

MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy
Research Brief

Author: Rick Graycarek
Director, State Fiscal
Analysis

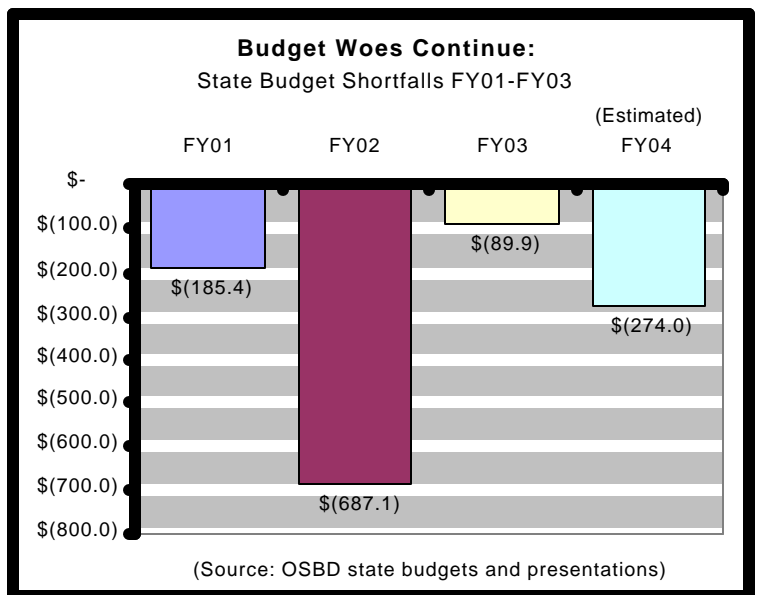
No More Rabbits Left in the Hat: Kentucky's Revenue Problems Continue

- Purpose** To examine and explain the recent state budget shortfalls.
- Kids Matter** Programs for children like education, child care, health care, and safety rely upon state general fund revenues to provide these services.
- Summary** Revenue projections for the current fiscal year, 2004, show little sign of improvement. The estimated budget shortfall for FY2004 is \$274 million. Budget shortfalls from FY01 to FY03 totaled \$962 million. A series of one-time financial moves and spending cuts were used to balance those budgets. To balance the current shortfall, therefore, policymakers will likely have to either cut education, health care, child care, and public safety spending, or find additional revenue sources, which may include raising taxes. Policymakers will not find more rabbits inside the one-time revenue hat to solve this fiscal crisis.

Kentucky's revenue problems continue. The current revenue projection places the fiscal year 2004 general fund budget shortfall at \$274 million. That equals about four percent of state general fund spending.

The current shortfall is nothing new. Over the previous three fiscal years, Kentucky has faced budget shortfalls of \$185 million, \$687 million, and \$90 million, respectively. (See Graph 1.) The cumulative total of these shortfalls is more than \$1.2 billion.

Graph 1



This Money Matters paper examines the past three budget shortfalls and explains why they occurred and how they were balanced. It also explains why Ken-



This KYA report is funded through the Ammie E. Casey Foundation, Open Society Institute, Stoneman Family Foundation, and the generous support of local benefactors. Contents of this report are the sole responsibility of Kentucky Youth Advocates.

tucky's real budget shortfall in fiscal year 2003 exceeded \$640 million and why Kentucky now faces severe fiscal and budgetary challenges in the current fiscal year and beyond.

How Were These Shortfalls Balanced?

Kentucky balanced the past three shortfalls by cutting spending and making other one-time changes. The following page shows a list of those actions in table form as well as in a pie graph.

Transfers from the state's rainy day fund, or budget stabilization fund, totaled \$278.8 million. These transfers topped the list of fiscal actions taken to balance the budget.

The rainy day fund is the state's reserve fund. Kentucky created this reserve fund so it could meet an unexpected rise in expenses or an unexpected drop in revenues.

Policy-makers drained the entire rainy day fund to help balance the state's budget. Unfortunately, even the \$278 million used from the rainy day fund was not enough to cover all the shortfalls.

More about the Rainy Day Fund

Think of the rainy day fund like a personal savings account—the savings account is there in case you have an unexpected bill like a new transmission for your car or braces for your child's teeth. It is also there if you have less income than expected, perhaps because you lost your job.

