Budget Footnotes

A Newsletter of the Ohio Legislative Budget Office — September, 1996

FISCAL OVERVIEW

— Frederick Church

aaaTax revenues fell short in August, more than offsetting the small overage from July. After two months, FY 1997 tax revenues are $4.5 million below estimate (this is a forecast error of only 0.3 percent). Throughout FY 1997, the estimates of tax revenues in this report will be OBM's revised estimates, done in July for the purposes of determining the tax year 1996 income tax cut authorized in S.B. 310 (the budget correction bill). While LBO was tempted to stick with the original estimates from July 1995 — the set of estimates that the biennial budget was based on — the adoption of the income tax cut changes the estimate of income tax collections and total tax collections so drastically that the original set of estimates is no longer particularly relevant. On the disbursement side, LBO will also be using OBM's revised FY 1997 estimates.

The biggest tax shortfalls after two months are in the personal income tax and the non-auto sales and use tax. The strong income tax withholding performance from July may have been a fluke, since employer withholding fell short and turned in a weak growth number in August. The shortfall in the non-auto sales tax is not too surprising given the weak numbers for U.S. retail sales the prior month.

So far, the news on the revenue side is really not in taxes but in federal reimbursement, which is $63.7 million below estimate and down 6.8 percent from last year. At least some of this can be attributed to underspending in welfare programs that draw federal money. For example, Medicaid and ADC combined are already $59.5 million below estimate, and have dropped by 2.7 percent from last year. However, at this point it looks like the decline in federal reimbursement is greater than current spending patterns can explain. Whether some of the federal shortfall is due to retroactive adjustments is not yet clear.

Spending in August was far below estimate, and after two months of the fiscal year the variance is $74.0 million. Spending in the welfare and human services areas is actually $93.8 million below estimate; the overall variance is smaller because of partially offsetting overages in categories like property tax relief ($25.9 million) and primary and

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STATUS OF THE GRF

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Budget Footnotes examines the fiscal position of the state GRF on a monthly basis. Each issue also contains summaries of Controlling Board actions that have policy implications, and articles on fiscal issues of current interest.

For questions or comments regarding specific sections:

GRF Revenue:
Fred Church 466-6274

GRF Spending:
Chris Whistler 728-4810

Other Articles:
Barbara Riley 644-9097

Legislative Budget Office
77 South High Street
8th Floor
Columbus, Ohio
43266-0347

Telephone: 614/466-8734

TABLE 1
General Revenue Fund
Simplified Cash Statement
($ in millions)

	Month of August	Fiscal Year 1997 to Date	Last Year	Difference
Beginning Cash Balance	$278.1	$1,138.5		
Revenue + Transfers	$1,148.2	$2,303.8		
Available Resources	$1,426.3	$3,442.3		
Disbursements + Transfers	$1,387.3	$3,403.4		
Ending Cash Balances	**$38.9**	**$38.9**	**($134.6)**	**$173.5**
Encumbrances and Accts. Payable		$541.9	$554.0	($12.1)
Unobligated Balance		**($503.0)**	**($688.6)**	**$185.6**
BSF Balance		$828.3	$828.3	
Combined GRF and BSF Balance		**$325.3**	**$139.7**	**$185.6**

secondary education ($18.8 million). Aggregate spending growth (excluding inter-fund transfers) is only 4.5 percent, well below the budgeted 7.1 percent.

Looking at total outlays, the biggest difference between FY 1997 and last year is in transfers out of the GRF. Last year, the GRF made $858.2 million in transfers in July: $535.2 million to the Budget Stabilization Fund (BSF) to meet the 5 percent balance target, and $311.0 million to a variety of other purposes. This year, the GRF made less than half the transfer made in FY 1996. Last year's big surplus went to beefing up the BSF and helping school districts; this year's surplus was used to provide a big personal income tax cut to Ohio taxpayers. Of the $405.2 million transferred out of the GRF in July, $400.8 million went to the newly created Income Tax Reduction Fund (ITRF). For more details about the income tax cut, please see last month's issue of this report.

Owing to the fact that fewer transfers were made from the GRF this July, the unobligated GRF balance is $185.6 million larger this year. Since the BSF is unchanged — no new transfers, and its interest earnings are being diverted elsewhere — the change in the combined GRF and BSF balance is identical to the change in the GRF balance.

TRACKING THE ECONOMY

U.S. economic growth was even stronger in the second quarter than was originally reported. The real GDP growth figure was revised upward from 4.2 percent to 4.8 percent. The revision was based on a smaller trade deficit (fewer imports) than the original numbers showed. Second quarter growth was led by federal expenditure, housing, and consumer spending. In the third and fourth quarters, higher mortgage rates are expected to slow residential investment, and housing and trade are expected to act as brakes on economic growth. Federal spending growth is also expected to turn negative. Continued but slower overall growth will be led by consumer spending and a resurgence of business investment, including inventory restocking. Projections for third and fourth quarter growth vary widely, as shown in the table below, but estimates of around 2.5 percent appear to be the median.

Comparison of Real GDP Growth Estimates from Economic Forecasters

Forecasting Group	1996:3	1996:4	1997:1	1997:2
DRI/McGraw-Hill, September 1996	2.9%	2.2%	1.8%	1.4%
Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia, August 28, 1996	2.5%	2.4%	2.1%	1.9%
WEFA Group, September 1996	1.4%	2.0%	2.2%	2.0%

Once again, there are fears afoot that the economy is overheating. Just as this issue went to press, it was announced that the Federal Reserve did not increase the target federal funds rate at its September 24th meeting. Some economists, expecting a 0.25 percent increase at this meeting, believe that this means that the Fed may have to increase rates by 0.5 percent at the next meeting on November 13th. It is unclear at this point how financial markets will react to the Fed's decision not to act. There is some evidence that the bond markets had already built a small increase — e.g. from 5.25 percent to 5.5 percent — into their expectations. The risk is that long-term interest rates will rise as investors build higher inflation forecasts into their expectations, and that higher long-term rates will depress economic growth.

