Budget Footnotes

A NEWSLETTER OF THE OHIO LEGISLATIVE BUDGET OFFICE — FEBRUARY, 1998

FISCAL OVERVIEW

— *Frederick Church*

The state's fiscal picture continues to look very strong. Tax revenues were over the estimate in January, despite a shortfall in the non-auto sales tax, and spending was again below the estimate. Through a quirk of timing, bottom line revenues appear to be well below estimate for January, but this should be corrected next month. The anticipated transfer into the GRF from the Income Tax Reduction Fund (ITRF) to compensate for the 4.0 percent cut in marginal rates in taxable year 1997 was postponed until February. This means that $235.3 million that was anticipated in January will instead be deposited into the GRF this month.

December and January are very important months for the sales tax and the income tax, and since the sales tax and the income tax are the biggest GRF revenue sources, months that are important for them are by definition very important for the GRF. The Christmas shopping season is important for the sales tax, and the end of the calendar year is important for the income tax in several ways. January is traditionally by far the biggest collection month for employer withholding, fueled by seasonal hiring and employee bonuses. January is also the biggest month for quarterly estimated payments, as taxpayers make their final estimated payment against the prior calendar year's tax liability. Analysts at OBM and LBO traditionally breathe a sigh of relief if January finishes with no ugly surprises. Since the income tax was very strong in January and the sales tax was only slightly below estimate despite reports of poor Christmas sales in December, the outlook for the remainder of the year is now stronger. We should be able to expect good filing season results for the income tax, based on quarterly estimated payments so far. The sales tax may also rebound in February, based on reports of strong post-Christmas sales in January. For the remainder of FY 1998, solid employment and wage growth should result in steady increases in sales tax revenue.

For the year, tax revenue is $154.7 million over estimate, with the income tax generating $114.3 million of the overage. Most of the remaining $40 million overage is from the sales and use tax ($23.5 million) and the public utility excise tax ($15.5 million). Total non-federal revenues are $21.3 million below estimate, but if one adjusts for the late transfer from the ITRF, there would be a $214.0 million overage. Federal reimbursement continues to run a huge shortfall, but this is due to underspending on human services programs that draw federal matching money.

GRF spending excluding transfers is $461 million below estimate. Total outlays including transfers are $418 million below estimate — the

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STATUS OF THE GRF

ISSUES OF INTEREST

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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.

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

	Month of January	Fiscal Year 1998 to Date	Last Year	Difference
Beginning Cash Balance	($742.1)	$1,367.7		
Revenue + Transfers	$1,966.6	$9,819.2		
Available Resources	$1,224.6	$11,186.9		
Disbursements + Transfers	$1,332.3	$11,294.6		
Ending Cash Balances	**($107.7)**	**($107.7)**	**$509.5**	**($617.3)**
Encumbrances and Accts. Payable		$505.3	$405.4	$99.9
Unobligated Balance		**($613.0)**	**$104.2**	**($717.2)**
BSF Balance		$862.7	$828.3	
Combined GRF and BSF Balance		**$249.7**	**$932.5**	**($682.8)**

difference is due to some unanticipated transfers from the GRF to bond funds (since repaid). Welfare and human services programs account for $283.6 million in underspending, or more than 60 percent of the total. TANF and Medicaid are neck and neck in the race for biggest variance, with underspending of $121.7 million and $120.7 million, respectively. To repeat what we have been saying, most of the underspending here is due to declining welfare caseloads, but most of the TANF underspending cannot result in a year-end savings of state dollars, due to the complicated nature of the state's maintenance of effort (MOE) requirement for state spending. The Medicaid news is better, since the state should be able to capture whatever state-share year-end savings there are.

The underspending in Medicaid is not surprising given that average monthly Medicaid recipient counts have dropped by over 5 percent from FY 1997. The number of TANF/Healthy Start recipients has declined by over 15 percent, while the number of Aged, Blind, and Disabled (ABD) recipients has increased slowly. It should be noted, however, that this includes multiple contacts per recipient. Hospital and HMO spending are well below estimate. If not for overages in long-term care and prescription drugs, the picture would be even brighter.

In TANF, the state really can't save much GRF money because the terms of the federal block grant program require that the state's MOE spending be at least 75 percent of the base year amount. It appears likely that the Department of Human Services will spend all the required state money and not as much federal funds as anticipated, leaving a substantial reserve of federal money that can be carried forward to future years. This reserve would be in addition to the $75 million already built in through the budget bill. This has implications for total GRF revenues, and for the fund balance, which is discussed in greater detail below.

Despite the good news in revenues and spending, Table 1 shows that the state's combined GRF and BSF balance is substantially less than it was last year at this point. The combined GRF and BSF balance is down by about $717 million. Some of this difference will be erased when the GRF gets the $235 million owed to it by the ITRF. Some of the difference will remain, based on the fact that transfers out of the GRF to other funds are about $146 million higher this year than last year. As previous issues of ***Budget Footnotes*** have pointed out, most of these transfers were done at the beginning of the year, using GRF surplus money from FY 1997 to fund various items of education capital.

Finally, although it appears that the decision to spend state dollars for TANF and hold federal dollars in reserve has not yet affected the bottom line (see the disbursements section), it will do so in coming months. Since the GRF will spend state dollars to hit the MOE requirement, but the state will not draw its full allocation of federal money, the federal reimbursement shortfall will be even larger than one would expect based on the total underspending in Medicaid, TANF, and other welfare items. This means that total GRF revenue will be substantially lower than it would have been, and that the unobligated GRF fund balance will also be reduced. While this appears not to be a factor in the federal reimbursement shortfall to date, it will become one. ❑

TAX POLICY UPDATE ON INTERNET COMMERCE AND STATE SALES TAXES

— Frederick Church

Last month, as part of its roundup of explanations of why the sales tax has not grown faster during the CY 1997 economic boom, LBO mentioned that the Federal Reserve's January 1998 *Beige Book* report specifically mentioned that for the Fourth District (which includes Ohio) the volume of catalog sales rose sharply again in 1997, helped in part by the growing popularity of the Internet. Internet sales are a problem that has been vexing state and local governments for some time now, with interest coming to a boil this year. From a state's point of view, the issue is essentially the same as for mail-order catalog sales: the states have trouble taxing mail-order sellers because the sellers don't have sufficient physical nexus in most states.[1] The *National Bellas Hess* verdict of 1967 established the "bright line" physical presence tests that most retailers use, and the 1992 *Quill vs. North Dakota* decision reinforced this interpretation. If the mail-order seller has stores in a given state, that state can clearly charge sales tax (Ohio has now gained that ability with Gateway 2000 computers since Gateway has established its "country stores" within the state). In Ohio, as in most states, consumers who buy mail-order products actually still owe the state use tax, but many do not pay, and the state finds auditing individual consumers very costly. Over the years, the states have petitioned Congress to make interstate mail-order sales explicitly taxable, in the sense that sellers would have to collect the tax and remit it to the state. Bills have been introduced, but none have passed.

Toward the end of CY 1997, there was a big controversy about state taxation of mail order sales, as the press reported that a tentative agreement had been reached between the states (represented by groups like the Federation of Tax Administrators, or FTA) and large mail-order retail firms. Apparently the newspaper articles touched off waves of angry letter-writing that caused the retailers to reconsider, and the matter has been quiet for the last couple of months.[2]

Meanwhile, the Communications and Electronic Commerce Taxation Project (CECTP) held a national forum in November in Chicago as a "piggyback" onto the National Tax Association (NTA) annual meetings. When the project report is issued, it is supposed to include model legislation for the states in taxing electronic commerce.[3] The states are looking at a number of options for taxing Internet commerce, including a sort of nationwide software application that would overlay the Internet and determine how much sales tax was owed and where, based on the rules programmed into it by policymakers. While this may at first seem like a "pie-in-the-sky" solution, policymakers and industry people took it very seriously at this year's Federation of Tax Administrators (FTA) conference for tax policy and revenue estimation.

The most recent news in this area is that the National Governors Association (NGA) has just endorsed an effort led by Colorado Gov. Roy Romer to tax merchandise sold via the Internet. Mr. Romer, a Democrat, and Utah Gov. Mike Leavitt, a Republican, want to develop a single Internet sales tax for each state. Access fees to connect with Internet providers won't be taxed under the plan. The NGA endorsed the plan during its winter meeting in Washington, D.C.

Predictably, the governors aren't united in supporting the effort. States with large Internet businesses objected, saying the idea would damage the information-technology market. Specifically, Virginia and California both objected to the tax plan: Virginia is the home of America Online Inc. and California has a huge number of companies engaged in Internet commerce.

One spur to action for state governors is the so-called Internet Tax Freedom Act, a bill before Congress that would place a six-year moratorium on state and local Internet taxes. The bill, which has broad backing from the computer industry, passed the Senate Commerce Committee last fall, but its momentum has stalled since then. The states fear that the moratorium will lead to huge revenue losses and set a dangerous precedent that will be almost impossible to reverse six years later when Internet commerce is even more entrenched than it is now.

Mail-order companies also oppose the imposition of "new" Internet taxes. They fear that the imposition of sales taxes on Internet commerce will be the "crack in the armor" that could lead to a change in the rules for companies with mail-order businesses as well.

While no consensus estimate currently exists of the amount of sales tax revenue that the states are losing due to Internet commerce, everyone seems to agree that number is large and will get much larger in the next few years.[4]As Nicholas Negroponte points out in his book *Being Digital*, soon the technology will exist for most book, magazine, movie, and music sales to be done through computers. This includes not just the selling of books through Web sites like amazon.com, where the books are ordered over the Internet but shipped the old-fashioned way, but the actual delivery of the product from one computer to another. As Negroponte says, anything that can be transmitted as bits rather than matter is fair game for Internet commerce.[5] Finally, the tax policy consideration of fairness attached to the mail-order sales question is present in Internet commerce also. Simply put, what theoretical support is there for allowing companies that ship across state lines, without physical nexus, a tax advantage over companies that have stores, employees, or some other physical presence within the taxing state?[6] Although states have been trying unsuccessfully for more than 30 years since the *National Bellas Hess* decision to get mail-order sellers to collect state sales tax, the battle is not over. Given the revenues at stake and the fundamental fairness questions involved, it is likely that debate over the taxation of Internet commerce will intensify in the coming years, particularly when the next economic downturn comes and states find themselves in need of additional revenue. ❑

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[1] There is a difference between mail order and Internet sales that has to do with the "passive" nature of Internet commerce. Companies that sell through Web sites are not regularly soliciting markets through mailings in the way that mail order sellers are. There is no consensus about how crucial this difference is for tax purposes.

[2] Actually, the FTA, state tax officials, and the Direct Marketers Association (DMA) have at least a draft of a Voluntary Collection Agreement (VCA), which is still on the table. A key feature of the VCA is that participating retailers would collect state sales tax prospectively, but would be immune from litigation for back taxes.

[3] The first draft report has been issued. It assumes that marketers of digital products (music, videos, software, etc.) have nexus where they have customers. The DMA has objected to the report.

[4] Companies like Forrester Research estimate that Internet sales will hit $6.6 billion in the year 2000. At an average state tax rate of 5 percent, states would lose $132 million in revenue. However, some estimates of Web commerce are higher. There is still disagreement about the revenue loss from mail-order sales as well. The ACIR has estimated that state and local governments lose $3.3 billion to untaxed interstate mail-order sales. However, the DMA estimate is only $1.4 billion.

[5] Interestingly, there are about a dozen states that already impose broad-based sales or use taxes on on-line "content" transferred by means of electronic commerce. Some states tax all or some of the following on-line services: data processing, E-mail, computer bulletin boards, news and weather reports, credit reports, airline reservations, games, legal and medical data bases, 900 number service, cable television, software downloads, and fax services. These states may be better able to deal with the increasing transformation of some goods and services to bits rather than as matter.

