

January 2009

Weighing Budget Shortfall Options in Times of Economic Crisis FY 2008-2010

In October 2008 state government revenues were officially projected to be \$456.1 million less than the General Assembly budgeted for FY 2009. This news came on the heels of significant spending cuts taken in the spring of 2008 to account for a \$432 million shortfall. In response to the latest shortfall, Governor Beshear released a three-fold plan to deal with the budget shortfall that includes a combination of spending cuts, new revenue, and transfers from reserves and restricted funds. In turn, the leadership of the legislature asked all state agencies to submit a plan to cut their budgets by 6.7 percent – the amount necessary to handle the shortfall with spending cuts alone. **Although the governor’s proposal is preferable, the impact of either proposal will result in significant job loss in the public sector at a time when unemployment is mounting in the private sector. Growing unemployment in the state will increase economic hardship and further erode consumer confidence, decreasing demand for goods and services. The fact of the matter is that significant new revenues are needed to balance the budget now and for the future stability of the Commonwealth.**

The Economic Climate in Kentucky

If the current revenue shortfall is remedied with spending cuts alone the total decrease in state spending would be more than \$888 million in 18 months – reflecting a significant decrease in spending on Kentucky’s health, safety, and progress for the future. The current budget shortfall, projected to be \$456.1 million in 2009, is the second consecutive significant shortfall in Kentucky’s budget. Last spring Kentucky faced a shortfall of \$432 million that was dealt with entirely through spending cuts. State Cabinets and agencies were required to cut spending mid-year ranging from 4 percent to 20 percent of their budgets (Table 1). As a result of the shortfall and the mandates of the 2008-2010 Biennial Budget over 2,000 public positions were lost. As a result, the state’s workforce was cut by more than 2,000 employees and multiple public programs were downsized or eliminated.¹

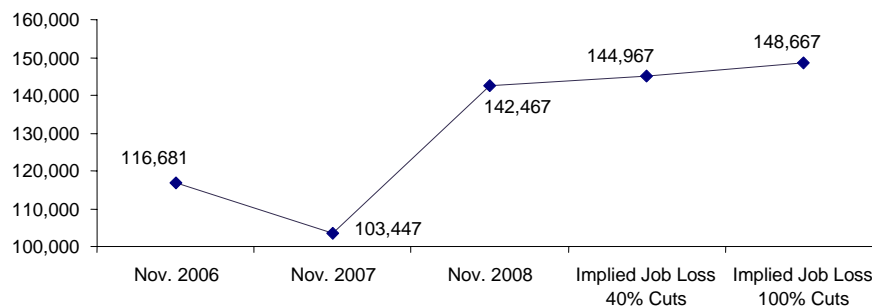
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Table 1: Selected Budget Cuts in 2008	
Economic Development	20%
Kentucky Educational Television	18%
Local Libraries	18%
Environmental Protection	13%
Veteran's Affairs	11%
State Police	10%
Community Based Services	6%
Public Health	6%
Source: Office of the Governor, Office of the Budget Director	

If the 2009 projected budget shortfall is remedied with budget cuts alone, it could lead to 6,000 jobs lost in addition to the more than 2,000 lost in 2008 – a total of 8,000 jobs eliminated. In addition to government layoffs resulting from budget cuts, unemployment has been steadily increasing in the state over the past year. Kentucky's unemployment rate has increased by at least 1.9 percent since November 2007, up sharply from 5.1 percent to 7.0 percent (Chart 1).² The Center for Economic and Policy Research projects that more than 6,000 jobs in the public and private sector combined could be lost if the entire budget shortfall is remedied with spending cuts alone.³ Alternatively, if 40 percent of the budget shortfall is remedied with spending cuts this could result in a loss of 2,500 more jobs in the near term (Chart 1).⁴

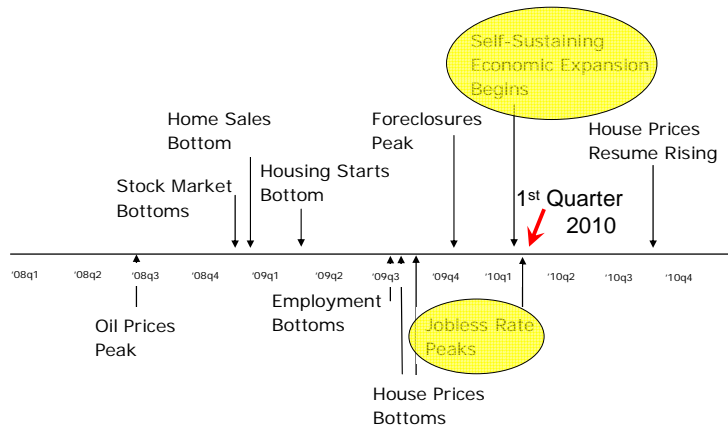
Chart 1: Kentucky Unemployment Numbers & Projected Unemployment Numbers with Spending Cuts



