Year-end financial report

to Interim Joint Committee
on Appropriations and Revenue

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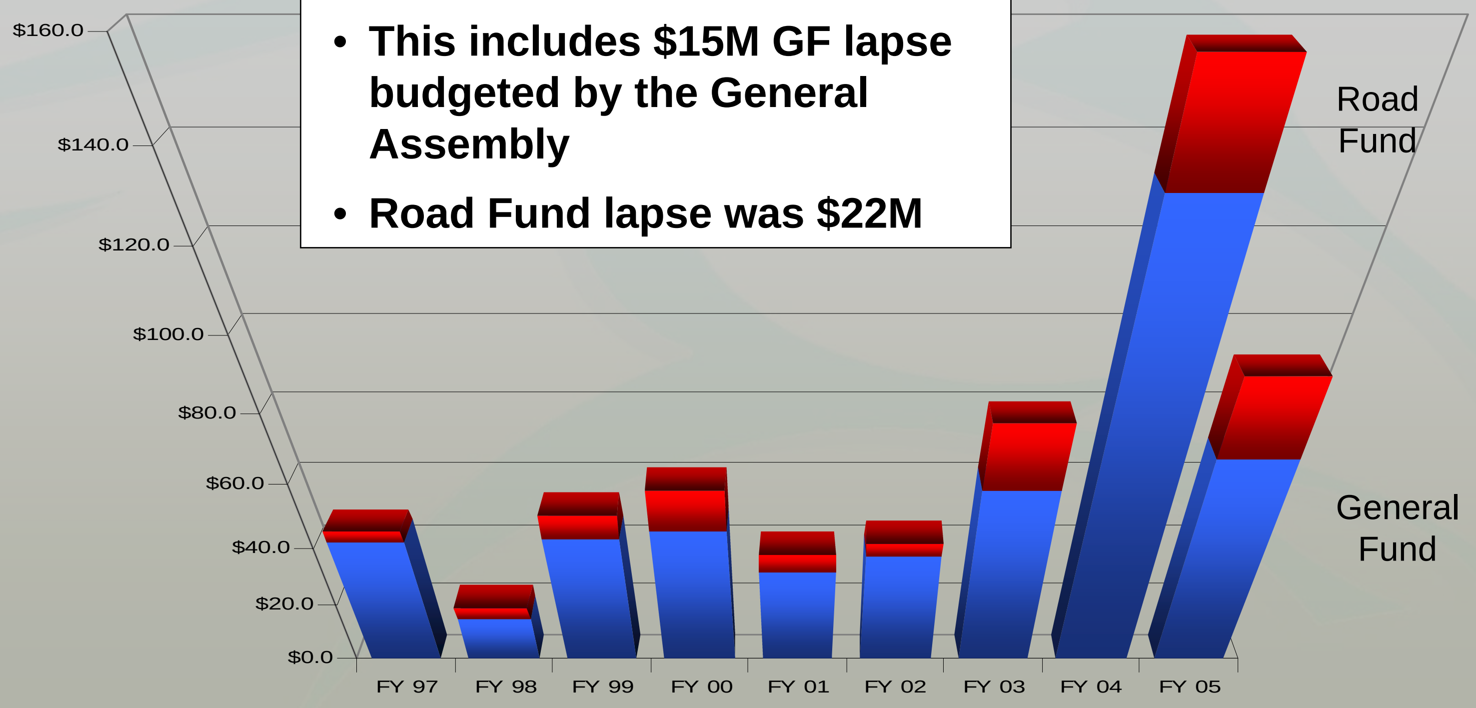
State Budget Director

August 25, 2005

FY05 lapses were remarkably high

- Actual GF lapse was $67M
- This includes $15M GF lapse budgeted by the General Assembly
- Road Fund lapse was $22M



