

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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A Compendium of State Fiscal Issues

"The last fiscal crisis for states, which occurred in the midst of a mild recession, was dubbed a perfect storm. This one could be more perfect." —Donald J. Boyd and Lucy Dadayan, Nelson A. Rockefeller Institute of Government

Just days after the state made its second downward revision to projected tax revenues for Fiscal Year (FY) 2009, the nation's economy became mired in a combined financial and credit crisis that will cause the state, and its localities, further problems and worsen its own budget crisis. After examining the status of the state's General Revenue Fund (GRF), this report examines a number of state fiscal issues including:

- The impact the national problems pose for Ohio's budget;
- Continuing difficulties in understanding the "cuts" that the state made in FY 2008 spending, and that have been announced for FY 2009;
- The prospects for federal fiscal relief;
- How other states are reacting to budget problems;
- Whether Ohio is a high, or low, taxing state; and
- Whether Ohio is a high, or low, spending state.

Status of the State GRF

On September 10, the state Office of Budget and Management (OBM) reduced its FY 2009 revenue forecast for the second time this year. Receipts for the month of October show that the move was justified, with taxes coming in \$34.8 million over the new, lower estimates. However, a new problem, unanticipated when revenues were re-forecasted, and directly related to what is happening to the national economy, has arisen. That problem involves interest earnings.

Because of what has happened to the stock market, the state reports that interest earnings are \$42.4 million below estimates for the month. While that is reported in the text of OBM's monthly financial report, the amount is not included in the table summarizing actual versus estimated receipts. That table shows that, after excluding a shortfall in federal grants that is probably only a matter of timing, overall receipts are \$40 million above estimates. However, if the loss in interest earnings is deducted, that overage would be more than wiped out.

The reason the interest earnings shortfall is not included in the comparative table is somewhat confusing and relates to how earnings are to be calculated under a new OBM directive. Without trying to explain it, the end result is that interest earnings will be reported only quarterly, with the report for the first quarter of this fiscal year (July through September) being reported next month. However, it can be expected that these earnings will continue to fall below projections because of the national



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fiscal crisis, and, since this shortfall was not anticipated on September 10, when tax revenues were re-forecasted, another examination of total receipt projections is warranted.

Why Budget Problems Will Worsen

Despite the fact that revenues during the month of September appear to confirm the latest downward revision of revenue estimates for FY 2009, the possibility of further revenue losses, as well as other fiscal problems, is still very real. Because the revenue forecast was made before the

collapse of the nation's financial and credit systems, none of the effects of these events could have been foreseen. In the coming months,

there is the likelihood that increased unemployment, continued loss of consumer confidence, and further tightening of consumer credit will result in a further deterioration of state individual income and sales tax collections. Some of these effects were taken into consideration when forecasts for these taxes were revised more than a month ago. What was not taken into account was the fact that because of the collapse of the financial services industry, taxes levied on them will be considerably reduced. Also, the investment income of taxpayers is likely to fall significantly, and "the loss of so much asset value and a decline in confidence will lead to much greater slowing and, in fact, decline in the real economy than forecasters previously expected."¹

Another impact is the effect that a loss of stock value will have on the payment of capital gains as a component of the individual income tax. Capital gains payments are generally shown when taxes are filed in spring, so, the expected declines will not become evident until the last quarter of this fiscal year. ¹ Donald J. Boyd and Lucy Dadayan, "The Damage is Just Beginning," State Revenue Report, Nelson A. Rockefeller Institute of Government, October, 2008, No. 73, p.12.

Without even considering what has happened to the stock market in October, the Rockefeller Institute of Government was showing a reduction in the estimate of stock market value for calendar year 2008 of 14 percent, down from the 2007 calendar year average. "This certainly suggests that capital gains will decline in 2008 and that spring income tax payments in April-June of 2009 will also decline."² And, the decline in real estate values could also drive capital gains down further.

Another unanticipated effect of the current fiscal situation is the effect it will have on the incomes of higher-income bracket taxpayers. An analysis of what happened during the last recession, shows that, probably, as a result of large declines in executive compensa-

tion, bonuses, and stock options, federal income tax returns with an adjusted gross income of \$200,000 or more, great by 20.5 percent in 2000, but then fell by 7.7 percent in 2001, and by a further 8.7 percent in 2002. The revenue loss was even greater for returns of \$500,000 or more.³

Another problem that has recently surfaced is the difficulty that states and localities are now having in selling bonds. And, the bonds that are sold are carrying high interest rates, thereby increasing the state's debt service payments.