On the surface at least, the current economic situation looks similar to the one from 1989. The question is, are we in for a spurt of inflation such as the one that began then? In 1989, the unemployment rate dropped down around 5 percent (well below the NAIRU), wage inflation picked up quickly, unit labor costs rose, profits dropped (prompting articles calling profits a "rusting beam of expansion" and so forth), and price inflation accelerated quickly. In response, the Federal Reserve raised the federal funds rate (and the discount rate) several times in an attempt to slow the economy down.[1] In fact, the economy slowed down enough that it was vulnerable to a supply shock, which the Iraqi invasion of Kuwait provided. The 1990-1991 recession followed.

There are some similarities this time around. The U.S. unemployment rate in August dropped to 5.1 percent, a seven-year low; the lowest since 1989. Wage pressures are clearly increasing, although slowly. The level of household installment debt is again very high, rekindling fears that consumers are overextended. On the other hand, output prices are still under control, and some other indicators like capacity utilization are not showing the bottlenecks that they did in 1989. Although opinion varies widely, the consensus as we see it is that forces are already in place to slow economic growth somewhat in the third and fourth quarters, so that only one or two small interest rate increases by the Federal Reserve will be necessary to keep inflation from getting out of hand.[2] This expectation is built on a series of assumptions about factors including: where the full employment rate — non-accelerating inflation rate of unemployment, or NAIRU — is, what is going to happen to labor force growth, and what is happening and expected to happen to productivity and therefore to growth in unit labor costs.

Unemployment and Wage Inflation

On first glance, if current estimates of the NAIRU are close to right, then the unemployment rate is alarmingly low. Most estimates of the NAIRU are around 6 percent, like DRI's estimate of 5.9 percent, although there have also been lower estimates, in the 5.5 percent to 5.6 percent range.[3] While wage inflation has accelerated somewhat, the surprise is that it has not increased more. However, things are not so simple as they seem.

Private sector job growth has actually slowed down, despite the gaudy overall numbers from last month. Total employment growth jumped back up to 250,000 jobs in August, but private sector job growth was only 173,000. More than 30 percent of the job growth, or 77,000 jobs, were in government — mostly local government, particularly teachers. Furthermore, there is evidence that the big bulge in teaching jobs is the result of using a different survey week, and perhaps a misleading seasonal adjustment, rather than any change in real activity.

Comparison of Total and Private Sector Employment Growth, U.S., Last Four Months
(numbers in thousands)

	May 96	Jun 96	Jul 96	Aug 96
Total Nonfarm Employment Growth	407	219	228	250
Private Sector Jobs Only	346	226	189	173

In that case, why the drop in the unemployment rate? The household employment survey (the one used to calculate unemployment rates) showed solid but unspectacular job growth of 171,000 in August, close to the pure private sector number in the establishment survey. The force pushing down the unemployment rate was the fact that the labor force declined by 296,000. While the one-month figure may be a blip (people going back to school, etc.) the generally slow growth in the U.S. labor force over the last year has put the country in the same position that Ohio has been in for quite awhile: moderate job growth plus slow labor force growth equals a very low unemployment rate.

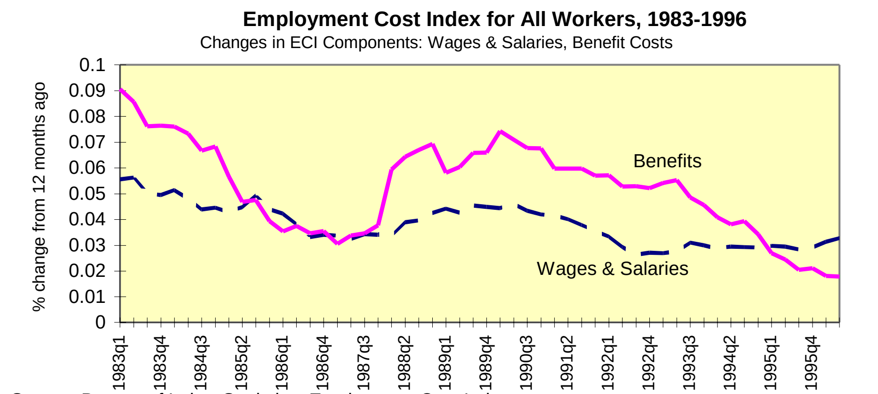
The WEFA Group sees growth in the labor force picking up over the second half of CY 1996. There are several reasons why this should happen: wage gains are improving so the incentive to seek a job is higher; welfare reform at the federal and state level is pushing more people into the labor force; the increase in the minimum wage will provide incentives for both the young and the elderly to look for work. Both those age groups have had low labor force participation rates in the 1990s. The WEFA Group expects that in the intermediate to long run, the labor force will grow enough to push the unemployment rate back up close to the NAIRU, probably around 6 percent.[4]

Productivity, Unit Labor Costs, and Price Inflation

Perhaps in the longer run a resurgence in labor force growth will push the unemployment rate back up and protect us from wage inflation and thereby from a cost-push price inflation, but what about now? Are we in for a bout of accelerating price inflation in the short run?

The answer, despite the low unemployment rate, may still be no. Once again, the big econometric forecasting firms are divided on this issue, with DRI being somewhat more pessimistic. DRI cites the recent uptick in the Employment Cost Index (ECI), noting that the ECI rose by 3.2 percent at an annualized rate in the second quarter of CY 1996, while compensation inflation for all of 1995 was 2.8 percent. Furthermore, DRI projects that strong labor demand and pay increases due to the increase in the federal minimum wage will push the annual increase in the ECI to 3.7 percent by CY 1997.

An interesting sidebar to the ECI data is that for the first time in quite a while, wages are rising faster



Source: Bureau of Labor Statistics, Employment Cost Index

than fringe benefit costs, which are under control. Over the 12 months ending in June, wage and salary costs have increased by 3.2 percent, but fringe benefits have risen by only 1.8 percent. This has kept total labor compensation costs relatively under control.

While the ECI data show that there has been some acceleration in wage inflation, this has not yet resulted in rising output price inflation. The question is, will it? The answer lies in projections of the growth in labor productivity, and the resulting change in unit labor costs. What really matters to producers is the net price of a unit of labor (unit labor cost), and the change in unit labor cost depends not only on changes in compensation but also on productivity growth. If wage inflation minus productivity growth is greater than output price inflation, then unit labor costs are rising faster than prices. Producers can either raise prices or see their profits reduced. This creates inflationary pressure. If productivity rises fast enough that unit labor costs are rising at a rate equal to or less than price inflation, then the labor market shouldn't be causing pressure for price inflation.

