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State Revenue Growth Should Be Put Into Context

The first of a series of state revenue estimates released this week projects modest growth over the next few years. But increases in revenue should be put into context. The economy is only slowly emerging from a deep hole, and continued growth is very uncertain. Without tax reform, revenue is expected to rise in dollar terms but continue to shrink as a share of the Kentucky economy. And high unemployment and longstanding budget needs mean serious demand for whatever revenues the state can generate.

The state’s Consensus Forecasting Group (CFG) is charged with developing official state revenue estimates. In August of each odd-numbered year, it produces planning estimates for the current and the next four fiscal years. The CFG will meet again in October and in January to develop refined and then official estimates for the next two-year budget.

At its August meeting, the CFG approved a planning forecast that projects revenue growth of 3.3 percent for 2013 and 3.6 percent for 2014. 2012 revenues are projected to be $192 million (or 2 percent) above the official forecast almost entirely because business tax revenues (corporate and limited liability entity taxes) are stronger than expected.

Increases in revenue are good, but must be put into context. The normal expectation should be for revenues to grow—they have decreased only four times in the past 66 years. But experts have identified problems with Kentucky’s tax system that mean revenues don’t grow fast enough to keep up with economic growth, much less Kentucky’s needs. Analysis of the information presented to the CFG suggests that trend is likely continuing. As a share of personal income, General Fund revenues are not projected to bounce back to pre-recession levels, but to level off and then decline (Figure 1).

Figure 1

Nominal Revenue Growth but Relative Revenue Decline

Sources: Author’s calculation, Office of the State Budget Director, Global Insight
While the $192 million in potential extra revenues for 2012 is welcome news, the state still faces an unresolved $189.9 million budget gap for 2012. What’s more, the 2012 budget was balanced using significant one-time measures, by pushing costs off to future years and through serious cuts to a range of important services. The surplus is not extra money given the unsoundness of the budget that passed.

Economic uncertainty remains an important factor. GDP grew at very weak rates of only 0.4 percent in the first quarter of 2011 and 1.3 percent in the second quarter. The economy suffers from a lack of adequate demand—consumers aren’t spending, and businesses aren’t investing because consumers aren’t spending. The political situation in Washington adds to the risk, as budget cutting will further pull demand from the economy and as the conversation drifts away from efforts to create jobs. There is also risk that the financial crisis in Europe will spread and cause serious problems for the world economy.

Here in Kentucky, the CFG forecast suggests that the state economy will grow more slowly than the nation. Kentucky’s personal income is projected to increase 3.3 percent in 2013 and 4.6 percent in 2014, while U.S. personal income will grow 3.8 percent and 5.1 percent. Kentucky faces a large gap in employment. At the end of June, Kentucky still had 77,800 fewer jobs than it did in December 2007. While that number is up from the trough of 117,700 lost jobs—which occurred in February 2010—it still suggests a large gap that impacts state revenue. Fewer jobs mean less worker income and ability to spend and therefore less revenue from income and sales taxes. Kentucky has only added 1,500 jobs a month on average over the last year, pushing employment recovery out many years into the future without faster job growth.

On top of troubling trends in the economic and political context are the longstanding challenges with Kentucky’s tax system. In the last few years, Kentucky has relied heavily on 2009 tobacco tax increases, higher coal prices and the subsequent rise in severance tax receipts, and increased corporate profits leading to higher corporate tax revenues. Those sources are important yet highly uncertain. Tobacco tax revenues are expected to level off or even decline over the next four years according to the forecast, as are corporate tax revenues after 2012. Coal severance revenue growth depends on high and rising coal prices since production of coal in Kentucky has been decreasing over time. The more serious needs are to broaden the base of both the sales and individual income taxes, which together account for three-fourths of the General Fund.

In addition, Kentucky faces substantial budget needs and pressures when crafting the next two year budget, including the following:

- Costs were shifted forward to the 2013-2014 budget to help balance the 2011-2012 budget, meaning the new budget starts out structurally imbalanced.
- Previous strategies to shift costs elsewhere or to future years are being appropriately curtailed, such as the underfunding of public pensions.
- High unemployment means greater need and eligibility for a range of public services, such as Medicaid, leading to continued extra spending needs.
- Some programs and services have been cut as much as 30 percent over the last few years, meaning significant resources are needed simply to return funding to pre-recession levels.
- Important needs in a range of areas, such as early childhood education, remain unfunded.

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important state fiscal and economic policy issues. KCEP seeks to create economic opportunity and improve the quality of life for all Kentuckians. Launched in 2011, the Center receives support from foundation grants and individual donors and is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP’s website at www.kypolicy.org.


4 Global Insight Control Scenario presented by the Office of the State Budget Director to the Consensus Forecasting Group, August 4, 2011.

5 Bureau of Labor Statistics, Economic Policy Institute