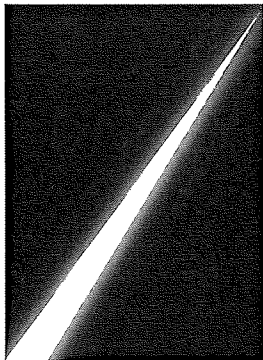




THE LOST DECADES:
KENTUCKY'S ECONOMIC
UNDERPERFORMANCE 1980 - 2020

A Bluegrass Institute Policy Point
by Andrew McNeill • November 2020



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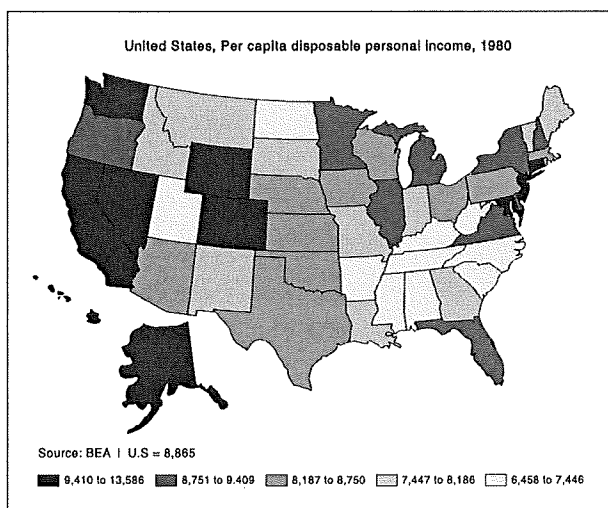
EXECUTIVE SUMMARY

The COVID-19 pandemic has changed the conversation on nearly every public policy topic in Kentucky. Priorities have been shuffled, resources redirected and the executive branch's authority to govern under emergency orders is being tested.

The ramifications of this tragic disruption will remain with Kentucky for the foreseeable future. A short-term horizon is likely to shape policymaking in 2021. While this is understandable in the current climate, our state cannot keep this mindset for long. We simply have too much ground to make up.

Kentucky must fundamentally reorient itself if we want to provide a better life for our citizens. For too long, Frankfort has clung to the notion that progressive redistribution was capable of manufacturing conditions conducive to shared prosperity. The redistributionist framework embraces an activist government allocating resources to meet societal goals of the prevailing majority. Liberal majorities support government programs and regulation favoring their political constituencies – labor unions, public sector employees, disadvantaged populations and urban centers. Conservative majorities can place redistribution at the center of their agenda by favoring rural constituencies and big business.

**“ WE MUST
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This study looks back over the past 40 years to demonstrate how Kentucky has fallen short in creating the robust economic growth generated by our competitor states. While Frankfort's political class has sold the notion that "Kentucky continues to move forward," the fact is our per capita income has fallen from 86.2% of the U.S. average in 1999 to 72.9% in 2019. The state's economy grew over the period but not fast enough to keep pace with the rest of the United States.

Kentucky's historical embrace of redistribution – and the significant burden born by taxpayers to finance it – has held the state back

for generations and continues to do so. Other states like Tennessee and North Carolina have

chosen another path, economic freedom, and are reaping the rewards, growing wealth and opportunity for their residents. Kentucky remains a laggard, as this report will show.

This report evaluates Kentucky since 1980 against four states – Alabama, Indiana, North Carolina and Tennessee. Why these states? And why 1980? A fact likely to surprise many: Forty years ago, Kentucky was essentially as wealthy as North Carolina and Tennessee. Indiana was better off; Alabama was slightly trailing.

The question of why Kentucky couldn't keep pace with its competitors is complex. This report, however, argues that a critical distinction can be drawn between Kentucky and these other states – a distinction that holds back the reins on our state's potential to realize the gains witnessed in other places.

The argument presented ignores political affiliation to dig deeper into what forces are at work and what philosophy prevails in the public policy outcomes coming from Frankfort. **The fundamental policymaking tension within Kentucky is less about partisan labels than it is about whether policy favors economic freedom or progressive redistribution.**

Economic freedom at the state level is positively associated with a variety of measures of the per capita size and growth of the economy as well as various measures of entrepreneurial activity.

Kentucky has a strong preference for higher levels of government spending, the lifeblood of progressive redistribution. Higher taxes, high government spending and substantial debt firmly place Kentucky in fiscal categories normally reserved for larger "blue states." Kentucky occupies fiscal-rankings space reserved for New Jersey, Connecticut and Illinois.

“THERE'S NEVER ENOUGH FOR INTEREST GROUPS WHOSE MISSIONS DEPEND ON THE GROWTH OF GOVERNMENT.”

Kentucky's taxpayers bear a significant tax burden to support Frankfort's spending and debt. Kentucky ranks 21st nationally in highest overall tax burden. The state's income tax burden ranks sixth. Only five states – New York, Oregon, Maryland, Minnesota and California, respectively – have heavier income-tax burdens than Kentucky.

The price of redistribution as the dominant governing principle within Kentucky has led to stagnation while Tennessee and others favoring economic freedom have lifted incomes and generated wealth. Rejecting redistribution will require challenging a status quo that powerful constituencies forcefully defend. Even when revenue growth exceeds the rate of

inflation, these groups argue it isn't enough. Why? Because there's never enough for interest groups whose missions depend on the growth of government.

The consequences of their economic ideas are extremely unfriendly and burdensome to hard-working taxpayers and job creators. Too often, Kentucky's General Assembly has bent to their pressure for more spending and higher taxes.

Structural reform is needed to put Kentucky on a different path. This report provides 11 recommendations to restrain government spending, tackle our crushing debt and protect taxpayers from an ever-increasing burden to fund Frankfort's agenda.

Recommendation 1: The General Assembly should place a constitutional amendment enacting a Taxpayer Protection Act on the ballot for voters to ratify.

Recommendation 2: The General Assembly should dedicate revenues exceeding the revenue growth limits established by the Taxpayer Protection Act to Kentucky's Rainy Day Fund.