Unit Labor Costs = Hourly Compensation / Labor Productivity

- Increases in productivity lower unit labor costs, other things constant.
- Increases in hourly compensation raise unit labor costs, other things constant.
- If both hourly compensation and productivity move together, unit labor cost is unchanged.

The BLS measure of hourly compensation is not the same as the ECI.

Until late 1995, unit labor cost growth had been below output price inflation since 1987. (Unit labor costs grew faster than the CPI in 1986 and 1987, and CPI inflation accelerated not only in those years but all the way through 1990.) Weak productivity growth in late 1995 and in the second quarter of 1996 have temporarily let unit labor costs rise faster than output prices. This has led some analysts to fear that an acceleration in output price inflation is imminent. However, other economists believe that:

(i) the current U.S. productivity data is not all that reliable, since there are long-standing problems in measuring the productivity of workers in the service sector, and;

(ii) even with flaws in measurement, productivity will bounce back to a 1 percent annual growth rate in the coming months, relieving pressure on output prices.

Summary

The preceding arguments are not meant to suggest that there is no danger of rising inflation. If wage growth keeps accelerating and productivity does not rebound, the core inflation rate could rise and long-term interest rates would increase, hurting investment and GDP growth. In fact, the Federal Reserve will probably approve small increases in the target federal funds rate as a precautionary anti-inflation measure. However, the balance of evidence seems to suggest that in the longer run, faster increases in the labor force will push up the unemployment rate toward the NAIRU and relieve some of the upward pressure on wages. Meanwhile, in the

Status of the General Revenue Fund

short run, current wage inflation should be offset by a bounceback in productivity that will reduce annual increases in unit labor costs to 3 percent or less. With increases in unit labor costs at or below the rate of CPI inflation, the likelihood of "cost-push" acceleration in inflation coming from the labor market would be greatly reduced.

Within the economics profession and the business community, opinion over the future course of inflation is divided. A recent survey by the Federal Reserve Bank of San Francisco found that 55 percent of respondents expected no change in inflation over the next 12 months, but a sizable majority of nearly 40 percent expected inflation to accelerate. Furthermore, it is known that within the Federal Reserve System generally, a majority of regional bank presidents were calling for a small increase in interest rates, and some members of the Federal open Market Committee (FOMC) felt strongly that the Fed should act now to preempt increases in inflation and calm the financial markets, even if the indicators showed CPI inflation still under control for the present. Obviously those voices did not carry the day this time. There are already forces at work slowing economic growth in the third quarter, but if growth does not slow enough, it is likely that the Fed will have to raise short-term interest rates in November.

REVENUES

— Frederick Church

Tax revenue experienced a small shortfall of $12.5 million in August, pushing year to date revenue $4.5 million below estimate. At this point, no individual tax source is far from the estimate: there are shortfalls in the non-auto sales tax ($6.4 million) and in the personal income tax ($4.2 million) and overages in the auto sales tax ($4.9 million) and the tobacco tax ($2.8 million).

Federal reimbursement was short again in August, and is now $63.7 million below estimate for the year. For the most part, this variance is the result of lower than estimated spending in ADC, Medicaid, and other human services programs that draw federal matching money. It seems as though the shortfall is a little bigger than what one would expect based on the underspending in those categories, but perhaps this is due solely to timing factors. These issues should become clearer over the next few months.

Sales and Use Tax

The non-auto sales tax has been slightly below estimate in both months so far this fiscal year. The year to date shortfall is $6.4 million. The weak performance of Ohio tax collections seems to follow fairly directly from slow growth in U.S. non-auto retail sales in June and July (Ohio non-auto tax collections are based primarily on prior month retail sales activity). Now, as the following table shows, the relationship between growth in quarterly U.S. retail sales and growth in Ohio tax collections is not always tight, but usually the direction of change is the same.

After a strong showing in April and May, non-auto sales have weakened somewhat. For the last three months, year-over-year growth has stayed in the 4.0 percent to 4.6 percent range. Looked at another way, after a very good May, non-auto sales fell in June, and by August had still not regained the May level. Some of the momentum has gone out of retail sales, and consumer spending generally. This

Comparison of U.S. Retail Sales With Ohio Tax Collections, by Quarter
Year-Over-Year Changes

	U.S. non-auto retail sales	Ohio non-auto tax collections
1994Q1	5.0%	5.4%
1994Q2	5.4%	3.5%
1994Q3	6.4%	9.4%
1994Q4	6.0%	7.2%
1995Q1	5.8%	6.2%
1995Q2	4.9%	7.3%
1995Q3	3.5%	4.0%
1995Q4	2.9%	3.6%
1996Q1	3.3%	6.9%
1996Q2	4.7%	6.0%

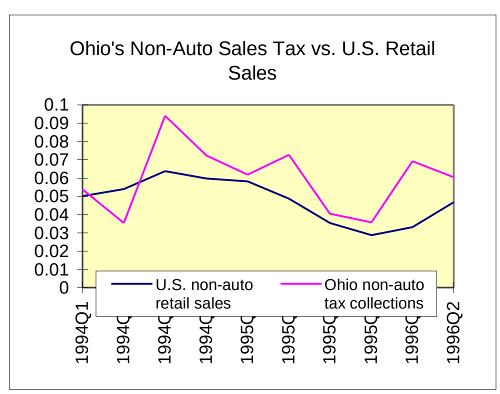


Table 2
General Revenue Fund Income
Actual vs. Estimate
Month of August, 1996
($ in thousands)

