

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

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy  
Research Brief

Author: Rick Graycarek  
Senior Analyst,  
SFAI Project Director

Special points of interest:

- Kentucky had a \$687 million budget deficit in fiscal year 2002; this represented about 10 percent of the state's general fund budget.
- After transfers from other sources, \$231 million in cuts were made to agency budgets.
- Fiscal year 2003 began without an enacted state budget.
- Kentucky is currently operating under Governor Patton's "spending plan."



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

## Making Ends Meet: Fiscal Year 2002 Budget and Fiscal Year 2003 Spending Plan

### Introduction

Fiscal year<sup>1</sup> 2002 ended with bad news on top of more bad news. First, state revenues again fell short of expectations, leaving Kentucky with a \$617 million year-end revenue shortfall. (See Graph 1.) In turn, this shortfall helped produce a \$687 million budget deficit, which represented about 10 percent of the state's general revenue fund. Second, the legislature failed to pass a budget for fiscal year 2003, which began on July 1<sup>st</sup>.

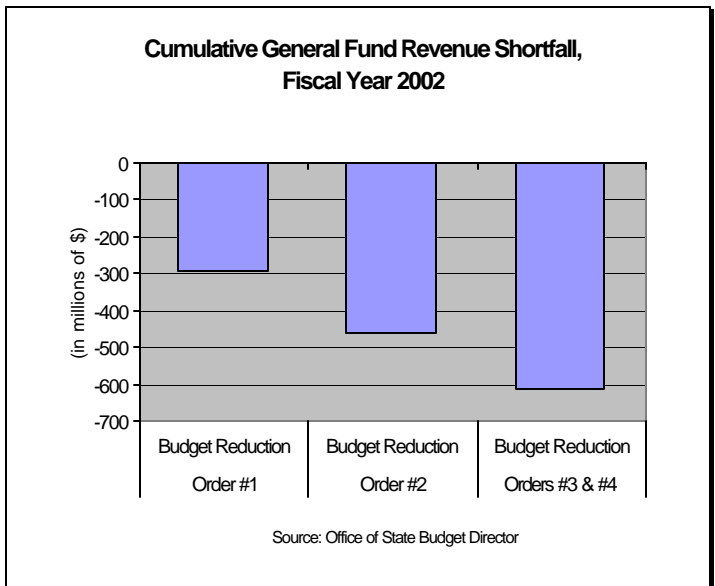
The budgetary trauma created by these two events prompted bond rating agency Moody's to place Kentucky on its "watch" list—which essentially is a cautionary notice to all investors that Kentucky may not be able to meet its current or future debt service obligations. Fortunately, things have improved slightly since then.

State government continued to operate after June 30th, even without an enacted budget. The state also paid its bills on time, including debt service payments. In addition, revenues in July and August were higher than at the same time last year.

In this report, we focus on last

year's budget cuts and the Governor's current year spending plan. The two issues are inter-related. Last year's budget deficit left the state with no rainy-day funds and less money than anticipated to

Graph 1



be carried over to fiscal year 2003. The latter situation meant that Kentucky started the new fiscal year with a revenue shortfall. This problem, and others, will play an important role in the state's ability to balance its budget this year. In detailing this fiscal crisis we begin by describing the last two rounds of budget cuts in fiscal year 2002. We then summarize the state's budget deficit for fiscal year 2002. Finally, we review Governor Patton's spending plan for fiscal year 2003.

**The Decision**

Like most boxing matches, Kentucky’s budget shortfall could not be declared over after only one round. Instead, Kentucky faced, in total, four budget-cutting rounds in fiscal year 2002. The first two rounds were described in previous Money Matters reports: “*Fiscal Year 2002 State Budget Cuts: Round One*” and “*Fiscal Year 2002 State Budget Cuts: Round Two*.” Round one occurred in September of 2001. Round two occurred in December 2001.

By the time May 2002 rolled around it was clear that another round of budget cuts was needed. Revenues were already well-short of expectations. With only two months remaining in the fiscal year it was apparent that the only way revenues would cover expenditures was with an extraordinary rebound—and that did not happen.<sup>2</sup> Given the limited period of time before the end of the fiscal year, Governor Patton opted against additional agency budget cuts. He instead balanced the \$160 million shortfall by other means.<sup>3</sup> Here is what happened.

**Round Three**

The third budget cut (or “third budget reduction order”) came in June 2002 and totaled \$155 million. It primarily consisted of the following:

- a) \$120 million transfer from the state’s rainy day fund to the state’s general fund;
- b) \$16 million in savings from lower debt service payments; and
- c) \$14 million transfer from various restricted funds to the state’s general fund. (See Table 1.)

Here are a few details about each of these actions.

