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Budget Footnotes

A NEWSLETTER OF THE OHIO LEGISLATIVE SERVICE COMMISSION

SEPTEMBER 2007

REVENUE AND DISBURSEMENTS

— *Phil Cummins and Allan Lundell*

Status of the General Revenue Fund

The transition at the beginning of FY 2008 from Ohio's former accounting system to a new system disrupted the flow of information that in the past was the basis for our revenue and disbursements reports. As a result, this month's combined report is necessarily brief. Implementation of the new system, referred to as the financial component of the Ohio Administrative Knowledge System (OAKS), has required resolving issues related to appropriate entry of transactions. The tables included in this report consequently are preliminary in nature and subject to revision. They include among the categories a line for "Pending Payroll" not yet posted to the various agencies.

Through August, fiscal year-to-date General Revenue Fund (GRF) receipts of $3,893.2 million were $4.9 million (0.1%) below the August 2007 estimate of the Office of Budget and Management (OBM). State-source receipts were above estimate by $10.4 million (0.4%) and federal grants were below estimate by $15.3 million (1.4%). Tax revenues were above estimate by $3.6 million (0.1%). Nonauto sales tax revenue was above estimate by $26.0 million (2.3%) and cigarette tax revenue was above estimate by $11.2 million (11.0%). Personal income tax revenue was below estimate by $11.4 million (0.9%) and corporate franchise tax revenue was below estimate by $11.1 million. Compared to FY 2007, total receipts were up 3.3%, state-source receipts were down 0.5%, and federal grants were up 15.1%. Tax revenues were down 1.2%. Nonauto sales tax revenue was up 4.2% and cigarette tax revenue was up 4.6%. Revenue from the personal income tax was down 2.7%.

Year-to-date GRF disbursements, including transfers out, of $5,121.2 million were $189.7 million (3.8%) above estimate. Year-to-date disbursements from the GRF were $204.7 million (4.2%) higher than a year earlier. Further details are shown in the accompanying table entitled "General Revenue Fund Uses."

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Budget Footnotes examines the fiscal position of the state General Revenue Fund on a periodic basis.

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Agency variances, in general, are shifted toward spending less than the estimates because of payroll not yet posted.

The discussion above and the information in the accompanying tables are based on OBM's *Monthly Financial Report* dated September 10.

General Revenue Fund Sources
Preliminary Actual vs. Estimate
FY 2008 as of August 31, 2007
($ in thousands)

	Actual	Estimate*	Variance	Percent	FY 2007	Percent Change
TAX REVENUE						
Auto Sales	$175,985	$183,700	-$7,715	-4.2%	$176,897	-0.5%
Nonauto Sales & Use	$1,152,128	$1,126,100	$26,028	2.3%	$1,105,320	4.2%
Total Sales & Use Taxes	$1,328,113	$1,309,800	$18,313	1.4%	$1,282,217	3.6%
Personal Income	$1,187,227	$1,198,600	-$11,373	-0.9%	$1,220,744	-2.7%
Corporate Franchise	-$6,648	$4,500	-$11,148	-247.7%	$39,231	-116.9%
Public Utility	$41,642	$44,900	-$3,258	-7.3%	$45,035	-7.5%
Kilowatt Hour Excise	$61,444	$60,700	$744	1.2%	$59,151	3.9%
Commercial Activity Tax**	$0	$0	$0	---	$0	---
Foreign Insurance	$16	$0	$16	---	$48	-66.7%
Domestic Insurance	$41	$600	-$559	-93.2%	$233	-82.4%
Business & Property	$281	$490	-$209	-42.7%	$192	46.4%
Cigarette	$113,130	$101,900	$11,230	11.0%	$108,161	4.6%
Alcoholic Beverage	$10,587	$10,600	-$13	-0.1%	$11,000	-3.8%
Liquor Gallonage	$5,939	$5,900	$39	0.7%	$5,772	2.9%
Estate	$160	$300	-$140	-46.7%	$4,631	-96.5%
Total Tax Revenue	**$2,741,932**	**$2,738,290**	**$3,642**	**0.1%**	**$2,776,415**	**-1.2%**
NONTAX STATE-SOURCE REVENUE						
Earnings on Investments	$45	$0	$45	---	$0	---
Licenses and Fees	$13,169	$11,450	$1,719	15.0%	$12,071	9.1%
Other Revenue	$7,891	$10,404	-$2,513	-24.2%	$13,374	-41.0%
Nontax State-Source Revenue	**$21,105**	**$21,854**	**-$749**	**-3.4%**	**$25,445**	**-17.1%**
TRANSFERS						
Liquor Transfers	$39,000	$37,000	$2,000	5.4%	$23,000	69.6%
Budget Stabilization	$0	$0	$0	---	$0	---
Other Transfers In	$15,386	$9,900	$5,486	55.4%	$7,768	98.1%
Total Transfers In	**$54,386**	**$46,900**	**$7,486**	**16.0%**	**$30,768**	**76.8%**
TOTAL GRF before Federal Grants	**$2,817,423**	**$2,807,044**	**$10,379**	**0.4%**	**$2,832,628**	**-0.5%**
Federal Grants	$1,075,742	$1,091,040	-$15,298	-1.4%	$934,347	15.1%
TOTAL GRF SOURCES	**$3,893,165**	**$3,898,084**	**-$4,919**	**-0.1%**	**$3,766,975**	**3.3%**

