Ohio Legislative Service Commission

Forecast of GRF Revenues and Public Assistance Spending For the FY 2006-FY 2007 Biennial Budget

Testimony before the House Finance and Appropriations Committee

February 14, 2005

Testimony of LSC Staff by
Steve Mansfield, Chief of Fiscal Analysis
With assistance from other LSC Tax and Human Services Fiscal Staff

---

Chairman Calvert and members of the House Finance and Appropriations Committee, I am here today to present the forecasts of the staff of the Legislative Service Commission (LSC) for fiscal years (FYs) 2005, 2006, and 2007. This testimony and the other information in your packet includes an overview of the economy and an outlook on future economic performance, forecasts for GRF revenues, and forecasts for expenditures in the Medicaid and TANF (Temporary Assistance for Needy Families) programs.

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

Summary

LSC forecasts total tax revenue to be $18.4 billion in FY 2005, $17.8 billion in FY 2006, and $18.5 billion in FY 2007. Our forecasts for tax revenues are slightly higher (0.7%) for the next two fiscal years than those in the executive budget. While, the difference in our forecast for the current fiscal year (FY 2005) is negligible, the estimated tax revenue differences between the Office of Budget and Management's (OBM's) baseline forecast and LSC's baseline forecast for FY 2006 and FY 2007 are $96.8 million and $160.6 million, respectively.

LSC's baseline forecasts of Medicaid shows total expenditures (before offsets) to be approximately $10.6 billion in FY 2005, $11.9 billion in FY 2006, and $12.9 billion in FY 2007. Our estimated expenditures are 0.3% below OBM's baseline forecast for FY 2006 and 1.1% below their forecast for FY 2007. The estimated expenditure differences are shown in the following table:

	State	Federal	Total
FY 2006	$ 13.0 million	$ 19.2 million	$ 32.2 million
FY 2007	$ 54.5 million	$ 80.7 million	$ 135.2 million

In FY 2006, the difference between LSC's forecast and OBM's forecast is $32.2 million, of which $13.0 million is state share. In FY 2007, the difference between the two forecasts is $135.2 million, of which $54.5 million is state share.

The Economy

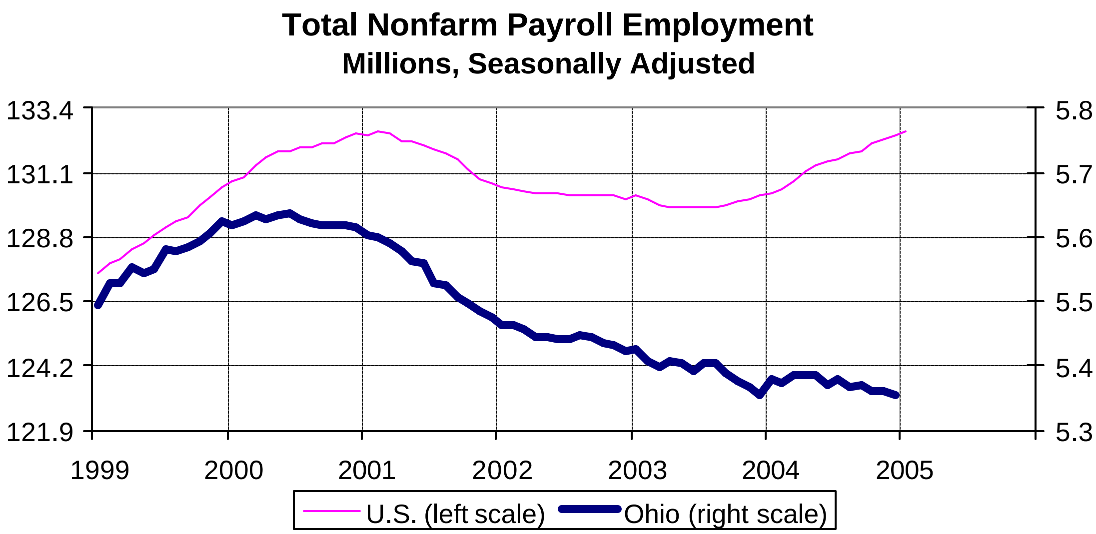
In calendar year 2004 the U.S. economy grew at a rate of 4.4% — the strongest growth since 1999 — and was led by consumer spending and the housing market. This growth was significantly augmented by an upturn in business capital spending, which was in part stimulated by a temporary acceleration in the depreciation schedule for business fixed investments. However, for the next two years, Global Insight (a leading national forecasting firm) anticipates slightly slower growth in consumption, housing, and government spending. Although at a slower pace, leadership in the expansion is thus expected to shift to business capital spending and also to exports. With consumption and the housing market slowing somewhat, the U.S. growth rate is also expected to slow to 3.5% in FY 2005, 3.1% in FY 2006, and 3.2% in FY 2007.

