Baseline Forecast of GRF Revenues and Medicaid Expenditures for the FY 2018-FY 2019 Biennial Budget

Testimony before the Senate Finance Committee

March 28, 2017

Chairperson Oelslager, Vice-Chairperson Manning, Ranking Member Skindell, and members of the Senate Finance Committee, I am Mark Flanders, Director of the Legislative Service Commission (LSC). I am here to testify on LSC's forecasts for General Revenue Fund (GRF) revenues and Medicaid expenditures in fiscal years 2017 through 2019. The information in the accompanying LSC forecast book includes an overview and forecast for the economy, forecasts of GRF tax revenues, and forecasts of expenditures in the Medicaid Program. These are baseline forecasts, LSC's predictions for revenues and expenditures as if current law were to remain unchanged throughout the next biennium.

Comparison of LSC and Executive Budget Baseline Tax Revenue Forecasts

LSC forecasts somewhat higher baseline GRF tax revenue for the current fiscal year and the next biennium than are forecast for the executive budget. The differences between LSC's forecasts and those in the executive budget are summarized in the table below. The differences are presented as LSC's forecast minus the executive's, so the positive numbers indicate a higher LSC forecast for each year.

Summary of LSC and OBM Baseline GRF Tax Revenue Forecast Differences

	FY 2017	FY 2018	FY 2019
Dollar Difference	$111.8 million	$141.5 million	$193.5 million
Percent Difference	0.5%	0.6%	0.8%

As you have likely read or heard, Ohio's experience with tax revenue in recent months points to weaker economic growth than expected for the last budget. That corresponds with economic indicators related to manufacturing and mining production, which have been similarly weak for the last year or so. Recent developments thereby illustrate the important effects changes in the economy have on tax revenue. I will now focus on these topics, starting with the economy.

The Economy

The outlook for state government revenues is greatly influenced by the course of Ohio's economy and the economy of the nation. The U.S. economy has expanded since June 2009, according to the National Bureau of Economic Research, a length to date of 93 months. The average expansion since World War II has lasted 58 months, leading many to raise the question whether we are nearing another recession. The broadest measure of economic activity is inflation-adjusted gross domestic product (real GDP). Nationwide, real GDP continued to grow in the second and third quarters of last year, at annualized rates of 1.4% and 3.5%, respectively. Growth slowed in the fourth quarter to 1.9%, and for all of 2016, real GDP rose 1.6%, a bit slower than annual growth since the Great Recession. The economy nevertheless has continued to grow, and both Ohio and the U.S. have added to employment. From the low point seven years ago, Ohio nonfarm payroll employment has increased more than 519,000 jobs, an increase of just over 10%. Nationwide, payroll employment has grown about 16.1 million jobs in the last seven years, a 12% increase. In the latest year, through February 2017, nonfarm payroll employment in the U.S. grew 1.6% and in Ohio grew 0.8%. The durable goods manufacturing sector has experienced job losses in the last year or so, for the nation and Ohio, and mining has seen steeper job losses, but most other sectors have seen job gains.

The employment growth has brought down the unemployment rate. In Ohio, unemployment as a percent of the labor force was 5.1% in February. Nationwide, the unemployment rate in February was 4.7%. According to this measure, the labor market appears healthy at the moment for job seekers, but the declines in these unemployment rates are a result not just of the job gains but also of lower rates of participation in the labor force, as more people of working age are neither employed nor looking for work.

LSC's forecasts are based on our expectation, informed by an economic forecast from the consulting firm IHS Economics (formerly known as IHS Global Insight), that the economic expansion will continue at a moderate pace. A number of risks could alter the course of that expansion. Recent escalation of the value of the dollar in foreign exchange markets is making U.S. exports more expensive for buyers abroad and increasing the attractiveness for U.S. purchasers of buying imported goods and services. This shift in relative prices could slow economic activity in this country, perhaps by more than is reflected in the economic forecast that underlies LSC's revenue forecasts. Growth in the economies of some of our trading partners remains slow, and there is still some uncertainty related to the exit of the United Kingdom from the European Union. The new administration in Washington has suggested there will be fiscal stimulus proposals in the near future, but details on any tax reductions or spending increases are not available yet, and there remains the question of how Congress will act on the proposals. As always, there is the possibility of unforeseen geopolitical risks.

As you consider our projections, then, please remember that economic forecasts are inevitably uncertain things, just like any other attempt to predict the future. We are confident in our methodology, but we know that the forecast will be wrong in some respects and to some degree. Our baseline forecast could prove too optimistic regarding economic growth in the nation and Ohio. Alternatively, it could be too pessimistic.

In developing our forecasts, LSC economists have relied on IHS Economics for the economic predictions that underlie the forecasts. Specifically, we have used the company's December baseline forecasts for the nation and Ohio as the sources for most input or explanatory variables in our models.[1]

As is detailed in the accompanying forecast materials, this forecast shows national real GDP growing at about a 2% annual rate during the period corresponding to state FY 2017, by 2.4% during FY 2018, and by 2.6% during FY 2019. Ohio real GDP also grows through the end of the forecast period, but more slowly. Personal income in Ohio, which is not adjusted for inflation, is forecast to grow faster, by 3.1% during the current fiscal year, by 4.1% during FY 2018, and by 4.4% during FY 2019. Inflation, measured by the consumer price index, is projected to be 2% in FY 2017, and to increase slightly to about 2.4% annually over the upcoming biennium.

