OBM

AM. SUB. H.B. 66
CONFERENCE COMMITTEE TESTIMONY
FISCAL YEAR 2006 AND 2007 OPERATING BUDGET

THOMAS W. JOHNSON, DIRECTOR
JUNE 9, 2005

Mr. Chairman, members of the Committee, thank you for the opportunity to testify on the FYs 2006 and 2007 biennial operating budget and present the Office of Budget and Management's revised revenue and caseload estimates for the upcoming biennium. Lieutenant Governor Bruce Johnson will also testify today on tax reform issues.

Before beginning, on behalf of Governor Taft, I would like to commend the work of the General Assembly to-date, specifically for adopting the major provisions of the Governor's tax reform proposal and for controlling overall spending growth. We look forward to working with the General Assembly in the days ahead.

Throughout my testimony, the current revenue and Medicaid spending estimates will be compared to the current version of House Bill 66, which used LSC estimates, to clearly outline available resources. As a preview of my testimony today, the chart on the next page highlights revenue and Medicaid spending estimates for the current fiscal year and the next biennium. The chart shows, that when considered together, additional resources are available to the Conference Committee of approximately $480 million in FY 2006 and $330 million in FY 2007.

	Senate HB 66 Estimate	OBM Revised Estimate	Dollar Difference	Percentage Difference
FY 2006 State-Only Revenues	$19,741.5	$20,192.2	$450.7	2.28%
FY 2007 State-Only Revenues	$19,874.3	$20,311.7	$437.4	2.20%
FY 2006 State Share Medicaid Spending/525	$3,777.4	$3,751.8	$25.6	-0.68%
FY 2007 State Share Medicaid Spending/525	$3,795.9	$3,903.2	($107.3)	2.83%

ECONOMIC FORECAST AND REVENUE ESTIMATES

The current national economic expansion is now in its fourth year. The forecast over the next two years is for continued growth, but at a gradual rate.

The recent performance of a number of indicators creates some cause for concern. Employment growth this May was the weakest since the summer of 2003. Purchasing managers have reported weaker conditions in the manufacturing sector almost every month during the past year. Industrial production declined in May and orders for factory goods have weakened. Construction activity is still going strong, but it is questionable how long that can last, with the Federal Reserve raising interest rates. These measures temper some of the enthusiasm economists had been feeling.

Given these concerns, the forecast is a little slower than the recent experience, but still plans for real economic growth near the long-run trend rate of 3.25 percent to 3.50 percent. Generally, forecasters expect inflation to be a bit higher than it has been recently, but to remain relatively low by historical standards. Employment is seen as rising at the recent pace of approximately 175,000 per month nationally and the unemployment rate is expected to remain flat. Finally, while the direction of long-term interest rates is historically difficult to predict, the Federal Reserve has repeatedly stated its intention to lift short-term rates.

Even though the forecast calls for largely uninterrupted growth, the elevated price of energy, international political tensions, the widening U.S. trade deficit, and the federal budget deficit create the potential for negative adjustments.

Against this backdrop, the forecast assumes that growth in Ohio's personal income will slow from an estimated 5.0 percent in FY 2005 to 4.7 percent in FY 2006 and to 4.5 percent in FY 2007. Growth in corporate profits is projected to slow from 13.3 percent in FY 2005 to 13.0 percent in FY 2006 and to 5.9 percent in FY 2007.

The administration believes that this generally positive economic scenario is reasonable. Lower tax rates at the federal level and, as OBM expects, a much improved tax climate in Ohio are supportive of economic growth. Businesses and consumers have adjusted to higher energy prices and rising financing costs. The Federal Reserve has secured a low-inflation environment, which is conducive to a smoothly operating economy, and the decline in the dollar has helped Ohio businesses compete in overseas markets. The uncertain nature of projections and the series of false starts to the current economic expansion, which was experienced in the Midwest, have been considered.

OBM, in consultation with the Department of Taxation, translates this economic forecast into revenue estimates, which are being presented here today. There is good reason to expect continued favorable conditions for the next two years, particularly given the strength with which some of our key revenues are ending in FY 2005.

Fiscal Year 2005 Tax Results Improve

FY 2005 tax receipts appear to be stronger than previously expected. Based on the results of the tax filing season, both the personal income and the corporate franchise taxes have turned out much better than expected, however the sales tax results have weakened in recent months.

Personal income tax receipts estimates for FY 2005 have been revised upwards by $481 million in comparison to the Senate version of House Bill 66. Receipts from withholding continue to be on-estimate, but receipts from the more unpredictable, non-withholding sources have increased above estimate. Other payments include quarterly estimated payments and payments made with annual returns. State refunds are subtracted from these payment sources. However, refunds are also less than estimated in this turnaround year. These other payments depend on mostly non-wage sources of income including capital gains, interest, dividends, and rental income, and are much more volatile than wage income.

