

State Budgeting Matters

BY RICHARD SHERIDAN, FINANCIAL CONSULTANT,
THE CENTER FOR COMMUNITY SOLUTIONS

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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.

Is A State Tax Increase Inevitable?

State agencies and the Office of Budget and Management (OBM) are in the process of preparing their budget request for the Fiscal Year (FY) 2010-FY 2011 biennium, which will be submitted to the General Assembly in early January, 2009. A number of actions, or inactions, that have taken place in recent months affecting the current budget will have important adverse financial implications for the next budget, making it virtually impossible to avoid a general state tax increase. Of special concern are the following factors:

- Current and projected economic conditions, along with the continued phase-in of individual income tax reductions and the phase-out of the corporate income tax, foretell revenues for the next biennium that may not reach the levels of revenue collections for this biennium.
- Expected depletion of current Rainy Day Fund balances will require the state to budget for new reserves in the next biennial budget.
- Probable increased fiscal difficulties in financing some large state programs such as Medicaid and adult corrections will place new burdens on the state's General Revenue Fund (GRF).
- The gubernatorially led 10-year plan for higher education will require an influx of state funds exceeding normal growth.
- The incomplete education reform process will require an influx of state funds exceeding normal growth.
- Gubernatorial and legislative leadership agreement on an economic stimulus package which, if approved by the legislature, will require an influx of new state funds.

Added together new demands on a rapidly depleted state GRF could very well result in a large general tax increase as the only way of balancing the next state budget. This report examines each of the factors leading to this conclusion.

Revenues for the Next Biennium

OBM is in the process of gathering data from state agencies to use in preparation of the FY 2010-FY 2011 state budget that will be submitted to the Ohio General Assembly in just eight months. Until the Executive Budget Request is released, official revenue estimates will not be known. However, the governor's budget submission for the current biennium used trend data and what was known at the time to give a rough indication of what to expect in terms of GRF state-only revenues and spending in the next biennium.

Much has changed since that forecast was made, especially in terms of reduced revenues because of the downturn in the economy. What this would suggest is that those early forecasts may actually be too optimistic. Yet they forecast state-only GRF revenues of only \$21,661.5 million in FY 2010 (compared to the then-estimate of \$21,196.7 million for FY 2009) and \$22,336.8 million for FY 2011. The early estimate shows the smallest GRF revenue growth



1226 Huron Road
Suite 300
Cleveland, OH 44115
(216) 781-2944
www.CommunitySolutions.com

for the state in decades (at least since before Governor Gilligan proposed the state's personal income tax as a way of dealing with a similar problem in the early 1970s). This is without accounting for how state revenues are currently deteriorating in the present recession economy.

Part of the problem results from actions taken by the legislature at the tail end of the Taft administration when tax reform was enacted and phased-in. Converting the state's corporate franchise tax into a commercial activity tax has meant that, instead of those corporate taxes going to the state, they will go to local school districts. Thus, in its early forecast of revenues for the coming biennium, \$1,310 million in corporate franchise collections estimated for this biennium decline to only \$310 million for FY 2010-FY 2011 — a \$1 billion loss in revenues.

In the same vein, the reduction in individual income tax rates will result in lower collections of those taxes, as the five-year phase-in of that tax reduction is completed.

What OBM projected a year and a half ago for the coming biennium is only \$1,140.1 million, about 2 percent growth per year, in "new" GRF revenues to satisfy all of the state's next biennium spending requirements. The remainder of this report describes a number of reasons why such meager growth is totally inadequate to deal with new spending requirements already known, beginning with the replenishment of the state's Rainy Day Fund.

Replenishing the Rainy Day Fund

Regular readers know that, for several months now, *SBM* has argued that, because the GRF deficit for the current biennium is more likely to be \$1.8 billion or more, rather than the \$733 million acknowledged by the Strickland administration, it is inevitable that some or all of the state's accumulated \$1.1 billion in Rainy Day Fund reserves will have to be drawn down. If that prediction is correct, then an interesting problem is posed for the next biennium.

