Legislative Service Commission

Forecast of Revenues and Public Assistance
Before The House Finance and Appropriations Committee
On The FY 2002 - 2003 Biennial Budget

Dennis Morgan, Legislative Budget Officer ***January 30, 2001***

Mr. Chairman, members of the House Finance and Appropriations Committee, I am here today to present the forecasts of the Legislative Service Commission (LSC) for the FY 2002-2003 biennium. This testimony and the accompanying packet of information include forecasts for revenues, for the Medicaid program, for TANF (Temporary Assistance for Needy Families), and for the Disability Assistance (DA) program.

Included in today's information are some tables comparing the executive forecasts with our forecasts. Please view the comparisons for human services as tentative at this point, as we have not met with the Office of Budget and Management (OBM) to discuss the policy changes they have assumed in their forecast, such as expanding home or community-based services. Our human services forecast is therefore a baseline forecast of existing policy.

In our revenue forecast we believe we were able to incorporate the executive's major policy changes. For example, we have included the impact of the proposed local government freeze in our estimates. In the next several weeks we will complete our comparisons. For human services, these completed comparisons will be presented to the subcommittee.

Summary

Our forecasts for tax revenues are slightly higher (0.5 percent) for the next two years than those in the executive budget. However our forecast for the current year (FY 2001) is slightly less (0.2 percent). These estimated GRF tax revenue differences are shown below.

FY 2001	$ -38 million
FY 2002	$ 86 million
FY 2003	$ 85 million

Our baseline forecast on Medicaid expenditures represent growth in FY 2002 of 11.4 percent and in FY 2003 of 8.8 percent, and are 5 percent higher than OBM, as shown below.

	State	Federal	Total
FY 2002	$ 138.2 million	$ 173.8 million	$ 306.6 million
FY 2003	$ 194.2 million	$ 270.4 million	$ 464.7 million

Our forecasts for Disability Assistance are lower (6.9 percent) for the next two years than those in the executive budget. These estimated GRF differences are shown below.

	DA Total
FY 2002	$6.3 million
FY 2003	$5.5 million

Obviously the good news in revenues is offset by higher Medicaid cost estimates and by lower Lottery Profits estimates, but they do not take into consideration the executive's proposed changes in Medicaid and the lottery. Before we begin to look at the forecasts in detail, I would like to review the forecasts for the economy.

The Economy

The economy has been slowing lately and this slowdown seems more pronounced than was imagined a few months ago. The harshness of this slowdown is all the more distressing, coming as it does after five years of unbelievable growth. After all, it has been a long time since we had a significant slow down, and 11 years since we have had a recession. The last month has reminded us that during a slow down – no matter how soft – painful things happen: Sales and profits decline, workers are laid off, some businesses close, consumers become more cautious, auto and appliance sales are hard hit, businesses cut back on capital good purchases, and on and on. How much these things happen – just a little or a lot – will determine whether this slow down turns into a recession.

So far the slowdown appears to be just that, although the soft landing may be hitting a few bumps. Declines are significant, but not yet widespread. Many of the declines appear great because the heights reached were so high. Autos and housing are good examples. Auto and light truck sales averaged 17.4 million units for calendar year 2000. Sales are expected to be 15.5 to 16.2 million units in 2001 according to WEFA and DRI economic forecasts. Even at the low end of the range, sales will top every year of the 1990s except for 16.8 million units in 1999. Still, 15.5 to 16.2 million units represent a 7 to 11 percent drop in unit sales. The drop in sales will include fewer imports, but a good portion will come from lower production here in the U.S. Since the auto industry is centered in Ohio and the surrounding states, these effects will be felt strongly here. Lower production means less overtime, temporary layoffs, less purchases from suppliers, less hiring, lower profits, etc. A recession would look much worse: a 15 to 25 percent drop in sales.

U.S. housing starts are also declining. About a 7 percent decline is expected for 2001. Even after this decline, housimg starts would be better than the first seven years of the 1990s.

U.S. manufacturing has been flat or worse over the last two quarters and the current quarter should be about the same. Many sectors are cutting back investment due to higher interest rates and stagnating or declining sales. Ohio is a major producer of durable equipment used in manufacturing production, which is one of the more cyclical areas of manufacturing.

In fact, several of the forecasting firms are announcing that traditional manufacturing is already in a recession. It is estimated that the old manufacturing sector declined by 1.4 percent in the third quarter of last year and declined by a further 5.1 percent in the fourth quarter. Examples of industries in this sector include: lumber, primary metals (steel, iron), motor vehicles and parts, textiles and apparel, petroleum, rubber and plastic products. DRI's January forecast projects that this "old economy manufacturing" – that excludes computers and semiconductors – is going to experience another two quarters of negative growth.

