agencies from Original 2008 Budget to 2018

| | 2008 Enacted | 2018 | Percent Change | Inflation-Adjusted Percent Change |
|---|--------------|--------------|----------------|-----------------------------------|
| Energy Development and Independence | \$2,341,500 | \$1,249,200 | -47% | -55% |
| Kentucky Arts Council | \$4,182,500 | \$2,640,700 | -37% | -46% |
| Kentucky Educational Television | \$16,816,100 | \$13,923,200 | -17% | -29% |
| Secretary of State | \$2,298,100 | \$1,784,100 | -22% | -34% |
| Attorney General's Office | \$14,113,100 | \$11,034,400 | -22% | -33% |
| Auditor | \$5,828,300 | \$4,948,600 | -15% | -28% |
| Environmental Protection/ Libraries and Archives | \$26,118,000 | \$22,479,100 | -14% | -27% |
| Commission on Women | \$266,200 | \$237,400 | -11% | -24% |
| Kentucky Nature Preserves Commission | \$1,166,500 | \$1,061,500 | -9% | -23% |
| Vocational Rehabilitation | \$13,134,400 | \$11,872,700 | -10% | -23% |
| Deaf and Hard of Hearing | \$933,000 | \$873,900 | -6% | -20% |
| Commission on Human Rights | \$1,859,100 | \$1,781,800 | -4% | -19% |
| Commission for Children with Special Health Care Needs | \$5,917,000 | \$5,824,800 | -2% | -16% |
| Public Health | \$73,823,000 | \$74,548,200 | 1% | -14% |

Source: KCEP analysis of OSBD data. Calculations do not include additional budget reductions for FY 2018 made on Dec. 28, 2017.

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PENSION CHANGES COULD REQUIRE MASSIVE NEW DOLLARS BE PUT INTO SYSTEMS

A major question going into the next two-year budget is the state's plan to fund pensions. There are big implications resulting from what actuarial assumptions are used and whether changes are made to prior benefits earned and the structure of future benefits moving forward. Those choices will affect the size of the annual contributions the state will make to pay down existing liabilities.

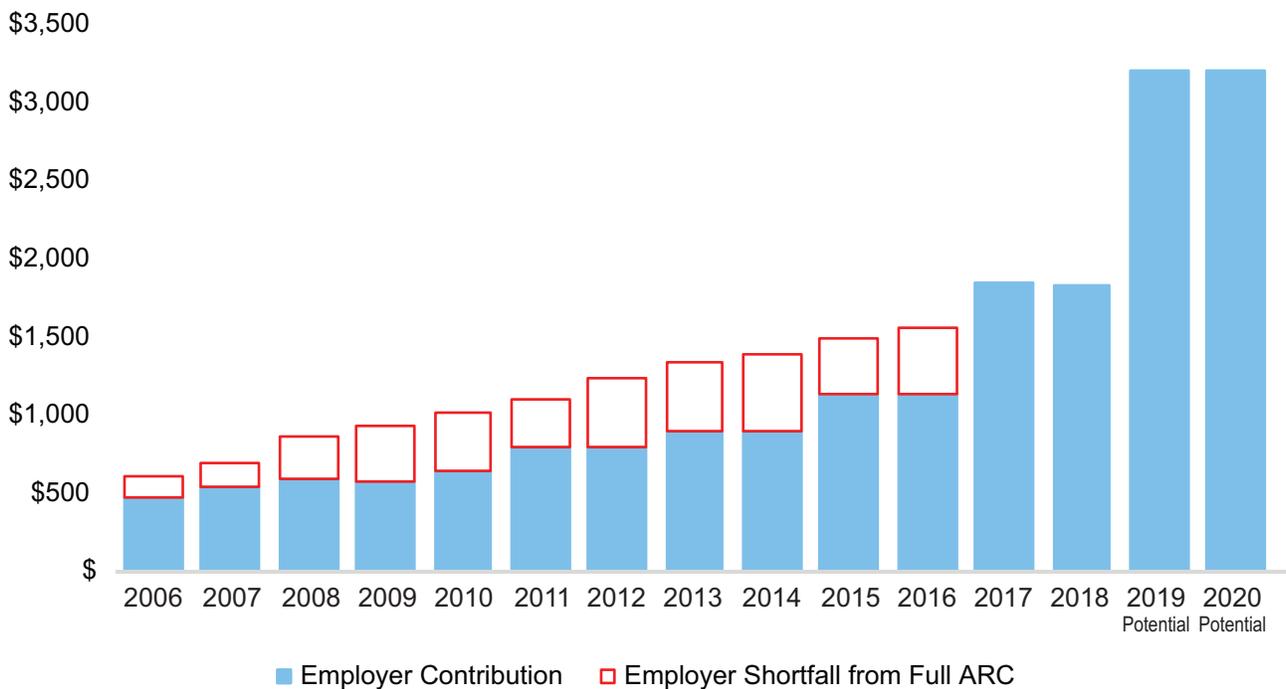
After many years of underfunding, the 2017–2018 budget included major new contributions to the pension plans, a total of an additional \$1.16 billion over the biennium, or an increase of 63 percent in 2017 above what was contributed in 2016. The budget included an amount close to 100 percent of the actuarially required contribution (ARC) for the Teachers' Retirement System (TRS) and \$185.8 million above the ARC over the biennium for the Kentucky Employees Retirement System (KERS) and State Police Retirement System (SPRS). These contributions constituted the first time in recent years the state has made what can be considered responsible payments to these systems. The budget also put \$125 million into a new "permanent fund" that the governor said at the time was intended to be distributed to pension plans following a performance audit (an additional \$25.8 million has been added to the fund since then).

Despite that recent, impressive progress, the governor wants to enact pension “reform” that will mean massive additional contributions must be made to the plans. The additional contributions come largely from shifting to the so-called level dollar method of paying down all of the liabilities. The level dollar approach requires liabilities be paid off with the same dollar contribution each year for 30 years, ignoring how revenue and therefore ability to pay grows on average about three percent each year. In combination with a big reduction in investment return assumptions for most of the plans, Kentucky would have by far the most austere approach to funding pension liabilities in the country.¹⁰⁷

This approach—which massively front-loads the costs of paying down liabilities—would call for contributions that are approximately 75 percent higher in 2019 than in 2018—or about 185 percent above what we put in just a few years ago, as shown in the graph below. The additional contribution would be approximately \$1.4 billion in 2019, of which between \$700 million and \$1 billion would come from the state’s General Fund.

On Top of Dramatic Increase in Pension Funding in 2017, Proposed Approach Would Cause Steep Increase in 2018–2020

Employer contributions to KERS, TRS and SPRS systems, in millions



Source: KCEP estimates based on KRS, TRS, Cavanaugh Macdonald, PFM data. Subtracts 2011 bond issue from TRS. Assumes level dollar funding begins in 2019. Employer contributions are from all sources.

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The only proposals put forward in the draft pension bill to reduce that added cost include legally questionable benefit cuts and a three percent cut to employee wages, both of which have apparently been abandoned by legislative leaders. The proposal to shift new workers to 401k-type defined contribution plans will just add costs in

the future, as closed defined benefit plans earn lower investment returns, making it more expensive to pay down existing liabilities. That fact was noted by the actuary to TRS, who estimated that shifting to a defined contribution plan and making other changes in the draft pension bill would make that system's unfunded liability rise from \$9.6 billion in 20 years to \$11 billion.¹⁰⁸ The actuary to Kentucky Retirement Systems (KRS) also did an analysis of the draft bill, but that report was abruptly taken off the agenda of a KRS board meeting and never publicly released.

More must be put into the pension plans for the next budget, in the range of several hundred million dollars, but using the level dollar method for all plans dramatically increases that needed contribution.¹⁰⁹ The majority of new dollars from this approach wouldn't even go to the poorly-funded Kentucky Employees Retirement System (KERS) non-hazardous plan, but to the teachers' plan which is now on much stronger footing.¹¹⁰ The new actuarial valuation for TRS shows its funded ratio climbed from 54.6 percent to 56.4 percent this year thanks in part to the added contributions in the current budget.¹¹¹

NEW COSTS IN NEXT BUDGET MOUNTING

On top of the funding needs created by previous and pending budget cuts and pressures to make added contributions to fund pension liabilities, Kentucky faces new costs in the 2018–2020 biennium that will be difficult to cover given weak expected revenue growth.

- **Corrections:** As described previously, state corrections costs will continue to grow without needed reforms. Among the factors impacting the higher inmate population than was budgeted in 2017 were more people being incarcerated and a lower rate of parole being granted than expected.¹¹² HB 333, as well as several other criminal justice bills passed by the 2017 General Assembly will result in added costs.¹¹³
- **Routine Cost Increases:** The state budget must account for inflation. According to the U.S. Bureau of Economic Analysis, basic inflation for state and local governments' costs increased 0.9 percent between 2015 and 2016.¹¹⁴

Inflation in health care costs is a particularly large expense for the state as it tends to be higher than other forms of inflation. Under current law, national health expenditures are projected to grow at an average annual rate of 5.6 percent between 2016 and 2025.¹¹⁵ Spending for Medicaid expansion also will increase as previously described.