In 1995, the legislature enacted Section 131.43 of the Ohio Revised Code (ORC) providing that "it is the intent of the general assembly to maintain an amount of money in the budget stabilization fund [commonly called the 'Rainy Day Fund'] that amounts to approximately five percent of the general revenue fund revenues for the preceding year." That section of law goes on to mandate that "the governor shall include in the state budget he submits to the general assembly under section 107.03 of the Revised

Code proposals for transfers between the general revenue fund and the budget stabilization fund for the ensuing fiscal biennium." In other words, if the state uses up the mandatory five percent reserves in order to balance this biennial budget, then the governor's next budget must make provision to restore that sum. In practical terms, what that means is that, if \$1.1 billion is used to keep spending at levels appropriated for this biennium, the governor must make provision for setting aside roughly the same amount from spending in the coming biennium.

Assuming GRF revenues grow by the amounts projected in the FY 2008-FY 2009 Executive Budget Request for the next biennium, the total additional GRF new money that can be expected is \$464.8 million for FY 2010, and \$675.3 million for FY 2011, for a biennial total of \$1,140.1 million. That means, assuming the accuracy of those early revenue projections for the next biennium, if the current Rainy Day Fund is depleted to balance this biennium's budget, then all of the new revenue expected for the next biennium would have to be used up satisfying the requirements of ORC Section 131.43, which requires the maintenance of a five percent reserve in the Budget Stabilization Fund. Stated differently, there would be no money at all to provide for any increases in spending in the coming biennium.

Admittedly, utilizing those early revenue projections is questionable considering all that has occurred to the state economy since they were made. However, what has actually occurred has been a reduction in current revenues. So, those early forecasts for the next biennium may very well prove to be overly optimistic rather than pessimistic. Unless the legislature decides to set aside the provisions of ORC Section 131.43 for the coming biennium, using up current Rainy Day Fund budget balances to solve this biennium's growing fiscal problem will mean that there will be no money left to satisfy all of the spending requirements that other current policy decisions in the areas of higher education reformulation, education reform, and job development. In addition, there are some spending areas that will require even more spending than currently anticipated in future years.

State Budgets in Distress

Medicaid spending continues to grow at rates that outstrip current appropriation authority. Indeed, part of Ohio's fiscal problem is a growing Medicaid population

and the failure of enacted cost containment measures to produce projected cost savings this biennium. And, as pointed out in the March issue of *SBM*, new federal Medicaid rules being implemented are likely to require even more state spending on Medicaid in the future. Additional money appropriated for Medicaid this biennium will have the effect of increasing the base upon which next biennium's Medicaid spending will be established. But Medicaid is not the only area likely to cause future fiscal stress.

Already, there have been reports that more money will be needed for a number of unexpected purposes, including finding funds to correct the problems with the state's \$90 million computerized central foster care registration system. Also, the Ohio Department of Youth Services has reported settlement of a court case that will require departmental reforms costing an estimated \$20 to \$30 million annually.¹ Not yet shown on the fiscal distress radar screen, however, is a brewing problem with respect to funding Adult Corrections.

Adult Corrections

Nationally, state spending on Corrections "has risen faster over 20 years than spending on nearly any other state budget item—increasing from \$9 billion to \$41 billion a year."² This is certainly the case in Ohio, where spending on Adult Corrections has grown far faster than state revenues in recent years. In 1997, GRF spending for the Department of Rehabilitation & Corrections (DRC) reached \$1 billion for the first time. By FY 2007, the appropriated total was \$1.5 billion, a 50 percent increase. When the governor submitted his budget request for the agency, he requested total appropriations of \$1,763.7 billion for FY 2008 and \$1,819.9 billion for FY 2009. The enacted budget appropriated only slightly less than was requested (\$1,758.7 billion for FY 2008, and \$1,814.9 billion for FY 2009). However, when the Governor ordered cuts to state agencies to help balance the current biennium's budget, he ordered a \$4.8 million cut in DRC FY 2008 spending and a \$70.6 million cut in FY 2009 spending. The problem is that most of the DRC budget is driven by staffing costs (one out of every four state employees works for the DRC) and by the prison population, and making these cuts next fiscal year may be virtually impossible without risking prison disruptions.

