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Forecast of GRF Revenues and Public Assistance Spending For the FY 2004-FY 2005 Biennial Budget

Testimony before the House Finance and Appropriations Committee

February 4, 2003

Testimony of LSC Staff by
David Brunson, Division Chief for Education and Taxes
With assistance from other LSC Tax and Human Services Fiscal Staff

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Chairman Calvert and members of the House Finance and Appropriations Committee, we are here today to present the forecasts of the staff of the Legislative Service Commission (LSC) for fiscal years 2003, 2004, and 2005. This testimony and the other information in your packet includes forecasts for GRF revenues, for the economy, for the Medicaid program, for TANF (Temporary Assistance for Needy Families), and for the DA (Disability Assistance) program.

The estimates provided today assume current law continues throughout the next biennium. As better information on the executive's tax and human services proposals become available, we will augment these baseline forecasts with information on those proposals.

Summary

The executive has estimated a shortfall of $720 million for the current year, FY 2003. Our shortfall estimate is slightly less at $651 million. The executive shortfall is composed of a GRF revenue shortfall of $680.3 million versus our shortfall estimate of $638.4 million.

The executive's human services shortfall is $40 million in state funds versus our estimate of $13 million.

The LSC revenue estimate for FY 2004 GRF income (excluding federal) is $17,209 million ($17.209 billion). The LSC estimate is $41.9 million more than the executive's estimate. For FY 2005, the LSC estimate is $18,063 million. This is $126.7 million more than the executive's estimate.

Our baseline forecast on Medicaid expenditures is approximately $9.02 billion in FY 2004 and $9.69 billion in FY 2005. Our estimated expenditures are 1.04 percent below the Office of Budget and Management's (OBM's) baseline forecast for FY 2004 and 2.78 percent below their forecast for FY 2005. LSC's forecast is lower than the executive's forecast by the following amounts:

	State	**Federal**	**Total**
FY 2003	$ 27.0 million	$ 37.8 million	$ 64.8 million
FY 2004	$ 39.0 million	$ 55.3 million	$ 94.3 million
FY 2005	$ 111.6 million	$ 158.0 million	$ 269.6 million

Both LSC and OBM predict that Medicaid expenditures for FY 2003 will be greater than what is currently appropriated. OBM estimates that appropriations for the Medicaid program will fall $40 million short in state share in FY 2003. LSC estimates that appropriations for the Medicaid program will fall $13 million short in state share in FY 2003. The difference in estimated shortfalls is equal to the difference between both forecasts for FY 2003 (i.e., $27 million in state share). These shortfall estimates or funding differences also take into account the DA Medical program which is now part of the Medicaid line item. One of the reasons the LSC estimates are less than the OBM estimates is that our estimates of DA Medical are lower by $5.6 million in FY 2003, $6.9 million in FY 2004, and $13.2 million in FY 2005 than the OBM estimates.

Our forecast for the Disability Assistance (DA) Cash program is also lower than the OBM forecast. The LSC forecast is lower by $2.2 million in FY 2004 and by $2.9 million in FY 2005 than the OBM forecast. However, the LSC forecast is higher than the OBM forecast by $0.2 million in FY 2003.

The Economy

On its way out of what was thought to be a short and shallow recession, the economy hit a sizable soft spot, and its recovery appears to have stalled.

According to the National Bureau for Economic Research (NBER), which dates recessions in the U.S., the recession officially began in March 2001, although it is likely that the Ohio economy had already been in recession for some time. The NBER has yet to call the end of the recession. Many economists announced that it ended in March of last year, and their optimism seemed validated when the Bureau of Economic Analysis (BEA) announced that gross domestic product (GDP) grew by 3.1 percent over the third quarter of 2002 (that is, over the July through September period). That number was subsequently revised upward to 4 percent, but by then the economy had started to falter.

