5 YEARS LATER

THE LEAKY BUCKET

JULY 2014

Kentucky Chamber
Uniting Business. Advancing Kentucky.

CONTENTS

INTRODUCTION

The Leaky Bucket: Where we stand five years later

In 2009 during the Kentucky Chamber's Business Summit, Chamber President and CEO Dave Adkisson unveiled the Chamber's research on government spending in Kentucky, identifying three unsustainable "leaks" in the state spending budget.

IT HAS BEEN FIVE YEARS since the Kentucky Chamber of Commerce released the original Leaky Bucket report that found spending on corrections, Medicaid and public employee health insurance to be growing at a faster rate than the overall state budget. Spending in these areas accounted for more than half of all growth in the budget from Fiscal Year 2000 to FY 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 2011 update found substantial progress had been made in reining in some of the unsustainable spending identified in the Leaky Bucket report. This progress included the implementation of several significant policy initiatives that were recommended by the Kentucky Chamber:

- The implementation of statewide Medicaid managed care to better manage Medicaid spending
- Landmark legislation reforming Kentucky's Penal Code that is expected to save $422 million over 10 years
- A reduction in spending on public employee health insurance, cutting the annual growth rate by half[1]

But the 2011 update also found the state faced continuing – and significant – challenges in curtailing the skyrocketing spending increases that undermine prospects for economic growth. These challenges included massive unfunded liabilities in Kentucky's public pension system and continued underinvestment in education.

The public pension system represents a particularly significant leak that continues to worsen. This leak was not addressed in the original Leaky Bucket report as the state implemented initial reforms enacted in 2008. As noted in this report, the state has since enacted additional, more sweeping changes that show promise, but Kentucky is still considered one of the worst performers in the nation in this critical financial area.

This update examines state spending trends since the 2011 update, outlines significant actions that have taken place to address the leaks since then and identifies the challenges that remain.

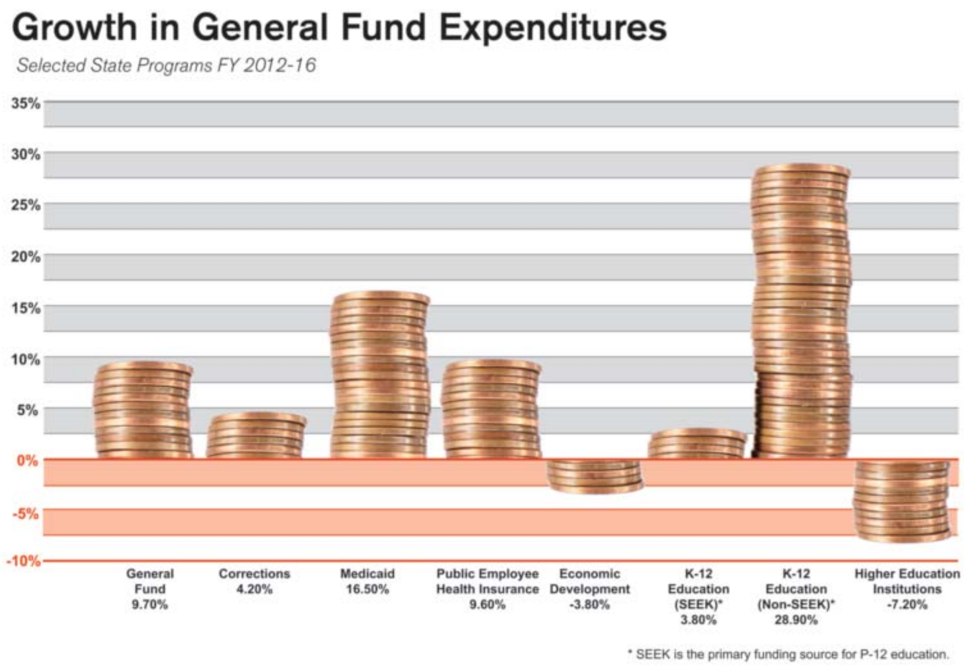
State Spending Trends

THE 2011 LEAKY BUCKET UPDATE, Building a Stronger Bucket, found that from fiscal year 2000 to 2012:

- Kentucky's overall General Fund spending had grown 42.8% — about the same rate as the state's economy.
- Corrections spending was growing about 50% faster than the overall budget (60.4% vs. 41.4%).
- Medicaid spending was growing about three times faster than the overall budget (117% vs. 41.4%).
- Public employee health insurance costs were growing four times faster than the overall budget (190% vs. 41.4%).[2]

The report also noted that the national economic downturn resulted in a significant reduction in both revenue and spending in FY 2009 and FY 2010. Spending declined 3.3% in 2009 and 6.2% in 2010, and state revenue levels were down 2.7% in 2009 from 2008 and another 3.3% in 2010.[3] Overall, spending was reduced by approximately $1.6 billion; Kentucky was able to mitigate the effect of these cuts with more than $3 billion in time-limited federal stimulus funds.

CHART 1



Notes:
FY 2012 expenditures are actual expenditures as revised by GOPM.
FY 2016 expenditures are based on the enacted budget (14 HB 235).
Non-SEEK expenditures do not include health insurance for teachers.

Sources: 2012-2014 and 2014-2016 Executive Budget in Brief, Office of State Budget Director; 12 HB 265 as enacted; 14 HB 235 as enacted

Current Spending

THE STATE BUDGETS enacted since the 2011 Leaky Bucket update show promising signs that the troubling spending trends identified by the Chamber are slowing. An analysis of General Fund spending from FY 2012 to FY 2016 (which reflects the current enacted budget) reveals that:

- The total General Fund grew 9.7%.
- Corrections spending, which had been growing 50% faster than the General Fund, grew only 4.2% in the past two budgets — less than half the rate of General Fund spending.
- Medicaid spending grew 16.5%. While still outpacing General Fund spending growth, the rate has slowed significantly since 2000 to 2012, when it grew three times faster than General Fund spending.
- Public employee health insurance, the fastest growing area of spending, had been growing about four times faster than total General Fund spending. It is now growing at 9.6% — less than the rate of growth for the General Fund.
- General Fund spending on the SEEK program, which funds K-12 education, has increased only 3.8% since 2012, but spending on non-SEEK items (such as textbooks and preschool) has grown 28.9% in the period due to additional appropriations in these areas in the FY 2014-2016 budget.
- Postsecondary institutions have experienced a 7.2% reduction in spending since 2012.

(See Chart 1 for a graphic presentation of these trends.)

K-12 Education's Share of the State Budget Pie Has Grown

A PARTICULARLY WELCOME development is education funding. The percentage of the state General Fund budget going to K-12 education has increased since the first Leaky Bucket report. In the FY 2008-10 biennial budget, 43.8% of Kentucky's General Fund budget went to K-12.[4] In the FY 2014-16 budget just enacted, K-12 education's share has grown to 44.2% of the General Fund budget.[5] However, this trend has not been replicated in postsecondary education, which has turned to annual tuition increases to replace diminishing General Fund support.

Key Developments

Several developments have contributed to the reduced spending increases in key areas.

CORRECTIONS: A key factor in the reduced growth in corrections spending was the enactment of major legislation in 2011 to reform Kentucky's Penal Code and stem the growth in the prison population. A 2010 legislative task force found Kentucky's prison population had increased 45% since 2000 (compared to 13% nationally) and the Commonwealth had the fastest growing prison population in the country.[6] The task force, working with the Pew Center on the States, recommended legislation (House Bill 463), strongly supported by the Kentucky Chamber and passed overwhelmingly by the General Assembly, that focused on four key goals:

