

## Remedy for the Budget Shortfall:

### More Budget Reductions, More Fund Transfers, and Limited New Revenue

Earlier this month, Governor Beshear signed House Bills 143 and 144 into law. Together the two bills enact a combination of spending cuts, fund transfers, and new tax revenue to close the \$456.1 million shortfall in the current year state budget.<sup>1</sup> The new revenue will protect funding for P-12 education and Medicaid while other programs are likely to face significant cuts for the second year in a row. In the absence of a revised revenue projection for FY 2010, the General Assembly took little action to reduce a likely similar shortfall in the second year of the biennial budget; instead they appear to be relying on the American Recovery and Reinvestment Act – federal stimulus dollars to balance next years' budget. This paper summarizes the details of the two House bills, the projected impact on state programs and a brief overview of the ARRA, which is expected to bring some fiscal relief to the state.

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### Budget Balanced Mainly with More Spending Cuts and One-Time Money

Following similar proposals from the Governor and the General Assembly, the budget gap will be filled using a combination of spending cuts, internal “borrowing” or restricted fund transfers, and increased taxes (Table 1). House Bill 143 is the budget reduction bill that gives the Governor the authority to transfer funds and make spending cuts to balance the budget. House Bill 144 increases taxes to bring in additional revenue to help close the shortfall.

**Spending Cuts** - Approximately 30 percent of the gap in the budget will be filled through direct spending cuts to most areas of state government. House Bill 143 does not spell out specific areas for cuts; rather the authority is given to the Governor to make the necessary cuts to balance the budget. However, the House Bill does specifically protect some areas from spending cuts, like Medicaid and the SEEK formula which provides for P-12 education.

**Restricted Fund Transfers** - The largest portion of the “fix,” nearly 60 percent, will come from fund transfers. The General Assembly, through House Bill 143, gave the Governor the authority to transfer certain unappropriated funds from a variety of restricted accounts and to transfer up to \$219 million from the Budget Reserve Trust Fund (BRTF) – a savings account for times just like these when the economy is sluggish.

**Increased Taxes** - Just over 10 percent of the plan is new revenue in the form of increased taxes on cigarettes and related products - including a tax increase on alcohol. The increases go into effect on April 1<sup>st</sup> and are projected to bring in an additional \$52 million in tax revenue before the end of the fiscal year on June 30<sup>th</sup>.

The Governor originally planned to require all state employees to take 3 day furloughs. This would have saved the state \$8 million. There was no mention of furloughs in the General Assembly’s plan that passed and was signed by the Governor. Therefore, it is anticipated that furloughs for state workers will not be necessary to balance the budget. However, under the authority given to the Governor to balance the budget with spending cuts he could still require such furloughs.

<b>Table 1</b>		
<b>Plan to Balance the Budget <sup>2</sup></b>		
<b>(millions)</b>		
<b>HB 143</b>		
Restricted Fund Transfers	\$52.6	
SEEK Lapse	\$15.0	
Heritage Land Fund	\$7.0	
Rainy Day Fund	\$219.0	
<b>Fund Transfers</b>	<b>\$293.6</b>	<b>59.5%</b>
<b>Spending Cuts</b>	<b>\$147.1</b>	<b>29.8%</b>
<b>HB 144</b>		
<b>New Revenue</b>	<b>\$52.2</b>	<b>10.5%</b>
<b>TOTAL</b>	<b>\$492.9</b>	<b>100%</b>

Source: Presentation by the Office of the State Budget Director to the Joint House and Senate Appropriations and Revenue Committee, January 13, 2009; FY 2008-2009 Balance Sheet provided to the General Assembly by the Appropriations and Revenue staff. February 2009.

**Budget Balanced with Second Round of Cuts to Programs that Support Low-Income Families**

As the result of a similar budget shortfall in the spring of 2008, departments across the state were cut by 4 percent resulting in significant job loss and program cuts last year. As part of the plan to remedy the current, and second consecutive budget shortfall. The Governor and the General Assembly agreed to cut most departments across the state by

4 percent once again. However, this time the plan expressly safeguards the SEEK formula – the formula by which Kentucky’s school districts are funded – from any cuts and equally protects Medicaid and Mental Health/Mental Retardation. In addition, the state police and the Kentucky Department of Education budgets’ will be cut by 2 percent rather than 4 percent (Table 2). Because the actual spending cuts are not outlined in the budget reduction bill, the exact budget cuts won’t be known until an order written by the Finance and Administration Cabinet is filed with the Secretary of State.