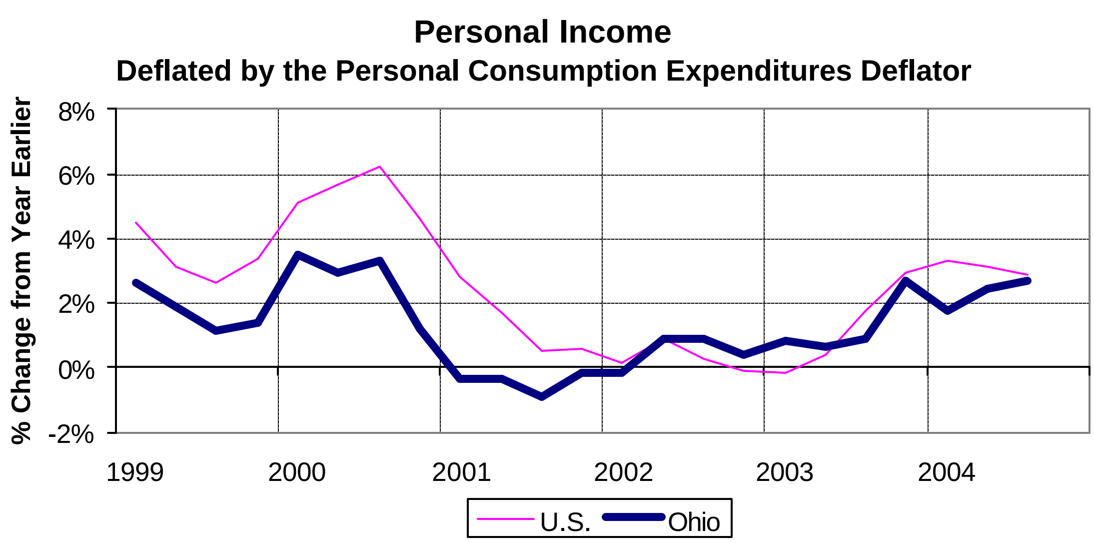
This slower but steady growth with business investment and exports leading the way is expected to also have the advantage of helping to reduce the foreign trade imbalance.

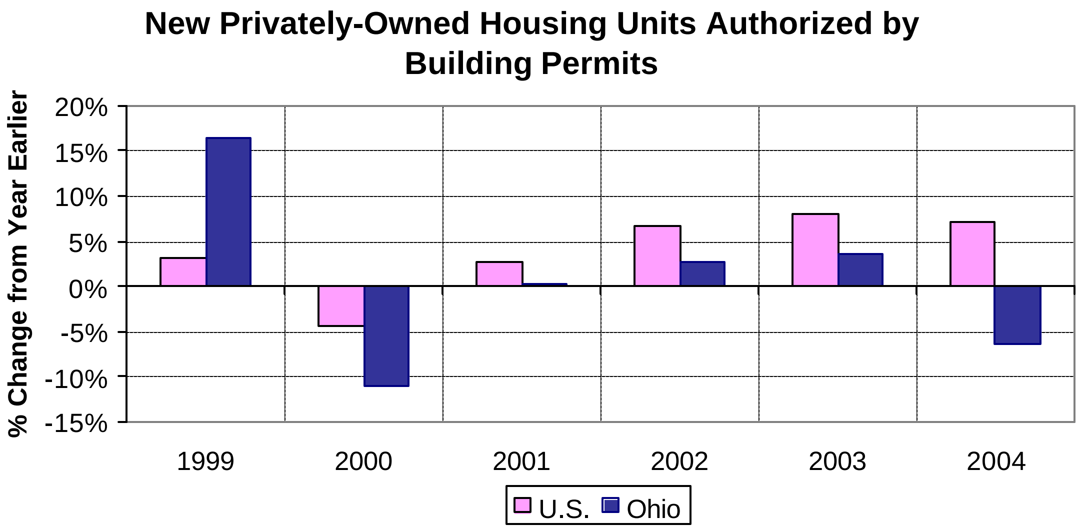
The latest Federal Reserve "Beige Book," which summarizes economic activity through early January, and presents its analysis by region, said that the U.S. economy was growing in 11 of the 12 regions of the country. The exception was the Cleveland Federal Reserve District, which includes Ohio. For this region economic conditions were characterized as "mixed." There are several factors that could be presented to fill out the meaning of the term "mixed." Some of them are:

- Ohio's economy trailed the nation's in the recession four years ago, has continued to lag in the recovery since then, and probably will continue to trail that of the nation.

- Payroll employment here turned down nearly a year ahead of the nation, and in December 2004 was barely above its recession low of a year earlier. In contrast, nationwide payroll employment rose to a new all-time high in January. (See chart.)
- Personal income growth was weaker in Ohio than nationwide ahead of and during the recession, and in the upturn since mid-2003 (although in the latter period the difference was smaller). (See chart.)
- Housing permits rose more slowly in Ohio than nationwide during 2002 and 2003, and fell here last year in contrast with continued growth in the U.S. (See chart.)







Nevertheless, Ohio's economy is expanding, and we expect it to continue to do so. Consider the following factors:

- Gross state product history from the US. Bureau of Economic Analysis shows recovery in 2002 from the 2001 recession, and expansion in 2003.

- Real personal income in Ohio has been growing through third quarter 2004 (latest actual).

- Weakness in employment resulted in part from exceptional growth of productivity. Now, however, productivity growth appears to be slowing, which will tend to result in more employment growth, but may also tend to feed into higher inflation. Total Consumer Price Index (CPI) inflation is expected to slow this year, however, because last year's jump in energy prices is not forecast to be repeated.