Recommendation 3: The General Assembly should require 50% of unspent restricted fund balances be deposited to Kentucky's Rainy Day Fund at the end of each fiscal year.

Recommendation 4: The General Assembly should precisely define Kentucky's Rainy Day Fund's purpose as a program to balance state government's budget during economic downturns with a 10% fund balance requirement.

Recommendation 5: The General Assembly should enact a 5% statutory limit on General Fund appropriation-supported debt service.

Recommendation 6: After the 10% minimum Rainy Day Fund balance is achieved, deposits required from the Taxpayer Protection Act and restricted fund excess balances should be statutorily dedicated to resolving Kentucky's unfunded pension liabilities.

Recommendation 7: The General Assembly should require the Finance and Administration Cabinet to develop a comprehensive website detailing Kentucky's debt to inform taxpayers of the long-term obligations current decisions create for future generations of Kentuckians.

Recommendation 8: The General Assembly should identify all programmatic spending over \$5,000 within the budget documents for each branch of government.

Recommendation 9: *The General Assembly should require an annual report from the Office of the State Budget Director identifying all nonprofit organizations and businesses receiving more than \$5,000 in state funds for program implementation.*

Recommendation 10: *The General Assembly should enact five-year sunset provisions for existing state government programs and require such sunsets for all future state government programs.*

Recommendation 11: *The General Assembly should enact a statutory requirement that every revenue and appropriations bill must be publicly posted for 72 hours and include a fiscal note prepared by the Legislative Research Commission prior to final passage.*

Kentucky is faced with a profound, yet potentially transformative, challenge. Our state's historical embrace of redistribution has led to sluggish progress in creating higher living standards for everyday Kentuckians. Other states have demonstrated there is an alternative: economic freedom.

Making the necessary changes to place Kentucky on a different path will not be easy. The evidence of the possibilities offered by economic freedom is overwhelming. We hope the political will resides within our elected officials to take on the difficult, but necessary, choices leading to a level of prosperity that will provide a whole new level of opportunity to our fellow Kentuckians.

THE LOST DECADES: KENTUCKY'S ECONOMIC UNDERPERFORMANCE 1980 - 2020

Reflecting the optimism of a new century and confidence of progressive convictions, Paul Patton, Kentucky's first governor eligible to serve consecutive terms, stood before the General Assembly 20 years ago and predicted the budget he was presenting would lay the foundation upon which the next century of Kentucky's history would be built.¹

Patton's list of new government spending was long: \$211 million in new education spending, \$92 million in new school construction. A \$48 million increase for Kentucky's universities and \$32 million in increased funding for community and technical colleges. Medicaid funding increased 13%. Spending on public employee health insurance increased by 19% and an additional \$20 million for state employee compensation.

Patton's goal was ambitious. In his first term, he committed to raise Kentuckians' quality of life and standard of living above the national average within 20 years.²

Kentucky's collective belief in the capacity of activist government to engineer desirable social outcomes was strong. Properly targeted public investments supported by progressive taxation coupled with regulatory management of the private sector would, according to Frankfort's conventional wisdom, manufacture conditions conducive to shared prosperity.

By nearly every measure, things have improved for the vast majority of Kentuckians since Patton laid out his goal. The state's per capita income in 1999 was \$38,890. In 2019, it was \$42,386.³ We have access to better health care, educational resources and technology. The bundle of goods and services available to the average consumer far exceeds anything imaginable two decades ago. Kentucky might be considered a poor state, but very few, if any, Kentuck-

¹ "Governor Paul E. Patton introduces the 2000-2002 Executive Budget to the General Assembly," Kentucky Office of the State Budget Director, <https://osbd.ky.gov/Archives/Documents/Budget%20Period%202000-2002/2000-2002%20Executive%20Budget%20Recommendation/Budget%20Address.pdf>

² "Setting the Course for a New Century." Kentucky Office of the State Budget Director <https://osbd.ky.gov/Archives/Documents/Budget%20Period%202000-2002/2000-2002%20Executive%20Budget%20Recommendation/Setting%20the%20Course%20for%20a%20New%20Century.pdf>

³ Per capita real GDP by state (Chained 2012 dollars), Bureau of Economic Analysis, www.bea.gov.

ians experience anything close to poverty as understood in developing nations. Our most disadvantaged citizens have a quality of life most of the world's population will never know.⁴

The goal, however, was a living standard that *exceeded the national average*.⁵ By that measure, Kentucky hasn't only come up short but has actually regressed. Kentucky's per capita income has fallen from 86.2 percent of the U.S. average in 1999 to 72.9 percent in 2019. (Table 1)

TABLE 1: PER CAPITA INCOME COMPARISON 1999 - 2019

	1999	2009	2019	% GROWTH 1999-2019
KENTUCKY	\$38,890	\$38,224	\$42,386	9.0%
UNITED STATES	\$45,192	\$49,577	\$58,107	28.6%
KENTUCKY AS PERCENT OF NATIONAL AVERAGE	86.1%	77.1%	72.9%	

Source: United States Bureau of Economic Analysis. www.bea.gov

The state's economy grew over the period but not fast enough to keep pace with the rest of the US, revealing a critical point. To be truly evaluated, Kentucky's economic performance must be compared to the performance of other states, not just against itself.

To illustrate this point, consider horse racing. Horses are loaded into the starting gate. The gates open and every horse makes progress around the track. The purpose, however, isn't for a horse to make progress relative to where it started the race; rather, it's to beat the other horses.

An owner with a horse finishing last yet finding satisfaction their horse "made progress" is similar to the usual assessment of Frankfort's political class that "Kentucky continues to move forward." Kentuckians understand, better than anyone, that horse owner is in the wrong business.