REVENUE SOURCE			
TAX INCOME	Actual	Estimate*	Variance
Auto Sales	$67,634	$63,807	$3,827
Non-Auto Sales & Use	354,215	357,966	(3,751)
Total Sales	$421,849	$421,773	$76
Personal Income	$379,783	$391,700	($11,917)
Corporate Franchise	2,888	6,852	(3,964)
Public Utility	24	0	24
Total Major Taxes	**$804,544**	**$820,325**	**($15,781)**
Foreign Insurance	$99	$0	$99
Domestic Insurance	200	0	200
Business & Property	413	675	(262)
Cigarette	27,310	24,778	2,532
Soft Drink	0	0	0
Alcoholic Beverage	5,032	4,618	414
Liquor Gallonage	2,262	2,228	35
Estate	309	0	309
Racing	0	0	0
Total Other Taxes	$35,625	$32,299	$3,325
Total Taxes	**$840,169**	**$852,624**	**($12,455)**
NON-TAX INCOME			
Earnings on Investments	$0	$0	$0
Licenses and Fees	2,991	3,250	(259)
Other Income	7,302	9,000	(1,698)
Non-Tax Receipts	$10,293	$12,250	($1,957)
TRANSFERS			
Liquor Transfers	$4,000	$3,000	$1,000
Budget Stabilization	0	0	0
Other Transfers In	64	0	64
Total Transfers In	$4,064	$3,000	$1,064
TOTAL INCOME less Federal Grants	**$854,525**	**$867,874**	**($13,349)**
Federal Grants	$293,668	$337,541	($43,873)
TOTAL GRF INCOME	**$1,148,193**	**$1,205,415**	**($57,222)**

* July, 1996 estimates of the Office of Budget and Management.

is one of reasons that many economists feel that GDP growth will be slower in the third quarter (see "Tracking the Economy," above). If Ohio's September tax collections follow the pattern of the nation's retail sales for August, then there may be a small shortfall in September also.

The Federal Reserve System's ***Beige Book*** summary has some information on sales at the regional level. The September 11th report states that in the 4th District (Ohio and surrounding areas) apparel sales were strong, but sales of appliances and other big-ticket items were slow. This is consistent with the tax data.

The auto sales tax has shown the opposite experience. Two months of small surpluses have left the tax $4.9 million over estimate for the year. Collections have grown by 6.2 percent from last year. In this case, Ohio tax revenues are outperforming U.S. sales figures. U.S. Commerce Department data shows that over the past two months dollar sales of automobiles have grown by only a little over four percent from last year. Tax collections have also outperformed expectations that one would have based on the ***Beige Book***, which describes auto sales as "flat or declining slightly." However, the report does state that the Cleveland Fed was one of three regional banks (there are 12 in all) that said that auto demand might still be strong, but thin dealer inventories were hurting sales.

Last month, we reported that unit sales of light vehicles had tailed off in July after a very strong first half. While this is true, it is also true that after August, with $^2/_3$ of CY 1996 done, sales are 10.41 million units, as opposed to 10.06 million last year (a gain of 3.4 percent). Many analysts now expect CY 1996 sales to finish at around 15.1 million units, up from CY 1995's 14.75 million. At the beginning of the year, many of those same analysts had expected flat sales in CY 1996. Most forecasts of CY 1997 sales are slightly weaker, around 14.9 million units. Nevertheless, if these forecasts hold, Ohio should be able to meet the auto sales tax estimate, since even OBM's revised estimate only calls for 1.5 percent growth (the original estimate actually allowed for a 0.7 percent decrease).

Personal Income Tax

The shortfall in the income tax is the result of a shortfalls in withholding and an overage in refund payouts (which reduces net collections). These are partially offset by an overage in quarterly

Table 3
General Revenue Fund Income
Actual vs. Estimate
Fiscal Year-to-Date 1997
($ in thousands)

REVENUE SOURCE	Actual	Estimate*	Variance	FY 1996	Percent Change
TAX INCOME					
Auto Sales	$131,851	$126,935	**$4,916**	$124,199	6.16%
Non-Auto Sales & Use	718,027	724,455	**(6,428)**	697,323	2.97%
Total Sales	$849,878	$851,390	**($1,512)**	$821,523	3.45%
Personal Income	$765,009	$769,200	($4,191)	$720,357	6.20%
Corporate Franchise	10,622	13,133	(2,511)	12,471	-14.82%
Public Utility	24	0	24	1	2300.00%
Total Major Taxes	$1,625,533	$1,633,723	($8,190)	$1,554,351	4.58%
Foreign Insurance	$282	$0	$282	$38	640.87%
Domestic Insurance	200	0	200	63	217.46%
Business & Property	843	1,215	(372)	1,599	-47.28%
Cigarette	39,773	37,021	2,752	35,745	11.27%
Soft Drink	0	0	0	1	-76.92%
Alcoholic Beverage	10,142	9,487	654	9,527	6.45%
Liquor Gallonage	4,393	4,483	(90)	4,466	-1.63%
Estate	310	0	310	1,367	-77.35%
Racing	0	0	0	0	#DIV/0!
Total Other Taxes	$55,941	$52,206	$3,735	$52,805	5.94%
Total Taxes	**$1,681,474**	**$1,685,929**	**($4,455)**	**$1,607,156**	**4.62%**
NON -TAX INCOME					
Earnings on Investments	$0	$0	$0	$0	#N/A
Licenses and Fees	7,771	8,125	(354)	7,883	-1.42%
Other Income	12,297	16,800	(4,503)	20,785	-40.84%
Non-Tax Receipts	$20,068	$24,925	($4,857)	$28,668	-30.00%
TRANSFERS					
Liquor Transfers	$6,500	$5,000	$1,500	$4,500	44.44%
Budget Stabilization	0	0	0	$0	#N/A
Other Transfers In	64	0	64	0	#N/A
Total Transfers In	$6,564	$5,000	$1,564	$4,500	45.86%
TOTAL INCOME less Federal Grants	**$1,708,105**	**$1,715,854**	**($7,749)**	**$1,640,324**	**4.13%**
Federal Grants	$595,682	$659,383	($63,701)	639,436	-6.84%
TOTAL GRF INCOME	**$2,303,787**	**$2,375,237**	**($71,450)**	**$2,279,760**	**1.05%**

* July, 1996 estimates of the Office of Budget and Management.

estimated payments. In all cases, the difference between actual and estimated receipts is small. This early in the year, the variances in estimated payments and refunds are of no consequence: the dollar amounts are small and the variances are probably due to timing factors. The first real test of quarterly estimated payments in FY 1997 is in September. The third payment against taxable year 1996 is due September 15th, and the estimated take this year is $200.8 million. This number is 4.9 percent higher than actual collections last September — the estimated growth would be higher but the Tax Department estimates assume that some taxpayers will start reducing their quarterly payments due to the passage of the 6.6 percent income tax cut.

