

State Budgeting Matters

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The governor faces many challenges in producing and maintaining a balanced budget that meets Ohio's needs.

This series is an opportunity for our readers to get involved by e-mailing their Ohio budget questions to our Ohio budget expert, Richard G. Sheridan, at rsheridan@CommunitySolutions.com.

Please note that Richard G. Sheridan's opinions are not necessarily those of The Center for Community Solutions.

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The Cats are Out of the Bag

In just the first few days of December, the Strickland administration released data to show that:

- General Revenue Fund (GRF) spending for Fiscal Year (FY) 2008, which ended on June 30, exceeded appropriations made in the current biennial budget (H.B. 119);
- The size of the GRF shortfall for the current biennium will total \$1.938 billion—\$640 million more than the previously announced \$1.298 billion shortfall;
- In rebalancing the budget so far (without accounting for the additional \$640 million shortfall predicted for the remaining seven months of this biennium), budget cuts of \$543.4 million for the biennium account for only 41 percent of the actions taken to bring the budget back into balance so far;
- GRF tax revenues for FY 2010 are projected to be \$992.1 million less than the reduced revenue forecast for this fiscal year, and FY 2011 GRF tax revenues are projected to be \$30.9 million less than FY 2010; and
- In order to accommodate the reduced revenue forecasts for the next biennium, agencies (except for Medicaid, debt service, and property tax reimbursements) were told to submit budgets at 90 percent of their current spending levels. But, even by doing so, actions will still be required to prevent the submission of a budget request for the coming biennium that is \$4.7 billion less than expected revenues.

Each of these new conclusions about the state budget are analyzed in this article, as well as the question of what caused these problems and what the options are to solve them.

FY 2008 Spending

In order to balance last fiscal year's GRF budget, in the light of declining tax revenues, the Office of Budget and Management (OBM) reported that it cut spending by \$185.8 million and, in addition, agencies lapsed (failed to spend) another \$120.2 million. Presumably, that would mean that total spending would be \$306 million less than was appropriated. However, state accounting reports that \$25,721,782,776 was expended during FY 2008, or \$269 million more than was appropriated in H.B. 119. How was the state able to spend more than was appropriated even after declaring that state agencies spent \$306 million less?

The answer appears to lie in actions taken to bring the Medicaid budget back in balance.

OBM told the state legislature a year ago that it needed an additional appropriation of \$91.4 million in state funds (which would be matched by federal funds which are deposited into the state GRF) to pay for FY 2008 Medicaid overruns. Had the leg-



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islature granted this request it might help explain the \$269 million in overspending. Together, the additional state (\$91.4 million) and federal matching moneys would approximate the \$269 million in overspending if the legislature had increased appropriation authority as the governor requested. But they did not.

So, lacking specific authority to spend more than was appropriated, OBM reported to the Senate Finance and Financial Institutions Committee on December 2, that it moved the FY 2008 Medicaid obligation into the following (current) fiscal year:

“To manage within H.B. 119 appropriations we planned to move the final budgeted Medicaid payments for fiscal year 2008 into fiscal year 2009 and encumber the remaining GRF appropriation of \$304 million. As a result of the timing of the managed care payment (which is usually disbursed on the fourth Monday of every month) and several other provider payments, totaling \$434 million dollars, these payments were disbursed from the fiscal year 2009 appropriation.”

Leaving aside the question of the legality of that action—a question that regretfully must be raised—that action could account for spending exceeding appropriations for FY 2008. But, if that explains the overspending, what happened to the \$306 million that was reported to have been “saved” through budget cuts and agency spending lapses?

Furthermore, OBM reported that it had \$98.8 million of FY 2008 moneys that were not needed for FY 2008, and were therefore “carried forward” to be used to help solve the FY 2009 budget shortfall problem. If the state spent \$269 million more than was appropriated, how could it still have \$98.8 million to carry into FY 2009?

The answer may involve Controlling Board actions, use of Medicaid Reserve Funds that are held in an off-budget location, and supplemental appropriations. The point is that the data so far supplied for FY 2008 spending raises questions that need to be answered. Further clarification of these questions is needed and, perhaps, will be sought by the legis-

lature before it proceeds to address the additional problem of balancing the state’s FY 2009 budget.