Source: Kentucky Office of Employment and Training; Center for Economic and Policy Research; KYA calculation

If spending cuts remain the only option on the table going into 2010, Kentucky could be facing a compounded spending decrease of more than \$1.2 billion in less than 3 years' time and public sector unemployment of more than 10,000 jobs.⁵ Economists predict that the national economic downward spiral will not bottom out until early 2010 (Chart 2).⁶ This means the nation will only begin to pull out of the recession at that point. It is highly likely that Kentucky will also face a shortfall in FY 2010, at least equal to the current \$456 million

Chart 2: A Timeline to Recovery



Source: Mark Zandi, Chief Economist, Moody's – Economy.com
November 18, 2008

The Governor's Proposal: Preferred but Not Sufficient

The governor's plan is not enough to strengthen the state budget this year and does nothing to protect the state from an expected revenue shortfall of similar magnitude next year. Individually and as a package, the options in the governor's plan are appropriate responses to a one-time budget shortfall. Unfortunately, this budget shortfall is not an isolated incident. In fact, the proposed spending cuts and transfers come on top of significant spending cuts less than a year ago and it is widely agreed upon that there will be a similar shortfall again next year. The only new revenue proposed – an increase in the cigarette tax – will be needed to reimburse the “rainy day” fund which is scheduled to be spent in FY 2010 as part of the budget passed by the General Assembly.

The governor should be commended for proposing a plan that seeks to protect education, healthcare, and public safety. The governor's plan provides complete protection for SEEK, the mechanism through which the state funds elementary through secondary education. In addition, the plan shields some public health programs, the state police force, and higher education by requiring only a 2 percent budget cut. Most other agencies in state government will take at least a 4 percent cut under the governor's proposal.

The governor proposes the following mix of spending cuts, new revenue, and transfers from other accounts, to total \$456.1 million – the total amount of the projected budget shortfall in FY 2009.⁷

Spending cuts

- **Direct cuts to state agencies totaling \$147.1 million on top of the severe cuts taken last year.** Though the total spending cut proposed safeguards critical education and healthcare programs and is less than half of the spending cut taken last year, it still has the potential for increased loss of employment and increased loss of public programs that prevent future costs to the state. Assuming the governor's proposal is adopted, direct spending cuts in 2009 would account for 32.2 percent of the total plan and could result in additional public sector unemployment of nearly 2,000. Total job loss for the 2008 – 2009 shortfalls would be well over 4,000.
- **Furloughing state workers for three days would save \$8 million.** Furloughing state workers for a brief time is certainly preferred to universal layoffs because it mitigates an increase in unemployment. However, furloughs have a disproportional impact on employees based on their level of income. Employees at the higher end of the salary schedule will be less impacted than those making lower wages. For this reason, thought should be given as to the time frame in which employees are expected to take their furloughed days.

New revenue

- **Increasing the cigarette tax by 70 cents would increase revenue by \$81.5 million.** A significant increase in the cigarette tax is good fiscal policy for Kentucky.⁸ We have one of the lowest cigarette tax rates in the nation and we have the highest smoking rate in the nation. Consequently we have very high public and private costs associated with smoking and smoking related illnesses. A significant increase in the cigarette tax rate is the most effective way to decrease the rate of smoking and, over the long-term, decrease smoking related costs paid by all taxpayers.
- However, the additional revenue gained by the increase will necessarily go to repay the Budget Reserve Trust Fund or “rainy day” fund in 2010. The Office of the State Budget Director estimates that additional cigarette tax revenue, if increased, will amount to \$144 million annually. In 2010, this entire amount will be directed to the Budget Reserve Trust Fund to replace part of the \$178.9 million that the governor proposes to borrow to fill the current revenue shortfall. In short, the increased cigarette tax revenue will not be available as new revenue next year.

Transfers

- **The plan includes borrowing \$178.9 million from the Budget Reserve Trust Fund.** Also known as the “rainy day” fund, the Budget Reserve Trust Fund exists for the express reason of filling revenue shortfalls in times of economic downturns. Unfortunately, the money currently in the “rainy day” fund was appropriated in the budget for use in FY 2010. This means the governor will necessarily repay the fund with the expected increase in cigarette tax revenue in FY 2010.
- **Transfers from restricted funds of \$40.6 million.** These transfers are one-time monies appropriate for a short-term fix. They include money that was earmarked for other purposes, like the coal severance dollars restricted for economic and community development projects in coal producing counties.