*Rainy Day Fund*

The rainy day fund operates like a savings account for the state. In good

Rainy Day Fund	\$ 120.0
Debt Service	\$ 15.6
Restricted Fund Transfers	\$ 14.3
Tobacco Funds	\$ 5.0
Add. Appropriations	\$ (0.3)
<b>TOTAL</b>	<b>\$ 154.6</b>

Source: Office of State Budget Director

economic times, funds are added to it so, in bad economic times, funds can be withdrawn. A rainy day fund, therefore, helps dampen or eliminate large dips in state spending when revenues unexpectedly decline or expenses unexpectedly rise.

In fiscal year 2002, revenues fell sharply. Consequently, Governor Patton looked to the rainy day fund for financial help. During the year, Governor Patton used the entire \$240 million rainy day fund to help balance the budget.<sup>4,5</sup> In the first round of budget cuts, Governor Patton transferred \$120 million from the rainy day to the general fund. He transferred another \$120 million during the third round. Although some people have expressed concern about using the entire rainy day fund, the alternative would likely have been an additional \$240 million in cuts.<sup>6</sup>

*Debt Service Payments*

Lower state debt payments also played a role in the third round. Savings from debt refinancings and refundings, as well as lower than anticipated debt payments helped the state generate almost \$16 million in savings. Debt service appropriations were correspondingly reduced by \$16 million to help balance the general fund.

*Fund Transfers*

Transfers from restricted funds to the

*The rainy day fund lived up to its promise—it helped balanced the state’s budget during last year’s fiscal turmoil.*

state's general fund contributed another \$14 million to the state's budget balancing efforts.<sup>7</sup> The transfers came from three restricted funds (Flexible Spending Account Fund, Malt Beverage Educational Fund, and Fire and Tornado Insurance Fund). Typically, restricted fund balances just "lapse" at year-end (i.e., unspent dollars in restricted funds generally stay in that fund the following year). In this situation, however, the state transferred a portion of these balances to the general fund.

*Tobacco Settlement*

Although many revenue categories declined in fiscal year 2002 (corporate taxes declined the most)<sup>8</sup>, some revenue items posted positive gains. Among the revenues that exceeded projections were tobacco settlement funds. Actual tobacco settlement revenues to the Governor's Office, Cabinet for Families and Children, and Public Health were \$5 million more than expected. This allowed the state to use these higher revenues to help balance the budget without cutting agency spending by a like amount.

*Expenditure Increases*

Not all changes were confined to the revenue side of the ledger. A few expenditure changes were also made. This included \$300,000 in additional appropriations for the Kentucky Horse Park and \$30,000 for the Attorney General's Office. The former was for the Chinese exhibit and the latter for unanticipated litigation costs.

**Round Four**

The fourth budget reduction order closely followed the third and totaled just \$5 million. It was essentially a clean-up order. Once the accounting books were closed for fiscal year 2002, a small imbalance of \$5 million still remained. Table 2 details the actions.

Debt service payments in round four were again lower than expected and pro-

Debt Service	\$	16.6
Flex. Spending Account Fund	\$	(14.0)
Other	\$	2.7
<b>TOTAL</b>	<b>\$</b>	<b>5.3</b>

Source: Office of State Budget Director

duced \$17 million in savings. Instead of applying the entire amount to the budget deficit this time, though, Governor Patton essentially transferred \$14 million of this amount to the Flexible Spending Account Fund—a restricted fund. In the third budget cutting round, the Governor transferred \$16 million out of this fund to help balance the budget. This move replaced most of those previously transferred dollars.