**Table 2**  
**Likely General Fund Reductions by Cabinet**  
(as proposed by the Governor’s plan to close the budget shortfall)

Budget Reduction (millions)	Cabinet
\$63.3	Finance and Administration Cabinet
\$22.6	Postsecondary Education
\$18.6	Cabinet for Health and Family Services
\$11.1	General Government
\$7.1	Department of Education
\$5.6	Justice and Public Safety Cabinet
\$2.9	Energy and Environment Cabinet
\$2.5	Education and Workforce Development Cabinet
\$1.2	Personnel Cabinet
\$1.0	Economic Development Cabinet
\$0.9	Tourism, Arts and Heritage Cabinet
\$0.2	Labor Cabinet
\$0.2	Public Protection Cabinet
\$0.2	Transportation Cabinet

Source: FY 2009 Governor’s Budget Proposal; Presentation to the Joint Session of the House and Senate Appropriations and Revenue Committees; January 13, 2009

As part of the Governor's proposal, all areas of state government submitted plans for their projected budget reductions. Because some areas within Cabinet budgets are protected, like Medicaid and SEEK, Cabinets will need to cut specific programs by more than 4 percent or eliminate programs altogether to arrive at a 4 percent cut to the overall Cabinet budget. The following sample of likely program cuts comes from the Cabinet proposals submitted to the Governor and presented by the Office of the State Budget Director to the Appropriations and Revenue Committees:

**Cabinet for Health and Family Service:** reduce certain foster and child care reimbursement rates; eliminate funding for Kentucky Homeplace Project; eliminate grant funds for Mobile Health clinic; reduce funding for Norton's Poison Control Center; eliminate grants and subsidies for grandparents serving as primary caregivers for grandchildren; eliminate access to the underinsured assistance program for children with special health care needs.

**Cabinet for Justice and Public Safety:** reduce 20 private child care beds; eliminate funding for Gateway and Mary Kendall homes; cancel all 8 community juvenile partnership grant programs; cut funds for Youth Challenge program operated by Military Affairs; reduction in the number of public defenders.

**Education and Workforce Development Cabinet:** reduce the number of disabled clients served by 686; general reduction in services at two facilities; possible loss of \$2.7 million in federal matching funds; possible elimination of Kentucky Educational Television: Education Classroom channel providing educational programs to classrooms.

**Energy and Environment Cabinet:** slower than anticipated ramp up of mine safety expansion.

### **Majority of the Fund Transfer is Questionable**

The largest restricted fund transfer authorized by the General Assembly is from the Public Employee Health Insurance Trust Fund of up to \$50 million and, because of fiduciary responsibilities, it could be legally challenged.

The bill includes language that requires prior documentation that any transfer will not compromise the ability of the Commonwealth to cover its fiduciary responsibilities. It is possible a legal challenge will be made to "test" this transfer due to the fact the fund includes payments by state employees for things like dependant health coverage and health reimbursement accounts. This transfer represents the largest total fund transfer in the proposal. Should, either of these issues result in this transfer not being implemented, other transfer areas would have to be maximized or spending cuts would have to increase to account for the loss of this transfer.

The total Restricted Fund Transfer from other funds within state government is expected to be \$52.6 million dollars. The exact amount and fund will not be known until the Secretary's Order is issued by the Finance and Administration Cabinet and is filed with the

Secretary of State. That is likely to be within a few weeks time and possibly prior to the end of the current session of the General Assembly.