[6] This is not just an American state and local tax question, but a global problem. For example, Australian retailers are clamoring for their government to remove existing tax exemptions for imported goods ordered over the Internet.

Status of the General Revenue Fund

REVENUES

— Frederick Church

The income tax overage continues to dominate the revenue story. Through January, GRF income tax collections are $114.3 million over estimate, have grown by 8.2 percent from last year, and are 3.3 percent above the forecast. Total collections are $127.7 million above estimate. The percentage growth figures are slightly less gaudy than they were through the end of December, since more of the January estimated payment was "pre-paid" in December than usual, but on the whole the picture has not changed much.

The other major overage is in the sales and use tax. The January shortfall in the non-auto tax was not enough to wipe out the overage accumulated through December. In this case, actual revenues are extremely close to the estimate in percentage terms — combined auto and non-auto collections are 0.7 percent above the estimate. However, since the base is so large, 0.7 percent still translates into a year-to-date overage of $23.5 million.

Table 2
General Revenue Fund Income
Actual vs. Estimate
Month of January, 1998
($ in thousands)

REVENUE SOURCE	Actual	Estimate*	Variance
TAX INCOME			
Auto Sales	$52,130	$45,276	$6,854
Non-Auto Sales & Use	509,660	520,098	(10,438)
Total Sales	$561,790	$565,374	($3,584)
Personal Income	$868,570	$854,457	$14,113
Corporate Franchise	180,905	171,830	9,075
Public Utility	442	0	442
Total Major Taxes	**$1,611,707**	**$1,591,661**	**$20,046**
Foreign Insurance	$1	$0	$1
Domestic Insurance	3	0	3
Business & Property	23	93	(70)
Cigarette	23,265	22,738	527
Soft Drink	0	0	0
Alcoholic Beverage	3,797	3,485	312
Liquor Gallonage	3,258	3,105	153
Estate	1,866	0	1,866
Racing	0	0	0
Total Other Taxes	$32,213	$29,422	$2,791
Total Taxes	**$1,643,920**	**$1,621,082**	**$22,838**
NON-TAX INCOME			
Earnings on Investments	$0	$0	$0
Licenses and Fees	4,168	3,365	803
Other Income	7,757	3,721	4,036
Non-Tax Receipts	$11,925	$7,086	$4,839
TRANSFERS			
Liquor Transfers	$4,000	$3,500	$500
Budget Stabilization	0	0	0
Other Transfers In	31,004	235,300	(204,296)
Total Transfers In	$35,004	$238,800	($203,796)
TOTAL INCOME less Federal Grants	**$1,690,849**	**$1,866,968**	**($176,119)**
Federal Grants	$275,800	$301,080	($25,280)
TOTAL GRF INCOME	**$1,966,649**	**$2,168,048**	**($201,399)**

* July, 1997 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

Most of the other taxes are relatively close to the estimates. The public utility excise tax is $15.6 million over estimate, but most of this comes from higher than estimated reconciliation payments at the end of calendar year (CY) 1997. The October estimated payment was close to the forecast, so we anticipate that the March and June payments will be also. The existing overage should not be expected to increase as the fiscal year continues. On the other hand, the corporate tax may be somewhat inflated, and the existing $5.8 million shortfall may increase

Table 3
General Revenue Fund Income
Actual vs. Estimate
Fiscal Year-to-Date 1998
($ in thousands)

REVENUE SOURCE					
TAX INCOME	Actual	Estimate*	Variance	FY 1997	Percent Change
Auto Sales	$407,613	$396,508	$11,105	$389,021	4.78%
Non-Auto Sales & Use	2,783,288	2,770,866	12,422	2,651,281	4.98%
Total Sales	$3,190,901	$3,167,374	$23,527	$3,040,302	4.95%
Personal Income	$3,618,596	$3,504,274	**$114,322**	$3,345,166	**8.17%**
Corporate Franchise	188,530	194,334	(5,804)	310,945	-39.37%
Public Utility	229,593	214,043	15,550	212,164	8.21%
Total Major Taxes	$7,227,619	$7,080,025	$147,594	$6,908,577	4.62%
Foreign Insurance	$146,909	$147,642	($733)	$143,327	2.50%
Domestic Insurance	438	440	(2)	205	113.66%
Business & Property	480	1,072	(592)	1,021	-52.99%
Cigarette	160,829	159,478	1,351	162,583	-1.08%
Soft Drink	0	0	0	18	-97.81%
Alcoholic Beverage	30,259	29,155	1,104	30,153	0.35%
Liquor Gallonage	16,695	16,436	259	16,510	1.12%
Estate	51,808	46,078	5,730	46,117	12.34%
Racing	0	0	0	0	#N/A
Total Other Taxes	$407,418	$400,302	$7,116	$399,933	1.87%
Total Taxes	**$7,635,037**	**$7,480,326**	**$154,711**	**$7,308,510**	**4.47%**
NON -TAX INCOME					
Earnings on Investments	$65,400	$42,319	$23,081	$50,988	28.27%
Licenses and Fees	21,471	46,218	(24,747)	46,558	-53.88%
Other Income	63,216	45,671	17,545	51,469	22.82%
Non-Tax Receipts	$150,087	$134,208	$15,879	$149,014	0.72%
TRANSFERS					
Liquor Transfers	$50,000	$39,500	$10,500	$36,500	36.99%
Budget Stabilization	0	0	0	$0	#N/A
Other Transfers In	32,932	235,300	(202,368)	398,780	-91.74%
Total Transfers In	$82,932	$274,800	($191,868)	$435,280	-80.95%
TOTAL INCOME less Federal Grants	**$7,868,057**	**$7,889,334**	**($21,277)**	**$7,892,804**	**-0.31%**
Federal Grants	$1,951,107	$2,219,779	($268,672)	2,154,217	-9.43%
TOTAL GRF INCOME	**$9,819,163**	**$10,109,113**	**($289,950)**	**$10,047,021**	**-2.27%**

* July, 1997 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

somewhat by the end of February. The first of the three payments against taxable year 1997 was due January 31st. Revenues from this payment are distributed unpredictably between January and February, based on factors like processing and posting by State Accounting. It appears that a greater than expected share of the total first payment may have come in during January, meaning that February's payment may be smaller than expected.

In non-tax income, investment earnings continue above estimate (by $23.1 million) despite the fact that the unobligated GRF fund balance has dipped so far below last year's level. Liquor profit transfers also show a $10 million overage. License and fee income is far below estimate, but this is still thought to be a timing problem that will be corrected by year's end. Federal reimbursement is even further below estimate than one would expect based on the underspending in welfare and human services programs. Readers should expect a very large gap by year's end also, since — as mentioned in the Fiscal Overview — the state will spend state TANF dollars to reach the MOE and leave a large amount of federal money unspent and in reserve for future years.

Personal Income Tax

The income tax component with the biggest overage is still employer withholding. January did not have double-digit year-over-year growth as November and December did, but the increase was still a very respectable 7.4 percent (compare this to the original estimate of withholding growth for the fiscal year, which was only 5.5 percent). For the year, withholding is $100.4 million over estimate, and year-over-year growth is 9.1 percent.

As we stated last month, the most current Ohio labor market data for the most part do not support such

Tax Year	Quarterly Estimated Payment Growth	Fiscal Year (January – June)	Net Settlements (millions)	Net Settlements Difference from Estimate (millions)
1993	8.90%	1994	($104.5)	($79.2)
1994	0.20%	1995	($121.6)	($72.2)
1995	10.52%	1996	($49.4)	$72.0
1996	16.48%	1997	$13.4	$131.2
1997	7.37%	1998	??	??

an increase in withholding. Both the household and establishment survey data show year-over-year employment growth for the last seven months to be only about 1 percent. Of course, prior experience tells us that the employment numbers may be revised upward when re-benchmarking is done this March. On the other side, the wage data does show an upward spike. The broadest Ohio-specific measure that we have to go on is average hourly earnings in manufacturing, which increased by 4.7 percent in the fourth quarter (compared to last year). If wage growth of that magnitude is common to other sectors besides manufacturing, that would go part way to explaining the surge in withholding revenue. There may also be other factors at work, like late-year employee bonuses, that are also a factor, although we have neither hard data nor much anecdotal evidence to support that theory right now.[1]

Now that the final quarterly estimated payment against tax year 1997 liability is in, we can compare payments against this tax year to recent history, and draw some inferences. The January estimated payment was $11.1 million above estimate, which pushes the year-to-date overage to $40.7 million. For the fiscal year, growth is 10.6 percent, compared to an estimate of only 4.3 percent.

Regular readers of this report will recall the point made in prior years that the January estimated payment is a pretty good indicator of filing season activity. The January payment is the fourth and last estimated payment against tax year liability (in this case, the final estimated payment against tax year 1997 liability). This means that the last estimated payment is often used as a reconciliation payment. Some taxpayers who do preliminary calculations of liability may find that they owe significantly more in tax than they had been assuming in making their first three estimated payments. Those taxpayers will often make a big final payment. Conversely, taxpayers who have been overestimating their liability may make a much smaller final payment. In a year when the final estimated payment is well above the OBM or LBO estimate, one may assume that many taxpayers have higher liability than they anticipated and so the state can expect good filing season revenues. Just the opposite has happened in weak income years.

Based on the performance of quarterly estimated payments this January, and for the tax year as a whole, we would expect filing season results — annual return payments and refunds — to be favorable. The table above seeks to show a relationship between the growth in estimated payments for an entire tax year, and the difference between actual and expected net settlements over the ensuing January through June period. The relationship is far from perfect, but it does appear that in years with strong estimated payment growth, it is more likely that the state will see better than expected net settlements.

Sales and Use Tax

The sales and use tax is over estimate by $23.5 million, despite having lost some ground in January. Although the auto component of the tax was $6.8 million above estimate, the non-auto component fell $10.4 million short, leaving a net shortfall of $3.6 million. For the year-to-date, the performance of the auto and non-auto components has been remarkably similar: the auto tax has grown by 4.8 percent and is $11.1 million over estimate, while the non-auto component has grown by 5.0 percent and is $12.4 million over estimate.

The late January ***Beige Book*** (the Federal Reserve's report on regional economic activity) for the Fourth District reported that, although early December sales were slow, consumer spending rebounded sharply in the two weeks leading up to Christmas. For the month overall, reports were mixed. A few retailers reported high year-over-year gains, some reported growth of about 5 percent, and some were below 5 percent. Discount stores did better than department stores, and the best selling items were electronics, housewares, and jewelry.

At the national level, most retailers reported strong sales in early January, partly as the result of aggressive price markdowns. This may result in strong February non-auto tax collections in Ohio.

In the automotive sector, the ***Beige Book's*** Fourth District report stated that sales of new cars were slow in December, but sales of minivans, sport utility vehicles, and small trucks remained strong. As a result, new car inventories are generally heavy. High rebates at the end of the 1997 model year are blamed for the recent sales slump.

At the national level, January unit sales of cars and light trucks declined by 6.6 percent from a year ago. However, much of this decline was anticipated. As with the Fourth District, much of the January slump is blamed on sales incentives that caused some January sales to be accelerated into December 1997. Analysts currently believe that demand in the auto market should rebound in the coming months.