- **Debt Service Costs:** To reduce immediate budget costs at the time, the state restructured some of its debt between 2009 and 2012, pushing debt forward to future years—which costs more in the long run. As a result, appropriation-supported debt service as a share of total revenue has been on the rise in recent years. It was higher at an estimated 6.14 percent in 2018 than in 2016 at 5.42 percent.¹¹⁶ The “rule of thumb” the General Assembly strives to meet is that debt service costs not exceed six percent of total revenue.

The 2016–2018 budget included \$1.25 billion in principal debt, with \$582 million in General Fund supported debt for capital projects.¹¹⁷ There were \$1.5 billion in bonded projects in the 2014–2016 budget and \$239 million in the 2012–2014 budget.¹¹⁸

EMERGING PRESSURES ON THE STATE BUDGET

OPIOID EPIDEMIC

Kentucky has been one of the states hit hardest by the national opioid epidemic. In 2000, nine counties in the United States had drug overdose death rates of more than 20 per 100,000 people, and four were located in Kentucky.¹¹⁹ By 2014, 64 of Kentucky's 120 counties had overdose death rates that high, and rates have continued to rise. Kentucky is tied with Ohio as having the nation's third highest rate of death due to drug overdose.¹²⁰

The impacts of the state's addiction problems are being felt by individuals and families across Kentucky as well as the state's corrections, foster care and public health systems:

- A recent analysis identified low-level drug crimes as a primary cause of Kentucky's growing inmate population. Incarceration for low-level Class D felony drug possession alone increased 102 percent in just five years between 2012 and 2016.¹²¹ Low-level theft crimes related to addiction are also a significant contributor to the overcrowding of jails in our state, which typically do not provide access to substance abuse treatment. These programs and services are particularly lacking in jails housing women, who are often incarcerated for charges related to addiction.
- The opioid epidemic has also contributed to the surge in the number of children in foster care between 2011 and 2017. In nearly 25 percent of cases, children were removed from their homes due to drug abuse by the parent.¹²²
- Public health spending, also suffering from cuts in recent years, has been strained by the opioid crisis. In 2015, Kentucky was among seven states the Centers for Disease Control identified as having more than twice the national rate of new Hepatitis C cases, often resulting from injection drug use or infants being born to a mother with the disease.¹²³ While curable, the cost of treatment is very high. Kentucky's Medicaid program spent \$83,735 per person on pharmacy claims to treat Hepatitis C in 2016. Increased spread of HIV is also a concern, with 54 counties in Kentucky identified as among the most vulnerable in the nation to disease outbreak. More than 30 of these counties do not yet operate a needle exchange. The increased prevalence of opioid-dependent newborns is another serious and costly public health issue.¹²⁴

DECLINING FEDERAL INVESTMENTS IN VULNERABLE KENTUCKIANS

Federal funding made up 37 percent of Kentucky's state spending in 2016 (compared to 31 percent nationally)—resources jeopardized by recently passed federal tax cuts for the wealthy and cuts to vital programs proposed by Congress and the President.¹²⁵ These federal funds allow us to invest in critical programs that support vulnerable Kentuckians. Non-defense discretionary funds, already at historic lows, support education programs such as Head Start, assistance for low-income kids and families and a wide range of other services that make our communities safer and healthier and that develop the workforce and economy.¹²⁶ Mandatory programs like Medicaid, Medicare, and the Supplemental Nutritional Assistance are also at risk, putting increased pressure on the state budget to maintain supports for vulnerable Kentuckians.

NEED FOR INVESTMENTS AND POLICIES THAT HELP KENTUCKY THRIVE

The legislature's top priorities in the 2018–2020 budget should be making necessary pension payments, protecting critical areas of the budget from further cuts and restoring cuts wherever possible. Unfortunately, in such a tight fiscal environment where the priority is to prevent further damage, it is easy to lose sight of more aspirational investments and other policy changes that would improve quality of life and strengthen the economy in the long term.

ADVANCING EDUCATION

Investment in education is widely understood to be critical for building a strong state economy and a high quality of life for Kentuckians. However, despite the growing number of postsecondary degrees conferred in recent years our state remains undereducated.

Further investment in early childhood education in particular would have a considerable long-term pay off. According to some estimates, every \$1 investment in quality early child care and education results in as high as \$16 in benefit to society later in life.¹²⁷ Investment in universal preschool has also been shown to create twice as many jobs for state residents and increase earnings 15 percent more than investment of the same amount of money in business tax subsidies. Increased funding for preschool and for full-day Kindergarten statewide are important investments in Kentucky's future.¹²⁸

Additional efforts to improve college affordability, such as prioritizing need-based aid along with increasing investments in public postsecondary education, are also essential.

IMPROVING HEALTH

Kentucky should be investing more in the long-term dividends of improved health instead of planning to kick people off coverage through a harmful waiver proposal. Strengthening Kentucky's mental health and substance abuse treatment services, and using Medicaid to encourage innovative integrated care in clinical settings would have major benefits now and down the road for our communities and economy.

TAKING SMART APPROACH TO SAFETY

Similarly, rather than continuing to roll back the progress we've made with criminal justice reforms in 2011, Kentucky needs to pass new reforms that will result in reductions in the inmate population and savings to the state. It is important for Kentucky to better support appropriate community-based treatment options and job opportunities that will make a lasting difference in the lives of those involved in the criminal justice system and their families. Bail reform, increasing the felony theft threshold, reclassifying some low-level felony offenses as misdemeanors and making changes to repeat offender laws are all important components.

Furthermore—instead of passing additional criminal justice legislation that further increases penalties (which has a disproportionate impact on communities of color, doesn't deter crime and doesn't rehabilitate offenders)—Kentucky should focus on expanding drug courts and the Alternative Sentencing Worker program.¹²⁹ These investments would support Kentuckians struggling with addiction in their recovery and reattachment to the labor force.

CREATING LADDERS OUT OF POVERTY

Kentucky is consistently one of the poorest states in the country. According to the most recent census data, Kentucky's overall poverty rate of 18.5 percent makes it the fourth poorest in the nation.¹³⁰

Solid strategies for supporting families as they strive to move out of poverty include increasing access to high quality child care, creating a state Earned Income Tax Credit (EITC), providing more affordable financial services like state-sponsored public retirement accounts and increasing affordable housing options. Budget cuts lead to rungs on the ladder of opportunity cracking or breaking off, holding back individuals and the state as a whole.

The state can also help low-income families by promoting high-quality jobs in Kentucky. We should target workforce and economic development dollars only to businesses that offer competitive wages and benefits, use responsible scheduling practices and offer paid family and sick leave; and we should bar partnerships with employers that have a track record of wage theft.¹³¹

IMPROVING RACIAL EQUITY

This report examines many budget-related obstacles to progress in the commonwealth. One overarching barrier to a stronger state is persistent racial disparities—and our lack of attention in crafting policies, including the budget, to eliminate these disparities. While Kentucky as a whole has high poverty rates, African American and Latino Kentuckians are twice as likely to live in poverty and have a lower median income; less likely to graduate from college on time; less likely to be able to go to the doctor when they need to; and African Americans in particular are overrepresented in our state's criminal justice system.¹³²

Because marginalized communities are hit hardest by inadequate budgets, generating new revenue to invest in a stronger commonwealth overall would especially help communities of color. But the impact of policy on people of color should also be specifically scrutinized: One way legislators could better promote racial equity is to use racial impact notes for proposed legislation, similar to what is already done with local and health impact notes. This kind of lens is needed on many issues such as the criminal justice system and our state's persistent educational achievement gaps between white and minority students.

PART 2: REVENUE

WEAK REVENUE GROWTH TO CONTINUE

The second half of this report discusses the revenue the state expects to collect over the 2018–2020 biennium and how far it will go to meet budget needs described in the first half of the report.

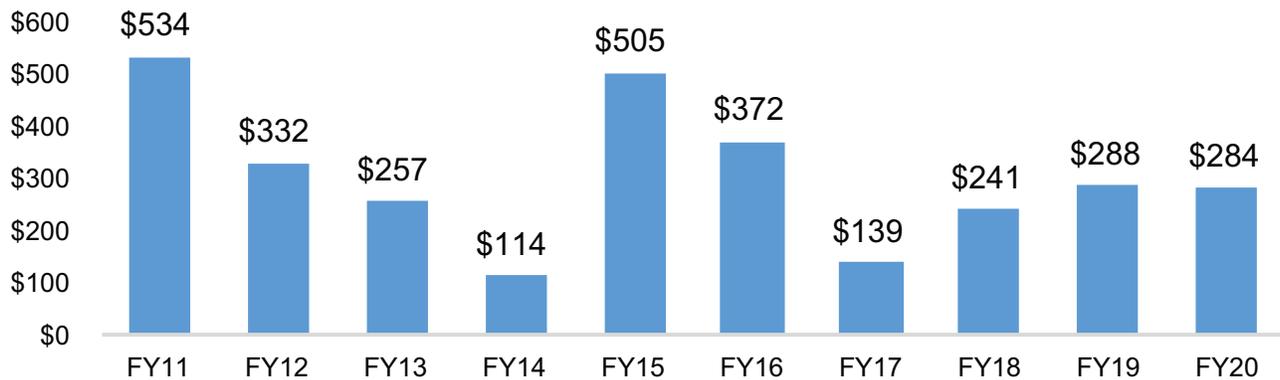
On the whole, General Fund revenue growth is and will continue to be weak. Fiscal year (FY) 2017 ended with a General Fund shortfall of \$138.5 million. Actual receipts were 1.3 percent below the official estimate, due largely to slower than anticipated growth in the corporate income tax and sales tax.

