

Money Matters

Two-Year Budget Approved by General Assembly; Governor Vetoes \$370 Million in Capital Projects

Introduction

After failing to adopt a biennial budget prior to the beginning of the budget period in 2002 and again in 2004, the 2006 Kentucky General Assembly passed a spending plan on time, allocating over \$40 billion for all aspects of state government. Appropriations of “state general funds,” those dollars collected through the regular taxing function of state government, amount to nearly \$16 billion over two years. The remaining money comes from federal funds, various fees and licenses, the national tobacco settlement agreement, and road funds (gas tax collections).

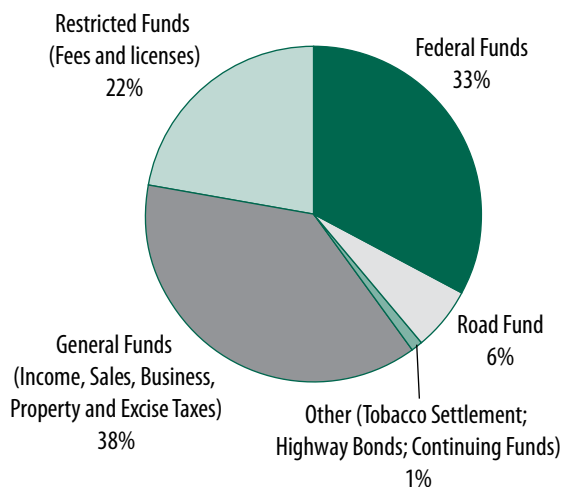
The General Assembly adjourned *sine die* on April 12th, after using all 60 legislative days constitutionally allowed. Governor Fletcher was free to use his line item veto authority without concern about legislative override. On April 24th, the Governor vetoed \$370.3 million worth of capital construction projects saving \$11 million in state general funds annually for debt service. The Governor’s veto eliminated 15.8 percent of the bond projects included in the legislature’s final budget.

Where Does the State’s Money Come From?

Just like a family’s budget, the state budget is a plan for both income and spending. For state government, the income sources are primarily taxes, funds from the federal government, and some fees.

The largest category of income is called the *state general fund* and it is made up of individual and business income taxes, sales taxes, state property taxes, and a variety of smaller tax sources, including tobacco, inheritance, alcohol, and coal severance taxes. (See Chart 1.) It is the general fund over which the legislature has the most control – through both setting taxing policy and determining funding priorities. Federal funds, restricted funds, and the other funds are largely earmarked for certain uses.

Chart 1:
Kentucky Revenue Sources: FY 2007 and 2008



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Support

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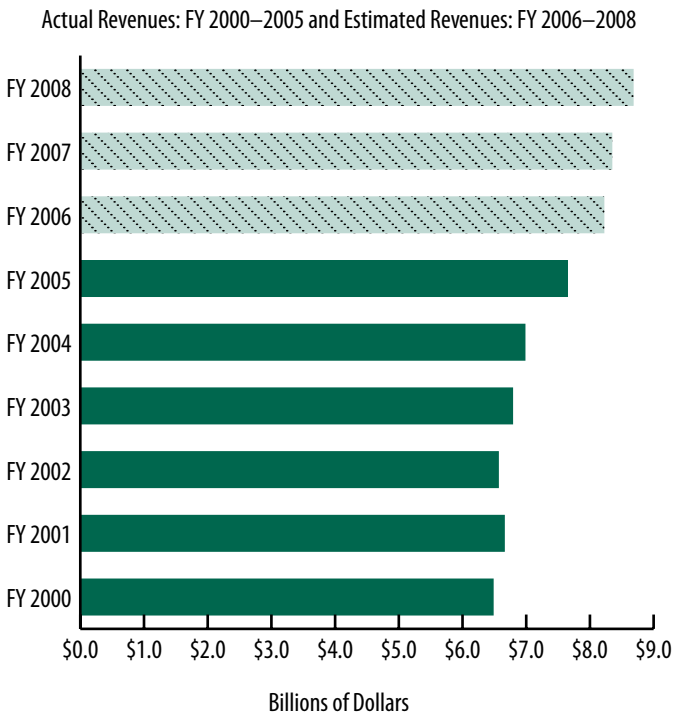
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The law requires that a group of economists appointed by both the executive and legislative branches of government meet to make an official consensus revenue estimate for the coming legislative budget session. Both the Governor’s budget recommendations and the budget approved by the legislature are required to balance to the consensus estimate and any additional changes in law made during the legislative session. The consensus forecast officially adopted December 22, 2005, called for revenue growth (over the previous year) of 7.5 percent in FY 2006, 1.5 percent in FY 2007 and 4.0 percent in FY 2008.