The third quarter GDP growth was due almost entirely to consumer spending, particularly on durable goods. Spending on residential construction also contributed to the high growth rate. At the same time consumer confidence had been falling since June -- particularly in consumers' assessment of current conditions. This indicator tends to reflect the current employment situation, and employment has been virtually flat throughout 2002. (For all of 2002 total nonfarm payroll employment declined by 181,000. This compares to a loss of 1.4 million in 2001.)

In October, the Conference Board index of consumer confidence fell by 15 percent to its lowest level since November 1993. In addition to ongoing concerns about employment, consumers in October were concerned about volatile stock markets, geopolitical uncertainty, the West coast dock strike, and the Washington area sniper attacks. These factors all acted to increase uncertainty and decrease confidence. Consumers continued to spend but at a much lower rate, and their purchases shifted away from durables to non-durable items. Indicators of business confidence also declined in the fourth quarter, leading Alan Greenspan to announce in November of last year that the economy had hit a "soft spot."

The economy remained in this soft spot throughout November and December. December unemployment remained at an eight-year high and employment fell for the third time in four months. Retail sales grew less than expected and sales excluding motor vehicles were flat.

The BEA's advance estimates of GDP growth for the fourth quarter of 2002 (released January 30, 2003) was 0.7 percent -- substantially lower than the third quarter increase of 4 percent. The chief driver of growth was defense spending by the Federal government: it increased by 11.2 percent. Personal consumption expenditures increased by only 1 percent (compared to the 4.2 percent increase in the third quarter). Investment expenditures and net exports both negatively affected GDP growth.

All evidence seems to suggest that the economy has not yet moved beyond the soft spot. Moreover, the general consensus among economists is that it is unlikely to do so until the uncertainty in the international environment -- particularly with respect to the possible war with Iraq -- is resolved, and consumer and business confidence improve.

While forecasting is always fraught with difficulties, the heightened importance of the international political situation makes economic forecasting especially difficult at this time. It basically requires the forecaster to predict not only whether there will be a war, but also to predict how long and how extensive the war will be.

The January 2003 Global Insight forecast that we have relied on for most of our revenue projections assumes a 60 percent likelihood of a short and successful war with Iraq during the first quarter of 2003. According to the forecast, the war will first have a depressing impact on both consumer confidence and GDP growth, but both will improve considerably after the first quarter. Global Insight predicts a GDP growth rate of 2.6 percent for the first quarter of 2003, increasing to 3.5 percent in the second quarter and 5.5 percent in both the third and fourth quarters, resulting in an annual average growth rate of 3.1 percent for all of 2003.

Employment is predicted to recover much more slowly, much like the "jobless recovery" following the 1990-1991 recession. The forecast assumes that employment bottomed out in the fourth quarter of 2002 and remains flat in the first quarter of 2003. Employment is expected to start growing in subsequent quarters, but it is not expected to regain its previous level (which peaked in May 2000) until the second quarter of 2005.

The slow growth of employment is attributed in part to the substantial productivity improvements of the 1990s. Tremendous technological advances resulted in economy-wide productivity gains that underscored much of the prosperity of the 1990s. Advances in productivity allowed businesses to expand output proportionately more than inputs (especially raw materials and labor), which, in turn fostered much of the increase in real incomes in the late twentieth century. These trends appear to be continuing in the new century.

The technological improvements were typically made through major capital investment projects. Since the recession of 2001, those massive capital investments have resulted in substantial excess capacity throughout the economy. As a result of the excess capacity, businesses have little incentive to invest, especially since demand is weak. Furthermore, even as demand recovers, businesses can expand production considerably without adding more workers. Ohio employment, in particular, is unlikely to increase until the GDP growth rate exceeds 4 percent. According to this forecast, that will not happen until the second half of 2003 (i.e., in FY 2004).

The reluctance of businesses to invest is further compounded by the Iraq situation and low business confidence. In any case, employment is unlikely to increase in the absence of substantial capital investment, and business can easily expand production without making that investment. Hence, employment is expected to remain flat for the first quarter and to pick up gradually after that.