62% of GF appropriations are protected

- ✓ Lapse = the unspent portion of an appropriation which reverts to the General Fund (GF)
- ✓ Lapse does not include any increase in tax receipts or transfers
- ✓ 62% of GF appropriations are protected against lapse by re-appropriation within the budget bill (only 38% of GF appropriations are subject to lapse)

Road Fund achieved $29M surplus

- ✓ Surplus represents 2.5% of enacted appropriations
- ✓ No small achievement when revenues grew less than 1%
- ✓ Surplus funds will be directed into the state highway construction program
- ✓ Transportation Cabinet saved $22.5 million in Cabinet activities; funds can now be dedicated to highway construction

FY05 GF revenue up $667M (9.6%) over FY04

Why FY05 revenue is higher than FY04

- ✓ Strong national economic trends were mirrored in Kentucky
- ✓ Substantial revenue increases were nearly across the board
- ✓ Sales and use taxes grew 6% (highest growth rate since FY96)
- ✓ Cigarette tax became effective in June (increased collections by $16.9M)
- ✓ Enhanced collections by Dept of Revenue

General Fund Receipts, FY04 and FY05

	FY05 ($Mil)	FY04 ($Mil)	Diff ($Mil)	Diff (%)
Sales and Use	2,595.0	2,447.6	147.4	6.0
Individual Income	3,036.2	2,796.3	239.9	8.6
Corp. Inc. & License	612.6	427.4	185.2	43.3
Cigarette	33.7	17.1	16.6	97.1
Coal Severance	184.4	147.5	36.9	25.0
Property	472.6	448.8	23.8	5.3
Lottery	161.3	173.8	-12.5	-7.2
Other	582.9	536.2	46.7	8.7
Total	7,645.0	6,977.60	667.4	9.6

FY05 GF rose $195M over projections

Why GF revenue rose faster than expected?

- ✓ Stronger uptick in Kentucky economy than predicted
- ✓ Consistent with other states, national trends
- ✓ Encouraged by business and consumer confidence in Kentucky business and governmental climate
- ✓ Business signals sent through tax modernization may have played small role in the strengthening of the economy but implementation has just begun

Did tax modernization affect FY05 receipts?

Mostly no, because J4K hasn't fully kicked in yet.