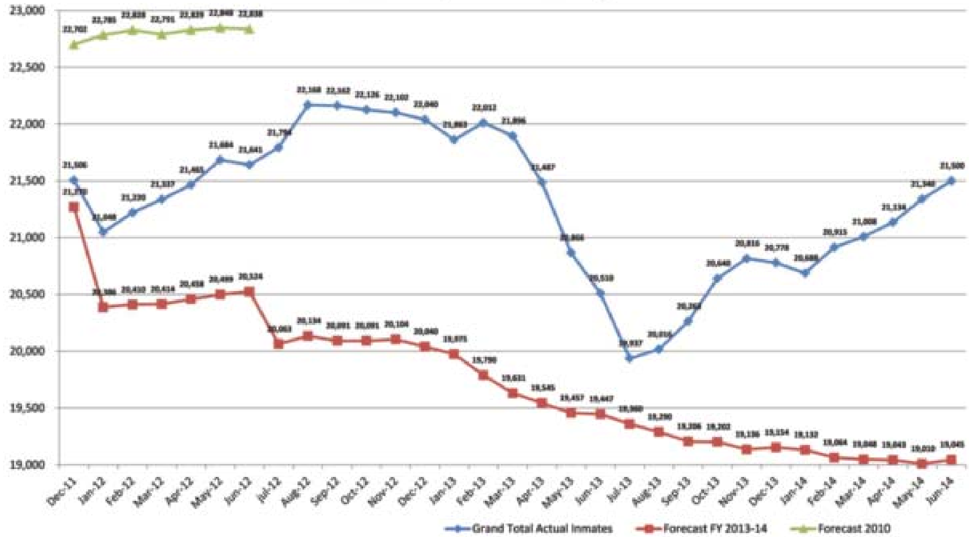
- Strengthening probation and parole by basing key decisions on the risk posed by offenders, linking offenders to appropriate community resources and improving parole and probation supervision
- Modernizing drug laws by reducing prison time for low-risk, non-violent drug offenders who possess small amounts of drugs and reinvesting related savings in increasing drug treatment for those offenders who need it
- Supporting and restoring victims by improving restitution and creating web-based tools to provide key information on offenders
- Improving government performance with better ways to measure and encourage a reduction in recidivism and criminal behavior[7]

The legislation is projected to save more than $422 million over 10 years from a reduction in incarceration.[8] While the prison population has not declined as quickly as originally predicted, the reforms are having a significant impact. (See Chart 2) In the past year, Kentucky has moved to terminate contracts with three private prisons due to a reduction in the prison population, and total corrections costs are now growing at only half the rate of the total budget.[9] These results indicate the need for the General Assembly to stay the course on the implementation of the 2011 reforms and resist the urge to increase penalties for nonviolent crimes.

CHART 2

Kentucky Inmate Population

December 15, 2011-January 15, 2014



Source: Kentucky Department of Public Advocacy (Kentucky Department of Corrections data)

MEDICAID: As noted in the 2011 Leaky Bucket update, General Fund spending on Medicaid, the federal-state program that now provides health coverage to more than 1 million Kentuckians, grew at a rate three times faster than overall state spending from 2000 to 2012. One approach to addressing this growth, advocated in 2009 by the Chamber, was to expand the use of managed care companies to provide coverage to Medicaid patients statewide to better control costs. The current administration implemented such a program in November 2011 under which three additional private managed care organizations (MCOs) provide health coverage for about two-thirds of Medicaid patients. This represented a significant change from the traditional fee-for-service Medicaid program in that the private MCOs are paid a fixed monthly amount to provide services to Medicaid patients as opposed to the state directly paying for services billed by health providers.

While some health providers have complained about the adequacy of provider networks and timely payments under managed care, the program is projected to save $375 million through 2014. As illustrated in Chart 1, the increase in Medicaid spending has slowed to a degree, growing at a rate of 16.5% from FY 2012 to FY 2016 as compared with overall state spending growth of 9.7% and a previous growth rate of three times that of the state budget.

PUBLIC EMPLOYEE HEALTH INSURANCE: With the Commonwealth of Kentucky providing health insurance to more than 266,000 state employees, teachers, retirees and their dependents, spending on health insurance was growing four times faster than overall spending—faster than any other major item in the budget.