Global Insight mentions several "risks" to the forecast, which could further complicate the economic recovery:

- The war against Iraq could take longer and be a lot messier.
- There could be another major terrorist attack in the U.S. or Europe.
- The stock market could take another dive.
- The "housing bubble" could burst.
- The value of the U.S. dollar could fall precipitously.
- There could be another financial crisis.

Alternatively, the following events might hasten the economic recovery:

- The situation with Iraq might be resolved without a war.
- Improvements in the international situation could cause businesses to increase investment spending more quickly.
- Europe and Japan could grow more quickly, spurring demand for American exports.

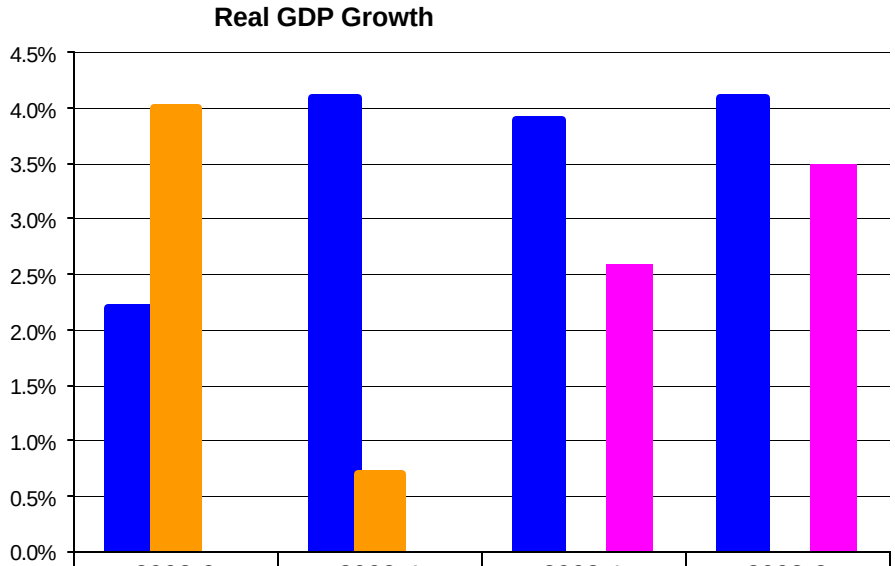
And, of course, many as yet unthought of things could happen.

After 2003, the forecast becomes much brighter. At that time both national and international economic forces will be favoring economic recovery and expansion. Global Insight projects a real GDP growth rate of 4.7 percent for 2004 -- the best growth rate since 1985. While the growth rate for 2005 is forecast at only 3.3 percent, employment should be recovering by then, so that it will at least feel better.

Revenue Estimates

Based on our current economic forecast, LSC believes that revenue estimates for the current year, FY 2003, should be reduced by $638.4 million. The economy barely expanded in the 4th quarter of calendar year (CY) 2002, and slow growth is expected for this quarter and possibly the second quarter of 2003 as well. The original estimates assumed that Ohio and the US would have fairly good growth all this fiscal year as the economy pulled out of the recession, and that employment growth would have started last quarter. Instead, employment is shrinking and employment growth is still a couple of quarters off into the future.