Ohio has still to sell \$1.3 billion in bonds that are part of the job stimulus package approved by the legislature several months ago and, if sold, are likely to raise the state's debt service burden above expectations:

"Analysts said the dysfunction in the municipal bond markets appeared to signal the end of an era of relatively cheap money for governments and, prob-

² *Ibid.*, p.16.

³ *Ibid.*, p. 19.

ably, the start of an era of tough choices for communities. When the market starts moving again, they said, it will look a lot like the municipal bond market of 10 years ago, before the arrival of financial wizardry in the form of structured-finance products, which lowered borrowing costs but added big new risks. Instead, governments will probably be issuing plain-vanilla bonds with fixed rates of interest, higher than they are accustomed to.”⁴

In order to stave off a downgrade in the state’s financial rating, which would raise the state’s borrowing costs, the Governor of New York announced that he would be submitting his executive budget in mid-December instead of late January—a month early.⁵ Governor Strickland might well consider a similar action, particularly in recognition of the contentiousness likely to occur in trying to balance Ohio’s next biennial budget.

In addition to the problem of not being able to issue bonds, is the reduction in government construction that would have been supported by those bonds. A reduction in state and local government construction would have a ripple effect, leading to more unemployment and reduced sales and income tax collections.

The downward economic spiral will also affect state spending, but those effects will probably not be felt until the next biennium. High on the list of problems will be the expected loss of local property taxes, resulting from the removal of foreclosed homes from property tax rolls, and lower assessments, resulting from the decline in property values.

Especially hard hit among local governments will be schools, mental health special districts, mental retardation/developmental disabilities special districts, and others that are heavily dependent on property

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4 Mary Williams Walsh, “Under Strain, Cities Are Cutting Back Projects,” *The New York Times*, October 1, 2008.

5 Danny Hakim and Jeremy W. Peters, “Paterson Seeks \$2 Billion in Budget Cuts,” *The New York Times*, October 4, 2008.

taxes for support. A recent survey, conducted by the National League of Cities, reported that four out of five financial officers said their cities would be less able to meet needs in 2009 than this year, and that because property tax receipts on reduced values will not be collected for at least 18 months, the next two years will be especially difficult for local governments.⁶

To compensate for those property tax losses, local governments can try to convince voters to increase property tax rates. Seeking voter approval for higher property taxes in a bad economy will prove especially difficult. It is likely that increased state support will be sought as localities try to maintain current service levels with substantially reduced revenues. Another area of spending that could become problematic for the state is Medicaid.

Understanding Budget Actions Taken

Understanding what actions were taken in FY 2008, and are being taken in FY 2009, to bring the state’s budget back into balance is important because of the implications those actions will have on the next and future state budgets. Especially important, is determining just how much agency appropriations were reduced and why they were reduced.

If disbursements (amounts expended) are lower than the appropriations authorizing that spending, this could be because the agency was not able to spend all of its appropriation. That could occur for lots of reasons, such as having overestimated the number of individuals eligible

for a given program, or because an agency was able to purchase merchandise for a lower price than they expected to have to pay when they put their budget together. When reasons such as these are the cause of spending less than were appropriated, the un-

6 Susan Saulny, “Financial Crisis Takes a Toll on Already-Squeezed Cities,” *The New York Times*, October 7, 2008.

spent sums are called “lapses.” But, a different set of circumstances apply when a budget is cut.

For example, in an agency that disburses funds to persons eligible for a given program, when their budget is cut the need for support does not go away; it means that some eligible persons must be turned away and not receive state aid. Or, it can mean that needed personnel are not hired or planned purchases are not made. The need for funds does not go away; it is simply postponed.

So, in the case of a “lapse,” no one is disadvantaged, and using the reduced appropriations level as the base to build the next budget request is appropriate. In the case of a budget cut, however, using the reduced level as the base for the next year’s budget means that the affected program will continue to serve fewer people, needed employees will continue not to be hired, and so on. This distinction is offered in order to explain why it is important to understand the reason that disbursements in FY 2008 were lower than appropriations. On October 1, OBM produced a list showing, by line item, the appropriations reductions made in FY 2008. One column in the list purports to show actual cuts totaling \$185,768,451, and another column shows “other savings/actions in addition to Budget Directive 3 reductions,” and that column totals \$120,235,807. In reality, it appears that at least some of the items listed in the cut column are actually lapses, as well as cancelled encumbrances from prior years that have nothing to do with FY 2008. The Department of Education is a case in point.