In the period from 2012 to 2016, spending increases on health insurance have been reduced to 9.6% — a rate that is less than the growth of overall state spending. Several actions have contributed to this:

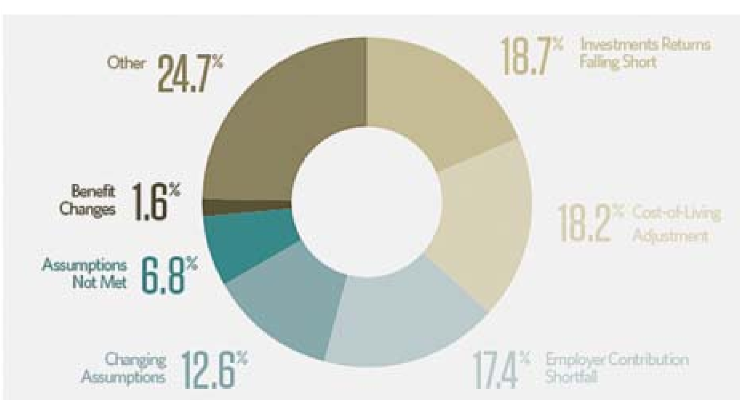
- The 2010 General Assembly reduced requested funding for health insurance by $100 million over the FY 2010-12 biennium and mandated savings in the health plan. As a result, annual deductibles paid by employees were increased from $33 to $500 (depending on the level of coverage), and co-pays for prescriptions were increased by $5. These actions helped reduce the rate of growth from an average of 15% per year to 7.8% for the FY 2010-12 biennium.[10]
- The employer contribution increased only 2% in 2014, compared to annual trend projections of 8% to 9%, and premium incentives provided to nonsmokers were increased and expanded to include all tobacco products.[11]
- Health plan options offered to employees for the 2014 plan year were redesigned to include two "Living Well" options that offer better benefits in the form of lower employee cost-sharing if the employee completes a health assessment.[12]
- High levels of unfunded pension liability create economic uncertainty — which can be a concern to businesses looking to expand or locate in Kentucky.
- The downgrading of Kentucky's bond rating means it will ultimately cost taxpayers more to finance important public projects such as the Ohio River bridges, new school construction and infrastructure improvements. Higher costs to issue bonds will reduce the number of projects Kentucky can undertake.[14]
- Illinois provides an excellent example of how a downgrade in a state's credit rating due to large unfunded pension liabilities can end up costing taxpayers more for construction projects. A planned $500 million bond issue was recently downgraded by rating agencies due to unfunded pension liabilities in Illinois, which would have cost the state an estimated $95 million in additional interest costs over the life of the bonds. (The bond issue was cancelled due to unfavorable conditions.)[15] At current average school construction costs, $95 million could fund the construction of at least four high schools or 12 elementary schools in that state.[16]

PENSION REFORM: Public employee pensions, although not addressed in the original Leaky Bucket report, have been of concern to the Kentucky Chamber since 2007. (Employer contributions for pensions do not appear as a line item in the state budget and as such are not included in this report's trend analysis.) Kentucky has one of the worst-funded pension systems in the country, and unfunded pension liabilities were a key reason both Moody's Investor Service and Fitch ratings have downgraded Kentucky's bond ratings and financial outlook several times in recent years.[13]

CHART 3

How Kentucky's Public Pension System Became Underfunded

Funding and contribution figures from Kentucky Retirement Systems



Source: Kentucky's Successful Public Pension Reform, Pew Charitable Trusts, September 27, 2013

The problems with the state pension system affect the private sector and taxpayers generally in a number of important ways:

- Increased spending on public employee benefits is taking needed funding away from economic development and education at all levels. This is particularly disturbing, as increasing education attainment is the key to creating jobs and growing our economy.
- The high costs of pensions to local governments in Kentucky are taking funding away from needed public services such as fire, police, public works, parks and local infrastructure projects.

