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FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal Policy Research Brief
By Kentucky Youth Advocates

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Headed Down Another Slippery Slope? A Look at Kentucky's Revenue Woes

The fiscal outlook for Kentucky does not appear good. Tax receipts—the sum of all revenues collected from state taxes, such as income and sales—for the month of March declined by 12.3 percent from one year ago. All revenues—which include tax receipts as well as non-tax receipts such as fines and fees—declined by an equally dramatic 11.6 percent from the year earlier. (See Table 1 below.) Because state revenues continue to fall short of analysts' expectations, it appears increasingly likely that another round of budget cuts will occur before July 1st 2002, the beginning of the next fiscal year.

Three obvious questions arise from this bleak fiscal forecast. First, why are state revenues declining? Isn't the economy, after all, in recovery? Second, what happens next? Are additional budget cuts imminent? Third, what does this mean for the 2002-2004 biennial budget and beyond? Can policy-makers do something to limit similar revenue problems in the future?

Revenues

Kentucky has already gone through two rounds of budget cuts this fiscal year. In total, \$533 million, or about 7 percent of the general fund budget, was cut. Following these cuts, the state's revenue forecasting group projected that current fiscal year (July 1, 2001 thru June 30, 2002) revenues would only grow by 0.9 percent. Unfortunately, even such a slight revenue growth rate has failed to materialize since December 2001, when the forecast group last met. Instead, total general fund receipts for fiscal year 2001-2002 are actually 0.8 percent lower this year than they were at the same time last year! In order to realize the projected 0.9 percent growth rate, therefore, total revenues will have to rise by more than 5 percent for each of the last three months of this fiscal year (April, May, and June); a difficult proposition even during prosperous times.

Table 1

	March		% Change	July thru March		% Change
	2001	2002		2000-2001	2001-2002	
TOTAL GENERAL FUND	511,766,984	452,488,981	-11.6%	4,792,547,696	4,754,985,563	-0.8%
Tax Receipts	490,756,309	430,364,435	-12.3%	4,595,304,900	4,554,371,559	-0.9%
Sales & Gross Receipts	195,960,711	198,470,484	1.3%	1,817,033,480	1,858,681,520	2.3%
License & Privilege	80,909,421	78,116,859	-3.5%	255,808,889	248,894,737	-2.7%
Income						
Corporation	40,625,626	14,671,984	-63.9%	173,198,388	106,587,962	-38.5%
Individual	140,190,446	117,638,956	-16.1%	1,917,198,818	1,898,944,115	-1.0%
Property	20,676,110	16,165,040	-21.8%	363,454,336	376,057,577	3.5%
Inheritance	11,562,779	4,439,563	-61.6%	61,336,095	56,643,466	-7.7%
Miscellaneous	831,216	861,550	3.6%	7,274,895	8,562,182	17.7%
Nontax Receipts	20,321,439	21,531,599	6.0%	191,325,864	194,254,220	1.5%
Redeposit of State Funds	689,237	592,947	-14.0%	5,916,932	6,359,784	7.5%

Source: Office of State Budget Director, March 2002 Tax Receipts Report

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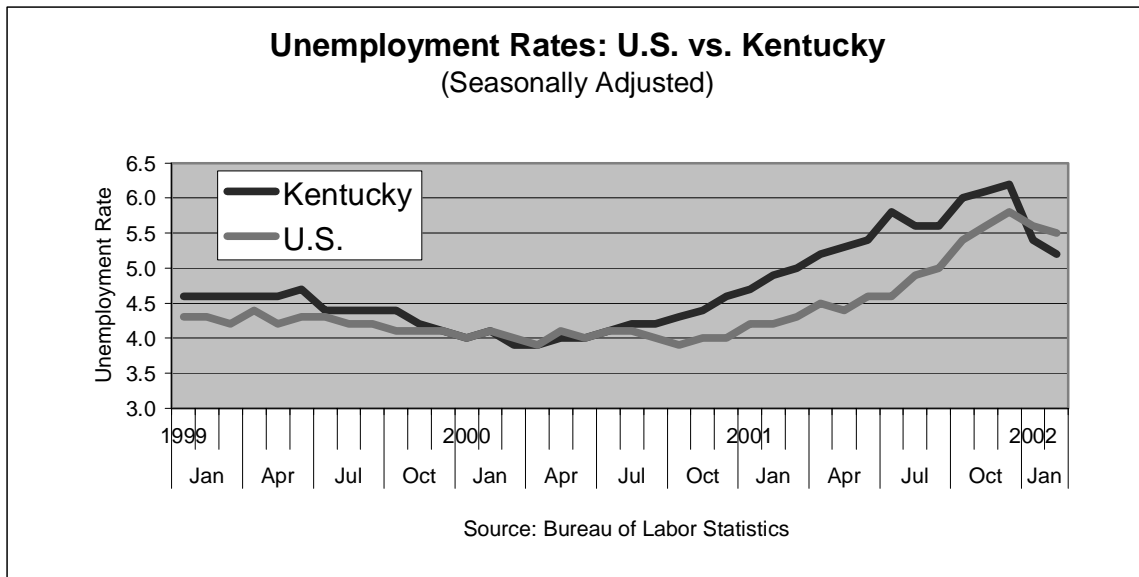
Why are Revenues Declining?