To repeat a section from last month's report, it is possible that in the next few months, consumption and retail sales may get a boost from the recent wave of mortgage refinancings. Refinancing activity has been heavy as mortgage rates have been lingering around their lowest levels since 1993. Some economists say that there is also evidence that homeowners have become more financially sophisticated and more sensitive to refinancing opportunities. In any case, mortgage refinancing makes consumers feel richer and generally leads to some boost in spending (it propelled the initially weak recovery to much more solid ground in 1993). This may help retail sales and state sales tax collections in the last few months of FY 1998. ❑

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[1]Limited data from around the country show that a number of other states are also experiencing very high withholding growth rates. The LBO has also received calls from tax analysts in other states asking if withholding growth seemed out of line with official employment estimates, so Ohio is not alone there either.

DISBURSEMENTS

*— Jeffrey E. Golon**

Hey, somebody stop me if you have to, but I gotta say "it's déjà vu all over again!" After a one-month hiatus, the parade of negative monthly disbursement variances restarted its stroll through the fiscal year, with the state posting a $72.9 million underage in January. Excluding GRF transfers, state spending closed the month of January $460.9 million under estimate year-to-date, a new high water mark for FY 1998. Keep in mind that blended in with that number was federal money associated with the state's welfare and human services spending. The most notable program components — TANF and Medicaid — contained $126.7 million in underspending that, although tracked as GRF appropriations, was actually federal money. This meant that around 27 percent of the total amount of year-to-date underspending was really federal money. Once that federal money was backed out, the year-to-date underspending of non-federal state GRF was reduced to more like $334.2 million.

Table 4
General Revenue Fund Disbursements
Actual vs. Estimate
Month of January, 1998
($ in thousands)

USE OF FUNDS

PROGRAM	Actual	Estimate*	Variance
Primary & Secondary Education (1)	$346,478	$369,470	($22,992)
Higher Education	150,838	150,901	(63)
Total Education	$497,316	$520,372	($23,056)
Health Care	$369,434	$418,928	($49,494)
Temporary Aid to Needy Families	81,578	99,134	(17,556)
General Assistance/Disability Assistance	4,231	5,172	(941)
Other Welfare	35,613	45,716	(10,103)
Human Services (2)	107,300	74,125	33,175
Total Welfare & Human Services	$598,156	$643,074	($44,918)
Justice & Corrections	$163,958	$174,085	($10,127)
Environment & Natural Resources	9,592	9,366	226
Transportation	2,783	2,492	291
Development	6,741	8,348	(1,607)
Other Government (3)	24,194	22,137	2,057
Capital	432	491	(59)
Total Government Operations	$207,700	$216,919	($9,219)
Property Tax Relief (4)	$4,250	$0	$4,250
Debt Service	18,885	18,921	(36)
Total Program Payments	**$1,326,307**	**$1,399,286**	**($72,979)**
TRANSFERS			
Local Govt Distribution	$0	$0	$0
Budget Stabilization	0	0	0
Other Transfers Out	6,002	0	6,002
Total Transfers Out	$6,002	$0	$6,002
TOTAL GRF USES	**$1,332,309**	**$1,399,286**	**($66,977)**

(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.

* August, 1997 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

Almost four-fifths, or 79 percent, of the year-to-date underspending was directly attributable to three areas of state government — the Medicaid program ($121.7 million), the Department of Education ($121.2 million), and the TANF program ($120.7 million). The Department of Education's underspending appeared to be largely matters related to timing, suggesting that much of the underage will be disbursed in FY 1998 or encumbered for disbursement at some later date during FY 1999. We'd venture that some amount of the FY 1998 money appropriated for special education (line item 200-504) and vocational education (200-507) will turn out to be truly a surplus and thus lapse. However, we don't feel particularly comfortable quantifying what that surplus amount might be at the moment for

Table 5
General Revenue Fund Disbursements
Actual vs. Estimate
Fiscal Year-to-Date 1998
($ in thousands)

USE OF FUNDS PROGRAM	Actual	Estimate*	Variance	FY 1997	Percent Change
Primary & Secondary Education (1)	$2,705,785	$2,825,598	($119,813)	$2,551,368	6.05%
Higher Education	1,307,824	1,314,288	(6,464)	1,221,930	7.03%
Total Education	$4,013,609	$4,139,886	($126,276)	3,773,297	6.37%
Health Care	$2,984,134	$3,105,840	($121,706)	$2,857,345	4.44%
Temporary Aid to Needy Families	546,567	667,275	(120,708)	217,105	151.75%
General Assistance/Disability Assistance	34,447	38,651	(4,204)	100	34346.82%
Other Welfare	272,205	283,328	(11,123)	760,635	-64.21%
Human Services (2)	722,471	748,286	(25,815)	669,807	7.86%
Total Welfare & Human Services	$4,559,824	$4,843,381	($283,558)	$4,504,992	1.22%
Justice & Corrections	$937,882	$940,771	($2,890)	$846,977	10.73%
Environment & Natural Resources	88,109	81,614	6,495	76,808	14.71%
Transportation	14,143	22,725	(8,582)	13,090	8.05%
Development	73,081	87,447	(14,366)	79,019	-7.51%
Other Government (3)	225,955	253,976	(28,021)	218,552	3.39%
Capital	2,773	5,724	(2,951)	4,873	-43.10%
Total Government Operations	$1,341,944	$1,392,258	($50,314)	$1,239,319	8.28%
Property Tax Relief (4)	$515,563	$516,897	($1,334)	$490,020	5.21%
Debt Service	100,055	99,481	574	91,405	9.46%
Total Program Payments	**$10,530,995**	**$10,991,903**	**($460,908)**	**$10,099,034**	**4.28%**
TRANSFERS					
Capital Reserve	$0	$0	$0	$0	#N/A
Budget Stabilization	34,400	34,000	400	0	#N/A
Other Transfers Out	729,237	686,766	42,471	576,949	26.40%
Total Transfers Out	$763,637	$720,766	$42,871	$576,949	32.36%
TOTAL GRF USES	**$11,294,632**	**$11,712,669**	**($418,037)**	**$10,675,983**	**5.79%**

(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.

* August, 1997 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

fear that we'd be served a dinner of crow down the road. On the other hand, declining human services caseloads continued to suppress TANF and Medicaid disbursements, suggesting that the FY 1998 appropriations for these respective programs actually contain potentially sizeable amounts of surplus money that should lapse back into the GRF's available cash balance at the close of the fiscal year. However, TANF moneys that are not spent on cash assistance due to declining caseloads may be spent on prevention, retention and contingency efforts, thereby potentially negating some portion of the TANF lapse. In addition, TANF state GRF will be fully expended, leaving lapses only in TANF federal dollars.

That in a nutshell was the state's year-to-date disbursement picture through the month of January. For those interested in some selective disbursement details read on my friends.

Primary and Secondary Education

Department of Education. A $21.9 million underage in January pulled the department's negative year-to-date disbursement variance even further under, bringing it up $121.2 million. However, this monthly underage was deceptive as it appears to have been driven by a planned $48.0 million semiannual disbursement of Auxiliary Services funding (line item 200-511) that simply did not happen. This load of money —which will most likely be released by the Controlling Board sometime in February — is distributed to the state's chartered nonpublic elementary and secondary schools for the provision of secular services and materials, including textbooks, health services, programs for the handicapped, and transportation to services offered off-site. There are around 890 of these chartered nonpublic schools serving in the neighborhood of 240,000 students statewide.

If one were to back out a very large delayed Auxiliary Services distribution which we know will eventually take place, then the department was probably really looking at a $26 million or so overage for the month of January and not an underage. This would have translated into a decrease, rather than an increase, in the department's previous negative year-to-date disbursement totaling $99.3 million.

Health Care/Medicaid

Medicaid spending in January registered a significant negative disbursement variance of $49.5 million, which further boosted year-to-date Medicaid disbursements to $121.7 million, or 4.0 percent, below estimate. (For more detail on monthly and year-to-date Medicaid spending, as well as a comparison to FY 1997 spending, see Tables 6 and 7, respectively.)

In general, this lower than anticipated Medicaid spending can be attributed primarily to continued declining caseloads across all recipient groups (although the decline in the Aged, Blind, and Disabled (ABD) population is a more recent phenomenon), and lower than expected utilization of services, for all eligibility categories for which claims were paid in January. Specifically, payments for acute care services and HMO coverage contributed the largest amounts to underspending. Spending on acute care was $9.2 million below estimate, with the inpatient category alone falling below estimate by $7.7 million. Payments for HMO coverage of eligible recipients continued its all too familiar pattern of underspending, posting a negative disbursement variance of $21.3 million relative to the estimate.

It also appeared that a significant amount of underspending occurred for the "Buy-in" component, due to an estimated $10.1 million January payment that was not made. We have noted previous delays in these

Table 6
Medicaid (400-525) Spending in FY 1998

	January '98				Year-to Date Spending			
Service Category	**Actual**	**Estimate**	**Variance**	**Percent Variance**	**Actual** thru' Jan.**	**Estimate** thru' Jan.**	**Variance**	**Percent Variance**
Nursing Homes	$158,630,698	$162,442,648	($3,811,950)	-2.3%	$1,111,997,740	$1,065,661,937	$46,335,803	4.3%
ICF/MR	$29,882,990	$29,471,220	$411,770	1.4%	$199,036,204	$200,469,891	($1,433,687)	-0.7%
Hospitals	$75,943,209	$85,178,680	($9,235,471)	-10.8%	$656,849,887	$709,661,350	($52,811,463)	-7.4%
Inpatient Hospitals	$59,266,962	$66,932,572	($7,665,610)	-11.5%	$508,452,888	$547,787,859	($39,334,971)	-7.2%
Outpatient Hospitals	$16,676,247	$18,246,108	($1,569,861)	-8.6%	$148,396,998	$161,873,491	($13,476,493)	-8.3%
Physicians	$19,536,351	$20,588,190	($1,051,839)	-5.1%	$158,970,066	$169,333,062	($10,362,996)	-6.1%
Prescription Drugs	$20,756,947	$17,386,810	$3,370,137	19.4%	$279,030,731	$260,702,224	$18,328,507	7.0%
Payments	$46,392,641	$39,495,387	$6,897,254	17.5%	$355,173,676	$335,507,424	$19,666,252	5.9%
Rebates	$25,635,694	$22,108,577	$3,527,117	16.0%	$76,142,945	$74,805,200	$1,337,745	1.8%
HMO	$39,040,290	$60,360,578	($21,320,288)	-35.3%	$322,467,064	$376,945,217	($54,478,153)	-14.5%
Medicare Buy-In	$0	$10,070,814	($10,070,814)	na	$71,459,475	$78,275,223	($6,815,748)	-8.7%
All Other***	$25,565,087	$33,429,080	($7,863,993)	-23.5%	$183,065,156	$244,787,571	($61,722,415)	-25.2%
TOTAL	$369,355,571	$418,928,020	($49,572,449)	-11.8%	$2,982,876,323	$3,105,836,475	($122,960,152)	-4.0%
CAS	$369,434,208		($49,493,812)		$2,984,134,592		($121,701,883)	
Estimated Federal Share	$214,826,732	$243,659,347	($28,832,615)		$1,735,099,079	$1,806,615,921	($71,516,842)	
Estimated State Share	$154,528,840	$175,268,673	($20,739,833)	-11.8%	$1,247,777,244	$1,299,220,554	($51,443,310)	-4.0%

* This table only includes Medicaid spending through Human Services' 400-525 line item.

** Includes spending from FY 1997 encumbrances in service categories for July & in the All Other category for August & September.

*** All Other, includes all other health services funded by 400-525.

Source: BOMC 8300-R001 Reports, Ohio Department of Human Services.