1 "Price Tag Set at \$20-30 Million for DYS Settlement," Capitol Connection, Hannah Report, April 4, 2008.

2 National Association of State Budget Officers, State Expenditure Report 2004, Washington, D.C., 2005.

At the end of FY 2007, the state's 32 correctional facilities housed 49,488 inmates—the highest population total since 1998, when there were 49,029, according to the Legislative Service Commission's Final Fiscal Analysis for the FY 2008-FY 2009 biennium. By the end of FY 2009, it was estimated that the total inmate population would reach 53,603, and that is the number that was used in finalizing the appropriations for the agency for this biennium. However, prison population projections prepared by the DRC show this number will rise to 55,543 by July, 2009, the beginning of the next biennium, and to 58,161 by July, 2010, the end of the first year of the coming biennium. By the end of the next biennium, the state's prison inmate population will be 60,182.³

Here's the problem.

If the agency is forced to cope with a \$70 million budget cut next fiscal year (\$57.3 million of which is to come from institutional operations), the state must find a way to reduce its prison population, which currently costs the state an average of \$25,280 per inmate. Unfortunately, current state sentencing laws make that difficult to do. And, if the prison population continues to rise as projected, the state is looking at spending increases for the next biennium of more than \$100 million per year just to accommodate the increased prison population now forecast, not to mention the fact that the state does not currently have space to house the growing number of additional inmates in existing open facilities.

If the state were to change its sentencing laws to permit greater judicial discretion in sentencing, particularly with respect to drug-related crimes, fewer inmates would be incarcerated in state prisons. If local communities had the capacity to handle more serious offenders, they would not have to be housed in state facilities. Part of the problem is the recidivism rate: More than one-half of those released from prison return within three years and even more are rearrested.⁴ Another problem results from a February, 2006, Ohio Supreme Court ruling that judicial act-finding in the imposition of sentencing decisions is unconstitutional.⁵ As a result of that ruling, maximum or consecutive sentences are allowed without stated

3 Brian Martin, "Ohio Prison Population Projections and Intake Estimates," Ohio Department of Rehabilitation and Corrections, Bureau of Research, Office of Policy and Offender Reentry, June 2007.

4 P.A. Langan and D.J. Levin, "Recidivism of Prisoners Released in 1994," U.S. Department of Justice, Bureau of Justice Statistics, Washington, D.C., 2002.

5 State v. Foster, et al.

justification. Since that decision, aggregate sentences have increased from one to four months across felony levels, except among female felony one offenders, for whom average stays have increased 15 months since April, 2006.⁶

There are ways that the state could avoid the costs of the newly burgeoning state prison populations. A recent report from The Sentencing Project makes these recommendations:

- “Mandatory minimums have not been shown to reduce criminal offending, while the impact of the disproportionately severe sentences, particularly among African Americans, has been well documented. There is no single act that a legislature can do to return balance and fairness to sentencing than to repeal mandatory minimum provisions and return discretion to judges....
- Legislators should continue to support alternatives to revocation for technical violations of parole and implement strategies that allow people to remain in their community....
- Addressing the problem of parole revocations requires not only changing the approaches and tools available to parole officers, but also requires expanding reentry services for persons before they are released from custody.
- In recent years a number of states have expanded the types of offenses eligible to earn ‘good time’ and the amount of sentence reduction individuals can earn. This is a promising strategy that assists prison administrators in easing overcrowding while also rewarding incarcerated persons who demonstrate commitment to personal change....”⁷

It is certainly possible that legislative policy changes could deal with the problem of increased incarceration rates and lessen the budgetary impact of them in the future, but, in Ohio, legislative attention is directed in the other direction—toward even more stringent mandatory sentencing. Legislation currently under consideration concerning increased penalties for sex offender registration violations and requiring three-year mandatory terms for all categories of repeat violators

⁶ Brian Martin, op. cit., p.5.

