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TERMS TO KNOW**Revenue Shortfall** –

Difference between estimated revenue used to plan the budget and the actual revenue received year end.

Budget Shortfall –

Consists of the revenue shortfall and additional spending obligations that were not provided for in the budget; an example would be an increase in the Medicaid caseload.

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Recurring Budget Shortfalls Require

Balanced Approach for the 2011 – 2012 Budget

Since 2008 the Kentucky budget has faced consecutive revenue shortfalls; each increasing in magnitude as the impact of the national recession ripples through the states. To balance each year's budget, Kentucky's leaders have turned to the rainy day fund; Recovery Act money; transfers of agency funds; and recurring rounds of spending cuts. As the state plans for the 2011-2012 biennial budget, revenues are still projected to be low; the rainy day fund is dry; what little Recovery Act money is left must be used in 2011; and state agency resources are the slimmest they have been in a very long time. This report outlines the impacts of the national recession on Kentucky's revenues and recommends taking a balanced approach in crafting the upcoming budget that includes new revenue measures.

National Recession is the Major Factor Affecting the Budget

In January 2008, at the time Governor Beshear took office, Kentucky was beginning to feel the effects of what would be a prolonged national recession - second only to the Great Depression of the 1930's. Unemployment stood at 5.5 percent and would reach a high of 11.1 percent by the fall of 2009. State revenues from taxes were beginning to decline with an announced budget shortfall of \$265 million that would grow to a shortfall of over \$1 billion by fiscal year 2010. The Commonwealth was only at the beginning of what would be a long economic downturn that would impact individuals and families across the state and have serious effects on Kentucky's ability to provide for the increasing demand on government services that comes with a recession.

The national economy began to slow in 2007 and no one could predict how long and deep the recession might be. Kentucky typically lags much of the rest of the nation with respect to economic activity, so the state was only just beginning to notice the downturn in the economy in 2008 – when the legislature was building the budget for FY 2009 and FY 2010. At the time, the difference between the actual tax revenue and the estimated revenue amount used to build the 2008 budget would be negative \$214.8 million (Chart 1).¹ The revenue decline in 2008 was driven by very slow growth in the sales and use tax

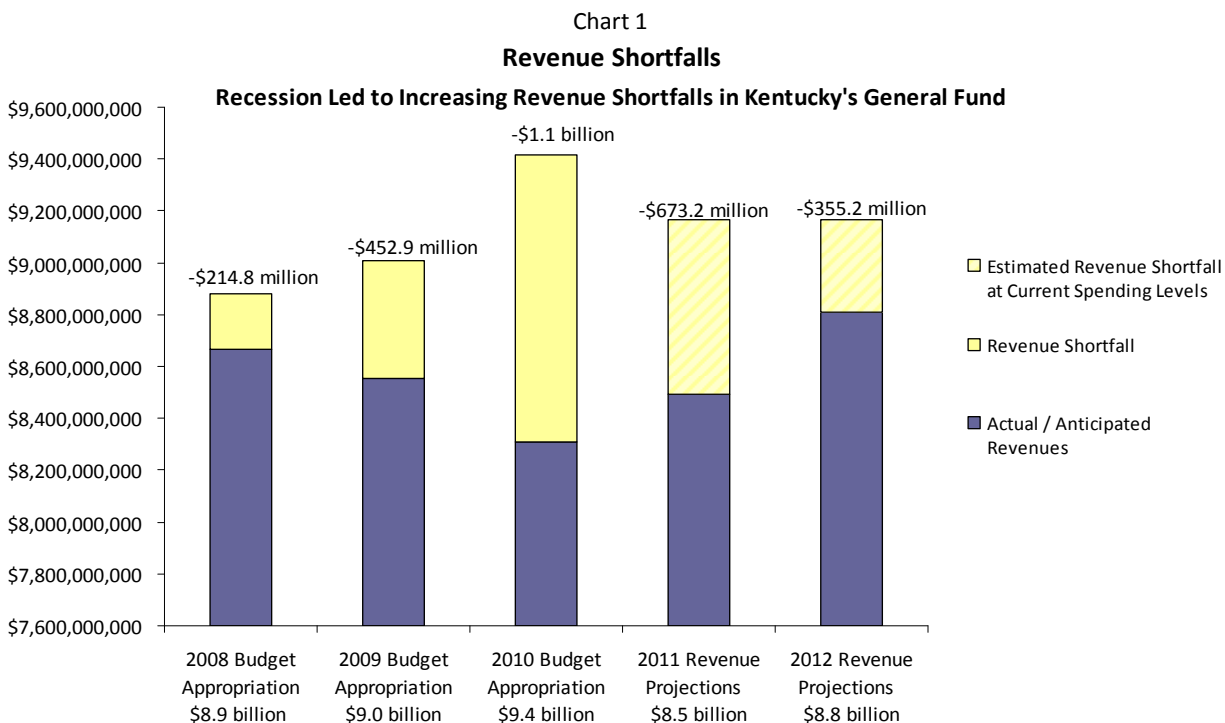
receipts and the corporation income tax receipts. At the time, individual income tax receipts were still strong and unemployment was just beginning to rise.