Table 7
FY 1998 to FY 1997 Comparison* of Year-to-Date Spending

Service Category	FY 1998[1] Yr.-to-Date as of Jan. 98	FY 1997 Yr.-to-Date as of Jan. 97	Variance	Percent Variance
Nursing Homes	$1,111,997,740	$1,034,708,074	$77,289,666	7.5%
ICF/MR	$199,036,204	$189,963,862	$9,072,342	4.8%
Hospitals	$656,849,887	$702,261,928	($45,412,041)	-6.5%
Inpatient Hospitals	$508,452,888	$536,886,617	($28,433,729)	-5.3%
Outpatient Hospitals	$148,396,998	$165,375,311	($16,978,313)	-10.3%
Physicians	$158,970,066	$166,068,166	($7,098,100)	-4.3%
Prescription Drugs	$279,030,731	$236,082,307	$42,948,424	18.2%
Payments	$355,173,676	$312,278,640	$42,895,036	13.7%
Rebates	$76,142,945	$76,196,333	($53,388)	-0.1%
HMO	$322,467,064	$255,315,150	$67,151,914	26.3%
Medicare Buy-In	$71,459,475	$79,720,813	($8,261,338)	-10.4%
All Other***	$183,065,156	$201,703,318	($18,638,162)	-9.2%
TOTAL	$2,982,876,323	$2,865,823,618	$117,052,705	4.1%
Estimated Federal Share	$1,735,099,079	$1,690,835,935	$44,263,145	
Estimated State Share	$1,247,777,244	$1,174,987,683	$72,789,560	6.2%

* This table only includes Medicaid spending through Human Services' 400-525 line item.

1 . Includes FY 1997 encumbraces of $78.5 million.

estimated monthly payments that ultimately have to occur. Based upon the fact that this anticipated January payment must eventually happen, a spending adjustment was necessary in order to portray a more accurate picture of year-to-date Medicaid disbursements. Thus, factoring out this missed January "Buy-in" payment, year-to-date underspending became more like $111.6 million.

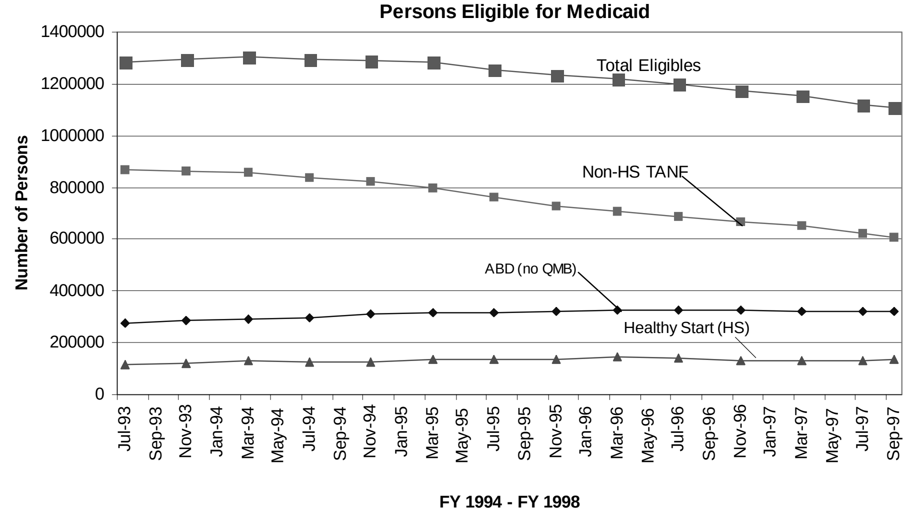
Last month, we had noted that Prescription Drugs, in the midst of generally lower than expected Medicaid spending, had produced a rather significant $14.1 million overage. We then went on to characterize the two prior months of Drug Rebates, a component of Prescription Drugs that actually represents revenue coming back to the state rather than a disbursement, as being abnormally low. Drug Rebates rebounded to post strong collections totaling $25.6 million for January (the first month of this quarter's payment series), the practical effect of which was to constrain the overage in Prescription Drugs to a relatively small $3.4 million.

In the midst of all the good news about declining TANF caseloads, an issue of significant importance causes concern. Are caseloads declining too quickly? (See Chart 1, Persons Eligible for Medicaid, for a pictorial of the caseloads trends of various eligibility groups from July 1993 through September 1997.)

Why quibble with the rate of decline, you ask? While declining TANF caseloads are a very welcome guest and good for the state's fiscal health, controlling costs is but one of the goals of a program as large as Medicaid, along with access to, and quality of, heath care for all eligible persons.

We raise this issue because recent reports based on anecdotal information would have one believe that many persons eligible for the TANF program are simply not utilizing its services. The fact that caseloads were already declining before TANF was implemented, as well as the absence of in depth research, makes uncovering the truth of the matter more than a bit problematic. That said, we do believe from a limited analysis of events that, like all new major program changes, TANF's implementation has sent substantial shocks throughout the human services system. Before TANF, eligibility for ADC and for Medicaid was closely linked. A person who received an ADC check was automatically entitled to Medicaid. This link, however, has been severed. Medicaid eligibility is not

Chart 1
Persons Eligible for Medicaid



dependent on TANF eligibility. It is inconceivable that these shocks will not continue to reverberate throughout the system until state and local program administrators and the recipient community becomes accustomed to this very new way of doing business.

The state has undertaken several initiatives intended to minimize these TANF-generated Medicaid service delivery disruptions. The major initiative in this regard is a Medicaid outreach program, funded with a 90 percent federal match, targeting individuals who meet Medicaid eligibility requirements, but are at risk of losing contact with the Medicaid program because they are not TANF recipients.

We will continue to investigate and analyze events as more data become available, to determine the true nature of this dramatic decline in Medicaid caseloads, and to ascertain whether these lower caseload levels are sustainable. In addition, we will attempt to ferret out the impact of outreach activities on caseloads. We also will be watching to see if the new State Children's Health Insurance Program will uncover previously eligible persons who were not enrolled.

TANF

TANF disbursements continued to run substantially below estimate. The January variance was $17.6 million, or 17.7 percent, below the monthly estimate, dragging year-to-date TANF spending even further under as it hit $120.7 million, or 18.1 percent, below the year-to-date estimate. Over $59 million of this negative year-to-date variance has occurred in state-funded GRF line items 400-410 (TANF State) and 400-413 (Day Care Match/MOE). The remainder, or $55.2 million, of the negative year-to-date variance was attributable to the federally funded GRF line item 400-411 (TANF Federal Block Grant).

What does our crystal ball foretell? In the remaining five months of FY 1998, we expect the pace of disbursements in the two state GRF components of the TANF program to speed up, while that of disbursements from the TANF Federal Block Grant will slow down. Any federal dollars remaining at the end of a federal fiscal year are available to the state over the lifetime of the TANF program, as long as the State of Ohio has met the appropriate level of its Maintenance of Effort (MOE) spending. The Department of Human Services is now projecting that the resulting cumulative unobligated reserve of federal TANF grant funds will hit approximately $155 million in state FY 1998 and build to around $261 million in state FY 1999. All state GRF moneys, on the other hand, will be expended.

The continuing decline in the number of cash recipients accounted for the bulk of the negative monthly disbursement variance. In January, the TANF caseload declined by close to 10,000 recipients. In the current fiscal year, TANF recipients have declined by 16.4 percent. From the same month a year ago, the number of recipients is down by 25.1 percent. And, from the peak in March 1992, the number of recipients has declined dramatically by 48.1 percent. However, TANF allotments may be spent on services beyond cash assistance, and as counties refine their ability to spend dollars on prevention, retention and contingency services, we may see a leveling of the downward trend in expenditures, even if caseloads continue to decline.

General Assistance/Disability Assistance

The January disbursement for the Disability Assistance program (DA), a state and county funded effort which provides cash and/or medical assistance to persons ineligible for public assistance programs that are supported in whole or in part by federal funds, was below estimate by about $940,000, or 18.2 percent. For the fiscal year the variance was $4.2 million, or 10.9 percent, below estimate.

The story stays the same. The DA caseload continues its steady decline, having dropped 16.0 percent so far this fiscal year, 22.3 percent from the same month a year ago, and a cliff diving 42.1 percent from the same month two years ago.

Also of note was an action taken by the Controlling Board in the waning days of January. On the 26th, the Controlling Board approved without objection a Department of Human Services request to transfer $5.0 million in biennial appropriation authority from the Disability Assistance line item (400-511) and create a new GRF line item 400-414, State Option Food Stamp Program. The new line item will be used by the department to undertake a new initiative or program to provide food stamps to a portion of the legal immigrant population who lost food stamp benefits as a result of federal welfare reform. (For a more in-depth discussion on this new food stamp program, see the piece by Steve Mansfield that appears under

"Issues of Interest" in this issue of ***Budget Footnotes***.)

Other Welfare

Human Services. The Other Welfare component of the Welfare and Human Services program category fell below estimate for the month of January by $10.1 million. (The Other Welfare component basically includes all of the Department of Human Services' line items exclusive of Medicaid, TANF, and GA/DA.) The bulk of this underage was attributable to two line items: 400-416, Computer Projects, and 400-504, Non-TANF County Administration. The former was below the monthly estimate by $4.7 million, while the latter was below the monthly estimate by $3.9 million. A negative disbursement variance in the Computer Projects line item was not all that surprising since predicting the timeframes for the initiation and completion of computer projects can be fraught with many unknowns. With regard to the Non-TANF County Administration line item, which pays counties the state's share of the administrative costs associated with the Disability Assistance, Medicaid, and Food Stamp programs, counties as a group requested fewer funds than were estimated. Since counties actually receive their administrative cost sharing payments in advance, it may have been that some may have been overpaid in the prior month's advance, which would have meant that an adjustment (in effect a reduction) would then have been made in a subsequent advance.

Perhaps more noteworthy is the relative absence of disbursement activity in the $2.5 million FY 1998 appropriation associated with the state's Electronic Benefits Transfer (EBT) system (line item 400-402). To date, the department has disbursed only 7 percent, or $180,000, of the FY 1998 appropriation.

Clearly, the EBT system must not be expanding as quickly as the department had hoped. EBT was initiated as a pilot Food Stamp program operating in Dayton. Under the pilot, recipients are issued magnetically coded cards (smart cards) rather than traditional monthly paper coupons. These smart cards are presented by the recipient at the point of purchase and automatically track the individual's monthly food stamp allocation, deduct the cost of all eligible purchases, and maintain the available balance. The budget includes appropriations to expand the program statewide.

Other Human Services

Mental Retardation. Last month, the department registered what we described as a whopping $41.7 million negative disbursement variance for December and ascribed its appearance as no more than a matter of timing. One month later, the department has registered a sizeable overage totaling $24.4 million, leaving us around $17 million shy of the prompt correction we expected from the December underage. We have come to believe that much of the last two month's worth of disbursement variance was directly attributable to changes afoot with the purchase of service (POS) program, but need more time to research this matter before we can provide more detail or write with much more certainty.

Mental Health. A combination of three departmental subsidies helped produce a $10.9 million overage for the month of January. Specifically, line items, 334-408, Community and Hospital Mental Health Services, 335-502, Community Mental Health Programs, and 335-508, Services for Severely Mentally Disabled, were approximately $6.7 million, $1.6 million, and $2.6 million over estimate in January, respectively. The department disburses these subsidy funds to community mental health boards quarterly, with each board allowed to determine the timing of their quarterly subsidy allocations. The FY 1998 disbursement estimates reflected the assumption that most boards would choose to receive their allocations toward the beginning of each quarter. However, in January, many more boards chose to draw down their third quarter allocations in January rather than February and March as had been anticipated. Overages of a similar nature previously occurred at the beginning of the second quarter of this fiscal year as well.