- Capital spending is likely to continue to grow, which will tend to support Ohio's producers of various types of equipment as well as the state's suppliers to original equipment manufacturers.

- The decline in the value of the dollar, particularly against currencies of our European trading partners, may help Ohio's exports.

- Consumer spending likely will continue to grow particularly if employment begins to pick up as it is expected to do.

- Employment growth is likely to be concentrated in the service sector, particularly health care and business services, which includes temporary workers. Manufacturing employment is expected to show a small rise.

Finally, the forecasts of key economic variables produced by the Governor's Council of Economic Advisors and by Global Insight provide much of the basis for LSC's revenue and public assistance expenditure forecasts. The forecasts by Global Insight are made on a monthly basis, whereas the Governor's Council last met in November.

Since November, Global Insight's forecasts have been showing stronger growth nationwide and in Ohio. U.S. Real Gross Domestic Product (GDP) growth was revised up 0.1% for both FY 2006 and FY 2007, and growth in Ohio Personal Income was revised up 0.6% for FY 2006 and 0.5% for FY 2007. The following table presents forecasted changes in several of the economic variables in the forecasts of both the Governor's Council of Economic Advisors and Global Insight. These stronger growth figures are reflected in LSC's forecast of higher tax revenues, especially the revenues from the income tax.

Economic Variables
Forecast for FY 2006-2007
Annual Percentage Change (except where noted)

	FY 2006		FY 2007	
	GCEA	**GI**	**GCEA**	**GI**
Real GDP	3.4%	3.1%	3.3%	3.2%
Consumer Price Index	2.1%	1.5%	2.3%	2.0%
U.S. Personal Income	5.2%	5.3%	5.0%	5.4%
Ohio Personal Income	4.7%	4.9%	4.9%	4.9%
U.S. Unemployment Rate (%)	5.3%	5.2%	5.2%	5.2%
Ohio Unemployment Rate (%)	5.7%	6.1%	5.6%	6.0%

GCEA: Governor's Council of Economic Advisors, November 2004

GI: Global Insight, Ohio forecast January 2005, U.S. forecast February 2005

There are, of course, always risks that economic forecasts must consider. Chief among the negative possibilities is another spike in oil prices caused by increased demand and/or a disruption of oil supplies. Another negative possibility is a continued increase in the foreign trade imbalance, which if it goes too far could accelerate the decline in the value of the dollar to the point of stimulating excessive inflation and thus upsetting the bond and housing markets.

On the positive side, high productivity gains could continue, foreign growth could be stronger than anticipated, business investment could continue at a stronger rate, and oil prices could drop more than expected. If those factors combine, growth would be stronger and sustainable, much the way it was in the recovery after the recession of the early 1990s.

Global Insight sees a 20% chance for the negative scenario and also a 20% chance for the positive scenario occurring. Within the last few weeks other issues such as the debate over Social Security funding and nuclear proliferation have taken on a significance that ultimately could impact economic performance depending on how they play out. Of course, many as yet un-thought of things could also happen.

Revenue Forecasts

LSC expects Ohio's economic growth to support revenue growth. However, revenue growth depends on both economic growth and the tax structure. The LSC forecasts for FY 2006 and FY 2007 assume a return to the statutory tax structure. The state sales tax rate returns to 5%, income tax brackets are indexed starting tax year 2005, the income tax on trusts ends, and the local government funds freeze ends. The return to the statutory tax structure will act to reduce GRF revenues.

LSC forecasts total tax revenue to be $18.4 billion in FY 2005, $17.8 billion in FY 2006, and $18.5 billion in FY 2007. We mention a few details here regarding our forecast of revenues in each of these years and how it differs with the Executive's forecast; additional details of the forecasts for the state's revenue sources are included in your packet.

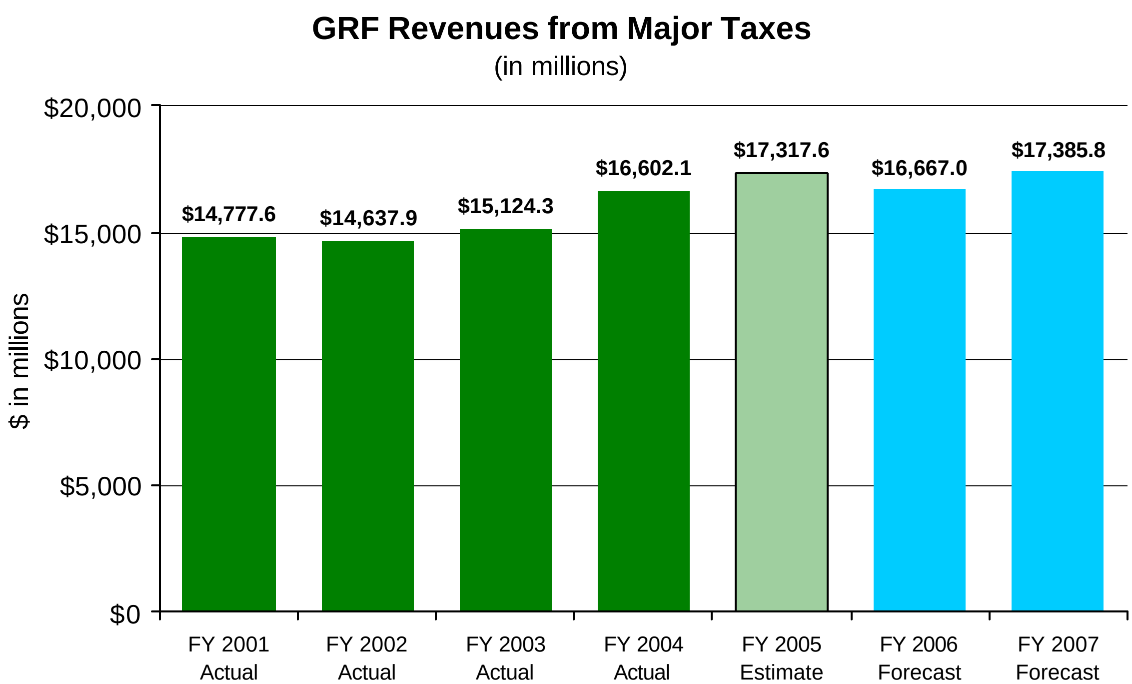
For FY 2005, LSC estimates that tax revenue will be $19 million lower than the OBM estimates made at the start of the fiscal year. The Executive's revised estimate for FY 2005 reduces total tax revenue by $18 million.