In the 2011 Leaky Bucket update, the Chamber made several recommendations to shore up the pension system, including a reduction in health costs, suspension of COLAs provided to retirees and the adoption of a 401K-style retirement plan (in which employees are given a fixed amount each month to invest in a retirement account as opposed to a guaranteed retirement benefit).[17]

The legislature subsequently created a task force in 2012 to examine the Kentucky Retirement System and recommend changes to address the unfunded liability. Working with the Pew Center on the States, the task force found Kentucky's $13.9 billion pension funding shortfall (covering employees other than teachers) was caused by (see Chart 3):

- Failure of state government to pay the full employer contribution for employee pensions
- Providing annual COLAS and other enhanced benefits without properly funding them
- Investment losses by the pension system
- Poor actuarial assumptions that did not accurately reflect the cost of the current system[18]

The task force recommendations formed the basis of Senate Bill 2 that passed the 2013 General Assembly with the strong support of a business coalition organized by the Kentucky Chamber. SB 2 included three key reforms (that do not affect the Kentucky Teachers' Retirement System) that are estimated to save more than $5 billion over the next 20 years:

- A requirement to begin paying the full amount owed by the state into the pension system and a funding plan that dedicated nearly $100 million a year to help meet this promise
- A freeze on future Cost of Living Adjustments unless the benefit is fully funded
- A new cash balance retirement plan where new workers accumulate retirement savings from both employer and employee contributions, receive a guaranteed minimum 4% investment return and retire with a lifetime benefit based on the account balance

These reforms were a major step toward putting the Kentucky employees' pension system on the path to financial sustainability. To achieve this goal, it is critical that policymakers provide the full funding necessary for the system and maintain adequate oversight over the system's operation.

JUVENILE JUSTICE REFORM: Another significant change by the 2014 Kentucky General Assembly that will address spending was the enactment of legislation to reform Kentucky's juvenile justice system. A legislative task force studying that system reached a number of disturbing findings:

- Kentucky places large numbers of lower-level juvenile offenders outside their homes even though their offenses, such as running away or being truant, are not crimes.
- These low-level public offenders spend almost as much time in out-of-home placements as do youth who commit more serious crimes, including felonies.
- The taxpayers' tab for this approach, which research has shown does not result in good outcomes for the children, is high — with juvenile detention facilities averaging up to $87,000 per bed per year. By way of comparison, tuition and fees at any of Kentucky's public universities for four years would cost less than that one year of out-of-home placement.[19]

The task force made recommendations that became the basis of Senate Bill 200, which was supported by the Kentucky Chamber and enacted by the 2014 Kentucky General Assembly. Similar to the 2011 reforms of Kentucky's criminal laws affecting adults, SB 200 redirects the use of the most expensive state resources, like incarceration, toward the most serious juvenile offenders and improves public safety by reducing recidivism. Of particular significance are provisions to increase the use of community-based programs and policies that are proven to work in addressing the problems of youth who commit low-level offenses. These important policy changes, which take effect beginning in 2015, will save an estimated $24 million over five years—a win-win for both the youth and taxpayers of Kentucky.[20]

Continuing Challenges

Pensions

AS DISCUSSED EARLIER, Kentucky has made major strides toward a more sustainable public pension system with the enactment of the 2013 reforms. Over time, the increased financial contribution by the Commonwealth (in the form of the fully required employer pension contribution) and the revised benefit levels for new employees should work together in reducing the unfunded liability of the Kentucky Retirement System. However, there is an important part of the pension problem that was not addressed by the 2013 pension legislation: The Kentucky Teachers' Retirement System (KTRS).

CHART 4

Schedule of Employer Contributions: KTRS

FY Ended June 30	Annual Req'd Contributions	Actual Employer Contributions	Percentage Contributed
2008	$563,789,483	$563,789,483	83%
2009	$600,282,735	$600,282,735	74%
2010	$633,938,088	$633,938,088	76%
2011	$678,741,428	$678,741,428*	153%
2012	$757,822,190	$757,822,190	74%
2013	$802,984,644	$802,984,644	71%

*Includes Pension Obligation Bond Proceeds of $465,384,165

Source: Teachers' Retirement System of Kentucky, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2013

Although KTRS was not included in the 2013 reforms that applied to retirement systems covering state and local employees, it also has significant unfunded liabilities. The 2013 financial statements for KTRS (released in December 2013) indicated the system had approximately 75,000 active and 47,000 retired members and a funding level of 51.9% as of June 30, 2013, with $13.85 billion in unfunded liabilities.[21] A key reason for this underfunding is the fact that actual employer contributions to KTRS in recent years have been significantly less than the full amount required to meet the system's financial obligations (see Chart 4).