With revenues continuing to lag through the first quarter of FY 2018 and another anticipated shortfall, the Consensus Forecasting Group (CFG) reduced the official revenue estimate for FY 2018 by \$157.1 million at its December 2017 meeting.¹³³ The revised estimate predicts growth of 2.3 percent in 2018 based on the reduced (actual) revenues in 2017.

Projected growth for 2019 is 2.7 percent and for 2020, 2.6 percent. This means the CFG is predicting \$241 million more in new revenues in 2018 after the downward revision, \$288 million more in 2019 and \$284 million more in 2020.

Lackluster New Revenue Expected to Continue

Forecast General Fund Growth in Millions



Source: OSBD.

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The budget challenges described in the first part of this report—which in large part stem from weak revenue growth—cannot be addressed with the modest new General Fund revenues predicted over the coming biennium. This new revenue is small compared to the structural deficit Kentucky has accumulated over the years, the pension liabilities we owe and the strains we are experiencing in providing a variety of services. In fact, the gap between the recurring revenue Kentucky generates and what it will take to get our state back on track is likely to grow by 2020.

ENACTING A BALANCED BUDGET WILL CONTINUE TO BECOME MORE DIFFICULT

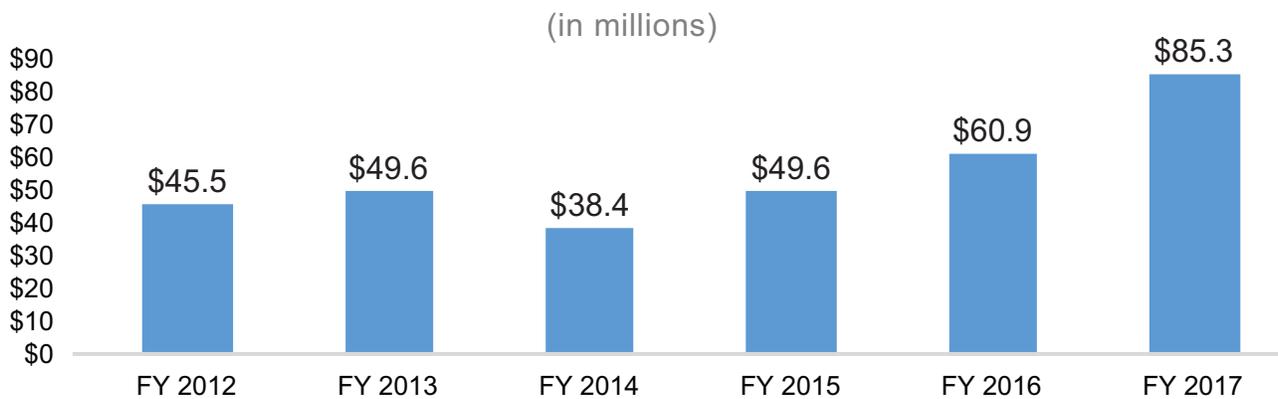
Kentucky has a well-documented, persistent and growing structural deficit—which means recurring revenues do not match recurring expenditures.¹³⁴ As the first part of this report describes, one of the ways the budget has been balanced despite the structural deficit is through round after round of budget cuts. Since 2008, budget cuts have totaled close to \$2 billion.¹³⁵ Other appropriation-side accommodations have included underfunding pensions and shifting the cost of providing public goods to local governments.

On the revenue side, legislators have dealt with the structural deficit by increasing their use of necessary governmental expenses (NGEs), drawing from the Budget Reserve Trust Fund, transferring funds from agency restricted funds and other one-time gimmicks.

NECESSARY GOVERNMENT EXPENSES

Traditionally, NGEs have been used to authorize unanticipated expenditures beyond amounts appropriated for things like emergencies and fire suppression that cannot be easily predicted. However, over the past several budget cycles, the General Assembly has included known recurring expenses as NGEs. Between 2015 and 2017, NGEs increased by \$35.7 million, or 72 percent.¹³⁶

Use of NGEs Has Grown in Recent Years



Source: OSBD.

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Corrections and guardian ad litem fees (for court-appointed attorneys representing minors) are two areas where increasing, recurring expenses have been funded through NGEs. Corrections NGEs, which made up 50 percent of total NGEs in 2017, saw an increase of \$31 million between 2015 and 2017 primarily due to growth in incarceration and increased medical and staffing costs. These line items have been chronically underfunded in the budget for several years because of the specific authorization for any overages to be considered NGEs. Similarly, guardian ad litem fees—which are required by statute yet do not have a line item appropriation in the budget at all—increased from \$7.8 million to \$12.4 million between 2013 and 2017.¹³⁷

Identifying an expense as an NGE doesn't provide additional revenue, but does permit expenditures not included in the "bottom line" amount appropriated in the budget bill. This allows the General Assembly to pass a budget

that actually authorizes General Fund expenditures exceeding total General Fund revenues. The expanded use of NGEs is concerning; because they are not capped as normal appropriations would be, the total amount is not known until the end of the fiscal year and since they are paid from the Budget Reserve Trust Fund, they reduce the balance available for true emergencies and year-end revenue shortfalls.

BUDGET RESERVE TRUST FUND

The purpose of the Budget Reserve Trust Fund (BRTF) or “rainy day fund” is to have resources on hand for unanticipated expenses and to provide funds if revenues are less than projected. Preparing for the next recession by saving money during economic expansions is therefore a primary purpose; in fact, credit rating agencies may downgrade states that spend down their rainy day fund during expansions.¹³⁸ Yet because Kentucky is unable to pay for recurring expenses with recurring revenues, this is exactly what has been happening in our state.

The balance of the BRTF at the beginning of FY 2017 was \$235.8 million, which is 2.3 percent of General Fund revenues—far below the statutory goal of five percent of General Fund revenues.¹³⁹ After the balance was reduced by \$85.3 million in NGEs in 2017 and \$56.7 million was appropriated to the General Fund to support the FY 2018 budget, the current available balance is \$93.8 million—just 0.9 percent of the General Fund. The current balance in the BRTF will not be sufficient to cover 2018 NGEs if they continue to increase as they have over the past three years—let alone any emergencies, disasters or downturns that occur. Thus the BRTF likely will be depleted this year.

FUND TRANSFERS, LAPSES AND BEGINNING BALANCES

Using “one-time” resources to balance the budget means applying non-recurring revenues to recurring expenses. This includes fund transfers, lapses and beginning balances.

In the 2016–2018 budget, the General Assembly transferred a total of \$510.3 million from various agency-restricted funds to the General Fund in the budget bill—often from accounts that receive revenues for a specific statutory purpose. When revenues came up short at the end of 2017, the governor transferred an additional \$77.4 million, and when they came up short again during the middle of this fiscal year, the governor transferred an additional \$1.5 million from these funds as part of budget reduction orders, for a total of \$589.2 million in fund transfers to the General Fund over the biennium.¹⁴⁰ They include:

- \$375 million from the Public Employee Health Insurance Trust Fund from amounts that have accrued because employees have paid in more than has been paid out in claims and other expenses.¹⁴¹ An additional \$125 million went to the newly established Pension Permanent Fund in 2016.
- \$32.4 million from the Petroleum Storage Tank Environmental Assurance Fund, which includes \$16.9 million in the budget and \$15.5 million as part of the budget reduction order issued in July 2017.¹⁴²
- \$29.7 million from various agencies associated with the Finance and Administration Cabinet.
- \$61.7 million from agencies that are part of the Public Protection Cabinet.

The 2016–18 budget also provided for a lapse of \$14.1 million from the Public Service Commission (PSC) to the General Fund. The PSC is funded through an annual assessment on the utilities it regulates. The assessment can be included in expenses recovered from the customers of the utility and is supposed to be set at a level that will simply offset the costs of operating the PSC.

Another one-time source of funds was the \$115.6 million beginning balance of the General Fund going into FY 2018. This planned carry forward from the previous year will not be available going into FY 2019. This is an example of why recurring expenses should be paid for with recurring revenue: Fund transfers, forced lapses and other one-time resources may not be available next time around.