Significant spending cuts were also made. From fiscal year 2001 to 2003 just over \$264 million in spending cuts were implemented. These cuts fell on all cabinets, including education. (See KYA publication "Making Ends Meet: Fiscal Year 2002 Budget and Fiscal Year 2003 Spending Plan" for more detail.) K-12

education saw central office expenditures reduced and money for new textbooks cut. Local school districts also pared expenditures. Some districts, like Hardin County Schools, delayed scheduled purchases of buses or deferred maintenance.

Post-secondary education appropriations were also scaled back and spending cuts were imposed. The result has been significant post-secondary tuition increases for the 2003-2004 school year for full-time in-state students. Tuition increased by as much as 25 percent at public colleges and universities.

Tuition Hikes for 2003-2004

- ? Community and technical college students will pay 23.4 percent more.
- ? University of Kentucky students will pay 14.4 percent more.
- ? Tuition at University of Kentucky's professional schools—dentistry, medicine, and law—rose 25 percent.
- ? Students at the University of Louisville will pay 9 percent more.

Other actions were also taken to balance the 2001 to 2003 fiscal year budget shortfalls. Kentucky realized \$162.7 million in savings from refinancing and re-funding existing bonds and issuing new bonds at lower interest rates than anticipated. Fund transfers totaling \$129.2 million also helped balance the budget. These transfers came from non-general fund sources including: the state's flexible spending account and the Fire and Tornado Insurance Fund.

Kentucky also received \$68.7 million in federal fiscal relief in the Spring 2003. These funds were part of a federal tax bill. Kentucky will receive an additional \$68.7 million in federal fiscal relief in October 2003. Those funds have already been figured into the budget shortfall projection for FY04. That is, the esti-

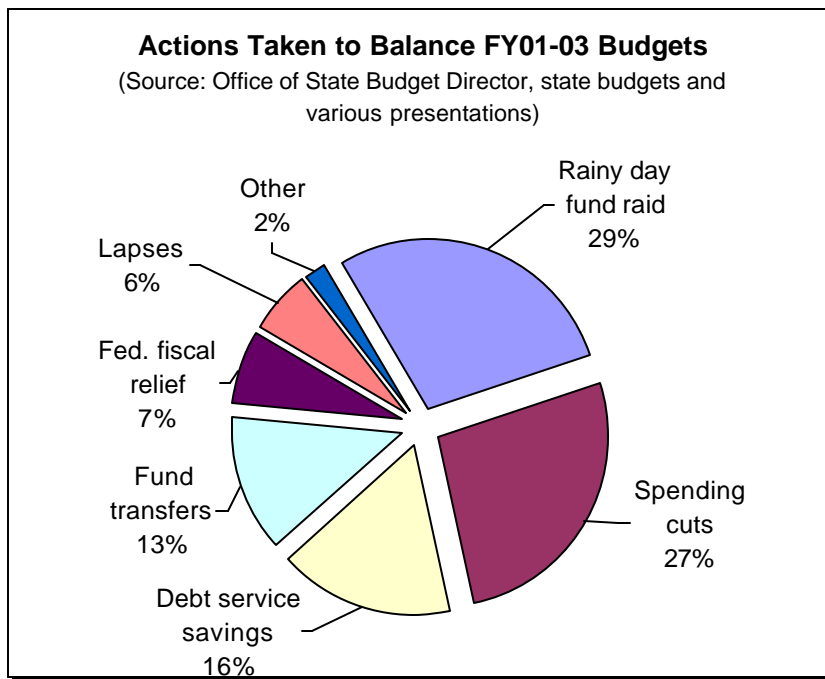
Between fiscal years 2001 and 2003 just over \$264 million in spending cuts were implemented.

Table 1

Actions Taken to Balance FY01-03 Budgets				
(in millions of \$)				
	FY01	FY02	FY03	Total
Budget Shortfall	185.4	687.1	89.9	962.4
Balancing Actions				
Rainy day fund raid	38.8	240.0	-	278.8
Spending cuts	32.7	231.5	-	264.2
Debt service savings	49.8	112.9	-	162.7
Fund transfers	29.3	97.3	2.6	129.2
Fed. fiscal relief	-	-	68.7	68.7
Lapses	26.0	-	35.4	61.4
Other	8.8	5.5	7.0	21.3
Total	185.4	687.2	113.7	986.3
Year-end balance	-	-	23.8	

(Sources: OSBD state budgets and various presentations)

Graph 2



One thousand executive branch employees are expected to be cut by December 2003. This includes 154 employees from the Cabinet for Families and Children.

mated \$274 million budget shortfall for fiscal year 2004 reflects this additional fiscal relief. Had those funds not been available, the budget shortfall would be \$342.7 million.