The cut column for the Department of Education shows a total of \$17,650,025, and the lapses and cancelled encumbrances column shows additional “savings” of \$59,000,000, including a reduction of \$12,000,000 from an \$11,533,494 appropriation (personal services). How, one may ask, can one cut more than is appropriated? That question led to questions

about other line items. When the Department of Education was contacted, this is what they reported:

- The School Management Assistance program was not cut (OBM lists a cut of \$200,000);
- The \$12,000,000 reduction in personal services is the total of prior year encumbrances that were cancelled, and is not a lapse or a cut;
- A \$47,000,000 reduction shown in the School Foundation program consists of \$45 million in lapses, plus \$2 million in MR/DD Special Education payments (which should be shown under that line item).

Similar problems exist with the list of

\$198.3 million in budget cuts for FY 2009, released by OBM.

The cuts listed for the Department of Jobs and Family Services include \$36,037,248 from the Medicare Part D line item. The chief fiscal officer for the department reports that these moneys will, in fact, lapse, because “too much had been appropriated to cover the state’s ‘clawback’ amount due the federal government.”⁷ He also reported that the cuts in four line items are actually cuts in both federal and state funds. In reality, only cuts in state appropriations can be used to help solve a budget problem consisting exclusively of state money not meeting projections, so the “cut” list is overstated by at least the amount of federal money included in it.

There is a need for further clarity about which line items were cut, how much would have lapsed anyway, and how much of the “savings” have nothing to do with FY 2008, or FY 2009, because they are cancellations of prior year’s encumbrances that should not have remained open this long in any case. There also appears to be a disconnect between what individual agencies think they did and what OBM reports them to have done, in terms of reducing “ODJFS Official Discusses Budget Cuts,” *Hannah Report*, October 8, 2008.

There also appears to be a disconnect between what individual agencies think they did and what OBM reports them to have done, in terms of reducing appropriations levels.

ing appropriations levels. It is essential that there be agreement about what was lapsed and what was cut as decision-makers move forward in preparing the state's FY 2010-2011 budget.

How Other States Are Coping

One thing Ohio has in common with the 28 other states reported to be struggling with budget shortfalls, is the avoidance of an increase in taxes as a solution to the problem. Like Ohio, most of the states have been using one-time revenues, including budget reserves, and cutting spending in order to bring their budgets in balance. The Center on Budget and Policy Priorities, which is regularly tracking state budget problems, notes that 22 states have taken actions that reduce services to their residents, especially their most vulnerable families and individuals:

- “For example, at least 14 states have implemented or are considering cuts that will affect low-income children’s or families’ eligibility for health insurance or reduce their access to health care services.
- Programs for the elderly and disabled are also being cut.
- At least 11 states are cutting medical, rehabilitative, home care, or other services needed by low-income people who are elderly or have disabilities, or significantly increasing the cost of these services.
- At least 13 states are cutting or proposing to cut K-12 and early education; several of them are also reducing access to child care and early education, and at least 17 states have implemented or proposed cuts to public colleges and universities.
- In addition, at least 19 states have proposed or implemented reductions to their state workforce. Workforce reductions often result in reduced access to services residents need. They also add to states’ woes by contracting the state economy.”⁸

⁸ Elizabeth C. McNichol and Iris J. Lav, “State Budget Troubles Worsen,” Center on Budget and Policy Priorities, Washington, DC, Updated, September 26, 2008, p.3.

Even more serious cuts are in the offing. Actions taken in three states illustrate this.

New York State, where Wall Street accounts for one-fifth of the state’s revenues, is planning a special legislative session, right after the November election, where lawmakers are expected to cut Medicaid and education.⁹

California, one of the states especially hard-hit by the downturn in real estate, has come up with an alternative to new taxes that borrows against the state lottery, and requires businesses and individuals to pay their taxes earlier, thereby pushing its financial problems into the future where there is little, or no, hope for a rebound of revenues. Even after laying off state employees, not making payrolls, and cutting services, the legislature was unwilling to raise taxes despite conservative Governor Schwarzenegger’s support.¹⁰

New budget problems in **Virginia**, which previously re-balanced its budget through scattered layoffs, a clampdown on hiring, travel and contracting, freeing cash through increased use of bonds, and using rainy day fund money, tried to insulate education and human services from cuts. Now, Virginia Governor Kaine is warning that may no longer be possible.¹¹

Actions being taken in these three states are fairly typical. The pattern is to first use up budget reserves, layoff some state employees, and then cut non-education and non-human services spending. As budget problems worsen, education and human services programs then face the chopping blocks. So far, every state with budget problems has ruled out increasing taxes this year, but none appear to be ruling out tax increases for next year as the fiscal crisis continues and other options are exhausted. That option appears even more likely for those states

⁹ Hakim and Peters, *op. cit.*

¹⁰ Evan Halper, “California Lawmakers Reach Compromise on Budget,” *Los Angeles Times*, September 15, 2008.