FY 2009 Budget

Before the announcement of the most recent \$640 million shortfall for FY 2009, OBM had taken actions to cover a FY 2009 budget shortfall of \$556.6 million. Budget reductions covered \$198.3 million, or 35 percent, of that problem. The rest was made up of actions that shore up continued increased spending. Now, OBM is reporting that it expects tax revenues to decline by an additional \$640 million and proposes no solution to the problem at this time. Governor Strickland has joined the rest of the governors in appealing to the President-Elect to provide the state with additional federal money to cover this shortfall. No action on this request is likely to be taken until sometime after the new president is sworn into office on January 20. So the big question for state policymakers is whether they should wait until next February to find ways to cover the newly-announced \$640 million shortfall, or act now?

The two options available to the state at this time, in order to accommodate the reduced revenue forecast, are to make budget cuts that would have to be far more severe than those already made, or use some or all of the balance in the Budget Stabilization or Rainy Day Fund.

Because the legislature chose to use \$200 million of the fund to help pay for an economic development program, the available balance is now less than \$700 million. Legislators, in their lame duck session, are attempting to spend another \$200 million of the remaining balance to pay for a new veterans’ bonus program. One could (and perhaps should) question the legitimacy of using money to institute new programs that was accumulated to deal with just such a recession as the state is now facing. Leaving that question aside, there is another question of how to pay for a projected multi-billion shortfall for the upcoming FY 2010-2011 budget.

The longer the state delays in addressing the \$640 million FY 2009 budget problem, the fewer the op-

tions that will be available to it. Trying to cut that amount in the last four months of the biennium (if the state waits until February to do something) would require unimaginable drastic effects. The longer the state waits to cut the budget, the more likely it is that the state will have to use its Rainy Day funds to shore up the budget. Waiting for the federal government to act on a state-aid package before addressing the problem may make sense politically, but the question is whether doing so makes sense fiscally?

FY 2010-2011 Budget

It is unclear how the conclusion was reached that the state is “projected to face an exceptionally large, more than \$7 billion deficit in the upcoming 2010-2011 operating budget” as reported in a December 1, 2008, press release from Governor Strickland’s office. The release further declared:

“Based on current economic and revenue indicators, an approximate \$7.3 billion deficit is forecast for the FY 2010-11 operating budget. Even after assuming a 10 percent reduction to all state agency budgets, based on the February 2008 recalibrated spending levels, the projected deficit is approximately \$4.7 billion.”

The reason that it is difficult to understand this problem, is because the Department of Taxation reported estimated GRF tax revenues for FY 2010 to be \$921.1 million below FY 2009 revenues, and FY 2011 revenues to be \$30.9 million below FY 2010. Taken together, the projected revenue shortfall is less than \$1 billion. So how does one reach the conclusion that the state is facing a \$7.3 billion deficit for the coming biennium?

Part of the answer has to lie on the spending side, details of which were not made available in budget briefing materials submitted to accompany the governor’s December 1 press conference. However, in suggesting that a 10 percent reduction in agency spending would reduce the deficit by \$2.6 billion (a footnote explains that debt service, tax relief, and Medicaid were exempted from the 10 percent cut), it has to be assumed that projected increases in these

three major state GRF expense areas are increasing sufficiently to account for the rest of the reported anticipated budget gap of \$4.7 billion. More information is clearly needed on the spending side of the ledger to fully understand how a tax revenue shortfall of \$952 million (\$921.1 plus \$30.9) could result in a budget shortfall of \$7.3 billion.

Another problem relates to the failure to exempt a number of agencies and line items from further cuts, as has been the case in the past. Cutting the adult correction’s \$1 billion budget is virtually impossible without making changes in the state’s mandatory sentencing laws. Otherwise, the result would be cuts in guards and food which would only result in overcrowding and explosive conditions, potentially leading to prison riots as they have in Ohio’s past. Other agencies, such as those providing juvenile correction services and institutional agencies, such as mental health and mental retardation/developmental disabilities, are in similar positions where cuts can be made only by restricting institutional enrollments.

Regardless of the resolution of these problems, it is important to understand that Ohio’s budget problems are not exclusively the result of adverse economic conditions. They also result from a number of decisions made during both the Taft and Strickland administrations to take tax revenues out of the state GRF.

Causes of the State’s Budget Problems: Global Economy

In a testimony before the Senate Finance Committee on November 19, State Budget Director J. Pari Sabety summarized the adverse effects that the national economy has had on Ohio:

- “Ohio has lost jobs at the same pace that the national economy has been shedding jobs. And many of our communities are reeling. In the past 6 months; DHL has ceased US operations; GM, Ford and Chrysler are all asking the Federal government for loan or grant assistance.

