

# State Budgeting Matters

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## FY 2010 - FY 2011 State Budget: Weaknesses

*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](mailto:rsheridan@CommunitySolutions.com).*

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

One-third of the members of the Ohio House of Representatives are busily dissecting Governor Strickland's main operating budget request for the coming biennium (H.B. 1) in subcommittees of the House Finance and Appropriations Committee. This process will continue well into April, when the full committee will begin to prepare its own substitute spending plan. Meanwhile, the multi-billion dollar transportation budget, which spends dedicated gasoline tax and related motor vehicle taxes and fees on highway-related functions in a separate bill (H.B. 2), is proceeding toward passage. Both of these measures are dependent on the receipt of substantial federal economic stimulus funds, which have meant that the legislature will not have to make the difficult spending reductions and policy choices that would have otherwise been required given the state of the economy and Ohio tax revenues. Despite this, H.B. 1, far more so than H.B. 2, is quite contentious. Indeed, much of its contentiousness stems from its weaknesses, which will be more fully exposed as the budget hearing process progresses. This issue of *SBM* examines some of the major weaknesses of the FY 2010-2011 budget as presented to the legislature by Governor Strickland.

### Economic Forecast/Revenue Estimates

The foundation of the governor's proposed budget rests on its revenue estimates and they, in turn, depend on the forecast of what will happen with the economy. For purposes of economic forecasting, the state employs a professional firm of economists, IHS Global Insight, and then subjects its forecasts to review by a group of business representatives appointed by the governor to a Council of Economic Advisers. Together, they concluded that the current recession will only last for three more months. In this regard, they are out of step with most other national economists who are currently predicting that the recession has not yet "bottomed out" and will last, at least, until the end of the current calendar year—another nine months.

Using his optimistic economic forecast, the governor expects non-farm employment to rise by 1 percent in 2010 and by another 1.7 percent in 2011. Nationally, Ohio accepts the forecast that unemployment will peak at 9.2 percent in the first half of 2010 and remain above 8 percent throughout 2011. These, too, are unreasonably optimistic.

Employment and unemployment are key indicators in revenue projections because the unemployed do not pay personal income taxes on their wages—the largest revenue-producer of Ohio's General Revenue Fund (GRF)—and they also spend less on sales taxable commodities, thus reducing the state's sales tax receipts.



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In reality, national unemployment is already at 8.1 percent and is projected by many economists to rise to 12 percent by the end of 2009. Ohio's unemployment rate is higher than the national rate. In addition, average hours worked per week has dropped from 40 to 33, as more full-time workers become part-time workers and businesses (as well as government) reduce hours in order to avoid employee layoffs. All of this suggests that personal income and sales tax receipts will continue to fall and that the governor's revenue estimates for the coming biennium, much as they have been throughout FY 2009, are far too optimistic and need to be revised downward.

When the Legislative Budget Office (LBO) was established in 1973, one of its charges was to produce independent revenue estimates as a way of preventing data manipulation by the executive branch and "keeping them honest." Even after the Legislative Service Commission (LSC) absorbed that agency and changed its mission, their revenue-estimating role was retained. Unfortunately, not once during their 36 years of LBO revenue forecasting has the legislature chosen to accept the estimates of their own forecasters in preference to those of the Office of Budget and Management (OBM). At least once, the legislature "split the difference" between the estimates of OBM and those of LBO and they do serve to help keep the OBM estimates reasonable. But, one of the problems is that the estimates of the two agencies are typically quite close to one another. For the coming biennium the LSC/LBO forecasts GRF revenues to be \$226.9 million below those of the governor for FY 2010 and \$471.1 million above those of the governor for FY 2011. Overall, the LSC/LBO is even more optimistic (\$244.2 million for the biennium) about the economy and GRF tax revenues than the governor.

*SBM* believes that GRF receipts for the coming biennium will be considerably below those projected by both the governor and the LSC/LBO.

In an effort to provide a meaningful alternative set of revenue forecasts to be used in evaluating those presented to the legislature by the governor and the LSC/LBO, The Center for Community Solutions

(Community Solutions) decided to develop its own revenue forecasting model. This model was presented to the legislature last month and has been revised since then to account for tax actions incorporated in the federal stimulus package. After taking into account the changes to the Federal Adjusted Gross Income, caused by the passage of the federal stimulus package, Community Solutions estimates GRF tax revenues to be \$525.2 million lower in FY 2010 than the governor's current estimates and \$541.8 million lower in FY 2011 for a biennial total deficit of \$1,067 million. Ohio's state legislators would do well to avoid adopting a spending package for the coming biennium that is based on unreasonably optimistic tax revenue estimates. To this end, they may well wish to consider the alternative forecasts presented in Community Solutions' model.

