

# State Budgeting Matters

Volume 4 • Issue 7  
September, 2008

*The governor faces many challenges in producing and maintaining a balanced budget that meets Ohio's needs.*

*This series is an opportunity for our readers to get involved by e-mailing their Ohio budget questions to our Ohio budget expert, Richard G. Sheridan, at [rsheridan@CommunitySolutions.com](mailto:rsheridan@CommunitySolutions.com).*

*Please note that Richard G. Sheridan's opinions are not necessarily those of The Center for Community Solutions.*



THE CENTER FOR  
COMMUNITY SOLUTIONS  
RESEARCH • PLANNING • ACTION

1226 Huron Road  
Suite 300  
Cleveland, OH 44115  
(216) 781-2944  
[www.CommunitySolutions.com](http://www.CommunitySolutions.com)

BY RICHARD SHERIDAN, FINANCIAL CONSULTANT,  
THE CENTER FOR COMMUNITY SOLUTIONS

## Options to Stave Deepening State Budget Hole

The news about the state budget, after the first month of the second fiscal year (FY 2009), is all bad and signals the need to once again re-open it in order to bring it back into balance.

In July, every tax source produced less revenue than projected resulting in total General Revenue Fund (GRF) tax revenues producing \$139.8 million less than is needed to sustain rates of spending currently authorized. Not only did all tax revenues come in below estimates, but for the first time this biennium, personal income tax collections were significantly below estimates (13 percent) because of unemployment caused by the current recession, rather than increased refunds resulting from efficiencies in tax processing. The size of this shortfall, and the fact that Ohio's unemployment rate continues to rise, suggests that personal income tax collections will continue to fall below estimates as the fiscal year progresses.

Besides causing a continuing decline in state revenues, worsening economic conditions have resulted in Medicaid caseloads exceeding estimates on which Medicaid appropriations are based. What this suggests, is that, as *State Budgeting Matters* (SBM) has maintained for months, the size of the biennial budget deficit is closing in on the worst-case scenario of a \$1.8 billion biennial problem projected by the Office of Budget and Management (OBM) in January, 2008, rather than the \$733 million problem used as the basis for executive and legislative budget actions taken just last month.

The state managed to get through the first year of the biennium by raiding non-GRF fund balances held by state agencies in various funds and accounts, reducing selected approved appropriations, and employing some financial maneuvers that avoid having to make the kind of budget cuts that seriously affect service delivery and having to raise taxes or use up accumulated reserves. This approach is typical of how Ohio, and most other states, reacts to budget shortfalls. In fact, there is a quite predictable sequence of fiscal responses to budgetary distress, all of which precede consideration of raising more money through changes in the state's tax rates or bases.

### The Sequence of Fiscal Responses

When revenues fail to meet expectations, the natural assumption is that spending must be cut or revenues raised. In fact, there are a number of steps that states typically take before taking either of these actions, and it is only when these other alternatives are exhausted, as has become the case now with Ohio's current budget, that serious consideration is given to making severe cuts in approved spending or raising taxes. Here is the typical order of fiscal responses employed by states to bring their budgets back in balance.

**1. Raid Other Funds and Accounts.** Typically, when there is a budgetary shortfall, budget analysts are directed to review all non-GRF funds and accounts (in Ohio there are hundreds of them), to determine if they are carrying balances that are not needed. State agencies are allowed by state law to carry over balances not spent from appropriations to special accounts (previously called “rotaries”) and various funds that do not lapse at the end of the period when the appropriations expire (usually the end of a biennium). Here’s how it works:

Often, some or all of the unspent monies are “encumbered” by the agency implying that there is a legal obligation attributable to the fiscal biennium in question, which, for a variety of reasons, was not satisfied during the biennium but will still require payment in the future. For example, a machine may have been ordered and delivered but before payment was made it was found to be defective and returned to the vendor for replacement. Until the state receives a satisfactory replacement, it will not authorize the disbursement of funds to pay for the machine, even though replacement will occur in a new biennium. The problem is that many of the encumbrances will never be used, and agencies then retain large balances in appropriation authority from prior biennia that need to be justified. There is no regular schedule for examining all these balances, but they become the first place that OBM analysts look when called upon to come up with additional money to solve a fiscal problem, as was the case last year. The problem is, these are one-time, non-recurring revenues and it will take at least another biennium before any further unused appropriation authority is built-up.

