



OUR COMMONWEALTH:
A PRIMER ON THE
KENTUCKY STATE BUDGET

OUR COMMONWEALTH: A PRIMER ON THE KENTUCKY STATE BUDGET—2020

A Publication of the Kentucky Center for Economic Policy

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The Kentucky Center for Economic Policy (KCEP) is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the Commonwealth. Launched in 2011, the Center is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website at www.kypolicy.org

WHY THE BUDGET MATTERS

Every two years, the Kentucky General Assembly passes a budget in the form of four separate bills for the executive branch, legislative branch, judicial branch and the Transportation Cabinet. This budget establishes how the state will invest in education, health, transportation, public safety, human services and other areas that help build a strong state economy. However, the budget is only half of the picture: Equally important in building a strong state economy are the revenues that pay for these investments. Although there are many players involved in the process, the ultimate constitutional responsibility for both raising revenues and appropriating funds rests with the General Assembly. In fulfilling these two responsibilities, the General Assembly establishes the blueprint for Kentucky—who we are, what we value, what we aspire to be, and how and whether our communities prosper and flourish. The budget is the primary policy document of the commonwealth, and revenues provide the means by which those policies are carried out.

This primer provides a basic, high-level overview of how the budget is developed, considered, and enacted, and where the resources that support it come from. The primer also examines Kentucky's fiscal health and makes the case that our current revenues are not sufficient to pay for the high quality public services that help to make Kentucky a good place to live, work and raise families; that empower homegrown entrepreneurs; and attract people to our state.

The ultimate goal of this primer is to explain why we should care about our state budget. It is a powerful document, backed by the force of law. Along with the revenues that support it, the budget represents the primary way our lawmakers carry out their charge to invest responsibly and build shared prosperity. By understanding the basics, we can be better citizen advocates for a healthy budget supported by revenues sufficient to provide the programs and services we all want and need to grow and prosper as a state.



WHERE THE MONEY COMES FROM

The resources Kentucky has to invest in public needs come from a variety of taxes and other revenue sources that are categorized broadly as **General Fund Revenue, Road Fund Revenue, restricted funds, bond funds, federal funds and Tobacco Settlement Funds**. The largest source of projected revenue in fiscal year 2020 is federal funds, at 38 percent of overall revenues. General Fund revenues provide 32 percent, restricted funds another 25 percent, with the remainder consisting of tobacco settlement funds, road fund receipts, and investment income.

Projected Resources by Fund Source— The Budget of the Commonwealth, 2020 (in billions)

Federal Funds	\$13.9
General Fund	\$11.9
Restricted Funds	\$9.1
Road Fund	\$1.5
Tobacco Settlement Funds	\$0.1
	Total \$36.6

Numbers, which include carry forward balances from previous years, are based on estimates in the enacted 2018–20 Budget of the Commonwealth—Budget in Brief.

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The General Fund: The General Fund is Kentucky’s primary pool for revenue generated within the state, largely by taxes. This money is used to pay for numerous state programs and services, including education, human services and health care. The individual income and sales taxes are the two largest sources of state tax revenue, and together comprise nearly three-fourths of General Fund revenue. Other sources, shown in the graph on the next page, include property taxes and taxes on cigarettes, coal severance and corporations. Levying an assortment of taxes on a variety of bases that respond differently to changes in the economy ensures a more stable funding base for schools, health care, public safety and other priorities.

