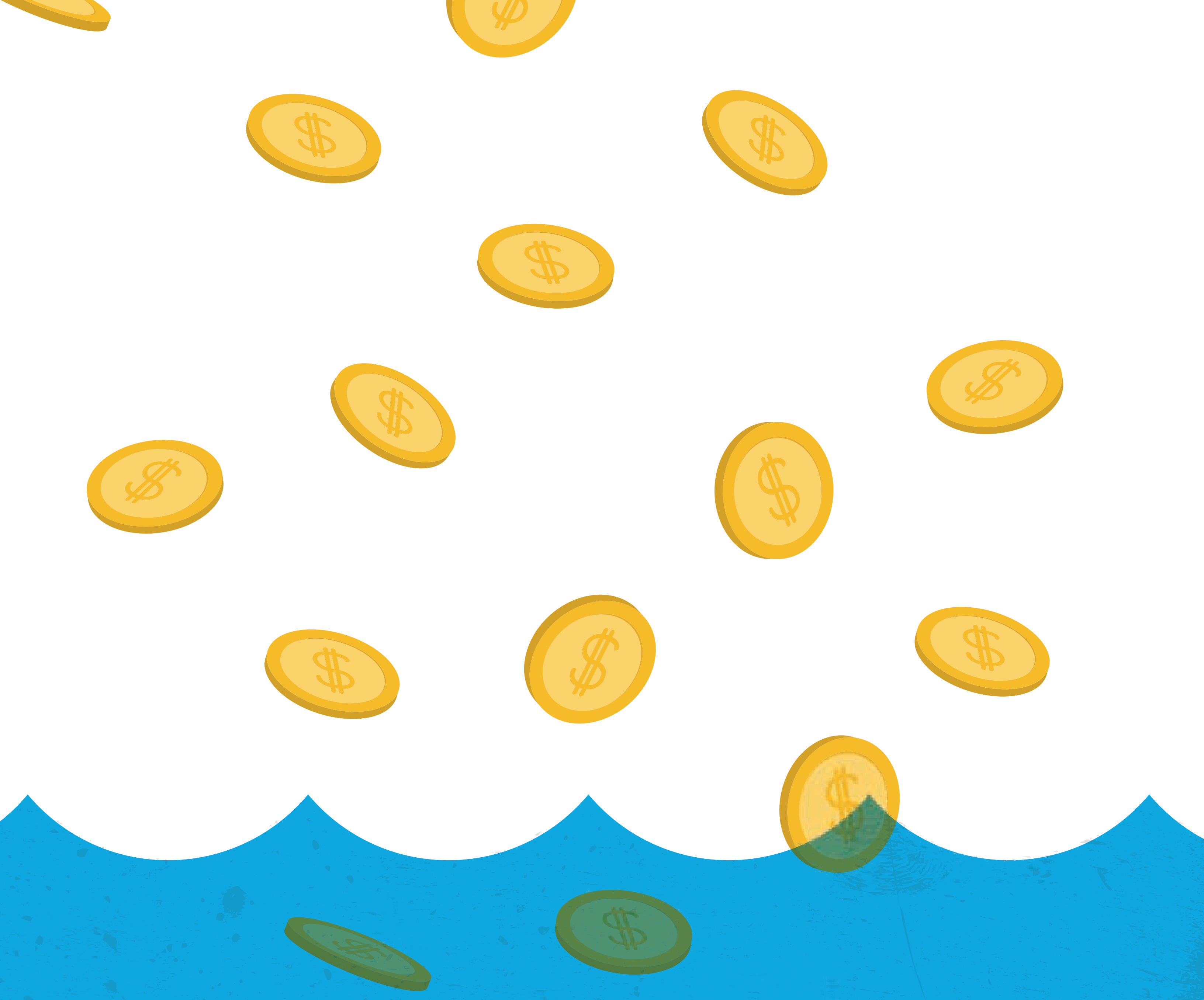
THE LEAKY BUCKET

10 YEARS LATER

JANUARY 2020

Kentucky Chamber



Current trends show an unfortunate reversal of progress in controlling spending in key areas. New data reveals that spending on Medicaid, corrections and pensions continues to outpace overall state spending.

INTRODUCTION

It has been ten years since the Kentucky Chamber of Commerce released the original *Leaky Bucket* report, a review of spending that identified the biggest "leaks" from the "bucket" of state revenue. That initial report found spending on corrections, Medicaid and public employee health insurance to be growing at a rate faster than the overall state budget and faster than the state's economy could produce new revenue. Spending in these areas accounted for more than half of all growth in the budget from 2000 to 2010. This alarming trend had a particularly disturbing bottom line: more money for the unsustainable leaks in the state spending bucket meant a diminishing commitment to education—the state's key investment in its future.

A July 2014 update of the *Leaky Bucket* report, five years after the initial report, found that significant progress had been made in slowing growth in the key areas of Medicaid, corrections and public employee health insurance. The update found a slight increase in spending on K-12 education, while funding for postsecondary education continued to erode. Kentucky's unfunded public pension liabilities were identified as a major concern.

The current update examines state spending trends since 2014, noting actions that have been taken in the past five years to address the leaks, identifying the challenges that remain and offering recommendations for moving forward.

The trends show an unfortunate reversal of the progress documented in 2014. New data reveals that spending on Medicaid, corrections and pensions continues to outpace overall state spending. Although Kentucky has had record business investment and low unemployment, and the General Assembly enacted tax reforms in 2018 and 2019, these actions have not eliminated the need for program funding cuts.

Given the persistence of Kentucky's state spending woes, the fact that states across the country are experiencing similar trends, the forecast for modest revenue growth in the near term, and the need for increased pension funding, the conclusion of this report that more revenue is required in addition to continued program reforms represents a significant departure from the Chamber's earlier *Leaky Bucket* reports.

GLOSSARY

ACA: The Patient Protection and Affordable Care Act, the federal health care law enacted by Congress in 2010

ARC: Actuarially Required Contribution, the amount of money that actuaries calculate an employer needs to contribute to a retirement plan during the current year for benefits to be fully funded by the end of the amortization period

CJPAC: The Criminal Justice Policy Assessment Council, a gubernatorially created task force to review the criminal justice system and recommend reforms

CMS: The Centers for Medicare and Medicaid, the federal agency that administers Medicare, which provides health insurance to people age 65 and older, and Medicaid, which provides health coverage to qualifying low-income people

GSP: Gross State Product, a measurement of a state's economic output

HEALTH: The Helping to Engage and Achieve Long-Term Health program, a federal waiver program that seeks to change traditional Medicaid benefits

KERS: The Kentucky Employee Retirement System, the retirement program covering state employees

NH: employees in non-hazardous occupations

KTRS: The Kentucky Teachers' Retirement System, the retirement program covering public school teachers

SEEK: The Support Education Excellence in Kentucky (SEEK) funding program, a formula-based allocation of state funds to local school districts

PREVIOUS
SPENDING TRENDS

Total General Fund spending **grew 9.7% from FY 2012 to 2016.**

The 2014 *Leaky Bucket* update, *The Leaky Bucket: 5 Years Later*, found promising signs that the troubling spending trends identified by the Chamber were slowing.

From fiscal year 2012 to fiscal year 2016:

Corrections

Corrections spending, which had been growing 50% faster than the General Fund, **grew only 4.2%** in the previous two budgets.

Medicaid

Medicaid spending **grew 16.5%** — considerably less than the pace of growth between 2000 and 2012, when it grew three times faster than General Fund spending.

Public Employee Health Insurance

Public employee health insurance **grew 9.6%** after growing about four times faster than total General Fund spending.

K-12 Education

General Fund spending on education **increased 3.8%** for the SEEK program, the base funding for K-12, and 28.9% for such non-SEEK items as textbooks and preschool.

Postsecondary

Postsecondary institutions experienced a **7.2% reduction** in spending.

Continuing challenges noted in the 2014 update included meeting the legislative commitment to fully implement the 2013 pension reforms to bring fiscal stability to the Kentucky Employee Retirement System and the need to address the funding problems of the Kentucky Teachers' Retirement System.

CURRENT
SPENDING TRENDS

Total General Fund spending **grew 14.5% from FY 2016 to 2020.**

State budgets enacted since the 2014 update show a return to spending in key areas that significantly outpaces overall state spending growth, particularly in Medicaid, corrections and pensions. An analysis of the General Fund spending for fiscal years 2016 to 2020 (including the current enacted budget) reveals the following below. The following chart reflects these trends.

Corrections

Corrections funding, which had **grown only 4.2%** in the 2014 update, increased by 15.9% — faster than the overall budget.

Medicaid

Medicaid spending **grew 25.6%** compared to 16.5% from FY 2012 to 2016.