* August 2007 estimates of the Office of Budget and Management.

** Existing law requires all CAT revenue during FY 2007-FY 2011 to go to school districts and local governments.

Detail may not sum to total due to rounding.

General Revenue Fund Uses
Preliminary Actual vs. Estimate
FY 2008 as of August 31, 2007
($ in thousands)

PROGRAM	**Actual**	**Estimate***	**Variance**	**Percent**	**FY 2007**	**Percent Change**
Primary and Secondary Education (1)	$1,437,451	$1,183,782	$253,669	21.4%	$1,190,073	20.8%
Higher Education	$423,590	$430,199	-$6,609	-1.5%	$382,538	10.7%
Total Education	$1,861,041	$1,613,981	$247,060	15.3%	$1,572,611	18.3%
Public Assistance and Medicaid	$1,940,295	$2,018,436	-$78,141	-3.9%	$1,829,857	6.0%
Health and Human Services	$188,532	$268,817	-$80,285	-29.9%	$261,099	-27.8%
Total Welfare and Human Services	$2,128,827	$2,287,253	-$158,426	-6.9%	$2,090,956	1.8%
Justice and Public Protection	$176,349	$419,985	-$243,635	-58.0%	$391,903	-55.0%
Environment and Natural Resources	$6,945	$22,898	-$15,953	-69.7%	$21,090	-67.1%
Transportation	$2,941	$2,841	$100	3.5%	$3,315	-11.3%
General Government	$28,379	$61,552	-$33,172	-53.9%	$47,139	-39.8%
Community and Economic Development	$8,625	$12,822	-$4,197	-32.7%	$23,818	-63.8%
Capital	$0	$171	-$171	-100.0%	$46	-100.0%
Total Government Operations	$223,239	$520,269	-$297,030	-57.1%	$487,311	-54.2%
Tax Relief and Other	$92,460	$88,995	$3,465	3.9%	$148,504	-37.7%
Debt Service	$141,987	$141,987	$0	0.0%	$140,096	1.4%
Total Other Disbursements	$234,447	$230,982	$3,465	1.5%	$288,600	-18.8%
Pending Payroll	$385,800	$0	$385,800	---	$0	---
Total Program Disbursements	**$4,833,354**	**$4,652,484**	**$180,870**	**3.9%**	**$4,439,478**	**8.9%**
TRANSFERS						
Budget Stabilization	$0	$0	$0	---	$394,034	-100.0%
Other Transfers Out	$287,883	$279,078	$8,805	3.2%	$82,981	246.9%
Total Transfers Out	$287,883	$279,078	$8,805	3.2%	$477,015	-39.6%
TOTAL GRF USES	**$5,121,237**	**$4,931,562**	**$189,674**	**3.8%**	**$4,916,493**	**4.2%**

(1) Includes Primary, Secondary, and Other Education.

* August 2007 estimates of the Office of Budget and Management.

Detail may not sum to total due to rounding.