⁴ More than half (56%) of Americans were high income by the global standard, living on more than \$50 per day in 2011, the latest year that could be analyzed with the available data. Another 32% were upper-middle income. In other words, almost nine-in-10 Americans had a standard of living above the global middle-income standard. Only 7% of people in the U.S. were middle income; 3% were low income and 2% were poor. <https://www.pewresearch.org/fact-tank/2015/07/09/how-americans-compare-with-the-global-middle-class/>

⁵ In a 2000 paper, University of Kentucky economists estimated Kentucky's per capita income needed to be equal to 92% of the U.S. average to account for the state's low cost of living. "Kentucky Annual Economic Report – 2000," University of Kentucky Center for Business and Economic Research, <http://cber.uky.edu/sites/cber/files/publications/Kentucky%20Annual%20Economic%20Report%202000.pdf>

Within Kentucky, the Golden Triangle⁶ is hailed as an area where growth has provided access to higher standards of living for Kentuckians living within it or close enough to commute to available jobs. While other pockets of Kentucky – Owensboro, Paducah, Elizabethtown/Ft. Knox and Bowling Green – have seen success, satisfaction with the relative prosperity of these areas compared to the rest of the state skews the perspective of those areas' true condition – and the state.

Only two counties in Kentucky – Oldham and Kenton – exceed the national average in per capita personal income. Kentucky's two largest counties, Jefferson and Fayette, fall more than \$2,500 below it. (Table 2) An honest assessment acknowledges Kentucky's most successful areas don't match up against their peers. Louisville is no Nashville. Lexington is no Austin. The Golden Triangle doesn't merit mention with North Carolina's Research Triangle.⁷ And, if those areas of the state haven't been able to keep up with Kentucky's competitors, our middle- and lower-tier counties languish even more.

TABLE 2: WEALTHIEST KENTUCKY COUNTIES VS. NATIONAL AVERAGE 2018

Oldham	\$63,039
Kenton	\$57,982
U.S. Average	\$54,446
Jefferson	\$51,937
Woodford	\$51,753
Fayette	\$50,180

Source: "Local Area Personal Income 2018." Bureau of Economic Analysis www.bea.gov

To evaluate Kentucky's performance in generating higher standards of living for its residents, the scope must be expanded. Benchmarking Kentucky since 1980 against four states – Alabama, Indiana, North Carolina and Tennessee⁸ – provides a set of comparative outcomes that can then lead into a discussion of what fundamentals underly our status as a laggard.

⁶ The Golden Triangle is an economic region in Kentucky which contains most of the state's population, wealth and economic growth. The area refers to the triangular shaped area outlined by Lexington, Louisville and northern Kentucky and connected by Interstates 64, 71 and 75. [https://en.wikipedia.org/wiki/Golden_Triangle_\(Kentucky\)](https://en.wikipedia.org/wiki/Golden_Triangle_(Kentucky))

⁷ North Carolina's Research Triangle Park is the largest research park in the US, named for its location relative to Raleigh, Durham and Chapel Hill. https://en.wikipedia.org/wiki/Research_Triangle_Park

⁸ See Appendix 1 for a discussion of the criteria utilized to select these four states.

TABLE 3: PER CAPITA DISPOSABLE PERSONAL INCOME 1980 - 2019

	1980	1990	2000	2010	2019	% OF PER CAPITA DISPOSABLE PERSONAL INCOME COMPARED TO KY (1980)	% OF PER CAPITA DISPOSABLE PERSONAL INCOME COMPARED TO KY (2019)
KENTUCKY	\$7,209	\$13,788	\$21,818	\$30,161	\$39,279		
ALABAMA	\$7,082	\$14,175	\$21,606	\$30,992	\$39,995	98.2%	101.8%
INDIANA	\$8,176	\$15,638	\$24,745	\$32,291	\$43,952	113.4%	111.9%
NORTH CAROLINA	\$7,320	\$15,425	\$23,864	\$32,444	\$42,567	101.5%	108.4%
TENNESSEE	\$7,420	\$15,129	\$24,375	\$33,300	\$44,731	102.9%	113.9%

Source: United States Bureau of Economic Analysis. www.bea.gov

Comparing the progress made by Kentucky and Tennessee against Indiana's performance provides an interesting juxtaposition. In 1980, Kentucky's per capita disposable income (\$7,209) was equal to 88% of Indiana's (\$8,176). By 2019, the Bluegrass State improved its position relative to Indiana by 1.5 percentage points. Nice progress, right?

TABLE 4: COMPOUND ANNUAL GROWTH 1980-1997 & 1997-2019

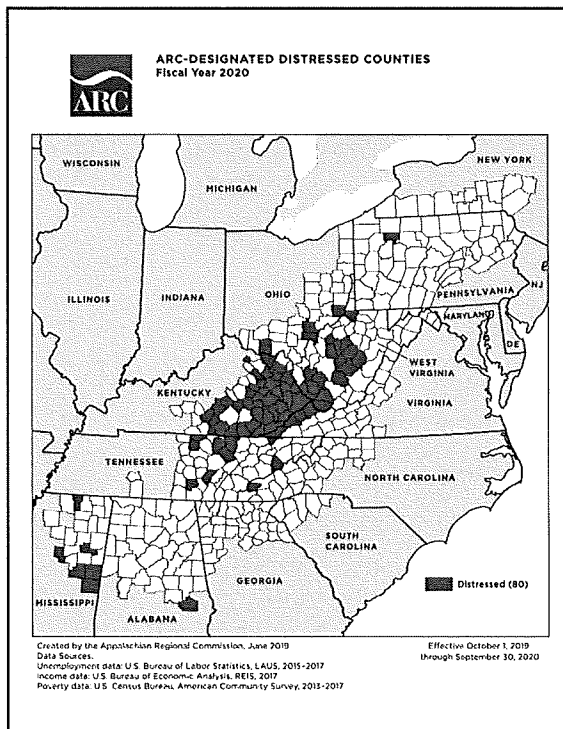
	Compound Annual GDP Growth Rate 1980-1997	Compound Annual GDP Growth Rate 1997-2019
KENTUCKY	3.0	3.3
ALABAMA	2.9	3.7
INDIANA	2.9	3.7
NORTH CAROLINA	4.2	4.3
TENNESSEE	3.8	4.2

Source: United States Bureau of Economic Analysis. www.bea.gov
The Bureau of Economic Analysis reports state GDP by SIC from 1963-1997 and by NAICS from 1997-forward. See "Regional Data-GDP and Personal Income"

Tennessee not only closed the gap that existed with Indiana in 1980, but by 2019 the Volunteer State's per capita personal disposable income exceeded the Hoosier State's. Kentucky made progress against our neighbor to the north but our neighbor to the south showed what real progress was possible over the 40-year period.