KENTUCKY FACES A LARGE STRUCTURAL DEFICIT HEADING INTO 2019

To illustrate the magnitude of the problem facing the General Assembly in crafting the 2018–20 budget, the table below adds together the items identified above that constitute one-time monies used to balance the 2018 budget that will have to be found just to get us back to where we started in 2018:

One-Time Transfers Used to Balance 2018 Budget

| One-time Money | Amount |
|-------------------------|----------------------|
| Fund Transfers | \$ 252,707,000 |
| Beginning Balance | \$ 115,553,400 |
| Appropriation from BRTF | \$ 56,700,000 |
| PSC Lapse | \$ 7,000,000 |
| Total | \$432,960,400 |

Source: Kentucky OSBD.

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In other words, our budget “hole” starting out the next fiscal year is \$433 million. Projected new revenues for FY 2019 are \$287.5 million, leaving a negative balance of \$146 million without including any routine cost increases, new agency budget needs, emergencies or the amount needed to fully fund pension obligations.¹⁴³

THE GENERAL FUND IS ERODING AS A SHARE OF KENTUCKY’S ECONOMY

Not only is recurring revenue insufficient to keep up with needs, but it is actually eroding relative to the size of our economy. Kentucky’s General Fund as a share of total personal income will continue to shrink through 2020, making it increasingly difficult to balance the budget. The graph below shows that General Fund revenue will shrink from 5.9 percent of personal income in 2017 to 5.7 percent in 2020. Though a seemingly minor drop, 0.2 percentage points in a \$199 billion economy amounts to \$427 million less for investments in our schools, pension system, court system, family and community services and more by the end of the biennium.

As illustrated, revenue has been eroding since 1991. In 1990, under a Kentucky Supreme Court order requiring adequate and equitable funding of public schools in the commonwealth, the General Assembly enacted revenue-raising tax reform as part of KERA. State-level tax changes included (in order of how much revenue they

Erosion in Kentucky's General Fund to Continue Over Biennium

General Fund as a Share of State Personal Income



Source: CFG, Global Insight, OSBD, Bureau of Economic Analysis.

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generated) eliminating several individual income tax deductions, increasing the sales tax rate from five percent to six percent and increasing corporate income tax rates. Since then, the tax code has been amended many times and in almost all cases, rates have been reduced and tax breaks have been added or expanded, so that the ground gained in 1991 has been lost—and then some. In 2020, the General Fund will be a smaller share of Kentucky’s economy than it was before the tax changes enacted as part of KERA. If revenue had simply kept up with economic growth since 1991, in 2017 the state would have had \$2.6 billion more to invest.

What this disconnect between Kentucky’s tax system and its economy means is that regardless of the level of economic growth (discussed in the next section), relative General Fund performance will continue to decline.

TAX BREAKS ARE GROWING DUE TO LEGISLATIVE ACTION

Every other year before a budget session, the Office of the State Budget Director (OSBD) publishes a tax break report—known as the tax expenditure analysis—that provides insight into Kentucky’s growing revenue hole. In the last budget biennium (2016–2018), the difference between what Kentucky spent on tax breaks and collected in revenue grew from an estimated \$1.6 billion to \$2 billion.¹⁴⁴ The new analysis for the 2018–2020 biennium estimates tax breaks will drain \$9.2 billion from the General Fund in 2018—a huge amount that excludes entire categories of tax breaks, costing billions more—that should have been counted in that total and were included in the 2016-2018 tax expenditure analysis.¹⁴⁵

Every year, this list grows and becomes more costly as consecutive General Assemblies pass new, or expand existing, tax breaks. Between 2009 and 2017, legislators acted more than 40 times to increase the size

and number of tax breaks that, for the most part, exist permanently in Kentucky’s tax code without further consideration by the General Assembly.¹⁴⁶ Many of these are described as “economic development incentives” rather than “tax breaks,” but the legislation establishing them lacks reporting and oversight requirements needed to evaluate their economic return. Independent analysis suggests many such tax breaks are not cost-effective, especially when compared with traditional direct budget investments in an educated workforce through preschool, K-12 education and college affordability.¹⁴⁷

Here are just a handful of breaks that have been enacted and expanded in the past nine sessions, with cost estimates from the Legislative Research Commission at the time the legislation was enacted:

Annual Costs of Selected Tax Break Legislation

| Year | Tax Break | Annual Cost |
|---------------|---|----------------|
| 2017 | Expanded aviation fuel tax credit for Amazon | -\$3 million |
| 2016 | Extended UPS Metropolitan Tax Credit for 10 years | -\$4 million |
| 2015 and 2014 | Expanded film industry credit | -\$6.5 million |
| 2014 | Expanded Historic Preservation Tax Credit | -\$6 million |
| 2012 | Expanded tax breaks to automaker and supply parts manufacturers | -\$18 million |
| 2009 | Expanded incentives for existing manufacturing companies | -\$30 million |

Source: KCEP analysis of Kentucky Legislative Research Commission data.

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The cumulative estimated cost of these few incentives is high even though they represent only a small share of those that have been enacted or expanded in recent years. In some cases, the fiscal impact estimate used at the time a tax break was enacted turned out to be far too low based on actual experience. One example is the film industry tax credit expansion enacted between 2014 and 2015 that removed the program cap, made the credits permanent, reduced the qualifying investment threshold and increased the maximum award amount per project.¹⁴⁸ Though the total expansion was estimated to cost \$6.5 million annually (and the 2016 tax expenditure analysis assumed a modest total cost of only \$1 million annually), the explosion in approved projects since 2015 could conceivably cost hundreds of millions of dollars over the new budget cycle.¹⁴⁹ Many of the approved projects would probably have occurred regardless of the incentives—one of the reasons why other states have found them wasteful and scaled back or eliminated film industry credits in recent years.

Another example of a costly tax break with questionable benefit to the state is Tax Increment Financing (TIF). TIF was originally created as a way to encourage the redevelopment of blighted urban land by giving to developers the difference between taxes collected prior to and after the development to offset their costs. Since 2002, TIF statutes have been expanded eight times, increasing program costs and making them far more generous than what other states offer.¹⁵⁰ Because many developments would occur even in the absence of TIF, existing businesses may relocate to developments financed in part by TIF, and the program lacks job creation requirements, it is questionable how much new economic activity TIF actually generates. The 2017 tax expenditure analysis estimates TIF will cost the state \$22.6 million in 2020.

TAX BREAKS ARE GROWING DUE TO CHANGING ECONOMY, STATE

Another primary reason for erosion in the General Fund is that existing tax breaks are growing in size due to the changing nature of our state and our economy. For example:

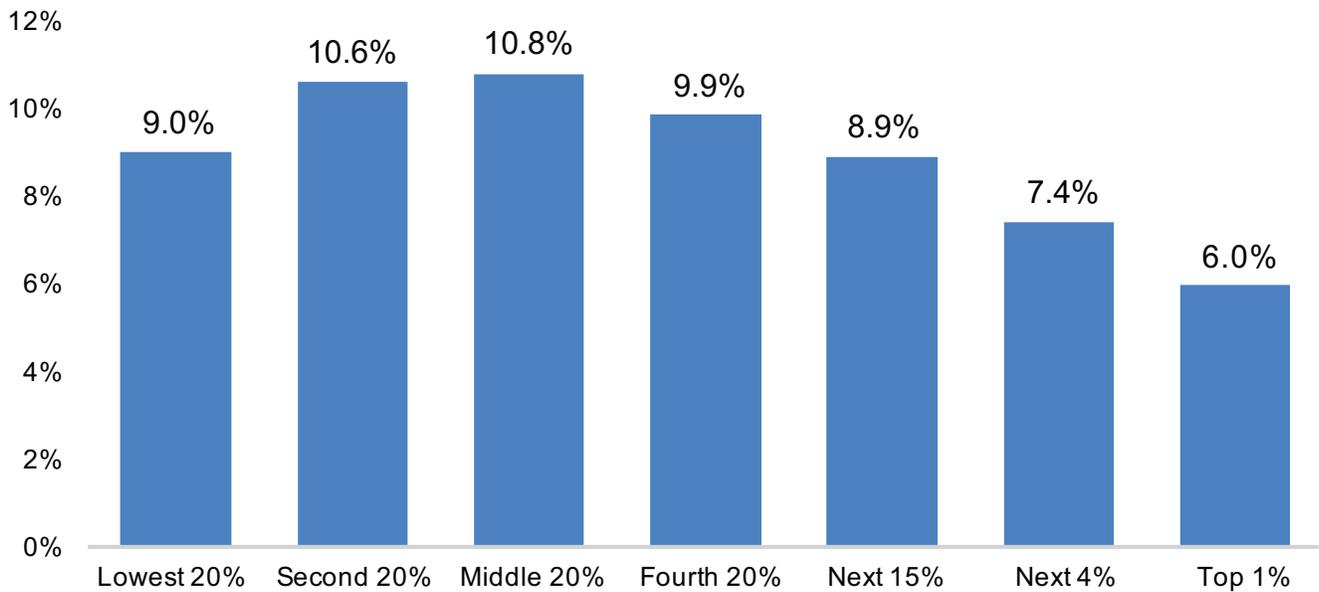
- In our increasingly service-oriented economy, Kentucky's exemption of the vast majority of services from the sales tax creates a growing hole in sales tax revenue. According to the revenue forecast, sales tax revenues will have declined as a share of our economy from 2.2 percent in 2000 to 1.9 percent by 2020. That erosion represents \$684 million in lost revenue in 2020. Similarly, with a larger share of sales taking place online, the state could do more to ensure that sales taxes are being collected on internet purchases.¹⁵¹
- In 1995 the General Assembly exempted the first \$35,000 in private retirement income from taxation which grew to \$41,110 by 2007. As Kentucky's population ages, baby boomers retire and retirement income as a share of all income continues to grow, the tax break will grow too. Between 2004 and 2014, retirement income as a share of total adjusted gross income reported on Kentuckians' federal tax returns increased by 29 percent.¹⁵² The share of Kentucky residents over age 65 is forecast to rise from 15 percent to 21 percent between 2015 and 2030.¹⁵³
- In 1979, legislators passed a four percent cap on state property tax revenue growth from year to year that has pushed our property tax rate down from 31.5 cents per \$100 in property valuation to 12.2 cents as the property tax base has grown. If property tax revenue had been allowed to grow with property values over the last 38 years, meaning the rate stayed the same, the state could expect to collect \$554 million more in 2020.
- As income and wealth in our economy become increasingly concentrated at the top, preferential tax treatment for the wealthiest Kentuckians prevents revenue from keeping up with the economy. Between 1979 and 2014 in Kentucky, real income grew for the top one percent by 76.2 percent while for the bottom 99 percent, it dropped 1.7 percent.¹⁵⁴ Yet instead of paying their fair share in taxes on their vastly higher income, the wealthiest one percent of Kentuckians pay the least as a share of their income in total state and local taxes (see graph on next page).

