

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

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal and Budget Policy  
Research Brief

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Special points of interest:

- Kentucky cut spending by more than 3 percent in fiscal year 2002.
- Kentucky faces a \$2.3 billion budget deficit by 2010.
- Single-issue proposals do not solve long-term mismatch between revenues and expenditures.
- Only comprehensive tax reform can maintain services and improve state's economy.



KENTUCKY YOUTH ADVOCATES

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## THE CASE FOR COMPREHENSIVE TAX REFORM IN KENTUCKY

Over the past year, forty-five (45) states have seen their budgets fall out of balance.<sup>1</sup> Due primarily to declining revenues, states have been confronted by their worst fiscal situation in a decade.<sup>2</sup> The reasons for the implosion could be found on the front page of any newspaper—loss of corporate integrity; a falling stock market; terrorism; declining tax revenues; and the list goes on.

In what has been termed a “perfect storm” of factors, state economies have been struck a severe blow. As a result, states have been forced to cut spending or raise revenues or both.<sup>3</sup>

Both actions are tried and true. They can each solve a state's present fiscal crisis by balancing expenditures and revenues. However, most spending cuts and some revenue increases fail to achieve long-term success. That is, they only solve a state's current budget crisis and fail to deal with any longer-term problems. In a manner of speaking, such actions are similar to a car driver avoiding a deer on the road in front of her but failing to see the “Bridge Out Ahead” sign.

To avoid driving off a proverbial cliff, Kentucky must be willing to make long-term, comprehensive changes to the way revenues are collected and spent. Temporary, short-term proposals will only serve to make future attempts to balance the budget more difficult by shortening

the time available to actually solve the budget problem. Here is an example.

### THE STORY OF MARY

Mary, an upstanding citizen of Pleasantville, lives in a house with her two dogs, Scooby and Rufus, and one cat, Sylvester. She has a monthly mortgage, grocery, utility, car, insurance, and various other expenses. She is not well-off. In fact, her income is below average for Pleasantville.

One day Mary is told that her salary will gradually be reduced. “New economy” issues, she is told. That same day she also learns that her health insurance bill will go up. Mary does not have any savings.

What can Mary do? Pretend a financial problem does not exist? Spend less? Work more?

### SITUATION IN KENTUCKY

If the story of Mary sounds familiar, it should. Like Mary, Kentucky has below average income, rising health expenses (primarily Medicaid and employee health insurance), and aging residents. It also has no savings account, having used the entire \$240 million rainy day fund to help balance last year's revenue shortfall. Here is what the situation looks like for Kentucky.

*“ . . . casino gambling or other single-issue proposals will not solve the state’s long-term mismatch between revenues and expenditures. . . ”*

*Revenues are down.* For the last fiscal year (2002), state general fund revenues declined year-over-year for the first time in almost a half century.<sup>4</sup> The state’s \$687 million budget deficit was primarily created by a \$617 million revenue shortfall.<sup>5</sup>

Looking down the road, revenue growth appears equally bleak. The state’s revenue forecasting group has projected only minimal revenue growth this fiscal year and next.<sup>6</sup> Because Kentucky relies heavily on sales tax revenue (more and more consumer purchases now fall under the currently untaxed “service” category) and up-and-down revenues like corporate income, Kentucky is positioned for even greater future problems. In fact, a legislative consultant reported in February 2002 that Kentucky faces a \$2.3 billion budget deficit by 2010 under its current revenue and spending system.<sup>7</sup> That makes last year’s budget problems almost look rosy.

*Expenses are up.* Kentucky also faces rising expenses. Many beneficial programs have experienced spending jumps in the past few years, some outside of state control (e.g., Medicaid spending). In addition, education and social service costs continue to grow—a necessary expense since Kentucky continues to lag the rest of the nation on many important measures, like high school and college graduation rates. Even day-to-day expenses have risen in order to provide small salary increases and meet rising health care costs.

Expenses will continue to rise even if Kentucky wants to just maintain existing services. Such events simply represent the rising costs of doing business—something common to both public and private organizations. To even contemplate raising the quality and quantity of such services would require even greater expenditure increases.

*No savings.* To balance the fiscal year 2002 budget, the Governor used the entire rainy day fund—about \$240 million. While this was a prudent decision, it does leave Kentucky without a reserve fund. With a \$140 million budget shortfall expected this year, the state has no savings to cushion the blow.<sup>8</sup>

## **POLICY OPTIONS**

Faced with a financial crisis, Kentucky has essentially the same options as Mary. Unfortunately, not all options solve the problem and some may even make it worse.

The first is do nothing; roll the dice and hope the economy improves dramatically over the next seven months. For those who want to wish away the “Bridge Out Ahead” sign, this option carries appeal. Unfortunately, denying a problem exists only sets up a bigger problem down the road. If changes are not made today, spending cuts and revenue increases later this year and beyond will be even more drastic. This would be like Mary deciding to work less or spend more despite her employer cutting her salary by 10 percent. That would not be a wise decision.

