

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.

Solving the State's Budget Problems

In order to prevent the state from ending the current biennium with a (constitutionally prohibited) General Revenue Fund (GRF) shortfall of \$733 million, the Office of Budget and Management (OBM) cut spending authority to a number of state agencies, instituted a new casino-like gambling game, and recommended a number of other actions that will require legislative approval. On March 10, OBM issued its Monthly Financial Report for February. Actual GRF receipts to date, compared to the revenue estimates on which the budget is based, are \$184 million below estimates. Even more worrisome is that it shows the state has received \$59 million less than OBM's revised revenue forecast anticipated, suggesting that the "least-worst" scenario postulated by OBM is already out of date.

In the opening Economic summary of the February Financial Report, OBM Director J. Pari Sabety writes:

"The economy continued to deteriorate in February. Forecasters, including the Federal Reserve, lowered projections for real GDP growth further. Evidence of impending recession continued to accumulate, with the Leading Economic Index signaling that the economy is following the typical path toward recession (emphasis supplied)."

What this suggests to this writer is that, as stated in last month's issue of *State Budgeting Matters*, Ohio should be taking action to close a \$1.884 billion shortfall--the amount that OBM says will be needed if there is a recession--not just a \$733 million shortfall assumed if the state was merely experiencing "slow growth." As great as a \$1.884 billion shortfall may appear, the state's shortfall may be even greater than this when additional problems not included in OBM's calculations are considered.

This month *State Budgeting Matters* examines these additional fiscal problems that are not even considered in the state's "worst case" scenario: (1) federal actions affecting the state budget, (2) the impact on the state of property tax losses by local units of government, and (3) the state's FY 2010-FY 2011 budget.

Besides just identifying these additional problems several ways of dealing with the overall state fiscal problem are described, including (1) using accumulated reserves, (2) postponing individual income tax reductions, (3) eliminating certain tax expenditures, (4) eliminating individual income tax "carryback" deductions, (5) adopting a state economic stimulus package, and (6) adopting a budget just for FY 2010--not for the FY 2010-FY 2011 biennium.

New Problems on the Horizon

As described by OBM, the state's budget problem consists of an anticipated loss of GRF tax revenues as a result of the national recession, and a need for additional appropriations to support the Medicaid program that provides medical services to elderly and poor Ohioans. Through December, 2007, Medicaid caseloads were 19,000 higher than estimated when the budget was adopted. That increase, and a failure to achieve expected cost containment savings,



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resulted in a new estimate that the state will need to appropriate an additional \$91 million in state and federal Medicaid funds for FY 2008 and another \$271 million for FY 2009. These appropriations are needed even after Governor Ted Strickland postponed the implementation of certain medical provider increases included in the current state budget. But, even under the worst-case scenario, the state's revenue problems may be greater, and the need for Medicaid appropriations higher, because of recent federal actions.

Federal Actions. The February issue of *State Budgeting Matters* pointed out that, after OBM made its new forecasts of the size of the state's budget shortfall under three alternative scenarios, the federal government enacted an economic stimulus package that includes a "bonus depreciation" provision and an investment "expensing" provision. Because of the linkages between the federal and state tax code, Ohio is expected to lose an estimated \$144 million in corporate taxes next year. This amount needs to be added to the shortfall projected by OBM.

In addition to this new problem, the U.S. Department of Health and Human Services has issued a series of new regulations that will result in additional state costs if the current programs are to be continued and could reduce services to certain Medicaid recipients.

Here are some of the new federal rules impacting Medicaid that could further strain Ohio's Medicaid budget:¹

- Ohio is one of many states that supplement Medicaid payments for public hospitals that serve uninsured recipients and that maintain neonatal intensive care units, burn-treatment units, and other services provided to benefit the entire community. The new regulation, which is designed to save the most federal money, severely restricts the use of federal funds for this purpose. Congress delayed the implementation of this provision until May 25, 2008, after which time hospitals will either have to find alternative revenue sources (including state funds) or raise prices.