Preferential tax treatment for wealthy Kentuckians occurs because of the many tax breaks that reduce the effective tax rate for this group. For example, data from the IRS shows Kentuckians with adjusted gross income in the top 20 percent receive about 70 percent of the total value of itemized deductions.¹⁵⁵ Unlike many other states, including the majority of our neighbors, our tax code does not limit itemized deductions. Similarly, the Institute on Taxation and Economic Policy (ITEP) estimates the top 40 percent of Kentuckians receive 77 percent of the total value of the state's overly generous retirement income exclusion. And as income has soared for those at the top while stagnating for everyone else in recent decades, a top marginal tax rate that starts at \$75,000 does not effectively reflect the stratification in today's economy (income for Kentuckians in the top one percent starts at about \$441,000, but averages \$1.3 million).

A tax system that asks more of low-income earners and less of those at the top is called "regressive." In addition to limiting the ability of recurring revenues to keep with economic growth, Kentucky's regressive tax code also exacerbates after-tax income inequality and worsens racial disparities. Forty percent of white Kentuckians are

in the second and third income quintiles depicted below facing the highest effective tax rates of 10.6 and 10.8 percent whereas 45 percent of African Americans and 50 percent of Latinos in Kentucky pay these rates.¹⁵⁶ Conversely, 21 percent of white, 13 percent of African American and nine percent of Latino Kentuckians are in the top 20 percent of all taxpayers—the group paying the lowest effective tax rates.

State and Local Taxes Are Higher for Low to Middle Income than Wealthy Kentuckians as a Share of Family Income



Source: ITEP.

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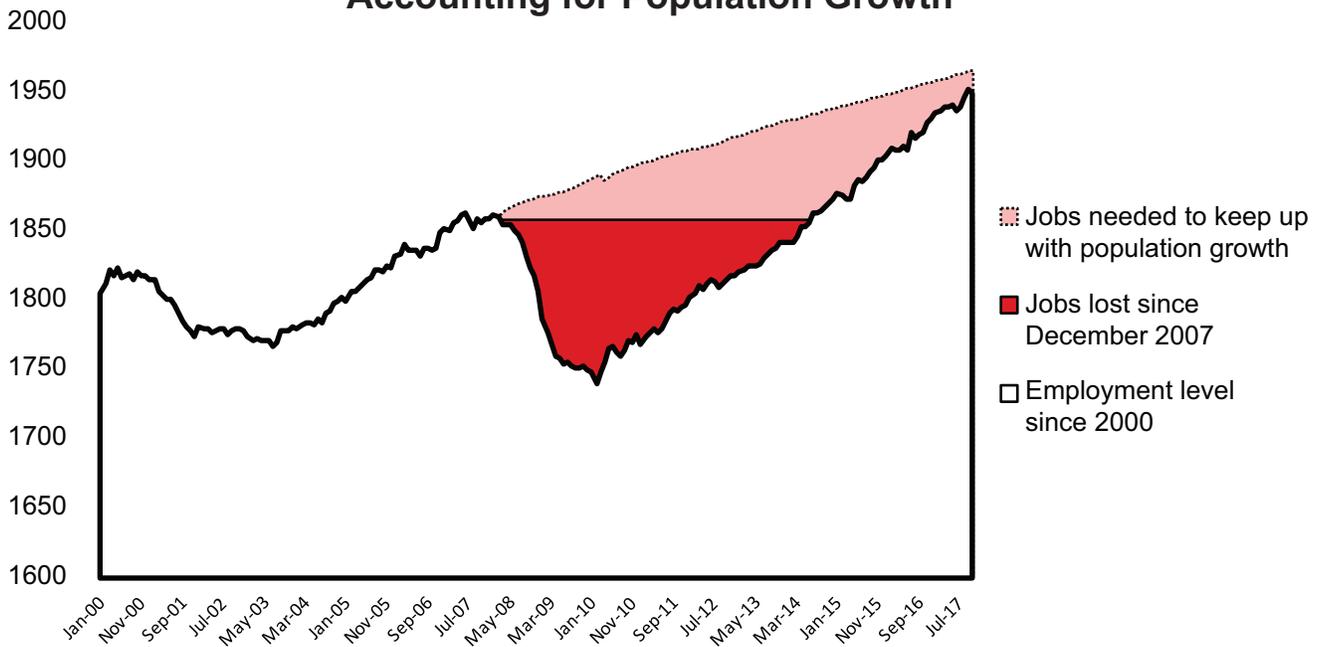
ECONOMIC RECOVERY HAS LEFT MANY BEHIND, DAMPENING REVENUE GROWTH

Though Kentucky’s plethora of tax breaks undermines General Fund growth regardless of economic strength, the state of our economy, especially the labor market, also impacts revenue. When more Kentuckians are employed at higher wages, General Fund revenues grow because more taxes are paid on those earnings and people can better afford to purchase taxable goods and services. When the economy and labor market are weak, however, revenue is weak as well.

Since 2010, Kentucky’s recovery from the Great Recession has been long and incomplete. In October 2017, Kentucky’s unemployment rate was 5.0 percent, 0.5 percentage point less than it was in December 2007. But because job growth has not kept up with population growth since the recession, Kentucky actually faces a gap compared to employment levels in December 2007 of 16,400 jobs.

If the benchmark is moved farther back to the last time the Kentucky and U.S. economies were both at full employment in 2001—an economy characterized by high employment levels and broad-based wage growth—there would have been 90,100 more jobs in October 2017.

Kentucky Still 16,400 Jobs Short of Full Recovery, Accounting for Population Growth



Source: EPI analysis of BLS data.

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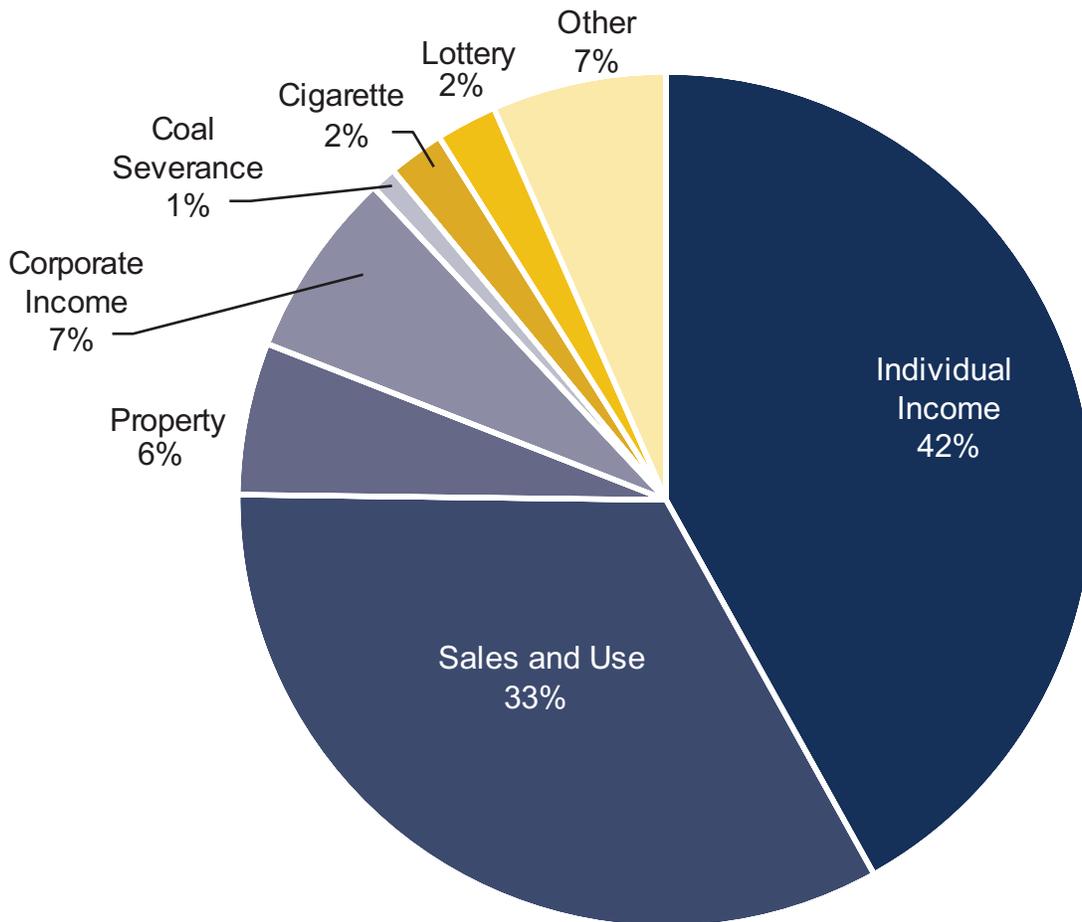
The employment-to-population ratio, or EPOP, is a more robust employment indicator than the unemployment rate because it accounts for discouraged workers who have not looked for work in the last month. In 2016, Kentucky's prime age EPOP (limited to ages 25–54 to remove the effect of aging baby boomers) was 73.4 percent—down from 75.9 percent in 2007 and 77.1 percent in 2001.