Public Employee Health Insurance

Public employee health insurance spending **grew only 5.5%** — a rate 40% less than the growth in overall spending and an improvement over that documented in the 2014 update.

K-12 Education

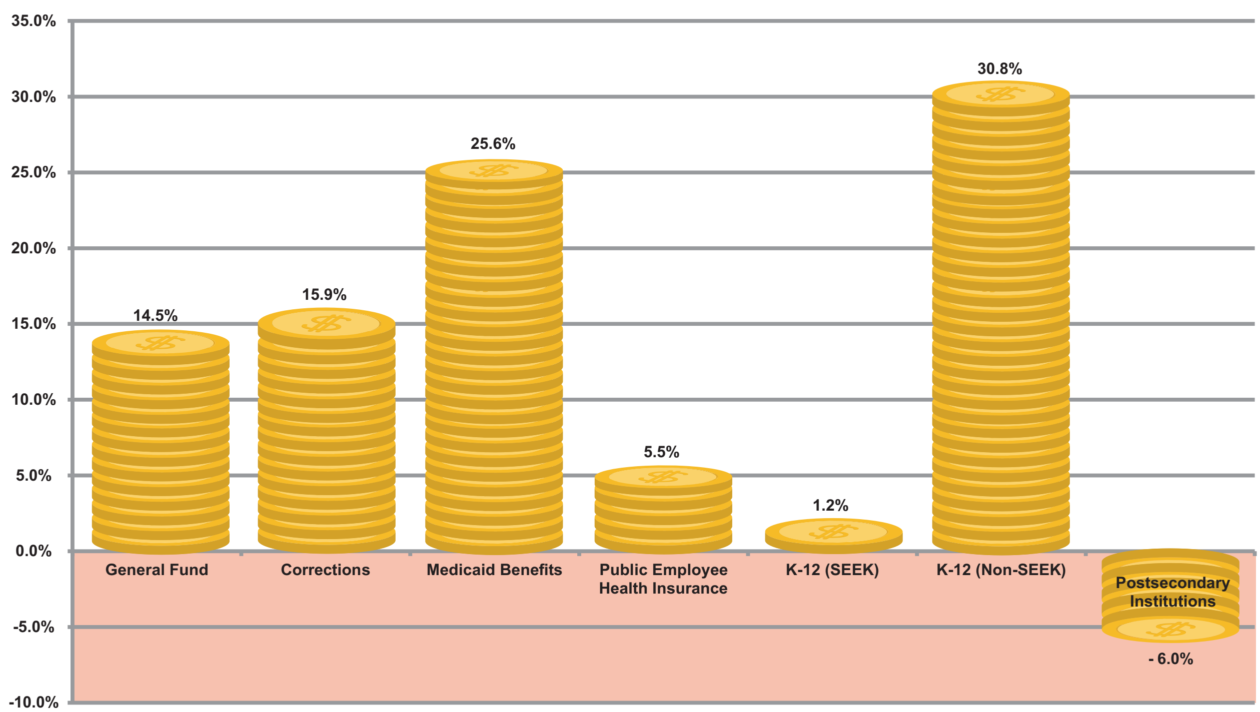
General Fund spending on the SEEK program, which provides basic funding for K-12 education, has **increased only 1.2%** since FY 2016, but spending on non-SEEK items (such as textbooks, preschool, health insurance for active teachers and pension contributions) has grown 30.8% in the period; this is primarily due to increased contributions to the Kentucky Teachers' Retirement System.

Postsecondary

Funding for postsecondary education **decreased by 6%**, continuing the trend identified in earlier Leaky Bucket reports.

Growth in Kentucky General Fund Expenditures in Selected State Programs

Fiscal Year 2016 to Fiscal Year 2020



Sources: *FY 2014-2016 Executive Budget in Brief and FY 2018-20 Executive Budget in Brief, Office of State Budget Director*

Notes: All expenditures are as published by GOPM. Non-SEEK funding includes significant supplementation appropriations made to KTRS. Postsecondary includes performance funds in the FY 2018-20 budget.

DEVELOPMENTS
IN FAST-GROWING AREAS OF SPENDING

CORRECTIONS

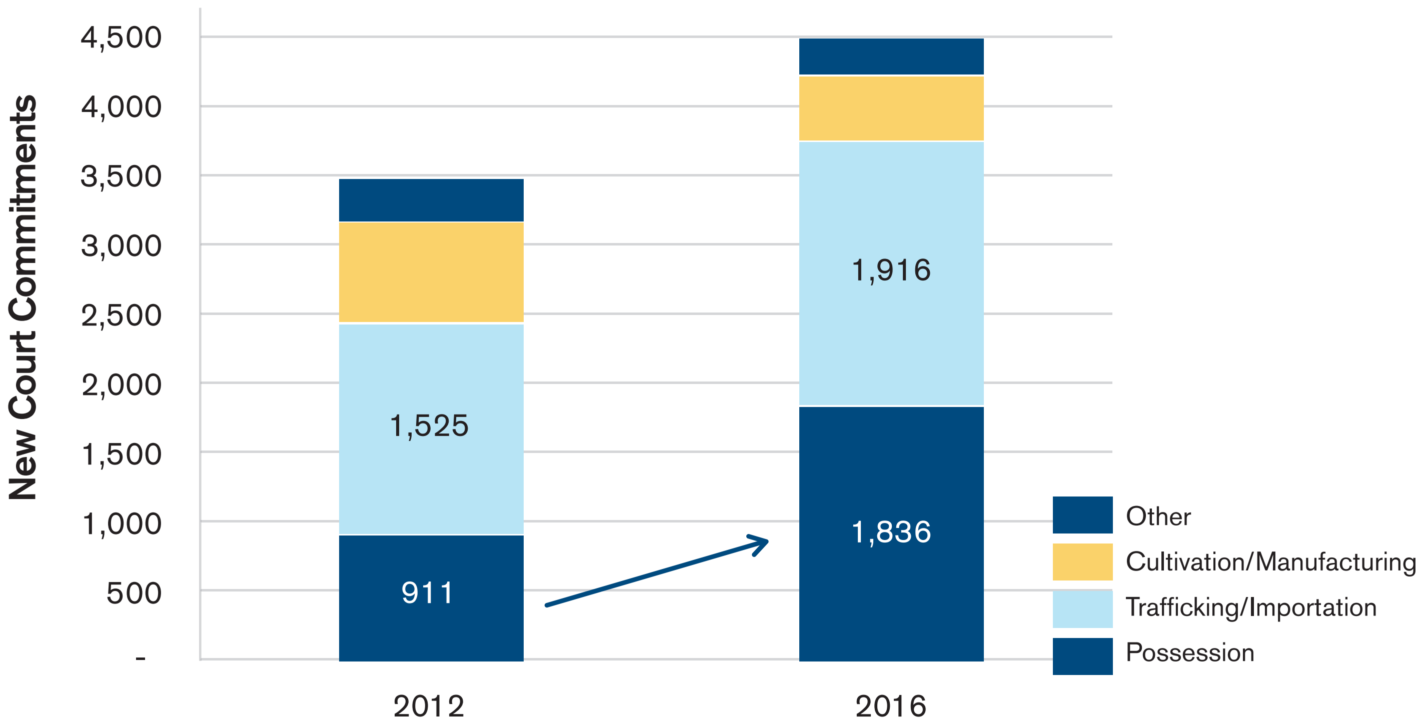
While spending on corrections slowed from 2012 to 2016, this latest update shows it is again growing faster than the overall budget. The main reason for this growth is that Kentucky, like many other states, is in the grip of an opioid abuse crisis. A recent report by the Kentucky Chamber, *Opioid Abuse in Kentucky*, found that Kentucky's drug overdose rate in 2017 was the fourth highest among the 50 states, with 1,565 Kentuckians dying from a drug overdose. That is more than the number of murder victims and traffic deaths combined. Kentucky's rate of opioid prescriptions was the seventh highest in the country the same year.

The main reason for growth in corrections spending is that Kentucky, like many other states, is in the grip of an **opioid abuse crisis.**

This high rate of drug use has an impact on the corrections system. A 2010 legislative task force found the percentage of offenders imprisoned for drug offenses rose from 30% to 38% from 2000 to 2009. In addition, 25% of all inmates were being held for drug offenses, and 70% were imprisoned for a first offense. In response to these and other findings, the 2011 General Assembly revised criminal statutes to reduce prison time for low-risk, non-violent drug offenders in possession of small amounts of drugs.