- Ohio banks and companies are experiencing a significant credit freeze. Bank credit has declined at a precipitous rate not seen in the last 40 years. Companies like Goodyear have had to turn to credit markets to make payroll. This is indeed dangerous. As I am sure you have heard from businesses throughout your districts, without access to credit, companies cannot grow or invest, thus moving our economy forward.
- Ohio's workers are feeling the pinch. Withholding taxes--one of two reliable indicators of the 'real time' status of our state's economy--have gone negative, with several months of negative year-over-year performance in this fiscal year. Ohio's income and sales tax revenues have been volatile, and the risk to those two revenue sources is on the downside.
- The Labor Department released new figures on first time unemployment claims on November 13, showing that initial claims had risen to 516,000 for the week ending November 8th, matching the number of claims filed in September 2001. This increase in first time claims along with the increase seen in the unemployment rate, which was revised upward to 6.5 percent last week, is a significant negative sign regarding the employment situation. Typically, employment levels tend to rise following a recession, and with current predictions being that the US has just entered a recession and that negative growth will continue through the first half of 2009 the employment situation is likely to worsen further. Since December 2007 the US has lost 1.2 million jobs nationally; 520,000 of those jobs were lost within the last 60 days. Over the past year, Ohio lost 17,600 jobs, 3,400 of them in September alone.
- And Ohio's consumers have grown cautious. Consumer confidence is at a level below the levels achieved in the 1980-1982 recession. October retail sales declined by 2.8%, the largest amount since November 2001. The decline was spurred by a substantial drop in automobile sales which fell 2.2%. As consumer spending accounts for nearly two-thirds of gross domestic product (GDP) in the United States, such a dramatic decline will most likely result in negative GDP growth for the current quarter. Should GDP growth for the current quarter turn out to be negative, the US would then fall under the typical definition of a recession, two consecutive quarter(s) of negative GDP growth, as GDP growth declined 0.3 percent in the third quarter. Additionally, such a large decline in retail sales will only further negatively impact sales tax collections, which were already coming in well below their 2007 levels.
- Consumers are rightfully cautious. The housing crisis has taken on trillion dollars out of household wealth in the US over the last year alone. And every 1 penny decrease in consumer wealth translates into a nickel less consumer spending. When consumer spending falls, our economy suffers.
- The National Association of Realtors (NAR) released updated figures on November 7 for their forward looking pending home sales index which showed a 4.6 percent drop in September falling in three of the four regions, and rising only in the West. The index is considered a leading indicator because it is based on pending home sales, which are home sales that have a signed contract but have not been closed. The index was up strongly in August, and was appropriately followed by increases in both new and existing home sales. Overall, the index is still 1.6 percent above its September 2007 level, which suggests that we are currently in a period of prolonged stabilization, according to Lawrence Yun, Chief economist at the NAR."

This explanation clearly shows the economic conditions contributing to Ohio's fiscal problems. Equally important are changes made by the state in the past few years to take revenues out of the state GRF.

Causes of the State's Budget Problems: Tax Policy

It is too easy to blame the state's budget problems solely on the recession, and it is wrong to do so. Long before there was any inkling of an economic

downturn, state budget officials warned the legislature that it would face difficulties in the next biennium’s budget. That warning was included in budget information accompanying the introduction of H.B. 119, the current state budget. OBM estimated that revenues for the FY 2010-2011 state budget would be less than were estimated to be available for the current biennium. Why? Because the state had decided to “reform” its tax structure, with “reform” used as a euphemism for “reduce taxes.” The main ingredients of that “tax reform,” that are now adversely affecting the state’s ability to meet its constitutional responsibilities to provide for

education, health and human services, are shown in the table below.

This table was prepared by OBM and included in the explanatory materials submitted to the General Assembly almost two years ago. It shows that for the coming biennium there would be a reduction in tax revenues to the GRF totaling \$4.4 billion. But, even with the information that tax reform would result in reduced revenues for future biennia, with the passage of H.B.119 the state took additional actions that would further erode state GRF revenues.