This situation prompted the actuary for the system to reach the following conclusion in a Dec. 6, 2013, letter to the KTRS board:

> *In our opinion, the System is not being funded on an actuarially sound basis since the actuarially required contributions are not being made by the employer. If contributions by the employer to the System continue to be less than those required, the assets are expected to become insufficient to pay promised benefits. Assuming that contributions to the System are made by the employer from year to year in the future at rates recommended on the basis of the successive actuarial valuations, the continued sufficiency of the assets to provide the benefits called for under the System may be safely anticipated.*[22]

Simply put, KTRS will eventually run out of money and be unable to pay benefits promised to teachers unless the state starts to make the full employer contribution to the system.

In legislative testimony in September 2013, the executive director of KTRS estimated the state will need to provide as much as $400 million per year in additional funding to the system to compensate for years of underfunding.[23] The Kentucky Chamber subsequently sent correspondence to all 138 members of the General Assembly during the 2014 legislative session requesting action "to undertake a bipartisan review of the Kentucky Teachers' Retirement System to recommend a sustainable path forward to ensure financial stability."[24] House Concurrent Resolution 179 was introduced during the 2014 session to establish the Kentucky Teachers' Retirement System Task Force to conduct such a review, but the resolution was not acted upon in the House of Representatives.[25]

In addition to the concerns at KTRS, a recent ruling of a federal bankruptcy court found that Seven Counties Services, the mental health agency in the Louisville region, was a private entity and may withdraw from the Kentucky Retirement System. (The agency argued it could not afford the higher pension contributions required by the 2013 reforms and filed for bankruptcy; however, the current budget provides additional funding for health departments and mental health agencies to cover the higher contributions.) Officials of the Kentucky Retirement System maintain the withdrawal will leave the system with $90 million in unfunded liabilities for Seven Counties employees who are or will be drawing benefits from the system and that Seven Counties should be required to pay this amount to the system before being allowed to withdraw. If not, other employers in the system will be forced to pay increased contributions to cover this liability. Concerns have also been expressed that the ruling sets a potential precedent for 12 other community mental health centers (and similar agencies) to leave the system.[26] The ruling is now under appeal.

Medicaid

The Kentucky Medicaid program now covers more than 1 million people and has a total annual budget of $8.26 billion (including federal funds). As this report has noted, the escalating trend in Medicaid spending has been reduced in recent years in large part through the implementation of a statewide Medicaid managed care system. Despite this positive development, a large and difficult financial challenge awaits policymakers with respect to Medicaid in the next biennial budget (FY 2016-2018). This challenge stems from the decision of the administration last year to expand Medicaid eligibility (as permitted by the Affordable Care Act) to persons with annual incomes up to 138% of the federal poverty level ($26,951 for a family of three) beginning in January 2014. The federal government will pay 100% of the state's additional cost for the expansion from 2014 to 2016. However, the state is required to begin paying part of the costs beginning in 2017. Chart 5 shows the federal and state share of Medicaid expansion costs through 2020 and beyond.

In May 2013, the Kentucky Cabinet for Health and Family Services estimated 164,000 additional Kentuckians would be eligible under the Medicaid expansion in FY 2014 and that number would grow to more than 209,000 by 2017 and beyond.[27] (See Chart 6)