Chart 2 shows the size of the state general fund since 2000; the numbers for FY 2006–2008 are the official December estimates. After four years of essentially no growth, with a nearly unprecedented decline in revenues between FY 2001 and FY 2002, revenue growth recovered in FY 2005, but is predicted to slow again in the next two years.

Chart 2:
Kentucky General Fund Revenues



How Are the Budgeted Funds Spent?

The legislature approves three separate budgets – one each for the legislative, judicial, and executive branches of government. While the importance of the legislative and judicial branches of government is unquestionable, their size pales in comparison to the executive branch of government. As a percent of the state general fund operating budget, the legislative branch budget is one half of one percent and the judicial budget (for all courts from traffic and small claims to the Ken-

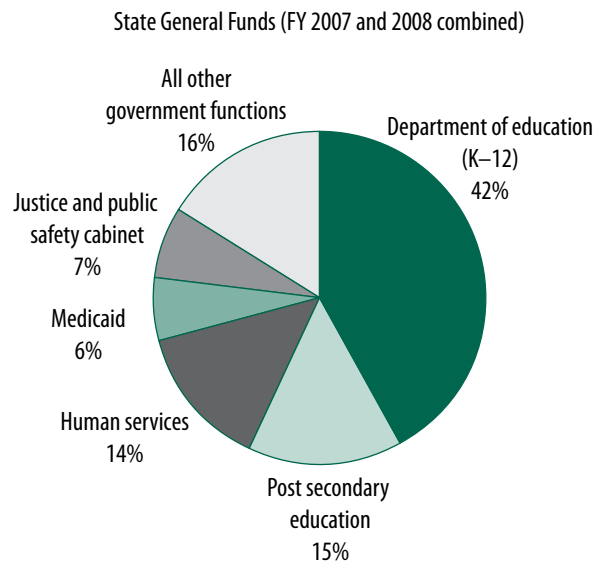
tucky Supreme Court) is about 3 percent, leaving 96.5 percent for the executive branch of government.

The largest single area of state spending in the executive branch budget is public education (K–12). (See Chart 3.) The Department of Education, through which state funding for public schools flows, makes up 42 percent of the executive branch budget. Additional funding for public schools comes from federal funds and property and other taxes collected at the local level. Following the 1989 court decision that prompted the Kentucky Education Reform Act (KERA), state funding is allocated to ensure equitable per pupil funding regardless of the relative wealth of individual school districts and their ability to generate sufficient revenues.

The second largest expenditure area is post secondary education. Fifteen percent of the executive branch budget supports this area. It includes funding for the state’s four-year public colleges and universities and the Kentucky Community and Technical College System (KCTCS), as well as student financial assistance.

Human services and Medicaid (health) services, both administered by the Cabinet for Health and Family Services, make up 14 and 6 percent, respectively, of the executive branch state general fund appropriations. Medicaid would be a larger piece of the budget pie if all funds were included, as the approximately \$1 billion in state general funds are matched by nearly \$4 billion in federal funds. The Medicaid program provides health insurance for over 700,000 Kentuckians who have no other access to care due to their disabilities, age, or income. When Medicaid is separated from the Cabinet’s budget, a broad array of human services and other health services remain, including public health and mental health.