*Ohio has already used this option in its first attempt at re-balancing the current biennial budget.*

**2. Change Collection/Disbursement Schedules.** The state collects taxes and other revenues on a fixed schedule, where vendors (in the case of sales tax), employers (in the case of personal income tax withholding), corporations (in the case of various business taxes), and others send the state money to pay for taxes owed. In the past, the state has accel-

erated the collection of taxes to bring more money into a fiscal biennium than would otherwise have been transmitted. To some extent, this method of dealing with a fiscal problem is nothing more than a gimmick, since any revenues thus “borrowed” from a future fiscal period will result in fewer collections during that ensuing fiscal period. When this device is used, it is argued that future improvements in the economy will produce sufficient revenue to replace the amount thus “borrowed.”

Disbursement schedules can also be changed so that the state delays the payment of obligations to cross over into a new fiscal biennium. Since the vast bulk of state GRF appropriations are passed on to units of local government, who actually deliver the services for which the state pays, partially or totally, there are a considerable number of appropriation line items whose disbursement schedules can be altered to have the effect of appearing to reduce the state’s obligation. For example, in the past the state has postponed the payment of state aid to local schools. Since the schools are not in session during the summer, moving the June payment into July or August has little effect on school finances and, in addition, schools receive local property tax money, which they can use until expected state aid arrives. Other candidates for manipulating of disbursement schedules include various local health and human services boards and institutions of higher education.

Of course, it must be noted that when disbursements of monies appropriated for spending in one fiscal period are instead distributed in the succeeding fiscal period, all that is done is increase the state’s obligation in the new biennium. As is the case with accelerated tax collections, it can be argued that improved finances in the future will permit satisfying the additional burden painlessly. But, in the case of delayed disbursements, the state also has the option of reducing appropriations in the future by any amount, including the amount of the delayed disbursement.

*This short-term option is still open to the state but has the effect of postponing the resolution of the problem rather than solving it.*

**3. Postpone New Program Initiation.** Every state budget includes the initiation of new programs. Without overturning the decision to establish the new program, it is possible to reduce new program costs by postponing program initiation, or eliminate them completely if program initiation is postponed to the following biennium.

*It is too late in the biennium to delay the implementation of new programs created in H.B. 66 of the 126th General Assembly (the current main operating appropriations bill).*

**4. Cut Administrative Expenses.** Most state GRF spending is distributed in the form of subsidies to units of local government or individuals, including the payment of medical bills for indigent persons. The vast bulk of the residual amount that is spent directly by the state, goes to pay for wages and benefits of the state's roughly 60,000 employees. The remainder, appropriated as agency operating expenses, represents such a small portion of overall spending that reducing spending on supplies and materials, travel, and similar administrative expenses will have little effect in reducing a budget problem of the size Ohio faces.

*Further reductions in administrative expenses, even if possible, would do little to solve the state's budget problem.*

**5. Reduce Workforce/Benefits.** A reduction in the size of the state's workforce, numbering more than 60,000 in the case of Ohio, is another way of reducing expenses. The usual methods of reduction include not filling vacancies, eliminating open positions, offering and encouraging the use of early retirement plans, and/or laying off workers. Savings from layoffs are not dollar for dollar since there are statutory and collective bargaining agreements that have to be met, and the state is obligated to

pay for accumulated sick leave and other accrued compensation to those who are laid-off, as well as possible employment security benefits. In addition to the problems of work disruption and worker morale caused by employee layoffs, some collective bargaining employees will have "bumping rights," enabling a laid-off higher seniority employee to remain by "bumping" another employee with less seniority, even, in some instances, when the job done by the bumped employee is quite different. In California, where the state has not yet adopted its FY 2008 budget, Governor Arnold Schwarzenegger laid-off up to 22,000 part-time and temporary state workers, and cut the pay of 200,000 others to the minimum wage of \$6.55.<sup>1</sup> No state has reported that it has cut employee benefits directly, or indirectly, for example, by requiring increased health care contributions. However, both Rhode Island and Tennessee report having reduced benefits without specifying which ones.

*As part of its first budget re-balancing strategy,*

**Any further spending cuts to be made will require major policy choices that would result in shifting costs to local units of government or eliminating existing programs.**

*Governor Strickland announced he would eliminate as many as 2,700 positions through early retirements, lay-offs, and unfilled vacancies,*

*a large proportion of the cuts affecting the Department of Jobs and Family Services. Any further cuts could seriously affect the delivery of essential state services.*

**6. Cut Marginal Spending.** Assuming that the state's budget problem was only \$733 million, in February of this year, Governor Strickland decided to make \$350.4 million of targeted cuts in authorized spending for selected state agencies.<sup>2</sup> Those cuts involved the last fiscal year, as well as the current fiscal year. Since the approach taken by the state was to examine the budgets of every state agency, rather than using the more common ap-

<sup>1</sup> Dennis Cauchon, "Official Spending Outpaces Revenue," *USA Today*, August 7, 2008.