The good news is that manufacturing comprises a smaller and smaller share of the U.S. economy, so that a recession in manufacturing does not necessarily portend a more widespread recession. The bad news is that durable goods manufacturing (including industrial equipment, motor vehicle, and primary metals production) are major players in Ohio's economy. Ohio is likely to feel like it's in a recession even if it's not. Statistics on Ohio manufacturing employment show declines of 12,800 or 1.2 percent from December of 1999 to December of 2000. At the same time total (nonfarm) employment grew by 28,100 or 0.5 percent.

Last week, Federal Reserve Chairman Alan Greenspan summed up our present position when he said, "As far as we can judge, we have had a very dramatic slowing down, and indeed we are probably very close to zero [growth] at this particular moment."

So the immediate questions now are:

- How long will the weakness last?
- How much worse will the weakness get?
- When will growth resume?

Fortunately, the weakness is not expected to last much longer or get much worse. There will be more hits in the near future. Statistics like the unemployment rate will start showing changes indicating the declining economy. (It should be noted that the unemployment rate is a "lagging" indicator. It generally hits bottom *after* the economy has started to improve.) Battling the march of negative statistics showing the slowdown are the effects of lower interest rates. A second interest rate cut by the Federal Reserve is expected tomorrow. This should improve business and consumer confidence and should lower costs for home, auto, and business equipment purchases. Mortgage refinancing is also starting to save homebuyers money.

While forecasters believe that moderate growth will resume this summer, the next six months to a year will be a vulnerable time for the economy. Shocks from various quarters could cause the slowdown to worsen and delay the resumption of growth. Some possible sources for an unexpected shock include:

- A significant decline in stock prices over the next six months
- Reduced business investment for a prolonged period

- Poor consumer confidence and a delay in its rebound.
- International economic troubles
- Worsening California electric power troubles
- Oil price and oil supply problems

When the Federal Reserve lowered the federal funds rate by 50 basis points on January 3, the intent was to avoid or lessen the chance that the first three shocks on the list would be the source of unexpected trouble. The rate cuts are expected to bolster both consumer and business confidence. (Increases in home mortgage refinancing and improvements in corporate bond yields provide some evidence that the strategy is working.)

It was also hoped that the rate cuts would prevent the U.S. slow down from weakening our international counterparts. The jury is still out on whether the rate cuts are having the desired impact there.

California's energy woes are unlikely to directly impact Ohio. The biggest problem is the effect the electric shortage may have on consumer or business confidence. In general, Ohio's experience with electric restructuring is unlikely to follow California's. Moreover, the recent spurt of construction of new electric generation facilities in Ohio (resulting in part from some generous tax incentives that followed the electric restructuring legislation) will help to offset much of the impact the economic down turn may have on nonresidential construction and investment in Ohio.

Rising energy prices are always a concern. Rapid increases in oil and energy prices have been a precursor to most of the economic downturns since the 1970's. While the odds are still against recession, the recent increases in oil prices and then natural gas prices have contributed to the current slowdown by leaving consumers with less discretionary income to spend on other goods and services, and by reducing their willingness to spend it.

It all comes back to consumer (and business) confidence.

Ebbing consumer confidence could significantly prolong or intensify the slow down. Falling consumer confidence levels preceded both of the last two recessions. However, in each of those cases consumer confidence was at a much lower level to begin with. Consumer confidence reached an all time high in the first quarter of 2000. While it has fallen considerably in the last quarter of 2000 – the drop was especially precipitous in December, and the January numbers are *expected to be* even lower – confidence is still higher than at any time before 1997.

Rising energy prices were not the sole source of the drop in consumer confidence. In December the declining stock market finally took its toll, as consumers apparently suddenly realized that 2000's decline in equity values was no fluke. DRI estimates that the value of household wealth was down over 10 percent from the previous December. The Fed's January 3 action appears to have halted the decline in the NASDAQ, but for the most part stocks are still trading sideways. Household wealth is not expected to recover vis-à-vis the previous year until the second quarter of 2001 at the earliest.

Another source of consumer angst was the rising number of layoffs in the second half of 2000. These included layoffs in the dot.com's, as well as manufacturing and retail. The biggest losses, however, were in the temporary employment category, which has been declining since April. In December it reached its lowest level since the 1991 recession. Both the growth in temporary employment and the stock market are considered leading indicators. These data clearly indicate that the economy has not yet turned the corner.

Assuming that we do achieve yet another soft landing – albeit a rather abrupt and bumpy one – what will the economy on the other side of the landing look like?