The corporate franchise tax has fared better than expected this year and is an estimated $165.8 million above estimates used in the Senate version of House Bill 66. U.S. corporate profits were strong in 2004 and are reflected by the strong pick-up in the Ohio tax.

The estimate for the non-auto sales tax has not changed, but the auto sales tax estimate has been reduced by $39.5 million. Auto sales have slowed and automakers have pulled back on incentives. GM's new promotional pricing might mostly affect July receipts, since tax flows take a few weeks to reach the state and other manufacturers have not yet countered GM's move.

The estimates for the other revenue sources have also been adjusted to reflect results through May and to reflect any available information regarding June receipts.

Based on these revised revenue estimates and on OBM's current expectation of state spending, after accounting for the customary reservation of one-half of one percent of fiscal year revenues, OBM estimates an unobligated, FY 2005 ending GRF balance of approximately $500 million.

Revised Fiscal Year 2006 and 2007 Revenue Estimates

In May 2005, OBM convened a meeting of the Governor's Council of Economic Advisors to discuss the current state of the economy and formulate the traditional Conference Committee consensus forecast for the upcoming biennial budget.

As a result of this meeting and FY 2005 performance, OBM has increased estimates of total revenue sources, excluding federal transfers, by $451 million for FY 2006 and by $437 million for FY 2007. These higher estimates result largely from increases in the personal income and corporate franchise tax receipts during FY 2005. The tax reform estimates have been adjusted to reflect these changes. Additionally, the increased revenue base will also increase the amount of savings through the local government fund freeze and cut, as proposed in the Senate version of the budget.

Auto Sales

After several years of high sales, the auto sales tax has not performed as well in FY 2005, as sales incentives were reduced. Current FY 2005 projections leave this tax source $39.5 million under estimate. Part of the lower than expected revenues can be explained by the switch, from buying to leasing, in consumer purchasing of new autos, which shifts sales tax revenue from the auto sales tax to the non-auto sales tax. Recent BMV data shows a 15 percent increase in leasing between 2004 models and 2005 models. OBM's revised auto sales tax estimates reflect a continuation of leasing at rates slightly higher than historical trends. Also reflected in the estimates is the low growth expected in U.S. light vehicle unit sales. U.S. light vehicle sales drive the models used in these projections. The estimated revenue from the auto sales tax is below the Senate Budget estimates by $78 million in FY 2006 and $66 million in FY 2007.

Non-Auto Sales

The non-auto sales tax is tied to a consumer's ability and willingness to spend. In FY 2005 an Ohio consumer had a greater ability to spend due to 4.2 percent growth in Ohio wage and salary income, but lower growth in sales tax receipts raises questions about the consumer's willingness to spend. The sales tax is projected to grow 5.3 percent in FY 2005. However, law changes that effect the sales tax rate and base gradually took effect in FY 2004 inflating year-over-year growth. The months of February through May are the only months where growth primarily reflects economic factors not law changes, and non-auto sales tax revenues grew only 0.7 percent.

Non-auto sales tax revenue is based on Ohio wage and salary income and a variable for household financial wealth (i.e. the S&P 500 index). The Governor's Council of Economic Advisors' May forecast of Ohio wage and salary growth slightly decreased growth rates in both FY 2006 and FY 2007 relative to the November forecast. This trend coupled with the recent weak performance of the non-auto sales tax caused OBM to reduce estimated revenue from non-auto sales by $61 million in FY 2006 and $2 million in FY 2007 compared to estimates used in House Bill 66, as passed by the Senate.

Personal Income

The withholding revenues in personal income tax are determined mainly by wage and salary income. The other components of the tax depend on the less predictable non-wage components of personal income. In OBM's estimate, non-wage income, capital gains, and stock market performance are used to adjust for the uncertainty. Although Ohio has seen a significant growth rate in these non-wage components in FY 2005, OBM does not expect the same level of growth to be carried forward into the next biennium. This was a turnaround year, as losses changed to gains. The stock market is down slightly for the year, meaning capital gains will likely fall compared to last year. While corporate profits are estimated to rise for the year, these profits are notoriously difficult to predict. Additionally, small business profits -- which are more important to the personal income tax -- may follow a different path in Ohio from the national corporate profits. On the other hand, the Governor's Council of Economic Advisors reduced the forecast of the growth rate of Ohio wage and salary for FY 2006 and FY 2007.