House Bill 143 authorizes the Governor to transfer certain unappropriated Restricted Funds to the General Fund. These could include any unbudgeted money in restricted accounts and is expected to follow the funds identified in the Governor's budget reduction plan. The authorization for fund transfers is on top of the enacted transfers of \$302 million that are currently part of the biennial budget.<sup>3</sup>

Transfers included on the balance sheet provided to legislators include the following:

- SEEK lapse – this is money appropriated to provide for P-12 education that was not needed based on pupil attendance – the base criteria for school district funding. In other words, based on a lower than anticipated student attendance or enrollment rate across the state there was excess money in the SEEK appropriation. This excess will be transferred to the General Fund for use in balancing the budget.
- Heritage Land and Conservation Fund – this is cash on hand for purchases by the Fund. The cash will be moved to the General Fund and the difference will be made up in bonding capacity. In other words, the cash will be used today and purchases will be made with credit to be paid for in the years to come.

As part of the Governor's plan, additional transfers are expected from the Rural Development Trust Fund, the Finance & Administration Cabinet, and the Capital Construction – Contingency Account.

The General Assembly specifically prohibited transfers from coal severance accounts, such as the Local Government Economic Assistance Fund and the Local Government Economic Development Fund – also known as the Multi-County Coal Fund.

### **Increased Excise Taxes Safeguard Priorities This Year - But Not Next Year**

In the current budget year the new revenue from increased taxes will be used to protect state funding for P-12 education and Medicaid. In the second year of the current biennium, FY 2010, the new revenue will be used to replenish the money from the Budget Reserve Trust Fund – or Rainy Day Fund which is also being used to help fill the shortfall in FY 2009. The Rainy Day Fund was already budgeted for general use in the second year of the budget – FY 2010 – so the money “borrowed” from the Rainy Day Fund this year must be replaced for use next year. (See more on the Rainy Day Fund below).

House Bill 144 increases taxes on tobacco and alcohol to raise a projected \$52.2 million in new revenue by June 30, 2009. The increases include additional surtaxes on cigarettes and related products as well as requiring that packaged alcohol be subject to the state's 6% sales tax. The new taxes take effect April 1, 2009. There are two different annual revenue projections associated with these additional taxes so the exact amount gained in FY 2010 is unknown. However, estimates are somewhere between \$158 million and more than \$184 million.<sup>4</sup>

**Tobacco Taxes** - The Governor originally proposed an increase of 70 cents per pack on cigarettes and a doubling of the excise tax on all other tobacco products. This would have increased tax revenues by \$81.5 million. Alternatively, the legislature arrived at an agreement to double the per pack cigarette tax from the current 30 cents to 60 cents and double the excise tax rate on other tobacco products and snuff to 15 cents and 19 cents respectively. Combined, the increased excise taxes are expected to increase tax revenues by \$42.1 million between April 1 and June 30, 2009.<sup>5</sup> In FY 2010 the new taxes on cigarettes and related products are expected to amount to \$106.9 million.

**Alcohol Tax** - Previously, packaged alcohol was exempt from the state sales tax. Instead, alcohol was taxed at a wholesale rate of 11 percent. House Bill 144 removes the sales tax exemption and retains the wholesale tax rate. This measure is expected to increase tax revenues by \$10.1 million by June 30, 2009 and increase FY 2010 revenue by \$51.9 million.

**Use of the “Rainy Day Fund” is Borrowing from FY 2010**

Through House Bill 143 the Governor has the authority to transfer to the general fund up to \$219 million of the Budget Reserve Trust Fund (BRTF) or Rainy Day Fund. The “rainy day fund” exists for the purpose of helping offset lower than projected revenue. Unfortunately, these funds were already appropriated in FY 2010 and therefore the Governor will have to “borrow” from money that is already committed next year.

The BRTF has a current balance of \$226 million dollars, of which \$191 was appropriated in the second year of the current two-year budget – FY 2010. Because the BRTF was appropriated in the second year of the budget, the additional tax dollars in the FY 2010 from tobacco and related products (\$184m) will be deposited into the BRTF fund for use next year (Table 3). Essentially, the additional tax revenue will not be available to help offset a likely revenue shortfall in FY 2010.