Productivity is still a factor. Many economists think that the plethora of innovations in information and communications technology and the diffusion of these innovations in the 1990s led to the extraordinary growth of labor productivity in the latter part of the 1990s. While output per hour rose by 1.5 percent per year between 1970 and 1990, it more than doubled that rate between 1995 and 2000. The fact that in spite of all the slow downs in production over the last six months the economy is still growing – albeit at an annualized rate of about 2.2 percent – suggests that the much vaunted productivity gains of the last 5 or so years are probably here to stay. Consequently, the trend rate of growth of productivity is probably closer to 2.25 to 2.5 percent – a lower growth rate than we've seen over the last five years – but around one percentage point higher than that of the 1970 to 1990 period. Some of the "old" economy stalwarts have yet to take full advantage of the high tech possibilities, so that Ohio growth rates could be even greater.

Another factor to take into consideration is the effect of the probable federal tax cut, which – with Greenspan's green light – now appears to be sooner rather than later. This could impact not only the economy but also Ohio's income tax receipts, depending on how the tax cut is structured. Any tax cut is unlikely to take effect quickly enough to jumpstart economic activity or to forestall a recession. Its impact should be measured against the long-term prospects of the economy.

In summary, the long expected slow down has unexpectedly arrived. As David Wyss of DRI put it, "[E]conomic turning points always come later than expected, but when they do come they are often more abrupt." As, indeed, the current downturn appears to be. Another thing about slowdowns is that the economy, which is basically extremely resilient, is much more vulnerable at these times. Another energy price shock or worsening international finances could greatly affect the duration and depth of the slowdown. Revenue forecasting in such circumstances is even more problematic than usual. It is thus with cautious optimism that we present our revenue projections for fiscal years 2001 to 2003.

Revenue Estimates

GRF tax revenues are projected to fall $37.8 million below the OBM estimates for the current year (FY 2001) and exceed the OBM estimates by $86.1 million in FY 2002 and $85.0 million in FY 2003. These estimates assume the executive proposed local government funds freeze. The freeze is recalculated based on the LSC estimates by source. Each of the three funds has a particular set of tax sources and percentages of revenue that feeds each of the funds.

The personal income tax is the largest source of revenue—49 percent of the total, excluding federal funds. This tax has become more difficult to estimate in the late 1990s because option income, capital gains, and pass through entity profits have grown more quickly than wages, interest, and dividends. These last three sources are fairly stable, but it is the far less stable and unpredictable sources of income that have blossomed in importance. If capital gains can increase 25 to 50 percent in each of several years, they also have the potential to shrink quickly and perhaps unexpectedly. Greenspan recently opined, "What if, for example, the forces driving the surge in tax revenues in recent years begin to dissipate or reverse in ways that we do not now foresee? Indeed, we still do not have full understanding of the exceptional strength in individual income tax receipts during the latter 1990s. To the extent that some of the surprise has been indirectly associated with the surge in asset values in the 1990s, the softness in equity prices over the past year has highlighted some of the risks going forward." If he feels he doesn't understand what went on with the income tax with his army of researchers and economists, you have to know that rest of us have a lot of unanswered questions.

The income tax reduction mechanism has altered income tax receipts for the last few years. In this process, budget surpluses from additional revenues or lower spending are returned to taxpayers through reduced income tax rates for the tax year that includes the end of the surplus year. So the budget surplus for FY 2000 resulted in a tax cut for tax year 2000 (returns due April 2001). The revenue effect of the tax cut lowers receipts in the January to June period for FY 2001 with some spill over to the July to December period of FY 2002. This month the surplus for FY 2000 that was collected in the income tax reduction fund, was returned to the GRF to help pay for the reduction in revenues from the tax cut. On the revenue forecast table, this transaction is included in the "Transfers In – Other" line and accounts for the amount falling from $599 million in FY 2001 to $40 million in FY 2002. At this point, no surplus is forecast for the end of FY 2001 so no transfer for this purpose is anticipated for FY 2002. As a result, Personal Income Tax revenues are expected to grow 2.8 percent for FY 2001, 13.3 percent for FY 2002, and 6.3 percent for FY 2003.

LSC estimates for the Sales Tax exceed OBM's by $175.2 million in FY 2002 and by $283.2 million in FY 2003. However for FY 2001, LSC estimates are less than OBM's by $33.9 million. This reflects the slightly deeper downturn now forecast during FY 2001. About two-thirds of the revenue difference each year is due to the Non-Auto portion of the tax. Growth of 2.2 percent for FY 2001, 7.3 percent for FY 2002, and 5.6 percent for FY 2003 is forecast. This is fairly robust growth for the next biennium.