⁷ Ryan S. King, “The State of Sentencing 2007, Developments in Policy and Practice,” The Sentencing Project, Washington, D.C., January 2008.

could, if enacted, increase state prison inmates even further than current prison projections foresee.⁸ Absent a significant change in prison policies, the next budget will have to deal with significant cost increases to accommodate the projected sharp increases in the state’s prison population.

Higher Education Reformulation

With a great deal of fanfare, and considerable favorable media attention, the governor and his new cabinet-level chancellor released the state’s first *Strategic Plan for Higher Education* on March 31, 2008. The plan is reported to be designed to make higher education more affordable and accessible while assisting students in obtaining the skills they need to be competitive in today’s economy. One of the plan’s components calls for the state to provide additional money to catch up to the national average in per-student spending. According to the state chancellor, more than \$420 million will be needed in state GRF appropriations, an increase of \$42 million per year, to finance the plan.⁹ In the spending forecast for the coming biennium, included with the Executive Budget Request for this biennium, higher and other education spending was programmed to increase by \$67.2 million in FY 2010, and by \$68.9 million in FY 2011. If the strategic plan costs are on top of this, the state is looking at an additional \$84 million commitment to higher education for the next biennium to pay for it. And there’s another issue.

In the first round of cuts made by the Governor to re-balance the current state budget, higher education was permitted to push \$90 million in spending authority for the Choose Ohio First Scholarship program into the next biennium, along with \$15 million appropriated to the Ohio Research Scholars program. If the state is to pay for those two programs next biennium, the costs would be at least an additional \$105 million above already projected spending increases or costs to implement the new strategic state plan.

Education Reform

When Governor Strickland campaigned for election, he promised “education reform” as a major tenet of his administration. A major Education Reform Process

⁸ State prison population projections conclude that enactment of such legislation would add 600-700 additional inmates in four years and over 2,200 by 2016. See Brian Martin, op.cit., pp.6-7.

⁹ Encarnacion Pyle, “Plan’s Cost: \$42 Million a Year,” The Columbus Dispatch, April 1, 2008.

is now underway and, other than an effort to create a director of education as a cabinet appointment by the Governor, no other components, or their costs, are yet known. However, a document released in March outlines the guiding principles and policy areas that will be considered as the reform process proceeds. Almost all the ideas advanced would require additional money. Here are examples of the items included for further consideration:

- Creating a differentiated pay ladder for “emerging, associate, teacher, lead teacher, and master teacher” categories;
- Creating a statewide teacher peer evaluation and professional development program;
- Implementing a site-based management program after training principals for the transition;
- Creating a school administrative manager position for all elementary schools;
- Creating a Professional Learning Community Center and requiring all educators to be trained in it;
- Expanding the Governor’s Institute for Creativity and Innovation;
- Creating a statewide positive behavior intervention and support program;
- Creating a school repair and maintenance program to keep school buildings warm, safe, and dry when the district is unable to pass a bond initiative over three consecutive years;
- Expanding the current Closing the Graduation Gap program;
- Creating a P16 education budget and requiring early adoption before the operating budget every two years;
- Earmarking certain general revenue sources and combining them with a state fund from Class II property for education;
- Maintaining and expanding the parity aid program;
- Creating weights for gifted, English as a second language, and high-risk students; and
- Creating the Urban Rural Education Center and Compact to address the unique educational needs of urban and rural children from difficult circumstances.

There is no way of knowing whether any of these, or the other policy suggestions included in the draft, will make their way into the next biennial budget. What is known, is that early planning for the next biennium,

assuming revenue growth of \$1,140 billion, allowed for only primary and secondary spending increases of \$151.9 million in FY 2010, and \$155 million in FY 2011. Those amounts would hardly be sufficient to pay for the kinds of changes the education reform process is now considering, much less ordinary growth based on uncontrollable inflationary-fed staff benefits and school maintenance costs.