The withholding shortfall is a disappointing echo of the last half of FY 1996. Employer withholding in July was above the estimate and up 11 percent from last year. As always, one should not count any one month's results too heavily. In August, collections were below estimate, and growth was only 1.6 percent. Probably what happened is no more complicated than some withholding payments expected in August were actually made at the end of July. Once again, while Ohio is experiencing solid employment growth, wages are not growing very fast (despite all the concerns about wage inflation covered in the prior section) and this is apparently keeping withholding revenue from growing as fast as one might expect based solely on the job figures. The ***Beige Book*** reports that, although the cost of new hires is accelerating, wage growth in the Cleveland Federal Reserve District is still in the 2 percent to 3 percent range.

As the review of the macroeconomy indicates, faster wage growth *without* increases in productivity will only push up unit labor costs, put pressure on output prices, and lead to inflation that will eventually slow down real economic growth. Increases in labor productivity are thus the key for increasing personal income tax revenue in the long run, although wage inflation, despite its deleterious long run impact, would increase revenues in the short run.

[1] For a differing perspective on Federal Reserve actions that does not use the language of "fine tuning" where the Federal Reserve is assumed to explicitly try to adjust short–term real economic growth to the economy's estimated long–run potential, see Jerry Jordan, "Must the Fed Fight Growth?" *Economic Commentary*, Federal Reserve Bank of Cleveland, July 15, 1994.

[2] The WEFA Group believes that the Federal Reserve will not have to raise interest rates in the second half of CY 1996, although they concede that the risk has increased. See the WEFA Group's *U.S. Economic Outlook 1996–1998*, September 1996. In contrast, DRI's baseline forecast presumes 75 basis points worth of increases in the federal funds rate over the next half year, bringing the rate up to 6.0 percent. See Roger Brinner and David Wyss, "How Long to Wait, How Hard to Hit," *DRI U.S. Forecast Summary*, September 1996.

[3] In an NBER paper from earlier this year, three prominent economists estimated that the NAIRU was currently around 6.1 percent, but they also said that confidence intervals around the point estimate were very large, and that the NAIRU could be anywhere from 4.6 percent to 6.9 percent. The authors suggested caution in using the NAIRU as a guide to monetary policy. See Douglas Staiger, James Stock, and Mark Watson, "How Precise Are Estimates of the Natural Rate of Unemployment?" National Bureau of Economic Research, Working Paper Number 5477, March 1996.

[4] See Kurt Karl and Peter Jaquette, "U.S. Outlook," *WEFA Group Executive Summary,* September 6, 1996.

APPENDIX

LBO's original GRF revenue estimates for FY 1997, which were used in formulating the FY 1996-1997 biennial budget, and OBM's revised FY 1997 estimates, used to derive the tax year 1996 income tax rate reduction, are compared in the table below. The biggest change is clearly in the personal income tax. Looking at the net change alone makes it hard to tell what the underlying assumptions are. First, after the withholding shortfall in FY 1996, the baseline GRF estimate was reduced from $5,464.9 million to $5,408.8 million (this still takes into account the increase in the personal exemption passed in the budget bill). Then the $400.8 million rate cut was subtracted — the GRF share is $358.7 million — but the impact on the GRF is less than $358.7 million because it is assumed that almost 14 percent of the tax year 1996 cut is actually felt in FY 1998, not FY 1997. The net GRF impact of the 1996 rate cut is thus about $306.5 million ($5,408.8 - $306.5 = $5,102.3). Actually, this simplifies somewhat the interaction between the tax rate cut and the personal exemption increase, but the more precise estimate does not change the numbers much.

Note that the designation of the revised estimates as OBM estimates does not mean that they were done in isolation or that LBO questions them. In many cases LBO and OBM collaborated on the estimates, but the final judgments belonged to OBM, since they were charged with certifying the budget surplus to be used for the tax cut.

Original and Revised GRF Revenue Estimates, FY 1997

all amounts in millions of dollars

	Original	Revised	Difference
Auto Sales	$663.8	$678.8	$15.0
Non-Auto Sales & Use	$4,261.5	$4,261.5	$0.0
Total Sales	$4,925.3	$4,940.3	$15.0
Personal Income	**$5,464.9**	**$5,102.3**	**($362.6)**
Corporate Franchise	$1,109.1	$1,142.0	$32.9
Public Utility	$677.7	$640.0	($37.7)
Total Major Taxes	$12,177.0	$11,824.6	($352.4)
Foreign Insurance	$298.9	$290.0	($8.9)
Domestic Insurance	$60.8	$58.0	($2.8)
Business & Property	$9.0	$9.0	$0.0
Cigarette	$276.0	$291.5	$15.5
Soft Drink	$0.0	$0.0	$0.0
Alcoholic Beverage	$53.8	$50.2	($3.6)
Liquor Gallonage	$25.5	$27.5	$2.0
Estate	$85.0	$85.0	$0.0
Racing	$0.0	$0.0	$0.0
Total Other Taxes	$809.0	$811.2	$2.2
Total Taxes	**$12,986.0**	**$12,635.8**	**($350.2)**
NON-TAX INCOME			
Earnings on Investments	$66.0	$75.0	$9.0
Licenses and Fees	$70.0	$65.0	($5.0)
Other Income	$85.0	$90.0	$5.0
Non-Tax Receipts	$221.0	$230.0	$9.0
TRANSFERS			
Liquor Transfers	$56.0	$56.0	$0.0
Budget Stabilization	$0.0	$0.0	$0.0
Other Transfers In	**$0.0**	**$363.7**	**$363.7**
Total Transfers In	$56.0	$419.7	$363.7
TOTAL INCOME less Federal Grants	$13,263.0	$13,285.5	$22.5
Federal Grants	$3,924.9	$3,924.9	$0.0
TOTAL GRF INCOME	**$17,187.9**	**$17,210.4**	**$22.5**

The "Other Transfers In" category contains mostly money flowing back into the GRF from the Income Tax reduction Fund (ITRF) to repay the GRF for the revenue lost due to the income tax reduction.