Estimated Fiscal Impacts of Major Tax Law Changes in H.B. 66 of the 126th General Assembly (\$ in millions)

<i>Tax Law Change</i>	<i>FY 2010</i>	<i>FY 2011</i>
Sales and Use Tax Increase permanent tax rate from 5 percent to 5.5 percent	\$772	\$798
Personal Income Tax Phase-in 21 percent rate cut over five years; credits adjusted so filers with Ohio taxable income below \$10,000 pay no tax	-2272.6	-2381.6
Corporate Franchise Tax (a) Phase-out over five years for non-financial corporations	-1642.2	-1642.2
Commercial Activity Tax (b) Phase-in over five years	1676	1573
Tangible Personal Property Tax Phase-out with commensurate increase in state payments to local entities	-1624.1	-1650.7
Cigarette Tax Increase tax rate	398	390
Local Property Tax Eliminate 10 percent rollback on commercial and industrial property and thus decrease state expenditure	365	383
Subtotal of Listed Impacts	-2327.9	-2530.5
Total Impact on All State Funds	-2268	-2443.9
Total Impact on General Revenue Fund	-2110.9	-2282

Source: Office of Budget and Management, Executive Budget for FYs 2008 and 2009, Table B-1a, p. B-8. Original Footnote (a) is omitted.

(a) This is an unadjusted estimate which does not factor in potential taxpayer behavior—specifically, increased apportionment of taxable income into Ohio by multi-state companies—occurring as the result of the phase-out of the corporate franchise tax. To the extent such behavior is occurring, these figures overstate the revenue being foregone by the repeal of that tax on most taxpayers.

(b) Assumes a commercial activity tax rate reduction will occur in FY 2010, with the full impact being felt in FY 2011.

The budget bill for the current biennium included a number of new tax breaks, the most expensive of which was an expansion of the state's Homestead Exemption which was extended to all seniors aged 65 and older, their surviving spouses, and totally and permanently disabled persons, regardless of their economic situation. The state removed the means test and thereby expanded the exemption from an estimated eligible population of 220,000 persons statewide to 775,000. To pay for the additional costs of this tax benefit, which would have resulted in a decrease in revenues to local governments, the state took tobacco settlement moneys that could have been used in the GRF and, instead, dedicated it to replace lost local property tax revenue. As a result, \$5.5 billion of revenue was removed from GRF use and instead will be used to pay local governments for the cost of expanding the homestead exemption.

The important point is that a good deal of the state's current economic problems are of its own making.

How to Solve the State's Budget Problems: Feds to the Rescue

Ohio has joined other governors in seeking assistance from the federal government in making up for revenues lost because of the collapse of the nation's financial market, the erosion of stock values, rising unemployment and other economic conditions outside of its control. So far, Ohio has not had to make the kinds of sacrifices other states have already made to restore their budget shortfalls. Across the nation states have increased taxes, cut school aid significantly, cut enrollments in the State Children's Health Insurance Program (SCHIP), and made other cuts in the Medicaid program. Ohio is hoping to avoid some of these actions by asking the federal government for assistance on several fronts, only one of which would help the state's GRF operating budget.

State's are asking the federal government for money they can use to accelerate their construction programs, thereby increasing employment in

the construction industry. If granted, these moneys would not affect the state's GRF budget. Similarly, a request for additional TANF (Temporary Assistance to Needy Families) moneys to cover expected increased enrollments would not help the state GRF because the program is fully federally funded. What would help Ohio's GRF problems is an increase in the federal match for the Medicaid program. To assist states during the last recession the federal government did just that:

*"The only time Congress enacted a temporary increase in federal Medicaid aid was in March 2003 to help states during the recession after the Sept. 11 attacks. That \$10 billion—part of a \$20 billion total package in general aid for states—was 2.95 percent above states' usual federal allotment and lasted 15 months."*¹

But, there is an important difference in state actions taken then compared to now:

*"At the time, states were making big Medicaid cuts. Every state froze or reduced payments to medical providers such as doctors or hospitals. Others cut back on benefits; in 2002, Massachusetts cut dental services, which led to 100,000 fewer adults receiving dental benefits in 2004 than in 2001."*²

As a result, the federal help carried the condition that states not cut people from the Medicaid program. The effect of that was to remove from potential budget cutting the state's largest single line item. It is likely that if Congress responds to the nation's governors' request for aid, this time a similar condition would be applied thereby protecting Medicaid but not other state programs from budget cuts to accommodate budget shortfalls. In any case, what Ohio's policymakers must soon wrestle with is whether they should postpone action on the declared budget shortfall for the remainder of FY 2009, in the hope of additional federal Medicaid matching money that, if granted, would clearly not be available until at least next February, or act now to shore up this year's state budget.

¹ Pauline Vu, "States Ask Feds for Health Care Help," *Stateline*, November 26, 2008.