**Total Fiscal Year 2002 Budget Cuts**

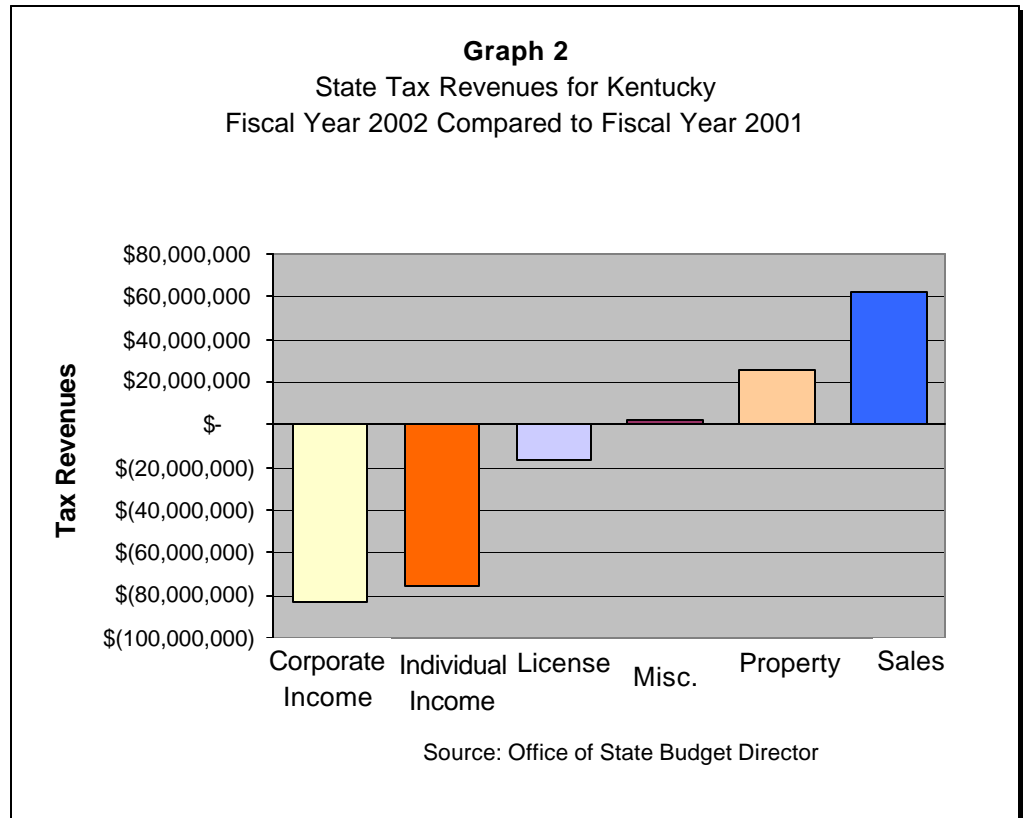
For the entire fiscal year, Kentucky had a \$687 million budget deficit. This amounted to almost 10 percent of the state's general fund budget—the state's all-purpose fund used to operate many government programs and services. Fewer revenues than expected, not higher spending, were the primary cause for the budget deficit. (See Table 3 and Graph 2.)

Revenue Shortfall	\$	617.6
Necessary Gov't Expense	\$	16.7
Other	\$	52.8
<b>TOTAL</b>	<b>\$</b>	<b>687.1</b>

Source: Office of State Budget Director

The fiscal year 2002 budget was balanced using several methods. (See Table 4.) Transfers from the rainy day fund totaled \$240 million and were the single

*For fiscal year 2002, Kentucky had a \$687 million budget deficit.*



*Executive agency budgets totaled \$227 million of the \$231 million in agency budget cuts.*

largest source of funds used to balance the budget. Agency budget cuts were a close second, totaling \$231 million. Executive branch budget cuts represented most of this amount. (See Table 5.) In total, executive agency budgets were reduced by \$227 million of the \$231 million in agency budget cuts. Overall, legislative branch cuts were greater than the executive—3.4 percent compared to 3.1 percent.

On the executive side, the Labor Cabinet experienced the deepest cuts—two-thirds of its general fund budget. (See Table 6.) Most of this reduction, though, was the result of \$14.2 million in lower appropriations for the Workers Compensation Funding Commission. Other agencies had budget cuts of between 15 and less than 1 percent. Of these, the Education Cabinet stands out because of the Governor’s efforts to maintain K-12 education funding. The K-12 education cuts shown in Table 6 were primarily central office expenditures and not school funding. Also, the

**Table 4**  
Fiscal Year 2002  
Budget Balance Actions  
(in millions)

Rainy Day Fund Transfers	\$ 240.0
Agency Cuts	\$ 231.0
Debt Service Savings	\$ 113.0
Fund Transfers	\$ 97.0
Other	\$ 6.0
<b>TOTAL</b>	<b>\$ 687.0</b>

Source: Office of State Budget Director

**Table 5**  
Fiscal Year 2002  
General Fund Budget Cuts by Branch

Branch	Total Cuts	% G.F. Cut
Executive	\$227,147,300	3.12%
Legislative	\$2,028,200	3.39%
Judiciary	\$2,300,000	1.12%
<b>TOTAL BRANCH</b>	<b>\$231,475,500</b>	<b>3.07%</b>

Source: Office of State Budget Director and author calculation

Cabinet for Finance and Administration budget cut does not include debt service savings.

**Governor’s 2003 Spending Plan**

Legislative wrangling over the appropriation of money to partially fund gubernatorial elections led to a budget stalemate. By July 1<sup>st</sup>, the start of fiscal year 2003, the House and the Senate could not agree on campaign finance funding and, consequently, failed to pass a state budget for the 2002-2004 biennium.