Department of Aging. At the risk of sounding like a broken record, the Department of Aging once again spent nursing facility franchise fee revenues in January to fund PASSPORT rather than dipping into its GRF money (line item 490-403), as was assumed in the original Office of Budget and Management estimates. (We noted this apparent decision to first tap franchise fee revenues rather than GRF money in the two preceding issues of ***Budget Footnotes***.) The result was that PASSPORT's GRF disbursements, which provide home health care to Medicaid eligible older persons, landed approximately $2.6 million short of the estimate for the month of January, bringing the line item's negative year-to-date disbursement variance up to $7.6 million.

Employment Services. In the November/December issue of ***Budget Footnotes,*** we called attention to the fact that customer service center disbursements had to date exhibited a rather sluggish pattern (line item 795-411, Customer Service Centers), a trend which, for various reasons, is not expected to continue through the remainder of the fiscal year. For example, several remodeled customer service centers, aka employment and training centers, were scheduled to open by the end of the calendar year, thus providing a disbursement boost. Checking into the matter, we learned that two such centers did in fact open in December, one in Athens and one in Sydney (Shelby County). However, despite the push these openings provided to December and January disbursements, year-to-date, this line item's disbursements were still running more than 50 percent under estimate.

Will this disbursement trend reverse itself sometime during FY 1998?

An answer to this question begins by examining the plan that lay behind the biennial budget for this line item. The plan called for the opening of four new employment and training centers in FY 1998 and another four in FY 1999. That plan was subsequently altered when the bureau received Controlling Board approval in October 1997 to transfer their entire FY 1999 appropriation for this line item ($1.0 million) into FY 1998. What this meant was that the bureau now had the necessary financial resources available to open all eight centers in FY 1998, yet it had only opened two of the four planned for FY 1998 as the state rounded the halfway mark at the close of December. The remaining six centers, to be located in Tiffin (Seneca County), Elyria, Cleveland East, Batavia (Clermont County), Columbus, and Medina, are expected to open around May 1, 1998. If this prediction holds true, then customer service center disbursements should accelerate greatly from now through May or June, resulting in the entire adjusted FY 1998 appropriation of $2.0 million being spent by the end of this fiscal year.

Tied into the state's service delivery system transition of local unemployment/employment offices into "one-stop" employment and training centers was the establishment of telephone registration centers, which will allow people to file claims for unemployment compensation benefits and register for employment services via the telephone. Some champion the establishment of these telephone registration centers as a means to simultaneously cut operating costs and increase customer convenience. Two million dollars in GRF funding (line item 795-407, OBES Operations) was budgeted for this purpose. The Bureau has opened telephone registration centers in Dayton and Toledo, with another five expected to open in the near future. The average cost to open a telephone registration center is running in the neighborhood of $300,000.

Justice & Corrections

Youth Services (DYS). Based upon the department's total monthly underage alone, a paltry $211,111, one would have been right to think that not very much in the way of disbursement activity occurred during the month of January. However, a closer look inside the number, revealed that relatively small overages in several line items, some timing related, masked a much larger negative disbursement variance of nearly $1.2 million buried in line item 470-401, Care and Custody.

The Care and Custody line item is the state's vehicle for funding RECLAIM Ohio, a nationally-recognized program that provides for institutional placement and court community program services to juveniles convicted of a felony, as well as any delinquent, unruly, or juvenile traffic offender under the jurisdiction of the court. Critical to the disbursement of the Care and Custody funding is the number of felony adjudications in county juvenile courts and the number of juveniles committed to the department's custody, both of which have been running under estimate. This reality has translated into less money being spent than had been anticipated. Year-to-date, Care and Custody disbursements are $4.4 million under estimate. For the department at least, this fiscal reality has led it to trim institutional operations, most specifically at the Training Institution of Central Ohio (TICO), from what they might have otherwise been. ❑

**Numerous colleagues here at the LBO have contributed to the development of this issue, including, in alphabetical order, Ogbe Aideyman, Clarence Campbell, Deborah Gavlik, Rick Graycarek, Steve Mansfield, Jeff Newman, Chuck Phillips, and Jeffrey M. Rosa.*

Issues of Interest

SCHOOL FUNDING REFORM

FREDERICK CHURCH, DEBORAH GAVLIK, SHARON HANRAHAN

The Ohio Supreme Court's ruling in the *DeRolph* case requires that Ohio's system of financing primary and secondary education undergo a systematic overhaul, in order to comply with the Constitution's requirement that the state provide a "thorough and efficient system of common schools." Since March 24, 1997, legislative activity directed at finding a remedy has been ceaseless. First, in August 1997, the legislature adopted S.B. 55 dealing with educational outcomes and H.B. 412 dealing with school district financial management. Then, in early February 1998, after intense debate, the legislature adopted three separate bills that constitute the state's financial response to the *DeRolph* decision. The outcome of this effort now hinges on the statewide referendum vote on the 1 cent sales tax increase, scheduled for May 5th.

By far the most complicated of the three bills is HB 650, which changes the state aid distribution formula. Perhaps the most important feature of the bill is the adoption of Dr. Augenblick's general methodology for setting the foundation amount. Responding to the Court's critique of the state's use of "residual budgeting" to back into the formula amount, the legislature used Dr. Augenblick's method of using student performance data to estimate the base cost of providing an adequate education. H.B. 650 implements this change by setting a target foundation formula for FY 2002, and phasing-in to this level by adding one-fourth of the difference between the FY 1998 level and the FY 2002 target in each intervening year. The full phase-in of the new distribution formula is not complete until FY 2004.

H.B. 650 changes numerous other aspects of the distribution formula. While special education is changed most dramatically, no major aspect of funding is left untouched. Vocational education, gifted education, pupil transportation, and disadvantaged pupil impact aid (DPIA) are all changed also. H.B. 650 also addresses the "gap" phantom revenue by providing state money to schools who do not raise the local money assumed by the foundation formula, and provides an incentive for additional tax effort for poor districts (power equalization).

H.B. 650 also addresses the funding of the new distribution formula by making $100 million in state agency spending cuts for FY 1999 and using the money to increase education's budget. Not only does this provide additional money for education in FY 1999, it reduces the expenditure base for future years, helping to fund the transition to the new funding structure by FY 2004.

The other two pieces of the legislative package, H.B. 697 and H.J.R. 22, provide the other pieces of the financing package: new revenue and additional bonding authority, respectively. HB 697 sends a 1 cent sales tax increase to the voters on May 5th. LBO estimates that the new sales tax will bring in about $1.05 billion in FY 1999, the first year of the tax, and that revenues will increase to about $1.4 billion by the end of the phase-in in FY 2004. Half of the new sales tax money is to be used for school purposes: operations, technology, facilities, and debt service. The other half is to be used for property tax relief on owner-occupied housing, with the form of the relief not yet specified. The amount of tax relief that could be funded is significant: enough to reduce every homeowner's bill by 11.5 percent to 12 percent, if an equal percentage reduction were adopted.

H.J.R. 22 would put before the voters a plan to make two changes in state debt financing. The first would allow the state to issue general obligation bonds, backed by the full faith and credit of the state, for both primary and secondary facilities and state-assisted colleges and universities. General obligation bonds would be a less costly way for the state to finance its share of school facility spending than the lease-purchase obligations currently employed.

The second piece of H.J.R. 22 would formalize the 5 percent cap on debt service as a percentage of state revenue. The state has observed a 5 percent debt limit as a rule of thumb for over a decade. This resolution would put the 5 percent limit in the Constitution and broaden the definition of state revenue to include lottery proceeds, increasing state debt service capacity by about $33 million annually.

Highlights of all three bills are presented in greater detail below. Readers who desire even more in-depth analysis are referred to LBO's fiscal notes, available in hard copy or online through the World Wide Web <www.lbo.state.oh.us>.

Am. Sub. H.B. 650

- **Appropriations**: Makes FY 1999 GRF appropriations of $5,257,055,773 to the Department of Education. This represents a 7.29 percent increase over FY 1998 appropriations, and is $122.9 million greater than the FY 1999 GRF appropriation to the Department of Education in the budget bill.

- **Appropriation Reductions**: Reduces GRF appropriations to most other state agencies by three percent for FY 1999 with certain exceptions. The following agencies' GRF appropriations are not reduced: the Ohio School for the Blind, the Ohio School for the Deaf, the Office of Information, Learning and Technology, and the School Facilities Commission. Most appropriations to the Board of Regents are reduced one-half of one percent; appropriations to the Departments of Mental Retardation and Developmental Disabilities, Youth Services, and Rehabilitation and Correction are reduced by two percent; appropriations to the Departments of Taxation and Mental Health and various small agencies are reduced one percent; and the Director of Budget and Management may reduce appropriations for Medicaid by up to one percent.

- **Transfers:** Transfers FY 1998 ending year balances that would otherwise go to the Income Tax Reduction Fund to the School District Solvency Fund ($30 million) and to Fund 021, School Building Assistance ($170 million, with $30 million of this amount to be used to assist equity districts with emergency repairs.

- **Base Cost**: Establishes a base cost per pupil sufficient to fund an adequate education in FY 1999, and inflates that cost by 2.8 percent per year for each year through FY 2004. To allow for an orderly phase-in of the increased per pupil amount, the bill specifies lesser amounts through FY 2001, after which the cost per pupil amounts needed to fund an adequate education would be in effect. The base cost amounts and the phase-in amounts are highlighted in the accompanying table.

Fiscal Year	Base Per Pupil Cost Sufficient to Fund an Adequate Education	Phase-In Amount
FY 1999	$4,063	$3,851
FY 2000	$4,177	$4,038
FY 2001	$4,294	$4,226
FY 2002	$4,414	Same as Base Cost
FY 2003	$4,538	Same as Base Cost
FY 2004	$4,665	Same as Base Cost

- **Special Education**: For the first time, special education students are counted in the district's average daily membership (ADM), instead of being counted in special education units. In addition to being counted as 1 ADM, special education students are assigned excess "weights" as shown in the accompanying table.

Category	Handicaps Included in the Category	Special Education Weight
One	Learning Disabled, Other Health Handicapped, Developmentally Handicapped	0.22
Two	Hearing Handicapped, Orthopedically Handicapped, Vision Impaired, Multihandicapped, and Severe Behavior Handicapped	3.01
Three	Autistic, Having Traumatic Brain Injuries, or both Visually and hearing Disabled	3.01

- **Vocational Education**: Vocational education students will also be counted in a district's average daily membership, instead of being counted in vocational education units. These students will not be assigned any additional "weights", but a supplemental amount will be provided to high school vocational programs in FY 1999. Joint vocational school districts will continue to receive unit funding. A total of $125 million is earmarked for joint vocational school districts in line item 200-545, Vocational Education Enhancements.

- **Gifted Education:** Funding for gifted education will be provided through units for FY 1999. In FY 2000, districts will be assigned a weight of 0.1 for 10 percent of their students. This additional funding is to be used to provide gifted education services.

- **Transportation:** Provides for a new method of funding transportation using an efficiency model developed by the Department of Education. The model determines an efficient transportation cost for each district. Over a five-year phase-in period, each district receives a transportation payment equal to 60 percent of the district's average number of transported students times an efficient transportation cost per student.

- **Disadvantaged Pupil Impact Aid:** Two changes are put into place to provide more stable DPIA funding:
  a) Funding is now based on the district's DPIA index, rather than the district's ADC or TANF percentage. This index compares each district's percentage of ADC students to the statewide average.
  b) A five-year average count of ADC/TANF students is used instead of a three-year average.

  Each district is guaranteed to receive at least the amount of DPIA funding it received in FY 1998.