Tracking the Economy

— Ross Miller

The preliminary estimate of U.S. real[1] gross domestic product (GDP) growth in the second quarter was 4.0%, much stronger than growth in the first quarter. July data on U.S. manufacturing shipments and new orders showed solid growth, and the Federal Reserve reports that the near-term outlook for manufacturing in the Cleveland District[2] is generally stable. Inflation continues to be under control. Ohio's unemployment rate has started back down.

Despite some positive news, risks to economic growth have grown more worrisome in the two months since the last edition of *Budget Footnotes*, especially in the construction industry, in financial markets, and for many homeowners that hold adjustable rate mortgages (ARMs). The Federal Open Market Committee (FOMC) of the Federal Reserve has changed its view markedly in the last month or so. The press statement released after its August 7 meeting indicated that FOMC members still considered inflation to be the "predominant policy concern" regarding the economy. By August 17 financial markets had experienced such turmoil that the Federal Reserve Board approved a 50 basis point reduction in the discount rate, the rate the Federal Reserve charges banks that borrow from it, and encouraged borrowing at the discount window, in order to ensure that markets had sufficient liquidity. That decision was made between meetings of the FOMC. Then at its regularly scheduled September 18 meeting, the FOMC voted to reduce the discount rate by an additional 50 basis points, and to reduce its target for the federal funds rate, the interest rate banks charge each other on short-term loans, by 50 basis points from 5.25% to 4.75%. The press release issued after the meeting stated that "[t]oday's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." The committee was careful to point out that members believed that some risk of inflation remains, but clearly the emphasis has shifted toward preventing a sharper slowdown in economic growth.

Despite the pickup in growth during the second quarter, economic forecasters generally seem to agree with FOMC members that growth is threatened. Global Insight, for one, has lowered its forecast of growth in the second half of 2007 and into next year, trimming a half percentage point off its projection of 2008 economic growth between its August and September forecasts. Why have views changed so significantly so quickly? In August lenders and other investors became sharply more worried about being repaid and/or earning returns on investments. This was a response to rising default rates on mortgages and the consequent deterioration in the returns investors were receiving from mortgage-backed securities—i.e., bonds backed by mortgage payments. Global Insight reports that about $1.2 trillion worth of mortgage debt has been securitized and sold to investors, but that no one has a complete picture of who is holding those bonds now. Turmoil in financial markets this month increased significantly after certain European banks announced that they had suffered losses related to U.S. mortgage-backed securities.

The level of uncertainty in financial markets is still high, but the markets appeared to view the Federal Reserve's actions of September 18 very positively. The Dow Jones Industrial Average rose nearly 336 points, or 2.5%, the day the cut in the federal funds rate target was announced. The underlying risks to the economy remain, however, and it is too early to tell whether the Federal Reserve's actions will be sufficient to sustain economic growth.

Production and Income

Real U.S. GDP grew by (an annualized) 4.0% in the second quarter of 2007.[3] Consumer spending contributed to the growth in output, though modestly (just 1.03 percentage points of growth compared to 2.56 percentage points in the first quarter), and contributions to growth came from all the other major spending categories: gross private domestic investment (0.72 percentage points), net exports of goods and services (1.42 percentage points), and government consumption expenditures and gross investment (0.79 percentage points). The only significant drag on growth came from fixed residential investment, a subcomponent of gross private domestic investment, which subtracted 0.61 percentage points of growth. This "preliminary estimate" of growth is subject to one more revision.

Growth in the second quarter was significantly faster than growth experienced during the first quarter (0.6%).[4] The positive contribution from investment was particularly welcome, as this component had subtracted from growth during each of the three preceding quarters. This contribution was due to stronger growth in nonresidential fixed investment and to a turnaround in the effect of changes in inventories (which subtracted strongly from growth in the first quarter and the fourth quarter of 2006). Similarly, net exports had subtracted from growth in two of the preceding three quarters.

