2017 Budget Landscape

Clients & Friends Conference Call
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Agenda

- Background on Budget Process
- Major Budget Challenges
  - Recession?
  - Medicaid
  - Other Policy Efforts
- What to Expect
- Open Discussion

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Background on Budget Process

Background

- Every two years, Ohio establishes its GRF budget for the next two fiscal years.
  - July 1, 2017 through June 30, 2019.
- Initial proposal from Governor
  - To be introduced last week of January or first week of February.
  - Actual legislation will follow sometime in February.
- Governor Kasich's Last Biennial Budget
  - Opportunity to finalize his legacy and policy agenda.

Background

- Governor's Last Two Budgets Proposals
  - Significant personal income tax cuts
  - Broadening of sales tax base
    - Personal & professional services
    - Royalties
    - Intercompany transactions
  - CAT rate increase

- Last Budget: Obtained significant personal income tax cuts
  - 6.3% across the board cut
  - Reduced top rate on PTE income to 3% (a 43% decrease)
  - Increased Business Income Deduction over 2 years
  - No CAT or sales tax increases

Background

- Last fall, Tax Commissioner Joe Testa reached out to Ohio business associations to identify and discuss problems with Ohio's current tax system.
  - Participants focused on issues with the current sales tax on services and the municipal income tax system.
  - Gave no feedback on potential budget proposals.

- Most groups believe Governor Kasich's last budget will continue his effort to reduce the personal income tax.
  - Increase of severance tax.
  - Broadening of sales tax base to more services.
  - Changes to CAT structure or a CAT rate increase.

Background

- While Governor Kasich may seek additional reductions in the personal income tax, the state faces some important budget challenges even without the potential tax reductions.
  - Possible recession
  - New Medicaid funding mechanism required - $1.1 Billion
  - Other policy priorities

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Major Budget Challenges

Recession?

- Definition: *Economic slowdown generally identified by a fall in GDP in two successive quarters*.

- Historically, Ohio enters into a recessionary period every 8 – 12 years.
  - 8 year mark

– Last month, Governor Kasich spoke with House and Senate members and publicly stated:

“*We are on the verge of a recession in our state*.”

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Impacts

- Lame Duck: The General Assembly and Administration put most legislation that could have had a significant revenue impact on hold.

- Current Budget: Built-in cushion is expected to cover any revenue shortages.

- Upcoming Budget: Downward trend will push future revenue estimates lower.
  - Forecasts for the coming budget will be reduced.
  - Spending groups will likely have reduced budgets.

Why a Recession?

- Not clear why the Administration believes Ohio is on the verge of a recession.
  - Some leading indicators exist, but often contradicted by similar positive data.
  - Historical experience
  - Prudence dictates being careful

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Recession Indicators

- Actual YTD revenues are coming in weaker than expected.

  - *Revenues* are 3.5% below budgeted/estimated revenues YTD.
    - $611 million less than expected (but, see the detail)

  - *Other states* are experiencing weak personal income tax withholding growth.
    - Ohio's withholding is down $144.1 million (3.4%) compared to estimate.
    - OBM's view: Falling wage income explains shortfall.

  - *Ohio's economy* slowed in late summer and early fall.
    - But showed improvement in November.

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Recession Indicators

- Nationally, *industrial production* has decreased 0.4% in November. In Ohio:
    - Primary metals: +2.3%
    - Fabricated metals: -0.7%
    - Machinery: -1.5%
    - Motor vehicles: -2.3%

- *Personal income* has stalled and personal consumption slowed in November.
    - But up +3.5% compared to last year.
    - Ohio's personal income grew faster than national average during the 2^{nd} and 3^{rd} quarters.

Anti-Recession Indicators

- Third quarter GDP was revised upward to 3.5% after a 2% growth during the previous 3 quarters.

- Ohio non-farm employment increased by 9,100 jobs in November.
  - After 3 months of decline

– Ohio's 4.9% unemployment rate unchanged in November.
  - 5th straight month below 5%

– Construction put-in-place up 4.1% year to year.

– Housing starts down in November: (2.1%)
  - Year to Year Nationally: +1.4%
  - Year to Year Midwest: +9.5%

True or False

- GRF revenues are down $611 million compared to budget - TRUE.
  - But – the details matter (**Also TRUE**).

– Tax revenue is down $296.6 million compared to BUDGET
  - Lower non-tax receipts = $324.6 million
    – Reduced Federal grants (i.e., Medicaid): ($336.8 million)
  - Year-to-Year tax revenues are down $138.2 million, not $296.6 million

Tax Type	Variance from Prior Year
Personal Income	($214.6 million)
Sales & Use	$97.2 million
CAT	$6.0 million
Cigarette & Tobacco	($29.2 million)
KwH	$11.1 million
Other	($8.7 million)

Source: OBM Monthly Financial Report through December 31, 2016.

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Actual & Budget

Difference between Actual to Actual v. Actual to Budget

Tax Type	Variance from Prior Year YTD	Variance from Budgeted YTD
Personal Income	($214.6 million)	(182.9 million)
Sales & Use	$97.2 million	(104.9 million)
CAT	$6.0 million	($21.0 million)
Cigarette & Tobacco	($29.2 million)	($3.9 million)
KwH	$11.1 million	$19.9 million
Other	($8.7 million)	$3.8 million
Total	($138.2 million)	($296.6 million)

Source: OBM Monthly Financial Report through December 31, 2016.