Jobs, Jobs, Jobs

In his February State-of-the-State Address, Governor Strickland sent out a trial balloon to test the legislative and public response to a proposal to ask the voters to approve the state issuing \$1.5 billion for a variety of economic development projects. On April 3, the two Republican leaders of the legislature joined Governor Strickland in releasing a substitute package, on which they agree, that would only require voter approval in November for the issuance of \$400 million in new bonds. The remainder of the package would be financed as follows:

- Issuance of \$570 million in already-authorized bonds;
- Using \$66 million in bonds from the Coal Development Authority through Air Quality;
- Taking \$230 million from the Ohio Tobacco Prevention Foundation;
- Taking \$200 million from the Ohio Turnpike revenue;
- Using \$120 million in previously authorized public works funding that is raised from bonds;
- Using \$184 million in liquor-profit backed bonds issued by the Department of Development; and
- *Using \$370 million in General Revenue Fund money.*

If the legislature approves of the package, it could go forward even without voter approval of the \$400 million in new bonds component. What is crucial for this discussion, however, is the commitment of \$370 million in GRF money for the project. It is not clear how much of that total would have to be appropriated as part of the next biennium’s budget, but it is clearly a commitment to a new use of what little “new money” is likely to be available for spending in the coming biennium.

The Consequences

The picture that is painted for the coming biennium in this analysis is not pretty. Under the best of

circumstances, without accounting for the effects of the current recession on the GRF receipts for the next biennium, the state is looking forward to only \$1.1 billion more to spending in the coming two years than it had these two years. Already there are commitments, or probabilities, that could require significantly more than that sum, not counting amounts needed to pay for increased debt-service costs, built-in state employee benefits costs, and increased fuel, energy, and other maintenance costs affected by rising inflation. If the Rainy Day Fund is used up to prevent a budget deficit this biennium, replacing it could require the total amount of new money available next biennium. But, even without that occurring, the state will have problems funding its goals for higher education, primary and secondary education reform, or the proposed economic stimulus package, not to mention Medicaid and adult correction deficits, and commitments to settle the juvenile corrections lawsuits.

Does all of this mean that a general tax increase is the only way to balance the next biennial budget? Should advocates begin to work on strategies to protect their appropriations? Should advocates begin examining tax increase alternatives and prepare to support or reject them?

Even with all the dire news about the next biennial budget, the state could avoid raising general taxes. To do so, it would have to take certain other drastic measures. The state could, for example:

- Give up on the idea of making higher education more affordable and permit higher education institutions to raise tuition and fees by whatever amounts are necessary to pay for higher education goals;
- Make education reform changes dependent on voter-approved local school district property tax levy increases;
- Reduce state subsidies to a variety of health and human services programs that receive local government support;
- Reduce or eliminate state general revenue-sharing to local units of government; or
- Reduce coverage for Medicaid.

This is not an exhaustive list of options but illustrates the kinds of options that are likely to be offered before the state seriously considers the problems that tax reductions in a recession economy have wrought on the state

budget for the next and succeeding biennia. Forewarned is forearmed, as the saying goes. After reading this analysis, it should be clear that it is not too early for advocates to begin developing their budget positions for the next biennium, including positions on tax increases, even though the FY 2010-FY 2011 Executive Budget Request will not be unveiled for another eight months.

Meanwhile....

Revenue collections for March are, once again, below both the original estimates on which the current budget was based and the revised estimates used by the administration in categorizing the biennium's fiscal distress as a "\$733 million problem." With three months remaining in this fiscal year, GRF tax revenues are \$262.4 million below estimates and \$133.6 million below the revised "no recession" forecast. The legislature still has to address the question of what the size of the projected deficit will be, and its own Legislative Budget Office is strangely silent on the issue. *State Budgeting Matters* continues to maintain that the total deficit for this biennium will exceed the worst-case scenario of a \$1.884 billion problem. Advocates should prepare for the worst when the legislature finally comes to terms with the issue.

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!