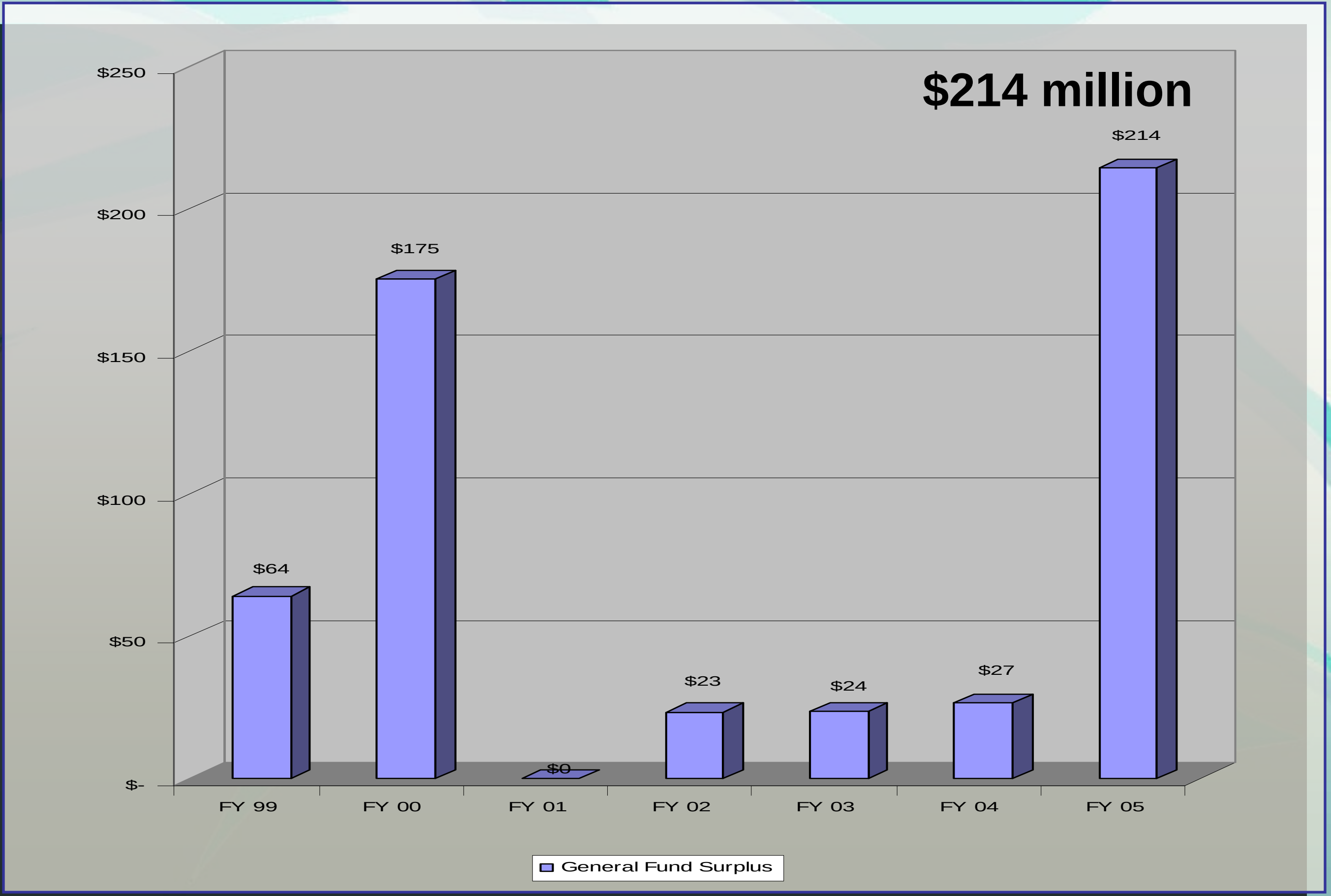
But with three qualifications

1. Yes, new cigarette tax revenue ($16.6M more, due to cigarette tax changes)
   - ✓ JOBS for Kentucky (J4K) increased tax from 3c to 30c per pack for one month (June)
   - ✓ J4K imposed floor stocks tax (to equalize tax on existing inventories)

Did tax modernization affect FY05 receipts?

2. Yes, individual income tax receipts fell in June
    - ✓ LLE members anticipate credit for business tax
    - ✓ J4K reduced income tax rates
    - ✓ (J4K low income tax credit had not yet affected receipts)
3. Mixed, corporate income tax
    - ✓ Some portion of increase resulted from inclusion of LLE's in corporate income tax
    - ✓ But increased business tax receipts resulted primarily from higher corporate profits (other states also have big boosts)

FY05 General Fund Surplus was up sharply



General Fund Surplus on June 30, 2005

	$ Millions
General Fund Revenues in excess of enacted	$195
Tobacco Settlement – Phase I payments in excess of enacted	$3
Fund Transfers less than enacted (due to injunction on KAPT $13.7m)	($5)
Necessary Government Expenses-unbudgeted expenditures	($14)
Judgments payments-unbudgeted expenditures	($3)
Off-budget expenditures (Abandoned Property Fund/KAPT)	($17)
Unbudgeted Lapses (excl. budgeted lapse of $15)	$52
Lapse of Continued Appropriation	$2
General Fund Surplus	**$214**

Budget bill's surplus spending plan

Governor is permitted to choose among five options:

1. **Budget reserve trust fund** (up to 1.5% of projected FY06 GF revenue)
2. **Increased classroom teacher salaries** to the average level of contiguous states
3. **Additional funding to (P-16)** necessary to return base appropriations to the pre-Budget Reduction /Stability Initiative of fiscal year 04
4. **Medicaid** (limited to an amount certified as needed by the secretary of H&FS and approved by the State Budget Director)
5. **Necessary government expenses** (including judgment liabilities not funded by General Assembly)