Chart 3:
General Operating Budget: Executive Branch



The next largest cabinet budget is the Justice and Public Safety Cabinet, which includes corrections, juvenile justice, the public defender system, state police, and support for local jails. The size of this budget has grown given the increased number and cost of inmates in jails and prisons. The general fund budget allotment increased by 41 percent from the enacted FY 2000 budget to the enacted FY 2008 budget. Spending in this cabinet is 7 percent of the overall executive branch general fund spending.

The category of all other executive branch spending includes transportation, economic development, environmental and public protection, state government personnel, education cabinet (libraries, KET, and other educational agencies), as well as administrative functions such as finance, revenue, the governors' office, the attorney general and other constitutional officers. Each area of this remaining spending is a relatively small slice of the budget pie. For instance, the Cabinet for Environmental and Public Protection, which includes environmental protection and natural resources, mining regulation, the department of labor, horse racing regulation, and the department of insurance, is the next largest cabinet budget, but is just a little more than one percent of the state general funds budgeted to the executive branch.

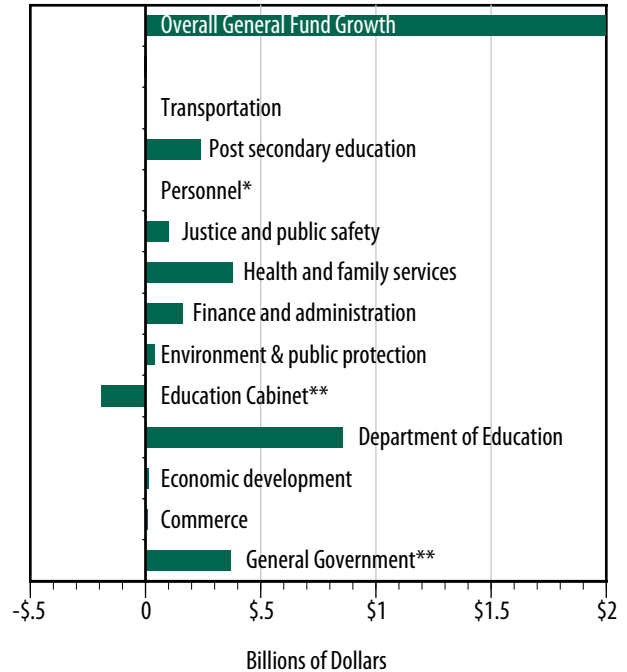
Who Were the Winners and Losers in the 2007–2008 Budget?

The single biggest winner of new dollars in the biennial budget was the Department of Education (K–12 schools), with nearly \$1 billion in additional funding out of the total \$2 billion additional general fund dollars. All cabinets within the executive branch, with the exception of the Education Cabinet, received increased general funds. (See Charts 4 and 5.) Two major programs, the teachers' retirement system and the school facilities commission, were moved from the Education Cabinet to General Government and account for the lion's share of the changes in those two budget areas. The Cabinet for Health and Family Services is the next biggest winner of new funding, with nearly \$400 million additional over the next biennium. Post secondary education, recovering from major budget cuts in earlier years, received new general funds for the two-year period in the amount of \$241 million.

The figures for Charts 4 and 5 were calculated by using the enacted appropriations for the 2006–2008 biennium as passed by the 2006 General Assembly in HB 370. The 2004–2006 biennium calculations include the appropriations for FY 2005 as enacted by the 2005 General Assembly in HB 267 and the revised appropriations for FY 2006 as enacted by the 2006 General Assembly in HB 370. Because of revised revenue estimates, an additional \$56 million in general funds was available to be added to FY 2006 appropriations. Some cabinets' budgets were actually revised downward in order to

Chart 4: Winners and Losers

Dollar Change in General Fund Enacted Appropriations, 2006–2008 Biennium over 2004–2006 Biennium