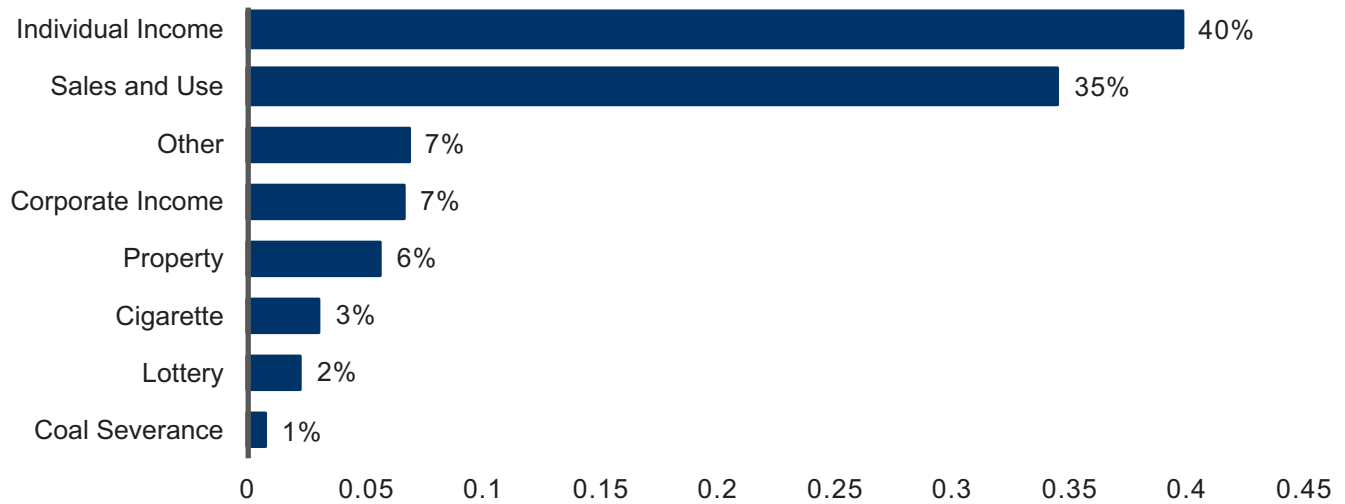
The Road Fund: Road Fund revenues are used to invest in Kentucky’s roads and bridges. The motor fuels tax provides more than half of Road Fund revenue, with the motor vehicle usage tax (a tax on the purchase of cars) contributing about another third and license and privilege taxes contributing about 15 percent.

Federal Funds: The federal government disperses grant funds and other forms of assistance to states for a variety of purposes, such as Title 1 funds for poor schools, the National School Lunch Program, Temporary Assistance to Needy Families (TANF), Medicaid, Head Start, and highway construction and infrastructure. While some funding is based on a formula or the number of eligible recipients in Kentucky, other funds are provided based on direct appropriations for specific projects or according to other means as determined by Congress. The General Assembly typically has very little say in how federal funds are expended.

Tobacco Settlement Fund: A legal settlement in 1998 between major tobacco manufacturers and states, known as the Master Settlement Agreement, established payments from tobacco companies to states for costs associated with tobacco-related illness. Payments to Kentucky since the inception of the agreement have totaled nearly \$2 billion.

Where Kentucky's Revenue Comes From

Revenue sources comprising and their shares of the General Fund



Source: Office of the State Budget Director.

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Restricted Funds: Restricted funds are moneys received by state agencies or statutorily created entities from fees, dues, tuition and other charges the use of which is restricted by statute. Although these funds are legally designated for particular purposes, the General Assembly sometimes transfers amounts from these funds for General Fund use.

Bond Funds: Bond funds come from debt issued by the Commonwealth and are typically used to fund the construction of buildings, roads and other infrastructure. Bonds are paid off over time and the payments, referred to as “debt service” are usually paid by the agency or entity benefiting from the debt financed project.

The Budget Reserve Trust Fund or “Rainy Day Fund”: When Kentucky faces a revenue shortfall—when tax collections are less than were projected—or emergencies and unanticipated needs arise, cash reserves in the state’s “rainy day fund” can be used to limit budget cuts and meet needs. By law, a portion of any General Fund surplus at the end of the year goes into the budget reserve trust fund, although the General Assembly often directs through language in the budget, that the surplus funds be used elsewhere. The state can also appropriate money to the fund in good times.

Factors affecting revenue in Kentucky: By establishing what the state taxes, what it exempts, and the rate at which taxes are imposed, Kentucky’s tax laws directly impact the amount of revenue the state has to do its work. Economic conditions also have a major impact on revenues to the extent that tax laws preserve a healthy connection between the state’s economy and revenue system. In addition, funding decisions by the federal government impact the resources available to provide services.



PATH TO A HEALTHY, RESPONSIBLE BUDGET

Because Kentucky's budget must be balanced—meaning the state cannot spend more than it takes in each year—the General Assembly must ensure that revenues are sufficient to support the appropriations made in the budget. Over many years, Kentucky has built up a large structural deficit—which means that the revenues generated from taxes and other ongoing resources are less than the amounts appropriated in the budget. The difference has been made up with one-time fixes, such as fund transfers, the issuance of greater amounts of debt, and categorizing expenditures as necessary government expenses rather than providing a specific line item to pay for them. In addition, the actual funding provided in the budget has been far less than what is needed, with multiple rounds of direct cuts or indirect cuts (through funding freezes) resulting in many program areas in crisis.