Economists at Global Insight expect growth to slow but remain above 2.0% in the third quarter[5] before falling below 2.0% (but remaining above 1.0%) in each of the following three quarters. They have reduced their forecast of growth in 2008 by a half percentage point (to 2.0%) in the last month. In large part, the expected reduction in growth is due to a continuation of the second quarter's weakness in consumer spending, due to problems in the housing market and little relief from high energy prices. They do not expect a recession during the coming quarters, despite revising downward their growth estimate for that period, due in part to continued strength in net exports.[6]

The U.S. Bureau of Economic Analysis (BEA) released its annual revision to U.S. GDP figures in July. Each year, BEA revises GDP figures for the preceding three years in light of information that became available subsequent to the previous year's revision. The revision this year affected GDP figures from the beginning of 2004 through the first quarter of 2007. Although the growth rate for real GDP was revised upward for a couple of quarters, revision downward was more common. The overall effect was to reduce estimates of real GDP growth by 0.3 percentage points per year for the 2003 through 2006 period.[7]

Similarly, the minutes of the August 7 meeting of the Federal Open Market Committee indicate that the staff of the Federal Reserve Board had lowered "somewhat" their projections for economic growth during the second half of 2007 (and during 2008). Developments in financial markets since that meeting caused concern at the Federal Reserve to increase significantly, as evidenced by its interest rate reductions, suggesting that the growth rates Federal Reserve staff are projecting are more likely to have fallen further since that date than to have increased.

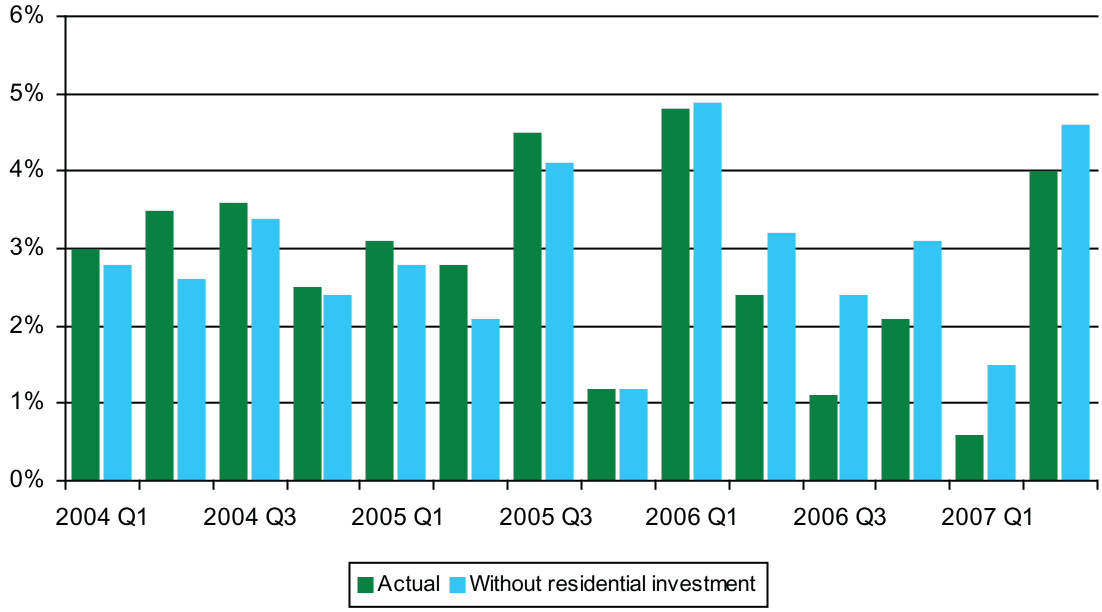
Chart 1 shows real GDP growth in recent quarters and the change in the role residential construction has played (from aiding growth in 2005 to restricting it starting in mid-2006).

Personal income increased by 0.5% in July, at a seasonally adjusted annual rate, and by 0.4% in June. Personal income increased by 3.9% during 2007 through July. Disposable personal income (DPI—personal income minus personal current taxes) increased by 0.6% in July, though after adjusting for inflation it rose by 0.5%. For the year to date, DPI has increased by 3.7%, and real DPI is up 1.6%.

Employment, Unemployment, and Productivity

U.S. nonfarm payroll employment decreased by 4,000 in August, after seasonal adjustment, which brought total U.S. employment to 138.0 million. This was the first drop in national employment since mid-2003. Employment growth had weakened prior to that, with July employment growing by a downwardly revised 68,000 and June by a downwardly revised 69,000. By comparison, employment had grown by an average of 134,000 per month during the first half of the year.