¹ An analysis of these Medicaid regulations is found in "Medicaid Overview and Impact of New Regulations," Kaiser Commission on Medicaid and the Uninsured, January, 2008, and in Allison Orris and Judith Solomon, "Administration's Medicaid Regulations Will Weaken Coverage, Harm States, and Strain Health Care System," Center on Budget and Policy Priorities, Washington, DC, Revised March 4, 2008.

- Also eliminated, with implementation postponed until May 25, 2008, by Act of Congress, is the elimination of federal Medicaid funding for the costs of graduate medical education provided by teaching hospitals. This change will undoubtedly result in the need for additional state funding to compensate higher education institutions for this funding loss.
- The new regulations eliminate Medicaid funding for school-based administrative activities. This change could result in failure to identify Medicaid-eligible school children. It has been postponed by Congress until June 30, 2008.
- Rehabilitative services provided to people with serious mental illness will be severely restricted when this provision becomes effective. Medicaid coverage for rehabilitation services that are intrinsic elements of other programs, such as foster care or child welfare, are to be eliminated. Congress has postponed implementation of these provisions until June 30, 2008.
- Medicaid coverage is eliminated for therapeutic foster care where children are placed with foster parents who are trained to help improve a child's condition.
- The state's mental retardation/developmental disabled children's program will be affected by a provision eliminating Medicaid coverage for "day habilitation" programs designed to help those with intellectual and other developmental disabilities to acquire the skills they need to live in community-based settings instead of institutions.

Even though the implementation of several of these new recommendations has been postponed for a few months by congressional action, their application is imminent and will add to the state fiscal problems already identified by OBM.

Property Tax Losses. Local units of government that budget on a calendar year basis, and that are dependent on the receipt of property taxes, can expect to experience difficulties in balancing their CY 2009 budgets. Most of the impact of foreclosed properties, property tax delinquencies, and reduced home values will begin to be felt by next year and will continue as the state undergoes its regular property tax reappraisals. Cities are already beginning to have budget problems as local income tax collections lag expectations; the same is occurring with counties whose sales tax collections are lagging

projections. Special districts providing health and human services, along with school districts, will be particularly hard-hit. All of these local governments will be seeking state financial help. While the state is under no obligation to provide financial assistance, in these cases it will be politically difficult to turn a blind eye to the burgeoning financial problems of Ohio's local governments. This problem is most likely to become part of the problem of balancing the state's next budget.

Next Biennial Budget. Preparations for the state's FY 2010-FY 2011 budget are currently underway. OBM issued instructions to agencies that will have until September 15 to submit their budget requests. Between then and January 30, when the Executive Budget Request is expected to be submitted to the General Assembly, OBM will whittle down the budget requests to fit their new estimates of available revenue. When the current budget was submitted, it was already recognized that, because of the continued implementation of tax relief, that budget will have less money to fund programs and services than the current one. Now that revenue forecasts for this biennium have been reduced, the base upon which the next biennium's revenue forecast will be made is even further reduced. The problem is that the state needs to plan for ways of providing adequate resources for the next budget while it continues to craft solutions for the current budget problem, which likely will exceed the \$1.884 million OBM forecasts as its "worst-case" scenario. In other words, the solutions selected to solve this biennium's budget shortfall can either help or add to the problem of financing the next state budget.

Some Solutions

The budget solution crafted by the Strickland administration to deal with the lowest estimate of the size of the state's GRF budget shortfall--\$733 million--consists of reductions in spending authority of \$439.9 million; unspent appropriations totaling \$181.1 million; \$50.3 million in transfers from other funds to the GRF; collecting an additional \$25 million from tobacco securitization bonds sold but not yet used; and \$73 million from a new state Keno gambling game. None of these actions have formally been reviewed by the legislature, and several of them require legislative approval before they can become effective.