Budget actions must take the economic climate into account. The prescription for the budget shortfall cannot be separated from the current economic crisis. New York Times columnist and noted economist Paul Krugman recently opined that the fate of the nation's economic recovery is in the hands of the 50 state governors. Why? Many historians and economists agree that the Great Depression was made worse because the government was intent on cutting spending to balance the budget during a national recession. What happened was the loss of safety net programs that people needed coupled with increasing unemployment in the public sector at the same time that the private sector was contracting. Krugman asserts that states will effectively counteract federal stimulus efforts if they balance their budgets with severe spending cuts resulting in a similar experience of the 1930's.⁹

The governor's plan will likely add an additional 2,000 to the unemployment number and will result in some decrease in public services that people are likely to need now more than ever. These actions will prove to further aggravate both the state economy and consumer confidence. For instance, the state's Medicaid budget was based on a monthly growth of 1,000 persons; however, the current rate is growing by over 3,000 per month. The governor suggests that his plan is just the beginning of a conversation that must be had about sustainable revenues adequate to support our shared values. Certainly this is true. Though the governor's plan minimizes many negative impacts it cannot be viewed in the context of a one-time shortfall - separate from the compounding effect of the current recession. The fact of the matter is that the plan is being proposed in the midst of an economic crisis paralleled to the Great Depression.

Plans to reduce spending by the full amount of the shortfall, just this year, would likely result in an increase in unemployment of 6,000, on top of more than 2,000 last year. If the shortfall persists, which is likely, unemployment could surpass 10,000 through 2010. The worst case scenario in this economic climate would certainly be to cut spending equal to the projected revenue shortfall. Spending cuts of \$456 million this year and likely the same or more next year would result in unprecedented increases in unemployment and severe cuts in all public programs. Progress toward our shared values of a safe, healthy, and educated population, lending to a vibrant workforce would not only halt, but likely step back years.

Both macroeconomic theory and our own history as a nation teach us that in times of recession it is necessary for the government to act in a way that encourages stability and consumer confidence. Nobel Prize winning economist Joseph Stiglitz and former director of the Congressional Budget Office and current director of the Office of Management and Budget, Peter Orszag write,

“ Basic economic theory suggests that direct spending reductions will generate more adverse consequences for the economy in the short run than a tax increase or a transfer payment reduction. The reason is that some of any tax increase or transfer payment reduction would reduce savings rather than consumption, lessening it's impact on the economy in the short run, whereas the full amount of government spending on goods and services would directly reduce consumption.. ”¹⁰

The length and severity of the recession in Kentucky is, in part, dependent on the choices we make to handle the budget shortfall. To lessen the impact of the national recession, both short-term new revenues and sustainable new revenues need to be a significant part of the plan.

ENDNOTES

¹ “Protecting Our Values: Education, Health Care, Public Safety” Commonwealth of Kentucky Office of the Governor. December 11, 2008. Available at <http://governor.ky.gov/pressrelease.htm?PostingGUID=%7B402B7444-700F-4EAF-8B91-D1B8191BA5BC%7D>. Accessed December 2009.

² Kentucky’s Unemployment Rate available at <http://www.workforcekentucky.ky.gov/cgi/databrowsing/?PAGEID=4> . Accessed January 2009

³ Sherman, Matthew (2008). “Will Workers Survive State Budget Belt Tightening?” Center for Economic and Policy Research. Available at <http://www.cepr.net/index.php/publications/reports/will-workers-survive-state-budget-belt-tightening/>. Accessed January 2009.

⁴ Ibid

⁵ KYA calculations based on CEPR estimations.

⁶ Zandi, Mark (2008). “When Will It End?” Presentation to the Center on Budget and Policy Priorities, State Fiscal Analysis conference. November 19, 2008

⁷ “Protecting Our Values: Education, Health Care, Public Safety” Commonwealth of Kentucky Office of the Governor. December 11, 2008. Available at <http://governor.ky.gov/pressrelease.htm?PostingGUID=%7B402B7444-700F-4EAF-8B91-D1B8191BA5BC%7D>. Accessed December 2009.

⁸ Ramsey, Brigitte (2008). “The Right Tobacco Tax Rate: Balancing Efficiency and Equity.” Kentucky Youth Advocates. Available at http://www.kyyouth.org/Issue_Areas/budget/index.html.

⁹ Krugman, Paul. “Fifty Herbert Hoovers.” New York Times Op-Ed Column, December 28, 2008. Available at <http://www.nytimes.com/2008/12/29/opinion/29krugman.html>. Accessed January 2009.

¹⁰ Orszag, Peter and Stiglitz, Joseph (2001). “Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?” Center on Budget and Policy Priorities. Available at <http://www.cbpp.org/10-30-01sfp.htm> . Accessed January 2009.

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