Governor contributes $90M to trust fund

Target at 1.5% of FY 06 revenues	$	119,015,085
BRTF ending balance for FY 05	$	28,764,829
Maximum Deposit from surplus	$	90,250,256

- ✓ $124 million available for other options
- ✓ Governor is currently studying options and evaluating the needs of the Medicaid program

FY06 good news: revenue

Already budgeted:

- ✓JOBS for Kentucky (J4K) was revenue neutral over five year period (FY04-08), but included cash flow "bump" ($110M) in FY06 (already budgeted)

Not budgeted:

- ✓Beginning balance is higher than anticipated due to lapse and stronger revenue in FY05
- ✓CFG forecast for FY06 is $ $325.8 more than the enacted budget

FY06 bad news: expenditure pressures

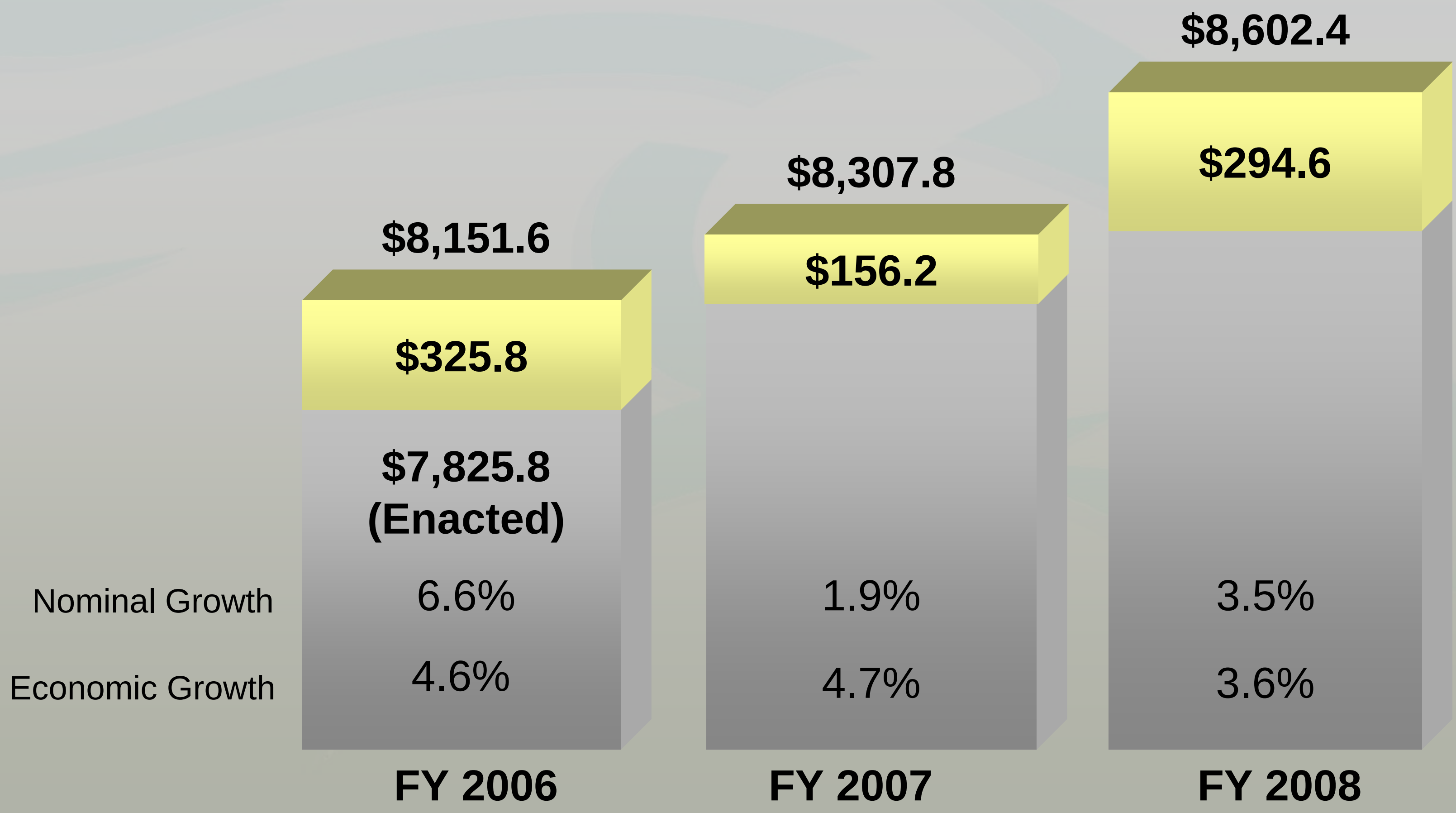
- ✓ Medicaid is way out of balance
- ✓ Prison population is increasing, but at lower rate
- ✓ State employee health insurance costs were budgeted for 20% increase to CY06