## **FY 2012 – FY 2013**

For reasons that have not been explained, the governor's budget request for FY 2010 – FY 2011 fails to make estimates of GRF revenues for FY 2012 – FY 2013 and the biennium after that, as has been the practice in the last few budget requests. As imperfect as this longer-term look is, it at least enables the legislature to see the expected implications of acceptance of the governor's budget proposals on the future and the state's ability (or inability) to sustain that spending beyond the current biennium. This forward look was especially important during the last few biennia when the state approved a five-year tax reduction plan. It was important that everyone understand the future implications of that decision.

In the upcoming biennium, the governor has chosen to propose using up all of the state's Budget Stabilization (Rainy Day) Fund moneys and his budget employs a number of other non-recurring revenue sources to substitute for the loss of tax revenues resulting from the phased-in tax reductions and the declining economy. The state will also be using billions of dollars of one-time, non-recurring federal funds to continue and expand spending, especially for the Medicaid program. The impact of these proposals on the next biennium are just as crucial as the implications on the decision to reduce state GRF taxes, but

the governor makes no attempt to put those implications into numbers. The table showing total FY 2012 – FY 2013 GRF revenues is simply omitted from the governor’s budget request.

This omission has prompted a number of legislators to complain, publicly, about the fact that approval of the governor’s budget request, as presented, virtually guarantees tax increases to balance the succeeding state budget. Whether or not these complaints, which have only been voiced by a small number of legislators, have any impact on decision-making remains to be seen. If the governor had not chosen to keep legislators and the public in the dark about the future implications of his budget proposals it would have been more difficult to ignore those implications. In the absence of this kind of data, state representatives will find it easier to accept the fact that their term of office is only for two years and that the FY 2012 – FY 2013 state budget will be the responsibility of the next assembly and not them. But none of this will change the fact that even if the economy recovers by 2011, state GRF receipts for the following biennium will probably be inadequate to support the spending levels proposed by the governor for the coming biennium.

In order to better understand the future implications of proposed budget decisions for the upcoming biennium, Community Solutions has made its own projections for FY 2012 – FY 2013. The table below shows the GRF tax revenue estimates made by Community Solutions for those two years compared to the FY 2011 projections of Community Solutions and the governor’s budget request.

For FY 2012, Community Solutions is projecting that tax revenues will increase by 5.67 percent over FY 2011 and by another 6 percent in FY 2013. On the

basis of these projections, it would appear that there would be sufficient tax revenues forthcoming to support the continuation of this biennium’s proposed spending levels if, and this is a big “if”, federal injections of cash for the coming biennium are spent on non-recurring one-time purposes. That is, of course, not what is being proposed in the governor’s budget request, nor what the federal stimulus package requires of states. Using federal funds to increase spending levels for ongoing programs insures the need for additional tax revenues in the coming biennium. Failure to address that issue now simply means that the tax increases required in the next biennium will be considerably higher than they would be if the state faced the issue squarely as it prepares its FY 2010 – FY 2011 budget.

So, legislators should be concerned about how the state will be able to sustain the levels of increased spending, particularly for education and Medicaid, which will result from injecting billions of dollars of federal funds into the state’s budget.

## The Size of the Budget

The governor’s budget proposes to spend more money in the coming biennium than official budget documents suggest. The original budget submitted by the governor contained a significant error which, when discovered by sharp-eyed partisan legislative fiscal staff, resulted in OBM issuing an errata page on its web site. The error showed FY 2009 spending as being \$483,202,599 higher than it should have been. The effect of the error was to understate the dollar and percentage increase in spending for the coming biennium in the governor’s budget request. The executive budget document shows the growth rate of GRF spending for the coming biennium at only 4.4 percent; in reality, after correcting the error, the growth rate is really 6.3 percent. But, the growth rate

### Projected GRF Tax Revenues

	<i>FY 2011</i>	<i>FY 2012</i>	<i>FY 2013</i>
<i>Governor</i>	\$17,262.10	None	None
<i>Community Solutions</i>	\$16,720.30	\$17,669.80	\$18,743.90
<i>\$ Change</i>	—	\$949.50	\$1,074.10

is actually higher than this because of the way that federal Medicaid spending is being shown.