CHART 5

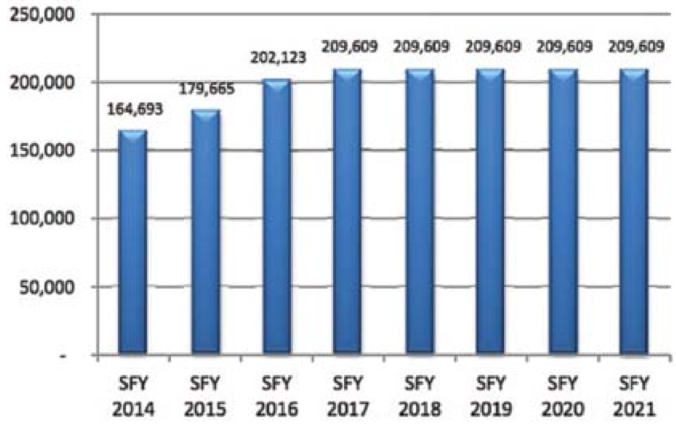
Federal Matching Rates for Medicaid Expansion to 138% of Poverty

Calendar Year	Federal Matching Rate	State Share
2014	100%	0%
2015	100%	0%
2016	100%	0%
2017	95%	5%
2018	94%	6%
2019	93%	7%
2020 +	90%	10%

Source: Federal Register, Medicaid Program; Eligibility Changes Under the Affordable Care Act of 2010; August 17, 2011

CHART 6

Total Estimated Medicaid Enrollment Increase



Source: Analysis of the Affordable Care Act Medicaid Expansion in Kentucky, Kentucky Cabinet for Health and Family Services, 2013

This estimate, now shown to be significantly too low, included an additional 17,000 to 20,000 Kentuckians who were already eligible but not enrolled in Medicaid under the existing eligibility rules (under which the state pays 30% of total benefit costs) who are expected to sign up due to the new requirement that individuals obtain health coverage or pay a penalty.[28]

The total additional cost to the Commonwealth was estimated at $13 million in General Funds beginning in FY 2014 and increasing to $187 million by 2021. (See Chart 7)

CHART 7

Estimated Additional State General Fund Expenditures Under Medicaid Expansion

	Federal Share	State Share	Total
SFY2014	$595 M	$13M	$608M
SFY2015	$1,259M	$28M	$1,287M
SFY2016	$1,384M	$31M	$1,415M
SFY2017	$1,331M	$63M	$1,394M
SFY2018	$1,344M	$105M	$1,450M
SFY2019	$1,384M	$124M	$1,508M
SFY2020	$1,410M	$158M	$1,569M
SFY2021	$1,444M	$187M	$1,631M

Source: Analysis of the Affordable Care Act Medicaid Expansion in Kentucky, Kentucky Cabinet for Health and Family Services, 2013

The cabinet's analysis concluded that the health and economic benefits of expansion would offset the additional state costs due to an infusion of $15.6 billion in new federal dollars in Kentucky's economy that would create an estimated 17,000 new jobs.[29] The analysis also concluded that Kentucky employers could face up to $48 million in annual fines for failing to provide insurance if Medicaid was not expanded as many existing employees would become eligible.[30]

However, these cost estimates are based on the assumption that Medicaid enrollment would increase by 164,000 in FY 2014, growing to 209,000 by 2017 and sustaining that level in subsequent years. In fact, enrollment data as of April 21, 2014, indicate that 330,615 additional Kentuckians have already qualified for Medicaid through Kentucky's health insurance exchange — a number that is almost twice the estimated amount for FY 14 and 50% more than estimated for 2017.[31] This actual enrollment experience suggests that Kentucky will face a much higher cost than originally estimated, especially in 2017 when the state will be required to pay 5% of the costs of those newly eligible under expansion.

Recommendations

Corrections

Continue full implementation of 2011 sentencing-reform legislation to control the growth in corrections costs and carefully consider legislative efforts to increase penalties that will result in higher corrections cost. Continue this positive trend in more appropriate use of expensive corrections resources with full implementation of 2014 juvenile justice legislation. The General Assembly should also continue reviewing the Kentucky Penal Code with the goal of creating more alternatives to incarceration for low-level, non-violent crimes and focus on jail time for more serious offenses. Potential areas for review recently identified by the Kentucky Department of Public Advocacy include:

- Alternative sentencing for flagrant non-support instead of imprisonment for a felony
- Modification of the persistent felony offender statute
- Increasing the dollar amount for the felony theft limit
- Presuming parole for eligible low-risk offenders
- Adoption of a "clear and convincing" standard for pretrial release
- Creation of a "gross misdemeanor" classification for low-level felonies[32]

Medicaid

Continue statewide Medicaid managed care and include more wellness activities and incentives in the program. Undertake a data-driven review of the program, including benefits and program administration.