The road ahead: FY07-08 budget

Budget challenges have shifted from lack of revenue to unsustainable expenditures

- ✓ **Revenues are coming in nicely.**
- ✓ **The big four (Medicaid, health insurance, pensions and corrections) are competing with everything else in the budget**

CFG revenue outlook for General Fund FY06-08



CFG August GF revenue estimates

	FY06 ($Mil)	FY07 ($Mil)	FY08 ($Mil)	FY09 ($Mil)	FY10 ($Mil)
Sales & Use	2,714.8	2,772.5	2,891.1	3,034.1	3,164.6
Individual Income	2,820.6	3,000.8	3,158.1	3,317.7	3,472.2
Corporation Inc & Lic	974.0	915.2	896.8	896.0	873.1
Coal Severance	199.1	202.9	190.3	180.1	170.3
Cigarette	181.8	169.1	169.1	169.1	169.3
Property	495.7	476.2	501.0	525.9	552.3
Lottery	160.0	165.5	170.5	175.5	180.0
Other	605.6	605.6	625.5	643.7	663.4
Total General Fund	**8,151.6**	**8,307.8**	**8,602.4**	**8,942.1**	**9,245.2**
Growth Rates	**6.6%**	**1.9%**	**3.5%**	**3.9%**	**3.4%**

CFG Road Fund August Estimates

	FY06 ($Mil)	FY07 ($Mil)	FY08 ($Mil)	FY09 ($Mil)	FY10 ($Mil)
Motor Fuels	526.2	560.1	557.3	561.5	569.0
Motor Vehicle Usage	422.8	436.1	441.1	447.5	452.4
Motor Vehicle License	93.0	94.0	95.6	97.2	98.8
Motor Vehicle Operators	15.9	17.3	17.5	18.0	18.2
Weight Distance	84.4	86.2	89.3	92.5	95.7
Investment	3.8	4.1	4.3	4.3	4.3
Other	43.5	44.2	41.4	39.6	40.5
Total Road Fund	**1,189.6**	**1,242.0**	**1,246.5**	**1,260.6**	**1,278.9**
Growth Rates	**5.6%**	**4.4%**	**0.4%**	**1.1%**	**1.5%**