¹¹ Jeff E. Schapiro, “Va. Facing \$3 Billion Shortfall,” *Times-Dispatch*, September 24, 2008.

which, like Ohio, have used non-recurring, one-time receipts to shore up current year spending, thereby pushing their fiscal problems into the future where there is now little reason to expect tax revenues to rebound.

Some, however, are hoping that the federal government will come to the aid of troubled states.

The Prospects for Federal Government Relief

The Housing and Economic Recovery Act of 2008 (H.R. 3221) was signed into law in July, 2008. One part of the act allocates \$3.92 billion in emergency assistance grants to state and local governments, with the greatest need to redevelop abandoned and foreclosed homes and residential properties. Details about the Neighborhood Stabilization Program, which provides the emergency grants through the U.S. Department of Housing and Urban Development (HUD), are only now being developed. Ohio is one of three states (California and Texas being the others) that can potentially receive \$100 million, in addition to what may be allocated to its localities. An action plan for the use of the funds must be submitted by December 1, and the funds must be used, or committed, within 18 months of receipt. Although these funds will not directly solve the state's budget problems, they will enable the state to alleviate the fiscal problems resulting from the housing crisis. These moneys can be used for:

- Establishing financial mechanisms for purchase and redevelopment of foreclosed homes, including soft-seconds, loan loss reserves, and shared-equity loans for low to moderate income home buyers.
- Purchasing and rehabilitating abandoned or foreclosed homes in order to sell, rent, or redevelop the property.
- Establishing land banks for homes that have been foreclosed.

- Demolishing blighted structures.
- Redeveloping demolished or vacant properties.¹²

Congress was also considering a plan to provide direct aid to states, in a proposal that is modeled after the one used to assist states in coping with the last recession in 2003. The House of Representatives proposal would provide \$14 billion in fiscal relief through a temporary increase in the federal share of Medicaid program (FMAP) costs. Under that plan, Ohio would receive an estimated \$659 million in additional state aid.¹³

No matter where Ohio ranks nationally, there are those who argue that taxes must be cut in order to spur economic development.

The Senate proposed to send the states \$20 billion, \$6 billion more than the House proposal, by increasing all states' FMAP by four percentage points for a period of 15 months, starting October 1, 2008. Both

plans required that, to be eligible, states could not have Medicaid eligibility levels that were more restrictive than the levels in effect on September 1, 2008.

Before Congress could act on either the House or Senate plan, the nation's banking system began to collapse, and Congress turned all its attention to the enactment of what became a \$700 billion bank "bailout" (or "rescue" plan, depending on one's ideology). With the federal deficit growing alarmingly, the prospects for congressional action on the state "bailout" plan now appear fairly dim.

How Ohio Ranks: Taxes

Rightly or wrongly, there is a common perception that businesses make location and expansion deci-

12 Diana Hinton Noel, "Housing and Economic Recovery Act of 2008: Emergency Grants Funding Formula Announced," Labor & Economic Development Information Alert, National Conference of State Legislatures, October 6, 2008.

13 Iris J. Lav, Jason Levitis, and Edwin Park, "House Stimulus Plan Effectively Targets Fiscal Relief to the States," Center on Budget and Policy Priorities, Washington, DC, September 26, 2008, p. 5.

sions based on a state’s tax structure. No matter where Ohio ranks nationally, there are those who argue that taxes must be cut in order to spur economic development. For this reason, data about state rankings is considered to be important. It is especially useful to know how the state ranks when it comes to considering options for balancing the state’s next budget, when all indications are that there is likely to be a considerable gap between revenues available from current sources and the appropriations needed to continue ongoing programs in the GRF.

The Illinois Commission on Government Forecasting and Accounting publishes comparative data on national rankings, using data from the federal government’s annual Census of Governments, and its report includes information about Ohio. The following table of comparative tax rankings for Ohio

was compiled from the new report just issued by the Commission.¹⁴

As this table shows, in the case of total taxes, as well as those individual taxes that comprise the state’s General Revenue Fund, Ohio’s per capita tax burden is below the national average, in every instance, and close to the bottom. What this suggests, is that Ohio has considerable room to increase state taxes without risking being considered a “high tax” state by these measures. However, there is also the question of Ohio’s local taxes.