More resources are needed to address budget crises: More than \$2 billion has been cut from the Budget of the Commonwealth since 2008. Funding for public schools is still less than it was prior to the Great Recession, once inflation is taken into account, resulting in harmful cuts as well as a widening funding gap between wealthy and poor school districts. Public service areas ranging from mental health and child protection to need-based college aid have also been severely underfunded for many years. And to continue improving pension system health, the state must not return to the past habit of underfunding the plans.

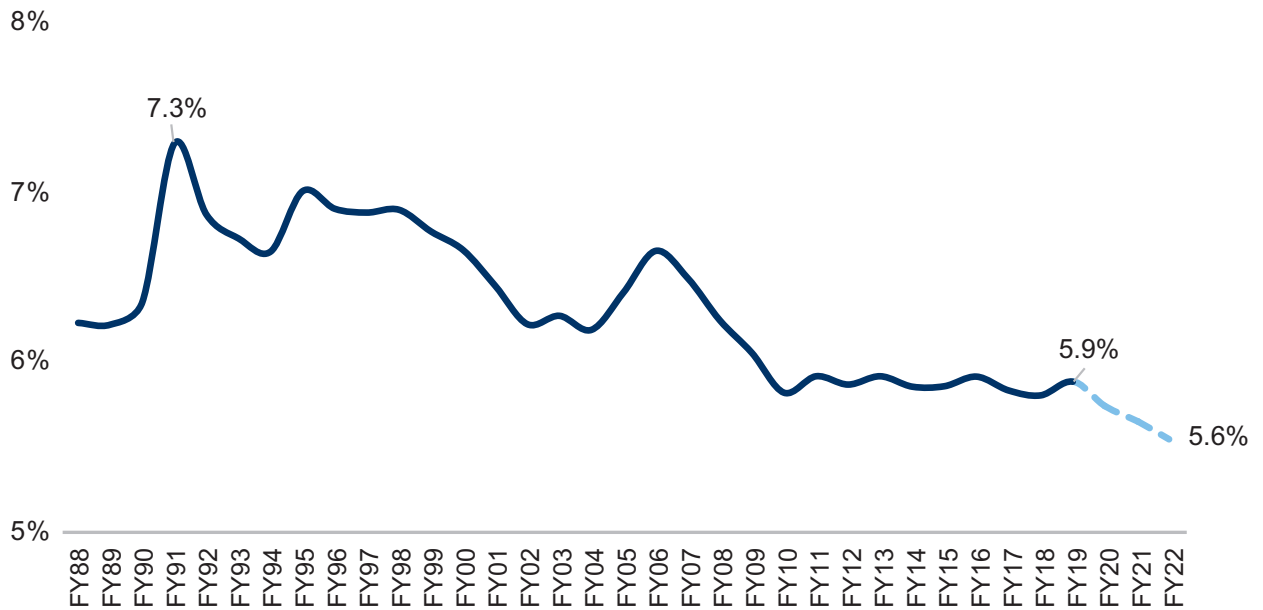
We have less to invest than in the past: Relative to the state's economy, General Fund revenue is shrinking, and new tax cuts and a shift in reliance from the income tax to consumption taxes enacted in 2018 and 2019 make this problem even worse. Absent commonsense changes to the state's tax code, the current trend will continue, the structural deficit will grow and Kentucky will have fewer resources available to sustain crucial investments, even at the current significantly reduced levels.

Time to clean up tax breaks: Despite levying a variety of taxes, Kentucky struggles to generate enough revenue because there are hundreds of exemptions, exclusions, credits and other tax breaks that result in billions in lost revenue. These tax preferences narrow our tax base, and favor some groups at the expense of others (see page 10 for more on these “expenditures”). There is need for the General Assembly to generate new revenue by cleaning up tax breaks as they did in 1990 through the Kentucky Education Reform Act (see subsequent revenue growth in graph on next page), and to protect the General Fund by regularly scrutinizing existing tax breaks and refraining from passing new ones.

We rely most heavily on moderate- to middle-income families and the least on the wealthiest: Even though all Kentuckians benefit from good schools and other services that our taxes provide, low and middle-income Kentuckians pay between 9.5% and 11% of family income in state and local taxes, while the top 1 percent pay just 6.7%. This “upside-down” system exacerbates racial income inequality and the income gap between more affluent, urban areas and poor, rural ones. Cleaning up special interest tax breaks for the wealthy would help alleviate this disparity in Kentucky's tax system.