For decades—rightly or wrongly—Ohio’s budget has deposited federal Medicaid matching moneys in the state’s GRF. The American Recovery and Reinvestment Act (ARRA), the federal stimulus package, includes a provision that increases the percentage of Medicaid spending that the federal government contributes to Ohio by 6.2 percent. The original state executive budget request underestimated the additional federal funds Ohio would receive. After increasing its estimate, the governor’s budget proposes depositing the additional federal funds totaling \$3,777,190,076 in FY 2010 and \$3,193,650,099 in FY 2011, in non-GRF line items, rather than into the GRF as the state has always done with these federal funds. If these federal funds were deposited into the GRF then proposed GRF spending for the coming biennium would be as shown in the table below.

As the table shows, the governor proposes spending that is 7.2 percent higher in FY 2010 than in FY 2009 when federal enhanced Medicaid funds are included and 5.2 percent above that for FY 2011.

## State Appropriation Limit (SAL)

In 2006, the legislature passed a bill requiring the state to hold GRF spending increases to a specific percentage. The limit was to be the greater of 3.5 percent or

the sum of the inflation rate plus the rate of population change. Under certain specified emergencies the limitation can be exceeded and in order to exceed the limit in any given year three-fifths of the legislature must approve. In calculating the spending limit, moneys received from the federal government are excluded as are appropriations made for tax relief, tax refunds, or refunds of other overpayments. In a special analysis incorporated into the governor’s budget request for the coming biennium the conclusion is reached that the SAL has not been reached. A new base year will be established for FY 2012, according to the legislation, and it will be based on FY 2011 estimated aggregate GRF appropriations, not on an inflation adjusted figure for the FY 2011 SAL. That raises two interesting issues. Both involve the receipt of federal stimulus funds.

In 2006, when the legislation was enacted, there was no one who would have predicted that the federal government would provide the state with money that they could use to shore up state GRF spending. The exclusion of federal funds from the SAL calculation contemplated only the exclusion of Medicaid moneys. This is why FY 2011 spending can be increased, as the governor proposes, by 8.4 percent (far above the 3.5 percent intent) and still not violate the legislative SAL. That is the first issue and one which the legislature may wish to consider when it sets the state’s FY 2011 budget. The second issue is related.

### Proposed GRF Spending With and Without Additional Federal Medicaid Moneys (amounts in millions of \$)

	<i>FY 2009 (corrected)</i>	<i>FY 2010</i>	<i>FY 2011</i>
<i>Without Non-GRF Federal Medicaid*</i>	\$26,930.60	\$26,987.30	\$29,190.50
<i>Percent Change</i>	—	0.20 percent	8.40 percent
<i>With Non-GRF Federal Medicaid</i>	\$28,707.40**	\$30,774.40	\$32,384
<i>Percent Change</i>	—	7.20 percent	5.20 percent

\*Appropriations, lapses, and transfers as shown in the corrected table accompanying the special analysis on Federal Stimulus Fund Use issued by the Office of Budget and Management on March 3, 2009.

\*\*Estimated.

Because of the use of federal funds in FY 2011, the calculation of the base for determining the FY 2012 SAL will make it very difficult for the state to continue FY 2011 spending in the following year without violating the SAL (and requiring a three-fifths legislative vote to do so). If the federal funds used to shore up the state's FY 2011 budget are eliminated in making the base calculation, then GRF spending will be shown as billions of dollars lower than were actually spent in FY 2011. To stay within the recalculated SAL in FY 2012—regardless of how much GRF revenue the state generates—spending will have to be cut, perhaps even below actual FY 2011 spending levels that include the use of the federal economic stimulus funds. When considering the setting of FY 2011 spending levels legislators would do well to consider how their actions will affect FY 2012 spending, including the application of the SAL to a recalculated FY 2011 base.

### Fungible Federal Funds

To assist in balancing the current (FY 2009) state GRF operating budget the state expects to receive \$815 million in additional federal Medicaid moneys from the ARRA and another \$11.5 million for child welfare programs. The receipt of these unanticipated federal moneys means that the state will not need to use state GRF funds to maintain current authorized levels of GRF spending. In other words, those federal funds will make up for the continued reduction in state tax receipts that has been occurring since the last official downward revenue revision made by the state Department of Taxation and reported by OBM last December. Since then, state GRF receipts have continued to decline. The decline between now and June 30 is not likely to exceed \$500 million and so the state ending cash balance for FY 2009 should actually be larger than is being shown. However, as described above, the decision to deposit enhanced federal matching moneys into the federal special revenue fund, rather than into the GRF, confuses the issue. And this is where the “fungibility” of the federal funds in the state budget becomes significant.