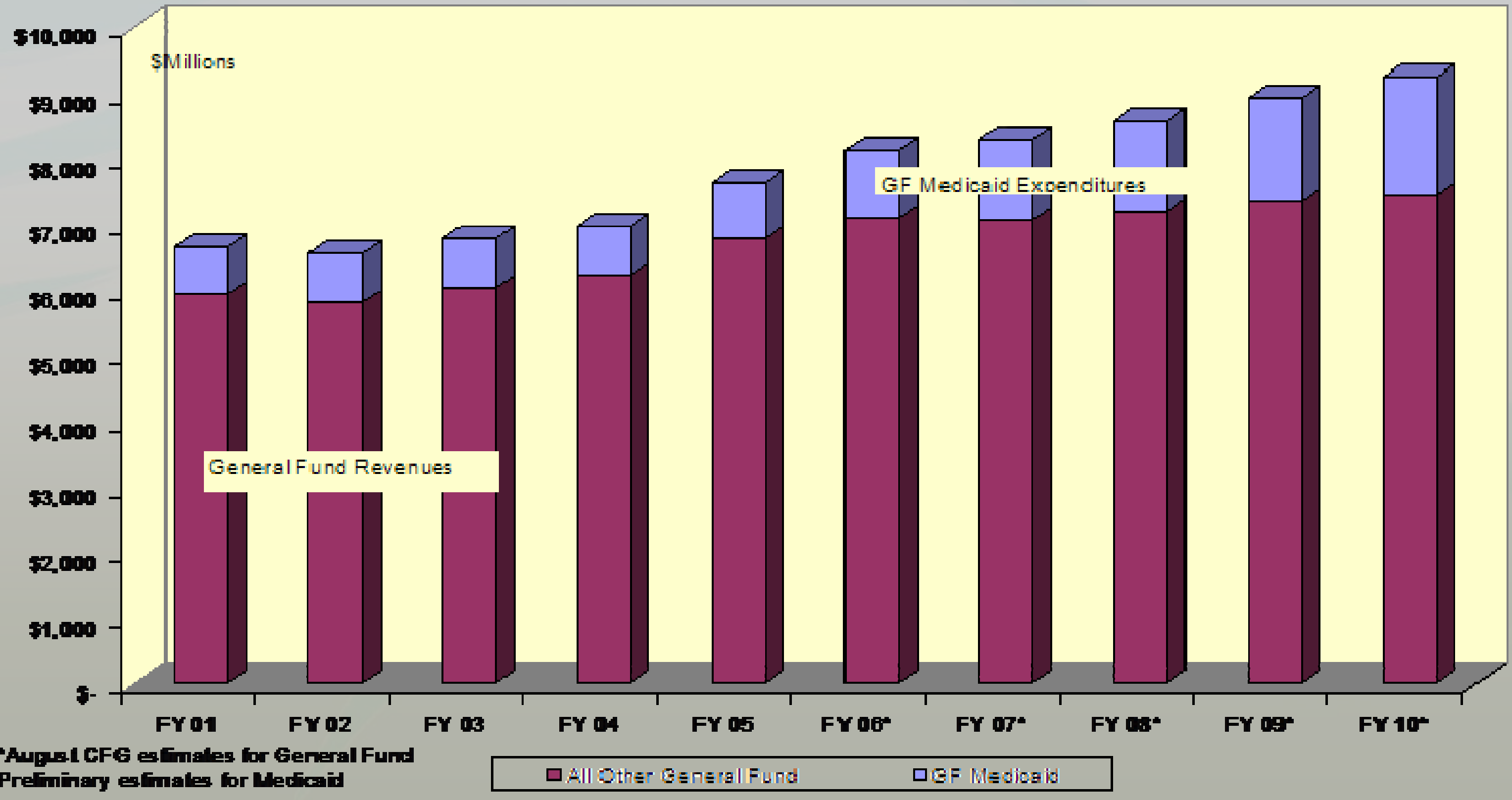
Structural imbalance on revenue side

- Structural imbalance = current conditions which cannot feasibly be extended into the future
- On the revenue side:
  - FY07 slides down the back side of J4K "bump" in FY06
  - We are placing heavy reliance on restricted fund transfers
  - The big cash carryforward into FY06 may not be available in FY07, depending on use of anticipated FY06 revenue