DISBURSEMENTS

— *Chris Whistler**

Spending from the GRF (including transfers) was under estimate by $94.8 million in August, which led to a $74.0 million negative variance for the fiscal year-to-date. Although most of the monthly variance was due to timing issues in the **Primary and Secondary Education** and **Human Services** spending components, "true" underspending occurred in a variety of areas — most notably **Health Care** (Medicaid).

Table 4
General Revenue Fund Disbursements
Actual vs. Estimate
Month of August, 1996
($ in thousands)

USE OF FUNDS			
PROGRAM	Actual	Estimate*	Variance
Primary & Secondary Education (1)	$399,075	$426,165	($27,090)
Higher Education	146,103	141,098	5,005
Total Education	$545,178	$567,263	($22,085)
Health Care	$374,642	$400,883	($26,241)
Aid to Dependent Children	71,503	74,811	(3,308)
General Assistance	13	0	13
Other Welfare	59,994	63,876	(3,882)
Human Services (2)	67,179	104,764	(37,585)
Total Welfare & Human Services	$573,331	$644,335	($71,004)
Justice & Corrections	$101,889	$110,316	($8,427)
Environment & Natural Resources	9,008	15,345	(6,337)
Transportation	1,449	1,902	(453)
Development	11,188	11,520	(332)
Other Government (3)	23,282	34,914	(11,632)
Capital	143	962	(819)
Total Government Operations	$146,959	$174,959	($28,000)
Property Tax Relief (4)	$101,051	$74,812	$26,239
Debt Service	20,798	20,798	(0)
Total Program Payments	**$1,387,317**	**$1,482,167**	**($94,850)**
TRANSFERS			
Local Govt Distribution	$0	$0	$0
Budget Stabilization	0	0	0
Other Transfers Out	16	0	16
Total Transfers Out	$16	$0	$16
TOTAL GRF USES	**$1,387,332**	**$1,482,167**	**($94,834)**

(1) Includes Primary, Secondary, and Other Education

(2) Includes Mental Health, Mental Retardation and Developmental Disabilities, and Other Human Services

(3) Includes Regulatory and Nonregulatory agencies, Pension Subsidies, and Reissued Warrants.

(4) Includes property tax rollbacks, homestead exemption, and tangible property tax exemption.

* July, 1996 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

Primary and Secondary Education spending for the month of August was $26.0 million under the estimate of $394.2 million. The variance was primarily the result of underspending in the following line items: 200-406, Head Start ($2 million); 200-408, Public Preschool ($9.7 million); 200-411, Family and Children First ($4 million); 200-431, School Improvement Models ($12 million); 200-520, DPIA ($2 million); 200-521, Gifted Pupil Program ($0.9 million); 200-526, Vocational Education Equipment Replacement ($1.3 million); and 200-534, Desegregation Costs ($5 million). The monthly variance partially offset the $45.9 million timing overage in July, leaving fiscal year-to-date spending only $18.8 million over through August.

In the Public Preschool line item (200-408), only $20,000 of an estimated $9.8 million was disbursed. The appropriation of approximately $17 million is used to provide funds to school districts to help with preschool programs for three and four year-olds. The variance partially balances the $5.0 million overage in July.

Another item in which significant underspending occurred is the School Improvement Models line item (200-431). These $25,000 competitive grants are awarded to schools that demonstrate the capacity to invent or adapt school improvement models. The Department had projected that the bulk of these grants would actually be disbursed to districts in August. The Department must have been ahead of the game, because most of the grants were actually sent out in July.

The Disadvantaged Pupil Impact Aid (DPIA) line item (200-520) was over estimate in July, and was under estimate by $2 million for

August. The purpose of the line item is to assist school districts with low revenue raising potential by distributing moneys according to the percentage of pupils enrolled in each school district whose parents receive Aid to Dependent Children (ADC) benefits. A spokesperson from the Department of Education reports the number of pupils in ADC recipient families has gone down drastically — from 282,000 in FY 1996 to 255,000 in FY 1997. However, since a three year average is used (FY 1995, FY 1996, and FY 1997), the effect on the DPIA line item will be less than might otherwise be expected.

In addition to the DPIA payments, there is a set aside in the 200-520 line item that had an effect on this month's disbursements. A total of $5 million is allocated for the school choice (voucher) pilot program in Cleveland. Since this is the first year of the program, the Department did not know how things would operate and based disbursement estimates on a level pattern of monthly spending. Since the program was legally challenged, officials at the Department have been very careful about administering the program and have not yet decided whether checks should be made out to the parents or to both the parents and the school. The Department is now estimating that one third of the $5 million set aside will go out in October, one third in February, and one third in May. Meanwhile, the private schools attended by the children in the pilot program are naturally wanting their tuition.

Also worth noting in the **Primary and Secondary Education** component is a variance in the Desegregation Costs line item (200-534). Only half of the projected $10.2 million was disbursed from the line because the payment to the Cleveland City School District was not made; however, the Department expects to make the payment in the near future.

Although spending in the **Aid to Dependent Children** (ADC) component for the month of August was only $3.3 million under estimate, the small variance does not represent a dramatic change in the pattern of **ADC** spending from FY 1996, when the variance for the year exceeded $100 million. The Department of Human Services, predicting a lapse of $40.0 million relative to appropriations, revised the FY 1997 ADC cash assistance (400-503) spending estimate downward to $842.8 million. Thus, **ADC** spending discussions in this section of ***Budget Footnotes*** will refer to the revised estimates throughout FY 1997. (Estimates were not revised for the other component of **ADC** spending, 400-536, ADC Day Care.)