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The Budget & Recession Indicators

- How actual tax revenues compare to budgeted revenues is a weak indicator of economic turmoil.
  - Must assume that the revenue estimates were not too optimistic.
  - Tax cuts add uncertainty until fully phased in.

- How actual tax revenues compare to last year's actual revenues is a stronger indicator of economic performance.
  - While PIT is down 5.1% compared to last year, ZHF believes the impact of the 2015 tax cuts were still being felt because the BID was phased-in and the impact of the 3% cap on PTE income was not fully understood.
    - Extended 2015 returns were due on October 15, 2016.
    - Business owners have likely adjusted their withholding to reflect the 3% top rate.

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Bad Omen

- OBM has stated that "*consumers are continuing to spend on autos but not so much on non-automotive goods.*"

- <u>OBM Hypothesis</u>: "*. . . consumers may have shifted a significant portion of their spending to services in satisfying a post-recession pent-up demand for such services.*"

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Source: OBM Monthly Financial Report through December 31, 2016, at p. 12.

Spending Compared to Budget

- Actual YTD spending is $412 million (2.2%) below budgeted spending.
  - Does not include transfers out (e.g., BSF)
  - 98% of this under-spending is attributable to lower than expected Medicaid spending
    - $404 million below expectations (YTD)
- Compared to FY2016, YTD spending is flat
  - $11 million under last year (0.1%)

Source: OBM Monthly Financial Report through December 31, 2016.

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Budget Stabilization Fund (BSF)

- BSF (the “Rainy Day Fund”) is used as a “bank account” or cushion against future revenue or spending challenges.
  - By law, can be up to 8.5% of the preceding year’s GRF revenues.
  - Had a balance of $0.89 at the beginning of Governor Kasich’s administration in 2011.

- Balance in the BSF is $2.034 billion
  - Equals 6% of FY2016 revenues.

Source: Office of Budget & Management – July 27, 2016 Release, http://obm.ohio.gov/Budget/stabilizationfund/

Medicaid Funding Mechanism

Current Medicaid Funding

- In 2008, Ohio adopted a new tax structure to fund the state's share of Medicaid.
  - $1 Ohio = $2 Federal

- Generally, Ohio imposed a sales and use tax on health care services when paid for or otherwise made available by a Medicaid health insuring corporation.
  - MCOs did not mind paying this tax because they could charge it back to the government in its premium.
  - This tax was an unexpected bonus to county governments, especially those in poorer areas.

- This structure was expected to be permitted for only a couple of years.

Current Medicaid Funding

- Ohio was notified by CMS that it must desist from imposing this sales tax.
  - Deadline considered to be June 30, 2017.
  - A couple other states also received this notice.

- GRF impact is a **$550 million** reduction in GRF per year.
  - Plus, local impact of **$200 million** per year reduction
    - Concentrated in some poorer counties.
    - This estimate is a projection of future revenue, not revenue received in the past by the counties.

- Used by the Administration and General Assembly to stave off potential other reductions of revenue or spending increases this past year.

Options to Address Medicaid Funding

- Spend less on Medicaid.
  - Will spend far less than budgeted in FY2017.
  - Unknown impact: ACA repeal.

- Create a broad-based tax to raise the additional revenue.
  - Would impact all taxpayers.
  - May not address local government funding.

- Create a new tax targeted at the industry.
  - Risks CMS disapproval if not structured correctly.
  - Likely will not address local government funding.

- Combination of the above.

Other Policy Efforts

Opioid Crisis

- Ohio and other states are experiencing an unprecedented opioid crisis.
  - Impacting all areas of Ohio and all economic classes.
  - Impacting employers' ability to hire and grow their businesses.
  - Impacting local government budgets
    - Naloxone

- Push for multi-pronged approach
  - Regional treatment centers
  - Increased interdiction
  - Education

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Unemployment Tax Reform

- Policy makers were committed to completing reform of Ohio's unemployment system last year.
  - Not completed.

- This will be a priority this session by the policy makers.
  - Likely to increase unemployment tax on businesses, at least for the near future.

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Energy Mandates

- Policy makers were committed to addressing the expiration of a freeze on energy mandates by end of 2016.
  - General Assembly passed a solution, but it was vetoed by Gov. Kasich.
  - Would have turned mandates into "goals."

- Energy efficiency and renewable energy mandates are now back in place at their original levels.

- Legislators have a willingness to reform mandates due to the increased cost on doing business in Ohio.
  - Special focus is on the energy efficiency mandates.

What to Expect

Look Out For . . .

- Additional personal income tax cuts.

- Tax increases to pay for such PIT cuts.
  - Severance tax increase
  - Broader sales and use tax base
  - Higher CAT rate or bifurcated structure

- Possible mix of good and bad.

ZHF Client Coalitions

- Past budget proposals included significant tax increases on businesses and individuals in exchange for personal income tax cuts.

- ZHF formed client coalitions to successfully support good tax policy, including no new taxes on business and job creation.

- Many benefits from participating in a client coalition.

Next Steps

- Too early to determine whether the Governor's budget proposal will include tax increases.
  - Watch for the budget proposals within the next two or three weeks.

- ZHF will analyze the proposal and communicate the changes to our clients and friends.

- ZHF will contact you if the budget proposal illustrates a need and benefit from another client coalition.

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OPEN DISCUSSION

Sources

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