For FY 2006, LSC forecasts that tax revenue under statutory law will fall by $652 million (3.5%). The Executive forecasts that under statutory law tax revenue will fall by $749 million (4.1%) in FY 2006. The fall is due to the return of the sales tax rate to 5%. LSC forecasts a $985 million (12.6%) reduction in revenue from the sales tax; the executive forecasts a $1,072 million (13.6%) reduction. Revenues from taxes other than the sales tax increase by $334 million (3.1%) in the LSC forecast and $323 million (3.1%) in the Executive forecast.

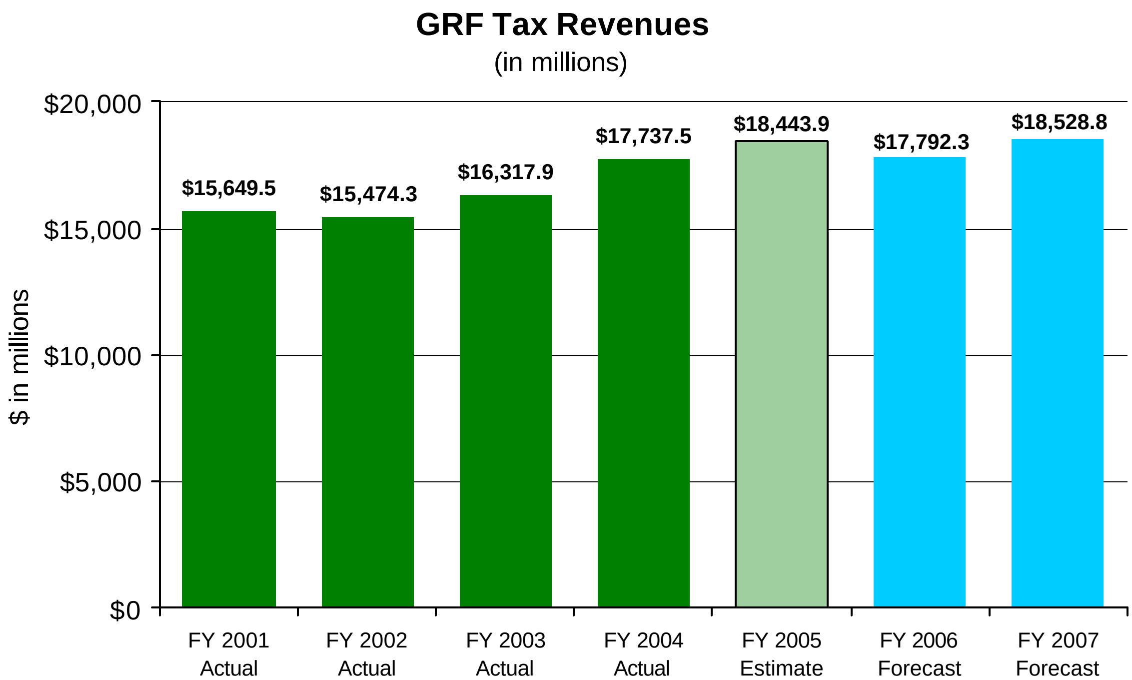
For FY 2007, LSC forecasts that tax revenue under statutory law will increase by $736 million (4.1%). The Executive forecasts that tax revenue will increase by $673 million (3.8%).