More recent data released in December 2017 by the CJPAC Justice Reinvestment Work Group found that, despite the 2011 statutory changes, the number of offenders sent to state prison for drug possession **more than doubled** from 2012 to 2016, and 38% of all offenders were sentenced for drug offenses. As the following graph shows, the number of offenders imprisoned for drug trafficking grew from 1,525 in 2012 to 1,916 in 2016 (a 25.6% increase), while the number of offenders being jailed for drug possession increased from 911 in 2012 to 1,836 in 2016 (a 101.5% jump).

New Court Commitments by Drug Offense Type, *2012 vs 2016*



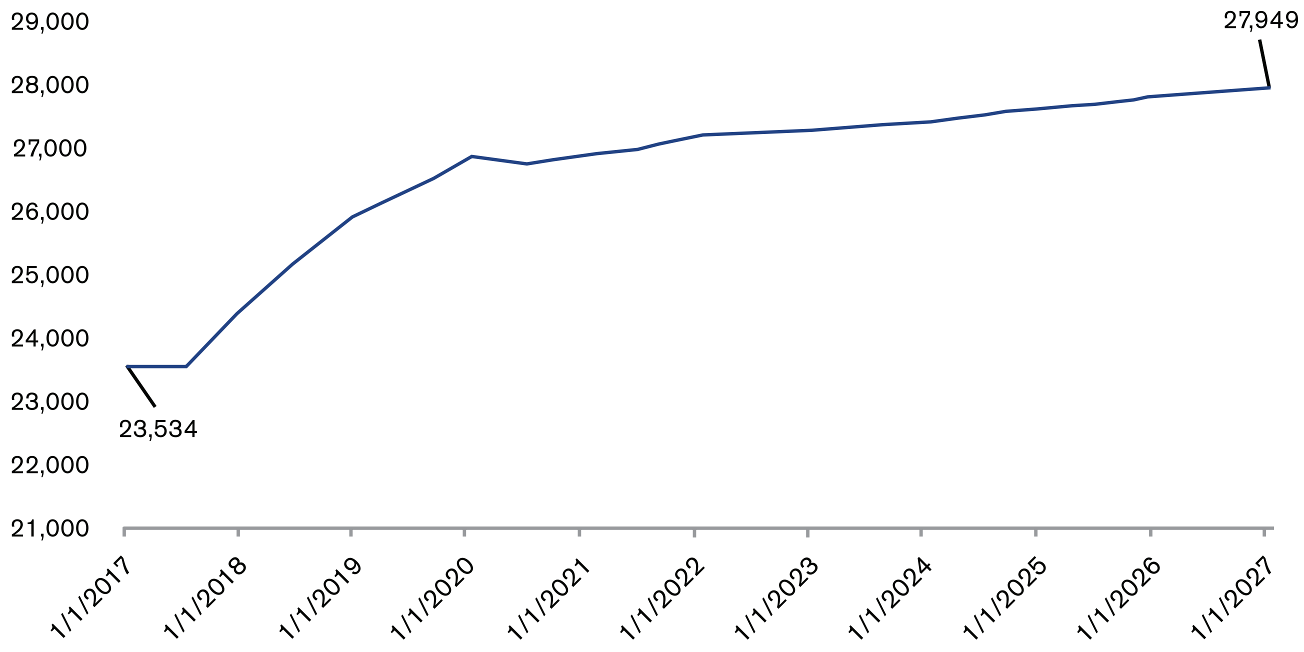
Source: *Subgroup Report Recommendations, CJPAC Justice Reinvestment Work Group, November 29, 2017*

Another grim statistic is that Kentucky has the fifth highest rate of incarceration of women in the United States. The Justice Reinvestment Work Group found that admissions of women to correctional facilities grew 54% from 2012 to 2016 while overall admissions grew 32%. The work group noted that 70% of the female population is housed in county jails, where they are "less likely to receive programming and substance abuse treatment than their male counterparts."

It costs more than $18,000 a year to incarcerate one person in Kentucky. The Justice Reinvestment Work Group estimates that Kentucky's prison population will grow by 19% by 2027, which is expected to cost the Commonwealth an estimated $600 million over ten years. The Work Group has recommended a number of policy changes to slow prison growth, which are covered in the recommendation section of this report.

Kentucky's Prison Population Projected to Grow 19% in the Next Decade

Kentucky Prison Population Projection 2017-2027



Source: *Kentucky CJPAC Justice Reinvestment Work Group, Final Report, December 2017*

Medicaid spending **increased 25.6%** in the past five years.

MEDICAID

As noted earlier, Medicaid spending increased 25.6% in the past five years, compared to 16.5% for the previous five-year period. The main reason for the increased spending growth was the 2014 expansion of the Medicaid program under the federal Affordable Care Act (ACA). The ACA permitted states to expand Medicaid eligibility to people with incomes up to 138% of the poverty level (now $29,435/year for a family of three). As Kentucky's Medicaid income eligibility was relatively low at the time (62% of the federal poverty level), the expansion allowed 450,000 Kentuckians to become eligible for Medicaid coverage. As of September 2019, 1,341,869 Kentuckians were covered by the Medicaid program—30% of the state's population.

As of September 2019, **1,341,869 Kentuckians** were covered by the Medicaid program — **30%** of the state's population.

A March 2019 report from the Commonwealth Institute at the University of Louisville cited a number of benefits from the expansion:

- Kentucky's uninsured rate fell from 20.4% in 2013 to 7.8% in 2016—the largest drop in the country.
- Access to health care has increased dramatically.
- Each Medicaid dollar spent in the health care economy generates a return ranging from $1.35 to $1.80.
- More than 16,000 jobs have been created in the health care and social services sector since 2014.
- The expansion injected approximately $1 billion into Kentucky's health care economy.

These benefits have come at a cost. Medicaid is normally funded under a matching formula, based on the state poverty level, in which the federal government pays part of the cost and the state provides the remainder. As a high-poverty state, Kentucky's Medicaid matching rate is 70.5% federal—29.5% state. However, to encourage states to expand the program, the cost of the Medicaid expansion under the ACA was 100% federally funded in 2014, 2015 and 2016. Starting in 2017, the state had to begin gradually picking up part of the cost, as indicated in the following chart.

Calendar Year	State Share of Medicaid Expansion Costs
2017	5%
2018	6%
2019	7%
2020 and beyond	10%

Source: *Federal Register, August 17, 2011*

The Kentucky Cabinet for Health and Family Services, which administers the Medicaid program, has estimated the Commonwealth's additional cost of the Medicaid expansion at $1.2 billion from FY 2017 to 2021.

Estimating state savings of $329 million over five years, the Cabinet announced the creation of the Kentucky HEALTH (Helping to Engage and Achieve Long-Term Health) program in 2016 to modify traditional Medicaid benefits for participating adults.

Because the HEALTH program contained elements outside the traditional Medicaid program, special permission to implement the program, or a waiver, would have been required from the federal Centers for Medicare and Medicaid (CMS). The waiver was challenged in federal court, and the HEALTH program was not implemented.

Governor Andy Beshear rescinded the HEALTH proposal and withdrew the waiver request upon taking office in December 2019.

PUBLIC EMPLOYEE HEALTH INSURANCE

As our latest spending review indicates, the increase in spending on public employee health insurance has dropped to its lowest level since the Chamber undertook its initial review 10 years ago. In 2009, spending on health insurance for state workers was the fastest-growing area of state spending—increasing four times faster than the overall General Fund budget.

The current review found this spending to have grown at a rate of 5.5% over the past five years—well below the General Fund growth rate of 14.5%. This dramatic turnaround has been accomplished through the imposition of many elements found in private-sector employee health plans that the Chamber recommended in earlier reports.

These include:

- Higher deductibles and co-pays for employees
- Higher employee premium contribution
- A rewards program that incentivizes healthy behavior
- Health counseling for employees with chronic conditions

The 2018 Employer Health Benefits Survey, conducted annually by the Kaiser Family Foundation, found that premiums for employer-provided health insurance for single coverage increased 3% in 2018, while the cost of family coverage increased 5%. Considering these increases are for only one year, and Kentucky's costs have increased 5.5% for five years, the Commonwealth has made excellent progress in this area.

Kentucky's high levels of unfunded pension liabilities have resulted in numerous downgrades of Kentucky's credit rating, resulting in **higher borrowing costs** that increase the cost of public projects.