Based on this economic analysis, the current estimate of personal income tax receipts is based on higher FY 2005 revenue. Compared to the estimate presented in the House Bill 66, as passed by the Senate, the personal income tax receipts projection is revised upward by $455 million in FY 2006 and by $358 million in FY 2007.

Corporate Franchise

Through May, FY 2005 receipts were over estimate by $130.9 million, or 15.5 percent. With one month left in the fiscal year, the corporate franchise tax is expected to end the year showing strong growth over FY 2004. This is largely due to the improving corporate performance in 2004.

Although the Governor's Council of Economic Advisors raised the forecast of U.S. corporate profit growth for CY 2005 and CY 2006, OBM recognizes that corporate profits are difficult to predict and the economy in the Midwest is performing less robustly than the national economy. Based on higher FY 2005 revenue, the Ohio tax growth rates in FY 2006 and FY 2007 are decreased from the U.S. profit growth rates. In FY 2007, lower loss carry-forwards estimates boost tax growth.

As a result, the corporate franchise tax receipts estimates are revised upward in both FY 2006 and FY 2007 by $154 million and $171 million, respectively.

Other Taxes

There were no major changes made to the revenue projections of the state's other tax sources, although in many cases, there were minor adjustments made to reflect additional information that OBM has received since introducing the Executive Budget in January.

The following table reflects the variance between House Bill 66, as passed by the Senate, using LSC's January revenue estimates, and the bill, as passed by the Senate, using OBM's new revenue estimates. These figures incorporate both baseline and tax reform revisions.

GENERAL REVENUE FUND ESTIMATES

Projected Revisions ($ in millions)

Revised OBM Estimates vs. HB 66, Passed by Senate	FY 2006		FY 2007	
Revenue Source	**Variance**	**% Change**	**Variance**	**% Change**
Auto Sales & Use	(77.5)	-7.4%	(66.0)	-6.3%
Non-Auto Sales & Use	(60.8)	-0.9%	(1.8)	0.0%
Personal Income	454.8	5.5%	358.4	4.2%
Corporate Franchise	153.7	19.5%	171.2	26.0%
Public Utility	(4.6)	-3.0%	(2.9)	-1.9%
Kilowatt-Hour Tax	(15.4)	-3.1%	(17.9)	-3.5%
Foreign Insurance	11.2	4.8%	6.8	2.8%
Domestic Insurance	3.3	2.0%	0.5	0.3%
Business & Property	(3.7)	-12.3%	(3.4)	-11.2%
Cigarette	(3.0)	-0.3%	(7.3)	-0.8%
Alcoholic Beverage	0.0	0.0%	0.2	0.3%
Liquor Gallonage	0.5	1.6%	0.7	2.1%
Estate	6.3	11.3%	5.3	10.0%
Total Tax Sources	**464.8**	**2.4%**	**443.8**	**2.3%**
Non-tax Receipts	14.4	-2.4%	(6.5)	-1.2%
Total Sources (excluding Federal Grants)	**450.7**	**2.3%**	**437.3**	**2.2%**

REVISED MEDICAID ESTIMATES

The administration has also re-projected Medicaid caseloads, which are a main driver of the costs in the Medicaid program. The administration's new caseload estimates show continued growth in the number of people being served by Medicaid, but at a slower rate than previously projected. The new caseload estimates show overall growth of 2.5 percent in FY 2006 and 1.8 percent in FY 2007.

As you know, the Medicaid program is jointly funded by the state and the federal government. For most Medicaid expenses, the Federal Medical Assistance Percentage, or FMAP, is used to calculate the federal government's share of expenses. The federal government adjusts each state's FMAP each federal fiscal year based on a calculation driven by the state's per capita income relative to the national per capita income. In federal FY 2005, Ohio's FMAP rate is 59.7 percent and in federal FY 2006 Ohio's FMAP rate will increase to 59.9 percent. However, current projections indicate that in federal FY 2007, Ohio's FMAP rate will decrease to 59.2 percent. While the overall spending stays the same, the state share increases while the federal share decreases. The increase in the state's share of expenses will be $54.8 million in state FY 2007. The Taft Administration believes it is prudent to budget for the potential decrease in the FMAP rate.

The caseload re-projection has been used to recalculate costs. These updated costs combined with increased funding for the FMAP and policy changes will impact the required funding levels. Based on the Senate As Passed version of the bill, these changes free up $25.6 million state share funding in FY 2006 and will require an additional $107.3 million state share funding in FY 2007.

PERSPECTIVES ON HOUSE BILL 66

From the analysis completed to-date, the Governor's Office and OBM are very grateful for the support the General Assembly has given to the Executive Budget and are pleased to say House Bill 66 continues a majority of the Governor's vision for Ohio. We are specifically pleased that the General Assembly has retained the major provisions of the Governor's tax reform proposal. I would like to offer the Taft Administration's perspective on several priority areas.