In the maxim "a rising tide lifts all boats," the rising tide is economic growth. Growth drives demand for goods and services. Entrepreneurs start businesses. Employers expand hiring. Unemployment drops. Wages rise. Purchasing power expands. These are the fundamentals of wealth creation and higher standards of living.

Critics try to undercut the power of growth with an economic-inequality narrative. Their argument ignores the overwhelming evidence that nothing has come close to the widespread bene-



fits – including for those people in lower socioeconomic strata – generated by economic growth.¹⁰ The central lesson from the past 50 years of development research and policy is that economic growth is the most effective way to pull people out of poverty and deliver on the wider objectives for a better life.¹¹

In 2018, the states with the highest poverty rates were Mississippi (19.7 percent), New Mexico (19.5 percent), Louisiana (18.6 percent), West Virginia (17.8 percent), Arkansas (17.2 percent), Kentucky (16.9 percent) and Alabama (16.8 percent).¹²

Eastern Kentucky is among the poorest areas in the US, sharing that distinction with Native American Indian reservations, the Louisiana Bayou and Mississippi Delta.¹³ Eastern Kentucky was once

home to a massive coal industry that fueled America’s climb to becoming the wealthiest civilization in history. Much of the wealth from the region was exported. Much of what remained was squandered on unproductive public investments and political patronage. Regional industrial parks, paid for by coal severance funds, sit empty throughout the region. State-owned golf courses built in the districts of powerful lawmakers lose money every year, leaving taxpayers on the hook to keep them open.

The tragedy is magnified by the fact that poverty isn’t necessarily a permanent condition, but a temporary setback for most people.¹⁴ Evidence from Tennessee indicates poverty isn’t a perma-

¹⁰ “Growth: Building Jobs and Prosperity in International Economies,” Organization for Economic Cooperation and Development <https://www.oecd.org/derec/unitedkingdom/40700982.pdf>

¹¹ Ibid.

¹² “2018 Poverty Rate in the United States,” US Census Bureau, <https://www.census.gov/library/visualizations/interactive/2018-poverty-rate.html>

¹³ “Kentucky counties make up 10 of the 25 worst places to live in the US.” March 13, 2019. <https://www.courier-journal.com/story/news/2019/03/13/kentucky-counties-dominate-worst-places-to-live-list/3151985002/>

¹⁴ Episodic poverty is experienced by individuals falling into poverty for two or more consecutive months in a given time period. Chronic poverty is when an individual is in poverty every month for the duration of a given time period, usually three to four years. See <https://www.census.gov/topics/income-poverty/poverty/about/glossary.html>.

ment condition at the county level either, suggesting solid, consistent economic growth can reach a state’s most impoverished areas.

The Appalachian Regional Commission (ARC) defines a distressed county as one that ranks within the lowest 10% of the nation’s counties.¹⁵ In FY2020, 80 counties were designated as distressed by the ARC, 38 of which were in Kentucky.¹⁶ (The state with the next highest number, West Virginia, had 16 distressed counties).

In 1980 there were 32 distressed counties in Kentucky; Tennessee had 16. From 1980 to 2020, seven counties in Tennessee shed the “distressed” label while the number of Kentucky counties joining the ranks of the nation’s most distressed increased by six. Tennessee’s rising tide lifted many boats. Kentucky hasn’t been capable of producing the same results for our people.

Additionally, Kentucky suffers from a significant number of people capable of working but who aren’t in the labor force. We have the second-lowest labor force participation rate in the US¹⁷ and the lowest among the five benchmark states. (Table 5)

TABLE 5: LABOR FORCE PARTICIPATION RATE

KENTUCKY	54.9
ALABAMA	58.1
INDIANA	63.0
NORTH CAROLINA	58.7
TENNESSEE	61.0

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 ”

Source: Labor Force Participation Rate
 September 2020, Seasonally Adjusted
<https://fred.stlouisfed.org>

¹⁵ ARC uses an index-based classification system to compare each county in the nation with national averages on three economic indicators: three-year average unemployment rates, per capita market income and poverty rates.

¹⁶ Appalachian Regional Commission, “ARC-Designated Distressed Counties, Fiscal Year 2020,”
<https://www.arc.gov/map/county-economic-status-in-appalachia-fy-2020/>

¹⁷ West Virginia had the nation’s lowest September 2020 seasonally adjusted labor force participation rate, 53.8%.
<https://fred.stlouisfed.org>

“

THE FUNDAMENTAL

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”

which nevertheless holds back the reins on our state’s potential to realize the gains witnessed in other places. *The fundamental policymaking tension within Kentucky is less about partisan labels than it is about whether policy favors economic freedom or progressive redistribution.*

The freest economies operate with minimal government interference, relying upon personal choice and markets to answer basic questions regarding what’s to be produced, how it’s to be produced, how much is produced and for whom production is intended. Economic freedom at the

state level is positively associated with a variety of measures of the per capita size and growth of the economy as well as various measures of entrepreneurial activity. As government imposes restrictions, there’s less economic freedom.¹⁹

On the other hand, activist government redistributes income, allocating resources to meet societal goals of the prevailing majority. Liberal majorities support government programs and regulation favoring their political constituencies – labor unions, public sector employees, disadvantaged populations and urban centers. Conservative majorities can place redistribution at the center of their agenda by favoring rural constituencies and big business (“crony capitalism”).²⁰

Many will disagree with that last point. Their disagreement is refutable. Liberal majorities erect barriers to competition like certificates of need in health care. Conservative majorities shirk from dismantling those barriers in the face of intense lobbying from local hospitals. Liberal majorities prefer grants or public investment funds to spur local development. Conservative majorities prefer ever-expanding tax increment financing programs for the same purpose. Both embrace preferential tax treatment in the form of subsidies, credits and incentives and both vote for more government spending.