For the month of August, **Medicaid** spending was $26.2 million under estimate because of a lower-than-expected HMO payment and because of the timing of other provider payments. The HMO payment was below estimate because both enrollment and capitation rates were lower than budgeted. Enrollment is down because the number of ADC-related Medicaid eligibles is below the estimates used in forecasting Medicaid expenditures — not because the Department has failed to move recipients into managed care plans. The primary reason for the below estimate capitation rates is that the "six percent managed care savings" incorporated in the FY 1997 rates set by the Department was not anticipated during the budget process. (See the "Disbursements" section of the August issue of ***Budget Footnotes*** for a more thorough explanation.) For the year-to-date, **Medicaid** spending is below estimate by $43.4 million.

Despite the adjustments to the spending estimates of the 400-503, ADC, line item, estimated spending in the **Medicaid** (400-525) spending category remains unchanged. Although FY 1996 obligations were $35.5 million below spending authority (FY 1996 appropriations plus FY 1995 encumbrances), the Department of Human Services was likely reluctant to adjust estimates given the volatile history of Medicaid spending. Furthermore, the magnitude of ADC-related Medicaid expenditures per eligible is very small in comparison to the per-eligible expenditures generated by Aged, Blind, and Disabled (ABD) recipients — an eligibility group which has continued to grow at the same time that ADC eligibility has dropped. As the decline in the ADC caseload starts to bottom out, expect to see the increase in the ABD population begin to exert an upward pressure on **Medicaid** costs, driving spending closer to estimate.

Other Welfare spending is $17.2 million under estimate for the year-to-date ($3.9 million under in August). Underspending on the Disability Assistance program, which is due to lower-than-expected caseloads, accounts for half of the variance. Disability Assistance spending was under estimate by $5.9 million and $3.3 million in July and August, respectively.

In the **Human Services** component, August spending was $37.6 million below estimate. Over half of the variance, or $19.6 million, was underspending by the

Department of Mental Health. The variance, which offsets the July overage of $19.8 million, can largely be attributed to the timing of funding "draw-downs" by local mental health boards. The Department of Mental Retardation and Developmental Disabilities and the Department of Health also had significant negative variances in August ($11.1 million and $4.4 million, respectively).

Table 5
General Revenue Fund Disbursements
Actual vs. Estimate
Fiscal Year-to-Date 1997
($ in thousands)

USE OF FUNDS PROGRAM	Actual	Estimate*	Variance	FY 1995	Percent Change
Primary & Secondary Education (1)	$791,893	$773,120	$18,773	$738,050	7.30%
Higher Education	292,508	293,755	(1,247)	286,815	1.98%
Total Education	$1,084,401	$1,066,876	$17,525	1,024,865	5.81%
Health Care	$800,205	$843,642	($43,437)	$814,093	-1.71%
Aid to Dependent Children	202,081	218,128	(16,047)	215,706	-6.32%
General Assistance	34	0	34	7,462	-99.54%
Other Welfare	127,991	145,143	(17,153)	115,611	10.71%
Human Services (2)	240,668	257,909	(17,241)	218,641	10.07%
Total Welfare & Human Services	$1,370,979	$1,464,823	($93,845)	$1,371,512	-0.04%
Justice & Corrections	$241,937	$249,566	($7,629)	$221,381	9.29%
Environment & Natural Resources	26,173	30,229	(4,056)	28,934	-9.54%
Transportation	2,577	2,443	134	2,676	-3.70%
Development	25,708	24,769	939	18,714	37.37%
Other Government (3)	73,278	84,250	(10,972)	61,815	18.54%
Capital	184	1,383	(1,199)	1,537	-88.03%
Total Government Operations	$369,858	$392,641	($22,783)	$335,057	10.39%
Property Tax Relief (4)	$102,186	$76,248	$25,939	$67,112	52.26%
Debt Service	70,678	71,546	(868)	69,761	1.31%
Total Program Payments	**$2,998,102**	**$3,072,134**	**($74,032)**	**$2,868,307**	**4.53%**
TRANSFERS					
Capital Reserve	$0	$0	$0	$12,000	-100.00%
Budget Stabilization	0	0	0	535,214	-100.00%
Other Transfers Out	405,253	405,237	16	311,039	30.29%
Total Transfers Out	$405,253	$405,237	$16	$858,253	-52.78%
TOTAL GRF USES	**$3,403,355**	**$3,477,371**	**($74,016)**	**$3,726,560**	**-8.67%**

(1) Includes Primary, Secondary, and Other Education

(2) Includes Mental Health, Mental Retardation and Developmental Disabilities, and Other Human Services

(3) Includes Regulatory and Nonregulatory agencies, Pension Subsidies, and Reissued Warrants.

(4) Includes property tax rollbacks, homestead exemption, and tangible property tax exemption.

* July, 1996 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

The Department of Rehabilitation and Correction's (DRC) existing GRF budget contains readily identifiable pools of state financial assistance to assist local criminal justice systems with absorbing some of the fiscal effects of Am. Sub. S.B. 2, the felony sentencing reform act of the 121st General Assembly (effective July 1, 1996). Two of these "pools of money" include appropriation line items 501-407, Community Nonresidential Programs, and 501-408, Community Misdemeanor Programs. The former has a "prison diversion" focus, meaning it funds local sanctions that offer judges alternatives to shipping an offender off to the state's prison system, while the latter has a "jail population reduction" focus, meaning it funds local sanctioning alternatives for reducing or eliminating jail stays for certain offenders.

At the start of FY 1997, 70 of the state's 88 counties were scheduled to draw some funding from this mix of prison diversion (501-407) or jail population reduction (501-408) program funds — 18 counties were not in the line to receive any allocation. This funding picture was altered by the Controlling Board on September 16, 1996 when it approved a DRC appropriation transfer request that tossed in another $1.02 million into the mix, thus raising the FY 1997 total for these two program funds up to $20.72 million. The additional appropriations will permit DRC to distribute money to 12 more counties during FY 1997 (Ashland, Brown, Geauga, Huron, Jackson, Knox, Madison, Mercer, Morgan, Morrow, Paulding, and Van Wert), as well as pump more money into nine counties that are already receiving some of these funds. This will bring the total number of counties receiving such financial help during FY 1997 up to 82, with 44 of those 82 counties expected to draw from money from both programs (407 and 408).