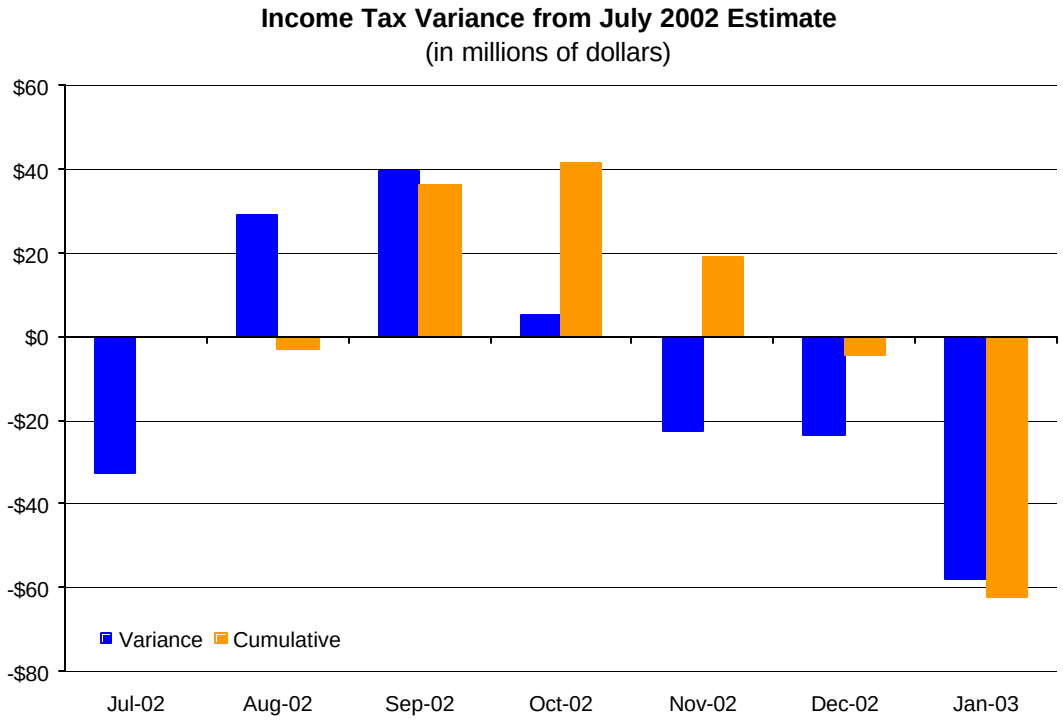
Revenues for the personal income tax and the non-auto sales tax have essentially followed national economic trends during the first seven months of FY 2003. In the first quarter, the economy expanded at a 4.0 percent rate and revenues were above estimates. However in the second quarter (the last quarter of CY 2002), the economy had an annualized growth rate of only 0.7 percent, employment decreased, unemployment increased, and state tax revenues were below estimates in October, November, and December. This same revenue trend has continued for January and a meager revenue performance is now expected for the rest of the fiscal year.



	2002-3	2002-4	2003-1	2003-2
May 2002 Forecast	2.20%	4.10%	3.90%	4.10%
Actual	4.00%	0.70%		
January 2003 Forecast			2.60%	3.50%