In testimony before the House Finance Committee on February 26, OBM Director J. Pari Sabety stated that "we

anticipate pursuing the initiatives requiring legislative approval in the April-May time frame and prior to the end of the fiscal year." The items requiring legislative approval include:

- Authority to transfer unused funds from state special revenue funds or rotaries.
- Authority to use the additional \$25 million expected from tobacco securitization interest proceeds.
- Legislation to realign the funding and postpone the implementation of new scholarship programs in the Ohio Board of Regents.
- Legislation to require the electronic filing of income tax returns from paid tax preparers who file more than 50 returns.
- Postponement of pay increases for exempt employees planned for FY 2009.
- Additional appropriations to fund the Medicaid program.
- Authority to postpone the FY 2009 PASSPORT provider increase.

When that legislation is introduced, the legislature will have its first opportunity to review the administration's estimates of the size of the budget problem and to consider alternatives to the solutions recommended by the administration. One solution, especially applicable to the administration's "worst case" scenario, is to use the state's budget reserves that were built up exclusively for use during periods of recession.

Rainy Day Funds. Since its institution, however, the legislature has shown great reluctance in actually using its rainy day funds for their intended purpose. This reluctance is usually the result of a concern that using the funds too soon would make them unavailable should the state's budget problems worsen. However, it could be argued that that argument is untenable when it comes to the current state budget.

Even before the governor's budget cuts, this budget provided the lowest increase in spending in several decades. With the additional \$439.9 million in budget cuts, almost \$20 million of which will directly affect local school districts, and which also cuts vital health and human services programs, it can be argued that there is no room for further budget cutting. It is time to utilize the state's rainy day funds. A recent national report supports this position.

In a February 21 report, the Center on Budget and Policy Priorities stated that “during an economic slowdown, cutting state programs while leaving a rainy day fund untouched is generally unwise” for the following reasons:

1. **“It’s good for the state’s economy.** Both tax increases and spending cuts reduce demand for goods and services, dampening sales, profits, and job growth. This is the opposite of what a state needs during a downturn. Using rainy day funds, in contrast, takes money from savings and puts it into the state’s economy in a way that can maintain demand for goods and services.
2. **It gives the state time to respond sensibly to its budget problems.** Often, the budget cuts and tax increases that a state can make most *quickly* to close a budget gap are the least *appropriate* measures to take in a recession. For example, they often fall most heavily on the people who can least afford them. Using rainy day funds allows a state to maintain needed services while it devises a more carefully considered solution to close whatever remaining budget gap it anticipates in this fiscal year and beyond....
3. **It can help a state avoid cutting its ‘automatic economic stabilizers.’** These are the programs for low-income families that rise in cost when the need for them rises due to higher unemployment and lower wages; examples include health care and cash assistance.
4. **Never using the state’s rainy day fund is tantamount to not having one at all.** Rainy day funds were specifically designed to provide a quick infusion of resources into the economy during a downturn to help avoid debilitating cuts to public services at the very time the services and programs are needed most. It makes little sense to save money as a means of preventing possible cuts in the future if doing so means making definite cuts in the present.”²

But there is an important caveat to the use of rainy day funds that applies especially to Ohio. The budget reserves should not be used to pay for program spending that cannot be sustained in the future. This is especially important with respect to the FY 2010-FY 2011 state budget since all indications are that, even with a recovery

2 Elizabeth C. McNichol, “Is It Raining Yet? Yes, And It’s Time for Many States To Use Their Rainy Day Funds,” Center on Budget and Policy Priorities, Washington, DC, February 21, 2008, pp.3-4.

from the recession, the state will not have enough GRF revenues to continue spending at its current rates. That means that the use of state rainy day funds should be accompanied by the postponement of continued scheduled tax relief as well as the development of a fiscal plan to fully fund the next biennial (or annual, which is a better idea) state budget.

Postponing Tax Relief. In 2005, the state authorized a 21 percent reduction in income taxes paid by individuals and businesses. That reduction was phased in to be completed at the end of 2009. According to the Department of Taxation, the reduction cost the state \$350 million in lost revenue in 2008. An equal or greater amount will be lost in 2009. It behooves the state, considering the condition of its budget and the need to preserve critical health and human services programs, to postpone the further implementation of these budget reductions. Failure to do so will simply exacerbate the budget problems the state will be facing next January when it considers the adoption of the next state budget. It might even be worthwhile considering the adoption of an income tax surcharge to be applied to high-end taxpayers to deal with the current and future budget problems.