Many economists are cautiously proclaiming an end to the recession that began in March 2001. Federal Reserve Chairman Alan Greenspan even made uncharacteristically optimistic remarks about the nation's economy during congressional testimony last month. So, if the nation's economy is moving toward, or is even in, recovery why are Kentucky's revenues shrinking?

The reasons for Kentucky's poor revenue picture are at least twofold. First, the unemployment rate in Kentucky has generally been tracking higher than the nation as a whole. Graph 1 below shows that Kentucky's unemployment rate has exceeded the national average from July 2000 through December 2001.

Higher unemployment rates generally translate into lower personal income tax and sales tax revenue. Indeed, personal income tax revenues are one percent lower so far this fiscal year than they were at the same point last year¹. This makes sense since the unemployment rate from July 2000 through June 2001 never exceeded 4.6 percent. Since July 2001, however, the unemployment rate has exceeded five percent every month except two!

Graph 1



Despite the run-up in unemployment, sales tax receipts have remained surprisingly robust. Strong automobile sales, pushed by low interest rate loans, have helped prop up these tax revenues.

Second, corporate income tax revenues have plummeted, leaving a big hole in the state's budget. For March 2002, corporate income tax revenues were an amazing 63.9 percent lower than the same month in 2001. Year-to-date, corporate income taxes are off by more than 38 percent, or \$66 million. The decline partly reflects weak corporate earnings. Overall, businesses are not as profitable now as they were two or three years ago.

¹ The one percent individual income tax decline is for July 2001 thru March 2002. Looking just at the March 2002 individual income tax revenues we find that these revenues are 16 percent lower than the same month in 2001 (see Table 1). Administration officials cited an increase in the number of electronic filers as one explanation for the year-over-year change. That is, people who file their tax returns electronically generally receive their refund checks sooner than those who do not because electronic filing reduces mail and processing times. It does not necessarily mean that the amount of tax refunds has increased year-over-over. Tax refunds offset income receipts.

What Happens Next?

If state revenues do not improve significantly in the month of April, Governor Patton will likely move to consider one or more of the following actions: cut agency budgets; postpone certain expenditures; or appropriate unused funds.

Of these three actions, the most direct—and blunt—method would be to balance the state's budget by reducing the amount of money that agencies spend. This would effectively lower expenditures by an amount equal to the lower revenue projection. Unfortunately, agency budgets have already been cut twice in the past six months. Further cuts, therefore, would increase the likelihood of severely harming agency programs. Additional budget cuts would be like applying the scalpel to someone with no fat. Several cabinet secretaries even made their 2002-2004 biennial budget presentations to the legislature around the theme of a “bare-bones” budget.

Another possibility is postponing bill payments until after June 30th. This would effectively transfer some spending activity from this fiscal year to the next. Kentucky could either delay some bill payments until the new fiscal year begins or not recognize certain expenditures until after June 30th.² Granted, these changes only cosmetically fix the revenue shortfall; they just postpone the day of reckoning. Therefore, if future revenue growth is not sufficient to pay these expenditures, the postponed payments will create a budget shortfall the following year. Postponing expenditures could make fiscal sense if it is grounded in reasonable expectations that state revenues will experience increased revenue growth during the following biennium.

The last possibility involves taking presently unused funds and applying them to the revenue shortfall. A similar action was taken during last year's budget cuts. For instance, underground storage tank funds were diverted from that program to the state's general fund to help balance the budget. These funds were essentially counted as “revenue” in order to lessen the actual amount of budget cuts that agencies would have to take. Other states have done this as well. The downside to this action is that no new recurring revenue is created. It's just a one-time surge in revenues that masks an underlying permanent revenue problem.

Solutions to the “Slippery Slope”

Elementary physics tells us “objects in motion tend to stay in motion.” At present, Kentucky's revenues are moving downhill fast. In fact, a recent report by a legislative consultant warns of a \$2 billion structural deficit by 2010. (Fox, 2002) What this means is that state revenues are expected to grow more slowly than state expenditures over the next eight years unless something changes. What can Kentucky do to avoid placing itself in this cycle of fiscal crises? Below are four options.