	Withdraw	Deposit	Balance
FY 2008	--	\$11.3	\$226.1
FY 2009	\$219.0	\$0	\$7.1
FY 2010	\$191.1	\$184.0	\$0

Source: Presentation to the Joint Session the House and Senate Appropriations and Revenue Committees; January 13, 2009 FY 2008-2009 Balance Sheet provided to the General Assembly by the Appropriations and Revenue staff. February 2009

## **Fiscal Stimulus Money Provides a Short-Term Fix for the Cyclical Downturn - But Not the Structural Deficit**

The General Assembly recognized the American Recovery and Reinvestment Act of 2009 (ARRA) in HB 143 and set guidelines for the use of the fiscal stimulus dollars. Including:

- Funds received from the ARRA are not to be used to permanently expand existing programs or to permanently create any new programs.
- Funds received should be used to restore support to programs that have been cut in FY 2008 and FY 2009.
- General Fund dollars that are not required, due to the receipt of the ARRA, will be transferred to the Budget Reserve Trust Fund.

Now that the ARRA has been signed by the President, the fiscal stimulus money should be available for use in a relatively short amount of time. However, it is unknown if the money will be available quick enough to help restore the impending cuts associated with the recently passed budget reduction bill.

House Bills 143 and 144 do little to mitigate a likely budget shortfall in FY 2010. HB 143 provides only general direction to the Governor concerning his ability to reduce the budget given a similar shortfall next year. The bill recognizes the fiscal stimulus provided by the Federal government as part of the plan to balance the budget in FY 2010 and provides the Governor with specific criteria in utilizing funds to be received through ARRA.

Even though the ARRA dollars come to the state with specific criteria for use, it is possible for the Governor and the General Assembly to maximize the dollars to help prevent budget cuts in FY 2010. Specifically, the ARRA dollars can be used as intended and free up General Fund dollars for use elsewhere in the budget. The extent to which the ARRA dollars can fill a likely FY 2010 budget shortfall is currently unknown.

## **Conclusion**

The approved plan to balance the budget includes millions of dollars in spending cuts and the use of restricted funds, both for the second consecutive year. Though there is no official revenue projection for FY 2010, the economic outlook is not any better. Certainly, the fiscal stimulus will provide some short-term relief. But, as Senate President, David Williams, and many others stated during the committee discussions and floor actions in the respective legislative chambers, the new revenues, budget cuts, and fund transfers enacted by the General Assembly are a “stop gap” measure; comprehensive tax reform is still necessary in the short-term and for the long-term adequacy of the state budget.

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<sup>1</sup> The official budget shortfall as projected by the Consensus Revenue Forecasting Group is \$456.1 million, however according to a balance sheet circulated to legislators by the Appropriations and Revenue staff, the actual budget shortfall that legislators were trying to fill included a Coal Severance Revenue Adjustment of \$19.2 million in the Governor’s proposal and \$36.8 million in HB 143 bringing the total shortfall to \$475.3 and \$492.9 respectively. Legislators passed a budget reduction bill and new tax bill to cover a shortfall of \$492.9 million. See footnote 2.

<sup>2</sup> The total shortfall reflects the General Assembly’s Coal Severance Revenue Adjustment of \$36.8 million. These adjustments allow the coal severance dollars to remain intact and for all coal severance projects to move forward without delay due to funding. See footnote 1.

<sup>3</sup> Office of the State Budget Director; Presentation to the Joint House and Senate Appropriations and Revenue Committees; January 13, 2009. <http://www.osbd.ky.gov/>

<sup>4</sup> The fiscal note that accompanied HB 143 projected additional cigarette tax revenue in FY 2010 at \$106.9 million and the sales tax on alcohol in FY 2010 at \$51.9 million for a total increase of \$158.8 million annually. However, the balance sheet provided to the General Assembly uses a projected \$184.0 million in additional tobacco taxes in FY 2010 that will be available for transfer to the Budget Reserve Trust Fund or Rainy Day Fund.

<sup>5</sup> As stated in the Fiscal Note on HB 144, “FY09 amount includes the one-time floor stocks tax.” This means all inventory on the floor, whether it be at the wholesale or retail level, is also required to carry the increase in tax rate and revenue should be submitted by the seller in full or part at defined intervals by June 10, 2009.