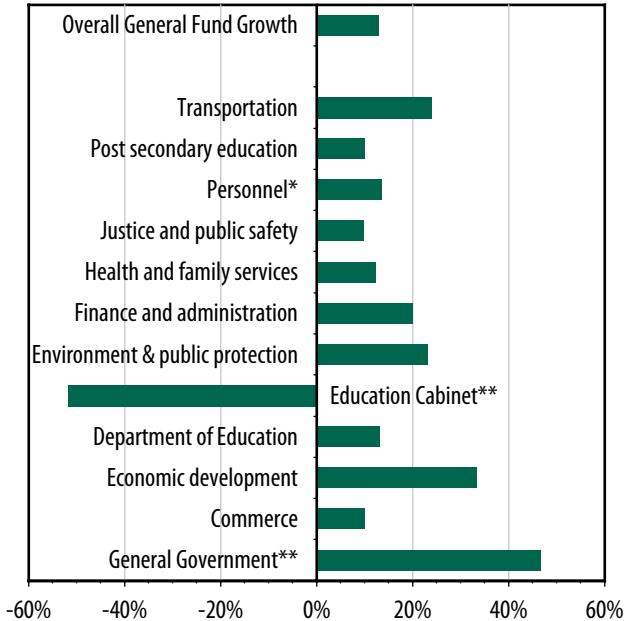
*State government employee health insurance costs moved from Personnel Cabinet to personnel expenditure categories in all cabinets. Funding for all state employees' salary increments included here.
 **School facilities commission and teachers' retirement system moved from Education Cabinet to General Government.

provide for the \$95 million dollars allotted to the Cabinet for Health and Family Services, almost all of which went to Medicaid in order to retain the same array of services for a growing number of beneficiaries. The Department of Education, for instance, lost \$6.6 million and post secondary education was cut by \$17 million.

Chart 5 identifies winners and losers during the 2006 Kentucky General Assembly budget process by examining the *percentage increase* in each major program area. The percentage change provides a more meaningful look at how well the program is able to meet increasing costs and also expand current services to new areas or begin entirely new services. Disregarding General Government, which received two major programs transferred from the Education Cabinet, the largest percentage of increased funding was provided to the Cabinet for Economic Development. Transportation received the second highest percentage increase in general funds. This increase includes the debt service for the significant amount of highway bonding authority approved by the 2006 General Assembly. (Debt service is the annual payment of interest on

Chart 5:
Winners and Losers:

Percent Change in General Fund Enacted Appropriations,
2006–2008 Biennium over 2004–2006 Biennium



*State government employee health insurance costs moved from Personnel Cabinet to personnel expenditure categories in all cabinets. Funding for all state employees' salary increments included here.

**School facilities commission and teachers' retirement system moved from Education Cabinet to General Government.

multi-year bonds sold to finance large capital projects, such as roads or new construction.)

While the Department of Education received the largest amount of new funding for K–12 education, it did not receive the largest percentage increase. The increase for state funding of K–12 education was 13.3 percent over the previous biennium, nearly identical to the overall general fund growth of 13 percent. One might observe that schools received a proportional share of additional state funding, but no more. The smaller cabinets for Finance & Administration and Environment & Public Protection received relatively large percentage increases, exceeding the overall general fund growth.

The Cabinet for Health and Family Services lagged a little behind the overall general fund growth with a biennial increase of 12.3 percent in general fund appropriations.

Balancing the Budget Required a Few Budget Tricks

While the state constitution requires the budget to be balanced, it is worth noting that in the second year of the biennium, \$5 million is taken from the budget reserve trust fund to achieve the required balance. In addition, the budget transferred some \$218 million from funds that are not part

of the general fund. These transfers took funds from accounts designated for other purposes or emptied out accounts that accumulate over time. Unlike taxes that are collected each year (and generally grow with the economy), these funds will in all probability not be available to balance future budgets, at least not to the extent they were used to balance the budget this year. With decreased future availability of transferred funds, subsequent biennial budgets will be more solely dependent upon tax revenues. Enacted tax changes will predictably depress business tax revenues and all tax revenues are subject to the strength of the state and national economies.