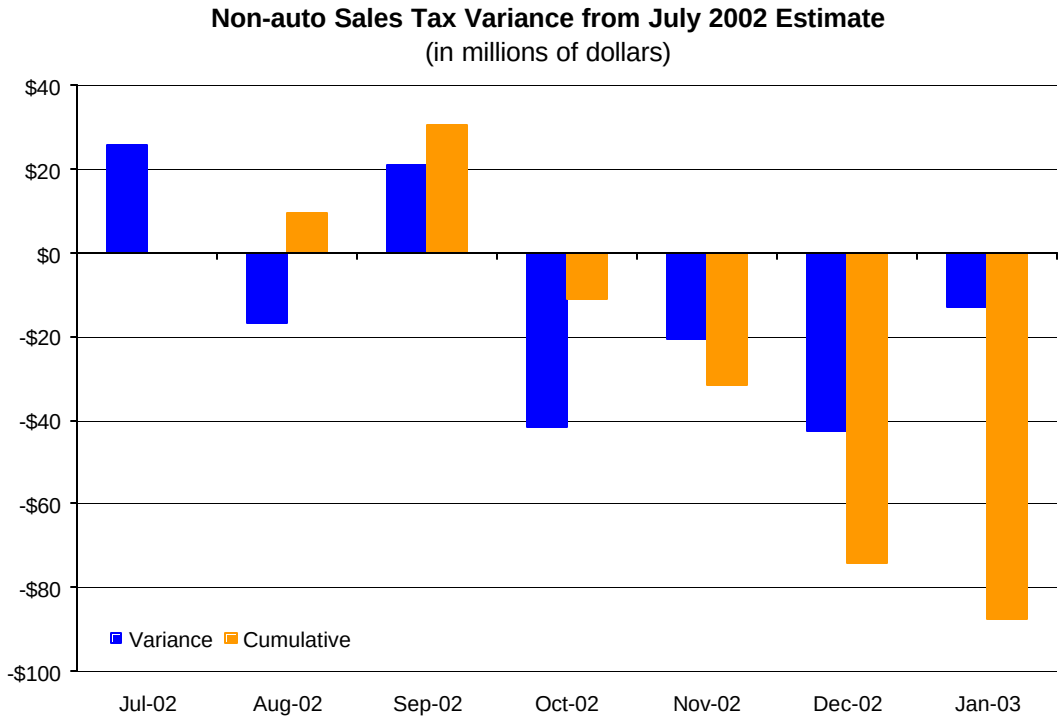
Source: Forecasts by Global Insight

Personal income tax monthly receipts have generally followed the same pattern as the economy. August and September were positive months off-setting July. However, part of the overage during this period was higher than estimated revenue from the new tax on trusts. This overage is not expected to continue due to further changes to the tax made in the capital bill. October had a small monthly surplus followed by widening monthly shortfalls over the November, December, and January period. Clearly, receipts are not heading in a positive direction. Downward movement in employment, consumer confidence, profits, and stock prices are holding back receipts whereas the May forecast assumed improvement for these measures by year's end. For the fiscal year to date, receipts are up 3.7 percent over the same period last year. Our forecast for FY 2003 calls for 4 percent growth for the year, with about 1 percent of that growth due to the new tax on trusts.



The non-auto sales tax shows a similar revenue pattern. Two out of the first three months had positive revenue results. Then, the months of October through January all had negative tax results. The overall shortfall has grown to $87 million for the seven months.

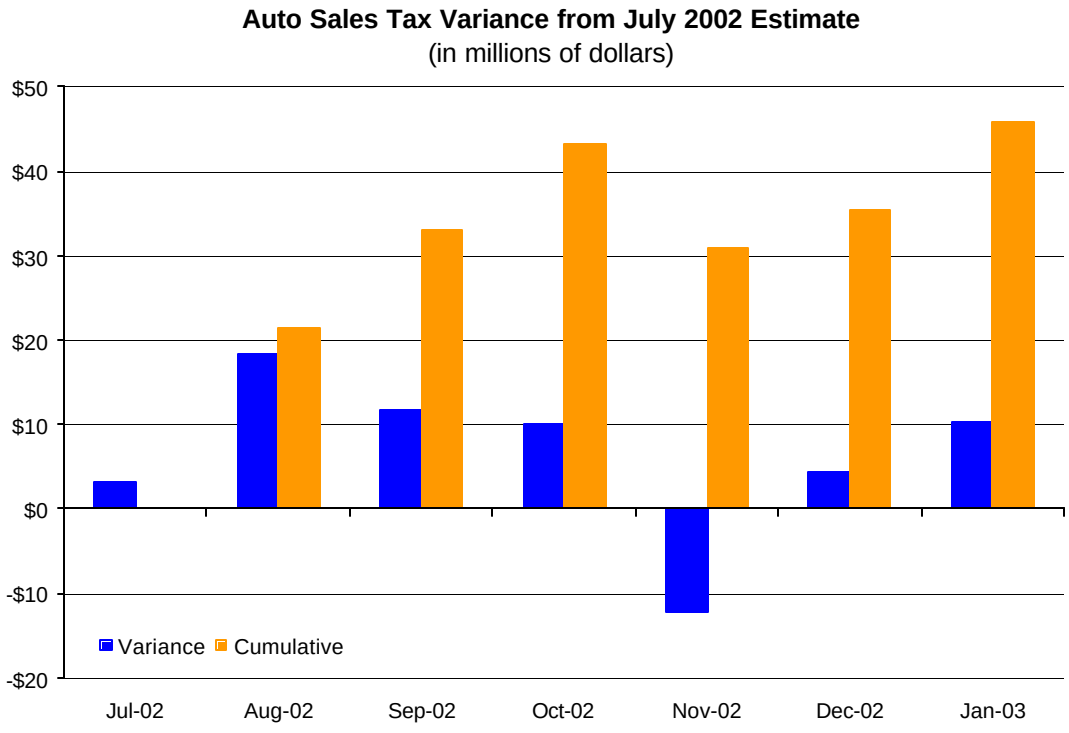
Compared to last year, receipts are up 2.1 percent (or $64 million). However, we believe that this growth was due to the auto leasing tax change that was effective about February 2002. This tax change increased the receipts the second half of last fiscal year by about $85 million with a similar increase possible this year for each six-month period. This is why we are predicting a 1.7 percent growth rate for the year as a whole. If you take out the tax change from both this year and last year, the tax revenues would be about the same for both years.