Consider a comparison with Tennessee for a further discussion of the premise. It’s clear Tennessee has cleaned Kentucky’s clock over the past 40 years. It’s really quite incredible that two

¹⁹ Economic Freedom of North America 2019 Edition, Fraser Institute, <https://www.fraserinstitute.org/studies/economic-freedom>.

²⁰ “Crony capitalism” is a term describing an economy in which success in business depends on close relationships between businesspeople and government officials. It may be exhibited by favoritism in the distribution of legal permits, government grants, special tax breaks or other forms of state interventionism. See <https://www.journals.uchicago.edu/doi/pdfplus/10.1086/686474>.

states which, on initial inspection, are so similar²¹ have had their paths diverge so significantly. So, what was it?

Two prominent free-market think tanks – the Cato Institute and the Fraser Institute – analyze states based upon variables measuring economic freedom. Cato scores all 50 states on their overall respect for individual freedom and regard for three dimensions of freedom considered separately: fiscal policy, regulatory policy and personal freedom.²² Fraser measures the extent to which the policies of individual states were supportive of economic freedom and the ability of individuals to act in the economic sphere free of undue restrictions.²³

Fraser ranks Tennessee within its “Most Free” category. According to Cato, “Tennessee has long been one of the economically freest states.” The best praise Cato can muster describing Kentucky is “a middle of the pack state.” Fraser places Kentucky in their “Least Free” category.²⁴ Translation: Tennessee favors economic freedom over redistribution. Kentucky, not so much.

Kentucky is ranked poorly by both organizations on fiscal policy and understandably so.²⁵ The evidence is compelling. Higher taxes, high government spending and substantial debt firmly place Kentucky in fiscal categories normally reserved for larger, “blue states.” Let’s take a closer look at Kentucky’s fiscal data to continue analyzing these questions.

GOVERNMENT SPENDING: The Pew Charitable Trusts *Fiscal 50* examines key trends in state finances.²⁶ Average government spending in Kentucky from 1993 to 2012 was equal to 15.3%

²¹ In 2010, 13% of adult Kentuckians lacked a high school diploma or equivalent compared to 12% in Tennessee, <https://www2.ed.gov/about/offices/list/ovae/pi/AdultEd/state-profiles.htm>. A 2012 release by the federal Department of Education reported 33.3% of Kentuckians had some kind of postsecondary degree compared to 32.8% in Tennessee. <https://www.ed.gov/news/press-releases/new-state-state-college-attainment-numbers-show-progress-toward-2020-goal>.

²² “Freedom in the 50 States,” Cato Institute, <https://www.freedominthe50states.org/fag>.

²³ “Economic Freedom of North America,” Fraser Institute, <https://www.fraserinstitute.org/economic-freedom/approach>.

²⁴ Cato Institute’s “Freedom in the 50 States,” <https://www.freedominthe50states.org>, and Fraser Institute’s “Economic Freedom of North America: 2019,” <https://www.fraserinstitute.org/economic-freedom>.

²⁵ Kentucky is ranked 34th by Cato in fiscal policy. Fraser ranks Kentucky 48th in government spending – the low ranking reflecting the high level of government’s spending.

²⁶ “The Fiscal 50: State Trends and Analysis.” Pew Charitable Trusts. www.pewtrusts.org

(compared to 11.3% in Tennessee). To further examine this point, five additional “blue states”²⁷ – California, Illinois, Michigan, New York and New Jersey - were included for comparison. (Table 7) Kentucky's level of government spending is higher than all of them.

TABLE 7: GOVERNMENT SPENDING AS A PERCENTAGE OF STATE PERSONAL INCOME

	STATE	FEDERAL	STATE + FEDERAL
KENTUCKY	10.5	4.8	15.3
ALABAMA	8.4	4.7	13.6
INDIANA	8.6	3.5	12.2
NORTH CAROLINA	8.4	4.1	12.4
TENNESSEE	7.0	4.3	11.3
CALIFORNIA	9.2	3.7	12.9
NEW YORK	8.4	5.6	14.0
NEW JERSEY	7.8	2.7	10.3
MICHIGAN	9.8	3.9	13.7
ILLINOIS	7.1	2.8	9.9
U.S. AVERAGE	8.4	3.8	12.2

Source: Data drawn from “Fiscal 50: State Trends & Analysis.” Pew Charitable Trusts.

The **STATE** column is important. It reveals policymakers’ decisions at the state level, therefore serving as a proxy for states’ preferences when deciding between economic freedom or redistributive spending. Kentucky redistributes a higher percentage of its residents’ income through state government than any of the four benchmarks identified at the beginning of the report as well as five additional states selected to further evaluate the question.

The size and scope of Kentucky’s state government is defined by more than its General Fund. Restricted funds are agency funds collected from fees, dedicated surtaxes and other miscellaneous collections taxpayers pay, often without much idea of what they’re paying for, or why. For

²⁷ Walter Russell Meade first identified the deterioration of the “blue state model” in a 2010 article in *The American Interest*. The Hoover Institute’s Richard Epstein observed, “The harm done by excessive regulation, taxes, and public expenditures plays itself out time and again in liberal bastions like Massachusetts, Vermont, California, Connecticut, Illinois, and New York.”

example, when purchasing new tires Kentuckians pay \$2 per tire in addition to the sales tax to fund a waste tire disposal program. For every gallon of gas sold, consumers pay \$0.014 to fund an abandoned underground fuel tank remediation program.

These relatively small taxes and fees, which are supposed to be “restricted” to fund specific programs, add up to significant dollars. Restricted funds accounted for \$7.3 billion in spending in fiscal year 2018. What’s more, the General Assembly has been diverting funds (“sweeping”) from these programs for years to fund general operations within state government. Since 2010, \$1.3 billion of restricted funds have been swept to Kentucky’s General Fund. These shadow taxes feed policymakers’ appetite for ever-increasing amounts of government spending.