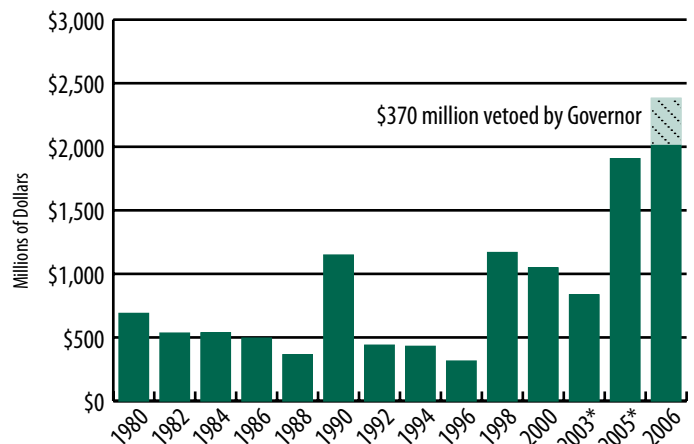
It is regular budgeting practice to have an undesignated balance at the end of each year for unexpected expenses and for carry-over to the next year. At the end of FY 2007, the undesignated amount is \$435 million (down from \$544 million in FY 2006) and by the end of the biennium, the undesignated balance will be just a little over \$10 million. Before Governor Fletcher's veto of projects totaling \$370 million thus eliminating general fund debt service of about \$11 million, the undesignated balance left by the legislature was not even \$200,000.

The budget passed by the General Assembly also assumes revenue from at least three sources that may not materialize:

- \$55 million from non-participating cigarette manufacturers' voluntary assignment of escrows from the Master Settlement Agreement with cigarette makers;
- \$20 million in "economic development growth impact funds;" and
- \$7 million in lottery receipts beyond the consensus projection.

In addition, the budget mandates \$78 million in executive branch "efficiencies" as well as \$4 million in judicial

Chart 6:
Debt Authorized by Sessions of the Kentucky General Assembly



*Budgets adopted one year later than normal.

branch “efficiencies.” In other words, the legislature did not identify specific budget cuts, but instead mandated that the governor and the judiciary find savings in these amounts. The Governor’s staff responded that since taking office in 2003, considerable efficiencies have been implemented and it is unclear whether additional cost savings can be made without doing harm to state services. For instance, slowdowns in hiring social workers, state police, or other employees would result in savings, but at what cost?

Authorized Debt Hits New High

The 2006 Kentucky General Assembly made the largest capital investment in the history of the Commonwealth. However, bonds issued for highway construction and building projects at universities, state parks, and the like carry annual debt service (or interest) obligations for the life of the bond. The annual debt service payments become an ongoing obligation for the general fund and are necessarily budgeted first.

Chart 6 shows that even with Governor Fletcher’s veto of \$370.3 million of the \$2.4 billion authorized by the legislature, the amount of debt authorized in 2006 is the largest in the state’s history.

About half of the vetoed projects were to be financed with general fund bonds. The remaining projects were supported by bonds financed with agency funds, such as university dormitories and parking structures financed by student fees. Savings in annual debt service to the general fund for the vetoed projects was \$11.6 million.

Thirty-three of the 43 specific projects vetoed by the Governor were related to universities, the community and technical college system, or the Council on Postsecondary Education. Projects that related to children under 18 include two technology projects in the Kentucky Department of Education (\$18 million) and a \$2 million bond project at Brooklawn in Louisville, a facility that provides a range of services for children who are abused or neglected.