- **DPIA Funding for Districts with a DPIA Index Greater than One:** Aid provided for districts with a DPIA index greater than one is intended to:
  1) Provide all-day kindergarten – funding in the DPIA formula provides funding equal to one half of the foundation amount.
  2) Reduce class size in grades kindergarten through three – the formula is designed to provide more aid for class size reduction, the higher the district's DPIA index. If the district's index is greater than 2.5, funds are provided to reduce the pupil/teacher ratio to 15/1 in grades kindergarten through three, assuming that the district is at the statewide average ratio of 23/1.
  3) Furnish a subsidy for remediation and security – The district's DPIA index is multiplied times $230 to arrive at the district's per pupil amount for security and remediation.

  - **School Foundation Guarantees:** Guarantees each district at least the total in state foundation funds (basic aid, special education, vocational education, gifted education, DPIA and equity aid) that it received in FY 1998.

  - **Caps on State Increase:** Limits each district's increase in state foundation funds to the greater of 110 percent of such aid for the previous year or the amount provided by a 106 percent increase in per-pupil funding over the previous year's per pupil funding. The caps on state increases would be in effect in fiscal years 1999 through 2002.

- **DPIA Spending Requirements**: For fiscal year 1999 through 2002, requires each district to spend the lesser of its actual DPIA aid calculation or the amount by which the district's state foundation funds exceed the previous year's state foundation funds, on the activities specified in the DPIA section of law.

- **Power Equalization:** Provides school districts with valuations per pupil less than the statewide valuation per pupil an incentive to levy more than 23 effective mills on residential and agricultural property. If a district levies more that 23 effective mills, for each mill or portion of a mill up to 2 mills, the district would receive a payment equal to the difference between the local revenue generated and the amount that would be generated if the millage were imposed in a district with the average statewide valuation.

- **Charge-off Supplemental Payments**: For any district receiving payments based on the basic aid formula that do not raise enough local revenue to meet the requirements of the charge-off, the district will receive a payment (the charge-off supplement) equal to the difference.

Am. Sub. H.B. 697

- **Sales Tax**: Increases the state sales tax by 1.0 percent, beginning July 1, 1998. Because of the one-month lag in collecting the non-auto portion of the sales tax (about 87 percent of the total), this will result in 11 months worth of collections in FY 1999, and a full year of collections in FY 2000 and subsequent years.

  The sales tax increase provides additional revenue to the newly created School Trust Fund and Property Tax Relief Fund, with the new revenue divided equally between the two. Since LBO estimates that the additional tax reduces pre-tax purchases of taxable items, thus reducing the tax base, this has a negative impact on the state GRF, the local government fund (LGF), and the local government revenue assistance fund (LGRAF). This also reduces collections of permissive sales and use tax by counties and transit authorities. These impacts are summarized in the table below.

Fiscal Year	School Trust Fund Gain	Property Tax Relief Fund Gain	GRF Loss	LGF and LGRAF Loss	County and Transit Auth. Loss
FY 1999	$520.3	$520.3	($50.0)	($2.5)	($11.1)
FY 2000	$586.3	$586.3	($56.4)	($2.8)	($12.7)
FY 2001	$612.6	$612.6	($58.9)	($3.0)	($13.3)
FY 2002	$640.2	$640.2	($61.6)	($3.1)	($13.9)
FY 2003	$669.0	$669.0	($64.3)	($3.2)	($14.5)
FY 2004	$699.1	$699.1	($67.2)	($3.4)	($15.1)

All amounts are in millions of dollars

- **School Revenues (School Trust Fund)**: The new sales tax money is to be used for school operations, education technology, cash spending on school facilities, and debt service for school facilities. LBO has done some risk management analyses that show that an economic downturn in the FY 1999-2004 period would require sales tax money just to met the operating funding targets set by HB 650 (see previous section). Also, proceeds from the new sales tax could be needed to meet operating targets even without a downturn, depending on the path of non-education GRF expenditures and the legislature's willingness to make spending cuts in other programs.

- **Property Tax Relief Fund:** The bill does not specify what form the property tax relief is to take. The bill language appears to restrict the tax relief to owner-occupied housing. Numerous options for using the tax relief money have been publicly discussed. Among the options are a fixed-dollar credit per household, an increase in the existing 2.5 percent rollback for owner-occupied housing, or an intermediate sort of refundable income tax credit. The tax relief could also take the form of a circuit breaker, an increase in the homestead exemption for the elderly and disabled, or some combination of any of the options listed above (or something not yet mentioned).

  In any case, one of the difficulties in giving back 50 percent of the sales tax in property tax relief is that none of the relief programs mentioned above is likely to grow at exactly the same rate as sales tax revenue. Whatever tax relief mechanism is chosen will have to be flexible, or subject to periodic adjustment. For example, if the 2.5 percent rollback is increased, then either the additional rollback will have to be recalculated every year, or the tax relief fund will have to be allowed to maintain positive or negative balances in between periodic adjustments. The same is true of a flat credit, or of the mixed income tax credit (percentage credit with a fixed-dollar cap).

- **Maintenance of Effort (Earmarking) Requirement**: GRF per-pupil education spending after FY 1999 is required to grow by inflation, as measured by the national CPI-U, as a safeguard against using the new sales tax money to supplant GRF education funding. GRF education spending does not have to rise by the same percentage as the CPI on an annual basis — instead, the target in any year is FY 1999 spending plus *cumulative* CPI inflation since FY 1999. This allows flexibility in dealing with economic cycles.

Am. Sub. H.J.R.22

- **General Obligation Bonds:** Authorizes the state to issue general obligation bonds to support primary and secondary education as well as state-supported and state-assisted institutes of higher education. Bond issues would pay for the costs incurred in the acquisition, construction, improvement, expansion, planning, and equipping of facilities and would be issued for no longer than 25 years.

  The state currently issues lease-back obligations to pay for these facilities. Issuing general obligation debt should reduce interest costs because general obligation bonds are considered more credit worthy than lease-back obligations. LBO estimates that for each $1 billion in bonds sold, the state will save $979,000 annually or $14.6 million in debt service over the assumed 15 year life of the bonds issued. For 20 year bonds, the savings decrease to $688,000 annually or $13.7 million over the life of the bonds.

- **5 percent Limit:** Imposes a 5 percent limit on the ratio of debt service as a percentage of combined expenditures from the GRF **and** net lottery proceeds. While the state has observed a debt service cap of 5 percent of GRF expenditures for over a decade, Am. Sub. H.J.R. 22 adds net lottery proceeds to the debt limit calculation. The inclusion of net lottery proceeds allows for approximately $33 million in additional debt service payments. Lottery proceeds can only be used, however, for debt service on bonds issued for primary and secondary education.

  The 5 percent limit may not apply to a particular issue or amount of obligations if it is waived by an affirmative vote of at least three-fifths of the members of each House of the General Assembly. Certain obligations issued to retire bond anticipation notes are also not subject to this limitation. ❑

CONTROLLING BOARD APPROVES STATE FOOD STAMP PROGRAM

STEVE MANSFIELD

On January 26, 1998 the Ohio Controlling Board approved a request by the Department of Human Services to create a new GRF appropriation line item to fund the purchase of federal food stamps with General Revenue Fund state dollars. The new program will serve a portion of the immigrant population who had lost food stamp assistance as a result of changes in federal law. The new line item will be 400-414, State Option Food Stamp Programs, and is funded by a transfer of appropriation authority from GRF 400-511, Disability Assistance. The Controlling Board approved the transfer of appropriation authority of $1,000,000 in SFY 1998 and $4,000,000 in SFY 1999. The program is to begin operation on April 1, 1998.

Prior Federal Law

Prior to the 1996 federal welfare reform law, the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA), most legal immigrants were eligible for food stamps as long as they met the same income and resource requirements expected of citizens. During their first three years in the U.S., immigrants were required to include their sponsor's income (if they had a sponsor) in their eligibility calculations.

The Change in Federal Law Regarding Food Stamps for Legal Immigrants

The PRWORA eliminated food stamp and Supplemental Security Income (SSI) eligibility for most noncitizens as of August 22, 1997, unless they: become citizens, demonstrate 40 qualifying quarters of work in the U.S., or meet the five-year or military exemptions. Refugees, asylees, and those granted withholding of deportation are exempt from the food stamp ban for their first five years in the U.S. In the process of signing the law, President Clinton pledged to try to restore the cuts.

The federal Supplemental Appropriations Act of 1997 restored SSI benefits but not food stamp benefits for this population. However, the Act made it possible for states to purchase food stamps from the federal government on behalf of immigrants who have lost their food stamp benefits under the PRWORA. So far, twelve states have chosen to provide state-funded assistance to some or all legal immigrants. Legislation was introduced in other states but failed to pass. Several other states are now reviewing the food stamp purchase option. President Clinton's budget proposal for federal fiscal year 1999 contains a provision that would restore food stamp benefits to legal immigrant families with children, and for disabled and elderly legal immigrants who entered the country before the PRWORA was signed.

Eligibility and Ohio Temporary Law

Relative to the Disability Assistance program (line item, 400-511), the biennial budget bill covering FYs 1998 and 1999, Am. Sub. H.B. 215, earmarks $3 million in FY 1998 and $5 million in FY 1999 to provide cash assistance to legal immigrants and refugees who were to be cut off Supplemental Security Income under the PRWORA, and also meet certain qualifications. Section 67.03 of the budget bill specifies that benefits may be provided to those legal immigrants and refugees who: 1) formerly qualified for Supplemental Security Income; 2) resided in Ohio as of August 22, 1996 and maintained Ohio residency since that date; and 3) have been in the

U.S. for 60 months and are in the process of naturalization or unable to naturalize because of age or disability, including language disability, but do not qualify for an Immigration and Naturalization Service exemption. While section 67.03 provides for cash assistance to meet the need created by the cut off of SSI cash benefits, the department's proposal is to provide food stamps for refugees and legal immigrants with the Disability Assistance earmark funding previously intended for cash assistance for refugee and immigrant assistance.

Under section 67.03, the Department of Human Services is authorized to adopt rules and procedures "to set eligibility requirements and benefit levels" for qualified legal immigrants. In its request for approval of the new line item, the department stated that "the eligibility for this program will be based on the population who had Supplemental Security Income benefits restored by the federal Balanced Budget Reconciliation Act," and who meet all of the other criteria outlined in the paragraph above. For its estimate on the size of the population served by the State Option Food Stamp Program, the Department of Human Services relies on a study by the Government Affairs Committee of Ohio Jewish Communities, Inc. that reports that 5790 legal immigrants who received SSI benefits resided in Ohio as of December, 1996. Based on the study's estimate that 40 percent of these individuals would not qualify because they would not meet the five year residency requirement, or would be in a Nursing Home and thus be receiving food assistance in another program, or be in another federally exempt category, the study concludes that about 3,400 individuals are qualified for this assistance. However, LBO inquiries to the Social Security Administration's Office of Research, Evaluation and Statistics yielded the following information: As of August, 1996 (the month the PRWORA was signed) there were 6090 legal immigrants and refugees receiving SSI benefits residing in Ohio. In December, 1996 that population had declined to 5340, and by August, 1997 it had declined to 4840. These declines were due to naturalization, death, and otherwise being exempted from the ban. If this number is reduced by 40 percent, the number eligible would be approximately 2900.

Item A

3,400 qualified individuals x $89 per month per person = $302,600.00

$302,600 x .0028 federal administrative fee = $847.28

$303,447.28 per month

Item B

7690 qualified individuals x $89 per month per person = $684,410.00

$684,410 x .0028 federal administrative fee = 1,916.35

= $686,326.35 per month

The department's conclusion regarding eligibility also depends on the equation of the phrase in section 67.03 of the population being "formerly qualified" with the population "who had Supplemental Security Income benefits restored." If the eligible were, in addition, to include those legal immigrants and refugees who were qualified under the three conditions stated above but had never applied for SSI, the number of people needing food stamp assistance would be larger. A study by the Center on Budget and Policy Priorities estimates, after adjusting for residency requirements, naturalization, and other caseload declines, that Ohio has 7690 legal immigrants who either actually did qualify for SSI benefits, or would have qualified if they had applied.