For the FY 2010 – FY 2011 budget the state expects to receive \$5,002,209,269 in federal economic stimulus funds. Some of this money is dedicated and can only

be used for specific purposes including education, TANF (Temporary Assistance for Needy Families), childcare development, child welfare, unemployment compensation, and the Reed Act. However, \$319.9 million is provided to the state to use in any fashion it wishes. And, since the enhanced Medicaid match is available to replace state money, the unneeded state GRF money is also released to be used in any fashion that the state legislature chooses. The governor's budget request chooses to include only \$419 million of the enhanced Medicaid match into the state GRF; another \$1.39 billion is being deposited into non-GRF accounts in the Department of Job and Family Services (JFS).

The governor chooses to propose spending the additional “free” federal stimulus moneys on expansions of programs in three state departments besides JFS that spend Medicaid moneys (Mental Health, Mental Retardation and Developmental Disabilities, and Alcohol and Drug Addiction Services), as well as Rehabilitation and Corrections, Youth Services, Aging, Natural Resources, Agriculture, and Transportation. All of these choices are subject to legislative modification.

It is important for legislators and advocates to understand that the choices made in the governor's budget proposal for the use of “free” federal money (the amounts that are not restricted to specific uses or bound by maintenance of effort requirements) are subject to legislative change. What is “fungible” about these federal funds is:

- The year in which the moneys are used.
- How federal money dedicated to education is used within the Department of Education's budget.
- How federal money dedicated to higher education is used within the Board of Regent's budget.
- How much of the enhanced Medicaid match is deposited into the GRF and how much is put in non-GRF special revenue accounts.
- How much of the enhanced Medicaid match is appropriated to the Medicaid spending agencies besides JFS and to which of several possible Medicaid line items.

- To which of the state’s agencies the “free” federal money is to be appropriated.

and some eliminated. The double-digit spending increases deserve special scrutiny.

With respect to this last point, it is important to understand that in what purports to be a “tight” state budget, there are many line items that the governor proposes large, double-digit percentage increases while other line items are being reduced significantly

## Double-Digit Spending

Just looking at FY 2010 spending compared to FY 2009, seven state agencies stand out as recipients of significant increases in GRF spending as proposed by Governor Strickland. These are shown in the following table.

<i>Agency</i>	<i>\$ Increase</i>	<i>Percent Increase</i>
Air Quality Development Authority	\$1,669,863	19.14 percent
Department of Commerce	\$451,077	26.83 percent
State Employment Relations Board	\$747,101	22.34 percent
Department of Health	\$23,223,875	29.31 percent
Department of Taxation	\$77,630,844	13.52 percent
Veterans’ Organizations	\$183,890	11.39 percent
Department of Veteran’s Services	\$5,125,016	19.01 percent

In addition, within individual state departments there are numerous line items proposed for significant, double-digit increases. Examples of these in FY 2010 are shown in the following table.

<i>Agency</i>	<i>Line Item Name</i>	<i>\$ Increase</i>	<i>Percent Increase</i>
Administrative Services	IT Security Infrastructure	\$257,520	27 percent
	Risk Management Reserve	\$3,000,000	116.80 percent
	State Printing	\$2,488,073	16.88 percent
Agriculture	Animal Disease Control	\$385,678	11.93 percent
	Consumer Analytical Lab	\$410,014	48.44 percent
Commerce	Labor & Worker Safety	\$451,077	26.83 percent
Controlling Board	Emergency Purposes	\$4,000,000	1,000 percent
Development	Strategic Business Investment Division	\$1,210,703	25.92 percent
	Ohio Main Street Program	\$336,875	141.47 percent
Education	Personal Services	\$1,711,994	16.40 percent
	Policy Analysis	\$552,053	109.40 percent
	Educator Preparation	\$1,159,111	133.10 percent
Health	Free Clinics	\$431,737	223.68 percent
	Infectious Disease Protection & Surveillance	\$1,237,929	695.65 percent
	Help Me Grow	\$23,213,895	174.72 percent
Hispanic/Latino Affairs	Personal Services	\$171,137	108.85 percent
State Library Board	Ohioana Library Support	\$163,744	131.19 percent

<i>Agency</i>	<i>Line Item Name</i>	<i>\$ Increase</i>	<i>Percent Increase</i>
Natural Resources	Real Estate & Land Management	\$301,833	17.77 percent
	Division of Forestry	\$832,627	13.71 percent
Public Defender	Multi-County: State Share	\$595,962	83.67 percent
	Trumbull County	\$202,695	89.09 percent
Rehabilitation & Correction	Community Nonresidential Programs	\$5,378,435	32.50 percent
	Mental Health Services	\$7,438,958	10.13 percent
Rehabilitation Services	People with Disabilities	\$5,545,290	42.03 percent

These are only examples, not a complete listing of proposed double-digit increases; nor are the double-digit increases proposed for FY 2011 shown. Legislative scrutiny of agency budget requests will undoubtedly require special justification for increases of this magnitude, especially when the implications for future funding in succeeding biennia at higher levels is considered.