Second, single-issue proposals like casino gambling can be enacted. While these changes may provide a temporary reprieve from the fiscal problem, they only obscure fiscal reality. The fact is casino gambling or other single-issue proposals will not solve the state’s long-term mismatch between revenues and expenditures any more than winning \$1,000 in the lottery would make the rest of Mary’s life financially secure.

What are the long-term problems? Namely that state revenues come almost exclusively from slow growing sales and income taxes. Because sales tax revenues are not growing as fast as the economy (primarily because people spend more and more of their money on non-taxed

services like tanning and house cleaning) and income taxes have grown slowly, state revenues are not growing as fast as the economy.<sup>9</sup> Services demanded by government, however, continue to grow. These include education, health care, public safety, and aging services. As a result, revenues are not rising quickly enough to match needed program and service expenses.

Third, expenditures could be cut. In general, this may be practical advice. Certainly, if Mary had a financial advisor, she would suggest the same. Unfortunately, additional spending cuts, at some point, will do more harm than good. For Mary, spending less on groceries, medical treatment, or utility bills could make her worse off. If Mary gets ill, for example, and decides not to seek medical treatment, but then misses work for two days, is she really better off? Probably not. The same would be true for Kentucky.

Given that Kentucky cut general fund spending by more than three percent in fiscal year 2002, further spending cuts could harm programs and services across the state. Even worse, trying to balance the state's projected \$2.3 billion budget deficit by solely cutting spending would require drastic actions. It would take, for instance, the following cuts to balance the budget. (Other examples could be used as well.)

???Eliminate all post-secondary education funding (\$1.1 billion); **AND**

???Eliminate all state prison funding (\$460 million) **AND**

???Eliminate all state Medicaid spending (\$770 million).

Fourth, revenues could be raised by comprehensively modernizing the state's revenue system. While some may find such action undesirable, it nonetheless represents an honest and objective solution to the state's looming \$2.3 billion budget deficit. Clearly, the other three

options (do nothing; single-issue solutions; and spending cuts) fail to achieve long-term fiscal stability and balance. Only by modernizing Kentucky's revenue system will these problems be corralled.<sup>10</sup> For Mary, this is tantamount to investing in her future through education and training so she does not have to make a trade-off between groceries and electricity or medicine and housing.

### THE ROAD AHEAD

Like Mary, Kentucky faces a difficult time. However, the solutions to the problem are quite clear—maintain investments in education, health care, child care, and other services that promote stable and financially secure families and jobs.

How can this be done given the state's fiscal disarray? Simple. Modernize the state's tax system so that it meets the needs of a 21<sup>st</sup> century economy. This will invariably mean that some people will pay more taxes. It will also mean that many more people, including children, will continue to receive an improved education, important worker training skills, valuable health care, quality drinking water, and dependable public safety, among other things.

Legislative consultants have already laid the groundwork for change.<sup>11</sup> Other people have also seen the writing on the wall and want to avoid driving the state's economy and its valuable services off a cliff. Editorial boards for the Lexington Herald-Leader and Louisville Courier-Journal have said it. The Prichard Committee has said it. Thomas D. Clark, Kentucky's Historian Laureate, has said it. The Chamber of Commerce has said it. So have many other civic and political leaders. Now it is time that state policymakers *acted* on it.

*“Revenues could be raised by comprehensively modernizing the state's revenue system.”*

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## THE CASE FOR COMPREHENSIVE TAX REFORM IN KENTUCKY

### Endnotes

<sup>1</sup> National Association of State Budget Officers. [www.nasbo.org](http://www.nasbo.org). 2002.

<sup>2</sup> Ibid.

<sup>3</sup> National Governor's Association and the National Association of State Budget Officers. "Fiscal Survey of States." November 2002.

<sup>4</sup> Kentucky Office of State Budget Director. "Fourth Quarter 2002 Annual Edition, Kentucky Quarterly Economic and Revenue Report." 2002.

<sup>5</sup> Kentucky Office of State Budget Director. "Report to Interim Joint Committee on Appropriations and Revenue." August 22, 2002.

<sup>6</sup> Governor Paul Patton's Office. "An Assessment of Kentucky's Fiscal Condition." November 2002.

<sup>7</sup> Fox, William. "Report to the Subcommittee on Tax Policy Issues." February 2002.

<sup>8</sup> Governor Paul Patton's Office. "An Assessment of Kentucky's Fiscal Condition." November 2002.

<sup>9</sup> Kentucky Office of State Budget Director. "Kentucky Losing Ground on State Sales Tax." *OSBD Issues*. Vol. 1. Iss. 2.

<sup>10</sup> See, for example, Kentucky Long-Term Policy Research Center. Financing State and Local Government. 2001. Frankfort, KY; or Fox, 2002.

<sup>11</sup> See, Barents Group. Report to Kentucky Commission on Tax Policy. 1995. Updated, 1999; and Fox, 2002.