Cost

Under the State Option Food Stamp Program, the State will pay the Secretary of Agriculture the value of the benefits, plus an administrative fee of 0.28 percent to cover costs such as printing and shipping. The Department of Human Services has set the benefit level at $89 per month for a single person, as this is the amount that would have been received for food stamps under the federal standard, while also receiving the average Supplemental Security Income benefit. This yields a monthly cost calculation as indicated in Item A, above.

This monthly estimate is the basis for the transfer of $1,000,000 for SFY 1998 and $4,000,000 for SFY 1999.

If the calculation was performed using the Center on Budget and Policy Priorities' higher estimate it would yield the following result, as indicated in Item B, above.

Only time and experience with this new program will allow us to judge if the current transfer of funds will be adequate. ❑

Spirituous Liquor GRF Transfers and the Conversion of the State Liquor Store System

Rick Graycarek

Introduction

Every issue of Budget Footnotes details the general revenue fund transfer from the sale of spirituous liquor. In recent months, some may have noticed that the GRF transfers have exceeded estimates. This overage has generally been attributable to the state removing itself from the operation of retail and wholesale spirituous liquor stores. Although analyses had predicted the effects of this change, a detailed fiscal analysis of the post-state liquor store era has not been completed. To that end, this paper will provide a map of the fiscal changes created by the conversion of state-operated stores to privately-operated ventures and to suggest appropriate conclusions. The paper will look at trends in Liquor Control GRF transfers, spirituous liquor revenues, and operating costs.

History of Conversion

The State of Ohio operates as a liquor control state. All spirituous liquor sold in Ohio is regulated by price, quantity, and location. The sale of spirituous liquor has always occurred through state-operated or agency liquor stores. Agency liquor stores are not new in Ohio. Soon after the inception of the Department of Liquor Control in 1933, agency liquor stores took root. They were established primarily in rural areas where it was economically infeasible for the state to operate a liquor store. In these locales, spirituous liquor sales could not wholly sustain a state-operated store. However, locally established businesses could fill this market segment by selling other goods in addition to spirituous liquor. Agency liquor stores essentially allowed the "best of both worlds" — for the state to sell spirituous liquor in otherwise unprofitable locales and for agents to earn a commission on such sales. The number of agency stores has typically numbered around 126, with the total number of liquor stores around 391. Then, in 1991, the process of converting state-operated liquor stores to agencies began. Eventually, legislation passed in 1993, 1994 and 1995 allowed the Department of Liquor Control to convert all state-operated liquor stores to agencies[1]. This conversion process was completed in November of 1996 and marked the end of a period in Ohio where the State directly sold spirituous liquor. All spirituous liquor sold in Ohio now occurs through privately operated stores. These stores sell spirituous liquor on behalf of the State and receive a commission on their spirituous liquor sales[2]. The total number of stores has since remained around 391.

The conversion of state-operated liquor stores to agencies is significant for three reasons. First, the sale of spirituous liquor directly contributes to the finances of the state. A portion of the spirituous liquor profits is transferred to the state's general revenue fund on a monthly basis[3]. These revenues contribute to the operation of state government and are factored into the state's budget. Significant changes to these GRF transfers can have an impact on the state's fiscal outlook. Second, by eliminating all state-operated liquor stores the state thinned the ranks of state employment. Central office staff in the Department of Liquor Control was also cut[4]. Third, the conversion of state-operated liquor stores resulted in a huge real estate divestiture. Although the Department of Liquor Control did not own any of the state liquor store sites, they maintained leases on every property. All together, the action of converting every state-operated liquor store significantly changed the fiscal picture for the

Department of Liquor Control and the State of Ohio.

Change from Department to Division

On July 1, 1997, the Department of Liquor Control was eliminated. In its place, a Division of Liquor Control was created in the Department of Commerce. The division maintains all the previous functions of the department with the exception of liquor enforcement. All liquor enforcement personnel were transferred to the Department of Public Safety in 1995 as part of Am. Sub. S.B. 162 of the 121st General Assembly, the government restructuring bill. This legislation also provided for the elimination of the Department of Liquor Control and the creation of its successor, the Division of Liquor Control, within the Department of Commerce. It is noteworthy to mention this fact here for two reasons. First, changing the Department of Liquor Control to a division within the Department of Commerce resulted in the elimination of numerous duplicative Liquor Control positions. Funding for several administrative positions also changed from Liquor Control to the Department of Commerce. This is important because the formation of these administrative economies of scale occurred at the end of the conversion process. Any analysis that looks at reasons for changes in the GRF transfer in fiscal year 1998 and beyond, therefore, must take into account any savings from the consolidation of Liquor Control. Second, the Liquor Control organizational change is raised here to explain to the reader the synonymous use of "Department of Liquor Control" and the "Division of Liquor Control" in this paper. Although each clearly represents a different period in the regulatory agency that oversees the sale of spirituous liquor, the choice of names does not need to be heeded differently in this paper. Both refer to the regulatory agency that oversees the sale of spirituous liquor in Ohio.

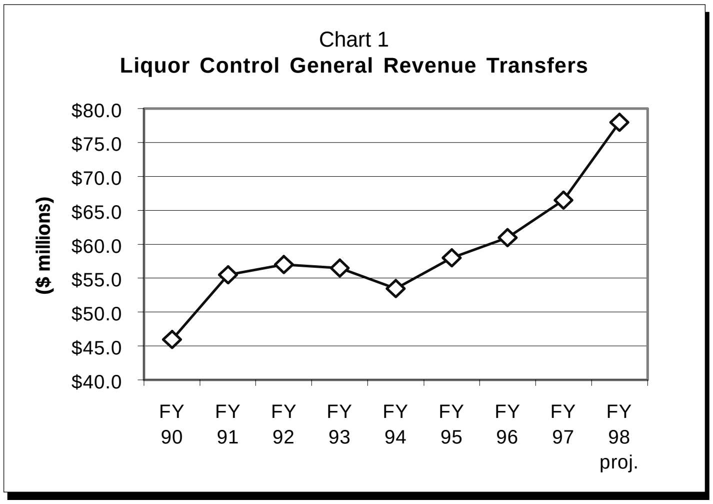
Analysis

GRF Transfer/Obligations

The following analysis lends a critical eye to the changes that have occurred in the sale of spirituous liquor in Ohio since 1990. The timeline for the analysis was chosen by the fact that it includes the period in which executive and legislative changes to the state store system were made.

Spirituous liquor sales earn money for the state. This is most apparent by examining the amount of money transferred to the general revenue fund from the sale of spirituous liquor (see Chart 1). The GRF transfer represents one measure of how much money the state earns on the sale of spirituous liquor. It essentially reflects profits minus obligations. These obligations include all taxes, Liquor Control operating expenses, transfers to ODADAS, transfers to the Department of Development 166 loan program, liquor enforcement expenses of the Department of Public Safety, operating expenses for the Liquor Control Commission, and the costs of the Department of Health alcohol testing unit. Of all these obligations, the last two are especially important in this paper — Liquor Control Commission operating expenses and Department of Health alcohol testing unit. Am. Sub. H.B. 210 and Am. Sub. H.B. 215 of the 122nd General Assembly, the Department of Transportation budget act and the state budget biennial act respectively, required that Liquor Control pay these expenses out of their liquor profits (Fund 043). Previously, Liquor Control Commission operating expenses came from the general revenue fund and gasoline tax money paid for the alcohol testing unit in the Department of Health. By requiring spirituous liquor profits to pay these expenses, Liquor Control will have approximately $1.2 million less available each fiscal year to transfer to the GRF. This fact is mentioned here because their effects will show up starting in fiscal year 1998 (and beyond). Any analysis of the effects of the conversion process will have to account for these factors. Otherwise, an inadequate fiscal picture will be developed.

In Chart 1 we can see that since fiscal year 1990 the GRF transfers have generally increased. In fact, the fiscal year 1998 GRF transfer amount is projected to be $78 million, significantly higher than fiscal year 1997. The one notable, and recent, dip in the GRF transfer occurred in fiscal year 1994. The annual transfer fell $3 million, from $56.5 to $53.5 million. Although this occurred in the midst of the conversion process, a 50 percent increase in the gallonage tax, effective January 1, 1993, was the likely cause. The tax increase raised the average price per gallon of spirituous liquor and pulled down demand. Lower demand lead to fewer spirituous liquor revenues and, hence, a lower GRF transfer. Demand did rebound the following year, appearing to make the tax increase essentially a one-time reduction in spirituous liquor revenues. Sticker-shock, or dismay over the noticeably higher prices, probably defined why the effect lasted for only one year.



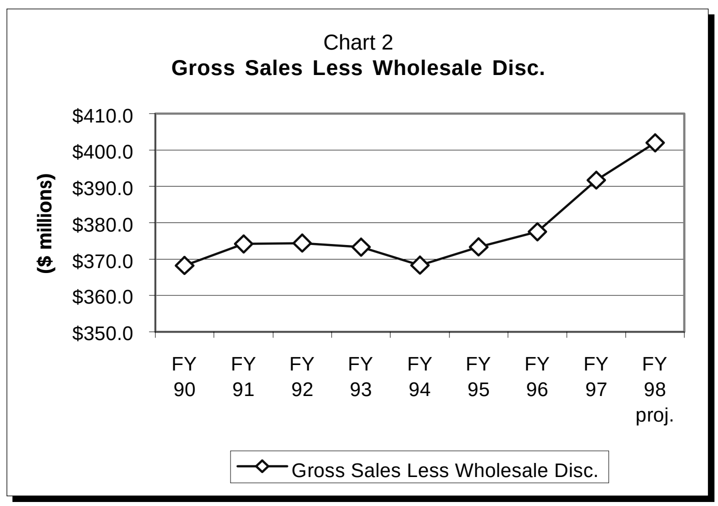
GRF Transfer/Profits

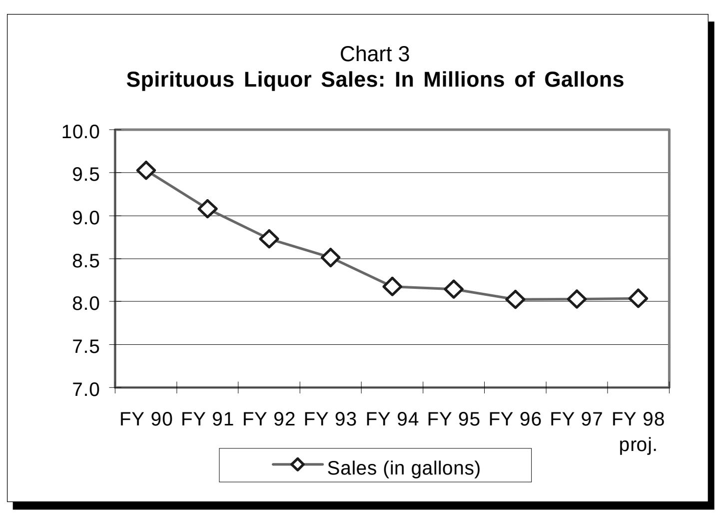
Since we just discussed obligations in the GRF transfer picture, let's turn to the other influencing factor in determining the GRF transfer amount — profits. Profits are the money left after paying all obligations. Spirituous liquor profits are directly derived from the sale of spirituous liquor. Revenue remaining after paying all obligations is transferred to the GRF.