Subsequent to the approval of this Controlling Board request, six counties (Coshocton, Crawford, Harrison, Hocking, Perry, and Preble) were left that are not scheduled to receive any of this money during FY 1997. The reasons for this "nonparticipation" appear to vary. For example, in order to receive some of this money, a county had to submit a comprehensive plan for DRC's review. At least three of these six counties did not submit a comprehensive plan; a fourth submitted a comprehensive plan after the deadline established by DRC for allocating FY 1997 moneys. Also, two of the six counties simply did not submit a request for any of this money.

To this list of reasons must be added the possibility of other factors that shaped local thinking, including a "let's just wait-and-see" attitude to determine the appropriate programmatic response, a belief that existing locally-available sanctioning tools (community-based correctional facility (CBCF), jail, and halfway house beds, as well as state-provided probation services) were sufficient, or a feeling that the amount of potentially available state money was not worth the paperwork headache of the grant negotiation process.

So, you ask, what does all this have to do with **Justice and Corrections** disbursements, specifically spending by DRC? Basically, it means that we should see spending overages totaling around one-half million dollars or so by the end of FY 1997 in both appropriation line items 501-407 and 501-408. Why? Because OBM's original disbursement estimates would not have been built to reflect unplanned or unexpected GRF appropriation transfers. Predicting when a noticeable overage may actually develop in either appropriation line item is somewhat problematic though, since the nature of the grant negotiation and invoicing process will vary from county to county. That said, however, it would not surprise us to see some overages occur late in calendar year 1996 or early in calendar year 1997.

**Contributions to this article were made by Jeff Golon, Grant Paullo, and Deborah Zadzi.*

APPENDIX

The following table compares the original FY 1997 spending authority (as determined through Am. Sub. H.B. 117 of the 121st General Assembly) with OBM's July, 1996 disbursement estimates. It should be noted that the "Appropriation" column only includes the spending authority as given by the budget bill. Therefore, the appropriation amounts include neither encumbrances nor transfers in spending authority from FY 1996 to FY 1997, nor do they include supplemental appropriations in subsequent bills.

The "Estimate" column, however, includes all spending estimated to occur from these categories during FY 1997. Thus, the estimates account for spending from the transfers noted above, spending against prior year encumbrances, and expected lapses and encumbrances at the end of FY 1997.

It is clear from the description of this table that the "Difference" column generally understates the variance between what can legally be spent and what is expected by OBM to be spent. However, the actual difference between total spending authority and estimated spending was calculated in the process of determining the income tax rate reduction included in the recent budget correction bill (S.B. 310).

Appropriations and Spending Estimates, FY 1997

all amounts in millions of dollars

USE OF FUNDS

PROGRAM	Appropriation	Estimate*	Difference
Primary & Secondary Education (1)	$4,057.4	$4,060.2	$2.8
Higher Education	2,115.9	2,108.8	(7.1)
Total Education	$6,173.3	$6,168.9	($4.4)
Health Care	$5,323.0	$5,323.2	$0.2
Aid to Dependent Children	957.1	918.2	(38.9)
General Assistance	0.0	6.2	6.2
Other Welfare	684.2	719.2	35.0
Human Services (2)	1,048.7	1,032.5	(16.2)
Total Welfare & Human Services	$8,013.0	$7,999.3	($13.7)
Justice & Corrections	$1,392.6	$1,382.2	($10.4)
Environment & Natural Resources	115.1	111.6	(3.6)
Transportation	38.4	38.1	(0.3)
Development	110.0	123.0	13.0
Other Government (3)	390.0	384.0	(6.0)
Capital**	13.1	5.7	(7.4)
Total Government Operations	$2,059.2	$2,044.5	($14.7)
Property Tax Relief (4)	$907.4	$907.4	$0.0
Debt Service	119.6	95.7	(23.9)
Total Program Payments	**$17,272.6**	**$17,215.9**	**($56.7)**
TRANSFERS			
Local Govt Distribution	$0.0	$0.0	$0.0
Budget Stabilization	0.0	0.0	0.0
Other Transfers Out	0.0	535.2	535.2
Total Transfers Out	$0.0	$535.2	$535.2
TOTAL GRF USES	**$17,272.6**	**$17,751.1**	**$478.6**

(1) Includes Primary, Secondary, and Other Education

(2) Includes Mental Health, Mental Retardation and Developmental Disabilities, and Other Human Services

(3) Includes Regulatory and Nonregulatory agencies, Pension Subsidies, and Reissued Warrants.

(4) Includes property tax rollbacks, homestead exemption, and tangible property tax exemption.

* July, 1996 estimates of the Office of Budget and Management.
** Because Capital spending is appropriated for two years, appropriation is set equal to estimate.

Detail may not add to total due to rounding.

Government Services Television Network Index

By Joshua N. Slen

The Legislative Budget Office receives a monthly video tape which offers general training and information segments that are applicable to all levels of government. The video tapes are kept at the LSC library, which is located on the 9th floor of the Vern Riffe Center for Government & the Arts, and are available to all members of the Assembly and their staff. If you have questions about the availability of one of the tapes please contact the LSC library at 466-5312. The *August* edition of the GSTN video contains five different programs/segments which are outlined below.

Segment/Topic	*Running Time*	*Content/Description*
GSTN Journal / Various newsworthy topics from around the country.	9:45	This month=s journal includes segments on how NAFTA is impacting border communities, improving fiscal conditions in U.S. cities, and neighborhood revitalization, among other topics.
Leadership Spotlight/Participation, Partnerships, Protection: Local Governments and Superfund	12:00	A brief overview of one community Superfund cleanup. The segment includes several contact numbers for information from federal government and nonprofit sources.
Training Track/Ethics in the Workplace, Part 2 - Ethics in Decision Making	17:00	A good program that utilizes three examples of workplace decision making to draw out the components of an ethical decision, some guidelines for making ethical decisions, and a few obstacles to making ethical decisions.
Human Factor/Shared Savings: An Employee Incentive Plan	13:30	This segment focuses on how Pittsburg, CA utilized an innovative program within the parks department to control costs while rewarding employees.
Money Watch/Telecommunications - Partnering for Development	12:30	Utilizing the city of Austin, Texas, the program examines the unique role of public and private partnerships in the telecommunications development process.