What Doesn't Meet the Eye

Although Kentucky officially balanced

the past three budget shortfalls by employing the actions described above, that is an incomplete explanation. Other behind-the-scenes actions were also taken.

On the administrative side, staff travel, overtime, printing, copying, and other costs were limited in many cabi-

Kentucky revenues come from taxes, fees, fines, transfers, and investment income. Taxes, such as income, sales, and property fund many government activities.

Revenue from various special accounts (e.g., Nursing Board and Early Childhood Development) were transferred to the state's general fund in order to help balance the books.

nets. Open positions also stayed vacant. In addition, 1,000 executive branch employees are expected to be cut by December 2003. This includes 154 employees in the Cabinet for Families and Children, 95 employees in the Cabinet for Health Services, and 18 in the Department of Education.

In fiscal year 2003, significant one-time revenue events also helped policy-makers approve a budget with higher revenues and expenditures than would otherwise have been available. These events included: fund transfers, a tax amnesty program, and an unanticipated jump in inheritance and income tax revenues. (Note: These fiscal events were recognized in the budget adopted by Kentucky's Legislature in March 2003, almost a year passed the April 15th, 2002, budget deadline. Therefore, the budget was enacted nearly nine months into fiscal year 2003. Despite these one-time events, though, Kentucky realized soon after the budget was enacted that the fiscal year 2003 budget faced an \$89.9 million shortfall.)

Transferring funds to the state's general revenue fund from various special revenue funds added \$331 million to the state's revenue. Funds were transferred from a variety of sources including, the Nursing Board, Early Childhood Development, and the Board of Medical Licensure. The general fund will not replace these transfers. The table on the following page lists the sources and amounts of some fund transfers. (See Table 2.)

To fill the budget gap, Kentucky also implemented a tax amnesty program. More than \$107 million in back taxes were collected during fiscal year 2003.

A large, unanticipated increase in inheritance and individual income tax revenues also added \$23 million and \$100 million to the state's general fund coffers, respectively. Not many details are available on either event. The Reve-

nue Cabinet and the State Budget Office have cited confidentiality as the reason. The point is, however, that these were significant one-time revenue spikes. It is unlikely that similar revenue increases will occur in fiscal year 2004.

In sum, these one-time revenue events added more than \$550 million to the state's general fund in fiscal year 2003. Without these dollars, Kentucky would have faced a budget shortfall in excess of \$640 million (\$89.9 + \$330 + \$107 + \$23 + \$100).

What Caused The Budget Shortfalls?

Like many other states, Kentucky's budget shortfall was primarily the result of declining revenues. Unanticipated expenditures were only a small factor.

In 2001, Kentucky's economy began slumping around the same time that the national economy was heading into recession. Revenues quickly fell short of expectations.

In 2002, \$617 million of the \$687 million budget shortfall was due to revenues coming in lower than budgeted. The 2003 budget shortfall was also primarily due to lower than anticipated revenues.

In 2003, revenues were \$75.7 million lower than anticipated. This represents a majority of the \$89.9 million shortfall.