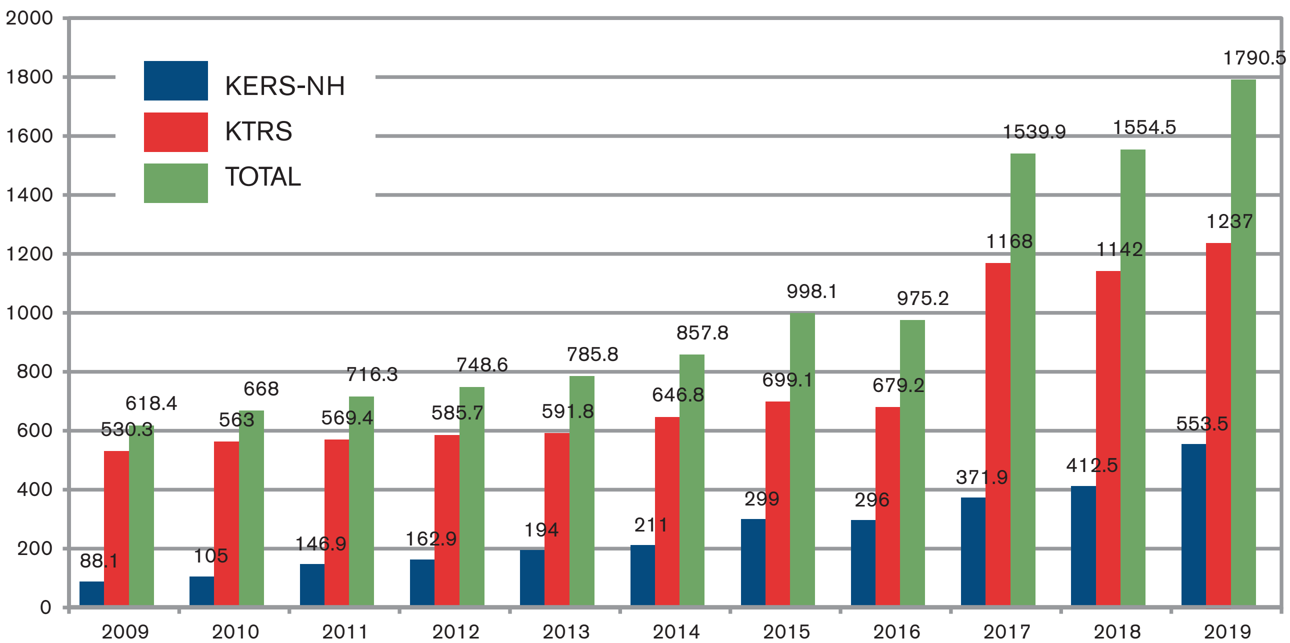
PENSIONS

As the Chamber pointed out in earlier versions of the *Leaky Bucket*, public employee pension costs and more than $40 billion in unfunded pension liabilities are a major concern for the business community. Kentucky's high levels of unfunded pension liabilities have resulted in numerous downgrades of Kentucky's credit rating, resulting in higher borrowing costs that increase the cost of public projects. The Chamber has made numerous recommendations and supported a number of reforms in public pension benefits.

Employer pension contributions—those paid by state agencies—are part of overall state personnel costs and are embedded in program costs instead of being listed separately in the budget. Recent initiatives to fully fund the state and teachers' pension systems, which were strongly supported by the Chamber, have dramatically increased the amount of state funds going to these systems. The following chart estimates the state funds allocated to the Kentucky Employee Retirement System and the Kentucky Teachers' Retirement System over the past ten years.

Estimated Kentucky General Fund Appropriations to Pensions

Fiscal Year 2009 to Fiscal Year 2019 (In Millions of Dollars)



Source: *Estimates based on GOPM data and LRC staff presentation to Pension Working Group in 2019*

As the chart indicates, Kentucky is now putting about $1 billion per year more into pensions than it was five years ago. Several important factors affect this trend:

- The full actuarially required contribution (ARC) for both pension systems was not paid until the biennial budget that took effect in FY 2017.
- As noted in studies of Kentucky's pension systems by the PFM Consulting Group and the Pew Charitable Trusts, the ARC as calculated for many years was not adequate due to failure to meet actuarial assumptions and investment performance targets.
- During the period in which the ARC was underpaid/under calculated, retirement benefits continued to be enhanced, adding to unfunded liabilities.
- In the past several years, KERS (the plan for state government workers) has revised assumptions (explained below), resulting in a higher ARC for KERS.
- Kentucky has mature pension systems, with fewer employees working than are drawing a pension in some pension funds, which increases costs.

Kentucky also has made significant changes to its retirement systems since the 2015 *Leaky Bucket* update. The following summarizes these changes by year of enactment by the Kentucky General Assembly or administrative changes:

2016 — New System Management: A gubernatorial executive order reorganized the Kentucky Retirement Systems board, which oversees the Kentucky Employee Retirement System, and added board members with investment expertise. The new board subsequently hired a new executive director, an investment professional, and took action to revised outdated assumptions used to determine the ARC.

2018 — Updated Actuarial Assumptions: Reviews of the Kentucky Employee Retirement Systems by outside experts have found that assumptions used in determining the Actuarially Required Contribution (the percentage of salary that employers contribute to the pension system) were inaccurate and resulted in an ARC that was too low and contributed to underfunding of the system. In particular, assumptions made about state payroll growth, growth in the number of employees and interest earned on investments were higher than actual experience. The new KRS board has taken action to revise these assumptions—lowering the assumed rate of return on investments, growth in employees and payroll growth—resulting in a higher ARC that will infuse more funds into the system. The chart below shows the change in employer contribution for the ARC for KERS in recent years:

Employer Contribution Rates for KERS

	Pension		Insurance		Total	
	Recommended	Actual	Recommended	Actual	Recommended	Actual
2009	16.54%	5.79%	12.06%	4.22%	**28.60%**	**10.01%**
2010	18.96%	6.65%	12.33%	4.96%	**31.29%**	**11.61%**
2011	21.77%	9.58%	16.81%	7.40%	**38.58%**	**16.98%**
2012	24.30%	11.59%	16.41%	8.23%	**40.71%**	**19.82%**
2013	28.03%	14.86%	16.52%	8.75%	**44.55%**	**23.61%**
2014	32.57%	17.29%	12.71%	9.50%	**45.28%**	**26.79%**
2015	30.84%	30.84%	7.93%	7.93%	**38.77%**	**38.77%**
2016	30.84%	30.84%	7.93%	7.93%	**38.77%**	**38.77%**
2017	40.24%	40.24%	8.35%	8.35%	**48.59%**	**48.59%**
2018	41.06%	41.06%	8.41%	8.41%	**49.47%**	**49.47%**
2019	71.03%	71.03%	12.40%	12.40%	**83.43%**	**83.43%***

**** Quasi agencies (i.e. health departments, regional mental healths, universities, and certain non-state agencies) maintained the 2018 contribution rate.***

Source: *FY 2018 Summary Comprehensive Annual Financial Report, Kentucky Retirement Systems*

2016 to Present — Full Funding of ARC: After more than a decade of underfunding, the FY 2016-2018 state budget provided more than $1.1 billion in additional pension funding. The full ARC plus an additional $150 million was provided to the Kentucky Employee Retirement System (KERS) over the biennium. This trend continued last year with the enactment of the FY 2018-20 budget, which fully funded KERS and KTRS.

2018 — Benefit Reforms, SB 151: While a hybrid retirement system for new employees created in 2013 was retained in 2018 reforms, the guaranteed rate of return it originally included was eliminated. In addition, new teachers were placed in a hybrid cash balance plan. The Supreme Court of Kentucky found this legislation unconstitutional on procedural grounds (the rapid manner in which the bill was passed) in December 2018.

2019 — Quasi-Governmental Legislation, HB 1: Legislation enacted during a special session of the General Assembly in 2019 allowed quasi-governmental organizations (such as health departments, mental health centers and regional universities) to leave the Kentucky Retirement System provided the organization paid (either in a lump sum or over a period of years) the total unfunded liabilities that had accrued for its employees in the system.

K-12 EDUCATION FUNDING

Funding for SEEK, the primary program that funds K-12 education in Kentucky, increased only 1.2% in the past five years, while non-SEEK funding increased by more than 30%. While non-SEEK categories include such things as textbooks, teacher training programs and instructional resources, the 30% growth in that area was primarily due to increased appropriations to the Kentucky Teachers' Retirement System. To illustrate this point, the table below shows the net increase in total Kentucky Department of Education funding (which includes both SEEK and non-SEEK funds) over a ten-year period when funding for teacher health insurance and pensions is removed.

Funding for SEEK, the primary program that funds K-12 education in Kentucky, **increased only 1.2%** in the past five years.