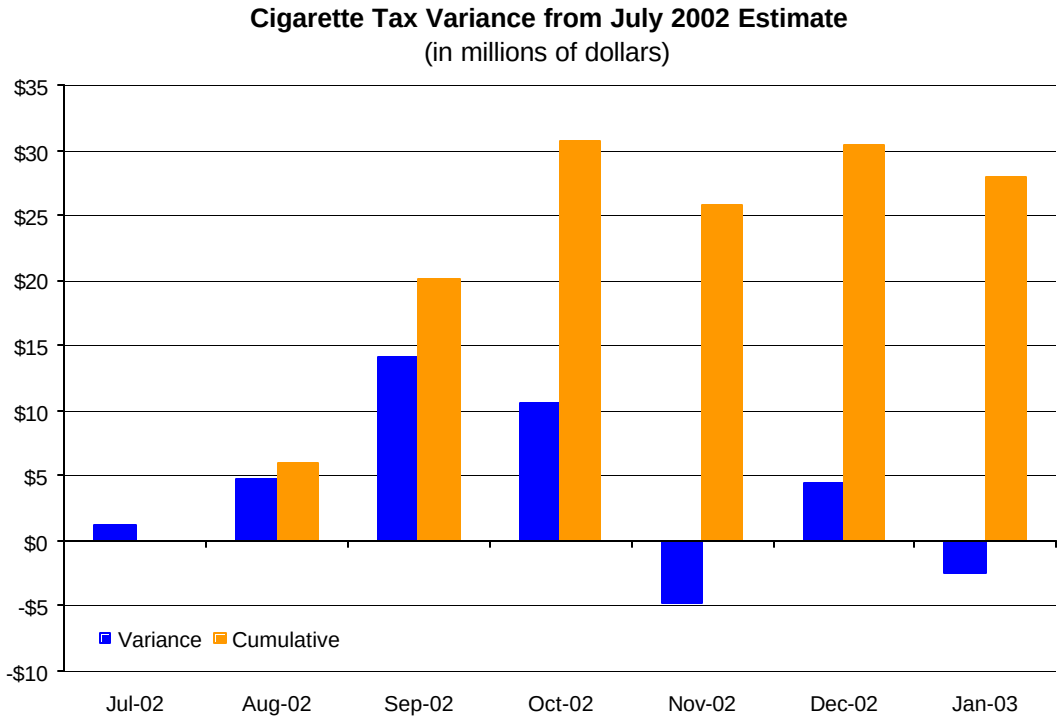
The auto sales tax has continued to perform amazingly well so far this year. The surplus revenue for this portion of the tax traces to the first four months of the year. November was a down month as the auto industry tried to reduce incentives to purchase new cars and light trucks. Vehicle sales plunged. The incentives were reinstated. It is clear that until the economy is more robust and consumer confidence is restored, this market is controlled by the level of auto maker provided incentives.