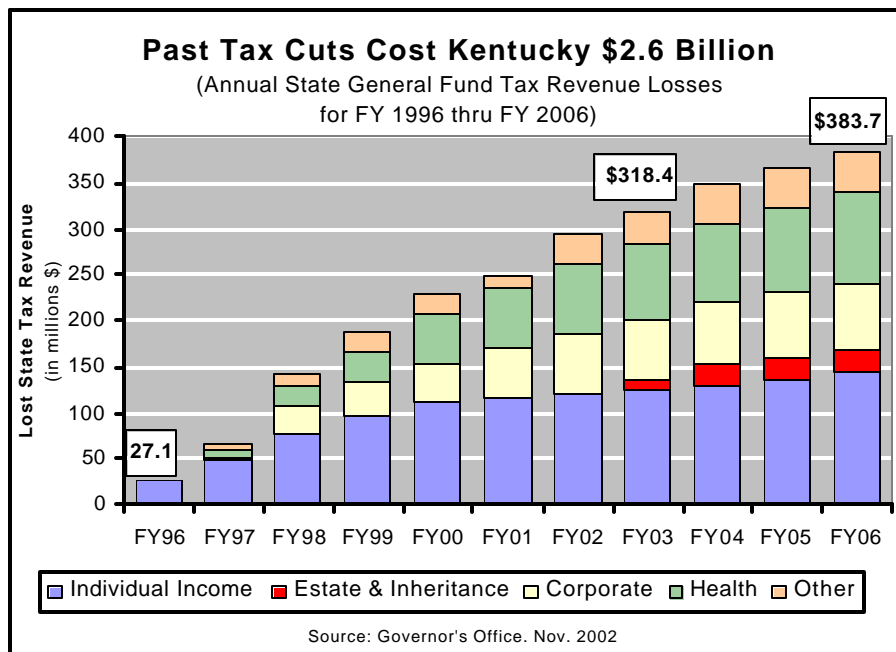
Another contributor to the budget shortfalls is past tax cuts. Over the past decade, Kentucky policy-makers have significantly reduced various taxes. Consequently, revenue has grown more slowly. The cost of these tax cuts is estimated at \$318 million in fiscal year 2003 and almost \$350 million in fiscal year 2004. These figures represent lost revenues to the state. Over the fiscal year 1996 through 2006 period, these tax cuts are estimated to reduce general fund revenues by \$2.6 billion. (See Graph 3.)

Table 2

Partial List of FY03 Fund Transfers used to Balance the Budget	
Transfers Amounts are from Special Revenue Funds to the General Fund	
	FY2003
Governor's Office of Early Childhood Development (KRS 200.151)	\$ 1,861,800
Boards	
Accountancy (KRS 325.250)	\$ 300,000
Dentistry (KRS 313.350)	\$ 56,000
Medical Licensure (KRS 311.610)	\$ 794,000
Nursing (KRS 314.027 and 314.161)	\$ 1,574,700
Pharmacy (KRS 315.195)	\$ 811,700
Social Workers (KRS KRS 335.140)	\$ 163,400
Education	
School Districts Flexible Spending Accounts	\$ 14,000,000
Learning and Results Services--KY Successful Schools Trust Fund (KRS 157.067(1)	\$ 10,995,200
Arts and Humanities	
KY Arts Council (KRS 153.210 to 153.235)	\$ 57,200
Cabinet for Families and Children	
Community Based Services--agency revenue funds	\$ 15,000,000
Cabinet for Health Services	
Aging Services--other special revenue funds	\$ 131,700
Children w/ Special Health Care Needs (KRS 200.151)	\$ 50,000
Justice	
Juvenile Justice--agency revenue funds	\$ 6,000,000
Natural Resources & Environmental Protection	
Environmental Protection--agency revenue funds	\$ 1,100,000
Post-Secondary Education	
CPE Student Financial Aid & Advancement Trust Fund (KRS 164.7911 & 164.7927)	\$ 406,200

Source: Conference budget report

Graph 3



Kentucky Youth Advocates

2034 Frankfort Ave. Louisville,
Ky 502-895-8167 and 624
Shelby Street Frankfort, Ky
502-875-4865

Contacts: Rick Graycarek and Kathleen Hoyer
Phone: 502-875-4865 or 502-895-8167
E-mail: rgraycarek@kyyouth.org
khoyer@kyyouth.org



*"An Independent Voice for Kentucky's
Children"*



Consequences of the Budget Shortfalls

The fallout from these shortfalls is taking shape.

- **Child care waiting lists for about 7,500 children;**
- **Eligibility for child care subsidies lowered from 165 percent of poverty to 150 percent;**
- **Nearly 1,800 Kentuckians denied Medicaid services;**
- **Significant college tuition hikes.**

Balancing the current fiscal year \$274 million budget shortfall may exacerbate these consequences. With nearly all one-time revenue sources tapped out, Kentucky policymakers are left with two choices—cut spending further or find

additional revenues. As noted previously, they have basically used all the one-time revenue and expenditure options that they could.

With services like education, child care, and health care for children and families hanging in the balance, KYA strongly encourages Kentucky's policymakers to avoid further spending cuts. Revenues are the fundamental policy issue. Public reports from legislative consultants and committees over the past decade confirm that this is the case. Without a modern and equitable revenue system, Kentucky will likely find itself in budget crisis after budget crisis. An updated revenue system would help solve what has now become an annual story line—Kentucky faces another budget shortfall.