A slack labor market where there are many potential workers for each available job, the low quality of many available jobs and the failure of policy makers to maintain a basic floor of labor standards (for instance a higher minimum wage and overtime threshold) have all suppressed Kentuckians' wages, and therefore, revenue growth.¹⁵⁷ Real median wages have hardly budged in the last 15 years: Half of Kentuckians made more, and half made less, than \$16.73 in 2016—up only 1.6 percent from \$16.46 in 2001.

STRENGTHS AND WEAKNESSES OF INDIVIDUAL REVENUE STEAMS

The revenue forecast for the upcoming biennium recognizes continuing economic and structural challenges facing each of Kentucky's revenue sources. The section that follows examines historical and forecast performance for each major source of revenue in the commonwealth, including the impact of particular tax breaks. The chart on the next page shows how much each revenue source contributes to the total General Fund in FY 17.

Revenue Sources Comprising the General Fund



Source: OSBD.

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INDIVIDUAL INCOME TAX

The individual income tax (IIT) is Kentucky's single largest, best growing and most progressive source of revenue, generating \$4.4 billion in FY 2017 and accounting for 42 percent of the total General Fund. It also generated the most nominal revenue growth for the General Fund in 2017: IIT receipts were \$112 million higher than in 2016, a modest 2.6 percent growth rate, with the next highest contributor being the property tax at \$25 million, followed by the sales and use tax at \$23 million.¹⁵⁸ The growth in the IIT in 2017 was low compared to more robust growth in recent years—5.2 percent in 2016 and 8.5 percent in 2015—and was actually \$17.2 million below the CFG estimate.

Still, growth in the income tax has been stronger than that of other revenue sources over the long term. Since 2007, the IIT has grown 45 percent compared to 24 percent growth for the sales and use tax, Kentucky's second largest source of revenue.¹⁵⁹ And while income taxes have been criticized as being volatile by those advocating a heavier reliance on consumption taxes, the nature of that volatility is an asset to the General Fund over time: Even though income taxes fell more precipitously during the Great Recession than sales taxes, they have also recovered more sharply.

The CFG expects the IIT to grow 2.6 percent by the end of FY 2018. Over the next biennium, the CFG predicts 3.1 percent growth in both 2019 and 2020. Nominally, the IIT is forecast to generate \$4.5 billion in 2018, \$4.6 billion in 2019 and \$4.8 billion in 2020.

Although the IIT is our largest source of revenue, receipts from this tax are diminished by a number of tax expenditures that are projected to total \$5.1 billion in 2020, some of which are listed in the table below.

Selected Individual Income Tax Expenditures, FY 2020

(In millions)

| | |
|---|-------|
| Capital Gain on Property Transferred at Death | \$225 |
| Capital Gain on Gifts | \$15 |
| Charitable Contributions | \$143 |
| Gain on the Sale of a Personal Residence | \$162 |
| Home Mortgage Interest | \$193 |
| Private Pensions and IRAs | \$362 |
| Postsecondary Education Tuition Tax Credit | \$31 |

Source: KCEP analysis of OSBD data.

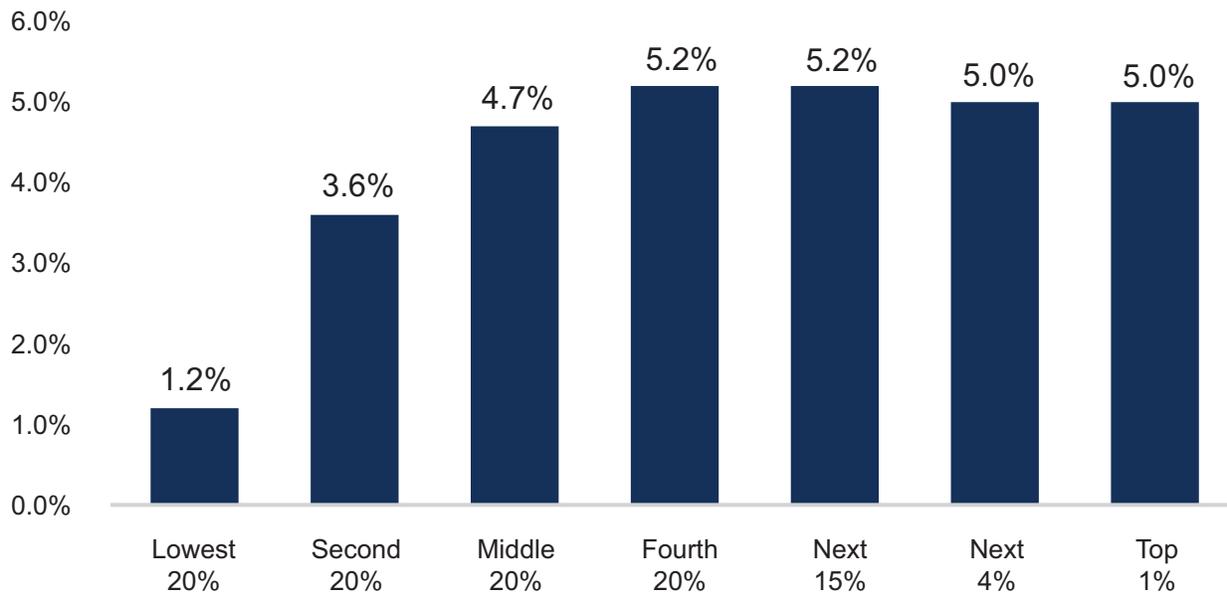
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One large category of tax deductions that many states have limited are those Kentucky allows by generally conforming with the provisions of Internal Revenue Code (IRC). These costly itemized deductions provide a bigger benefit to the wealthy as described in the prior section of this report. A particular example is the home mortgage interest deduction which is expected to carry a price tag of \$193 million in FY 2020. This deduction benefits homeowners over renters and can be used on up to two homes with larger deductions for more expensive homes.

Another expensive tax break, the retirement income exclusion, is more generous than what other states provide and gives the full credit even to very wealthy people. At the current rate of \$41,110, a married household where both partners receive the full exclusion and the average amount of Social Security income (untaxed in Kentucky) would have \$110,000 in untaxed annual income.

Due to these growing tax expenditures and a relatively flat rather than progressive rate structure, revenues from the IIT are not keeping up with Kentucky's economy. The erosion will continue in the future, with the IIT expected to be 2.4 percent of personal income in 2020—a decrease of 0.5 percentage points from 2.9 percent in 1991 representing \$940 million in lost revenue in 2020 alone. A potential explanation for this erosion is that 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 due to their use of tax breaks.

Personal Income Tax Share of Family Income



Source: ITEP.

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SALES TAX

The sales and use tax is Kentucky's second largest source of revenue. At \$3.5 billion in FY 2017, it comprised 33 percent of total General Fund revenue. Although the second largest source of revenue, sales tax growth is predicted to be tepid over the next few years; the CFG estimates the sales tax will grow by 3.6 percent to \$3.6 billion in 2018, 2.4 percent to \$3.7 billion in 2019 and 2.5 percent to \$3.8 billion in 2020.

Since 2007, sales tax revenue has grown 24 percent—significantly less than the IIT. The tax has also continued its long-term erosion relative to the economy from 2.2 percent in 1991 to two percent in 2017. According to projections, sales tax revenue will continue to erode over the biennium to just 1.9 percent of the economy. As previously described, a large share of this erosion is due to the exclusion of most services from the sales tax base, even as consumption shifts toward more spending on services and less on goods. Of the 168 services that at least one other state taxes, Kentucky taxes only 28, ranking it among states that tax the fewest services.¹⁶⁰ The tax expenditure report estimates that excluding services will cost Kentucky at least \$4 billion in 2018.