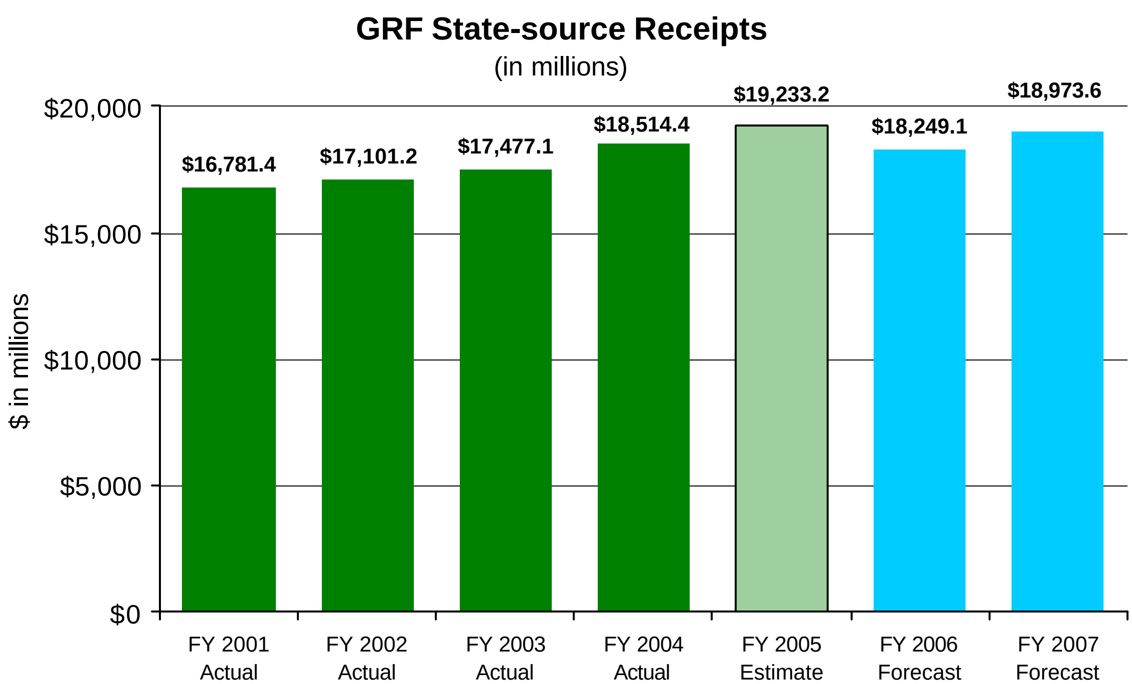
For the FY 2006-2007 biennium, LSC forecasts that GRF tax revenue will be $140 million (0.4%) higher than revenue for the FY 2004-2005 biennium. The Executive forecasts a decrease of $118 million (0.3%). Under the LSC forecast, revenue from the sales tax is forecasted to be $1,430 million (9.3%) lower and revenue from the personal income tax is forecasted to be $1,406 million (8.9%) higher. Under the executive's forecast, revenue from the sales tax will be $1,513 million (9.8%) lower and revenue from the personal income tax will be $1,282 million (8.1%) higher.

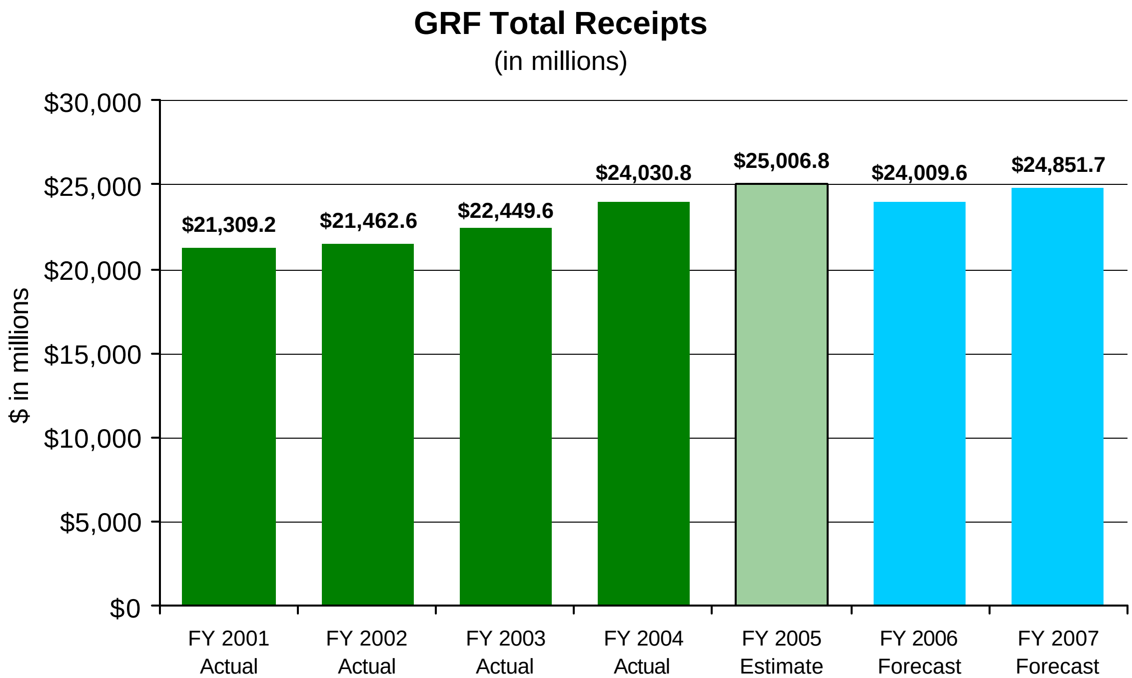
The following four charts provide overviews of total GRF receipts and key subtotals. The first chart presents the forecast of GRF revenues from major taxes,[1] the second chart presents the forecast of all GRF tax revenues, the third chart adds the forecast for nontax receipts, and the fourth chart adds federal grants that are included in the GRF, which are mostly Medicaid grant funds.