Table 1: Department for Community Based Services Budget Highlights

Department for Community Based Services	FY 2006 (July 2005–June 2006)	FY 2007 (July 2006–June 2007)	FY 2008 (July 2007–June 2008)
All Fund Sources:			
General Fund (Tobacco)	7,259,400	6,970,400	7,420,400
General Fund	307,125,300	316,033,500	341,729,700
Restricted Funds	122,699,400	133,505,800	136,301,300
Federal Funds	514,614,000	511,118,200	523,230,400
Continuing Funds	127,400		
Total	\$951,825,500	\$967,627,900	\$1,008,681,800
Base Level Budget Total: (all fund sources)	\$946,925,200	\$921,346,100	\$924,406,100
Additional Budget Total: (all fund sources)	\$4,900,300	\$46,281,800	\$84,179,700
Additional Budget Items: (all fund sources)			
Increase out-of-home placement availability	4,900,300	32,427,900	55,771,900
Foster parent rate increases		0	8,833,800
Raise private child care (residential) rates		0	3,428,500
Performance incentives for hard to place youth		0	1,142,800
Foster youth transitional assistance		1,000,000	1,000,000
Staff technology improvements		1,576,400	1,300,000
Increase state supplementation for SSI		0	277,500
EBT for food stamps		1,270,500	1,925,300
Child care subsidies		(federal only) 3,757,000	(federal only) 3,864,900
Weatherization		(federal only) 900,000	(federal only) 900,000
LIHEAP		(federal only) 4,800,000	(federal only) 4,800,000
KY Baptist Children’s Homes youth center		150,000	150,000
Save the Children rural literacy project		250,000	250,000
Methodist Children’s Home		150,000	150,000
Debt service for Home of Innocents’ bonding		0	385,000

Budget Highlights: Department for Community Based Services

The Department for Community Based Services (DCBS) is the primary administrative unit providing services to children who are abused or neglected. DCBS workers throughout the state investigate reports of child abuse or neglect and then coordinate necessary services to children and families. When out-of-home care is necessary to protect children, DCBS contracts with foster parents and private agencies for residential services.

DCBS was allotted over \$960 million in total funds in FY 2007 and \$1 billion in FY 2008, including \$130 million in

“new funds” over the biennium. New funding is designated to increase the numbers of children served in out-of-home care as well as to increase the rates paid to foster parents and residential services providers in the second year of the biennium. Despite recent attention to high caseloads for DCBS workers, no funding was provided to increase staff. An increase of nearly \$2 million was designated for new computers, digital cameras and printers for adult and child protection workers.

Despite the good news in additional funding, the budget approved contains a reduced “base level” allocation. In other words, the allotted funds to continue regular services were reduced at the same time increased new funds designated for particular purposes were approved. Consequently, DCBS will

Table 2: Medicaid Budget Highlights

Medicaid Benefits	FY 2006 (July 2005–June 2006)	FY 2007 (July 2006–June 2007)	FY 2008 (July 2007–June 2008)
All Fund Sources:			
General Fund	993,496,600	1,001,577,900	1,041,097,000
Restricted Funds	404,836,900	383,400,500	388,805,100
Federal Funds	3,170,763,000	3,100,931,200	3,212,280,900
Continuing Funds	(3,264,000)	876,700	2,387,300
Total	\$4,565,832,500	\$4,486,786,300	\$4,644,570,300
Base Level Budget Total: (all fund sources)	\$4,277,566,600	\$4,222,990,200	\$4,213,355,600
Additional Budget Total: (all fund sources)	\$288,265,900	\$263,796,100	\$431,214,700
Additional Budget Items: (all fund sources)			
Support inflation, increased utilization, Provider increases, case mix changes	288,265,900	247,444,600	399,711,600
Supports for community living		6,187,500	21,312,500
Increase adult day care rates		2,295,100	2,301,100
Expand school-based health services		819,700	821,800
Expand services for ventilator-dependent persons		3,278,700	3,278,300
Expand breast and cervical cancer program		491,800	493,100
Expand acquired brain injury program (plus 65)		3,278,700	3,287,300
Medicaid Administration			
	FY 2006 (July 2005–June 2006)	FY 2007 (July 2006–June 2007)	FY 2008 (July 2007–June 2008)
All Fund Sources:			
General Fund	34,403,700	37,882,400	36,441,700
Restricted Funds	18,306,000	14,075,000	13,080,000
Federal Funds	78,246,600	56,945,500	46,579,400
Continuing Funds			
Total	\$130,956,300	108,902,900	96,101,100
Base Level Budget Total: (all fund sources)	\$89,486,400	\$63,361,600	\$61,392,400
Additional Budget Total: (all fund sources)			
Contracts with administrative agent, Pharmacy benefits administrator, Information systems	\$41,469,900	\$45,541,300	\$34,708,700

be forced to reduce spending in some areas to accommodate the increases in other areas. Details are provided in Table 1.