Net Kentucky Department of Education Funding Fiscal Year 2010 to Fiscal Year 2020

	FY 2010	FY 2020
Total Dept. of Education Funding	$3,629,474,121	$4,124,254,500
Less funding for teacher pension contributions in SEEK and health insurance	$930,996,700	$1,141,976,000
Net funding	$2,698,477,421	$2,982,278,500
Increase in net funding from Fiscal Year 2010 to Fiscal Year 2020: 10.5%		

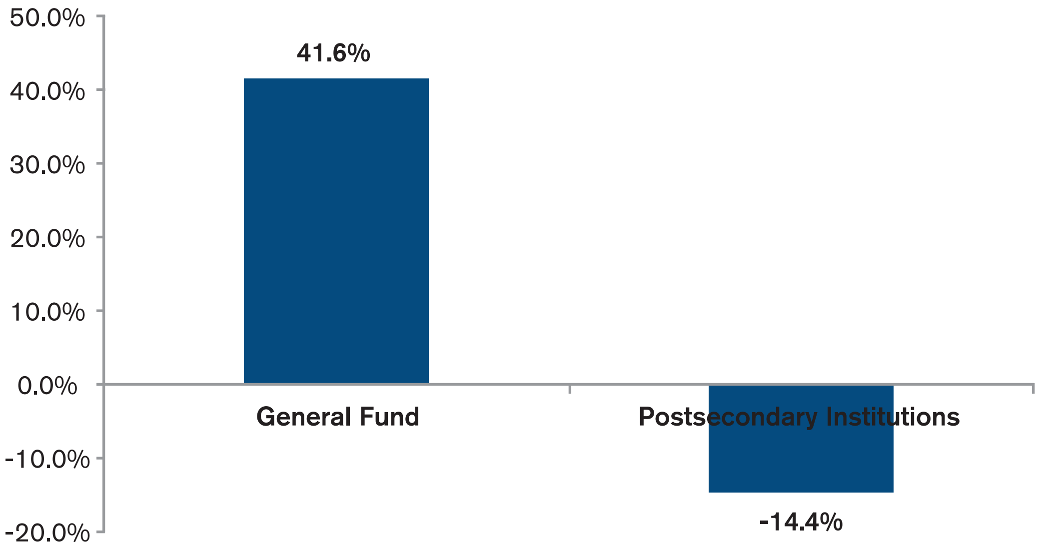
Source: *Executive Budget in Brief, Office of State Budget Director*

Net funding for the Department of Education increased 10.5% over the past 10 years. Total General Fund spending increased 41.6% in the same period. The Department of Education's share of the total General Fund budget has also decreased over the past ten years. It represented 45.1% of the General Fund budget in FY 2010-12; this had dropped to 43% by the FY 2018-20 budget.

POSTSECONDARY EDUCATION FUNDING LAGGING

Postsecondary education has been the primary victim of budget cuts as spending has increased for Medicaid, corrections and pensions. Kentucky now provides dramatically less funding to state postsecondary institutions than it did ten years ago, in FY 2010. At that time, $1,007,481,100 in state General Funds were appropriated to state universities and community colleges. By the current fiscal year, this amount has dropped to $862,900,800—**a 14.4% reduction** of more than $144 million over the ten-year period. This reduction is particularly sobering in view of the fact that overall General Fund spending has increased by 41.6% during the same period.

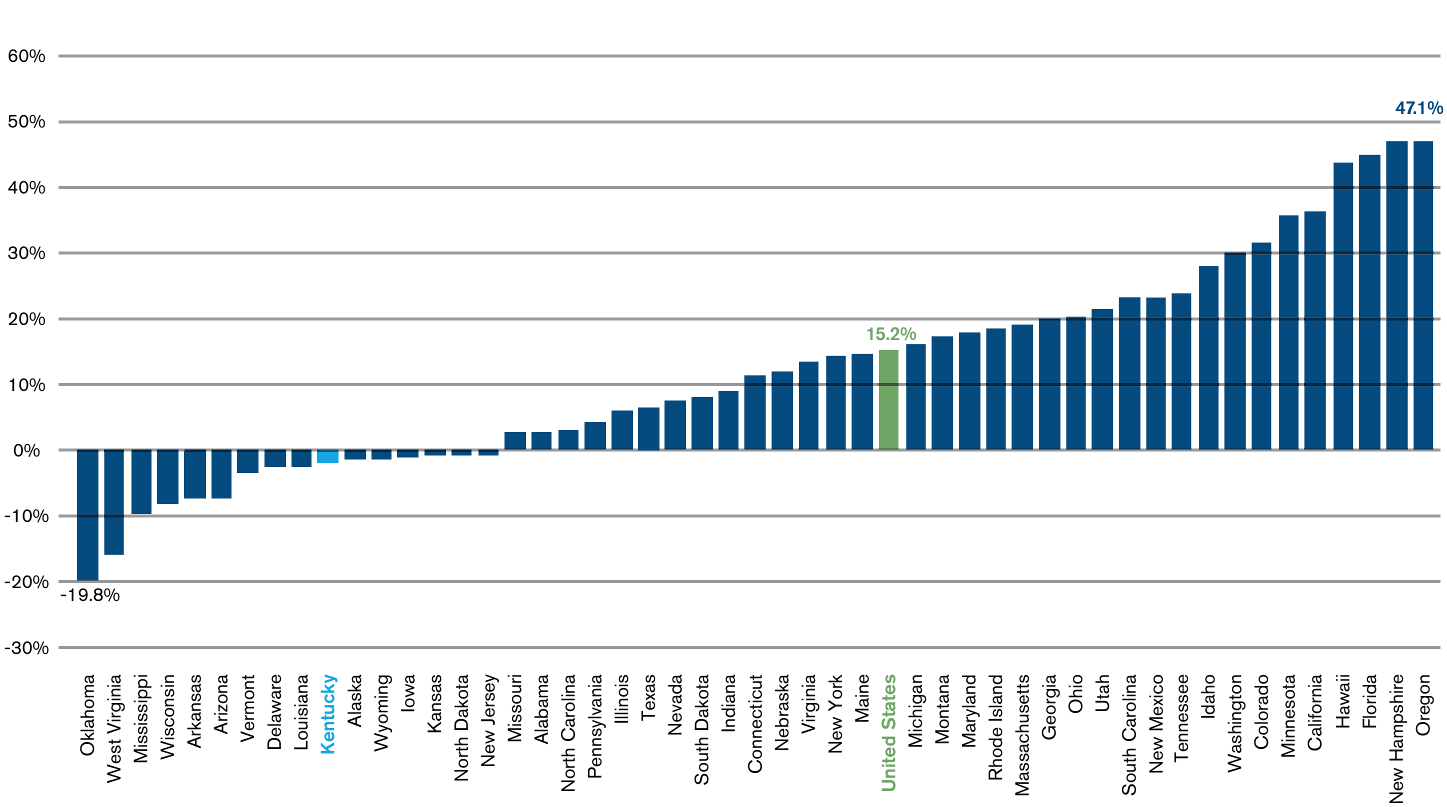
Change in Kentucky General Fund Spending Compared to Funding for Postsecondary Institutions: Fiscal Year 2010 to Fiscal Year 2020



***Source:** FY 2010-12 Executive Budget in Brief and FY 2018-20 Executive Budget in Brief, Office of State Budget Director*

Compared to other states, Kentucky is falling behind in appropriations per full-time postsecondary student. As the following chart indicates, appropriations per full-time student increased 15.2% on average among the states from FY 2013 to FY 2018, while in Kentucky it decreased by 2% during that period. Since the 2008 recession, appropriations per student have fallen 25.4% in the Commonwealth.