<sup>2</sup> See *State Budgeting Matters*, Vol. 4, Issue 2, February, 2008.

proach of ordering an across-the-board cut to all agencies (with exceptions), it can be assumed that the “easy” cuts have already been made. In addition, since the new fiscal year has begun, the institution of further budget cuts will have to be more and more drastic the later in the fiscal year that they are to be applied.

*Any further spending cuts to be made will require major policy choices that would result in shifting costs to local units of government or eliminating existing programs.*

**7. Increase or Establish Fees.** In addition to levying taxes as a way of raising revenues, the state also imposes a variety of fees on individuals and businesses. Some of the revenues from the fees go directly to the state GRF, while others are charges levied by state agencies for services they provide (such as professional licensing) and these are deposited into agency special accounts. In the case of the former, an increase in fees directly inures to the benefit of the GRF. In the case of the latter, what has to happen, in order to make the fee increase benefit the GRF, is to reduce an agency’s GRF appropriation by the amount expected to be raised by the increased fee.

*While there are many fees that the state legislature could raise in order to reduce its GRF budget problem, the revenue yield from such increases depends on how soon they are enacted and implemented.*

**8. Other Options.** This is not an exhaustive list of “easy options” to solve a budget crisis and, indeed, one of the tasks of a budget analyst is to come up with ingenious and, hopefully, painless options.<sup>3</sup> The main purpose of describing these more common options, is to illustrate that Ohio, and other states, have already used them in order to avoid the more difficult political decisions called for once it is

3 Readers may wish to review a more detailed discussion of the short- and long-term options included in *State Budgeting Matters*, Vol. 4, Issue 1, January, 2008.

accepted that the initial budget problem addressed is more structural than ephemeral, and more long-term than short-term. There is little left in terms of easy budget solutions. What is left for Ohio’s policy-makers facing another budget deficit are the more difficult options.

## The Difficult Options

After the use of these relatively easy responses to budgetary distress, states must make the difficult choice between: (1) serious spending cuts that will reduce government services generally, or to certain service recipients; (2) exhaust accumulated fiscal reserves (rainy day funds and budget balances); and (3) making adjustments in taxes by changing the base (such as eliminating tax expenditures) or

the rates. It is at this point that the most difficulty arises, and the point at which Ohio now finds itself with respect

to rebalancing the FY 2009 state budget.

### Budget Reserves

So far, the state has chosen to avoid using any of its Budget Stabilization (or Rainy Day) Funds to address the state’s dual problem of not having enough revenue to pay for authorized appropriations and an expanding Medicaid caseload. These resources amount to about \$1 billion and, if used in their entirety, could enable the state to re-balance its budget without resorting to further spending cuts, increasing taxes, or employing other budget-balancing options. As already reported, Ohio is not alone among the states postponing using these funds for their intended purpose. As soon as the state officially recognizes the continuing nature of the state’s budget problems, it is likely that some or all of the state’s budget reserves will have to be applied toward their solution.

### Severe Spending Cuts

Twenty states have decided to solve their fiscal problems by making severe cuts in services to some

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of the most vulnerable families and individuals, according to a recent report by the Center on Budget and Policy Priorities.<sup>4</sup> Some of the more severe cuts imposed include:

- Reducing the maximum income level at which parents can receive public health insurance from 185 percent to 175 percent of the federal poverty line, requiring low-income elderly people to pay higher rates for subsidized adult daycare, and reducing the number of children who can be served by Head Start and similar services (Rhode Island);
- Limiting hospitalization and other needed medical services to 30,000 to 40,000 seriously ill people (Tennessee);
- Elimination of dental and other services for adults in Medicaid, and rolling back eligibility from 107 percent of poverty to 61 percent, reducing the number of working parents who could qualify by 400,000 (proposed in California);
- Eliminating homemakers services for about 1,100 older adults (Alabama);
- Reducing community-based services for the mentally retarded (Tennessee); and
- Eliminating funds for gifted and talented student programs, and a magnet program for students who are deaf or hard of hearing (Nevada).

As Ohio considers further action to bring the state budget back into balance, it is likely that further budget cuts will be an option. The implications of such cuts on vulnerable populations, as well as on the ability of local government to sustain jointly funded state-local programs, needs to be fully assessed.