Structural imbalance on the spending side

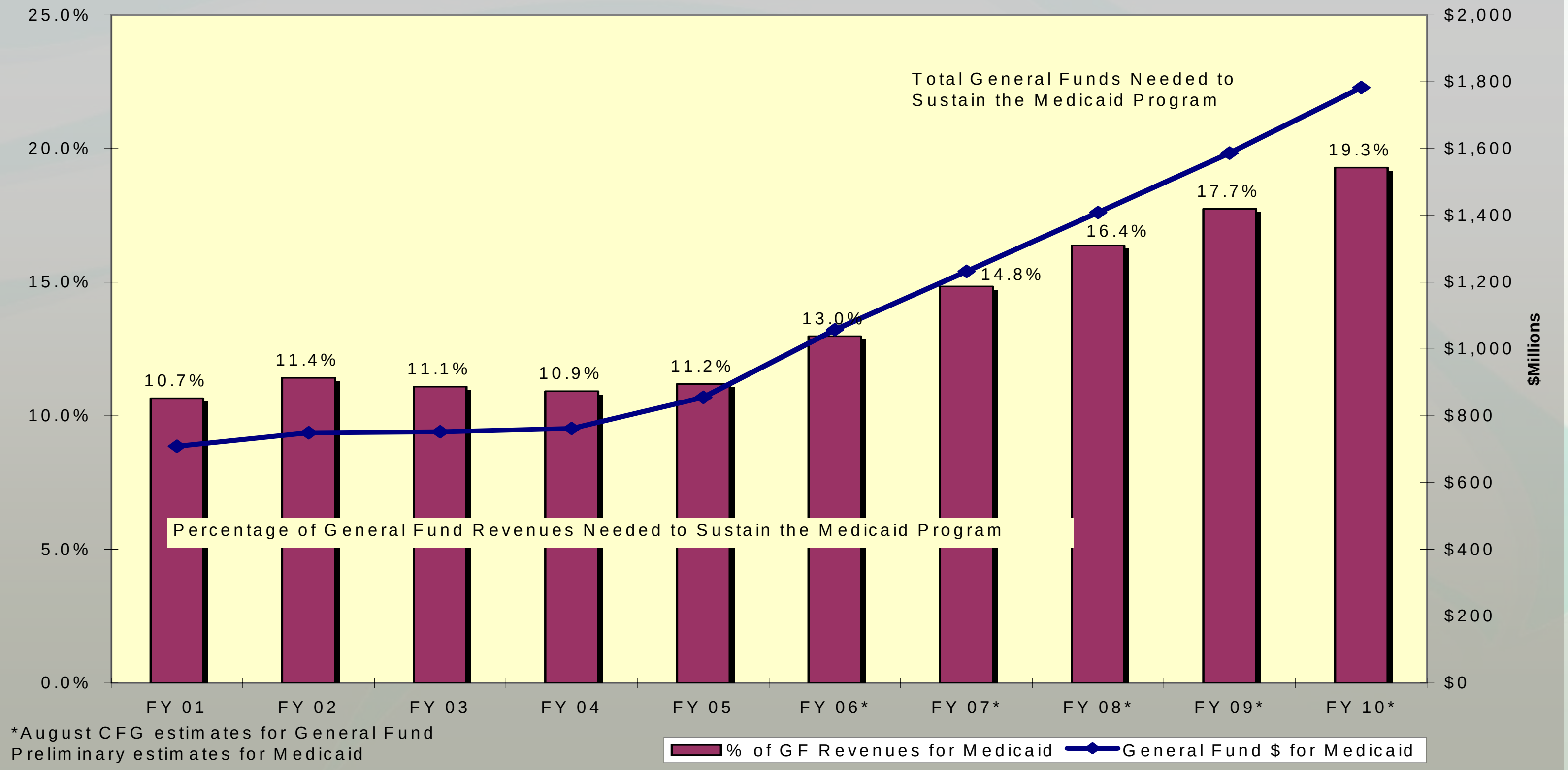
- ✓ Unsustainable rates of increase in cost of Medicaid and state health insurance
- ✓ Shift of debt service from half year to full year
- ✓ No appropriations for necessary government expense