Public Higher Education Appropriations per FTE:
Percent Change, FY 2013-2018

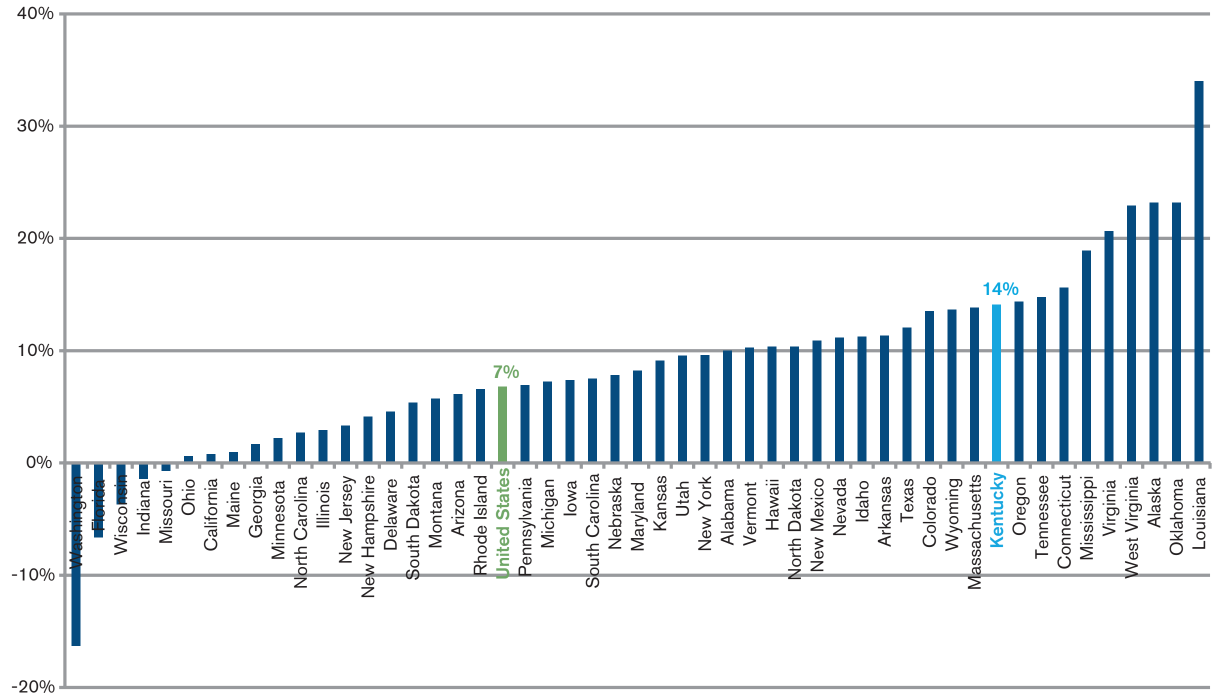


Source: *State Health Education Finance: FY 2018, State Higher Education Executive Officers Association, 2018*

To compensate for more than a decade of funding cuts, Kentucky's public colleges and universities have increased tuition and fees. The chart on the next page, from the most recent Annual Survey of Colleges report, shows that in-state tuition and fees for four-year public institutions in Kentucky increased twice as fast as the national average over a five-year period. Kentucky increased 14% while the national average was 7%.

In-state tuition and fees for four-year public institutions in Kentucky increased **twice as fast** as the national average over a five-year period. Kentucky **increased 14%** while the national average was 7%.

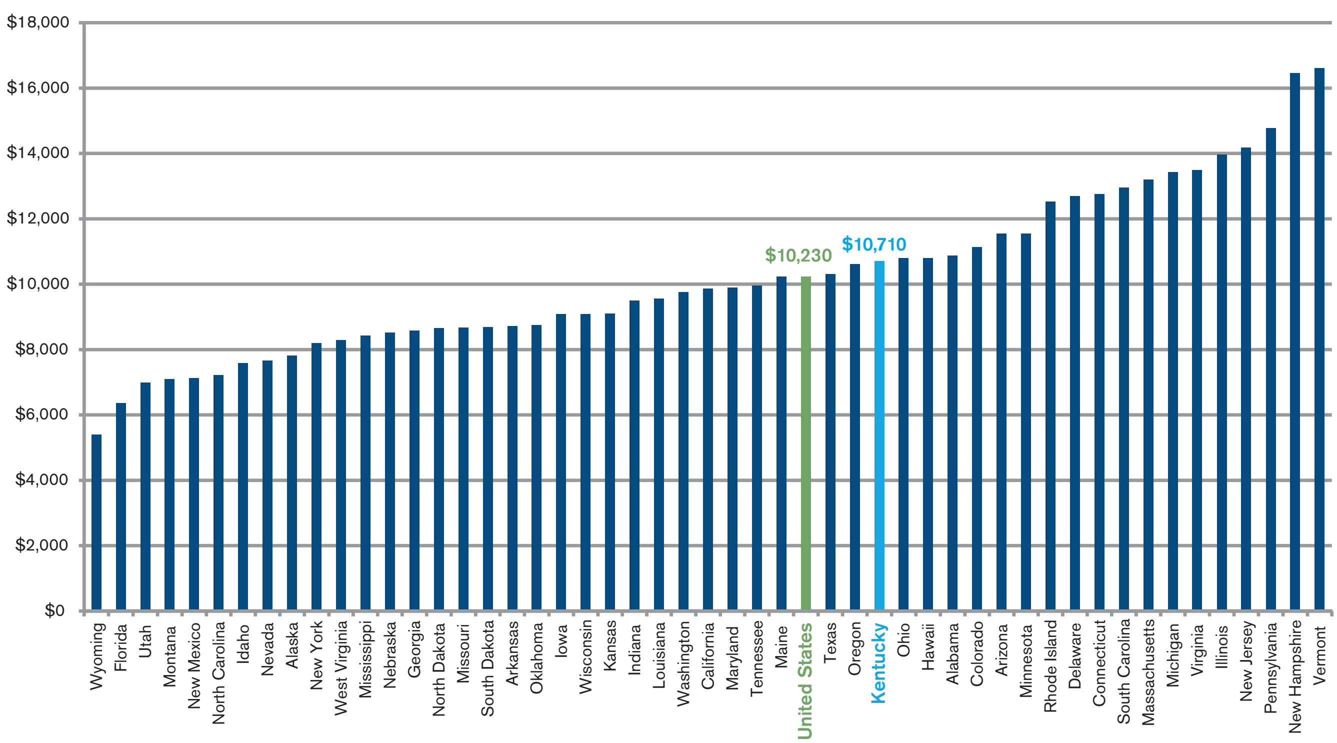
Five-Year Percentage Change in Inflation Adjusted In-State Tuition and Fees for Public Four-Year Institutions



Source: *Trends in College Pricing 2018, The College Board*

For the 2018-19 school year, average in-state tuition at four-year public institutions in Kentucky was $10,710 compared to the national average of $10,230.

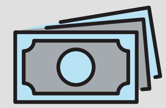
In-State Tuition and Fees for Public Four-Year Institutions 2018-19 School Year



Source: *Trends in College Pricing 2018, The College Board*

The trend for tuition for two-year public institutions is similar. The College Board reports the average tuition for two-year public institutions in Kentucky increased 14% from 2013 to 2018, while the national average was 5%. The average tuition for two-year public institutions in Kentucky was $5,310 for the 2018-19 school year, compared to $3,660 nationally.

Rising tuition presents a challenge to students in a low-income state such as Kentucky and contributes to the number of students who must borrow to pay college costs. The Project on Student Debt estimates that 64% of all Kentucky students in the graduating class of 2018 had student debt, ranking the Commonwealth seventh among the states in the percentage of graduates with debt. The average debt in Kentucky is $28,435, just below the national average of $29,200.



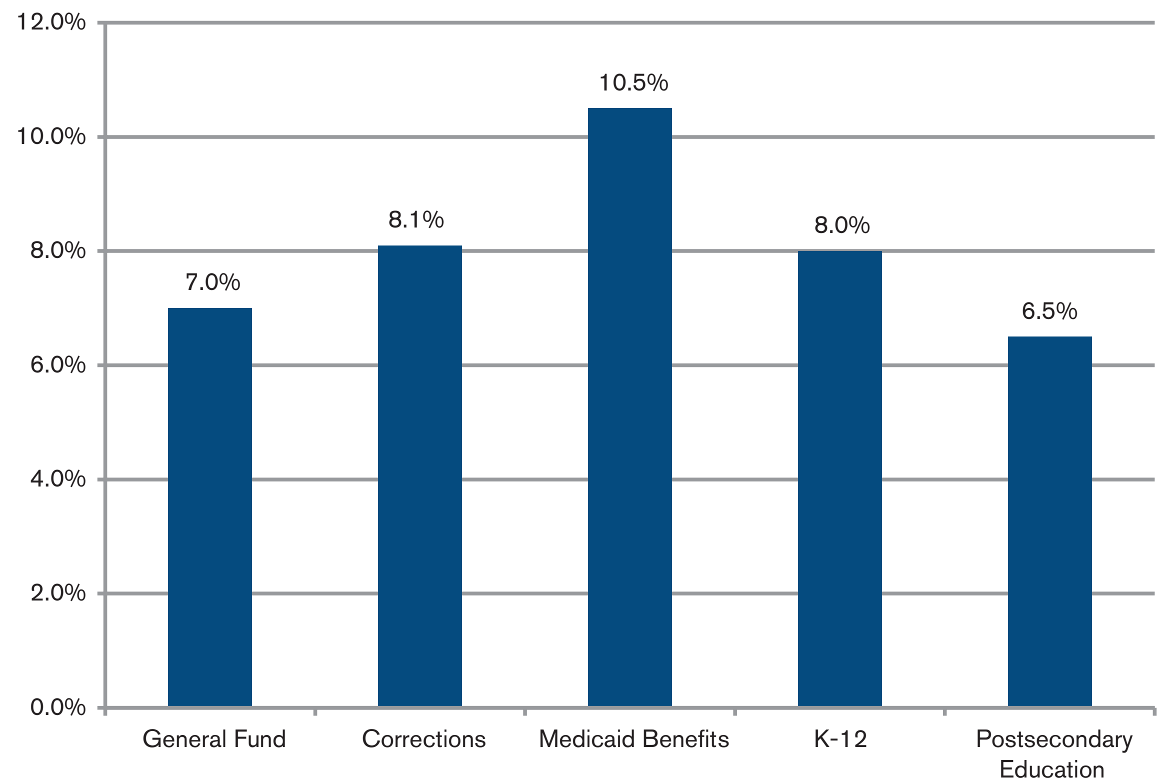
Rising tuition presents a challenge to students in a low-income state such as Kentucky and contributes to the **number of students who must borrow to pay college costs.**

SPENDING TRENDS IN OTHER STATES

The trend of state spending in Medicaid and corrections outpacing overall General Fund spending is not unique to Kentucky. The National Association of State Budget Officers publishes an annual state expenditure report that tracks spending among the 50 states in key program areas. The most recent report, released in 2018, tracks spending from Fiscal Year 2016 to 2018. The following chart below shows the percentage change in each area.