### Tax Actions

According to a compilation reported by the Center on Budget and Policy Priorities<sup>5</sup>, a number of states have chosen not to make deep cuts in vital services, by instead enacting temporary or permanent revenue increases, including Maryland, which enacted

<sup>4</sup> See Nicholas Johnson, Elizabeth Hudgins, and Jeremy Koulish, "Facing Deficits, Many States Are Imposing Cuts That Hurt Vulnerable Residents," Center on Budget and Policy Priorities, Washington D.C., Updated August 5, 2008.

<sup>5</sup> *Ibid.*

a \$1.35 billion tax increase in late 2007 (along with \$277 million in budget cuts), and Michigan, which raised taxes sufficiently to raise an expected \$1.365 billion in FY 2008 (and still has a problem with balancing its FY 2009 budget which begins in October, 2008). New York closed tax loopholes, delayed tax credits, raised cigarette taxes, and required collection of taxes for more on-line purchases, and increased various fees to raise \$1.5 billion in revenue. Alabama and Massachusetts closed a number of corporate loopholes. Tax actions that have been undertaken in other states include changing or eliminating various tax expenditures (often euphemistically called "loopholes") such as:

- The elimination of property tax rebates for households with incomes over \$150,000, and a reduction in property tax rebates for some other residents (New Jersey);
- The reduction of a renters' credit for families with incomes under \$50,000, previously worth \$200 or more per family, to a maximum of \$80 per family for non-elderly, non-disabled renters (New Jersey);
- The elimination of a tax credit for foreign taxes paid, capping a tax credit for motion picture production, and a moratorium on new projects qualifying for the historic structure tax credit (Rhode Island); and
- Elimination of tax breaks for businesses (proposed in California).

## Ohio Is Not Alone

Annually, the National Conference of State Legislatures (NCSL) tracks and reports on budget and tax actions in all 50 states.<sup>6</sup> They found that in FY 2007 every state reported stable fiscal conditions. They also found that they had aggregate year-end balances approaching 10 percent of general fund spending. In one year, for the 43 states that reported the information to the NCSL, 31 states saw their balances decline and, overall aggregate year-end balances fell 13 percent. Revenue grew by a meagre 1.1 percent

<sup>6</sup> The data reported here is from Corina Eckl and Bert Waisanen, "State Budget and Tax Actions 2008: Preliminary Report," *Special Fiscal Report*, National Conference of State Legislatures, Denver, Colorado, and Washington, D.C., July, 2008.

above FY 2007 levels, while state spending grew 5.9 percent above the prior year, thus helping to explain the dip in year-end balances. Fiscal problems among the states increased as they adopted their FY 2009 state budgets (all states on a July 1-June 30 fiscal year basis have now done so, except for California).

For FY 2009, states continued to hang on to their budget reserves. For the 43 reporting states, the balance projected is 8.9 percent of state general fund spending, compared to 10 percent in FY 2009. General fund revenues are projected to grow by 2.2 percent over FY 2008, with nine states expecting to collect less revenue in FY 2009 than they did in the previous year. General fund appropriations are budgeted to fall 0.4 percent below FY 2008 spending levels for the 43 reporting states, with 18 expecting to spend less in FY 2009 than in the previous year. To close the budget gaps, the primary tack taken was to cut spending, although, as noted above, a few levied tax or fee increases and/or used budget reserves. This is how states reported they had addressed their budget gaps:

- Across-the-board budget cuts (10 states);
- Targeted cuts to higher education (12 states), elementary-secondary education (11), Medicaid (10), corrections (9), aid to local government (8), and Temporary Assistance to Needy Families (3);
- Reductions in work force (6 states);
- Hiring freezes (9 states);
- State employee travel bans (6 states);
- Reduced employee benefits (6 states);
- Contribute less than the full amount to retirement funds (4 states);
- Freeze employee salaries (3 states);
- Institute early retirement program (1 state);
- Increase taxes (7 states);
- Raise fees (8 states);

- Use Rainy Day Fund (many states including Nevada using \$267 million, or almost all of its balance, Minnesota using \$500 million, or half the balance, and Massachusetts using \$310 million);
- Use or borrow non-general funds (6 states);
- Expand gaming operations (4 states);
- Freeze purchases (3 states);
- Institute tax amnesty program (2 states); and
- Improved tax compliance (1 state).