TABLE 8: PER CAPITA STATE SPENDING

	Per Capita State Spending	Ranking
New York	\$8,384	11
Kentucky	\$7,633	16
New Jersey	\$6,839	21
California	\$6,834	22
Illinois	\$5,720	33
Michigan	\$5,671	34
Alabama	\$5,578	35
Tennessee	\$5,049	39
Indiana	\$5,021	40
North Carolina	\$4,800	43

Source: Kaiser Family Foundation
 FY 2018 total state expenditures per capita

Per capita state spending figures compiled by the Kaiser Family Foundation further substantiates Kentucky has a strong preference for higher levels of government spending - the lifeblood of progressive redistribution. (Table 8)

DEBT: Government debt is an intergenerational transfer of wealth, which occurs when future taxpayers are required to pay for current obligations. Kentucky’s \$54 billion debt adds up to

more than \$12,000 for every man, woman and child in the state.²⁸ In addition to the state's well-known pension liabilities, Kentucky is burdened with debts of \$11.2 billion in appropriation- and non-appropriation-supported bonds.²⁹ The price for all this debt doubled in less than a decade. Debt service to support Kentucky's borrowing mushroomed from \$474 million in 2010 to \$1.18 billion in 2018. (Table 9)

TABLE 9: DEBT SERVICE AS A PERCENTAGE OF GENERAL FUND

	GENERAL FUND	DEBT SERVICE	% OF GENERAL FUND
FY 2010	\$ 8,345,457,799	\$ 474,822,664	5.7%
FY 2012	\$ 9,332,236,465	\$ 752,199,566	8.1%
FY 2014	\$ 9,702,406,197	\$ 1,013,770,720	10.4%
FY2016	\$ 10,222,281,936	\$ 1,056,426,283	10.3%
FY2018	\$ 11,234,291,748	\$ 1,181,581,578	10.5%

Source: Figures drawn from totals contained in Kentucky budget documents.
Office of the State Budget Director www.osbd.ky.gov

According to Fitch Ratings, Kentucky's 24.9% ratio of net pension liabilities and debt to personal income – versus the U.S. states' median of 5.7% – is among the highest for a U.S. state.³⁰ Only New Jersey and Illinois were rated lower than Kentucky in Standard & Poor's recent state credit ratings.³¹

²⁸ Kentucky's debt is spread across three categories: Appropriation supported (\$9.03 billion), Non-appropriation supported (\$2.26 billion) and Unfunded pension and other post-employment benefit liabilities (\$43.3 billion). "An Examination of the Outstanding Debt and Debt Service of the Commonwealth," Auditor of Public Accounts, www.auditor.ky.gov

²⁹ Ibid.

³⁰ Fitch Ratings Service, <https://www.fitchratings.com/research/us-public-finance/fitch-affirms-kentucky-idr-at-aa-rates-spb-35mm-revs-a-outlook-negative-07-05-2020>.

³¹ Standard & Poor's, <https://www.spglobal.com/ratings/en/research/articles/190319-u-s-state-ratings-and-outlooks-current-list-1738758>.

The Mercatus Center identifies Tennessee among the most fiscally responsible states in the country.³² North Carolina and Alabama also fare well in Mercatus' fiscal rankings.³³

Kentucky occupies Mercatus' fiscal-rankings space reserved for New Jersey, Connecticut and Illinois.³⁴ According to the Cato Institute, our government debt at about 25% of adjusted personal income is extremely high, ranking Kentucky second-worst in the country after New York.³⁵

TAX BURDEN: Kentucky's taxpayers bear a significant tax burden to support Frankfort's spending and debt. Kentucky ranks 21st nationally in overall tax burden, meaning taxpayers in 29 states have lower tax burdens than those in the Bluegrass State. The state's income tax burden ranks sixth.³⁶ Only five states – New York, Oregon, Maryland, Minnesota and California, respectively – have heavier income-tax burdens than Kentucky.

Despite being a high-tax state, a popular narrative exists that Kentucky's revenue stream is inadequate to support a sufficient level of services and programming. Policymakers should recognize those organizations arguing there isn't enough revenue coming into Frankfort really mean there isn't enough to match their redistribution agenda.

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KENTUCKY'S TAXPAYERS
BEAR A SIGNIFICANT
— TAX BURDEN —
TO SUPPORT FRANKFORT'S
SPENDING AND DEBT.

Revenue growth for Kentucky state government between 2015 and 2019 was 11.2%.³⁷ Inflation was less than 2% annually during the same four years. What's more, during the same four years, Tennessee's total revenue – propelled by faster economic growth – grew by 16.8%. It's a fascinating paradox policymakers need to understand: Limiting the size and scope of government boosts Tennessee's capacity to generate the tax dollars to provide essential services to its residents.

Especially troubling is the fact that constituencies favoring higher taxes and redistribution continue to prevail in Frankfort. Despite rhetorical characterizations to the contrary, the 2018

³² The Mercatus Center's "State Fiscal Rankings" ranks Tennessee third in the nation for fiscal health. <https://www.mercatus.org/publications/urban-economics/state-fiscal-rankings>.

³³ Mercatus ranked North Carolina ninth and Alabama fourteenth. <https://www.mercatus.org/publications/urban-economics/state-fiscal-rankings>

³⁴ The Mercatus Center, <https://www.mercatus.org/publications/urban-economics/state-fiscal-rankings>.

³⁵ The Cato Institute, <https://www.freedominthe50states.org/fiscal/kentucky>.

³⁶ "2020's Tax Burden by State," <https://wallethub.com/edu/states-with-highest-lowest-tax-burden/20494/>.

³⁷ "Census Bureau Annual Survey of State Government Tax Collections," U.S. Census Bureau, <https://www.census.gov/programs-surveys/stc.html>.

lators to make their case. Yet the consequences of their economic ideas are extremely unfriendly and burdensome to hardworking taxpayers and job creators.