## Rainy Day Funds

As regular readers of *SBM* know, I am not a fan of Rainy Day Funds. In theory, I believe that it is not the business of government to collect taxes and hoard them in the eventuality that they will be needed sometime in the future because of the imperfections of revenue estimating. Revenue shortfalls occur because of failure to recognize the nature of the business cycle and overly optimistic economic projections. When these occur, I believe, is the time to consider ways of making up the difference between actual and estimated tax collections. Because of the way Ohio budgets, the state managed to get through this entire biennium, where revenue estimates were scaled down four times, without resorting to using accumulated Rainy Day Funds. This meant that appropriations' spending was scaled back and the state drew on its other "slush fund", the balances in the hundreds of state special revenue funds that agencies are permitted to accumulate, to bring the state budget back into balance.

Having said all this, it should also be recognized that, as a practical matter, Ohio made the decision in 1981 to collect more tax money than it needs and deposit some of it into a Rainy Day Fund. That fund, along with the ending GRF fund balance, is projected to

have \$949 million at the end of FY 2009. The governor proposes using up the Rainy Day Fund to support a proposed 8.4 percent GRF spending increase in FY 2011 over FY 2010. He proposes leaving \$180.4 million in unspent GRF funds on June 30, 2011.

Considering the influx of new federal stimulus funds included in the proposed budget, the size of proposed FY 2011 spending increases, the implications for sustaining such spending in future biennia, the continued uncertainty about the length and breadth of the current economic crisis, and the revenue forecasts based on probably overoptimistic projections, legislators would do well to consider the wisdom of using up the state's accumulated state reserves at this time.

## What Needs To Be Done

The proposed budget for the next biennium is the most difficult to understand, much less modify, that this writer has ever seen. It is difficult to unravel because of conditions applied to the spending of federal economic stimulus funds and the way in which the governor's budget request mingles the federal money with state generated receipts. Especially problematic, is the way in which federal Medicaid moneys are assigned to the several human services agencies providing Medicaid services and the placement of billions of dollars of federal moneys into special revenue accounts, rather than into the GRF as has been the state's practice for decades.

It is incumbent on the state legislature to clearly recognize the implications of using federal stimulus moneys for recurring expenses on future biennia. Despite the fact that the governor failed to include

revenue projections for the FY 2012 – FY 2013 biennium in his budget request, Community Solutions' estimates show tax revenues rising about 6 percent per year—far less than will be needed to support an FY 2011 operating budget that the governor proposes to increase by 8.4 percent over FY 2010. Community Solutions is projecting that the governor's revenue estimates for the coming biennium are more than a billion dollars too high.

Because of all of the uncertainties about the economy in the coming years, and revenue estimates based on an overly-optimistic economic forecast, the best thing that Ohio's legislators could do is to adopt an annual, rather than a biennial, budget for FY 2010 alone, leaving FY 2011 to be decided a year from now when more, and better, information is available about revenue and spending needs and priorities.

In the FY 2010 budget that the legislature adopts, it should consider not spending the state's Rainy Day Fund money, as the governor proposes, but rather continuing to save it for possible use after the federal economic stimulus money dries up by FY 2012 when the state will have to find ways of maintaining the spending levels they authorized based on the use of non-recurring federal stimulus moneys. It may be that some or all of the Rainy Day Fund money will be needed in FY 2011, but by adopting a one-year budget legislators would be able to postpone that decision until there is greater certainty about when there will be a national economic recovery and what its fiscal implications for Ohio will be.

Legislators should also carefully review the spending increases proposed by the governor that are not required by the conditions of the federal economic recovery legislation, especially the line items proposed for double-digit percentage increases. Holding all spending increases for those items to FY 2009 spending levels would certainly be a reasonable approach and would enable the legislature to easily reduce the FY 2010 proposed GRF operating budget by \$100 million or more.

If the legislature were to take these actions, the state would be better positioned to avoid having to raise

state taxes to accommodate the continuation of spending levels established by using one-time, non-recurring revenues such as federal stimulus funds, Rainy Day Funds, accounting gimmicks, and the like, once those revenue sources are no longer available in FY 2012.

### **Do You Have Questions about Ohio's Budget?**

*E-mail your questions to budget expert Richard Sheridan at [rsheridan@CommunitySolutions.com](mailto:rsheridan@CommunitySolutions.com).*

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