Forecast Shows Continued Erosion in the General Fund

Total General Fund Revenue as a share of Kentucky Personal Income, historical and projected

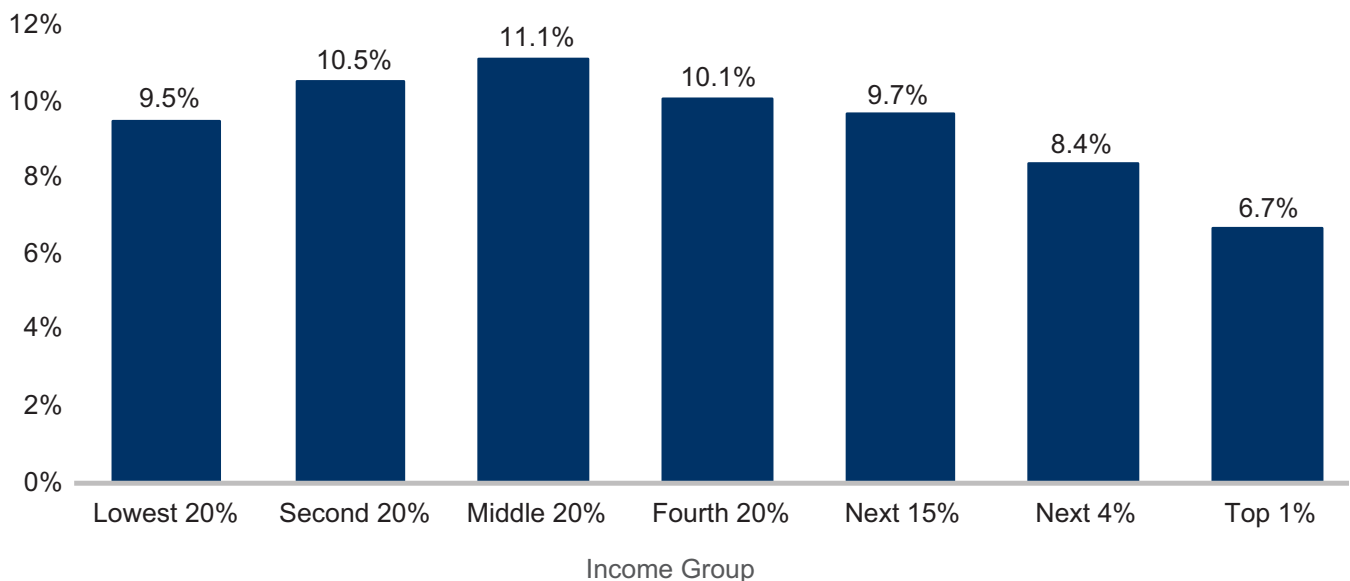


Source: KCEP analysis of data from the Office of the State Budget Director, Bureau of Economic Analysis.

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Kentucky's Tax System Asks the Least of the Wealthiest Residents

State and local taxes paid as a share of family income



Source: Institute on Taxation and Economic Policy.

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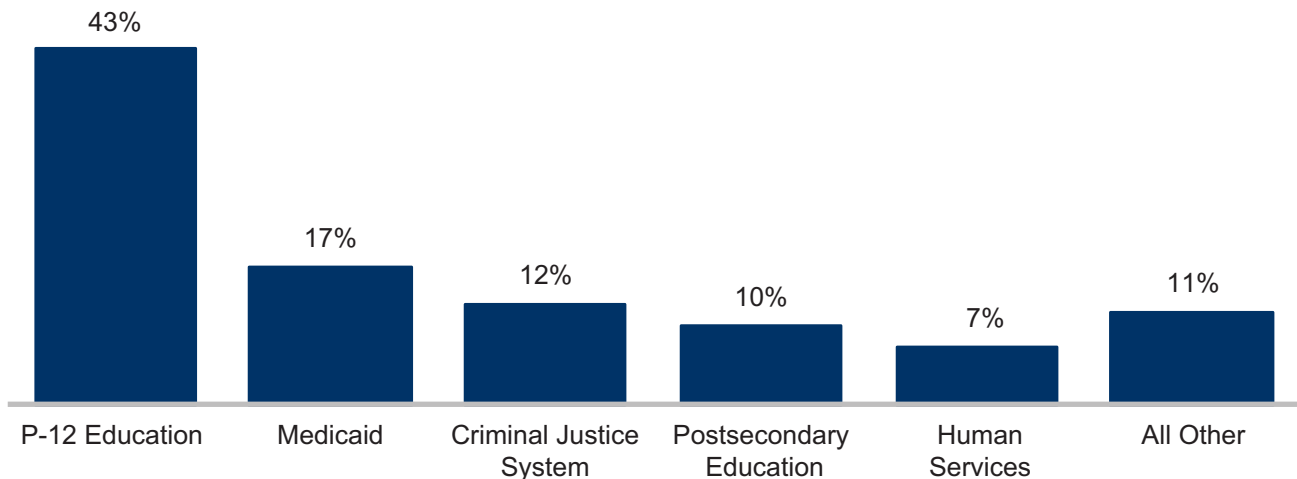
WHERE THE MONEY GOES