[1] The "major taxes" are the personal income tax, the sales and use tax, the corporate franchise tax, the public utility excise tax, and the kilowatt-hour tax. In addition to providing revenue for the GRF, these taxes contribute to the Local Government Fund (LGF), the Local Government Revenue Assistance Fund (LGRAF), and the Library and Local Government Support Fund (LLGSF). GRF revenue from these taxes was increased by the local government funds freeze. These taxes account for approximately 70% of total GRF revenue and 90% of state-source GRF revenue.


GRF Tax Revenues
(in millions)
$ in millions
$20,000
$15,000
$10,000
$5,000
$0
$15,649.5
$15,474.3
$16,317.9
$17,737.5
$18,443.9
$17,792.3
$18,528.8
FY 2001 Actual
FY 2002 Actual
FY 2003 Actual
FY 2004 Actual
FY 2005 Estimate
FY 2006 Forecast
FY 2007 Forecast


GRF State-source Receipts
(in millions)
$ in millions
$20,000
$15,000
$10,000
$5,000
$0
$16,781.4
$17,101.2
$17,477.1
$18,514.4
$19,233.2
$18,249.1
$18,973.6
FY 2001 Actual
FY 2002 Actual
FY 2003 Actual
FY 2004 Actual
FY 2005 Estimate
FY 2006 Forecast
FY 2007 Forecast



Public Assistance Expenditure Forecasts

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, Health Care/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, expenditures for these waiver programs are capped at the level at which they are appropriated. In contrast, traditional Medicaid is an entitlement program. In other words, the state must provide federally mandated services to all those who meet the eligibility criteria. Therefore, in order to get an idea of what level of appropriations will be needed to fund the traditional Medicaid program in Ohio, we forecast the caseload and expenditures each biennium.

Medicaid Expenditures**.** As noted above in the summary, for the upcoming biennium, LSC's baseline forecast for Medicaid expenditures is approximately $11.9 billion in FY 2006 and $12.9 billion in FY 2007. These figures, however, do not include offsetting revenues in the program. After including offsetting revenues, total payments from the 525 line item are expected to be approximately $10.6 billion in

FY 2006 and $11.6 billion in FY 2007, with the state share being $4.3 billion and $4.7 billion, respectively.

Caseloads. The total number of persons eligible for Medicaid grew by approximately 9% from 1.55 million in FY 2003 to 1.64 million in FY 2004. The total number of eligibles is estimated to reach 1.72 million in FY 2005 (approximately a 5% increase over FY 2004). LSC forecasts that the number of persons eligible for Medicaid will continue to grow to 1.77 million in FY 2006 (approximately a 3% increase), before falling to 1.75 million in FY 2007 (approximately a 1.2% decrease).

Poor labor market conditions associated with the recent recession have been the primary driving force behind the growth in total caseload. An additional factor behind the recent growth in caseload has been the CHIP-II program expansion that began on July 1, 2000. The CHIP-II program covers uninsured children under age 19 in families with incomes between 150% and 200% of the federal poverty guidelines (FPG). The eligible population for CHIP-II grew by 17.1% in FY 2003 before slowing to 7.7% in FY 2004, a rate more comparable to the other categories of eligibility.

LSC forecasts that the overall Covered Families and Children (CFC) caseload, which includes Healthy Families, Healthy Start, CHIP-I, and CHIP-II will peak in the first half of FY 2006, and begin to drop in the third quarter of FY 2006 as the labor market in Ohio experiences the recovery.

CFC eligibles access their health care benefits through either the traditional fee-for-service system or the Medicaid managed care program. The Medicaid managed care program has three different enrollment categories: mandatory, voluntary, and preferred option. In FY 2001, the state introduced the preferred option to Medicaid managed care. Under preferred option, recipients are automatically enrolled in managed care if they fail to select the traditional fee-for-service. This policy has pushed up the HMO penetration rate from approximately 28% in FY 2001 to 39% in FY 2004. LSC's baseline forecast assumes that the HMO penetration rate will continue to rise due to the preferred option. But it is expected to rise more slowly to approximately 41% or 42% for FY 2006 and FY 2007.

Growth in the Aged, Blind, and Disabled (ABD) caseload decelerated in FY 2004, but early signs for FY 2005 suggest that growth may accelerate again. Those eligible due to disability are the largest single subcategory within the ABD category of eligibility. LSC forecasts the number of ABD eligibles to grow by 4.3% from FY 2004 to FY 2005, with growth decelerating to 4.2% in FY 2006 and 3.0% in FY 2007.

Costs. Medicaid program costs are estimated separately for each of the nine major expenditure categories: long-term care (nursing facilities and Intermediate Care Facilities for the Mentally Retarded), hospitals (inpatient and outpatient), physician services, prescription drugs, health maintenance organizations (HMOs), Medicare buy-in, waiver, all other care, and DA Medical. After forecasting changes in the caseload, a cost per Medicaid recipient is projected. The cost per recipient is itself broken down into two components: the average number of claims per recipient, called the "utilization rate," and the average cost per claim submitted. The average cost per claim depends heavily on overall health care inflation — Medicaid spending on health care services that are market driven significantly outweighs program payments to providers that are tied to fee schedules. In addition, payment rates for long-term care, inpatient hospital care, and prescription drugs are statutorily connected to market place trends. Consequently Medicaid, like any other third party payer, is very susceptible to market forces.