² *Ibid.*

Regardless of what the federal government does, Ohio, whose budget problems are the result of its tax policies, as well as national economic conditions, needs to consider actions to insure that the state will have sufficient resources to provide essential, and constitutionally required safety net services in the long run.

How to Solve the State's Budget Problems: For the Long Run

Even if, as *State Budgeting Matters* continues to predict, additional steps will need to be taken in order to end this fiscal year on June 30, 2009 with a positive balance, finding ways to do so will pale in comparison to the difficulties to be faced in balancing the next biennial budget. Even if ways are found to muddle through the rest of this biennium without using the state's \$750 million Rainy Day Fund balance, the governor will be precluded from using any of that money to balance next biennium's budget. State law requires that the governor submit to the legislature a budget that is balanced using only existing revenue sources. Thus, his budget cannot be based on transferring Rainy Day Funds nor on increasing taxes. This is the main reason that agencies were requested to submit budget requests that are 10 to 15 percent below current (FY 2009) spending levels. That kind of budget will have to call for drastic reductions in Medicaid spending (which would probably be prohibited if the federal government provides state aid in the form of an increased Medicaid match), higher education tuition increases, lessened support for primary and secondary education, and possible reductions in aid to local governments. The big question will be whether legislators will be able to withstand pressures from their constituencies to resist such drastic cuts and use alternative methods of balancing the budget.

The obvious alternative open to the General Assembly is to increase tax rates, either permanently or temporarily. Since the five-year budget reductions enacted during the last days of the Taft administration have one more year to go before full implementation, the legislature could postpone the final year

of implementation until some time in the future. They could also impose an increase in the sales tax. Either of these alternatives could produce sufficient additional revenues to produce a balanced budget without the drastic spending cuts that would otherwise be necessary.

Other alternatives available to the legislature include:

- Utilize the remainder of the Rainy Day Fund (assuming it is not used to bring the current state budget into balance);
- Expand the base of the state's personal income tax by eliminating selected deductions and exemptions;
- Expand the sales tax base by eliminating some of the current non-food (which is constitutionally protected) exemptions, especially in the area of service provision;
- Phase out the state's local government revenue-sharing program;
- Utilize so-called "working capital balances" that institutions of higher education maintain in order to be able to issue their own checks, but transferring that function to the state;
- Increase the share of spending on certain human services programs (mental health, mental retardation/developmental disabilities, drug and alcohol addiction, and so on) required to be provided by local governments; and/or
- Institute a state property tax.

This is not a complete list of options, but should illustrate the fact that there are ways of balancing the next budget without creating the kinds of hardships that reliance on spending cuts alone would require. An important consideration for the next legislature should be a concern for not just the next biennium, but the longer term fiscal health of the state. The Taft-inspired budget cuts were not only poorly-timed but were based on a flawed assumption that they would promote the economic growth of the state. Such thinking completely ignores the economic reality that economic growth is dependent on factors completely beyond the control of an indi-

vidual state or region and, as we are now discovering to our dismay, may even be beyond the control of the national government despite its monopoly on public fiscal policy.

It behooves the next General Assembly, as they focus on preparing a balanced budget for FY 2010-2011, to consider establishing a framework that will insure the long-term fiscal health of the state rather than considering what it will take for the state to maintain its primary responsibility to provide for the health, education, and welfare of its citizens in good times and in bad times, and for the long term, not the short term.

Post Script: Medicaid

As the state wrestles with how to address the worsening budget condition, human services advocates should take note of an important change in federal rules governing the Medicaid program:

“It hasn’t all been clamping down on states and localities out of HHS, though. A new federal rule now offers states significant discretion in what they choose to charge Medicaid clients for premiums, co-pays and prescription drugs.

But this newfound discretion presents an obvious dilemma for states. Although the idea behind the new rule is to reduce costs for the feds and states, an obvious consequence of such things as increased co-pays could be to discourage clients from seeking needed care. That, in turn, could lead to people accessing the system when they’re sicker, something that could just increase costs down the road.

So here’s a thought in keeping with the notion of a new role for HHS under an Obama administration: The feds should work with states on analyzing the actual impact of the new Medicaid billing rules on both the health of budgets and the health of the public so that officials can make informed judgments about those impacts and decide whether to make adjustments. That would be a new and welcome kind of federalism.”³

Do You Have Questions about Ohio’s Budget?

E-mail your questions to budget expert Richard Sheridan at rsheridan@CommunitySolutions.com.

Answers to your questions could be the topic of future issues!

³ Jonathan Walters, *Governing Human Services E-Letter*, December, 2008.