Spending Restraint and Structural Balance

The Governor's Executive Budget proposed the lowest GRF spending growth Ohio has seen in 40 years, and we are thankful for the General Assembly's actions to continue this spending restraint. Such restraint is one of the key concepts for ensuring structural balance, as championed by the Governor. The other key concepts for structural balance are:

- A balance between on-going revenue and on-going expenditures;
- Limited use of one-time revenue; and
- A provision for a deposit into the Budget Stabilization Fund (BSF).

Disposition of Newly Projected Revenue

As this Committee considers the new revenue estimates provided today, the administration is conceptually supportive of the Senate amendment where priority has been given to the BSF and to the Ohio School Facilities Commission (OSFC) for FY 2005 excess revenue. Support for OSFC will ease the financial pressure on future capital appropriation bills, while deposits to the BSF better position the state for future, potential economic downturns.

Meanwhile, for FYs 2006 and 2007, the Governor encourages the Committee to build on the work already completed in the Senate and House to prioritize assistance for local governments. Specifically, the Governor recommends using a portion of the available revenue to return local governments to the same level of funding they received in FY 2005. In addition, the administration encourages the Committee to use a portion of the revenue to continue transferring dollars to the BSF and to continue funding the Governor's ReBuild Ohio School Facilities Plan.

Tax Reform

The General Assembly's support for Governor Taft's tax reform package is appreciated, because this proposal is vital for Ohio's economic prosperity. The Lieutenant Governor will provide additional testimony on this priority issue.

Medicaid Provisions

The Executive Budget called for a decrease of 3 percent in FY 2006, followed by flat funding in FY 2007, in the nursing facility reimbursement rate. Both chambers of the General Assembly used franchise fees to maintain nursing facility funding at FY 2005 levels. The administration feels the General Assembly should return to the Executive Budget funding levels for nursing facilities to maintain provider funding parity and to accurately reflect Ohio's long-term care priorities.

In addition, while the Administration has long advocated for removing the nursing facility reimbursement rate formula from statute, if the formula is to remain in statute, the preference is for the price-based model used by the Senate.

Further, both chambers built upon the Governor's executive proposal to increase managed care. The administration feels that each chamber's proposal has merit and we are prepared to work with you to contain costs, while providing quality care.

Regarding ICF/MR waivers, the Governor appreciates the provisions of the current bill that provide individuals with choices for long-term care. However, as the Conference Committee continues, the administration would like to work with you to refine the language.

As you know, both the House and Senate versions of the budget bill contained proposals regarding the review of the administrative structure for the Medicaid program. The administration continues to develop ideas on the optimum administrative structure and would appreciate the opportunity to present those ideas, which build upon the House and Senate proposals.

Lastly, the administration continues to work through a number of concepts advocated by the Commission to Reform Medicaid that are contained in the bill. As the administration continues to review and study a number of the Medicaid provisions within the current version of House Bill 66, there might be issues that the Governor's Office would like to work with you on.

Primary and Secondary Education

As you know, the Governor incorporated the recommendations of the Blue Ribbon Task Force on Financing Student Success in his proposal for primary and secondary education funding over FYs 2006 and 2007, to implement the building blocks funding model. The House and Senate have adopted most of the provisions for this funding model and the administration would like to work with you to maintain these features.

Outside of basic school funding, the Governor is concerned about a few provisions that were either added or amended by the General Assembly. The first concern is the current funding level for student assessments, and the administration is hopeful that this important component for student success is adequately addressed. Secondly, when determining eligibility for the school voucher initiative, the Governor requests that the measurement of a school's academic success remain at the building level, rather than at the district level. Third, the administration supports the concept of pooling school district health insurance and recommends adjusting the House proposal to ensure the most efficient approach. Lastly, the administration recognizes the hard work by both chambers on the Early Learning Initiative. However, the Governor's Office hopes that you will revisit the provisions that place the provider rates in statute and allow for providers to determine eligibility.

Higher Education Funding

The Taft Administration appreciates that the Executive Budget funding for higher education has been supported throughout the budget process. Difficult, yet prudent, funding decisions were made in developing the higher education budget, and maintaining these funding levels is critical. Further, the administration recognizes that differences exist between the tuition cap proposals and stands ready to work with you on reaching a consensus.