I will briefly highlight our forecast of costs for the three largest Medicaid expenditure categories: nursing facilities, hospitals, and prescription drugs. These three categories combined represent approximately two-thirds of total Medicaid spending in the 600-525 line item.

Payments to nursing facilities are based on cost reports. Nursing facilities annually submit cost reports to Department of Job and Family Services (JFS), which are used to calculate facility-specific per diems for the following state fiscal year. The per diem rates are then adjusted quarterly to account for differences in each resident's needs — known as the "case-mix adjustment."

The biennial budget act for FY 2004 and FY 2005 temporarily suspended the statutory per diem rate formula and established a cap on growth in the per diem rates. For FY 2004, the mean total per diem rate for all nursing facilities in the state, weighted by Medicaid days, after applying the cap was $156.84. Department of Job and Family Services officials report that the mean would have been approximately $164.11 if the statutory formula had been followed. For FY 2005, the equivalent figure after applying the cap is estimated to be $159.31, while JFS officials indicate that the mean would have been approximately $170.58 under the statutory formula.

The per diem rates are forecast to average $183.89 during FY 2006 and $192.17 in FY 2007. The FY 2006 per diem rate forecast represents an increase of 7.6% over the JFS estimate of the statutory formula per diem for FY 2005, and the FY 2007 forecast represents an increase of 4.5% over the FY 2006 average. Estimated expenditures for Nursing Home Services are $3.18 billion in FY 2006 and $3.34 billion in FY 2007. The rise in the state's per diem is fueled by heightened acuity levels, increased capital costs, and to a larger extent, elevated direct care costs.

JFS is amending rules to update and provide a more current weighting of the relative weights for Diagnostic Related Groups (DRG) used in the prospective payment system for hospital services, and to require annual recalibration updates thereafter. The Department estimates that the recalibration of the relative weights for DRGs will result in a decrease in reimbursement for hospital services. Thus, the growth rate in spending for hospital care is projected to be approximately 8% from FY 2005 to FY 2006, and 10% from FY 2006 to FY 2007. Estimated expenditures for inpatient and outpatient hospital services are $2.3 billion in FY 2006 and $2.5 billion in FY 2007. The Ohio Administrative Code requires an annual inflationary update to inpatient rates; however, outpatient rates are based on a fee schedule that is not automatically inflated.

Expenditures for Prescription Drug Services were $1.80 billion and represented approximately 18% of expenditures from the 525 line item in FY 2004. Offsetting the prescription drug services expenditures was the prescription drug rebate of $455.4 million in FY 2004.

LSC expects prescription drug spending growth to decelerate but to still be one of the fastest growing health sectors. Growth in drug spending peaked in FY 2001 at 25%, slowed to 17% in FY 2004, and is projected to decelerate to 13% growth in FY 2005. Growth is projected to be 16% in FY 2006 and 14% in FY 2007. The high growth rate of FY 2001 was associated with increases in utilization, price, and the number of eligibles.

TANF

With the introduction of the federal Temporary Assistance for Needy Families (TANF) program in 1996 and Ohio's implementation of that program with the Ohio Works First (OWF) and the Prevention, Retention, and Contingency (PRC) programs in 1997, the purpose of cash assistance was changed from an entitlement program to a block grant program with temporary benefits designed to assist people as they move to the workforce. While the number of cash assistance recipients in Ohio began to drop before welfare reform was implemented, as the economy improved in the mid-1990s, OWF's stronger participation requirements and PRC's short-term assistance efforts accelerated the reduction in Ohio's cash assistance caseload. Today, Ohio's cash assistance caseload is about 87,750 assistance groups, one-third of the caseload peak experienced in March 1992.

Ohio's annual TANF block grant award from the federal government is approximately $728 million. Ohio is required to meet an annual minimum maintenance of effort (MOE) requirement of $390.8 million.

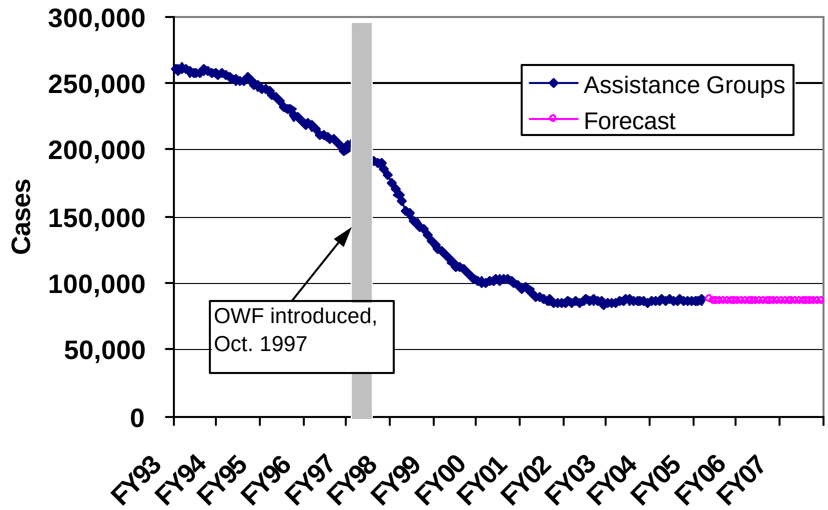
One of the consequences of the block grant funding arrangement is that reductions in recipient caseloads reduce the amount of "baseline" cash benefits, thus leaving more funds available for other TANF-related program services or activities. If TANF grant funds go unspent in a particular year, the federal legislation provides that "a State may reserve amounts paid to the State under [this legislation] for any fiscal year for the purpose of providing, without fiscal year limitation, assistance under the State program funded under [this legislation].'[2] At the end of FFY 2004 (September 30, 2004), Ohio's TANF balance was $836.1 million, with $505.2 million reported as unliquidated obligations, and $330.9 million as the unobligated balance. Accordingly, Ohio has enough unobligated TANF reserve funds to pay for more than one year of cash benefit payments at current benefit levels. These figures do not include funds that have been transferred to the Social Services Block Grant, but which had not yet been spent as of that date. The unspent balance is held at the federal level, and is available to be spent on cash benefits or on other services or activities during the period in which the funds may be obligated.