Things Kentucky can do before June 30th, 2002:

For this fiscal year, before proposing any additional agency budget cuts, policymakers should first tap unappropriated, unobligated funds. While Governor Patton already made similar moves over the past six months, another look is warranted. Only three months now remain in the fiscal year potentially making it more clear how much money will be available by June 30th.

How to Improve Kentucky's Revenue Picture:

This fiscal year:

1. Take unappropriated, unallocated fund balances and transfer to the general fund.
2. Postpone certain expenditures until after July 1st, 2002, if a reasonable expectation exists that revenues will be higher next year.

Next fiscal year and beyond:

3. Enact comprehensive tax reform.
4. Appropriate up to \$60 million from the state rainy day fund.

² An accounting method used to describe the time period when a bill shows up in the books.

The second action that can be taken this fiscal year is to postpone certain expenditures. As noted previously, such action may just delay the day of financial reckoning. However, if reasonable expectations exist that future revenues will be sufficient to cover any postponed expenditures, then such action may be justified.

Things Kentucky can do after June 30th, 2002:

For next fiscal year and beyond, policymakers should pursue the following courses. At the top of the list is comprehensive tax reform legislation. Reports from the Kentucky Long-Term Policy Research Center, Kentucky Youth Advocates, and others have already made a case for such reform³. They each recommend that Kentucky address its budget and fiscal problems, in part, by modernizing its system of collecting taxes.

Kentucky's tax system today is still based on how the state's economy functioned in the 1950's. Consequently, many economic activities that are commonplace to today's world (e.g., Internet and catalog sales, most services, and even certain employment activities) avoid taxation. State revenues, as a result, cannot grow as fast as the state's economy.

This out-dated tax model also applies to situations of over-taxation. Take, for example, Kentucky's individual income tax system. The current system begins assessing the top marginal tax rate on a person's annual earnings at just \$8,000. While \$8,000 represented an above average income during the 1950's, today a person earning the minimum wage and working full-time has an annual income of \$10,000, which is \$2,000 more than this amount.

Furthermore, Kentucky's tax structure inappropriately places an excessive tax burden on working families and children. Persons with the lowest income pay more taxes as a percent of their income than anyone else. (Legislative Research Commission, 2001)

Up to \$60 million from the state's rainy day fund could also be used to temporarily balance the budget. At present, the state's rainy day fund has a \$120 million fund balance. Under law, policymakers may appropriate, at most, 50 percent of the balance annually. Assuming the maximum rate that would mean \$60 million is available for next fiscal year. While the economic times currently call for such action, policymakers should agree to replenish this reserve fund when more prosperous times return.

Using Rainy Day Funds is Not Bad
Research by the Center on Budget and Policy Priorities (CBPP) shows that using rainy day funds in times of fiscal distress is not necessarily a bad course of action. (Zahradnik, 2002) Although others have argued against using these monies during economic downturns due to the belief that it would lower credit ratings and ultimately result in higher borrowing costs, the CBPP proves otherwise.

The CBPP found that credit rating agencies understand the nature of rainy day funds—that they were created for use during difficult economic times. Appropriating rainy day funds when it is actually “rainy”, therefore, is not necessarily viewed as a negative action and doesn't tend to raise borrowing costs. Long-term fiscal imbalances, such as Kentucky's structural deficit, however, could have a negative impact on the state's credit rating and future borrowing costs.

³ See “Funding State and Local Government”, Kentucky Long-Term Policy Research Center, 2001; “Tax-Relief, Selecting the Right Low-Income Option”, Kentucky Youth Advocates, 2002; and “Report to Subcommittee on Tax Policy Issues”, Bill Fox, 2002.

Conclusions

Kentucky is once again faced with the prospect of lower than anticipated revenues, raising the specter that additional budget cuts may be made. Before taking such action, policymakers should consider several other options to balance the budget. They are:

- appropriate unused, unobligated fund balances;
- postpone certain expenditures if reasonable expectations exist that future revenue growth will sufficiently cover these costs;
- appropriate up to \$60 million from the rainy day fund;
- enact comprehensive tax reform.

Because Kentucky is already faced with an austere budget, further agency budget cuts will only likely crimp the effectiveness of programs. While “belt-tightening” is certainly a prudent response to difficult fiscal times, other courses of action exist and should be considered as well.

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- ✓ enact comprehensive tax reform.

This research brief is produced by Kentucky Youth Advocates, through the State Fiscal Analysis Initiative. Any questions or requests for further information concerning this "Money Matters" publication should be directed to Rick Graycarek, Senior Analyst, 624 Shelby Street, Frankfort, KY 40601, rgraycarek@kyyouth.org, 502-875-4865. Additional tax and budget information can be found at KYA's website, www.kyyouth.org.