The Corporate Franchise tax, on the other hand, is forecast to stay at roughly the FY 2001 level for the next two years. While baseline revenues are expected to grow slowly, tax changes and increased investment tax credits are expected erode that growth. As a result, LSC estimates are less than OBM in each of the three years by $28.2 million, $141.7 million, and $173.6 million, respectively.

Many of the remaining sources of tax revenues also have significant tax changes affecting them. There have been "wholesale" changes to the Public Utility Tax and then there is also the new Kilowatt-Hour Tax. These tax changes are complex and there is a good explanation of these changes in the forecast detail section of this material. The Foreign and Domestic Insurance Taxes are undergoing a multi-year change to equalize tax rates. This is causing the foreign tax to hold steady or go down slightly and the domestic tax to increase quickly. Cigarette Tax collections are falling slowly due to price increases connected with the tobacco settlement and higher federal taxes. Finally, Estate Tax credits were substantially increased to lower taxes. Most of the effect of the tax cut was shifted to the state and away from local governments. Hence tax revenues are expected to drop significantly for the GRF. Please see the tables and the forecast details if you want to read more about it.

LSC estimates of Lottery Profits are less than OBM's by $20.9 million in FY 2001, $40.5 million in FY 2002, and $85.8 million in FY 2003. LSC estimates do not include the effects of two executive proposals: joining an out-of-state "super lotto" type game and lowering below 30 percent the percent of sales that must be transferred as profits. LSC estimates of sales are also lower by 2.5 percent, 6.3 percent, and 17.5 percent, respectively.

Public Assistance

Medicaid. Medicaid has many funded programs within the state budget, including waiver programs such as PASSPORT, and others designed to provide care in a home or community based setting. To the extent that these programs allow people to avoid institutionalization, they also divert expenditures from the 600-525 Medicaid line item to other places within the state budget. These waivers are growing pieces of Ohio's medical assistance for low-income individuals, and should be seen as a part of the overall medical care policies and expenditures for the state. However, for today's purposes, we will focus on the traditional Medicaid program.

Medicaid Summary. In FY 2000, the Aged, Blind and Disabled (ABD) category represented 34 percent of Medicaid eligibles. However, this same category was responsible for 80 percent of Medicaid spending. The Healthy Start and Healthy Families categories (also referred to as Covered Families and Children) represented 66 percent of eligibles in the same year, but were responsible for only 20 percent of Medicaid spending.

Medicaid costs are projected to increase by over 15 percent in FY 2001. The costs for this year and the upcoming biennium are driven by three factors: caseloads, utilization of services by consumers, and the cost of medical care.

Caseloads. During the current biennium, Medicaid eligibility was expanded in three areas.

- Expanded coverage to pregnant women from 133 percent to 150 percent of the federal poverty level (FPL),
- Phase two of the Children's Health Insurance Program (CHIP), expanding Healthy Start eligibility to uninsured children from families with incomes between 150 percent and 200 percent of the FPL, and
- An expansion of coverage to parents with enrolled children for families with incomes at or below 100 percent of the FPL under the Healthy Families program.

The Healthy Families Medicaid caseload is expected to grow by 28.23 percent in FY 2001 due to the expansion mentioned above, as well as the reinstatement of a number of eligibles to the program. Many families who left cash assistance under the Ohio Works First (OWF) program mistakenly believed they were no longer eligible to receive Medicaid benefits. These families have been notified regarding their eligibility and are now returning to the Medicaid program in large numbers.

The ABD Medicaid caseload is also increasing, although at a slower rate. The number of Ohioans age 85 and older is growing and this age group is the most likely to need long-term care. In addition, the disabled population continues to grow. LSC forecasts that the ABD caseload will grow at 2.6 percent in FY 2002 and 2.1 percent in FY 2003.

The total number of persons eligible for Medicaid grew from an estimated 1,251,155 people in FY 2001 to 1,313,481 in FY 2002 and 1,332,997 in FY 2003, a growth of almost 5 percent and a 1.5 percent increase, respectively.

Utilization. While most of the utilization rates for Medicaid are expected to remain relatively stable over the next biennium, one trend regarding the ABD group is worth noting. The number of prescription drug claims per ABD eligible has been steadily increasing in recent years. The prescription drug utilization rate for ABD eligibles is expected to increase by 6.76 percent in FY 2001, 6.08 percent in FY 2002, and 6.24 percent in FY 2003.

Of course, expenditures for prescription drugs are also rising due to increases in: (1) market prices resulting from the introduction of a large number of new drugs, and (2) mass market consumer advertising (in particular television).