A recent study by the Center on Budget and Policy Priorities pointed out that raising taxes, especially on wealthy households, is less economically damaging than cutting many types of services. To support their argument, they identified two noted economists, Nobel prize-winning Massachusetts Institute of Technology economist Joseph Stiglitz and Brookings Institution economist Peter Orszag, who have recognized that tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run.³ The study further notes that:

- State taxpayers will not bear the full cost of the surcharge because state income taxes are deductible on the federal tax returns of taxpayers who itemize.
- Because the tax is based on income, a surcharge can be targeted to exempt low- and moderate-income families who are being hardest hit by the current economic downturn and can be designed to focus on high-income taxpayers who are best able to afford tax increases.
- High-income taxpayers have benefited most from

3 Peter Orszag and Joseph Stiglitz, “Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?,” Center on Budget and Policy Priorities, Washington, DC, revised November 6, 2001.

the federal income tax cuts in 2000 and 2001 with those having incomes above \$200,000 receiving an average \$17,000 tax break in 2007 as a result of these measures.

- High-income families benefited most from the economic expansion of the last 29 years and, thus, are most able to afford tax increases.⁴

Besides postponing scheduled cuts in Ohio's individual income tax and considering placing a surcharge on high-income taxpayers, there is another tax change contributing to the state's economic problems.

In 2008, the state's tax on tangible personal property such as machinery, equipment, furniture, fixtures, and inventory will be assessed for tax purposes at 6.25 percent of true value, down from 12.5 percent in 2007. In 2009, these assessment rates will fall to zero for most businesses, making Ohio one of only 10 states to have eliminated this kind of tax. The state should consider postponing the elimination of this tax until a study can be undertaken to determine whether its reduction resulted in the kind of economic stimulus to the manufacturing industry it was purported to have.

Income Tax "Carryback" Deductions. Another way the state could increase its revenues is to change an obscure provision in its tax code which permits businesses that pay individual income taxes, rather than corporate income taxes, to amend their income tax for past years when they were profitable in order to use current year business losses to offset those profits. They then receive refunds of taxes paid in past years. Ohio is one of only 19 states that permit this net operating loss "carryback" deduction as it is known. During the last recession, three states repealed their carryback deductions during the years of tight state finances that followed the 2001 recession.⁵

The purpose of the deduction is to permit businesses to average profitable years and loss years to recognize that beginning new businesses may result in operating losses for a few years before they become profitable. Further, 4 Elizabeth C. McNichol and Andrew C. Nicholas, "Using Income Taxes to Address State Budget Shortfalls," Center on Budget and Policy Priorities, Washington, DC, February 21, 2008, pp. 3-4.

5 Michael Mazerov, "Now Would Be A Good Time for States Still Granting Net Operating Loss 'Carryback' Deductions to Eliminate Them," Center on Budget and Policy Priorities, Washington, DC, February 21, 2008. The states are Kentucky, Illinois, and North Dakota.

businesses may very well experience temporary losses

during an economic downturn. However, allowing refunds for prior taxes creates unnecessary fiscal problems for states and could be remedied by changing the income-averaging policy and, instead, permitting "loss carryforwards" so that businesses deduct any losses they suffer against their future profits. In fact, that is what a majority of states, not including Ohio, already do.⁶ This change would be appropriate for Ohio to consider. It is also a good time to re-examine other state tax loopholes.

Eliminating Some Tax Expenditures. In 1987, legislation was enacted requiring the submission of a special tax expenditure report as a supplement to the governor's biennial budget. The reason for the enactment was that the legislature wanted to know how much revenue is lost to the state as a result of deductions, exemptions, credits, and other provisions of tax law presumably in order to permit them to determine whether to continue or eliminate specific provisions. The problem is that there are lobbyists who are paid to keep tax breaks in state law; attempts to remove tax breaks, especially when the budget is in good shape, meet strong, often insurmountable, political resistance. However, in a poor economy, such as is now the case—when the choice is between eliminating an unjustified tax break, cutting critical governmental services, instituting a new tax, or postponing scheduled tax relief—a review of tax expenditures is a highly desirable alternative.