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

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

Our Budget Invests in a Broad Array of Vital Public Services

Categories of state-funded public services as share of General Fund appropriations



Source: Commonwealth of Kentucky 2018–2020 Budget of the Commonwealth: Budget in Brief.

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Of the resources Kentucky budgeted to P-12 education in 2019, **60% went to the state's core spending on students** (the Support Education Excellence in Kentucky or SEEK formula); 32% to improving learning and performance through programs such as preschool, extended school services and teacher professional development; and 8% to administrative, technological and other support services for schools.

The next largest expenditure areas are Medicaid and criminal justice, which includes juvenile justice, the state police and corrections. Other areas where state resources are spent include human services programs like women's health, aging and independent living and child care assistance; tourism promotion, workforce development, energy and the environment, agricultural development, educational television (KET), libraries and parks.

Taking all funds into account, including the General Fund, Road Fund, federal, bond, restricted and Tobacco Settlement Funds, spending on Medicaid comprises 30% of all expenditures (Medicaid expenditures substantially increase when all funds are considered because the federal government pays most Medicaid expenditures), while P-12 education and higher education make up 35% of all expenditures. Payment for capital projects constitutes 10% of all expenditures, with transportation, human services, criminal justice and other services comprising the rest.

THE BUDGET PROCESS

As noted previously, the General Assembly alone has the constitutional authority to raise revenue and appropriate funds, however the process of developing the budget proposals involves several steps and many other individuals and entities.

KEY PLAYERS

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

1

TIMELINE

PREPARING FOR THE BUDGET SESSION (DURING ODD NUMBERED YEARS)

APRIL State agencies submit six-year plans for improving old structures and building new facilities to the Capital Planning Advisory Board.

JULY The LRC issues budget instructions and forms to state agencies.

AUGUST The OSBD and CFG issue a budget planning report with economic projections, preliminary revenue estimates for the General Fund and Road Fund and Tobacco Settlement Funds for the coming biennium.

SEPTEMBER The Finance and Administration Cabinet issues budget instructions and forms to the executive, legislative and judicial branches as well as the Transportation Cabinet to create their budget recommendations.

OCTOBER The OSBD and CFG refine their August forecast and provide a preliminary revenue estimate that is the basis for budget planning. State agencies estimate their own restricted funds and federal funds.

NOVEMBER The Capital Planning Advisory Board presents its six-year state capital improvement plan to the Governor, Chief Justice and LRC.

Agencies submit budget requests to branch officers and to the LRC. Proposals are based on funding needed to continue current levels of service and additional funding for new or expanded services.

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THE BUDGET PROCESS DURING THE LEGISLATIVE SESSION

DAY 1

The legislative session begins on the first Tuesday after the first Monday in January. In 2020, that date is January 7.

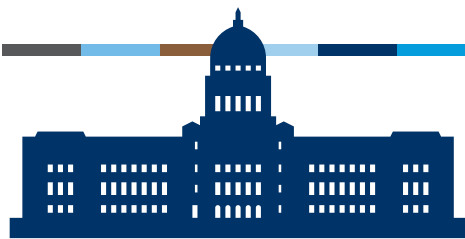
DAY 10

By the 10th legislative day (or the 15th following the election of a new Governor), the Governor, Chief Justice and LRC submit their budget proposals to the General Assembly, including a proposed branch budget bill which is introduced, usually in the House. At this time, the Governor gives the budget address.