The Prescription Drug category represented about 12 percent of Medicaid expenditures in FY 2000. LSC estimates that over 87 percent of all Medicaid prescription drug claims paid in FY 2002 will be generated by ABD eligibles.

Costs. Costs are rising for a variety of reasons.

- Hospital Care spending is projected to grow by 11.65 percent in FY 2002, and 6.35 percent in FY 2003. Inpatient rates are subject to annual inflationary increases.

- Physician Services are projected to grow by 22.8 percent in the current fiscal year (partially due to a rate increase), and grow by 11.38 percent in FY 2002, and 6.86 percent in FY 2003.

- In Nursing Homes (the primary driver of the Medicaid budget)
  - Waiver and other service programs have diverted the less frail from institutions, leaving the most ill and costly recipients in residence.
  - Prescription drug costs and capital costs are escalating.
  - A shortage of and increased demand for healthcare workers, such as RN's, LPN's and aides, coupled with an increase in opportunities for these occupations, is driving up labor costs (wages and benefits).

We foresee an increase in Medicaid expenditures in FY 2002 over the current fiscal year of 11.4 percent, or $764 million in combined state and federal GRF dollars, with a state share increase of $336 million. For FY 2003, we expect total Medicaid expenditures to go up by another 8.8 percent, or $658 million in combined state and federal GRF dollars, with a state share increase of $274 million.

TANF

With the funding for TANF having been transformed into a block grant you might wonder why we continue to forecast caseloads and cash assistance expenditures. There are a number of reasons, including the fact that these are used in forecasting Medicaid, and that expenditures for cash assistance dictate the amount of federal block grant and state Maintenance of Effort (MOE) moneys that are available for TANF services such as education and training, Prevention, Retention, and Contingency (PRC), transportation, child care, etc.

Clearly the purpose of cash assistance has changed from an entitlement program to one with a temporary focus designed to assist people as they move to the work force. In addition, the ancillary services provided with TANF dollars are meant to develop a strong workforce and put in place supports that will allow individuals to fully participate in employment and to enhance their income potential. Under that philosophy, we have imposed time limits, the effect of which began to be felt in October of 2000, and strict work requirements, which are now in place and enforced with a system of sanctions.

In order to carry out the workforce development focus, we have available to us approximately $728 million per year in federal TANF block grant funds, and we are obligated to provide state funding to meet our federally mandated MOE level of $417 million. Ohio also has determined that $75 million of the federal block grant funds in each year will not be appropriated, but will be left at the federal level as a reserve for use in an economic downturn. However, because of lower spending levels, more grant funds were left unappropriated. The proposed budget leaves $150 million unappropriated each year from the TANF block grant, the same level as the current year..

That said, where are caseloads now, and where are they going? The cash assistance caseload steadily declined from the spring of 1992 to the fall of 1999 when it began to level off somewhat, and now has a pattern of fairly slow decline. We anticipate the average monthly caseload in FY 2001 to be about 91,200 assistance groups. We are projecting a decline in FY 2002 of 2.1 percent and in FY 2003, a further reduction of 1.6 percent. This equates to cash grant funding of $330.5 million in FY 2002 and $325.2 million in FY 2003.

Therefore, for FY 2002 we will have available $728 million in federal funds, plus $401 million in state dollars (for a total of $1,129 million), less the $150 million left on reserve, less the $330.5 million for cash assistance which leaves $648.5 million for administration, work, education and training activities, PRC, transitional services, and other activities. For FY 2003, a similar calculation yields $653.8 million for services and activities other than cash grants.

At the end of FFY 2000, Ohio's TANF reserve was $721.7 million.

Disability Assistance

Disability Assistance (DA) is a wholly state and county funded program, which provides cash and medical assistance to persons not eligible for TANF or SSI. Ohio has divided that program into two components – DA Cash, and DA Medical. There are no time limits, and all those receiving cash benefits also receive medical benefits—currently about 10,800 recipients. An additional 2,500 or so individuals currently receive medical benefits only.

The DA cash and medical recipient caseloads both exhibited a steady decline until the fall of 1999. Since then, the cash assistance caseload has been increasing slowly and the medical caseload has been declining slowly. LBO forecasts that these trends will continue at the same pace and that the inflation rate in medical costs, especially for prescription drugs, will push costs up for the medical caseload despite a slightly smaller number of recipients. This will result in an annual increase of $7 million in the biennium.

In closing Mr. Chairman, I have simply highlighted the forecast material that accompanies my testimony. There is a great level of detail and analysis available on all the topics I have covered.

My colleagues and I stand ready to answer any questions the committee may have.

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