Normally the auto sales tax has one or two years of significant decline during a recession period. Because of the auto manufacturers' strategy of offering massive incentives, this decline has not occurred during this recession. We are truly in uncharted territory.

So far this year, receipts are about even with last year (0.2 percent over). We are anticipating a slight erosion in this position for a 1.5 percent decline for the year. Through January revenues are $46 million over estimate. This is estimated to erode to $9 million by year's end, since new car sales this spring are not expected to match last spring's brisk selling rates.



As of July 1, 2002, cigarette taxes were increased from 24 cents to 55 cents per pack. Cigarette tax revenue showed small monthly surpluses for the first four months of the year and has been close to the estimate the last three months. The surpluses appear due to two factors: the floor tax brought in more revenue than expected and the fall-off in cigarette consumption was not entirely immediate. The floor tax, the tax on unsold cigarettes in inventory, was more than expected as inventories were higher than expected. This was a one-time gain. Some additional gain was due to cigarette consumption not decreasing as quickly due to the tax increase as was expected. However, this appears to be temporary, since consumption has been on target the last several months with some possibility that consumption will fall more during the second half of the year. The tax is now $28 million over estimate and we estimate the overage will slip to $20 million over estimate by year's end. We estimate that consumption will decline 6 percent this year due to the tax increase. This is in addition to the normal decline of 1½ percent per year.



Turning to the other sources of income for FY 2003, we estimate that:

- Because economic growth stalled out in the last quarter of 2002, we have reduced the corporate franchise tax estimates for FY 2003. We now show a 3.1 percent decrease from FY 2002 due to declining corporate profits rather than the originally expected increasing profits for CY 2002. Through January, the tax is $22 million

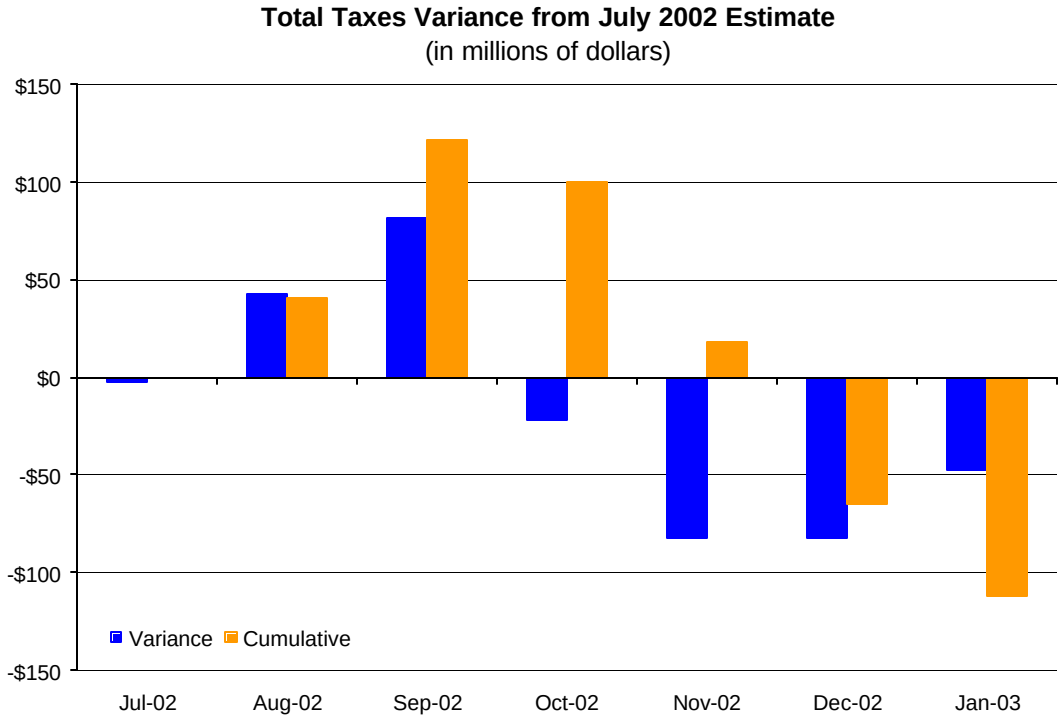
under estimate but ahead of last year's low receipt pace that was caused by very high refunds.