Official revenue projections released in January of 2008 for budget years 2009 and 2010 expected continued growth but at a slower rate than previous planning estimates would have suggested. No one foresaw the stalling of the economy that would take its toll on the biennial budget that was being worked out in the legislature.

Just a few months into the FY 2009 budget, in the fall of 2008, it became clear that the nation was in for a sustained economic downturn. States across the nation were projecting significant revenue shortfalls that would have to be remedied through budget cuts, new revenue, or some combination of the two.

In FY 2009, Kentucky's actual revenue shortfall, at year end, was \$452.9 million (Chart 1).² The shortfall was driven in large part by significant declines in the individual income tax and the corporation income tax, and continued slow growth in the sales and use tax receipts. In the spring of 2009, unemployment in Kentucky reached 10 percent.

Now, midway through FY 2010, the budget has been reduced twice to account for a projected \$1.1 billion revenue shortfall (Chart 1).³ Individual and corporation income tax receipts continue to come in much lower than originally projected in 2008 and sales and use tax receipts have been steadily declining since the beginning of the fiscal year. Unemployment has been holding steady at around 11 percent.

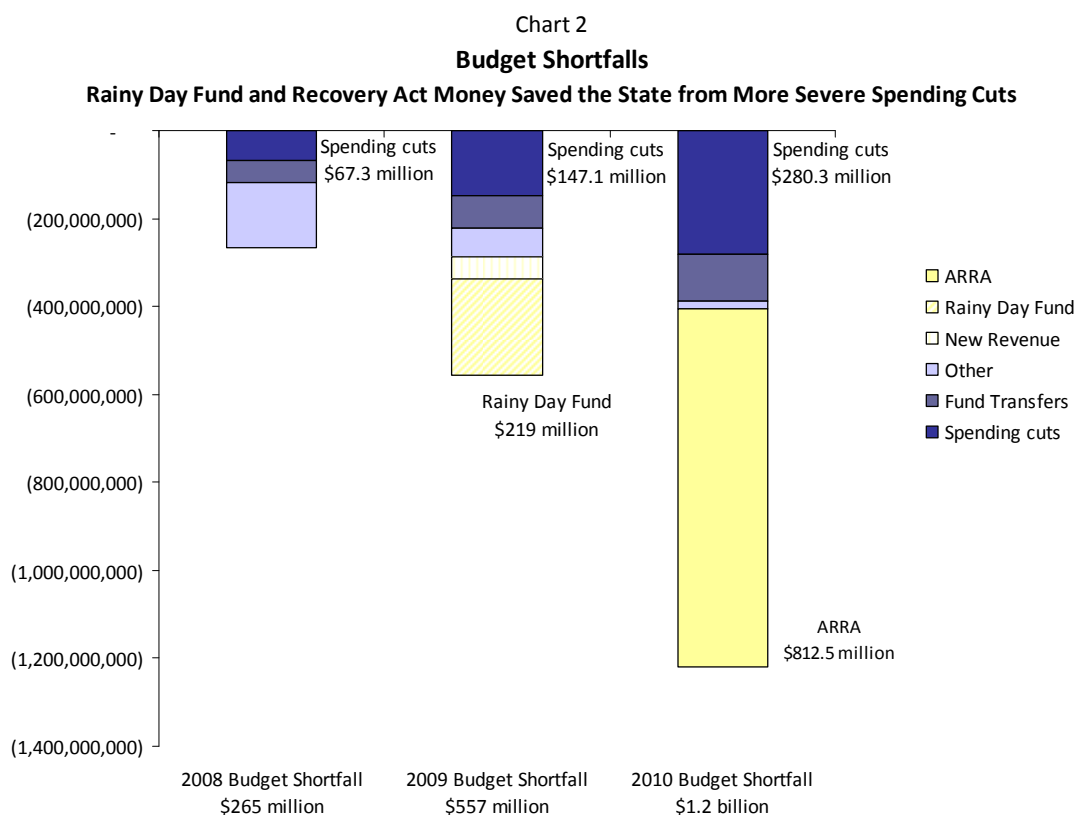


Source: Compiled from Office of the State Budget Director, General Fund Budget Reduction Orders

Balancing the Budget and Protecting Priorities Proves Difficult

As the revenue shortfall grew, it became increasingly difficult to balance the budget. In order to eliminate the resulting budget shortfalls, policymakers continually increased spending cuts and transferred agency funds to the general fund. In addition to cuts, policymakers used all of the Budget Reserve Trust Fund (rainy day fund), raised the cigarette tax, and used roughly 70 percent of the Recovery Act money to fill the gaps.