Budget Highlights: Medicaid

Medicaid, the federal/state health insurance program for individuals who are uninsured due to poverty, disability or age, provides health care for about 700,000 people in any given month. It is by far the biggest program within the budget of the Cabinet for Health and Family Services, totaling nearly \$5 billion when state and federal funds are combined.

Since the end of 2005, Kentucky has been working with the federal government to make broad changes in the Medicaid program. The new KYHealth Choices program is designed to save money (such as a four-prescription limit and co-payments for some services) and to emphasize more preventive and community-based services. After Congress passed the Deficit Reduction Act in early 2006, Kentucky submitted state plan amendments to implement the new program. Medicaid administrators say the changes will save \$1 billion during the next seven years (over what the program would have cost without these changes) and prevent wholesale cuts in program benefits or recipients.

Despite receiving additional funding in the current year and the two years of the biennium, the overall Medicaid benefits budget actually decreases by \$79 million, or 1.7 percent, between FY 2006 and FY 2007. While base level funding declines again in FY 2008, additional funds of \$431 million provide the bottom line total a boost of 3.5 percent over FY 2007 appropriations. Additional funding was also provided within the Medicaid administration budget for contracts for an information system, pharmacy benefits administration, and a Medicaid administrative agent.

Other expansions in Medicaid benefits include additional community living placements for persons with developmental disabilities and specialized care for persons with acquired brain injuries and those who are ventilator dependent. Table 2 provides highlights of the Medicaid budget.

Budget Highlights: Other Cabinet for Health and Family Services Programs

Within the Cabinet for Health and Family Services, several other program expansions were enacted that will add services for children and their families. These include the following:

- \$6,268,000 in FY 2007 for upgrades to the TWIST data system for child protective services;
- \$2,028,200 in federal funds for an eight-county children's mental health initiative in Northern Kentucky;
- \$50,000 each year to support the Boys and Girls Club of Kentucky;
- \$50,000 each year to support the state lead poisoning prevention program;

- \$90,000 each year to support a multi-generational osteoporosis prevention and education program (critical bone mass is set in adolescence);
- \$1,000,000 each year (\$66,000 per district) for additional support of rape crisis centers;
- \$1,000,000 each year to support child advocacy centers – \$32,000 per regional center and funds for a half-time forensic interviewer in each district;
- \$677,500 each year (\$45,000 per district) for additional support of domestic violence services;
- \$1,250,000 in FY 2007 and \$2,000,000 in FY 2008 to establish a grandparent assistance program for those under 150 percent of poverty level who are primary caregivers of grandchildren; and
- \$4,567,800 over the biennium to increase funding for family resource and youth service centers (FRYSCs) and an additional \$3,433,800 to fund FRYSCs in 54 additional eligible schools.

Other expansions not as directly related to children include adult mental health services, a Healthy Kentucky initiative, aging services, diabetes and epilepsy treatment, dementia treatment, and increased assistance to health departments.

The base level budget for the entire Cabinet decreases from FY 2006 to FY 2007 and again in FY 2008. With the addition of line items for expanded or new programs, the overall budget still dips in FY 2007 but recovers in FY 2008, ending the biennium with an overall 2.4 percent increase from FY 2006 to FY 2008. The challenge for state government administrators will be to meet continuing expenses and provide for the legislatively mandated expansions within such a small growth factor for the biennium.

Budget Highlights: Department for Juvenile Justice

The budget for the Department for Juvenile Justice (DJJ) increases some each year of the biennium. Total funding increases 3.6 percent in FY 2007 and another 1.3 percent in FY 2008. All new funds are state general funds. The only additional money provided is \$50,000 each year for the Mary Kendall Home in Owensboro, Kentucky.