Even when revenue growth exceeds the rate of inflation, these groups argue it isn't enough. Why? Because there's never enough for interest groups whose missions depend on the growth of government. Too often, Kentucky's General Assembly has acceded to their pressure for more spending and higher taxes.

Structural reform is needed to put Kentucky on a different path.

ENACT A TAXPAYER PROTECTION ACT: Without structural changes, Kentucky will continue to spend at a rate that retains our place among the nation's highest-spending states. Enacting a constitutional amendment requiring a Taxpayer Protection Act will fundamentally shift Kentucky towards a greater embrace of economic freedom. Such a policy would protect taxpayers by forcing policymakers to practice the critical discipline of identifying spending priorities offering the best use of limited resources. Once passed, it would force politicians to act more prudently with taxpayer dollars by tying spending increases to inflation and population growth.

Recommendation 1: The General Assembly should place a constitutional amendment enacting a Taxpayer Protection Act on the ballot for voters to ratify.

STRENGTHEN KENTUCKY'S RAINY DAY FUND: Kentucky's Rainy Day Fund has one of the lowest balances among the 50 states. Current statute targets a 5% Rainy Day Fund balance. Because the General Assembly ignores this sensible fiscal objective, Frankfort often scrambles to find politically acceptable tax increases to fund its spending agenda.

Rainy day funds are most effective if used as part of a multiyear strategic plan. Rating agencies favor states that design their rainy day funds to align with turns in the economic cycle by depositing revenue during good times and spending those reserves when things turn bad.³⁸ Maintaining healthy rainy day funds and reducing wasteful spending offer the best lines of defense against tax increases when states face budget shortfalls.

Without structural changes, Kentucky will continue to neglect adequately saving for rainy days.

Recommendation 2: The General Assembly should dedicate revenues exceeding the revenue growth limits established by the Taxpayer Protection Act to Kentucky's Rainy Day Fund.

³⁸ "How Using Rainy Day Funds Affects State Credit Ratings" Pew Charitable Trusts. August 24, 2020. <https://www.pewtrusts.org/en/research-and-analysis/articles/2020/08/24/how-using-rainy-day-funds-affects-state-credit-ratings>

Recommendation 3: *The General Assembly should require 50% of unspent restricted fund balances be deposited to Kentucky's Rainy Day Fund at the end of each fiscal year.*

Recommendation 4: *The General Assembly should precisely define Kentucky's Rainy Day Fund's purpose as a program to balance state government's budget during economic downturns with a 10% fund balance requirement.*³⁹

DEBT LIMITS, DEBT RETIREMENT AND DEBT TRANSPARENCY: Kentucky has the seventh-highest debt as a percentage of personal income among the 50 states.⁴⁰ (Tennessee is ranked 49th). The Kentucky State Auditor's Office reported that among Kentucky's seven neighboring states, only Illinois has a worse rating for its bonds. Indiana, Missouri, Tennessee and Virginia had the highest possible ratings from the three bond-rating agencies.⁴¹

We could go on but believe this issue is clear: Kentucky must get serious about its debt problem. Just as the commonwealth's families cannot become debt-laden without endangering their financial futures, Frankfort cannot continue to borrow without restraint and not harm the opportunities for future generations.

Recommendation 5: *The General Assembly should enact a 5% statutory limit on General Fund appropriation-supported debt service.*

Recommendation 6: *After the 10% minimum Rainy Day Fund balance is achieved, deposits required from the Taxpayer Protection Act and restricted fund excess balances should be statutorily dedicated to resolving Kentucky's unfunded pension liabilities.*

Recommendation 7: *The General Assembly should require the Finance and Administration Cabinet to develop a comprehensive website detailing Kentucky's debt to inform taxpayers of the long-term obligations current decisions create for future generations of Kentuckians.*

BUDGET TRANSPARENCY, PROGRAM PERFORMANCE REVIEW AND STATUTORY SUNSETS: Kentucky's budget documents are opaque, providing limited detail on what's contained within Cabinet budgets. The lack of budget transparency denies taxpayers an opportunity to know how their dollars are spent – or wasted – in Frankfort, or the information needed to ques-

³⁹ State budget policy experts often refer to this Rainy Day Fund commitment as establishing a counter-cyclical revenue and stabilization program.

⁴⁰ "Fiscal 50: State Trends and Analysis." <https://www.pewtrusts.org>

⁴¹ "An Examination of the Outstanding Debt and Debt Service of the Commonwealth." Auditor of Public Accounts. http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2018KyDebtBulletinReport.pdf

tion the effectiveness of specific expenditures and hold those who vote for wasteful spending accountable.

State government programs continue to be funded without much, if any, examination of their effectiveness. For instance, since the enactment of the Kentucky Innovation Act 20 years ago, \$112 million has been spent to create a knowledge-based economy in Kentucky. Where has the money been spent and what are the program's results? There isn't a good answer. The program doesn't undergo any periodic review by the legislature. At the very least, such cases call for program sunsets, which, though not perfect, can begin the process of determining what value is created by government spending and inform lawmakers of whether programs deserve ongoing support from taxpayers.

One of many other examples involves Dataseam Inc., a nonprofit which since 2006 has received \$27 million to implement a Coal County Computing initiative. State contracts for the program have bypassed the competitive bidding requirements of Kentucky's Model Procurement Code. Over that period, \$4.49 million has been spent on administrative overhead, including \$3.5 million for salaries. There's no easily accessible public reporting on nonprofit contracts to implement state government programs. Taxpayers deserve better.

Recommendation 8: The General Assembly should identify all programmatic spending over \$5,000 within the budget documents for each branch of government.

Recommendation 9: The General Assembly should require an annual report from the Office of the State Budget Director identifying all nonprofit organizations and businesses receiving more than \$5,000 in state funds for program implementation.

Recommendation 10: The General Assembly should enact five-year sunset provisions for existing state government programs and require such sunsets for all future state government programs.