In 2008, the budget shortfall of \$265 million was remedied with surplus money from 2007, spending cuts, and fund transfers (Chart 2).⁴ The governor required some state agencies to cut spending midyear by up to 3 percent. The Personnel Cabinet was cut by more than 20 percent. As a result of the spending cuts and efforts to cut costs, the state’s workforce was cut by more than 2,000 employees.⁵



Source: Compiled from Office of the State Budget Director, General Fund Budget Reduction Orders

In 2009, the total budget shortfall of \$557 million was remedied with spending cuts, fund transfers, increased tobacco and alcohol taxes, and the rainy day fund (Chart 2).⁶ Approximately 30 percent of the gap in the budget was filled through direct spending cuts to most areas of state government; ranging from less than 1 percent to a high of 11 percent in the Finance and Administration Cabinet. Just over 10 percent of the gap was filled with new revenue from increasing the cigarette tax, and the rest of the gap was filled with fund transfers, including use of the Budget Reserve Trust Fund, and the use of \$63.2 million from Medicaid funds. Today the balance in the Budget Reserve Trust Fund, also known as the rainy day fund, is \$0.

In 2010, the impact of an anticipated budget shortfall of \$1.2 billion has been mitigated with money from the Recovery Act (ARRA). Still, the large revenue shortfall also required significant spending reductions and fund transfers (Chart 2).⁷ To date, officials used \$812.5 million of the Recovery Act money to close the budget gap in FY 2010. Of all fifty states, Kentucky used the third largest percentage of federal stimulus money to close the gap. While this was the intent of the aid, the state has significantly less money to work with in 2011.⁸

Crafting the 2010-2012 Biennial Budget Requires a Balanced Approach

At their December meeting to generate official revenue estimates for Fiscal Years 2011 and 2012, the group of economic experts, known as the Consensus Forecasting Group, determined revenue growth is likely to recover over the course of the two-year period, but will do so slowly. The agreed upon revenue estimate for FY 2011 is \$8.5 billion and the estimate for 2012 is \$8.8 billion.⁹ State budget records show Kentucky maintained an average spending level of \$9.16 billion from 2008 to 2010 – after spending reductions. At this flat level of spending the estimated shortfalls for the next two years are \$673.2 million and \$355.2 million, respectively (Chart 1). As legislators begin crafting the next biennial budget, the Budget Reserve Trust Fund is empty and what little is left of the Recovery Act money must be used in 2011.

Underlying the economic downturn is the fact that Kentucky's revenue structure is outdated. State revenues are not growing at a pace that covers the normal increase in costs based on inflation and increase in demand for services like public education, state roads, and access to healthcare. If this isn't addressed, problems with the revenue structure will persist and make it increasingly difficult for Kentucky to sustain the public programs and infrastructure we need, even after the recession is over. Enacting a balanced approach to the economic problems, as outlined below, would result in significant new revenue to balance the next two budgets and move the Commonwealth toward a more structurally sound revenue structure that will meet our needs in the future.

Components of a Balanced Approach:

A balanced approach to closing the projected budget shortfall will update the tax code to make it more modern and responsible, make government more efficient and effective, and increase accountability and transparency to the public.

1. Update the Tax Code to make it more Modern and Responsible.

- **Balance the income tax structure to ensure adequate revenue.** Those making between \$8,000 and \$75,000 a year are taxed at the same rate of 5.8 percent. Those making more than \$75,000 are taxed 6 percent. Adding a top tax bracket of 7 percent for Kentuckians earning more than \$250,000 annually would increase revenue and ensure Kentucky's struggling families are not bearing more of a tax burden than Kentucky's wealthiest.
- **Recognize the changing face of business.** Out-of-state businesses operating in Kentucky have a distinct advantage over Kentucky-owned businesses. Multi-state corporations can choose in which state they pay taxes. If Kentucky required these multi-state corporations to

pay corporate income taxes in Kentucky by adopting combined reporting, like 25 other states, the Commonwealth would increase revenue from corporations and ensure home-state corporations compete on a level playing field with multi-state corporations.

- **Account for the new ways we spend money.** The sales tax base reflects 1950 spending levels. More people spend their income on untaxed services than on taxed goods – leaving more than 40 percent of consumption untaxed. Broadening the base of the tax structure to include selected services would increase revenue and bring the sales tax structure back in line with growth in the economy.