- The public utility tax is short by $30 million so far and we expect it to finish short by $36 million for the year.

- Foreign insurance tax revenues are estimated to be $31 million below estimate while domestic insurance tax revenues are estimated to be $7 million over estimate for the year.

- Earnings on investments estimates were lowered $52 million due to low cash balances for investments and low interest rates. Results for seven months are $36 million under estimate.

- Liquor transfers estimates were increased $10 million due to favorable results for the first seven months.



The total taxes chart for the first seven months of FY 2003 shows two things. (This chart excludes earnings on investments, liquor profits and several other categories of non-tax revenues.)

- Revenue variances, on the whole, were positive for the first three months of the year.

- By October, revenue variances had turned negative.

Tax revenues are estimated to grow 3.8 percent in FY 2004 and 5.0 percent in FY 2005. Most categories of receipts should have reasonable growth. Some exceptions are:

- The auto sales tax should have no or very slow growth both years due to the high level of sales in FY 2003 caused by the auto manufacturer incentives. Current high sales levels limit the upside revenue potential as we emerge from the recession. The normal reason for large growth for this source coming out of a recession is consumer pent-up demand. This is where consumers put off making a new purchase during a recession because of the economic uncertainty or because their income is reduced. Due to the large incentives, pent-up demand may exist for those with reduced incomes, but not for most families. In fact the danger is that auto companies are pulling sales forward from the future by the great deals, and that sales may actually decline for a period of time. As with the current year, sales levels during the biennium will be greatly affected by manufacturer decisions on incentives.

- The cigarette tax is estimated to decrease 3.8 percent in FY 2004 and 1.4 percent in FY 2005. The decrease in FY 2004 is due to the play-out of the 6 percent decline in consumption caused by the tax increase and the one-time revenue from the floor tax in FY 2003. (Essentially, due to a year long adjustment period to the higher tax, the ending consumption level in FY 2003 is below the average consumption level for the year.) The FY 2005 decline reflects the general on-going slow decline in cigarette consumption.

- The estate tax declines 24 percent in FY 2004 due to the tax changes previously enacted for that tax. Growth of 4.3 percent is estimated for FY 2005.

- The public utility excise tax is estimated to fall slightly at the rate of 0.4 percent in FY 2005 reflecting slow erosion in the regulated utility markets for local telephone service and natural gas.

- The ISTV's & IDC's category is estimated to fall to $60 million in FY 2004, since there are no BSF (Budget Stabilization Fund) moneys left to transfer and that any other transfers that might be made are subject to additional legislation and are not in place under current law for these baseline estimates.

While the executive is proposing additional law changes for both FY 2003 and the new biennium, these law changes have not been included in our estimates. We will be estimating these changes after the proposed bill containing these changes becomes available. For the three Local Government Funds we have assumed the current statutory percentage rates for deposit into those funds. The executive's proposed cap on the percentage increase going into those funds will redirect funds to the GRF from the LGFs.

Also not included in our estimates are effects from proposed federal law changes that might impact state tax revenues. One federal proposal that would affect state revenues is the exemption for stock dividends from the U.S. personal income tax. The normal workings of the tax would remove this income from FAGI (Federal Adjusted Gross Income), the starting point for income under the Ohio personal income tax. Almost all states with personal income taxes will face a decision as to what to do about this proposal should it become law. The general effect on states will be to cut state income tax revenue by about 2 to 3 percent.