Medicaid costs are mushrooming



*August CFG estimates for General Fund
Preliminary estimates for Medicaid

Medicaid's increasing share of General Fund



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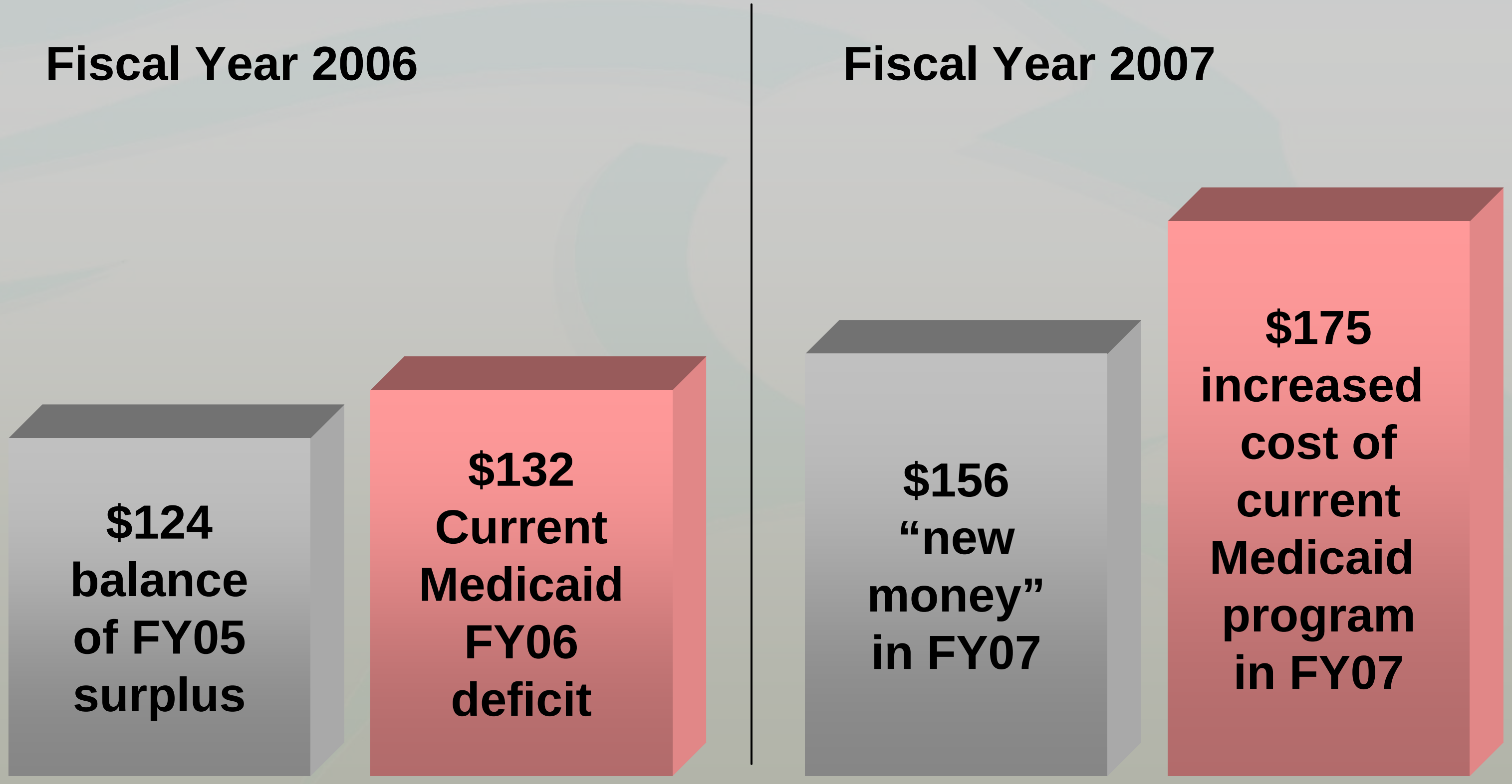
Medicaid could absorb revenue gains



Thanks

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