Some states have already begun the process of examining their own tax expenditures with a view toward eliminating some. California's chief legislative fiscal analyst issued a report identifying a dozen tax breaks ripe for modification or elimination, including tax credits that individuals can claim for dependent children and seniors, and that companies can claim for research and development, as well as for hiring low-income workers.⁷

Ohio's tax expenditure report for the current biennium identifies 146 tax breaks that cost the state an estimated \$6,395.8 million in lost revenue during the current (FY 2008) fiscal year and \$7,123.5 million during FY 2009. Some of the tax expenditures, including some very large ones, are justifiably unassailable, especially during an economic recession. An example of this would be the

⁶ *Ibid.*, p.2.

⁷ Evan Halper, "State Analyst Offers Own Formula to Target Budget Shortfall," Los Angeles Times, February 21, 2008.

exemption of prescription drugs and medical supplies from the state sales tax. But many other tax expenditures are difficult to justify in even the best of economic times, such as not paying sales taxes on watercraft trade-ins or the \$20 personal exemption credit on the individual income tax. Now would be an appropriate time to review existing tax expenditures for the purpose of eliminating those of limited value compared to the economic costs of cutting vital state services or raising general taxes.

Economic Stimulus Package. Since enactment of the federal economic stimulus package, some states have argued that there should be a state economic stimulus package to help improve the state's economy as a possible solution to the forecasted state budget problems. For example, Governor Blagojevich of Illinois recommended \$300 per child rebates to jump-start the state's ailing economy as part of his proposed 2009 budget. The governor proposes to pay the \$900 million cost of the proposal by borrowing against tobacco settlement funds due to the state.

In Ohio, Governor Strickland has proposed his own bond-funded economic stimulus package. In his 2008 State of the State address he proposed the issuance of \$1.7 billion in bonds, to be used to "create more than 80,000 good-paying jobs in Ohio and lay the foundation for future economic prosperity by investing in the state's energy economy, distribution infrastructure, biomedicine, bioproducts, public works, our downtown neighborhoods and the Clean Ohio fund." Such bonds would either have to be approved by a legislatively advanced submission to the voters or a campaign to place the issue on the ballot directly. Even if the proposal reaches the ballot and is approved by the voters, it would not have an impact on the state's economy for several years, unlike Governor Blagojevich's proposal the impact of which would be short-term. And there is also a problem in identifying sufficient GRF revenues to pay the interest on \$1.7 billion worth of bonds.

Annual Budget. Unlike the other solutions included in this article, changing from a biennial to an annual budgeting process, if only for the next biennium, would not raise any additional money for the state or plug the state's budget hole, regardless of its size. It would, however, make a big difference in reducing the problems associated with the provision of governmental services during periods of fiscal uncertainty. The arguments for annual state budgeting were made in greater detail in the

last issue of *State Budgeting Matters*. However, it deserves continued mention until it receives appropriate state executive and legislative attention.

Commentary

It is only a matter of time before the administration will be forced to recognize that Ohio's budget problems are far greater than \$733 million and could very well exceed the currently-estimated \$1.884 billion "worst-case" recession scenario. The sooner the administration submits its long-awaited budget revision legislative proposal, the sooner the legislature will be able to assess the true extent of the state's budget problems and craft solutions that will prevent the kind of fiscal uncertainty that accompanied Governor Bob Taft's second term of office where budget revisions were made over and over again. And, as the legislature examines budget solutions, it should not only look at their impact in the short-run but also on the next state budget, which is likely to be even more constrained than the current one. It would be wise to consider adopting a budget for FY 2010 and leave the issue of the budget for FY 2011 to a future discussion when the nature of the current recession, and its implications on Ohio, will be more fully known.

Do You Have Questions about Ohio's Budget?

E-mail your questions to budget expert Richard Sheridan at
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Answers to your questions could be the topic of future issues!