Budget Highlights: Kentucky Department of Education (K-12 schools)

The Kentucky Department of Education (KDE), which provides the state support for public schools across the Commonwealth, was the biggest winner of new general fund dollars. KDE received \$860 million additional general funds in the FY 2007–2008 budget period over the previous two years. (See Chart 4, Winners and Losers.) The Department's increase was 43 percent of the overall growth in general fund dollars for the new budget period.

Given the relatively large amount of new state general funds, the overall KDE budget grew by 3.0 percent from FY 2006 to FY 2007 and by 7.5 percent from FY 2007 to FY 2008. (See Table 3.) Federal funding was projected to remain essentially steady across the biennium.

The budget increased salaries for teachers, added instructional school days, and expanded a number of programs. Key budget increases in the KDE budget were:

- \$23.5 million each year for increased preschool funding – family income eligibility was increased from 135 to 150 percent of poverty;
- Funding for teacher salary increases of 2 percent in FY 2007 and \$3000 in FY 2008 – classified staff will receive 2 percent in FY 2007 and 5 percent in FY 2008;
- \$9.5 million in FY 2007 and \$12.5 in FY 2008 for expanded funding for the Read to Achieve program;
- \$1.2 million in FY 2007 and \$1.4 million in FY 2008 for the Collaborative Center for Literacy Development;
- \$3 million increase in mathematics program funding in FY 2008;
- \$7.7 million for debt service for \$69.25 million in bonds for new technology programs;
- \$250,000 each year to expand the Save the Children rural literacy program;
- \$430,000 in FY 2008 for the Partnership for School Success program to increase parental and community involvement in K–12 education;
- \$250,000 each year in additional funds for the Safe Schools program; and
- \$500,000 each year in additional funds for the education of children in state agency programs (either children committed to DCBS or DJJ).

Conclusion

After twice failing to enact biennial budgets on time, the 2006 General Assembly finished its work and sent to Governor Fletcher a balanced, albeit barely balanced, budget. Some legislators proclaimed the budget to be the best since 1990 and passage of the Kentucky Education Reform Act because of the additional funding carved out for education, both K–12 and post secondary. The Governor vetoed \$370 million in capital projects; however, overall borrowing for the biennium is still at the highest level in the state’s history.

The first hint of possible trouble for the budget may be the fact that April 2006 revenue receipts are 6.6 percent less than one year ago. Without growth in revenue receipts for the last two months of FY 2006 in the neighborhood of 10 percent, the state will fail to meet its revenue forecast. The immediate effects will be to reduce the undesignated balance in FY 2006 that begins the FY 2007 revenue balance sheet and to raise the possibility of early budget cuts in FY 2007. The long-term effect will depend upon the strength of the economy over the next two years. Economists are increasingly uneasy, given trends in the housing market, stock market, and gasoline prices. The state’s dependence on undesignated balances at the end of each year and the relatively small “rainy day fund” leave little room to meet the budget if revenue forecasts are not met.

Data Sources

Conference Committee Report (CCR) and Budget Memorandum for HB 267 (2005); Free Conference Committee Report (FCCR) and Budget Memorandum for HB 370 (2006); Governor Fletcher HB 370 Veto press conference materials; April 2006 Revenue Receipts from Office of State Budget Director, KYA calculations.

Table 3: Kentucky Department of Education (K–12 schools) Budget Highlights

Kentucky Department of Education (K–12)	FY 2006 (July 2005–June 2006)	FY 2007 (July 2006–June 2007)	FY 2008 (July 2007–June 2008)
All Fund Sources:			
General Fund (Tobacco)	1,888,400	1,388,400	1,508,400
General Fund	3,385,590,700	3,510,448,600	3,827,034,300
Restricted Funds	4,943,400	9,831,300	9,831,300
Federal Funds	687,250,500	687,646,900	687,371,400
Continuing Funds	7,300,600	0	0
Total	\$4,086,973,600	\$4,209,315,200	\$4,525,745,400
Base Level Budget Total: (all fund sources)	\$4,086,973,600	\$4,076,433,900	\$4,083,958,400
Additional Budget Total: (all fund sources)	0	\$132,881,300	\$441,787,000