Another explanation for the sales tax's weak performance relative to the income tax is the growing income disparity among Kentucky's residents. Households at the top of the income scale have received a greater share of the economic gains from the recovery, and higher-income households are more likely to save rather than spend additional income.¹⁶¹ As discussed previously, those who are less well-off and spend all or most of their income on necessities have experienced stagnant or declining wages.

Kentucky is also losing revenue from untaxed internet purchases. Some progress is being made as more online retailers voluntarily collect taxes on behalf of Kentucky. However, with this sector of the economy growing much faster than the "bricks and mortar" retail segment, additional revenue erosion could occur in the future.

To address this issue, Kentucky is a member of the Streamlined Sales and Use Tax Agreement, the purpose of which is to simplify state sales tax collections so that Congress will enact legislation allowing states to require remote sellers to collect and remit sales taxes. Although there have been several proposals introduced, Congress has yet to act on this issue.

Other large sales tax expenditures include exclusions for food items, prescription drugs and devices, and residential utilities from the sales tax base. Although these exclusions are large, they help to make the sales tax somewhat less regressive. If these items were taxed, lower income people would pay a disproportionate share of the amount collected. The share of family income that families in the bottom 20 percent of the income distribution pay in sales and excise taxes is 5.5 percent, while the top one percent pay just 0.8 percent.¹⁶² Specifically, if groceries were added to the sales tax base at the full six percent tax rate, the tax increase as a share of income would be 10 times larger for the bottom 20 percent of Kentuckians than the tax increase for the top one percent.¹⁶³

CORPORATE INCOME TAX AND LIMITED LIABILITY ENTITY TAX

Kentucky imposes two income-type taxes on corporations—the corporate income tax and the limited liability entity tax (LLET).¹⁶⁴ The taxes work together, with amounts paid under the LLET credited against the corporate income tax. For this reason, we discuss these two taxes together.¹⁶⁵

Kentucky's corporate income tax generated \$497 million and the LLET generated \$246 million for a total of \$743 million in 2017, comprising seven percent of the General Fund. In 2018, corporate income tax receipts are forecast to grow by 12.3 percent and LLET receipts to drop by 24.2 percent. The CFG projects 7.5 percent growth in both the corporate income tax and LLET in 2019 followed by 5.3 percent growth for both sources in 2020. Nominally, these receipts combined in 2020 are forecast to be \$843 million.

Corporate taxes are notoriously volatile and therefore difficult to estimate for all states, not just Kentucky.¹⁶⁶ This is true in large part because of differing state tax codes, which provide multi-state corporations with a multitude of tax avoidance opportunities that may shift from year to year resulting in large swings in individual states. Because receipts from these taxes comprise a relatively small part of the General Fund, the volatility is not particularly harmful overall.

In addition to the tax avoidance opportunities created because of the differing state tax codes, corporate income tax receipts are also reduced by loopholes allowing (generally large) corporations to avoid taxation through various tax planning strategies. For example, Kentucky loses at least \$50 million annually by not requiring “combined reporting” on corporate income taxes and by not disallowing “tax haven” transactions, as is the law in more than half of corporate income taxing states.¹⁶⁷ 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 functionally related entities on their tax returns. And as discussed in a previous section of this report, a plethora of costly business tax breaks also diminish the corporate income tax base (as well as other tax bases).

The largest exemption from the LLET is the small business exclusion that allows all businesses with less than \$3 million in gross profits or receipts to pay a minimum tax of \$175. Businesses with gross receipts or profits between \$3 and \$6 million receive a partial credit that phases out as gross receipts or profits approach \$6 million. This credit is very generous and results in substantial revenue losses of \$41 million annually.

COAL SEVERANCE TAX

Between 2012 and 2017, coal severance tax receipts fell by 66 percent, from \$298 million to \$100 million. The decline is the result of a variety of factors including low natural gas prices, reduced demand for coal, and environmental regulations for coal-fired power plants. Despite President Trump's executive order to begin rolling back the Clean Power Plan rule curbing carbon emissions, the revenue forecast for the biennium does not anticipate recovery. The coal severance tax is expected to drop by 12 percent in 2018, 12 percent in 2019 and another 16 percent in 2020 for a new low of just \$65 million in 2020—just 22 percent of 2012 receipts. In addition to the impact on the state General Fund, the dramatic and continuing reduction in coal severance tax receipts has significantly diminished local government revenues in coal producing counties. Historically, these local governments received up to half of the coal severance tax revenues and the loss of those funds, coupled with a change in the way unmined minerals are assessed, has left many of these governments reeling and with few good options to raise other revenues.¹⁶⁸

PROPERTY TAX

Property taxes grew by 4.3 percent in 2017 to \$602 million. The forecast assumes one percent growth in 2018, 2.1 percent in 2019 and 2.3 percent in 2020 to \$635 million in 2020.

Real property constitutes the largest component of the overall property tax base.¹⁶⁹ Because the statutes require the real property tax rate to be adjusted annually to produce no more than four percent revenue growth over the previous year, total property tax revenue is relatively stable but also suppressed. Though housing prices have begun to recover since the crisis, they have not grown enough to trigger a reduction in the rate since 2008. As previously described, between 1979 and 2008 the rate fell from 31.5 cents to 12.2 cents per \$100 in assessed value. If assessment growth does not trigger a rate reduction between now and then, the cap will cost the commonwealth \$554 million in 2020.

CIGARETTE TAX

Cigarette tax revenues grew substantially in 2006 and 2010 after cigarette tax increases in each of the preceding years. Kentucky's cigarette tax is currently just \$0.60 per pack—lower than all four of our neighbor states to the north and \$1.11 below the national average of \$1.71.¹⁷⁰ The state could raise needed new revenue by increasing the tax—at least initially. Because raising the cigarette tax also reduces consumption, it cannot be relied upon to provide a growing stream of revenue over the long term. Combined with other anti-smoking efforts and changing attitudes, cigarette consumption and therefore revenues from the tax are declining. Since 2010, cigarette tax revenue has fallen each year except FY 2016—a 1.5 percent bump possibly due to tax increases in Illinois and Ohio. The CFG predicts cigarette taxes will continue to decline (slightly) from \$214 in 2018 million to \$202 million in 2020.

LOTTERY REVENUE

At \$242 million, lottery dividends made up 2.3 percent of the General Fund in 2017. These revenues exceeded the official estimate by \$7.6 million but fell 0.1 percent when compared to 2016. The forecast predicts growth of 0.6 percent in 2018, 2.5 percent in 2019 and 2.8 percent in 2020. Revenue from Kentucky's lottery is primarily devoted to providing college scholarships and supporting other education-related initiatives.

OTHER REVENUE

Growth in the coming biennium is expected to be weak for “other revenue,” a category for miscellaneous revenue sources including the insurance premium tax, bank franchise tax and the telecommunications tax. These sources accounted for seven percent of the General Fund in 2017. Revenues from these sources declined by 2.7 percent in 2017, with receipts totaling \$690 million. Revenues are expected to grow 0.6 percent in 2018, 0.3 percent in 2019 and 1.4 percent in 2020.

Inheritance taxes, also classified as “other” tax revenue, contributed \$45 million to the General Fund in 2017. Since federal tax changes in the early 2000s eliminated Kentucky’s estate tax, taxes on inherited wealth in Kentucky have dropped 46 percent.

TOBACCO SETTLEMENT FUNDS

As a result of the Master Settlement Agreement (MSA) between tobacco companies and states in 1998, companies make annual payments to states for costs associated with treating tobacco-related illness.¹⁷¹ 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 \$1.95 billion in payments since 1998.

MSA payments in 2017 were \$93.4 million, exceeding the estimate by \$6.4 million. According to the 2016–2018 budget bill, 50 percent of the extra revenues were distributed to the Agricultural Development Fund, 36 percent to the Early Childhood Development Fund, and 14 percent to the Health Care Improvement Fund. MSA payments are expected to grow to \$115 million in 2018, \$120 million in 2019 and \$118 million in 2020. The average annual payment over the first 10 years from 2004 to 2013 was \$107 million. While a recent settlement regarding tobacco companies not participating in the MSA boosted payments in the short term and smooths out future payments, declining consumption means tobacco settlement monies will be a shrinking share of Kentucky’s total revenue over time.

FEDERAL REVENUE

Federal discretionary and mandatory spending cuts—the second part of an already-begun two-step plan to pass tax cuts for the wealthy and cut services benefitting Kentucky communities—would reduce the dollars that flow from the federal government through Kentucky’s budget. Alongside erosion in Kentucky’s own revenue sources, a reduction in federal resources would further squeeze the state’s ability to maintain services. Though changes to the federal tax code could also impact the taxes Kentucky collects, the General Assembly would have to vote to conform with those changes, unlike other states that automatically conform.