Other Specific Issues

The Governor's Office is thankful for the General Assembly's work on merging the SchoolNet Commission with the Ohio Educational Telecommunication Network Commission. The redesigned agency will soon be able to concentrate on the core responsibility of promoting educational achievement through the use of technology. However, there are a few issues, specifically with the governance of the new agency that the administration looks forward to working with you to resolve.

It is recommended that funding for the Department of Development, specifically for the business development grants, be returned to the Executive Budget levels. Maintaining this funding is important for investing in Ohio's entrepreneurs.

Both the House and Senate versions of the budget bill dramatically reduce funding for the litter prevention and recycling programs within the Department of Natural Resources. The administration looks forward to working with you to increase funding for this program. One suggestion is for the construction and demolition debris fee, added by the House, to be redirected from the Division of Soil and Water Conservation to litter prevention and recycling. General revenue funds could then be made available to the Division of Soil and Water.

The Governor appreciates the work in the Senate to change language regarding the Environmental Protection Agency's wetlands permitting program, however, additional changes are still needed before the administration could support this change in regulatory structure. Finally, concerns remain for the exemptions from regulation for certain industrial wastes, added by both the House and the Senate. As with many of the mentioned issues, the administration is willing to work with you in this area too.

ADDITIONAL CHANGES

In addition to these higher profile issues, my Assistant Director, Tim Keen, will be presenting you with a series of amendments throughout the Conference Committee process. In many cases, these amendments will be fairly technical in nature, and are meant to help make the programs work as intended. We appreciate your willingness to allow OBM to clean up these issues throughout the Conference Committee process.

With this, Mr. Chairman, I would be happy to answer any questions that the Conference Committee might have.

OBM Conference Committee Revenue Revisions for FY 2006 and FY 2007

($ in millions)

REVENUE SOURCE	FY2006 Senate Estimate	FY2006 June OBM Estimate	*Senate vs. June OBM* **Variance**	FY2007 Senate Estimate	FY2007 June OBM Estimate	*Senate vs. June OBM* **Variance**
Auto Sales & Use	1,044.5	967.0	(77.5)	1,042.5	976.5	(66.0)
Non-Auto Sales & Use	6,574.5	6,513.7	(60.8)	6,836.9	6,835.1	(1.8)
Total Sales & Use	7,619.0	7,480.7	(138.3)	7,879.4	7,811.6	(67.8)
Personal Income	8,296.7	8,751.5	454.8	8,559.3	8,917.7	358.4
Corporate Franchise	790.0	943.7	153.7	657.2	828.4	171.2
Commercial Activity Tax	169.6	169.6	0.0	0.0	0.0	0.0
Public Utility	151.2	146.6	(4.6)	149.5	146.6	(2.9)
Kilowatt-Hour Tax	500.5	485.1	(15.4)	510.8	492.9	(17.9)
Foreign Insurance	232.4	243.6	11.2	244.1	250.9	6.8
Domestic Insurance	169.5	172.9	3.3	177.6	178.1	0.5
Business & Property	30.1	26.4	(3.7)	30.4	27.0	(3.4)
Cigarette	1,042.4	1,039.4	(3.0)	959.5	952.2	(7.3)
Alcoholic Beverage	57.5	57.5	0.0	57.8	58.0	0.2
Liquor Gallonage	32.1	32.6	0.5	32.6	33.3	0.7
Estate	55.9	62.2	6.3	53.1	58.4	5.3
Total Tax Receipts	**19,146.9**	**19,611.7**	**464.8**	**19,311.3**	**19,755.1**	**443.8**
Earnings/Investment	46.6	65.0	18.4	58.8	90.0	31.2
Licenses and Fees	73.7	69.5	(4.2)	75.8	69.5	(6.3)
Other Income	132.0	127.0	(5.0)	132.0	127.0	(5.0)
ISTV's & IDC's	67.0	59.7	(7.3)	67.0	59.6	(7.4)
Total Non-Tax Receipts	319.3	321.2	1.9	333.6	346.1	12.5
Liquor Transfers	129.0	123.0	(6.0)	126.3	117.3	(9.0)
Transfers In - Other	133.0	123.0	(10.0)	128.8	118.8	(10.0)
Transfers In - Temporary	13.3	13.3	0.0	0.0	0.0	0.0
Total Transfers In	275.3	259.3	(16.0)	255.1	236.1	(19.0)
LGF Incentives	0.0	0.0		0.0	0.0	
Total Sources W/O Fed	**19,741.5**	**20,192.2**	**450.7**	**19,900.0**	**20,337.3**	**437.3**
CAT Transfer	0.0	0.0	0.0	(25.6)	(25.6)	0.0
Total Sources w. CAT Transfer	**19,741.5**	**20,192.2**	**450.7**	**19,874.4**	**20,311.7**	**437.3**