Chart 1
Growth Rate in Real GDP
Actual vs Without Residential Investment



The U.S. Bureau of Labor Statistics (BLS) described the overall 4,000 drop as "essentially unchanged." However, several industries sustained more significant employment decreases: manufacturing lost 46,000 jobs, construction lost 22,000, and local government education lost 32,000. The loss for local government education may be due to changes in the start of the school year that were not accounted for in the seasonal adjustment. Employment grew in health care (by 35,000), in social assistance (14,000), and in food services and drinking places (24,000).

The U.S. unemployment rate remained unchanged, at 4.6% (after seasonal adjustment). There has been little variation in this figure recently—August 2006 was the last month the unemployment rate was outside the range 4.4% to 4.6%. In addition to the number of unemployed, BLS tracks the number of discouraged workers each month—those who are classified as out of the labor force, rather than unemployed, because they did not look for a job during the four weeks preceding the survey specifically because they did not believe that they would find one. There were 392,000 discouraged workers in August nationwide, in addition to the 7.1 million unemployed workers. The number of discouraged workers decreased somewhat over the last year (from 448,000 the preceding August), while the number of unemployed workers was essentially unchanged.

Ohio nonfarm payroll employment fell by 8,400 in July, but then increased by 2,400 in August. The net change of 6,000 (0.1%) over the two months reduced employment to just under 5.44 million. Employment decreased by 1,800 in goods-producing industries in August, but increased by 4,200 in service-providing industries. Ohio's (seasonally adjusted) unemployment rate fell in July from 6.1% to 5.8% and fell again in August to 5.7%. The number of unemployed Ohioans dropped from 363,000 in June to 337,000 in August.

BLS unveiled state-level estimates of a relatively new set of labor market data in July. The payroll employment figures discussed above are informative, but because they are net figures they are the result of the combined effect of job losses and new jobs. More detail is obtainable from data compiled in administering the unemployment insurance program. BLS has begun to analyze gross changes in the number of jobs using these data and has labeled the result "business employment dynamics" data. These data also have limitations—they are available on a quarterly basis, not monthly, and they are available only for the full private sector, not at the industry level. They allow us to glean, however, the relative importance of job losses and creation of new jobs in the overall change in employment.

The data are currently available through the fourth quarter of 2006. The payroll employment (net) data indicate that Ohio employment grew by around 10,000 from December 2005 to December 2006. The gross job loss data show somewhat fewer job losses in each quarter of 2006 than in the fourth quarter of 2005. The gross job gain data show a significant slowdown in the creation of new jobs in 2006. In the second quarter of 2005, there were 294,309 new jobs created in Ohio (after seasonal adjustment). The number of new jobs dropped steadily to 275,509 in the first quarter of 2006, edged up to 279,118 in the second quarter, and then dropped to 263,540 in the third—over 25,000 fewer new jobs than were created in the third quarter of 2005. The number of new jobs created in the fourth quarter increased but was still fewer than gross job losses.