THE ROAD FUND

ROAD FUND BUDGET OVERVIEW

Like the General Fund, resources available in the Road Fund to address identified transportation infrastructure needs are inadequate.

During the last biennium, state Road Fund expenditures exceeded available revenues by \$498 million, creating a critical shortage of cash in the Road Fund. In order to begin restoring the cash balance, at the beginning of the FY 2017 the Transportation Cabinet instituted the “Pause-50” plan delaying the start of new state road projects.¹⁷² Under the plan, there were no new state-funded projects in the second half of calendar year 2016 and only \$50 million during the 1st half of calendar year 2017.¹⁷³

Currently, Kentucky has more than 1,100 structurally deficient bridges and more than 3,700 miles of roads that need significant repairs. The backlog of pavement improvements alone totals approximately \$1 billion and is growing at a rate of 500 miles of roadway each year.¹⁷⁴ The Transportation Cabinet highway plan released in June 2016 identifies over \$50 billion in unmet highway needs across the commonwealth, including \$3.1 billion in identified state priority projects that remain unfunded.¹⁷⁵

To help prioritize projects and identify critical needs in this time of inadequate resources, the Transportation Cabinet is in the process of implementing a planning process it calls the “Strategic Highway Investment Formula for Tomorrow” (SHIFT) to establish a data-driven approach to transportation projects.¹⁷⁶ SHIFT will be used to develop the governor’s recommended highway plan to be presented to the 2018 General Assembly. Regardless, Kentucky’s infrastructure funding challenges will prohibit needed progress on these projects.

ROAD FUND REVENUE

The Road Fund is the primary source of state funds for road construction and maintenance in Kentucky. Kentucky’s Constitution requires that any license or excise tax or fee relating to gasoline and other motor fuels or to the registration, operation or use of vehicles on public highways be spent on our highways.

Road Fund revenues in FY 2017 were \$1.5 billion—\$51 million or 3.5 percent more than the estimate and up slightly from the previous year. However, the Road Fund has still not recovered from a steep drop of \$78 million in receipts between FY14 and FY16 due largely to a drop in the motor fuels tax rate.¹⁷⁷ The forecast for the coming biennium is flat, with just \$0.5 million more in the Road Fund in 2020 than in 2017.

The largest source of revenue for the road fund is the motor fuels tax—51 percent of revenues in FY 2017. Currently 26 cents per gallon for gasoline and 23 cents per gallon for diesel, the tax has several components:

- A variable rate that adjusts annually based on nine percent of the average wholesale price of gasoline (currently 19.6 cents) subject to a floor and limitations on total increases and decreases.
- A supplemental highway user’s fee of five cents for gasoline and three cents for diesel.
- An underground storage tank fee of 1.4 cents.

A big factor in the inadequacy of Road Fund receipts over the last biennium was a drop of 6.5 cents per gallon in the motor fuels tax rate in 2015, with each penny reduction equaling approximately \$32 million in lost Road Fund revenues.¹⁷⁸ In order to safeguard current revenues and prevent further precipitous drops, in the 2015 General Assembly legislators increased the “floor” (a minimum rate that will be imposed regardless of the wholesale price) and established a new smoothing process for future rate changes.¹⁷⁹ Though stabilized, revenues are not expected to grow robustly in the future as cars become more fuel-efficient and fuel prices remain relatively low. Many other states are experiencing the same problems as Kentucky, with several raising their taxes over the past two years to address significant unmet needs.¹⁸⁰

The Motor Vehicle Usage Tax, imposed at a rate of six percent on the purchase price of motor vehicles, is the second largest source of revenue for the Road Fund, comprising 33 percent in 2017. Despite legislation enacted by the 2014 General Assembly that allowed the price paid for a new vehicle to be reduced by the value of a trade-in when calculating the motor vehicle usage tax, receipts exceeded expectations in 2016 and 2017. This growth is likely due to a recovering economy with long-term pent up demand for vehicles, which is not likely to recur in the near future.

Other factors impacting the Road Fund in the coming biennium include:

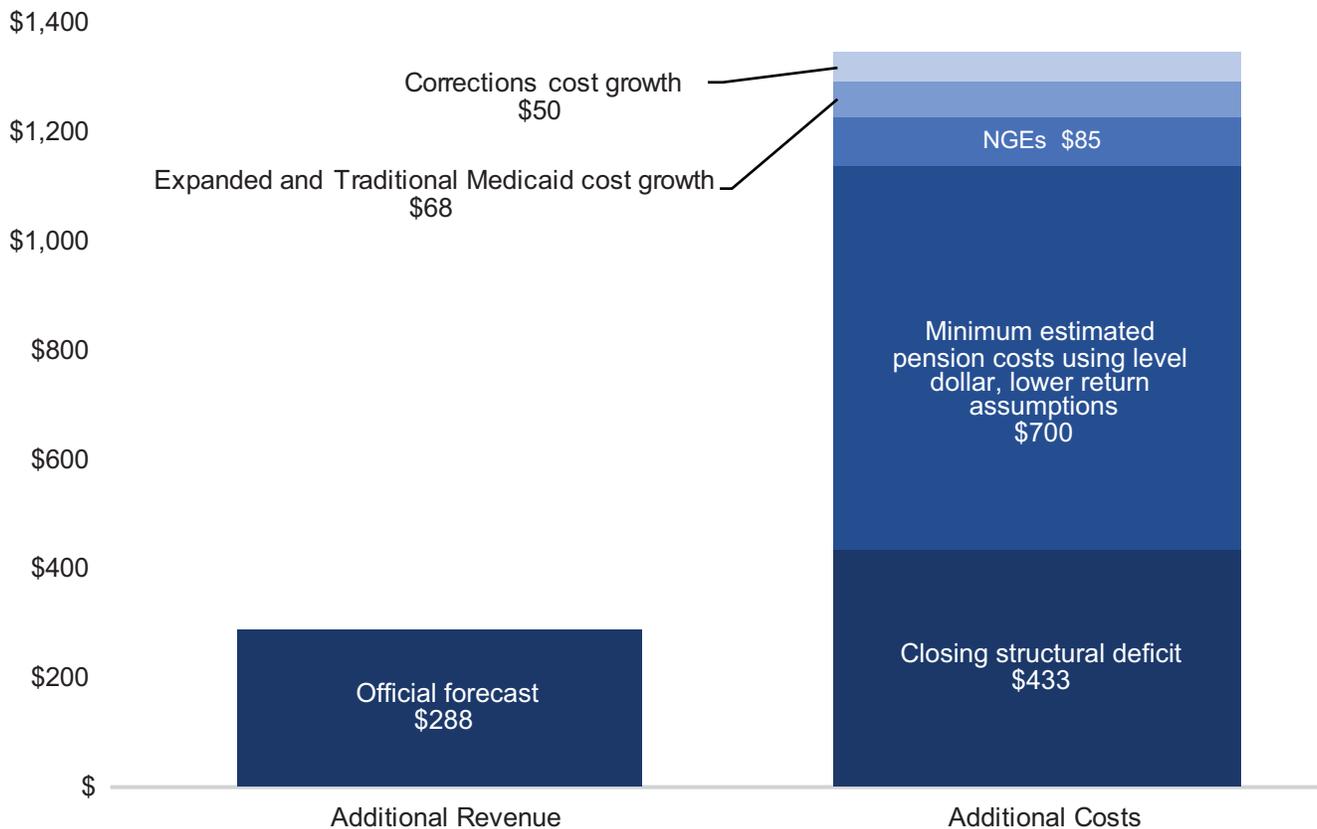
- In FY 2018, \$143 million in Road Fund revenues have been allocated to other areas of state government, the largest of which is approximately \$80 million to Kentucky State Police. These fund shifts started during a period when Road Fund receipts were strong and General Fund receipts were lagging. But transfers from the Road Fund have continued and could occur again in FYs 2019 and 2020.¹⁸¹
- In 2020 a federal toll credit program that has provided the state match for federally funded projects will expire. This means Kentucky will have replace these lost resources in the future.¹⁸²

CONCLUSION

An eroding revenue system and a decade of budget cuts are clearly taking a toll on the commonwealth. Not even counting the new revenue it would take to begin reversing cuts and reinvesting in Kentucky communities, the state will have far less in 2019 than we need just to stay afloat. The graph below shows the gap between forecasted new revenue in 2019 and how much is needed to simply maintain current levels of service and pay down debts.

New Revenue Far Short of Expected Costs

(in millions)



Source: KCEP analysis of Kentucky state agency data found throughout “Commonwealth at Risk: A Preview of the 2018-2020 Kentucky State Budget.”

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Even if the state continues its current approach to funding pensions and the amount needed is less than the \$700 million shown above, the state will still need hundreds of millions in additional revenue to pay its bills. Without new revenue, this situation will lead to additional cuts that will further undermine Kentucky’s ability to prosper. Legislators face a choice between further dismantling the building blocks of a thriving Kentucky or generating new revenue by cleaning up tax breaks. Additional resources are needed to help reverse these damaging trends and put a down payment on a stronger future.

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