2. Make Government More Efficient and Effective.

- **Ensure spending is in line with the state’s priorities for the future.** This fall, the Kentucky Chamber issued a report, “A Leaky Bucket,” outlining their reasons and solutions for the Commonwealth’s budget crisis. The report explains that spending priorities have shifted away from education and toward paying for increases in Medicaid, public employee benefits, and corrections systems.¹⁰ The report highlights the need to prioritize state spending – particularly during periods of economic declines. Taking a hard look at spending priorities, fits into a balanced approach to fixing the Commonwealth’s current revenue problems and provides for long-term financial stability.
- **Evaluate the effectiveness of tax expenditures.** In 2010, Kentucky can expect to forfeit \$6.9 billion in various taxes because of tax breaks extended to several different businesses in the Commonwealth. These tax breaks amount to significant revenue losses for Kentucky. Policymakers should evaluate these expenditures to ensure the benefit of the tax break outweighs the cost.¹¹

3. Increase Accountability and Transparency to the Public.

- **Require routine preparation of a current services budget.** To fully understand whether revenues are keeping pace with economic growth and the needs of Kentuckians, the state should publish a budget that reflects the cost necessary to maintain current services for the population. A “current services budget” or “continuation budget” with planning estimates would help to clearly identify if revenue levels are adequate and sufficient to cover the costs of established programs today and for the future.

The crushing national recession continues to wreak havoc on Kentucky. As a result, the needs of families are growing at the same time that the state has fewer resources to help them. The problem presented by the recession is simply too big to solve with only one approach. Spending cuts alone will hurt families who are already struggling to stay afloat. In addition, relying heavily on cuts hurts Kentucky’s investments in areas like education, transportation, and workforce development and jeopardizes our future growth as a state. It is time policymakers adopt a balanced approach – one that includes revenue increases – to ease the economic troubles of the Commonwealth.

¹ The documented revenue shortfall here is the difference between the projected revenue for 2008 of \$8,879,172,400 used to balance the budget as originally passed and the actual revenue receipts of \$8,664,336,663 at year end. Kentucky Secretary of State, “General Fund Budget Reduction Order 08-01”. Available at <http://www.sos.ky.gov/executive/journal/>. Accessed January 2010 and Office of the State Budget Director, “General and Road Fund Receipts Reported for Fiscal 2008.” Available at <http://www.osbd.ky.gov/publications/taxreceipts.htm>. Accessed January 2010.

² The documented revenue shortfall here is the difference between the projected revenue for 2009 of \$9,005,737,000 used to balance the budget as originally passed and the actual revenue receipts of \$8,552,851,513 at year end. The 2009 actual revenue included additional General Fund revenues as a result of HB 144. Office of the State Budget Director, “General Fund Budget Reduction Order 09-01” and “General Fund Budget Reduction Order 09-02”. Available at <http://www.osbd.ky.gov/>. Accessed January 2010.

³ Office of the State Budget Director, “General Fund Budget Reduction Order 10-01” and “General Fund Budget Reduction Order 10-02”. Available at <http://www.osbd.ky.gov/>.

⁴ Kentucky Secretary of State, “General Fund Budget Reduction Order 08-01”. Available at <http://www.sos.ky.gov/executive/journal/>. Accessed January 2010.

⁵ “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.

⁶ Office of the State Budget Director, “General Fund Budget Reduction Order 09-01” and “General Fund Budget Reduction Order 09-02”. Available at <http://www.osbd.ky.gov/>. Accessed January 2010.

⁷ Office of the State Budget Director, “General Fund Budget Reduction Order 10-01” and “General Fund Budget Reduction Order 10-02”. Available at <http://www.osbd.ky.gov/>.

⁸ Fehr, Stephen C. July 27, 2009. “Tracking the recession: Lawmakers dreading end of stimulus dollars.” Available <http://www.stateline.org/live/details/story?contentId=415153>. Accessed August 2009.

⁹ Office of the State Budget Director, “2010 – 2012 Official CFG Revenue Estimates.” Available at <http://www.osbd.ky.gov/>. Accessed January 2010.

¹⁰ Kentucky Chamber. November 2009 “Leaky Bucket.” Available <http://www.kychamber.com/Dockycc1/governmentaffairs/LeakyBucket/LeakyBucketWhitePaper.pdf> Accessed January 2010.

¹¹ Blackford, Linda and John Cheves. January 3, 2010. “Tax breaks are budget loophole.” Herald-Leader. Available http://www.kentucky.com/latest_news/story/1079832.html. Accessed January 2010.

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