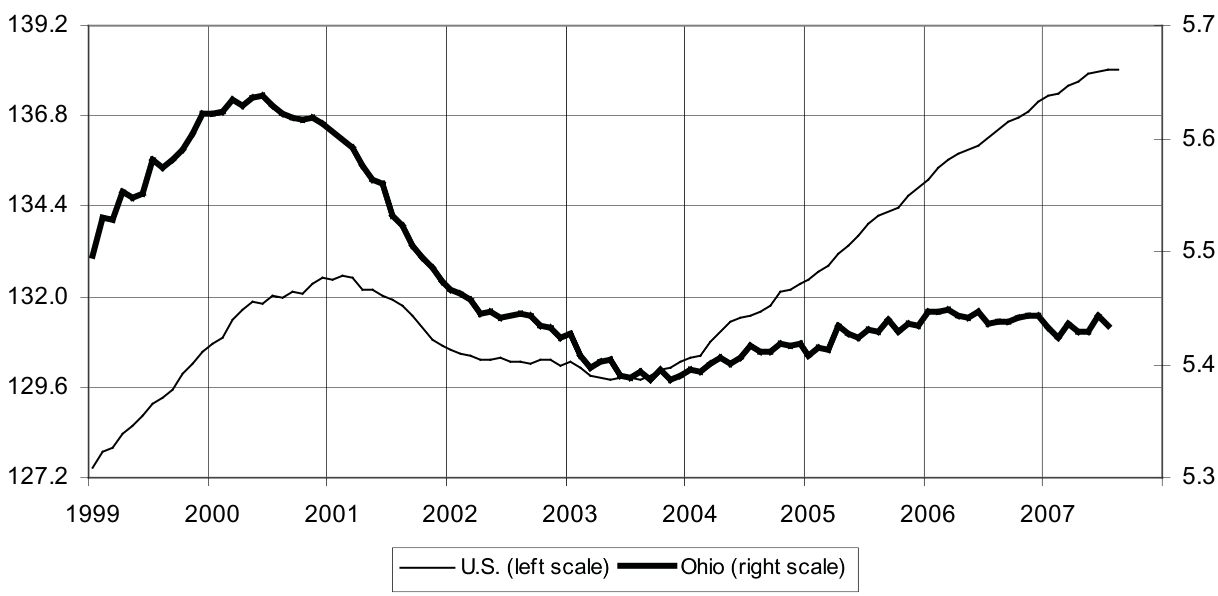
Manufacturing

July was a good month for manufacturing, according to U.S. Census Bureau data. Shipments of manufactured goods rose by 2.6% to $425.9 billion, the highest level reached since 1992. This was the fourth increase in the last five months. Shipments of durable goods increased by 3.9% and also achieved the highest level since 1992.[8] The biggest contributor to growth was transportation equipment, shipments of which increased by 9.4%. Defense spending contributed to the positive numbers for the month, but modestly; shipments excluding defense increased by 2.5% for the month.

Looking forward, the picture remained positive. New orders for manufactured goods rose by 3.7% in July, the fifth increase in the last six months. New orders for durable goods were up even more strongly, by 6.0% (also the fifth increase in six months). Transportation equipment was a major driver here too, with orders up by 11.0% (following a 9.1% increase in June).

The Federal Reserve's "Beige Book," published September 5, indicated that conditions in the Cleveland Federal Reserve district manufacturing sector were generally positive. Specifically, it stated, "Most district manufacturers reported that production has been stable to increasing since mid-July. Further, a majority said they had increased their output on a year-over-year basis. Looking forward, almost all of our contacts anticipate production remaining at current levels or increasing slightly."

Chart 2: Total Nonfarm Payroll Employment
(in millions, seasonally adjusted)



Housing Markets and Construction

The biggest news in the housing and construction sector has been a steady increase in home foreclosures. RealtyTrac, a private company that tracks foreclosure filing data nationally, reports that the number of foreclosures in August was 36% higher than in July and had more than doubled compared with August 2006. The national foreclosure rate reached one for every 510 households. Ohio had the fifth highest foreclosure rate, behind Nevada, California, Florida, and Georgia.

The number of foreclosures is widely expected to continue rising over the next several months as the number of adjustable rate mortgages (ARMs) on which the interest rate is scheduled to reset is increasing. In the current market environment, as these adjustable rates are reset they will increase, meaning homeowners with ARMs will face higher mortgage payments. To the extent that homeowners are not able to afford these higher payments, foreclosures are likely to result. The increase in mortgage defaults appears to be the biggest single cause of financial market turmoil this summer. Federal Reserve action on September 18 was a response to an increase in such turmoil associated with the discovery that some European banks were exposed to problems with the U.S. subprime mortgage market.

Sales of new homes rose a seasonally adjusted 2.8% in July nationally, surprising many analysts. Prices also rose nationally, with the median price increasing from $237,900 to $239,500. Despite the increase in sales since June, though, the market remains weak: sales in July were 10.2% lower than in the preceding July. Weakness in the Midwest was unambiguous, with sales falling by 0.9% since June, to a level 18.2% below the previous year.

Forward-looking statistics provided little ground for optimism regarding the near future. Nationally, housing starts in August were 2.6% below July's level and 19.1% below the preceding August's, with building permits down even more sharply. Midwest housing starts rose by 4.2% in August but remained 0.8% below the figure of a year ago. Midwest building permits were down 9.5% in August compared with July and down 27.6% since the preceding August.

The "Beige Book" indicates that most industry contacts in the Cleveland District "reiterated that inventories are approaching acceptable levels." These contacts are reportedly uncertain about when residential construction might begin to recover in the district though.