Lacking a state budget, Kentucky entered fiscal year 2003 with many constitutional and fiscal questions. The most fundamental question was whether the state could operate without a legislatively approved budget. The answer, according to the Governor’s legal advisers, was “yes.” As a result, Governor Patton introduced a “spending plan” for fiscal year 2003. Although it looks a lot like the budget Governor Patton proposed in January, it can only be called a “spending plan”; a “budget” requires legislative approval for appropriations to be made. Instead of appropriating funds the spending plan is viewed as the “continuation of government services and programs.”<sup>9</sup>

Other vexing fiscal and constitutional problems exist. For example, how to deal with expiring temporary law sections? Without an enacted budget, many sections of law enacted in the 2000-2002 biennial budget expired on June 30th, 2002. These so-called temporary law sections only function for the term of the enacted budget and, unless renewed in a subsequent budget or enacted into per-

<u>Cabinet</u>	<u>Total Cuts</u>	<u>% G.F. Cut</u>
Labor	\$14,389,100	66.49%
Public Protection & Regulation	\$11,251,500	15.47%
Transportation	\$1,221,900	11.49%
Revenue	\$4,402,500	4.71%
Families & Children	\$15,590,818	4.61%
Justice	\$23,485,300	4.59%
Post-Secondary Education	\$41,131,157	3.47%
Health Services	\$38,046,985	3.46%
Economic Development	\$646,200	3.09%
Workforce Development	\$1,610,400	2.97%
Personnel	\$115,500	2.95%
Education, Arts, & Humanities	\$6,147,800	2.93%
Tourism Development	\$1,174,500	2.93%
General Government	\$12,650,740	2.81%
Natural Resources & Protection	\$1,529,200	1.89%
Education	\$52,174,500	1.82%
Finance & Administration	\$1,249,200	0.57%
Additional Approp.	\$330,000	
Subtotal Executive	\$227,147,300	3.12%

Source: Office of State Budget Director and author calculation

manent law through legislation, they cease to exist when a budget ends. For example, temporary law in the last enacted budget bill allowed the state to employ more workers than allowed by statute. By not enacting a budget this year, the legislature effectively let existing law preside. Now the question becomes does the state need to reduce the number of employees?

**Conclusion**

A \$687 million budget deficit left Kentucky scrambling to balance its budget in fiscal year 2002. Through four rounds of budget reductions, the Governor cut spending, transferred funds, and drained the rainy day fund to balance the budget.

As if the budget shortfall was not enough, Kentucky also failed to enact a new state budget. Now, fiscal year 2003 revenues are already falling short of expectations. The state’s fiscal situation for the remainder of the year, as a result, remains in jeopardy.

*Legislative wrangling  
over partial public  
financing for  
gubernatorial elections  
led to a budget  
stalemate.*

Kentucky Youth Advocates

2034 Frankfort Avenue  
Louisville, Ky 40206

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

Visit Us On the  
Web!  
[www.kyyouth.org](http://www.kyyouth.org)

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



---

## Endnotes

- <sup>1</sup> Kentucky's fiscal years begin on July 1<sup>st</sup> and end on June 30<sup>th</sup>.
- <sup>2</sup> See Kentucky Youth Advocates' Money Matters report "*Headed Down Another Slippery Slope? A Look at Kentucky's Revenue Woes*", April 2002, for more detail.
- <sup>3</sup> Ibid. In this report Kentucky Youth Advocates called for no additional agency budget cuts. The report instead suggested balancing the budget by using the rainy day fund and postponing certain expenditures.
- <sup>4</sup> Twenty-one other states used their rainy day funds to help balance their budget. (National Governor's Association. May 16, 2002. "State Fiscal Woes Continue.")
- <sup>5</sup> According to the National Conference of State Legislatures, total rainy day fund balances fell from \$16.5 billion at the end of fiscal year 2001 to \$10.8 billion at the end of fiscal year 2002. ("Preliminary State Budget and Tax Actions Report 2002." August 28, 2002.)
- <sup>6</sup> See, for instance: Zahradnik, Bob and Nick Johnson. January 31, 2002. "*State Rainy Day Funds: What to Do When It Rains.*" Center on Budget and Policy Priorities: Washington, D.C.
- <sup>7</sup> Restricted funds are funds established with a specific purpose and a defined source of revenue. For example, tax revenue from the sale of gasoline is deposited in the state's Road Fund. In this case, the Road Fund has a specific purpose—maintaining and developing the state's roads—and a defined revenue source—gasoline (among others).
- <sup>8</sup> See Kentucky Youth Advocate's Money Matters report "*Kentucky's Corporate Income Tax*", July 2002, for more detail.
- <sup>9</sup> Governor Patton's Spending Plan, 2002. [www.osbd.state.ky.us](http://www.osbd.state.ky.us)