ADHERE TO FUNDAMENTAL PRINCIPLES ON TAX POLICY: Frankfort continues to accept the premise of progressive redistribution when enacting tax changes. Raising more revenue to fuel wasteful and unaccounted-for spending drives current tax policy. Repeating an earlier point, the 2018 tax legislation, though characterized as a step towards a more pro-growth tax code, intended to raise taxes on Kentuckians by nearly a half-billion dollars. The 2018 tax changes were sold as enhancing Kentucky's competitiveness. To anyone making that argument we pose a simple question: How does increasing one of the highest tax burdens in the country promote Kentucky's ability to compete against states that favor economic freedom through lower taxes and less government spending?

This report reveals states that favor economic freedom over progressive redistribution realize higher levels of economic growth. Tax policy to support redistribution hinders productivity, stunts growth and ultimately dampens the economy's capacity to produce revenue for important public services.

A pro-growth tax policy shifts taxation away from income and investment towards consumption. Many policymakers argue that the complete elimination of Kentucky's income tax should be the goal. The practical question of whether the General Assembly is willing to consider the necessary expansion of the sales tax – which almost certainly means an increase in the sales tax rate above the current 6% *and* applying it to consumer items like groceries and utilities – is often ignored. Bringing Kentucky's tax code more in line with Indiana's is a far more realistic reach.⁴²

That being said, Kentucky's tax code should be improved. Changes, however, must be driven by principles that support economic freedom. We recommend a three-part test to drive tax policy in Kentucky:

1. Are the tax changes revenue neutral at a minimum and, therefore, won't increase the overall tax burden on Kentuckians?
2. Do the tax changes favor taxing consumption over income, savings and investment?
3. Do the tax changes favor individuals and entrepreneurs over narrow special interests?

Future changes to the tax code that affirmatively meet these criteria will move Kentucky closer to placing economic freedom at the center of its policymaking framework, whereas tax changes that violate any one of these will continue to prop up the culture of progressive redistribution which has held the state back for generations.

Transparency is critical to adherence to these principles. The General Assembly's practice of presenting and passing massive revenue and spending bills at the end of legislative sessions without allowing for even limited public scrutiny must end immediately. Constituents must have the opportunity to weigh in with their elected representatives before votes are taken to levy new taxes and spend their tax dollars. In order to do that, sufficient time must be granted to the public and rank-and-file legislators to know what's in a bill before it's passed.

Recommendation 11: The General Assembly should enact a statutory requirement that every revenue and appropriations bill must be publicly posted for 72 hours and include a fiscal note prepared by the Legislative Research Commission prior to final passage.

⁴² Indiana has a flat 3.23 percent income tax rate and 7% sales tax. Adjusting Kentucky's current 5% income tax rate and 6% sales tax rate to something closer to Indiana's is far more feasible than completely eliminating the state's income tax and significantly increasing and expanding Kentucky's sales tax.

Kentucky is faced with a profound, yet potentially transformative, challenge. Our historical embrace of redistribution has led to sluggish progress in creating higher living standards for everyday Kentuckians. Other states have demonstrated there is an alternative – economic freedom.

Making the necessary changes to place Kentucky on a different path won't be easy. This report provides 11 recommendations to fundamentally reform the state's fiscal trajectory. The evidence of the possibilities offered by economic freedom is overwhelming. We hope the political will resides within our policymakers, especially elected officials, to take on the difficult, but necessary, choices that will lead to an environment of prosperity which provides a whole new level of opportunity to our fellow Kentuckians.

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**EVIDENCE
OF THE
POSSIBILITIES
OFFERED BY**

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”

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APPENDIX: SELECTION OF BENCHMARK STATES

Elected officials often inquire about other states' specific policies and programs. Their questions in Kentucky tend to place an emphasis on neighboring states. This approach is understandable but isn't always the best method for the issues discussed in this report.

The better approach when considering issues covered in this report is to compare Kentucky to states that shared similar economic and demographic characteristics in 1980. To determine those states, we started with Kentucky's neighboring states and states within the Southeast United States (excluding Florida). We then compared their populations, largest urban areas and per capita disposable personal income to Kentucky's in 1980.

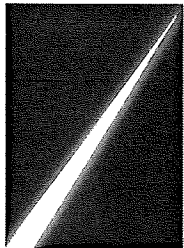
Illinois and Ohio, with much larger populations and urban areas, are very different from Kentucky. The populations of Georgia and Virginia weren't much bigger than North Carolina's (a benchmark state) but Atlanta and the Washington D.C. metro area were significantly larger than Louisville.

Mississippi's and South Carolina's total populations were smaller than Kentucky's in 1980, but not by so much as to eliminate those states as good benchmarks. Louisville, however, was considerably larger than their largest cities, Jackson and Charleston, respectively. In 1980, West Virginia was much smaller in terms of total population and its largest city, Charleston, was one-third the size of Louisville. An argument could be made to have included Missouri, although it had two large urban areas, Kansas City and St. Louis, whereas Kentucky only had one, Louisville.

TABLE: BENCHMARK STATES

STATE	POPULATION 1980	LARGEST CITY (COUNTY)	POPULATION 1980	PER CAPITA DIS- POSABLE INCOME 1980	% OF KENTUCKY 1980
KENTUCKY	3,660,324	LOUISVILLE (JEFFERSON)	684,648	\$7,209	
ALABAMA	3,894,025	BIRMINGHAM (JEFFERSON)	671,325	\$7,082	98.2%
INDIANA	5,490,210	INDIANAPOLIS (MARION)	765,233	\$8,176	113.4%
NORTH CAROLINA	5,880,095	CHARLOTTE (MECKLENBURG)	404,270	\$7,320	101.5%
TENNESSEE	4,591,023	MEMPHIS (SHELBY)	777,113	\$7,420	102.9%

The 1980 state populations were drawn from the Census Bureau's "1990 Census of Population and Housing." The county populations for each state's largest city were drawn from the Census Bureau's "County Intercensal Tables 1980-1990." Per capita disposable income was drawn from the Bureau of Economic Analysis "Regional Data – Disposable Personal Income."



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