In Chart 2 we can see what has been happening to spirituous liquor revenues since fiscal year 1990. They have been increasing. In fact, spirituous liquor revenues have closely followed the GRF transfer amount. Which is no coincidence. As spirituous liquor revenues fare, so too does the GRF transfer amount.

Chart 3 provides an interesting graphic. It shows that, while spirituous liquor sales, in dollars, have been increasing for the past several fiscal years, spirituous liquor sales, in gallons, have been stagnant. These two facts would seem contradictory. How can spirituous liquor revenues increase at the same time spirituous liquor gallonage sales remain unchanged? The only explanation is that the average cost of spirituous liquor is increasing or that people are consuming more expensive liquors. According to the Department of Liquor Control, the latter is true. They have witnessed a significant shift in consumer selection toward more expensive spirituous liquors. This may be borne out by the fact that since fiscal year 1990, the average price per gallon of spirituous liquor sold in Ohio has increased from $40.59 to $51.32 in fiscal year 1997[5].

Does anything else influence spirituous liquor profit? Yes. The other factor determining the GRF transfer amount is net operating profit. Because there are inherent costs to selling spirituous liquor, namely purchase, distribution, and sale, it follows that the difference between these costs and the revenues from the sale of spirituous liquor are important.

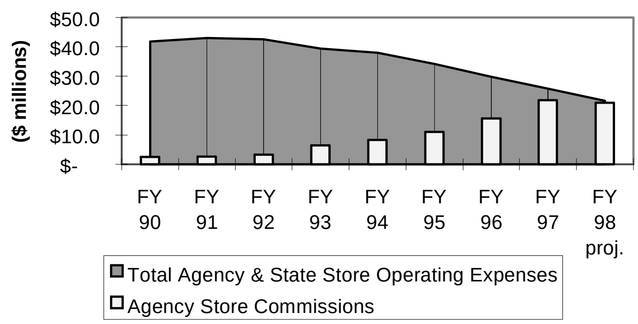




In the day-to-day business of selling spirituous liquor, various expenses are incurred. Whether the spirituous liquor is sold from a state employee or from an agency store employee, the Division of Liquor Control has to pay certain operating costs. These costs were different, depending upon the type of store. State-operated store expenses resided primarily in employee costs (e.g., salary, health insurance, workers' compensation, and vision insurance), and rent. Overhead expenses also ate up a significant part of the budget. These included lighting, heat, and telephone service. When state-operated stores were converted to agencies, unemployment compensation and early retirement expenses became significant, but temporary, operating costs. On the agency store side, the Division of Liquor Control also incurs certain operating expenses. Foremost is the commission paid to agency liquor store owners for every bottle of spirituous liquor they sell. The increase in the number of agency stores has had a corresponding increase in total commission paid. The state also incurs other minor expenses which include providing paper supplies and postage to the agency stores.

Chart 4 provides a look at total state and agency liquor store operating expenses and agency commissions. Total liquor store operating expenses measure the state's costs for maintaining retail liquor establishments, state and agency operated, across Ohio. As indicated above, these expenses have varied depending upon whether the state or an agency operated the liquor store. With the conversion of state-operated liquor stores over the past eight fiscal years, the most notable change was that agency commissions now comprise a much larger portion of total liquor store operating expenses. In fact, now that all liquor stores are agencies, almost all of the operating expenses are a product of agency commissions. Supplies, postage, exchange, bottle loss, and advertising costs make up the small difference between agency commissions and total liquor store operating expenses.

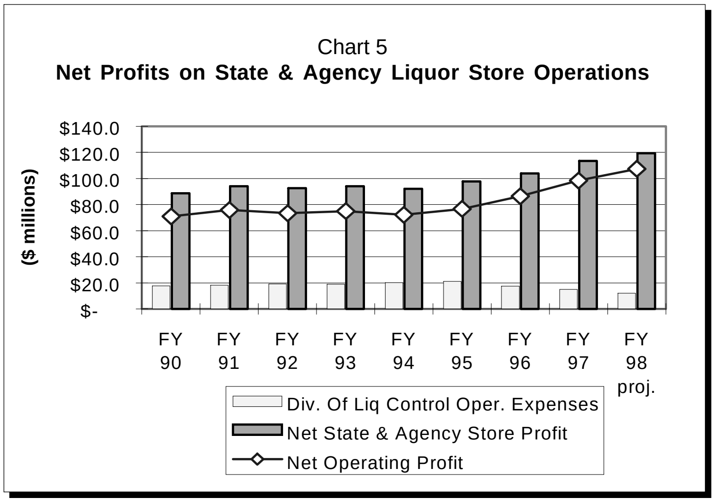
Chart 4
Agency Store Commissions as Portion of Total State & Agency Store Operating Expenses



In Chart 4, another important fact is depicted. Total operating costs have steadily declined since fiscal year 1991. This is important. Despite the increase in agency commissions, which can be essentially inferred as the trade-off between operating state liquor stores and having private individuals and businesses operate them, total store operating expenses have declined. From fiscal year 1990 to fiscal year 1997, total liquor store operating costs have dropped 67 percent. Considering that total cost includes unemployment compensation charges from laying-off state liquor store employees, there is little doubt that the drop shows the benefits created by converting state-operated stores to agencies. Further, it is projected that fiscal year 1998 total liquor store operating costs will drop even further to around $21.6 million — approximately one-half of total liquor store operating expenses in fiscal year 1991.

Although the above data indicates that Ohio's switch to an all-agency liquor store system has produced noticeable fiscal benefits, we still can examine one more area. Chart 5 shows the net profits earned on the sale of spirituous liquor in Ohio. Where this chart differs from those previously is that it incorporates the Division of Liquor Control expenses[6] and the cost of spirituous liquor into the picture. By accounting for total Division expenses we accomplish two things. First, we can determine whether the conversion of state-operated liquor stores to agencies has had a corresponding fiscal effect upon the administration of the Division. Second, by including total Division expenses in the net profit picture, we are able to see the "bottom-line." That is, the chart encompasses all the administrative and operational costs involved in selling spirituous liquor.

Chart 5 shows that the net profits on the sale of spirituous liquor have been increasing yearly since fiscal year 1994. The increases have been dramatic. In fiscal year 1994, net profits totaled $72.6 million. Net profits increased to $76.8 million in fiscal year 1995. By fiscal year



1996, net profits were $86.4 million and in fiscal year 1997 they jumped to $98.5 million. Right now, fiscal year 1998 net profits are projected to exceed $107 million. Over this same timeframe, total Division operating expenses should drop by around $8 million.

Conclusions

Has the conversion of state-operated liquor stores to agency stores driven the entire increase in the spirituous liquor GRF transfer? To quote a phrase from an auto rental commercial: “not exactly.” External factors, such as an increase in spirituous liquor revenues, undoubtedly contributed to the recent surge in the GRF transfer. Still, the fiscal influence of the conversion of state-operated liquor stores to agencies should not be summarily dismissed. Let’s look at what we know and make some logical conclusions about the conversions affect on the GRF transfer.

First, we know that the GRF transfer from the sale of spirituous liquor has increased from $46 million in fiscal year 1990 to $66.5 million in fiscal year 1997. Second, we know that revenues from the sale of spirituous liquor have increased (at a time when sales, in gallons, have been flat). From fiscal year 1990 to 1997, gross spirituous liquor revenues (minus the wholesale discount) increased from $368.2 million to an estimated $391.7 million. Third, we know that Liquor Control has recently gone through significant internal and external organizational changes. The internal changes precipitated with the replacement of the Department of Liquor Control with the Division of Liquor Control in the Department of Commerce. As a result, numerous positions were eliminated. Liquor Control also saw a dual state and agency liquor store system evolve into an all agency store system — an external organizational change. Even more positions were eliminated. Basically, we can deduce that the increase in the GRF transfer has been driven by an increase in spirituous liquor revenues and internal and external organizational changes to Liquor Control. The question we want answered is to what degree have external changes (i.e., conversion of state-operated liquor stores) contributed to the increase in the GRF transfer?

One way to answer this question is to look at net operating profit. We know that net operating profit is the net state and agency liquor store profit minus Division of Liquor Control operating expenses. Because net operating profit is increasing, we know at least one of two things is occurring — net state and agency profit is increasing and/or division operating expenses are decreasing. From Chart 5 we know that both are occurring. Net state and agency profit is increasing because the expense of operating liquor stores is declining (see Chart 4). Since the number of stores has remained relatively constant, we can strongly conclude that the influencing factor in the drop in store operating expenses (or increase in net profit) has been the conversion of state-operated liquor stores. This supports the conclusion that the conversion process has contributed to the increase in the GRF transfer. We also know that Liquor Control operating expenses are declining (see Chart 5). Lower operating costs are primarily attributable to fewer central office employees. Most staff reductions resulted from the conversion of liquor stores (e.g., the elimination of the Liquor Control’s State Store Administration and Real Estate programs). This fact also leads us to the conclusion that the conversion process reduced Liquor Control administrative expenses and helped add to the GRF transfer. Fiscal year 1998 GRF transfers and beyond, however, will also be influenced by administrative

Net operating profit equals the net state and agency profit minus Division of Liquor Control total expenses. This figure reveals the total profit solely from the transaction of spirituous liquor. No other deductions or sundry income are included.

Net State & Agency Profit
— Division of Liquor Control Expenses
Net Operating Profit

savings from Liquor Control's consolidation with the Department of Commerce.

It can be concluded that the conversion of state-operated liquor stores to agencies has contributed to the increase in the GRF transfer. The portion of the increase driven by the conversion was significant. It was led by a $21 million drop in liquor store operating expenses since fiscal year 1991 and an $8 million drop in Division operating expenses. Higher spirituous liquor revenues and savings from the consolidation of the Department of Liquor Control, starting in fiscal year 1998, have also helped raise the spirituous liquor GRF transfer. ❑

[1] H.B. 152 and S.B. 167 of the 120th General Assembly, and H.B. 57 of the 121st General Assembly.

[2] The Division of Liquor Control published in January 1998, a legislatively required report titled "Agency Commission Study" which examined the effects of raising the commission rates. It provides detailed information about the commission process.

[3] Please also see the Legislative Budget Office's monthly publication "Budget Footnotes" under the revenue section for further information.

[4] Under the agency system, every liquor store employs their workers.

5 The average price per gallon of spirituous liquor is calculated by dividing gross spirituous liquor sales by the total number of gallons sold.

[6] This is different from liquor store operating expenses. Division of Liquor Control expenses pay for the central administration of Ohio's liquor system. Liquor store expenses pay for the operation of the stores themselves.

Ohio Facts Extra!

The Ohio Facts Extra! section grew out of the booklet, Ohio Facts, a publication developed by LBO to provide a broad overview of public finance in Ohio. Each month in Budget Footnotes, a different area of interest will be presented in graphics and text.

State Fuel Tax Generated $1.3 Billion in FY 1997

— *Joshua N. Slen*

- The state fuel tax is 22¢/gallon consisting of five levies each with a different purpose. 22¢ is currently the maximum amount allowed by law.

- The portion to ODOT (excluding debt retirement) is approximately 47% of its total budget (balance from the federal gas tax and GRF).

- The portion to the Highway Patrol is $140.6 million and the portion to Public Safety Administration is $4.9 million.

- Local governments receive about 5.25¢/gallon ($305.5 million) which is distributed as follows: 1.95¢ to counties, 2.25¢ to municipalities, and 1.05¢ to townships. In addition, another cent ($60 million) is distributed through the Local Transportation Improvement Program.

- The "Other" category is as follows: $13 million to Development, $6.8 million to the Waterways Safety Fund, $4.3 million to Taxation, $4.8 million to Health, $2.3 million to the Turnpike Commission, and $1.2 million to the Public Utilities Commission.