Unfortunately, data for local tax collections is available only for 2006, and therefore cannot be combined with state 2007 data. Nevertheless, it is 14 Commission on Government Forecasting and Accountability, “Illinois National Rankings in State Government Financing, 2008 Edition,” Springfield, Illinois, September, 2008.

Ohio State Government Tax Revenue in 2007 and Rankings

Indicator and State Rank	Ohio Amount	National Amount
Total Tax Revenue (8th)	\$24.8 billion	\$750.1 billion
Per Capita Total Tax Revenue (38th)	\$2,164	\$2,487
Total Tax Revenue as a Percent of Personal Income (34th)	6.20 percent	6.40 percent
Individual Income Tax Revenue (7th)	\$10 billion	\$265.9 billion
Per Capita Individual Income Tax Revenue (25th)	\$875	\$882
Corporate Net Income Tax Revenue (10th)	\$1.3 billion	\$53.4 billion
Per Capita Corporate Net Income Tax Revenue (37th)	\$114	\$177
General Sales Tax Revenue (10th)	\$7.8 billion	\$236.3 billion
Per Capita Sales Tax Revenue (30th)	\$679	\$784
Alcoholic Beverage Tax Revenue (18th)	\$0.09 billion	\$5.2 billion
Per Capita Alcoholic Beverage Tax Revenue (41st)	\$8	\$17
Tobacco Product Sales Tax Revenue (8th)	\$1 billion	\$15.2 billion
Per Capita Tobacco Product Sales Tax Revenue (10th)	\$87	\$51
Motor Fuel Sales Tax Revenue (5th)	\$1.7 billion	\$36.5 billion
Per Capita Motor Fuel Sales Tax Revenue (15th)	\$150	\$121
Motor Vehicle and Operator’s License Tax Revenue (8th)	\$0.9 billion	\$19.4 billion
Per Capita Motor Vehicle and Operator’s License Tax Revenue (25th)	\$64	\$64
Insurance Premium Tax Revenue (7th)	\$0.45 billion	\$15.3 billion
Per Capita Insurance Premium Tax Revenue (39th)	\$39	\$51

useful to note that local taxes in Ohio are also comparatively low. With local tax revenue of \$4,350 per capita for 2006, compared to a national average of \$4,705, Ohio ranks 14th in the nation. When it comes to property taxes, which comprise the majority of local taxes, Ohio's tax revenue on a per capita basis is \$1,095, compared to a national average of \$1,151, thus ranking Ohio 21st in the Nation.

When it comes to combined state and local spending, Ohio is above the national average in per capita total spending, as well as spending for elementary and secondary education, housing and community development, and public welfare. It is below the national average in per capita spending on higher education, police protection, and corrections. Separate data is not available for state spending.

How Ohio Ranks: Spending

Besides questions about how Ohio ranks in taxes, there are those who are also concerned that Ohio not be considered a high spending state. The Illinois report includes this data as well, and Ohio's rankings are summarized in the following table.

Ohio State and Local Government Spending in 2006 and Rankings

Indicator and State Rank	Ohio Amount	National Amount
Total State and Local Expenditures (7th)	\$97.5 billion	\$2,372 billion
Per Capita Total State and Local Expenditures (15th)	\$8,506	\$8,393
Elementary and Secondary Education Expenditures (8th)	\$19.9 billion	\$501 billion
Per Capita Elementary and Secondary Education Expenditures (14th)	\$1,734	\$1,675
Higher Education Expenditures (8th)	\$7.1 billion	\$192 billion
Per Capita Higher Education Expenditures (32nd)	\$621	\$642
Police Protection Expenditures (7th)	\$2.7 billion	\$79 billion
Per Capita Police Protection Expenditures (21st)	\$235	\$265
Corrections Expenditures (8th)	\$2 billion	\$63 billion
Per Capita Corrections Expenditures (31st)	\$174	\$210
Housing & Community Development Expenditures (6th)	\$1.9 billion	\$42 billion
Per Capita Housing & Community Development Expenditures (10th)	\$163	\$141
Public Welfare Expenditures (6th)	\$16.6 billion	\$370 billion
Per Capita Public Welfare Expenditures (11th)	\$1,452	\$1,240

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!