Retail Sales

U.S. retail and food services sales in August were 0.3% higher than in July, after adjustment for seasonal variation and holiday and trading day differences, and were 3.7% higher than they had been the previous August. Increases for the year were fairly broad based. Several retail categories (e.g., sporting goods, hobby, book, and music stores, clothing and clothing accessories stores, and nonstore retailers) experienced growth over 6% for the year, while only two experienced reduced sales (building material and garden equipment and supplies dealers and gasoline stations; the latter is due at least in part to lower prices for gasoline compared with the preceding August).

The "Beige Book" depicted retail activity in the Cleveland District as mixed. It indicated that general merchandise sales since July had been steady (or increasing slightly), while apparel retailers had experienced declining sales and sales at automobile dealers had been slow. It also noted that, while new car sales were down, used car sales were higher.

Inflation and Prices

The consumer price index for all urban consumers (CPI-U) decreased by 0.1% in August after seasonal adjustment but increased by 2.0% over the year ending in August. Energy prices were the primary reason for the decrease in August, having fallen by 3.2% for the month. The index excluding food and energy, often referred to as measuring core inflation, rose by 0.2% for the month and increased by 2.1% since the preceding August.

The producer price index for finished goods decreased by 1.4% in August (seasonally adjusted). As with the CPI-U, energy prices played a major role, having dropped by 6.6% for the month. Excluding food and energy the index increased by 0.2% in August. For the year, the index increased by 2.2%.

Ohio experienced a jump in gasoline prices during the week of September 3 that was not matched by national data. While the average price of gasoline (all grades) jumped by nearly 20 cents per gallon in Ohio that week, it jumped by less than a nickel per gallon nationwide. By the week of September 17, though, prices in Ohio had fallen back below the level they had been at prior to the jump. An official with the U.S. Energy Information Administration reports that the temporary jump in prices was due to refinery outages, both planned and unplanned, at refineries serving the Midwest.

Poverty Rate

Once a year, the U.S. Census Bureau compiles a report on poverty rates in the U.S., in states, and in local areas of the country. The poverty rate is the percentage of individuals who live in a family with a household income below a threshold level that varies by size and composition of the family. For example, in 2006 a family of four, two of whom were dependent children, was counted as poor if household income was below $20,444; similarly, a single mother with two children was considered poor if her income was below $16,242.

There was good news in the report on the national level—the poverty rate fell from 12.6% in 2005 to 12.3% in 2006.[9] For Ohio the report was less favorable. The poverty rate, already above the national rate at 13.0% in 2005, rose to 13.3% in 2006. Cleveland, which had the highest poverty rate of any U.S. city in 2005, fell to the fourth highest rate in 2006, behind Detroit, Buffalo, and Cincinnati. The poverty rate in Cincinnati was 27.8% and the rate in Cleveland was 27%. The poverty rate exceeded 25% in six of Ohio's ten largest cities.

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[1] Economists use the term "real" to indicate that a number, in this case gross domestic product, has been adjusted for inflation.

[2] The Cleveland district includes all of Ohio, plus parts of Pennsylvania, West Virginia, and Kentucky.

[3] This "preliminary estimate," released on August 30, was revised upward from an initial estimate of 3.4% growth.

[4] The July edition of *Budget Footnotes* reported a final estimate of first quarter real GDP growth of 0.7%. The change is due to the annual revision of GDP figures conducted by the U.S. Bureau of Economic Analysis each July. The annual revision is discussed further below.

[5] These projections are taken from the September issue of the Global Insight publication *U.S. Executive Summary*.

[6] One of the primary reasons exports are expected to remain strong is the recent depreciation of the U.S. dollar.

[7] Real GDP growth for 2004 was revised from 3.9% to 3.6%, while growth for 2005 was revised from 3.2% to 3.1% and growth for 2006 was revised from 3.3% to 2.9%.

[8] As pointed out in the news release, 1992 was the first year that data were reported on the basis of NAICS classifications. Prior to that they had been reported on the basis of SIC classifications.

[9] The poverty rate fell from 12.7% in 2004 to 12.6% in 2005, but that drop was not statistically significant. In contrast, the drop from 2005 to 2006 is statistically significant.