Revenue Forecasts

The LSC baseline forecasts for FY 2018 and FY 2019 assume the current Revised Code tax structure. Among the implications is that the personal income tax forecast reflects changes enacted in recent years, including reduced tax rates, the business income deduction, the earned income credit, and increased personal exemption amounts for lower income taxpayers. As we did two years ago, we have dropped pages in the accompanying forecast book for the corporate franchise tax, dealers in intangibles tax, and estate tax, which have all been repealed. These taxes have continued to generate revenue effects into FY 2017, from delayed filings and refund applications, but no revenue is assumed in the upcoming biennium. Finally, the Public Library Fund is projected to receive 1.66% of GRF tax receipts, down from 1.70% of such receipts currently, as a temporary provision of H.B. 64 that required use of the higher percentage expires.

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[1] Forecasts based on revenue models that use Ohio personal income and wage and salary income as explanatory variables have employed an alternative, slightly more pessimistic forecast by IHS Economics. In the view of LSC economists, the alternative values track recent experience with income tax withholding revenue better than the values in the baseline forecast.

LSC was advised that the executive's baseline revenue forecasts would include sales tax revenue from Medicaid health insuring corporations (HICs), so the LSC revenue forecast includes such revenue in the baseline to allow direct comparison between the two baseline forecasts.

For FY 2017, LSC estimates total GRF tax revenue to be $22.25 billion, after distributions to the local government funds. This is almost $112 million higher than the current estimate by OBM.

For FY 2018, LSC forecasts total GRF tax revenue to be $23.08 billion, an $821 million (3.7%) increase from FY 2017. Economic growth forecast by IHS Economics is expected to lead to moderate growth in most tax sources. Income tax revenue is forecast to grow by 4.9% due to further improvement in labor markets, gains in proprietors' income, and income from investments. Revenue is expected to increase 4% from the nonauto sales tax, reflecting steady but slow economic growth and what would be growing revenue from Medicaid HICs. A projected decline in cigarette tax revenue is due to the continuation of a long-term trend. A leveling off of revenue from the kilowatt-hour tax is due to weak growth in all funds revenue being offset by growing allocations to the Public Library Fund, which are debited in part against this tax.

For FY 2019, LSC forecasts total GRF tax revenue to increase to $23.96 billion, an increase of $885 million (3.8%) from FY 2018. Revenue growth is forecast to continue for most taxes. Receipts from the auto sales tax, however, are expected to decrease slightly. Cigarette tax receipts are also expected to decline further.

Medicaid Expenditure Forecast

Medicaid services are an "entitlement" for individuals who meet eligibility requirements. This means that if eligible for Medicaid, the individual is guaranteed the benefits and the state is obligated to pay for them. Medicaid expenditures also comprise a significant portion of the state GRF budget. It is for these two reasons that the executive and LSC forecast Medicaid expenditures.

The differences between LSC's Medicaid forecasts and those in the executive budget are summarized in the table below. The differences are presented as LSC's forecast minus the executive's, so the negative numbers indicate a somewhat lower LSC forecast for each year.

Summary of LSC and OBM Baseline GRF Medicaid Forecast Differences		
	FY 2018	**FY 2019**
Dollar Difference	-$234.9 million	-$386.8 million
State Share	*-$6.6 million*	*-$56.0 million*
Percent Difference	-0.8%	-1.4%

The differences between LSC's and the executive's baseline projections are heavily influenced by somewhat different forecasts for individuals who became eligible for Medicaid through the federal Affordable Care Act (ACA). The federal share for this group (Group VIII) is much higher than for many other individual groups covered by Medicaid. This is why the differences in state share are much smaller than the differences in combined state and federal shares.

For FY 2018, LSC's baseline forecast for Medicaid expenditures is estimated to be $27.84 billion in combined state and federal dollars. This is a $1.4 billion (5.3%) increase from estimated expenditures of $26.44 billion for FY 2017. For FY 2019, combined state and federal Medicaid expenditures are projected to be $28.44 billion, a $600.1 million (2.2%) increase from FY 2018.

Medicaid caseload is driven by a number of factors. The business cycle is an important determinant, particularly for nondisabled adults and children. Given the moderate growth in the Ohio economy forecast by IHS Economics, total Medicaid caseload is not projected to change very much over the biennium. The total number of persons enrolled in Medicaid is expected to rise from an estimated 3.06 million in FY 2017 to 3.07 million in FY 2018, a 0.4% increase, and then decrease slightly in FY 2019.

Chairperson Oelslager and members of the Committee, thank you for the opportunity to present the LSC forecasts. My staff and I would be happy to answer any questions that you may have.

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