TANF Reauthorization. TANF was extended in its current form on September 30, 2004, its eighth extension since it was originally set to expire in 2002. The latest news from Washington indicates that there is growing momentum to act on reauthorization in March before the latest extension expires. To what extent there will be programmatic changes in the reauthorization act is unclear at this point, however, several proposals have garnered support from both the President and the Congress, making some alterations in the current TANF program more likely. Possible modifications to the legislation include: raising work participation requirements to 40 hours a week, increased child care funding with or without state match requirements, and stagnant TANF block grant levels.

TANF/OWF Forecast. As the chart detailing the trend in the OWF combined caseload indicates, the number of OWF (formerly ADC) cases experienced a long-term decline as Ohio and the nation recovered from the recession of the early 1990s. The rate of decline was strong prior to the implementation of OWF, but the rate of decline clearly accelerated around the time of the introduction of OWF.

[2] H.R. 3734, Personal Responsibility and Work Opportunity Reconciliation Act of 1996, sec. 404 (e).

OWF Caseload, FY93-FY07, with Forecast



Several important demographic changes also developed in conjunction with the decline in the overall caseload. One of the most significant developments in the changing demographics of TANF recipients in Ohio is the increase in the number of "child only" cases. These cases occur when adults in the household are ineligible for TANF benefits or they are recipients in other programs such as supplemental security income (SSI). Data indicates that in Ohio the relationship of nonrecipient adults in the households where "child only" cases occur is most often that of the catch-all category of "other relative," followed by grandparent, natural or foster parent, sibling, nonrelatives, and step parents.[3] Such cases are exempt from time limits and work requirements. "Child only" cases in December 2004 comprised nearly half (47.4%) of the total caseload. Because the children in these cases remain eligible until age 18 and they are not subject to adult participation requirements, they form a stable core of the OWF caseload.

LSC expects the total number of TANF cases (or assistance groups) to decrease in FY 2006 to an average of 86,514 monthly cases from a FY 2005 average of 86,919. Assuming current benefit levels do not change, the decline in the total number of TANF cases will result in approximately $2.3 million less being spent on TANF cash benefits in FY 2006 than LSC estimates for FY 2005 expenditures. The total spending on cash benefits is forecast to be $315.0 million for FY 2006.

[3] U.S. Department of Health and Human Services, Administration for Children and Families, Office of Planning, Research and Evaluation, "Characteristics and Financial Circumstances of AFDC Recipients" FY 1996, Table 33.

The decline in the number of TANF cases is expected to continue into FY 2007. The monthly average of cases is expected to decline to 86,162, representing a decrease in spending for TANF cash benefits of $3.5 million for the year. That estimate brings total spending for cash benefits, assuming current eligibility and benefit levels, to $311.5 million for FY 2007.

TANF/OWF - LSC Baseline Estimates

	FY 2005	FY 2006	FY 2007
Average monthly cases	86,919	86,514	86,162
Total cash benefits (millions)	$317.3	$315.0	$311.5

The TANF cash benefits are paid from line items 600-410, TANF State; 600-658, Child Support Collections; and 600-689, TANF Block Grant. The Executive has recommended FY 2006 total funding for the combination of these three line items at $1,055.9 million. The total recommended funding level for these three line items in FY 2007 is $1,081.3 million.

Funding cash benefits for FY 2006 at the forecast level of $315.0 million, and at $311.5 million for FY 2007 leaves $740.9 million in FY 2006 and $769.8 million in FY 2007 from these three line items for employment services, work activities, PRC services, transitional services, direct payments from TANF federal funds for child day care,[4] and other allowable activities.

A more detailed presentation of the Public Assistance Expenditure Forecasts is also contained in your packet.

Thank you for your kind attention. Let me just say in closing that the estimates and forecasts that we have presented are based on sound economic principles and forecasting models. Situations do change, however, and we will update this information as any new information becomes available. I and the people who actually did the hard work in preparing this forecast, and who are sitting behind me, will be happy to answer any questions that you might have.

[4] In addition to receiving funds directly from the TANF federal block grant, child care receives funding from other sources.