Public Employee Health Insurance

Require public employees to contribute a reasonable amount for health insurance and continue more focused efforts to provide incentives for wellness.

Pensions

Ensure full implementation of 2013 pension reforms, including full funding of required employer contributions to the system. Create the Kentucky Teachers' Retirement System Task Force to conduct a bipartisan review of the Kentucky Teachers' Retirement System to recommend a sustainable path forward to ensure financial stability for action by the 2016 Kentucky General Assembly.

Conclusion

As this report has documented, Kentucky has made significant progress in starting to plug the leaks in the state budget originally identified in the 2009 Leaky Bucket. Since that time, major legislation has been enacted to address spending in corrections and unfunded pension liabilities. And significant administrative changes have taken place to rein in spending on Medicaid and public employee health insurance.

Yet serious problems remain with funding the Kentucky Teachers' Retirement System and the expansion of Kentucky's Medicaid program in the next budget. Policymakers must stay the course and continue the progress they have made to date on state spending. The alternative is to return to a trend in which Kentucky is paying even more to treat health conditions and incarcerate those who break the law instead of investing more in education. Increased education attainment is the true path out of the cycle of poor health and poverty that has plagued Kentucky and its economy for generations.

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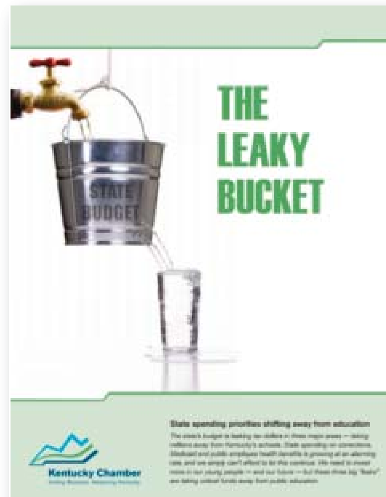
Kentucky Chamber

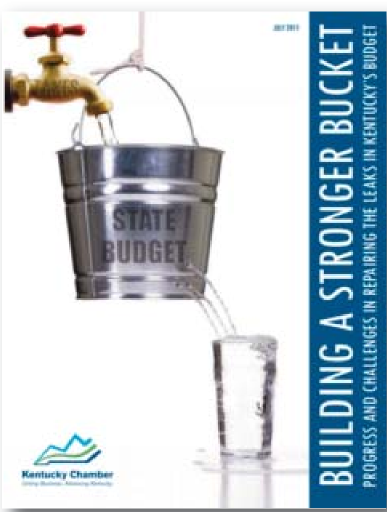
CHANGING THE CONVERSATION

LEGISLATORS PRAISE THE LEAKY BUCKET REPORTS



"The Chamber's Leaky Bucket reports have highlighted the need to manage state spending. The Chamber backed up their report by supporting corrections and pension reform efforts to help move Kentucky to a more sustainable fiscal position."

ROBERT STIVERS,
PRESIDENT OF THE SENATE



"The Chamber's leadership was crucial in criminal justice reform: A smart-on-crime strategy that improves public safety at less cost to Kentucky taxpayers. The legislation has become a national model, and the leadership offered by the business community has been a large part of the conversation."

REP. JOHN TILLEY
CHAIRMAN, HOUSE JUDICIARY COMMITTEE

"The Chamber played a critical role in educating the public and legislators on the importance of pension reform. Its testimony and public campaign in favor of reform laid the groundwork for success."

DAMON THAYER
SENATE MAJORITY LEADER

"The Kentucky Chamber's report has been helpful as we pursue solutions to the Commonwealth's most pressing issues. I am pleased with the progress that we have made and hope we can continue to improve."

REP. RICK RAND
CHAIRMAN, HOUSE APPROPRIATIONS AND REVENUE COMMITTEE