As this list shows, the actions taken by states facing problems similar to Ohio are pretty much traditional. Even those states that resorted to a tax increase, did so after, or in combination with, either budget-cutting actions or reductions in budget reserves. With respect to budget cutting actions, including laying-off employees, canceling vendor contracts, reducing payments to service providers, and cutting benefit payments, one of the problems is that often the cuts made will have serious negative conse-

quences for the affected state's most vulnerable families and individuals. According to a recent study, "at least 2 states have enacted budget

cuts that will affect services for children, the elderly, the disabled and families, as well as the quality of education and access to higher education."<sup>7</sup> Ohio is one of the states whose cuts have already affected the delivery of essential education and health and human services. And such cuts may prove to be short-sighted, since they have the effect of removing demand from the economy (as do tax increases) which, in turn, worsens an economic downturn.<sup>8</sup>

## Reforming State Spending

Instead of resorting to budget cuts that can harm vulnerable populations, or which can have the effect of worsening an economic downturn, scarce resources provide states with the opportunity to make important policy decisions that would be difficult

**...scarce resources provide states with the opportunity to make important policy decisions that would be difficult to implement in better economic times.**

<sup>7</sup> Johnson, Hudgins, and Koulisch, *op. cit.*, p. 3.

<sup>8</sup> *Ibid.*, p.2.

to implement in better economic times. A recent survey, undertaken in Michigan, illustrates this possibility. Detroit Renaissance, a private, nonprofit leadership organization, whose goal is to boost Michigan's economic growth, conducted a poll which asked voters to examine 12 often controversial solutions to Michigan's structural deficit. They found:

- Almost 80 percent supported finding means of punishment for nonviolent offenders, other than prison;
- Nearly 75 percent said they would support increasing health care premiums for state employees who pay between 5 and 10 percent of health care premiums, compared to private sector employees who typically pay between 16 and 28 percent; and
- About 74 percent support changing retirement benefits for new teachers, favoring a 401(k)-type individual contribution plan.<sup>9</sup>

Other options, supported by a majority of the 800 poll respondents, included releasing some non-violent offenders before parole, reducing the length of mandatory prison sentences, and imposing small co-pays for Medicaid health services.

## Crafting A Workable Budget Solution

Usually, what happens is that, reserves are used up first and then, if they are insufficient, a combination of severe budget cuts and tax actions ensues.

However, there is an inexplicable reluctance in Ohio to use its Rainy Day Funds until it can be demonstrated that all other options, including further budget cuts, have been exhausted, and increasing state taxes will most likely not even be considered until the state's reserves are down to zero. So where Ohio's leaders now find themselves

<sup>9</sup> Marisa Schultz, "Survey: Reform State Now," *The Detroit News*, August 7, 2008.

is at the point of deciding (1) when to take further action to bring the budget in balance; and (2) how to do it.

As to timing, the longer the state delays in recognizing its fiscal problem, the fewer options it will have. If further budget cuts are to be considered, the longer they are delayed, the more drastic they will have to be. For example, a 10 percent cut in annual spending authority implemented in January, would be an effective 20 percent cut since it would apply only to six-months of the fiscal year.

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In determining which solution to use, timing is also important. The longer the state

postpones addressing the problem, the more likely it will be that most, or all, of the problem will have to be resolved through the use of accumulated state budget reserves.

Budget cuts enacted this biennium would have the effect of reducing the state's obligations in the next biennium, and make it easier to balance that budget. Use of budget reserves, permits continued spending at a rate that may not be sustainable if economic conditions do not improve. Regardless of when the state finally recognizes the need to once again re-balance the FY 2009 budget, and regardless of whether it addresses the problem through the use of further budget cuts, use of budget reserves, or a combination of the two, what the state did in 2004 to reform its tax structure will make it virtually impossible to balance the next state budget without finding a way to increase revenues. Ohio's fiscal problems are likely to become worse in the next, and succeeding biennia, because of those tax actions, as well as the fact that it is likely to feel the lingering effects of the current recession on state finances for several more years.

## The Center for Community Solutions Study

The Center for Community Solutions has just begun a study to examine alternatives for the state to consider in order to pay for essential services in FY 2010 and beyond. Part of the study will seek to determine what effect state tax reforms enacted in 2004 have had on relative tax burden; the ability of the state to finance the delivery of essential services; the state economy; the state budget; and the finances of local government. Another part of the study will seek to determine what changes in state tax policy need to be considered to ensure state economic vitality; ensure the continued delivery of essential state services, especially education and health and human services; distribute the tax burden fairly between individuals or different economic classes; and distribute the tax burden fairly between businesses and individuals. Future issues of *SBM* will report on progress toward the completion of this study, especially when results might prove useful to solving the budget problems remaining in this fiscal year.

### Do You Have Questions about Ohio's Budget?

*E-mail your questions to budget expert Richard Sheridan at [rsheridan@CommunitySolutions.com](mailto:rsheridan@CommunitySolutions.com).*

*Answers to your questions could be the topic of future issues!*