The budget bills include two primary appropriations sections—Part I is the operating budget, which provides for the day-to-day expenses of agencies, and Part II is the capital budget, which provides funding for buildings, equipment, and other capital expenses. The budget bills also include several additional parts that address fiscal administration and budget policy.

DAY 15

By the 15th day, the OSBD and CFG present the state's official revenue forecast (The past few years, the CFG has issued the official revenue forecast in mid-December of the prior year).



3

AFTER THE BUDGET IS PASSED

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

State law allows some revisions to the budgets after they are passed. Interim budget reductions, requests to spend surplus federal or restricted funds, natural disaster spending and other budget adjustments during the fiscal year must be reported to the Interim Joint Committee on Appropriations and Revenue. However neither the General Assembly nor any of its committees has any authority to act outside of a legislative session.

The budget bill then becomes law and is effective on July 1 for the next two years.

The revenue estimates used in the finally enacted budget, incorporating changes made by the General Assembly during the session, become the official revenue estimates for the biennium.

After the session, the OSBD produces final budget documents that incorporate any vetoes, veto overrides, and updated revenue estimates.

The bills then go to the Governor, who has four options: To sign the bills into law; let them become law without signature; veto an entire bill; or exercise the power to veto specific provisions of a bill through use of the line item veto. The legislature can override vetoes with a majority vote in both chambers, and each separate line item veto must be considered and voted upon separately.

SIX WEEKS

Appropriations and Revenue Committees (including six subcommittees in the House and one full Senate panel) review the budgets as introduced and make alternative proposals.

Hearings are conducted in the House over a six-week period. Agencies and, at times, members of the public testify about budget needs and concerns. The LRC provides legislators with documents comparing agency budget requests with recommendations from the Governor, Chief Justice and LRC, and also provides documents comparing the House and Senate budgets to each other, and to the budgets presented by the Governor and Chief Justice.

The House Appropriations and Revenue Committee amends and passes the budget bills, which are then brought before the full House, where a majority vote of at least 51 representatives is required for passage.

The budget bills then move to the Senate, where substitutes or amendments are made before the Senate's version of the budget bills are passed, also on a majority vote.

Differences between the budget bills passed by the House and Senate are worked out in a conference committee. The reports of the conference committee reflecting the agreement of the conferees cannot be amended by either body—they must be voted up or down by a majority vote in both chambers for final passage.



DIVERTED RESOURCES

Hundreds of tax expenditures, including deductions, exemptions, credits and other tax giveaways, will drain billions of dollars from the General Fund in 2020. Unlike budgeted items which go through the appropriations process and are subject to cuts, tax breaks are written into the tax code and do not undergo routine evaluation by lawmakers to determine their costs and benefits to the state.

State taxes are a very small portion of business costs. Businesses typically make decisions about location and expansion based on other factors such as presence of an educated workforce, access to markets, good schools, and a quality transportation infrastructure. Research also shows that people rarely move across state borders and when they do, it's for family and job-related matters, not taxes. The money tax breaks drain from our state coffers leave us with fewer resources to invest in the building blocks of economic growth and in the things that really matter to all of us—supporting a competitive workforce, good roads, state-of-the-art technology, strong public safety and court systems and healthy, beautiful communities.

Scrutinizing and cleaning up these tax breaks would give us more revenue to invest in our shared interests.

SHRINKING INVESTMENTS

Kentucky has made great strides over the last century thanks to investments through the state budget that have built a better Kentucky, one school, one road and one healthy community at a time. But in recent years, the state has lost ground and will likely lose more unless tax breaks are cleaned up. As revenues shrink in proportion to Kentucky's economy, we are less able to educate the state's current and future workforce and invest in the public goods and services that make Kentucky a good place to live and do business. This is bad for all Kentuckians, but the impact of underfunding education, health and other public services falls hardest on communities already facing structural barriers to wellbeing and economic security.

A BALANCED APPROACH TO THE BUDGET

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

FURTHER READING

[Budget of the Commonwealth](#): The State Budget Director's webpage contains downloadable budget documents, including the full biennial Budget of the Commonwealth.

[Tax Expenditure Analysis](#): Kentucky's biennial tax expenditure report (on the Budget Director's webpage) allows you to see what groups get what tax breaks, and how much they cost the state.

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

["Who Pays:"](#) The Institute on Taxation and Economic Policy explains why Kentucky's tax code is upside-down.