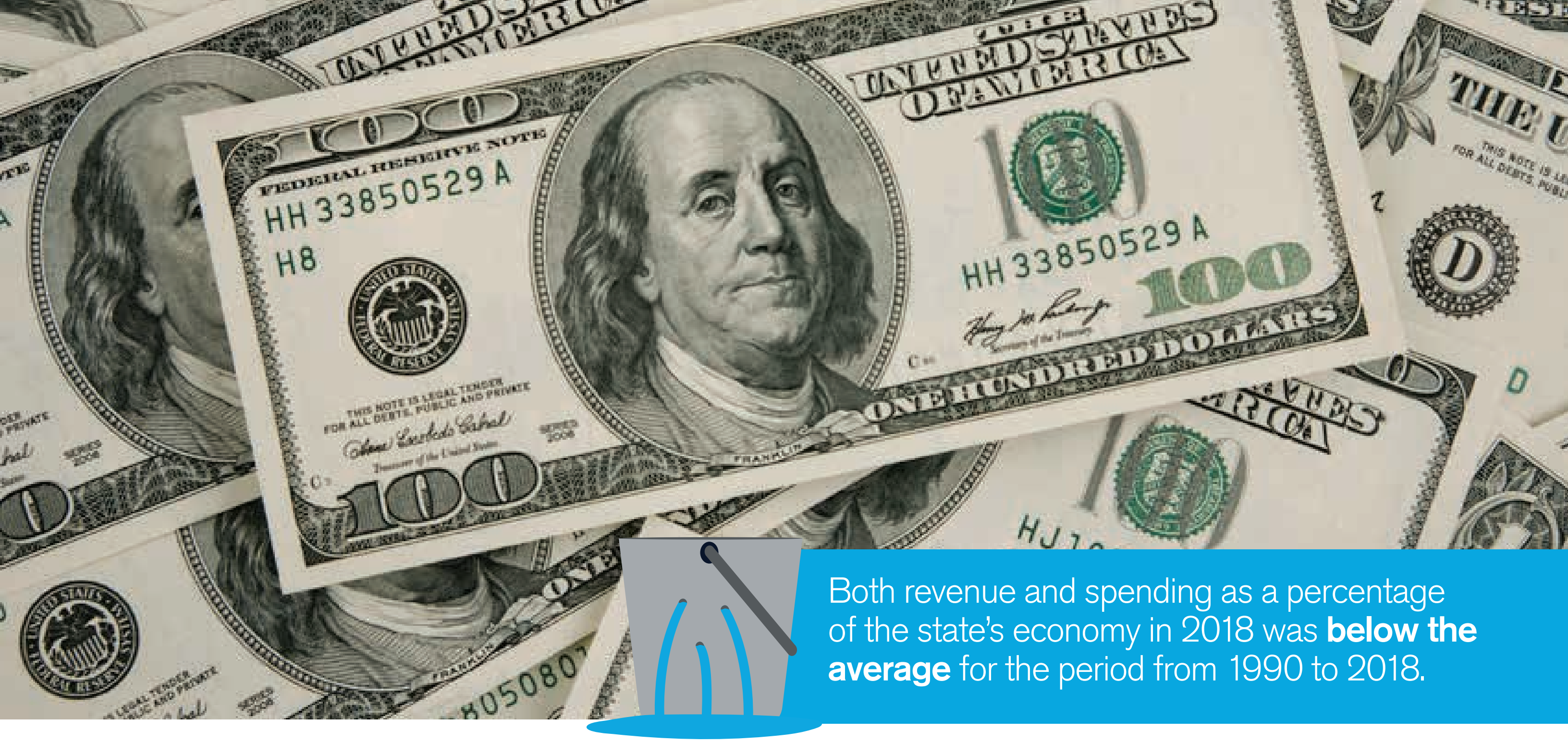
Growth in State Fund Expenditures in Selected State Programs for all 50 States

Fiscal Year 2016 to Fiscal Year 2018



Source: *2018 State Expenditure Report Fiscal Years 2016-2018, National Association of State Budget Officers*

The national trends for FY 2016 to 2018 are similar to Kentucky's: Spending on Medicaid and corrections is outpacing the growth in overall state spending across the country. But there is one significant difference: Spending on K-12 and postsecondary education has increased across the nation, while K-12 spending has barely increased and postsecondary spending has significantly declined in Kentucky.



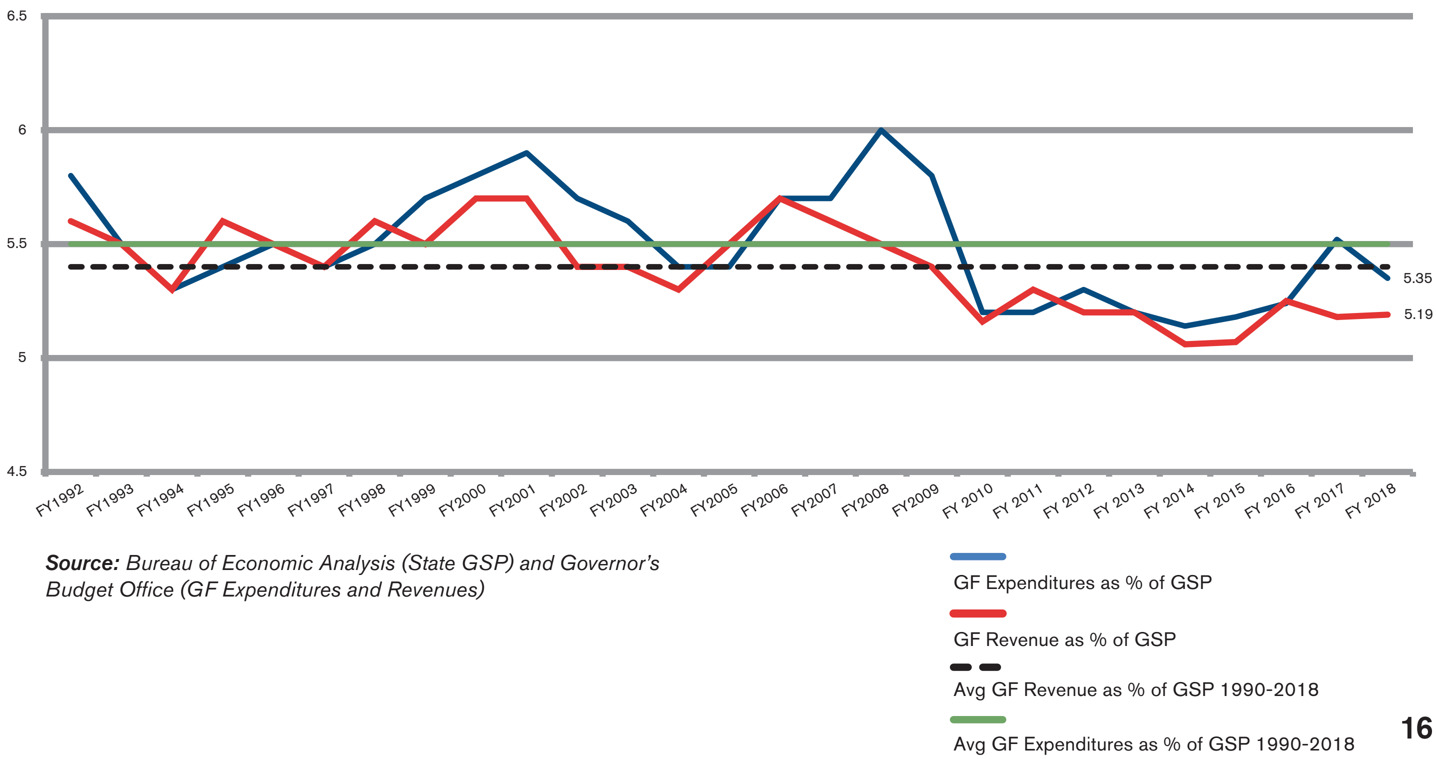
Both revenue and spending as a percentage of the state's economy in 2018 was **below the average** for the period from 1990 to 2018.

KENTUCKY'S REVENUE OUTLOOK

In the original 2009 *Leaky Bucket* report, the Chamber began tracking state spending and revenue as a percentage of the total state economy as a way to gauge the relative size of state government. The chart below updates this data through 2018:

Kentucky General Fund Expenditures and Revenues as a Percentage of Gross State Product: 1990 to 2018

(General Fund Revenue as % of GSP Average = 5.4%, General Fund Expenditure as a % of GSP Average = 5.5%)



Source: *Bureau of Economic Analysis (State GSP) and Governor's Budget Office (GF Expenditures and Revenues)*

As the chart indicates, both revenue and spending as a percentage of the state's economy in 2018 was below the average for the period from 1990 to 2018.

While spending and revenue are down relative to the size of the economy, Kentucky's revenue outlook is modest. The 2020 General Assembly will be faced with limited revenue growth when crafting the next biennial budget. The Consensus Forecasting Group, a team of economists created under state law that provides the revenue projections used by the General Assembly to write the state budget, released planning revenue estimates for the next budget period in December 2019.

December 2019 Planning Estimates — General Fund (Millions of Dollars)

	FY 21	FY 22
Total General Fund	$11,722	$11,929
New Money	$148	$207
Percent Change	1.3%	1.8%

Source: *Consensus Forecasting Group, December 2019*

Based on these estimates, there will be about $150 million to $200 million per year in new funds available for the next biennial budget. Faced with rising Medicaid and corrections costs, funding for school safety legislation enacted in 2018, and an expected increase in agencies' pension costs, writing the next biennial budget will present particular challenges for the 2020 General Assembly.

POLICY RECOMMENDATIONS

CORRECTIONS

The Chamber supports broad comprehensive penal code reform, such as the recommendations of the Kentucky CJPAC Justice Reinvestment Work Group, which include:

- Reclassify drug possession as a misdemeanor—the increased cost of incarcerating drug abusers is unsustainable and resources should be prioritized toward treatment.
- Limit the use of money bail.
- Increase the felony theft threshold from $500 to $2,000.
- Revise the persistent felony offender statute for nonviolent offenders.
- Expand home incarceration and administrative release.

The Work Group's total package of recommendations is projected to reduce growth in the prison population by 79% and save $340 million in corrections costs through 2027.

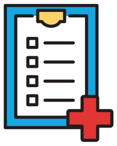
MEDICAID

The Chamber recommends a top to bottom review of the Medicaid program, conducted by an outside expert, to identify potential efficiencies and/or cost savings in the program.

SMOKING

The Chamber supports a statewide ban on smoking and an increase in the cigarette tax to curb smoking and related health costs. The Chamber also supports taxing vaping products at the same level as cigarettes.

PUBLIC EMPLOYEE HEALTH INSURANCE



As spending growth in this area has slowed dramatically—only 5.5% in the past five years—the Chamber would encourage continuation of existing efforts, particularly those promoting employee wellness.

PENSIONS

The Kentucky Chamber has been speaking out about the state's pension challenges for more than 12 years. We have produced a number of reports and provided legislative testimony highlighting the negative impact of rising benefit costs on other important areas of state spending, especially education, and advocating changes to make the retirement systems more sustainable. We led a coalition of organizations to support the successful 2013 pension reform legislation and supported changes enacted in 2018 that were subsequently overturned on procedural grounds.

Moving forward the Chamber believes:

- Benefits provided to public employees should mirror the private sector to the extent possible under state law.
- Public employees should work longer before being able to retire (similar to private sector).
- Retirement promises made to public employees for benefits already earned should be honored.
- Continued emphasis should be placed on reducing public employee health insurance costs.
- The full actuarially required contribution (ARC) should be made to Kentucky's pension systems, and assumptions on which the ARC is based should be periodically audited to ensure their accuracy

It is important to note that while benefit changes can result in savings over the long term, they will not result in a reduction in the employer contribution in the near term.

EDUCATION

As this update demonstrates, funding for postsecondary institutions has been cut by more than 14% since 2010, resulting in tuition increases that are rising twice as fast as the national average and creating challenges for a low-income state that needs to increase education attainment. Similarly, funding for K-12 education is lagging as most funding increases have been allocated for teacher benefits. As education is the top priority of the Kentucky Chamber, efforts should be made to restore funding to postsecondary institutions and to increase appropriations to the SEEK program to stop the continuing slide in education funding.

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CONCLUSION

LOOKING BEYOND THE BUCKET

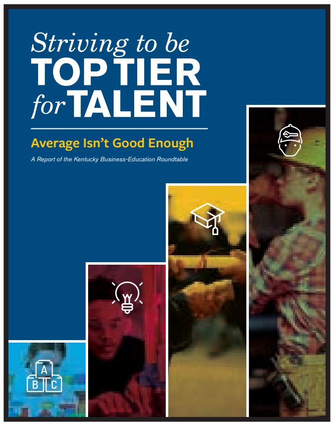
Kentucky has a history of intractable problems with which policymakers have struggled for generations:

- Low-income levels and high rates of poverty
- Education attainment levels that trail the national average
- Poor health status
- High levels of drug abuse and incarceration
- A workforce participation rate that is among the nation's lowest

Previous *Leaky Bucket* reports have advocated policy reforms to address unsustainable spending in lieu of tax increases to raise more revenue. The General Assembly has adopted numerous reforms recommended by the Chamber and others over the past 10 years that have limited growth to some extent, and the Chamber applauds those efforts.

But as this update documents, troubling spending trends persist. While additional reforms can help reduce growth in some areas, it is time recognize that additional revenue will be needed to address Kentucky's underfunded pension systems, better fund education and improve Kentucky's workforce.

The Kentucky Chamber has recognized the need for revenue in several reports. In recent years, the Chamber convened the Kentucky Business Education Roundtable, a group of state education and business leaders and advocates, which has developed an ambitious agenda to improve education attainment and workforce quality.

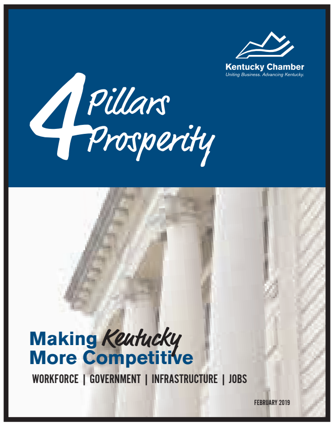


The Roundtable framed this work around the four key goals of:

1. Investing in early care and education
2. Reinventing high school
3. Ensuring every adult obtains a marketable degree or credential
4. Engaging employers to define needed skills and develop talent supply chains

The Roundtable's December 2018 report, *Striving for Top Tier Talent: Average Isn't Good Enough*, observed:

> "Increased revenue resulting from economic growth and additional resources, wisely invested, will be necessary for Kentucky to build a higher quality education system, to enlist all employable adults in meaningful work, to avoid downstream costs (such as prisons, welfare, drug addiction) and to produce more and better talent for our economy and society."



Similarly, the Chamber's 2019 strategic plan, Four Pillars for Prosperity, outlined a vision for Kentucky that rests on:

1. A healthy, educated and skilled workforce
2. Quality, knowledge-based jobs
3. 21st century infrastructure
4. Effective and efficient government

The Four Pillars report noted:

> "As we strive for progress in a state with limited public resources, it is becoming more apparent that additional resources, wisely invested, will be necessary for Kentucky to achieve its goals for individuals and the state as a whole."

If Kentucky is to overcome its historically high levels of poverty, poor health status, and low levels of education attainment to develop a 21st century workforce, greater investments will be required in programs that will ensure the prosperity of the state and its people. We cannot strive just to keep pace with our competitors. We must accelerate our efforts, and provide the resources to fuel them.

The Commonwealth cannot reform or cut its way out of current funding challenges without falling further behind in areas critical to our future. We must "look beyond the bucket" to generate additional revenue. Kentucky needs pro-business tax reform that improves the Commonwealth's competitiveness while producing net new revenue to support education and develop a modern workforce.

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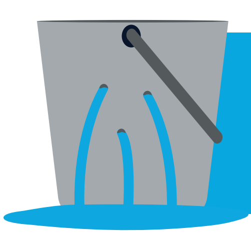

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